



# Seven Questions for Your Reinsurers

## on Enterprise Risk Management

As an insurer, you are keenly aware that the business of risk is increasingly complex. Not only are the costs of risk escalating, but so is the potential for catastrophe – natural or man-made. The global economy is highly sensitive to financial and geopolitical crisis, and regulators are raising the bar for insurers and reinsurers. Ultimately, for a company to be successful – and for a reinsurer to provide consistent and secure capacity to its cedants – it must incorporate effective risk management into its long-term strategy.

A reinsurer's willingness and ability to assume your risk and pay your claims now and in the future are the first measure of their value. You need to know what steps your reinsurers take to protect their financial strength and how they mitigate the strategic and operating risks inherent in their businesses.

Relying on third party evaluators can be dangerous, as recent events in the markets have illustrated. With this in mind, we put forward a tool to help you assess for yourself the strength and quality of your reinsurer's value to you. Here are seven questions about enterprise risk management that you might consider asking your reinsurer the next time you meet. As always, you should assume your right to challenge your reinsurance partners and their practices.

### How does risk management fit within your organization's structure and governance?

In a well-managed company, risk taking is supported through appropriate governance and a risk management system with the right balance of centralized control and decentralized management. The recent failures in the banking industry illustrate this very well; in many cases, the responsibility and ownership

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of risk management was separate from the business organization. To manage risk effectively, the overall risk framework and appetite must be set and articulated centrally at the board and executive levels to ensure consistency, but managers must have enough authority to be accountable to the process. You should look for clear communication of core principles and policies and an organizational structure that places authority for decision-making with the business units.

### How do you balance your liabilities with your asset risks?

Recent failures highlight the risk of allowing the investment division or financial product area to operate with different risk appetites or controls from the reinsurance side of the business. However, assuming a moderate amount of investment risk can enhance a re/insurer's profitability and their ability to both pay claims and offer capacity in good times and bad – provided there's a rigorous risk management system in place.

There are several ways you can evaluate your reinsurer's approach to investment risk. First, look at how well they monitor the aggregation of risk across the company. One risk source may well affect both assets and liabilities. For example, the same drivers that impact credit default and market risk on the asset side can affect underwriting and reserving risk on the liability side. Second, look for consistency in the rules governing both the underwriting and capital markets risks.

The most successful reinsurers will be those that find a prudent balance between capital markets risk and traditional reinsurance, with a consistent risk management approach on both sides of the balance sheet.

## How does your company evaluate and value risks?

Today more than ever, cedants should be looking for reinsurers with the core skills of risk assumption, which lie in the evaluation, valuing and managing of risks, rather than the packaging and selling-on of risk. Proprietary quantitative and qualitative analysis are essential to understanding the nature and extent of risks, so that underwriters can make an informed evaluation, and an accurate value – or price – can be determined. Correct pricing is critical: if your reinsurer is not getting an adequate price for the risks they assume, the security you are buying is compromised. As important as good risk modeling is the need to have people with the skills to interpret the outputs from

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the models, and the experience to select appropriate assumptions for the models. The days of underwriters putting down a line based on “feel for the market” are over.

Understanding risk is as important in capital markets as it is for underwriting. If your reinsurers are taking on significant capital markets risk, they should not be overly dependent on third party risk evaluators but should have strong in-house expertise to evaluate that risk.

## How does your company manage exposure to risks that might damage your ability to pay claims?

A reinsurer should have a clearly defined risk appetite, in terms of how much they are willing to lose within a certain period of time. That needs to be translated into a set of absolute tolerance limits on potential exposures (on both the reinsurance and capital markets sides of their business) and embedded into the strategy of the company in conjunction with the return goals.

Your reinsurer should be able to tell you where they stand on the risk/return spectrum, and how they manage

the company within that risk appetite. They should have defined tolerances for critical risks such as catastrophe, casualty reserving and equity investment, with systems in place to continuously measure exposure to ensure they do not exceed the limits set. Be wary of an over-reliance on models, which are only as good as their data.

## How much capital do you hold?

The purpose of a reinsurer's capital is to protect its cedants. The current financial crisis has shown that capital markets cannot be relied upon to provide liquidity when it is most needed; reinsurers must have an appropriate amount of capital to back their assets and liabilities.

So how do you determine whether your reinsurer has the right level of capital? You can look at the assessment of regulators, rating agencies and brokers, but in the end, only you can decide if it is the right level of adequacy for your needs. To help you make that judgment, ask your reinsurers about their capital at risk methodology. Are their models only used for high-level strategic planning, or are they also applied to pricing risk on a day to day basis? Do their models capture data from every treaty and asset on the books? What kind of 1-in-250 year loss scenarios have they thought about? Do they hold enough capital to survive such an event, or hold capital above that level to deal with model error and “unknown unknowns”? There is no right answer for what is adequate capital, but you can determine minimum acceptable levels.

## Is your company's approach to risk management reflected in its culture?

An effective risk management culture will extend beyond senior management and should be institutionalized at all levels in the company. The culture has to reflect the values and shared beliefs and risk tolerances of the whole organization. Everyone in the organization has to take ownership and responsibility for the risk management policies and processes, and not see them as something to get around.

You should also check that your reinsurer's risk culture is aligned with their return goals. Compensation systems should reward behavior that builds long-term value, not just short-term profit.

## How much information are you willing to share about your risks?

Reinsurers should be able to articulate the enterprise risks they face, and should be transparent about their risk appetite and tolerances, both within the organization and in their communications with clients, analysts and the media.

## You deserve honesty and transparency from the people that hold your financial future in their hands.

If a reinsurer is not willing to share data on their assets or their reserves, or if they are not willing to discuss their significant risks and the policies they have in place to manage them, you should not do business with them. You deserve honesty and transparency from the people that hold your financial future in their hands.

Communication is a two-way street, so your reinsurers should also seek to engage you in discussion about your business and your markets. Only through transparent dialogue can they acquire the understanding of your needs that is critical in delivering value.

### Checklist

- Clear governance structure for decision making
- Risks identified and quantified across organization
- Clearly defined risk appetite
- Limits to control big risks
- Consistent methodology for valuing risk
- Compensation systems aligned with risk/return goals
- Transparency about all of the above