BUILDING OPTIMAL RISK RESILIENCE

THE PIVOTAL ROLE OF INSURANCE BROKERS

INCREASING RISK COMPLEXITY AND INSURANCE COSTS PAVE THE WAY FOR ALTERNATIVE RISK FINANCING

The increasing frequency of natural disasters, a high dependency on connected systems and workforces, and an increasing number of unpredictable secondary peril events is putting the risk managers of medium and large enterprises under ever-increasing pressure; risk managers often find themselves inadequately covered for rapidly evolving risk exposures. At the same time, the markets are witnessing a surge in global commercial insurance prices:[1] as reported by insurance broker Marsh, the average annual premium price increase in 2021 was 15%. The World Insurance Report 2022[2] from Capgemini and Qorus states that one of the key reasons for this surge in costs is the growing and evolving risk ecosystem, due to climate change, customer preferences, and new business models. This has left customers and their businesses in a state of turmoil.

Over time, almost all industries have recognized and acknowledged the benefits of diversification and so have followed the age-old adage of not "keeping all of their eggs in one basket." Insurance is no longer an exception: many businesses have begun to diversify risk management strategy through alternative products and approaches, in addition to traditional commercial re/insurance. Consider a couple of recent examples:

- Global re/insurance broker Aon structured and placed the first catastrophe bond issued from a Hong Kong domicile in September 2021. It was sponsored by state-owned China Property & Casualty Reinsurance Company (CPCR) and issued by Greater Bay Re Limited to provide $30 million-per-occurrence retro reinsurance protection to CPCR against typhoons.[3]

- Alphabet, the holding company of Google's tech operations, entered the catastrophe bond market for the first-time last year. This capital-markets-backed solution helped them to secure more earthquake insurance protection for its assets in the state of California.[4]

The industry has also been trying to adapt to new technologies and competitors, both on the InsurTech and alternative capital sides. While during the last few years the Insurance has become something of a value-destroying industry – struggling to earn their cost of capital, brokers are the clear winners as they have gathered up the value being shed by reinsurers: this is a clear indication that brokers are going to lead the way with alternative risk financing options in the future.

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[1] https://www.businessinsurance.com/article/20210727/NEWS06/912343506/Commercial-prices-up-average-15-globally-in-Q2-Marsh
[2] https://worldinsurancereport.com/
[3] https://aon.mediaroom.com/news-releases?item=138124
[4] https://www.artemis.bm/news/alphabets-googles-first-catastrophe-bond-priced-on-target-at-237-5m/

INSURANCE BROKERS BENEFIT FROM HIGH CUSTOMER TRUST

Insurance brokers have always been considered closer to their customers than have insurance providers. Because of their familiarity with and ability to deliver niche insurance coverages and a history of meeting client needs and expectations, brokers are often the most trusted provider channel.

Capgemini research advocates that the Convenience, Advice and Reach (CARE) equation is crucial to be adopted across the insurance value chain in order for insurance industry players to grow and sustain their businesses. And, the close alignment of insurance brokers' business strategy with the CARE equation provides them with an edge over other players:

- **Convenience:** Brokers adopt the latest technologies to ensure convenience and responsiveness around the clock.
- **Advice:** Brokers dominate this area with investments in relationship and research, alongside trust earned as true advisory partners.
- **Reach:** Brokers combine digital channels for engagement and in-person/live connection for empathy.

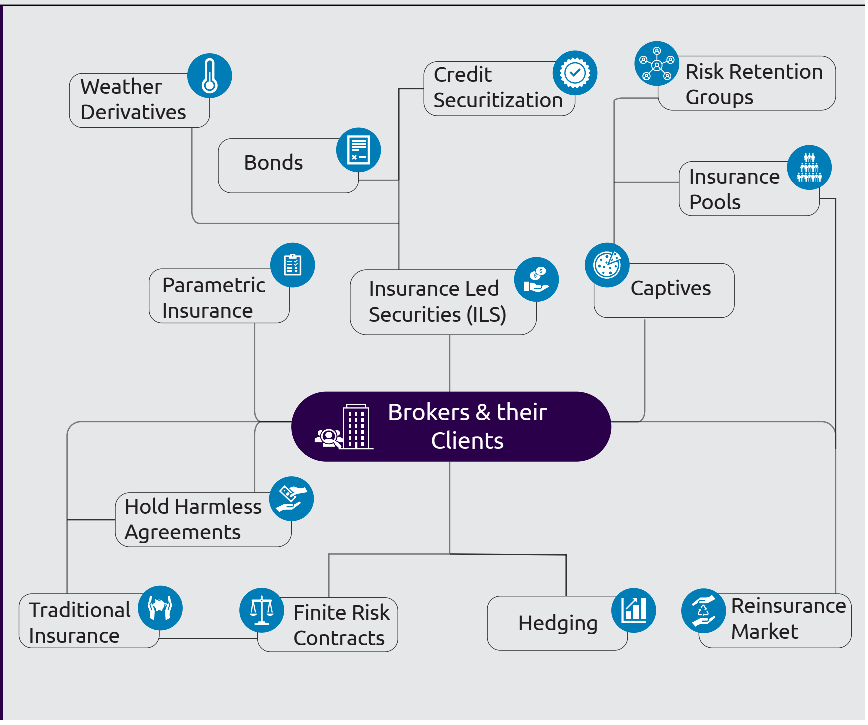
During the past five to ten years, brokers have emerged as the clear winners of the insurance industry, with both public and private investors recognizing their position of strength in the insurance value chain. This reaffirms our belief that brokers are trusted most as partners by risk managers and therefore will play a central role in expanding the alternative risk financing industry.

RISK FINANCING ALTERNATIVES BETTER MEET CURRENT MARKET NEEDS

Given experience, expertise, and access to diverse opportunities, insurance brokers are well-positioned to help structure adequate risk capital for the risks that are insurable or that can be managed using alternative options.

Exhibit 1: Broker-Led Market, Striking Balance Between Insurance & Risk Financing Alternatives

- CAPTIVE INSURANCE
- INDEX-BASED/PARAMETRIC INSURANCE
- INSURANCE LINKED SECURITIES (ISL)
- NON-INSURANCE RISK TRANSFER TOOLS



CAPTIVE INSURANCE

Traditionally, insurance brokers were involved in educating customers about risk exposures and then collating appropriate insurance coverages for them. Over time, this broker role has evolved into advisory services around risk management and financing, too.

- Less than half of Fortune 500 companies had captives in year 2000, but that percentage has increased to 90% today.[5] Brokers are playing a key role in this growth by investing in powerful advisory tools.
- One such example is the finance modelling tool[6] from Willis Tower Watson. It allows businesses to perform due diligence and assess the potential value of forming a captive insurance company as compared to purchasing traditional insurance. The tool is a web-based interactive platform that can run stress tests and scenario tests – changing assumptions to quickly evaluate capital adequacy and determine future capital needs.

Consider the example of a multinational company that manages risk at subsidiary levels using individual insurance policies leading to higher insurance premiums. Using their experience, technology tools, and relationships with various partners, a broker can help the company to better understand and classify the risks in terms of what can be retained versus transferred. The retained risks can be further addressed through captive insurance; this also helps brokers to better identify insurance coverage options for remaining risks.

COVID-19 exposed inconsistencies in multi-national companies' employee benefit programs. Here too, brokers are advising organizations to procure, organize, and manage employee benefits related to health and wellbeing in a more consistent manner via captives.

With more and more organizations aspiring to manage capital optimally and to drive improved employee experiences, they will turn to brokers for building and managing their captive insurance strategies.

INDEX-BASED/PARAMETRIC INSURANCE

Index-based or parametric insurance is an emerging model, where the insured receives an agreed amount upon the occurrence of events with specified intensity, such as an earthquake or a hurricane. This can be a great tool for businesses to manage short-term stresses on capital, because traditional insurance claim payments can take weeks or months to arrive.

More sophisticated models can be designed based on the extent of damages, a specific time window, or a customized list of losses, both natural and human-driven; a comprehensive and reliable dataset of the risks, along with analytical tools, are required to define these parameters. Brokers are a natural fit as they have first-hand access to both client data and the tools. Calculating parameters helps the broker and the insured to tailor coverages per requirements and reduce insurance premiums.

Insurance brokers play an important role in establishing and enforcing a robust method for purchasing a parametric policy. This expertise goes beyond traditional products, to balance the coverage limits with risk exposure. Brokers have a large potential role in identifying key loss drivers, reviewing traditional covers, and identifying gaps that can be bridged with parametric insurance. Additionally, brokers can offer their expertise to identify relevant data sources to build an index appropriate to the exposures or coverage needs of the insured, especially for non-traditional risks.

[5] https://www.captiveinternational.com/contributed-article/captives-by-numbers
[6] https://www.globenewswire.com/en/news-release/2020/06/10/2046286/0/en/Willis-Towers-Watson-launches-a-group-captive-solutionfor the-middle-market.html & https://www.willistowerswatson.com/en-US/News/2018/08/financial-modeling-tool-for-captive-owners

INSURANCE-LINKED SECURITIES

Insurance-linked securities (ILS) have been on a rise for last few years, with 2021 being another record setting year. ILS were primarily used by insurance companies and public initiatives to reinsure high-severity and low-frequency events like natural disasters. As a fast growing trend, ILS can help address high severity risks through weather are derivatives bonds, and credit securitization.

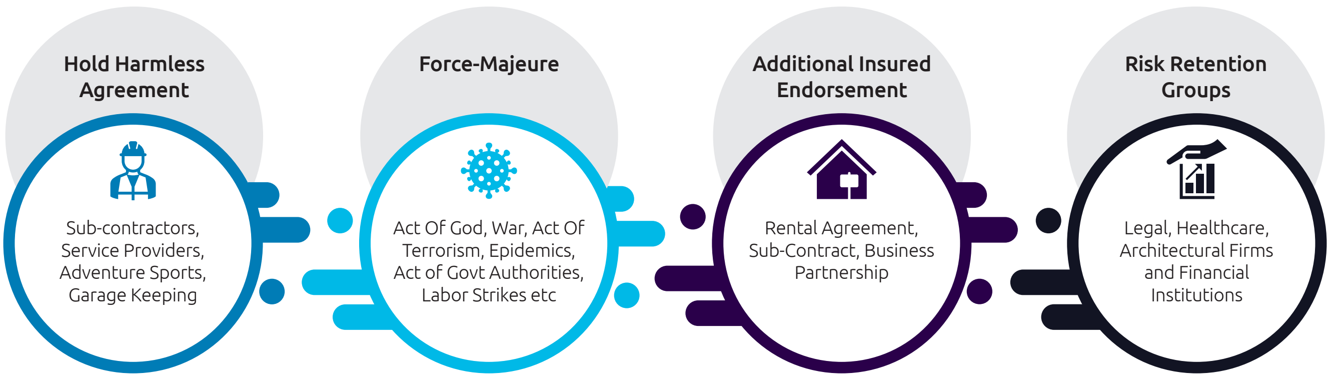
The numbers from Artemis[7] indicate increase in usage of such risk financing strategies. The issuance of catastrophe bonds and ILS risk capital has doubled during the last five years from $7 billion in 2016 to $14.5 billion in Q3 2021. Similarly, the yearly total of outstanding catastrophe bonds and ILS risk capital increased to a record of about $51 billion. This reinforces the fact that brokers are intelligently leveraging alterative risk management tools to optimize overall risk portfolios for their clients.

Brokers, through their networks, can play a significant role in determining the regulatory regime and regional support for ILS as a diversifying asset class or investment option. They can help locate important risk transfer hubs and gateways for global capital to support non-traditional risk transfer solutions. This will serve to maintain momentum and solidify the position of ILS as an effective component of companies' risk transfer strategies as they rethink access to capital.

NON-INSURANCE RISK TRANSFER TOOLS

One growing trend is to identify solutions to complex alternative risk financing through non-insurance techniques. Brokers with deep domain acumen and years of experience have thought creatively to stitch together appropriate solutions combining multiple tools. In some cases, such arrangements have helped to make the business more insurable by releasing some of its liabilities that otherwise would have created challenges by limiting the risk financing options for a given business.

Exhibit 2: Non-Insurance Risk Transfer Tools



[8]

[7] https://www.artemis.bm/dashboard/catastrophe-bonds-ils-issued-and-outstanding-by-year/
[8] https://www.akerman.com/en/perspectives/the-coronavirus-and-force-majeure-clauses-in-contracts.html & https://www.captiveinternational.com/contributed-article/strengthen-your-bargaining-position-with-risk-retention

DESIGNING AN ALTERNATIVE RISK FINANCING STRATEGY FOR RESILIENCE

As an example, consider a medium-sized enterprise dealing with three categories of risks. The table below illustrates how a broker might help in effective risk financing and mitigation.

Exhibit 3 : Example Approach for Alternative Risk Financing Strategy

<table>
<tr><th></th><th>ROLE OF BROKER</th><th>CATEGORY A RISK: LOW SEVERITY, LOW FREQUENCY</th><th>CATEGORY B RISK: MEDIUM SEVERITY, MEDIUM FREQUENCY</th><th>CATEGORY C RISK: HIGH SEVERITY, LOW FREQUENCY</th></tr>
<tr><td>PHASE 1: INITIAL INSURANCE SETUP</td><td>• Evaluate and classify the risks
• Explore risk prevention and reduction techniques
• Optimize solution for risk portfolio</td><td>• Retention through captives</td><td colspan="2">• Risk transfer to insurance company
• Complement with non-insurance risk transfer tools</td></tr>
<tr><td>PHASE 2: OVER THE LONG RUN</td><td>• Monitoring and re-assessing the captives
• Explore other alternatives for risk financing</td><td>• Continue retention through captives</td><td>• Continue risk transfer to insurance company</td><td>• Retain a larger portion of risk and opt for ISL kinds of engagement with a reinsurance firm on a facultative basis for excess loss</td></tr>
<tr><td>PHASE 3: REVIEW AND REDESIGN</td><td>• Continue to monitor and assess the need to reclassify the risk portfolio</td><td colspan="3">• Examine the risks across Categories A, B, and C
• Recategorize the risks and select alternative risk financing and mitigation options</td></tr>
</table>

CONCLUSION

BROKERS CAN HELP SHAPE THE FUTURE OF RISK RESILIENCE

As the risk ecosystem continues to shift, business risk managers are ever more challenged to adequately cover evolving risks while minimizing the impact of the increasing costs of traditional insurance. In reaction to this changing environment, brokers have put alternative finance management to appropriate use: they have the reach, diversification, efficiency, and technical or data advantage, and are also increasingly becoming marshals of risk capital. These are the key reasons for the shift in value from the underwriting to the broking community in recent years.

Looking ahead, insurance brokers should focus on intricately and methodically stitching together the most efficient risk capital strategies, traditional and alternative, for their risk manager clients: embrace new technologies alongside capital market tools to create entirely new ways for risk and capital to be matched and traded. Brokers have the clear potential to lead in future by clearly demonstrating and monetizing the value they bring to the risk-to-capital value chain through alternative risk financing tools and options.

A brilliant case from Aon strengthens our viewpoint further. Aon is leveraging its data to more efficiently channel capital to risks, effectively blurring lines between underwriter and broker. Aon's "Marilla" catastrophe reinsurance facility,[9] set up towards the end of 2020, involves capacity being marshalled on an automatic following basis to take up to a 5% line on global catastrophe excess-of-loss reinsurance program renewals that Aon has brokered. Backers of this facility include global reinsurance players Swiss Re, PartnerRe and AIG owned Validus. Marilla is also an ILS investment manager operation, bringing third-party investor capital to certain catastrophe reinsurance programs, with Aon acting as an investment and capital manager.

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[9] https://www.artemis.bm/news/aon-marilla-re-collateralized-bermuda-catastrophe-reinsurance/

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