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AGENT-OWNED REINSURANCE COMPANIES

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MR. CHARLES G. BENTZIN: What is an agent-owned reinsurance company? Agent-owned reinsurance companies are an exciting and challenging activity currently going on at this time. As in any new activity there is some question about nomenclature. An agent-owned reinsurance company (AOC) is a reinsurance company which is owned partly or wholly by an agent or agents who are responsible for producing insurance which will be partly or wholly reinsured by the AOC.

Various names have been used to describe AOCs. They are sometimes referred to synonymously as a producer reinsurance company (PRC). They are also referred to as captive reinsurance companies (CRCs). The designations AOC and PRC more frequently refer to companies reinsuring ordinary life insurance, whereas the designation CRC more frequently refers to companies reinsuring

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credit life and credit accident and health insurance. It does not have to be that way; it just seems to be the way it is evolving at this point.

History -- CRCs date back well into the 1950s. When I was chief actuary at the State of Arizona Insurance Department in 1959, there were about 35 in existence. Currently, there are hundreds. Most of them are credit life and credit accident and health related.

There was, however, at least one agent-owned captive that dated back into the 1960s, that we are aware of. There was also another company that attempted to advertise the opportunity to be involved in an AOC to ordinary life agents. (To my knowledge, that particular company was not successful in doing this.) In fact, the major interest in the AOCs dates back into the late 1970s. One of the leaders in the field at that time was Mr. Jerome J. Schwartz, who is one of our panelists.

It is estimated that there are probably about 30 to 35 agent-owned companies now in existence. No one knows precisely what the number is, since there is still a question of what the definition of an AOC is.

Why would a direct writing company encourage the the formation of AOCs? Reasons are to (1) attract agents, (2) improve mortality experience, (3) improve persistency experience, (4) increase sales, (5) retain agents, (6) reduce marketing expense, (7) meet competition, and (8) add an additional marketing tool.

Why would agents wish to participate in an AOC? In exchange for, in some cases, an investment or a reduction in commissions, they would have hoped to, in turn: (1) increase earnings (2) participate in the design of products (3) better understand and participate in the insurance business (4) create an estate, and (5) obtain the benefit of investment income.

If there are all these advantages to the agents and to the direct writers, why isn't everybody doing it? There are a number of reasons given as to why companies choose not to go into it, or at least not to go into it at this time:

1. They do not want to give up a portion of the company's profits.

2. The profit margins on the business are too small.
3. Additional data processing systems are required.
4. The agents may be disappointed if the company does not perform as they had wished it would.
5. There might be difficulty in reinsuring certain products such as single premium deferred annuities.
6. They may have to negotiate with agents in more areas such as product design and marketing techniques. One direct writer who is involved in an agent-owned captive has indicated that their involvement is like making love to an elephant -- you can't stop when you want to.
7. They may lose a large block of business if all the agents involved in a reinsurance company get mad at once and leave.
8. Perhaps they think they can meet the objectives by other means.

Mr. W. Grant Hardy, who is Executive Vice President and General Manager of the Gerling Global Life Insurance Company in Toronto, Canada will explore some of these things. Mr. Hardy graduated from the University of Waterloo in 1974 and he obtained his Fellowship in November of 1976. He started with the Gerling Global and had a number of different responsibilities there, which of course have ultimately culminated in his being Executive Vice President. He is also on the board of his company and frequently travels to Germany to meet with his company's owners.

MR. W. GRANT HARDY: My presentation is going to come from the perspective of a reinsurer who has been involved with a number of direct writing companies who are involved in AOC programs. I will attempt to illustrate the program of one company to give you a better idea of the approach that they have taken, although Gerling currently has four clients who are actively developing agent-owned reinsurance business.

I want to first touch on the general factors that I feel have been affected by an AOC program. Second, I will discuss the specifics of the sharing of risks between the producers and the direct writers of one of the clients. Finally, I will discuss the association of client companies formed by this client for the purpose of education and exchange of ideas in the AOC program. I think one of the most important things that this client has attained was the education of the producers in terms of understanding what they have.

An AOC program can affect your distribution system in a positive way by adding an additional element in the relationship between the producer and the company. I think this element is very positive because it can help both in the short-term and long-term profits of each party. Also by having an AOC program, I have seen experiences where there is a longer term continuity of the sources of production.

However, it must be remembered that AOC programs cannot be used as a substitute for good relationships with producers. I feel that lasting success is built upon good relationships with the producers whether or not you have an AOC program.

From our experience at Gerling, we have seen a greater sense of trust and confidence develop between the producer and the direct writer and the reinsurer since all realize, to a greater extent, the effect that they have on the others. I know quite a bit about the program at Executive Life, and I think some of the primary reasons for the success of the Executive Life program has been: (1) the trust and confidence that exists between the producers and the Executive Life management; (2) innovative products or packaging of products; (3) sound underwriting philosophy which is necessary to insure the mortality results; (4) above-average investment rates of return; and (5) reinsurers who were there at the right time and provided the required services when Executive Life needed them.

In our experience, AOC programs have also affected field underwriting practices. The producers seem to take more care and due diligence in answering some of the questions on the application form. If they are concerned about the quality of the risk, they may refer it to another source.

In terms of substandard risks, we found that the producers are less inclined to push for a more favorable rating once the company has assessed what it feels is appropriate. There is a greater understanding that by reducing the assessment, they themselves could get inadequate amounts for the risk premium.

Additionally, in one instance where there has previously been guaranteed issue under group contracts for pension business, the producers have chosen to issue

the business on a simplified issue basis rather than on the guaranteed issue basis. I think that this has improved the experience.

There is an expectation of better persistency in early years since poor persistency can affect potential earnings of an AOC. Also, if the relationship sours there is greater probability of being left with only bad risks.

The basic principles of the one program that I want to discuss is the Inter-American Insurance Company program. They chose to go the route where individual producers have established their own individual companies rather than doing it through a management basis.

Each individual producer under this program has ownership of 50% of the business up to 10 times the retention that the producer is willing to have within his AOC. Many of these companies have only a $5,000 retention at this time so they end up with ownership of $50,000 of a $100,000 policy and the profit potential on that $50,000. The excess over their $5,000 retention, up to the $50,000 is like an inner earning and overwrite allowance which provides them a second source of income. They have the potential source of income off the profits of their own retention and also the source of profit from an overwrite allowance on the retrocession business.

For larger policies, in their instance $100,000 or more, they formed a reinsurance pool of all of these AOCs. In this way, it allowed each producer to develop a greater amount of business in his company, giving him a greater spread of risk. What we have seen in this instance is that there has been indirect peer pressure in the producer group, to not place questionable risks in the pool because of having to answer to peers for any bad experience.

They have created three elements of potential profit: (1) mortality profits on personally produced business, (2) excess allowances on retrocessions, and (3) mortality profits on business produced by their peers.

To deal with the educational issue effectively, Inter-American formed an association of the individual AOCs. Initially, they held these educational seminars on a quarterly basis which provided a forum for the producer owners to discuss the issues and concerns that they might have.

Informational topics were provided which included (1) understanding financial statements, particularly the impact of statutory accounting on the financial statements, (2) various investment options for insurance companies, and (3) understanding some of the concepts and terms that would be used in the reinsurance field.

In early meetings, quarterly reinsurance statements to these producer owners were distributed with the checks. This had a very positive effect. It brought the reality of the AOC closer to the producer and generated more questions and enthusiasm, and therefore a better understanding of the program. Since Inter-American was a relatively small company at the time, the involvement of Gerling as an international reinsurer lent greater credibility to their program.

In the later meetings that they have developed in the last one to one and a half years they have concentrated mostly on open forum discussions on (1) investment opportunities, (2) how to increase the investment yields, (3) opportunities to participate in additional reinsurance business that is not related to the standard AOC concept, and (4) trying to find additional ways to create additional profits for the producers.

From Gerling's experience as a reinsurer, we have seen significant improvements in the early mortality results and in the early persistency. My feeling is that in five to ten years, the mortality differential between agent-owned business and regular business will not be that great. I think that we can and will see irregular persistency patterns depending on the profit stream that's coming out of the business. I believe that there has been more open discussion between the producers and the company in terms of the impact of the various assumptions that go into the pricing. I have seen an increased pressure for liberalization of underwriting requirements, not a liberalization of the underwriting decisions, but the requirements of building up greater trust and confidence between the two parties.

In closing, I'd just like to say that AOC programs will not, by themselves, attract producers or improve experience. Mutual trust and confidence between producers and company personnel will attract other producers and improve experience. Participation in an AOC program can help to build that trust and

confidence since there is a greater sharing in the risk through this type of partnership arrangement.

MR. BENTZIN: Mr. Schwartz is president of Windsor Insurance Associates which is a national life insurance marketing company that has created the Executive Life Insurance Company of Arizona, frequently referred to as ELAR. Mr. Schwartz has been in the insurance and securities business since 1959, has been a personal producing general agent (PPGA), a registered representative, an agency manager and owner of his own broker/dealer firm. From 1970-76, he was executive vice president and operating officer with Public Integrated Financial Services Company, with a responsibility for 30 branch offices and over 800 duly licensed salespeople. In 1976, he formed Windsor with the expressed intent of creating an agent-owned reinsurer. In 1979, ELAR started business as the first AOC, as we know it today. He believes that this success has spawned a number of other companies throughout the industry.

MR. JEROME J. SCHWARTZ: This particular subject has been bandied around now for quite a few years and in great frequency. How many of your companies have actually taken a good hard look at AOCs and are doing so now? I think there's quite a few companies around the country that have. Tillinghast is putting on some seminars around the country on AOCs which happen to be very good. I attended one in Washington, D.C., not too long ago to see what I could learn about what was happening in this regard, and the attendance list of the carriers that were interested was significant. I'm not sure whether or not they will participate.

There are only approximately 35 companies that have actually participated to date since we started our company in 1979. I think there's some real good reasons for that and some of them are mentioned here. The problems are significant, but I think there is opportunity. I will give you some numbers that will give you an indication of what it has meant to myself and the agents that are involved with the Executive Life Companies, ELAR specifically. There are five other AOCs at Executive Life.

The name of the game by the direct writer or the partner in the program is commitment. The program won't work without any commitment on the side of the direct writer. That's a flat statement. I don't equivocate on it, it just won't

work. The commitment on the part of Executive Life from day one, when I presented the idea to Mr. Fred Carr in 1976, has been significant. Because of that, I think we've been successful at what we've been able to do.

A lot has been said about AOCs recently. The Life Insurance Marketing and Research Association (LIMRA) has put out something on AOCs. Tillinghast felt it was important to sponsor seminars and charge fees for it. There have been a lot of people that have been interested in it, but there are still only 35 companies. I'm not quite sure why. Maybe there's not a clear understanding of what the purpose is all about.

I would like to share with you what I believe the purpose of this concept is all about. Refer back to what Mr. Bentzin said, the reasons why a direct writing company would encourage the formation of AOCs, and distill these down to what they really mean. I would assume the reason would be the same reason for which you do anything else: to make money. If you think that there's any other reason for doing it, then you might be misled on what your corporate purpose is.

If you flip to the other side and refer to what Mr. Bentzin said, the reasons why an agent would wish to participate in these companies, and distill these down, you get the same reason: the agent wants to participate because he wants to make money. That's what we're in the business for. Agents look to create commission income. They're independent PPGAs for the most part, especially the agents that are involved in AOCs. They are not captive organization situations. They are not career agents, for the most part, or at least they are moving out of the career agency system. In ELAR, we have about 115 shareholders today that produce about $20 million of annual life premium. This doesn't include single premium annuities or pour-ins, just annual ongoing life premium of $20 million. Executive last year did about $100 million of that type of ongoing life premium of which about $70 million came from participants in AOCs, numbering about 300 producers. This is quite a significant percentage and a significant number.

The efficiency of the distribution system of Executive Life is also significant. The cost of putting all of this together, the recruiting and training, generating the income and premiums, managing the business, and everything else really

falls, in my case, on my shoulders at ELAR, not Executive Life's shoulders. When I travel out and recruit somebody, when I put something together, when I train, when I do a marketing program, when I come here, it's on my nickel, not on the company's nickel.

That's the distribution system that we have at Executive and it was done by design, as a matter of fact, way back in the late 1970s when we started the arrangement. So, if you're looking to make money, obviously, you have to have a commitment to it that makes some sense.

There are a number of different ways of making money. You make it as you know, through mortality gains, investment income, and by keeping expenses down. As the products have evolved over the last 7 or 8 years, the spread on the investment income has come down. The profits have been narrowed dramatically, and the information that the owner of a reinsurance company needs to know is how that money is really made.

That is what Mr. Hardy was referring to a little earlier when he said that we do a tremendous amount of training of our agents. They understand surplus relief reinsurance, mortality risks, death claims, and the statutory financial statement. We spend a lot of time in trying to make them legitimate owners and partners, helping them understand what is going on so that they can make money.

How many of your boards of directors, executive officers, or owners of your companies are willing to give up a legitimate 50% of the profits on the business that you write? How many of you are willing to give up a legitimate 50% of the profits downstream on the business? Why would you do that? You do that probably because you could make more than you would make on the other 50% because of the improvement in the persistency and mortality experience, because of the increased sales, because you retain the agent, and because your marketing expenses are lower. So, the bottom line really might come out a little bit better for you if you did that and put together an AOC.

When I say legitimate profit, I mean the profit on the investment earnings also. Now that may become a difficult problem for some people. In the companies that Mr. Hardy referred to, the profits come from mortality, either directly or indirectly. The profits in our business come from mortality and investment earning

spreads. We take on the full risk on a full coinsurance basis and make the investment earnings spread. I don't manage the money, Mr. Carr does.

Taking on the full risk causes us some problems, of course. Those problems relate to needing capital in order to build our company and grow our company. We've had to put in significant amounts in capital. We do that in a number of ways, but we've been successful in convincing the stockholders of our companies that it's important to them to legitimately capitalize these companies with hard dollars so that we can take on not only the investment risk, but the mortality gains which seem to, in today's products, make up a bigger percentage of the long-term profits on a compounding basis. That is the way we run our companies, and we've been very successful in doing it that way.

All of this requires, once again, a commitment. It requires commitment on the fronting company's part and an understanding. It requires the training of the agents that are involved and significantly, that training becomes very important because, as you are all aware, the agent usually wants to negotiate commissions to be higher rather than lower. That becomes an important part of creating the profits. That becomes a difficult project to pass through to the agents. It took us quite a bit of time. I'm not saying that we did this overnight.

At the beginning, back in 1979 when we created ELAR, we had 35 agents who were stockholders of the company. We did a secondary offering in 1982 and brought in another 35, and we've done a tertiary offering and brought in additional people. We've lost some people, obviously, over the years. We call them if they don't produce certain minimum requirements. We call them if they don't produce certain minimum levels of persistency.

As Mr. Hardy mentioned in his comments, the peer pressure to write good business is very strong. We have stockholder meetings where we involve ourselves in legitimately understanding where our profits are coming from and how they're being derived. That has been a very successful approach for us.

But, although I'm president of the carrier, and I am responsible for the reinsurance company, and I sign the statements and am pretty aware of what's happening, following every single death claim as it hits because it comes out of my 20% of the company surplus, the major effort that I have is through Windsor

Insurance, which is a marketing organization that I own. The responsibility of that organization is to recruit the shareholders, train them, make them understand, make them have a commitment, a loyalty (as Mr. Hardy mentioned earlier), and all of the other things that are necessary.

We accomplish that by really growing our company on a good basis. As I said, we started out with 35 people. We now have about 115 who are legitimate shareholders of the company. We had two reinsurance companies that I owned and we recently merged them into one because the second one, which was started for a marketing reason, was no longer necessary. Now, after about 7 years, we have built our company from scratch up to where we have $27 million of premium income on our side on a 50% basis. This means that we generated about $54 million of annual ongoing premium. We've got about $27 million of assets also, but we do not take on any of the single premium, the pour-ins, or the annuities from a surplus strain standpoint. We have $3.6 million dollars of surplus and $422,000 in the mandatory securities valuation reserve (MSVR). Our company is pretty solid. The agents are pretty solid.

We still have no problem recruiting to the concept. The values are now there. Coopers & Lybrand is an independent actuarial valuation firm. They have done our values independently of Executive Life looking at all the pieces that are necessary in order to do that valuation. This is reported along with the statement to our shareholders every year, and the company is truly an independent company. It's not owned by Executive Life at all. It's owned by us. We own 100% of the stock, and it will be our company to capitalize sometime in the future. Executive Life has been a legitimate partner, has shared a legitimate 50% of the profits on the business and has helped us dramatically and tremendously in understanding the business. All of its senior management have been totally immersed in the marketing distribution system. This has been a major effort on the part of Executive, as Mr. Hardy is aware, and some other reinsurers that have been involved in developing the life end of the business. We do not involve ourselves in the annuity end of the business that Executive has been heavily involved in and has built its assets with.

In closing, basically, what we want to do is make money. What you want to do is make money. If everybody sits down at the table and designs the program in

such a way that everybody sees that money can be made on the back end when the company is capitalized, then I think you can have a successful program.

MR. BENTZIN: After leaving the State of Arizona Insurance Department in 1960, I formed my own actuarial firm, Charles G. Bentzin Associates in Phoenix, Arizona. Our first clients were captive reinsurance companies, which have continued to be a very important part of our work since that time. I think it's fair to say that since 1960, we've probably done more work in the area of captive reinsurance companies than any other firm.

We have been responsible for the development of some of the techniques which are now used such as: (1) simple, (2) exotic, and (3) hybrid companies. A simple company has a single class of stock, and no special accounting within the company. If you have 10 shareholders and they each own 10% of the stock, then the person gets 10% of the combined profits of the company.

The development of exotic companies is something that we initiated. An exotic company is the opposite, shall we say, of a simple company.

In an exotic company, you typically have two classes of stock, sometimes more. Class A stock is voting stock, it's control stock, and it elects the Board of Directors. Class B stock is what we refer to as participating stock. Participating stock has a large number of different series, either 100 series or 1,000 series, as the case may be.

The advantage of the exotic company is that usually all of the outstanding shares of a particular participating series is sold to a single producer or, in some cases, a group of producers. The business actually produced by that producer or group then is seeded to that particular series and, consequently, the value of that series can be related to the amount and the quality of the business written by that particular producer or group. Consequently, you can put unrelated people in the same company but have the value of their shares based on their own efforts and not necessarily co-mingled with the efforts of other producers.

Outside of simple and exotic reinsurance companies, there's our hybrid reinsurance companies which may have features of both. For example, there may be no

sharing of persistency risk, but there may be a sharing of a portion of the mortality risk, or other various arrangements.

In the hybrids or in the exotics, I'm fond of saying that all exotics are not created equal. The question is, what do you want the company to do? What kind of needs do you anticipate to meet or problems do you intend to solve with it? Basically, we've had people who have wanted to come to us with some sort of cookbook and say, can't we copy so-and-so's company? Our answer is, sure you can copy it, but are your needs and problems the same as their's? In many cases they are not, in which case, they really should start from first principles and determine what their needs and problems are.

If you decide to have a company, then one question is where to form it. There are basically three categories: (1) Arizona (2) offshore (3) all other. As of now, virtually all the agent-owned companies that we are aware of have been formed in Arizona. There are, I think, some very good reasons for that. We've been very concerned about what we refer to as the care and feeding of captive companies. We have been successful to influence the legislation in this area. For example, Arizona is the only state where the capital and surplus requirements and other features regarding the organization of the AOC are separate from those for direct writers. In Arizona, to form a life reinsurance company, you must have a minimum capital of $100,000 and a minimum surplus of $50,000. To form a direct writer in Arizona, however (one that intends to write direct for the public), you have to have $400,000 of capital and $200,000 surplus.

There have been some other more subtle reasons why companies form in Arizona. For example, under the Insurance Holding Company Act, the model permits the insurance departments to investigate or to examine all affiliates of the company. So, if you have a company which is owned by a manufacturing firm, you might run into the anomalous situation that literally, the insurance department could examine General Motors, or something like that. Well, that's a little bit absurd, but it's also a possibility that in the wrong political situations it might occur. In Arizona, for example, we modified the model act to where the insurance department can examine the affiliated firms only to the extent of any transactions with the affiliated firms. So, there's a much reduced possibility for mischief on the part of the regulators. I could go on with a whole series of other things where we have influenced legislation to make it a more friendly environment.

As far as off-shore is concerned, the principal advantage there is reduced capital and surplus. There used to be some tax advantages if you had what was referred to as a "noncontrolled formed corporation." The 1986 Tax Reform Act did away with that. We have quite a number of companies that we formed off-shore which we're assisting in the managing of, but most of those are not in the ordinary life area. The ordinary life area has chosen to go to Arizona at this time.

There can be a number of other advantages for going offshore, the flexibility of investments, the lack of regulation, and other things. In some cases, those things that appear to be advantages may also be disadvantages. You could spend several hours discussing all the considerations in choosing a site.

We haven't seen many choices other than Arizona and offshore. In a few cases, they are left over from other companies in other states and have capital and surplus, but now the capital and surplus in most states is too large for new reinsurance companies. Since states are increasing the capital and surplus requirements for direct writers, the reinsurance companies go along with them. In Arizona, as I mentioned, the reinsurance companies are actually in a different section of the statutes.

What do you have to do to keep the company going? Obviously, you have to prepare the necessary reports. These include: (1) accounting, (2) annual statements, (3) tax returns, and (4) allocations.

In our firm, for example, we will do probably more life insurance company tax returns than any other firm in the country, principally because of the captive reinsurance companies that we're working with.

The allocations are quite important. Allocations are basically a determination of the value of each of the participating series of stock, if you have an exotic company. If you have a simple company, then there is no such thing as an allocation.

Another question is the control of funds, including: (1) checking accounts, (2) investments, and (3) trusts. Who controls the checking accounts? Usually it's the clients, or in Mr. Schwartz's case, he's very much involved in that. Who

makes the investments? That's an important decision. As Mr. Schwartz pointed out, in his case the president of a direct writing company, Executive Life, makes it. You can also engage outside firms. Surely, many of the assets will be kept in trust, frequently because the direct writer will want to take credit for the reserves that are seeded to the reinsurance company, who almost always will be an unauthorized reinsurer as far as the direct writer is concerned.

There are some additional considerations, which include: (1) assumption of risk; (2) pooling of risk; (3) stop-loss and other reinsurance; (4) stock purchase; (5) stock sale; (6) decisions and control.

The first is the assumption of risk. How much risk should the company assume? What kind of risks? Mr. Schwartz very appropriately pointed out that in his case they're assuming investment risk as well as mortality risk. It almost surely should involve persistency risk because that's something that an agent can have a very significant impact on.

If you're going to assume risk, who within that company should assume that risk? Should it be each individual agent within an exotic company? Should it be pooled in a simple company, or should it be pooled in an exotic company as well? There are advantages and disadvantages of pooling and having the risks stand separately.

Then there is the question of stop-loss and other reinsurance arrangements. Should you have a retrocession treaty of some kind? If there's pooling, should there be some kind of stop-loss there?

How are you going to sell the stock in the first place? There's the issue of securities offerings. How much are you going to charge? Are you going to require an agent to reduce his commissions or not? Various questions are very important in that regard. What sort of requirements are you going to have as far as volume of business, persistency, age in the business, or whatever?

It is extremely important in our view that you have a compatible group of agents. The last thing you want is to put all the agents together and then find they're at each other's throats at the meetings. In Executive Life's situation, they have six different companies which are dedicated to six different groups of

agents. We've been fortunate to form the companies and we are their statutory home office in Arizona, but I think it is frequently better to even clone and have a duplicate of the company if you have agents who aren't going to get along with each other.

It's our view that if after you get all done, and you're producing the same business with the same people for the same mortality and the same persistency that you did before, it's not a very exciting concept. What we should do here is improve the mortality, improve the sales, reduce the sales expenses, improve the persistency, and so forth. You will have a win-win situation where the company ends up making more money, the agent's making more money, and the public is better served because the business isn't being twisted off as often.

Mr. Schwartz has mentioned the Tillinghast seminar. My view about seminars is a little different. We have a seminar that we give to our perspective reinsurance companies -- we've given it over 100 times -- and we've found that very frequently the questions get down to specific agents, specific agencies, specific personalities, specific products, and specific strategies. This is the type of thing that you have to deal with within each individual company, because each individual company has a corporate culture which is probably different than most other companies. You cannot follow the same recipes as any other company.

In addition to who's getting in, another very important question is, how do you get out? Who determines that -- a board, a committee, or an individual? Under what circumstances do you get out -- whether it's sales, a mortality criteria, or other things? For what value do you get out? Who determines that value?

In our seminars, I'm fond of saying that even though we've been involved with companies for a long time, we certainly don't believe that there's one concept which is used in conjunction with all the other concepts. I don't think agent-owned companies are going to be replacing agents' conventions, for example. There will still be a need for agents' conventions. There will still be a need for contests. No one technique is going to replace all the others.

I agree with Mr. Hardy on the point that you have to be able to communicate with the agents. We believe very strongly that an agent-owned company has to

be thought of, in part, like an employee benefit plan. No responsible employer will put in an expensive employee benefit plan and then not continue to communicate it to his employees. It's the same way with the AOCs. If you put it in and don't communicate, reinforce, and explain it, it's probably not going to work very well. It may not work at all.

MR. ALDEN W. BROSSEAU: I've got a question for all of you: Is the following view realistic? Right now, the direct business that's being written is not profitable. Certainly we can support the investment being made with the old book, but the new business is not profitable. We're paying too much for it and the business is not staying on the books long enough to meet the assumptions on which it's priced.

It would seem as though the agent reinsurance company might be an answer, given that situation, and if you grant that the interest of the company on the one hand and the interest of the agent on the other hand are antithetical now. We are almost at war. The agent does things that help make money for him at the expense of the company. Agent-owned reinsurance might seem like an answer because that would apparently be a way of lining up the interest of the agent and the company in two ways.

First, you would negotiate compensation to the agent that would reflect the true productivity, the contribution that they are really making in bringing on business. Second, the business would stay on long enough because it would be in the interest of the agent to keep it on. So, that kind of a scenario would seem to me to be perhaps a hope of continuing to write ordinary business in the future. I'd be interested in the views of the panelists and whether that's a realistic scenario.

MR. SCHWARTZ: As far as the business not being profitable, that depends on each company and their ability to distribute. Some of the reasons the business may not be profitable is because of the weight within that company from overhead that might have been created from prior business or the inability of the company to invest their dollars and get the spread that they should be getting because it was bogged down by other factors. There's a lot of different reasons why the business is not profitable. Obviously, if the business is not profitable, or if I thought the business that we wrote was not profitable I would

not be interested in being involved in the 50% ownership of it either. We don't believe that to be the case in our situation.

As far as the agent and the company being at war, that's clearly been the case in the past. In our situation we are not at war. We are definitely in concert. It's a legitimate partnership. We do split everything equally -- expenses and everything else. I think that your scenario will play out. It's kind of like a Catch 22. If you want to make the business profitable, and if you make your agent a legitimate partner and he's making a profit and you're making profit, then maybe the future business that is written will then be profitable and your starting point will turn around to be the ending point. That is the view we took of it ten years ago. That was our direction, to make the business profitable in the environment that we were operating in. Of course, understand that we might have been a little bit different in that we've never had any traditional ordinary life business and don't have any on our books at all. It's all interest-sensitive from day one back in 1979, so our pressure, as far as making the business profitable, is the earning interest spread on the money. I would believe that your scenario will play out correctly, but it's a commitment that will have to be made and it seems to me that the second point might make the first point a moot point.

MR. HARDY: I think the key aspect in improving profitability can be the breaking down of the adversarial relationship between the producers and the companies. An AOC is one way to do it, but it's not the only way. There are many ways that it can be done. We, as a reinsurer, have the majority of our new business today through AOC direct writers, and we prefer it that way because we think the profitability will be much better on the individual line in that instance.

MR. LAWRENCE SILKES: What's to prevent an agent from going to five companies with agent-owned reinsurance? I'm a general agent, and I would want to get as many agent-owned reinsurance companies under my belt. Obviously, there must be some threshold where it will not proliferate itself. Is there any method of doing that?

MR. SCHWARTZ: Not really. There are a couple of guys that I've got that are in our company who are also owners of other AOCs. We have one of our larger

producers who recently started an AOC. The interesting fact is that he started it with a smaller company, not that we weren't very small at the time when we started. But the amount of business they were producing with us prior to the time they put together their own, was less than the business they're producing with us today. This basically means that they are a little concerned about their new carrier being able to really deliver on its promises in the future. I think that's where the effort that has to go.

MR. SILKES: Is there an initial contribution that would tend to deter agents from going to other companies?

MR. SCHWARTZ: I have not found that to be the case in our company, but we don't have a large initial contribution at all. Some companies have fairly large initial contributions, $25,000 to $100,000. In our situation, we've only gone on a contribution that equated to a certain number of shares that they could buy in at, and that related only to statutory book values and not real values. We have not had any problems in that regard.

MR. ROBERT E. SWETT: What do you consider should be the minimum amount of production for someone to be eligible for this type of arrangement? Do you have any estimate about what the population of this size producer is?

MR. SCHWARTZ: When we started out back in 1979, obviously, the concept was fairly new. Executive Life had $60 million of assets and $6 million of net worth and a par whole life and an annual renewable term -- no interest-sensitive products. So, the production that we were looking for was quite different than the production we're looking for today. At that time, it was only $25,000 of annual paid premium. That has been moved up over the years to where the minimum contract, depending on the marketing organization, is $75,000 of paid premium (not annualized) on the ordinary side only -- no pour-ins, no cash value, no single premium -- just annual ongoing paid premium. In addition, you get the other peripheral products.

In one of the marketing organizations at Executive Life, the minimum premium that they look for is $250,000. In our organization now, frankly it does not pay an agent to come in to ELAR unless they're going to do somewhere between $150,000-$200,000 of annual paid premium. That is because it does not pay for

the agent to come in unless he/she is going to do at least the average premium or better than the average at this point in time and seven years downstream. It varies on that basis.

In my view, a reasonable minimum would be $75,000-$100,000. This is because if you start out as a private placement and you bring in 35 people under the private placement laws on a securities offering and they each do $100,000, that's $3.5 million of premium which makes some sense. If you are going to get $500,000, or $1 million of premium and it can't grow dramatically, then it is not going to provide any significant profits in the future for anybody.

The universe of $100,000 premium producers is probably quite large. The universe of $250,000, obviously, is narrowed down significantly, but there are a legitimate number of partnerships that have gotten together with two, three, or four people. So it varies.

MR. BENTZIN: The minimum premium level and whether it is a simple or an exotic company will vary from company to company. Exotic companies tend to have greater variability in the producers' volumes that they can handle and still maintain the level of equity; whereas, simple companies are fairly well constrained so, to maintain equity they have to have people producing approximately the same amounts of premium.

MR. SCHWARTZ: You want to do that with annual premium, not annualized premium.

MR. BROSSEAU: You mentioned the universe of $100,000 producers. That leads to the question of, what kind of market penetration do you think has taken place so far?

MR. SCHWARTZ: By agent-owned company producers? Minute.

MR. BENTZIN: I presume, Mr. Brosseau, that you are referring to the percentage of agents producing $100,000 or more who are now participating in agent-owned companies.

MR. BROSSEAU: The denominator would be the potential number of agents who might be eligible for such an arrangement, and the numerator would be how many are taking part.

MR. SCHWARTZ: Obviously, one of the reasons for creating AOCs is so that agents don't twist their business every year. You keep going in circles on that. It becomes a Catch 22. I would say the market is significant because of this. If you just go up to the Forum you're looking at $350,000 premium producers or better, probably 400-500 members. I've got about 34 members in our company. Central Producers Group has about 60. I would say there's probably overall between the "M" Group and a few others, 150 to 200 Forum members that are involved, so you've got a spread there on the top end. You can also get down to the Top of the Table. Both those are blocks that you can look at. There aren't very many. If there are only 35 companies, I don't know where they all are. You can look in Best's and find half a dozen -- "M" Life, our companies, and a couple of others. Those are the only ones that are significant at this particular point in time. I think there's a lot of room. I don't find any problem recruiting.

MR. SILKES: Does an agent know his buy-out at all times?

MR. SCHWARTZ: Yes. In our company the agent knows his buy-out at all times.

MR. SILKES: So each year he gets a list of his earnings plus the present value of his buyout?

MR. SCHWARTZ: No. As far as we're concerned, if anybody wants out prior to the time we sell the company, they get out at statutory book value.

MR. SILKES: In addition, what's to prevent this organization from going to someone other than Executive?

MR. SCHWARTZ: Nothing. We choose not to by design. We have the ability to have reinsurance treaties with anybody we want.

MR. SILKES: Have you ever considered having your company write direct?

MR. SCHWARTZ: That will be one of our options. Since we are 7 years old, we have to look for some level of capitalization at a real multiple of earnings in the not too distant future. We had a 5-year plan originally which ended at the end of 1984 and everybody opted for another 5-year plan. It was like the army. If I come back to them at the end of 1989 for another 5-year option, I'll probably get hung. So, we need to find a way to legitimately capitalize the present value of future profits. We are in the process now of looking at all of those options. There are obviously four or five options that are viable ones including: going public, back-dooring a public issue, and becoming a direct writer which, of course, would be prior to going public. If the tax laws don't change too much, we can just take the profits and let them run off. There's a lot of things that we can do; at least a half dozen options.

We have a book of business right now that equates to about $27 million of premium, 80% of it being ordinary life interest-sensitive products. The rest is ordinary life 14% of which is comprised of guaranteed issue or guaranteed exchange products and 5% is term. That's our block of business.

No producer has produced more than 3% of the total production of our company. The persistency is about 95% on the overall block of business from the time we wrote it to now. I would think that there would be a market for that kind of business.

MR. BENTZIN: In regard to the issue of becoming a direct writer, how many of you were around in the 1960s and remember the agent-sponsored direct writing companies? Let me give you a little bit of history on that. Back in the 1960s, in fact, starting in the late 1950s, there was a whole series of companies that were sponsored by agents. For the benefit of those who are not familiar with it, usually what happened is that there was a single dynamic producer who got together and said, "Hey guys, why are we letting the direct writers have all these profits? Why don't we form our own company and be the stockholders?" He would then gather a group of people around him. Sometimes they would have a stock issue, sometimes they would finance it themselves. There were various ways of doing it.

The question I will then ask is how many of you know of companies that are direct writers who are principally owned by agents at this time? My observation

of these agent-owned direct writers is that what happened so often is that you took a good or a great agent and turned he/she into a lousy company president. Not only was he not producing business any more, he was doing a bad job of running his company too. Consequently, many of those companies didn't stick around very long. I have long felt that an agent-owned company is a far better way to go because of the fact that you have the agents doing the things that they do best, namely selling insurance; you have actuaries hopefully doing the things they do best, crunching numbers and all those things that actuaries are supposed to be doing; and managers doing the things that they do best. You basically unbundle the situation, instead of trying to have one person be all things to all people, which obviously very rarely works out very well.

As far as buying the services that a direct writer provides, or creating those services, any company would have to be in a very substantial position in order to do the things as cheaply as a well-run direct writer charges for the processing of the business; if you look upon the processing as a separate industry, so to speak.

MR. FRANK EDWARD WALKER: Would you comment on the viability of putting annuity business in the captive companies? I would assume that in general the answer is "no." Also, what options are available to the company and how often is it used to allow the company to be able to take credit for the reinsurance credit because the company is unauthorized? What can they do?

MR. BENTZIN: I'll answer the second question. As far as taking the direct writer credit for the reinsurance, there's a couple of options, assuming you want to take credit. Occasionally we run into companies who do not intend to take credit, so that's one option. But if you want to take credit, there are a couple of things you can do: (1) get a letter of credit, and (2) establish a trust or custodial account. There is a model Non-Admitted Reinsurers Act under the National Association of Insurance Commissioners (NAIC). That act was adopted quite some time ago by the NAIC, but to my knowledge, has not been adopted by any states as such. In dealing with the captive reinsurance companies, we have been very successful in getting the states to adopt the model Non-Admitted Reinsurers Act administratively; and say that if you provide these things the state will let you take credit for the reserve ceded.

There are basically three ways to do this, the first of which is for the direct writer to hold the funds under a modified coinsurance reinsurance agreement. This is not usually totally satisfactory because you have to have at least some funds that are ceded on a coinsurance basis; otherwise, you may have adverse tax effects.

The second is to cede the funds and to actually let the funds flow down to a trust account which is under the joint control of the direct writer in the ceding company. In those cases, the funds definitely belong to the reinsurance company and the investment income belongs to the reinsurance company, but you can take credit for the reserve ceded because the funds are under joint control. Most states permit that. A few states have specific statutory language permitting it; such as, California under Section 922.4, and New York under Section 65.

The third way is a letter of credit. Letters of credit, of course, have been under a great deal of discussion lately in that a number of states have come out with regulations that require, basically, the letter of credit to be perpetual -- perpetual as defined in a fairly narrow sense -- and unrestricted, meaning that the letter of credit can be drawn upon without any restrictions by the direct writing company. As a result of that and also as a result of the heavy use of letters of credit in a large number of transactions, the price of letters of credit has climbed significantly. Consequently, we are finding more and more trust accounts and fewer and fewer letters of credit.

MR. SCHWARTZ: As to the annuity business going into the AOC, we choose not to do that, but it would seem to me that's purely a business decision. Our view is that we don't have the surplus. Our view is that the ordinary life business will provide longer-term profits for us than the annuity business. Therefore, we choose to spend our surplus that way and not to spend it on surplus relief costs or any of that. That's primarily the reason.

As we grow and as we build our surplus, we may take some of that business. I would like the assets. We review that constantly. It's a matter of where you want to spend your money.