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LEVERAGING THE CONTRIBUTION OF INTERNATIONAL REINSURANCE MARKETS

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Reinsurance markets play an important role in managing the financial impacts of catastrophe risks. Leigh Wolfrom shares some of the findings from a recent analysis of the contribution of reinsurance to managing property catastrophe risks.

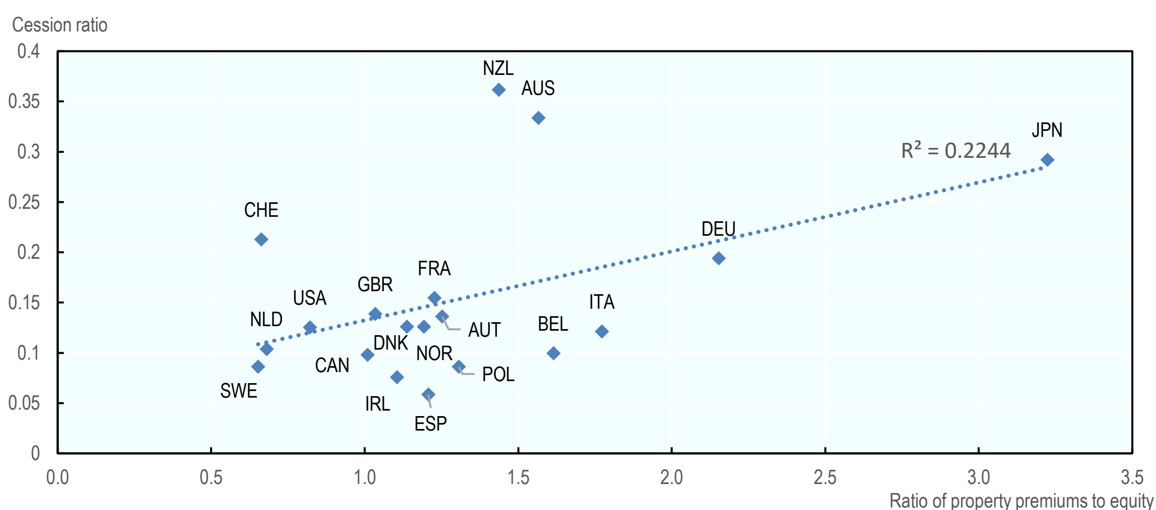
Insurance markets play an essential role in mitigating risks in the economy by encouraging proper risk management and providing a source of financing to respond to the damages and losses incurred by households, businesses and governments as a result of insured events. The pooling of risks faced by many insureds allows for the diversification of those risks across populations, regions, risks, and time, leading to a reduction in the aggregate cost of protection and providing individuals and businesses with the financial protection necessary for making longer-term planning and resource allocation decisions. The pooling of risks by reinsurers allows for further diversification (in addition to the diversification of risk realised by primary insurers), providing an additional layer of risk absorption capacity at a lower cost than can be achieved (in aggregate) by insurance companies individually. The global nature of international reinsurance markets also allows for some portion of the losses from an event to be absorbed by international markets (and investors), thereby diversifying the burden away from the domestic financial system.

Using a unique set of data on property reinsurance premiums and claims provided by reinsurance companies, a recent OECD report provides an empirical assessment of the contribution of that reinsurance markets have made across four areas: (i) increasing primary market capacity; (ii) managing catastrophe risks; (iii) reducing economic disruption in the aftermath of catastrophe events; and (iv) reducing primary insurance market disruption from catastrophe events. The report finds that property catastrophe reinsurance is being used by cedants (primary insurers) to increase the amount of coverage that they make available and to manage catastrophe risks and that property catastrophe reinsurance coverage appears to have had a positive impact on reducing the economic disruption of past catastrophe events and reducing post-catastrophe disruptions in primary insurance markets.

The core functions of reinsurance

Reinsurance provides insurance coverage to primary insurers (or cedants) based on a contractual arrangement to indemnify losses or otherwise provide a payout to the cedant based on the occurrence of a triggering event, such as a loss incurred by the cedant. Cedants may seek reinsurance coverage for a number of reasons, including to: (i) reduce volatility in underwriting results; (ii) increase underwriting capacity; (iii) support entry into a new line of business or market; or (iv) establish an appropriate level of risk diversification. The use of reinsurance should allow cedants to write more business as a portion of the risk that they assume is transferred to reinsurers and therefore does not usually need to be covered by reserves or capital to the same extent that it would need to be covered if retained. It should also support the management of catastrophe risks based on the capacity of reinsurance markets to diversify risks across geographies, perils and lines of business. The OECD report confirmed these benefits - including that cedants in countries that make greater use of reinsurance are providing more coverage.

Figure 1. The use of reinsurance for underwriting more business



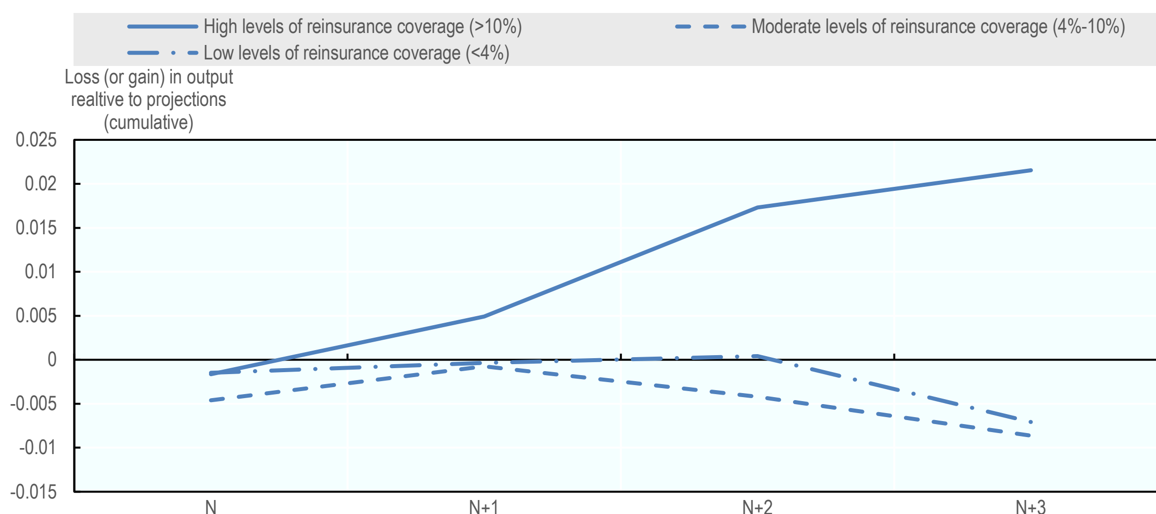
The benefits of reinsurance for reducing post-catastrophe disruption

Insurance markets can make an important contribution to reducing economic disruption in the aftermath of a disaster event. The contribution of primary insurance markets to reducing economic disruption is usually assumed to be due to: (i) the ability of those affected to more quickly recover after an event based on their access to a (relatively) quick source of funds for recovery and reconstruction - reducing the disruption to economic activity and also the financial stress on households and business that would otherwise need to absorb those losses; and (ii) the more limited impact on public finances in countries with high-levels of insurance coverage for damages and losses as governments will often provide financial assistance to affected households and businesses without sufficient insurance coverage. Reinsurance should also contribute to reducing the level of economic disruption in the aftermath of a disaster event to the extent that reinsurance markets diversify the costs of disasters to global markets that are better able to absorb those costs.

The OECD's report examined the impact of reinsurance on reducing the economic disruption in the aftermath of 26 major natural catastrophes (or series of natural catastrophes) that occurred between 2010 and 2016. The report found that countries where a relatively high share (10% or more) of economic losses related to the specific event(s) were reinsured recovered more quickly after the event and had higher than projected GDP growth in

the following three years – while those countries with lower levels of reinsurance coverage struggled to recover and faced a cumulative loss in output relative to pre-event projections.

Figure 2. Cumulative loss (or gain) in GDP relative to pre-event projections for different levels of reinsurance coverage



Impediments to a global reinsurance market

Insurance regulators and supervisors in most jurisdictions impose some regulatory or supervisory requirements on the transfer of risk to reinsurance markets (and, particularly, for cross-border risk transfer), normally (but not always) aimed at ensuring that counterparty and execution risks are appropriately managed – and that, ultimately, domestic policyholders are well-protected. Some of these requirements may be creating other risks to cedants and the broader economy by concentrating risk domestically and limiting the ability of cedants to fully capitalise on the benefits of risk transfer to reinsurance markets.

Ensuring the appropriate regulation and supervision of reinsurance companies in home jurisdictions and enhancing supervisory cooperation, information exchange and recognition could provide a better approach to managing the risks of international property catastrophe reinsurance markets (than regulatory and supervisory measures that lead to domestic risk concentration), while leveraging the benefits of international diversification that these markets provide.

References

OECD (2018), The contribution of reinsurance markets to managing catastrophe risk, www.oecd.org/daf/fin/insurance/the-contribution-of-reinsurance-markets-to-managing-catastrophe-risk.htm

OECD work on insurance policy issues:
www.oecd.org/pensions/insurance

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