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REINSURANCE—STRESSING FINANCIAL OBJECTIVES AND THE ALTERNATIVES

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Panelists: DENNIS L. CARR
ROBERT H. GLASSNER*
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Recorder: MELVILLE J. YOUNG

- Cost of capital versus debt (surplus notes)
  —The impact of federal income taxes
  —Reflecting risk-based capital
  —Availability of intelligent support
- Reinsurance and the joint venture
  —Annuities
  —Disability income
  —Noncore life products
- Structuring reinsurance for the audience of the 1990s
  —Rating agencies
  —Regulators

MR. MELVILLE J. YOUNG: Our session is going to focus on some of the different uses of reinsurance. John Laughlin, our second speaker, is going to give us some confidence that the regulators and the rating agencies are going to allow us to continue be in the reinsurance business.

First of our four speakers is Hank Sulikowski, who is with the Guardian. He's director of reinsurance marketing at Guardian Life and his responsibilities generally run the gamut with respect to financial reinsurance: marketing, pricing, financial analysis, treaty design, etc. He's on the ACLI Reinsurance Committee and the Membership Committee of the National Alliance of Life Companies. He's a graduate of the University of New York and he's an Associate of the Society, Member of the Academy, and he says that I should say he speaks frequently. I promise you when we're together he doesn't have an opportunity to speak very often. Hank is going to be comparing financial reinsurance and surplus notes. Those of you who are members of the Reinsurance Section know that Hank and I recently co-authored an article on that subject [Slutzky, Marc, Sulikowski, Hank and Young, Mel, "A Comparison of Reinsurance and Surplus Notes for Raising Capital," *Reinsurance Section News*, Issue 36, March 1994, pp. 1, 10-12].

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Our second speaker is John Laughlin. John's been with ITT Lyndon Life for 15 years. He has a bachelor of science and a master of finance degree. He's been in reinsurance actively for 11 years, and he's vice president and director of reinsurance of marketing and administration for ITT Lyndon. John is going to address rating agencies and regulators, and how they look at what we all do for a living.

Denny Carr is with Analytical Risk Management, which recently purchased Integrity and National Integrity Life Companies from National Mutual. Denny had been with Capital Holding before joining ARM, and before that he was with Tillinghast. Those of you who are familiar with Tillinghast know that Denny was involved in the original design of the Tillinghast software, and hopefully, one or two of you in the room know what that is. His specialties are interest-sensitive products and asset/liability management. Denny's going to talk about annuity joint ventures in reinsurance.

Our last speaker is Bob Glassner. Bob's with Business Men's Assurance Company of America. Bob is typical of reinsurance. He's been with BMA his entire career, he has moved five miles from his original birthplace, and that's the extent of his travel. Pretty typical of all the rest of us in the room. In any case, he's been with BMA throughout his career and he's marketing VP in charge of reinsurance. Bob's going to talk about using reinsurance for joint ventures regarding other products, life and beyond.

MR. HENRY SULIKOWSKI: As everyone knows, companies have been looking to enhance their internal capital with external sources of capital. Much has been written about surplus notes, and a lot has been said about surplus notes. What I'd like to do today is give a little bit of equal time to reinsurance. What I'd like to do is take a closer, side-by-side look at reinsurance and surplus notes. How do they compare, and what are the issues that you really need to consider if you're going to pursue either?

Before we get started, I think we'll just take a quick informal survey by show of hands of how many in the room work for companies that have either issued a surplus note or undergone demutualization? A couple. How many in the room have worked for companies that have had a stock offering? That's also a couple. How many in the room work for companies that have not been visited by either Mel, John, or myself in the last year?

Which is the best route? Well, if your company needs external capital, the best route is really going to be determined by your specific set of objectives. But to make an informed decision, you need to compare certain features of each, and I'll try to outline them here. You start with the bottom-line cost, but you also need to look at the regulatory implications as well as how your key rating agencies might view what you're going to do. And you really also need to familiarize yourself with issues like availability, flexibility, and the level of support that you're going to get both initially and ongoing from your reinsurer or your investment banker. These are all important considerations. Because of the time constraints that we have here today, what I'd like to do is focus mainly on cost, but I will touch briefly on each of the other considerations.

In terms of structure, surplus notes are typically issued for a fixed period of say 10, 20, or 30 years, perhaps longer. They're generally sold through the market, so they're quite widely held. Terms are generally fixed at issue, so that if the issuing company's needs should change over time, its ability to prepay could be somewhat limited. I mean that if your situation changes, it might be difficult to renegotiate surplus notes.

Reinsurance, on the other hand, is negotiated with one, or perhaps two, reinsurers providing for payback out of the profit on the reinsured block. The terms are fixed. The period is open, but typically a treaty will provide for flexible recapture terms. A ceding company can terminate the treaty early and repay any surplus if its financial needs change. In addition, reinsurance in treaties is easily modifiable if circumstances warrant, and in practice treaties frequently are modified.

Probably the most significant difference between reinsurance and surplus notes is that reinsurance covers losses. If you're losing money on the underlying block of business, then the reinsurer will be expected to cover its share of the losses on that. This is a key feature of reinsurance and something we'll see later on showing up in the cost aspects of reinsurance.

In terms of availability, vast markets would appear to exist for surplus notes. They're frequently a product of investment bankers, and they've been used to raise literally billions of dollars in capital. On the flip side, an investment banker will probably not be interested in new issues under, let's say, $50 million, and in fact, some of the transaction costs such as legal fees and origination fees might price smaller companies out of the market. The surplus notes issued thus far have been limited generally to larger companies in the top financial tiers. It's fair to say that they have definitely not been for everyone.

The supply of financial reinsurance, on the other hand, is more limited. It's offered by a small number of professional reinsurers and one or two direct writers who specialize in the coverage. But, generally speaking, over the recent past, there's been enough domestic capacity to meet the reinsurance demand. In terms of transaction size, reinsurance has been used to generate $250–$300 million in capital, but practically speaking, you're probably looking at a maximum somewhere in the $50–$100 million range for a single agreement. Probably the best way to summarize all this is to say that surplus notes may prove to be an option for the biggest and the best, while reinsurance is widely available to companies of various sizes and financial conditions.

What about added value? Can an investment banker or a reinsurer bring additional value to your organization over and above the capital provided? When a surplus note is issued, an investment banker or an institutional investor will generally be concerned about the overall financial condition of an organization. When they exercise due diligence, they might do an operational review on a macro level, but realistically speaking, you're not going to expect a banker to provide real insight into your business.

A reinsurer, on the other hand, is going to perform an overall financial review, though probably not to the same extent as the investment banker, but you can and should

expect the reinsurer to provide expert advice on your products. In addition, many reinsurers are well equipped to help you out with actuarial advice, investment advice, and perhaps even administrative advice.

I've also listed assumption reinsurance on the bottom as a benefit of reinsurance. If you have a block of business that is no longer a good strategic fit at your organization, the reinsurer may be willing to take on those liabilities directly via assumption reinsurance and also relieve you of administration on the block.

I'll touch on the "two R's" only briefly. John is on deck, and he's going to talk about the regulatory and rating agency aspects of reinsurance in detail, and there have been other sessions that have done the same for surplus notes. So what I'd like to do is just highlight some of the key aspects. Surplus notes have been approved for use by many states, but there are variations from state to state, something you need to think about. Given states may also restrict how you employ the capital raised through a surplus note. Generally speaking, the commissioner of your state is going to want to approve each interest or principal payment before you make it. Surplus notes are accepted for risk-based-capital (RBC) computations, but do not offset your risk-based capital requirement. With respect to rating agencies, attitudes may vary. Some rating agencies may view the note as debt. Other rating agencies may view longer-term issues favorably and short-term issues as debt, so you really need to sit down on a case-by-case basis.

With respect to reinsurance, there was somewhat of a bumpy regulatory road and a bit of a tarnished image during the 1980s. That gave rise to the current generation of what we call "risk-transfer regulation," and as a result, we have an NAIC model that will be fairly widely adopted in the states. I think over the next year or two we're going to see a wide adoption of that regulation. What the model regulation has done is help clear up some of the earlier confusion over reinsurance. Not that it's all gone by any means—John will provide more of the details on that. With respect to risk-based capital, you get virtually full credit for capital derived from reinsurance, and you also get an RBC offset for coinsured risks. I think the bottom line is that the regulatory and rating agency aspects of both surplus notes and reinsurance will continue to evolve. Neither is fixed in stone, and if you're at all confused or concerned about either, it's best to sit down with your regulator or your rating agency. We've found that the more they understand, the more likely they are to approve of what you're doing. And by all means, whatever you do, don't get hooked. These transactions are designed to enhance, not to replace, internally generated capital. You really are going to find that it's important to keep your leverage under control.

Cost is, of course, an important factor, and when all is said and done, cost might be the most important factor for your organization. Based on the analysis we've done, when all factors are taken into consideration, reinsurance can be structured so that the cost is favorable or at least competitive with surplus notes. The factors that are really going to affect the net cost or total cost of each are the base-cost factors, such as charges and fees and interest rates quoted, the impact on your federal income taxes, as well as the impact, if any, on risk-based capital. The latter two items, tax and RBC, need to be taken into consideration to get at the true cost of either approach.

In terms of the base cost of a surplus note, the most important considerations will be your overall financial condition, which will influence the interest rate on the note, and the transaction costs arising as a result of the issuance. Of course, the other factor is the general interest rate environment and the size of the note. Presumably a $1 billion surplus note will be less expensive than a $50-million dollar note. Those of us up here can certainly attest to the competitive nature of the reinsurance business. I'm sure there are competitive forces at work in the surplus note market, but truthfully, I'm not sure of the extent to which those factors are important.

For a reinsurance transaction, the base cost will be a function of your financial strength and the nature of the reinsured risks. And, as with a surplus note, the size of the reinsurance transaction will be a factor. There are no transaction costs, and as I mentioned, reinsurance is absolutely a competitive environment. I think this is evidenced best by the fact that 400 of the 800 people attending this meeting are from reinsurance companies.

MR. YOUNG: And the other 400 wish they were.

MR. SULIKOWSKI: The other 400 are consultants. Taxes are fairly straightforward. Interest paid on a surplus note is treated as a deduction in computing tax. The investment income earned on the proceeds would generally be taxable. From the "it's too good to be true" category, while the face amount of the surplus note is treated as equity for statutory purposes, it's treated as debt for tax purposes. With reinsurance, on the other hand, it may be necessary to generate a taxable event, but this is something you can sit down and discuss with your reinsurer. With some careful thought and planning, that doesn't have to be the case. There are situations where you can develop a reinsurance agreement that will allow you to realize part or all the capital tax-neutral. From a purely tax perspective, a surplus note would appear to have a distinct edge.

When we come to RBC, reinsurance offers a significant advantage. Keep in mind that the reinsurer has accepted all the risks on the business reinsured, and as a result, if you have a co-insured liability, the reinsurer is going to have to establish the risk-based capital for the business, or at least its share of the business, and bear the costs of maintaining it.

To quantify the shift in RBC is a little difficult at 8:30 in the morning, so let's take a look at a quick example. If you can earn 8% pre-tax on your invested capital, which amounts to 5.2% after a 35% tax, then you're going to have to make up the difference between your hurdle rate of 13% and the 5.2, if you want your risk-based capital to return 13%. That amount in this particular example is 7.8% of the RBC, and that is the cost that will be shifted to the reinsurer.

We've done a fair amount of modeling with respect to the various cost factors, and in order to tie everything together, what I'd like to do is share some quick results with you. Table 1 indicates that we've modeled a vanilla surplus note, alongside a vanilla co/mod co-reinsurance transaction. There are many assumptions that go into this model: the structure of the reinsurance, the structure of the note, interest rates, tax

rates, RBC factors. Unfortunately, we don't have time to go into the detail here now, but if anyone is interested at a later point, we can certainly go into it.

TABLE 1
HYPOTHETICAL SURPLUS NOTE @ 1.70% OVER TREASURIES
VERSUS
CO/MOD CO-REINSURANCE WITH 2.50% RISK CHARGE

Inv Assets Spread over Treasuries	Cost As a Level Percentage of Surplus Provided		
	Reinsurance before RBC	Reinsurance after RBC	Surplus Note
0.20%	1.63%	0.54%	0.86%
0.50	1.63	0.56	0.69
0.80	1.63	0.59	0.52
1.10	1.63	0.61	0.35
1.40	1.63	0.64	0.17
1.70	1.63	0.66	0.00

What I'd like to do at this time is highlight some of the results. For both the surplus note and the reinsurance, the last two columns show the annual cost as a level percentage of the capital provided. This would be after tax and RBC. You'll notice I've included the cost of reinsurance after tax but before risk-based capital, to show you the impact of the RBC cost shift. And in each of these scenarios, it's about 100 basis points each year. What I've done in the first column for our modeling is to start out with a fairly conservative investment scenario, where my spread on invested assets is fairly low and gradually increases so that I'm investing, in effect, at a rate that is equal to the cost of my surplus note. And it's the relationships here that are fairly interesting. You'll notice that where there's a wide disparity between the spread on invested assets and the costs of the surplus note, in the first row, that reinsurance clearly outperforms the surplus note. On the other hand, if you're able to invest the proceeds essentially at the cost of the funds, which would be the bottom line, then a surplus note would be the better option. In between, say in the 50-to 80-basis-point range, which is probably where most of us would be, it's sort of a toss-up. The reinsurance might outperform the surplus note or vice versa. The bottom line is that reinsurance, as shown here, can be very competitive when you look at it from a bottom-line-cost perspective. And perhaps the other advantages we've discussed would make it the best option for you.

To wrap things up, I know that we've covered a fair amount of ground in a limited amount of time, but I think there are two key items that I'd like to have you take away. One is that whether you're considering a surplus note or reinsurance, you need to consider things like market conditions, flexibility, capacity, and the level of support, in addition to the issues that we all know about: rating agencies, regulations, and cost. The second is that depending on the interest rate environment, and this might be particularly true as rates creep upward, reinsurance may be surprisingly competitive with a surplus note, even on the basis of pure cost. Again, it will depend

on your circumstances. It may make sense to do both types of transactions. It may make sense to do neither. The key is to look at the advantages and disadvantages as they relate to your company.

MR. YOUNG: It should be pointed out that the example Hank has used shows that C-1 and C-3 risks remain with the ceding company. Current reinsurance regulations force these risks to be assumed by the reinsurer. The RBC formula is wrong and should ultimately be amended. If it were amended, reinsurance would have been shown to be more favorable still. If we had included a health mix in the block of business being modeled, the RBC would have shown a significantly higher cost, and, therefore, reinsurance would have looked better in either comparison.

MR. JOHN LAUGHLIN: Mel asked me today to talk about structuring reinsurance for the audience of the 1990s, and I guess my first reaction was the audience of the 1990s is getting a little crowded. It's almost standing-room-only sometimes. We have so many parties focusing on our business these days, stockholders, policyholders, regulators, rating agencies, agents, the Internal Revenue Service, even the media. I'm sure many of you saw *The Wall Street Journal* article recently on risk-based capital, which even cited risk-based-capital ratios for several companies. I think the attention is on us. We've always had stockholders, policyholders, and agents to keep happy, but even they have a heightened awareness of some of the previously unimportant details of our business operations. So I think the audience of the 1990s is very interested in what we're doing, sometimes curious; and I think we need to rise to the responsibility as life insurance managers to fully understand and be able to present all the material aspects of our financials and the accounting and economic impacts of our decisions. This is especially true of reinsurance and, specifically, financial reinsurance because these are typically complex, material transactions.

My objective today is to share with you some of the perspectives that I've gathered, from rating agencies and regulators, about how they regard financial reinsurance and what sort of things they look for in reinsurance agreements. And I'll echo Mel's comments and some of Hank's. Financial reinsurance is not dead. I think bad financial reinsurance is dead, and I think there are many ceding companies here and many reinsurers here. We see these regulations come across our desk one after another, and I think unless we spend time to really understand them, the impression we get is that financial reinsurance is just being outlawed. Really, the regulations are all positive developments, and they're trying to refine and distinguish between good reinsurance and bad reinsurance.

First, I'll talk about the rating agencies. Ratings have become very important in the life insurance industry. And as a result, rating agencies have become very important considerations in our business decisions. Some of our most important decisions regard earnings and surplus. Earnings and surplus are very critical to good ratings, so they're heavily reviewed by rating agencies. Financial insurance affects earnings in surplus, so it's not too surprising that rating agencies have become interested in financial reinsurance transactions. And if we're going to use reinsurance to manage earnings and surplus, we need to structure transactions that make economic sense and comply with all existing regulation. We also need to be able to explain the transaction to any interested party. We need to make it our responsibility to explain

the motivation for the transaction, the treaty itself, the accounting impact, and the economic impact of the agreement.

One of the major uses of reinsurance is to smooth financial results, whether it involves smoothing mortality, or commissions, or any other expenses. In this regard, reinsurance helps manage profitability. The largest single reason for rating change is poor profitability, and I think it's prudent for us as managers to use every tool that's available to us to help effectively manage profitability. So I believe that reinsurance, rating agencies, profitability, and capital are all very closely related variables that affect each other and shouldn't be considered independently.

All right, what do the rating agencies look for? Well, that's a fairly broad question. I'm sure many of you have had the opportunity to sit down with an analyst either from A. M. Best or one of the newer entries, Duff and Phelps, Moody's, Standard and Poor's, and talk about what they look for. But even if you haven't, all those companies will provide you with some level of detail about rating agencies, and how they rate insurance companies. At its annual seminar, Standard and Poor's walks through a mock rating of an insurance company, which is fairly informative. But at a very high level, the rating agencies look very thoroughly at management, capital, earnings, and your market, and you can just about put that in one sentence. They want to see a solid management team working from a strong capital base, with strategies in place to provide consistent earnings in appropriate, hopefully, well-entrenched markets. And interestingly, reinsurance can support three of these categories: capital, earnings, and your market. The management review is very qualitative. They're asking very broad questions. Do these people know what they're doing? Do they have the strength and vision to improve their company? Is their strategic plan achievable, and do they have the resources and market presence to succeed?

Capital and earnings are closely related and, again, two elements that can be positively impacted by reinsurance. As far as capital is concerned, they're looking at current capital levels, projected growth, and the quality of the capital components. I think the analyst's dream is to see capital grow from profits, thrown off by existing products, at a rate faster than asset growth. But even after saying that, I think the agencies are realistic enough to recognize that insurance companies have tough times financing their own growth. It's just a fact of our system.

For earnings, they're looking for consistent earnings, past and projected, and a strong market position. And I mentioned that reinsurance can support capital, earnings and market. Capital, as Hank pointed out, by hopefully introducing some lower-cost capital and reducing your overall cost of capital and also by enhancing risk-based capital. Earnings, again to smooth the profitability pattern, and your market by expanding sales of profitable products and entrenching your position with your agents.

What do rating agencies look for in a reinsurance agreement? I think, first and foremost, they want to understand the motivation for the transaction. Be prepared to explain the economic value and the accounting impact, and how it entrenches your market position and allows overall profits to increase. Show them how, for instance, you might be introducing a piece of lower-cost capital to your overall capital structure.

You want to quantify the amount you plan to introduce over the plan period and why it is efficient to do so, and these are all things your reinsurer can help you with. Your reinsurer can provide you with accounting illustrations that illustrate how the agreements affect your statutory statements, for example.

Now you want to be careful when you're talking with rating agencies. If you tell an analyst that you're going to use financial reinsurance, for example, or reinsurance support in lieu of a capital contribution this year, the devil's advocate kicks on in the rating agency's mind and says, "Aha! This means the parent is no longer willing to support the subsidiary." Instead I think you want to provide a broad explanation that you're measured on a return-on-equity basis, and that over the last five years the parent has contributed $100 million of capital to your company, and this year you're going to introduce $20, or $30, or $40 million of outside capital, at a lower cost, through reinsurance support that will, hopefully, reduce your overall cost of capital and increase your return on equity. Another situation could be that your capital position might constrain sales toward the end of the year, and instead of turning off the faucet and turning off your agents, you use financial reinsurance support for a portion of your sales. As long as your product is profitable and the reinsurance cost is less than other forms of capital, and less permanent than other forms of capital, you're adding value to your company. And don't expect a hardy response if you tell the analyst that you're going to increase sales tenfold through reinsurance support. Analysts get very nervous about meteoric growth. A smaller percentage is smarter. Explain how the reinsurance program is a component of your overall capital strategy, and lay out your overall capital strategy.

Now, as a reinsurer, this is something that we do all the time because, remember, rating agencies rate us as well on our side of the transaction when capital is leaving our books in pretty big numbers. So we take great pains to explain to the rating agencies how, even though our overall capital is being reduced by hundreds of millions of dollars, we're adding value to our company. We make sure that at the end of the day the rating agencies understand the impact on our operations, and that's how we maintain our high ratings. The financial strength of the reinsurer is, again, something that's very important and something I hear continually from the rating agencies. They like financial strength behind your reinsurance. They like a company that they rate or that they're familiar with.

Risk transfer and financial strength of the reinsurer are very closely tied. In a financial reinsurance agreement, you need to be able to explain to the rating agency how the agreement is reducing your company's overall risk profile. Once they understand that's the case, they want a strong party on the acceptance side of that risk. Flexibility is also very important to the rating agencies. The reinsurance very effectively provides the flexibility to support new business. Craft your agreements to provide support on an ongoing basis as business is written. This avoids untimely exits from the market and, also, alienating your agents, both of which could ultimately cause persistency problems. Structuring your agreement to provide ongoing support adds flexibility and predictability in economic value. And here reinsurance can be used like a line of credit. The support is there if you need it, but if you don't, you're not paying for it. In other words, if your sales take off, the reinsurance support is in place to support the capital required for those additional sales. If your sales taper off, then

the reinsurance doesn't kick in and you're not incurring a capital cost that you would have, had you gone out and gotten a more permanent source of capital to support those sales.

I think in fairness, analysts also are assigning value to the ability on the ceding company's behalf to exit a reinsurance agreement should your profits or your financial conditions improve to a point where you can finance all your new growth. And, typically, reinsurers will agree to a minimum time for a contract to be in place with a reasonable notice period for exiting. And I'll mention here that in the current regulation, the ceding company can have the right to recapture in a reinsurance agreement, but the reinsurer cannot.

All right, let's take a look at current regulation and some of the things that regulators look for in reinsurance agreements. Since the mid-1980s, as Hank pointed out, regulators have been very active in legislating reinsurance. New York's Regulation 102 was one of the first and, ultimately, led to the NAIC Model Regulation on Life and Health Reinsurance that was adopted in 1988. In 1992, the NAIC updated, revised, and issued a new model regulation, and again, both regulations were positive developments for our industry. They were both aimed at eliminating some of the conditions that were being incorporated in reinsurance agreements that were considered abusive and used by less-than-responsible parties.

The 1988 model regulation is required for state accreditation and now the 1992 Model Reg is required for state accreditation. And, again, while they were both positive changes for the industry, you have several states in the process of adopting these regulations that have added their own little nuances, which has caused confusion in the marketplace and also, sometimes conflict, in trying to comply with various state regulations. Regardless, several states have adopted regulations since 1992, and some followed the model closely, while others have substantial differences. I think most of you are familiar with the model regulation, so I'll just touch briefly on the major requirements and then talk about what regulators look for in reinsurance agreements.

In the 1992 model regulation, the reinsurer must cover anticipated, allocable renewal expenses. The agreement cannot force the ceding company to recapture, but again, the ceding company has the right to recapture, the reinsurer does not. Reinsurance profits can only emerge from profits generated by the business reinsured. Significant risks inherent in the product must transfer to the reinsurer, and this is incorporated in the model in the form of a matrix, which lists by product line what sort of risks are inherent in each product and, therefore, must pass to the reinsurer. Assets must transfer or be segregated when investment risk is present. Ceding companies cannot represent or warrant future performance of the reinsured business or anything unrelated to the reinsured business, such as the financial condition of the ceding company.

Agreements or binding letters of intent must be executed no later than the "as of" date of the financial statement impacted. What this means is that if you're going to enter a reinsurance agreement that affects your third-quarter statutory statement, for example, you need to have an agreement fully executed by September 30, or a

binding letter of intent between the reinsurer and the ceding company, again, dated on or before September 30, that outlines all the major terms of the reinsurance agreement; and the reinsurance agreement must be executed within 90 days of that letter of intent. The treaty must constitute the entire agreement. This means there can be no side agreements or side letters that govern or change the behavior of the agreement. And then YRT, stop loss, and nonproportional reinsurance are excluded.

OK, what are some of the things regulators look for when reviewing reinsurance? First, that the appropriate risks have transferred. They look at the treaty mechanics and make sure they require the reinsurer to pay any losses. They like those losses to be in cash or those payments to be permanent and in cash. They might ask about scenarios in which reinsurance losses might occur, and again, this is something that your reinsurer can help you with, because in the process of analyzing your business, the reinsurer does a multitude of scenarios and sensitivity testing. A portion of those show negative experience, either during a period or throughout the life of the contract. And if a regulator wants to see one of those scenarios, your reinsurer might have them on the shelf and can provide them. They want to see that renewal expenses are reimbursed. They look in the file at the current accounting and settlement reports. They look to make sure there are no warranties regarding the profitability of the business or financial condition of the ceding company. New York requires dividend reimbursement when participating products are reinsured, and a couple of states look to make sure settlements occur in cash.

Regulators also look at the structure of the agreement. My experience is that regulators and rating agencies alike are comfortable with coinsurance. Coinsurance seems to be easier to follow, and I think when assets and reserves both pass to the reinsurer, inherently they figure that on the surface, at least all the appropriate risks have passed. Coinsurance also typically has the greatest risk-based-capital pickup, so if that's one of your objectives in your reinsurance program, that's a consideration to keep in mind. There is very broad acceptance of modified coinsurance and a combination of coinsurance and modified coinsurance. Regulators, I think, are coming to the fore in terms of recognizing and understanding these types of structures.

There are conversations going on right now among a number of states regarding the acceptability and preference of some of these forms. And I think in the next few months, we'll have something definitive about what types of structures regulators prefer. I'm convinced that the acceptability of the reinsurance agreement is based as much on the terms as it is on the structure. In other words, good terms to the ceding company add economic value. And whether it's coinsurance, or modco, or co-modco, the good terms in a treaty that add economic value should be easily accepted by regulators and rating agencies. The contrary is true I guess. Poor terms, regardless of the structure, can cause any reinsurance to be a negative event.

In closing, I think what Mel said in the beginning is absolutely true. Financial reinsurance is still thriving, but it's not the kind of financial reinsurance that existed ten years ago, or even five years ago. They are transactions that add value to both companies, and you need to work with your reinsurer to make sure that that's true. Again, regardless of the type of the reinsurance you use, it's very important to be able to explain to the rating agency, or the regulator, or any interested party, the motivation

for the transaction and how it adds value to your company. Good business decisions add economic value, and financial reinsurance does this when used prudently and structured properly.

MR. YOUNG: I don't know if there's anybody from the rating agencies in the room, but I think that we all do have a professional obligation to ourselves and to our companies to continue the education process, following what John just said, to try to make sure that those different audiences recognize the changes that have happened in reinsurance regulation and practice of the 1990s, because they're still living in the pre-1980s, I think, a lot of them. FASB and your auditors might give you some trouble with reinsurance agreements because most accountants don't recognize yet that reinsurance starts with the letter "r." They think they're experts on the subject. If you have a problem with any of those audiences, I think if it's a modern-day agreement, you should be able to explain it eventually. I'm going to now turn everything over to Denny Carr.

MR. DENNIS L. CARR: From the descriptions earlier, I'm an odd duck at this session because I'm not from a reinsurer and not a consultant, although at one time I was a consultant. As Mel mentioned earlier, I work with a company called ARM Financial Group, which was recently formed. Our business strategy concentrates on accumulation business. We're using insurance companies as a platform. One of our strategies for growth is strategic partnerships, and some of these will involve reinsurance and some will not.

Before getting started, I think it's helpful to define what I mean by the accumulation business, just to make sure we're starting from a common base. ARM is focused on spread management, that is, products where we earn more on our assets than what we pay on our liabilities. It involves both deferred and payout-type annuity products. A deferred example would be single-premium deferred annuities (SPDA). A payout example would be structured settlements. We're also involved both on institutional products, e.g., GICs, and retail-type products, such as the SPDA. We are involved in both the fixed and variable sides of the business. We do variable annuity products as well as fixed annuities. We're involved in both a risk-based business and fee-based business. The risk-based are products such as SPDAs, where we take the investment risk directly, and fee-based are variable annuity-type products, where separate accounts are involved. Finally, these markets involve both qualified and nonqualified business. In summary, we're in the annuity business and the GIC business.

Before getting into some specifics on partnerships, I'd like to share a couple of statistics that illustrate the growth of this type of business. The source of this information is the ACLI *Life Insurance Fact Book*. Table 2 shows the growth of annuity reserves. From 1977 to 1992, individual annuities exhibited compound growth rates of 20–25% a year. On the group annuity side, you have 15–20% growth rates for the first ten-year period, while the last five-year period slows down to 7%. I think most of that is due to the credit crunch, where we had a couple of major company failures and the institutional market proved to be very sensitive to credit ratings.

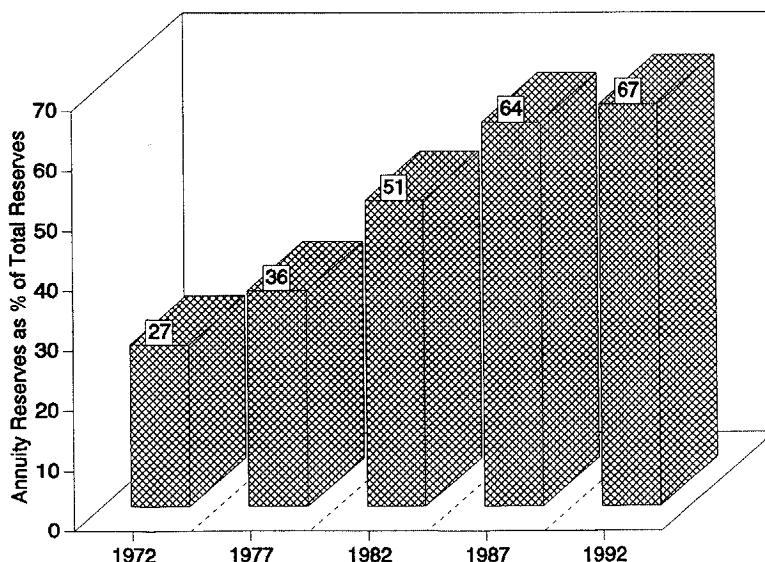
TABLE 2
GROWTH OF ANNUITY RESERVES
ANNUAL COMPOUND GROWTH RATES

Period	Individual	Group
1977-1982	22%	18%
1982-1987	25	15
1987-1992	20	7

Source: ACLI

The growth of annuity reserves has affected the overall balance sheet of life insurance companies. Again, from the ACLI fact book, Chart 1 shows the growth of annuity reserves as a percentage of the total reserves of life insurance companies. In 1972, annuity reserves represented 27% of total life insurance reserves. This percentage grew dramatically, and in 1992, two-thirds of the reserves of the life insurance industry were in annuity products. The nature of the life insurance business has changed a great deal due to the rapid growth of annuity products.

CHART 1
THE CHANGING BALANCE SHEET
ANNUITY RESERVES AS % OF TOTAL RESERVES



Source: ACLI

As I mentioned earlier, strategic partnerships are part of our growth strategy. I'd like to discuss the objectives that the partners might have in entering a partnership.

- Product Manufacturing. We've seen that in various types of products, disability income, for example, but it's also applicable to accumulation or annuity-type products. It might involve particular expertise in a product, such as variable annuities.
- Distribution. Obviously, companies that are in the accumulation business and selling annuities are after more and more distribution.
- Administration. Some of these products, variable products, in particular, might be rather cumbersome to administer, so a partner might be looking for administration.
- Capital or risk-based capital. Companies might be looking to move some of this risk off their balance sheet through coinsurance or another vehicle to improve their capital position.
- Credit enhancement. In our case, our credit ratings are a concern for institutional or GIC business, so we're looking for some way to credit-enhance our product.
- Asset/liability management. This is a key skill. That's more my area of expertise than reinsurance. A partner might be looking for that type of expertise in managing his or her annuity businesses.
- Regulatory compliance expertise. Here I think mostly of the variable products, but it could go across other product types. In the variable business you have to deal with the SEC and a whole new regulatory scheme.
- Tax savings. Another possible situation you might have is because of the growth in annuity business. Perhaps a small company has grown its balance sheet through annuity business, so that it's no longer a small company for tax purposes. Some sort of coinsurance arrangement might move them back to small-company tax status and save some income taxes.
- Simplified cash-flow testing. To the extent that you have accumulation-type businesses, you have to do a more thorough job of cash-flow testing. If you coinsured out your accumulation businesses, you might be able to simplify the cash-flow testing requirements.

If those are some of the partnership objectives, what are some of the building blocks that are involved in the structure of these partnerships? On the reinsurance side, coinsurance is one obvious type of structure. You might also have modified coinsurance. You might also have a distribution arrangement for some type of product. Trust agreements might come into play in a coinsurance arrangement, where one of the parties is concerned about the credit ratings of another party. In that case, you might put assets under a trust agreement. Finally, you might do private labeling, where you produce a product for a company on that partner's paper.

With the objectives and building blocks as background, I'd like to discuss three generic types of partnerships in which we've been involved. The first one is a GIC example, involving both coinsurance and a trust agreement. Here the assuming partner needs credit enhancement. This company wants to be in the institutional business, but lacks the credit ratings to be in that business. On the other hand, the ceding partner that provides the credit enhancement may have never been in the GIC business. This partner may have capital to deploy. The GIC market is attractive, but

it lacks the expertise. This partner may need things like distribution, asset/liability management, and product manufacturing. As you match up the two partners, you're able to put together an agreement where through coinsurance, GIC business is written on the higher-credit-rated company. You coinsure a portion back to the other party, who is the expert in the institutional business. Each party gets what it desires out of the partnership.

A second type of partnership might involve coinsurance of single-premium deferred-annuity or flexible-premium deferred-annuity types of business. Here, the assuming party would be interested in creating assets under management and perhaps in obtaining further distribution for its products. The ceding company perhaps had a small block of SPDA business as an accommodation for its agency force. The ceding partner may be looking for asset/liability management skills. It may be looking to free up capital through coinsurance. And, finally, as I mentioned earlier, if the company is a small company for tax purposes, or on the borderline, this may allow it to stay a small company for tax purposes and provide tax savings.

Our third type of partnership is a distribution agreement for variable annuities. Over the past year or so sales of variable annuities have grown significantly. A product provider is looking for distribution. The margins on variable annuities tend to be slimmer than on other annuity products, and you do need to develop critical mass as soon as possible, so doing a volume of business is important. Also, a product provider might be looking for diversification of its distribution channels. A distributor, on the other hand, is looking for skills in terms of product manufacturing and perhaps in terms of administration. Variable products require a whole different administrative system. The distributor might also be looking for regulatory compliance, including dealing with the SEC.

In establishing and managing strategic partnerships, you are bound to face many challenges. The first of these is culture clash and the related concept of bias for action. In my experience, it always seems that one party wants to move faster than the other. One of the challenges is to keep these partnership opportunities moving along. It can get a little frustrating if you're trying to get somebody else to act on a partnership opportunity.

Another challenge is dealing with the customers of another company. If you enter into coinsurance arrangement on SPDAs, it will be necessary to negotiate as partners what interest rate you're going to credit on the SPDA. That is generally one of the biggest challenges in constructing the agreement.

You may also be gaining access to another company's customers. Your partner, in that case, is likely be very guarded with their client lists. You need to take that into account as you structure partnership opportunities.

Critical mass—don't underestimate the amount of work that's going to be involved in putting partnerships together. You need to make sure that there's enough payoff to make the whole thing worthwhile. While out-of-pocket dollar costs may be small, the investment in time and energy of your staff can be significant.

Another challenge is what I would refer to as corporate ego; that can show its face in several different ways. Although it may the logical thing to do, companies may not want their agents selling the products of other companies. It might make sense for a company to downsize and coinsure some annuity business to get small-company tax treatment; however, it would cause the company's balance sheet to shrink. Although economically such a partnership may make sense, the company may be unwilling to shrink due to corporate ego.

In closing, I'd like to go through my short list of the characteristics of a successful partnership. The first is risk-sharing, and by that, I mean both sides are on the hook for something in the partnership. If it's too one-sided, it probably will fizzle out. I think you need a long-term commitment. It's going to take some time to get the partnership up and running. By long-term, I mean a three- to five-year commitment. An open, honest relationship. From the start, both parties need to disclose their partnership objectives fully. A bias for action. When you bring two parties together, it tends to move slower than either party does separately. You need to keep things moving. And, finally—win, win, win. The first two wins are obviously the partners. I think each of the partners needs to have a stake in the partnership and needs to be able to see a clear and significant success coming out of the partnership. If it's not significant for one partner and it is significant for the other, the partnership will probably never get off the ground. The third win represents the customer. Both partners need to concentrate on the customer to make sure that they are fulfilling customer needs. If you line up two partners to satisfy the customer's needs, you have the best chance of achieving a successful partnership.

MR. YOUNG: I just want to add one little thing to that. When entering a joint venture, remember to include a prenuptial agreement, i.e., an exit strategy. The next and last speaker is Bob Glassner. Bob, as I said earlier, is with BMA, who has been, for some time, successfully offering joint venture partnerships in the life and DI product lines.

MR. ROBERT H. GLASSNER: First of all, just a few comments about myself. I do have a bachelor of science degree in marketing from Northern Arizona University. I've been in the business 25 years. I'm calling on most of your companies and dealing with the people in this insurance industry. I find myself very privileged with what I have to do on my job, and they pay me to do it. I travel all over this beautiful country, and sometimes even outside the country, and get to meet all the wonderful people in this industry. I ask you to join me in celebrating my twenty-fifth anniversary because it's been a lot of fun.

What I will try to do is tell you really what's going on from my perspective of traveling around the country and seeing some of these deals really being put together. I might also make a comment that it's not a reinsurance marketplace on this joint venture; that's really a misnomer. Lots of companies that are not professional reinsurers are in the process of doing joint ventures with other companies, and so we don't have any kind of monopoly on this market. I think we're geared to do certain things a bit better, but I'm going to try not to do any advertisement for any particular company. That's difficult. But joint ventures are being done by both professional reinsurers and the nonprofessional reinsurers.

Quickly, let me go over my list of reasons for joint ventures, and it does correspond a bit with Mr. Carr's remarks. 1. Credit enhancement or ratings are not acceptable for the marketplace. There was a real rising need over the last two or three years with respect to capital and surplus needs. I think that's probably been visited more this year and last than in the history of the organization. The message I hear from most of you when you come back from the meeting with Best, is they want us to do our capital and our business, both the top and the bottom line at the same time. That's awfully difficult to do. Reinsurance and/or joint ventures help in that arena. 2. Companies are seeking additional distribution, which was covered by Dennis. 3. Competitive term is very difficult to do for some companies. 4. Systems investments are too high for development. 5. Past experience keeps management out of the market. Bodily injury (BI) is a perfect example there. They got burned many years ago and just do not ever, ever want to do it again. 6. Expenses and mortality levels can't be reached. 7. Product development and marketing expertise is needed. Shift in sales and distribution to market and new strategies and tactics of business are necessary sometimes. You need help in getting into those certain areas.

I think the coinsurance markets are a good example there. The term product is being joint ventured and has been joint ventured for many years. I refer to the eastern mutuals. Some of you are represented here who have reduced the retentions on the term portfolio to a fairly small amount for the main purpose of protecting the dividends. It's so important to the real core business, which is their par/whole life product or that kind of line. In addition, the reinsurance market has been very competitive.

It's not a secret to anybody that when analyzed, a reinsurance agreement on the term portfolio offers a good financial reason to lower your retention. This is a market that's been around. It's starting to step up to include development of product. It's not uncommon today for a company to walk in, and again, these are not just professional reinsurers; it's being done in the other arenas also, to walk in and help the product to be designed from the mortality, the expense, all aspects of the product, and then the negotiation of sharing that risk. There are some companies that want to share no risk. Most companies are avoiding it. I don't think it makes for a healthy relationship, but it's not uncommon to have a 90/10 split, an 80/20 split on the risk.

Cut through agreements. It's a term that is not familiar to everyone. There's another concept in the marketplace actually being done today. Cut through is a casualty term that's very common in that marketplace. It simply says as a rider or an attachment to a policy that if company A falters in any way of meeting the liability of that particular policy, company B, which usually is a reinsurer, will then step in and pick up that liability, or the growth in this particular market. I don't know that it will go very far, particularly because it deals with assumption of that block of business if, in fact, certain triggering mechanisms are hit and those triggering mechanisms were set a little bit higher than any kind of a solvency test. And, as you know, assumption reinsurance is being looked at by many of the states. The problem is that not only the state, but the policyholder, has to agree on an assumption, so I don't know how far that agreement will go. I will tell you I think it's a very good tool, particularly for those companies that are not AAAAAA rated. In fact, I think it's a sin that the market is so focused on ratings. There's nothing wrong with a B-plus company in

my opinion. In fact, there's a Texas president of a B-plus company who was quoted not too long ago as saying that only A-plus companies have gone under, and he says, "why in the heck are we concerned about B-plus companies?" So I think there's some truth to that.

Let me give a few definitions that I'll use here briefly. One is turnkey. Turnkey, if you will be the consumer and I'll be the provider for a second, is my product, your paper, your administration, your underwriting, your everything. All I do is come in and provide the product and allow you to keep a portion of that risk, which I mentioned earlier, is negotiable. True turnkey—these are my definitions, they're not universal—is my product, my administration, my underwriting, my everything, distributed through your account. The market appears to want more true turnkey, and I'm not really sure why. The problem I have with true turnkey is if I come in with a product, maybe whole life disability income or whatever, and I bring all the functions of issuing that policy back into my shop, which does save you having to put it on your system, it doesn't really truly lower your cost. I say that because you still have an underwriting staff. You still have a system, and yet you're taking part of that load that could have been placed on that system and given to me. Now with certain products like variable life, I think my argument doesn't hold up very well because it's just too complicated to buy the system. But in the area of disability income, for example, there's no reason why you can't maintain the underwriting and the administration if, in fact, I, the partner, am willing to assist you to get there. On the other hand, a lot of companies just don't want to do that.

Another definition I might throw out is corporate agency marketing, and if your company's not a member of an organization called the Inter Company Marketing Group that meets in January in Phoenix, it will not surprise me that somebody's not looking to become a member of that particular group. It's actually one of the largest growing meetings in the industry right now from my observation, and quite frankly, it is nothing more than kind of an option, a place to go and expose yourself. That's another good term in today's world. I basically go in and tell you what I can do for you and what you can do for me. It's predominantly marketing people, and really when you go there, it's a matter of rubbing elbows with people who have product they're going to provide for your distribution to sell my product, and likewise, I'm there looking at your product line and maybe thinking to bring some of that in for my distribution.

A story I read recently, when I looked at it, took a block of companies that fall in your category, we'll just say $500 million to $1 billion of assets. They're annualizing those companies to point out which is the most expensive company. One of the interesting things of doing business, the expense of doing business on a scale of 100 (100 being the least expensive and zero being the most expensive company), and one of the things I noticed in the study is that companies that are the least expensive in this marketplace today are doing fewer types of products. They're more focused on one product. They're not trying to be everything to everybody. And those are the same companies that we see that are very open to the idea of marketing other people's products. It may be on their paper, which usually is the preference because of the pride issue we mentioned earlier, but some companies have even broken that barrier, a philosophical change of worrying about an agent representing BMA, New York Life,

or whoever. It doesn't bother them that much, particularly when you see that the agency forces are doing that anyway, and when you bring the product of BMA's disability income, if I could use that as an example, into your distribution, you at least have the control over the commission dollars. You can also monitor those commission dollars to find out: is this something I ultimately ought to look at, because I'm seeing a production growth coming out of my agency or distribution force, and is this worthwhile enough for me to get involved in?

The structure to these agreements is not all that difficult to do. The corporate agency marketing, for example, does require a company to set up a corporate agency. I think the simplistic reason for that is that I, a life insurance company, can't pay another life insurance company a commission, so therefore I pay the 100% commission to an agency, and your company receiving that then distributes that with my assistance, listing who sold what. You may choose to keep an override, you may choose not to keep an override. I would say that most companies do keep an override simply for reasons of just covering their expenses.

The turnkey is fairly simple to do. The problem in turnkey possibly would be that the consulting world might look at it as a challenge and/or competition when a product is taken from an existing company's shelf and placed into another company, because you're really talking about consulting actuarial services. You can't hide it; that's what's going on. But you can also look at the reasons for doing it. I've got a certain cost in a product, and if I can get something back other than just my own sales for distributing that product, it's an asset to me and, likewise, the investment of bringing new products up is reduced. I think as an industry, we're all a little tired of that expenditure, particularly in markets where we didn't get anything back at all.

The last-to-die market is a perfect example. In fact, one of the biggest distributors of the last-to-die today, through these concepts of the true turnkey, is not a professional reinsurer; and if I mention a company, it's in the Midwest, I think most of you know who it is. They're doing a very good job of actually bringing a quality product through your distribution, putting it on your paper, and doing all the administration. They're really heads up. We lag behind in the administration part just a bit. We hope to get there where we can do the true turnkeys on all our product lines, but again, I'm not in such a hurry to do that because I'm a proponent of leaving that in your store to keep your expenses, to fill your systems up, and to keep your own underwriting staff and administrative and POS people as busy as possible. And the fact is that I really don't know how effectively we can handle your customer, even though we would try to do it as well, but I don't think we ever could do it as well as you can do it yourself.

Looking into the future a bit. There are some things that I noticed in Canada that went on and I found interesting. I can't verify it, but a good friend of mine from Manufacturer's Life wrote and told me this was actually going on. I couldn't actually find an example of it, but there were two company names on the same policy. One brought distribution, the other brought all the other aspects; product development, capital needs, to be able to market the product. And I'm told that is actually going on. Why couldn't that happen here in the U.S.? I don't have any reason why it shouldn't. I'm not a regulator, but if you look into the future, that might be in it. The

problem I have when I travel around the country is that I have a lot of empathy for people who aren't from New York Life, even though New York Life people are good friends of mine. I'm not putting anybody down, but there's a lot of quality companies out here that are really handcuffed today because they can't do certain things because of all the rating agencies, risk-based capital (RBC), you can go through them as well as I can. Anyway, we as a reinsurer or we as a group of companies can help these companies through sharing concepts, product ideas. I think it's healthy. I don't think it's healthy to look forward and see this trend of 1800 life insurance companies, a number of years ago, and where that trend is going.

I used to come out to this great city of San Francisco for a week and make reinsurance calls. There's probably one or two customers out here now that you can actually call on, and that's a shame. L.A. is the same way. It's just disappearing and I think it's almost our obligation to do everything we can to keep people together.