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The First Thirty-Five: Part 1

By John Tiller

For the 35th anniversary of *Reinsurance News*, I was asked to write about changes that have taken place in the life, health and annuity reinsurance world in the past 35 years. I assume this honor is because I was a founder of the Section and served on the Section Council when the newsletter began.

This discussion focuses primarily on the U.S. life reinsurance market. The memories and opinions are mine and do not represent those of the Reinsurance Section or any company. Further, these comments are generalities; exceptions can be found to all of them. This is the first article of two, addressing the period surrounding the founding of the Section and *Reinsurance News*.

THE GOOD OLD DAYS

To understand the changes, a common understanding of "The Good Old Days," the period prior to roughly 1980, is needed. Reinsurance was much different than today, applying primarily to life insurance. Ceding companies knew little about reinsurance, depending on their reinsurance "partners" to tell them what they needed to know.

Most reinsurance was ceded on a yearly renewable term (YRT) basis, and a meaningful portion of that was experience rated. Coinsurance was rare. Market forces led to profitability and product offerings that were roughly the same for all players. My company's standard profit objective was roughly $1 per thousand in force per year. Most reinsurers had two YRT rate scales for all insurers, one experience rated and one non-refund. Most scales had a positive first-year premium, creating little if any surplus strain for the reinsurer. Other than updating these scales for evolving experience, the reinsurance world had been relatively stable for decades.

Many "big Eastern mutuals" ceded reinsurance on a modified coinsurance (mod-co) basis with experience refunds. A block of this mod-co at my company showed gross margins in excess of $3 per thousand each year.

There was no objective standard for minimum capital. Risk-based capital had not been created; capital was not considered in pricing. When necessary, we applied a return-on-investment hurdle of roughly 15 percent, where the investment was the surplus strain without capital.

Reinsurance relationships were treated as partnerships. Most cedants had only two automatic reinsurers and were loyal to them. If a reinsurer lost money, the ceding company tried to find a way to "make it up." If a ceding company made an error in underwriting, the reinsurer tended to accept the claim.

A second layer of automatic reinsurance sometimes brought in more reinsurers. Most facultative reinsurance was due to underwriting concerns or capacity needs and was submitted to the automatic reinsurers only. Facultative submissions were sent by mail and took about two weeks to turn around.

Individual cessions were handled on a manual basis. The ceding company sent information to the reinsurer, who created an administrative record for each cession and billed on each policy anniversary. The cedant was required to notify the reinsurer of any changes in the policy and to review an annual listing of in-force reinsurance. That worked well as long as the number of cessions was relatively small.

DRIVERS OF CHANGE

So what evil snakes entered and destroyed this Garden of Eden? There were several, appearing in roughly the order discussed here. All occurred largely in a five-year period from 1979 through 1983.

The Product Revolution

Prior to roughly 1980, most insurers primarily sold whole life, either participating, non-par or both. Only a few companies sold significant amounts of term insurance. Most term insurance had level premiums and benefit periods of 10 to 20 years or up to age 65. Decreasing term plans were intended to meet specific needs, such as paying a mortgage or putting a child through college. Conversions to whole life were common. Some actuaries and insurers believed that term insurance was a poor deal for the policyholder who paid premiums and had no non-forfeiture benefits. Term insurance was considered risky, with worse experience than whole life. Direct product margins were high, and reinsurance margins reflected this.

Annual Renewable Term

Around 1980, the term market leaders introduced long-term annual renewable term policies, for which premiums increased annually. Insurer and reinsurer actions in response to these new products led to what I call "the first quota share mess." These new term products, and others that will be addressed later, resulted in a rapid increase in sales at a time when many direct insurers were skeptical or hesitant regarding such products. But insurers needed term products to complete their product offering and satisfy their agents. Reinsurers were joyous to provide reinsurance for these products, usually on a coinsurance basis, and for the other new products that quickly followed.

Annual renewable term (ART) coinsurance generally provided 100 percent allowances in the first policy year, a new concept that allowed the reinsurer to participate in the surplus strain. Many insurers moved to reinsure on a quota share basis, partly because they were afraid of the product and the volumes sold, but primarily because of the great deals the insurers obtained.

ART rates were based on issue age without a select period. Then one company introduced select and ultimate term. The direct premiums were based on issue age and duration with a select period. As the product spread, it developed that a healthy policyholder obtained lower premiums by applying for a new policy elsewhere. A newly underwritten select and ultimate rate could be lower than the second-duration rate of a policy issued one year earlier, and the agent could collect a new first-year commission. Companies felt compelled to allow healthy policyholders to "reenter" by issuing a new policy. The effect of this was a snowballing problem for the industry. Healthy policyholders moved elsewhere, leaving the remaining group with poorer mortality than anticipated.

The large volume of competitive term insurance policies changed the nature of the reinsurance industry. Reinsurers had to design products for each product of each ceding company. Each quote had to live and die on its own, and insurers pushed for lower and lower reinsurance costs. The $1 per thousand per year margin became a present value $1 per thousand by 1985, and even that level of margin deteriorated quickly.

Over 50 percent of term business was ceded to reinsurers, and many insurers made a profit on the reinsurance. By 1983, most reinsurers were losing money. Many insurers also realized the situation was untenable. The day before its spring 1983 meeting in Chicago, the Society of Actuaries (SOA) sponsored a term insurance seminar to discuss product issues with both insurers and reinsurers.

I missed this meeting due to a prior commitment. After about two weeks out of the office, I returned to a different world. One reinsurer had begun to reprice all of its term coinsurance, and most other reinsurers followed. Quote share was replaced by excess reinsurance on more profitable terms. So ended the era of the first quota share mess, but there were ramifications for years to come.

Note that reinsurers' mortality assumptions were largely correct at issue. The problem was that persistency was much worse than anticipated. Acquisition expenses were not recovered as expected, and mortality on the renewal risks was somewhat worse than expected as many healthier risks left the pool by re-entering another pool.

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Universal Life

The second part of the product revolution was the introduction of universal life (UL) around 1981. At first only a few stock insurers offered UL, but the product quickly gained popularity with agents and buyers, eventually replacing non-par whole life.

The effect of UL on reinsurance was as great as that of the new term products. With the introduction of UL, the old concept of a YRT scale for all companies died. By necessity, all reinsurance pricing was now "tailor-made." The introduction of select and ultimate costs of insurance was the final brick in the road to lower margins. Insurers also wanted monthly reinsurance premium calculations that stressed their administrative capabilities.

Nonsmoker and Preferred Products

In the early 1980s, data showed that nonsmokers had significantly lower mortality than did smokers. Nonsmoker products became the rage, with reinsurers supporting this somewhat experimental product. Soon other preferred products, such as those for positive lifestyles or better medical metrics, were introduced and dominated the direct insurance markets. Reinsurers naturally followed.

Brokerage, Sales and Underwriting

Prior to the introduction of these new products, most agents sold primarily for one insurer, and brokerage was rare. Now agents began to search for the best product, price or underwriting through brokerage. The old bond between the agent and the insurer was redefined, with less loyalty. Insurers responded by introducing new products, often with strong reinsurer support. Facultative underwriting became relatively common in order to obtain the best rating. In some instances, direct insurers began to loosen their own underwriting standards.

Administration

Many insurers were now ceding part of every term risk. Most insurers also wanted monthly reinsurance cost calculations on UL products. The administrative capacities of both insurers and reinsurers were overwhelmed. Self-administration was assumed to be the solution. However, with no industry-accepted standards and no commercial systems, each insurer and reinsurer developed the new processes separately. These systems usually took longer than anticipated to develop and were prone to error.

AIDs and Blood Testing

At the same time, the industry became aware of AIDS and its potential effect on insured mortality. The Reinsurance Section sponsored the SOA's first major spotlight on AIDS with a seminar in the mid-1980s. This seminar helped the industry understand and adapt to the situation. Fortunately for the industry, the major group of individuals that contracted AIDS had not purchased life insurance. There was no meaningful increase in claims. However, it was clear that the old underwriting processes needed to be changed to guard against unknown future risks.

New and less expensive medical tests were developed about this time, and blood testing became the "game-changer." It became cost-effective to obtain tests for multiple conditions. Underwriters could answer questions they had not even considered a few years earlier.

Tax-Driven Reinsurance and Surplus Relief

The 1959 Tax Act had some interesting provisions regarding reinsurance. As interest rates increased in the 1970s, a few companies realized that reinsurance could be used to significantly reduce federal income tax based on provisions of the 1958 Tax Act for some insurers, especially larger mutual companies. In about three years, using the then-applicable IRS Code Section 820, the tax revenue from U.S. life insurers was reduced by about 70 percent. The IRS and Congress reacted and wrote a new tax code for insurance companies, including the infamous Section 845.

In the mid-1970s, reinsurers and some insurers began to provide surplus relief thorough very low risk reinsurance vehicles. Traditional coinsurance, mod-co or combination treaties provided reinsurance to a ceding company using high allowances in the first year to create a gain in the ceding company and a loss in the reinsurer. No cash was transferred except for a fee to the reinsurer. There was little economic risk due to the pricing. Typically, the reinsurer was repaid from earnings on the reinsured block in five to six years, and the ceding company recaptured the block. Statutory regulation did not have the tools to block these low-risk treaties.

Repercussions on the Reinsurance Industry

Beginning with the quota share mess, most reinsurers lost money and became cautious for about 20 years. Several suffered GAAP loss recognition, at least one exited the business, and others avoided term coinsurance for decades. Reinsurance relationships changed; the partnership concept was replaced with "give me the lowest cost or get out." Agents and insurers came to see facultative options as a way to significantly increase sales rather than as a source of assistance in underwriting. Margins reduced to a level that was too low to support the capital needed for many reinsurers. This led to lower prices and lower margins for direct insurers as well. The profitability of the industry has never recovered. Perhaps all of these changes were desirable, but it is hard to see that, even from this distance.

For some years, the profits from tax-driven and surplus relief transactions allowed some reinsurers to show significant profits. By 1985 the 1958 Tax Act was history; IRS Code Section 845 shut down most tax-driven reinsurance. Surplus relief continued to some extent, but the final nail in that coffin came with Life and Health Reinsurance Agreement Model Regulation in the 1990s.

It was in this world that the Reinsurance Section and *Reinsurance News* began.

This article is the first of two. Part 2 will be included in the next edition of *Reinsurance News* and bring events forward to today. ■

John Tiller, FSA, CERA, MAAA, has over 45 years of experience in the world of reinsurance, including responsibilities for accepted and ceded reinsurance, assumptions, and mergers and acquisitions. He can be reached at *jetiller@jetiller.com*.