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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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slowing consolidation of the leading life reinsurers and growth in the use of strategic alliances by life reinsurers.

Since our customers' needs shape the environment in which we'll operate, my predictions are based on the trends, issues and macroeconomic factors facing the life insurance industry. Although still strong and dynamic, life insurers have evolved over the last 20 years, increasingly emphasizing investment-oriented products over traditional protection-based ones. Life insurers' assets under management have grown rapidly through annuity sales and the acquisition of mutual fund businesses, while life insurance sales were relatively flat over that period. The industry also moved into variable products during the economic boom of the 1990's. These trends have increased the importance of fee-based income to life insurers. Additionally, the increasing proportion of life insurance reinsured may be a sign of life insurers striving for a more predictable bottom line and a growing aversion to earnings volatility.

The above industry trends are reflected in the top two concerns of life company management. Surveys have shown their two top concerns are achieving profitable growth and improving distribution efficiency and productivity. Management's goal is to improve their company's profitability, and this is a tall order in a competitive market. Many life insurance companies are overcapitalized. While this situation is good for their financial strength ratings, it's poor for shareholder returns. Growth—organic or through acquisition—can create scale and critical mass to improve shareholder returns. The strong trends of consolidation and demutualization are two indications of the underlying pressures life insurers are facing to improve profitability and to grow and reach economies of scale.

I also expect economic and demographic forces to continue to put pressure on life insurance company growth and profitability. Competitive pressures, overcapacity and consolidation trends are therefore likely to result from these forces as well. I expect excess global industrial capacity to limit inflation, which should lead to relatively low interest rates over the next few years, as well as a lackluster equity market. Such an economic scenario will likely result in sluggish demand for fixed and variable investment products. Changes in tax policy may also reduce sales by life insurance companies, not only through changes in the estate tax, but also indirectly by increasing the amounts that can be contributed to 401(k) plans. As the new $20,000 annual 401(k) plan annual contribution phases in, there will likely be a significantly reduced long-term demand for annuities. In addition, the Baby Boomers were behind much of the growth in assets under management seen over the recent past. As this demographic group eventually begins to shift from savings to payout as they retire, this major source of growth will disappear. It is also questionable if Generation X can provide the demand for insurance products to make up for the drop in demand caused by Baby Boomers moving into retirement. First, the Baby Boomer generation is much larger than Generation X. Furthermore, Generation X'ers are believed by experts to be survivors, independent and "do-it-yourselfers." Therefore, people may be less likely to be interested in "bundled" insurance company investment products and more willing to invest directly in mutual funds or equities.

In summary, the life insurance industry is transforming into a broader financial services business with a focus on savings products. The playing field is not only crowded with insurers, but with the likes of Merrill Lynch, Charles Schwab and Fidelity. Insurers may have a long-term advantage (or disadvantage?) with their strong (but expensive) distribution channels, but the competition from these other players will continue to put pressure on profitability.

Demutualization and consolidation will continue as companies attempt to improve profitability, resulting in fewer and larger companies. Demographics have recently helped life insurance companies grow their assets under management, but these trends are shifting. As a result, life companies will take increasingly stronger actions to improve shareholder returns. My predictions are:

Prediction #1: Growth in recurring net amount at risk reinsured will slow to that of the growth of insurance sales within three years. As the proportion of face amount reinsured continues to climb, it eventually must reach a limit. The rapid increase seen in the 1990s implies that reaching this limit will come more quickly than slowly. I expect that ultimately, no more than roughly 75% of the life insurance industry's net amount at risk will be reinsured. Many life insurance companies will continue to retain the bulk of their mortality risk and only reinsure risk in excess of their retention. The life insurers that decide to outsource their mortality risk will be required by reinsurers to retain significant risk in order to avoid moral hazard. What are some implications for life reinsurers? More competition, much slower growth and a growing emphasis on expenses and efficiency.

Prediction #2: Competition for life reinsurance new business will remain strong, or even intensify, and industry profitability will disappoint shareholders. We are in a very competitive market today, and offshore start-ups continue to put pressure on the market. With a predicted decline in the growth rate of new reinsured volume, competitive pressures will likely increase. Some observers have suggested single-digit rates of return should be expected on some recent acquisitions by life reinsurers. This is a sign of an environment in which I expect shareholders won't be very happy with returns. The result will be a continued healthy tension between management and owners.

Prediction #3: Profitable reinsurers will be those offering a compelling value proposition to clients. In a consolidating market, life insurers will outgrow the need for commodity reinsurance. Most large insurers don't need to outsource their mortality, but they will when enticed to do so. A good price is one way to win business, but that doesn't necessarily solve the ceding company's problems. I expect risk management will take on a lesser role (although post September 11 it will remain important) with capital and earnings arbitrage coming to play the major role as that addresses the primary profitability concerns of life insurers.

> **"The life insurers that decide to outsource their mortality risk will be required by reinsurers to retain significant risk in order to avoid moral hazard."**

Prediction #4: Financial strength and ratings will increasingly separate the strongest reinsurers from the rest of the pack. Consolidation in the life insurance industry is creating ever-larger life insurance companies. These companies will demand bigger and stronger counterparties. Along with financial strength and rating, they will also look for a strong commitment to the market. Size and financial strength are two signs of this commitment that leading reinsurers will use to grow market share.

Prediction #5: Consolidation within the life reinsurance industry will continue, but at a slower pace. If my prior prediction about market growth and size and strength is true, then many of the smaller reinsurers may be acquired, and that trend may even accelerate, presenting some smaller companies the chance to consolidate to become one of the top ten. Thus, I'm limiting this prediction to the top five to ten players only. I believe that client diversification needs will ensure opportunities for many in the industry and that consolidators will eventually reach a point where additional acquisitions will not add incremental market share above a level around 20%. As there are a number of reinsurers closing in on that limit, the top five to ten players are a more stable group than was historically the case. This prediction may prove wrong if the industry falls out of favor and if acquisition prices fall to the point that they don't need substantial new business to justify the price paid. Then we may see many acquisitions being completed as blocks of in-force business, rather than as going concerns.

Prediction #6: Securitization of mortality or longevity risk will not occur to a significant degree. Reinsurers need not worry about competition from the capital markets. Why? First, life insurance companies don't need a public market when they already have a competitive, efficient private market for transferring risk to highly rated life reinsurers. Second, any true transfer of risk would require a very complex structure and quite a fair amount of uncertainty over a long period of time. Such transactions are expensive to

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complete, and have very limited market potential given the educational hurdles with potential buyers are substantial.

I also do not believe there are many natural buyers of long-term longevity risk (other than life reinsurers). Pension funds to the typical long-term investor, are already exposed to longevity risk in their pension plans. That makes them a natural buyer of mortality risk (if old age mortality rates improve, they win on the securitization, which can help make up losses in their pension plans). Given a pension plans' ability to invest in equities, perhaps they could best hedge their longevity risk by buying stock in life reinsurers, rather than entering into complex structures they don't have the expertise to underwrite.

Prediction #7: Life reinsurers will increasingly and materially participate in strategic alliances and generate substantial opportunities with alternative distribution channels. When your current customers aren't growing your business, you find new customers. Life reinsurers have the expertise to develop, underwrite and manage protection products. They just need the distribution. Both liberalizing financial services legislation and the "new economy" present opportunities for non-insurers to enter the life insurance marketplace. Life reinsurers, with their strong expertise and ability to assume risk, may be their ideal partners. What are the implications? Such strategic alliances will be a source of stability and growth for life reinsurers if insurers lose business to other financial service providers such as banks, mutual funds and dot-com distributors.

Prediction #8: The reinsurer that enables life insurance companies to successfully market payout annuities that provide balanced fund returns with guarantees against outliving savings will have a competitive edge for a month—unless they're reckless or crazy, in which case the competitive edge will last two months. One of the biggest opportunities I see for insurers is to capture IRA and 401(k) rollovers as the Baby Boomer generation reaches retirement age. However,

the life insurance industry doesn't yet have a product that both protects the individual against outliving their assets and provides an attractive "balanced fund" level of long-term return. As life reinsurers were instrumental in helping annuity writers provide aggressive Guaranteed Minimum Death Benefits (GMDB), they also could play a role developing longevity guarantees on balanced funds.

I'm being just a little sarcastic by saying that whoever solves this dilemma has a month's head start. But news travels fast in this business. With reinsurers going into, then out of, the GMDB reinsurance business, I also wonder if there are companies out there that would follow a competitor into such a business line before having the time to do a full risk evaluation.

Prediction #9: The real competition between life reinsurers will be recognized as one for top talent. Life reinsurance is a business that requires strong expertise to succeed. One of my biggest challenges has been finding strong and experienced talent. There isn't enough is out there, especially given the growth the life reinsurance industry has seen over the last ten years. While you can develop the staff you need, you must also strive diligently to retain them.

Prediction #10: The fond memories of Bermuda will be real, but getting rich from an IPO or acquisition are only dreams. The IPO mania that was rampant in the high tech area in the 1990's may have even spilled over to reinsurance. If any of the offshore start-ups have a business plan of selling out after a few years of building up a book of business, I think they will find only modest success. Many of these reinsurers will build successful businesses, but I don't see a compelling reason for them to demand high valuations in such a crowded and competitive market. At least Bermuda is a great place to live for a few years!

Jess A. Skriletz FSA, CFA is general manager and chief executive officer of ING Re and ING Institutional Markets. He began his 20-year career with ING at Security Life of Denver Insurance Company and has served in various actuarial, investment and management capacities, including several years in the Netherlands as an actuary of the International Division of Nationale-Nederlanden. He can be reached at jess.skriletz@ ing-re.com