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Letter from the Chairperson

by Barry L. Shemin

The life insurance industry was founded to assume mortality risks from individuals and reduce them in the aggregate by pooling/diversification. This was the primary "value-added" of the industry. Yet, in the last decade, in the U. S. at least, direct writers have been ceding an increasing proportion of mortality risks to reinsurers, despite the slow growth of the life insurance market and the surfeit of capital in the industry.

What accounts for this trend? The initial impetus was probably provided by the NAIC Life Insurance Illustration Regulation. This regulation prohibited the use of mortality improvement assumptions in illustrations, but allowed the reflection of reinsurance in the self-support test. Although most reinsurers state that they do not explicitly assume mortality improvement in pricing, I believe the margins they require are reduced at least implicitly by the expectation of mortality improvement. The result is that more favorable illustrations are often produced if the mortality element of the illustrated product is reinsured.

Regulation XXX also increased the use of reinsurance. Reinsurers have a better set of tools to manage the additional XXX reserves than most direct writers, and are able to offer attractive terms to reduce the impact of these reserves.

Life insurance sales have been increasingly focused in upscale markets, especially for survivorship products, and the larger face amounts this entails (along with reduced numbers of policies being sold) creates additional nondiversification risk, which can be addressed by increased reinsurance.

The wave of demutualizations, has also contributed to the trend. The large mutual companies that were relatively unruffled by a quarterly mortality fluctuation have been replaced by public companies whose quarterly results are scrutinized for signs of an adverse mortality trend. Reinsurance helps these companies stabilize mortality experience.

Although the increasing use of reinsurance has by and large met the industry's needs, there are a couple of potential downsides. Perhaps foremost is that direct writers are relinquishing the favorable long-term impact of mortality improvement. Also of concern is the increasing concentration of the life reinsurance industry, creating uncertainty about the level of protection in the event of widespread adverse mortality experience.

WHAT ARE THE IMPLICATIONS OF THESE TRENDS FOR FINANCIAL REPORTING ACTUARIES?

One implication is that direct writing companies need a continuing process to examine their exposure to reinsurers and evaluate their financial condition. Each company needs to evaluate what level of concentration of exposure it is comfortable with, and conduct enough financial due diligence to alter its exposures if concerns arise.

Another potential concern is the interrelationship between mortality and expense assumptions used in pricing. It is not uncommon to use current unit expense levels in pricing, and the rationale for this may rely in part on the expectation that future mortality gains may offset expense inflation. If a significant part of the mortality risk for a particular product has been reinsured, this offset will not be realized.

On the more technical side, the mortality assumptions used for asset adequacy testing should be reviewed to see that reinsurance is properly reflected in any assumed mortality improvement.

Finally, there is the broader question of whether mortality improvement should be assumed for GAAP estimated gross margin projections under FAS 97 or benefit premiums under FAS 60. For FAS 97 products in particular, assuming improving mortality should produce a projection of increasing margins, and this would defer DAC amortization into the future, thereby improving the emergence of GAAP earnings. This approach would result in different earnings streams for products whose mortality risks are reinsured and those where the risks are retained, a difference which otherwise would not appear until many years in the future. ❖

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