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Life Reinsurance Consolidation — The Ceding Company Perspective

Track: Reinsurance, Smaller Insurance Company

Moderator: R. Dale Hall

Panelists: R. Dale Hall
William J. Briggs
Paul A. Schuster

Summary: The number of North American life reinsurers continues to shrink dramatically. This consolidation — and the possibility of more — affects virtually every aspect of the ceding company reinsurer relationship. Ceding company representatives discuss the effect of continuing consolidation in the life reinsurance industry on pricing, underwriting and other aspects of managing their business, detailing how this continuing consolidation affects the ceding company reinsurer relationship.

MR. R. DALE HALL: Our first speaker, Bill Briggs, is the vice president and head of corporate reinsurance at John Hancock. Bill will give the perspective on the consolidation movement from a large company's point of view. I am Dale Hall, Chief Actuary from Country Insurance and Financial Services. I will try to provide the view from a small-to-midsize insurance company's perspective, how this industry

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consolidation creates some threats and opportunities along the way. Then Paul Schuster, executive vice president of the U.S. division at RGA, will provide some perspective on how the reinsurance industry views its relationships with its ceding companies and some ideas for the future. Let me start by turning it over to Bill Briggs.

MR. WILLIAM J. BRIGGS: I generally like to get the mathematical part of my talk done first, so I'll present a quantitative history of how consolidation has occurred, using two simple metrics. Then I'll talk about current effects on pricing, underwriting and other matters, plus potential issues that will face large companies soon, if they haven't already. After I had prepared that talk, I suddenly realized I hadn't answered the questions in the title of the talk. So, I added a section on ceding company responses.

All my data on sales are derived from the Annual Life Reinsurance Survey conducted for the Society of Actuaries by the Munich American Reassurance Company, www.marclife.com. I'm going to look at two metrics, the two measures of consolidation. One is the market share percentage. I took the Munich Survey's total new business volume and divided it into each company's new business volume, and then calculated the market share percentage. Then I added the first five together, then the next five together by size of new business and so on. Then I did the same thing for volume of new reinsurance business. The market share percentage is more significant because when we get to the volume we'll see that there's so much change in the volume that it's not meaningful to compare volume over five-year periods.

In 1993, the top five companies — TransAmerica, RGA, Lincoln, ING and Life Re — had 60 percent of the market for new business. The next five companies had 22 percent. The next five had 11 percent. And the rest of them had a total of 7 percent. There were a total of 27 companies operating, some of them admittedly quite small, but some of the smallest companies have actually survived longer than some of the larger companies. In 1983, there were 29 companies in the Munich Survey, and in 1988 there were 31. Anybody who's been in the life reinsurance business for the last 20 years knows there's a lot of change, even though the numbers were relatively flat. In 1998, the top five companies were again Transamerica, RGA, ING, Lincoln and Swiss Re. They now have less market share, but you'll notice that instead of 27 companies, there are only 20. It's clear that there's a consolidation in companies going on and that buyers of reinsurance like me have fewer and fewer choices.

In 2003, the top five companies had a 75 percent market share, and the rest of the industry had a 25 percent market share. There are only 15 companies. When I prepared this slide show, we already knew that two of those companies were not trading in 2004. So, we were down to 13. And after the events of the last two weeks involving the transaction between Scottish Re and ING Re, the number of companies that will be taking on new business in 2005 will be 12. So, we've gone from 27 companies to 12. Why is that? Well, maybe they didn't grow fast enough to please their managers.

Let's look at the volume of new business. In 1993, the entire industry wrote $166 billion, with the top five companies writing $100 billion. By 1998, the total had increased to $678 billion, and the top two companies in 1998 together wrote more than $166 billion. So, there's been tremendous growth. According to the Munich Survey, Transamerica doubled its volume but dropped two places in the standings. RGA tripled its volume but dropped two places in the standings. ING Re quadrupled its new business but dropped one place in the standings. So there was tremendous growth. The top five moved around a little bit, but RGA, ING and Transamerica are always in the top five.

If we move forward to 2003, we now have the top five companies writing $796 billion, which is more than the entire industry did five years earlier. The total industry has gone from $166 billion in 1993 to $1.058 trillion of new business volume. Now, that's growth. Those of us who remember something about compound interest don't believe that a 20 percent annual growth rate is possible forever, but it's certainly been a wild ride. The volume has gone up tremendously. Growth has not been a problem, at least for the survivors. So, what's going on here?

My theory is that when I started in the life insurance business 30 years ago, life insurance and, by extension, life reinsurance, was about the widows and the orphans. Unfortunately, I would say that now it's about money, and the people who have money and are investing it are looking for a certain rate of return. Whoever is providing the capital is looking for a return. The company ranked 11th in 2003 wrote $17 billion. It would have been ranked third with that volume in 1993. No matter who your corporate parent is — an insurance company, a reinsurance company, a bank or just the provider of capital — if you don't make the corporate ROE target consistently, you're going to be declared a non-core business if you're a life reinsurer, and you're going to be sold down the river. That's kind of obvious, I think. It's gotten pretty brutal.

The other aspect is that the in-force volume is absolutely huge. My theory was that life reinsurance companies weren't making the double-digit ROE targets, but they were earning in the low or middle single digits. That theory was dealt a blow with the details of the acquisition of ING by Scottish Re. It now appears that perhaps some life reinsurers are making a negative single-digit ROE.

What are the effects of consolidation? There always used to be a price leader, otherwise known as the crazy man on the block. It's been a different reinsurer every year. It's impossible for one reinsurer to sustain that position, so the title has moved around. But there's always been someone that forced other reinsurers that wanted to grow to accept lower prices. Recently, however, since the demise of a certain offshore company, there appears to be a dearth of people willing to be the crazy man on the block as far as pricing goes. In fact, at least two large reinsurers, to my knowledge, have repriced all their business and are telling all the direct writers how much more we're going to be paying. That leads to the question whether the law of supply and demand is finally taking hold, but against the ceding companies. I think my earlier mathematical presentation suggested it was taking hold among the reinsurers.

I estimated two years ago that the total underwriting capacity of the life reinsurance community, excluding retrocessional, is about $75 million. Obviously, with the disappearance of ING and others, it's a lot less. The retrocessionaires have also lost capacity. Fifteen to 20 years ago, all three of the major retros were mutual companies that were capable of taking a fairly large amount of business. They've all demutualized, and what they can keep directly is a lot less, and some of them have lost their retro capacities. What happens to underwriting when the capacity for big cases has decreased? A life insurance company makes it or breaks it pretty much on how the underwriters do the job on the band that includes the $500,000- to $1,250,000-size amounts. But senior management only looks at the large numbers, and so when their total capacity decreases, the big-case producers are unhappy. Senior management becomes unhappy, and that makes the underwriters unhappy.

Another effect of consolidation is that the reinsurers are coming around to the point of view that maybe it's appropriate to do a few more administrative and underwriting audits. Some reinsurers are asking for the underwriting workup of death claims that don't look quite right. If they conclude that the policy was poorly underwritten, they're saying, "Our treaty with you says that we are reinsuring business that you fully underwrite according to normal standards, and obviously you didn't do that here." Consequently, they claim that they are not on the risk.

That leads to the potential issues that result from consolidation. As far as pricing is concerned, the big companies went to first dollar quota share sometime in the 1990s. I think the company I used to work for was the last large company to go to first dollar quota share because the deal looked good. Will they go back to excess of retention?

There is concern about underwriting issues. About 10 years ago, the entire life insurance industry went through something called restructuring, reengineering, downsizing, streamlining, upgrading or improving. Part of that trend was to get rid of the underwriters who were in their 50s and had been working for 30 years with a 3 percent annual compound growth rate in their salaries and replace them with young underwriters who were about 27 or 30. That has led to two things. The value of an underwriter with 30 years of experience is that he has a nose for speculation. He can sniff out anti-selection. In addition, by that time he's developed the backbone to say no to a big producer. A 27-year-old guy who's getting beat up by the agent and the agency manager with the full support of the home office agency structure has a hard time standing up to that pressure. Consequently, we're seeing more disputes. We're also seeing reinsurers concerned about classes of business, including viatical. I got a letter several months ago from a prominent reinsurer. It was nicely written by their lawyers, but essentially said we don't like this class of business, we don't want you putting this into our automatic pool, and if we catch you doing it, we're not going to take the risk. The only problem was I didn't know what they were talking about. So, I asked somebody on the product side of John Hancock what this class of business is. They said that Hancock doesn't write those kinds of policies, so don't worry about it. But someone must be writing it, because this was obviously a form letter.

Reinsurers appear to be moving to proactive stances in ceding company underwriting practices and procedures they do not like. I have worked 31 years for large direct writers, and I feel I can comfortably say that large life insurance companies do not like to be told what to do. In particular, they don't like anyone telling them how they should be underwriting. It'll be interesting to see what happens here. This is a developing story. For reporting issues, how many errors and omission situations is a reinsurer going to tolerate before it reacts? And how are the ceding companies going to respond to that reaction?

For more than 10 years, large ceding companies have been in the driver's seat as reinsurers have competed, sometimes carelessly, for their business. How are they going to react when or if they figure out that they're not in the driver's seat anymore? That brings us to the last part, which is actually the answer to the question, “How are large direct writers reacting to what's going on in the reinsurance industry?” There are three responses that I have seen.

First, many large companies talk a lot about being proactive, and I've observed that some actually are proactive, but most are not. I asked a well-known reinsurance executive of a large direct writer how his company was responding to the consolidation of the industry. And this is his verbatim response: "We're going to wait and see." That is the typical response of large companies.

Then the event happens. The letter comes asking for more net premium: "Effective 91 days from now, the net premium we're getting from you under this treaty is going to go up by X percent. If you can't see your way to doing that, consider this letter your 90-day notice." Or, as I said, a claim gets rejected for reimbursement. So what happens? Another very common response: denial and the SARAH syndrome, S A R A H. Shock is the first stage of denial. What? They want what? Then there's the second stage. How dare he! Who does he think he is? Anger. And then rejection. This example is a hearsay quote, so I'm not sure it's accurate, but it's priceless. When confronted with the letter from the reinsurer saying they're decreasing allowances on co-insured term business, an actuary responded, "That is totally unacceptable. We can't possibly reprice our term portfolio in 90 days." But whose signature is on the reinsurance treaty that provides for 90-day notice? Then there's the stage of acceptance. You might try to do the best you can, maybe call the reinsurer and work out some kind of a deal. The last stage, traditionally, is hope. I have to tell you I have not seen that stage yet.

I suggest a third response that is more rational and, therefore, more actuarial. My former company did this. You have to take the man-from-Mars approach. The man from Mars comes down. He doesn't know anything about actuarial science. He doesn't know anything about calculating premiums. He doesn't know anything about reserves. You tell him what your business is, and he sits there and looks dumb for a minute, then he says, "Why are you doing this reinsurance stuff? What are you getting out of it?" This is tough to do, but large companies need to reexamine their value proposition. Why are we doing this? Prices are going to be going up. They're going to be looking over our shoulders and questioning our underwriting. They're going to be auditing how we actually administer this business. Why are we doing this?

By the way, have any of the actuaries ever actually calculated the cost of administering some of these weird reinsurance arrangements they've entered into and factored that into the pricing? When The Equitable went first dollar quota share the first time, the actuaries put $50,000 a year into their pricing for reinsurance administration. I thought that was a very nice gesture, but I never actually saw the

$50,000 coming through my expense budget. It's too soon to tell where this is going, too soon to detect a trend.

MR. HALL: Thank you very much, Bill. Let's jump into the smaller company perspective. There definitely is a trend emerging in reinsurance consolidation of companies leaving the field. I want to give you a little perspective how this consolidation affects small to mid-size companies. Let me start with the types of roles a reinsurer would play at a company of that size.

During my career at smaller companies, it's been clear to me that the reinsurance industry provides a lot of value along the way. Smaller companies tend to lack some substantial resources and don't always have the luxury of the large amounts of data or experience to make the most educated decisions. But reinsurers can certainly allow us to enter some new and evolving product lines. At Country Insurance and Financial Services, we joke at times that for many, many years we sold the “Robert Redford” term package. It was the good old standby, a 10-year renewable and convertible term product. Maybe it had its day in the 1970s and 1980s and into the early 1990s, but it really hadn't changed. It didn't keep up with the lowering of premium rates that was going on in the competitive term industry and hadn't been switched over to a level term followed by an ART schedule.

With the assistance of a reinsurer, we were able to replace our “Robert Redbird” term package with the new “Tom Cruise” term package, a set of products that had a 10-, 20-, and then eventually a 30-year level term series, followed by that ART scale to age 95. I saw a movie recently where Tom Cruise had gray hair and was starting to look pretty old. Maybe we should rethink that name and make it the “Toby McGuire” term package or something to bring it into the 21st century.

With the help of some data and some pricing expertise from a reinsurer, we got this new product out to our field force. We have had excellent and continuing success with it to the point where sales have grown consistently, 10 percent to 15 percent per year for several years in a row.

Reinsurers also help small or mid-size companies provide a much wider array of policy benefits. There are always the stories where reinsurers are maybe helping them price waiver of premium or accidental death benefits in exchange for the reinsurance of that risk. At Country, we certainly provide our own disability income and long-term-care products, but we wouldn't be able to do that without the assistance and support of some pretty big reinsurers.

Reinsurers also enable us to take an appropriate amount of risk in exchange for some perhaps outlandish, but hopefully corresponding, amount of reward through allowances and net premiums. On certain lines of business, we certainly can't handle the claims volatility, or perhaps the contingencies that are involved in those types of products are only beginning to emerge. It might not be clear where those lines of business are headed. We need to be able to share that risk instead of keeping it ourselves.

In addition to the actuarial reasons reinsurers have been helpful to small companies, there certainly are marketing reasons why these relationships are important. Reinsurers can allow us to give the appearance of size to our agents and clients. We can show them that we're playing a similar game to some of the big carriers. We can provide a broader array of insurance and financial services products by using a reinsurer's help. In some cases, we also want to promote that we are unique. Small companies often get into some niche lines of business. Maybe there is a smaller insurance company that wants to get into a niche line and distribute it, and a partnership forms with a reinsurer's help. The things that reinsurers enable small companies to do over time range from the actuarial, technical side to the branding and marketing side. When the availability of this reinsurance seems to be dwindling, it really does put a scare into smaller companies.

The use of reinsurance has increased a lot in the last decade. The use of reinsurance in the life insurance industry grew from 15 percent of new life insurance reinsured in 1993 to more than 60 percent just 10 years later. The large-volume term writers have mainly driven that statistic. Perhaps these are the ones who would fall into a brokerage, managing general agency (MGA), “CompuLife Top

10" type of company, but small and mid-size companies have followed suit in using a lot of reinsurance as well. At Country, our relationships with reinsurers enabled us to present ourselves as a reasonably priced term provider. Were we going to be one of the low-cost leaders? Certainly not. Were we going to change our strategy from emphasizing and providing more permanent life insurance policies? No. We wanted to be a permanent provider, but also knew that we could get there by offering more competitive term products. Being able to compete with these CompuLife-type companies, plus leveraging off our multiline distribution and our brand, certainly helped us capitalize with some large increases to our production during the past five years.

Breaking the addiction to reinsurance is often hardest for companies of a smaller or medium size. Once small companies grow their production, it is a hard thing to give up. You get addicted to that growth, and A.M. Best wants to see you continue that growth. If it's happening in a company that doesn't write a wide variety of products, it might be hard to forgo the reinsurance and give up that growing production. If two companies — for example, one with a $100,000 per-life retention and another with a multimillion dollar retention — are faced with a main reinsurer leaving, getting out of the business or terminating them for new business, I think it's clear that the one with the $100,000 per-life retention would have a much harder time adjusting.

Small companies in general would also be less tolerant in waiting for new reinsurers to enter the picture or for the reinsurance industry to change over. In addition, can a small or mid-size company even generate enough volume to attract new reinsurers? The perception is out there that some reinsurers are beginning to focus on their biggest clients, and I can see the logic in that. They certainly want to keep those clients who consistently produce a lot of volume, but it leaves some fairly well established relationships with small and mid-size carriers to fade a little bit. As the reinsurance industry consolidates, there is the fear that if a primary reinsurer of a small to mid-size company disappears, the direct writing company could be out of that line of business before it can try to find an acceptable replacement.

In addition, reinsurers for smaller companies are a valuable source of underwriting knowledge for the direct writers. The number of cases we see at Country is certainly small in comparison to what a large writer or reinsurer would see. Consequently, when a strange impairment or an unusual occupation comes up, it might just be that we don't have the breadth of knowledge to know how to classify that particular risk or how to relate it to other impairments that might be on the case. The training and exposure to underwriting manuals and the discussions that often occur in the facultative underwriting process between the direct writer and the reinsurer create a lot of value to a smaller company.

I'd like to share a few comments on how small companies end up making reinsurance decisions. It might not be radically different from big companies, but I want to emphasize some of these points and then give you some information from a recent industry survey that a reinsurer provided to its clients and see if we can draw some conclusions from that. First, it comes down to the fact that small companies know they need some help or support. There are clearly people who can provide that support, who can do it with the greatest amount of value. Unfortunately, value isn't always an amount that you can strictly calculate.

The actuaries in the company would recommend finding whoever provides the most robust allowances. That's where your value is. But it's not always so simple a calculation. It's clear that there's certainly a value in underwriting, training and facultative service that reinsurers can provide. There's value in innovation discussions with reinsurers. They can suggest getting a new idea that someone else is trying into your distribution. There's also value in having people out there with their fingers on the pulse of the industry working on your behalf to know what's going on in a fast-changing industry. We don't always have the benefit of knowing what's going on at all companies at all times, and reinsurers can often fill that void for us. They might be able to tell us what's going on with conversion features or what's going on with waiver of premium. People are starting to offer this “own-occupation period” or this “to-age-whatever” on their waiver of premiums, and reinsurers can be a big help with that type of feedback.

The value in a long-term relationship is pretty hard to measure, but it is something that we constantly talk about in small to mid-size companies. We have members of a board of directors at Country who are what you might call the handshake promise type of people. It's the way they learned their farming business. They grew up with their buyers and suppliers and became very accustomed to having a handshake type of promise. Every year, we're required to provide our board of directors with a reinsurance report. It shows which companies we're working with, how much business we're doing, how much we're ceding to each of those companies, what their ratings are. All those types of statistics fall into that report.

A few times along the way, we've been able to describe to them these nice, evolving relationships that we have built with reinsurers, and we've been able to give them that handshake promise feeling. Unfortunately, we've also had to go back to them a couple of times and say, "Remember when we were describing that handshake feeling last year? Well, so-and-so was acquired, or so-and-so terminated us for new business, or they've been downgraded." Sometimes it can become a discussion about whom we're comfortable doing business with. I'd love it if we never had to have that conversation again, but clearly, with the consolidation that's going on, we might have to have that conversation several more times.

The reinsurance decision made by a smaller company is further magnified by the results of a recent survey that a reinsurance company did of their client base. It echoes some of this value idea. One of their clients said, "I'm looking for cooperation from that reinsurer. I'm looking for good faith in the context of a long-term partnership. I'm looking for capacity to place the larger risks, and I'm looking for service." Another client added, "I think you can always ask for the moon. Obviously, some of the things they [the reinsurers] can't provide because they consider them valuable to their business or confidential. Something we'd like to see is the types of products they're seeing most often come into their shop for quoting. Are they're seeing term versus whole life? Are they seeing rates being raised or lowered?" It shows another example of how reinsurers help companies of smaller size keep their fingers on the pulse of a changing market.

In the whole survey, there were five main points that came shining through. They want a reinsurance partner who understands the market. They want someone who's reliable. That reliability extended from being reliable when you provide a timeframe for a quote to being reliable when it came time to recover on claims. They want someone who offers capacity and who is flexible. I don't know if those first four are consistent with or mutually exclusive of the last one: providing a competitive price. Maybe they don't have to be the price leader, but can they at least provide a competitive price? What companies have to do, maybe both small and large, is determine that price and weigh it against the things of value that a reinsurer might provide.

There are some comments and observations that people from small companies have been telling me during the last couple years, specifically about the evolution of the term direct writer life insurance market. A.M. Best does an annual survey of the top 50 direct term writers. They might send it out to hundreds of companies, but they certainly publish it in their *Best Week.* As you might guess, the top 25 or so on that list fall into two categories.

These are companies that focus on term insurance. They're competitive. They write through brokerages. They sell a lot of business that way, including large-size policies. Then there are a whole bunch of companies out there that, if they're not in that competitive market, they're just kind of big. They sell a lot of insurance because they have a lot of agents or a lot of distribution. Some of those companies that are in the top 20 or 25 of that list weren't even on the list if you go back 10 years. That happens because companies have strategic changes in the way they offer all their product lines. As fast as our industry changes, it'll be pretty hard to predict what that list looks like even 10 years from now as things consolidate or people change their business plans.

The other side of that is that it's interesting to note who falls in spots 26 through 50 on that list. There's not a lot of volume difference between who finishes 20th and who finishes 40th or 45th. There are a lot of small to mid-size companies that end up making the tail end of that list. These are often small or mid-size companies that have done a very good job building their brand or successfully selling through affinity groups. As these companies grow production, the question is should there be reinsurers looking to them as potential clients? It's a pretty hard call. Reinsurers might end up focusing solely on their larger clients. If they do that, are they missing the chance of letting a relationship incubate so that something great might hatch five, 10 or 15 years down the road? I'm not sure I know the answer to that, but is there a tolerance for letting some of those relationships incubate, so as small companies grow to be big companies the reinsurers and the direct writer can both flourish?

There are several other items on the wish list from a smaller company's point of view. Some of these probably apply to a large company's point of view. We have a strong commitment to disability income and long-term care at Country. If you thought the life reinsurance market was small, welcome to the individual health reinsurance market. If there are companies out there willing to enter that market, that would be encouraging because there are good choices, but they're limited. You'd like to see more competition evolve as those lines of business grow. I've also heard a lot of people comment recently on simplified and guaranteed issue products. From a small company perspective, they might be able to offer these products without a huge investment in underwriting and lab costs and doing blood work. It might be attractive for a smaller company to get into that line. They tend to be smaller face amount products, so they can handle that risk more easily, but they might need expertise about the expectation of mortality and claims. Those types of partnerships might be beneficial.

Finally, there's probably a general need for more information on longevity risk on payout annuities. Companies might be willing to go into that as long as there's some asset accumulation risk involved as well. It's clear that everyone wants to get into that market as best as they can, and if reinsurers can provide mortality on payout annuities, then some partnerships might evolve.

I hope that I've been able to give a bit of perspective from a small to mid-size company's point of view. There are a lot of open questions, and I certainly don't know how they'll all be answered. Time will tell. Now I will turn it over to Paul Schuster from RGA.

MR. PAUL A. SCHUSTER: I have spent more than 25 years in the life reinsurance business. I've never seen a market like this in those 25 years. I made that comment to a friend who is perhaps a little older than I am, and he looked at me and said, "Paul, I haven't seen a market like this in more than 40 years." I hope I'll be able to provide some insights from my point of view, perhaps not even representing RGA's point of view. I certainly am not going to stand up here and be presumptuous enough to say I'm speaking for the life reinsurance industry. Some of this, though, might ring true for others.

The reality is it's not just consolidation, it's a change in circumstances. The change in circumstances is due to poor earnings, as evidenced by an offshore company and access to capital. Today's products — XXX term portfolios and others — require a great deal of capital in the life reinsurance market. Many reinsurers are composites, certainly the Europeans are. Composite in my definition means they're quite active with health, they're active with property casualty reinsurance. A cycle has gone on. The years 2001, 2002 and 2003 weren't particularly nice to the property casualty reinsurers. That's had an impact. Some reinsurers have had to choose a strategic direction. They only have so much capital. They want to support their direct lines of business. So they have decided to put their reinsurance operations up for sale.

The attractiveness of our market has diminished. For example, public statements by GE show that while the returns were certainly positive among life reinsurers, they wanted to put their money into jet engines or elevators or whatever it might be. The returns within their employer's reinsurance unit simply weren't attractive enough. The operative word is "enough." Of course, this is not just a U.S. issue. There are different accounting standards throughout the world. Many companies — again, particularly the Europeans — have the ability to invest more in equities on their balance sheets. Once again, in 2001, 2002 and 2003, we've seen some real hits to worldwide equity markets, and capital again has become an issue.

I'm going to ask you to consider some questions. First, how healthy is the life business? How important is it to have a healthy life reinsurance market in the United States? Related to that, how many healthy, well-rated life reinsurers do you think you need to run your business properly? Three quick measures of the health of a company might be growth in terms of the top line, growth in the bottom line, and what's happened to a company's ratings. Another question to consider is why aren't you asking the reinsurers more on these issues? At my company, we don't have people asking us these questions. I would urge you to try to get below the ratings and some of the statutory stuff that's out there and ask some questions. If it's important to you and the health of the people you're doing business with, you have to do better due diligence.

We have one client who's got provisions in its treaties to come in and sit down with our chief financial officer (CFO) or our CEO and ask some questions of how we're really doing. Premium growth has been fine, 20 percent plus compounded growth rates, but how have earnings been? I heard an equity analyst speaking about long-term care, and he said if this is such a great business, how come everybody's getting out of it? Likewise, what do you think is driving consolidation?

There are only two of us that are exclusively life reinsurers focused on the U.S. with public GAAP statements: Scottish Re and RGA. Looking at statutory numbers is important, but I'm not sure that's the best way to measure the health of a reinsurer. A negative ceding commission on the acquisition of a company might give you a hint that perhaps the business is not so sound. Clearly, another indicator is ratings. Just about 24 months ago, there were four AAA-rated reinsurers active in the market. Today there is one. Again, that's an indication that maybe things aren't so great.

The life reinsurance market in the United States, for the last couple of years, overall production tends to be flat. The use of reinsurance has been pretty flat as well. Going forward, the growth in the business will probably come from stealing market share from one another rather than actual growth of the business.

Beyond the issue of how healthy the business is, I would spend a lot of time thinking about how healthy our relationships are. I'm not sure this business can be conducted on a legal contract basis. I shudder to think what it's going to look like if we get to that point. While there have probably been a number of people who made light of this issue of a gentleman's agreement, fundamentally that has to be the basis of this business, and it addresses the issue of our relationships. There is a lot of stress in the market about this for obvious reasons. From my point of view, this issue is the one that concerns me the most today.

Many of you probably get contacted by Flaspoehler Research. Certainly, if you're a reinsurer, you contribute money to polling, and most of you folks with direct writers are probably on the list to be called. Satisfaction has been down. There are four classifications: very satisfied, somewhat satisfied, and then the final two are almost nonexistent. You can see some trends, the biggest one being a significant drop in what's happened to the top rating, "very satisfied with the life reinsurers that you use." Polling will start again late in the first quarter. When the numbers come out addressing this issue of the quality of the relationships, everyone should be concerned about that.

What are the issues that we're dealing with? I see three primary ones: underwriting audits, treaty language and administration. Please think about the comments I've made about relationships as we go through these. A lot of this, unfortunately, has put more stress on this whole issue.

For us, underwriting audits have become a necessity. We do them for two reasons: cost and internal risk management. Our board of directors gets a quarterly report on the controls that are in place. Sarbanes-Oxley has increased the importance of all this. Where costs are concerned, our best sources of information are the chief underwriters that we call on. When you used to go in for a visit you'd ask, "What's new? You're developing a new product. How are things going?" Today, the first question might very well be, "Who's giving you the most trouble?" People talk, and that gets on a list. If we're working with someone, we're going to look. The stresses in the relationship are becoming increasingly complex. We have to go in and look at multiple preferred classes and at table-cutting programs. We have to go in and look at high substandards and see what's happening and what might be declines, Table 8s or Table 4s.

Why have the reinsurers become the underwriting cops of the business right now? At an underwriting meeting I attended, Bill Moore, a good friend of mine from Swiss Re, summarized some results from three years of underwriting audits. They looked at 10,000 cases in their audits. Swiss Re had only found seven errors where the underwriting was in error. I agree with Bill, but I picked three examples to make my point here. These are all 90/10-quota shares, and these were all automatic. Keep in mind that these are 2001-2002 issue dates. The first one, a male, 77 years old, had a million-dollar face amount. He had prostate cancer and was treated with radiation. In 1995, the cancer returned and was treated with hormones. That's a bad sign. I had to work with my medical directors and my underwriters. This was issued. The client's own manual said it was a decline because of the hormone treatment for prostate cancer. We found it on an audit. We asked the question, and they agreed with us. It should have been a decline, as it was issued.

In another example, a 71-year-old man submitted an application for $5 million. In 1995, this gentleman had a heart attack. It revealed that there was damage to three major vessels. When they did the sound test on the heart, it showed that one of the major valves was leaking. In addition, during that test they found occlusion in the carotid arteries. In the workup, the agent needed standard. This client had an automatic substandard program. They rated it and issued it as standard. We said no way. The workup paper showed that the rating came from just looking at the three major vessels. There were absolutely no comments on the valve leakage or the emerging hardening in both carotid arteries.

In the last example, a 33-year-old applied for $5 million. In 1987, when the gentleman was probably in his teens or early 20s, he was treated for alcohol abuse. There were several DWIs. His application admitted that he is still drinking. In this case, their manual said that this should have been a decline, but it was issued standard. On the audit, we asked the company why they did this. They agreed that it should have been a decline. By the way, this one had elevated liver enzymes, and they didn't order another driving record exam. It was simply issued for $5 million. This is 90/10-quota share. So I would say when we're finding stuff like this, you can't ignore it. It's not pervasive in every audit we do, but when you're finding this you have an obligation to shareholders to address it.

To talk a little about how RGA has reacted, we're not trying to tell anybody how to underwrite. We're asking you to define and document what standards you're going to use. Let's talk about what would be acceptable exceptions to those standards. We're all working together to try to come up with a common format for audits. We know these underwriting audits are disruptive. From our point of view, we're increasing the number and the depth. We have to look at exceptions to preferred, exceptions to these table shaves, and some of the higher substandard ones. That has us led to increase our staff dramatically. Let's make sure we understand the standards you want to establish, and then we're going to hold you to it, and I think that's fair. I don't think those three examples that I showed are fair.

Many treaty issues have emerged just in the last 12 to 18 months. Once again, it puts stress on the relationships. None of this is fun from our point of view, and I suspect it's not fun from a ceding company's point of view. There are numerous requests for special termination clauses. What happens if ratings go down? What happens if you, the reinsurer, are acquired? We understand what's driving that request. I hope you understand that, from our point of view, these sorts of things restrict our flexibility dramatically just when we might need it the most. There's going to be pushback on this subject. Some of these are not easy to deal with.

As far as jumbo limits are concerned, the capacity's down. I think it's going to go lower. Conditional receipt clarity was a hot topic 15 years ago. Any of these issues could be coming back. We are trying to work on our language so it's absolutely clear which definitions are being used and who's responsible for what. Nobody wants to argue over a claim that emerges under conditional receipts. The clarity of recapture language is also an issue. The standard recapture language essentially says that if you, the ceding company, have held your full retention, after 10 years you can recapture up to your new retention. But what does that mean when there's a 90/10 quota share? You can interpret it a number of ways. We're not picking fights over this, but let's make sure it's clear so that everybody understands the privileges at the end of the recapture period because the standard language doesn't work.

Just about every treaty that I am familiar with has this simple phrase in it: "The risk is underwritten according to the ceding company's standard guidelines." That's a condition precedent for placement of automatic business. This language further illustrates my three examples and what happens with a $5 million claim. The underwriting papers clearly show that what they knew was not consistent with their standards, but declines ended up being issued as standards. I was talking about this at the annual Life Insurance Marketing and Research Association meeting in New York. I made the statement that I was unaware at that time of any reinsurer using this language to deny a claim. After my presentation, a couple of people came up to me to say they didn't think I should make that statement anymore, because arbitration is on the increase. It used to be there weren't arbitrations in the life business, just in health and property and casualty (P&C). But I think there are more coming, which unfortunately creates more stress in the relationship.

Some people think "errors and omissions" refers to blown underwriting, but it actually is administration. There will be more coming on this issue. The life reinsurers won’t necessarily direct it; things are happening at the retrocessional level that will flow through errors and omissions. There's going to be an enhanced understanding of this arcane and perhaps little understood provision in most treaties. The next issue of extra-contractual obligations will be claim audits. They're already being done. All the extra-contractual obligations are going to become parts of the negotiation of treaties more than they have been.

My personal pet peeve about treaties is why on earth can't we get these documents signed in a timely fashion? Some of these go on way too long, and I don't know where the problem lies. It's certainly equally shared. We have some that are more than five years old. We try to get them signed. Every reinsurance visit, we show up with a fresh document saying, "I dropped this off four months ago. Have you made any progress? If not, here's another copy. Let's get it moving through your legal area." Some of these issues are emerging and we need signed documents. It protects everybody.

Timeliness issues in administration will also impact the relationship. I believe this is being driven by the retrocessionaires. You should expect that to be some discussions about the timeliness and accuracy of your reporting. For people who are doing a good job, this isn't a big deal. For people who aren't doing such a good job, there are potentially some surprises that will emerge.

Pricing and capacity are currently hot buttons. A.M. Best reported that consolidation is driving a capacity crunch. In the same article, they went on to say that individual life capacity is down. I doubt that surprises anyone. My sense is that the trend continues. Standard & Poor's talks about shrinking competition and improving prospects, particularly about the hardening of rates in the marketplace. Conning & Co. recently issued a report that I'd urge you to look at. There are a number of others out there, all essentially saying the same thing.

Going forward, there'll be further changes in circumstances. I'm not going to speculate who or what will change, but I believe it's going to happen. There are going to be some new entrants. Our CEO told me he's aware of some specialty health reinsurers looking for a very narrow niche and attracting capital that potentially has somewhat higher returns than the broad U.S. life reinsurance marketplace. I think growth is going to lessen. The dramatic growth of the past 10 years is not going to continue. We're going to end up in a business where the reinsurers who are still standing will be fighting for market share among us or taking up the market share of the folks who have dropped out.

I hope stabilization in our relationships will emerge very soon. Audits are going to become more routine. We'll be working together. Pricing at some point has got to stabilize so there are no more surprises. Capacity, like a pendulum, is currently moving to a part where we see less capacity. That will attract more capital and more capacity. I don't know how long that will take, but I believe some individual life capacity will emerge and might draw a higher price. But ultimately the pendulum will start moving back in the other direction. This is the area of most concern to me. The relationships are already in bad shape, and I'd like to see them improve. I can't imagine a world where we are working together with a legal contract as compared to a reinsurance treaty. We have to be able to trust one another that some of this underwriting isn't going on. You need to be assured that we're in good shape. I see real work needed on the parts of both sides.

As I was preparing this, I found an absolutely terrific article written by Paul Rutledge of Transamerica. He's much more eloquent than I could be in summarizing the view of the relationship between ceding company and reinsurer and what the future holds. It touches on many of the topics I've raised here. He says, "First and foremost, reinsurers seek to do business with retail companies that value partnership and a healthy reinsurance community." It's in everybody's interest that the industry is healthy. Whether you're large, medium or small, if you follow the guidelines in his article, you're going to find a reinsurer who's interested and is going to treat you fairly in terms of pricing and capacity.

This is the end of his article, which I like a lot. "Ultimately, retail companies play a large role in determining the health of the life reinsurance industry. Those who partner with value-added reinsurers can leverage their resources to uncover innovative solutions necessitated by regulations, accounting practices and risk management needs. Those who view reinsurers as a commodity and an unlimited source of capital may find less capacity at higher rates." I'd urge you to read the whole short article. I called Paul to ask him if I could use this and told him what I was doing, and he graciously said to feel free. It expressed my point of view as well.

MR. HALL: We have some time for questions.

MR. JOE RAFSON: My question is less on capacity than exposure. We don't like to have too much of our capital at risk on the asset side with any single issuer. We also have limits on our reinsurers and how much we like to be exposed in terms of total reserves ceded to any given reinsurer. As the consolidation occurs, we find more and more our exposure suddenly doubling when two companies combine, and we're hitting a lot of our limits and having to reinvestigate our limits. How are companies dealing with this issue?

MR. BRIGGS: If you take any one of the 10 largest life insurers in the United States, it's likely that they will be ceding a lot of business to a group of reinsurers. According to the statistics, 60 percent of new business is reinsured, and five reinsurers control 80 percent of new business. So, if you are one of the top 10 companies, please tell me why you are reinsuring 80 percent of your business to a company, no matter how highly rated it is? Why are you ceding business to an entity that is a fraction of a fraction of your size? I don't have an answer. It makes no sense to the man from Mars.

MR. SCHUSTER: I'd like to add to that response. I don't know what you really can do. We've seen some companies ask to put some protective features within the treaties that deal with collateralization of reserves and provisions to allow recapture, perhaps even some language that talks about assignment. There's no easy way of dealing with it. Some of what he said is true, and I suspect it will continue. In some ways, companies can withhold judgment on acquisitions. I don't recommend that because it complicates everybody's life.

MR. HALL: We had a big relationship with one reinsurer for a long time on our reinsurance pool, and we were fine with that, as we were writing, relatively speaking, small volumes compared to big direct term writers. As that increased and the situations changed, we had to take a broader look at that. There is the issue of credit risk and how much do you want to have in one place? In our circumstances, as we started to write more, we probably needed some more facultative outlets. It was a case where we had a facultative outlet but wanted to make sure we were getting very good facultative outlets from a broad set of reinsurers rather than just a great outlet with one reinsurer.

MR. RONALD COLLIGAN: Bill, in your presentation you alluded to something where I think we've only seen the tip of the iceberg, and that's producer reaction to some of the changes that are happening. In effect, for the last 10 years we've heard reinsurers say, "We know mortality better than you do. Co-insure 90 percent of your business. We're going to give you low rates because we know that mortality is going to continue to go down." For 20 years we've heard reinsurers say, "We know underwriting better than you do. So, send us all your tough cases, and we're going to make better facultative offers than your underwriters are willing to make." We've created, particularly in the independent distribution system, an expectation of product that's going to continue to be there because it's been motivated by reinsurance price. On the underwriting side, in many ways we've created facultative reinsurance because some reinsurers went to agents directly to tell them not to believe the primary company underwriter until he's shopped the case. So, we've taken away some of the primary underwriter's credibility. We see something created in the field that's partially of the reinsurer's making that took 10 to 15 years to develop, and yet we see the reinsurance community almost trying to change it overnight. I'd like to ask the panel if there is any way for reinsurers to work with primary companies on helping them lessen the impact in the field of some of the changes that are taking place.

MR. SCHUSTER: You're probably correct about the issue of the underlying mortality assumptions. The hardening in the pricing reflects that long-term view. I would say, though, the hardening in pricing is not necessarily just mortality-based. This isn't YRT anymore. There are all sorts of capital charges that get folded into the coinsurance of the redundant reserves or, from your point of view, not redundant reserves of XXX. In terms of underwriting issues, I'm not sure any reinsurer really wants to be in touch directly with the producers. That's just not something we're trained to deal with; it hasn't been part of our culture. We deal with direct writers. In some ways, the large producers on these large cases are part of the problem, and further changes are coming.

MR. HALL: I'll add on to that. We don't have two or three big MGAs that we work with. We've got a broad, multiline distribution force of exclusive agents. The responsibility to our agents comes from the direct writer — ourselves. If we take too big of a risk, then I think we have some explaining to do. Maybe we should have been aware of that risk and not gone down that road, but I'm not sure we would be interested in bringing our reinsurers along to our sales congress have them explain to our agents why things have changed. That's probably the direct writer's responsibility.

MR. ROBERT BEUERLEIN: I sense from the discussion, and I agree, that there's going to continue to be pressure on the earnings of reinsurers. Paul mentioned several things — table-shaving programs, policies going to the reinsurers that could end up in the life settlement market as a zero lapse situation creating problems for reinsurers, options within reinsurance contracts, recapture provisions that allow direct writing companies to potentially cherry-pick the good business, bring it back and leave poor business with the reinsurers, and the trend of moving away from first dollar quota share to excess, thus lowering the amount of business going to the reinsurers. All these things seem to be going forward with a perceived guaranteed cost from the reinsurers to cover all these things. They're in this from the beginning. First of all, I'd like to say that we, as actuaries, owe it to our companies to get behind what Bill was talking about in underwriting practices. We have to look at lab results, computerize those and compare them to underwriting, and investigate how we end up coming up with our underwriting and see what was classified in the underwriting. We, as actuaries, can play a huge role in all this.

But let's go back to the reinsurers. We have a perceived guaranteed cost product, and I know there are some nonguarantees involved in it. In the future can we expect more nonguaranteed cost reinsurance products, specifically experience rated types? Is that where it's going or should we be expecting increases in rates on in-force policies within in-force treaties? How can the reinsurers shore up this perceived pressure on earnings?

MR. HALL: That idea definitely exists on some individual health treaties. Certainly in our long-term-care treaties, there are experience type provisions that if loss ratios are consistently behind, then we've got the right to change our allowances. Do any of the rest of the panelists think that would translate over to mortality risk transfer?

MR. SCHUSTER: I haven't seen a trend to date. Coinsurance rates are typically guaranteed for the lifetime, though pricing on new business can change. YRT transactions are different. Although arbitrations do not end up being public, there are rumors of one that was settled last year on this issue. It was a function of the specific language in the document at hand, which gave the reinsurer the right to raise rates on in-force business. They exercised it and won. YRT rates are a little harder to guarantee because of the potential for deficiency reserve issues. Consequently, most YRT arrangements do not have guaranteed rates. Protection on this issue of raising in-force rates varies from treaty to treaty. It'll change going forward as well, as it becomes a more timely issue. In terms of experience refunds on conventional business, we have seen no trend that way. In terms of requests on quotes, I don't think we've even had to address it, so there's no trend on that right now either.

MR. GORDON GIBBINS: I have two comments and a question. I have seen the experience rating refund feature a couple of times in recent visits. I think any company, especially if it's on an excess basis now, that believes in its own mortality and is not getting credit for it with the new reinsurance arrangements, is going to turn to experience rating refund as a way to put its money where its mouth is, so to speak. Secondly, working for a company that's expanded into the large company market, I can also respond to the first question from the floor. A number of the quotes I've seen in the last six months have been concentration-of-risk questions from companies trying to diversify using new reinsurers. You probably have to reconsider the other aspect of your due diligence requirements in order to be a little more flexible about who you use.

The real question I had was about those three audit cases. I've seen many underwriting audits with problems like that in the past. What did you do with those three cases? Obviously, they hadn't been paid out yet, so you had the chance either to decide you were going to honor those and presumably anything like that or give them back to the ceding company.

MR. SCHUSTER: Discussions remain underway on the treatment. We have to find a way to address the issue that an underwriting audit is simply a sample, and what we find might not be, and probably is not, the full extent of the potential problems in an existing book of business. Mercifully, there are so few of these overall that we work through each one individually. From RGA's point of view on that subject, in some cases we signed settlement agreements that there will be no broader disclosure.