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REINSURANCE NEWS

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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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Reasons for optimism

Fortunately, the reasons for optimism are numerous. The U.S. life insurance marketplace seems headed for a secure tomorrow, and what's good news for life insurers is also good news for life reinsurers.

As the American people look forward to longer and healthier lifespans, they'll need to set aside more money for their retirement years. The current interest rates of traditional savings vehicles are low, which makes life insurance even more attractive.

In addition, the U.S. life insurance industry has special characteristics that keep it poised for success. As a whole, U.S. life insurers are remarkably adept at developing new products, and their mortality knowledge gives them a significant comparative advantage on a global scale. Product distribution remains an area with great potential that so far has not been fully exploited. Also not fully exploited is the U.S. insurers' investment in technology. Money has been spent, improvements have been made, but the hoped-for cost savings due to lower expense ratios are still somewhere in the future.

On the downside...

Unfortunately, not everything is positive. There are challenges and obstacles on the U.S. insurance horizon that must be successfully navigated.

Chief among those obstacles are formidable new competitors created by the convergence of financial services industries in the United States. Mergers and acquisitions in this field have led to imposing competitors with substantial resources. Merrill Lynch and Morgan Stanley are good examples. Together, these two companies have greater market capitalization at their disposal than the top *eight* U.S. life insurance companies combined. Needless to say, that gives Merrill Lynch and Morgan Stanley a considerable competitive advantage.

In addition, these new competitors have a keen understanding of consumer needs. And if the factors that now give insurers an advantage—the tax-deferral subsidy and estate tax laws—are ever eliminated or restructured, these new competitors will eagerly move into our marketplace.

State insurance regulations remain, of course, a constant cloud on the horizon. Regulations drive up administrative costs and increase capital requirements, making it more difficult for the insurance industry to compete with financial services giants that aren't hobbled by 50 sets of state regulation.

As these giants compete for our clients, they also fish in our talent pool. The supply of underwriters, actuaries, accountants and management professionals is not unlimited. With more companies vying for these talents, fewer capable people are available to fuel the insurance industry's progress.

Fragmented roles and assets

Technology has contributed its own interesting wrinkle to the future of life insurance. With the Internet's ability to seamlessly link computers and systems, companies across state lines and international boundaries, it's now transparent to the consumer just who actually is providing the services he's receiving.

In the past, a single life insurer would have been responsible for managing investment assets, manufacturing products, distributing those products, providing customer service, taking on risk and administering its accounts. With technology, however, those roles have fragmented with life insurers often retaining only a portion of the responsibilities. Today, those functions fall to a variety of parties:

- **Managing investment assets**—handled by fund managers and insurers.
- **Manufacturing products**—still performed by life insurers.
- **Distributing products and providing customer service**—may be performed by a variety of credible, trusted advisors, such as banks, broker ages and independent financial planners, in addition to insurers.
- **Risk taking**—often handed off to reinsurers.
- **Administering accounts**—may be outsourced to professional third-party administrators.

This fragmentation of traditional life insurance roles has consequently led to a fragmentation of available assets, as well. In 1989, before this fragmentation began, life insurers had $1.4 trillion in assets under management. An equal amount was being managed by mutual funds, broker/dealers and market funds. This means the total available assets were split 50-50.

What a difference a decade makes. In 2000, with service fragmentation well underway, life insurers' assets under management rose to more than $3.1 trillion. But the assets managed by mutual funds, broker/dealers and market funds leap-frogged ahead to $7.7 trillion. It was no longer a 50-50 split. Instead, life insurers managed only 29 percent of those assets, with the remaining 71 percent going to other financial services companies.

As service fragmentation continues, life insurers are faced with managing a smaller portion of the available assets.

Reinsurance opportunities

For reinsurers, this service fragmentation offers new opportunities in the United States. As more life insurers look to share their risk, more business is available for reinsurance companies. We can measure the growth by looking at cession rates, which is the percentage of new face amount that has been ceded to the reinsurance marketplace. In 1993, the cession rate was 15 percent. By 2000, that amount had more than quadrupled to 64 percent. When the numbers are in for 2001, they could top 70 percent.

Overall, the U.S. reinsurance market grew at a compounded rate of 29 percent, compared to a mere 5 percent for the primary insurance market. There are several reasons for this increase in reinsurance buying:

- Primary insurers are eager to avoid earnings volatility, and reinsurance is a key tool to accomplish that goal.
- The transformation of insurers to a fee-based business model has made it more attractive.
- Reinsurance rates are tempting.

The last point bears expansion. Over the past five years, life reinsurance prices have actually gone down, largely due to strict underwriting that produces lower mortality assumptions. Before leaving the subject of prices, it should be noted that the terrorist attack of September 11, 2001, has moderately affected the price of vanilla reinsurance for the group life market, where there is a built-in concentration of risk. September 11 has had the greatest effect on the price and availability of catastrophic coverage for both group and individual life insurance. This coverage is dramatically more expensive and difficult to obtain. Only time and future events will tell us if these markets will ever return to pre-September 11 conditions.

"September 11 has had the greatest effect on the price and availability of catastrophic coverage for both group and individual life insurance."

Moderating the future

With falling reinsurance prices and rising cession rates, what does the future hold for U.S. life reinsurers? Are we on an unstoppable upward path? That would be nice, but it's unlikely. There is both good and bad news for life reinsurers:

1. Cession rates will level off. The 64 percent penetration rate of 2000 will likely hit a plateau at some point and will probably not top 75 percent.
2. An information advantage, an in-depth knowledge of underwriting and distribution effects on mortality will maintain the reinsurers' competitive edge .
3. New entrants into the life insurance business will be risk-averse, preferring to outsource their mortality risk-taking and underwriting.
4. As capital markets become more efficient and technology continues to make reinsurance arrangements transparent to the consumer, the cost of risk will eventually be driven downward to the level of commodity pricing.

Commitment and capital

What will it take for a reinsurer to survive—and even thrive—in this new century? Two words that come to mind are commitment and capital.

Commitment will increasingly matter to primary carriers. They won't be satisfied with a reinsurance relationship that's merely the "flavor of the month." Instead, they'll want to know they can count on a long-term business relationship with a highly rated reinsurer who has a demonstrated commitment to the life reinsurance business. This spells bad news for unaffiliated reinsurers and those with marginal operations.

Capital will also be a key issue because the supply of life reinsurance capital is bound to contract, perhaps as early as the third quarter of this year. The signs are already there; just look at the cost and capacity of current lines of credit that are used to manage the

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strain of XXX surplus requirements. The result is that to survive and thrive, reinsurers must be able to offer impressive capacity.

In the U.S. reinsurance marketplace of tomorrow, primary carriers will want three things:

- Longer-term reinsurance relationships.
- A few trusted places to concentrate their business, thus maintaining that relationship.
- A reinsurer who can supply their capital needs, product development and underwriting capacity for the long haul.

In response, successful reinsurers must:

- Deliver a broad range of product offerings.
- Include non-traditional reinsurance options.
- Improve their credit ratings, because lower-rated companies just won't cut it in the future.

Critical regulatory issues ahead

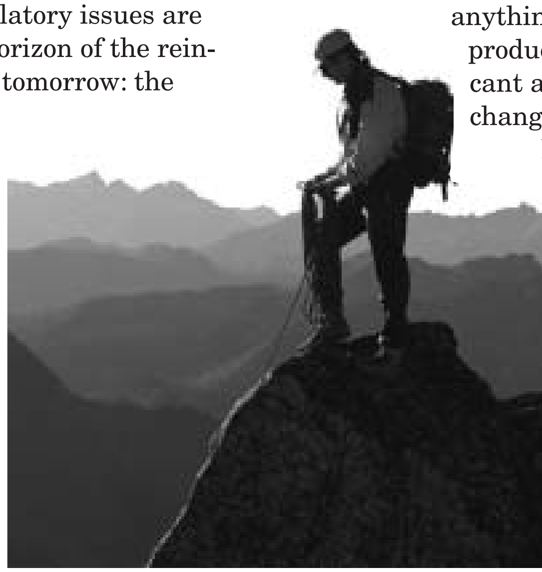
Two critical regulatory issues are looming on the horizon of the reinsurance world of tomorrow: the establishment of international accounting standards and the development of federal regulation of the reinsurance industry. While both proposals are likely a long way off, each would have significant long-term effects on the industry. The wise will keep these developing projects in view.

Our U.S. statutory accounting system is under some pressure. First, non-admitted reinsurers are asking that U.S. collateral requirements be relaxed. In addition, at least one international organization is pushing for reinsurer white lists.

"At the moment, regulation of insurance is the domain of the states, creating a 50-state maze of inconsistent rules and regulations that give insurers compliance headaches."

Still, others are advocating international accounting standards. In the end, these standards may look much like current U.S. or Canadian Generally Accepted Accounting Principles.

No matter how the international accounting standards evolve, anything that produces a significant accounting change will surely have an equally significant effect on the demand for reinsurance.



The imposition of federal rules is the other moving regulatory target. At the moment, regulation of insurance is the domain of the states, creating a 50-state maze of inconsistent rules and regulations that give insurers compliance headaches. But unless some compelling arguments are made for a single federal standard, the maze is likely to remain.

The most persuasive argument for a single federal standard would be to show how it would benefit consumers. But that's been difficult to argue because of the current perception that consumers can already get the products and prices they want, when and where they want them. Unless we can make a strong case for consumer benefit, federal regulators will be less motivated to seize control of the insurance industry.

But all is not lost for those who support federal regulation. Consumer arguments can be developed. The NAIC's inability to regulate consistently makes federal regulation more appealing to Congress. Gramm-Leach-Bliley is an example of what can be accomplished when the banks and insurers approach Congress together. In addition, the September 11, 2001, terrorist attack against the United States left Congress dismayed and frustrated when it realized it had no insurance expertise to call upon.

Hounded by the headlines

The September 11 terrorist attack and the collapse of Enron have had an impact on almost every American industry. The reinsurance industry is no exception.

A government backstop for catastrophic claims, such as those stemming from the September 11 attack appears dead for now, although some recent comments from Alan Greenspan and a report from the General Accounting Office could breathe some life back into the proposal. So far, the industry failed to prove its case to the federal government that reinsurance is unavailable for life products.

No one knows if Congress will act. But whether it does or doesn't, there are things the industry can and must do to better manage its risk. We need to learn from this experience, change how we do business and better manage risk concentrations. For this, we can look to the property-and-casualty industry and study the tools and behaviors they use to handle catastrophic claims, such as those from Hurricane Andrew in 1992. The industry developed methods to better identify risks and, when the risks were too concentrated, the industry worked to move those risks off their books.

The unprecedented collapse of Enron is another headline-grabber with reinsurance implications. Enron's covert deals and labyrinthine bookkeeping have left investors and the public with a wariness of big business and a distrust of complicated accounting.

For the reinsurance world, this means clients will be looking for simpler, more understandable business transactions—something they can count on without unpleasant surprises somewhere down the road. They'll want reinsurance contracts that provide guaranteed payments for defined losses. Surplus relief, securitizations and other complex transactions are bound to fall under the magnifying glass of investigators looking for accounting sleight-of-hand.

Preparing for tomorrow

Clearly, there are opportunities and perils awaiting us in the future of life reinsurance. Tomorrow will be ours to win or to lose, and the prize will surely go to those companies who have prepared themselves to avoid the perils and seize the opportunities.

Theodore Roosevelt once advised, "Whenever you are asked if you can do a job, tell 'em, 'Certainly, I can!' Then get busy and find out how to do it."

Can reinsurers meet the challenges that lie ahead? Certainly, we can. We're already busy finding out how to do it today.

When tomorrow arrives, we'll be ready.

Chris C. Stroup is chief executive officer of Swiss Re Life and Health, North America, and a member of the Life Executive Board of Swiss Re Life and Health. He is responsible for the life and health reinsurance business and activities for Swiss re in the U.S. and Canada.

Annual Meeting

Reinsurance Section Council Meets

Reinsurance Section Council members taking some time out of their meeting in New Orleans to pose for the SOA camera—

Back Row—Bob Beal (2000-2001 chairperson), Jim Keller, Bob Reale, Mel Young, Ronnie Klein, Jeff Katz (2001-2002 chairperson)

Front Row—Jack Bailey, Leigh Harrington, Jay Biehl, Jim Dallas, Dean Abbott (newsletter editor)