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A Snapshot of Large-Retention Companies' Reinsurance Needs

By Ronald Klein

In 1932, a brilliant Harvard University dropout named Edwin Land began a company called Land-Wheelwright Laboratories marketing his innovative polarizing technology which is used in sunglasses, windows and photography. Land's company was renamed in 1937 to Polaroid which is probably best known for "instant" photographs that developed in 60 seconds. Anyone aged over 40 will remember with delight seeing photographs in full color in just seconds as opposed to submitting film to a developing store and seeing the results in a few days.

While most people associate the name Polaroid with photography, the company actually played an integral part in World War II technology developing heat-seeking missiles, binoculars, gun sights, dark-adaptation goggles and target finders. In short, this was an innovative company that could only expand. Instant photography will always be necessary

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especially for "professionals like police officers" and Polaroid enjoyed being a household name.

Then, one-hour photo stores started to pop up and people could buy higher quality results in a reasonable time. Polaroid began to lose some steam. Next, digital photography was invented and Polaroid was all but dead. After reaching an all-time high of USD 60.31 per share in July, 1997, the stock dropped to just under USD 0.30 per share a few years later. Polaroid filed for bankruptcy in October, 2001.

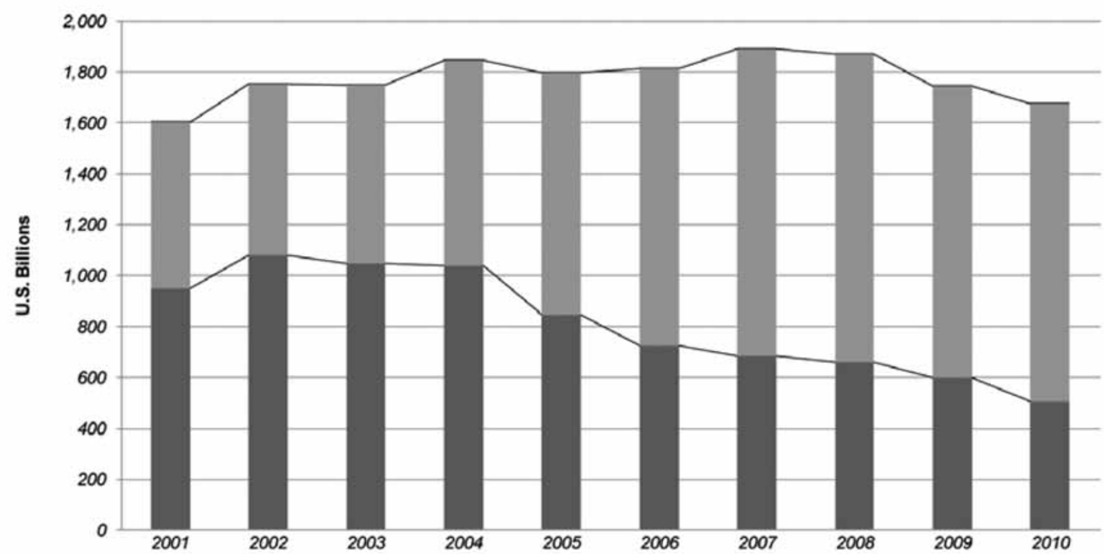
While an interesting history lesson on keeping up with the needs of your clients, you are probably asking yourself what Polaroid has to do with reinsurance. It is quite simple—if life reinsurers do not listen to the needs of their clients, could these companies fall to a similar fate?

Let's take a look at life insurance sales from 2001 through 2010 as shown in the November 2011 Reinsurance Section Newsletter:

From the chart below it appears that U.S. life insurance sales have been relatively flat during the past 10 years, while reinsurance sales have basically been cut in half. Admittedly the chart does not tell the entire story, however it should be an indication to reinsurers that their product offerings must change. Another way to look at this is simply to view a list of the life reinsurance companies that are active today. Has anyone ever heard of M&G Re, Life Re, Lincoln Re, Transamerica Re, ERC, Annuity and Life Re, Scottish Re, Gerling Global or Convarium? And how about the in retrocession markets—does anyone recall ManuLife, Sun Life or Equitable?

Life reinsurers have done a relatively good job in competing with banks for market share of structured solutions, yet one might conclude that life reinsurers have not done a good job competing with an even bigger and more powerful competitor—the client company's own retention limit. Is there anything a life reinsurer can do to change its business model to serve the needs of a large-retention life insurance company?

U.S. Ordinary Individual Life Insurance Sales



	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
% Reinsured	59.2%	61.5%	59.7%	56.2%	47.0%	39.9%	36.1%	35.2%	34.2%	30.2%
Amt Retained	653	675	705	809	952	1,089	1,207	1,212	1,148	1,170
Amt Reinsured	947	1,078	1,043	1,037	844	724	683	658	596	505

> **"I LIKE TO ASK THE HEAD OF THE LIFE INSURANCE LINE WHAT KEEPS HIM OR HER UP AT NIGHT? USUALLY THE FIRST REPLY IS 'NOTHING—I SLEEP QUITE WELL!'"**

The best way to answer this question would be to speak to decision-makers at large-retention insurance companies. With the benefit of working for two of these companies during the past five or six years, I have done just that. Basically, as the life reinsurance officer, I like to ask the head of the life insurance line what keeps him or her up at night. Usually the first reply is, "Nothing—I sleep quite well." I guess there are some things money can buy! Digging a bit deeper, usually the reply is, "… something that will destroy earnings for the year or, even worse, eat into shareholder equity." One large loss is not even on the radar screen of these executives. So, what is the best way to protect a large life insurance company from destroying earnings or eating into shareholder equity?

Larger life or multi-line insurance companies no longer need traditional quota-share reinsurance, and excess (above large retention limits) reinsurance is not appealing to reinsurers. The solution is for reinsurers to begin adopting a non-life reinsurer product offering. Products such as Stop Loss and Catastrophe covers can really assist large-retention insurers to manage their earnings and protect their balance sheets. It is not so long ago that Stop Loss was a standard product offered by reinsurers. Then came the days of large quota-share reinsurance arrangements and Stop Loss all but disappeared. The reason is simple—reinsurers did not want to cannibalize their own business. If a reinsurer offered a Stop Loss, the direct company would not need to reinsure on a quota-share basis.

Catastrophe covers are quite common in the life insurance industry and protect against natural or man-made events such as earthquakes or terrorism. While these covers are quite useful in protecting shareholder equity, the large deductible causes a large loss of earnings before the benefits are triggered. Stop Loss can be set at a level that actually protects some of the corporate earnings. Typically, a Stop Loss cover would trigger at 1+X percent of expected claims during the year (for example, 110 percent). X can be set by examining the variance of the loss curve and determining the desired trigger.

The benefit of Stop Loss is that all claim events are in scope. For example, pandemic flu or simply a very unlucky mortality year would be covered, whereas Catastrophe cover only pays in the case of a major event. Of course the price of the Stop Loss cover will depend upon the quality of the data, the variance of expected losses, the attachment point (that is, the value of X) and the amount of coverage. There is one important note to discuss which is the companies that need this type of cover would typically require a very large coverage amount. Not many reinsurers would be willing to offer coverage of USD 1 billion, for example. Therefore Stop Loss covers may require pools of reinsurers to complete a transaction.

In the current market, quota-share percentages have decreased drastically and have all but vanished for large-retention insurers. Therefore, it is time to reinstate the Stop Loss offering. Just think, life reinsurers can become more like non-life reinsurers by always worrying about renewals. "Do you have time to talk?" "No, I am working on the May renewals!" Renewals are like the full employment act for reinsurers. Also, the life industry will once again have to rely on intermediaries to place large layers of Stop Loss covers.

There are other needs for large-retention insurers and, in general, it is my experience that most life reinsurers do a very good job fulfilling the following needs.

- Assistance with products in certain regions where the direct company lacks expertise;
- Assistance with risks that are relatively new to the company or the market;
- Cheaper access to capital for certain products/country specific arbitrage; and
- Surplus relief reinsurance in certain countries.

While these are important aspects of reinsurance, I do not think that the above-listed opportunities will drive the growth necessary to satisfy shareholders of life reinsurers.

It is interesting that Standard and Poor's (S&P) released a similar opinion in its Global Credit Portal report of Sept. 23, 2011:

"*We expect that the low mortality reinsurance cession rates in the U.S., the potential contraction of*

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the European life reinsurance market under Solvency II, and the continued slow long-term growth of the dominant but mature mortality markets (primarily the U.S. and U.K.) are significantly increasing the pressure on life reinsurers ***to seek out nontraditional risks and expand into less-saturated markets to sustain growth."*** (Emphasis added)

Whether or not S&P considers Stop Loss as a nontraditional risk can be debated, but I am not too sure that I would lay much credence to an organization which rated securities as AAA and then downgraded companies that held these securities! However, S&P does see some short-term benefits as the Solvency II era unfolds. This opportunity may exist until the regulation is better understood by the industry as seen by another statement in the same article:

"In the short term there could be ***increased demand for reinsurance as*** *it is likely to be one of the main options available to insurers that* ***need to improve capital positions under Solvency II.*** *This would likely boost life reinsurance business opportunities, and many reinsurers have already set up special teams to exploit these opportunities."* (Emphasis added)

I also see other short-term opportunities for reinsurers as banks will be stressed for capital under Solvency II and will probably look to sell off any life insurance holdings to boost solvency ratios. Reinsurers that can effectively buy companies or blocks of business might outperform their peers for a few years, however direct insurers will also be vying for these properties.

Will selling Stop Loss and Catastrophe covers solve all the problems of life reinsurers? Obviously not. The main point of this article is to highlight that certain life reinsurers seem to be caught in the first phase of terminal illness (according to Dr. Kuebler-Ross) which is denial—for those of you that did not go through the exams at the same time as I did, the other phases after denial are anger, bargaining, depression and finally acceptance. The life reinsurance market is evolving and life reinsurers will have to be more creative to sustain growth. One way to do this is to service the needs of client companies that once were the main source of income for life reinsurers—the larger insurance companies—which are now large-retention insurers.

To summarize, life reinsurers must begin to change their business models to continue to service large-retention insurance companies in today's market. While Stop Loss and Catastrophe covers do not have the premium volume or longevity of traditional quota-share and excess reinsurance, the profit margins are much higher and reviewable premiums cause the business risks to be much lower. This, in conjunction with servicing mid- to smaller-sized insurers in more traditional ways, could be a viable solution to future growth in the industry. Add in some surplus relief, underwriting support, mortality analysis and expertise in emerging markets and you may just have a recipe for success.

Large-retention insurers need a strong and competitive reinsurance market. Hopefully life reinsurers will begin to offer more products geared toward their clients' needs. If this happens, both industries will develop into a beautiful (digital) picture. ■