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A.M. BEST U.S. LIFE REINSURANCE – MARKET REVIEW

Consolidation Brings Rational Pricing but Greater Competition

by Stephen Irwin

There has been a period of major change in the reinsurance landscape including the demise of Annuity and Life Re and the elimination of a number of companies with weaker franchises or lack of commitment to the market. As recently as 2000, the life reinsurance market included Lincoln National, American United Life, ING Re, Allianz and Employers Re—all of which either have exited the life reinsurance market or sold their life reinsurance books of business.

ING Re was sold to Scottish Re in 2004. This major acquisition was unique in that Scottish Re was paid (in the form of a negative ceding commission) to take the business. Although Scottish Re continues to assume a very significant volume of business from its in-force book of business, rating downgrades have resulted in a sharp reduction in new business. The transaction was a major event in the U.S. life reinsurance market for two reasons. First, Scottish Re, a relatively new player in the market, was catapulted from a modest market position to the top tier of the industry. The economics of the transaction underscored the underpricing that occurred in the late 1990s and early 2000s. The pricing environment has since rationalized, leading to better returns, but the volume of business ceded to the life reinsurance market has contracted.

While A.M. Best believes that most of the remaining companies will continue to thrive, certain elements of their business models may need to fundamentally change in reaction to an evolving landscape. The remaining players, for the most part, have very strong franchises, are well capitalized and compete head-to-head for a reduced volume of ceded business. Given that four companies now assume three-fifths of all business ceded and hold three-fourths of all life reinsurance in force, A.M. Best believes the major wave of consolidation has run its course.

Cession Rates Continue to Decline

As recently as three years ago, the percentage of new U.S. mortality business ceded was as high as 60 percent. In sharp contrast, the 2007 estimate is only 40 percent.

In the United States, the amount of business ceded has decreased significantly due to a number of factors. The decline may be attributable to direct writers' stronger balance sheets and excess capital, reflecting solid operating results, consolidation and benign credit markets, all of which have enabled the life direct market to fund greater retention levels. There has been a marked shift from coinsurance—with as much as 90 percent of the risk going to reinsurers—to excess of retention, whereby direct writers retain most of the business. Typically this would mean that direct writers are leaving themselves open to increased reserve strain. However, A.M. Best has not seen direct writers' profitability decrease yet. Should margins compress further—given the continued low interest rate environment and credit quality erosion due to the spillover effects from the subprime residential mortgage crisis—direct companies may again rely more heavily on reinsurance for capital strain relief. However, A.M.

Best does not foresee any major increase in the amount of business ceded to life reinsurers over the near term.

Cost is another major factor driving cession rates lower. Traditional life mortality reinsurance is sensitive to price increases. Life reinsurance was viewed as quite inexpensive in the early 2000s. Indeed many organizations viewed reinsurance as an arbitrage opportunity, often citing that the rates were too favorable to pass up. Inexpensive reinsurance translated into sub par returns and prices necessarily rose. In turn, demand from direct writers waned. A.M. Best believes cession rates will stabilize around the 2007 level—the lowest level seen in recent years. After experiencing very strong growth in past years, the life reinsurance market growth rate is expected to decline and should mirror closely the 4- to 5-percent estimated growth trends of direct life insurance writers.

Additional downward pressure may be placed on cession rates when Principle-Based Reserves (PBR) are implemented. Given that the framework is still being developed by the various regulatory working groups, coupled with challenges associated with state-by-state approvals, full implementation is likely to be two to three years away. However, when PBR become a reality, the mandated level of redundant reserves is expected to be reduced for some products. A.M. Best believes that any such change in reserving practices could further depress the amount of business ultimately reinsured.

Limited Growth Causes Reinsurers to Branch Out into Riskier Lines

As the U.S. life reinsurance market contracts, higher-risk avenues for revenue and growth are becoming more appealing. Product lines that reinsurers had stayed away from—such as variable annuities with secondary guarantees and long-term care—are now being offered or are under consideration. These lines have been underserved for several years as most reinsurers that underwrote these risks exited the market due to poor experience. Such product lines diverge from traditional mortality dynamics. For variable annuities with living benefits, mortality risks are intertwined with long-term financial market performance. With long-term care, longevity risks are coupled with health risks. A.M. Best's view on this trend is cautious as reinsurers have less experience in a number of these product lines that carry more risk.

REINSURERS REMAIN FOCUSED ON GROWING TRADITIONAL LIFE BUSINESS BUT ARE EXPECTED TO ENTER PREVIOUSLY AVOIDED LINES AND MARKETS. AS THEY DO THIS, THEY POTENTIALLY ADD TO THEIR RISK METRICS, AND CREATE FURTHER UNCERTAINTY ABOUT THE LONG-TERM PERFORMANCE OF THE U.S. LIFE REINSURANCE BUSINESS.

These competitive pressures, along with the shareholder or parent company expectations of continued favorable growth rates, also have fuelled expansion overseas. A prime example is RGA, a traditional U.S. and Canada mortality player that generates about one-fourth of its earnings outside of North America. Insurance in developing markets tends to be higher margin, although increased competition will likely reduce this somewhat. Some markets, however, have higher cession rates and are actively seeking reinsurance expertise in product development and other areas. While reinsurers may welcome these opportunities in developing markets, data is less robust and assumptions for mortality, morbidity and lapses may be more difficult to come by. Regulatory limits on ownership structure may also present challenges. Still, it appears that greater growth opportunities exist overseas, and that the reinsurance trends in international expansion should track with those of direct writers.

Reinsurance/Capital Markets Converge

Reinsurers not only provide mortality protection, but continue to offer direct writers capital manage-

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ment solutions. Although pure mortality cover is still the mainstay of most life reinsurers, capital management solutions are an important business line for many reinsurers. Unfortunately, capital management solutions are no longer within the sole domain of the insurance community and now include an increasing number of financial institutions who provide cost-effective alternatives to reinsurance. The convergence of the capital markets with reinsurance solutions picked up substantial momentum in recent years with the need to fund the so-called XXX redundant reserves (related to funding reserves required under Regulation XXX for level premium term products). And as life reinsurers function as an aggregator of redundant reserves on behalf of their clients, the life reinsurance industry itself has employed capital market solutions.

The largest insurance companies have the scale to avail themselves of capital market solutions directly and thus often cut out the reinsurance middleman. However, smaller companies seeking statutory reserve relief still rely primarily on life reinsurers. A.M. Best believes the market solutions available to smaller organizations will remain limited, thus providing reinsurers a continued source of XXX-type financing business.

Worries over Subprime's Effects on XXX Funding

The balance sheets of the major highly rated life reinsurers remain strong. However, reinsurers have not been immune from the impact of the subprime contagion as Scottish Re and Swiss Re recently made headlines about losses related to their exposure to subprime assets. The spillover effects from the subprime crisis has negatively impacted overall liquidity in the marketplace, including the Dutch auction market, which was used as one method of funding XXX reserves. Even if the disruption is temporary, failed auctions result in higher costs that ultimately translate into lower earnings. The contagion impact may also impact direct writers and reinsurers currently working with the capital markets for XXX reserve funding.

Regulatory Changes May Be On the Horizon

The National Association of Insurance Commissioners (NAIC) has been studying the issue of collateral requirements on a national basis for some time. At the winter 2007 National Association of Insurance Commissioners meeting, commissioners from 22 jurisdictions approved a framework Reinsurance Regulatory Modernization Proposal. The proposal reviews issues related to cross-border transactions including a potential reduction in collateral levels for non-U.S. reinsurers. The framework focuses on three main areas: a new department within the NAIC to determine which non-U.S. jurisdictions are entitled to enter into mutual recognition agreements; a single state regulator for U.S. reinsurers to adopt uniform minimum standards; and a single state regulator for non-U.S. reinsurers to allow access to the U.S. market through port of entry jurisdiction.

Earlier this year, a reinsurance task force had recommended creating a new Reinsurance Evaluation Office (REO) which would help set collateral requirements for all reinsurers. The amount of collateral required would depend on the rating each carrier received from the REO. In October 2007, the New York Insurance Department announced plans to change long standing collateral requirements for foreign reinsurers. Under current rules in the state, any reinsurance company not authorized or accredited to operate in New York must post collateral equal to 100 percent of its share of policyholder claims. Under the proposed rules, which if adopted would take effect for new contracts in July 1, 2008, reinsurers with the highest credit rating from any two rating agencies (including A.M. Best) would have to post zero collateral. A sliding scale is employed down to reinsurers with "bbb"—any reinsurers below this rating would still have to post full collateral. A.M. Best believes that new opportunities may exist for global carriers, but this will add to competition in the United States. However, the pace of progress on this issue remains slow.

Reinsurers Need Effective ERM

In light of greater risks in product designs, softening credit market markets, continued low interest rates and recent market problems stemming from subprime mortgages, A.M. Best believes enterprise risk management (ERM) needs to be a key component of companies' culture, accountability and ability to understand, measure and manage risks on an enterprise-wide basis. This is especially important for large global players that need to understand risks being assumed not only in the United States, but in the numerous countries in which they operate. All organizations—especially insurers participating in global reinsurance—must develop and constantly refine an ERM framework, as strong ERM is integral to the success of complex global life players. Most major domestic life reinsurers have large international parent companies and A.M. Best looks for an integrated ERM process. Companies, who in A.M. Best's opinion lack a strong ERM process, are expected to come under increased rating pressure as weak controls ultimately may result in entering businesses and product lines that are not well understood or that underperform.

Conclusion

A.M. Best's outlook for the U.S. life reinsurance market segment is stable. Some recent trends in the industry, however, lead us to be vigilant about the industry's future performance. Reasons for caution include: the significant reduction in cession rates, the high concentration among a few companies, competition between these players and from the capital markets, and increasingly complex regulatory and product challenges. Balancing these factors are the industry's strong capitalization, generally tighter treaty terms, stricter underwriting and rational pricing. In addition, reinsurers are looking outside of North America where certain markets, such as Asia, offer greater growth opportunities.

Our stable view follows a period of major changes in the marketplace. Reinsurers remain focused on growing traditional life business but are expected to enter previously avoided lines and markets. As they do this, they potentially add to their risk metrics, and create further uncertainty about the long-term performance of the U.S. life reinsurance business. ✷