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A Primer on Reinsurance Pricing Strategy: **A Checklist for Optimizing Reinsurance Negotiation**

By Larry Warren

Editor's Note: The following article is part two of a two-part series regarding reinsurance quote negotiation. For part 1, see the June 2012 issue of Product Matters!

This article is written with the idea that both the reinsurer and the direct writer could benefit from fully exploring all appropriate assumptions and considerations directly and indirectly impacting reinsurance pricing. The reinsurer benefits by being able to offer the lowest yearly renewable term (YRT) rates and the most competitive pricing it can justify, enabling it to win a share in the pool. The direct writer benefits by giving the reinsurer the additional insights and justification for a lower priced quote, thus reducing its reinsurance premiums and increasing bottom-line net income. This article addresses such assumptions and considerations based on my experience on the direct writer side of the negotiation. Part 1 of this article addressed important assumptions in reinsurance pricing. Part 2 addresses other important considerations.

Important Additional Considerations

1. Reinsurance is Not a Commodity

Purchasing First Dollar Quota Share YRT reinsurance is not exactly like purchasing a commodity where reinsurers with the lowest prices are necessarily the best deals.

Credit rating, financial strength, services provided, jumbo limits, facultative capacity, and transactional facility (ease of doing business) are some of the important attributes that should be recognized when selecting reinsurers.

2. Treaty Language and Provisions

Treaty language and provisions often vary from reinsurer to reinsurer and play an important role in the amount of effort and manpower needed in the overall administration of the reinsurance arrangement, meeting the expectations of both parties and the associated costs. Provisions such as errors and oversights and policy changes should be crisply and clearly written to prevent potential future disputes. Inclusion in your treaty documents of specific, clarifying examples may be quite helpful in preventing future interpretation issues.

Writing, defining and structuring treaty language and provisions is a specialist task requiring painstaking attention to detail. But the effort can pay dividends in litigation savings for both sides by preventing conflict in the first place. Elaborating on this aspect is beyond the intended scope of this article but it is worth mentioning two particular treaty provisions that, if not drafted with precision, can have significant financial ramifications for both parties.

Reinsurer Premium Guarantee Provision

The premium guarantee language must be clear, effective and have teeth. As indicated in part 1, the reinsurer's choice of which mortality table to assume (i.e., which mortality table they believe reflects the appropriate slope for the company to which they are quoting) and what level of mortality improvement factors to assume, have the greatest financial impact in pricing. There is clearly a significant amount of judgment and subjectivity involved in these two important assumptions and hence in projecting future mortality which the reinsurer uses in developing its pricing.

In a scenario where the actual claims are following the slope of the 1990–95 mortality table and the reinsurance premiums have been based on the 1975–80 mortality table, the mortality claims will increase at a faster rate than the reinsurance premiums. In a few short years, the reinsurers would find themselves in a situation where mortality claims are now considerably higher than the reinsurance premiums. This observation, or shall we say revelation, comes at a time as the experience unfolds, when the reinsured block of in-force business has become quite large and is generating significant losses to the reinsurers. A similar effect would also occur if the mortality improvement that the reinsurer built into its pricing fails to materialize.

To avoid or mitigate the recurring impact of significant losses, the reinsurers may consider raising rates, especially when the premium guarantee provision in the treaty is weak, unclear or ambiguous, which has very often been the case in YRT reinsurance.

An example of recommended premium guarantee language in YRT treaties that should prevent the reinsurer from raising its premium rates on in-force business follows:

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Larry Warren, FSA, MAAA, is executive vice president and chief actuary with National Benefit Life Insurance Co. He can be contacted at larry.warren@primerica.com.

1. *"We anticipate that the YRT rates shown in this agreement will be continued indefinitely for all business ceded under this agreement. However, because of statutory deficiency reserve requirements, the only guaranteed premiums are premiums equal to the 2001 CSO Mortality Table discounted with the maximum prevailing statutory interest rate according to the issue year."*

AND

2. *"We may only increase YRT rates if we increase rates for our entire class of YRT business with* **each** *of our clients. If we increase YRT rates, then you have the right to immediately recapture without penalty or recapture fee, any business affected by such increase."*

The original intent of the first paragraph of the premium guarantee provision was to guarantee the current reinsurance premium rates in such a way that the reinsurer could not raise its rates. If the reinsurer, however, explicitly guaranteed the current rates, it would be required to set up deficiency reserves. Therefore, the language was constructed in a way that falls short of actually guaranteeing the treaty rates.

The first paragraph, although quite common, gives the direct writer limited protection against the reinsurer increasing its rates on in-force business for any reason it considers justified—or even for any reason at all. The ambiguity in this paragraph can lead to disputes and arbitration proceedings with serious financial repercussions to the direct writer, reinsurer, or both.

The second paragraph denies the reinsurer the right to raise the treaty YRT rates unless it also raises YRT rates applicable to all other clients. Thus, by virtue of the second paragraph, a reinsurer experiencing significant losses as in the scenario alluded to above can only raise rates if it does so globally across all its YRT treaties, even for clients with favorable experience. Only a reinsurer exiting the YRT business would follow this course of action. Even in such an extreme case, the direct writer would have the ability to recapture without fee or penalty.

Clearly, the addition of the second paragraph substantially protects the ceding company. Keep in mind that requesting the reinsurer make treaty changes to the benefit of the direct writer in one particular area may require concessions from the direct writer on other items in order to make the agreement work for both parties. The direct writer may need to prioritize the provisions most important to them to maintain the appropriate balance for both sides.

Recapture Provision

In a reverse scenario, if the actual mortality claim rates are following the slope of the 1975–80 mortality table and the reinsurance premium rates have been based on the 1990–95 table, then the reinsurance premiums will increase at a faster rate than the death claims. After a few years, the direct writer will find itself in a situation where the YRT reinsurance premiums are now considerably higher than its mortality claims. This usually occurs at a time when the reinsured block of in-force business is quite large and is generating significant reinsurance losses to the direct writer. The direct writer will be strongly motivated to improve its situation and will likely attempt to recapture its business.

The recapture provisions in most reinsurance treaties are ambiguous for first dollar quota share arrangements, usually to the detriment of the reinsurers. For example, some treaties have no limitation at all regarding the business eligible for recapture. They merely allude to a recapture period (often shown on a separate schedule page). Other treaties refer to the fact that facultative and reduced retention cessions are not eligible for recapture, but never clearly identify quota share arrangements as reduced retentions. In addition, treaty provisions are often silent as to whether an increase in the ceding company's quota share retention (e.g., 10 percent to 100 percent), represents a true increase in retention scale or not. Of course, the ceding company would assert that it is to strengthen its justification to recapture. Since it is typically the reinsurers' intent that quota share business not be subject to recapture, the treaty provision language must deal with this issue clearly and unambiguously.

Until such time that the reinsurers revise and clarify the recapture provisions in their treaties, we will find management teams of direct writers that will be compelled to focus on any ambiguous, unclear or vague treaty language to recapture business experiencing significant reinsurance losses. For additional information and details of the importance of this issue, see this author's article "The Recapture Provision, Is it up to Date?" in the March 2004 issue of the SOA publication *Reinsurance News*.

Another helpful article titled, "How to Lose a Million Bucks Without Really Trying: Oversights in Negotiating Reinsurance Treaties" by Clark Himmelberger, may be found in the January 2011 issue of *Reinsurance News*.

3. How Many Reinsurers Should be Selected to Participate in the Pool?

There is no universal answer to this question. A higher number of reinsurers participating in your pool (e.g., six to eight) may increase the number of facultative outlets for your underwriters and increase automatic binding limits. It would certainly add stability to the pool in the event that some reinsurers decide to drop out after giving the required notice of termination. These are all important attributes of a pool of many reinsurers.

However, in today's business environment where most companies are very cost conscious, I suggest that a smaller reinsurance pool be considered.

There is typically an increase in overall reinsurance costs as we increase the number of participating reinsurers in our pool. When a large number of reinsurers participate in the reinsurance pool, there is an added burden and hence added cost related to managing paperwork and assisting multiple reinsurers through routine on-site underwriting, administration, and claims audits. Additional costs, which can become significant, relate directly to higher aggregate reinsurance premiums due to the fact that, in forming your pool, typically the lowest priced reinsurers are selected first. Therefore, each additional reinsurer will have a higher reinsurance premium rate than the previous one.

"I suggest that a smaller reinsurance pool be considered."

Let's assume a pool consisting of only three or four reinsurers can be formed to support both the automatic binding limits and facultative outlets your underwriting team requires. This should not be too difficult to obtain. Then the remaining attribute still lacking is stability; thus we must be able to assure that, if one or two members terminate, there is sufficient time to find replacement reinsurance companies before actual termination takes place.

Establishing stability in a smaller reinsurance pool can be accomplished during the negotiation process by requesting that the customary 90-day notice of termination be changed to a 365-day notice. We now will have produced the same attributes of a large reinsurance pool with stability, lower reinsurance premiums and a less costly smaller pool.

4. Modification or Changes to Underwriting Guidelines or Requirements

A. Minor Changes in Underwriting

When the direct writer modifies or changes its underwriting guidelines or requirements, there will be no credible mortality experience (reflecting this change or modification) to rely upon for some time afterward. Without credible mortality experience, the reinsurer will typically be more conservative out of necessity. If the underwriting guidelines or requirements were recently tightened, then the credible mortality experience reflecting the previous underwriting standards could be used as a starting point. A scaling factor recognizing the anticipated improved mortality can then be negotiated with each reinsurer. Some reinsurers will be more optimistic than others in their assumption of the level of mortality improvement resulting from the tightened underwriting, which can provide an opportunity for obtaining a more competitive quote from an aggressive reinsurer. Naturally, all of the considerations previously discussed in this article should be addressed in the negotiation process.

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When, on the other hand, underwriting guidelines or requirements are to be loosened, the rationale for this modification should be carefully explained to each reinsurer. The direct writer's underwriting department can be very helpful in communicating to each reinsurer what impact, if any, this underwriting change is expected to have on mortality for new business. The direct writer hopes this allows the reinsurer to get comfortable using the mortality experience reflecting the previous underwriting standards without any upward adjustment.

B. Major Changes in Underwriting

Significant changes in underwriting requirements continue to be made throughout the industry. For example, the transition from using blood and urine to oral fluid (subject to age and face amount limitations) was a major change in underwriting. Some reinsurers were initially more cautious than others in determining what impact this would have on mortality rates and how to reflect this in their pricing. Even today, there is still a noticeable variation in reinsurer pricing differentials when comparing blood-tested business and non-blood tested (oral fluid) business. We will address this issue further in our discussion on flexible reinsurance selection procedure below. Increasingly, companies are moving away from oral fluid testing toward the use of the prescription drug (Rx) database, subject to age and face amount limitations, and often with the incorporation of automated underwriting programs. The objective is to accelerate, simplify and streamline the agent and customer application and underwriting process.

Exactly what impact this will have on mortality rates and how to reflect this in their pricing is currently a big challenge to both direct writers and reinsurers alike. It should therefore come as no surprise that currently there is a significant variation among reinsurers in their pricing differential between blood-tested and nonblood-tested (using an Rx data base) business.

5. Flexible Reinsurance Selection

After discussing and fully exploring all appropriate assumptions and considerations with each reinsurer as outlined in this article, it may be advantageous to consider the feasibility of using a flexible reinsurance selection procedure (FRSP), a term I took the liberty to coin and which will be addressed shortly. Typically, on a first dollar quota share arrangement, each reinsurer would assume a fixed percentage of the face amount for each and every life reinsured regardless of the risk classification of that life (e.g., male/female, smoker/nonsmoker, blood-tested/nonblood-tested, etc). The ranking of the various reinsurance quotes is then developed by applying weights to the YRT rates of each reinsurer based on an assumed distribution of new issues by underwriting risk classification.

Some reinsurers have very competitive rates for male lives, but are not as competitive for female lives. This could happen, for example, when reinsurers build in aggressive mortality improvement factors for male risks but little or no mortality improvement factors for female risks. Similarly, some reinsurers can have very competitive rates for blood-tested business, but uncompetitive rates for nonblood-tested business. (This disparity can be especially pronounced in those situations when the use of the prescription drug database replaced the collection of oral fluid and urine).

In these situations, one should consider using an FRSP by reinsuring the blood-tested business and the nonblood-tested business separately. This would enable the direct writer to choose one group of reinsurers with the lowest prices for their blood-tested business and another group of reinsurers with the lowest prices for nonblood-tested business. Of course, some reinsurers will be competitive for both blood-tested business and nonblood-tested business and will be chosen for both risk pools. A similar approach could be employed when and if a big a disparity in rates exists between male and female lives.

It is hoped the ideas touched upon in this article will give the reader additional insights and knowledge into the important pricing concepts and considerations called upon in reinsurance pricing, and will serve as "a checklist for optimizing reinsurance negotiation." ◻