

Solvency II: Promises Promises

Reinsurance is just a promise to pay. The insurer remains liable for the claims of the primary policyholders and has a corresponding claim against the reinsurer. The impact of the inability to pay of a reinsurer could be devastating for a primary business. CEIOPS is incorporating this risk in Solvency II, but it seems that the process is far from smooth.

Promises Promises is a musical based on the 1960 film *The Apartment*. It spawned the hit “I’ll never fall in love again” for Dionne Warwick. Typically the story revolves around the romantic trysts of the executives of a fictional insurance business; Consolidated Life Insurance Company.

In this commentary, BRAVE Partners considers the less romantic trysts between a cedant and its reinsurer and the credit risk inherent in the promise to pay.

The credit risk inherent in reinsurance is often overlooked. Interestingly many insurers will have strict limits on the maximum exposure that the company can have to any one issuer in their asset portfolio. However, few such limits apply to the reinsurance carriers, or if they do the upper bound on the limit can be substantial; in fact often substantially more than the primary could afford to lose.

Credit risk

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No assumption of the liability

The critical point to remember about reinsurance is that there is, usually, no assumption of the liability by the reinsurer. The primary insurer maintains the liability to pay the policyholder claim. The reinsurance just creates a claim for the primary insurer against the reinsurer. Should the reinsurer not pay that claim, then the primary insurer can find themselves sitting on a large loss.

As the reinsurance industry consolidates, the issue becomes more pronounced. There are fewer counterparties with whom to place reinsurance, forcing cedants to place more with the remaining large providers. When Swiss Re bought GE Insurance Solutions, many cedants found their exposures combining to a very large number. This was not so much of a problem when Swiss Re was a AA rated powerhouse, but as AIG slid into US Government ownership many a cedant must have had a few concerned glances at the Swiss Re credit portfolio as the company’s ratings slipped and its losses mounted.

Credit risk capital

In contrast to a bank, the credit risk capital that an insurer has to hold has been small. Under the original Basel I framework, the credit risk capital assigned to a non OECD domiciled reinsurer would have been at least 6% of the notional. Most regulatory capital for insurers does not account for credit risk on reinsurance, apart from setting limits on the maximum amount of reinsurance.

The ratings agencies are not much harsher with high rated reinsurers, only consuming a few percent in terms of risk capital. While Basel II, the more recent banking regulations will significantly reduce the amount of capital that a bank would assign to a high rated reinsurance company, the regulation does bring in some harsh capital penalties for concentration risk and large exposures. The exposure that some insurers carry to the large reinsurers would fall under these rules, creating a significant capital allocation to those who concentrate their reinsurance program.

Model mayhem

In a recent GC Capital Ideas, Guy Carpenter reports on the current state of counterparty risk modeling in the CEIOPS Solvency II process. The QIS4 results have thrown up an anomaly. On a small concentrated portfolio of reinsurers, increasing the diversification can increase the required risk capital. This is counter-intuitive and outright wrong. Solvency II must provide insurers with a capital benefit for diversifying their reinsurance base.

Model paradise

The BRAVE partners preferred modeling framework was initially built to measure and manage the credit and counterparty risk within a bank. One of the first implementations was flamboyantly called COUGAR, where the CO was for counterparty. The model accurately measures the risk for a portfolio of reinsurers. It is also straightforward to measure the secondary effect - that there is only credit exposure on a reinsurance program - if there has been a loss that leads to claims and IBNR. Moreover, the modeling framework has a clear path in which to allow for dependencies between the default risk in the reinsurer and the rising exposures associated with large industry losses and claims.

In short, the BRAVE Partners' model framework is transparent, flexible and most of all accurate. The framework and its benefits are described in a number of other commentary pieces that are available on the archive of the website.

Model construction at the heart of an effective Solvency II implementation

BRAVE Partners had made the case that the choice of risk model framework is one of the first decisions that an insurance company should make when commencing on their Solvency II implementation program. The model is a critical element in the process and, in order to satisfy Solvency II, it must be

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integrated with the management and governance of the business. The GC Capital Ideas report is excellent, in that it highlights the confusion caused where a model framework is inadequate for the task. The QIS4 results on counterparty risk show that an inadequate model leaves managements with the confusing decision of taking the economically sensible task and allocating more capital, or taking the capital efficient route and exposing the firm to more risk. No wonder risk models have not been integrated with management processes if this is the result.

Promises Promises has a happy ending. BRAVE Partners can assist insurance companies in ensuring that their Solvency II projects are efficient and cost effective leading to a happy ending for the business and its management.

Straight through services

In addition to risk modeling skills, the BRAVE partners are highly experienced in developing structures to mitigate the credit risk in reinsurance recoverables. The challenges in developing these structures are outlined in the BRAVE Partners commentary entitled: "Run off with the recoverables". The firm has the skills and tools to provide advice on measuring and monitoring the credit risk on a reinsurance program all the way through to advising on a risk mitigation structure. BRAVE Partners is ideally placed to assist insurance companies in managing their reinsurer credit risk.

- *QIS4 has highlighted the downfall of getting a risk model wrong. The counterparty risk model has produced counter-intuitive (in fact incorrect) results.*
- *BRAVE Partners has highlighted the need to identify a powerful, yet straightforward and flexible modeling framework at the start of a Solvency II project.*
- *BRAVE Partners has promoted a solid modeling framework for Solvency II. Interactive examples are available on the website.*
- *BRAVE Partners also has the structuring skill and experience to design capital efficient risk mitigation structures once the risks have been identified and modeled.*
- *BRAVE Partners LLP can offer straight through services to take an insurance company from an effective and cost efficient Solvency II implementation to an efficient use of capital and resource under the new regulation.*

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