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The Current Reinsurance Market and What Term Writers Need to Consider

by Pasquale Rulli

The landscape as of late for the life reinsurance market is a troubling one for direct term writers. Today, term writers predominantly utilize quota share coinsurance and typically reinsure 80 percent to 90 percent of the risk. They reinsure a majority of their business to unload XXX reserves and to take advantage of aggressive reinsurance mortality assumptions, but are now seeing reinsurance capacity diminishing, increasing risk, and prices firming.

Industry downgrades are widespread and reinsurers are exiting the life marketplace, either because they choose to focus on other lines of business (e.g., ERC exiting life business in United States) or because of mass consolidation (e.g., Lincoln/Swiss Re merger). This has led to a major contraction in reinsurance capacity. Recent voracious competition and financial problems have also contributed. There are only a handful of reinsurers in the market and this has led to another issue, increased counter-party risk.

Simultaneously, banks are focusing on increasing margins and effective usage of capital, which is producing increased LOC (letters of credit) costs. Reinsurers are passing these higher costs on to ceding companies. In most cases, reinsurers are decreasing the amount of business they will accept from any one cedent, with exceptions made only to certain key relationships.

In this article, I present some views of what product managers should do in response to this environment and what the future is likely to bring. These are my personal views and do not necessarily reflect the views of my employer.

What Can Product Managers Do?

Start Monitoring Counter-party Exposure

Companies must establish a dynamic system to manage counter-party exposure. This is preferable to imposing rigid acceptance limits. Acceptance limits, determined for the spectrum of options, must be flexible under changing conditions (e.g., mass consolidations). The following factors should be considered when determining acceptance limits for counter-party exposure: the size of the reinsurer, their financial strength ratings, exposure as a percent of reinsurer surplus and allowances for maintaining key relationships.

Take More Direct Risk

Companies may choose to increase retention limits and accept potential volatilities in earnings. Product managers should perform scenario analyses to help them prepare for unanticipated changes (e.g., a key reinsurer exits the market) and continuously monitor the market opportunistically.

Consider Alternatives to Standard Coinsurance Arrangements
Some alternatives to standard coinsurance arrangements are outlined in the following chart.

Alternative	Advantages	Disadvantages
YRT Reinsurance	Lessens asset exposure to reinsurance company under adverse scenarios	Must hold XXX reserves
Affiliate Offshore Reinsurance	May be able to avoid holding XXX reserves	Changes in U.S. law and rating agency views may attempt to even the playing field, making this a less popular method in the future
Use Lower Quality Reinsurers to Expand Pool	Increases capacity; Potential for better pricing	Riskier — must do proper due diligence; Must limit amounts ceded
Life Securitizations	Untapped market; Outside investors provide capital relief	New development; Pioneers may encounter unexpected difficulties

Future Trends

Consolidations and downgrades are likely to continue, thus bringing the universe of acceptable reinsurers down in number even further. There could be some additional sources of support as some new reinsurers may emerge, likely backed by large insurance companies. There are also excellent opportunities for reinsurers to design capital solutions that minimize LOC cost volatility while still offering sufficient capacity.

Expect direct writers to be less active in the reinsurance market. According to Aon's analysis on the impact of the 2001 CSO Mortality table[1], XXX reserves decrease on average by 25 percent for issue age 45. Some direct companies implementing 2001 CSO will choose to increase retention limits in lieu of premium rate reductions. Direct writers will now have to take more responsibility for their own mortality and recent heavy reliance on reinsurers' aggressive mortality assumptions must be "shored up" by underlying mortality experience.

Term writers must proactively monitor their reinsurance portfolio and recognize potential problems as early as possible. Product managers need to be aware of the diversification risk that can be caused by the contraction in the reinsurance marketplace and the alternatives that can be used. Companies will need to take on more risk, explicitly or implicitly, in the future and they will need to change their approach in order to manage these risks effectively. □

[1]*Aon's Consulting's Research Brief, "Implications of the Adoption of the 2001 CSO For U.S. Life Insurers," July 2002.*

Pasquale Rulli, FSA, MAAA, associate actuary at Allstate Financial in Northbrook, Ill. He can be reached at prulli@allstate.com.