Negotiating the Reinsurance Curves:

A Panel Discussion Part 1

The October/November 2005 and the December/January 2006 editions of *The Actuary* contained articles on the state of reinsurance from the reinsurers' perspective. Now it's time to hear from the ceding companies.

ARRANGED AND MODERATED BY GAETANO GERETTO

Gaetano: Welcome to this panel discussion on the cession of insurance. We appreciate the time that you have all set aside for this morning's discussion and we hope that you find it as rewarding and enjoyable as the readers will. I would like everyone just to take a minute to introduce yourself, explain your current role, outline your experience in the reinsurance world and what you would like to get from today's discussion. Mary, why don't you get us started.

MARY: I am Mary Bahna-Nolan. I am the chief actuary for North American Company for Life and Health, otherwise known as NACOLAH. I am responsible for all of the life products issued with respect to NACOLAH, which includes all the product concepts, design, competition, pricing, product management, in force block management, as well as all of the reinsurance including reinsurance negotiation of contracts and administration. I have been involved with reinsurance on the ceded side since I have been with North American, which has been a little over eight years, and prior to that I worked in the insurance industry for a full service reinsurer for about five years.

Gaetano: What would you like to get from today's discussion, Mary?

MARY: From today's discussion, I want to understand better what is happening within the reinsurance area, to speak with my counterparts and understand the issues that they are facing and hopefully find some ideas of better ways to manage reinsurance going forward.

Gaetano: Okay, great. Jimmy?

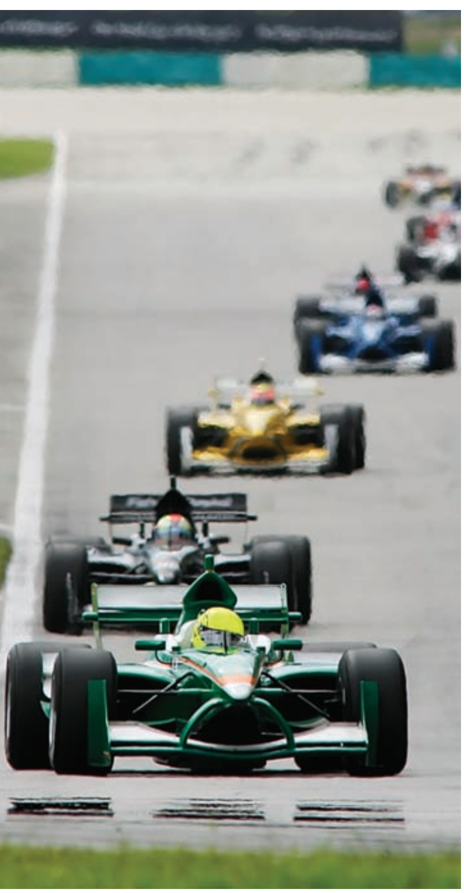
JIMMY: I am the chief actuary for Genworth Financial's life insurance business. I now deal solely with life insurance, but all aspects of it. I have been the life reinsurance buyer for Genworth and some of the companies that now form Genworth for many, many years. I have served on a number of reinsurance advisory councils including a few with my good friend Mary. Today I would like to put forth the ceding company's view on how reinsurance should be acquired, how it should be purchased and what kind of deals and arrangements we would be looking to make with reinsurers, with terms that are fair to both parties.

Gaetano: Thanks, Jimmy. Ronnie?

RONNIE: I'm Ronnie Klein. I am the senior life reinsurance officer for AIG. I have been in this role for about six months. My prior experience started with Mutual of New York. I was in charge of reinsurance for about two years from 1990 – 1992. Then I moved on to Life Re, which was bought by Swiss Re in 1998. Some of my responsibilities included pricing for North America, pricing globally and sales and marketing for North America. At AIG, I am in charge of global reinsurance, both internal and external reinsurance.

What I would like to get out of the discussion is to know from the other two experts on the call if they are having the same difficulties with reinsurers as I am having. Also, if they see any solutions that I could be missing.

Gaetano: I am Gaetano Geretto. I head up Pelecanus Strategic Advisory Services, which is a boutique consultancy providing strategic advice, risk management and stakeholder management services for ceding and assuming companies. I have worked in the retro world with Sun Life Re for two years in their marketing area. I was with Gerling Life Re North America, now Revios, first as chief actuary and then as CEO for a period of six and a half years. What I would like to get out of our discussion today is really to hear from all of you about what are the most topical issues in reinsurance. Also, both from a ceding and assuming company's perspective, how we work to develop a stronger overall relationship in terms of the supply chain between ceding companies, reinsurers and retrocessionaires. With that in mind, why don't we work into the second question, which is, what role does reinsurance play in your overall responsibilities? We will go back to Mary on this one. How much time do you spend on reinsurance, in your every day responsibilities?



MARY: That is a hard question. I think I probably touch reinsurance at least weekly. I do not know how to break it down into an exact percentage. Probably 15 percent of my time, maybe 20 percent of my time, in dealing with reinsurance issues of some nature.

Gaetano: Okay, and Ronnie?

RONNIE: Reinsurance is my essential role as the life reinsurance senior officer for AIG, so I do work with reinsurance daily. My larger role is more of a risk mitigation role, which encompasses more than just reinsurance. I would say that reinsurance is 90 percent of my responsibilities currently.

Gaetano: Jimmy?

JIMMY: I probably do about 10 percent of my work effort in the reinsurance area. That would be in reviewing pricing proposals and negotiating treaties and dealing with reinsurers to develop new business opportunities.

Gaetano: Great, thanks. Since we are doing this panel as a feature for *The Actuary* magazine and there are quite a few actuaries who don't have exposure to reinsurance as a business, as an actuary, what characteristics make for a good ceding actuary? We will start off with Jimmy this time.

JIMMY: The ceding actuary has to really know his or her own business. He or she has to know how it is priced and what it can afford to pay. He or she has to know where the risks are and how much reinsurance you really need or want.

One of the primary reinsurance decisions is to determine if you will use the quota share form or the excess form. It may depend greatly on whether or not you have a good understanding of the underwriting that you will be doing. Maybe it is some new venture where you do not have a great understanding of the market risks and you want a reinsurer's expertise and financial backing.

In addition to knowing your own business, you have to understand the whole reinsurance relationship, not just the actuarial aspects. Regarding underwriting, you have to understand what happens when you have a facultative case. You have to know what is going on in the claims. If there are any areas of contention between a reinsurer and the ceding company, the ceding actuary really needs to understand that as well. And in that light, it is important that the ceding actuary, with his/her deep knowledge of his/her own business and a broad understanding of the whole relationship, not only maintain the highest ethical standards for himself/herself, but also make sure that everybody else in the company is maintaining those high ethical standards. You must do everything you can to make sure your reinsurers are also doing the same thing, because as much as we would like to have everything be written in a contract and not require human interpretation to decide what money goes where, this is still a very much relationship-driven business and there is a good bit of trust and responsibility between the parties. In particular, in looking at the automatic treaty, the reinsurer is trusting and guiding the ceding company into underwriting according to a set of pre-agreed and hopefully understood standards. It is important that the ceding actuary maintain the highest ethics in terms of pricing and communicating to the reinsurer the various aspects of the block of business that will be reinsured, and in assuring that in the underwriting and claims and administrative areas they are also doing the same thing, operating in the highest good faith.

Gaetano: Very well said. Ronnie, do you agree with that perspective or do you have a different perspective?

RONNIE: Of course, Jimmy hit all of my points quite clearly. As usual, I agree with Jimmy. I will just reiterate some of the points for some of the younger actuaries who might want to get into the role of a reinsurance actuary. One of the things that Jimmy touched on that I would like to expand upon is understanding what is going on more broadly. Jimmy spoke about the reinsurance actuary needing to understand pricing and claims. That is something that was not emphasized previously, at least in my experience. Everybody worked in their own silos and this created a lot of problems, so Jimmy is absolutely correct. I will go one step further. If you work for a global company, you must understand what is going on in other countries as well and that a relationship that does not seem so important to you in one area of the globe may be very important in another area. It is important to check with other parts of your company to make sure that what you are doing fits into the profile of the entire company. Another thing that is really important for ceding actuaries is to be flexible. One of the problems that I have encountered in my new role is a stand-off between ceding companies and reinsurance companies who become inflexible for almost no reason. These are people who are not looking for solutions; they are looking for problems. A good ceding actuary, just like a good reinsurer, should be looking for a solution and be willing to be flexible and negotiate, but as Jimmy said, should pay heed to the risks inherent in the products, as well as the risk profile of the company. You have to understand why you are purchasing reinsurance and what the purpose is. You must be a good negotiator; to be able to get your points across, to be able to outline them for the other party, to understand what you are saying and realize that anything you negotiate could come up as a problem well beyond when you are at the company or your counterpart is at the company. The terms must be well documented.

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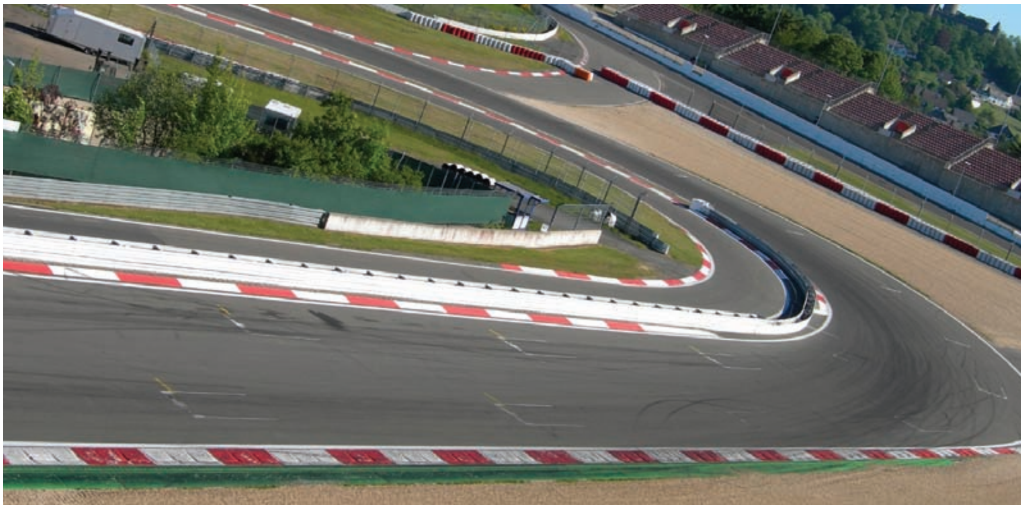
MARY: Between the two of them they hit just about every point that I had. I thought I had one and Ronnie just hit it, his last point. I agree wholeheartedly with what both Jimmy and Ronnie said. In addition, it is important that a good ceding actuary has an understanding of the financial impact of reinsurance for their own organization, both



from a GAAP and a STAT standpoint. What are the financial drivers and why are you using reinsurance and what are the different kinds of reinsurance—really understanding what varieties of reinsurance there are and how they might be used to help benefit or manage the risk, not only mortality risk, but capital management as well. I think it is important, along the lines of what Jimmy said, that the actuary have good, sound business knowledge—really understanding not only the product aspect, but certainly the underwriting aspects, the administrative aspects, as well as contracts and understanding the legal and contract portions of reinsurance. Integrity and honesty and just good, general communication skills are very important, knowing when you need to communicate with the reinsurers, how to communicate, what type of information is important and being able to negotiate. This goes along the lines of what Ronnie was saying. Along with the negotiation skills, being inquisitive, being able to ask questions and also being willing to listen to the answers to understand from the reinsurer's prospective why certain things are needed. You cannot be afraid to challenge or ask questions, to drill down in order to be able to find a solution that works for both parties.

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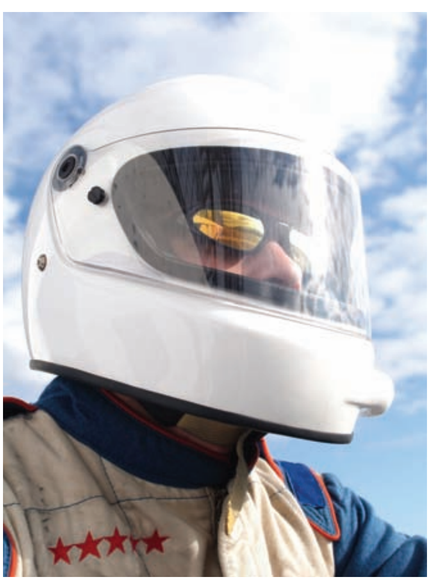


Gaetano: Among the three of you, I think you covered an awful lot of ground there and that sets the stage for our next question.

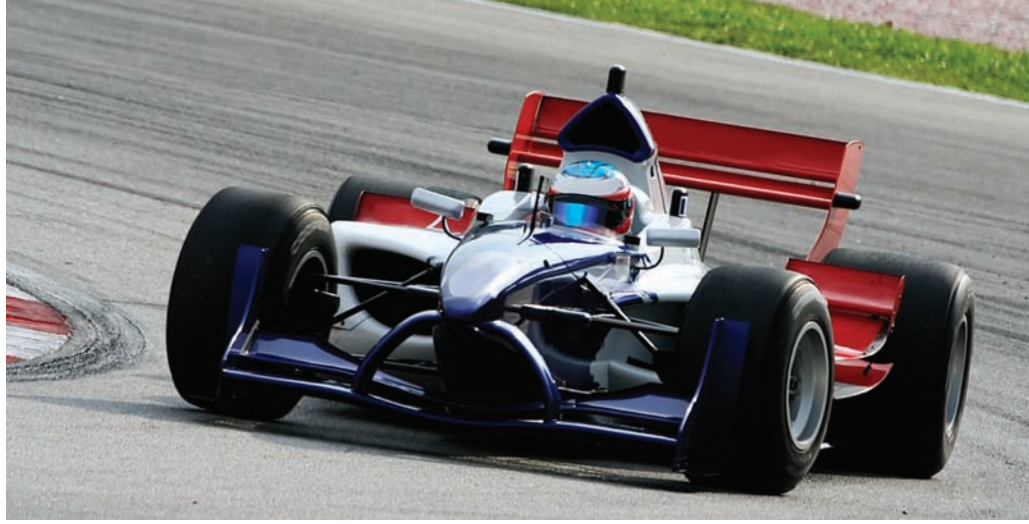
Let's talk about that negotiation point because a lot has been said about negotiation as a critical factor, not only in how reinsurance arrangements were set up in the past, but largely about how it negotiated confidence in the reinsurance contract.

Ronnie, as you said, the treaty sets the bar for people not only now, but certainly for successive generations who are occupying the positions which you are today. Has the nature of the negotiation changed? Why don't we start with you, Ronnie?

RONNIE: As a matter of fact, that is one of the key points that I would love to hear from Mary and Jimmy. As Jimmy was saying, you have to understand all the aspects of the transaction. I think the reinsurers have to understand all the aspects as well as the ceding company, and that is where most of the problems arise. You may be negotiating a non-traditional type of treaty, a catastrophe program, an annuity program or a health insurance program, something a little different than normal. You ask why a certain clause is needed. What is your intent? The reinsurer may come to you and say our lawyers require it or senior management requires it. This is not an acceptable answer. All parties need to understand the reason for these clauses and how they fit into the treaty. I would say the most important part of the negotiation is involving someone senior enough who understands the relationship and understands all the aspects of the content. As Jimmy said earlier, you need a reinsurance executive who understands all the aspects of the treaty. Then you can get to a meeting of the minds without digging your heels into the dirt.

Gaetano: Mary, did you want to add something to that?

MARY: I think the contract negotiation and the reinsurance negotiation have changed considerably over the past years. I think Ronnie alluded to the fact that a lot of it has moved from a gentleman's agreement and having discussions around issues to the lawyers and the attorneys actually being the ones to draft the contracts. I think the issue with the attorneys being involved in drafting those contracts is that they are not always close enough to the business issues. This is true of both the ceding company as well as the reinsurer—to really understand the impact of some of the language that they propose. The key to being able to negotiate does go back to having a very good understanding of the business in general and what it is that you are doing. The situation could improve greatly if the reinsurers had a better understanding of their own business as well as our business and how we do business, so that they can help in either explaining why certain things are necessary or



challenge their own senior leadership on why certain things probably will not work for the ceding company and that there needs to be a different solution.

JIMMY: Negotiation has definitely changed and from my perspective the turning point was the fall of 2004. From the reinsurer side, there has been a lot of consolidation, a lot of shrinkage in the number of major life reinsurers. There have been a few new entrants and there are a few more coming online now, but the world we knew 10 years ago has vanished. In that old world you came out with a new product, got a price quote and selected your reinsurers based on your criteria. If you listen to the reinsurers, they would say that the only criterion that seemed to matter was price. I think from a ceding company side, we also valued a long established relationship so that you could have a degree of trust between the two parties. You had to have some agreement on how the underwriting was going to be done and a comfort level between the two parties.

That was what used to happen, and then we worked out the details and finalized the treaty itself some time later—and some time later could have been a lot longer than it needed to be. Treaties could be outstanding for many months, perhaps years on the long end. From my perspective, today the treaty is the most important thing and the treaty has to be done first. All the terms of the treaty have to be set before the reinsurer has enough information to give me a price quote.

The details in the automatic binding provision describe which policies are reinsured and which ones are not. In the old days we simply assumed everything was covered. Now, reinsurers (and retros) seem to be pushing treaty language that gives the reinsurer more room to get off of a claim. A lot of times in the negotiation process, a reinsurer has told me that, yes, they need this particular language to protect themselves from having me give them bad business. They go on to say that they know I am not going to do that, but they just need it there just in case and not to worry, that while it really gives them the right to deny a lot of claims, they are not really going to do that, and I can trust them to be reasonable later. Well, no, I cannot do that. I cannot put my company in a position where a substantial portion of the claims could be denied even if it would be unreasonable to do so, and so now we have to go through a very detailed and very time consuming negotiation process to get the treaty terms on automatic binding, on recapture, on administrative errors, all kinds of things like that, set upfront and then, and only then, is it time to talk about what the price is going to be.

Gaetano: Jimmy, has the nature of the negotiation changed in terms of the parties involved?

JIMMY: I am going to agree with something Ronnie said earlier, which is that we are negotiating now not one-on-one, but with a committee that does not necessarily talk among themselves. It is very difficult when somebody who is not directly involved in the negotiations keeps saying, "No, a certain term or phrase must be in the treaty." As I read it, it now means something the opposite of what I know the reinsurer meant it to say and the opposite of what I need it to say. So you move a couple of commas around, send the treaty back with a paragraph explaining why you made that edit and what do you get back? You get back the original language, repeating "this must be in the treaty." As Ronnie said, you can't make progress until you either kick it upstairs to somebody who understands both sides of the issue and explains it to the other party, or get lucky enough to get that other party, which is sometimes now an attorney, on the phone, in person, to negotiate person-to-person. I have had the folks here who handle these treaty negotiations tell me that what we ought to do is forget all these letters back and forth, forget all these telephone calls, and just lock ourselves in a room with the reinsurer until the treaty is done, for days if necessary.

RONNIE: With no air conditioning.

JIMMY: With no air conditioning and work through these details, because the reality is that the treaty negotiation is taking months to do and it is just way, way longer than is good for the business process.

Gaetano: What I am hearing from the three of you is it seems that the whole process of how reinsurance was established in the past was really driven by the business people on both sides, ceding and assuming companies. It seems to be, that it has been taken out of those people's hands. How do we put it back into those people's hands and can it be put back into those people's hands? Mary, why don't you start?

MARY: I am not sure if it will go back into those people's hands. I think things have changed to such a degree that I do not know that we can ever go back that way. I wish I had the answer to how we deal with this. The biggest thing is just continuing to challenge and continuing to ask and continuing to demand to go up to the senior level to resolve the issues. I do see there being some softening from positions that were held a couple years ago, so I think the more the reinsurers are challenged to rethink their positions, the more there is constructive dialogue. The other thing is, we speak with our wallets, essentially, and to the extent that reinsurers are too inflexible, too difficult to deal with, or demanding clauses or covenants in their treaties that forbid us from doing business the way we need to do business in order to succeed, we just choose not to do business with them. While some companies have the luxury of that strategy, not all do, but I think you need to be willing to take a stand and I think the more we do and the more we challenge, hopefully the better understanding there is all around for what are the true needs and why we need certain things and why they need certain things.

Gaetano: Jimmy, Ronnie, did you want to add something?

JIMMY: I think what is going to be necessary before negotiations can go strictly back to the business people is that all the other parties that are involved now will have to get their issues settled in advance, and they are really all about treaty terms and conditions. I am telling all the new reinsurers that are now interested in doing business with us that the first thing we have to do is come to an agreement on a treaty and only after we have done that will we entertain taking them on as a new reinsurer.

Now, I have a number of existing treaties that maybe are not the same language that those reinsurers would want if they were doing a new treaty today. Perhaps it's the vaguer language of the past, and I am willing to live with the vaguer language because I believe that we have always interpreted it in an equitable and just way and will continue to do so in the future.

In order to get treaty negotiation back into the hands of the business people, all the issues that are involving the other people have to be resolved and moved out of the way.

RONNIE: Again, I totally agree with Jimmy. What we do at AIG is simple. We have an approved reinsurer list. We also prefer to have a global reinsurance contract where most of the wording is agreed to in advance (although all situations can never be addressed and may have to be re-negotiated). The real contentious standard clauses you should be able to work out in advance and have normal negotiations while you are not negotiating a live deal. This makes things a lot easier. We have been quite successful in doing this with certain companies, but with other companies, it is very, very difficult to do. There are some companies that act like international or global reinsurance companies and there are some that act as local ones. For example, one reinsurer that we work with says that he works locally in every country. There is not one central contact to discuss issues with. So I have to negotiate separately with 80 or 90 different country representatives! Again I think it needs to be raised a bit higher and the most senior people have to realize that this is an issue. Maybe this is a reason why the Society of Actuaries reinsurance survey shows a sharp decrease in reinsured volumes.

Gaetano: Would it be fair to say that based on how you have characterized it, that the nature of the relationship has changed. Has this become the most important issue confronting ceding companies and their dealings with reinsurers?

MARY: I am not saying the nature of the relationship changing is the biggest issue. I think it is certainly a driver of some of the other issues. I think the biggest concern, from at least our perspective, is now some uncertainty around interpretation of the contracts and deals that you thought you had and coverage that you thought you had, you may not really have. The deal and interpretation of the contracts have changed, and I think that has made the situation more tenuous because now there is an uncertainty as to whether or not you really have the coverage you thought you had. To me, that is a very big concern as a ceder of reinsurance. I think what is happening from the contracts and the nature of the relationship is what is driving a lot of that, I think you can deal with it. If you know what the rules of the game are, you can play the game and that is fine. The challenge is making sure that we know that the deals that we are setting up today are deals that will be enforced and that the coverage that we thought we had today, that we are purchasing, we really do have 10 years from now when we need it.

RONNIE: That is a great point, Mary, because what happens is you go out to the external reinsurance markets and put out a proposal. Then you entertain bids from eight or 10 different companies and make your decision based upon multiple factors. One of them is price. Had you known that one big claim was not going to be paid; suddenly that increases the price of a chosen reinsurer. Had you known this, you may have chosen a different reinsurer. Again if you knew the rules of the game it would be much easier to play. From the reinsurers' perspective (and I worked for a reinsurer for many years), you might say the ceding company is breaking the rules. From the ceding company's perspective, it appears somewhat random. One company will pay a claim and others are denying the same exact claim. It seems quite arbitrary unless it is worked out in advance. I think that is driving a lot of companies to look at alternative sources of reinsurance, like securitization, hedge funds, etc. We will be seeing a few more of these non-traditional solutions in the near future and I think eventually the reinsurers will get concerned. This will force reinsurers to revert a bit, as Mary said.

JIMMY: Clearly the key issue from a ceding company's point of view is that once a risk is ceded, if there is a claim from the policy owner, that the reinsurer pays its portion of the claim. Not paying claims for any reason is an extremely bad outcome, not only for the ceding company in not getting the claim covered, but in the ultimate relationship between the reinsurer and the ceding company. The relationship between the various parties is vital and it has been strained with turnover in conjunction with the consolidation. A lot of the players are different. Ronnie has changed sides. Thank you for coming over Ronnie.

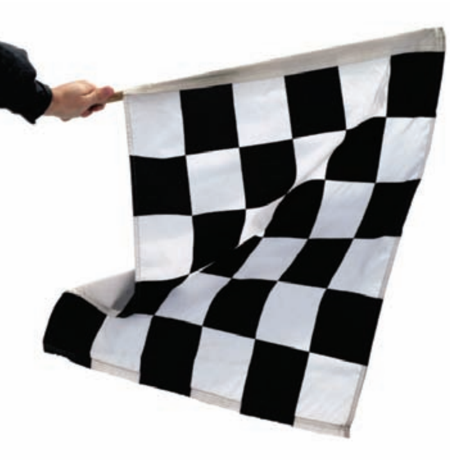
> I am willing to live with the vaguer language because I believe that we have always interpreted it in an equitable and just way. ...

RONNIE: I don't know if that was a compliment.

Gaetano: I think it was.

JIMMY: And so getting that definition of what is covered and knowing that we do not cede anything that will not ultimately be covered is number one. Assuring there is no reason for a reinsurer to balk at paying a claim is really the ultimate goal.

In the last couple of years, there have been some fairly spectacular denials from reinsurers that have really caused that wave of uncertainty in the ceding company world that Mary spoke of. The absolutely most devastating thing is to have a $10 million claim with a $500,000 retention and then find out that your reinsurer is not going to pay it for some reason that may



or may not be justified. The reason for the denial does not really matter from a ceding company's point of view. If there is an underwriting problem at issue, ceding companies have been operating for whatever period of time assuming that risk was covered and now it is not and it is too late to do anything about it. I think the issue is covering claims for policies that are ceded and not necessarily the relationship.

RONNIE: Jimmy mentioned that things changed with respect to the reinsurance treaty about two years ago. This is an important point. There was definitely a bright line when things started to change. This risk that Jimmy just talked about was a $10 million risk, $500,000 retained, and written four or five years ago before this so called change occurred. The rules of the game are changing during the game and that is not fair. If you want to write a treaty that says, "hey direct company, we will not pay your claims under these listed circumstances for any new business that comes on," that is fine. I can choose whether I want to sign that treaty or not sign that treaty. If I have business in force and during a 50-year relationship the reinsurer has paid all those types of claims, but suddenly somebody comes into office in a senior position and says, "Do not pay that claim because we really should not pay that claim," it is not fair. It is changing the rules during the game and it is not the way to do business.

The rules of the game are changing during the game and that is not fair.

Gaetano: Would it be fair to say, and certainly I would like to hear from each of you on this, that we have gone to much more of a P & C approach when it comes to claims payment as opposed to a life approach? Mary?

MARY: I am not sure if we have gone completely to that point, but I certainly think it has gone much more in that direction. I mean, what we are seeing is a lot of post claim underwriting and second guessing. It is always easy when somebody's dead to say you should not have issued the case, and I think we have seen a lot more of that. We are not seeing it on every single claim, so I do not think it has gone completely the direction of P & C, but it is certainly moving in that direction.

RONNIE: I am not an expert on property and casualty claims, but it always seems to me that with property and casualty claims the game is to delay payments as long as possible. Then the reinsurer can earn interest on the claim to mitigate the loss. In addition, it seems that claims are always settled for something less than 100 percent. It seems as if this is part of the pricing model and part of the negotiations. Please remember that property is usually a very short-term risk, so next year you can make up for any losses. I agree with Mary. I do not believe it has gone completely in that direction.

JIMMY: I would concur with those points, that the life insurance deal is a long-term deal that is not re-priced every year. Therefore, it is incumbent that the understanding that the parties had about what claims were going to be paid is simply understanding that all claims would be paid. If the reinsurer has an issue with the underwriting that was done by a company at inception, that needs to be addressed in a different way. The way that I would suggest addressing it is to monitor the underwriting as it is going on and if as a reinsurer you do not like what you are seeing, then you have the right under almost every treaty to, with notice, cut it off for new business. That is really the better remedy rather than not paying claims.

Gaetano: This brings us to the end of the first segment of our panel discussion. Many thanks to all of you. In our next segment, we will discuss alternatives to reinsurance, the nature of changes in reinsurance from quota share to excess, the role that reinsurance plays in the overall risk management of the ceding company and the future direction of the relationship between ceding companies and reinsurers.

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