SOCIETY OF ACTUARIES

Article from:

Reinsurance Section News

November 2007 – Issue No. 61

LIFE REINSURANCE SECTOR: RATING AGENCY VIEW

by Neil T. Strauss

Editor's Note: The following article was meant to appear in the previous issue of Reinsurance News. *We regret any inconvenience.*

Standard & Poor's Ratings Services' stable outlook on the U.S. life reinsurance sector reflects improved new business profits and improving availability of capital at low cost through securitization and other markets. However, the arrival of new entrants and low growth prospects in the largest markets might put the squeeze on profits in the future. Meanwhile, risk management and careful risk selection will continue the stable trend for most of the leading companies in the sector.

The overall reinsurance market has continued to shrink in the largest life reinsurance market—the United States. As per the SOA study, the cession rate (percentage of total life insurance risk reinsured) remained well below 50 percent in 2006—much lower than the earlier part of the decade. Pricing is part of the issue as pricing is higher versus that earlier time period. This is in spite of what has been a continued improvement in mortality for the population as a whole. The causes come from a few areas. First of all, aggressive competition among reinsurers in the early part of the decade led to pricing that was no doubt irrational. Reinsurers have simply come back to their senses. Second, reinsurers are tying up increasing amounts of their costs and capital in collateral to cover Triple-X reserves, and they have done a better job of reflecting this in pricing. Third, the reduction in reinsurer capacity due to consolidation means far greater pricing power for the remaining reinsurers. This improved pricing power means far better profit margins on newer business, but it is harder to come by.

Cedants are coping in a number of ways. Unable to pass the reinsurer price increases on in the competitive primary market, they must seek alternatives to maintain their own margins. One way is by simply retaining more. Whereas first dollar original terms coinsurance had been the norm (for example, reinsuring 90 percent of every risk on every term life insurance policy sold), the market norm is now excess of retention (reinsuring 100 percent of all risk above a fixed retention of $1 million or $2 million per life). This means that the reserve strain on the retained risk can be substantial.

However, increased availability of collateral sources has made this strain much easier to absorb. For the largest companies, this often means securitization of the excess reserve requirements. But for smaller companies, LOCs have become an increasingly viable option. Most of the top 30 U.S. life insurers now have a captive reinsurer to accept their excess reserve needs, collateralized by LOCs. European banks in particular have been willing to provide that collateral, with five-, seven-, or even 10-year (or more) LOC facilities now available for barely more than what a one-year LOC cost just a few years ago.

Following the more recent transactions of Swiss Re/ERC and SCOR/Revios, there have been not fewer than seven significant life reinsurance acquisitions in the past decade. During that time, major names such as Lincoln Re, Allianz Life Re, and ING Re have been removed from the map. And these latest 2 percent aforementioned transactions could indicate an end of consolidation in the sector. As a result, only five active companies had in-force market share of 5 percent or more in the U.S. in 2006 (based on the Society of Actuaries' study conducted by Munich Re). Given this level of consolidation—and the resulting improvement in margins—there is likely room for only modest further consolidation in the sector. Certain names will always be rumored due to lack of a clear strategic fit with larger global groups or financial impairment, but no further scurries for the exit are likely.

It is interesting to note that Scottish Re, with all of the turmoil associated with it over the past year, did not ultimately become a target of consolidation although it had been a consolidator. Following on the heels of troubled reinsurer Annuity and Life Re it would seem that the sector has more volatility than thought a few years ago and the accumulation of more mortality exposure is not necessarily a 'win-win'; it may not set the law of large numbers in motion if there are other issues.

With tough times finding growth in the United States as well as in the United Kingdom, another major life reinsurance market, companies are looking to new markets in unexpected places. Continental Europe is now seen as an attractive opportunity, with Solvency II seen as a key driver.

Although the ultimate impact of Solvency II is not yet known, the expectation is that capital requirements will increase for many life insurance products, which will spur EU life insurers to use more reinsurance than today. More importantly, capital requirements under Solvency II are expected to encourage diversification of reinsurance programs, which up to now has been far less common on the continent than in the United States or the United Kingdom. At the same time, many North American and other life reinsurers are intensely looking at emerging opportunities in the European and the under-reinsured Asian markets.

One of the biggest topics of interest for the sector recently has been the possibility of pandemic mortality. The most obvious risk that has received the greatest attention has been the H5N1 avian flu virus. Standard & Poor's Ratings Services continues to believe that the risk of human-to-human transmission of H5N1 remains low, but given the potential impact on life reinsurer capital, contingency planning is prudent.

Standard & Poor's regularly reviews the latest research on the area of pandemic mortality and continues to be skeptical of some of the most severe scenarios. In particular, the U.S. government's strategic plan (released May 2006) for coping with a pandemic has a worst-case scenario of up to two million United States deaths, which most critics have seen as unlikely. In its assessment, Standard & Poor's has considered a worst case, using the 1918 flu and other research as a basis, to be in the range of 30 percent - 50 percent additional deaths in a one- to two-year period, or as many as 1.2 million additional deaths in the United States. In our view, such a risk could be borne by most life insurers—particularly well-diversified ones—with only a moderate impairment to capital.

Life reinsurers, particularly those who focus purely on mortality risk, would be the most at risk and could become financially impaired by a major pandemic—which could have an impact on the primary companies that rely on them. Despite the low likelihood, the significant severity of such an event means that preparation is sensible, and the capital markets have stepped up to make this possible. Swiss Re bought $762 million in protection against extreme mortality events in its two Vita Capital transactions in 2003 and 2005. Scottish Re Group Ltd. entered into a similar facility through Tartan Capital Ltd. in 2006, raising $155 million of protection. Such capital market transactions are likely to evolve further—particularly as market makers match up parties that are long on mortality exposure (life insurers and reinsurers) with those long on longevity (annuity providers). A vibrant market for insurance-related securitization is becoming a strong risk-management tool for this sector. Meanwhile, the major reinsurers themselves are becoming much more comfortable with longevity risk as pricing has improved in recent years.

Rick Flaspöhler's life reinsurance survey (presented in the July 2007 issue) discusses the pendulum swing in the relationships between cedants and reinsurers. How much do those relationships matter between cedants and reinsurers? Standard & Poor's posed this very question to its panelists, Rick Flaspöhler, President, Flaspöhler Research Group; Donna Kinnaird, President, Swiss Re Life & Health America; and Ronnie Klein, Vice President, AIG; in New York City in June 2007 at its Annual Insurance Conference in a panel discussion devoted to life reinsurance which I moderated. If you were not present for this fascinating discussion, you missed an interesting discussion between the originator of the survey, the largest life reinsurer and a major user of reinsurance. For a recap, please contact me at my SOA address.

A number of risks—within their products and in the competitive environment—will impact the life reinsurance sector in the future. The industry at large is strongly positioned to maintain financial strength, particularly given improved profitability of recent new business and diversity of capital-raising options. Further review will focus on whether increasing competition results in irrational pricing or whether lessons from the last cycle will keep the industry disciplined in 2007 and beyond. ✺

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