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Big Interview: Hannover Re's Wolf Becke

When Wolf Becke took charge of Hannover Re's life reinsurance division in 1991, the only option to grow the business was to look for niche areas that had been overlooked by competitors.

Rasaad Jamie, Global Markets Editor

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The life reinsurance sector has been subject to significant transformation over the past three decades. These changes include the development of the unit-linked individual life market, the impaired or enhanced annuity market, the securitisation of the acquisition costs of life reinsurance portfolios and the use of increasingly sophisticated techniques to model the future revenue flows of life insurance/reinsurance contracts. But for Dr Wolf Becke, who retired at the beginning of 2012 as the executive board member responsible for the global life and health markets at Hannover Re, who was himself responsible for quite a bit of the transformation in the sector, there are some things that never change.

For Becke, chief among these eternal verities is the critical importance of identifying unserved or underserved areas of the market and developing the appropriate products and marketing strategies to cater to these niches. This is not to say Becke, who over saw the expansion of Hannover Re's life and health reinsurance portfolio from 6% of overall premium income in 1990 to 45% in 2012, is averse to acquisition. When Hannover Re acquired the life reinsurance operations of Hamburg International Re in 1990 to strengthen its own position in the sector, there was a limited set of options available to Becke and his management team in terms of further expanding the size of the combined life and health reinsurance portfolio. Becke had spent the previous 12 years of his career (seven of those as head of the life and health division) at Hamburg International Re, one of the many medium-sized life reinsurers in the market at the time.

“Right from the beginning I pointed out the importance of being open towards acquisition as far as such acquisitions can cover certain blank spots in our global portfolio, as we did with the acquisition of NRG Victory Life of Australia in 1993, with the business we acquired from Skandia International Insurance, Stockholm in 1997 and from Scottish Re in the US in 2009. But we have always emphasised our main thrust would be organic growth,” he says.

However, what Becke and his team had in mind back then was not just any kind of organic growth, but, more specifically, organic growth through the exploitation of opportunities in what at the time were very much regarded as niche markets or, in the case of the reinsurance of impaired annuities in the UK in the 1990s, not even regarded as a market by other companies in the sector. “For every market we looked at we always searched for an opportunity to access that market through a specialist niche programme,” he says.

Fully served

This strategy, Becke says, was very much dictated first by the structure of the life reinsurance market at the time and second by Hannover Re’s relatively weak position in that market. “When I joined Hannover Re in the autumn of 1990, one of the first questions I had to ask myself and my team was what it was we wanted to do in a life reinsurance market that was more or less fully served, not only by the big companies such as Munich Re and Swiss Re, but also by a number of other, very good medium-sized companies which, at the time, included companies such as Francona Re and Aachen Re. We basically made a few strategic decisions we have faithfully stuck to through the years and which, I think, my successors at Hannover Re will continue to follow.”

The first of these strategic decisions was to subject every portfolio of business to a rigorous process of cashflow modelling and testing. This was at a time when the cashflow evaluation techniques employed in the life reinsurance sector were relatively crude. “These unsophisticated techniques, of course, work well as long as the profit margins are big. But when the margins are tight, there is not a lot of room to get things wrong,” he says. Becke, however, had a significant advantage over his counterparts at other companies in this regard. Although, he was already in his early 30s when he was recruited by Hamburg International Re in 1978, he had a doctorate in Mathematics and had spent the previous five years employed as a lecturer in that subject at the universities of Bonn and Freiburg. While he was at Hamburg International Re, he had adapted a forecasting and simulation system recently developed in the US to serve as a prototype for the modelling of the future cashflow and earning streams from life reinsurance portfolios.

Another of the strategic principles adhered to by Becke and his team was it makes no sense in the life reinsurance sector when you are not the market leader to enter into direct competition with the market leader or leaders. “In life reinsurance, most of your relationships with your clients are one on one. This very different from the non-life reinsurance sector where brokers play a major role. There is very little to no intermediary activity in life reinsurance, so the established, bigger companies had a significant advantage over Hannover Re, which was effectively a new start-up back in 1991. The bigger companies have most of the customer relationships in the market and some of these relationships are years, if not decades, old and they have all the data, all the expertise in the main business classes.

“In these markets, there is very little you can offer as a new company other than to try to disrupt these customer relationships by price-cutting. Price-cutting was certainly not on our agenda because we wanted to – and I had given a commitment to the Hannover Re board we would – build a viable, profitable, long-term business. With price-cutting off the table, the only option we had to grow the business was to look for niches that for one reason or another had been overlooked by the big companies and our other competitors.”

Niches

According to Becke, he and his team were amazed in practically every market they looked at they found niches that could be exploited by Hannover Re. “In Germany, for example, it was unit-linked individual life business, which accounted for about 2% to 3% of new business at that point in time. All the traditional reinsurers focused their attention and activities on the 97% to 98% of non-unit-linked business in the market, so that provided us with a niche for the reinsurance of unit-linked business. It is a business that has grown very substantially. Over the years we have written a substantial portfolio of unit-linked treaties and have developed a leading position in this segment of the German market and, since we were the first reinsurer in this area, we were able to grow with the market.”

Hannover Re’s experiences in the UK in the early 1990s were even more striking. Becke, a qualified actuary, sensed there was something quite strange about the market. “While all the British life offices were very detailed and very sophisticated about the underwriting of mortality risks, we noticed nobody underwrote longevity risks in the form of immediate single-premium annuities. We talked to a number of people in the market, but nobody could give us an adequate explanation other than it had not been tried before. Everybody seemed perfectly contented to determine pricing for an annuity by just looking at the attained age and the gender of the person.”

Hannover Re then engaged a small actuarial consultancy to produce data on the differences in the survival rates of males aged around 65 according to certain illnesses. “It was quite obvious to us how long you will live from that point onwards very much depended on the state of your health and that was actually the first actuarial data produced in this area. We tried to convince several companies in the market to team up with us to design and market an annuity product for unhealthy people. Although there was a great deal of interest, nobody was really prepared to come in with us.”

But in 1995, Hannover Re finally found a partner that was prepared “to go beyond the normal thinking of reinsurers” and, in partnership with Hannover Re, set up a friendly society, the Pensions Annuity Friendly Society (Pafs), to write what was then called impaired annuity business. Pafs was demutualised in 2004 and, under its new name, Partnership Assurance, staged a highly successful initial public offering on the London Stock Exchange in the second quarter of 2013; a remarkable event for insurance company in these volatile times. Hannover Re entered into similar arrangements with other companies, including developing the first smokers’ annuity with a British life insurer. “By the beginning of the 2000s even the big players realised enhanced or impaired annuities were here to stay and it was best for them to create their own enhanced annuity product, so they turned to us for help because we were considered not only a pioneer in this market, but also the only company that had reliable actuarial data for this particular line of business.”

According to Becke, the majority of the enhanced business is written as single-premium business and accounts for close to €600m ($782.1m) of Hannover Re’s new business premium income every year. From 2005 there was a further development when enhanced annuities began to be written on a group basis but within a very specific format: longevity swaps for pensions funds. Here again, Becke says, Hannover Re chose to specialise in one particular area, the so-called “blue-collar” pension funds, where the lives covered are characterised by a shorter duration than is the case with pension funds focused on other socioeconomic groups.

Facultative life reinsurance business

The third strategic decision adopted by Becke and his team in the 1990s is reflected in Hannover Re’s approach to facultative life reinsurance business. The received wisdom in the

market at the time was facultative business was always better-quality business than treaty business. “Even during my time at Hamburg International Re, I had found this way of thinking very strange. Of course, the explanation was reinsurers believed with a facultative risk, they themselves can more easily make an evaluation of the risk in terms of the medical circumstances and the moral hazards associated with that risk, so there was a preference for facultative acceptances in the market compared to treaty acceptances.”

Becke’s understanding of the issue was very different. “My feeling was with facultative business you will never be able to generate a sufficient volume of business because on the life side, facultative contracts are only used for peak risks and there are not that many peak risks in the life sector. This, importantly, means there is no underlying volume, there is no underlying spread or diversification, so we took the opposite approach and focused our attention on treaty business.”

Hannover Re does write a certain amount of facultative life reinsurance business but, unlike most other reinsurers, it does not believe facultative business should be treated as a separate profit centre. “Our belief is a facultative arrangement or facility is there as a supporting service to an underlying treaty,” Becke says.

Securitisation

Hannover Re pioneered the securitisation of the considerable business acquisition costs associated with life reinsurance contracts into the capital markets in 1990s. According to Becke, this was forced on to the company by sheer necessity. Life reinsurers typically finance the marketing and other upfront business acquisition costs of the primary life companies they reinsure, “so there was a cashflow strain on Hannover Re in that regard”, he says. “But in the early years, that strain was relatively small and I could go to my non-life colleagues on the Hannover Re executive board and ask them to fund our business expansion and we would provide them with double the interest rate provided by government bonds. Basically, it was a kind of intra-group financing. But we soon ran into a wall when the rate of new business financing for life business was growing too rapidly and my non-life colleagues advised me to go to look for funding somewhere else.”

Becke and his team were faced with three options. One, they could slow down the rate at which new business was coming in. “For me, that was the least desirable option because I was convinced this was quality business and there is nothing reinsurers hate more than stopping quality business from flowing into their profit and loss accounts, so that option was not on the table as far as I was concerned.”

The second option would have been to approach one of the larger companies in the market and ask it for help. “This was not desirable in the long run, either, because I would have had to reveal all the terms and conditions attached to our business, our marketing strategies and a lot of other information I felt they should not know or know too clearly.

“So we were left with the third, untested option of securitisation. Hannover Re was a pioneer in this area by establishing four life securitisations called L1, L2, L3 and L4 in 1997 and 1998, which transferred the acquisition costs and expenses of blocks of European unit-linked business into the capital markets. That was a huge salvation for us. We could refinance our business acquisition costs through support from the capital markets.”

The financial crisis

For Becke, the financial crisis is having a significant transformative effect on the primary life insurance industry. In his view, the traditional life insurance business model is increasingly proving inadequate. “Most companies have gone into survival mode. Nobody is thinking

about expanding. The market is characterised by cost-cutting and the repricing and redesign of products. Modern life insurance products are characterised by a reduced level of financial guarantee. Life insurance markets all over the world are undergoing a massive transformation."

Life reinsurers like Hannover Re, he says, are a bit more insulated from this trend, in part because they are not exposed to the large investment risks in the same way in which the primary life companies are. "Ultimately, we are the business-to-business arena and what happens to our clients matter to us greatly," he says, "so for the reinsurers it is important to work closely with their clients and to provide them with solutions to help mitigate some of the pressures on them. Reinsurers have a big advantage over primary life companies because they are more diversified. Hannover Re benefits hugely from the fact its life and non-life operations are more or less the same size. If Hannover Re were to operate the non-life business on a standalone basis, separately capitalised, we would need substantially more solvency capital to support the operation and the same goes for the life business."

Reinsurers, he says, are further diversified according to lines of business and according to geographic regions. For example, close to 95% of primary insurance companies are monoline insurers. "They are either in life, health or non-life and, in the vast majority of cases, they operate in only one country, so the exposures associated with one class of business, with one country, are much more pronounced on their balance sheet compared with a reinsurer. Just by transferring the risks from the primary market to the reinsurer, the whole industry becomes more efficient in capital terms."