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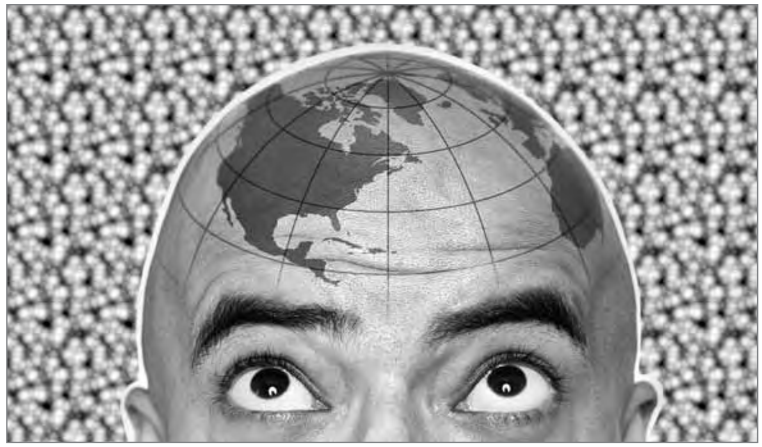
TRENDS AND ISSUES IMPACTING LIFE REINSURANCE TODAY—A BROKER'S PERSPECTIVE

by Sylvie Hand

In today's competitive environment, there is an increasing focus on the process of selecting life reinsurers, largely as a result of two industry trends, namely consolidation and the amount of reinsurance ceded.



The trend toward consolidation within the life reinsurance industry affects the manner in which reinsurance buyers select their risk partners. Consolidation is a familiar topic, with the statistics clearly demonstrating the degree of concentration that exists today. By our estimates, in 2003, the five largest reinsurers had 75 percent of the business while fully 90 percent was concentrated within the top eight. Further, there were only 14 reinsurers, compared to 23 in 1994. As a result, cedants are placing larger shares of business with fewer reinsurers, reducing their ability to diversify counterparty risk.

Why does this matter? In addition to increasing the impact any single reinsurer default might have, lack of diversity amongst reinsurers reduces cedants' opportunity to access a broad range of expertise. Further, the ability to effectively negotiate price, as well as terms and conditions, may be negatively affected.

The second trend affecting the choice of reinsurer is the amount of reinsurance ceded, or cession rate. This is another familiar topic, with many statistics demonstrating that in the United States, the amount of new business reinsured increased substantially over the past decade. According to an Aug. 26, 2004 report by Conning Research & Consulting, the cession rate leveled off in 2003 at around 60 percent. This has led to some discussion in the industry over whether or not primary insurers are becoming asset accumulators and distributors, with mortality risk outsourced to reinsurers. If so, this business model can be compared to the mortgage industry during the 1990s, when banks became loan accumulators. The resulting blocks of mortgage loans were syndicated out to investors via the capital markets, thus relieving the regulatory capital strain … a scenario that will sound familiar to most life insurance companies. However, rather than forecasting the future of syndication or securitization within the life industry, it is sufficient to note here that the high cession rate is evidence of a sharply increased reliance upon reinsurance. Because of that reliance, the rapid consolidation in reinsurance suppliers should be viewed with caution by ceding companies.

While cedants cannot control the consolidation trend within the industry, it is possible to exercise care and control over the elements of the risk transfer process that are manageable. As a result, we are seeing increased emphasis by insurers on managing the credit risk of reinsurers, along with an increase in the due diligence used in the selection of reinsurance partners. Both characteristics are a natural response to industry trends, and demonstrate prudent risk management.

As an aid to credit risk assessment, the ratings published by the various rating agencies represent a consistent, external and publicly available benchmark. However, considerable range and diversity exists within these ratings. Looking at Standard & Poor's (S&P) global top 150 reinsurers (See Figure 1 – both Life and P&C), the number of reinsurers rated "AAA" by S&P has dropped from just under 30 in 2001 to less than 10 in 2004.

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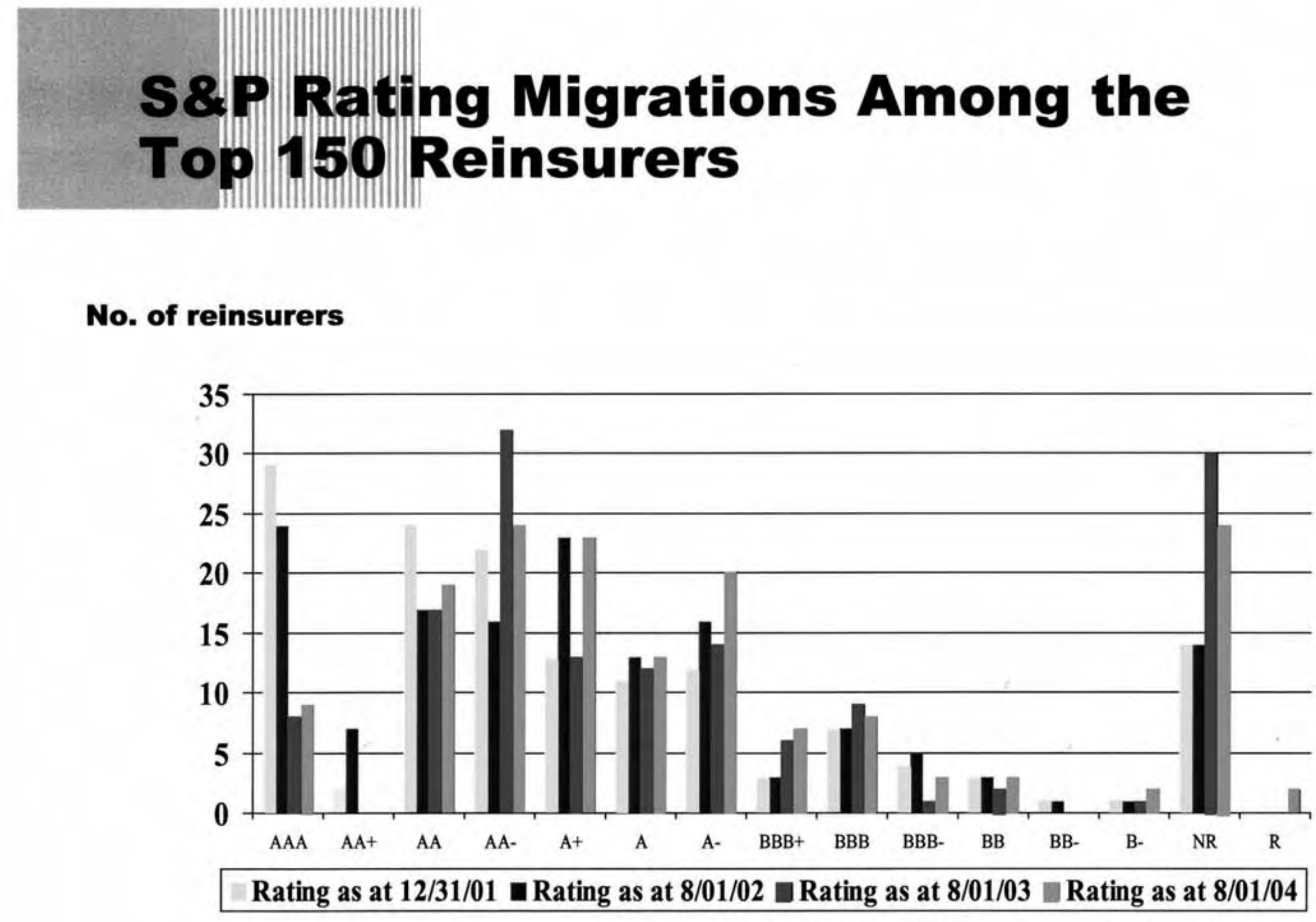
Figure 1



Further, the downward migration of ratings since 2001 is clear. So, while ratings are a good place to start, they definitely do not tell the whole story and in fact serve to illustrate the increasing complexity of assessing the financial picture.

Within this complex framework, cedants use reinsurance security guidelines in their evaluation process and are more actively tracking reinsurers for compliance, claims payment patterns and financial benchmarks. Intermediaries deal with a wide spectrum of reinsurers and are therefore well positioned to provide insight as to how various markets perform in these categories and as a result, their role has increasingly expanded beyond the traditional placement to include consultative services. This type of analysis, in addition to the ratings themselves, can add valuable insight to a cedant's risk selection process. Like any other risk management process, finding the right data and interpreting it in a meaningful way is essential.

Current Issues Impacting Ratings

One of the big issues facing the industry today is terrorism exposure and, naturally, this exposure has not escaped notice of the rating agencies. Companies that understand and control their terrorism exposures—to the extent possible—are generally looked upon more favorably in the ratings process.

Thus far, the property & casualty (P&C) side of the industry has been more heavily scrutinized in this regard. A.M. Best Company issues a supplemental ratings questionnaire (SRQ) for both life and P&C insurers, but only the P&C version includes a section on terrorism exposure. This section was expanded in 2005 to address a company's ability to both measure and model terrorism exposure. In addition, it also looks at the use of reinsurance, including the Terrorism Risk Insurance Act (TRIA) and any other potential federal solutions, should they exist. The life SRQ does not yet address catastrophic exposures of any sort, including terrorism, but A&H business written by P&C companies is captured within the P&C SRQ.

In its current form, TRIA does not extend to life insurers. It is interesting to note, however, that the estimated magnitude of group life exposure is roughly equal to that of the lines of business currently subject to TRIA. The proposal to renew TRIA does include group life insurance within its scope, and thus group life insurance would be subject to the reinsurance recovery offered by TRIA in a terrorist event.

It's helpful to look at the uncertainty surrounding TRIA in order to assess its implications for the industry. The issue of its renewal or non-renewal raises the following questions:

1. *In the absence of TRIA, how will the global demand and supply for terrorism reinsurance change?* Currently, the amount of terrorism reinsurance available is limited by the relatively small number of companies offering it and by the finite amount of capital they have dedicated to this line of business. Once this allocated capital is fully deployed, what will happen to the market for terrorism reinsurance? We have all seen how quickly the supply of capital can change when demand exceeds that supply. The global reinsurance market has proven itself to be very responsive to these situations. However, price will definitely be a concern in this scenario, as capacity will flow to where it can make the highest return, and thus may not be available for all lines of business. The life industry will have to compete with the property catastrophe industry, where generally greater data and modeling capabilities exist. Reinsurance providers may therefore be inclined to deploy their capacity toward the latter. The question of whether or not sufficient capacity will be available for life insurers should result in these companies assessing their requirements in terms of both TRIA and post-TRIA environments. Most experts take the view that, without a federal backstop, insurers will look to purchase greater amounts of full terrorism coverage.

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2. *With TRIA, how much reinsurance is needed to manage the retention?* Evaluating a company's own potential terrorism exposure is important for more reasons than just satisfying rating agencies; it is an important component of risk management. If TRIA's scope is extended to group life, multi-line writers may find their TRIA-mandated retention increase substantially. This in turn may impact the amount of full terrorism coverage they buy and, indeed, may alter the type of reinsurance purchased. Instead of buying terrorism coverage for each line of business, an alternative may be to purchase one blanket coverage with a high attachment point, but which responds to terrorism losses in all lines of business and from all regions.
3. *Finally, without TRIA, how will terrorism events be defined in policy wordings?* Currently, TRIA defines both certified and noncertified acts of terrorism. In the absence of TRIA, both original policy wordings and treaty wordings should be examined to ensure that coverage is as required.

Current Capacity

Terrorism reinsurance is currently available in two forms: full coverage and limited coverage, which excludes nuclear, chemical and biological causes and is commonly referred to as x-NBC. Capacity

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has increased significantly since 2001 and it is noteworthy that the sources of this capacity have also changed. Pre-9/11, it was life reinsurers who often offered this type of capacity. Now, we see the large, global catastrophe players writing this business, from Bermuda, London, Europe and North America.

These companies are willing to underwrite any form of catastrophic risk, as long as it can be reasonably quantified or assessed. Underwriting has, therefore, shifted from silos based on line of business to an assessment of the peril based on technical aspects. This is a fundamental shift in the industry and is the reason why catastrophic modeling capabilities are steadily increasing for life insurers. Of course, the cost of this reinsurance is what has attracted the new capacity and is indeed a source of debate among industry executives—is the cover worth the cost?

As this is a frequently asked question, we have been tracking rates, terms and conditions across a wide range of group life and personal accident catastrophe treaties. For full terror coverage, there is considerable price variation, even in similar programs but, as most programs have very different portfolio characteristics, it should be noted that our data set is not homogeneous. Retentions, concentrations and geographic areas all vary, each impacting the rate.

Overall, rates for full terrorism reinsurance have reduced from what was experienced in 2002 and 2003. For an entire program (rather than any one layer), the current range is generally from 2 percent to 12 percent in terms of rate on line (premium expressed as a percentage of total limit), reflecting the wide variance between the portfolios.

Further, the larger programs are reaching total limits of approximately $400 million, which indicates the amount of full terrorism capacity available has risen dramatically since 2001. With more capacity available, it isn't surprising that prices have come down, though not to pre-9/11 levels. However, they are certainly to a level where the viability can be considered. Several North American life insurers are reassessing the market and, since the Asian tsunami, we are seeing revived interest from European life insurers as catastrophe covers respond to a wide variety of loss causes, not just terrorism.

As discussed previously, full terrorism reinsurance capacity today is provided by the large global reinsurers. Of these, Lloyd's of London deserves special mention because it cannot be rated in the same way companies are rated and thus must be evaluated differently by prospective cedants. Lloyd's is a collection of syndicates, or a market, not a corporation. Both S&P and A.M. Best assign Financial Strength Ratings to the market as a whole. Immediately following 9/11, both agencies downgraded Lloyd's by one notch, as Lloyd's had the single biggest loss from that event—approximately $8 billion on a gross basis. But since then, $6 billion dollars in new capacity has flowed into the market and many reforms have been implemented. As a result, A.M. Best upgraded the market to its pre-9/11 level. S&P however, has not changed its opinion.

In addition to the overall market rating, A.M. Best, Moody's and S&P take different approaches to rating the individual syndicates. A.M. Best offers a financial strength rating for each individual syndicate, while Moody's offers a Syndicate Performance Rating, which is not a security assessment but simply an opinion of performance relative to other syndicates. Similarly, S&P offers a syndicate assessment that evaluates only the reliance an individual syndicate may have upon Lloyd's of London–its brand, infrastructure and, most importantly, the central fund. Less-highly capitalized syndicates are viewed as having a potentially greater likelihood of drawing upon the central fund relative to their peers, so the S&P ranking is an interesting one.

In conclusion, reinsurance is an important and strategic element of the life insurance industry business model. The global supply of capacity will continue to be influenced by the industry trends we see today and the complex picture highlights the need to select financially stable and secure reinsurers. While there is a great deal of publicly available information, it needs to be carefully interpreted and assessed as conditions change. ✺

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