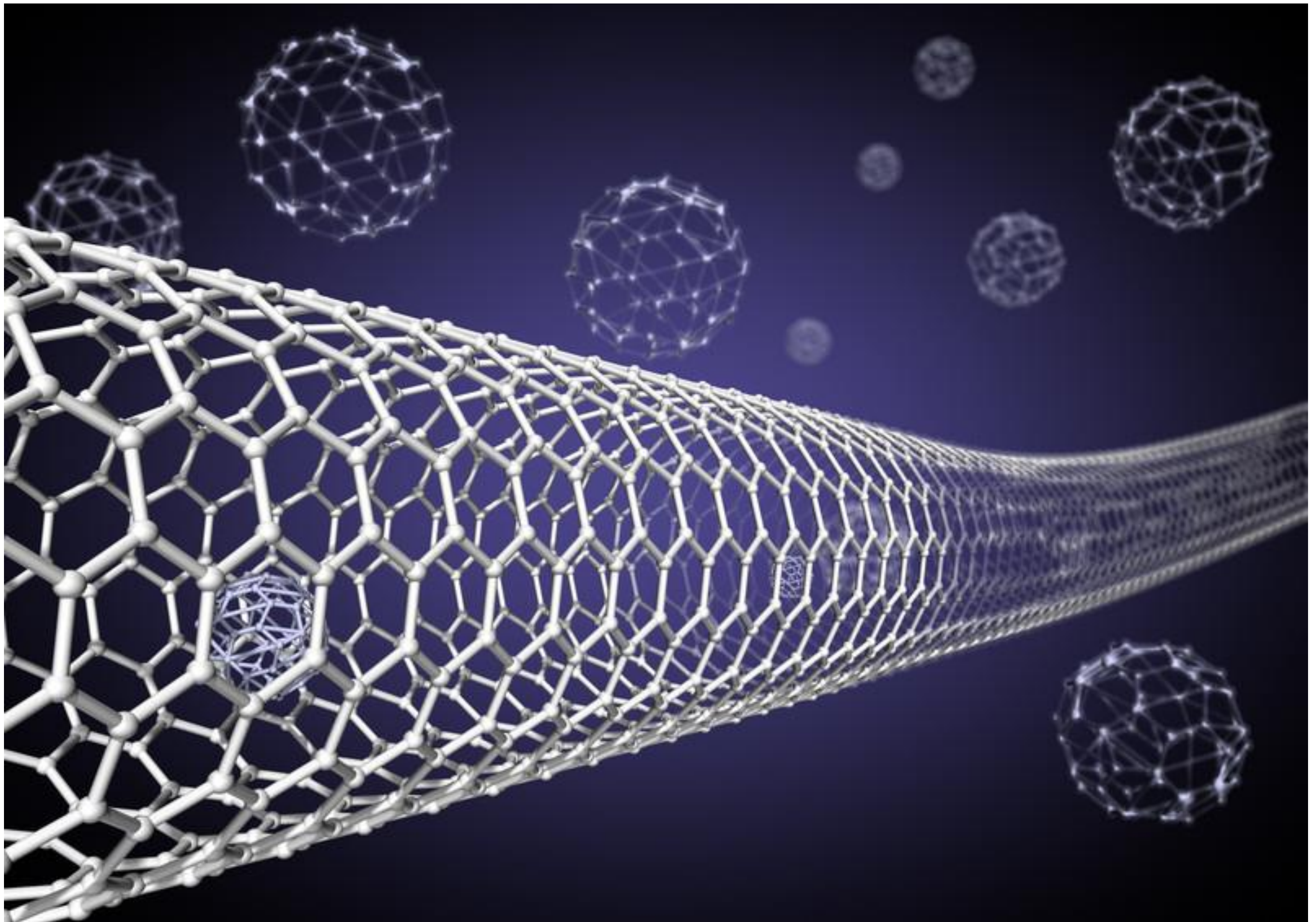
Reinsurance and Emerging Risks



Cybersecurity, nanotechnology, genetically altered crops, and climate change are all examples of emerging risks. Emerging risks are exposures that have arisen because of changes in technology, science, or legal theories, which are likely to become actual claims in the near future. The insurance industry is studying these and many other emerging risks very carefully.

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Reinsurance

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The examination of emerging risks helps insurance companies determine the size of the potential exposure and the effect of that exposure on the insurance company's ability to pay losses. These same risks are just as relevant to reinsurance companies.

The Purpose of Insurance

The purpose of insurance is to spread the risk of loss among policyholders in exchange for a premium payment. In this way, policyholders can purchase affordable insurance policies, and insurance companies can accumulate enough premiums from their policyholders to pay for the claims that come to fruition. Not every policyholder will have a loss in a given year, but the premium each policyholder pays to the insurance company helps spread the risk of loss among all policyholders.

The premium the insurance company sets for the policy is based on an evaluation of the potential exposures anticipated and the exposure to risk of the policyholder. Typically, the evaluation is premised on a historical view of anticipated exposures for that type of policyholder in that geographic region.

Reinsurance is a further step in the risk-spreading exercise. Insurance companies, which assume the risk of loss from their policyholders, spread that risk of loss further to reinsurance companies by entering into reinsurance contracts. Some of the premiums the insurance company collects from its policyholders essentially are paid to the reinsurance companies as the premiums for the insurance companies' purchase of a reinsurance contract.

Reinsurers set their premiums by also looking at the historical loss picture of the insurance company and the types of losses typically generated by the policies issued by that insurance company.

When put together, both insurance and reinsurance help spread the risk of loss among a wide group of companies, which helps to mitigate the potentially financially destructive effect of over-accumulation of risk.

The Role of Reinsurance

Reinsurance serves not only as a further risk-spreading mechanism but also as an important component of the capital structure of nearly every insurance company. Essentially, reinsurers supply capital to an insurance company in exchange for a share of the premiums on the policies that the insurance company issues to its policyholders. Basically, a reinsurance contract is an asset on the books of the insurance company, which offsets the liabilities created by writing insurance policies for policyholders to assume their risks. But this asset runs the risk of disappearing if the losses the insurance policies generate and the reinsurer reinsures are so massive as to cause the reinsurer to become insolvent.

Naturally, reinsurers are just as interested in emerging risks as the insurance companies that purchase reinsurance are. Reinsurers, just like insurance companies, want to know where their exposures will be coming from and at what loss amount.

Quite a few insurance companies with reinsurance subsidiaries and some smaller reinsurers themselves became insolvent when they discovered that they had over-accumulated asbestos and environmental exposures from old commercial policies written in the 1950s, 1960s, and 1970s. This is what makes the concern about emerging risks so important.

Because reinsurance companies typically reinsure an insurance company's entire portfolio of insurance policies (except for those insurance policies reinsured facultatively) rather than reinsure individual insurance policies, they generally are not aware of all the potential exposure from any one individual policyholder. Reinsurers rely on the ceding insurers to provide them with the risk analysis for the portfolio, which should include any emerging risks that might arise.

Reinsurers, by contract, are typically required to indemnify the ceding insurers for losses that are paid by the ceding insurers in good faith and that come within the terms of the insurance and reinsurance contracts. Emerging risks can strain the principles of follow-the-settlements,

especially if the ceding insurer chooses to pay emerging losses that were not previously anticipated under those policies.

Nevertheless, learning about emerging risks is critical to the reinsurers' knowledge of their overall exposure.

Claims Are Never Static

One of the few certainties in insurance is that there will always be new risks. New risks arise as new technologies are created and as new legal theories are developed to address those technologies. When the insurance industry wrote commercial insurance policies back in the 1940s and 1950s, they never considered that a substantial amount of the losses on those policies would arise from asbestos exposures. Similarly, insurance companies that issued commercial liability insurance policies in the 1950s and 1960s never considered that pollution would result in massive environmental losses cutting across multiple policies over multiple years as toxic waste dumps were uncovered.

As science advanced, and the truth about asbestos and groundwater pollution became apparent, legal theories developed to hold certain parties accountable. Included in that mix were insurance companies that were asked to defend and indemnify the allegedly culpable parties. The insurance industry then faced massive losses as the courts issued verdicts in favor of claimants and held that the insurance policies covered the losses. And these losses all attached to insurance policies that were purchased with modest premiums in comparison to the ultimate exposures to loss.

Science and technology never stop advancing. As we learn more about nanotechnology, climate change, genetically altered crops, and cyberrisks, concerns about bodily injury and property damage emerge. And, some of those claims can arise in unanticipated situations. For example, when countries ban grain imports from the United States because of a concern about genetically altered crops, will a products liability or business interruption claim be brought? Will the insurance policies written to cover standard business interruption or generic products liability for the agricultural industry have to cover claims arising out of the banning of imports of grain?

Today, science is studying the effect of subatomic particles on the human body. Some of these subatomic particles come from nanomaterials that we find in cleaning supplies, clothing, and many other products used on a daily basis. What are the risks of exposure to these particles, and will there be a new "asbestos" as a result?

Cyberrisks is another emerging claims area that runs the gamut from advertising injury because of access to personal information to business interruption claims to first-party property damage when computers are hacked and rendered useless. Insurance companies are already addressing climate change cases, with certain industries being blamed for damages caused by weather-related events.

The point is that risks continue to emerge and sometimes in unanticipated ways. Focusing on emerging risks allows the industry to consider what may be coming so that insurers can structure their policies and claims departments to address these potential exposures before they overwhelm the system.

Old Policies, New Exposures

As science, technology, and legal theories develop, insurance companies are being asked to defend and indemnify their insureds for losses that were not anticipated when the policies were written. Even with today's somewhat restricted claims-made policies, a change in law or a scientific development could result in new forms of loss exposure that did not exist when the policies were first written.

Older policies, especially those without aggregate limits, are prone to an expanding roster of risks. This is what happened with asbestos and environmental exposures. Comprehensive general liability policies, which were never written to assume asbestos and environmental losses, were saddled with billions of dollars of losses. Reinsurers are just as vulnerable to these losses if the reinsurance contracts are also written without any aggregate limits. Even with aggregate limits and claims-made policy forms with matching restrictive reinsurance contracts, reinsurers are still very interested in emerging risks.

Reinsurers and Claims

Besides providing indemnification for losses to the assuming insurers, reinsurers have a wider role to play in the insurance industry. Because reinsurers reinsure large numbers of policies from a variety of insurance companies, they have the advantage of seeing how new losses emerge and how they are being handled. Reinsurance claims personnel often provide loss mitigation and claims handling advice to ceding insurers because of this larger experience with similar losses arising under different policies from different insurance companies. This allows a reinsurer to provide economies of scale to its clients by accumulating the claims experience and knowledge across all its assumed insurance contracts and applying that knowledge back to the client companies.

By studying emerging risks, reinsurers are better able to advise insurance company clients on exclusions, policy wording, claims handling, and overall management of these risks. You can see the larger reinsurance groups are very active in developing white papers, studies, analyses, and other thought pieces on emerging risks for their clients and the industry as a whole. Many reinsurance companies will have experts attend client seminars to provide the claims personnel of clients with state-of-the-art industry knowledge. The insurance company benefits as well as the reinsurer by being better prepared to address emerging risks and by limiting unwanted exposures.

Conclusion

Reinsurers typically only address claims after the ceding insurer has paid them. This means that, by the time a long tail exposure claim reaches the reinsurance level, it has been around for a substantial period of time. So, why would reinsurers care about emerging risks? Because understanding new and developing exposures fueled by scientific advancement and developing legal theories is critical to managing loss and the financial viability of the industry. Reinsurers play a critical role in making sure the entire insurance industry is cognizant of what exposures should be expected in the future.

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