Reinsurance Purchasing Trends Follow Interest Rates

Direct writers do not always correlate reinsurance purchasing with sales activity. In fact, companies occasionally request requotes to compare prevailing rates for existing products. We saw this most prominently during the “term wars” of the early 2000s. However, the number of requests for quotes over the past year suggests that drivers other than price curiosity are at work. Two overarching issues have emerged: improvement in current loss ratios and concern over a sustained low interest rate environment.

Improved Loss Ratios

Many companies have experienced improved loss ratios resulting in operating profits from underwriting gains. At the same time, life insurers during the recession bulked up on capital. As a result, some companies are in a position to retain more risk.

This retention strategy is bolstered from a risk diversification perspective. Under attractive 90-10 reinsurance arrangements, life insurers ceded large portions of mortality risk. This has led some carriers to view their risk portfolio as light on mortality risk and too heavily weighted on other risks (e.g., interest rate risk, policyholder behavior risk). By moving to excess-of-retention reinsurance arrangements, they retain more first-dollar mortality risk while controlling for tail risk.

A higher retention limit may be beneficial in the short term, but if the economy continues to experience little growth, longer-term prospects may be less positive. The financial impact of a couple of million-dollar claims may be reasonable under a 90-10 reinsurance arrangement but introduce unacceptable volatility under a high-level excess-of-retention treaty (Figure 1).

Continued economic uncertainty also introduces increased policyholder behavior risk. While the most important assumption in life insurance pricing is mortality, lapse assumptions are also critical. An uncertain economic future leads to increased selective lapsation. Policyholders most intent on persisting are those who recognize...
the economic value in the policy – that is, individuals who perceive themselves as a higher risk. Therefore, the greatest lapse risk lies with insureds who believe they can get by without coverage until the economy improves – the specific lives an insurer wishes to retain. This raises the risk of claims frequency and severity that exceed pricing assumptions.

**Interest Rates a Key Concern**
The most prominent cause of requoting, though, appears to be the current sustained low interest rate environment and its effect on life insurance products. Low interest rates have an impact on both reserve financing considerations and general account performance.

**Reserve Financing Perceived as Less Important.**
Coinsurance allows direct writers to pass on a proportionate amount of their reserve strain to reinsurers. The financing offered through reserve credits drove growth in coinsurance, especially for XXX solutions. Charges for this financing often were less than the interest rates many lenders charged carriers for similar financing, leading to arbitrage opportunities. Because coinsurance financing is an integral component of risk transfer, its duration matches the duration of the redundant reserve liability. A letter of credit (LOC) issued by a bank, on the other hand, may result in duration mismatch and is not guaranteed renewable.

In addition the differences between financing structures, whether through coinsurance or LOCs, has become less pronounced. Since the beginning of the recession, interest crediting rates have converged for life insurers and reinsurers removing arbitrage advantages in XXX coinsurance arrangements. Additionally, the current capital position of many direct writers enables them to assume more reserve strain.

As companies retain more mortality risk and as reserve financing is less a priority, we have seen a decline in first-dollar coinsurance bids. In their place, requests for excess-of-retention YRT quotes have become more prevalent.

**Interest Rates Will Affect General Account Asset Returns.** A low interest rate environment will affect the general account of both life insurers and reinsurers. Interest-sensitive products experience the greatest exposure as insureds lock into minimum crediting rates that are higher than prevailing interest rates. But even traditional mortality products face challenges if a product’s interest rate assumptions are higher than actual yields for any prolonged time period.

As interest rates remain low, insurers must either replace maturing fixed income assets with similarly rated (but lower yield) bonds or seek similar returns through riskier instruments. The effect in either scenario is lower product profitability, but so far life insurers have been able to avoid raising premium rates. Because of the size and diversification of an insurer’s investment portfolio, they benefit from a “portfolio lag effect.” When interest rates drop, the size and time horizon of the bond portfolio allow them to continue experiencing appreciable rates of return (Figure 2). This results in company portfolios outperforming current bond yields.

Investment risk for all insurers is gradually increasing. A prolonged low-interest rate environment – especially in a stagnant economy – could weaken a firm’s general account. Most life insurers’ investment portfolios are large and diverse enough to sustain short-term rate drops. Continued historically low rates, however, will erode earnings at an increasing pace and force insurers to review their interest rate assumptions. Of course, this is an industry-wide concern, affecting all financial intermediaries.

**Reinsurers Can Share Risk and Knowledge**
In a flat sales and uncertain economic environment, maintaining profitability and shareholder value becomes more important as carriers wait...
for market conditions to improve. But there’s a fine balance between short-term profitability and long-term sustainability.

Life insurers continually assess their reinsurance programs. Reinsurers provide more than simple risk coverage and diversification opportunities. Therefore, regardless of the strategy a carrier pursues, having established relationships with reinsurers in place remains a core risk management strategy – not only to ensure that capacity is readily available if called upon, but also to allow a carrier to access the reinsurer’s risk advisory and assessment capacities. ∞