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Session 40OF
Designing Your Own Individual Disability Reinsurance Program

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Summary: This expert panel explores the many forms of individual disability reinsurance that are available for companies who wish to reinsure their business. These forms include excess coverage, quota share, stop loss, finite reinsurance, and financial reinsurance.

Panelists present a brief overview of these different types of reinsurance. The moderator facilitates a discussion in which participants actively explore the advantages and disadvantages of these approaches and consider their applicability to different business situations.

As a result of this session, participants will gain a fuller understanding of the reinsurance options that are available to individual disability income insurers.

Mr. Robert W. Beal: I'm a consulting actuary at Milliman & Robertson, and my panel consists of Bill Obert from Berkshire Life, Andy Castillo from Munich American Reinsurance Company, and Vincent DeMarco from John Hewitt & Associates, which is a subsidiary of General & Cologne Life Reinsurance.

The reinsurance market for individual disability income has undergone considerable change in the last few years, not unlike what has happened on the direct side. Poor profits have led a number of the reinsurers to exit the business, such as Paul Revere, Lincoln National, and Employers Re. Other reinsurers are consolidating—Swiss Re and M&G consolidated and then exited. There are some other reinsurers, though—some off shore—that are actually getting interested in this business. This may be a good time for direct companies to examine their reinsurance needs regarding individual disability and the forms of reinsurance that are available. One objective of this session is to review the various reasons for purchasing individual disability income

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reinsurance as a direct company, and the second objective is to survey the reinsurance options that are available to you.

Bill Obert will cover the reinsurance needs of the direct writer of individual disability. Andy Castillo will review certain considerations that should happen in designing a reinsurance program and discuss the main ways of funding the more traditional forms of reinsurance—namely, coinsurance and YRT. Vince DeMarco will review the various forms of traditional reinsurance covers: quota share, excess, and extended wait. Finally, I will review three forms of nontraditional individual disability reinsurance: stop-loss, direct writer's pool, and surplus-relief.

Mr. William A. Obert: I'm the valuation actuary at Berkshire Life. We're a mid-size company located in the Berkshires in western Massachusetts. We're a disability insurance (DI) writer. DI represents about 15% of our reserves. Life insurance is the bulk of our business, but DI is a growth product for us. Last year we wrote about $10 million or so of new premium, and this year we think we'll write about $12 million, so it's an important part of our company. We're a big buyer of reinsurance. We have two treaties in force, one that ended in 1997 and a newer treaty that began with 1997 issues. The older treaty is extended elimination period; the newer treaty is an excess share coinsurance treaty.

I'm going to discuss the needs for reinsurance from a direct writer's perspective. I'm going to discuss three areas: one is the basic need for risk sharing, the second consists of strategic reasons that reinsurance might be used, and the third is a miscellaneous grouping of some other considerations.

For risk sharing, disability income is a risk product. Morbidity risk is an important element of what the insurance company is providing. Reinsurance lets the insurance company issue policies that are larger than it would feel comfortable issuing on its own. Berkshire has a retention limit of roughly $4,000 monthly benefit on DI. We feel comfortable with that and wouldn't want to take on more risk on larger policies. We came up with this retention level several years ago. I don't think it was scientifically determined; it was based more on what management was comfortable with and was akin to our life insurance retention, which is $750,000 per life.

Risk sharing lets us manage growth, because we are in an upscale market. We sell to small business owners and professionals. We want to issue larger policies, but we also want to manage the risk so we can reduce the volatility of our statutory earnings and surplus to the point that we're comfortable. You can look at projecting your earnings under different morbidity scenarios to get a feel for how much risk you're comfortable with and then look at how much reinsurance protection you might get by varying the portion that you're ceding.

The basic coverages are directed toward either limiting claims on a single life or limiting the total claims in a year in aggregate coverage.

To balance out the reinsurance coverage, you also need to look at how much it's costing you and how much profitability you're ceding. The way we look at that is to

model our business on both a direct and a net basis as to reinsurance and by examining those two bases over a 10-year period. We look at our ROEs on a direct versus net basis to see how much the ROE is reduced through reinsurance. We also look at different morbidity scenarios in which we've changed the incidence and termination rates. You get a feel for how reinsurance can reduce the volatility, but also its impact on the ROE, so you have to weigh and balance that. Is the return give-up too much, or is it justified based on the fact that you've reduced your volatility?

The second point on cost is, if it's a YRT type of funding arrangement, are there guarantees on the YRT rates, or is there some kind of profit-sharing or experience-refund mechanism associated with it?

The next category involves the strategic reasons for DI reinsurance. DI is a capital-intensive product. The reserves on the product, the risk-based capital requirements, and the high acquisition costs can all contribute to capital needs. There are several ways to obtain capital if you're a mutual company, internally or through reinsurance. Reinsurance can provide some relief from the surplus drain through surplus relief reinsurance or through the expense allowances that are available on coinsurance treaties.

If you look at your business projections, where you're growing at 10% or 20% a year, you get a feeling for how much capital is required over that period and how important it is to have reinsurance help reduce the surplus drain and provide a source of capital.

A third strategic reason for reinsurance is in situations where you may be either exiting the business, or trying to grow through acquiring blocks of business. These transactions are usually settled using some sort of assumption reinsurance.

On the strategic side, recapture provisions are important to look at, given that, at some point in time, the company may be large enough that it can recapture some of the business that's reinsured. You need to have provisions available for that, and you need to spell out how they work. There's no cash value. So what do you use to measure the value of the business?

I want to cover a few miscellaneous reinsurer needs. The first is the reinsurer's strength and its commitment to the business. It's important to evaluate whether the reinsurer will be in business over the next 30 or so years and whether it will be in the DI business. Second, how hard or easy is it to administer the reinsurance treaty? No one wants to add substantial administrative costs to the product, so you want the process to be as seamless as possible.

Third, the reinsurer can bring a lot of value to a smaller company because it has a broader industry perspective on trends and can potentially help out on unusual claims, large-case underwriting, etc. It also has more experience data available, and might be able to help you in developing producing, pricing products, and developing valuation assumptions.

Mr. Andronico L. Castillo: I'm with Munich American Reassurance Company. I am responsible for the development and pricing of our DI and long-term-care reinsurance lines. While Bill's remarks are from a direct company's viewpoint that can help you identify and clarify the needs that can be addressed by reinsurance, I will confine my comments to some items you should think about as you design your disability reinsurance program. I will then discuss the two basic funding methods most commonly used today: YRT and coinsurance. Then Bob and Vince will discuss the various forms of traditional and nontraditional reinsurance coverage.

The first consideration is retention limits. There are many ways a company can go about determining the appropriate retention for DI. One way is doing a simulation model to see what the distribution of your aggregate losses could be. Another method is to look at the present value of future benefits when a claim occurs, comparing that with your life insurance retention, and comparing the volume of premium on business you write in your DI line compared to your life line. Another method is to survey what other companies have in terms of retention limits and then compare their volumes and their capital and surplus to your company's. Incidentally, a few years back, my company did a retention survey that covered about 100 or so companies. It primarily focused on life retention, but I believe we asked about retention for DI as well. If you're interested in that, I think we have that on our Web site at www.marclife.com.

Retention limits, as you know, may vary by policy form, benefit period, elimination period, rating, or occupational class. Typically, the best occupational classes have the higher retention, the longer benefit periods have lower retention, and the shorter elimination periods may have lower retention. Low retention amounts allow a company to manage the growth of the disability line while minimizing the potential for early adverse claim results, especially when you're entering a new market or if you're a new disability player. Relatively high retention amounts allow a company to limit the effect of claim losses from very large policies while minimizing the amounts reinsured. However, a reinsurer may not be as willing or eager to do business with you if there will be a relatively small base of reinsured risk over which to spread its claim costs.

Reinsurance rate guarantees have also become an issue because of the losses that the industry has experienced. If you're the ceding company and your business is non-cancellable, ideally, you would also want to have your reinsurance rates guaranteed. If not, at least you should discuss and clarify with your reinsurer the circumstances when rate changes may occur and make sure they are specified in your agreement.

Another area to consider would be the various services that may be available from a reinsurer. In terms of product design, because of the nature of the reinsurance product, reinsurers may be more familiar with many products and various practices in the marketplace. Reinsurers can give you feedback or input on various issues that cover underwriting or claims practices. The reinsurers can be good sounding boards on any product or design ideas you may want to pursue. In terms of underwriting, you may also think about the extent of facultative support that your underwriters

would need. Not only would the reinsurance underwriters provide the typical facultative function of individual risk assessment, but they could support and assist you in developing or setting underwriting guidelines and requirements. Again, this is especially helpful if you are contemplating entering a new market or developing products.

Depending upon the reinsurance program that you are contemplating, you and your reinsurer will have to discuss and come to an agreement on the appropriate automatic binding limit or automatic issue limit. The automatic binding limit is the maximum amount of DI coverage the ceding company's underwriters can issue with its sole authority to bind the reinsurer automatically. As an example, if the ceding company's retention is $3,000 monthly income, and the automatic binding limit, say, is $3,000 as well, then the maximum automatic issue limit is $6,000, up to which the ceding company does not have to submit underwriting papers to its insureds for approval.

The automatic limit is set based on the comfort level of your underwriters in underwriting large amount cases, as well as on their experience level and, of course, the comfort level and familiarity of the reinsurer's underwriters with the direct company's underwriters and underwriting practices.

Another valuable service that may be available from reinsurers is an underwriting audit or review, which could be beneficial to both parties. In the area of claims, one should also think about the level and types of support you need from a reinsurer. Similar to the automatic binding or issue limit on the underwriting side, an automatic claim limit may also need to be set. This claim limit is an amount wherein, if the policy reinsured is within this limit, the company does not need to seek its reinsurer's prior approval for claims payments.

Settlement limits or lump-sum settlement limits may also be addressed. This limit is a certain total dollar amount that the company may bind the reinsurer automatically to pay for its purported share of the settlement amount. Again, this may or may not be important for your company, depending on your company's philosophy on lump-sum settlements. Typically, extraordinary expenses that are not ordinarily covered or performed in the investigation of claims may or may not be covered by your reinsurers. Again, this is one item that you need to discuss with your reinsurer at the outset of the agreement.

Recapture provisions are another area to consider. These provisions can be an important item when you are contemplating a first-dollar quota-share arrangement, where a substantial portion of your disability production is reinsured. If retention is increased, can you recapture the retention increase on previously issued policies that were reinsured? If so, when will it be allowed? Is it 10 years, 15 years, or 20 years? Would recapture fees be involved? Those are some of the specifics that you need to discuss with your reinsurer. You may be attempting to address a number of needs and may need multiple reinsurance agreements in place to meet all those needs.

A final consideration is the reinsurer's financial strength and commitment to the DI market. That's crucial in today's market. We have seen a number of DI insurers, as well as reinsurers, exit from the DI product line. Because of this, some companies have sought to place their reinsurance with more than one reinsurer. Bill's company is not alone. There are quite a few companies wishing that there were more DI reinsurers to choose from.

Let me quickly go through the two traditional funding methods most commonly used today: YRT and coinsurance. Somebody might be wondering why modified coinsurance is not included. I think it's used rarely in DI, and if you wanted to do that, I guess you can use coinsurance and funds withheld. Bob may be talking about this.

YRT premium rates are independent of rates from the original plan of insurance. They may be experience-rated or not. The rates may not be guaranteed or they may be guaranteed for a limited period of time. As an example, I've seen one arrangement where the reinsurance rates were guaranteed up through, say, March 31, 2002; after that, the treaty allowed the reinsurer to change the rates for both existing in-force business and new business going forward.

YRT reinsurance is more common if you look at the universe of reinsurance treaties in place today, but I'm not so sure whether that's going to be true going forward.

One characteristic of YRT insurance is simplicity. The reinsurance can be for specific defined benefits. As an example, the reinsurance can cover just the basic benefits and the other features in the policy—the work-incentive benefit, rehab or survivor benefit, or total presumptive disability benefits—may not be reinsured. In YRT, the reinsurer's and ceding company's interests are aligned. If the ceding company is experiencing bad results on its retained portion, the reinsurer is likely to be experiencing bad results on the reinsured portion, though most likely at different degrees.

Depending on the parameters of the arrangement, in fact, the interests may not be aligned at all. One example would be an arrangement where the retention is set so high that the reinsured's portion is quite small and probably would exhibit volatile results compared to the retained portion. In YRT, as the name implies, there's a lower initial outlay and the initial premiums are low and increased by duration. A consequence, typically, is that there's minimal surplus relief.

Administratively, it may be hard to install YRT, at least initially. The volume of rates you have to develop and load into your system can be quite a chore. You need to make sure that the correct policy benefits are reinsured and covered and know how they are covered. As an example, will the reinsurance arrangement waive the reinsurer's policy's premiums during disability? Again, those are some things that you may need to think about.

Under coinsurance, however, the reinsurance coverage is essentially the same as that of the original policy issued, unless some features are specifically excluded, as

mutually agreed upon between you and your reinsurer. Under coinsurance, the reinsurer accepts its share of premiums and policies reinsured and pays an allowance to cover the ceding company's commissions and expenses. A characteristic of coinsurance is that the reinsurer shares proportionately in all risks underlying the business reinsured. First-year allowance is typically larger to cover acquisition costs, and, therefore, compared to YRT, the initial surplus relief is relatively more substantial.

In coinsurance, the reinsurer's and ceding company's interests are more closely aligned, and this is probably especially true when the arrangements are on a quota-share basis. Because the reinsurance premiums are basically the reinsurer's products and premiums, the reinsurance allowances developed are unique.

With respect to administration, it is much simpler to administer when the arrangement is on quota-share basis, because, basically, what the ceding company does is apply the reinsurer's quota-share percentage to the premiums, reserves, and benefits for reporting purposes. As you depart from a quota-share coinsurance arrangement, administration quickly becomes more complicated. Again, it is interesting to know that some companies prefer YRT to coinsurance. I think the main reason is that their reinsurance administration systems are already geared to do YRT, and they don't want to do any extra work to change that.

Mr. Vincent A. DeMarco: I'm the individual disability actuary for John Hewitt & Associates. For those of you who don't know my firm, we are majority-owned by General & Cologne Life Reinsurance. Today I'm going to talk about the traditional reinsurance cover, and then Bob will follow up with nontraditional covers.

What is a cover? It's the mechanism that defines which risks are ceded and which risks are retained by the direct-writing company. I'm going to talk about the three traditional forms, which are quota share, excess, and extended wait. Within these three covers are various hybrids and alternatives that create almost an infinite number of possibilities between 100% first-dollar quota share and high-dollar extended wait.

Quota share refers to traditional straight first-dollar quota share. A fixed percentage of each risk is ceded. The percentage can vary anywhere from 10 to 100%, depending on the underlying reasons for obtaining the reinsurance. Quota share is generally used when risks reinsured are either a small part of the company's overall business or a new venture. It is used when volatility is not the major reason for obtaining reinsurance.

Modified quota share is a hybrid between quota share and excess. It uses a variable reinsurance percentage or cede percentage, depending on the size of the policy or the size of the amount in force. The percentage can vary by two, three, or four tiers. For example, it could vary at $2,000 a month or $4,000 a month. It's generally used when a company wants volatility covered and a large amount of reinsurance or a partnership arrangement. The funding method for quota share is

usually coinsurance, although we have seen YRT used on a quota-share arrangement.
Quota share has the lowest cost or unit cost of any of the reinsurance covers, in part because of the spread of risk ceded, and in part because of the ability of the reinsurer to spread its costs over a large number of policies.

Under a quota-share arrangement, a portion of all policies is ceded, and this requires a true partnership between the reinsurer and the direct-writing company—especially with regard to alternative underwriting offers, which may not be reinsured under an excess agreement.

First-dollar quota share with a first-year expense allowance and then a flat renewal expense allowance is fairly easy to administer. (That's a relative term, because I don't think any reinsurance arrangement is easy to administer.) However, as you get away from straight first-dollar quota share and go to a modified quota share, administration quickly becomes more difficult and requires that the policy administration and the reinsurance administration systems be connected. One of the reasons we've seen YRT with quota share is that the reinsurance systems for individual companies have been set up to handle it.

Under excess reinsurance, the direct writer retains a specified maximum amount of coverage and then cedes excess of that retention limit up to its issue and participation limit. It's the most common method used in individual disability. Its funding method is either YRT or coinsurance. It's used generally because it cedes the volatility risk, which is the major risk most direct writers are looking to cede. Excess reinsurance has a higher unit cost than quota share, but a lower volume is ceded. If you combine the two, it creates a ceded premium that's roughly equivalent to a modified quota-share arrangement.

On first-dollar quota share, all policies are ceded, but on an excess arrangement, only policies where an insured has coverage above an excess limit are ceded, so it allows the direct-writing company to insure risks below its retention.

High excess covers have been popular in individual DI because of the ability to balance volatility and administration. At one time, it was readily available when overall reinsurance costs were lower. Today, I would say that high excess—$8,000 $10,000 or $12,000—DI reinsurance is not generally available, although it is offered by some companies. The reason is that some companies have lowered their issue and participation limits. A risk 10 years ago, where a company would issue a $30,000 a month policy, would be a large risk reinsured excess of $12,000. Today, with issue and participation limits between $10,000 and $15,000, an excess of $12,000 arrangement does not provide much premium to the reinsurer for a very volatile risk and does not create a true partnership in some instances, so it's not as widely available. Today, you'll see more low or moderate excess limits of four, two, and one arrangements.

As with quota share and excess coverage, extended wait has many hybrids or variations within it. The two most common extended waits are extended elimination

period and dollar deductible. Under a two-year extended elimination period, the direct writer would retain 100% of the risk on claims until two years of benefits have been paid; after that time, it would cede the remaining risk either wholly or partially to the reinsurer. Under a dollar deductible, like an individual stop-loss arrangement, the direct writer would retain 100% of the risk up to a specified dollar amount and, after a claim had been paid out to a specified dollar limit, then cede either in whole or in part the remaining risk to the reinsurer.

Extended wait reinsurance is used by companies whose main concern is to reduce volatility caused by large-size claims. Reinsurance premiums are either YRT or coinsurance. The way extended wait has been done on a coinsurance arrangement with a two-year extended rate is to take the "to age 65" premiums and subtract the two-year benefit period premium to derive the reinsured gross premium.

Extended-wait reinsurance focuses on covering the tail of the risk. This risk has the highest unit cost due to the volatility and the potential misalignment of the risk between the reinsurer and the ceding company. Any misalignment of interests creates issues for both the direct-writing company and the reinsurer. This coverage has the least amount of policies ceded, which makes the administration fairly straightforward under the extended elimination period, because any claim that comes in and lasts two years is reinsured.

Administering the extended dollar amount is a little bit more difficult, because that time period of when the dollar limit is reached varies for each policy, especially with partial or residual claims or overhead expense claims. This coverage used to be widely available. I would say today it's not utilized as much because of the potential misalignment of interests between the direct-writing company and the reinsurer.

Mr. Beal: I will be discussing aggregate stop loss versus individual stop loss, a direct writer's pool (which is a concept that was promoted a few years ago by CIGNA, Collins & Associates, and the M&R Office in Hartford), and finally, surplus relief, which I think has a role in today's DI market.

The idea behind stop-loss reinsurance is that the reinsurer is going to cover the aggregate claim costs in a year in excess of a level called the "attachment point." The attachment point is a specific percentage, say 125% of expected claims. This raises the question of how the reinsurer calculates expected claims. Does the reinsurer look at the direct company's financial projections and use the loss ratios as the basis of expected claims, or does it dig a little bit further? For example, I saw expected claims based upon the actual past claims relative to claim costs valued using the 1985 Commissioner's Individual Disability Table A (85 CIDA) so the reinsurer was able to track claims and see where the actual claim experience was relative to that basis. Over the attachment point, the reinsurer will reinsure some percentage of expected claims and, if claims exceed that limit, it will go back to the ceding company. The reinsurer carves out some piece of the risk in the middle.

Stop-loss reinsurance may also have a lifetime limit: a total amount of claims that the reinsurer will pay under this agreement. If claims reach this lifetime limit, the stop

loss is over. The reinsurance premium will be some percentage of premium, because premiums are the easiest thing to get your hands on. Such a premium might be 2% of total premium.

The term of a stop-loss agreement is typically limited. It might have a 10-year term, but may have specified ways in which the ceding company can get out of it early. If experience is starting to look bad, the ceding company may feel it wants to cut its losses and leave. There may be some profit sharing, because the reinsurer is assuming the tail of the risk or a piece of the tail of the risk, which may be hard to quantify. Because it's a relatively small amount, the reinsurer may pad its charges. If it charges 2%, it may only need less than 1% and feel as though some kind of profit sharing will return some of that excess premium if it doesn't use it.

So what does stop-loss reinsurance do for a company? One of the possibilities is that it could allow the direct company to increase its excess retention limit. The direct company may believe that it is passing out a high percentage of its premiums to the reinsurer, but feels that an increase in its retention limit creates too much potential volatility. In this case, they may get stop loss, which makes the direct company more comfortable with the potential volatility. It feels that, with the stop loss, its surplus is protected in the aggregate, and its reinsurance costs, in total, are less than what they had been before.

In terms of volatility, stop-loss reinsurance has limited effectiveness, in my opinion. If there is an attachment point of 125% of expected claims, most claim experience is likely going to be under the attachment point, and there is still a lot of volatility. Management of the direct company has to be willing to accept some level of volatility if it's going to rely totally on stop-loss reinsurance.

Stop-loss reinsurance is relatively inexpensive. The reinsurer is covering the tail of the risk so, therefore, the total reinsurance premium is probably pretty small. Stop-loss is not always available—not every reinsurer is willing to provide this. One of the reasons is that the reinsurer may not feel as though it has the statistical tools to evaluate that tail. To do it right, you probably need some kind of Monte Carlo simulation analysis to get a good sense of what that risk could be. Some companies may feel that they just don't have the tools, the time, or resources, or they might that that there's not enough premium to justify this type of analysis. However, I think some of the off-shore reinsurers may be taking more of a property/casualty perspective, where stop-loss is more in line with their way of thinking.

In one sense, administration of stop-loss reinsurance can be very easy. For example, the reinsurance premium is a specified percentage of total premium. Losses may be more difficult to calculate because they emerge over time. You're not going to know for sure at the end of the year whether you're going to have a loss that is going to be covered by the agreement. The agreement might require that claims be monitored over a period like five years for each year incurral. So you're going to have to bear with it for a while to see how the claims actually run out.

The other thing concerning stop-loss reinsurance is that it is not a long-term agreement. Under coinsurance and YRT, the reinsurer is bound to the risk while the reinsured policy is in force. Under stop-loss reinsurance, coverage is for a specified period of time, such as 10 years, but the reinsurer may be able to opt out sooner if experience is deteriorating.

The second type of nontraditional reinsurance is the direct-writer's pool, which would be formed by a group of direct writers. Typically, there is a TPA involved that will employ actuaries to assess the risk of each company each year in terms of YRT types of risk. They do this by evaluating the risk normally associated with a portfolio of products as well as the demographics. They may also look at each company's underwriting and claims practices and try to make a relative comparison between companies in order to make a fair judgment in terms of the expected cost for each company. The so-called YRT premiums then are used to determine what percentage of the total risk in the coming year each company will get. The total amount of reinsured claims, regardless of where they came from, then gets allocated back to each of the companies in proportion to those percentages. The direct-writer's pool allows each participating company to spread the risk without decreasing premiums or reserves.

One of the issues associated with the direct-writer's pool, and one of the major reasons why the concept hasn't received more interest, is that it requires similar risk-management philosophies among the participating companies. In one sense, it either requires similar risk management philosophies of all the companies involved or it requires a lot of trust—either trust in the other companies or trust that the TPA can perform an appropriate, consistent pricing of the various risks from company to company.

On the surface, the direct-writer's pool offers few of the services available from traditional reinsurers. In its simplest form, it is just a pooling mechanism. However, the TPA has an actuary and possibly an underwriter who can provide assistance to the direct writers for a fee.

Surplus-relief is where the reinsurer provides assets or a reserve credit to the direct company in order to fund the new business surplus drain or, in the case of buying a block of business, to actually cover the purchase price.

With one type of surplus relief, actual assets, equal to the amount of surplus relief, are transferred from the reinsurer to the ceding company. If $10 million of surplus is needed at the company, the reinsurer actually transfers $10 million of assets. Under other forms of surplus relief, there's a reserve credit for the amount of surplus relief. All of the other reinsured reserves are under a modified coinsurance arrangement. It gets very complicated, no doubt. The only money that gets transferred is essentially what the reinsurer is charging for the extra points on that surplus relief—whether that's 200 basis points or 300 basis points. The reinsurer maintains what might be called a surplus account to keep track of the profits on the particular business that has been ceded to them, which pays down the surplus relief over time. The reinsurer charges basis points on the outstanding surplus relief.

The treaty typically has some very strong financial incentives for the ceding company to recapture business once the surplus relief has been paid back, although it cannot require recapture. It cannot legally or regulatory-wise say the reinsurance ends after five or 10 years. The NAIC Model Reinsurance Regulation prohibits that.

The final point concerning surplus relief is that the reinsurer really assumes a significant portion of the risk. Surplus relief is not just some notional account that it once was when a very nominal amount of risk was transferred. The regulations have changed that. The reinsurer must assume a considerable amount of risk here. One of the biggest risks is the length of time it takes to pay back the surplus relief. If the business produces losses instead of profits, those losses just keep extending the period of time, so the reinsurer can have the business on the books much longer than it anticipated.

In spite of this, for the direct company, surplus relief may be inexpensive financing for the new business. If the direct company has priced its product to generate, for example, a 12% or 15% return, and the reinsurer is only charging 200 or 300 basis points over new money interest rates for that surplus relief, then the direct company can actually leverage its return, because the cost of that funding is less than it actually is making on the product. Therefore, the direct company comes out ahead.

One of the big disadvantages of surplus relief is that your finances look very odd. You've actually ceded a large portion of the business. What was there last year is no longer there this year. Maybe in five years it will be back.

One of the advantages, though, is that risk-based capital is reduced significantly under this method. Even if it's modified coinsurance or coinsurance, the premium component of the risk-based capital actually goes away. Surplus relief may help you minimize that capital intensity factor associated with individual disability. Another disadvantage, unfortunately, is that, even with the reinsurance regulations today, I think regulators and rating agencies may be still somewhat suspicious of surplus relief. It may be as good a deal, because you're borrowing money for less money than you're going to get, but it may suggest inappropriately that your company is not financially strong, so you have to deal with that.