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NEWSLETTER OF THE REINSURANCE SECTION

Embedded Derivatives and Financial Reinsurance

by Larry Carson

Disclaimer

The following paper sets out the approach being used by Reinsurance Group of America (RGA) to apply SFAS 133 Implementation Issue B36 to coinsurance funds-withheld and modified coinsurance transactions that are classified as "financial reinsurance." The information in this paper is provided only for information purposes and is not intended and should not be construed as accounting, auditing, legal or tax advice with respect to any specific facts or circumstances, as the facts and circumstances at other companies may be different materially from those at RGA and may result in different conclusions. RGA makes no representation or warranty as to the accuracy or completeness of the information provided herein, and you may not rely for any purpose on any ideas, judgments, opinions or analyses provided in this paper. You are encouraged to consult with your accountants, auditors, legal and other professional advisors to determine the proper course of action for your company in connection with the matters discussed in this paper.

Abstract

Financial reinsurance transactions contain two embedded derivatives as defined under B36: one within the funds-withheld asset and the other within the experience refund provision. The net of these two embedded derivatives, which is what must be placed at market value on the GAAP balance sheet, is zero at all points in time at which the transaction continues to be considered financial reinsurance.

Background

This white paper sets out a proposed application of SFAS 133 Implementation Issue B36 to coinsurance funds-withheld and modified coinsurance transactions that are classified as "financial reinsurance."

B36 requires the identification, bifurcation and valu-

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Implications of a Consolidating Marketplace

A report from an ACLI Annual Conference Session

by Hank Ramsey

What will be left of the reinsurance marketplace when the consolidations are over? That question and others were addressed by a session featuring an S&P analyst, a pricing actuary and a reinsurance executive on October 14, 2003 in Miami when the American Council of Life Insurers held their annual conference. The consensus was that direct writers have become "hooked on reinsurance" in recent years, and are feeling some pain as reinsurers consolidate. The remaining reinsurers are not bidding as aggressively, particularly for business that is not as profitable as they would like it to be.

Rodney Clark, a director at S&P, led off with his assessment of the market. He showed how the market has become much more concentrated in the last six years. In 1997, 16 reinsurers wrote 90 percent of the market. Today, that number is down to 11 reinsurers, and he estimated that we may be down to six to eight reinsurers by the end of 2005. Mergers and acquisitions account for most of the decline in reinsurers. Mr. Clark recited a quick list of transactions, based on 1997 rankings:

- #1 ERC bought #8 Phoenix Re, and then #11 AUL Re
- #3 RGA Re bought #10 Allianz Re
- #5 Swiss Re bought #6 Life Re, and then #7 Lincoln Re
- #9 Guardian has put their reinsurance business in runoff
- #15 Munich Re bought #16 CNA Re

[Subsequent to the conference, ERC announced that it was selling the old Phoenix Re business and placing their remaining life reinsurance operations in run-off.]

Mr. Clark said there are many reasons for the consolidation. Some companies have exited reinsurance as a line of business; others have succumbed to financial distress, capital strain or lack of scale. With the attractive margins available in the current hard P&C reinsurance market, access to capital has been limited for life reinsurers that are part of multi-line reinsur-

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ance enterprises. Most top-tier companies have been downgraded by ratings agencies, many because of capital problems caused by other lines of business.

The result of all of this consolidation has been a change of direction in life reinsurance rates. Rates had consistently fallen for a decade, but new rates quoted have leveled off and in some cases have increased. With consolidation, finding a diversified pool is increasingly difficult, and capacity is limited. Rates for group insurance, LTC and accident and health have increased, and between consolidation and the impact of 9/11, the rates for catastrophe reinsurance coverage have skyrocketed.

The rate increases are particularly hard for today's direct writers to deal with. Over the last decade, ceding companies have become addicted to reinsurance. In 1993, only 15 percent of new life insurance was reinsured, but by 2000, the rate had reached 62 percent, and in 2002 it was 61 percent. Many of the direct writers have changed their strategy to focus more on accumulation products than protection products, leaving the reinsurers to manage the mortality risks and the big reserves. "Ceding companies are addicted, and there is no turning back," said Mr. Clark.

Hank Ramsey suggested several ways that the ceding companies will likely respond. Mr. Ramsey, a vice president and actuary at Prudential Financial, said that companies will likely retreat where they can from the hardening market. If XXX relief is only available from a few reinsurers, and the price is as much as 50 percent higher than last year, then companies will "lose ground" every time they renegotiate terms, and so will not re-bid as often. Companies may also consider retaining a larger percentage of each risk if the rates are not as attractive. As this higher retention leads to more earnings volatility, ceding companies may look more aggressively for stop-loss programs. The tightening market for reinsurance will also result in companies being less active and aggressive in the term life market.

In addition to the issue of rates, Mr.

Who Controls 90 Percent of the Reinsurance Market?

1997 Rankings	2002 Rankings	2004 Rankings ?
1. ERC	1. Swiss Re	1. Swiss Re
2. Security Life	2. ING (Security Life + Reliastar)	2. ING (Security Life + Reliastar)
3. RGA	3. RGA	3. RGA
4. Transamerica	4. Transamerica	4. Transamerica
5. Swiss Re	5. Munich Re	5. Munich Re
6. Life Re	6. BMA/Generali	6. BMA/Generali
7. Lincoln Re	7. ERC	
8. Phoenix Home	8. Annuity & Life Re	
9. Guardian	9. Allianz Re	
10. Allianz Re	10. Scottish Re	10. Scottish Re
11. American United Life	11. Canada Life	11. Canada Life
12. Cologne		
13. BMA		
14. Manulife		
15. Munich Re		
16. CAN		

Source: SOA survey conducted by Munich Re

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Ramsey suggested that ceding companies should also be worried about the results of consolidation on counterparty risk. A less diversified pool of reinsurers means more concentrated counterparty risk. On the other hand, reinsurers are using their newfound leverage to push back on recapture triggers. [In December, Swiss Re announced a new global corporate policy against ratings triggers in their reinsurance agreements.] Reinsurers are also obviously less comfortable with change of control provisions. Finally, ceding companies are also concerned that the reinsurers will offer less support for underwriting manuals and intercompany mortality studies as they continue to squeeze their expenses.

Hank Ramsey is vice president and actuary at Prudential Insurance Company of America in Newark, NJ. He is also a new member of the Reinsurance Section Council. Hank may be reached at hank.ramsey@prudential.com.

Mr. Ramsey sees some hope for increased supply of reinsurance in the future. The increased capacity may come from traditional sources, as P&C reinsurers look to expand their operations, or it may come from unexpected sources. For example, investment bankers are aggressively seeking new securitization transactions, which could add significantly to the capital capacity of life reinsurers. However, securitization transactions to date have had some significant downsides. They are generally more expensive than the more traditional Letter of Credit approach, and they are only appropriate for very large transactions.

Paul Schuster, executive vice president at RGA Re, said that the market today is "all about profitability and capacity." The result of the price war in term reinsurance in recent years is that all of the profits have been "squeezed out." One response by reinsurers has been tighter contract terms. Another response is a hesitation to accept new kinds of risks. He views universal life policies with secondary guarantees as "flawed products." Ceding companies will either pay more to reinsure these products or will have to do business with second-tier reinsurers. Reinsurers are also requiring a higher standard of financial reporting. He suggested that for ceding companies fast and accurate reporting of reinsurance transactions may be a competitive advantage in the future.

Mr. Schuster sees the industry's need to fund XXX and AXXX reserves as the biggest challenge. He estimated that the need will be $100 billion in seven years, but the bank Letters of Credit total only about $25 billion today. He asked how we will meet the $75 million gap. He sees securitization transactions as the most likely factor to expand the market in the future. But Mr. Clark suggested that the growth in securitization transactions will be slow. "Investors don't like risks they don't understand," he said.

International Financial Reporting Standards and Insurance

by Sam Gutterman

Background

The Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) issued "The Norwalk Agreement" in October 2002, a memorandum of understanding that reaffirmed their commitment to develop a single set of high-quality accounting standards. At that meeting the two standard setters agreed to place a high priority on three steps toward achieving that goal:

1. Reduce, through a joint short-term project, (which is now mostly completed) the differences between U.S. GAAP and IASB standards in certain areas not already being addressed by major projects.
2. Remove other differences through the coordination of future work programs and continued progress on the joint projects already underway.
3. Encourage further coordination of the separate activities of their two interpretive bodies.