CPCU SOCIETY INSURING YOUR SUCCESS

Reinsurance Section Encounter RISE

Volume 23 Number 1 February 2005

Reinsurance Training and Education—Always in Vogue!

by R. Michael Cass, J.D., CPCU

R. Michael Cass, J.D., CPCU, is president and principal consultant for R.M. Cass Associates, an independent consulting firm located in Chicago. Formed in 1987, the practice emphasizes reinsurance and related matters. A graduate of Penn State University and Temple University School of Law, Cass is a member of the New York Bar; the American Arbitration Association's Panel of Neutrals; and a certified arbitrator for ARIAS–U.S. He is past chairman of the CPCU Society's Risk Management Section Committee; a former member of the Excess/Surplus/Specialty Lines Section Committee; and currently serves as chairman of the Reinsurance Section Committee.

The past year has placed the insurance industry squarely in the eyes of the public like never before. In New York, the attorney general has investigated and attacked industry practices and sought restitution for wrongdoing. Civil lawsuits and class actions were spawned by the inquiries in New York and elsewhere. At the same time, catastrophe losses, particularly in Florida, caused initial concerns about the industry's ability to respond and whether insurance would continue to be available in some geographic areas.

Reinsurance training and education are "always in style" . . .

Insurance and reinsurance professionals certainly do not have all the answers but your Reinsurance Section Committee is working diligently to provide programs around the country that address current market conditions. Reinsurance training and education are "always in style" and your committee has several events planned over the course of 2005. Chicago, Phoenix, and Atlanta are locations for our scheduled programs that we believe will have value and appeal to most of our members and the industry at large.

On February 3, 2005, in Chicago, the CPCU Society's Reinsurance Section partnered with a Reinsurance Education & Communication Hotline (REACH) quarterly luncheon event by presenting a workshop, "Understanding Reinsurance—What You Need to Know in Today's Marketplace." The workshop followed the REACH luncheon where CPCU Society President Donald J. Hurzeler, CPCU, CLU, addressed ethical issues in today's competitive marketplace.

Continued on page 2

What's in this Issue?

Reinsurance Training and Education—Always in Vogue! 1

Appointment of Reinsurance Arbitrators—A Burden for the Courts? . . .3

Reinsurance Section Symposium/
Associate in Reinsurance Completer Luncheon 4

Reinsurance—State of the Art 5

U.S. Reinsurance Underwriting Results Improve,
How Long Will the Recovery Last? 8

Reinsurance Section Research Project—Insurance Derivatives 12

Reinsurance Training and Education—Always in Vogue!

Continued from page 1

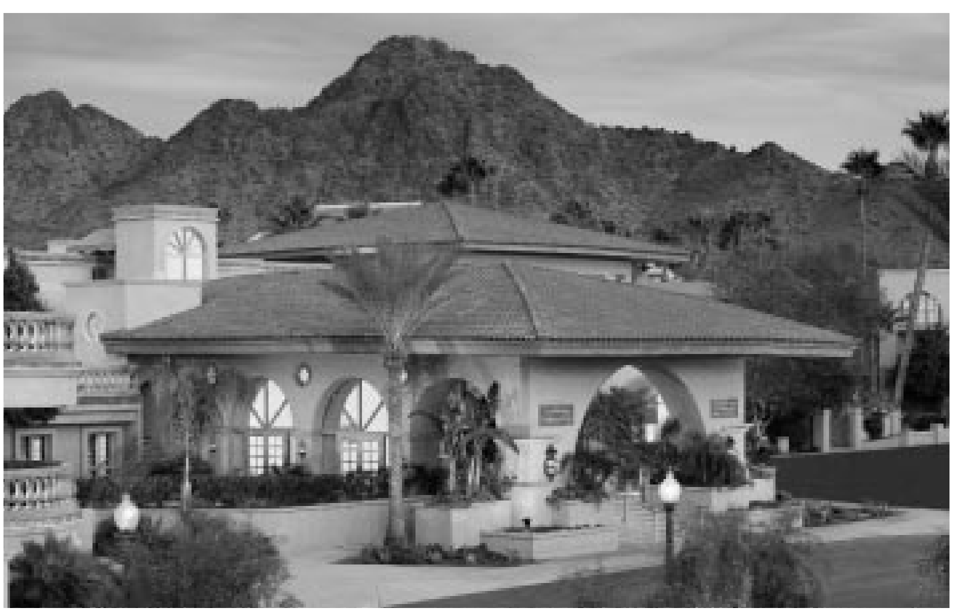
The workshop had two components, opening with a two-hour reinsurance fundamentals session. Titled “The Top 10 Reasons That Reinsurance Is Misunderstood,” basic reinsurance concepts were combined with some intended humor. In the second session, a panel of industry executives discussed current insurance and reinsurance marketplace issues. This workshop was an excellent opportunity to network and review reinsurance fundamentals while gaining a better understanding of the marketplace as it exists today.

Our annual Reinsurance Symposium will be held this year in Phoenix, Arizona. The dates are Tuesday and Wednesday, April 12 and 13, 2005, at the Pointe Hilton. Again, this program consists of two parts. The Tuesday morning program is a reinsurance basics session conducted by long-time industry professional and educator Professor Bruce D. Evans, CPCU. This program is entitled “Confirming Reinsurance Fundamentals—With Certain Twists.” We expect Professor Evans will present solid basics plus provocative issues that will be of interest to all attendees.

The Reinsurance Symposium will follow the reinsurance fundamentals session. The symposium begins at 1:30 p.m. and continues through Wednesday, April 13. The program includes a “View from the Top Panel” of industry executives discussing current market issues, a review of occurrence definitions in reinsurance contracts, loss aggregate and allocation issues, a catastrophe modeling session, governmental issues for reinsurers, and finally a session surveying securitization, finite reinsurance, and industry loss warranties.

As always, the Reinsurance Section will be represented at the CPCU Society’s Annual Meeting in Atlanta, Georgia, in October. This year, the section will be offering our traditional “Reinsurance—State of Art” program of industry executives. The focus of this year’s Annual Meeting seminar is fraud in the industry. In keeping with this concept, the Reinsurance Section is also developing a session that deals with fraud issues that sometimes surface in reinsurance.

I certainly encourage all section members to become involved in any of these programs in either the planning, facilitation, or attendance at the events. Please contact me at mikecassre@aol.com or any Reinsurance Section Committee member concerning your involvement or reach John Kelly, CPCU, at the CPCU Society offices at jkelly@cpcusociety.org. ■



■ *The Pointe Hilton Squaw Peak Resort is host to the 2005 CPCU Society Leadership Summit, April 13–16, 2005.*

Appointment of Reinsurance Arbitrators—A Burden for the Courts?

by Andrew S. Boris, Esq.

Andrew S. Boris, Esq., is a partner in the Chicago office of Tressler, Soderstrom, Maloney & Priess. His practice is focused on litigation and arbitration of insurance coverage and reinsurance matters throughout the country, including general coverage, directors and officers liability, professional liability, environmental, and asbestos.

Before attending law school, Boris worked for a major insurance company. He remains licensed as an insurance provider and has extensive experience in interpreting insurance policies and the coverage they provide. In addition, he has authored and spoken on a variety of topics including general insurance coverage, reinsurance, bad faith, and general litigation issues. Boris has served as an adjunct professor at the DePaul University College of Law having taught both litigation and legal writing classes.

Boris received his undergraduate degree from Boston College and his law degree, with honors, from DePaul University College of Law where he served on the law review and was a member of the Order of the Coif.

Editor's note: The opinions expressed herein are those of the author and do not reflect the views of Tressler, Soderstrom, Maloney & Priess or any of its clients. www.tsmp.com

One common reason offered to support the inclusion of arbitration clauses in reinsurance contracts is to keep the decision-making responsibility for the dispute with those who understand the business of reinsurance. While the ability to keep the reinsurance dispute in a private setting with a somewhat expedited and cost-efficient process is the preferred approach for many companies, it is probably most important that seasoned reinsurance and insurance professionals address the complex problems associated with reinsurance contracts. Traditionally, most arbitrators are chosen by the parties involved in the arbitration or by some form of lottery process. A recent opinion by a federal district court highlights the difficulties presented when the courts are asked to analyze the question of who should be appointed as an arbitration umpire. See *Travelers Indemnity Company v Everest Reinsurance Company*, 2004 WL 2297860 (D. Conn. 2004).

The factual background of the *Travelers* case is relatively straightforward. In 2001, Travelers and Everest entered into a treaty wherein Everest agreed to provide Travelers with reinsurance. Travelers issued certain bonds relating to the delivery of crude oil and natural gas by two subsidiaries of Enron. After Enron collapsed, a variety of third parties demanded that Travelers make payment on the bonds. Travelers engaged in litigation relating to its alleged liability for the bonds and ultimately settled the litigation for $7,700,000. Everest refused to indemnify Travelers, contending that the Enron bonds were not surety bonds and were more properly characterized as financial guarantee insurance. Further, Everest contended that the bonds were outside the coverage provided by the reinsurance contract. Pursuant to the terms of the treaty, the parties agreed to arbitrate their dispute.

The parties each identified a party-arbitrator, but they were unable to agree upon the selection of an umpire. The terms of the treaty identified the procedure to be utilized by the parties if they were unable to agree on an umpire. The treaty required that each of the parties identify three candidates with an umpire to be chosen by a federal judge from the federal court having jurisdiction over the area in which the arbitration was to take place. Sequentially, if the federal court declined to act, a state judge in the appropriate court would be asked to identify an umpire. If the state judge refused to act, the umpire would be chosen by drawing lots.

In analyzing the question of how to select an umpire, the court identified the qualities and characteristics desirable for an umpire involved in the instant

Continued on page 4

Appointment of Reinsurance Arbitrators—A Burden for the Courts?

Continued from page 3

reinsurance dispute. Relying upon the requirement that the arbitrators be active or former officials of insurance or reinsurance companies or underwriters at Lloyd's of London, the court concluded that executive-level knowledge of the insurance and reinsurance industry was a mandatory consideration. The federal court also concluded that the arbitrator must be impartial and have the necessary experience in managing arbitrations to facilitate an orderly and efficient dispute resolution process.

Of the three candidates proposed by Everest, the federal court summarily dismissed two of the candidates because they had no experience as an arbitrator. The third Everest candidate was also not selected by the court, but based upon a different analysis. In addition to serving as an umpire and party arbitrator for Everest in two prior arbitrations where Everest was a party, Everest's third candidate previously served as an expert for both Everest and the counsel engaged by Everest for the present reinsurance dispute. The court determined the mere impression of a possible bias that may be caused by the candidate's prior role as an expert witness was enough for the court to pass on his appointment as umpire.

The court found that each of the candidates proposed by Travelers had served or were serving as executives of insurance or reinsurance companies. The court also found each candidate had extensive arbitration experience. In the end, the court chose the candidate who exhibited the most arbitration experience.

This decision is interesting for a number of different reasons. First, the court's emphasis on arbitration experience was quite straightforward in its application. As the number of reinsurance-related arbitrations continues to increase, the demand for available arbitrators also increases. The court's significant emphasis on arbitration experience sends a message to those newly certified arbitrators—get experience. While many insurers and reinsurers appear willing to engage arbitrators with limited experience, courts are less receptive to the concept. Second, the court determined that one of the candidate's past service as an expert witness for one of the parties raised the potential appearance of bias. Some may view the court as having employed a very strict view of impartiality with respect to the selection of an umpire. While impartiality is a vital component to the umpire selection process, it is not entirely unusual for an umpire to have served as an expert witness for one of the parties in an unrelated matter. Thus, this case points out how the courts may read certain principles, such as impartiality, more strictly than parties to an arbitration may view the issue. Third, after examining all of the candidates, the court chose the individual with the greatest number of arbitrations. It is unclear what degree of investigation was conducted with respect to the particular strengths that each of the candidates might have possessed. Nonetheless, this potentially simplistic approach to umpire selection would seem to undermine the qualifications and strengths that each of the candidates may have possessed.

Many in the reinsurance industry continue to call for implementation of all neutral arbitration panels or greater use of the traditional legal system to resolve reinsurance disputes. By removing the party-arbitrator, many believe that the dispute resolution process would be more efficient if a completely neutral panel (or judge) were responsible for hearing the case. What becomes clear is that the combination of the courts and the selection of umpires, as exhibited in the *Travelers* case, may present an entirely different set of issues. ■

Reinsurance Section Symposium/Associate in Reinsurance (ARe) Completer Luncheon Moves to Phoenix on April 12 and 13, 2005!

Be sure to mark your calendar and plan to attend the annual Reinsurance Section symposium in sunny Phoenix, Arizona!

In addition to the usual one and one-half day symposium—at which noted reinsurance industry professionals will share their knowledge and opinions—the two-day event will feature a workshop that is both a refresher course for reinsurance professionals and a primer for those who need to understand reinsurance basics to improve job performance.

The workshop and symposium will take place on Tuesday and Wednesday, April 12 and 13, 2005. Your Reinsurance Section Committee is busily designing the instruction, and will share additional details soon. CPCU Society members and nonmembers may register for either or both education events.

We hope to see many Reinsurance Section members at these excellent education and networking events! And while you're there, you may want to extend your stay to attend CPCU Society National Leadership Institute (NLI) courses! Learn more about the NLI—and the entire CPCU Society Leadership Summit—by visiting **www.cpcusociety.org** or calling the Member Resource Center at (800) 932-2728, option 4.

See you in Phoenix!

Reinsurance—State of the Art

by Richard G. Waterman, CPCU

Richard G. Waterman, CPCU, is president of Northwest Reinsurance, Inc., a Minnesota-based management consulting firm specializing in the fields of insurance, reinsurance, and dispute resolution. Waterman is the former president and chief executive officer of American Equity Insurance Company and GRE-RE of America Corp. In addition to the duties of his consulting practice, Waterman has been appointed as an arbitrator or umpire on more than 100 panels to resolve industry disputes as well as serving as a neutral mediator, facilitator, and fact finder to assist parties in working out differences in a confidential setting. Waterman is a charter member of ARIAS US, is an ARIAS US Certified Arbitrator and Umpire, and chairs the ARIAS US Ethics Committee. He earned a master's degree in management from Hamline University and a bachelor of arts degree from Concordia College. Waterman has been a member of the CPCU Society since 1978 and serves on the Reinsurance Section Committee.

A long-standing tradition of the CPCU Society's Reinsurance Section has been to present a seminar at the Society's Annual Meeting and Seminars titled "Reinsurance—State of the Art." Each year's highly regarded panel discussion of knowledgeable industry executives examines a full range of interrelated contemporary topics affecting the insurance/reinsurance industry. Together with welcomed questions from the audience, this ongoing seminar series helps Annual Meeting audiences understand how the industry is affected by current developments and how the industry will likely meet present-day challenges to adapt to the future.

Introduction

Once again this year, Sandra L. LaFevre, CPCU, CPIW, vice president and assistant secretary of the Reinsurance Association of America, moderated this featured seminar. The distinguished panel was comprised of James Ament, CPCU, vice president-operations at State Farm Fire and Casualty Company; Joseph Dillon, CPCU, senior vice president, Fireman's Fund Insurance Company; Rupert C. Hall, president and CEO of Golden Bear Insurance Company; and Todd Hess, chief risk officer and deputy at Swiss Re Underwriting Agency.

Sandra L. LaFevre, CPCU, CPIW, served as moderator of Reinsurance—State of the Art developed by the Reinsurance Section. Panelists included (from left to right): Todd Hess, Rupert C. Hall, Joseph Dillon, CPCU, and .James Ament, CPCU.

To introduce the seminar topics, LaFevre explained that in recent years the stability of the worldwide reinsurance industry has been tested. Analyzing just the domestic market, the following signs of strain were noted:

- Over the past four years, Standard and Poor's has downgraded 14 of the 20 largest global reinsurance groups.
- The number of U.S. reinsurance markets has been greatly reduced. To underscore the consolidation, 115 companies reported reinsurance results to the Reinsurance Association of America (RAA) in 1980; in 1990, only 70 companies responded to the RAA's industry survey. Through the second quarter of 2004, only 30 companies, including Bermuda start-ups, reported reinsurance statistics to the RAA.
- In just the last two years, six major companies have left the reinsurance business.
- Since 2001, several of the remaining U.S. reinsurers have made significant reserve increases.
- Catastrophe losses during the third quarter of 2004 resulting from four major hurricanes that hit the southeastern states produced the second-worst catastrophic quarter and may result in total losses exceeding the amount incurred on September 11, 2001.

The panelists were generally optimistic about the current state of affairs of the reinsurance marketplace notwithstanding the financial difficulties experienced by many reinsurance companies over the past several years. It was observed that in the aftermath of huge 2004 catastrophe losses, major domestic reinsurers were not seriously impacted and remain financially strong with adequate capacity to meet the needs of primary companies in the year ahead. Unlike conditions after hurricanes Andrew and Iniki in 1992, the Northridge earthquake in 1994, and September 11, 2001 losses when reinsurance capacity for certain exposures was scarce and expensive, reinsurance capacity following the hurricane events this year remains strong, adequate, and stable.

It was mentioned during the panel discussion that the reinsurance industry is far more sophisticated and focused on quantitative analysis as a basis for rate adequacy in contrast to less precise market pricing techniques. The heightened level of underwriting discipline has apparently promoted a more stable reinsurance market that is far better prepared to absorb

Continued on page 6

Continued from page 5

catastrophe losses compared to years ago. Curiously, the panelists also mentioned that prior to the 2004 hurricane season there was some easing of reinsurance rates and conditions. That has now changed, due in part to the high level of losses incurred as a result of the four hurricane events. Reinsurance rates and conditions have stabilized while ceding companies continue a trend of increasing net retentions whereby reinsurance is purchased for true capacity situations and catastrophic exposures instead of merely trading dollars for frequency exposures that are statistically predictable and, therefore, should be manageable.

Focus on Security

The financial impact of reserve boosts and consequential rating downgrades, even among some of the world's largest and longest established reinsurers, was another topic the panel addressed. LaFevre introduced the subject by pointing out that before September 11, 2001, more than half the U.S. reinsurance capacity was rated AAA. Furthermore, primary insurers in 2001 could find $123 billion of U.S. reinsurance capacity rated AA or better. Today, only $67 billion of reinsurance capacity is rated AA. Remarkably, only one reinsurance company is rated AAA.

Confirming a heightened awareness on the part of primary companies of the need to look more closely at the quality of reinsurance security, the panelists acknowledged that what constitutes a secure reinsurance company is not always clear. In addition, adequate high-rated capacity is still more difficult for casualty lines of business than property. Nonetheless, the panelists believed that in most instances, a primary company can find adequate reinsurance capacity rated A+ or better for most classes of business.

Another closely related subject pertains to the increasing tendency of ceding companies demanding financial ratings linked to cancellation provisions or special funding provisions in reinsurance contracts. The surge in downgrades over the past two years has made ceding companies more sensitive to the credit worthiness of their reinsurers as well as their ability to meet their financial obligations. One technique ceding companies have implemented to deal with these financial risks is by negotiating special termination and special funding provisions.

The panelists generally agreed that termination triggers and special funding provisions are not a substitute for careful security analysis before accepting any reinsurance capacity. In fact, special funding provisions may give a false sense of security. The panel explained that the long-tail nature of casualty reinsurance may create a timing issue when the special funding provisions are activated. For instance, if a casualty reinsurer runs into financial difficulty, many ceding companies will invoke the funding provisions in their contracts, which may cause a "run on the bank" that would seriously inhibit the reinsurer from meeting all of its special funding obligations. In addition, a ceding company that did not negotiate a special funding provision in its contract would be seriously disadvantaged in the event a reinsurer's rating was downgraded. One panelist commented bluntly that if you have to ask for termination or special funding provisions, your interests may be best served by finding another reinsurer.

New Reinsurance Capital

The discussion moved on to the emergence of new reinsurance capital. LaFevre observed that last year A.M. Best estimated that $25 to $30 billion of new capital has entered the reinsurance market since September 11, 2001, when at the same time the industry lost at least $35 billion. The capital coming into the market has not been able to keep pace with demand. In the months after September 11, this capacity shortfall encouraged the formation of new reinsurers. Based mostly in Bermuda, those highly capitalized insurer and reinsurer start ups formed in the months after the 2001 terrorist attacks, are now considering ways to use that capital to keep their investors happy. The new Bermuda-based companies are performing well, but some say that the window of opportunity will not be wide open forever.

The panel then addressed some of the challenges faced by the new Bermuda reinsurers seeking profitable ways to use their capital to produce returns for their investors. In recognition that the Bermuda start-ups are well capitalized and professionally managed, it is likely that several will expand and write more business outside the scope of providing property catastrophe reinsurance. They may acquire or establish a subsidiary in the United States to write more reinsurance business or perhaps form a special purpose primary insurance company. Alternatively, if reinsurance rates are not attractive, Bermuda-based companies may decide to shrink their capital through stock repurchase buybacks or via other means to return capital to their owners.

Managing the Underwriting Cycle

Where are we on the underwriting cycle? In response to that question, the panelists did not believe that the 2004 hurricane losses will likely have a major impact on primary and reinsurance pricing, especially if the actual hurricane losses are calibrated with the catastrophe models that are widely used to measure potential catastrophe losses. And given the greater industry reliance on modeling techniques and related quantitative risk analysis for both pricing and reserving, which is often conducted by actuaries, underwriting cycles probably will be smoother compared to the pronounced market reaction in the mid-1980s. Nonetheless, even though primary and reinsurance pricing has become more data driven and less market driven, the panelists generally agreed that current market conditions are moderately competitive for both property and casualty lines of business.

Commenting on whether it is possible to manage underwriting cycles, panelists pointed out that non-economic analytical tools should be relied on to a greater degree. In addition, underwriters need to pay constant attention to risk management fundamentals and spread of risk. The use of models is another technique to manage cycle forces and balance geographic exposures. The panelists confirmed that various types of risk modeling have become de rigueur for many companies. Modeling technology has developed into a sophisticated tool to measure windstorm and earthquake aggregate exposures as well as workers compensation concentration exposures. And even though modeling is not a perfect risk analysis measurement, panelists mentioned that it is relied upon for many underwriting decisions.

Terrorism Risk Insurance Act (TRIA)

A recent study concerning the demand for terrorism coverage reported that nearly half of U.S. businesses opted to buy terrorism coverage in the second quarter of 2004. That is almost double the number compared to a year ago. Panelists pointed out that a component of the terrorist exposure is nuclear, biological, and chemical events, referred to as NBC perils. TRIA is the only protection insurance and reinsurance companies have for NBC losses. TRIA is a federal act that created a backstop with a potential industry-wide aggregate of as much as $100 billion for insurers faced with losses arising from a catastrophic terrorist attack and is slated to sunset on December 31, 2005. In some instances, reinsurers are providing protection for terrorism, although the NBC perils are generally excluded. In the event Congress does not extend TRIA through the end of 2007, primary insurance companies would have no protection for losses arising out of an NBC attack. Consequently, many primary insurance companies are seeking permission from state insurance departments to exclude NBC perils.

Panelists observed that reinsurers are extremely reluctant to offer protection for NBC perils. There simply is not enough data available to price the coverage. Additionally, several studies indicate that a hypothetical biological event, for instance, would likely produce a massively bigger loss than September 11, 2001. Therefore, given the unknown exposure, there is not adequate capacity for the NBC component of the terrorism risk. What is more, due to the unlimited magnitude of an NBC event, there is plainly not enough reinsurance capacity in the world to provide meaningful coverage beyond a capped industry loss. Therefore, Congress ultimately will need to provide legislation for protection above a capped industry limit for a terrorist event we hope will never happen.

Reinsurance Recoverables

The subject of reinsurance recoverables was another major topic the panelists addressed. To put the issue in perspective, LaFevre observed that some people believe there is an issue of collectibility in reinsurance recoverable assets. Actually, collectibility was one of the most talked about and controversial topics in 2003 largely because in 2002, recoverables represented 60 percent of the U.S. industry policyholders' surplus. This number worried many analysts, particularly because of the deteriorating financial strength of reinsurance companies and the increasing number of reinsurers going into runoff. Nonetheless, according to industry research, in 2003, the industry's exposure to reinsurance recoverables fell. Notably, the study revealed that 2003 recoverable values stayed the same at $172 billion while the industry's policyholders' surplus increased from $285 billion to $347 billion. Thus, reinsurance recoverables dropped as a percentage from 60 percent to 50 percent of policyholders' surplus.

The panelists reminded the audience to differentiate between companies that are financially unable to pay reinsurance recoverables from those reinsurers that will not immediately pay their loss obligations. Due in part to the number of reinsurance companies in runoff, there are a number of former reinsurers that scrutinize loss payment requests more carefully, ask an abundance of questions, and seemingly take an inordinate amount of time before they eventually pay reinsured losses. Moreover, the concern surrounding slow-paying or non-paying reinsurers is highlighted by the significantly increased number of arbitrations convened over the past several years to resolve disputes related to reinsurance recoverables.

Concluding Comments

Following long-established custom, the "Reinsurance—State of the Art" seminar panelists described, explained, and helped us understand important industry developments. In light of the broad spectrum of business issues the panel addressed, this recap focused on particular subjects of significant interest. The Reinsurance Section Committee members are especially indebted to Sandra LaFevre for her leadership as the seminar moderator and are grateful to the panelists for their contributions. We look forward to continuing the Reinsurance Section tradition at the 2005 Annual Meeting and Seminars and hope you will join us at the reinsurance seminar. ■

■ *Hess, Hall, and Dillon engage in an intensive discussion.*

U.S. Reinsurance Underwriting Results Improve, How Long Will the Recovery Last?

by Bradley L. Kading, CPCU

■ **Bradley L. Kading, CPCU,** is senior vice president and director of state relations for the Reinsurance Association of America.

In recent years as you've thought about reinsurance, you've likely evaluated legacy versus start-up carriers, falling financial ratings, higher prices, reinsurers in runoff, and collectibility of recoverables. Now it's time to add improved underwriting results to the list!

In the *Reinsurance Underwriting Review*, published last June, the RAA's year 2003 analysis of 51 reinsurance carriers (principally engaged in assuming unaffiliated reinsurance premium) reported an aggregate combined ratio of 101.1 percent. Not yet an underwriting profit for the group, but reported data show that 20 of those players earned an underwriting profit. Plus the report documents the best results in more than 20 years. But with the good news comes the bad. Trade press reports are full of speculation that the property and casualty industry, having reported record year-end 2003 surplus, including strong reinsurers results, caused suspicion that the hard market is at an end. Where you stand on this proposition is based on where you sit, as some wise owl once observed. But for the reinsurers, recording significantly improved underwriting results is good news, sorely needed.

In this article, the RAA will review the highlights of the *2003 Reinsurance Underwriting Review* and comment on some industry trends worth noting.

The highlights from 2002 to 2003:

1. The industry combined ratio improved from 117.4 percent to 101.1 percent.
2. Surplus grew from $46.7 billion to $62.1 billion.
3. Net premiums increased from $30.8 billion to nearly $33 billion.
4. Underwriting losses shrunk from $5.7 billion to $600 million.

Even with this good news, some concerns should be obvious:

1. After consideration of investment income, the return on equity was a low 6.6 percent.
2. In 1997, reinsurers reported a combined ratio of 101.5 percent, in par with 2003, yet 1997 turned out to be the beginning of a huge accident year hole, one from which reinsurers are still digging.
3. One large reinsurer recently reported substantial additional reserve boosts for the 1997–2000 accident years raising questions as to whether all the bad news has been reported.
4. Ceding insurers are concerned about reinsurance collectibility and have been scaling back their lists of acceptable reinsurers.
5. With the active hurricane season, 2004 numbers will reflect higher cat losses.

Combined ratios varied greatly among the field, with the best combined ratio coming in at 41.5 percent, and the worst—for the going concern reinsurers—reported at 159 percent. Loss ratios for the field ranged from 26 percent to 419 percent with the average at nearly 74 percent. As a group, the investment yield was 4.2 percent.

The growth in surplus is improving reinsurers leverage ratios. The liabilities to surplus ratio in 2002 was at 226 percent—this improved to 188 percent in 2003. The net leverage ratio (premiums and liabilities to surplus) improved from 291 percent in 2002 to 241 percent in 2003. Net leverage ratios for three companies that recently entered runoff exceed 1,000 percent. Net leverage ratios run from 20.5 percent to 534 percent for the going concern reinsurers. As a group, the premium to surplus ratio was a low 53 percent reflecting the fact that reinsurers are carrying substantial surplus to support business—old and new. As you can see, reserve development, leverage ratios, and other underwriting and financial ratios vary greatly across this spectrum so you need to review the complete report when benchmarking your own reinsurer.

The improving reinsurance results don't remove the focus from the reinsurance recoverables on the ceding insurers' balance sheets. The RAA recently compared the list of reinsurers reporting data to the association in 1990 with those reporting data to us in 2004. We found that 80 percent of the reinsurers on that 1990 list are out of business: merged, sold their reinsurance business, in runoff, or otherwise out of the market. That's a huge change in a mere 14 years, but reflects the rapid consolidation that took place in a time period where reinsurers were under constant pressure to increase their capital bases.

Insurance regulators, investment analysts, and ceding insurers are closely watching their reinsurance recoverables. Here's some data the RAA recently provided to the NAIC as it begins a review in its Reinsurance Task Force on the reinsurance recoverables issues.

In five years from 1999 to 2003, reinsurance recoverables to the U.S. property casualty industry grew from $177 billion to $264 billion.

Continued on page 10

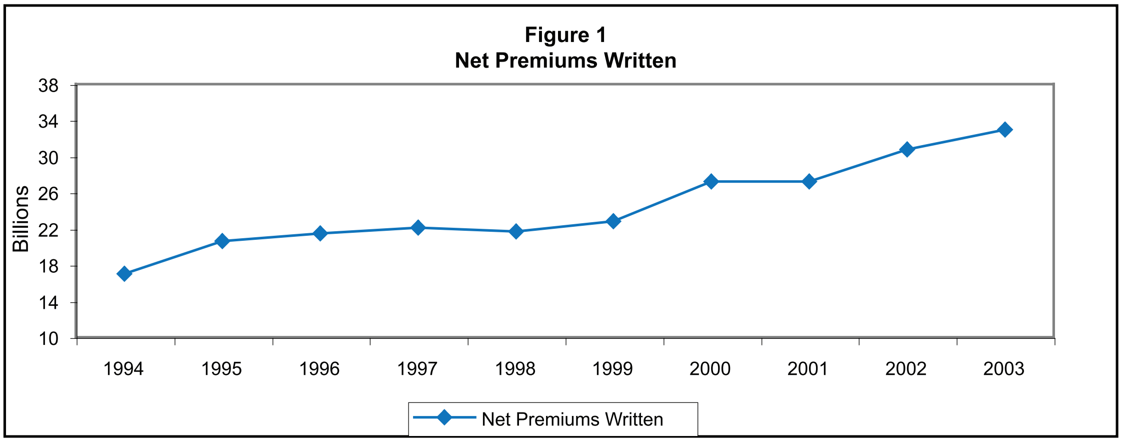


Figure 1
Net Premiums Written
Billions
38
34
30
26
22
18
14
10
1994
1995
1996
1997
1998
1999
2000
2001
2002
2003
Net Premiums Written

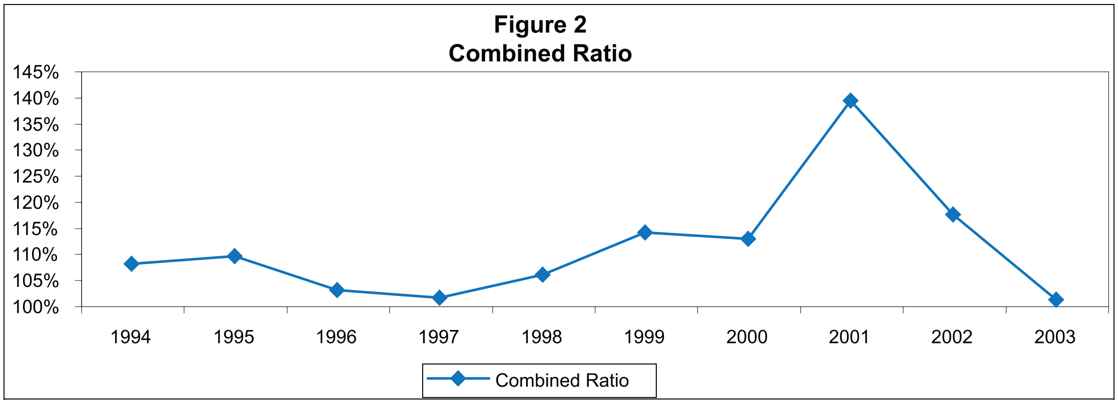


Figure 2
Combined Ratio
145%
140%
135%
130%
125%
120%
115%
110%
105%
100%
1994
1995
1996
1997
1998
1999
2000
2001
2002
2003
Combined Ratio

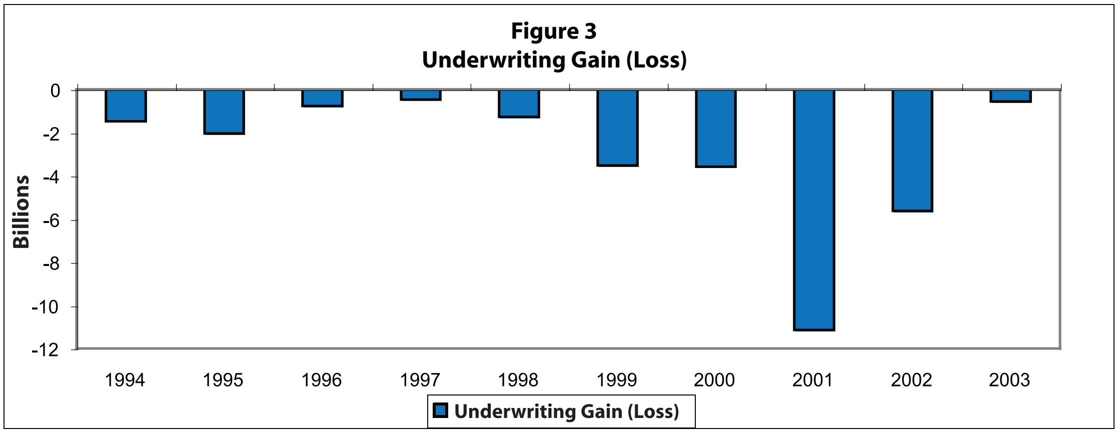


Figure 3
Underwriting Gain (Loss)
Billions
0
-2
-4
-6
-8
-10
-12
1994
1995
1996
1997
1998
1999
2000
2001
2002
2003
Underwriting Gain (Loss)

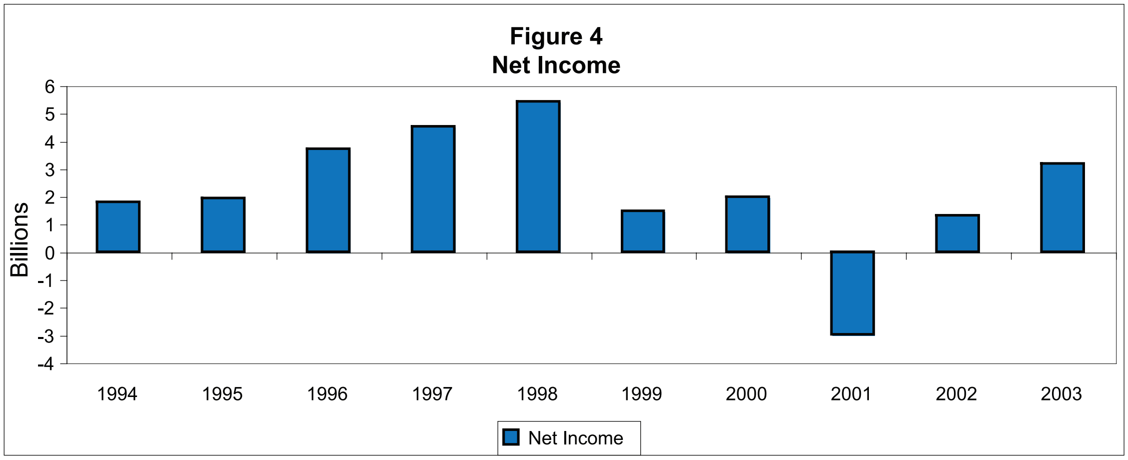
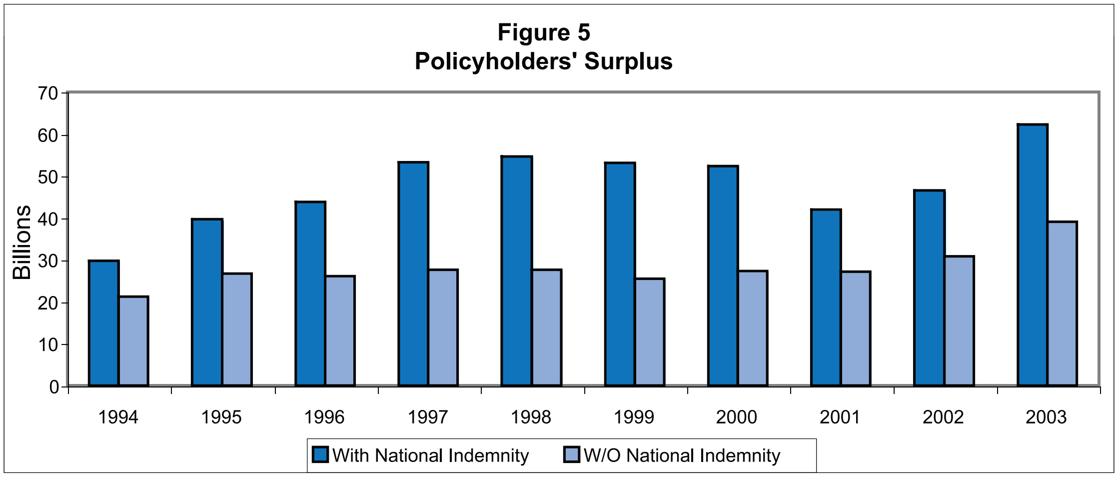
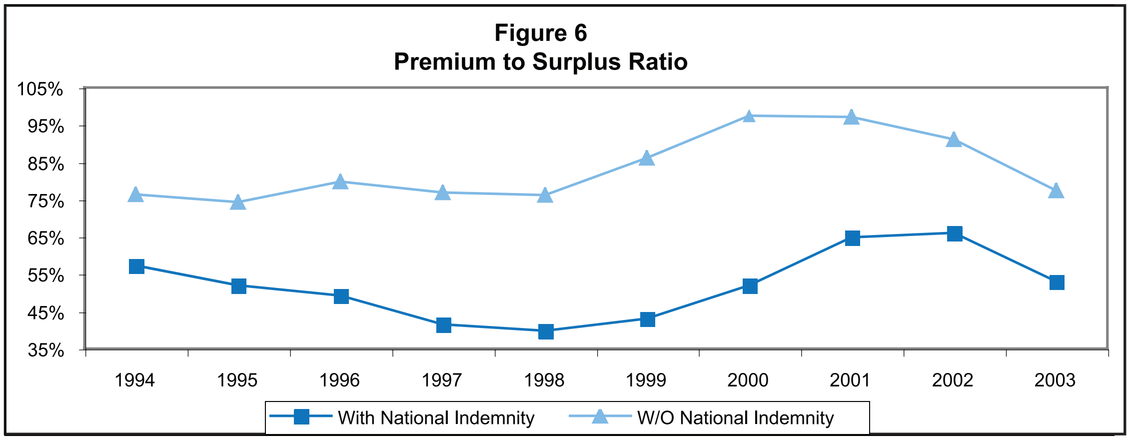


Figure 4
Net Income
Billions
6
5
4
3
2
1
0
-1
-2
-3
-4
1994
1995
1996
1997
1998
1999
2000
2001
2002
2003
Net Income

U.S. Reinsurance Underwriting Results Improve, How Long Will the Recovery Last?

Continued from page 9





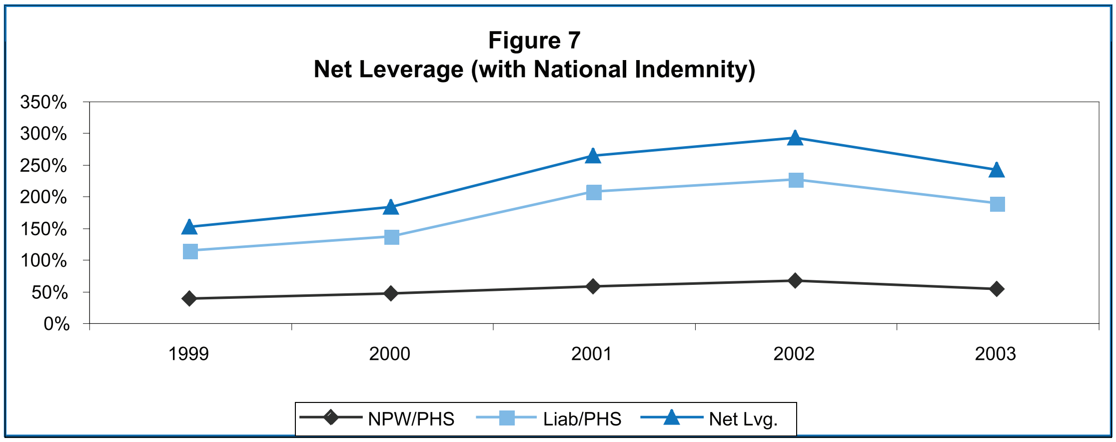
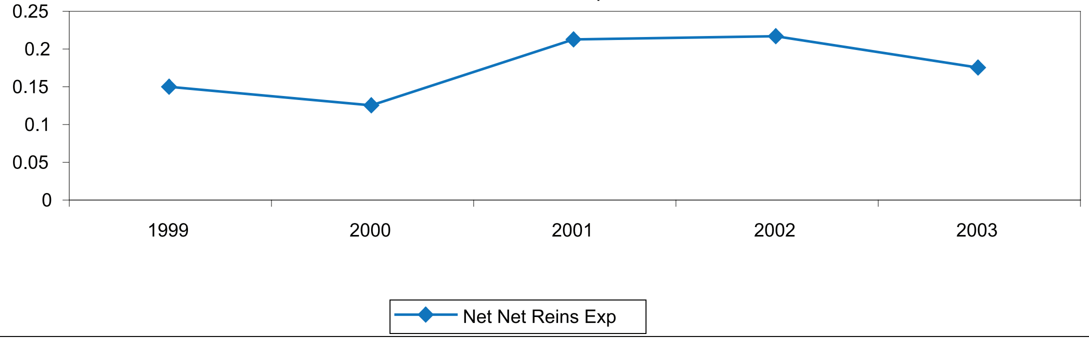


Figure 8
Net Net Reinsurance Exposure



This measure amounted to 51 percent of policyholder surplus in 1999; and now amounts to 72 percent of surplus in 2003.

Overdue reinsurance recoverables to the entire U.S. property casualty industry, as reported in the Annual Statement Schedule F, grew from $3 billion in 1999 to $6.8 billion in 2003. This is a 54 percent increase in five years. But as a measure of policyholder surplus, the amount remains small, 1.1 percent in 1999 and 1.9 percent in 2003.

The *2003 Reinsurance Underwriting Review* contains more than 60 measures of the individual reinsurers covering premium, underwriting, expenses, liabilities, surplus, investments, dividends, tax, and income. It's an invaluable benchmarking tool for any reinsurance stakeholder. You may order the RAA's *Reinsurance Underwriting Review* by calling (800) 259 0199; by e-mailing April Nelson at nelson@reinsurance.org, or online at www.reinsurance.org. The book costs $250. ■

Reference

1. "Net net reinsurance exposure" measures the company's exposure to reinsurance recoverables (less collateral offsets) relative to adjusted surplus.

Reinsurance Section Research Project—Insurance Derivatives

by R. Michael Cass, J.D., CPCU

Derivatives are "agreements" that can be used to seek a return based on virtually anything such as interest rates, stocks, stock indexes, currencies, and even insurance industry results. Derivatives can generate significant returns during good markets, and can produce equally significant losses during relatively bad markets.

■ *Exact numbers are difficult to determine, but some analysts believe there are more than $24 trillion in derivatives held by thousands of U.S. companies in all industry segments.*

Following Hurricane Andrew in 1992, various insurance and reinsurance derivative products that were based on industry results were offered as alternatives to traditional reinsurance catastrophe protection.

Exact numbers are difficult to determine, but some analysts believe there are more than $24 trillion in derivatives held by thousands of U.S. companies in all industry segments. One of the issues with derivatives is that they are generally off balance sheet items that are usually only found in footnotes in the financial statement. There is some speculation that it was mostly derivatives that resulted in the ultimate failure of Enron.

Because of the interest in these (until recently) obscure financial instruments, the CPCU Society's Reinsurance Section is initiating a research project to define derivative products and to explain their use as alternatives to traditional insurance products. Your Reinsurance Section Committee will focus on the derivative products that are specifically referred to as insurance and reinsurance derivatives. These are considered a separate class. We also want to provide opinions on both sides of the derivative controversy.

Your Reinsurance Section Committee is seeking those with an expertise or interest in insurance derivative transactions to assist with this research. Please contact any Reinsurance Section Committee member to become involved in this project or contact Professor Bruce D. Evans, CPCU, *RISE* editor. ■

Reinsurance Section Encounter
is published four times a year by and for the members of the Reinsurance Section of the CPCU Society.

***Reinsurance Section Encounter* Editor**
Bruce D. Evans, CPCU, ARe
University of Dallas
Phone (972) 721-5360
e-Mail: bdevans@gsm.udallas.edu

Reinsurance Section Chairman
R. Michael Cass, J.D., CPCU
R.M. Cass & Associates
Phone (312) 831-0470
e-Mail: mikecassre@aol.com

Sections Manager
John Kelly, CPCU
CPCU Society

Managing Editor
Michele A. Ianetti, AIT
CPCU Society

Production Editor/Design
Joan Satchell
CPCU Society

CPCU Society
720 Providence Road
Malvern, PA 19355
(800) 932-CPCU
www.cpcusociety.org

CPCU SOCIETY INSURING YOUR SUCCESS

Reinsurance Section Encounter RISE

Volume 23 Number 1 February 2005

CPCU Society
720 Providence Road
Malvern, PA 19355
www.cpcusociety.org

PRSRT STD
U.S. POSTAGE
PAID
BARTON & COONEY