Original Risk

Tempted by Sustained Profitable Growth?

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#ORIGINALRISK

The global reinsurance and insurance-linked securities (ILS) community faces a wide range of challenges—many of them well known and widely discussed. Abundant capacity, declining reinsurance rates, and a general increase in competition are among them. Yet, to focus specifically on the usual fodder making its way around the speaking circuit is to miss the real issue: sustained profitable growth. C-suites around the world are looking for new ways to drive significant growth in profit and shareholder value, and attaining those intertwined goals will take much more than getting better at what our industry already does well.

The real answers lie elsewhere.

- To return to the halcyon days of 15 percent return on equity (ROE), the global reinsurance and ILS community needs to find new forms of original risk to bring to the market. “Original risk” is a new insurable interest that a party brings to a risk transfer transaction. Taken to the extreme, it’s that first decision by a potential insured to transfer risk to an insurer in exchange for protection. But it can also include:
- developing new ways for cedents to hedge existing portfolios more effectively, resulting in more ceded risk
- improving the efficiency, effectiveness, and breadth of retrocessional activity
- attracting existing commercial original insureds to transfer additional risk that they’d otherwise be forced to retain
- identifying emerging risks for markets that may not even exist yet (for example, what’s the next asbestos?)

Original risk entails opportunity—the opportunity to grow, expand, create, and evolve. In an industry undergoing foundational change thanks to global interest in lower-correlated risk from a wide range of capital sources, original risk takes what’s necessary for survival and turns it into a powerful lever for shareholder value creation.

And it all starts with that first bite of the apple…

Plucking the Apple

Bringing original risk to market starts with that first taste. Of course, nobody rushes to bite the apple. New market entry requires careful evaluation, the use of data and advanced analytics (where available), and a review of the status quo to see how new forms of uncertainty could affect an existing portfolio or enterprise. And while the prospective taste of new markets may be difficult to resist, the reality is that the global reinsurance and ILS community is exceptionally adept at getting even better at what it already does well—succumbing to the temptation of the status quo rather than the possibilities beyond the garden. There are plenty of opportunities waiting to be exploited, but few will ever pluck that first apple from the tree.

So, what's available in the original risk orchard?

Throughout the year, our team has conducted extensive formal and informal market research, looking for both the greatest challenges our industry faces and speaking with new potential sources of original risk. None should come as a surprise, although some have gained momentum over the past year:

- microinsurance and other cover in emerging markets
- the "disaster gap" in mature markets such as Florida and California
- new and underserved lines of business—as well as those where market expansion would be possible by making them easier to address (examples include marine, terror, and casualty catastrophe)
- sourcing original risk for transactions farther up the value chain, such as bringing cedents to the exchange-traded risk equation

Sounds tempting? Pick your apple and give in. Navigate the uncertainty properly, and the taste can be delightful.

Taking a Taste

Making the decision to enter a market — or expand an existing market — can be daunting. How do you veer off the path you know so well? This is the first of many difficult decisions involved in bringing original risk to market: You need to flee your organization's comfort zone, invest in new learning and innovation, and be prepared that some forays into new areas may not generate returns.

Perhaps the most effective way to pursue original risk initiatives is to treat a collection of them as a portfolio. Some will fail; others will become modest successes. A few may generate significant returns and become future sources of consistent, reliable growth. But they must be measured together, with the winners compensating for those that didn't generate any traction. The overall portfolio of original risk initiatives should have a target result that represents the sum of all underlying activity — rather than assessing the relative success of every new venture explored.

Realistically, you're entering the orchard with an empty basket and the notion to fill it with a variety of choices. Some will have soft spots or worms, but others will explode with flavor upon that first bite. So, think about taking a spot under the shade of a tree, your basket by your side. Reach in. There's nothing left to do but take a bite.

Original “Risk” for a Reason

What comes of that first bite will always be a surprise. Many choices can look tasty, yet have a surprise lurking under the skin. You never know until you take that bite.

This is the moment of fear that comes with every new effort to bring original risk into the global insurance and reinsurance system. The more distinctive the opportunity, the less you know about it. Concerns may range from data quality to the relative absence of a formal market economy. Even the best laid plans won’t always prepare you for the nuances of an original risk. From prospective microinsurance customers to corporates pondering their first catastrophe bond issuances, the challenges you may face can include:

- market or client education on new, unique, or previously unencountered risk transfer alternatives
- showing the existence of a need for protection where one wasn’t perceived before
- a basic lack of trust (or interest) in the unfamiliar
- concern that what’s new isn’t any better than existing options

Sometimes, the barriers to progress can feel overwhelming, especially compared with simply eking more fractions of a basis point out of more traditional transactions. And it can feel like darkness is taking hold as you dig deeper into problems of global importance where the answers may not even exist yet.

It’s at this point that you need to decide what your ending will look like. Will you wait for your prince to come wake you? Or simply remain in the darkness, with your potentially society-changing initiative left to rot in the bright midday sun?

There’s one more way to move forward, of course. Fight through what plagues you. Commit resources. Plan and execute with discipline. Force yourself back into the light. And enjoy the fruits of your labor!

A Happy Ending

Obviously, the ending you want should bring happiness on a large scale. Sourcing original risk has profound implications for insurers, reinsurers, ILS funds, and other stakeholders in the global risk transfer sector. Customers, shareholders, and employees stand to find new satisfaction in their experiences with your organization, all of which contribute to growth in unique and powerful ways.

One bite isn't enough. Sink your teeth in again, and listen for that telltale "snap." That's the sound of progress, and every time you close your jaw around that juicy opportunity, you're taking one more step toward changing the world.

Eating and enjoying the apple is that stage where you develop your new idea, market, or original-risk-focused solution. You gain your reward for the risks you've taken and enjoy the sustenance that the accomplishment brings your company and stakeholders. And you gain newfound knowledge by entering the unknown and emerging successful. Specifically, you stand to:

- define new markets, which helps turn first-mover advantage into sustainable leadership
- secure the loyalty of early market entrants (brought there by you) and capitalize on their future willingness to grow into large, significant, and influential clients
- lessen your reliance on mature markets with higher levels of competition for shrinking returns (effectively a higher cost for lower revenue)
- deliver the types of profitable growth that lead to disproportionate shareholder value gains
- win new talent thanks to a demonstrable track record as an innovator—and as an organization that necessarily invests in its people to reach exciting results

It isn't easy. We all know that the first bite of the apple can lead to blissful or cataclysmic results. And while we tend to focus on the risks of that first bite, it's equally important to weigh the consequences of leaving that desire for original risk unsated. Given today's market conditions, committing to the conventional means accepting not current financial performance but the potential for ongoing erosion, ultimately requiring greater and greater effort to maintain the status quo. Of course, this eventually becomes a losing proposition because additional investment requires higher returns. Absent the latter, you'll find nothing but shrinking margins and a sector that eventually becomes ripe for destructive disruption (think about what Craigslist did to the community newspaper industry).

In the long run, you really do have no choice but to take a bite. How much better to do so of your own volition—rather than from fear?

Finding Your Way through the Orchard

There's no shortage of original risk worldwide. The orchard, if you will, is packed with trees bearing many different types of apples. The variety available today is sufficient to address the needs of capital with a wide range of interests. And one new original risk assumed by a primary insured today creates many more risk transfer (and growth) opportunities along the risk and capital supply chain.

Let's take a closer look at what's in the basket.

Emerging markets: Countries with low rates of insurance penetration represent nothing but long-term opportunity for the global insurance and reinsurance industry, including the ILS sector. Many of these markets take their own first substantial bites of the apple to secure commercial insurance protection. This could be a natural way to drive near-term growth while establishing a foundation for personal lines protection and other forms of risk transfer in the future. Many emerging markets have a basic familiarity with insurance and are ripe for further development.

Microinsurance: A bit different from the traditional emerging market opportunity, microinsurance truly has the capacity to change the world. According to some reports, an estimated 4 billion people worldwide make up the potential microinsurance market—a market that today generates approximately $40 billion in global premium. Yet, there are many ways for this sector to grow.

In addition to bringing coverage to more people and developing new forms of protection to benefit them, the most important factor to consider is the virtuous cycle that insurance protection affords. Insurance unlocks the capital that many prospective microinsurance customers put aside as savings to cover future losses. The injection of this capital into a local market fuels economic growth either from direct consumption or through investments, such as education for children, that stimulate even greater economic growth in the future. Sustained economic growth creates greater need for insurance and higher underlying insured values, both of which would only magnify early insurer investments in micro-insurance for decades to come.

Disaster gap: We don't need to look to emerging markets to find uninsureds. In many mature markets, there are pockets of prospective customers that insurers have been unable to reach because it hasn't been possible to develop a sufficiently profitable product—or simply because the conventions that govern how our industry operates have prevented us from thinking in a new way. That's beginning to change. In Florida and California, for example, the industry is looking at new ways to deploy capital, from protecting the original insured to accessing capital markets capacity to protect insurers and reinsurers. And there's still plenty of room for growth.

Low rates of insurance penetration in catastrophe-prone areas represent a risk for society as a whole. In emerging markets, financial support comes in the form of grants, aid, and other types of charitable relief. In mature markets, taxpayers usually shoulder the burden one way or another. Simply put, there's a risk we all assume, and there's no direct upside to it. If society is forced to assume a risk, how much better to find a willing risk-bearer who has devised a way to be compensated fairly for taking on the burden?

Emerging risks: Twenty years ago, how would you have described the need for cyber coverage? If you could have come up with an answer, it would probably be different from the one you'd formulate today. The same could be said for nanotechnology, certain medical technology breakthroughs, and the ever-evolving global supply chain. In each of those cases, we're seeing plenty of risk—and, of course, losses sustained by the bearers of original risk (be they corporations or households). However, absent sufficient insurance penetration, we lack a reliable loss history, and gathering loss data from uninsured events can be a difficult proposition at best.

A new approach to protection for emerging risks could profoundly change society — delivering near-term protection while supporting the development of a historical loss event set that could help the industry deliver this service. Fresh thinking regarding event magnitude, especially for time-element losses, could be exactly the bridge we need. Through our Verisk Maplecroft subsidiary, for example, we've already had dozens of conversations about the use of parametric-style measures to trigger payment for instruments covering political violence and other geopolitical risks.

We don't necessarily have to give up conventional solutions to insurance forever when considering emerging risks, but we probably should veer off the path for a little while.

New and underserved lines of business: Some lines of business have less access than others to risk transfer markets. Innovation can thus create original risk for reinsurance, retrocessional, and ILS transactions globally. Ocean marine is a great example. The development of newer tools for loss aggregation could support better program evaluation, index-triggered risk transfer, and more thorough portfolio analysis for improved capital allocation. Just because a market exists today doesn't mean it's as large or vibrant as it could be.

It's Time for You to Give In

New markets are waiting for you, along with the prospect of higher ROEs, happier employees, and delighted shareholders. To get your first apple, please contact:

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