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A New Look at Reinsurers and Term

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Direct writers have increasingly faced a "hardening" market for reinsurance on term and universal life with secondary guarantees.

While the dwindling number of reinsurers try to scramble to keep market share, they are also faced with trying to recoup what appears to be mis-pricing on mortality. At the same time the growing realization of future amounts of XXX reserves that reinsurers have already committed to is raising forecasts for fees on letters of credit above the levels that were used in original pricing.

This has created an unprecedented environment between direct writers and reinsurers. At the SOA meeting in October 2004, one speaker related reinsurer actions such as:

- Raising rates on existing treaties for new business,
- Audits of underwriting files with particular attention to exceptions of preferred criteria, and
- Increasing arbitration of claims.

Now, up the pressure. In December 2004, the NAIC was shocked—yes shocked—to learn that companies have avoided the AXXX reserves for UL by having very large guaranteed expense charges. The commissioners have called for an actuarial committee to create a valuation system that would move from a formula approach to a cash-flow testing methodology. The goal is to substitute a valuation system based on principles instead of being rule-based. The presumption is that a principle-derived calculation method would better provide adequate reserves without over-reserving. They gave the committee a six-month deadline. This move may or may not be long overdue, however it will not be accomplished in six months.

However, assume there is a counterproposal at the June meeting to "fix" AXXX by limiting guaranteed expense charges, for example, and this is accepted as a short-term compromise while the committee has more time to contemplate. The industry will now have new demands for capital to fund the XXX and AXXX reserves required by law.

Reinsurers have gained enormous market penetration (over 60 percent of new business face amount) by bundling their services into a convenient package called coinsurance. Presently reinsurers are trying to fulfill two roles in life insurance. They provide reinsurance to dampen mortality fluctuation of the direct writer and they provide capital to offset reserves that are above the level, that direct writers can economically afford. Since reinsurance has in large part gotten us into this mess, I thought I would explore how to use reinsurance to get us out of it.

Consider a switch from coinsurance to YRT.

1. Without repricing, the company must now deal with the extra reserves.
   a. If the company wishes to avoid using its own capital.
      i. The company can source its own capital through securitization, as did Genworth last year.
      ii. It can use an affiliate captive offshore reinsurer and do the capital management internally. The captive can retrocede the mortality risk to your reinsurer and hopefully recreate in a roundabout way the position of your current coinsurance.

   At present the first method is believed to be more costly than the second. I view this as the greatest opportunity for both direct writers and reinsurers. Reinsurers have the expertise and the ability to easily tap the capital market. They could start up a business of deliberately securitizing their exposure and, by bundling their blocks of business, retail it to their direct writers.
   b. The company uses its own capital. Until now, coinsurance provided the extra lift for a company's IRR results. I expect this to change in the future as reinsurers start to properly reflect the cost of LOC. Thus go ahead and include the true cost of YRT reinsurance. Raise the retention back to normal levels. It will probably help if the company is looking at profit margin as the profit measure since YRT cannot provide the IRR lift that co-insurance has up to now.

2. Reprice, but do this very carefully in today's hardened market. The advantage is that you might be able to get a jump on the companies that seem to be frozen into their current rate structure.
   a. 2001 CSO will help alleviate some of the XXX reserves.
   b. Move to a non-guaranteed premium structure. Make this more palatable to the field force by slightly increasing the compensation.
   c. If possible, introduce a premium scale that is reduced by dividends. It would not be possible to avoid the illustration regulation using this approach.

The direct company needs to be aware of the alternatives and monitor the environment. Be prepared for action the next time the reinsurer asks for a repricing of your existing reinsurance. ●