Zero to one billion in five years

Risk Transfer finds out from Scottish Re president and chief executive, Scott Willkomm, how to build a billion dollar business in five years

Scott Willkomm, president and chief executive, Scottish Re

Chinese philosopher Lau-Tzu said, "A tree trunk the size of a man grows from a blade as thin as a hair." This is the story of Scottish Re – a company that seven years ago was nothing more than a reasonably good idea, and today is one of the leading global life reinsurance specialists with over $8 billion dollars in assets; $1.3 billion dollars of capital; $1 trillion of reinsurance in-force, and clients in 45 countries around the world. Considering that seven years ago the company had a capital base that would have been insufficient to buy a cup of coffee, Scottish Re has to rank as one of the most remarkable stories in the reinsurance world.

Unlike most reinsurance start-ups, Scottish Re was not set up in response to a specific catastrophic event or dramatic shift in the world's insurance markets. Instead, Scottish Re capitalised on a number of trends influencing the global insurance and reinsurance industries, by developing a business model that was subtly different from anything else previously employed in the market.

If success can be summarised as having the right idea in the right place at the right time, developing a flexible business plan and strategy, and then executing against that plan consistently, the right idea in Scottish Re's case was responding to a supply - demand imbalance in the global life reinsurance industry.

By 1998, a number of changes had taken place in the global reinsurance markets that caused the availability of life reinsurance capacity to shrink. Consolidation reduced the number of life reinsurance specialists, as life re companies became takeover bait for other organisations. At the same time the cost of capital resources available to life reinsurers increased. Finally, the big European non-life and composite companies, that traditionally dominated the leadership of the life reinsurance business, pulled back from supporting many markets because of serious balance sheet impairment issues resulting from investment losses driven by the decline in world financial markets.

On the demand side of the ledger, market forces had created dramatic changes in the life insurance industry, and how the life industry approached its business. The evolution of the industry was prompting established life and annuity writers to re-evaluate under-performing lines of business, de-mutualise, consolidate and merge. An increasing focus was being placed on returns on capital, along with capital adequacy and efficiency.

As primary companies realised that the risk premium rates they charged the consumer were falling, they began to assess whether their capital might be more wisely employed elsewhere. Many companies were seeking to free up the capital reserves in their annuity and life businesses, to enable them to write more business elsewhere or enhance profitability. Insurance companies the world over were moving from being underwriters of risk to asset gatherers and distributors of a broad range of financial products. Retaining risk and the capital needed to support such risk was not part of that picture.

The Scottish Re team witnessed the opportunity to help these companies meet reserve and risk capital requirements, manage statutory capital strain and enhance their profitability, through the provision of reinsurance. They also crucially identified that the economic and demographic shifts that were driving change throughout the life insurance business around the world, provided the opportunity that reinsurers should not only provide capital support for their customers, but, more importantly, technical underwriting and actuarial support. If there ever was a case of market forces at work this was it.

In early 1998, Scott Willkomm was a Wall Street investment banker, raising capital for what would become the first publicly-traded life reinsurance companies domiciled in the Cayman Islands, when he was introduced to Mike French, the company's founder and Chairman. Mike and some partners had been dabbling around the offshore life insurance world as part of an investment management business they were building. Mike had been thinking that there might be an opportunity to leverage their experience in the offshore life business and apply it to the life reinsurance business. Together, they began drafting a plan to create and capitalise a brand new, offshore life reinsurance company that would be domiciled in the Cayman Islands.

Scott Willkomm remembers, "We sat down in earnest in early April 1998 and began drafting a business plan to launch Scottish Re. We had planned to capitalise the company initially with $250 million – virtually all of which would come from public investors in an initial public offering. We were, in the true spirit of the internet craze that was driving the stock markets at that time, public venture capital – we were nothing more than a business plan and a couple of people."

For the better part of four months they worked drafting the business plan and public offering documents; chartering the holding company and licensing the insurance company; recruiting a board of directors; beginning conversations with the ratings agencies, and keeping a look out for business opportunities. That summer a registration statement was filed with the US Securities and Exchange Commission, to sell 18 million ordinary shares to the public in an offering to be underwritten by Prudential (of the US), the Canadian Imperial Bank of Commerce, ING and UBS.

With the fledgling reinsurer well on its way to launching an IPO in the summer of 1998, the global capital markets had the wind knocked out of them with the one-two punch of the failure of Long-Term Capital and the Asian contagion. The markets tanked and, for Scottish Re, it looked like the opportunity to raise capital was slipping through its founder's fingers, just as the opportunities in the life reinsurance industry were expanding.

However, according to Willkomm, "We didn't give up, although the thought crossed our minds. Maybe we had already invested too much start-up money and too much effort just to shelve the project and write it off – but I think that we all had invested much more in emotional and spiritual energy. So we kept on pushing, and saw a slim window of opportunity open up in early November 1998 – and decided to jump through. The Arabian proverb, 'Throw a lucky man into the sea and he will come up with a fish in his mouth,' describes with great accuracy the experience of our IPO. I am happy to report that we made it through the window – barely – and raised approximately $250 million and listed our shares on NASDAQ in late November 1998."

1999, the company's first year of operations, did not go swimmingly. Willkomm explains, "We were slow to write business and were criticised by the market and some of our competitors for that and our share price suffered. Some of the people we had hired to run the business were the wrong people for the job, and an important element of our business model was flawed. Yet, we believed enough in the promise of our overall plan and strategy to persevere. Within six months of completing our IPO, we began re-examining our offshore reinsurance business model. Initially, we had felt that the regulatory and tax advantages of our offshore domicile would be sufficient to attract quality business opportunities. Certainly this had proven to be the case in the property and casualty reinsurance business that has been quite successful in the offshore market for decades."

But while the advantages of the offshore domicile were substantial, Scottish Re came to the conclusion that life and annuity reinsurance requires more interaction with clients than could be reasonably provided from its Grand Cayman base. Furthermore, their conservative approach to the tax and regulatory restrictions on marketing in the United States (which was the first market that Scottish Re intended to develop) forced the company to rely too much on reinsurance brokers and intermediaries to source business opportunities. Many of these brokered transactions were being actively sought after by many other market participants, resulting in pricing that did not meet Scottish Re's required return standards. Accordingly, many transactions in 1999 were passed upon, as a result of the pricing discipline that remains a core characteristic of the company to this day.

To build a meaningful life and annuity reinsurance business serving the North Americas, it was clear that an onshore operation was required in a big way. In late 1999, the company acquired Harbourton Reassurance, which is now Scottish Re (US) acquisition. Scottish Re started by developing its own platforms, and then bought businesses opportunistically in order to grow incrementally. In Scott Willkomm's own words, "We believe that's the right order of play. You don't buy a business just for the sake of it, but only where it makes economic sense, and meets your strategic ambitions. We hear a lot about the "art of the deal", which is shorthand for not over-paying for an opportunity. Acquisitions only make sense if the price is right; otherwise, you're buying future profits with future profits."

There's a saying that you must manage growth, or it will manage you. Runaway growth can be as destructive to a corporate culture as the lack of it. To give you an idea of the way in which the Scottish Re Group has grown, in its first year of operations, which was 1998, it reported $1 million of revenue; in 1999, $22 million; in 2000, $84 million. In 2001, revenues were $119 million; in 2002 they were $306 million, and in 2003, the year closed at $556 million of revenue. That sounds like unmitigated good news, but rapid growth is only good news if you anticipate, plan and execute with efficiency. History is replete with stories of those who had good ideas, but could not control the growth they engendered.

By 2002, much of the capital that was raised in the 1998 IPO had been efficiently deployed. In order to fuel continued growth, additional capital was required, and during 2002 and 2003, over $650 million of additional funds were raised. Willkomm says, "Capital is a critical area for us, and anticipating our needs in a timely fashion is central to what we do. Raise capital too soon, and it sits there and undercuts your earnings; raise it too late and you miss opportunities. Planning is everything in our business, because reacting won't cut it. A growth path like ours calls for continued good decision-making, if the wheels are not to fall off the entire venture. I believe the same is true in the taxi business. Scottish Re's return on equity objective for 2006 is 15 per cent. Due to thoughtful capital planning, we are well on our way to that goal."

Not everything went well in 2003, however. After 14 consecutive quarters of excellent results, a wall was hit in the third quarter of 2003. Scottish Re reported a loss for the first

Inc. They also hired a team of very experienced actuaries, underwriters and finance professionals and, in 2000, initiated a rapid expansion in the traditional mortality risk reinsurance business in North America. This made Scottish Re one of the top ten life reinsurance providers in the US markets. They could now originate and write reinsurance in the US while offering clients the best solutions, and competing effectively with both onshore and offshore reinsurance providers alike.

The acquisition also symbolised two key traits of Scottish Re's emerging culture. Firstly it demonstrated the ability and willingness to make acquisitions at the right point in time. Willkomm explains, "As we built the company, we selectively used acquisitions either to provide the company with a platform or franchise that would be difficult to create from scratch, or to enable the company to achieve economies of scale in an efficient fashion."

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The second trait was a willingness to constantly reappraise what you're doing and make key changes promptly whenever applicable. In that vein, corporate headquarters and with it offshore reinsurance operations were moved to Bermuda in 2001. While the Cayman Islands had been a good home, there was a realisation corporate activities and reinsurance operations would materially benefit from being closer to the reinsurance and capital markets. Bermuda, of course, is the reinsurance capital of the world and benefits from its close proximity to US and European financial centers.

This move greatly enhanced the ability to expand the reinsurance business and capital market activities as the company strove to become a leading participant in the global reinsurance community.

Moving to Bermuda was not the only smart thing Scottish Re did. Some excellent technical decisions were made along the way. Chief among these was the notion of limiting the amount of risk assumed on any one particular life to $500,000. That was a conservative decision that might initially have limited growth patterns, but it also limited the volatility in results. According to Willkomm, "I think there's a temptation when you start out to do whatever comes your way, not to set limits. Certainly, it's tempting to take that approach, and deal with the consequences as they arise, but we took the line that it might be better to avoid the consequences before they arose. These risk limits remain in place, and, frankly, that's one of the reasons we sleep at night."

While the acquisition of Harbourton established Scottish Re as a major presence in the North American Life market, the purchase of World-Wide Reassurance Company Limited (now Scottish Re Limited) on December 31st 2001, was a very important step in executing against a key strategy in the business plan. There had been deeply held conviction among management, from day one, that the life business was no longer a local or regional business. The purchase enabled Scottish Re to add experienced international management and staff and the resources of a company well known in many markets around the globe. As Wilkomm puts it, "Too many reinsurers have failed as global organisations, because they tried to export North American or Western European expertise and thinking to other parts of the world."

The purchase also went some way towards Scottish Re's objective of achieving economies of scale. Economies of scale allow the company to leverage its capital base more efficiently, both from a risk management point of view (broader spread of risk), a financial point of view (bigger balance sheet helps reduce our cost of capital), as well as an operating point of view (ability to spread operating expenses over a broader business base). To that end, late in 2003, Scottish Re purchased 95 per cent of the outstanding capital stock of ERC Life Reinsurance, a subsidiary of GE's Employers Reinsurance, for $151 million in cash. The business of ERC Life consisted of a closed block of mostly traditional life reinsurance written in North America. ERC Life had approximately $800 million in total assets and approximately $100 million of statutory capital and surplus. The gross face amount of the in force business acquired was approximately $170 billion. Said another way the ERC acquisition was to significantly improve Scottish Re's spread of risk in a capital efficient fashion.

Business people argue which is better: internal growth or developing a company by time in its history. One customer had been inadvertently under-reporting death claims for a period of years, and the reporting error was only discovered in late 2003. Instead of reporting $24 million of death claims only $12 million were actually reported. When the error was discovered by Scottish Re actuaries working in partnership with the staff of the ceding company the difference had to be made up. This was done promptly and without dispute. This is the bond of the reinsurer.

While there was a sense of personal and professional embarrassment with this matter, a lot of lessons were learned and reinforced as a result of this incident. These included:

1. we fulfill our commitments to our customers, even if they may have caused the error;
2. we cannot rest on our laurels despite great successes;
3. regular and ongoing due diligence and account review is part of the relationship between reinsurer and ceding company
4. admit your mistakes, take appropriate action and move on.

In the original business plan, there were three elements to the business strategy that paved the path for Scottish Re's success, and they remain today as the core-elements of the group's operating philosophy. The three elements are Risk Management, Relationship Management and People Management.

Risk management should be a core competency of any insurance enterprise. Accordingly, one of Scottish Re's three key principles is to apply prudent risk management disciplines. A prime example of this is the conservative underwriting policy of assuming no more than $500,000 risk on any single life.

As Relationship Managers, there is the undertaking to work in partnership with cedants, by providing them with access to Scottish Re's intellectual capital and technical know-how, and a long-term commitment to their business.

On the people management front Scottish Re, like most other financial institutions, is people and a balance sheet. A balance sheet needs good people to make it work.

Willkomm remembers, "From the founding of the company, we made a very firm commitment to hiring the best people, the most flexible and innovative people, that we could find. We began by bringing new senior leadership into the company, people with extensive experience in life reinsurance, asset and liability management and financial accounting."

"I'm not going to tell you that we made no mistakes, although I suspect that we made fewer than many companies. We tried to learn from the mistakes of others. Any business will make mistakes; the trick is not to make the same mistakes others did, or repeat your own. Once again, research and anticipation were our best friends."

Today, then, Scottish Re Group is fulfilling the business plan, in detail and in general, that it set out with five years ago. It has the key advantage of being the only independent global life reinsurance specialist in the world. Most of its competitors are subsidiaries or divisions of much larger organisations, which means that they do not control their own destinies. When the parent company changes its strategy, its reinsurance subsidiary may not be first among its thoughts.

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Willkomm believes Scottish Re's specialty approach is a key to its success, "There is one other secret, I believe, to building a billion-dollar company from a business plan and some crossed fingers, and that is focus. We are specialists in what we do. Life insurance-related risks are our specialty. All of our management talent, operational activities and capital resources are dedicated to the life business. We combined a high-volume, long-term business with a short-term, low-volume, high-maintenance business. Our experience tells us that you will succeed by devoting your efforts discretely, allowing elements of your management teams to focus on particular areas of your business. Mix and match may work in the candy business, but it's not recommended for different lines of business."

Scottish Re provided Risk Transfer with the best possible post-script to this feature on October 19th 2004 with the announcement that it had agreed to acquire the individual life reinsurance business of ING Re.

Scottish Re and ING Re have complementary, broadly diversified books of traditional life reinsurance business with minimal overlap. The transaction will allow Scottish Re to further increase its new business production while also giving Scottish Re the opportunity to further enhance its operational infrastructure and achieve economies of scale.

The press release states,

"This acquisition expands Scottish Re's North American platform, making it the 3rd largest life reinsurer by volume of U.S. life reinsurance in-force. Following the acquisition, Scottish Re will have approximately $1 trillion of face amount of life reinsurance in-force, $8.8 billion in assets, $2.1 billion in revenues, and a capital base of approximately $1.3 billion."

"Scottish Re and ING have agreed that ING will transfer the assets and reinsure the liabilities of all of its U.S. individual life reinsurance business to Scottish Re through a co-insurance transaction. Pursuant to the reinsurance agreement, ING will transfer to Scottish Re assets equal to reserves of approximately $800 million and pay Scottish Re a ceding commission of $560 million. These assets will be held in trusts to secure the reserve obligations of the business."

"Additionally, ING will transfer certain operating assets associated with the business. Scottish Re will assume the obligations of the business, including client service, administration and claims payments. All future business after the closing of the transaction will be written by Scottish Re, on terms and conditions consistent with Scottish Re's existing business."

"In addition to the assets to be transferred by ING Re, Scottish Re will raise an additional $230 million in new capital, which will satisfy the capital requirements for the acquired business. This new capital includes $180 million to be provided by The Cypress Group, a New York private equity firm, and an additional $50 million of trust-preferred securities. Scottish Re management anticipates that the acquisition pro forma for the new capital will be immediately accretive to Scottish Re's return on equity and earnings per share upon closing."

In the words of Nelson Bunker Hunt 'a billion dollars may no longer be what it used to be' but in terms of executing a business plan for the reinsurance industry Scottish Re's journey from zero to a billion should serve as a blue print worth following. RT