

TO: Our Colleagues in the Life Insurance Community

FROM: Nancy Bosley, CLU, ChFC

RE: Prospects for the Year 2005

Periodically, our industry is called upon to reinvent itself. Typically, a change of the magnitude we are about to see is driven by tax and legislative issues, economic conditions, pressure for higher corporate profits and competitive product issues.

The year 2005 will bear witness to a perfect storm created by the convergence of virtually all of these issues. The continued low interest rate environment coupled with an unstable market, the evaporation of “sweetheart” reinsurance agreements and the current emphasis on proper product reserves will result in a high degree of difficulty in doing business.

We view these challenges as healthy for our industry as they will create a stronger platform from which we can all do business. At the same time, 2005 will present a challenging environment for all of us, producer and general agent alike.

At Belman Klein Associates, we recognize the pressures created by the new dynamics of the marketplace. With that in mind, we too have undergone a reinvention process. We have evaluated our strengths and weaknesses in an attempt to position ourselves to be a better business partner to you. We want to positively impact your business with ideas and implementation strategies that will result in improved bottom lines for all of us. We are committed to learning about your practice and evaluating whether we can be a fit for you. We are not so naïve as to suggest that our services or even personalities are right for every broker. Our goal, however, is to get to know you better and make a commitment to bring you the appropriate fulfillment services relative to carrier selection, proposal capability and timely application processing.

We want our relationship with you to be both practice specific and friendly. This new business atmosphere creates the need for a brokerage partner with the experience and sophistication to know where cases can be underwritten. We have long standing and trusted business relations with carriers that themselves have impeccable financial credentials and impeccable business practices. The relaxed “wheeling and dealing” days of the insurance business are over. For those of us that didn’t fit well in that genre, this is a breath of fresh air. Professional and business best practices are the hallmarks of this new era and we feel comfortable working in that environment. We’d like to have you with us.

Enclosed please find the first in a series of articles discussing the issues that we feel will define much of 2005.

THE RIPPLE EFFECT OF REINSURANCE (1995-2005)

In the late 1990's we became accustomed to the near daily "fire sales" of term insurance products as Triple XXX loomed over our collective horizons. The regulations were implemented in the year 2000 and doom saying abounded that rates would rise and that underwriting would tighten as demands increased on carrier reserves. Remarkably, just the opposite happened. Product costs continued to decrease. Creativity in the development of No Lapse Guaranteed Universal Life soared. In some cases, underwriting liberalized through the advent of Table Shave and Life Style programs.

How, you might ask, could such things happen? The short answer to that critical question is: CREATIVE REINSURANCE. Let's do the basics of how those transactions initially worked in our favor and how subsequent historical events (9/11) and a pattern of economic trends have taken away what Triple XXX had given.

Insurance companies hold what is known as their RETENTION. This amount is the piece of the death benefit for which the carrier is directly responsible. Retention varies among companies and is generally a number in direct proportion to the carrier's financial strength and reserves. Excess amounts of coverage are "laid off" to reinsurers who assume the balance of the risk. Included in this agreement is definition of which company (direct or reinsurer) underwrites all or part of the case.

In 2000, Triple XXX changed everything by creating demands on life insurance companies to set aside additional reserves to cover claims exposure. At this point, a definitive change occurred in the world of reinsurance. Life companies needed to find ways to maintain the sanctity of their balance sheets and earnings pictures while simultaneously meeting the rigorous requirements of the regulators. The most efficient way of doing this was to ***transfer more of the risk to a reinsurer and retain less at the carrier level***. The interesting financial result was that the life insurance company could now write up to ten times as much coverage while only tying up a limited amount of reserves. Thus was born the process known as "Quota Share Reinsurance".

Quota share means that a larger amount of any risk is reinsured. Conceivably, as little as 10% of a case, no matter how small, is held by the life carrier with the other 90% going automatically to a pool of reinsurers. On the surface this is a “good deal.” Reserving problems are reduced and carriers can be creative with pricing and product development. Looking deeper into this approach, however, reveals the root causes for the problems with which we find ourselves contending in 2005.

Under quota share arrangements, reinsurers are now directly involved in virtually every case written. Unfortunately, this need for additional reinsurance capacity occurs at a time when availability is actually shrinking.

Over the past decade and especially in the last five years, the reinsurance market has been impacted negatively by three issues:

- Consolidation
- Pressure for better operating performance
- Higher than projected mortality, especially at older ages

Relative to consolidation, the numbers of reinsurers have declined from as many as 25 to fewer than 10. Capacity on an individual life has dropped from as much as \$200 million to \$80 million.

The operating results of carriers have been hugely affected by three financial events:

- 1) A prolonged low interest rate environment
- 2) A challenging environment of currency fluctuation
- 3) Unstable stock markets

Finally, older age mortality has been significantly higher than anticipated.

All of these issues force reinsurers to implement strategies to improve their bottom lines and garner favor from the rating services and capital markets. Because first dollar quota share is so prevalent, the life insurance carriers are finding themselves in incredibly difficult positions as they negotiate new

reinsurance treaties. The most important issue will likely be a requirement for absolute adherence to much more rigid underwriting guidelines.

Naturally, all of this filters down to the producer. So what shall we watch for this year?

- 1) Potential for price increases in both term and guaranteed U.L. products
- 2) Compensation decreases, especially on older age cases
- 3) “Business decision” underwriting is likely to disappear as reinsurance companies ratchet up post-underwriting audits.
- 4) Disappearance or pullback from table shave programs
- 5) Reduction in large case capacity

Given these pressures, it will be particularly important for producers to align themselves with resources that know their way around these underwriting minefields.

This article was prepared from a number of resources, including personal interviews with carriers. Special thanks go to our colleague, Chris Greis, who has made an exhaustive study of the reinsurance topic.