SOCIETY OF ACTUARIES

Article from:

Small Talk

November 2010 – Issue No.35

The Smaller Company Reinsurance Issue

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It is a competitive disadvantage when professional reinsurers don't provide reinsurance to smaller insurance companies at the same prices they provide reinsurance to larger insurance companies (or don't provide reinsurance at all). This is especially true for products like level term insurance, where reinsurance is a valuable tool for building a viable product. Sometimes, the unfortunate answer for many smaller insurance companies is to forego developing a product when they cannot attract a competitive reinsurance solution.

As Carl Spackler once said about gophers, "My enemy, my foe, is an animal. In order to conquer the animal, I have to learn to think like an animal. And, whenever possible, to look like one."

Looking at the reinsurance transaction from a reinsurer's perspective helps shed some light on the difficulties of developing a reinsurance solution for the smaller insurance company. Hopefully, some insight into the reinsurer's operational issues will help smaller insurance companies increase their opportunities to transact successful reinsurance deals.

The Reinsurer's Perspective

From the reinsurer's perspective, it's a costly investment to develop a reinsurance treaty. It takes time to underwrite the insurance company, price the product and negotiate the allowances and then negotiate the reinsurance treaty. Twenty years ago it was more common for a reinsurer to develop a "one size fits all" mortality assumption, but in today's competitive reinsurance environment it is almost universal to customize a mortality and persistency assumption for each product line within each insured's product portfolio. For developing the terms of a reinsurance treaty, the reinsurance underwriters, actuaries and lawyers don't come cheap. About $40,000 is not an unreasonable estimate of what it costs a reinsurer to underwrite and establish a typical term coinsurance treaty.

It is the allocation of this upfront reinsurer cost of doing business that prevents a smaller insurance company from achieving the same successful reinsurance transaction as a larger insurance company. Applying a $40,000 upfront cost to a reinsurance treaty with a two-year shelf life for an insurer writing $200,000 of reinsurance premiums per year amounts to 10 percent of premium expense. Compare that to a larger insurance company annually writing $5,000,000 of reinsurance premium, where that expense becomes less than 0.5 percent of premium.

There aren't many insurance product opportunities out there in the market that can withstand a 10 percent expense disadvantage and still result in a successful insurance product. On the one hand, it's kind of rude for a professional reinsurer to decline to even quote on a company's reinsurance proposal; but on the other hand, it's frustrating for a reinsurer to put together a competitively priced quote (from their end) that fails to gain acceptance because the fixed expense cost imbedded in the reinsurance quote results in a noncompetitive underlying insurance product for the insurer.

Economies of scale are critical to a reinsurance transaction, and a targeted minimum treaty size is just as important to a reinsurer as it is for a direct insurer to maintain a minimum policy size on the policies it sells to its policyholders. Nobody benefits from losing money reinsuring or selling policies that can't produce the revenue necessary to cover the costs of maintaining them.

The reinsurer spends the bulk of its developmental cost on pricing (actuarial), risk selection (underwriting) and treaty negotiation (legal, executive and other managerial disciplines). This repetitive process undertaken with each reinsurance opportunity is time-consuming and expensive. But as the reinsurer spends its money, the big question is whether it is possible for an insurer to provide shortcuts that reduce the expense burden of the upfront cost, and in turn increase the potential for a reinsurance transaction to take place between a professional reinsurer and a smaller insurance company.

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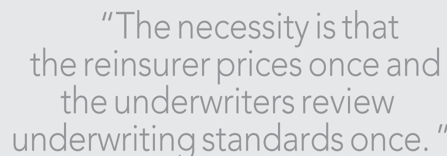
Potential Reinsurance Solutions for the Smaller Insurance Company

How can you respond to a reinsurer's insistence that reinsurance isn't available due to the small size of the transaction? With many reinsurance reps, a good dialogue can help identify hurdles that can be overcome as well as, equally important, the hurdles that can't be overcome. With most reinsurers, the subject matter that's going to help advance your case is the one where you can identify what reinsurer costs you can reduce or eliminate to make the transaction feasible.

Unfortunately, utilizing reinsurance is often a trade-off in sovereignty versus conformity. Accessing affordable reinsurance for smaller insurance companies may at times feel like a painful process of complying with reinsurer ideologies, particularly when those reinsurer requirements are not as efficient as the process your company has sensibly and confidently gravitated to through the years of experience of knowing your business.

The first thought that comes to my mind as I listen to many smaller insurance companies discuss reinsurance issues is that conglomeration seems the most logical solution to attracting reinsurer interest. If a small volume of reinsured business is unattractive, then a pooled volume of multiple insurance companies totaling a large volume of reinsured business would then of course be more attractive.



Conglomeration

If like-minded life insurance companies can present a significant amount of reinsurance volume and a method for overcoming the reinsurer's overhead expenses, capitalism has a good chance of prevailing. For sure, there would be a significant loss of autonomy in conforming to a reinsurance "standard." I think it all comes down to the value of a potential reinsurance transaction versus the value of independence to customize your products for the benefit of your policyholders. But regardless, the obstacles for smaller insurance company reinsurance programs continue to face an uphill battle unless companies find a way to overcome reinsurer fixed-cost expense issues. Below is my pipe dream of a conglomeration methodology that could overcome reinsurer costs related to pricing, underwriting and treaty compilation.

Pricing

Excluding the cost of providing premium guarantees, a reinsurer's profit depends only on the net reinsurance premium (premiums less reinsurance allowances). Becoming part of a reinsurance conglomeration does not necessarily mean all companies would have to charge the same premiums. An insurer charging higher premiums would get higher reinsurance allowances (that is, more money available for expense coverage and/or profits) and an insurer charging lower premiums would get lower reinsurance allowances. The reinsurer would price once with a single scale of net reinsurance premiums, and assure itself that each insurer product portfolio meets the reinsurer's profit criteria.

This would unfortunately still require insurers in the conglomeration to all conform to certain underwriting class criteria to assure consistency across all underwriting classes.

Underwriting

Similarly to premiums, uniformity of underwriting standards wouldn't necessarily be required, but in all likelihood a set of *minimum* underwriting requirements would be. The necessity is that the reinsurer prices once and the underwriters review underwriting standards once. Although companies can achieve similar underwriting results by being stricter on some requirements and looser on others, in order to achieve a single review of underwriting standards, a single set of minimum requirements would lead to the desired expense savings.

Treaty Negotiation

Lawyers are expensive. Identical treaty terms mean identical administrative processes, claims processes, company protections, etc. It should be conceivable that insurers interests are similarly aligned and that a single treaty could provide sufficient protections for all insurers, and accepting a $4,000 communal treaty might be more advantageous than negotiating a $40,000 gem of an individually negotiated treaty. No, the $4,000 agreement won't contain the exact protections each life insurance company desires, but if the benefits of reinsuring under uniform terms are not worth the missing reinsurance treaty protections, then declining to participate in such an agreement is the right choice for that particular insurance company.

Conglomeration Summary

A good question to ask is why there isn't a history of successful conglomerations already in existence? It seems obvious that if a reinsurer can't afford to price smaller individual reinsurance transactions, that it would benefit from aggregating those potential revenue sources. Certainly, the sacrifices a company would have to make to participate probably have a lot to do with it. But maybe the starting point of a motivated insurer willing to invest the time to organize and solicit a reinsurance conglomeration is the missing ingredient.

Although conglomeration seems the most logical method to achieving economies of scale, there are potential single-insurer actions that can also chip away at the cost of providing reinsurance transactions. These "nonconglomeration" efforts merit a mention here to give the smaller insurance company additional ideas of how to make themselves more attractive to a potential reinsurer.

Non-Conglomeration

The sections that follow outline a few steps that I think can make a difference in how a smaller company is perceived by a professional reinsurer, and potentially can make a smaller insurance company more attractive to do business with.

Pricing

If you don't know how your claims translate to a particular level of mortality, it's difficult for a reinsurer to justify using a competitive mortality assumption. For most small insurance companies, there is always going to be the issue of credibility in the mortality results, but that shouldn't preclude the company from making the efforts to quantify. Quantifying does two things: it shows the reinsurer you manage claims, and it provides valuable feedback on how well the company's mortality results stack up to past mortality assumptions used in pricing. There are low-cost options out there to analyze mortality results in a cost-effective manner, and the small efforts to compile a mortality study are well worth it.

Underwriting

This is potentially the most difficult aspect of the reinsurance quoting process. Many insurance companies pride themselves on their flexibility and ease of doing business with, and judiciously choose when to enforce stricter underwriting requirements and when to waive standard underwriting requirements. The problem here is that a reinsurer may be left with no security of knowing whether your flexibility is prudent underwriting process management or simply a lack of underwriting control. Developing an underwriting process where there is consistency (conformity) in the risks that would be eligible for reinsurance is an excellent step towards simplifying the reinsurance underwriting review process. Reinsurers want to see evidence that the risks they assume will be underwritten in a consistent manner. Providing documentation of clear unwavering underwriting guidelines for reinsurance risks will improve how a reinsurer views your risk selection process.

Treaty Negotiation

Treaties outline the rights and obligations of the reinsurer and insurer. Negotiation of those rights is extremely important; however, if a reinsurer's boilerplate treaty effectively manages the reinsurance transaction, and costs the reinsurer relatively little to produce. There may be some justification for simplifying the reinsurance treaty negotiation into a simpler "in totality" accept/reject process instead of a hotly (line-by-line, word-by-word) contested reinsurance treaty negotiation. Yes a smaller insurance company deserves the same consideration in customizing their reinsurance treaties as a larger insurance company, but affording the cost of that customization contributes to the overall obstacle of creating a cost-effective reinsurance transaction. If a reinsurer includes the cost of developing a treaty as an impediment to reinsuring your business, try requesting a boilerplate treaty and agreeing to accept or reject it as a whole prior to advancing to the reinsurance pricing and underwriting process.

Can Reinsurance Work for the Smaller Insurance Company?

The repetitive process that a reinsurer undertakes with each reinsurance quoting opportunity is a time-consuming and expensive process. When it comes down to it, though, the reinsurer is basically ensuring that each deal it puts on its books meets its profit, expense and risk objectives. Theoretically, each deal is priced to the same profit, expense and risk objectives, and each negotiated treaty merely specifies the accounting, administration and actuarial details that result in that theoretical level of profit, expense and risk. Aggregating insurer business would reduce reinsurer expense but otherwise leave the profit and risk objectives unchanged. Additionally, providing a reinsurer with information or structure that reduces their quoting expense creates opportunity for reducing the expense burden of your potential reinsurance opportunity as well. Increasing economies of scale or reducing quote-associated reinsurer expense both seem like win-win situations for all parties involved, and can work to increase the opportunities for reinsurance solutions. ●

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