Negotiating the Reinsurance Curves

A Panel Discussion, Part II

Part II of a panel discussion on the state of life reinsurance included panel members Jimmy Atkins, Genworth Financial; Ronnie Klein, American International Group; and Mary Bahna-Nolan, North American Co-Life/Health. Gaetano Geretto, Pelecanus Strategic Advisory Services, Inc. moderated the discussion.

In the August/September issue, our panelists addressed the key drivers in negotiation that are fundamentally changing the nature of the relationship between ceding companies and reinsurers. In this issue, we will address 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. You can find the first article on the Web site at www.soa.org, *Research and Publications,* The Actuary *Magazine, August 2006, Negotiating the Resinsurance Curves, A Panel Discussion, Part I.*

Gaetano: I would like to build on something previously mentioned by Ronnie, which was life insurers choosing to manage their risks on their own or through different means. Ronnie, you mentioned securitization. At Pelecanus, we have done some research on that subject among life reinsurers and that issue shows up as the fourth most important, greatest risk that life reinsurers manage in today's life reinsurance world. Do each of you see that in a similar way or a different way, and Ronnie, since you brought it up, let us start with you?

RONNIE: You are saying it is the fourth biggest issue to manage?

Gaetano: That is right. The fourth biggest issue to manage based on a poll of life reinsurance CEOs and/or business line heads.

RONNIE: There are different types of securitizations that go into different buckets. I am not a huge fan of in force securitizations for embedded value. To me this is akin to mortgaging of the future—taking some money up front for profits that would have occurred in the future. The statement is that your senior management today is the smartest that the company ever had or will ever have. The company is taking future profits and investing them today in whatever it wants to invest them in. If you are using the money for something specific, it could be beneficial. Risk mitigation, catastrophe bonds and other types of specialty deals can be beneficial to a company.

I think you will see more of these specialty-type securitizations popping up. This will put pressure on reinsurance companies to either provide these solutions or become a little bit more flexible in how they deal with the ceding companies for traditional reinsurance, because to date traditional reinsurance is still the easiest, cheapest way to mitigate risk. It is just becoming much more difficult right now and it is forcing direct companies to look at alternative means. Does every company really need a securitization? I am not so positive that every company really needs it, so fourth seems a little bit high for me, but it is an important issue.

Gaetano: Jimmy, you were at the forefront of this issue. How do you see it playing out today with the benefit of hindsight?

JIMMY: I think the worse case scenario for the reinsurance world is to provide treaty terms that are so onerous or to charge prices that are so high or to deny claims to the point where the

ceding companies lose confidence in reinsurance as an option. If it gets to be so severe that we lose faith in the ability of the reinsurance community to meet our needs, then it is quite possible that ceding companies will pool together and provide that risk-sharing element amongst themselves and effectively cut out the reinsurers. If that ever happens, then it will be very, very difficult to go back the other way. Once we have set up the infrastructure needed to run a ceded pool, the reinsurer's profit will then come back into the ceding company's pockets.

Now, I'm assuming reinsurance is indeed a cost. Reinsurers might tell you that in the years past they were giving it away. I would not necessarily disagree with them as it was a very competitive reinsurance market and market share seemed to be their number one priority. Maybe we might say that we were getting reinsurance at cost. If we are not getting reinsurance at a cost, if it is an outrageous price and/or even worse if we are not sure the claims are going to be paid, then we go into some type of a pooling arrangement and there will be no going back.

On the securitization front, I do not know that securitization is going to replace reinsurance as an option, however, I do believe that securitization may replace retrocession in that if the capital markets are willing to take a little bit of mortality risk, that the current retro may transfer their risk to the capital markets. Reinsurers could pool together to transfer their risk to the capital markets and eliminate the need for retro or eliminate dependence on the handful of retros that exist.

MARY: I do think that access to the capital markets, whether it be securitization or other solutions that are alternatives to reinsurance, are changing the paradigm of reinsurance. Reinsurers need to be careful not to drive the customers away from them, because I agree with Jimmy, once companies go that direction, it is very hard to go back. To some extent they have driven at least some of their largest customers away and it is going to be difficult to get them back. That is unfortunate, but I do think that that is the case. I do not think that securitization or other capital solutions are going to be the replacement to reinsurance. For many companies and for many different reasons, those types of solutions or transactions just do not make a lot of sense. They are not available for every type of risk, at least today, they are not available for all the risks that companies would utilize reinsurance for. I do think that those markets will continue to develop

and that they will continue to be a risk for the reinsurers in that it is now competition for them.
I agree with Jimmy in that I think the retrocession market probably is very vulnerable for that risk, maybe more so than the direct reinsurers are.

Gaetano: You bring up a good point. I just pulled out the 2006 SOA reinsurance survey that Munich American Re conducts on behalf of the industry. What is interesting is recurring new business has dropped by 15 percent year over year from '04 to '05. Is this the beginning of a trend where ceding companies are being a little more deliberate in the way they put out offers for reinsurers who want to assume business from their specific companies?

MARY: I think so. What has happened in the market has really forced companies to go back and rethink their reinsurance utilization strategy, to revisit their retention levels and what they are comfortable taking. I think a lot of companies are more comfortable taking more risk. Going back to something Jimmy said earlier, a few years ago a company could lock-in profit by ceding reinsurance. At least we thought so if we thought the claims were going to be paid, and that is no longer the case.

Companies are no longer seeing that, so there is not as much of a driver to give a large or a considerable percentage of your business away and cede it away to the reinsurance market. Companies are spending a lot more time analyzing what the appropriate level of reinsurance is and how we want to use it going forward. I think that you are seeing that in the numbers in the SOA/Munich survey, which is, I think, what Ronnie was referring to. As companies are re-designing and re-pricing products, I think historically there would be a re-design and they could back out for reinsurance to see if we can use reinsurance to help us be more competitive. Today you are probably seeing less of that and you are seeing companies try to revise designs of products so that they do not have to go back out and negotiate the reinsurance, so that they can continue with the terms that they have.

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JIMMY: I think a lot of the shift you have seen in the survey has been due to people moving from 80 percent to 90 percent quota share back to an excess of retention and the reason they have done that is because, as Mary was describing, in times past it would appear that you could either lock-in a profit and/or maybe even at the very least control your costs with the quota share treaty. Now the prices have moved and the uncertainty of claim payment has moved so that you might as well not do the quota share, but keep a lot yourself. That could easily move a company from 90 percent overall reinsurance to only 20 percent overall. It does not take too many of those to move the total.

Gaetano: Yes, I can understand that. Ronnie, did you have anything further to add on this?

RONNIE: I would like to say that I am not sure that the 90 percent/10 percent quota-share model was healthy anyway. I would much prefer to see excess or surplus reinsurance. It is odd that the larger reinsurers want to move back to quota share reinsurance. Just a few years ago the reinsurers said they did not like the business model for quota share. Reinsurers said to ceding companies, "We do not think that you are worried about your own claims enough, so we are going to charge you more money." Then your company moves back to excess and the prices do not come down, even though the risk management has to be even better because your company is retaining most of the risk. It was a short lesson learned and I would almost like to say to a reinsurer, "What do you really want from a direct company?" I am not sure that 90 percent quota share is the best model.

Gaetano: So, has the role of reinsurance within the overall risk management framework of the company changed? Ronnie, why don't you start?

RONNIE: I think Jimmy and Mary said it before. At a certain point in time, when the ceding companies were looking to lock-in profits and just develop the products and distribute them, reinsurance was not really a risk mitigation tool. It was just the model and the model has changed. So I would say that the role of reinsurance should really be a risk mitigation tool. A company should have an appetite for risk. It is in the risk business.

Insurers should just take the risk and move on. I would say yes, supply and demand definitely changes the role of the use of reinsurance as risk mitigation of the company. If the price goes too high, you are going to change your whole model. If the price goes too low, then you are going to change your model again. I think there is a supply and demand aspect to it, and I think it will continue to change.

JIMMY: From my prospective, the role of reinsurance has not changed lately, but it did change a few years ago. As I see it, the reinsurer's role is to clip off the peaks of the large claims, to help us control our volatility, to advise us on new ventures and perhaps provide second opinions on underwriting, either on a specific, facultative case or just general underwriting discussions between the reinsurer's underwriters and the ceding company's underwriters. Reinsurers can also help us with new ventures, if we are going into an area where we have no expertise, but the reinsurer purports to have some and is willing to back it up with reinsurance. That role has been unchanged for Genworth since 1999. We moved from quota share back to excess in 1999 because we had additional insights into mortality and realized that the reinsurance was not being given away, that there was actually some profit there. We wanted to get that piece of it back. I think a lot of other companies are finally getting around to making that type of analysis and that is one of the reasons they are able and willing to move away from quota share.

The other thing I did not mention before, but is also a use for reinsurance and that is in the illustration regulation, there is a requirement that the illustration actuary certify that mortality assumptions do not include future improvements. It is, however, permissible to substitute reinsurance pricing for mortality and if the reinsurer can justify assuming mortality improvements because they really truly and all of us believe there will continue to be mortality improvement in the future, then it is conceivable that you can actually come out with a marketable product if you do a lot of reinsurance, that you cannot justify looking at your own historical data. There is a possibility if you do not have good insights into your own data, your own experience, that you may have to rely on the reinsurer to substitute a reinsurance price for a mortality assumption you do not have any data or experience to make.

Gaetano: That is a good point. Mary, let's hear from you now that you have had more time to ponder the question.

MARY: Does reinsurance really play a different role in our risk management? I do not think so. I do think we are aware, as Jimmy's company was, moving away from using reinsurance to help with capital management and now just using reinsurance to better manage just general mortality risk, using it for underwriting expertise and what not. We are moving a little bit away from the capital management and trying to do that more internally or with other solutions outside of the reinsurance market. I do think though with our overall risk management strategies, that reinsurance has taken on a much higher profile within the organization. Before it was just something that was handled and managed and reported back on. Now it is something that is very actively managed and has the attention of individuals all the way up in the organization. So I do think it is taking a much higher profile. What that might mean going forward, I do not know, but it is certain that there has been more interest in the management of the reinsurance and how we use it to mitigate risk. But I do not think that overall what we have done has really changed that much.

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Gaetano: Let's build on that in a different way. This issue that Ronnie addresses: the appetite for risk. At each of your companies, have you looked at your appetite for risk in a different way and specifically given much consideration to the things that have changed in the world, the specter of terrorism, increased national catastrophes, and a big issue that the SOA's looking at right now, the risk of pandemics? Has your appetite for risk as a company changed, and, if so, what steps have you taken to manage this increased risk? Jimmy, why don't we start with you this time?

JIMMY: Our appetite to accept risk has not changed much in recent years, but we certainly have a robust risk management function. We have a risk manager position and even staff in every one of our insurance businesses, as well as at the headquarters level. It has been active for many, many years and it looks at all types of risk, not just the natural ones that we might think of in the insurance business, but some of the other things as well, including this risk of terrorism that we have all had a heightened awareness of since 9/11 and the potential for a pandemic and what that might mean on the mortality side for the near future. We are looking at all those things. We are recognizing that we cannot necessarily get rid of all the risk, and so the job of the risk manager is not to eliminate all the risk, but to find a way to balance out the cost of bearing risk and the potential profit for bearing risk.

I believe that the function of reinsurance will become not so much the function of locking in a price for the ceding company, but going back to their traditional roots of being something that controls the volatility of the financial impacts on the ceding company. ...

MARY: I would say we're along the same lines as Jimmy. I do not think that our appetite has necessarily changed, although we are in the process of building a much more robust risk management approach for the organization. I do not think we are as far along as Jimmy's organization, but we do have an executive risk management committee. We do have a much more robust mortality analysis and projections and that type of information feeding up to the executive risk management committee to help identify where our exposures might be and things that we might be able to do to mitigate those. So, I think certainly there is a lot more discussion and awareness of some of the issues than there was five years ago, but our overall appetite for risk probably has not changed that much.

RONNIE: Since I have been at AIG the risk appetite has changed a little bit. Our risk appetite has increased. We are working hard to raise our individual retention. On the other hand, for catastrophic coverage—pandemic, flu, earthquakes, volcano erupting, etc.—we are looking at risk mitigation for higher levels. We are exploring selling a mortality bond. We put a life catastrophe program in place. We try to manage the risks as we see them. We employed RMS to do research for us concerning pandemic flu. As far as changing the risk profile of our company because of the current prices of reinsurance, our risk profile is changing and we are accepting more risk. Since Board of Director approval is required for retention increases, it is a major change to the risk profile of the company. So, different from what the others said, we are looking to accept more risk as opposed to less risk.

MARY: I would go back and kind of echo that. I mean we certainly are looking at increasing our retention, so from that perspective, has the appetite for risk increased? Probably so, but that is relative to the impact that that would have to our bottom line and our financials. I don't think our appetite for the overall impact or magnitude of the impact to the bottom line has changed very much, but we certainly are looking at taking on more risk.

Gaetano: Let's move into the last part of the discussion now, which is future directions and certainly we touched upon it at length during the call, but let us get into some specifics going forward. What do you think is the future direction of the relationship between ceding companies and reinsurers? Also, what piece of advice would you give to the reinsurance community today to strengthen that relationship?

JIMMY: I think that the reinsurance community will, and, as the other folks said, has already turned a little bit back toward the middle and is realizing that they cannot totally alienate their customers and expect to get them back at a higher price later. They know now they should not force us to develop new technologies that would eventually make them obsolete. I believe that the reinsurance community and the ceding company community will come back together. I believe however, it will not be the same as it was. There will be more of a mutual win/win, lose/lose possibility, both types of companies winning or losing together. To make that happen I see a very large growth in the experience rated treaty. I know a couple of companies who have already done those types of treaties and others that are talking about it. I believe that will be the mechanism by which a reinsurer and a ceding company can make sure that they both maintain an interest in having overall claims as low as possible, while providing the services to the end customer. I believe that one of the functions of a reinsurer that will be strengthened will be their underwriting and medical knowledge and passing that on and advising the ceding company on how to underwrite.

There are a lot of things, especially when you get into smaller companies where they may not be able to keep up with all the medical advances and the reinsurer certainly can provide that knowledge and make sure that the writing companies are underwriting to the best of medical knowledge available to the whole community. I believe that the function of reinsurance will become not so much the function of locking in a price for the ceding company, but going back to their traditional roots of being something that controls the volatility of the financial impacts on the ceding company either from a statutory solvency viewpoint or a GAAP type look.

The reinsurers will also become a mechanism to do more capital management. We were touching on securitization earlier. It is something that can be used, as Ronnie mentioned, to do some financial management of a block of business. It, however, requires a great deal of infrastructure and scale, so smaller and mid-size companies will not be able to do that directly, but a reinsurer can do that for them. So, I see that as the ultimate function of a reinsurer, providing some form of access to capital markets for the purpose of capital management and also providing that volatility control. It is really traditional, getting back to the roots. That is where I think it is going.

MARY: I think it is going to move into the direction back more towards a partnership, but not to the extent that it was prior to the past couple of years. In order for both companies to succeed, I think there has to be a better understanding of each other's business and a better meeting of the minds; that will only come with a partnership approach towards the relationship. That said, I think it will continue to be managed on a contract basis, and so the negotiations up front and a clear understanding of what the agreement is, is going to be critical for that relationship and for the reinsurance to grow. Were you asking about the advice as well?

Gaetano: Yes.

MARY: I think the advice that I would give to the reinsurance community is to truly understand what the value proposition for the company and the reinsurer is. For the reinsurer, why does a direct company need to do business or why would they want to do business with you. I would say to reinsurers, I think you need to really understand how what you are offering can work towards helping the direct writer grow and be successful, that you do have those win/win situations. The reinsurance community used to be there a long time ago. I think they moved away from that and I think they are now trying to move back in that direction. That is: to really understand the issues the direct company or the ceding company is facing, what their challenges are in being able to grow their business, being able to find that solution, truly understanding, having people on the street that can understand and can take the message back to their offices to help find the solution or partner with the company to find that solution. I think that would be my one piece of advice. If I am looking for someone to purchase reinsurance from, that is what I would like to see.

> Companies are spending a lot more time analyzing what the appropriate level of reinsurance is and how we want to use it going forward.

RONNIE: I agree with Jimmy and Mary that things will revert back a bit. Reinsurers felt the direct companies were taking advantage of the reinsurance community and therefore retaliated with very, very strict treaty interpretations. They went from one extreme to the other. But I think a middle ground will be reached. I will make a prediction: if it does not happen soon, some of these reinsurers will go into run off. The advice I would give is for reinsurers to have a main contact at a fairly senior level with global insurance companies. One point of contact helps when there is an issue anywhere around the world. That person could be contacted and help to solve the issue.

The problem that I see with the reinsurance community is a sense of snobbiness. Sometimes the decision maker at the reinsurer might be extremely senior. At the ceding company, the decision maker may be junior compared to the reinsurer. The appropriate person at the reinsurer may be the CEO or the president of the reinsurance company and they must deal with a chief actuary or product actuary or a lowly senior life reinsurance officer. This is a problem, because some of the CEOs at reinsurance companies think that it is beneath them to talk and negotiate with the product actuaries at a direct company. The advice I would give is everybody at a reinsurance company should be a salesman and be willing to discuss and negotiate with anybody at their ceding client company.

JIMMY: Let me add my piece of advice too. I do not think I did that before. To a reinsurer it would be, "be reasonable, customers have long memories."

Gaetano: We will move into our last question. I come back to a point that Mary made right at the very outset of our first segment, which is: a reinsurer should have a better understanding of their business. So, here is your opportunity to put yourself into the role of the reinsurer. If you were to exchange your current role today for a similar role at a reinsurance company, what would be your first priority? We will start with Ronnie first, then Mary and then Jimmy.

RONNIE: It is interesting because I just did that, but the other way around. Are you asking me to go back to the dark side, emperor? What I would do immediately is what we had discussed earlier. I would go through the treaties and rip them completely apart. Put in what really needs to be said and take out the ambiguities. I would probably go through the claims section first as Jimmy said. Maybe we should go a little towards non-life. State that "every claim is included except for," and then, specifically list what you would not pay. For example, I would not pay if the person was dead before they were issued the policy. I would not pay if the person was on their death bed before they were issued the policy. Of course, those are extreme examples, but if you want to exclude something as a reinsurer, let us list it, let us make it specific so at least the ceding company knows what they are buying. That would make everybody happy.

MARY: I might start at a little higher level than the ceding company, although I think what Ronnie said is very important. I would actually come in and I would try to understand what our reinsurance value proposition is, why should ceding companies want to do business with us, what is our strategy for getting ceding companies to want to do business with us and then getting that business. Reinsurers have lost sight of that and that is sort of a fundamental strategic question that would need to be addressed before any of the other stuff I think can be done. That would really be the first thing, although I like Ronnie's suggestion too, because that is something a little closer to my heart, at least in what we are dealing with today.

Gaetano: What strict operating suggestion, what very strategic suggestion, would you give, Jimmy?

JIMMY: You know me, I am very practical.

Gaetano: Jimmy, we are going to give you the last word.

JIMMY: Thank you. If I were a reinsurer I would know what my own needs and capabilities were. Then I would make it my business to assure my client that our company was here to meet his or her needs, but meet them at a fair price and at fair terms and without putting myself in a position for the ceding company to take advantage of me. Those needs that I intend to meet are: I am going to help them with their volatility and their risk management; I am going to help them with underwriting; and, I am going to help them with their capital management. Those are fundamental needs that every client company has. I would assure them that my company is here to meet those needs and do so not just for the next quarter, but for decades into the future.

Gaetano: I want to thank you all for taking time away from your regular day-to-day schedules today. I know you are all very busy with all the activities in the last few years both inside your own companies and also outside in terms of what each of you have done for the profession. Thank you for what you have done for the profession today.

Gaetano Geretto is president of Pelecanus Advisory. He can be contacted at *gaetano.geretto@pelecanusadvisory.com.*

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