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ASSET COINSURANCE

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- How does this arrangement work?
- What are the risks involved? What is accomplished?
- Satisfying the regulators and company management

MR. KIN K. GEE: We have two panelists. Mel McFall is second vice president, annuity reinsurance, at the Lincoln National. He had prior experience in research and underwriting. Dave Ingram is the head of the corporate actuarial department at Provident Mutual in Philadelphia where his responsibilities include annuity pricing and product development, as well as reinsurance. Dave also has spoken at financial reporting and surplus management seminars.

Perhaps asset coinsurance has been regarded as an oxymoron. Coinsurance (CO) in the old days by definition included transfer of premium and, therefore, accumulated investment income would lead to sufficient assets to support the reserves. Then in the 1980s with some of the tax treaties using modified coinsurance (MODCO), and some of the financial reinsurance treaties where coinsurance transactions were being done on a funds-withheld basis, as well as some CO and MODCO, had to use the term asset coinsurance to talk about the kind of transaction where the reserves or ceding commission were done on a cash basis. Specifically, while this could apply to all lines of business, including universal life and other interest-sensitive products, by and large we tend to mean the reinsurance of Single Premium Deferred Annuities (SPDAs), where the premium and reserves are being transferred over from the ceding company into the reinsurer on a cash basis. Why are ceding companies becoming so interested in this form of asset coinsurance? What recent events have focused the need for this type of reinsurance?

MR. DAVID N. INGRAM: Prior to the recent downturn in interest rates, annuity sales were booming, fixed annuities particularly. They were one of the last tax advantage vehicles left in the marketplace, and at the same time holders of many other kinds of fixed assets in the financial services industry, banks and S&Ls, were having their own troubles. They were under pressure to get their balance sheets in a much stronger position. Poor performing assets contributed to the problem to get better margins on their products. They were interested in actually getting rid of some of their assets. A number of insurance companies provided banks with a way of taking assets off their books and adding profits to their income statement at the same time if selling annuities, and, in general, the interest rates that insurance companies were willing to offer to annuity clients looked good. All that produced growth pressure in the annuity business. What seems to have happened in that business is that quite a number of companies have gone into it and then suddenly found out that the amount of capital they had available to them to write this business was less than their capacity to write the business. We've always thought of the SPDAs requiring capital on the order of about 10% of sales, which comes, roughly, half and half from the strain from selling the business as well as the risk-based surplus needed. Many parent organizations of

companies selling this business quickly lost interest in putting up the amount of capital to do that, and the avenue of receiving surplus relief through annuities has been shut down fairly effectively by the regulators.

Concerning financial strength everybody needs to control their leverage. It's quite possible to find out at some later date that one didn't anticipate capital need on either the investment side or due to a new surplus calculation. Some of the time you need more capital if you're in this business to try and please some rating agencies who are prejudiced against the annuity business, but most company chief financial officers really hate getting year-end surprises, and a surge in annuity sales at year-end is not appreciated.

Another meaningful motivation for looking at annuity reinsurance is that after you get a real feel for what you can do and what you can afford to do, you start talking to major distributors of annuities. One of the things you'll continually do in the marketplace is try and find additional distributors. The successful, large distributors only want business if promised nearly unlimited capacity to write business. Most of them have been burnt by at least one company with whom they spent the time and the effort to work up marketing programs related to a company's offering only to have it pulled out from under them. So, they're interested in having a company tell them, yes, we can take all of the business that you can write and that we're not going to play games either by withdrawing the product or by just running the rates out of competitive range to waste your time some time later in the year.

Another motivation might be that you don't know as much as you'd like to know about all aspects of managing the business. This is a traditional reason for any kind of reinsurance, trying to get some kind of partner who has some expertise that can be shared through the reinsurance arrangement. Lastly, the owner or parent or whoever is putting up the capital may want a second opinion about the business. Getting a reinsurer to share in the business gives them a strong opinion from somebody with a vested interest.

I'm with the Provident Mutual, and we've been marketing annuities since 1983 or 1984, and in 1989 we found that our sales were going much better than anticipated. In fact, by some time in May we had hit our year's sales goal, and around that same time – our annuity sales are primarily through our subsidiaries – the parent company decided to stop sales from one of the subsidiaries. As they were doing long-range surplus planning, they decided annuities was not a place where the company wanted to continue to put additional capital. The company wanted to restrict our sales to about one third of what previous plans had been, yet cover all our expenses.

Also we had a significant marketing capacity that we had spent money to create and maintain, and that we were just going to lose it by making that decision. The alternative that we worked out was to find a partner with whom we reinsured two thirds of our annuity sales, and that allowed us to continue on with business plans largely unchanged.

MR. GEE: The smaller stock companies who had been writing a significant amount of SPDAs up until about April 15, 1991, were able to finance a lot of their growth in SPDAs through financial reinsurance where the requirement to pass the investment

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risk was not as extensive as today. In April, California came out with the famous bulletin that CO/MODCO will now cease and desist. Concurrently was the National Association of Insurance Commissioners (NAIC) work on the new model regulation which California has in October 1991. The passage of the new NAIC model regulation on financial reinsurance also further stimulates this asset coinsurance as opposed to financing their growth through financial reinsurance. What are the reinsurer's mechanics in this kind of transaction with emphasis on the regulatory changes which are the key to the transaction working?

MR. MELVIN C. MCFALL: Before I address that question, I was going to summarize the reasons that we have seen that companies have an interest in annuity reinsurance in the first place. There are four or five of those. The first is for help with their financial ratios. When you write annuity business it increases your assets and liabilities fairly quickly and probably ties up some of your surplus. By coinsuring the annuity business you slow down the surplus drain and also slow down the growth in assets and liabilities so that the ratio between your surplus and your assets or your surplus and your liabilities can be maintained at appropriate levels. A second reason is to tap the investment expertise of the reinsurer. A third is to help slow down the surplus strain resulting from writing new business. The fourth reason that we have encountered, although not often, is to help spread a concentration of risk. Suppose your company is writing a lot of annuity business through one distribution system, and you're not comfortable retaining all of that risk yourself. You can address that need through reinsurance. A fifth reason, as a couple of companies have inquired about, is reinsuring annuity business to avoid the cash-flow testing requirement.

There are a number of ways that you can reinsure annuities. By far, the most prevalent is quota share coinsurance of individual deferred annuities. About 80% or so of the requests that we have received relate to coinsuring individual deferred annuities. Occasionally you'll get a request to quota share coinsure immediate annuities or structured settlements or pension buyout annuities or things of that sort. When we get one of those we usually work with our pension department. They have more expertise in the kinds of assumptions that you have to make to price that kind of business. A third possibility is quota share modified coinsurance of individual deferred annuities, and along with that, quota share coinsurance funds withheld. Finally, we've seen some interest in what I call a turnkey program where a company would like to get into the annuity business, but doesn't have the financial wherewithal or the investment expertise to handle the investments. They need assistance with product development and perhaps administration, and by teaming up with a company that can provide assistance with product and administration we can do the reinsurance and meet their needs in a fairly convenient package.

Next let's look at how quota share coinsurance works. I mentioned that's the most frequently demanded product. First, let's talk about the payments to the reinsurer. The ceding company pays to the reinsurer its quota share of the premiums less the agreed-upon allowances, and then the reinsurer pays to the reinsured its quota share of surrender benefits, death benefits. If annuity benefits, annuitizations, are reinsured, then the reinsurer would reimburse the reinsured for the quota share of annuity benefits as well. Finally, the insurer is responsible for its quota share of the reserves on the arrangement.

Regarding the regulatory changes, the new model reinsurance regulation has a big effect on how these arrangements are structured. Under this regulation, reserve credit, which is the reason for doing the deal in the first place, would be denied if any of the large number of conditions are not met. The first one is that renewal allowances are not sufficient to cover anticipated allocable renewal expenses of the ceding insurer on the portion of the business reinsured unless the ceding insurer establishes a liability for the present value of the shortfall in expenses. So, either the renewal allowances have to be sufficient to cover the renewal expenses of the ceding insurer or the ceding insurer has to set up a liability for the present value of the shortfall. Second, the ceding insurer cannot be deprived of surplus at the reinsurer's option or automatically upon the occurrence of some stipulated event such as the insolvency of the ceding insurer. So, in other words, there's some insolvency risk that the reinsurer has to take on these arrangements. Third, the ceding insurer is required to reimburse the reinsurer for negative experience. If that's the case, you don't get reserve credit. Limited reimbursement of loss is acceptable on voluntary termination, but voluntary termination does not include what they call unreasonable provisions such as the ability to raise reinsurance premiums to unacceptably high levels. Fourth is scheduled termination. The ceding insurer must terminate or recapture at a specific time. That's not acceptable. Next are unreasonable payments, payments of amounts other than income from the reinsured policies. It's improper according to the regulation for reinsurance premiums to exceed the direct premium. Next, significant risks are not transferred. The treaty does not transfer all of the so-called significant risks inherent in the business being reinsured.

Next we show what those significant risks are. They are morbidity, mortality, lapse, credit quality, reinvestment, and disintermediation, and I've noted that with immediate annuities, those risks that are significant for immediate annuities, and with deferred annuities, those risks that are significant for deferred annuities. The risks that are considered significant for immediate annuities are mortality, credit quality, reinvestment, and the risks that are considered significant for deferred annuities are lapse, credit quality, reinvestment, and disintermediation. All of those risks have to be assumed by the reinsurer in order for the ceding insurer to take reserve credit.

Reserve credit is denied if assets are not transferred or segregated. Assets must be transferred to the reinsurer or segregated in a trust or escrow account. Noninterest-sensitive products are exempt. So, products like health insurance, fixed premium traditional life insurance, term insurance, are exempt, but interest-sensitive products like universal life and annuities are not exempt from this requirement. Settlements cannot be less frequent than quarterly, and payments due from the reinsurer must be made in cash within 90 days of the settlement date. The ceding insurer cannot be required to make representations or warranties that are not reasonably related to the business need. The ceding insurer cannot be required to make representations or warranties about future performance of the business reinsured. Finally, the agreement cannot provide surplus relief, usually temporary, without transferring all of the significant risks. That's kind of a repeat of the earlier one. Now, notwithstanding all of these preceding rules, the ceding insurer can take reserve credit if the commissioner approves the arrangement. There are filing requirements. Agreements must be filed within 30 days of the date of execution. The ceding company actuary must maintain adequate documentation to demonstrate compliance with the regulation. Finally, increases in surplus net of federal income tax must be identified

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separately on the ceding insurer's statutory financial statement. That would be the last requirement pertaining to income treatment. That's an overview of the regulatory changes that affect how annuity reinsurance arrangements will be structured in the future and have been structured in the recent past.

MR. GEE: Mel, up until recently there have been a limited number of reinsurers who are interested in taking on this risk. More recently, a number of reinsurers now have at least one asset coinsurance of SPDA on their books. What is a reinsurer looking for when choosing a partner in this kind of transaction?

MR. MCFALL: The critical factors that I think most insurance companies look for in choosing a reinsurance partner are as follows. The first is financial strength, and, of course, that has become increasingly important in the last year or so as a number of companies have had difficulties in that area. A second very important consideration is compatible investment philosophies. This is important even if one of the parties does all of the investing, and that's because the rating agencies look at the quality of your assets. Your investment department and you are probably not going to be comfortable with another party doing investing on your behalf unless their philosophy is compatible with yours. So, this one, probably more than any of the others, I think, is very critical. Consistent profit objectives are very important as well. I think of annuity reinsurance as a joint venture or a partnership, and it's more likely to be successful if both parties have similar expectations of the venture. So, that one I'd say is almost equally important as consistent investment philosophies. The emphasis in annuity reinsurance is on partnership. Quota share annuity coinsurance is more of a partnership than most traditional individual life or individual health reinsurance is, at least in my opinion. It's important that both parties view it that way, particularly when it comes to establishing things like an interest-crediting strategy. In order for this to work you need to agree on a well-defined strategy or otherwise there are going to be inevitable conflicts probably not too far down the road.

I already mentioned that the investment and risk management expertise of the reinsurer can be a factor in choosing a partner. That's particularly true of smaller companies who may wish to have access to a wider range of investments that a reinsurer could provide or to the asset/liability matching expertise of the reinsurer. Finally, annuity reinsurance tends to be a fairly long-term relationship, and this goes back to the partnership thing again. In a typical annuity reinsurance arrangement the reinsurer is stepping into the shoes of the ceding insurer, and that implies a relationship that's going to last at least several years, as long as the business is on the books. There's usually a fairly long recapture period associated with annuity coinsurance to allow the reinsurer adequate time to recover its acquisition expenses.

MR. GEE: David, can you address this same issue from the standpoint of a ceding company now? What do you look for in choosing a reinsurance partner?

MR. INGRAM: On the financial strength or quality issue of what you're looking for in a partner, you're looking for both perceived and actual strength. Think of it in the terms that the risk-based capital formula does. If you had taken the credit you were taking on reserves for the annuity coinsurance, and instead of using it as a contra-liability, if you put it up as an asset, how would that directly be affecting your risk-based capital? Is that AA credit or AAA credit, and would it be one of your

largest, single credits? In our case it is probably our largest, single credit, our annuity coinsurance arrangement. So, if you try and pose it in those terms it gives you a basis for evaluating how you're doing this because, in essence, what you've done is lent a lot of money to one entity, and you have to make sure that from a quality point of view that money is going to come back to you when it's needed. There are no C-3 risk concerns on this supposedly because the reinsurer's taking care of that, but you have to, in essence, know enough about the reinsurer to know whether in a stress situation of interest rates moving in a way that's adverse to the business, that they are going to have the capacity to give you that money back at that time should you need it.

On compatibility, Mel broke it down a couple of different ways. On profitability there are a number of aspects to compatibility on pricing or profit targets. One of them has to do with whether the pricing targets or the profit targets of the company are stated in terms of long-term or short-term profitability. What is the attitude of each company toward annual fluctuations in profit? One of the things that I found out as we first went into it is that we priced on something that was, in effect, a present-value calculation and did not spend any time at all looking at year-to-year fluctuations in our projected profits. Although we used a stochastic model for pricing, we looked at the fluctuations in the present value of profits among a number of scenarios, and what at least one other reinsurer we talked to about that did was that insurer concentrated on the yearly fluctuation and said this product is much, much too volatile for us. We couldn't possibly reinsure this. So, the scope or the way in which you look at profits becomes very important. Another thing related to profitability is the degree of flexibility or the kind of trade-offs that the reinsurer is willing to make. Is each decision a marginal decision on how they're pricing new business in each period of time? Generally, a direct writer does not do it that way. A direct writer wants to do an ongoing stream of business. The reinsurer really doesn't have a large commitment of expenses to this project generally and so is quite willing, if they did business one month, to not do business the next month just so long as overall you do as much business as both of you are happy with. The reinsurer has to have the same kind of flexibility on profits that allows you to get business to come through on as regular a basis as you need to.

The third item that you also need to think about is that as you are looking forward to renewal crediting strategies, one of the important things that comes into play is each company's attitude toward customers. It is not just merely a matter of what do we have to do here to make the financial part of this agreement work. What we're really dealing with is our customer's money and the interest or crediting on that. Does each company have a philosophy consistent enough on that so that you are going to both want to make the same kind of decisions about what level of interest and what level of adverse or favorable experience you pass through to your customers in setting that interest rate? You clearly don't want to go into a reinsurance arrangement like this with a company that has a very different attitude than you do about that.

Commitment is crucial. A whole long-term commitment is needed for each block of business that is reinsured. We were looking for a company that was going to make an ongoing commitment to taking additional business. Some companies don't necessarily do multiyear planning in businesses that are taking reinsurance. One thing I wanted to mention here is structure. The actual structure of the reinsurance treaty

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that we have is a facultative treaty where technically our reinsurer has the right to refuse any one annuity contract. It has been operated as if it was a quota share treaty, but that was the way they wanted to write it. We have our reinsurance treaty with a company that is not primarily in the reinsurance business, and that is an option that you also have. It's not quite as easy to find a partner who was not a reinsurer because they're not out there marketing themselves to do this, but it is possible to find a company who would like more annuity reserves and is going to do it through the reinsurance route. There are pros and cons to that. Some of these issues on compatibility work out a little bit easier if you're dealing with somebody on the other side who is in the same marketplace with you, making the same decisions. What you wind up doing then is just talking with them about your interest rate setting and your investment policies at the same time they're talking to their people on the same side doing that, and it's not like you have to bring up things for the first time to them. They've just made that same decision you're struggling with, but we'll be making it next week, and that makes that communication step a lot easier.

On the negative side toward dealing with a company who's not a reinsurer is that it's hard to be as sure that they have a long-term commitment to what they're doing. I would guess that direct writing companies that are not reinsurers doing this are probably doing some of this on a trial basis. Is this a viable way of getting more assets? It seems more likely that they would decide to turn away from reinsurance than a company whose bread and butter is reinsurance.

MR. GEE: Both you and Mel touched upon the investment side a little bit, but can you talk a little bit more specifically about the investment strategy, how that's handled, and how the credited interest rate is set, both the initial rate and upon renewal?

MR. INGRAM: I stand on two sides of that. One is you have to do a lot of talking about this because what you need to assure yourself is that the investment strategies that you have aren't going to cause you to want to do opposite things at some point in time in the future. You want to be sure that one company does not have a strategy that – just for an extreme example – is 100% into Collateralized Mortgage Obligations (CMOs) that have a high probability of early payback, while the other company's into long-term bonds with no repayment options. You have to realize in these discussions that you aren't going to get agreement. You aren't going to both sign a joint investment policy that will work on this business. The only way that you could work something out that way is if you did it on a basis where the reinsurer contracted with the direct company to manage the funds in, for example, a segmented account. You need to identify in advance the areas where you know there are potential problems. In our discussions with our reinsurer we were able to identify that there were two or three possible scenarios where for a short period of time we would want different things. What we decided was that those scenarios were – while they're not as unlikely as some of the New York 7 scenarios – things that we don't expect to happen a large percentage of the time in the future, and then we figured when they came about we would decide based on all the other circumstances that existed at that time how we would come to a compromise on the business.

In setting rates initially what we've done and what we've talked about to a number of people is coming up with some kind of an index against which you agree to set your rates. Again, in technical terms the treaty that we have gives the reinsurer the right to accept our rate on every policy or set its own rate on every policy. In a practical sense, though, what has happened is they've accepted our rate all the time. What that's taken, though, is a lot of talking because we've used three different indexes over the 2.5 years we've been doing this, and none of them have tracked well enough to the investment marketplace or the annuity marketplace that we could stay consistently with any one of them. One year the index was a particular set of published rates where we took somebody's seven-year utility rate and adjusted it for the difference between five- and seven-year Treasury Bonds. Next year we looked at an average of about 20 different bond rates. Next year we looked at Treasury rates. Every time something moved differently than it had in any past period, it suddenly meant that we wanted to set a rate that was outside the range we'd agreed on. The annuity market had changed differently than the investment marketplace.

On renewal rate setting you want to derive a rule. If you can state a simple rule then it might be easier to write that down and reach an agreement initially. I think you need to have a fairly complex rule if you want to have a successful long-term relationship within the agreement. Writing down fairly complex rules into reinsurance treaties is interesting. What you're going to wind up doing is having some formula which sets down how you're going to set renewal rates, and then trying to agree on what you are going to do in situations when that formula doesn't wind up giving you what you want. Mainly what's needed to make this work is the compatibility discussions that we mentioned earlier. If you believe that there's enough compatibility, then you'll be able to work out through a lot of discussion and a high degree of communication what is reasonable judgment, and come up with a compatible idea of what profits need to be and how investments are set. You can set your rates at any time, and what has wound up being our experience is that we've talked maybe not weekly but at least several times a month about rates throughout the time we've had this treaty, and there have been one or two times when we've been at conflict, but we've managed to work those out. We'll talk a little bit more about conflict resolution later.

MR. GEE: Mel, can you talk a little bit about that same issue in terms of the investment strategy, how that's handled, and how the credited rates are set from a reinsurer's standpoint?

MR. MCFALL: There are at least three alternatives for handling the investing. The first alternative is that it is possible that a third party could do the investment management. I say it's possible, but not very likely. If neither of the two parties to the agreement was totally comfortable with the other's investment philosophy but could somehow agree on a third party to do the investment management, you might have that situation. A second alternative would be for each party to invest its own share.

The advantage of that approach is that each investment department controls its own share of the assets. Investment departments I've observed tend to be very protective. Maybe years and years ago in the life reinsurance business reinsurers were probably reluctant initially to allow other companies to bind them with their own

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underwriting. So, facultative reinsurance probably was the first form. It's kind of the same thing here. A disadvantage, though, to each party investing its own share is that it's more difficult under that scenario to keep investments in sync. If your investments get out of sync then you have different yields, and the two parties may have differing opinions on what the appropriate credited rates would be because of the different yields in their portfolios. The third alternative, then, is for one party to do all the investing. That could be the ceding insurer or the reinsurer. The advantage, of course, is the mirror image of the disadvantage from the last one. Both parties would be working from the same base for setting credited rates and for measuring experience. The disadvantage is that one party loses some control over the assets.

Now, how would you set the credited rates? Well, you can do that jointly, as Dave has suggested. Representatives from both companies could meet monthly or in some cases more often than monthly to agree on the credited rates for the next month. That approach can be awkward, though, unless the companies are very compatible and are able to work with each other effectively. Another alternative to that, or at least a supplement to that, would be to agree on a crediting strategy, and I think that's a good approach if the two parties can agree on a general crediting strategy up front. That might be in the form of a formula which could be as simple as five-year Treasury rate minus 25 basis points for new money, or something like that based on an index, or it could be the earned rate on the portfolio minus a spread – that would be another very simple formula – or it could be as complex as you want to make it depending on such factors as market rates at the time and changes in the direction of rates, if you don't want to follow rates up as fast as you follow them down, for example. So, you could develop a formula for credited rates. You could also establish a hypothetical portfolio. It probably would be administratively challenging to do it, but you could agree on a hypothetical portfolio and base your credited rates on the performance of this hypothetical portfolio, and then each party would be free to pursue its own investment philosophy, investment strategy, knowing that the credited rates are going to be based on this hypothetical portfolio. Then, perhaps, if you wanted to take more investment risk in the hope of getting higher yield and more profitability, you could do that.

Finally, regardless of what approach is chosen, both parties need to be reasonably flexible. Annuity reinsurance is a partnership. For example, if your formula that you agree on calls for a credited rate of 5.97% for the next month or quarter or year, the two parties should be flexible enough to maybe round that up to 6% for marketing and psychological reasons.

MR. GEE: In addition to the investment strategy and issues of how you've set the credited interest rate, probably the next biggest issue that needs to be resolved in negotiation are two interesting things that are interrelated. One is the expense allowance in terms of what the ceding commission would be, and somewhat related to that is profit sharing or experience sharing. How big an issue is that or how big a factor in what consideration you give in terms of, perhaps, expense allowances and other items?

MR. MCFALL: Surplus relief agreements historically have been experience refunding. My understanding of the typical surplus relief arrangement is that the reinsurer up-fronts a conservative amount of profit on a block of business and then provides

refunds as the actual profits emerge, assuming the actual profits emerge on a more realistic basis. Obviously that's a simplification of the way surplus relief works, but that's my understanding, and I think historically most surplus relief arrangements have been refunding. Experienced refunding arrangements can work very well on annuity coinsurance, at least in special situations. For example, suppose the direct insurer and the reinsurer have different profit objectives, and the reinsurer's profit objectives are lower than those of the ceding insurer. Then the reinsurer could price the arrangement for its own objective and then refund most of the additional profit to the ceding company, assuming that it actually does emerge. That way the reinsurer can achieve its objectives, and through the refund mechanism, if experience emerges as expected, the ceding insurer can also achieve its objective. Another possible situation where an experience refunding arrangement might be appropriate would be if the two companies have different investment philosophies. Perhaps the form of the arrangement and credited rates could be based on the more conservative of the two investment philosophies, and then any additional earnings resulting from the more aggressive investment philosophy could be handled in the form of an experience refund. Now, there also may be situations where an experience refunding arrangement will not meet the need of the ceding insurer because the reinsurer, in order to provide a refund, will have to reduce up-front allowances. The refunding arrangement may fail to meet the need of the ceding insurer for relief of up-front surplus relief or surplus strain. It also may fail to completely meet the need for up-front relief on the target surplus associated with the annuities. In fact, our experience so far has been that a refunding arrangement, although it's very nice, often won't meet the need of the ceding insurer. So, most of the arrangements that we have either done or discussed have been nonrefunding. I think of them as a true partnership in which we step into the shoes of the ceding insurer and take the same risk that the ceding insurer does for the reinsured portion of the business.

MR. INGRAM: I think my experience matches that last line. In negotiating the treaty that we have, the possibility of experience refunds was discussed but we could not find any scheme that satisfied the reinsurer's needs for assurance of their appropriate returns on the business. We just went ahead without it and adopted the exact attitude discussed that this will just wind up being a true long-term partnership. One of the key things to us in entering into this, though, was the expense allowances. Mel mentioned earlier the regulatory restrictions on renewal allowances. The big area of negotiation here is the first-year allowance. Originally we were going into this with a certain amount of capacity for writing business and we wanted to continue doing that. We weren't looking at this as if it was providing us a way of writing more business. Maybe we were being slightly unrealistic, but that was our point of view. So, if we had expense allowances on this business that were too low, that would have caused us a real problem in going forward in that annuity business. The expenses that weren't being covered under the treaty would then have to be borne by the retail sales or some other part of our business and would eventually have dragged us away from wanting to do it. I believe sooner or later we would have decided that that reinsured part of that business was just not so profitable, and we wouldn't want to continue doing that. On the other hand, if we had done a much better job negotiating and gotten allowances that were too high, we would have been in the stance of saying the more business we make, the more profit we make out of it. There's actually profit in those expense allowances. It would have put us strongly at loggerheads with our reinsurer when it came time to set new business rates. We

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would have been constantly pushing for more and more there because not only were we at no risk, but we'd get a possible gain from writing the business, something that would have worked out well for us, but I think would have also destroyed the relationship in the long run. So, we realized, at least in our situation, that the only proper level of expense allowances that would keep this arrangement in the kind of partnership situation where our interests and the reinsurer's interests were fairly much aligned was that the expense level would have to be close to our average cost of writing the new business. One difference, though, in our point of view on expenses is that we've made the commitment to spend the money regardless of whether or not the business comes through, while our reinsurer has committed to spend the money only if there is business there. That produces some tension with us over rates where our interest is to keep the business flowing, to keep paying the bills for those expenses we've committed to. We don't have a new business clerk who only comes in on days that we have business. That's probably the biggest conflict we've wound up having, and that isn't much conflict because, as I said before, in our case our reinsurer is a direct writer who's facing the same pressures.

MR. GEE: Obviously, a lot of the standard reinsurance agreements have an arbitration clause. Can you talk a little bit about what -- including the arbitration clause -- what formal or informal conflict resolution procedures have to be discussed and negotiated?

MR. INGRAM: I've just barely read the formal arbitration clause. There are a lot of other control points, as I call them, in our treaty and in our practice which, in effect, are points where we resolve conflicts. One of them is in setting the new business rate. We have a complicated procedure where, though I said this was facultative, basically the reinsurer has agreed to look at the new business rates over a quarter at a time and that even if they tell us they don't like our rate this week, they have to come up with a weighted average between this week's business and the rest of that quarter if the business was really of a reasonable margin over that period of time. That is a real strong control point. If I get a call from the reinsurer saying your rate's too high it has to come down, that means that we've had a serious conflict. We have to talk even more about our new business rates to avoid getting another call like that because it may come at a time when I don't want it, and they've already been in so much of a turmoil about that they've already made a decision that, no matter how eloquently I argue against it, will be set in stone.

A second control point comes in setting of renewal rates, and there it is the same kind of procedure. We have had no conflicts over that mainly because interest rates have dropped since we started doing this in early 1990. Rates now are about 2.5% below where the bulk of the business was actually written. It's just a question of how far down we want to go and how profitable for the reinsurer this is going to be.

What we did as we were setting up this treaty was that we had a certain amount of correspondence that was of a formal nature outlining some of the agreements or some of the understandings we had at the outset. I don't remember whether this particular point is in the treaty itself or in these letters, but what we agreed to was that twice a year, at the end of the first quarter and the end of the third quarter, we would come to an agreement about the percentage of business that is reinsured. That's another one of these control points that lets one party let the other know that things aren't going as well as you might like. During this year to give us a message

our reinsurer said that we know rates are down, and we know sales aren't that high, but we still don't like how high you're setting the new business rates, so we'd like to take a slightly smaller percentage of the business. That was a control point in the treaty that allowed them to send us a clear message, and they felt like they were having their say on what goes on without shutting down the whole mechanism, without each of us pulling out our treaties and reading that formal conflict resolution paragraph. The point is that without getting that formal conflict resolution, the reinsurer has the right and we also have the right to stop submitting new business under the treaty. So, those are all the steps that we see as coming way before the actual arbitration clause. Both sides are very strongly committed to talking enough, trying to avoid conflicts, and trying to keep our relationship where we don't get to the point of using any of these control points.

MR. GEE: Mel, can you talk a little bit about how you see it from the reinsurer's standpoint?

MR. MCFALL: Obviously, one formal mechanism for resolving conflict is the arbitration clause in the reinsurance agreement. That's the very last resort. I prefer to think in a formal sense that what you try to do is prevent conflict from happening in the first place, and you do that by defining perhaps your investment philosophy and your interest-crediting strategy in the agreement, and if you do that, it should help to minimize conflict down the road. There are also a number of informal mechanisms, for example, agreeing on the parameters up front. Obviously, not everything can be documented in the reinsurance agreement or you'd never finish the agreement. It's important, however, to discuss the important parameters of the agreement up front to be sure that the two parties are in sync.

If the arrangement is structured as a partnership where both parties have similar risks and similar expectations, then I think that will greatly increase the chances that both parties will think of the same kinds of solutions if you run into problems down the road. If you structure the arrangement so that the interests of the two parties are as consistent as possible, then it's more likely that when a potential conflict arises in the future then the two parties will think fairly similarly on how to resolve it. Flexibility is necessary in a partnership. It's important for the parties to be flexible and adaptable when they encounter unanticipated obstacles.

I thought you might be interested in a very rough estimate of the size of the annuity coinsurance market. My guess is that the current market is maybe \$1-2 billion a year, but that constitutes a few very large deals, and a few arrangements that involve transfers of hundreds of millions of dollars each. I think the potential market in a few years could reach \$5 billion a year fairly easily, and that's because the annuity market is growing, and risk-based capital requirements are going to restrict a lot of companies in how much business they can write. So, this is a market that I think has the potential for considerable growth.

Finally, what have we learned so far in the relatively short amount of time we've been in the annuity reinsurance market? First, we've learned that investment compatibility and consistent profit objectives are critical for an annuity reinsurance arrangement to work, and, second, we have found that there is a fair amount of interest in turnkey annuity programs. We've established a couple of informal arrangements with other

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companies so that we can try to meet that need, and those arrangements involve the second company providing product assistance and administrative assistance, with us providing the investment expertise.

MR. INGRAM: The annuity coinsurance has been, in our opinion, an extremely effective business tool which allows us to leverage our marketing and administrative expertise, allows us to keep the coverage of those expenses at a level that we felt we needed and we were able to justify on the basis of our capacities. Finally, let me leave you with these words: partnership, partnership, partnership.

MR. COURTLAND C. SMITH: I'd like to say it was an excellent presentation by each of you. The key word is partnership. Another aspect is the need for ongoing management of not only the relationship, but of the assets and of the product in order to prevent problems from arising. I think actuaries too often think in terms of setting policy, getting agreement on policy, investment policy or whatever, enshrining that policy in the treaty, and then just moving ahead. Administration is assumed; everything will just work automatically. It doesn't work that way in this area. We're really talking about something that is sensitive to an economic environment that's quite volatile. We've been involved in a number of these relationships where we've had other partners handling assets themselves, and we found that watching our portfolio, and in certain situations turning it over in order to maintain certain basic relationships, was necessary just to protect ourselves. While others of us did not do that, we began to get problems developing. There are things you have to do to keep moving your portfolio in some situations just to protect yourself, for example, against the call risk. This is an area where I would suggest that you keep in mind not only the partnership aspect but also the need for ongoing management.

MR. INGRAM: The attitude we've taken toward the kind of decisions you make, and of the programs that you specify in the treaty, is that those are really our starting points for deciding what we're actually going to do as experience emerges. Just as when you're doing a cash-flow testing, you are putting into that expectations of what management actions are going to be on some kind of formula basis, but you do not think in terms of that locking you into doing exactly that when something similar to the situation you've modeled occurs. A simple example of that is how we've been setting renewal interest rates. We've been in this business for eight or nine years, but the period we're in right now is the first period where interest rates have been this low. Any of the assumptions we made previously about how our customers would behave in this kind of situation were just that, assumptions. They were not based on any experience we had. Month by month we are looking at our experience, and we're adjusting what we want our renewal crediting rates to be, based on what we're learning from the reactions of our customers. That is something we're doing as managers of the business in general, but we're doing it within a philosophy where we are considering that we are managing this business as if it was all our own, and then we're discussing with our reinsurer why we're doing that and getting their input and expertise since, as I said, they're making the same decisions. We're coming up with a joint agreement, but our starting point is those two things.

MR. MCFALL: I felt that Court's comments were right on target, and one of the last things I heard him say was that even if one party is doing all the investing, it doesn't mean that the other should just ignore it and let that party do whatever it wishes.

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There is a need for a very close, ongoing relationship, working together to make sure that whatever was agreed upon, investment or otherwise, is actually being followed.

MR. MELVILLE J. YOUNG: One point is that through the process there has to be a lot of discussion, and one of the things you have to watch out for is that you're coming from two different cultures sometimes, and, no matter how compatible you are, you may find yourselves talking at each other, and you have to avoid hitting a roadblock and stopping. If you start out with two companies that are roughly compatible, you can probably find your way around the roadblocks. The other point is that even though it may not always come up, in any joint venture there is an opportunity for the two companies to look for other things to do together, and there may be areas other than annuity coinsurance that you could be helping each other with.

MR. RONALD J. KNAPE*: This relates to the expense assumptions that entered into the negotiation between the company and the reinsurer partner. If you talk about using average expenses as opposed to marginal, when you negotiate the ceding commission, the first part of the question is, does your reinsurance partner tend to look more at the marginal cost of bringing capacity on-line behind you? Also is there any provision made within the treaty for improving economies of scale or unit cost, improvement such that it would keep the ceding commission in line with your own profit expectations and not put you in that position you talked about of profiting from the original assumptions made in the transaction?

MR. INGRAM: About the marginal cost, there is the other point of view that I alluded to as I was talking about setting expense allowances. We talked a lot about that as we set up our treaty, and agreed in principle to the kind of thing you described where we would reset costs if business volumes warranted or caused great economies of scale. At the same time, though, we agreed in principle to the idea of experience sharing. I've never worked out the details of either of those things, and given the fact that there are, as I've also alluded to, huge gains from interest rates dropping. I'll be glad to start talking about adjusting expense allowances when we start sharing those interest gains. If interest rates had gone the opposite way, the reinsurer would be asking me a lot more about the expense savings that we had because of being able to expand our capacity that way. So, in our experience it's just one of those things that I don't think we'll ever get to until it becomes very different than where we originally started out. Our particular volume of business has been such that, while our unit costs are different than they were three years ago, they are not half of what they were.

MR. MCFALL: We don't have much experience in dealing with that issue. We generally will accept the expenses that the ceding insurer gives us, and we'll try to cover those in renewal allowances if we possibly can.

We haven't been at it long enough to run into situations where the expenses are sufficiently different to justify a change. We did have one company recently that expressed concern that we had given them renewal expense allowances, and they

* Mr. Knape, not a member of the Society, is Executive Vice President of American Skandia Life Reinsurance Corporation in Shelton, Connecticut.

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were concerned that if their actual expenses turned out to be more than that, that they would incur a loss, and, of course, on the other hand, if they turned out to be less they'd get a windfall gain. So, we have run into the issue, but generally we try to address it by simply setting our renewal allowances at what the ceding insurer tells us they need to cover them which is what the regulation requires, and we've seen enough that we know what a reasonable level is. So, if we encountered an unreasonable level we might have to ask some questions.

MR. DOUGLAS MENKES: From the point of view of a ceding company, do you require some kind of cash-flow analysis on the reinsurers with regard to the business you've ceded them? If not, would you accept something with regard to all of their business, all their assets, versus their liabilities, and if it's the latter, do you have any idea whether that would be acceptable to the regulators with respect to you taking a reserve credit?

MR. INGRAM: In the situation that we went into here the amount of business we were ceding was a relatively small percentage of the entire business in that particular product line of the reinsurer, and we felt that just on a materiality basis that it would be hard for us to expect that there would be a cash-flow problem. We went into this before the current requirements on cash-flow testing and have not gone any further than that yet.

MR. MCFALL: My answer would be more theoretical than from actual practical experience, but we do plan to do cash-flow testing on our reinsured annuity business, and I don't see why we wouldn't share that testing with the ceding insurer on a treaty by treaty basis if they ask for it.

MR. YOUNG: One of our clients was doing a reinsurance agreement and we went to an insurance department for approval. The reinsurers felt uneasy about their own capabilities to look at the cash-flow testing and also the ceding company's capabilities in that area. One of the ceding company's requirements was that the reinsurer give them their cash-flow testing on an ongoing basis to give them some comfort that the company was properly managing its investments. This was one agreement.

MR. MARTIN P. KLEIN: With respect to the supply and demand of annuity reinsurance right now, what are your perspectives on the capacity and desire of reinsurers to take on this kind of business?

MR. GEE: A number of reinsurers have expressed a lot more interest than, say, two years ago. There are three active reinsurers in this market actively marketing and seeking business. There are a number of other reinsurers who, on a test basis, have done either one or two treaties and want to let that age a little bit or let the experience come through a little bit and see how comfortable they are with this kind of transaction. I think the capacity is somewhat limited, but there is enough interest at the moment. When it gets to five billion, who knows?

MR. MCFALL: We don't know as much as we would like to know about our competition in this market, and I would guess that capacity is a little bit limited right now. I know there's a lot of demand for annuity reinsurance, and we haven't been able to meet the need. The demand really is for, in many cases, lower-cost

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reinsurance than we're willing to provide. So, in that sense it may be tough to meet the demand until the expectations perhaps become a little more realistic.

MR. INGRAM: In testing the marketplace recently we found that the profit objectives of reinsurers who say they're interested in doing this are often higher than what the direct writers are getting on the business. Anything close to that kind of partnership arrangement is unlikely to occur there.

MR. YOUNG: I think I'd expand the list from three reinsurers that are now actively in the market to somewhat more than that. I think that a number of reinsurers recently have said they will be actively in the market, but the problem is in today's market it's tough to make a profit on new business, and I think that until that situation changes we won't be getting a lot of aggression in the market.

MR. MCFALL: It's difficult to earn an attractive return on new annuity business these days, but it's even tougher to reinsure a block of in-force annuity business on an attractive basis because the business was written in the past when interest rates were considerably higher, and so the terms of a reinsurance arrangement where a reinsurer takes over in-force annuity business have to reflect the fact that the reinsurer has to take cash or assets on its books at current market rates. It's very difficult. We've looked at several of these in-force arrangements and haven't done a single one.