RECORD, Volume 22, No. 1*

Marco Island Spring Meeting
May 29–31, 1996

Session 88D
The Reinsurance Company in the Year 2000

Track: Reinsurance
Key words: Futurism, Reinsurance

Moderator: RONALD L. KLEIN
Panelists: BRYAN J. FEATHERSTONE
MONICA HAINER
MICHAEL W. PADO
JAMES R. SENN
Recorder: RONALD L. KLEIN

Summary: This debate centers around what the reinsurance company will look like ten years from now. Opposing views are debated on many points, including:

- *Will traditional reinsurance continue to be the major part of the industry?*
- *Will block acquisitions and assumptions reinsurance be the only game in town?*
- *Is traditional reinsurance too expensive/unprofitable?*
- *Will Guideline XXX and Regulation 147 change the way companies do business?*
- *Will improved underwriting kill the business?*
- *What company formats will work?*

Mr. Ronald L. Klein: We have a pro side and a con side to our debate. At the beginning of the session, I will poll the audience and then we will have the debate. We'll poll you again to see if the panelists changed anybody's opinion as to what reinsurance will be like in the year 2000.

Our first speaker is Jim Senn. He is currently vice president of life reinsurance at Manufacturers Life Insurance Company. He has about 17 years' worth of industry experience on both the direct and the retrocession side. Our next speaker will be Monica Hainer, and Monica is now president of London Reinsurance Group. It is a start-up company in Pennsylvania. Monica also has retrocession and direct experience and reinsurance experience. Bryan Featherstone is executive vice president and chief actuary at Life Reassurance Corporation of America. Bryan has direct and reinsurance experience. Finally, Mike Pado is an actuary at Swiss Re Life Company America. Mike has 18 years of experience also on the direct and reinsurance side.

The question again is, will traditional reinsurance continue to be the major part of the reinsurance industry? By show of hands, how many of you would vote yes? Who would vote no? OK. It is exactly tied!

Here are the rules of the debate: I will ask all the panelists for opening statements and they'll have four minutes to complete their statements. They each have prepared opening statements. We will start with the pro side, and Jim Senn will lead off. Then we will go to the con side with Monica, followed by Mike on the pro side and Bryan on the con side. After that, we will have a rebuttal session. Each participant will have three minutes to rebut. For the opening statements, the panelists will have to read from their prepared statements.

For rebuttal, they are allowed to rebut anything else that one of the panelists said. We'll go in reverse order for rebuttal. After that, the panelists will pick one person from each team to make a one-minute closing argument. After the one-minute closing argument, we'll have a five-minute free-for-all. After the formal part of the debate is over, we will poll the audience again. We'll see if there are any shifts. Then I will entertain questions. At the beginning of the question-and-answer period, please ask your questions directly to one of the panelists. We'll keep it in that format. Panelists will have two minutes to answer it. We'll have a one-minute rebuttal. We'll try to continue that, and then we'll break out into general questions.

Mr. James R. Senn: Of course traditional reinsurance will be the major part of the industry in the year 2000. How our opponents could say anything else totally eludes me. First, let's consider what *major* means: *major* from an in-force point of view, *major* from an earnings point of view, or possibly *major* from a new business point of view. I'll address each of these in turn.

Clearly, traditional reinsurance will still constitute a significant portion of in-force business in the year 2000. It forms the backbone of the liabilities for most reinsurers today, and that will not change dramatically during the next four years. Also, because traditional reinsurance forms the bulk of the liabilities, it generates the bulk of the profits. That also will not change in the next few years. Finally, what about new business? Some prognosticators, and certainly our opponents, will try to tell you that the sales of traditional reinsurance are falling and will be of little importance by the year 2000. They may even provide information that appears to support this conclusion. But let me remind you of what Ruskin said: "The work of science is to substitute facts for appearances and demonstrations for impressions." Ladies and gentlemen, here are the facts.

By the year 2000, the baby boomers in the U.S. will be between the ages of 40 and 55, prime insurance-purchasing ages. All those policyholders will be buying policies that tend to be in the larger-sized range, and they will need reinsurance support. What kind of reinsurance support will that be? Much of it will be traditional reinsurance. There's also been a great deal of discussion at this meeting about potential changes in the direct writing market: new products, new distribution channels and, in fact, new provider companies (banks and other companies in the financial services sector). All those nontraditional companies will need support and advice from traditional players in the insurance business, such as reinsurers. What is one of the products that those reinsurance companies will provide to these new companies? Traditional reinsurance. Finally, during the next 10–20 years, trillions of dollars of wealth will pass from baby boomer parents to the boomers themselves upon the death of their parents. This will create huge estate-planning insurance sales opportunities in the U.S. Now, many of you are boomers and you know that boomers hate paying taxes as much, or more, as any age cohort in American history. All those sales of insurance policies will be made to baby boomers who now have this tax problem. What will be supporting those sales? Traditional reinsurance.

So far, I've limited my remarks to the North American market. We shouldn't be so narrow-minded. If we look first to the Far East, markets are exploding there. Economies are expanding and new middle classes are emerging in countries such as Singapore, the Philippines, and China. These are largely untapped markets with extremely low penetration rates for insurance. Scarcely a day goes by when you can't read in the North American press about another insurance company opening operations in the Far East, either directly or as a joint venture. There will be a large number of new insurance sales in the Far East, and what will they need to support those insurance sales? Traditional reinsurance.

Closer to home, the same sort of situation exists in Latin America and South America. There are the same kinds of emerging markets. There will be considerable opportunity, once again, for traditional reinsurance. I think those of you who believe that traditional reinsurance may not be important in the year 2000 are taking a myopic, pessimistic, and narrow-minded view. It would actually be humorous if it weren't, in fact, so tragic. Of course, traditional reinsurance will form an important part of the business in the year 2000.

Ms. Monica Hainer: Will traditional reinsurance continue to be the major part of the reinsurance industry? I think it's important that we ensure our mutual understanding of the terminology. "The traditional reinsurance market encompasses reinsurance, which primarily exists for mortality, morbidity, investment, or persistency risk-sharing, involving newly issued life, health, and annuity policies." This was written by John E. Tiller, Jr. and Denise F. Tiller in their best-selling masterpiece, now in its second edition, *Life, Health & Annuity Reinsurance*. I'm quoting the experts here. The authors go on to say that "The reinsurance of in-force blocks of business is generally restricted to financial reinsurance transactions." So, let's agree; traditional reinsurance is risk-sharing on new issues. Financial reinsurance is the terminology generally accepted to encompass everything else. In John and Denise's words, "Financial reinsurance is useful for several purposes. The most common uses are surplus relief, tax planning, and strategic business planning." So, by definition, traditional reinsurance is a small, focused part of the reinsurance world, and financial reinsurance is everything else.

At this point, I could just sit down, argument made. But, to ensure that no doubt remains in your minds, I'll state a few other obvious truths. Sales of traditional life insurance are under pressure. Companies face significant challenges, heightened competition, overcapacity, and high cost structures, according to *Best's Insurance Reports*. It goes on to suggest that downgrades can be expected, and that it is only a matter of time until banks will be permitted to underwrite. If sales are down, companies are no longer in need of significant traditional reinsurance. In fact, they no longer have the huge dollars of new premium available to feed the system. Furthermore, margins are tighter on the sales that are made. Gone are the fat insurance premiums of years ago. Then explain to me, please, what company will reinsure its hard-earned pittance? It will look for alternatives instead—alternatives that will allow it to retain as much profit as possible.

Financial reinsurance comes to mind. Companies are consolidating. In 1993, there were 32 life company mergers and 23 liquidations; only 15 new companies entered the market. In 1994, the numbers were 37 deletions with 21 additions. To these new, large corporations, traditional risk-sharing is of little interest. They don't need protection against mortality fluctuations caused by individual policies. Look at the numbers: the average capital and surplus for life companies in 1990 was $63 million and in 1994, the number was $89 million. These large corporations are interested in managing their financial statements. They have regulators and rating agencies to satisfy. There are capital requirements, risk-based capital (RBC) ratios, Standard and Poor's (S&P) ratios, Best's ratios, Moody's ratios, on and on, all of which look for results of the entire company, all of which can be improved by financial reinsurance. These corporations want to minimize tax and maximize profits.

A recent court decision said that the use of reinsurance for tax planning is appropriate. These companies are worried about the big picture, things that cause major impacts, not minor variances. They want to work with the reinsurance companies to solve these issues to the satisfaction of all those regulators and rating agencies. They want solutions that smooth their income statement: stop loss, spread-loss-type solutions that are cost-effective. They want to use reinsurance to front-end profit on in-force blocks of business. This will allow them the financing necessary for growth. This will provide the capital needed for that new business venture or acquisition. They want solutions that allow them to share in the profits their business generates. Only financial reinsurance provides this flexibility. Only financial reinsurance is this cost-effective. The answer is obvious: traditional reinsurance can and will continue to play a small role in our industry, but the major part will be played by financial reinsurance.

Mr. Michael W. Pado: The phrasing of today's question is reminiscent of one of those examination questions in which you anguish over what section of syllabus the examiners were referencing. You know, what do we mean by traditional and what do we mean by major? Jim has already addressed the former, so I'll focus on the latter. I submit that the traditional reinsurance market will be a major part of the life insurance industry in the year 2000 because the traditional needs of direct writers will still exist and continue to grow. These needs include, but are not limited to:

- providing capacity to write large-amount cases
- providing a vehicle to stabilize earnings
- providing a facility to underwrite unusual medical and financial risks
- providing a vehicle to mitigate the surplus strain associated with writing new business
- having the ability to assist in the product development process
- having the ability to assume excess risks and run off blocks of business
- having the ability to assume new and unusual commingled risks (such as the guaranteed minimum death benefit)
- having the ability to assume market risks associated with equity-indexed life and annuity products.

What should be apparent to those old enough is that the first four needs have been fulfilled by the traditional reinsurance market for decades. The latter four needs have been fulfilled by the traditional reinsurance markets to varying degrees for, relatively speaking, just a few years. The point is that the traditional reinsurance market will adapt and evolve to address the ever-changing needs of direct writers. What might appear nonconventional today will become commonplace or traditional in the near future. Given that, I further submit that reinsurance will constitute a major part of the industry; however, the market will need to be measured and assessed in more complex terms than it is today.

To date, most measures of reinsurance market size have been limited to reinsured volume. I believe in the future that additional measures, such as premium flow and underlying assets reinsured, will become an important measure of size and success as reinsured risk amounts will be greatly influenced by aggregate market performance.

Mr. Klein: Bryan Featherstone will be the last person on the con side and then we'll get into the rebuttal.

Mr. Bryan J. Featherstone: It's clear to me that traditional reinsurance will have a minor role in the year 2006, and the reason can be summarized in three Ps: purpose, that is, primary purpose of the reinsurance; price, the price of the reinsurance; and other profit alternatives. Reinsurance is defined as traditional reinsurance if and only if its primary purpose, and I stress *primary purpose*, is risk-sharing. If the primary purpose has to do with surplus strain, Guideline XXX reserves, capital management, or mutual company concerns about equity, then that is not traditional reinsurance. If the primary purpose has to do with your reinsurer doing product development work for you, then that is not traditional reinsurance. If the primary purpose has to do with reinsurance price because that price is less than your own pricing assumptions, then that is not traditional reinsurance.

Speaking of price, the second *P*, pricing margins on traditional reinsurance are so paltry today that we are literally pricing the product into oblivion. Today's pricing margins, and I mean margins before general expenses, are at best 4–7% of premium. Everyone take a second and deduct your own company's expenses from those margins. There's very little left for profit; the direct-side actuaries recognize this. Do you think reinsurance sales are up because the product is so good? No, they're up because it's so inexpensive.

Test the margins for yourself. Construct a company just from today's business. Take a company with $300 million of premium and at $2.50 a thousand, that works out to about $120 billion of in-force. At 4–7% of premium, gross margins on the $300 million of premium work out to $12–21 million. If a company can operate on $12 million of expenses, which is awfully lean for a $120 billion company, then net after-tax profits range from $0 to $5.9 million. Results like this won't get you much of an A.M. Best rating, trust me.

Let's discuss the third *P*, profit alternatives. The last time I checked, the word *profit* was not a four-letter word. Our stockholders certainly don't think so, and we are obligated to them to find business that gives them an adequate return.

Traditional reinsurance fails this test, especially when you consider support capital. Thus, we are obligated to find other types of reinsurance, or other markets that produce satisfactory returns, and this will naturally shift resources away from traditional reinsurance, which will further deemphasize the product and its strategic importance to a reinsurer.

In summary, the times have changed. Traditional reinsurance once worked well, but margins have dropped below supportable thresholds. That is not to say the reinsurance industry will abandon traditional reinsurance; however, the industry will relegate it to a minor product line.

Mr. Klein: We now will go into the second phase, the rebuttal statements.

Mr. Featherstone: Jim, don't you know reinsurers are trying to find all sorts of reasons remotely related to risk-sharing to sell reinsurance today? If risk sharing is not the primary purpose, then that's financial reinsurance. Look at the major reinsurance deals placed recently. With many, the ceding company is keeping the smallest share of the risk; that's not risk-sharing, that's full risk transfer. The issue is not whether excess reinsurance will exist ten years from today, the issue is how important it will be as a line of business. Given its lack of profit potential, I believe excess reinsurance will become a required service for our clients, just like facultative reinsurance is a required service today. The problem comes back to price.

Let me give you another example. Consider a stock company earning $26 million on an after-tax GAAP basis. Suppose that company needs to grow at 15% a year. It must find $3.9 million of profit from new business and that's ignoring lapses. That's $6 million, pretax. If it can generate a 4% profit margin, pretax, that company must write $150 million of new premium. It can't find $150 million of new traditional premium, so it either tells its stockholders they're out of luck or the company looks elsewhere for reinsurance business. Here's the biggest issue we, as reinsurers, face: we must, and I emphasize *must*, continue to provide top-notch service to clients, but at a significantly lower cost than is done today.

The successful and, more appropriately, surviving companies in the year 2006 will find a way. The reality of business in the year 2006 is that clients will continue to need facultative and excess reinsurance. Pricing margins are controlled by the market, not by any pricing actuary, and because there is an overcapacity in the market, the price will continue to drop until some equilibrium is reached. The challenge to operate in the year 2006 is to provide the same level of service at a lower cost and as part of a minor product line. In closing, on your mark, get set, overhaul your reinsurer.

Mr. Klein: We're on to Mike for his rebuttal statement.

Mr. Pado: That was a wonderful answer to a different question. Let me first say that I think that traditional reinsurers will continue to be utilized in the marketplace, but for somewhat nontraditional reasons. I think the traditional sources of demand will change. Monica mentioned earlier about banks and producer groups, but regardless of the source of demand, I believe that they will still have needs that will have to be supported by the traditional reinsurance market.

With respect to financial reinsurance, it will play a significant part in tomorrow's reinsurance world, but I submit that recent regulations require a transfer of risk along with the relief and hence, traditional reinsurers will still have a part to play.

Last, I'll respond to Bryan's comments. One of his peeves is that risk-sharing must be the primary purpose of the traditional reinsurance market. Risk-sharing only is simply too limited a scope in terms of definition and price. I believe that price is related to value, and the more value you can add the better margin you can receive.

Ms. Hainer: I heard Jim's point that traditional reinsurance has moved the bulk of profits and I think that's interesting for a reinsurer to say. I think it's exactly the reason why financial reinsurance is the way of the future. Nobody wants to move that bulk of profits from his or her company anymore. He went on to say what a smart crowd you were, but then, in the next sentence, he said you were myopic and pessimistic. Mike, of course, conceded the argument up front. He said that they were only *a* major part of the industry, not *the* major part. He repeated that in his rebuttal. He said that traditional reinsurance was used to stabilize earnings. Yes, really? To handle surplus strain? This is interesting and we'll have to talk afterward. Actually though, Mike didn't have too much to say. He finished well within his four minutes because there wasn't much on his side of the argument.

Mr. Senn: What you've said was quite confusing and at times very inconsistent. I found it very interesting that the fundamental arguments of our learned opponents are based on a definition of traditional reinsurance in the Tiller book. I hate to say, "I told you so," but I did warn you about a narrow-minded approach. To take a historical definition and say it defines the world as we know it is a dangerous thing to do. You could claim that we don't drive cars now because Henry Ford defined a car as something that is black, goes 20 mph, and must be started with a crank.

As we all know, the world continues to evolve, and to change. Markets and customers' expectations change. Simply because those things change and we respond to them doesn't mean that what we're doing today can't be called traditional reinsurance. In fact, in many of the new, evolving markets, needs that our opponents talked about will be met by traditional reinsurance. I fail to see why that business still wouldn't be called traditional reinsurance simply because a client is a bank or some other financial institution as opposed to an insurance company.

The other thing that I would remind you is that our opponents did seem to ignore a large portion of the world outside the North American continent, which as I said, will generate a great deal of traditional reinsurance business in the future. So, in conclusion, traditional reinsurance will still form a very important part of the market.

Mr. Featherstone: Jim, I'm glad you understand what the definition of the word *traditional* means. In any case, I believe that we can all agree on one thing: the key to the future is, in fact, creativity. I think the broad topic for discussion was, What will the reinsurance company in the year 2000 look like? I think that will depend on each one of us in our own creativity in being able to work on tightening profit margins in the future.

Mr. Klein: That's the end of the formal part of the debate.

Ms. Hainer: I'd like to follow up on my partner's comment. I think the ideas of creativity, new ideas, and new ways of handling old problems all fall under the realm of traditional reinsurance.

Mr. Pado: I agree completely. They all fall under the realm of traditional reinsurance.

Ms. Hainer: Let me pick up on that thought of nontraditional reinsurance. Anyone who thinks the old traditional reinsurance will satisfy the business needs of the future is missing the boat entirely.

Mr. Senn: What can I say? Monica just supported our argument, so there's nothing to add.

Mr. Featherstone: I think you can look at today's market and the reinsurance industry and see that most of the reinsurance that is being placed is, in fact, financial reinsurance, no matter how you measure it, by profits, insurance in force, or premium. Also, the insurance industry is changing. More and more companies are expecting their future growth to come from asset-based products and not mortality-based products. Their concerns will be statutory strain and target surplus support and not mortality risk transfer. Even today traditional reinsurance products are being used in nontraditional ways.

Mr. Senn: Absolutely. Traditional reinsurance products are being used to satisfy nontraditional needs. It doesn't mean they're not traditional reinsurance products anymore.

Ms. Hainer: It's not traditional reinsurance. Just because we take risk under a financial reinsurance deal does not mean it turns into a traditional reinsurance deal. We go back to Denise and John's definition of what is traditional; it's very limited. It serves new business, mortality, morbidity, investment, and persistency risk sharing. It's a risk-transfer concept that has nothing to do with anything creative. Financial reinsurance is used for surplus relief, tax planning, and strategic business planning. How can you think that someone would turn back the clock and go to the traditional YRT-type of mortality reinsurance? It's just absurd.

Mr. Featherstone: To follow up on Monica's comment, I don't think we should forget the fact that all reinsurance has to follow the model regulations for risk transfer. I think the definition of whether reinsurance is traditional or financial is based on the *use* of the reinsurance, as opposed to the *type* of the reinsurance. You can do financial reinsurance with YRT reinsurance. You can also do financial reinsurance on term products. It's the motivation for purchasing the reinsurance, as opposed to the type of reinsurance.

Mr. Pado: Bryan, you mentioned the emergence of asset-related coverages. Many insurance products are now commingled, in which a much greater investment risk is commingled with the mortality and perhaps persistency risk. There are different players being brought to the table to help measure and support those risks, but there are still traditional mortality and persistency needs that will be met by a reinsurer.

Ms. Hainer: We don't argue that there won't be traditional reinsurance. The argument is, Will traditional reinsurance continue to be the major part?

Mr. Klein: Five minutes are up. How many people were on the pro side and want to switch to the con side? One person. Was anybody on the con side who decided to switch to the pro side? Two people.

Mr. Michael Gerard DeKoning: Bryan and Monica, I was wondering how you view coinsurance of a term product? Is that considered in your definition of financial reinsurance, or is that supposed to be traditional reinsurance?

Ms. Hainer: Financial reinsurance, by definition, is not the structure, it's the underlying product that determines whether it's financial insurance. It's the motivation for the transaction. When you say there is straight coinsurance of a term product, if the reason for the coinsurance is strictly to risk-share the mortality on the business, then I would consider that traditional reinsurance. If the reason for the transaction is because you have a tax, statement, or an RBC problem, and you've chosen to use that block and coinsurance as the structure, that's financial.

From the Floor: But it just so happens that RBC is a relatively new phenomenon. We're using a traditional reinsurance transaction to solve a current problem.

Mr. Featherstone: Mike, I think the question is a good one because it indicates that there's a real blurring of the lines as to how reinsurance is being sold today, and that's probably why we're having this debate. I would argue that if a company comes to you to coinsure its term product excess, over its normal retention of $1,000,000 term, that's probably just plain vanilla risk-sharing and classic traditional reinsurance. If a company wants to coinsure 100% of its new term products because it can't handle the strain, I think that's financial reinsurance. If we recognize that, we will ultimately sell more reinsurance because we've understood the motivations of our customers.

Mr. Klein: Do we have a rebuttal from Mike or Jim on that question?

Mr. Senn: Yes. The debate aside, I think the real issue is what Bryan was referring to at the end: satisfying customer need. It doesn't matter what label you put on it. The issue that reinsurers are faced with is trying to understand what's going on in the direct marketplace and responding to customers' needs. How you label it is much less important than just making sure that you're meeting that customer's need in an innovative way.

Mr. Steven F. Wright: If you're a reinsurance supplier and you have owners as well, what would you rather be selling? Would you rather be selling traditional or financial reinsurance? That's open to the panel.

Mr. Pado: I guess it gets down to whether the rewards are commensurate with the risks undertaken. From our perspective, we're in the market for both and not relegating ourselves to just the traditional or the so-called financial reinsurance in and of itself.

Mr. Featherstone: There's no reason why you have to limit yourself to one or the other. I think we could have had this same debate 15 years ago about the difference between facultative reinsurance and automatic reinsurance. Which would you rather be selling? I think the answer is that you need to sell both.

Ms. Hainer: Financial reinsurance, absolutely. My company started marketing reinsurance maybe seven years ago. We looked at the market opportunities and we thought conventional, YRT mortality reinsurance is a commodity market and we have nothing to bring to that market. We can bring creativity, financial strengths, and many good things to a financial reinsurance market, so that's where we structured our whole organization, and it's where we intend to stay.

Mr. Klein: I'll direct a question to Bryan. Many reinsurance companies are now in the market of assumption reinsurance, assuming a whole block of business or actually purchasing companies. If you purchase a middle-sized company, you're taking over a great deal of reinsurance if you're the reinsurer. It could be direct business, but you could consider it reinsurance, I guess. Would you consider that traditional reinsurance, or would that be nontraditional reinsurance?

Mr. Featherstone: Again, you have to go back to the motivation of the seller. From what we have seen in the marketplace, the motivation of the seller is generally not of risk transfer, risk-sharing. The motivation is either to exit a line of business or to generate more capital. It's usually financially driven. The transaction usually occurs between the CEO or financial officer and the reinsurer, as opposed to the normal reinsurance channels in the underwriting area.

Mr. Klein: We're going to poll one more time. This is after the second poll. Again, did anybody switch from the pro side to the con side after the few questions that we had and some of the answers? No other people switched over. Did anybody else switch over? No.

I think both sides agreed that it's more a matter of serving the customer and defining what the customer needs. I also think much of the debate was on how you define the terms.