SOCIETY OF ACTUARIES

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effective approach due to the large diversification of risk of the member companies and the ability to share the cost of the coverage.

While everyone in the industry hopes the events of September 11, 2001 are a one-time occurrence, it's encouraging to see that new ways to deal with the risk of catastrophic events are evolving. The SAFE Pool appears to be among these new ideas that can help provide stability to the financial strength of its members even if future catastrophic events were to occur.

Capacity in the U.S. Life Insurance Market – A View from the Top of the Pyramid

by Michael DeKoning

For a variety of reasons, insurance companies significantly expanded their use of life reinsurance throughout the late '90s and early '00s. This has meant that volumes being ceded to the reinsurance market have continued to expand (after a brief respite in 2001) through quota share opportunities with direct insurers keeping only a portion of their published retention. The drive for growth and volume led the reinsurers to try to offer more per-life capacity to the market by looking for increasing automatic binding limits and jumbo limits from their retrocessionaires. Through the late '90s, most of the life retrocession outlets including the two full service, professional retrocessionaires (Manulife Reinsurance and Sun Life Reinsurance) were able to offer greater automatic binding limits and jumbo limits to service their life reinsurance clients who, in turn, offered higher limits to their direct writers. Direct writers had access to more than 25 life reinsurers active in the U.S. market and reinsurers and retrocessionaires typically also had access to European and Asian reinsurers not active in the U.S. market, who were willing to provide retrocession capacity on U.S. lives. So what has changed? I will try to give you the perspective of a company at the top of the capacity pyramid.

Clearly, the movement to quota-share reinsurance meant that direct writers were retaining less on a per-life capacity basis. Massive U.S. life reinsurer consolidation (Lincoln Re, AUL Re, Phoenix Re, CNA Re, Cigna Re, Allianz Re, Life Re, to name a few) has resulted in less choice for the Direct writers. It has also resulted in the loss of per-life capacity as the acquiring reinsurers have not, generally, increased their retentions sufficiently to make up for the loss of capacity owing to the acquisitions. This problem will only be further exacerbated by ERC's recent announcement of their withdrawal from accepting new business going forward.

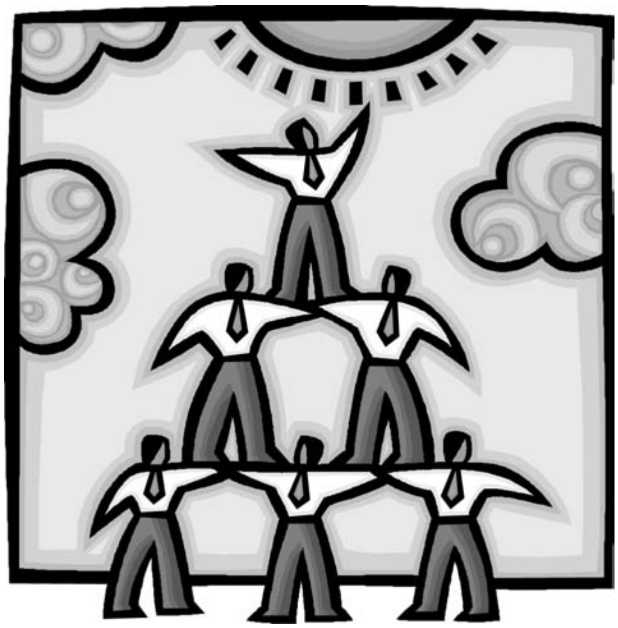
At the same time, many of the retrocession outlets for U.S. lives, smaller European reinsurers with little or no active U.S. operations, have also been acquired by the larger multi-lined and multinational reinsurers who are already active in the U.S. market. Finally, some of same smaller reinsurers have been hurt by large early duration claims that aggregated from their various retrocession relationships to a level that they were uncomfortable with, forcing many of these remaining companies to either stop accepting retrocession on U.S. lives or severly reduce their offered capacity.

I estimate that all of the above factors have resulted in a reduction of per-life capacity in the United States by more than $100 million. Considering the market started with somewhere between $225 and $300 million of capacity, this is a material reduction that is rippling through the market.

So how is this affecting the industry on a day-to-day basis?

Autobinding limits are under significant pressure. For retrocessionaires, being excess of both direct writers' and reinsurers' retentions means that typically only large policies see their way through to the retrocessionaire. The reduction in the number of reinsurers keeping a retention on the one side coupled with the reduction in the retrocessionaire's own retro pool capacity, has resulted in many retrocessionaires being forced to reduce the automatic binding limits they offer to the reinsurers. This, in turn, affects the amount of capacity offered by the reinsurers to the direct writers.

Increased pressure on jumbo limits. Jumbo limits, typically defined as the amount of insurance in force and to be placed on a given individual at application time, are tools used by reinsurers and retrocessionaires to control aggregation on very large policies. A policy on an applicant that is below the jumbo limit can typically be ceded automatically under a reinsurance treaty (assuming it meets the other automatic binding criteria based on age, underwriting rating, etc). Back in the early '90s, jumbo limits typically were in the $20-25 million range. In the mid to late '90s, jumbo limits exploded to $75 million and even, in limited circumstances, to unlimited amounts. For the retrocessionaires, the jumbo limit is probably the most important risk aggregation management tool there is. For any large policy, there could be mutiple direct writers and multiple reinsurers, but there are only a small number of retrocessionaires. As the risk takers at the top of the pyramid, retrocessionaires will invariably see the same life from multiple reinsurance arrangements. For a $75 million policy, for example, it is very likely that more than $55 million of this policy will end up in the retrocession market. The large retrocessionaires, like Manulife and Sun, could easily end up with $25-35 million of this one risk. As retrocession capacity dries up behind the active U.S. retrocessionaires, it is clear that controlling the amount of risk being ceded automatically on large policies is key to



controlling risk aggregation and retention management. While I do not see jumbo limits returning to their early '90s levels, I would expect that jumbo limits will reduce over the coming 12-24 months.

Data quality and lags. In addition to the aforementioned risk aggregation issues facing retrocessionaires, the other big issue is the lag in receiving accurate and detailed reporting for retrocessionaires to perform retention management. As the companies at the end of the reporting chain, the typical lag from the time a retrocessionaire is bound (which is concurrent with the policy issue date) to the time it actually received reporting is 18 months. This lag can be as long as 36 months due to late reporting, systems changes by either the insurer or reinsurer (or both!) or poor quality administration. The ability to effectively manage retention and over-retention situations as well as offer facultative capacity is severely limited due to the data problems in our business.

Higher retrocession costs. Due to all of the above risk and supply issues, the cost of retrocession in the life market has been under significant pressure. The cavern between inward premiums and the outward cost of ceding to non-U.S. retrocessionaires, still an important outlet for the U.S. reinsurers and retrocesionaires, has continued to

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widen. U.S. retrocession volumes have dropped over the last few years primarily due to the lower number of quota share opportunities offered to retrocessionaires. The amount of business assumed from high face amount policies, however, has only increased over the last number of years. Therefore, the proportion of business assumed by U.S. retrocessionaires that come from very large policies continues to increase. This means, however, that the higher retro costs have become increasingly burdensome to the U.S. retrocessionaire.

So, what can be done to stem this loss of per-life capacity? Be nice to your reinsurers and retrocessioniares.

A dramatic improvement in data flow is needed. We are all part of an industry that does not, at its core, have a closely followed data standard (there is a standard in place that is not well-adopted) nor does it have a common methodology for passing data between participants. Each insurer passes its data on to their reinsurers in their own unique format who in turn must translate that data, process it and then pass on the relevant information to their retrocessionaires. Can we not find a solution to this problem? The banks have done it, the investment firms have done it, what makes our business so different? There have been numerous attempts to standardize or even create a data hub for the passing of data from insurers to reinsurers and onto Retrocessionaires. I believe these types of initiatives need widespread industry support and can only improve data flow, cash flow and risk management. This will lead to greater capacity being available sooner to the market.

Current market market conditions could lead to insurers retaining more of their business. If market capacity continues to shrink, LOC costs increase and the often-rumored hardening of life reinsurance rates comes to pass, it is possible that some companies could turn their backs on first-dollar quota share reinsurance and return to retaining more business. This would increase the amount of total per-life capacity in the overall market.

Reduced collateralization requirements for U.S. business. While not a large impediment to non-U.S. companies, I believe that reducing the collateralization requirements for non-U.S. companies could increase the number of companies willing to accept U.S. risks.

Increased profitability of life reinsurers in isolation and relative to the P&C reinsurance market. Many U.S. life reinsurers are struggling to meet their shareholder return requirements. On a U.S. GAAP basis, very few if any, are making double-digit returns on their new business. It should come as no surprise, therefore, that there are few potential new entrants and/or few looking to expand in this market from their current position. This is especially true given the P&C reinsurance market is currently in the midst of a hard market, with potential returns often quoted in the 20 percent-plus range. I suggest you ask yourselves this one question: If you were going to invest in the insurance or reinsurance market today, would you invest in the life reinsurance market?

Increased use of facultative reinsurance due to lower automatic binding limits. Due to the aforementioned reduction in retrocessionaire and reinsurer automatic binding limits, the inevitable result will be greater amounts of facultative business. This, from a retention risk management point of view is a good thing, in that both reinsurers

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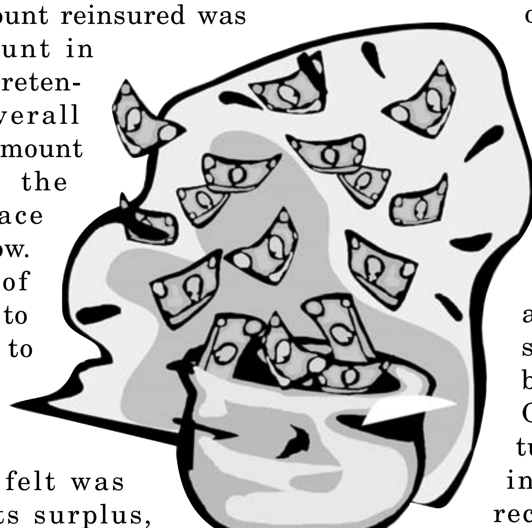
and retrocessionaires have the ability to better manage and control over-retention situations, thereby allowing them to offer more capacity without having to "hold any back." That said, this will only become a factor once the industry has been able to address its data issues and reduced the reporting lag to six to nine months.

I suspect the next few years are going to be very interesting in the mortality risk market. The dynamics are very fluid, with significant opportunities for both improvement in market efficiencies and risk management. That said, I believe the next 12-24 months will also see some interesting per-life capacity developments that could drastically change the insurer/reinsurer/retrocessionaire relationship. While I would not expect a return to the "strictly excess" and significantly limited automatic binding and jumbo limits that characterized the life reinsurance and retrocession markets up to the mid-'90s, I believe that the trend toward loosening these terms will reverse somewhat in the coming months.

THE RECAPTURE PROVISION
IS IT UP TO DATE?

by Larry Warren

The recapture provision is a standard reinsurance provision found in practically every reinsurance treaty. Historically, reinsurance was ceded on an excess basis (i.e. the amount reinsured was equal to the face amount in excess of the company's retention schedule). The overall ratio of the reinsurance amount ceded compared to the company's direct face amount was relatively low. The main purpose of "excess reinsurance" was to enable the direct writer to retain as much face amount as it could justify and merely cede the amounts which it felt was excessive relative to its surplus, earnings or other financial criteria. As experience unfolded, the direct writer was not especially concerned about the relationship between the mortality experience of the reinsured business and the reinsurance premium. (As we will soon discuss this is certainly not the case under the more recently utilized first dollar quota share reinsurance). The recapture provision was a logical, reasonable and benign provision that permitted the ceding company (i.e. gave it the option) to increase its retention limits on its in-force business (i.e. take back or recapture some of the reinsured business) if it increased its retention limits on new business.



If the increased retention limit exceeds the face amount of the policy reinsured, then that policy will be fully recaptured. Otherwise, it will be recaptured only to the extent of the increase in retention. The recapture provision typically has requirements such as a recapture (waiting) period (typically 10 years) as well as advanced notification of intent to recapture. Some recapture provisions require that the ceding company implement a recapture program within a

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