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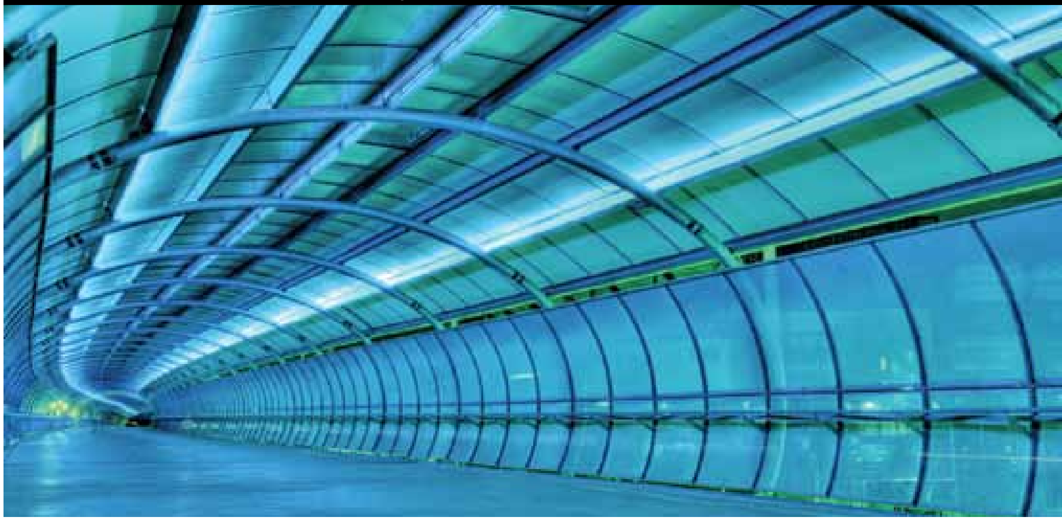

The Value of An "Expert" Life Reinsurance Intermediary

By H. Michael Shumrak and Todd Spooner

This article describes how a life reinsurance intermediary, possessing a combination of creativity, accounting, actuarial, reinsurance market and capital markets knowledge and experience, can bring unique mission-critical value to clients seeking reinsurance focused on special risks and/or focused on financial and tax planning objectives.

We use the term "expert" in the context of this article to represent a contingent fee-based life reinsurance intermediary with the foregoing skills to distinguish such an intermediary from others whose success is primarily based upon successfully matching buyers and sellers. In many of these situations, the expert can also play an important and valuable role for the reinsurance markets where these transactions are placed. We will overview the historical trajectory of the role experts have played in the placement of life reinsurance. Next we will discuss needs in today's market as they relate to the

CONTINUED ON PAGE 5

expert. To conclude, we will describe the current and likely future role of the expert based upon the current and likely future environment.

THE HISTORIC LAY OF THE LAND

Unlike property-casualty reinsurance, where direct writing insurers place a significant portion of their reinsurance through intermediaries ("brokers"), most life insurance companies place reinsurance directly with reinsurers. This is particularly true for the placement of yearly renewable term death protection and coinsurance of new business. For many years, the primary scenario that involved life reinsurance intermediaries was the placement of specialized risk protection reinsurance such as catastrophe, stop-loss and specialized accident and health reinsurance. These brokers included very large multi-line brokers and smaller specialist brokers with strong relationships with markets such as Lloyds. This segment of the business continues today in much the same manner, and while it is a very important segment of the life reinsurance brokerage business, it is not the focus of this article.

About 35 to 40 years ago, experts began to develop traction in the increased use of reinsurance for financial and tax planning purposes. Using their innovation, actuarial knowledge, and accounting expertise, these experts helped lead the development of what is now commonly referred to as financial reinsurance. In addition to these distinctive competencies, until the mid-1980s, they also enjoyed great flexibility in leveraging both the U.S. federal income tax and state regulatory frameworks to their advantage. They helped develop structures that would efficiently meet their ceding company clients' financial objectives, develop and maintain credibility with their reinsurance markets, negotiate and place these transactions and monitor them over time helping affect updates if and as needed. Their compensation was usually paid by the reinsurers based upon a percentage of the reinsurance premiums and/or risk fees. The particular financial planning objectives they were meeting included generating or using capital and surplus to acquire or divest blocks on in-force business, improving balance sheet strength to maintain or increase ratings or satisfy regulatory concerns and otherwise improving financial performance. In addition to adding value through innovative structuring, these experts also introduced clients to new reinsurance markets other than the usual suspects (the ever shortening list of professional U.S. life reinsurers). An example of a non-traditional reinsurance market would be opportunistic direct writers with reinsurance expertise holding excess capital.

Obviously, the reinsurers build the cost of the intermediary fees into their pricing as an additional expense, but the reinsurers generally benefit from "some" amount of savings in the time and effort it would have taken for their internal experts to design similar transactions for their clients. The reason for the use of the qualifier "some" rather than "total" is due to the fact that all professional U.S. life reinsurers maintain their own direct

CONTINUED ON **PAGE 6**

H. Michael Shumrak, FSA, MAAA, FCA is a consultaing actuary with Shumrak & Company, Consulting Actuaries & Reinsurance Intermediaries in Amelia Island, FL. He can be reached at Michael@ H-MichaelShumrak.com.

Todd P Spooner is Manager with Elevated Financial Solutions, LLC in Golden, CO. He can be reached at t_spooner@ comcast.net.

sales forces so they incur these costs regardless of the source of their business. At a minimum, however, the experts assisted the reinsurers in risk analysis and problem solving, roles beyond the technical knowledge and experience level of most professional life reinsurers' salespersons.

Once it became known how lucrative this line of work could be, a number of new entrants appeared on the scene. Many of them, like the typical reinsurance salesperson, did not possess the distinctive competencies of the experts, but were bold, aggressive and persistent in their work to match buyers and sellers of financial reinsurance in exchange for a commission. This worked to devalue the role of the life reinsurance intermediary in a market where direct writers had never viewed intermediaries as a necessity except for the placement of special-risk reinsurance as previously described. Direct writers began to not distinguish between the "pure matchmakers" and the experts. As reinsurance financing became more widely used by insurance companies, many developed internal resources and expertise to evaluate these transactions. Coupled with already established reinsurance relationships, pure matchmakers—and more broadly all intermediaries by association—were seen as providing little value. In a business where the intermediary seeks to secure the direct writer's commitment to work with them on an exclusive basis, the market devolved into one where the experts were faced with resistance to working exclusively with an external expert that could optimally structure the transaction, credibly approach a number of markets and successfully place the reinsurance transaction.

In response, some experts have given up on their intermediary practices by joining reinsurers or consulting firms. The professional reinsurers and consulting firms were delighted to acquire this special expertise. They were able to pay their new hires reasonably well as employees while capturing the upper end of the compensation that would have otherwise accrued to their hires in their former role as entrepreneurial experts.

The adoption of U.S. statutory reserve regulation XXX would have seemed like a boon for the expert, but instead turned out to be mainly a short-lived boost. XXX (and later AXXX) so greatly expanded the need for life insurance company financing that it attracted sources of capital outside the reinsurance industry in a big way. Banks entered the business through securitizations and the establishment of their own reinsurance divisions devoted to this business. Product offerings became highly commoditized and highly competitive, and while experts and matchmakers alike were able to share in some of the wealth by aiding in the development of these new markets, it was short-lived once direct relationships with the banks were established. More importantly, it further blurred the distinction between the expert intermediaries and the pure matchmakers. The commodity products were so inexpensive that there was hardly a need for further innovation and, therefore, little way for the expert to add value.

THE CURRENT & FUTURE NEED FOR EXPERT LIFE REINSURANCE INTERMEDIARIES

The 2008 financial crisis completely changed the landscape for insurance company financing and directly affected the role of the expert. Since the primary initial drivers in the evolving financial crisis were the problems in the sub-prime mortgage market and its associated securitization processes, this took the banks back out of the life securitization business. This also adversely affected reinsurers supporting XXX and AXXX reinsurance as letters of credit became hard to come by, and extremely expensive relative to their cost over the past years. At the same time, life insurers were all negatively affected by the crisis with varying intensity depending upon the amount and vintage of their sub-prime mortgage assets. Over time these problems spread to their general corporate bond holdings. This dramatically increased the demand for financial reinsurance solutions at a time when the supply had contracted materially. Since the asset rather than the liability side had been the primary source of direct writer pain from the financial crisis, many of the most effective financial reinsurance planning solutions require the experts to leverage their capital markets skills and expertise more so than in the past.

Many direct writers looking for financial reinsurance were concerned about their risk-based capital ratio for ratings purposes and some were in such dire straits they were close to takeover by the regulators. All of these situations presented reinsurers with much more serious credit risk underwriting considerations than had ever been the case on a broad basis. Again, the capital market dimension of the experts' skills and experience have emerged as key today more so than in the past. Financial reinsurance transaction activity slowed down substantially, but did not dry up completely, particularly those that did not require long term, high volume levels of LOC support. More recently, some LOC capacity has returned; there is a limited amount of securitization and more reasonable prices and terms have started to return. However, the days of ultra-competitive commodity transactions are over, although nothing lasts forever in this business.

Market conditions have forced companies to improve capital ratios through any means available. In many cases the quality of capital is lower than has historically been the case. Rating agency oversight, already kicked up a notch in response to the financial crisis, is looking at a level of detail beyond that previously used. Issues such as whether internally financed LOCs should count as leverage, the duration matching of LOCs versus the underlying business, and the value of internal reinsurance are all areas being given greater attention.

The need for innovative, customized and credible solutions to the capital finance needs of the life insurance industry is greater right now than it has been in some time. While many companies may be content to wait for the market to recover to recapitalize or willing to pay higher costs for commodity solutions, neither of these approaches is likely to produce a competitive advantage. It would seem that there has rarely been such an important time for the services of the expert.

As previously discussed, the direct writers' perception of the value-added of life insurance intermediaries used to solve capital management planning issues continues to be myopic, focusing on the price of commodities in a vacuum rather than in relation to the important competitive benefits experts can offer. There have been some situations where the direct writer who was negotiating intently on the pricing of a commodity, eschewed a better solution that, even without hard negotiations and after payment of the expert's fees, would have cut their net capital cost by two-thirds or more. In this scenario, everyone loses: the direct writer—by paying more for capital; the reinsurer—whose margin was eroded through intense price negotiations; and the expert intermediary—who was deprived of the opportunity to earn his/her compensation.

"MANY DIRECT WRITERS FAIL TO UNDERSTAND THAT THEY OFTEN CANNOT GET THE SAME EFFECTIVENESS OF STRUCTURE AND COSTS BY GOING DIRECT TO THE REINSURERS."

Many direct writers fail to understand that they often cannot get the same effectiveness of structure and costs by going direct to the reinsurers. In the absence of an oversupply of financial reinsurance providers or direct writers working with "experts in their corner," reinsurers are rarely pressed to introduce customized solutions. To do so would mean a large incremental investment of time, possibly losing the deal when the customer just wants something simple, and if successful, often times doing so for a smaller profit.

The depth and breadth of knowledge and experience necessary to properly execute a more complex, customized solution is a competency that exists within only a few reinsurance companies worldwide. Indeed, that competency exists with only a small subset of professionals. Routinely exposing such advanced concepts to the market risks educating one's competition. As there is usually no reference pricing for these customized transactions, the reinsurer is aware that their idea may be shopped to other reinsurers in the hopes of finding a better price, or at least validating the one they have. For all of these reasons, reinsurers will generally withhold their more advanced solutions unless specifically requested by the client, or in the case of a very special client, or in the case of a very large or "status" account where they are needing to pull out all the stops to get the deal done.

Experts can overcome these limitations by helping direct writers develop their own best solution to their financial planning requirements and get a fair hearing from a wider range of reinsurance markets. The expert intermediary should be able to provide all, or nearly all, of the following benefits in any given situation:

CONTINUED ON **PAGE 8**

1. Design/structuring expertise—the aim is to provide a solution which is more suitable, more flexible and/or more cost-efficient;

2. Fine-tuning existing structures—sometimes small changes to existing designs can produce measurable cost efficiencies and/or greater financing capacity;

3. Troubleshooting deal obstacles—creative problem-solving with reinsurers over a myriad of potential deal-killers helps the expert intermediary bring the greatest possible number of reinsurers to the table, thereby providing the greatest chance of success and best possible terms for his client;

4. Pitfall avoidance—the expert can identify trouble spots in the deal; the worst thing that can happen is that the mechanics of the deal don't work as anticipated or the deal fails to meet regulatory muster and in the meantime the market hardens forcing the company to renegotiate or recapitalize at the worst possible time; and

5. Access to new markets and negotiating expertise—often these are considered the only items of value in the intermediary's tool chest; in fact, they are the least important of those listed.

In today's market the livelihood of the expert intermediary depends upon differentiating oneself through the quality of one's solution. An expert intermediary realizes that companies often do, and often prefer, to deal directly with capital providers. Unless the expert intermediary can produce the goods—more suitable, flexible and/or cost-efficient solutions—he/she is unlikely to attract many clients. ■