SOCIETY OF ACTUARIES

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"GETTING TO WOE SOME"

by Rick Flaspöhler and Richard Jennings

Editor's Note: Rick Flaspöhler is President of The Flaspöhler Research Group, who have been conducting the biennial survey of ceding life company attitudes about life reinsurance and reinsurers since 1993. The results of these surveys are used by major life reinsurers to develop marketing and service strategies.

"Getting to Woe Some" is a thought-provoking title for Rick Flaspöhler's recent presentation to the ACLI Reinsurance Executive Round Table in March 2005. Flaspöhler presented the high-level findings of the biennial reinsurance survey, and in his words this industry has gone from "bad to worse." The reinsurance industry now finds itself in a unique and difficult situation that will require dramatic steps to improve things going forward.

When Flaspöhler first began working with reinsurers there were about 30 different companies, and now there are only eight to nine principal players. Of the 10 best reinsurers rated by ceding companies ten years ago, six are no longer here. Flaspöhler says this reminds him of what he has seen on the P&C side. Since 1995, there is only one reinsurer still operating with the same name in that market. Certainly if things don't improve, there could be a lot of new and/or different names on the life side a few years from now.

cedents "Can't get no … satisfaction"

In his 25 years working with varied industries and business sectors around the globe, Flaspöhler has never seen any industry sink to such a low level of satisfaction with its clients. Sixty-two percent of ceding companies rated that their relationships with reinsurers, overall, were declining, and only 16 percent of cedents were "very satisfied." Any client relationship manager will tell you that when a client is only "somewhat satisfied" with their supplier, they are 20 times more likely to move their business somewhere else, and 50 percent of cedents are "somewhat satisfied." Perhaps more disturbing is that 18 percent of ceding companies are "somewhat dissatisfied" and 4 percent are "very dissatisfied."

Ceding companies that rated themselves "very satisfied" have consistently dropped from 67 percent in 1995 to 46 percent in 2003, but in the last two years this level has dramatically reduced to 15 percent, unheard of in other service-orientated industries. When this satisfaction rating fell below 50 percent, this should have been setting off alarm bells. Instead it is now "beyond bad and become awful." Certainly reinsurers have their work cut out for them.

Impact of Reinsurer Consolidation on Direct Writers

When asked, "What were the most critical issues facing Direct Writers?" the number one issue was "Reinsurer Consolidation." Other important issues also noted were "Preferred Criteria and U/W Exceptions," and "Treaty Terms and Conditions."

It's not so much the fact that the reinsurance market has consolidated, but more the impact the consolidation has had on the remaining reinsurers and the sense that they can take advantage of this less-competitive market. Reinsurers are responding to

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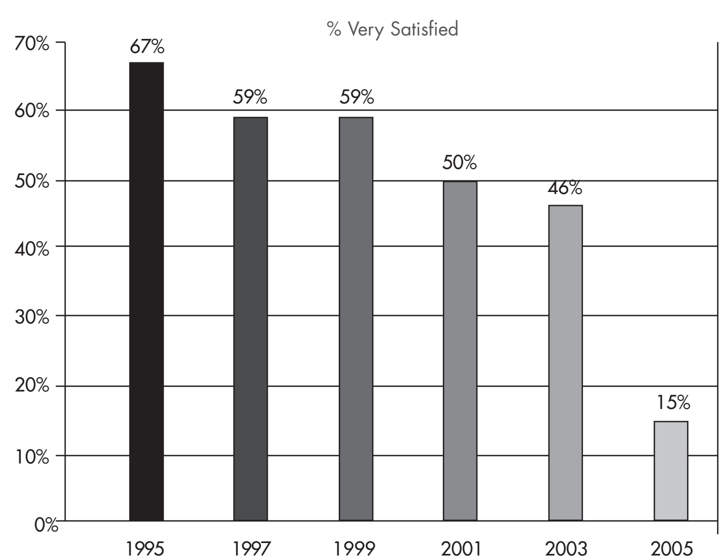

the consolidation by strengthening rates and tightening terms and conditions. It is the impact of this change in the ways of doing business that is being so strongly felt by direct writers. Here are some verbatim responses that highlight their concerns:

"It seems that the 'gentlemen's agreement' approach to doing business is being quickly replaced with the new contractual provisions which seem to protect the reinsurer at the expense of the ceding company. This appears to be driven by a belief that the ceding company is no longer as trustworthy."

"The rules have changed without warning, e.g. claims on cases underwritten years ago denied that would not have been denied in the past. Audited cases charged higher premiums. No difference of opinion accepted. No judgement allowed in underwriting. Rules, not guidelines, apply in all areas."

"Based on my experience, over the last year, the reinsurers have become reluctant to help me when I need an exception. I've actually had one reinsurer tell me we have been instructed 'no exceptions'. Keep in mind these are reinsurance underwriters but it is obvious they have been told to either be very careful if they make an exception, or not to make any exceptions...a major issue for me is the decline in overall reinsurance capacity. I understand the reasons for the decline, but it is an issue for me."

"As a direct writer, we have found that there is less compromise with reinsurers. The feeling is that there is much less flexibility or willingness to discuss options for obtaining the same information. It boils down to reinsurers being more black and white and less willing to consider positive factors of a risk as a way to offset negatives. I believe the reason is that there is far less competition between reinsurers."

"In the past reinsurers were willing to partner with direct companies to handle exceptions or disagreements on mortality evaluations. Today, they dictate terms and if direct writers deviate, they run the risk of paying 100 percent of a claim. Reinsurers used to be more flexible and willing to compromise, that is no longer the case."

At the same time that the reinsurers have been tightening up terms and conditions, ceding companies feel that there has been a decline in the level of trust and civility that used to exist in their relationships with reinsurers. Here again are some verbatim responses to the "loss of trust/civility" issue:

"...seems to be less trust. The treaty historically was used as a final resort to settle disputes. Now it seems more iron-clad and restrictive. [...] less flexibility in regard to business practices, and much more control exerted over activities. Repricing pools because of poor internal results, likely due to overly aggressive internal pricing. Any change to underwriting standards, no matter how minor, can be used as the rationale for repricing the pool."

AS A DIRECT WRITER, WE HAVE FOUND THAT THERE IS LESS COMPROMISE WITH REINSURERS.

"Reinsurance over the past 20 years was truly a partnership concept, based on general principles rather than a reading of the treaty terms as a strictly legal document. [now...] too many lawyers involved in treaty composition. Reinsurers are increasingly inflexible regarding treaty terms and provisions. Additionally, reinsurers reluctance to trust and participate in underwriting flexibility adds an additional layer of complexity to the direct carrier's day-to-day operations."

"Reinsurance is no longer a partnership relationship. The environment is now dictated by financial people, not risk selection professionals. Trust underwriting is no longer allowed, and guidelines have become rules. Also, the quality of the underwriting staffs within the reinsurers has sunk to a new low of inexperience and lack of ability to make decisions."

continued on page 24

"Getting to Woe Some" from page 23

"Much less flexibility and lack of overall cooperation. We realize it's a tough market but treat us with a bit more respect."

Relationships are a two-way street and not everything is the fault of the reinsurers. Ceding companies themselves admit that their own ways of doing business need to change as well. Some, not all, ceding companies may have abused the system and been too aggressive on price or pushing through too many exceptions. Other direct writers feel that they are paying the (higher) price, and that the reinsurers are increasing prices across the board because of some direct writer's experience.

REINSURERS NEED TO TALK CONSISTENTLY ABOUT UNDERWRITING QUALITY ISSUES, NOT JUST WHEN THE GOING GETS TOUGH.

"I believe that the direct carriers are no longer treated as clients by the reinsurance community. It is no secret that a handful of direct life carriers have taken advantage of their quota-share arrangements...had hoped that the frequent use of reinsurance audits would help to stabilize the aggressive nature of these renegade companies. Unfortunately, many of our reinsurance partners have decided that it would be best to treat all their clients as if they were involved in the great conspiracy against the reinsurance community. Years of valued relationships appear to have been thrown out the window. It is truly unfortunate and unfair."

"Rates increasing, underwriting becoming more conservative, due to reinsurance consolidation, reinsurers trying to take advantage of the situation and increase profitability, and some direct companies continuing to make exceptions to their own and reinsurer guidelines, spoiling the situation for the rest of us."

What Solutions are available?

When client companies are becoming increasingly frustrated and their suppliers are raising prices, even if they are only trying to get back to a 'reasonable' level, it would appear that new entrants will sense an opportunity and enter the market. This process has already begun.

"The reinsurers will have to take a few losses in court before they see the error of their ways. New entrants in the reinsurance marketplace with a more reasonable approach to doing business could take market share and hasten the healing."

"First, reinsurers must recognize that the problems they face did not occur overnight, and the solution can not be implemented overnight. They need to work with cedents, not against them, to correct the problems. Most underwriters are professionals who take pride in their work and have high ethical standards. The reinsurers do not recognize this and increasingly treat us as the enemy, with no respect. In my 30 years in this business, this is the most poisonous environment I have ever seen."

Are the 80 percent and 90 percent quota-share deals a thing of the past? Retentions are increasing, and treaties are shifting to excess of retention with higher attachment points. As this continues, direct writers will get back into the business of risk retention and risk management. This will induce them to behave in more sensible fashion with regard to the abuses of before. Also "what goes around, comes around," and reinsurers will be reminded of that when they go to negotiate their next round of renewals.

"Direct companies do need to restore integrity to risk selection. But reinsurers contributed to the problem with laxity in their own underwriting and audit standards in the '90s. We need to get away from the high percentage quota-share arrangements. Reinsurers need to talk consistently about underwriting quality issues, not just when the going gets tough. We need to get back to thinking of each other as partners. And let's not add language to the treaties, as at least one major reinsurer is doing, that gives reinsurers lots of ways to avoid automatic liability if they disagree with the underwriting."

Perhaps reinsurers should go back and reread Dale Carnegie's book, *How To Win Friends and Influence People*, which taught a simple lesson. Sometimes how you deliver the message is almost as important as the content of the message. Reinsurers need to remember this when revising their terms and conditions. In order to maintain their relationships, they need to work with their clients to come up with a way to do business that is mutually beneficial, not one-sided in favour of themselves.

"It would set a much better atmosphere if the reinsurers would explain why they are suddenly changing the wording, length of provisions and general tone of their agreements. Also, some of the new provisions are too one-sided. Finally, the reinsurers seem to feel that they are now able to dictate terms, as opposed to seeking compromises."

Some reinsurers will suffer because they won't figure it out. Others that continue to work with their customers, in a true sense of partnership, will build stronger and healthier franchises.

Conclusion – Flaspöhler's Thoughts

To the Direct Writers:

Accept the fact that you played a role in creating the problems faced today. Direct writers:

- Continued to demand low price, even when not justifiable
- Believed that it was easier to fight the reinsurer than the field
- Allowed too many exceptions in underwriting

To the Reinsurers:

Accept the fact that (some) reinsurers played a role in creating the problems faced today:

- Remember "what goes around, comes around"
- Let profitability and results be your driving factors
- Don't forget to treat especially well those who have performed
- Don't forget the "small" writer
- Communicate
- Communicate some more

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Rate Changes under Yearly Renewable... from page 21

treaty that was already breaking even or performing well. Moreover, in the former situation, a panel might look to how carefully the reinsurer had underwritten the business in the first place and the completeness and accuracy of the underwriting information furnished by the cedent. In the same vein, a panel might take an entirely different view of a situation in which the reinsurer was simply attempting to achieve a reasonable profit going forward as opposed to a situation where it was attempting to convert past losses into profits. And, in any case, a panel would probably look at least to some extent for guidance from the actual contract language as well as any evidence concerning the negotiation of the rate change provision.

None of this is meant to predict what a panel might actually do in a particular situation, but rather, simply to indicate the kind of questions that might be raised in a dispute of this type and how a panel might choose to approach those questions. Given the relative lack of dispute experience in this area, there are few actual signposts to follow. It seems likely, however, that the experience of the next few years will furnish more.