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How To Lose A Million Bucks Without Really Trying: Oversights in Negotiating Reinsurance Treaties

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Attorneys Spencer Alridge of Transamerica and Mark Sarlitto of Wilton Re graciously accepted invitations to participate with me in the 2010 SOA annual meeting session. Their astute perspectives built on their years of experience managing the reinsurance treaty function provided those in attendance with helpful insights into how to better manage the reinsurance treaty process.

The impetus for this session started with the premise that actuaries are very adept at modeling and negotiating the financial terms of a reinsurance quotation, but often an actuary's interest in the reinsurance treaty negotiation process wanes after the financial terms negotiation is over.

Where the actuary may have vigorously fought for an additional allowance point during the reinsurance negotiations, the actuary may also have been equally inversely complacent regarding treaty definitions that could (would) result in additional value. The best time for Tiger Woods to negotiate all the details of a prenuptial agreement was not while Elin was swinging a nine-iron. Similarly, the best time to negotiate the full terms of a reinsurance treaty is during the honeymoon phase while reinsurer and ceding company are constructively working together on a successful business relationship. Unclear or incomplete reinsurance treaty terms create additional business risk that can be mitigated with expanded efforts during the reinsurance treaty negotiating process. This was the consistent message (minus the golfing reference) from Spencer and Mark throughout the SOA session.

To help actuaries overcome their "competitive" disadvantage with attorneys with respect to drafting legal documents, the session also highlighted a number of valuable resources available to the actuary to guide them through the reinsurance treaty development process. These resources are identified and briefly described in the presentation slides which are available on the SOA website. (www.soa.org/professional-development/archive/2010-ny-annual-mtg.aspx)

It has been my experience in my reinsurance consulting practice that clients don't usually come in with reinsurance treaty financial modeling questions. The implementation of the reinsurance financial terms seems to universally meet with reinsurer and ceding company expectation. Where clients do seem to have their issues is when either the dynamics of the company or the dynamics of the business have evolved over time and the reinsurance treaty is unclear or unintuitive with respect to how the treaty relates to the block of business under the current circumstances. In short, reinsurance treaties work great when nothing ever changes, but poorly written reinsurance treaties lead to trouble when life doesn't turn out the way you planned. And life almost always doesn't turn out the way you planned.

An example of this, discussed during the session, is where a reinsurance treaty recapture clause states that the ceding company is entitled to recapture on a "to be determined" calculation of a recapture fee related to the profitability of the block of business. Clearly stating intentions (definition of profit, definition of assumption derivations) significantly reduces the cost of considering and/or implementing recapture. With an unambiguous recapture fee methodology included in the treaty, management can focus on the financial impact of recapture and quickly review the benefits of recapture and efficiently come to a decision. With no recapture fee methodology in place, management must first undertake drawn out negotiations for the recapture fee calculation methodology before ever being able to analyze whether recapture is a prudent decision. Most commonly an issue, the choice of a discount rate has a profound impact on the calculation of profits (or losses), and while agreeing to a discount rate might be a challenge during the treaty negotiation process, at the time of recapture it is near impossible. It is unfortunate that in some circumstances undefined treaty terms can lead to threatened arbitration (expensive) or in other circumstances it is effectively a cancellation (loss of value) of a potentially constructive treaty provision.

This example, and other examples highlighted during the session, recognizes that building a comprehensive, well thought out, reinsurance treaty defining the reinsurer and ceding company responsibilities under a range of conceivable future business environments is a time-consuming, tedious process. But it is the overwhelming consensus from the session panel that losing a million dollars in value due to an avoidable reinsurance treaty issue is not an uncommon industry occurrence. The frequent substantial loss of value emanating from poorly designed reinsurance treaties remain vivid examples that efforts spent improving the reinsurance treaty document are incredibly worth it. ■