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In the Middle: The Role of a Reinsurance Intermediary

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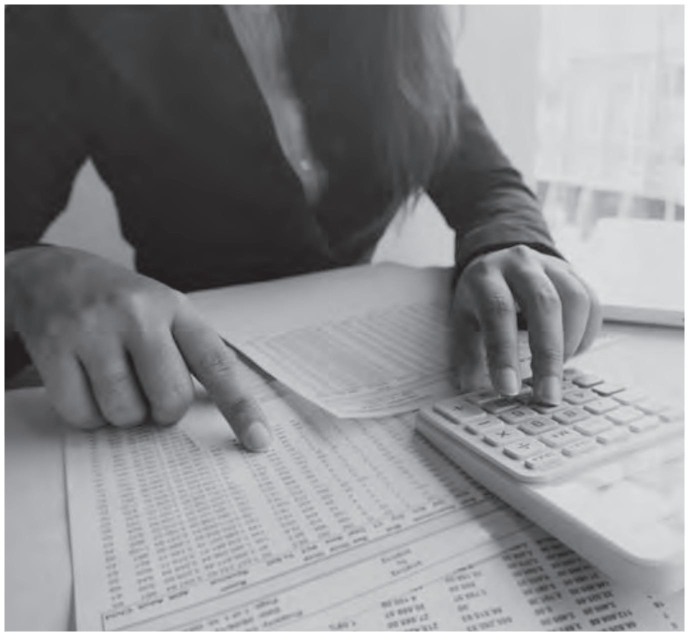

Picture yourself attending a social event, one not related to the insurance industry. We've all been there: Someone approaches you, introduces themself, you do likewise, then they ask "What do you do for a living?" You proudly answer, "I'm an actuary by training." If you live in Hartford (Connecticut, that is; and I lived there in the early 1990s), non-insurance industry individuals DO know what an actuary is; otherwise, the person stares at you with a glassy look in their eyes, politely nodding. You think to yourself, should I explain what an actuary is or add, "I'm a reinsurance intermediary"? The person in front of you has no clue as to either.

Since this article is appearing in a Society of Actuaries' section newsletter, there should be adequate understanding to the first part—actuary by training. As to the second part—reinsurance intermediary, you may have some idea what that is, or you may not have any idea what that is. In either event, please read on to come to a better understanding as to what I do.

WHAT I DO

My pat answer to explaining reinsurance intermediary includes using an example of the real estate agent who works on your behalf to sell your house, brings you prospective buyers and is compensated by THE buyer of your property. Incidentally, the said compensation is part of the negotiated price the buyer pays for the house—the compensation is disclosed in the settlement documents detailing the terms of the transaction.

Essentially, a reinsurance intermediary (aka, intermediary or broker) represents the ceding company in need of capital to support liabilities on their balance sheet. The intermediary brings sources of capital to the table willing to assume risks by purchasing the liabilities for a price—the negotiated reinsurance premium. The premium includes the intermediary's compensation and is disclosed in the settlement documents (aka, reinsurance treaty) detailing the terms of the transaction. Just like the real estate agent, the reinsurance intermediary "earns" compensation by bringing the two parties together.

That's not all the services the intermediary has to offer. In property and casualty reinsurance transactions, intermediaries actually receive the premium payments from the ceding company, remitting them to the reinsurer; likewise, intermediaries receive the benefit payments from the reinsurer, remitting them to the ceding company. The use of the intermediary relieves the ceding company of dealing directly with the reinsurer and/or negotiating terms of the reinsurance treaty. This places the intermediary in a significant financial position in need of liability insurance should there be any mix-ups in the reconciliation of payments, understanding of terms, etc.

Unlike in property/casualty reinsurance transactions, in life insurance (including annuities) reinsurance transactions, the two parties handle settlement of payments directly; the intermediary receives compensation (initial and renewal, if any) from the reinsurer. In health insurance reinsurance transactions, either practice may hold true at the choosing of the ceding company.

WHAT IS THE PURPOSE OF REINSURANCE?

Before delineating the services provided by reinsurance intermediaries, let's discuss what reinsurance is and why companies use it. Simply put, reinsurance is insurance purchased by an insurance company to cover all or part of certain risks on policies issued by that company. Reinsurance is a financial solution allowing companies to market, solicit and sell policies of any size regardless of the company's surplus position.

Actuaries determine the appropriate retention level for policies issued by the company in relationship to the surplus of the company. For example, suppose the actuary at ABC Life Insurance Co. determines its surplus is sufficient to assume $200,000 of risk on any policy sold by the company on any life. What happens when the agent for the company sells a $1 million life insurance policy? ABC retains the $200,000 of death benefit and sells to XYZ Reinsurance Co. $800,000 of death benefit. This transaction is seamless to the insured. ABC needs to rely heavily on XYZ to live up to their agreed part of the transaction when the insured dies.

Reinsurance doesn't involve just one policy; it involves blocks of many policies sold by ABC. Without reinsurance, ABC would be insolvent because it would need to hold enough surplus to cover all the potential death claims on the policies it sells. Therefore, the main purpose of reinsurance is the transfer of risks ABC doesn't want to retain. In exchange for the transfer of risks to XYZ, ABC doesn't need to hold the full reserve (liability) for the amount of death claims in excess of their retention. ABC therefore is allowed a reserve credit for the portion of the risk transferred to XYZ, and XYZ is required to hold the appropriate reserve for the risk it assumes.

WHAT ABOUT THIS TRANSFER OF RISK AND RESERVE CREDIT?

Hold your horses about the services provided by reinsurance intermediaries; let's continue to understand the financial implications of reinsurance on the ceding company (ABC) and reinsurer (XYZ). We all know insurance is a highly regulated industry. Insurance regulators are concerned with protecting the consumers of their jurisdictions to ensure insurance companies live up to the promises they make when selling policies.

Given a portion of the risks assumed by insurance company ABC is transferred to reinsurer XYZ in exchange for the reserve credit on ABC's balance sheet, regulators want to be sure the risks transferred comply with certain rules before ABC is allowed to take the reserve credit (a reduction in liabilities, increase in surplus).

Risk transfer is the equitable transfer of all significant risks and responsibility for payment of future benefits, from ceding company ABC in exchange for reserve credit, to reinsurer XYZ in exchange for compensation (reinsurance premium). There are 11 risk transfer rules applicable to "coinsurance" reinsurance transactions. Coinsurance is a form of reinsurance whereby ABC and XYZ share an equitable "partnership" in proportion to the premiums paid by the insureds, the benefits provided by the policies and the expenses incurred in administrating the policies. There are other forms of coinsurance, including modified coinsurance and coinsurance funds withheld. Any form of reinsurance with coinsurance in the title means the ceding company and reinsurer retain their respective partnership relationship.

If the reinsurance is defined as yearly renewable term (YRT), only seven of the 11 rules apply. YRT is a form of reinsurance whereby XYZ determines the reinsurance premium to be paid by ABC; each company is responsible for its respective proportion of benefits provided by the policies.

If relevant risk transfer rules are followed, ceding company ABC will be entitled to reserve credit because XYZ holds reserves for its proportion of the risks assumed. Just like there are rules for risk transfer, there are also rules governing the reserve credit allowed ABC and the collateral required to be held by XYZ. These rules accentuate the consumer protection imposed by the regulators to be sure ABC and XYZ are financially secure to pay benefits.

WHAT SERVICES DO REINSURANCE INTERMEDIARIES PROVIDE?

Let's turn our attention to the services intermediaries provide to ceding company clients. Since insurance and reinsurance are highly regulated, the services provided by intermediaries effectively help ensure relevant regulations are followed for ABC to transfer risks and receive reserve credit. These services include, but are not limited to:

- Follow ceding company's (client's) instructions and written standards
  - Identify client's need for capital and purpose for reinsurance
  - Identify what risks are to be transferred—in-force block of policies or new business policies as they are issued
  - Assist in the financial analysis of potential blocks of policies to be reinsured
  - Obtain written permission from client before negotiating reinsurance terms
  - Disclose to client any relationship with potential sources of solutions (sources could be banks, other insurance companies and/or reinsurers)
- Solicit from reliable sources potential reinsurance solutions
  - Obtain financial strength and solvency ratings of potential sources
- Assist in the review and analysis of proposed reinsurance solutions
- Facilitate the negotiation of terms and conditions for potential reinsurance solutions between client and potential sources
  - Not accept any terms or conditions on behalf of client
  - Provide only the data client has authorized to be exchanged
- Not accept any allowance, proceeds or other settlements or instructions from any of the potential sources on behalf of the client

Just as regulations govern the actions of ceding companies and reinsurers, intermediaries are required to be licensed by the state in which they are located and operate. It is generally agreed each state provides a reciprocal agreement eliminating the necessity to be licensed in all jurisdictions in which the intermediary may practice.

WHAT ABOUT THE FINANCIAL SIZE OF THE CLIENT?

Reinsurance is an infrequent activity—not something a company actuary entertains on a regular basis. The need for reinsurance arises with the development of new products, or an expressed need to raise capital embedded in a block of policies or acquire a block of policies from another company. I like to let my clients know they can consider me an extension of their staff. My purpose is to remove the burden of reinsurance solicitation and negotiation from their "plates" to allow them to concentrate on their everyday responsibilities.

Some of my recent client engagements include the following:

- Performing cash flow projections of future profitability to determine appropriate quota share proportions of a block to be reinsured
    - Assisting clients to evaluate appropriate levels of economic reserves for potential XXX/AXXX reserve redundancy financing solutions
    - Assisting clients to form captive reinsurance companies for the purpose of securing XXX/AXXX redundant reserve financing solutions
    - Assisting clients in securing financing solutions for XXX/AXXX redundant reserves
- Assisting clients to understand reserve requirements under Chapter 20 of the National Association of Insurance Commissioners (NAIC) Valuation Manual (VM-20), NAIC's Actuarial Guideline XLVIII (AG48) and principle-based reserves (PBR)
- Assisting clients to recapture blocks of reinsured policies because the client increased their retention limit
- Assisting clients to understand complex reinsurance structures for transferring variable annuity living benefit rider risks
- Assisting clients to understand how special banking transactions can overcome the high minimum guaranteed credited interest requirements in legacy fixed annuity blocks of policies
- Assisting clients to prepare requests for proposals to evaluate and select mortality risk reinsurance partners for term insurance products
- Representing clients in the role of expert witness to testify at arbitration or mediation proceedings

The degree of assistance depends on the size of the company. Many large clients have existing relationships with the same sources as I do. There is a reluctance to utilize my services because they realize intermediary compensation will be a factor in the price of the reinsurance solution. I like to demonstrate that by utilizing my services, the transaction can be completed in a much shorter time frame, my relationships with the potential source may be with the right decision-makers to complete the transaction, and my dedicated effort will free up internal resources for other, more important tasks at hand. And, my compensation is immaterial to the cost of the solution.

With medium and small clients, my expertise and knowledge play more important roles as I can open doors to potential sources for which the client has not previously been served, or utilizing me as an extension of their staff allows the reinsurance transaction to take prominence over other internal projects.

I have 45 year's experience in the insurance industry—reinsurance has played an important role in almost every position I have held. Since September 2002, I have been a sole-practitioner, consulting actuary and licensed reinsurance intermediary.

Back to that social event. At the end of our conversation we exchanged business cards. Across the center top of mine is my motto, "Securing financial solutions to improve the bottom line"; to which my new acquaintance said, "Oh, that's what you do!" ■

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