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State of the Variable Annuity Reinsurance Market in 2010

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Reinsurance for variable annuity guarantees (VA GMxBs) has often been characterized as unavailable over the last few years. In fact, this is not the case. Reinsurance is available, but the terms required by reinsurers are often inconsistent with the pricing of direct writers. Success with VA reinsurance in 2010 requires an understanding of the critical reinsurance design points discussed below.

VA reinsurance design has historically been strongly influenced by the background of each specific reinsurer. Traditional life reinsurers were comfortable with policyholder behavior and mortality risk, but not capital markets risk. Reinsurers affiliated with investment banks had the opposite view—comfort with capital markets risk, but not insurance risk. Time and experience have allowed these views to merge at some reinsurers. Programs with these reinsurers can now address both insurance and capital markets risks.

All reinsurers are currently employing some form of capital markets hedging strategy and evaluating assets and liabilities on a market consistent basis. This means that reinsurers will not speculate on how capital market conditions may change, funds must be highly correlated with "hedge-able" indices, and reinsurance pricing will be based on current market-implied conditions. Wide new business windows with uncertain volumes are incompatible with this risk management strategy. Instead, reinsurance can more readily be provided for in-force blocks or on a serial (e.g., monthly or quarterly) basis for new business.

Reinsurance pricing that varies with current market-implied conditions is fundamentally the same situation experienced by direct writers with their own capital markets hedging program. With this as a common baseline, reinsurance can provide direct writers with significant advantages over capital markets hedging programs.

"A HEDGING PROGRAM INHERENTLY CREATES AN OPERATIONAL BURDEN FOR THE DIRECT WRITER, AND SLIPPAGE IS COMMONLY REPORTED IN THE INDUSTRY. REINSURANCE PROVIDES RELIEF FOR BOTH PROBLEMS."

Under adverse policyholder behavior experience, the cost for variable annuity guarantees can increase dramatically relative to best estimate assumptions. It is important for direct writers to understand and quantify this difference in order to appreciate the value of potentially shifting this risk to reinsurers.

A hedging program inherently creates an operational burden for the direct writer, and slippage is commonly reported in the industry. Reinsurance provides relief for both problems.

The accounting treatment of risk management strategies is typically an important aspect for the direct writer. Under US GAAP, liabilities with a significant mortality element, like GMDB, are not typically fair valued. However, assets employed in capital markets hedging are fair valued, resulting in balance sheet asymmetry with the potential for significant volatility in capital position. Reinsurance accounting can rectify this situation, and provide superior reserve and capital relief.

Finally, it is very important to recognize that several types of reinsurance structures exist. Perhaps the most common structure provides coverage for guarantee claims in exchange for annual asset-based reinsurance premiums. Yet alternate structures can provide coverage for selected tranches of risk, or with an emphasis on insurance risk or capital markets risk.

To summarize the current environment, healthy reinsurance programs will typically be predicated on the following key points:

- Funds must be highly correlated with "hedge-able" indices, for which current capital markets conditions will form the basis for reinsurance pricing.

- Reinsurance is more readily provided for in-force blocks or on a serial basis for new business.

- Policyholder behavior needs to be recognized as a significant risk—reinsurance can potentially address this risk, hedging programs cannot.

- Reinsurance relieves the direct writer of the operational burden and potential slippage associated with a hedging program.

- Reinsurance can provide superior capital relief and stabilization.

- Different reinsurance structures are available, keyed to the needs and desires of the direct writer.

Acknowledgement of these points is likely to result in a successful variable annuity reinsurance program for direct writers and reinsurers, in 2011 and beyond. ■