

Will the next crisis be the same as the last

Specialist adviser on risk management **Dr Dennis Bessant** says adherence to globally accepted stress tested codes and standards is critical to reduce the cycle of catastrophe impact, recognising most national standards in Asia are the prescriptive 'minimum'. Investing more upfront is the primary way to ensure communities become safe and resilient from the vagaries of climate change.



Our re(insurance) industry is healthy and constantly lives in hope despite the constant barrage of catastrophes. Expressions of surprise assuage shareholders if it's another year of disappointing results due to active devastating catastrophes; and 'pats on the back' all round for a profitable, astute underwriting job if it's a benign catastrophe year. So good if life was so simple. The scapegoat of unexpected climate change can be used these days to defend poor results - before we had invented this term, it was poor underwriting, aggregate management, inadequate pricing or excessive per risk limits.

Foreseeable and unforeseeable

As we know, Einstein apparently said, "Doing the same thing over and over again and expecting different results is a sign of insanity." Or to put it more politically correctly, 'It's foolish to repeat ineffective actions.' Yet our industry consistently repeats the cycle in the mistaken belief that the provision of the capital buffer and financial engineering remains adequate to combat these dramatic, foreseeable exposures.

Protection gap is a myth

Then there is the protection gap myth. If only insurance penetration was deeper, asset owners more astute

and governments more prepared. All these factors help raise the bottom curve of insured losses higher through more purchase of insurance. So far so good. But the reality is coverage for catastrophe is outrageously expensive, with low capacity limits due to industry concern about aggregation and risk adversity driven by capital adequacy models.

Take earthquake-prone California. Insurance protection is, in most cases, unaffordable, used as leverage for other business or limited in capacity and is nowhere near market needs. So what hope is there for Asia Pacific which is prone to a multiplicity of catastrophe events?

So do we need to just 'Reload Reinsurance', which is the theme for SIRC 2018, or do we need to raise our sights even higher to 'Reinvent, redefine and strive for the proverbial paradigm shift'? The fact is that there is another way to secure long-term stability, reduce total cost of risk for all stakeholders and reduce the protection gap. But this time it's by lowering the extent of economic loss, the top curve. Not by selling more re(insurance).

The starting point is the premise that the majority of catastrophe loss is foreseeable. Its impact can be designed out, reduced or mitigated by reducing the shock to infrastructure and asset owners' operations rather than accepting the inevitable, leaving exposed government, taxpayers and asset owners to pick up the pieces.

Risk reduction is inexpensive initially

NGOs and the UN are now proclaiming the need to do more. The reality is that risk reduction is inexpensive at the construction stage and costly to retrofit, but it can be done. But it needs awareness, focus, stringent supervision and most importantly, finance or capital.

Our industry is well capitalised in the round globally. So rather than starting to drive from the back seat by withdrawing coverage for coal fired power plants as some firms are doing (what next? tobacco, diesel cars, big pharma?), they should divert surplus capital. Lead from the front by example rather than succumbing to political influence.

So, heartening to see a world-renowned Chinese insurer seeking to build a completely new smart city, not just technology but resilient infrastructure, laid out carefully with world-class construction standards. This is a paradigm shift. There is hope for existing assets too. Damage from catastrophe can never be eradicated but severely limited by simple additional technical things, where engineering meets underwriting.

Simple measures can prevent major losses

Additional nails to secure roofs, linings to impact-proof glass in high-rises, excess flow valves on flammable liquid piping, avoiding high-value equipment in basements; the list is endless and deserves a separate commentary. But what happens in reality? The latest example being the use of weakened quench tank (QT) rebar used as reinforcement in concrete construction of high-rise buildings rather than the stronger/more flexible micro-alloyed (MA) rebar and, most importantly, tolerant to cyclical movements from earthquakes.

To the uninformed, rebar is rebar is rebar, but QT rebar easily fails and comes at a lower cost to contractors, but asset owners continue to pay the same price as the MA rebar thereby the cost difference accrues only to the contractor and or manufacturer. People's eyes glaze over when technicalities like this emerge but essentially this widely spread practice means buildings in earthquake-prone areas will readily collapse.

It's easy to pick on thin pricing as a rationale for inadequate combined ratios and profitability shortfalls due to catastrophe. In fact, if we look under the bonnet of most commoditised insurance business models, we will find little room or income to manoeuvre for conventional perils and expenses after CAT coverage is accounted for. Why?

Buyers are often unaware of the actual or true cost of risk transfer or the final income (the insurance risk transfer price) actually received by the markets in return for the assumption of risk. Why?

Intermediaries' commissions inflate risk insurance pricing

Commissions paid to intermediaries are often not transparent and with such friction costs on a percentage basis as much as 15% to 30% deducted, no wonder insurance buyers can be

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unaware of the true cost of their risk transfer and the markets feeling short changed. Use of flat fees and greater transparency in emerging markets would allow buyers to understand how much income is left after friction costs to cover the risk transfer and pay claims. More transparency would improve results all round and, ultimately, improve affordability and increased penetration. Transparency will create the opportunity to incentivise and release additional capital for risk reduction upfront.

'Minimum' should no longer be accepted

What does all this mean? Construction, machinery and equipment and buildings and the like need to be designed and built to globally accepted codes which have been tried and stress tested to a first-class standard. No longer should it be acceptable to do the 'minimum' to hide behind the local or national standard. Often such standards in Asia are prescriptive, untested and developed around the table for industry stakeholder convenience. Codes need to be pragmatically tested to failure. Underwriting and engineering practices need to converge and be more aligned. A long-term sustainable future where the impact of catastrophe is marginalised does not have to remain a dream. The paradigm shift is attainable and the next crisis can be different with minimal impact if our industry looks beyond the next cycle and strives to fight the forces of nature with real life solutions structurally embedded in our strategies.

It only takes one small step ... to begin the change. 

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