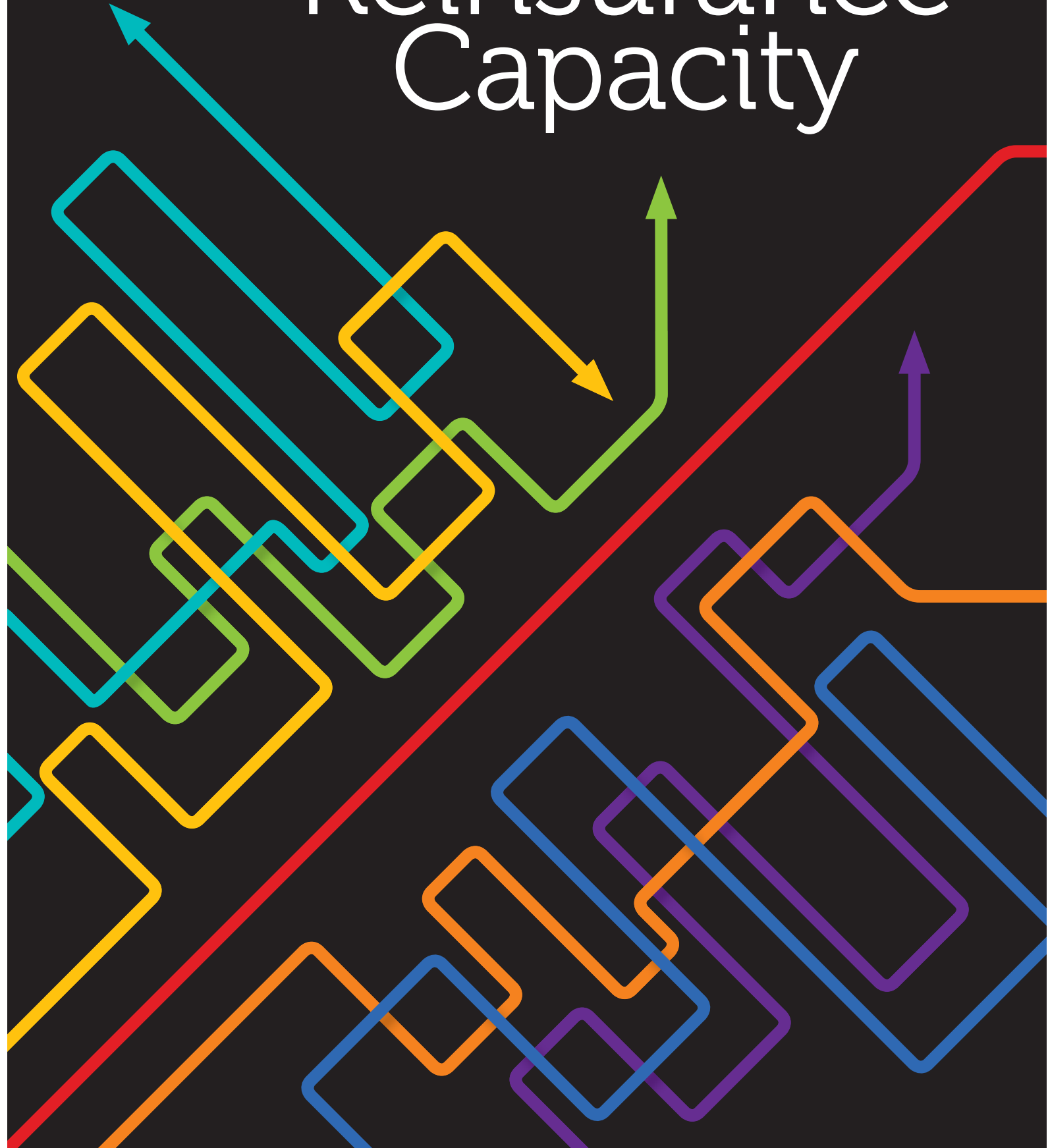
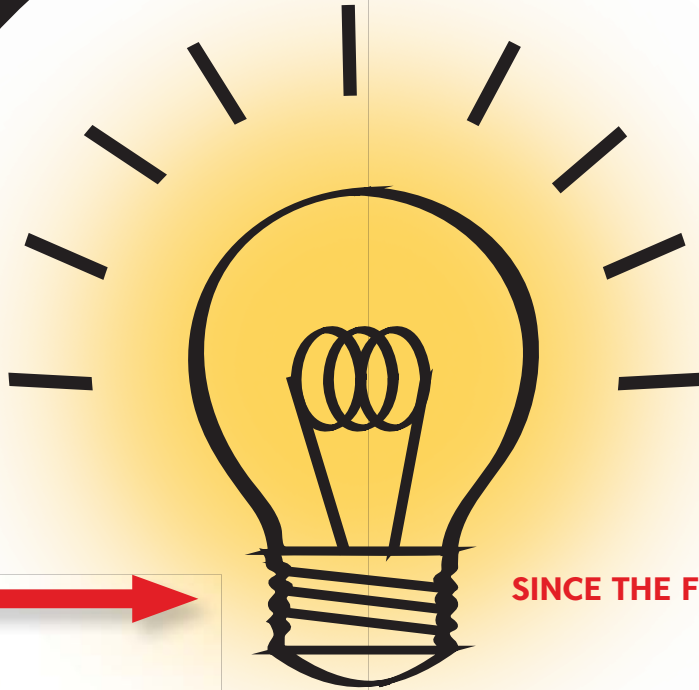


Revitalizing Reinsurance Capacity





SINCE THE FINANCIAL CRISIS OF 2007–2008,

U.S. life insurance companies have been buffeted by several powerful forces, all of them combining to create serious insurance capacity problems. First, the crisis adversely affected the solvency and reputation of the banking industry, dissuading investors from participating in capital market ventures that could be tapped to spread the risk of loss. Second, the U.S. Federal Reserve's handling of the economic disaster has contributed to a protracted period of low interest rates that have eroded insurers' investment returns. Finally, multiple regulatory interventions in the United States and the European Union have forestalled the development of innovative risk transfer methods because of concerns over enhanced scrutiny and skepticism. These developments constrain life insurers with few options to spread risk other than reinsurance capacity, which remains tight.

This dour scenario is vastly different from the robust environment of a decade ago, when banks were in the thick of developing insurance-linked securities and catastrophe bonds with values driven by insurance loss events. For life insurers, the instruments served to spread their risk; for investors, they provided an investment uncorrelated with other asset classes. Marketed as offering generally modest returns, the instruments largely performed well for investors. They certainly served as a vital risk-spreading mechanism for insurers. But while these instruments didn't default during the crisis, they were adversely affected by illiquidity and couldn't easily be sold or exchanged for cash without a substantial loss in value.

Life insurers can't continue to wait for the markets to resolve the impact the financial crisis has had on their capacity. New ideas are needed.

BY JEFF BURT

▶ This last took a toll on the instruments' reputation, effectively curtailing their continuation. Investors who backed them in the past no longer have the appetite, compelling banks to largely pull away from the market. Given banks' thorny challenges in the post-recession era, this isn't surprising. The ability of banks to fund increases in assets and to meet obligations as they come due without incurring unacceptable losses is under duress. It has created a liquidity crisis that has compelled many banks to restrict even traditional products like letters of credit.

The life insurance industry has its own financial problems, with some large investors now debating whether or not to continue investing in the companies because of the low return on capital. A case in point is the pressure applied last year by major shareholder and hedge fund manager John Paulson, who sits on the board of Hartford Financial Services Group, to split the company's life and property/casualty units. The insurer subsequently sold its block of 700,000 individual life insurance policies to Prudential Financial Inc. in a reinsurance transaction for \$615 million in cash.

The Hartford is not alone in this decision. The Allstate Corp. is selling its Lincoln Benefit Life Co. to Resolution Life Holdings Inc., reducing the regulatory-required capital in Allstate Financial by approximately \$1 billion. In addition, the company announced it would discontinue issuing fixed annuities. These decisions were based on its strategy to serve distinct customer segments in which it enjoyed a competitive advantage. Other insurers, like Aviva, have exited the life business in certain markets, as well.

Obviously, these developments don't bode well for life and health insurance underwriters in the United States. The companies are unable to source adequate reinsurance capacity to spread risk, they are stymied by a combination of regulatory and economic factors in achieving a decent return on investments, and they are pressured by lower demand for products as a consequence of the recession's effect on personal income.

Few traditional options exist to overcome what appear to be insuperable financial challenges. But necessity is the mother of invention. I would like to propose a structure that could support a potentially large source of risk-spreading capital for life and health underwriters. Given the mortality exposures at risk, it would be hinged to the development of a more transparent, stable, and long-term instrument offering solid risk-adjusted

returns for investors. Most important, it could set the stage for a return to the partnerships that existed among banks and reinsurance companies in the pre-financial crisis period. The difference this time around would be that the reinsurance industry would be taking the lead.

The concept is bold: Rather than banks becoming reinsurers, as in the pre-financial crisis period, the roles are reversed.

Unlike banks, which didn't necessarily specialize or concentrate on insured risk as much as on other asset-backed classes, reinsurers are experts in this regard. They underwrite only those exposures that they believe to be actuarially sound. The capital for this pool of reinsurance capacity could come from many of the same sources that invested in bank products prior to the financial crisis. The difference, however, would be a heightened degree of visibility into the underlying risks and the consequent higher comfort level that this transparency could provide.

Before I offer arguments for why this is a prudent investment, it might be worthwhile to explore more fully the factors that gave rise to the need for such a solution.



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Regulatory Changes

The array of complex global regulations promulgated in the aftermath of the financial crisis created difficult financial conditions for banks. From a historical standpoint, strict regulations are common following a crisis. During times of bank distress, governments often intervene in the activities of banks, as well as provide capital support to reduce bank risk taking. This intervention, in turn, affects a bank's liquidity creation, restricting the availability and cost of credit.

Several regulations governing bank liquidity and the risk-based capital of insurance companies either have been executed or are in the process of implementation on both sides of the Atlantic. These new rules include Basel 3, the Dodd-Frank Wall Street

Reform and Consumer Protection Act (particularly the so-called Volcker Rule), Solvency II, the Solvency Modernization Initiative of the National Association of Insurance Commissioners (more specifically the requirement that U.S. insurers routinely conduct an “Own Risk and Solvency Assessment,” known as ORSA), and the Common Framework for the Supervision of Internationally Active Insurance Groups (ComFrame), drafted by the International Association of Insurance Supervisors.

Without venturing into the specifics of each of these new rules, it’s enough to say that in combination they represent a heightened focus on risk transparency and management, and require more skin in the game, i.e., a greater level of capital held in reserve.

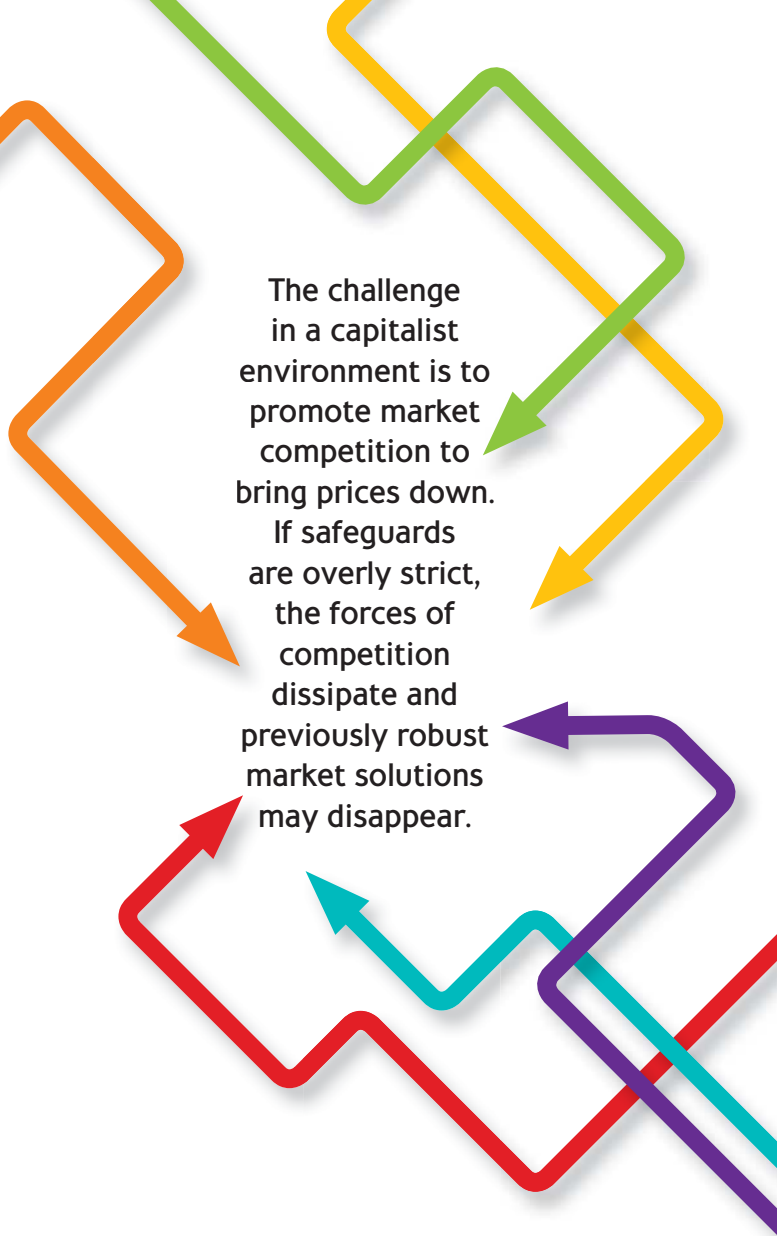
One can’t fault the regulatory agencies for this intervention—when awful things happen, the judicious response is to execute conservative safeguards to prevent them from happening again. As always, there is a delicate balance in determining the proper inflection point between acceptable risk and adequate safety—a satisfactory level of capital reserves versus an ill-advised amount, for instance. Without this balance, society comes to a point where every child under 16 years of age is pinned to a car seat by a 10-point harness.

Extreme safeguards may create market bottlenecks that add cost to the system. While a certain amount of friction is understandable, the challenge in a capitalist environment is to promote market competition to bring prices down. If the safeguards are overly strict, the forces of competition dissipate and previously robust market solutions may disappear. This is the situation in which many banks and reinsurance companies now find themselves. Investment capital to absorb risk has dried up, in no small part because of the regulatory environment.

In the life insurance industry, this dilemma has effectively put more insured risk on insurance companies’ balance sheets. Banks that readily absorbed a portion of this risk and shared it with their investors no longer have this appetite or the interest of the investment community. They effectively have abandoned the provision of capital market insurance-linked instruments. At the same time, the global reinsurance industry, which has a vastly smaller capital base to leverage than global banks, is finding that more stringent regulations are hurting its ability to increase the capacity it traditionally supplied, much less maintain that capacity.

The combination of more stringent regulations and continuing economic uncertainty is forcing life insurers to retain more risk on their balance sheets, at a time when sales are lagging, and traditional investments remain challenged by the historically low interest rate environment.

Society pays a price here: If the purchase of life insurance is uneconomic, more people will pass on the opportunity. Rather than absorb the credit risk of the insurance company, they will simply self-insure. Many individuals can’t do this, of course, and will fail to save enough money to protect themselves and their



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families from the financial impact of their deaths, jeopardizing their well-being.

A Convergent Solution

For life insurers and their investors, these developments cry out for a solution. Although many insurers believe the markets eventually will regain lost ground and return to historical norms, and regulators trust that the friction caused by their interventions ultimately will ease, there are no guarantees this will happen in the near term. Given the difficult business conditions confronting the life insurance industry, its customer base, and society at large, inertia isn’t the answer.

From a commercial perspective, the objective should be the development of a sound financial instrument in which investors put their capital at risk to absorb clear, transparent, and quantifiable risks aggregated in a new investable class. While this instrument contains the same insured risks marketed a decade ago in the capital markets, the difference is a better, more efficient, and inherently safer structure. Most important, it requires a convergent solution by the same industries—the capital markets and reinsurers—that put their balance sheets at risk of insurance exposures before the financial crisis surfaced.

I'm not promoting the formation of dubious risk-based capital instruments for life insurance companies and investors. Nor am I calling for a revival of something that was tried and that failed. Rather, I'm suggesting the creation of an efficient risk-bearing investment vehicle involving both the reinsurance and capital markets, with the ultimate aim of increasing global reinsurance capacity to spread insured risks.

This efficient structure is predicated on investor interest in participating in a market in which investors bear a portion of insured risks in return for a payback on their investment. To encourage investment, backers must be able to understand, assess, quantify, and digest the insured risks they would be assuming. They would further need an easily comprehensible way to invest, such as an insurance-linked security or a catastrophe bond. Reinsurers would insure the bond or security and provide a specified return to the investors over a long-term period. The capital would then be utilized to assume insured risk.

These instruments may sound like the same issuances that led to the financial crisis. The difference is that when the capital markets provided these asset-backed securities, they were not necessarily developed under the guidance of principal risk takers and underwriters—financial professionals who deal with the economic impact of risk and uncertainty on a daily basis.

At that time, few investors questioned the soundness of the underlying liabilities. Even fewer understood that the risks were fragmented into multiple pieces that defied calculated appraisal and valuation, were then re-assembled into tranches, and ultimately were packaged up into CDOs and CLOs (collateralized debt obligations and collateralized loan obligations, respectively). Unlike reinsurers, the banks that constructed these instruments enjoyed mammoth balance sheets and virtually could print money. They also were selling products with long-term horizons, and, in only a few cases, retained any of the underlying risk.

What if both the bank and the risk takers took part in the solution together rather than playing separate roles as before? Here's how such a collaborative venture would work: The reinsurers would acquire and even insure the insurance-linked instruments while the banks would provide the funding necessary to support the issuance. This would solve the problem of not having balance sheets large enough to assume higher levels of risk.

If both markets converged in a solution in which the banks brought their investors to the table to absorb insured risks in instruments for which reinsurers would provide a return, the benefit for the investors would be twofold: They would invest in a security in which the underlying risks are actuarially assessed and quantified by reinsurance actuaries, and these securities would represent a diversified class of investment, one that is arguably safer and more predictable from a return standpoint than what has been marketed in the past. Why? Because few entities understand underlying liabilities better than reinsurers, which routinely assume these risks from direct insurers.

The opportunity to develop this new form of risk-based capital investment is substantial. A recent report by the rating agency Moody's, for example, estimates the current financing of the insurance markets to be as high as \$600 billion. This works out to an approximate \$60 billion annual run rate, assuming an average 10-year liability duration from a risk-taking standpoint. If reinsurers are able to augment their financial capacity, the direct insurance markets will buy this capacity.



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Tweaking the Concept

Other potential solutions are percolating, including so-called sidecars that allow investors to take on the risk and return of a book of business written by an insurer or reinsurer, earning the risk and return that arise from that business. Another solution has been floated by the private equity and hedge fund markets, which are focusing on their particular value-added skill sets, i.e., they would open the door wider to providing asset management services to the insurance industry. I believe mine is the best solution because it addresses the societal implications of the insurance capacity squeeze.

What if private equity and hedge funds, as well as pension funds and family offices, invested in this solution? Investors would fund the instrument, and reinsurers would provide a fair return for the assumed risks over a long time horizon. Insurance actuaries would model and price the underlying risks over time to ensure all interests are aligned. And reinsurers would be repositioned as a financial guarantor on the insurance-related assets.

The transparency of the underlying risks, coupled with the promise of more predictable risk-adjusted returns, would encourage investors to reconsider insurance-linked securities. Despite the headwinds buffeting the captive space, it might

still make sense for the invested capital to reside in offshore or onshore captives or in special-purpose vehicles. This helps isolate the individual liabilities for underwriting purposes, while increasing investor transparency.

Reinsurers also can assemble these instruments without banks as an intermediary presence, collecting the risk takers and putting all the pieces of the puzzle together in a more cost-effective, direct approach. In another scenario, reinsurers could buy a large portion of the ultimate issuance and then sell off the remaining pieces to other investors. This concept is enticing since reinsurers' capital reserve requirements are built specifically to support long-term risk taking (although careful analysis still must be weighed). Despite this added flexibility, a more robust solution is to have banks continue to serve in their traditional intermediary capacity, as this is where the capital sourcing resides.

What is clear is that waiting for the markets to iron out the many wrinkles produced by the financial crisis may prove to be in vain. Certainly, no one forecasts an immediate reinvigoration of bank appetite for insured risks or a substantial increase in reinsurance capacity. The time has arrived for truly innovative solutions. □

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