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THE FUTURE OF LIFE REINSURANCE

The following articles are based upon presentations given at the ACLI's Reinsurance Executive Roundtable held at Amelia Island, Florida, on February 20-22, 2002. The Reinsurance Section newsletter thanks David Atkinson, Jess Skriletz, and Chris Stroup for writing the following articles for this edition.

The Future that Lies Ahead...

by Chris C. Stroup

CEO of Swiss Re Life & Health, North America

"Yesterday is not ours to recover, but tomorrow is ours to win or to lose."

— President Lyndon B. Johnson
address to the nation
Nov. 28, 1963

The future of life reinsurance in America is certainly ours to win or to lose. The forces of today—expanding technology, tightening capital, regulatory rumblings, mergers and acquisitions—will affect the focus of tomorrow. If we wish to win the day, one to prosper in a changing environment, we need to begin preparing ourselves now for the challenges that lie ahead.

What are those challenges? Any attempt to polish my crystal ball and peer into that future yields both positives and negatives, reasons to hope and reasons to tread carefully.

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Ten Predictions for the Future...

by Jess A. Skriletz

General Manager and CEO of ING Re

We've all had days when we wished we could know the future. The business decisions facing us would be much easier if only we had a crystal ball. I can't give you a crystal ball, but I can offer a number of predictions and observations for the future of life reinsurance over the next five years. If you are like me, you take predictions with a healthy dose of skepticism. I hope to give you some things to think about that will shape your own opinion of the future of life reinsurance.

What do I see? A competitive market with a significant slowdown in growth coming from the rapid pace of growth seen recently, an increasing appreciation by life insurance companies of the financial strength of their partners,

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Winners & Losers in a Converging Global Market

by David B. Atkinson

Executive Vice President and COO of Reinsurance Group of America

David Atkinson

There is an old joke about the difference between American and Sicilian actuaries. While both groups can tell you how many people out of a thousand will die in the coming year, the Sicilians can tell you their names. In this article I am going to name company names. Be rest assured that I have no ties to La Cosa Nostra—I will not make any offers that you cannot refuse.

I'm going to confine my observations to the U.S. life mortality risk market. I'll take a look back in time, roll in some discussion of current conditions, and stick my neck out to try and predict the future.

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(SEE INSERT) Apply To Join Today!

Winners and Losers...

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To start, I'd like to take you back to a time when the U.S. life reinsurance industry was quite different from what we see today. It was a long, long time ago—the year—1995. Way back then, there were 18 U.S. reinsurers with market shares of two percent or more. Over the last six years, would you believe that half of those 18 reinsurers have been acquired? Six reinsurers were merged into other reinsurers and no longer exist. The other three acquired reinsurers were left in tact by their new parents.

In Table 1, Swiss Re and the companies it has acquired are shown in bold type. A question for you is: How do you become the largest reinsurer? Simply combine the second, fourth, sixth, and seventh largest reinsurers, and voila! Altogether, Swiss Re acquired four reinsurers over the last six years with a combined 1995 market share of 27 percent. (See table above)

As a result of this consolidation, there are only 12 reinsurers left today that have market shares of 2 percent or more. On average, we've lost one reinsurer per year over the last six years. At this pace, my actuarial forecasting skills tell me there will be no reinsurers left in 12 years!

Now let's look at the current state of the market as shown in Table 2. Of the top six reinsurers today, Swiss Re, Employers Re, and Munich Re are the clear market share winners. They have vastly increased their combined market share from 11 percent in 1995 to 48 percent in 2001!

In the meantime, Transamerica Re, RGA, and ING Re managed to hold onto a collective 30 percent market share, which is down from 34 percent in 1995.

Six years ago, the top four U.S. reinsurers were U.S.-owned. Today, only four of the top 12 reinsurers are U.S.- owned. Perhaps you've noticed European companies purchasing U.S. life insurers over the last few years. That trend is even stronger among reinsurers. European-owned reinsurers now account for over two-thirds of all U.S. life reinsurance inforce, excluding portfolio reinsurance and retrocessions.

Table 1: U.S. Reinsurers in 1995[1]

Rank[2]	Company	Market Share[2]	Acquired By
1	Transamerica Re	16%	Aegon
2	**Lincoln Re**	**13**	**Swiss Re**
3	RGA	12	MetLife
4	**Life Re**	**8**	**Swiss Re**
5	ING Re	6	
6	**Swiss Re**	**6**	
7	**Mercantile & General**	**4**	**Swiss Re**
8	AUL	4	
9	Cologne Re	4	General Re
10	CNA	4	Munich Re
11	BMA	3	
12	Employers Re	3	
13	Phoenix Home	3	Employers Re
14	Allianz	3	
15	Hartford Intl Life Re	2	
16	Gerling Global	2	
17	**CIGNA Re**	**2**	**Swiss Re**
18	Munich Re	2	

[1] With a 2% or greater market share
[2] Based on 1995 SOA survey of U.S. ordinary life reinsurance in force, excluding portfolio reinsurance and retrocessions

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Winners and Losers...

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Table 2: U.S. Reinsurers in 2001[1]

Rank[2]	Company	Market Share[2]	Ownership
1	Swiss Re	30%	Swiss
2	Transamerica Re	11	Dutch
3	RGA	11	U.S
4	Employers Re	10	U.S.
5	Munich Re	8	German
6	ING Re	8	Dutch
7	AUL	5	U.S.
8	Allianz	5	German
9	BMA	3	Italian
10	Cologne Re	3	U.S.
11	Gerling Global	3	German
12	Annuity & Life Re	2	Bermudan

[1] With a 2% or greater market share
[2] Based on 2001 SOA survey of U.S. ordinary life reinsurance in force, excluding portfolio reinsurance and retrocessions, with adjustment to Swiss Re to include Lincoln Re recurring business
[3] Employers Re stands to gain an additional 4% market share pending its acquisition of American United Life's life reinsurance business in 2002

The U.S. life reinsurance market tripled in size from 1995 to 2000. During that time, a number of reinsurers maintained about the same market share, namely RGA, AUL, Cologne Re, BMA, and Gerling Global.

Employers Re and Munich Re tripled their market shares. When combined with the three-fold increase in the size of the market, Employers Re and Munich Re are 10 times larger than they were in 1995. Swiss Re is 15 times larger, with five times the market share it had in 1995.

Two reinsurers, ING Re and Allianz, added a couple of points of market share. Only Transamerica Re lost significant market share, but still managed to double its business in only five years.

As George Santayana said, "Those who cannot remember the past are condemned to repeat it." Now that we've examined our recent past, I'd like to speculate on the future. I will espouse a large number of questionable opinions. While I am bound to be wrong, I do hope you will find this interesting, provocative and not too offensive. To lessen the risk, I'll talk about companies in small groups.

The Major Acquirers: Swiss Re, Munich Re, and Employers Re

The clear market share winners over the last five years—Swiss Re, Munich Re, and Employers Re—have three things in common:

- P&C reinsurance as a core business, which has generally produced poor financial results in recent years,
- Deep pockets and
- Major acquisitions in the U.S. life reinsurance market.

For a few years, these three companies stood on the sidelines and watched the U.S. life reinsurance business growing very fast and passing them by with public companies like RGA and Life Re reporting attractive earnings. Not surprisingly, Swiss Re, Munich Re and Employers Re each decided to expand its U.S. life reinsurance presence through acquisitions. At the same time, each moved its pricing from conservative to more aggressive.

Acquisitions over the last six years have not been cheap—acquirers generally paid top dollar. Having some information about most of these acquisitions, I can tell you roughly what it took to have the winning bid:

- A willingness to settle for a return on capital in the neighborhood of 9-10 percent,
- An assumption that the great majority of expenses could be eliminated through consolidation and

- An assumption that the market share of the acquired company could be added to the market share of the acquiring company, even where that meant maintaining double shares of the new business of many ceding companies.

In general, the acquirers have done a good job of eliminating expenses through consolidation of operations. They have also done a good job of holding onto, and in some cases adding to, market share—largely through an increase in pricing aggressiveness that went well beyond the minor improvement you'd expect from consolidation-related economies of scale.

What does the future hold for these companies? First let's consider Employers Re, which is owned by General Electric. Due to its large property and casualty reinsurance business, financial results have been disappointing, especially by GE standards. GE is not shy about exiting a market that is no longer appealing. Their World Trade Center losses and concerns about future terrorist attacks could result in a decision to sell Employers Re. But who besides Munich Re might be large enough and interested enough to buy Employers Re? With too little demand, GE may elect to keep Employers Re and even expand it.

I expect Swiss Re and Munich Re to buy a little more market share, both through acquisition and aggressive pricing. I expect that they will earn no better than 9 percent of returns on additional capital invested. However, such returns may be quite attractive when compared to recent returns on property and casualty reinsurance.

The futures for Swiss Re and Munich Re hinge on a single question: What will their stockholders demand? The answers to this question hinge in turn on financial reporting issues:

- Will future financial reporting standards allow non-U.S. reinsurers to create earnings on demand by harvesting unrealized capital gains?

- Will non-U.S. reinsurers be able to save excess earnings for a rainy day by storing them in contingency or catastrophe reserves?

If the answers to these questions are "no," stockholders of non-U.S. reinsurers may be faced with much more volatile earnings going forward.

Munich Re boasts "hidden surplus" of tens of billions of dollars. If this hidden surplus becomes part of publicly reported capital and surplus, will it create a demand among stockholders for distribution of excess capital? Or, if capital is augmented by hidden surplus, will financial results show an unacceptably low return on equity?

My best guess is that change is in the air. Many of these financial reporting changes will happen, but not quickly. However, before the end of this decade, I think you will see several changes including:

- The reporting of more volatile earnings,

- The reporting of more realistic capital and surplus,

- Extraordinary dividends paid to stockholders to distribute excess capital and achieve a better balance between capital and risk and

- A renewed emphasis on the pricing discipline that helped Swiss Re and Munich Re become world-class leaders in the reinsurance business.

My prediction is that over the next few years, Swiss Re will struggle to maintain its market share while Munich Re acquires additional market share. After that, I expect both companies to lose some ground as they switch their focus from market share to producing satisfactory returns on equity for their stockholders.

The Friendly Giants: Transamerica Re, RGA, and ING Re

The other three of the top six U.S. reinsurers have grown their businesses organically, rather than through acquisitions. While large in the U.S. life reinsurance business, each of these reinsurers is only a small part of a much larger parent. Transamerica Re is wholly owned by Aegon, RGA is almost 60 percent owned by MetLife, and ING Re is part of ING. For each of these parent companies, reinsurance is not a core business.

I think a strong parental influence has contributed to a generally greater pricing discipline shown by this group in recent years. With luck and cleverness, Transamerica RE, RGA and ING Re may be able to hold onto market share because of their economies of scale, established reputations and relationships and the special products and services they bring to bear.

On the other hand, for the right price, each of these reinsurers could be purchased, just as Lincoln Re was recently purchased by Swiss Re. However, to the extent that these companies produce good financial results and generally keep their owners happy, the right price may be too high for a prospective buyer.

Collectively, I expect Transamerica Re, RGA, and ING Re to gain or lose a little market share over the next few years. Aggressive pricing by acquirers and new entrants would tend to decrease their market shares. Countering this, the desire among ceding companies to spread

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their risk among major reinsurers could help increase their market shares. For example, even with aggressive pricing, it may be impossible for Swiss Re to hold onto a 30 percent market share when most companies prefer to split their reinsurance between four or more reinsurers.

Each of these companies has experienced some large write-offs or significant turnover over the last few years, which cannot be pleasing to their parents. As a result, I would not be surprised if Transamerica Re, RGA and/or ING Re and Transamerica Re were acquired over the next few years.

The Lonely Lighthouse—American United Life

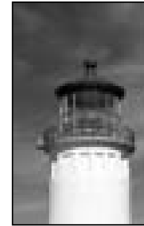
Nine of the top 10 reinsurers have parents with market capitalization of at least $20 billion. The lone exception is AUL, whose reinsurance business has lighted its way and become its most important line of business.

As a mutual holding company, AUL has limited access to capital needed to continue its growth. Recent losses from the World Trade Center terrorist attacks may have been the final impetus to AUL's decision to sell its life reinsurance business. With an efficient, good-sized life reinsurance organization, AUL had a choice of buyers. In May of this year, AUL announced the sale of its life reinsurance business to Employers Re.

The Europeans are Coming!

The Europeans are coming! No, wait—they're already here! We've already reviewed Swiss Re, Munich Re, Aegon, and ING. That's just the tip of the iceberg.

Allianz and BMA are smaller reinsurers with very large parents—so large, in fact, that reinsurance results may be rounding error to their ultimate parents. Allianz and Generali seem to be letting their U.S. operations run their own show as long as results are satisfactory.



While Allianz and BMA are more aggressive pricers than they were five years ago, they still seem to put more emphasis on financial results over market share. Unless results take a turn for the worse, U.S. management should have no incentive to sell their reinsurance operations. I expect Allianz and BMA to maintain or grow their market share. Like other survivors, they should benefit from further consolidation as ceding companies continue to spread their reinsurance among multiple reinsurers.

Cologne Re, now called General and Cologne Re, was acquired by General Re in the mid-1990s. Four years ago, General Re was acquired by Berkshire Hathaway, Warren Buffett's company. (Warren is famous for being a distant relative of Jimmy Buffett, but I digress.) In spite of its U.S. ownership, General and Cologne Re's life reinsurance business is primarily European.

In March of 1999, when massive workers compensation losses were disclosed, General Re infused hundreds of millions of dollars to Cologne Re to stabilize the situation and restore customer confidence. Since then, their U.S. life reinsurance unit has experienced some significant turnover, has become understandably more conservative, and its growth has lagged behind most of the industry.

Based on Cologne Re's success in some life reinsurance markets outside the U.S., I predict that their U.S. life reinsurance operation will be allowed to continue on its conservative course. Once U.S. market conditions improve and confidence in the life reinsurance business is rebuilt, Warren and Jimmy may surprise us. General and Cologne Re could find itself a small U.S. player with a very large parent willing to bankroll a tremendous amount of growth.

Gerling Global and two smaller U.S. players–**Hannover Re and SCOR Re**–are mid-sized, European-based companies specializing in property and casualty reinsurance with life operations in a number of countries around the world.

In the U.S. and some other life reinsurance markets, I see these companies faced with a choice: Either grow the local operation to capture a significant market share or exit the market. I think one or two of these companies will decide to concentrate its resources on its core P&C business, while refocusing life reinsurance efforts primarily on its more profitable domestic market. As a result, expect one or two of Gerling Global, Hannover Re, and SCOR Re to sell its U.S. life reinsurance operations, but not any time soon. I think the remaining one or two mid-size European reinsurers will commit to developing a more significant presence in the U.S. life reinsurance market, primarily through an acquisition over the next few years.

The Bermuda High

I'll finish with the two significant new entrants to the U.S. mortality risk market—Annuity and Life Re, and Scottish Re—Both Bermuda-based, publicly held companies. These two companies have been quite active in the U.S. life reinsurance market over the last couple of years. Their IPOs in 1998 raised a total of almost $600 million, along

with considerable pressure from Wall Street to quickly deploy that capital.

These two IPOs were successful because of the rapid growth taking place in the U.S. life reinsurance market coupled with competitive advantages already demonstrated by offshore P&C reinsurers, namely the use of more favorable GAAP accounting, a zero percent corporate tax rate, and the low overhead typically associated with a start-up operation.

As with all new entrants, Annuity and Life Re and Scottish Re have found the U.S. life reinsurance market a hard nut to crack. It takes years to build the relationships and reputation needed to compete on an equal footing with more established players. In the meantime, both reinsurers have compensated by using a low-price strategy to penetrate the market.

Because some clients won't send business offshore and because U.S. tax regulations make it difficult for a non-U.S. taxpayer to market to U.S. customers, both Bermudan reinsurers have established U.S. life reinsurance subsidiaries. Their sales results to date have been truly amazing. Combined, the two companies boast GAAP assets of $4 billion and GAAP revenue of $500 million—and this is after less than four years of serving the U.S. market.

Regarding profits, annuity results to date have been disappointing, mainly due to losses from one large annuity block. So far, life results have been encouraging, but life reinsurance results can be distorted by lags in reporting. When you're growing fast and lags are increasing, profits tend to get overstated. I learned that the hard way. When my company's administration finally caught up with the growth of the business, backdated premium refunds knocked earnings for a loop. Thankfully, that was before we were a public company!

Given the thin margins on the business most reinsurers have written over the last few years, profits are more sensitive than ever to the effect of lags. A company with a low-price strategy would have profits even more sensitive to lags.

My best guess is that, over the next few years, the Bermudan reinsurers will show a return on capital that disappoints investors. Both companies have seen their stock prices fall to within a few percent of age points their book values. If the stock price were to fall much below book value, there would be pressure to sell or liquidate the company. If one company performs much better than the other, look for the better performer to acquire the other and merge the two operations.

A Look Ahead to 2006

In summary, over the next four years, I think the U.S. market will consolidate down to eight significant reinsurers with market shares of three percent or more. I think the eight winners will face a more stable future, with little or no additional consolidation, few new entrants, and pricing that more regularly produces satisfactory returns to shareholders, at least on new business.

As a postscript, I'd like to point out that there are strong forces at work that may be bringing more pricing discipline to the market as you read this:

- The demand and perceived value of reinsurance is up and, due to capital losses and World Trade Center losses, the supply is down. That should cause reinsurance prices to firm up.
- Losses from the terrorist attacks and other recent earnings surprises are causing many reinsurers to reexamine their approaches to pricing, risk management and the connection between the two.
- The Enron scandal has many reinsurers reexamining the risks associated with moving business offshore, including unknown future letter-of-credit availability and costs, the financial handcuffs associated with long term placement of assets in trust and the risks associated with guaranteeing offshore companies.
- Some reinsurers have accumulated and analyzed a mountain of relevant mortality and lapse information by tracking the results of many millions of individual policies. This enables them to make better pricing decisions. Reinsurers without such information could become the victims of those that have it.

If these forces produce a stabilizing or upward influence on prices, profit margins and returns will rise, but probably at the expense of slower growth, since reinsurance sales are made to very astute and extremely price-sensitive buyers. In the past, many reinsurers have been able to walk the fine line that combines rapid growth with adequate profitability. As the U.S. life reinsurance market consolidates, this will become both more difficult due to the stronger competitors and easier due to fewer competitors.

Four years from now, you may recall this article and marvel at how incredibly wrong these predictions were. It might be interesting to follow up in 2006.

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