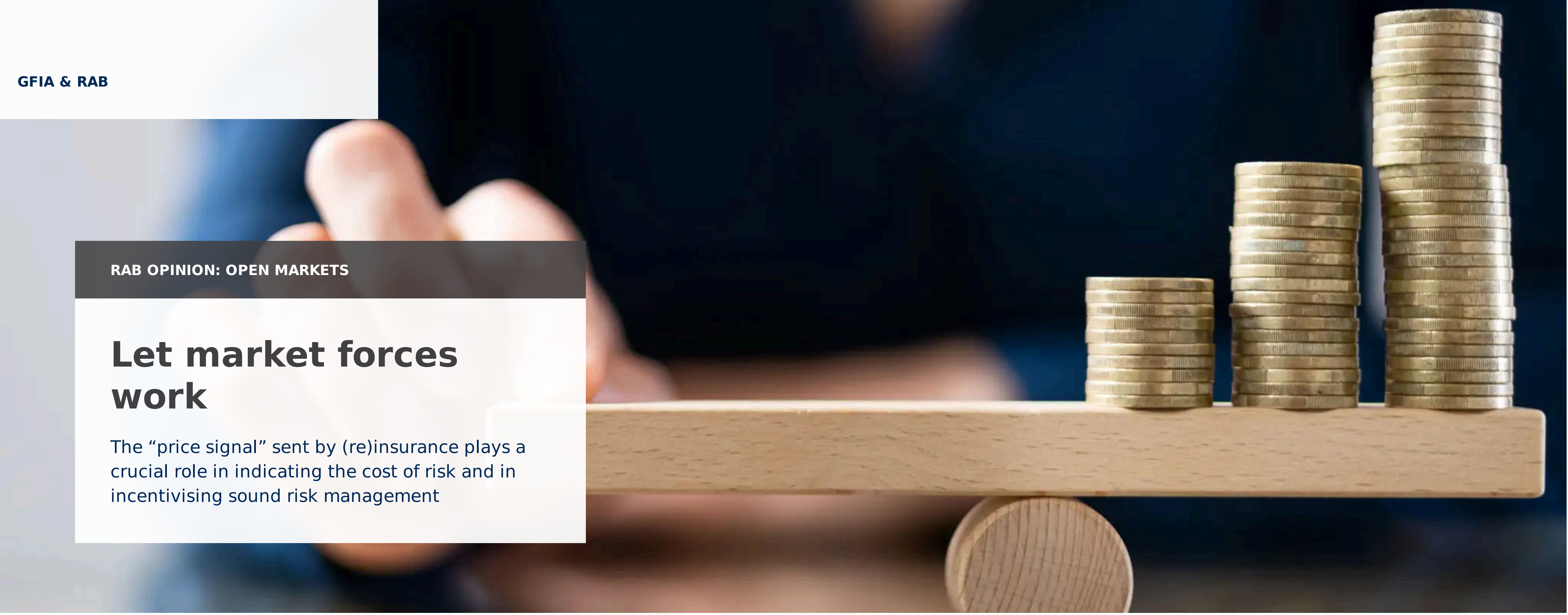
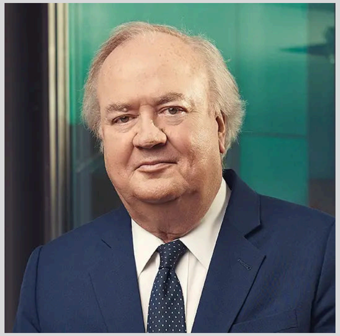


RAB OPINION: OPEN MARKETS

Let market forces work

The “price signal” sent by (re)insurance plays a crucial role in indicating the cost of risk and in incentivising sound risk management



Denis Kessler

Chair, Insurance Europe Reinsurance Advisory Board (RAB)

Chairman of the board of directors, SCOR, France

Insurance is a risk-transfer operation whereby economic agents — individuals and companies — pay a premium in return for financial compensation in the event of a covered risk occurring. The insurance premium paid by the insured — the policyholder — is risk-based; it is calculated to allow the insurance carrier to honour the contract and meet all of its commitments with a certain probability threshold, which can be seen as a security level. The greater the probability of the risk occurring and/or the potential severity of the risk when it does occur, the higher the insurance premium.

As the premium is an increasing function of the risk, it creates a "price signal", in the sense that it incentivises economic agents to act on their risks to reduce the premium they have to pay for being covered. This may be achieved by taking specific actions and adopting *ad hoc* prevention and mitigation measures, which respectively reduce the probability of risks occurring and contain their severity if they do actually occur. This phenomenon is made possible by the fact that, in most cases, the risk is not fully exogenous, ie, it does not originate entirely externally to the policyholder and is not completely beyond their control. On the contrary, most of the time, the risk embeds an "endogenous" component, ie, it may be influenced, at least in part, by the policyholder's behaviour and decisions.

For example, the risk of a car accident is influenced by the way the policyholder drives. And the risk of an earthquake (or cyclone) damaging a property is to some extent driven by the quality of construction and, particularly, its compliance with stringent seismic-resistant or cyclone-resistant standards. Likewise, the risk of a flood devastating a house is influenced by its location, ie, whether it was built in a flood-prone area. And the risk of a cyber risk compromising a company's IT infrastructure and data is strongly dependent on the quality of the cybersecurity measures implemented by that company. And so on.

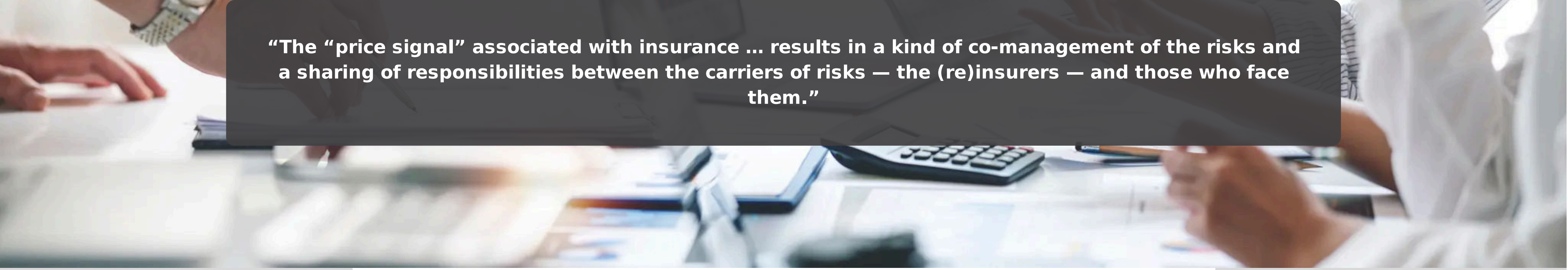
A virtuous signal

From this perspective, the "price signal" associated with insurance is a virtuous feature that results in a kind of co-management of the risks and a sharing of responsibilities between the carriers of risks — the (re)insurers — and those who face them.

More fundamentally, through this "price signal", insurance ensures that economic agents accommodate and properly take into account in their decisions the cost of the risks they are facing. In other words, risk is integrated — what economists dub "internalised" — by economic agents in their production processes. This ensures that the cost of risk is reflected in the prices and in the allocation of capital at the macroeconomic level. To put it plainly; risk is properly integrated in our collective behaviour from an economic standpoint.

reinsurance advisory board

What is the RAB?



> **“The “price signal” associated with insurance … results in a kind of co-management of the risks and a sharing of responsibilities between the carriers of risks — the (re)insurers — and those who face them.”**

Global consistency

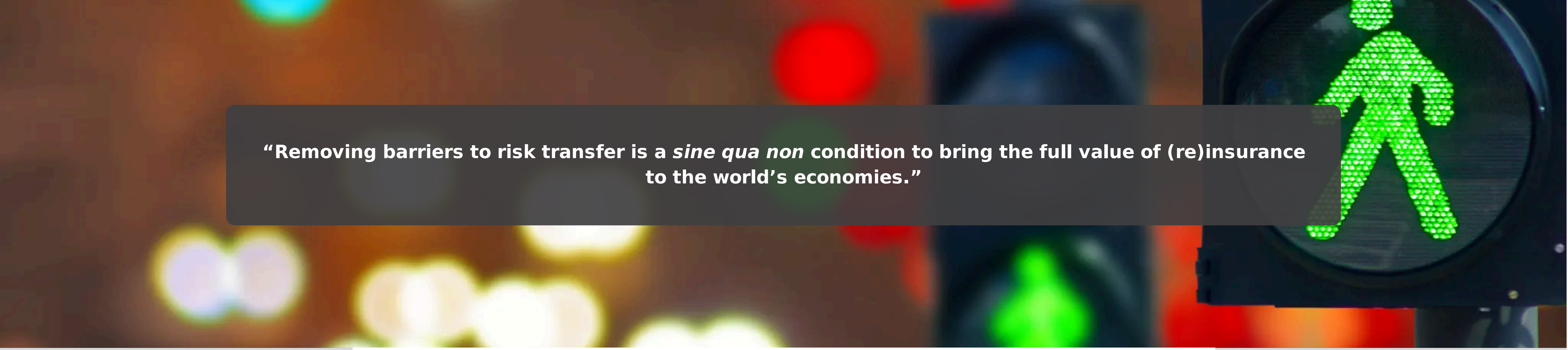
Reinsurance produces the same virtuous effect as insurance, but on a higher level in the risk transfer chain, at a global level. Through their technical expertise and risk knowledge, reinsurers send what they estimate to be the “right” price signal to insurers, who in turn percolate it down, at least partly, to each and every policyholder. Hence reinsurers are an essential cog in the wheel of making economic agents internalise the cost of risk and they make that “price signal” consistent on a global scale.

This process of market forces does work, as demonstrated by the dynamics observed in the P&C reinsurance market. Under the combined effects of three main developments, namely, soaring economic inflation — now at levels that have not been reached for 30 years —, creeping social inflation — fueled by the ongoing extension of the concept of liability and the development of litigation finance — and increasingly heavy natural catastrophe losses — likely to be, at least in part, due to global warming —, the P&C reinsurance market has turned sharply.

For similar coverage, P&C reinsurance prices are strongly on the rise, reflecting the sharp upward revision of the estimated cost of risk in the present environment. This upheaval in the market has resulted in material capacity shortages at the 1 January renewals, which are likely to feed through to the upcoming renewals. These developments show that market forces and their consequences on demand and supply in the risk transfer market are working effectively.

Rates must reflect cost of risk

In reinsurance, market equilibria are not instantaneous, because it takes some time for capital to be brought to (or removed from) the industry if there are capacity shortages (or oversupply). This explains why the market is experiencing cycles — a succession of “positive” and “negative” phases. But a market cannot be unbalanced over a long period of time. In the long-term, rates must reflect the costs of risks. A close look at the past shows that market forces do indeed play their role — adding or reducing capacity when needed to converge to a market equilibrium where risks are traded at the right price, satisfying both parties.



“Removing barriers to risk transfer is a *sine qua non* condition to bring the full value of (re)insurance to the world’s economies.”

That being said, market forces can fully play their role if, and only if, there are no “market barriers”, ie, political or administrative interferences limiting their effect. Trade barriers in (re)insurance can take many forms, such as collateral requirements, local presence requirements, restrictions on foreign ownership of businesses, compulsory cessions, right of first refusal rules or even government interference in risk pricing. And they all result in frictions in risk transfer, which skew what the market estimates to be the “true” price of risk. By doing so, market barriers distort the “price signal” sent to economic agents and bias collective behaviour. This results in a distortion of capital allocation and therefore in a modification of the market equilibrium at macroeconomic level, which does not internalise the cost of risk and which is therefore not aligned with the most socially desirable outcome. The economic and social cost of such a macro distortion may be huge.

This is one of the fundamental reasons why the RAB’s primary mission is to advocate for regulatory frameworks that facilitate global risk transfer. An April 2023 report by the Global Reinsurance Forum shows that barriers to trade in reinsurance are present or being considered in 54 territories, demonstrating the scale of this issue. Removing barriers to risk transfer is a *sine qua non* condition to bring the full value of (re)insurance to the world’s economies.

The RAB has focused its advocacy efforts on several priority markets throughout the world and contributed to the achievement of some positive developments. Going forward, the RAB will continue to be a strong advocate for open markets across the globe, so that reinsurance can operate optimally, infuse the cost of risk in the economy and accordingly orient collective behaviour and incentivise sound risk management, hence playing a crucial role in the continued growth, welfare and resilience of the world’s economies.

The Insurance Europe Reinsurance Advisory Board (RAB) is a specialist representative body for the European reinsurance industry. The RAB comprises the chairs or CEOs of the seven largest European reinsurance firms — Gen Re, Hannover Re, Lloyd's of London, Munich Re, PartnerRe, SCOR and Swiss Re — which together represent more than 50% of total reinsurance premiums worldwide.