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Managing Net Retained AD and AD&D exposure via Quota Share Reinsurance

Responding to the Question of Terrorism and Life Reinsurance: Will There Be An Impact?

Currently, there has been very little change in the way life reinsurers are marketing, underwriting, and pricing life reinsurance. This is due to:

1. Continued favorable mortality trends
2. Healthy competition nationwide and
3. Much of the Life Reinsurance market having relatively low losses from 9/11

How can this be, with all of the huge loss reports you've been reading about? The answer is: Catastrophe Reinsurance! In addition to excess group or individual life coverage that attached excess of a few hundred thousand dollars per person, most prudent companies bought catastrophe covers protecting their net retentions and limited their net exposure to a manageable number of lives. Additionally, many of the excess life reinsurers in turn hedged their risk by ceding good portions of their assumed exposure to other entities around the globe and the risk got filtered and spread-out as it should when the markets are working in harmony. The companies that bore the brunt of the individual and group life claims were the providers of catastrophe coverage who protected the net retentions of the insurance companies. This in large part explains why there has been very little change in the excess per life reinsurance arena to date. The life reinsurers realize that if they exclude terrorism or raise prices, they will either not be a viable market or they will be uncompetitive. If there is another major event, however, and without the catastrophe market as a safety net, I believe there will need to be changes in what the reinsurance products cover and how they're priced and I also believe there will need to be price increases at the consumer level.

What has changed dramatically in the wake of 9/11, is the way insurance companies are having to manage their net retained exposure. This is due to the following:

1. Catastrophe coverage is limited in what it will provide.
2. There is an increased need to report census broken down by state and zip code.
3. A&H market capacity has dropped from close to \$1 billion down to \$150 million or less.
4. Pricing has exploded in a classic case of supply and demand.
5. There is currently no state approval for any kind of group life or disability policy terrorism exclusion.

So what do you do now? It really starts with insurance companies taking an inventory of their exposure so they can make informed decisions on what the appropriate strategy should be with respect to reinsurance. Then, there's basically 5 options:

1. Pay the price for catastrophe coverage and peace of mind.
2. Roll the dice and retest the market in 2003.
3. Wait for a Federal backstop (which is dead for now and isn't going to happen any time soon).
4. Buy facultative catastrophe coverage on a group by group basis for the groups that concern you most, this would also apply for COLI/BOLI.
5. Manage your net retained exposure to Accidental Death via quota share reinsurance.

As a viable alternative to catastrophe coverage, it is certainly worthwhile exploring the quota share approach to managing your net retained exposure to Accidental Death. When determining whether or not this makes sense for you, the analysis simply consists of determining how much profit will be given up on the quota share approach versus how much expense you would incur buying a catastrophe cover, all other things being relatively equal.

By submitting census and experience data on your net retained portfolio of Individual Life, Bulk ADB, COLI/BOLI, Group Life, Group AD&D, and Common Carrier business, ING Re can assess the risk and offer a price for the AD and AD&D component which will enable you to hedge your position in the event of future adverse mortality related to accidents. This is the way much of reinsurance used to be done before the abundance of catastrophe capacity. The quota share coverage can be purchased with or without coverage for terrorism. For COLI/BOLI business and Group business, there is an occurrence maximum assigned based on a review of the concentration of risk. The occurrence maximum is generally \$20,000,000.

Depending on how much of the quota share arrangement you retain, coupled with the size of the book and historical profitability, a profit commission (P/C) may be available. The profit commission will utilize a claims fluctuation reserve (CFR), whereby the amount added from the P/C to the CFR each year is 25% of the Earned Premium (EP) to a maximum CFR of 50% of EP. Interest will be credited to the CFR starting at the first anniversary of the program. The interest rate applicable to the CFR shall be the average of the 90 day Treasury Bill Rate for the preceding 12 months. There is a three year sliding scale for early termination to the CFR – termination after one year: no return of the CFR; termination after year 2: 50% return of CFR; termination after year 3: 100% return of CFR. The funds in the CFR and the interest credited to the CFR belong to the ceding company, but are maintained in an account held by ING Re to be used to fund future claims in the event of adverse mortality. Once the CFR is fully funded, the entire P/C for future periods becomes payable.

Depending on your financial goals and risk management objectives, the first dollar quota share approach offers a risk sharing alternative in a very challenging environment and it may indeed signal a change in the way companies manage their net retained risk to Accidental Death going forward. In fact, some life insurers may simply adopt the philosophy of keeping the risk only from "death by natural causes" because that is the most predictable portion of the life risk.

To obtain quotes for the Accidental Death components of your portfolio, please contact your ING Re sales executive.