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Reinsurance of Equity-Indexed Annuities

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Summary: In this session, the panel addresses the reinsurance needs of the direct company writing equity-indexed annuity (EIA) products, reinsurance methods, the process of getting a reinsurance agreement in place, and the ongoing management of the business are covered.

Mr. W. David Fairhall: I'm from Transamerica Reinsurance. With me is Lynn Peabody, a consulting actuary in the Seattle Milliman & Robertson office, Mel McFall, director of annuity reinsurance at Lincoln National, and Inger Harrington, assistant vice president and actuary with CIGNA Reinsurance.

Given the stock market volatility recently, our topic is a particularly interesting one to discuss. We will talk about the reinsurance of equity-indexed annuities.

Lynn, our consulting actuary will go first, and he'll give an overview of the equity-indexed market, and then there will be three reinsurers who will tell you their approaches for reinsuring equity-indexed annuities.

Mr. J. Lynn Peabody: When I was asked to be on the panel, the objective was really for me to provide a view of things that I've heard as I worked with companies. I'll tell about some of the concerns that companies had and tell about some of the issues they've been dealing with because they look to reinsurers to help them deal with these issues. My objective is to try and talk about some of the issues that I've seen from the work that I've done with the clients with equity-indexed annuities products, and then lead into the reinsurance section of the discussion.

Even though most of you have probably been involved with equity-indexed products one way or another, I'd like to make sure that there's some common knowledge among us. I want to discuss some background about equity-indexed annuities, give you a little information about what we're seeing in the marketplace and how equity-indexed annuities have done. Then I'd like to discuss the issues that have been the primary concern, some of which lend themselves to reinsurance, some of which may not lend themselves to reinsurance. Finally, I'll lead into the presentations of the other panelists.

There have been at least two sessions that were entirely devoted to equity-indexed products. There was another one that talked about reserving annuities, and at least one-third of that was related to the reserving of equity-indexed products. There is no doubt that there is a lot of interest in these products. It has been that way for at least a year, and maybe two years in some cases.

The interesting thing about the products is, even though we've been involved for two years, I still consider them a work-in-progress to some extent. That's primarily related to the flexibility of the design in the products and some of the issues that are associated with them that are new and unique. As companies get involved in these products, they're going to have questions, the products are going to be modified, and I think these are going to continue to be a bit of a work-in-progress over time.

The activity on equity-indexed annuities or equity-indexed products in the last six months or so has been a little bit like the stock market. Last year was a buy, meaning a lot of people got into the market and they got into it very quickly with these products. There were some very good successes. The flurry of activity on product development last year was substantial related to these products.

This year, I wouldn't say it was a correction, but it was certainly a hole. The activity went up, and it has come down. I think the activity on new products this year has been fairly minimal, certainly, compared to last year. There are still new companies coming into the market. There were some things that came out with wait-and-see issues, and I think that a number of companies have been waiting a little bit to see how it was going to wash out. There's still more to be heard on these products.

What are the basic designs for the products? I would say the three primary designs are what we might call point to point where your gain in the product or your excess interest in the product is related to where you came in and then some point down the line (five years or seven years) it goes from point to point. It may be related to a percentage participation in that gain. It may be related to the total gain minus some point spread.

High water mark products are products in which you basically share in or get some portion of the highest gain in the index over a portion of the period of time that's defined as the term of the product. Ratchet type of products are the other primary type where basically the gains that you get each period are ratcheted up and either build on each other in a compound way or in a simple way.

Those are probably the three primary designs, and I'm sure you're probably familiar with those. Within those, you may have measurements that are related to annual averages, daily averages, or last six-month averages. There might be caps or there might be no caps in the gain. There may be floors. There are really many different product designs and features.

There have been special features that have been introduced in these products, and these are some of the things I know that the reinsurers will deal with. These aren't unlike the special features that you might get with other types of annuity products. There has been bonus interest that has been provided. There have been variable participation guarantee relationships that have been structured within the products. Annuitization bonuses were something else that had been built into some of these. And, there have been two-tier designs. These are some of the differentiating issues that have been built into the products.

And then, of course, there are minimum guarantees. The standard guarantee on a single premium annuity has been at the end of the period. You get 90% of the premium that was paid with 3% interest. There has also been 100% of the premium paid as a guarantee and 100% of the premium paid with 3% interest. There has been a 100% guaranteed with 5% interest. So again, you can see the numerous combinations that are associated with these kind of products. I think that kind of flexibility in product design, and the issues all tie into our topic.

We did a survey. Periodically, we'll do a survey in terms of what companies are selling in this marketplace. The last survey we did was in July, and I'll give some information from that survey. There were 27 companies who responded to the survey who had equity-indexed annuity products. Within those 27 companies, there were actually 39 products split between single premium deferred annuities (SPDAs) and flexible premium deferred annuities (FPDAs).

I was actually a little surprised by the number of flexible premium annuities partly because of the fact that the options associated with these kinds of products are a critical pricing element. Of course, flexible premium products have smaller amounts coming in. There may be some flexibility in when the amounts come in. I was a little surprised at the number of companies that have actually come to market with flexible premium products. Although I do know that the majority of those products are really being sold or administered as though they are single premium products. The basis is out there for flexibility.

Half of the products that showed up in the survey were point-to-point type products. Fifteen percent were compound ratchet-type products. Ten percent were high water term type products, and then within each of those categories, there were some of those alternative designs that I had mentioned earlier.

They have taken the characteristics of some standard annuities as far as some of the features that are attached to them or associated with them. Fourteen of the products had a nursing home waiver thrown in, I think you might say. Seven had a terminal illness rider. I think that those probably relate to the fact that the products that the companies were offering beforehand in the annuity market had those, and so adding them to the portfolio was probably something that they wanted to just include. I don't think that they had an awfully lot to do with the market for these products in particular.

In 1996, there was around $1.5 billion in new premium volume on these products, and that's a lot considering the fact that there were very few companies that were in the market long enough during that year. This was dominated by probably two or three companies in terms of writing 80% or 90% of the volume in 1996.

The projections were very rosy for 1997. They ranged from $5 billion to $6 billion. I have heard estimates for 1997 to be $10 billion. I don't think that it's going to hit that partly because of the lull that we've seen, and partly because of the fact that the companies weren't able to get their products approved in as many areas as quickly as what they wanted to. The sales have still been substantial this year. For a new product line, it has certainly made a mark.

The distribution system is encouraging; 20% of the distribution is done through financial institutions. A good part of that may have come with one or two companies, and that may be part of the reason for it. I think it's a product that is fairly well designed for marketing through financial institutions because of the inherent conservatism that's built into it. I think that down the line we will probably see a greater percentage of these products, at least on the annuity side, marketed in conjunction with the financial institutions because of the institutions' ability to appeal to people who have a little bit of risk aversion, but, at the same time, want a little bit of aggressiveness in the potential return that they're getting.

The things that really lead to reinsurance, reflect the uncertainty of the products. As Dave was saying, we should think about who won and who lost in the stock market on these products over the last two days. There are certain designs, and if your company happened to be buying its block of hedges on Monday, Tuesday, or Wednesday, your policyholders may have really won, or they may have lost, or the company may have won or may have lost in terms of the prices that they paid and in terms of their opportunities to get substantial benefits down the line.

There are some products that could definitely be out of the money after what happened on Monday. There are others that probably really wouldn't be affected at all given what happened over the last couple of days. It's that kind of uncertainty that leads to these primary issues. Management buy-in is really important. There aren't that many products with which I've been involved over the years where there has been the necessity to get management to buy in to the concept or to the type of product in general. That's mainly related to the investment issues.

We've had to help companies, in some cases, provide information to their boards to help them structure practices and written procedures in terms of their derivatives and the investments in that area. This isn't necessarily something that is usually there. I think that management, because of the 'd' word associated with these products, has been very cautious, and it has required a little bit more front end analysis on that side than what there has been with other kinds of products.

The design and profit analysis, because of the inherent flexibility, has been something that has been an important issue in the development of these products. These are definitely "what-if" kind of products. They're definitely sensitivity analysis kinds of products partly because of the fact that you have the investment people, the actuarial people, and the administrative people having to work so closely together in the design and the development of these products. It has required a substantial amount of understanding, training, and teaching of the design and the analysis. These groups must examine the alternatives. I think you'll see, as we go along, how that ties into our discussion.

A major issue has been compliance filing. As I said early on, I think the states had blinders when they accepted the products because they didn't understand them. Then they stepped back and some of the states actually reacted, or over-reacted and decided not to deal with the issue for a while. I think they are moving in the opposite direction now. There are probably at least a couple of states, such as North Dakota and Oklahoma, that I don't believe are accepting these products, but I may be wrong in that.

Arizona was that way for a while. I think that state has changed direction. Washington, strangely enough, will accept them, but you have to meet impossible criteria. That is how they've gotten away from the product. There has been one policy accepted that I know of in Washington State, but it has been a real issue because of the compliance and the filing.

Also, some of the companies or some of the states have required actuarial certifications. There's an index annuity model regulation and an index universal life (UL) model regulation that had been designed a number of years ago. Most states haven't passed it, but it did provide regulators with an opportunity to at least reach out and have something that would tie in with these products. As a result, some of the states have asked the actuaries to provide a certification, or to have someone provide a certification with the filing that the investment philosophy is appropriate, and to talk about the structure of what they're doing. That's something different.

The consequence is that the products have a lot of unknowns. An unknown, to me, means risk. When you have risk, you have a need for reinsurance in different ways. Historically, it has been a mortality risk business for these products, but it's not a mortality risk business. There are a lot of other unknowns and a lot of other risks associated with these.

There is another question that comes up, and an important issue. I'll be interested to see if there is an answer to this. The companies will say, can I share my market conduct risk? I don't know if any of your companies have been tied up with some of the lawsuits that we've all been dealing with over the last few years. That has been a terrible thing for the industry.

It has been an issue that developers of the equity-indexed products are concerned about and trying to deal with, and I am sure that there are lawyers out there that are just marking off on their January 2001 to-do list to file a class action suit on equity-indexed products. I think there will be some that do that because the Society has some very definite concerns in that area, and that's something that companies are concerned about.

We have illustration regulations in place. We have Insurance Marketplace Standards Association (IMSA) coming on board; it all deals with life insurance products. IMSA does deal with annuity marketing. So that may be one of the areas that will help that a little bit. The illustration regulations as they get finalized may help this, and the equity-indexed regulations as those get finalized will certainly help this concern to some extent, but that's an unknown. It's something that companies are wondering about.

Agent registration is one of the other issues. As most of you probably know, the SEC has asked the industry to provide comments in terms of what they feel the registration requirements of these products are. The industry is going to be responding. I know the ACLI, the actuaries, and the Academy have formed groups, and they're in the midst of developing statements that will be given to the SEC. It will be interesting to see where this comes out. I don't think we did ourselves a very good service in some cases.

The insurance industry and the marketing side has a tendency sometimes to bite off a little bit more than what it can chew, or to take a step on the other side of the line. I think when these products first came out, they really adhered to the safe harbor requirements, and we felt fairly good about the stance that we had that these are not registered products, or shouldn't be registered products. Then I think there were variations that came out that took a little chunk out of some of those safe harbors and started going a little bit across the line in terms of what they were saying. They started looking more like variable products. I don't know how that's going to get defended, but it's certainly going to be looked at by the SEC. So it's a risk, and it's an issue that companies are dealing with.

Hedge management is obviously the biggest issue with respect to these products, and I'm sure we'll be talking more about that during this session. Just understanding what happened in the last couple of days is enough to really emphasize the uncertainty of hedge management. Are companies going to be comfortable dealing with the information they're getting from their investment managers? What kind of information do they need in place in order to manage their business? How are the actuaries and the investment people really going to work together in some of these areas? Is there the adequate expertise on either of those sides to understand the implications of the products?

Reserving is just now becoming solidified from the actuary's standpoint. There are some options. There has been a lot of thought put into the reserving process. It seems to me that we're trying to balance the theory associated with reserving these types of products with the practical applications associated with them, and I think that's what's coming together in the industry. There are some compromises that have been made in terms of what some of the regulators might have wanted from the pure theoretical standpoint and what some of the companies needed from the practical standpoint. I think that's coming together.

The last issue is just plain management information. It has to be part of the equation when you're dealing with uncertainties and needs associated with these products. Various parties have different management information needs. Because of the nature of the products, the investment people, the actuarial people, the reserving actuary, and the marketing people have very different needs. I think that is another uncertainty associated with the products.

What do I see, from a reinsurance activity standpoint, that my clients and other companies need? They need some sort of risk management, but not necessarily risk management in the traditional sense of the word, at least from a reinsurance standpoint. They can certainly use some risk management in terms of the various other unknowns that they're dealing with; some of which are appropriate for reinsurance, and some of which aren't, but they all tie into the picture associated with these products.

It's a new experience for a lot of the companies. It's something that has unique solutions associated with them. They need help when they're dealing with unique situations. There needs to be practical solutions that tie in with the theoretical issues. Several companies are asking for help or they are going to be asking for help. It's the unknown that I've seen that leads to the discussion of reinsurance for these products.

Mr. Melvin C. McFall: I'm going to talk about reinsuring indexed annuities, and I'm going to focus on some annuity reinsurance issues in general with an emphasis on some of the key differences between reinsuring fixed annuities and indexed annuities.

We'll start by looking at the reasons that companies reinsure annuities in the first place, and then we'll highlight the differences between indexed annuities and fixed annuities. Those differences, of course, are what require somewhat different reinsurance approaches. We'll list three methods for reinsuring annuities and cover one method, quota share co-insurance, in some detail. Then we'll look at the risks that are assumed by the reinsurer in a typical quota share co-insurance arrangement, and then finally we'll conclude by looking at how to choose a reinsurance partner for reinsuring indexed annuities.

Why do companies want to buy annuity reinsurance in the first place? You buy life reinsurance or health reinsurance to protect the company against a large claim, but you don't have, for the most part, large claims in the deferred annuity business. So why would you reinsure annuities? The most common reason is to keep financial ratios at desirable levels. The most common financial ratios would be the risk-based capital ratios used by the NAIC, and the financial ratios used by the rating agencies such as A.M. Best, Duff & Phelps, Standard and Poor's, and Moody's.

Writing too much annuity business can cause your assets and liabilities to increase very rapidly, and that can throw your financial ratios out of whack. Annuity reinsurance is a way to keep those financial ratios in line while utilizing your distribution system to its full capacity. You do not cause harm to your financial ratios.

Some companies seek annuity reinsurance primarily as a way to gain access to the investment expertise of the reinsurer. With fixed annuities, it tends to be the smaller companies that need access to the investment or the asset/liability management expertise of the reinsurer. With indexed annuities, on the other hand, companies of virtually any size may need the help of the reinsurer in order to manage the indexed annuity asset mix and minimize the risk in doing so. Some types of annuity business can cause surplus strain when the business is written. The reinsurer absorbs the surplus strain on the portion of the business that's co-insured.

Finally, a company will occasionally seek annuity reinsurance as a way to reduce a concentration of risk. For example, we discussed annuity reinsurance a few years ago with one very large company who was marketing annuities through a large bank distribution network, and they were concerned about having too many eggs in one basket (i.e., having that much business from a single distribution source). They sought reinsurance.

Before delving into indexed annuity reinsurance, let's highlight the differences between indexed annuities and typical fixed single premium deferred annuities. As I said earlier, these differences then dictate reinsurance solutions. On most indexed annuities, management has little or no discretion in determining the amount credited to the policy owner. The credited rates are determined strictly by the market. On a typical SPDA, however, management has a lot of discretion in establishing credited rates; this applies to first-year and especially renewal rates.

For indexed annuities, derivatives are central to the investment strategy. For most SPDAs, on the other hand, many companies use no derivatives at all. Those that do use derivatives in an SPDA portfolio, probably do so primarily to hedge against increases or, perhaps, decreases in interest rates. Lincoln National, for example, does have interest rate caps in its fixed annuity portfolio to reduce our losses in the event of a large increase in interest rates.

It's common to use over-the-counter derivatives for indexed annuities. Exchange-traded derivatives are limited to maturities of a couple of years or less, and that's not long enough, at least on a buy-and-hold basis, for most indexed annuities.

It goes without saying that good asset/liability management is critical for any interest-sensitive product, but it's especially critical for indexed annuities since the investment strategy is usually the only way to manage the risk inherent in the product. On a fixed annuity, at least you can manage the risk through the investment strategy and through the credited rates. Fixed annuity bonds and other fixed-income investments support the entire amount that's credited to the policyowner.

For an indexed annuities, bond and other fixed-income investments generally support only the minimum guarantee, which for single premium products is typically 90% of the single premium accumulated at 3%. Equity options, of course, support the upside; the benefit in excess of the guarantee.

There are at least three approaches for reinsuring indexed annuities. I will cover quota share co-insurance. Dave will cover quota share modified co-insurance, and Inger will cover reinsuring the derivative risk.

Probably the most common approach for reinsuring indexed annuities is quota share co-insurance. Quota share is just a percentage, and co-insurance means that the reinsurer steps into the shoes of the original company. In other words, in a quota share co-insurance arrangement, the reinsurer assumes the risk on a percentage of each policy written by the original company.

Here's how quota share co-insurance works. The original company pays to the reinsurer the quota share or the premiums that it receives, less an allowance for its acquisition expenses and administrative expenses. Then the reinsurer reimburses the original company for the quota share of the surrender benefits, death benefits, and annuity benefits that are paid. The reinsurer is responsible for the quota share of the reserves.

For indexed annuities, co-insurance can be used to achieve objectives other than just the transfer of risk. For example, some companies are comfortable with part or all of the risks in indexed annuities, but they don't want the derivatives on their balance sheet. Inger is going to present one solution to this problem.

Another approach would be for the reinsurer to co-insure 100% of the business, and then reinsure a quota share back to the original company on a modified co-insurance, or co-insurance-funds-withheld basis. With that approach then, the ceding company participates in the risk to the extent of the quota share desired while the reinsurer has all of the assets, including the derivatives on its balance sheet.

What risks are transferred in a typical annuity co-insurance arrangement? I will list these roughly in the order of importance. The risk we worry about most for fixed annuities is interest rate risk or disintermediation. That's the risk that interest rates will increase significantly and annuity policyholders will surrender their policies in order to reinvest in other instruments. Maybe other annuities at the prevailing higher market rates.

For indexed annuities, disintermediation can happen because interest rates go up and/or because the stock market goes down. It's not uncommon for both of those things to happen at the same time. The effect of disintermediation on indexed annuities can be even more severe than for a typical fixed annuity. That's because only 65–75% of indexed annuity premiums are typically invested in fixed-income instruments that I'll just generically call bonds. The rest of the premium, the 25–35%, goes for commissions and expenses, and investments in options.

In the event of an early lapse, the income on the bonds hasn't had time to catch up to the guarantee. Take the extreme situation of a lapse right after the policy is issued. You have about 70 cents of each dollar invested in bonds, and your guaranteed cash surrender value is 90 cents on each dollar. The problem is just exacerbated, of course, if interest rates have gone up causing the value of your bonds to go down, or if the stock market has gone down, perhaps causing the value of your options to go down. So disintermediation risk, in short, is by far the most significant and worrisome risk associated with indexed annuities.

The annuity reinsurer also assumes its share of lapse risk; the risk that annuity policies will lapse sooner than expected and give the company less time than anticipated to recover acquisition expenses. For most fixed annuities, high lapse is reduced profitability. For most indexed annuities, however, high lapses (those lapses not motivated by market conditions) help profitability. In other words, indexed annuities tend to be lapse-supported products. For this reason, it's prudent, when you're pricing indexed annuities, to assume a pretty low level of base, non-market-sensitive lapses for indexed annuities.

The reinsurer assumes its share of credit quality or default risk. That's the risk that your investments won't perform as well as expected. Of course, credit quality risk is the risk that brought down some well-known companies in the recent years.

For indexed annuities, credit quality risk includes counterparty risk. This is the risk that the investment bank or the bank from whom you bought your derivatives won't be able to pay the benefits down the road.

In longer term annuity contracts like immediate annuities, for example, there's a risk that interest rates could go down in the future, and you'll have to reinvest some of your proceeds at a lower interest rate. Reinvestment risk tends not to be a major consideration on deferred annuities, including deferred indexed annuities.

Finally, there is some mortality risk associated with most annuities, and morbidity risk associated with some annuities. Those risks tend to be secondary to the investment-related risks.

What factors does an insurance company consider in choosing an annuity reinsurance partner? The financial strength of the reinsurer is an obvious consideration, and that has become more important in recent years. Consistent profit objectives are usually essential for a successful annuity co-insurance arrangement. Annuity co-insurance is like a partnership or a joint venture, and it's more likely to be successful if both parties have similar expectations.

For indexed annuities, it would seem to be desirable to find a reinsurer who's an independent agent, not associated with one bank or investment bank, who has experience with, and a market presence in derivatives. In addition to the market presence, the reinsurer should have the modeling expertise needed to price, analyze, and manage complex derivatives. One way to, perhaps, gauge the commitment of the reinsurer is to see whether it has dedicated resources; both personnel and systems for derivatives and for asset/liability management. Maybe I should have put this one first. The reinsurer must have the capacity to hold derivatives that are limited under the investment laws of many states.

Annuity reinsurance is more of a partnership than most reinsurance arrangements. It's important that both parties view it that way, particularly when it comes to establishing an investment strategy. Annuity reinsurance involves a long-term relationship between the original company and the reinsurer. The long-term relationship is just another aspect of the partnership emphasis that's so critical in an annuity reinsurance venture.

We've covered the reasons that companies reinsure annuities and differences between fixed annuities and indexed annuities, how quota share co-insurance works, the risks of a reinsured in a co-insurance arrangement, and how to choose a reinsurance partner. Now Dave Fairhall will tell us about quota share modified co-insurance.

Mr. Fairhall: As Mel mentioned, I'm going to cover modified co-insurance as a way of reinsuring equity-indexed annuities. First, I'm going to define modified co-insurance, what it is, how it works, and that type of thing. Then I'm going to relate it to reasons for using modified co-insurance. Several of the reasons really overlap what Mel has said. I'll try to gloss over where they overlap and simply point out some of the differences.

How does modified co-insurance work? It's quite similar to co-insurance in that the reinsurer receives a share of the premium and pays expense allowances and its share of the benefit. On the other hand, reserves are effectively returned to or left on deposit with the direct company. That's often referred to as the mod-co deposit in reinsurance terminology. Although we talk about how the reinsurer receives a share, in effect, the money is all netted out, so even though the money is left on deposit the reinsurer is really not actually receiving the cash.

The ceding company has to pay interest to the reinsurer for the reinsurer's share of the assets. This is referred to as the mod-co interest rate. However, the ceding company in this example is retaining control of the particular assets.

In modified co-insurance, a portion of all the product and investment risks are transferred to the reinsurer, but the reinsured portion of the assets and liabilities stays on the insurer's balance sheet. So the bottom line is that the co-insurance and modified co-insurance have the same effect on the income statement, but a different effect on the balance sheet (See Table 1 and Table 2). Like co-insurance, this is a true partnership for the reinsurer and the direct company.

The partnership issues include what's the product design? The reinsurer likes to be involved in considering the product design, being involved early in the process with the direct company, trying to get some understanding of what the risks are, and being comfortable with that as it relates to product design. Profitability is another issue. The reinsurer wants to be participating in a profitable product. Participation rate setting is another partnership issue. Co-insurance of fixed annuities involves looking at credited interest rates. On equity-indexed, now you have the setting of the participation rate. It's really a matter of how the participation rate is set, and how frequently it is set, and being comfortable that it's being adjusted regularly to reflect the changing interest and cost to the options. The other partnership issue is on the investment side. On modified co-insurance, the assets are being left with the direct company. The reinsurer needs to be comfortable that the direct company can manage the assets effectively relative to the underlying product.

TABLE 1
EFFECT OF 50% MODIFIED COINSURANCE ON FIRST YEAR INCOME STATEMENT

	Before Reinsurance		**After Reinsurance**	
	Ceding Co.	Reinsurer	Ceding Co.	Reinsurer
A. Revenue: Premiums: Gross Ceded	 $1,000 0	 $0 0	 $1,000 (500)	 $500 0
Net	$1,000	$0	$500	$500
Mod-co Adjustment (i.e., increase in reserves net of reserve interest credit)	$0	$0	$468	$0
Investment Income	$74	$0	$74	$0
Reinsurance Allowances	$0	$0	$35	$0
Total Revenue	$1,074	$0	$1,077	$500
B. Benefits: Claims Surrenders Reserving Increase Gross Ceded (i.e., Credit) Net	 $12 20 1,010 0 1,010	 $0 0 0 0 0	 $6 10 1,010 0 1,010	 $6 10 0 0 0
Mod-co Adjustment	$0	$0	$0	$468
Total Benefits	$1,042	$0	$1,026	$484
C. Expenses Reinsurance Allowance Commissions Acquisitions Maintenance	 $0 50 6 4	 $0 0 0 0	 $0 50 6 4	 $35 0 0 0
Total Expenses	$60	$0	$60	$35
Gain from Operations:	($28)	$0	($9)	($19)

There are reasons for modified co-insurance. I think you're going to see the same things that Mel talked about. It's really a risk management approach. It's a way of improving cash and capital in a surplus position. It's a way of improving financial ratios, and it's a way of improving marginal profitability. It's a way of accessing reinsurer expertise, and it's also a way of transferring hedges to the reinsurer's books. We're going to talk about each of these, although, again, there's some overlap and I'll try to gloss over where there is overlap with the co-insurance approach.

TABLE 2
EFFECT OF 50% MODIFIED COINSURANCE ON FIRST YEAR BALANCE SHEET

	Before Reinsurance		**After Reinsurance**	
	Ceding Co.	Reinsurer	Ceding Co.	Reinsurer
A. Assets Invested Assets	$982	$0	$1,001	($19)
Total Assets	$982	$0	$1,001	($19)
B. Liabilities and Capital: Policy Reserves: Gross Ceded	$1,010 0	$0 0	$1,010 0	$0 0
Net	$1,010	$0	$1,010	$0
Total Liabilities	$1,010	$0	$1,010	$0
Surplus	($28)	$0	($9)	($19)
Total Capital	($28)	$0	($9)	($19)
Total Liabilities and Capital	($982)	$0	$1,001	($19)

What are the risks? As Mel mentioned, there's a concentration risk, a persistency risk, an asset default risk, an asset/liability mismatch risk. Modified co-insurance addresses all of those risks. The concentration risk is really the idea of one company selling a lot of one product, or selling a product through one distribution channel.

Improving cash flow and surplus: In modified co-insurance, like co-insurance, the reinsurer ends up investing in the business by providing a share of the acquisition expenses, which helps the direct company be in the business.

Improving financial ratios: There are some little differences relative to co-insurance. If you look at it from a risk-based capital (RBC) point of view where co-insurance has the assets being transferred, you're actually transferring the C-1 component. In modified co-insurance, the assets are not being transferred. The direct company is keeping the C-1 component, although the C-3 component is being transferred. There is, indeed, some improvement in the financial ratios, but it's a little bit different depending on whether it's co-insurance or modified co-insurance.

Improving marginal profitability: In both co-insurance or modified co-insurance, reinsurance can contribute to increased profitability. The reinsurer may have a lower cost of capital which could lead to an increased ROI for example on the retained share of the business to the direct company. Or, the reinsurer's input on pricing assumptions could improve profitability. Another reason for using modified co-insurance is to access the reinsurer expertise.

Transferring hedges to the reinsurer's books in totality: This can be accomplished through 100% co-insurance, and then the reinsurer can use, for example, a 50% modified co-insurance arrangement back to the direct company so that the insurer is participating in 50% of the profits and risks. Of course, the reinsurer is participating in the other 50%. The net result is the companies are splitting profits and risks 50%. However, 100% of the assets, including the hedges and the reserves, are on the reinsurer's balance sheet.

Ms. Inger S. Harrington: I work at CIGNA Reinsurance. I've been in the division for just about two years now. A good part of my two years here has been spent in the EIA arena watching what's happening in the marketplace, and we've come up with an approach for reinsuring this risk that's a little bit different than what was discussed by Mel and David.

Before I go into the details on that though, I thought it would helpful for me to know a little bit about you in the audience. So I've come up with a few probing questions. I'd appreciate if you'd answer them honestly. I'll be answering them myself, so I'm not going to ask you anything too personal. The first question is, how many people in the room live in an apartment, a condominium or house? This should be everyone. How many people have wallpaper in their house? Some say no. How many people have helped to select the wallpaper that's hanging in their house? How many people have actually hung the wallpaper that's hanging in their house? We have a few home improvement types. That's good. So now, you're probably wondering what EIAs and wallpaper have in common. There is a connection, though.

What I'm going to be talking about is what is it that we reinsure under this approach, why a direct company would want to reinsure, and then how it works.

What we reinsure is the excess of the contract value over the guaranteed minimum value. If the market does well, we reinsure the excess over the guaranteed amount. If the market does poorly, there's really no benefit there that we have to provide. This is the benefit feature that causes the greatest concern to companies, particularly those that come from a fixed annuity background. Most companies are comfortable and understand the risk associated with managing a fixed annuity product. It's when you throw in this linkage to the S&P 500 Index that a lot of problems arise. We designed this reinsurer's approach to alleviate or minimize these problems for our customers. The reason customers want to reinsure is linked to the problems that we're helping them to minimize.

The first reason to reinsure is to keep the derivatives off your books. As many of you know, there are volume restrictions in states, such as the basket provision. Other states aren't going to allow you to invest in equity-backed derivatives at all. If you have derivatives on your balance sheet, it's going to arouse the attention of the rating agencies, which is something that a lot of companies would rather avoid, even though, in this case, we used the derivatives legitimately and appropriately. Finally, senior managers are concerned about derivatives. They've read the horror stories, and they're a little bit concerned when they see them.

So with reinsurance, you should receive favorable statutory accounting treatment. By that, I mean you should receive reserve credit for the risk that's transferred to the reinsurer. The treaty itself should not be viewed as an option from a statutory perspective. On a GAAP perspective, you will be dealing with a derivative. What you do by reinsuring under this method is transfer the derivative problems to the reinsurer. They just don't go away magically. It really is the reinsurer that has to deal with them.

The second reason to reinsure is to get access to expertise in the derivative market. Many companies, particularly those that come from a fixed annuity background, don't have the in-house expertise to deal with equity-backed derivatives. They can develop that expertise, but the market is not going to wait for them to do that. In the meantime, they can make some very costly mistakes. So by reinsuring, they can avoid that. The reinsurer is the one that makes the investment decisions. It's the reinsurer that's going to work with the investment bankers and select the appropriate investment or the hedging instruments.

A third reason to reinsure is so that you can transfer the hedge management responsibilities themselves to the reinsurer. This is a very dynamic process in the sense that the assets and liabilities are constantly changing. They have to be monitored, and the hedge has to be adjusted. It's a very time consuming and labor-intensive process. You might think, as I get more business on the book, I'm going to get better at this. In fact, it becomes more difficult. The more volume you have, the more moving parts you'll have to track. Given the current environment where a lot of companies have downsized, dedicating a lot of resources to this function is not particularly attractive.

With the reinsurance, you're receiving relief from this process. It's the reinsurer that's going to monitor the assets and liabilities. They're going to rebalance as needed. And because the reinsurer is going to be going to the market on behalf of many companies, they're going to be buying in larger volumes, and accessing. They are perhaps getting discounts that would make this more attractive financially, and they could pass some of those discounts on to you.

In addition, the reinsurer is in the position to manage the aggregate portfolio. They don't have to be managing each company separately. So one company can be overhedged, and another could be underhedged, and as long as, in total, they are balanced, it works. An added benefit is that with this approach, the direct writer gets to keep the majority of the EIA premium that they collect. This is the portion that they're going to need to back the minimum guaranteed amount. This is the piece where their traditional area of expertise is, and this approach allows the direct writer to continue to do what he does best.

How does it work? The indexed risk is transferred to the reinsurer. That means that the reinsurer is the one who has to set up the hedge and hedge the risk. And the reinsurer bears the hedge performance risk. This is probably the key distinction between this approach and the other approaches that were discussed earlier.

With reinsurance, the direct writer should be almost indifferent to the investment strategy of the reinsurance company. I say almost because, clearly, you don't want us to do anything that's financially unsound and is going to drive our company to insolvency. I know Brad doesn't want us to do that either. As long as we're not doing that, it doesn't matter how we invest to back our obligation. All the assets that we have in the company are backing our obligation to the direct writer, and not just the options we purchase on their behalf.

The reinsurance treaty is an exact match of the insurer's obligation to their customer. The obligation the reinsurer has is tied directly to the performance of the S&P 500 Index, and not to how well the hedge performs. There's straightforward language in there that's going to mirror the language that you have in your contract with your retail customer. You're not going to see references to strike price, notional amounts, and exercise dates. None of that is there because this is not an option treaty that we have with you. It's a reinsurance treaty.

The reinsurance premium itself is expressed as a percentage of the annuity premium. It's a percentage of the single premium that you receive from your retail customer. There are really two components to the premium: the option cost and the reinsurance risk charge. The premium itself has to change periodically. Right now, we're changing it weekly as the option prices themselves are changing weekly. It's set in advance of the sales.

So, at this point, I'm coming back to wallpaper. I didn't forget about it. A colleague of mine came up with this analogy to wallpaper not too long ago, and I thought it was a really good analogy. I'm not surprised that Tim came up with this analogy because he is a guy that shows up to work with paint speckles on his glasses and in his beard, and stains on his fingers. He's a real home improvement type. He has been working on his house for a long time. Tim was hanging wallpaper in this room and his wife was not there. His wife returned and came into the room, but didn't give him quite the reaction that he was looking for. What she noticed and what she commented on were the seams.

And this is exactly what you want to avoid with your EIA product. You don't want to have the seams show. A great deal of work goes into wallpapering. You spend hours looking through books trying to find the right pattern that's going to work. You lug the books home to compare them to your furniture, to the carpeting, and your lighting in the room. You make sure that it's going to go really well, and you make your final selection.

When you decide to go into the EIA market, it is similar to wallpapering. You do a lot of market research to find out what benefit design is going to work best for my customer. You narrow it down to a few. You bring them back to the home office. Which product is going to work best in your product portfolio? Which one is going to work best with your distribution floors? Which one is going to work best for you financially?

You make your final selection. You develop your marketing material, and you start to sell. You've done a lot of work. You're feeling really good, but you have a lot of work left to do. You still have to hang the wallpaper. You still have to manage the risk from the point where you receive the premium from your customer to the point where the contract ends. There's a lot of management and administration that needs to go in there. If you partner with a reinsurer there, it can go a lot more smoothly, and the reinsurer can help it appear seamless and help you get the results that you're looking for.

Let's discuss an example where we use weekly purchases. We're going to talk about planning for the new purchases, recording the sales, and some other logistics. When planning for new purchases, each week you have to get a reinsurance rate from the reinsurer. That rate determines your participation percentage. This is really an iterative process because you might decide to change your participation percentage which would change the rate.

Let's say on Tuesday, November 11, you get that rate from the reinsurer, you finally set the participation, you communicate it to the sales force, and it will be applied to all the upcoming week's sales (all those annuities that are sold between November 13 and November 19). If the market moves during that time frame, the reinsurer has the risk, not you. You have the price locked up.

One thing I should point out as I go through all these logistics is that it's not the design of the reinsurance arrangement that's creating these administrative things that have to be done. Whether you have reinsurance or not, you'd still have to do them. It's the nature of the EIA product itself that causes you to have to do this. So if you didn't have reinsurance, you'd be working with the derivative dealers to come up with your option cost, and what your anticipation rate would be. With reinsurance, you're dealing with the reinsurer.

So once you've finished the week, and closed out on say Thursday the 13th, what you have to do is report your sales volume to your reinsurer. That would cover all the contracts that were sold between November 6 and November 12. This is important because the reinsurer is going to use this to decide what hedges, if any, that it needs to purchase. If you have more than one product design, you have to provide the total volume by product because, clearly, that would impact the type of options that you would purchase. Of course, you have to wire the premium to the reinsurer so that they could pay for this.

Two days after the close of that week, Friday the 14th, you have to report all the seriatim details to your reinsurer. This can be done electronically. It can be done on a disk that's sent overnight. It should not be done in hard copy form because we're hoping you have large volumes, and it would be very burdensome to do it on a hard copy basis.

The reason we need this information is really twofold. One, we need to reconcile it with the volumes that you gave us the day before because we've already committed to make those purchases. And if there's any discrepancy here, now's the time to find them so we can make an adjustment in the hedging program.

Second, and, perhaps what's more important is we have to set up the tranche. All the policies there were sold during the week and are going to be grouped together from now until the end of the contract term, and they call it a tranche. We have to track what happens to the policies in that tranche, and we need the details to do that. If we weren't monitoring these details, you would be doing this. With reinsurance, you can dump all the details on us, and we're going to do this for you.

This brings us to some of the other logistics. I said we're going to be tracking these policies through time, and we need to know which of them die, which ones have surrenders, or partial withdrawals, and which ones finally reach maturity.

The benefit under EIAs may or may not include an index benefit for death and withdrawals. Typically, death benefits do get a portion of the index credits. With withdrawals, that varies more by companies. Sometimes you'll get some index credit, and sometimes you won't. Even if you don't have an index credit on these, they complicate the hedge. And they have to be reported so that the hedge can be adjusted. Whoever is doing the hedging has to make an assumption as to what percentage of your contacts are going to persist to the end of the maturity or to the end of the contract term.

If you assume 100% are going to persist, then you need to be notified right away when there are terminations so that you can undo some of your hedges. If you make an assumption that a lesser percentage is going to persist to the end of the contract term, you still need to know very quickly what the experience is, and what's starting to emerge. If it looks like your assumption is going to prove incorrect, you want to be able to adjust your hedge right away.

When you throw in the index credit on a withdrawal benefit, it's a little bit more complicated to do the hedge because you're not trying to hedge a benefit that's payable at the end of the contract term. Now you're trying to hedge a benefit but you don't know when it's going to be payable, but you know some of it is going to be payable every year. Timely reporting to the reinsurer is critical to manage that risk. Right now, monthly seems to be working well. As our volumes grow, we're also going to want weekly reporting of the terminations along with weekly reporting of the sales results.

There's a lot of risk associated with these terminations. It's not just how many people terminate; it's really when they terminate, and how long it takes to be reported to both the direct writer and to the reinsurer. There are a number of different ways that these can be handled in the reinsurance treaty itself, and a lot depends on the risk tolerance of the direct writer.

For example, you could transfer all of the risk associated with debt. However much is worked out in the specifics of the treaty, it will influence your reinsurance risk charge. I said there were two components to the reinsurance premium: the option cost and the risk charge. The more risk you transfer, of course, the higher your risk charge will be.

Now, we come to maturities. Maturities should actually be easy. We haven't had any contract reach maturity yet, not surprisingly. By the time a contact matures, we've already tracked all the information on it. The only thing we don't know is what has happened since the last reporting cycle. So a month's worth of terminations were missing, but that's it. As far as reimbursing the direct writer for the claims, at that point, it is a very quick and easy process. They can check what we do, or vice versa, and it works very smoothly.

So reinsurance of index credits is really not for all companies. I have to be quite honest. We have run into some companies that want to keep all their assets in-house. They understand the derivative marketplace. They want to control the hedge. They have the resources to do so, so this reinsurance approach is not going to work for them, but it does work for many companies. It works for companies that want to avoid having derivatives on their books. It works for companies who don't have the derivative expertise. It works for companies who want to minimize their in-house resources that they're going to devote to this hedge management process. Finally, it works if you want to transfer some of the termination risk as well.

Mr. Fairhall: One of the key issues with investing for the equity-indexed annuities is that you need enough weekly premium coming in to have enough assets to be purchasing call options; that is, the investment people like to limit the amount. Could someone address the amounts that they need to get from sales to actually purchase the hedges?

Ms. Harrington: A great deal depends on the strategy that you're using for your hedging. If you're buying over-the-counter derivatives, I know several companies are looking to buy in million dollar blocks. It is an advantage of reinsurance not to have to go to the over-the-counter market, but to go to the reinsurer.

We're using an approach where we're not buying over-the-counter derivatives. Right now, we're doing option replication, and this means that we're buying exchange traded derivatives with fairly short durations as well as futures and keeping a big chunk of it in cash. The minimum is less important under this approach because the exchange traded marketplace is very liquid, and you can buy in smaller quantities.

Mr. McFall: Our investment people tell us that a million dollars a week is kind of the minimum that the investment bankers look for in over-the-counter options. But if you write less than that, one approach to get around the problem is to pool your sales with that of other companies that are reinsuring with the same reinsurer; you thereby take advantage of the cost efficiencies of the reinsurer.

Mr. Armand M. de Palo: One of my concerns, as I watch this product develop in the marketplace, is that there's a concentration risk in this type of product. You have a regular mortality risk; some people die, some people stay alive and pay premiums, but if there's not perfect hedging here, or the hedge counterparty risk fails for some reason, the amount of liability that can be outstanding can be enormous because the market either went up a lot or went down a lot. How does the ceding company know that the reinsurer is properly hedged and that the counterparty risk on that hedging is real? How do they monitor it ongoing to know that the reinsurer may not, in effect, default if the enormous spike up in value occurs and the counterparties can't deliver on value?

Mr. Peabody: That was a good question, and I'll let them answer from the reinsurance standpoint. This is one of the areas where policies and procedures become very important, for the comfort of the company because, obviously, a weekly trust-me note from the reinsurer isn't going to do it. You have exactly the same problem even if you don't reinsure from the counterparty risk. That's a primary issue.

For a long time, banks and other financial institutions have tried to deal with that in terms of specifically getting information from the various counterparties in terms of what their own obligations are, and they can establish arrangements with the traders as far as the maximum and the minimum amounts that they're going to have on their books. The company can then write that into their own policies, or can define that in their own policies. They might not accept a certain amount from any one particular investment operation. Now the reinsurers have an opportunity to consolidate a lot of that risk as they're getting premiums in from different clients and different areas, and they can kind of manage their hedges from that standpoint a little bit, and possibly shift some of that risk. It's an area where you should definitely try and get something written down — understand the arrangement and be comfortable with it.

Mr. McFall: There could be a couple of components to my answer to that question. First, we're going to work pretty closely with the client to establish an investment strategy for their product, or whatever product we're reinsuring. It can give some comfort to the extent that it is a good investment strategy.

Second, we have diversification requirements for derivative counterparties just like you have diversification requirements for your regular investments. We hope that that's going to prevent having too much risk with one counterparty.

Ms. Harrington: I'd just like to add one other thing to that. Not all of our business is equity-indexed annuities. We have a lot of different types of businesses and with the particular approach that I mentioned, since you do have all the assets of the reinsurer backing the obligation, not just the particular derivatives that were purchased to hedge it, this approach might provide, if you are concerned, some more comfort for you.

Mr. Fairhall: The main thing I would add, and I think this is true of any annuity reinsurance arrangement, is you need an appropriate amount of due diligence. And this is really a two-way street. We talked about the partnership issue. It's really the reinsurer being comfortable with what the direct company is doing, and the direct company being comfortable with how the reinsurer is going to be involved. I think that's the main point I would add.

Ms. Grace M. Wong: You talked a lot about the rise of getting reinsurance support. You've also indicated the risks and the uncertainties and the fact that you need to have a lot of dedicated support in your in-house to manage the hedge management and all that. That is one reason why you need to have to look to reinsurance. What I want to ask the panel is, how do you advise a direct writer to choose the correct reinsurer who actually will know that they do have these in-house resources dedicated to the hedge management, and, especially those that are similar to the ones you talked about in the downsized environment. The same thing would be true for the reinsurance industry, too. How do you help us to be sure that we do understand the derivatives market? And how can you help us choose the appropriate approach because you talked about using three approaches here? I'd like to hear your opinion if you can stay objective enough to do that.

Mr. McFall: I listed several things to look for in a reinsurance partner. I think that's a good starting point in choosing your reinsurer. In order to tell how qualified they are, you do have to do some due diligence. I go back to the answer to the previous question.

We're going to design an investment strategy. Both our reinsurance people and our investment people are going to be working with the ceding company to design an investment strategy that will hedge the risk as effectively as we can and, hopefully, through the due diligence process and developing a joint strategy, your comfort level will increase.

Ms. Harrington: I wouldn't advise you to pick an approach just based on what we said. Anytime I buy something, I want to comparison shop. I think it's a good idea to talk to a couple of reinsurers, ask them a lot of questions, look at the type of support you're getting, look at the quality of the answers.

I think all three of us try to tailor our products to the needs of our customers. It's not like one product fits all. There are a lot of variables that come into play, and you have to find which one of us is going to best be able to meet your needs. Much depends on what your needs are.

Mr. Fairhall: I would certainly reiterate that. We would want to work with you to understand your needs, and maybe even to help you understand what your needs are by asking questions like, why are you seeking reinsurance, and is it trying to get the derivatives off the books? Is that the issue? Do you need help in actually purchasing the assets? It's really a discussion with and an understanding of what the answers to those questions are that leads to an appropriate approach.

Mr. Trevor J. Matthews: My basic question is how much reinsurance is going on at the moment? Can I just give you a bit of background of what's happening in Australia, which is quite interesting. We got a new retirement savings vehicle that's being introduced by the government just in the last couple of months on the bank's balance sheet. It's a capital guarantee vehicle short-term fixed-interest type retirement vehicle. It's a simplified approach to planning for retirement. Next year, we have member choice where every new employee must be offered a choice of five different retirement vehicles, and one must be this retirement savings account. There has been quite a bit of debate in Australia about the appropriateness of this sort of vehicle for long-term retirement planning. Of course, it's clearly not appropriate. An equity-indexed annuities type of approach could well be. I would expect in Australia in the next couple of years you're going to see the development of these sorts of vehicles on the bank balance sheet, rather than through the insurance companies. I'm very interested to hear what you're doing here, and the way this market is taking off.

My question really is what sort of volume of reinsurance is going on at the moment and how do you expect that to move in the next couple of years?

Mr. Fairhall: The amount of reinsurance going on in these products is relatively small in comparison to the amount of equity annuities business being sold. I think earlier Lynn mentioned there were 27 companies selling this product right now, and maybe we're getting close to two billion of premium. The truth is that premium is very much concentrated over three or four companies, and I think one of those products uses reinsurance. If you look at it by premium, you'd see that it really turns out to be used for a fairly small share of the total premium.

I think also, as Lynn commented, this is really a work-in-progress. It is sort of a new market. Some companies are in the wait-and-see mode. Reinsurers are in the wait-and-see mode, too, because of similar issues.

Mr. Peabody: Trevor, I think that you're probably going to see the reinsurance market grow for a couple of reasons. I think that the companies that had got in initially were fairly comfortable with the expertise that they had and their ability to manage the assets. I'm not sure that that was well founded, but I think they were comfortable with it.

I think as more and more companies get into the market, they will see the need for possibly going into the derivatives market in a way that provides them some efficiency that they can't get as a smaller player. I think that definitely the consolidation of the assets is something that is going to be beneficial to it. Things like what has recently happened in the stock market will create more concern in the minds of management. Management is going to be looking for ways to hedge its own risks. I think you'll see more of it there.

Similar products have been in Europe for a while. I think you may have had similar types of products in Australia. Some of the pieces are in place for the management of the process from a direct writer standpoint.

I was at your session, and you made some excellent comments on banking in Australia and financial institutions. The fact that you have that melding in places other than the United States probably provides a little more of an opportunity for organizations to handle some of those risks themselves. You're going to see reinsurance growing in the United States.

From the Floor: First, as I basically understand it, the reinsurance is on the equity-indexed part, the ceding company keeps the minimum guarantee, which they fund by using bonds.

Now, the Congress has been impelled to start looking at the use of derivatives. Is anybody in tune with what the outcome of something like that could be, and if there is a strong federal control of how derivatives are used and accounted for? This is going to have significant impact on the validity of contracts already issued.

Mr. Fairhall: Insurance companies will be able to hedge the risk, and this goes beyond just equity-indexed annuities. It's hedging all kinds of risks—interest rate risks and other areas of risk like that. I'd like to think common sense will prevail, and the end result of this is that there will be rules and we need to follow them. But we'll be able to hedge our risk appropriately.

From the Floor: Is there a real downside potential? Would the validity in the index equity reinsurance fall apart? I know there has been a lot of publicity about the concern that the Congress has about this being an unregulated area.

Ms. Harrington: My personal opinion is that we wouldn't even have EIAs today if we didn't have the equity-backed derivatives. Clearly, if they disappeared, it would hurt the product. I also have a lot of confidence in the creativity of the investment world to come up with yet another approach that will work if something happens to the derivatives.

So to the extent we have the right mix of products there, we don't even need to buy derivatives. I think direct companies themselves might be able to look at something like that.

Mr. McFall: It concerned me to hear Dave talking about common sense and Congress in the same sentence. I think this is one example that could really have a very substantial impact on this product, and another would be what the SEC decides. If they decide that all indexed annuities are variable product securities, then we're going to lose all or the vast majority of our market because it will be limited to the variable annuity writers. They're the big companies that, generally speaking, don't need reinsurance. There's very little to reinsure on a variable annuity anyway.

It's difficult to give a specific answer. I've been reading about some of the discussions of derivatives in accounting; therefore, the thing that I'm seeing is that I believe they're looking toward somewhat of a prudent approach where it's okay to purchase derivatives for in hedging purposes as opposed to speculative purposes.

To the extent that the rules emerge with some common sense, I think that insurance companies will be able to hedge the risk. This goes much beyond just equity-indexed annuities. It's hedging all kinds of risks, interest rate risks, and other various risks like that. I'd like to think common sense will prevail and that the end result of this is that there will be rules, and we need to follow them, but we'll be able to hedge our risk appropriately.