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THE U.K. LIFE REINSURANCE MARKET—CHALLENGING TIMES AHEAD

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The Life reinsurance market in the United Kingdom is currently in an interesting example of the laws of economics. The supply side is currently high, and the demand side should be low due to the decreasing U.K. Protection sales (most notably for Critical Insurance (CI) business) and the removal of most of the opportunities for regulatory arbitrage. This should dictate that volumes contract, prices reduce and then volumes reinsured increase again.

Yet the demand side never really did contract and volumes of business reinsured have held up well, though assessing exact volumes is difficult with so much business flowing to offshore balance sheets. One theory is that this is predominantly due to the reinsurers anticipating the next position in the cycle and looking to offer ultra-competitiveness to build market share.

This article explores the current market dynamics in the U.K. life reinsurance market and considers the sustainability of the current position.

Market Dynamics—Reinsurers and Insurers

In the United Kingdom there are currently nine active reinsurers: Swiss Re, Munich Re, SCOR, Hannover Re, RGA Re, Gen Re, XL Re, Pacific Life Re (the new owner of Scottish Re U.K.) and Partner Re. All of these companies, bar Partner Re, have a base in London or the surrounds.

However, the number of direct offices writing protection business is decreasing. Standard Life has stopped writing protection, Scottish Widows has pulled out of the broker market (where most business is written) and Scottish Provident now has the same parent as Bright Grey in Royal London, so these businesses may merge. In addition, there is a question mark about Friends Provident's long-term survival. The only positive is the recent arrival of Fortis in the United Kingdom. The direct market is dominated by Legal & General and, to a lesser extent, Aviva who have a combined market share of around 40 percent. Adding in the next five biggest companies brings the market share to around 75 percent.

Volumes of business, measured by policies written, are currently in decline. This is largely linked to the slow mortgage market following the credit crunch. However, vanilla Term Assurance sales reduced last year, CI sales are only around one-half of their level from five years ago and Income Protection (IP) sales always disappoint and are also down 50 percent from their 2003 level. Details are shown below:

Year	Term Sales ('000)	CI Sales ('000)	IP Sales ('000)
2003	1239	897	216
2004	1119	648	162
2005	1024	560	147
2006	1123	520	130
2007	1059	482	118

Source: Swiss Re Term & Healthwatch 2008

The U.K. Life Reinsurance Market Structure

Unlike most of Europe which still sees life reinsurance mainly on a surplus basis, the U.K. market operates with very high quota shares; most commonly on what is generally termed a "Modified net level" basis. Here the ceding office would pay an agreed level schedule of reinsurance premiums on each policy, but the level would not be directly linked to the underlying office premium charged to the customer. In addition, there would usually be a period at the start of the contract (often four years, to tie in with direct office commission earning periods) during which a reduced proportion, usually 50 percent, of the full net premium is paid.

The rationale behind this was originally based on direct offices wanting structures that helped alleviate new business strain and reinsurance capital generally requiring a lower rate of return than direct writers.

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The high quota shares also triggered regulatory arbitrage. This included:

- Gross roll up of reserves.
- The ability to allow for lapses in pricing (via offshore reinsurance).
- Scope for negative reserves on an individual policy level.
- Much lower statutory solvency margins.

However, following legislative changes introduced at the end of 2006, direct writers are now allowed to allow for a prudent level of lapses in valuing their in-force books and can treat individual policies as assets provided the overall reserve is not negative. In addition, long-term interest rates have generally fallen making gross roll up less important and the reduced statutory solvency margins will not be a factor post the impending EU Solvency II changes which will come into force around 2013.

Since the changes there has been some move to risk premium rather than "modified net level," especially amongst offices using a European Embedded Value basis where direct margins are added to basis items, but a low return on capital then assumed.

Justification

With the recent changes, some commentators expected much higher retentions, and even a move back to traditional surplus-based reinsurance used to stabilize experience and offload jumbo risks. This has not happened in practice, and Redmayne Consulting explored further at their annual Direct Writers Focus Group in April 2008 (held as a prelude to the Annual Redmayne Report on Reassurance). Reasons given include:

- Ultra competitive reinsurance rates.
- Reinsurers used for underwriting manuals and systems.
- Reinsurers used for technical support and access to medical experts.
- Statutory Solvency Margin & Capital reductions.
- Insurers have limited risk appetite and see themselves more as distributors.
- Reinsurer volumes enabling more aggressive valuation assumptions.
- Life business ceded ensures total volumes adequate to get good CI terms.

As a result of the above, it looks like U.K. reinsurers can still expect the heavy quota shares to persist over the next few years, though the equilibrium is quite fragile and could easily be broken by any attempts to push rates upwards.

Differences by Business Line

If mortality business does not deliver the same volumes of reinsurance, especially in the Post Solvency II regime, then from where else will the U.K. reinsurers pick up their business? Redmayne Consulting's 2007 reinsurer survey asked reinsurers to rate different lines of business in terms of attractiveness. The results are detailed below: (H=High, M=Medium, L=Low)

Attractiveness of business lines					
	Death	CI	IP	Annuity	In-force
Hannover Re	H	H	M	H	H
Munich Re	H	H	H	L	H
Partner Re	H	M	L	L	H
SCOR	H	H	M	L	H
RGA Re	H	M	L	H	H
Pacific Life Re	H	H	H	H	H
Swiss Re	H	H	H	H	H
XL Re	H	L	L	M	H

As can be seen by the detailed results, all companies find mortality business attractive and CI business is attractive to most. IP is mixed in attractiveness and Annuity business is generally love it or loath it (though XL, who made their name in the United Kingdom through annuity deals are now only lukewarm!). What is perhaps interesting is the high regard in-force business is held in, by all companies surveyed.

This is a relatively new area in the U.K. market, and one for which Swiss Re has the biggest name, having set up a company Admin Re solely to manage such business and having picked up some large volumes through it. Swiss Re seems eager to grow this area and in combination with Standard Life was outbid only by Pearl in the recent $10 billion hostile takeover of Resolution. Munich Re is also currently thought to be very active in this area.

Reinsurance Placement

The above is considered the typical reinsurance structures and the rationale for reinsurance. The final piece of the jigsaw is how the life offices determine which reinsurer(s) to work with.

Factors in Buying Reinsurance

The most important reason is the competitiveness of rates. Most large mortality reinsurance tenders are won primarily on price and usually at a discount to past experience, even though the business is often re-tendered annually. This is usually justified by some combination of expected future mortality improvements—faith (leaps of!) in future underwriting and claims processes and commercial decisions.

Cynics would say it's similar to the old adage about real estate, only with reinsurance it is "price, price and price." It is often hard to argue with this, especially for life-only mortality business where the degree of product and technical support required from reinsurers is very modest.

Cedants should attempt to quantify the non-price elements before making reinsurance business placements. These include the value placed on the financial strength, claims and underwriting approaches, and the quality and breadth of services from alternative reinsurers. These values naturally vary from office to office, but the overall difference in value will rarely exceed 1-2 percent on the price for the top six reinsurers. For other lines of business, the value of strength and services can sometimes overcome price differentials of around 5 percent.

There are also some hygiene factors that reinsurers generally must overcome to be able to win business. These include: financial strength ratings and nowadays a partnership approach to claims and premium reviews.

In recent years in the United Kingdom, there has been increasing emphasis on Treating Customers Fairly (TCF) both in terms of reviewing rates on reviewable contracts and on appropriate practices regarding claims handling. In the early 2000s many reinsurers had toughened their stance in both these areas, admittedly against a backdrop of poor practices amongst many cedants. This had left direct writers in an unenviable position where they either paid claims and could make no reinsurance recovery, or avoided the claim and faced Ombudsman/Court action and subsequent bad publicity. Accordingly, cedants now place much more emphasis on agreeing practices and recourse in advance with reinsurers.

The Impact on Reinsurers of the Current and Future Regulatory Landscapes

There are two legislative changes that impact U.K. reinsurers: the Reinsurance Directive which came into effect at the end of 2007 and Solvency II which is now expected to be effective in European law by 2013, though individual EC member states may decide to implement in advance of this date.

Reinsurance Directive

The reinsurance directive is an interim measure that introduces a minimum level of harmonized prudential supervision of reinsurance across the EU, in advance of Solvency II. It abolished restrictions on freedom of establishment across the EU and introduced Home Country control and supervision and a Single Passport to transact across Europe. This has influenced Munich Re in deciding to be regulated only by BaFin, the German regulator for its U.K.

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business and Swiss Re in its plans to move its U.K. life and health business to a new base in Luxembourg (along with all of its EU business).

The aforementioned formalized U.K. reinsurers' ability to circumvent the U.K. Financial Services Authority (FSA) reserving requirements (including Statutory Solvency Margins), but, in reality this already happened, often via co-reinsurance treaties with other parts of the same group. In any event, the relaxations of the FSA referred to earlier, render the move outside FSA jurisdiction of less relevance.

Following the directive, life reinsurers have the option of calculating the Statutory Solvency Margins on the nonlife basis of specified multiples of premiums or claims (net of retrocession) rather than using the traditional life reinsurer formulae based on net sum at risk and reserves. However, in reality this makes relatively little difference in determining profitability and hence available terms.

Solvency II

Solvency II sets minimum solvency standards for all EU insurers and reinsurers (except for small firms, the definition of which has not yet been made). It is based on a three pillar approach. The first contains quantitative requirements, the Solvency Capital Requirement (SCR) and the Minimum Capital Requirement (MCR) which represent differing levels of supervisory intervention. Breaching the MCR triggers withdrawal of authorization, whereas breach of the SCR requires an agreed action plan with the regulator to restore parity. The SCR can be calculated on either a prescribed or an Internal Approved model, akin to the Individual Capital Assessments currently used in the United Kingdom by companies as part of FSA requirements.

The second pillar contains qualitative requirements on risk management and supervision and the third more public disclosure, to bring greater market discipline and transparency. All of this should improve stability of insurers and reinsurers.

It is a moot point whether the advent of Solvency II will improve the outlook for U.K. reinsurers or not. There will certainly be even more focus on risk from direct writers, and it is certainly arguable that the benefits of global diversification will enable the large reinsurers to write risk business most effectively. However, it is also possible that the greater focus on economic reality will, over time, lead the largest insurers to question the value add from large quota shares.

It would be necessary to consider whether the same benefits of greater size and diversification large reinsurers enjoy could be available internally. If this is not immediately the case then maybe it could be via mergers and takeovers, and perhaps via more exotic tools such as inter-continental mortality and morbidity swaps, or swaps between assurance and longevity risk.

Conclusion

The U.K. life reinsurance market is ultra competitive, with at least eight serious players chasing the business of only 10-15 volume writers. The results are that mortality business is typically won by aggressive quotes assuming significant improvements on past experience and other lines requiring both low rates and high levels of added-value services. As a result of the above, business is frequently retendered by the leading direct writers and moves often between reinsurers, as well as being split on ways to suit the direct writer. The sustainability of this model, with its inherent inefficiencies is questionable and many reinsurers are looking at other routes to producing profitable business, such as in-force blocks, wider financing and diversification into new product lines.

The changes to the regulatory environment could actually increase the demand for reinsurance, at least in the short term, but only if the same market characteristics and dynamics persist. If the supply side were to reduce and prices were pushed upwards by reinsurers, price elasticity could be high and direct writers may well look to alternative routes of securing the benefits reinsurance currently provides.

There are tough times ahead for U.K. life reinsurers, but they have faced these before and come through strongly and the inherent risk aversion amongst U.K. insurers could see reinsurers continue to prosper. ✺