The German Life Market: A Rearguard Action

By Bernd Heistermann and Kai Kaufhold

If the German life insurance market has been making the headlines at all in recent months, the news was almost certainly a report on which life company was the next to put its participating life business into run-off. The most spectacular such case last year was the Munich Re-owned ERGO Group announcing its intention to put its traditional business into run-off and use a separate company for its new unit-linked and protection business. The ensuing wave of speculation as to the exact consequences of this decision has rocked the market, including the job market for actuaries. Within an international context, this is old news, in some countries decades old. What makes the German situation somewhat different from the wave of in-force block transactions in the late 1990's in the U.S. which followed in the wake of many mutual companies demutualizing, is that this development is by no means voluntary, but has largely been brought about by a combination of heavy regulation, the financial crisis and the advent of Solvency II capital requirements. There is no more hiding from the fact that selling products with interest rate guarantees can become a very expensive proposition.

An average life company in Germany will likely have up to 400 different products on its books today, of which only two or three dozen lines would be open to new business.

Challenging times do bring weaknesses in existing business models to light, it is true. However, they also offer the opportunity for creativity and rigorous review of those business models to find out what can be salvaged and what must be discarded. One could say that the German life market has been slow in facing these unwelcome facts. Another way of putting it would be that German life companies have become victim of their own success, and have long tried to avoid abolishing a business which is very attractive to consumers and which might have been redeemable if interest rates had not remained at their low level for such an extended period. Now that even the staunchest supporters of tradition have begun giving up on what is referred to as "classic life insurance," i.e., participating endowment life insurance, the question is: what to do with the legacy business?

BACKGROUND ON RUN-OFF IN GERMANY

A closer look behind the stage curtains reveals that run-off is by no means a new phenomenon in the German market. Since its de-regulation in 1994, the changes in tax rules at the beginning of the 2000's and the reform of individual pensions in Germany introducing the so-called Riester annuities shortly thereafter, numerous generations of new products have been developed and old, defunct product lines discontinued. An average life company in Germany will likely have up to 400 different products on its books today, of which only two or three dozen lines would be open to new business. However—and this is what gives the situation a mildly nightmarish touch—nearly all of those hundreds of different tariffs will include some form of increasing benefits and premiums, as well as requiring the rigorous administration of that part of the company's general account which represents accumulated profits for later distribution, lovingly referred to by actuaries as the "RfB.[1]" So, if administering lines of business in run-off is old news to the German market, too, what has changed? The change is really a far-reaching shift in paradigm driven by the realization that the life insurance business model must be changed for the industry to survive. The challenges are no longer simply administrative or driven by the need to stay competitive. They arise from the fact that shareholders, who enjoy a doubtful upside limited by mandatory 90 percent policyholder profit participation and are required to fund 100 percent of the cost of losses emerging from expensive guarantees, are no longer feeling the love for this particular investment. Solvency II has made it brutally obvious just how costly such guarantees really are, even if a gradual phasing-in or time-limited grandfathering has been granted. These exemptions, however, do not apply to new business, and so we are staring reality in the face for every new policy sold.

With the regulatory burden ever-increasing, and legacy systems being held together by thread and duct tape after the retirement of the last Cobol programmers, the cost of doing business continues to place a strain on what little bottom line might be eked out from those few long-term bond portfolios which some companies have managed to hold on to. Patching up the failing legacy systems and dealing with ever tighter quarter-end close schedules, few IT departments have the resources to spare to deal with the mounting challenges in a constructive and creative way.

Some companies are also considering run-off as a solution to either focusing their product lines on the few remaining profitable niches, or with a view to streamline their branding efforts. Many small to mid-size life companies to date still cater to all tastes and find themselves unable to offer all things to everyone anymore.

THE FOUR CATEGORIES OF RUN-OFF

Orderly as we Germans are purported to be, we do have a weakness for categorizing things, including business models. In addition to simply being quaint, this categorization may be helpful for actuaries in other markets to identify similarities and differences between their situation and the German market, and serve to help reinsurers identify opportunities to support companies in pursuing a run-off strategy which best suits their specific corporate challenges.

The ordering criterion, by which we suggest sorting the run-off categories, is how radically a company decides to break with the traditional business model:

1. Self-managed run-off within the existing company,
2. Administer run-off business in an existing company, but create new company for new products,
3. Create an isolated legal entity for run-off business within the group,
4. Sell the run-off business to an external third party.

In the first instance, a company may decide to focus on so-called "biometric products" which offer protection only, unit-linked or hybrid bank-style products. The legacy is still administered alongside the new products. The first step to really doing things differently is often to establish a new company for the new, modern, attractive product lines. Here, the emphasis is on the new and administering the old business is still left to the same systems and operational resources. One of the main reasons to keep run-off and new business within the same company will be funding acquisition costs for new products. Should there still be profits emerging from the existing book of business, it can serve as a source of liquidity to pay for production. As profits run dry, however, this opportunity will cease to exist. Then the potential branding and marketing advantage of a brand-new company for new business will likely outweigh the potential advantages of cross-funding generations of business. This especially applies to new types of business models, such as FinTech or InsurTech business, where the branding must emphasize the new tech-savvy approach.

The next level of commitment means establishing a specific vehicle for the run-off administration. This will include both a separate legal entity with run-off specific regulatory reporting requirements as well as building a team of experts focused on managing the run-off block as efficiently as possible. Some players have decided to take this route upon realizing that only a dedicated run-off operations team can hope to limit the losses which this business will bleed. Some have even decided to turn this necessity into its own business model and consider acquiring additional run-off blocks from external sources. Which brings us to the market for trading run-off portfolios between third parties. Such transactions are typically supported by life reinsurers, and in some instances the acquiring company is indeed the affiliate of a reinsurer. It is, however, important to note that reinsurance potentially has its role to play in each of the different categories, not just the external sale. Reinsurers can tailor their offering to the different needs of their clients. If the life company wishes to retain some of the branding and customer relationship benefits of the existing business, but wishes to operationally separate the two, ceding the business to a reinsurer and entering into an outsourcing arrangement for the operational aspects of the administration can already remove a large portion of the burden from the life company while retaining the benefits.

Which category the life company chooses will largely depend on its original motivation and which degree of separation between existing and new business best matches its marketing and brand strategy. Reinsurance will help offer some flexibility around implementation.

RISKS AND REWARDS

One of the main thresholds to overcome with respect to the most radical, and most reinsurance-like run-off category of trading portfolios, is German regulation relating to profit participation, which severely limits the upside potential for investors, including reinsurers. At the same time, the cost of providing interest rate guarantees and holding the required solvency capital is a strain on profits, too. German rules for participating business require investment and mortality gains to be shared at least 90/10 with the policyholder, while expense gains can be shared 50/50. This means that the most important source of earnings for a run-off specialist must be cutting administrative costs. At a high level, it would take at least a cost reduction of 30 percent to achieve a double-digit return on solvency capital. Such a cost reduction is only realistic, when the run-off business model offers economies of scale and enough scope for investments in systems innovation.

One risk which is particularly important for run-off business is the erosion of profits due to anti-selective lapsation. For most run-off strategies, customer service and crediting rates will be lowered to the bare minimum, leading to an increased tendency for policyholders who are healthy enough to qualify for life insurance at attractive new business prices to surrender their policies. The remaining lives will include those who hold on to their policy, because their health status has worsened. Even if anti-selective lapsation is only moderate, the portfolio will gradually decrease in size, leading to a substantial increase in the volatility of results. This is another opportunity for reinsurance to add value.

In summary, Germany has its very own flavor of run-off market. Its idiosyncrasies are mainly due to Germany's own brand of insurance regulation which even the EU-wide Solvency II initiative has not entirely thwarted. This also means that many companies have held on to flawed business models. Only time will tell, how many of these have drifted beyond the point of no return where even reinsurers will not be able to throw them the saving life-line. ■

Bernd Heistermann, Aktuar DAV, is running an actuarial consultancy in Sankt Augustin, Germany. He can be contacted at *bh@HeistermannConsulting.de.*

Kai Kaufhold, Aktuar DAV, is managing director of Ad Res, an actuarial consulting firm in Cologne, Germany. He can be contacted at *kai.kaufhold@adreservices.com.*

ENDNOTE

1 "RfB" stands for Rückstellung für Beitragsrückerstattung.