C-10: Efficiency: The New Thing in Reinsurance

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TEEING IT UP

Arguments You Might Hear Against Doing Things Differently:

"*That* can't be done...the market won't like it."

"There is no market for it…."

"Changing status quo is too difficult."

"I won't be able to explain this internally and get buy-in."

We hope this session provides you with
the tools to make your own decisions on these items.

AGENDA

1. **Reinsurance Basics**

2. **Value Analysis**

3. **Efficiency Analysis Example Using Value Analysis**

KEY STAKEHOLDERS

Parties That May Have a Stake in Reinsurance Decisions:

Primary Insurance Company
Reinsurer
Intermediary
Regulators
Rating Agencies
Shareholders

- **Stakeholders Need to See Value to Have a Transaction**
- **Value Weighs Costs AND Benefits**

Reinsurance Benefits

A Sampling of Reinsurance Benefits:

Downside Protection

Surplus Relief

Underwriting Insight

Additional Premium Volume to Flow through Other Entities

Rating Agency Metric Management

Smoother Earnings Patterns

- **Reinsurance Transactions Are NOT Always Motivated by Downside Protection**

Reinsurance Cost

Reinsurance Cost Has Multiple Components:

Gross Reinsurance Premium

- Reinsurer Profit and Expenses
- Reinsurance Recoveries
- Ceding Commission
- Brokerage!

Other Costs/Considerations

- Human Capital Cost
  - Opportunity Cost/Time
  - Legal
  - Scramble Cost
- Regulatory/Rating Agency Metric Changes

- **All Costs/Risks Should Be Considered in Value Analysis**

New World Observations

Recent Changes in Reinsurance:

Primaries Retaining More Risk

- Lower layers with high gross premiums
- Dropping top of tower purchase

Primaries Looking for Alternatives with Higher Perceived Value

- Want something different and more tailored to their needs

- **Drivers of Change Can Include Reduced Perceived Value of Traditional Reinsurance**

What Drives New Products?

Some Reasons for Innovation/Non-Traditional Products:

Reinsurers Looking to Gain More Business

- Trying to crack into a market
- Trying to grow revenue
- Trying to make up for revenue lost on risks now retained by primaries

Primary Carriers Looking for Something More in Line with Their Needs

- Financial strain can drive looking for new ways to protect balance sheet
- "Cheaper" coverage
- More responsive reinsurance
- Looking for a way to take more risk
- Responses to changes in view of risk (model changes, etc.)

Intermediaries Trying to Get New Clients

- Value opportunity to do something different and potentially better for client

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- **Many Reasons New Products Are Available**

NEW PRODUCT ROAD-BLOCKS

Some Items That Can Get in the Way:

Execution Risk

- New products require more debate and more time to understand
- New contract language
- Need to make sure value in deal for all parties

Complexity

- Not traditional – introduction of new products
  - May require more layers of approvals and take longer
- More sophisticated understanding required for all parties

Financial Considerations

- Some products can require larger up-front payments

- **All of These Items Can Be Overcome, and It Is Getting Easier**

NON-TRADITIONAL REINSURANCE

Examples of Non-Traditional Reinsurance:

Top-and-Drop

Working Layer Multi-Year

High Layer Multi-Year

Funded Deductible Products

- **How Can You Determine If These Products Work?**

Efficiency

Value Analysis Can Be Used to Search for Efficient Solutions:

Need to Determine VALUE METRIC to Compare Alternatives

Needs:

- **Baseline -** traditional structure
- **Alternatives -** cost estimates and benefit analysis of achievable structures

- Remember parties involved in a contract need to see value

Those Involved in Decisions Need to Understand the Value Metric

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- **Laying Out Options and Performing Value Analysis Should Suggest Efficient Purchase**

VALUE ANALYSIS: SIMPLE VALUE METRIC EXAMPLE

Upside
Downside

Upside = Cost = Change in Expected Income

Simple Example:

- Cost is Gross Cost of Reinsurance Contract LESS Expected Recoveries

Downside = Benefit = Change in Risk Measure

Simple Example:

- Risk Measure Defined by Company
- Example: Capital Charge

- **In This Framework, Lower Ratios are Better (Less Cost Per Unit of Benefit)**

VALUE METRIC USES

Benefits of Picking a Simple Value Metric:

Forces Consistency in Decision Making

Can Reveal Inefficient Purchases

- Are there better ways to deploy reinsurance dollars?

Testing of New Products

- Designed to fill a specific need
- Source of non-traditional reinsurance ideas

- **Value Metrics Can Be Used to Test Efficiency and New Ideas**
- **Sometimes the Most Efficient Choice May Be to Retain the Risk**

VALUE METRIC CHALLENGES

Hurdles to Value Analysis:

Defining Risk Tolerance Can Be Difficult

- Tough to get a defined risk tolerance
- Can get an idea based on prior purchase decisions

Inconsistencies Within a Company

- Not all are on the same page
- Not everyone within the company has the same motivations

- **Using a Value Metric Requires Extra Work, but the Benefits Often Far Exceed the Cost of the Extra Work**

Measuring Efficiency for a Primary Carrier

Gross to Net Analysis:

Look at Your Program Layers for Opportunities

Perform Upside/Downside Analysis on Each Layer

Are Any Layers Inefficient?

- Is there a better way?

Look at Alternative Reinsurance Options

- Non-traditional and traditional
- Do they perform better?

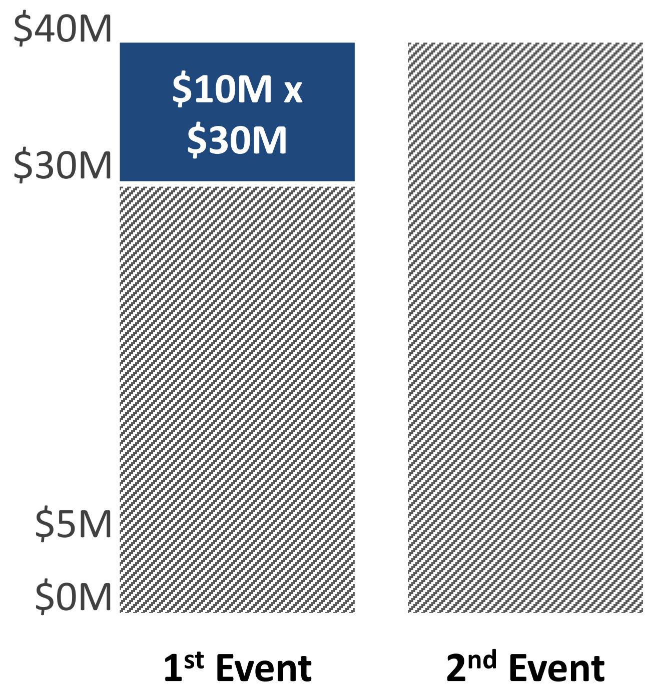
Upside / Downside with Numbers

Gross Economics

- Cat Exposed Line of Business
- Earned Premium = $40 Million
- Gross Loss & LAE Ratio = 55%
- Expense Ratio = 30%
- Gross Risk Metric: $40 Million

Current Top Layer Cover

- Excess of Loss Cover
- Reinsurance Premium = $1.125 Million
- Expected Recoveries = $0.3 Million
- Limit = $10 Million
- Retention = $30 Million
- Risk Metric after Purchase: $35 Million



- **We Have the Ingredients for Simple Upside/Downside Analysis**

UPSIDE/DOWNSIDE WITH NUMBERS

Upper Layer: Simple Value Analysis

Values in $1000's

	% of EP	Gross	Ceded	Net
Upside				
Earned Premium	100%	40,000	-1,125	38,875
Gross Loss & LAE $	55%	22,000	0	22,000
Expenses	30%	12,000	0	12,000
Expected Layer Reinsurance Recoverable		0	300	300
Expected Income		**6,000**	**-825**	**5,175**
Downside				
Risk Metric		**40,000**	**-5,000**	**35,000**
Upside/Downside		**15.0%**	**16.5%**	**14.8%**

- **Using This Metric, the Value of This Purchase Is Questionable**

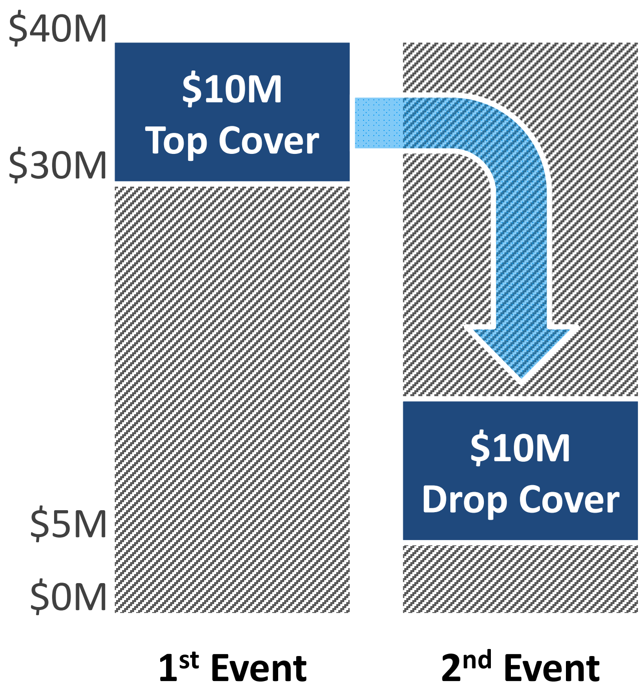
A Proposed Alternative: Top and Drop

Gross Economics

- Earned Premium = $40 Million
- Gross Loss & LAE Ratio = 55%
- Expense Ratio = 30%
- Gross Risk Metric: $40 Million

Top and Drop Cover

- Reinsurance Premium = $2.1 Million
- Expected Recoveries = $0.8 Million
- Limit = $10 Million
  - Can be used up Top *OR*
  - On 2nd Event above $5 Million
- Retention = $30 Million
- Risk Metric after Purchase: $31 Million



- **Value Analysis Can Compare the Two Coverage Options**

Upside / Downside with Numbers

Top and Drop: Simple Value Analysis

Values in $1000's

	% of EP	Gross	Ceded	Net
Upside				
Earned Premium	100%	40,000	-2,100	37,900
Gross Loss & LAE $	55%	22,000	0	22,000
Expenses	30%	12,000	0	12,000
Expected Layer Reinsurance Recoverable		0	800	800
Expected Income		**6,000**	**-1,300**	**4,700**
Downside				
Risk Metric		**40,000**	**-9,000**	**31,000**
Upside/Downside		**15.0%**	**14.4%**	**15.2%**

Prior Upper Layer Analysis:

Upside/Downside		**15.0%**	**16.5%**	**14.8%**

- **This Purchase Appears to Be More Efficient than Traditional**

CONCLUSION

Key Takeaways:

- **New Products Are Out There**
- **Reinsurance Decisions Should Consider Efficiency of Purchases**
- **There Are Ways to Evaluate Value for Traditional and Non-Traditional Products**
- **Challenges and Hurdles Do Exist in Non-Traditional Structure and Must Be Considered**
- **BUT, Proposed Value Can Outweigh Additional Costs/Considerations**