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EXECUTIVE PERSPECTIVES ON STRATEGY AND RISK IN REINSURANCE

by Gaetano Geretto

Attitudes on strategy and risk vary according to environmental circumstances for most companies. At best, they present a snapshot of people's thinking at a specific point in time. David Bruggeman's article elsewhere in this newsletter showed a dramatic drop in new business for U.S. life reinsurers in 2005, while the Canadian reinsurance market showed steady gains. These are certainly challenging and interesting times for life reinsurers in North America. In order to better understand the perspective of life reinsurers as they face a less certain future, Pelecanus surveyed executives from life reinsurers and retrocessionaires, in both the United States and Canada, on strategy and risk in the early part of 2006. What follows is an extract from the surveys with contrasts between the Canadian and American markets.

ATTITUDES ON STRATEGY AND RISK VARY ACCORDING TO ENVIRONMENTAL CIRCUMSTANCES FOR MOST COMPANIES. AT BEST, THEY PRESENT A SNAPSHOT OF PEOPLE'S THINKING AT A SPECIFIC POINT IN TIME.

Methodology and Participation

The survey was developed in accordance with the U.S. Safe Harbor requirements of the Federal Trade Commission and the Department of Justice on anti-trust compliance. Simply put, the requirements are that the survey would need to be administered by an objective third party, be based on data that was at least three months old, and have at least five participants, where no single participant's data could present more than 25 percent of any statistic.

There were 16 participants in the U.S. survey (11 reinsurers and five professional retrocessionaires) and five participants in the Canadian survey. Based on the data from the 2005 Munich American Re Survey of the U.S. life reinsurance market, these respondents comprise close to 70 percent of the new business assumed and 67 percent of the recurring business in force in the U.S. ordinary life reinsurance market. Similarly, the Canadian respondents comprise close to 100 percent of the new business assumed and almost 90 percent of the recurring business in force in the Canadian ordinary life reinsurance market.

Strategy—Industry

In reviewing strategy, it is usually of interest to executives to conduct a SWOT analysis (strengths, weaknesses, opportunities, threats) of the industry. In terms of the strengths of the industry, U.S. reinsurance executives (including retrocessionaires) believe the greatest industry strength was the strong existing in force business, whereas Canadian reinsurance executives felt the greatest industry strength was access to capital. Both groups felt that the greatest industry weakness was the weakening of relationships with life insurers.

There was consensus about the greatest industry opportunity in both markets being the development of new risk management processes such as securitization. However, U.S. executives saw the deterioration in actual experience versus expected experience as the greatest industry threat, whereas in Canada, similar to the industry's greatest weakness, it was felt to be the weakening of relationships with life insurers.

Strategy—Company

The reinsurance executives were also asked to do the same SWOT analysis, but with respect to their individual company. Not surprisingly, results differed.

In both the United States and Canada, from a company perspective, the greatest strength noted was capable and experienced staff in their company. The U.S. survey participants felt that the lack of profitable products and services was the greatest company weakness, whereas in Canada, it was the lack of access to capital. In Canada, it was interesting to note that their greatest industry strength was also perceived to be the greatest company weakness! This is not altogether surprising as the statutory capital and surplus requirements in Canada put a burden on growing companies.

Executives in both markets shared consensus about the greatest company opportunity which was seen to be the strengthening of relationships with life insurers. Whereas the weakening relationship with life reinsurers was viewed as the greatest company threat in the United States, the greatest company threat noted by Canadian respondents, was the lack of access to capital.

Strategy—Lines of Business

The business line credited with creating the most success for the industry and individual companies in Canada and the United States, was Individual Mortality Yearly Renewable Term (YRT). Group Long-Term Disability, Critical Illness and Group Life Mortality were considered more important in Canada than in the United States. Similarly, reinsurance on Corporate Owned Life Insurance (COLI) was a significant business line in the United States, but not in Canada.

Strategy—Issues Concerning Stakeholders

Among a list, the following were deemed as the first and second most important strategic issues in the United States and Canada by respondents:

- "We work with our shareholders to ensure their target returns for our business are met and the inherent business risk is appropriately managed."

EXECUTIVES IN BOTH MARKETS SHARE CONSENSUS ABOUT THE GREATEST COMPANY OPPORTUNITY AS IT IS SEEN TO BE THE STRENGTHENING OF RELATIONSHIPS WITH LIFE INSURERS.

- "We work with our clients to strengthen our relationship into a 'win-win' that recognizes the real cost of underwritten risks."

When respondents were asked to rank the various stakeholder interests which they manage, in the United States shareholders placed first and clients placed second, whereas the order was reversed in Canada.

With respect to their shareholders, the frustration at the lack of sustained financial performance and the actual returns being below target were the two most contentious issues identified by U.S. respondents.

In both Canada and the United States, the resistance to more explicit treaty language on counter-party risk, data reporting and underwriting were the most contentious issue of respondents with their clients. With respect to reinsurers dealing with their retrocessionaires, the most contentious issue in the U.S. survey was the continuing decrease in capacity, whereas in Canada, this issue ranked as the third most important issue after the increase in rates for excess retrocession capacity.

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With respect to reinsurers dealing with regulators, in the United States, the most contentious issue was the lack of understanding of the risks and rewards involved in the company's various business lines. In Canada, in response to the same question, the top issue was regulatory analysts who have little real understanding of the rewards and risks in the company's strategy.

Risk Management

The risk that most needed mitigation in the United States was mortality risk; in Canada, regulatory risk was the risk that most needs mitigation. U.S. respondents purchased catastrophe cover as the means to best mitigate risk followed by the purchase of currency hedges. In Canada, the same two tools were also used to mitigate risk, but their importance was reversed.

When asked to rank the greatest risk to be managed in today's reinsurance world, the U.S. respondents believed that sustained sub-par returns that taint the industry's risk management reputation to be the greatest risk. Canadian respondents ranked this particular issue fifth, but believed that life insurers choosing to manage risks through their own or different means to be the top risk to manage. U.S. respondents saw this latter risk as the fourth greatest risk to manage.

Respondents were asked to rank a variety of options to improve the evaluation of their business. The strengthening of the errors and omissions (E&O) clause in all treaties ranked first among U.S. respondents. Canadian reinsurance company executives had a diversity of opinions on this question. Some believed that the establishment of a risk management committee that meets regularly on internal controls has been the most valuable improvement to the evaluation of their business, while others believed the development of expectations of underwriting guidelines and exception thresholds in the treaty were more important.

Reinsurance executives believed that both their clients and their retrocessionaires need to share the same philosophy on specific reinsured risks as they do.

Enterprise Risk Management

Forty percent of companies in both Canada and the United States meet monthly on enterprise risk management issues. Respondents to both surveys used some form of risk management techniques, either developed in-house or developed by their parent company. GAAP earnings is the measure most often used to assess a change in risk by U.S. respondents and it is the second most popular measure in Canada after statutory capital. Half of the U.S. respondents will take immediate action when there is a greater than 10 percent decrease in earnings or capital, whereas 40 percent of Canadian respondents would do likewise at the same threshold.

Executives responding to both surveys see enterprise risk management, strategy development, execution and stakeholder management as integrated and related processes.

For reinsurers, as per the U.S. respondents, the risk appetite is generally developed jointly by company officers and the board of directors, but in the Canadian survey this process ranks second to the shareholders clearly communicating their tolerance for risk.

Sustainability

A purchase of a block of business that is no longer strategic to the seller was considered to be the best means to sustain one's business in the United States. This issue placed third in Canada, after finding a strategic partner to provide necessary capital to sustain growth, which was deemed first.

The most likely function to be outsourced by U.S. and Canadian respondents was investment management. In Canada, the least likely function to outsource was underwriting and was the fourth least likely function to be outsourced in the United States.

When asked to rank criteria among admired life insurance companies, superior execution was at the top of the list in Canada and the United States. When asked to rank the same criteria for admired life reinsurers, superior execution again was the most admired criterion by U.S. respondents and fifth most admired criterion in Canada. Being leaders in client service ranked first among Canadian respondents.

When applying the same criteria to the ranking of a list of retrocessionaires, Manulife Re was viewed as the most admired retrocessionaire by both U.S. and Canadian respondents. Sun Life Re placed second among U.S. respondents and tied for second with RBC Financial among Canadian respondents.

When asked the same question about life reinsurers, RGA was identified as the most admired life reinsurance company in the U.S. survey, followed by Munich American Re. Among Canadian respondents, RGA and Munich Re tied for the most admired life reinsurer in the Canadian market.

Participating Companies:

U.S. Survey Participants:

Reinsurers

ACE, Gen Re, Hannover, MAX Re, Munich American, Optimum Re, RGA, SCOR, Swiss Re, Transamerica Re, Wilton Re

Retrocessionaires

AXA Equitable, Manulife Re, RBC Financial, RMA (BMO), Sun Life Re

Canadian Survey Participants

Munich Re Canada, Optimum Re Canada, RGA Canada, SCOR Re Canada, Swiss Re Canada

Conclusion

The results of the survey give a snapshot into the thoughts and concerns of Canadian and American life reinsurance executives. The snapshot reflects their apprehensions about the market and how it has evolved over the last few years. The survey results also demonstrate the executives' strategic perspectives on their respective markets and the challenges of managing diverse stakeholder relationships. Their attitudes toward risk reveal how they choose to manage their businesses. The qualities that they admire in their clients, their peers and their retrocessionaires provide insights into their appreciation of excellence as a quality and their ongoing commitment to this goal.

Executives in the life reinsurance industry in both Canada and the United States are developing their strategic perspectives, managing stakeholder relationships, mitigating risk and sustaining their businesses, such that vibrant and dynamic reinsurance marketplaces flourish in both the United States and Canada. ✺

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