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Session 65OF
"R" Rated—Risk in Capital Management

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Interviewer: John E. Wade
Interviewees: Richard F. Kirk†
James D. Maughn
Michael J. O'Connor
Recorder: David H. Lister

Summary: This session features interviews with several authorities on the following current topics:

- *How the rating agencies view capital management in determining company ratings*
- *How the rating agencies view the independent review process*
- *How capital management is addressed at a non-insurance company parent*
- *How financial reinsurance can be used to strengthen your capital position*

Mr. John E. Wade: We will start with the point of view that the regulators and the rating agencies have and the kind of round field we are playing on. We will hear a little bit about how a holding company might try to manage the capital management situation. Last, we will discuss some of the ways that reinsurance might be a vehicle for improving a company's ability to manage capital and develop return on equity (ROE) for the stockholders.

The first panelist I would like to introduce is Richard Kirk. He is the vice-president for the life and health division at A.M. Best. Rich issues ratings and writes reports based on quantitative and qualitative analysis on a portfolio of small- to medium-sized life insurers. He also leads a team of analysts specializing in assigning financial performance ratings that stages companies for the receipt of an initial letter rating, combined with tracking the major life affiliates of property and casualty carriers. He also conducts research for special projects and speaks to insurance associations on Best's ratings system. His team is also responsible for reviewing the vast majority of fraternal societies and farm bureaus. Rich also coordinates and teaches financial analysis seminars for the company in conjunction with the College of Insurance.

†Mr. Kirk, not a member of the sponsoring organizations, is Vice-President of A.M. Best Company in Oldwick, NJ.

Prior to joining A.M. Best in 1988, Mr. Kirk was a business analyst for Dunn and Bradstreet and spent several years earlier as a field training consultant for Metropolitan Life. He holds a B.A. from Rutgers and is presently working on his Fellow of the Life Management Institute designation.

Mr. Richard F. Kirk: What I would like to do is walk you through how A.M. Best looks at capital management with small- to medium-sized insurers. My team and I meet with these companies on a daily basis, either at our headquarters in Oldwick, New Jersey, or at the company's site. In an eight-month period, I probably meet with a group of seven who manage about 135 accounts on a face-to-face basis. We are fairly active with the companies, and hopefully we have a finger on the pulse of their situations and the particular niches that these companies represent. Our platform for dealing with small companies is no different than the large companies. We go through the same type of analysis.

Basically, I think the biggest key for our review—and it is tough to boil it down to just one magic ratio or one magic qualitative aspect of our review—is that it combines a lot of elements. The face-to-face management meetings and the dialogue we have are key to the understanding of the accounts we cover. As far as looking at capital management, we have a unique opportunity. I have been with Best going on about 12 years. Whenever there is a merger, acquisition, or liquidation, a lot of that impacts the small- to medium-sized accounts.

I am talking about $100 million or less in total capital. We know both the buyer and the seller when we are dealing with insurance entities. From this vantage point, we are allowed to get our nose under the tent to get a feel for what is going on. Again, we do not breach any SEC rules or any confidentiality rules, but if a company is selling a particular letter-rated entity to another enterprise, we are going to have a good understanding about that. Hopefully we will get a good insight, if the price was warranted, as to how that is going to translate to the new acquirer's program or strategy.

Our process is trend oriented. We do not look at companies and focus on one quarter or one year; we look at a five-year period of time, and in addition to capitalization, we also look at profitability and liquidity issues. On the quantitative side, some of the documents we review obviously would be the NAIC blue blanks, brown blanks, white blanks, yellow blanks, etc., at least on the statutory basis. We also routinely look at GAAP financials, where available; embedded-value-type accounting; modified GAAP; and any alternative source above and beyond statutory. We use these parts in our review.

One topic I will not spend a lot of time on, but that I want to highlight, is the peer analysis. We have a database that enables us to look at a company over a five-year period and review approximately 5,000 data elements. A majority of those elements would come from the statutory statements that we crunch internally and scrub for accuracy. Another aspect is the supplemental rating questionnaire. There is a lot of crucial information we use when it is filled out completely for those relative areas.

As far as looking at companies, we have different business units that track different types of businesses. With small- or medium-sized accounts you get the unique opportunity to see the vast majority of the life and health industry. Presently, A.M. Best tracks over 6,000 domestic and international companies. In addition to life and health, there are the property and casualty (P&C) and the international division previously mentioned. There are some small capital groups or alternative risk areas that are also being conducted. During management meetings, whether the company is buying a block of business or a company in its entirety, we want to understand what the strategic fit is above and beyond the price.

We also look at what value added is really going to bring to the situation at the end of the day. If we have tracked a company and it is buying a company as a whole, we have a lower rating on that company, and then we want to understand how that is really going to fit in perhaps the higher-rated company's portfolio. Maybe they are both similarly rated, and we look to see how that is going to be a nice fit going forward. How do we judge the balance between organic growth? We look at business developed through the existing distribution systems and the acquisition activity, and how that folds into the total process and allows growth for the business.

The three tenets of our review process are market profile, financial strength, and operating performance. Financial strength directly impacts capitalization. Under the financial strength arena, there are probably six points, in that you have to understand the leveraged capitalization of the entity or the enterprise. Although there was modest activity in February 1999, A.M. Best officially got into the debt-rating process. It has been a slow process, but we have released several of those debt ratings, and we look for that to build going into the next few years.

At the end of this year, A.M. Best will have its 100-year anniversary. In all that time, the bread-and-butter activity has been following and assigning letter ratings on insurance entities. The capital structure of an account is crucial to our understanding. We want to know the mix between preferred stock and common stock. That certainly could be impacted by an acquisition. With regard to an acquisition, we also want to know if there are certain returns or thresholds that need to be met—whether it is on a GAAP basis and/or a statutory basis—so we can use it as a scorecard to track the accounts. We want to make sure that with an acquisition, whether it is a block or a whole company, those targets are going to be met by management and be executed.

If they are looking for return on assets on a GAAP basis of 12–14% or ROI of 13%, we do not hold them to within 10–15 basis points of that return. We expect it to come within the neighborhood so we can understand this going forward to build a comfort level, especially if that enterprise is going to do additional acquisition activity in the future. This is part of its role to grow business. Liquidity is obviously key.

Asset/liability (A/L) management is a good topic, because we send out an agenda four to six weeks before every meeting in which I or the people in my group are involved. Usually when there are interest-sensitive liabilities involved, we want a copy of the freshest cash-flow testing. If there is more frequent A/L modeling activity going on, we want to know how that is monitored and how those assets and liabilities are matched on an ongoing, active basis. This is a qualitative aspect of our review and one of the most important.

Management's expertise is connected with the face-to-face dialogues we have. We routinely have companies with 20–40 years of experience come in to visit with us. We go through their business plan, they share their projections, and we look to see their ability to execute. Some of the management from these particular companies will "semi-retire" and then maybe begin another start-up company and come back to visit with us. Our process for giving them a rating would be somewhat accelerated if we had a good understanding and a comfort level based on the past experience. By the same token, I know people who have driven companies into the ground and come back to meet with us several months later, without donning a different title or name. They assumed that we were going to start the company with a clean slate. Obviously, in those situations, the initial letter-rating process will be a little bit slower and a lot more cautious.

Measure capital adequacy. I think most people who deal with A.M. Best have a primary analyst assigned to them and are part of a team. We look at numerous ratios. We put a lot of weight on our proprietary model, which we do share with accounts upon request. It is called our best capital adequacy ratio (BCAR). If anyone here deals with P&C, there is a little bit of difference in that model because of different risks they view, but they call it BCAR. International is also developing one.

We also look at the NAIC risk-based capital (RBC), which our model closely follows in the four areas at risk. Ours has some unique tweaks to it, which I will address in a couple moments. Some key supporting ratios or relationships we look at are the adjusted surplus to liabilities, some of the old-liners such as net premiums to capital surplus, and direct premiums to capital surplus. Relative to what segment of business that is, what are some of the variances or ratios that would be acceptable for those peer companies? To oversimplify, an annuity company on an adjusted surplus-to-liability ratio is going to have a lower requirement than a life company. This would usually be in the single digits, as opposed to a company that is primarily a life company (by net premiums and reserves), which would be in the double-digit range.

For a peer analysis based on a company's rating, its size, and its mix of business, we can get very close to what some of those medians should be. We use that as a benchmark when we have the face-to-face meetings. Many people would argue that it is very difficult to find a peer company to represent your company, and I would agree. But we need something for a rough range and benchmarks relative to the ratings size and scope of business. We have more tangible items to discuss during our dialogue. We also get some unique qualitative information from visiting companies expressing flowery comments about their competitors. We will accept these comments, but we do not take them as gospel. On the other hand, if we have 10 or 12 companies making similar comments about their peer companies, it might be something worthwhile to look into. As part of our review, we could have additional dialogue with the company at hand to be fair and try to determine if there is something else we might be missing.

Our approach to the BCAR is a different one. It is small, medium, or large. The smaller companies are going to be held to a higher level or BCAR than the larger companies. One of the reasons is because of the inherent spread of risks that a larger company may have because of numerous insureds in its in-force business. The company may also have a large territory or be licensed in the U.S. plus select areas, as opposed to some small- to medium-sized company. These small- to medium-sized companies may say they are licensed in 10–15 states but are really obtaining business in possibly two states. There are some companies that are really modest in capital and surplus and might have $2–$3 million relative to the stage or the timing of the company's progress. If some of the key executive officers go out to lunch, this is going to have a negative impact if they charge it to the company on their capital and surplus. Based on some companies' size, there is a smaller margin of error—not that we particularly believe, as the banks did in the past, that the insurers are "too big to fail."

Some products that are in process as far as development require less strain in the first year, and maybe have a different commission structure attributed to them to manufacture. These are some things we consider that affect the model. There are different types of reinsurance that are in house or being developed that companies try to utilize for surplus relief. I think every company uses surplus relief, and I say that in the positive mode. I do not mean financial reinsurance. I mean that they lay off some risk, whether it is mortality or morbidity, with a larger entity just because of their present resources. I am not suggesting the old days, when a company would get a large ceding commission to do some window dressing of its balance sheet and then have to pay that back over a period of time.

The NAIC RBC is purely model driven. In A.M. Best's model, we use a lot of information that is supplied to us through the supplemental rating questionnaire to make some adjustments. We also use information from our management meetings and documentation from management that may allow the primary analysts to go back in and make certain adjustments—whether it is asset risk or interest rate risk—and enable us to have a better understanding. Our BCAR is going to be more conservative than the RBC because it is for rating purposes and also to differentiate between the low ratings and the high ratings or between what we call secure and vulnerable ratings as a starting point. When it comes to capital, this is always a major player in a review process to get at a certain level. It is all based on timing. Some companies may have a favorable rating, and everything else is going well. Marketing, operating performance, earnings, and returns are at levels where they should be versus peers for the specific rating, but they might be light on capital because they have had a growth surge. A statutory accounting framework has caused some first-year strain and eaten into that surplus base. They may have a parent with the financial wherewithal to make a contribution to keep that going. There are other companies that have come in, and all they want to know is how much capital they need to get an A rating. I hear it at least once a day, sometimes twice a day. Capital is a key part, but it is not the only part.

The other area that gets a lot of prominence in the higher-rated companies that A.M. Best looks at is what we call the "market profile." The market profile is the ability of companies to grow their first-year business on a consistent basis, and hopefully that business is a sound business and is profitable over a period of time. I am really addressing the noncommodity-type business, such as individual life. Variable products are great when the marketplace is doing well. They certainly are an alternative, and many companies have to have them in their portfolios. If the variable products and the annuity commodity products were carved out, the growth trends would look a lot different.

Capital also gives us a comfort level when a company has the ability to do three things. One, can the company generate it internally through its retained earnings? Two, can it be part of an organizational structure that has a parent willing to make a true contribution to support its growth and to give the comfort level to maintain the present rating? Three, can it take it to the next level?

Mr. Wade: Next I will introduce Mike O'Connor, who is the senior vice-president and the chief actuary for the American Annuity Group, with the parent holding company for Great American Life Insurance Company, and a number of other smaller niche companies that they have acquired over the past few years. Mike will speak on how the holding company tries to manage the needs for capital, vis-à-vis the regulatory and rating agencies and the group of stockholders who want a reasonable ROE.

Mr. Michael J. O'Connor: Reasonable ROE is one of the main points. American Annuity Group was formed just six years ago. At that point in time, Great American Life Insurance Company was our only life company. It remains our largest insurance company, with about $4.5 billion of assets. As of business-close today (October 19, 1999), we should have five other insurance companies; all of which have been acquired over the past five years. They tend to be in niches in either different parts of the country or different segments, or complementary segments to us. We do own a couple of marketing and sales agencies across the country as well. In total, we have about $7 billion of GAAP assets, so I consider our company, our organization, to be a medium-sized insurance company. From a capital management perspective, one of our ultimate focuses is GAAP ROE in terms of profitability measures. Like a lot of companies, we use statutory and total rate of return in the pricing process as a kind of proxy for GAAP ROE, but our ultimate profitability measure is GAAP ROE.

There are four different areas I will talk about. They are (1) the different types of things all companies should know about their different business units, (2) the business and the financial forecasting process,(3) the art of capital management, and (4) different ways of returning capital money upstream to a parent. My background is with a stock company, so if people are in a mutual company environment, hopefully some of the things I say will help or at least shed light on how we approach this process.

You have to know where your capital is. This sounds pretty trite, but one challenge for us over the past few years is that five years ago, we had one insurance company. It was very easy to know exactly where the capital was. Now I am talking about GAAP equity, as well as required surplus. But over the past five years, the lines have become blurred. Within one legal entity, we might now have three or four different business units operating in one life insurance company. Over the past year, we have been focusing on segmenting results by a profit center or a business unit. We have been trying to get to know exactly where our GAAP equity is by profit center, not just by legal entity. If you have the information in terms of where your GAAP equity is and where your capital is by line of business, then calculating your return on capital is fairly easy.

Another change we were focusing on this year is key profit drivers. We are measuring these things at the business-unit level, because our business has gotten a lot more diversified over the past few years, and we have entered into new lines of business: life insurance, long-term care, and a few others.

The question is, Where is your capital on a statutory basis? It is pretty simple and straightforward to segment your capital and required surplus into the various lines of business. You may or may not have any excess capital within your life companies. A rough approximation that can be used as GAAP equity is your required surplus, plus your after-tax deferred acquisition cost and GAAP differences. Technically, it is not this simple. There are a lot of other complicating items to go from statutory to GAAP equity, such as interest maintenance reserve, not-admitted assets, and a number of other items. But the value of this simple formula is a lot easier to get one's arms around where the GAAP equity is.

The last item, 65% of the excess of the statutory of the GAAP, is one thing I would like the pricing actuaries to focus on in the pricing process, to make sure they minimize that capital in effect. Most of our products are annuity products. With some other product lines, it is a little more difficult when you have GAAP reserves on a net-level basis and statutory reserves on a one- or two-year full preliminary term basis.

Key profit drivers. Again, this is one thing our organization is focusing on developing this year. Key profit drivers are developed from the ground up within the business units, making sure they have buy-in and presenting to us in the parent organization. What are the key profit drivers, both in terms of actual results compared with pricing and actual results compared with our business forecast? Some of the components can definitely be managed; some of the components are a little bit more difficult to manage, like mortality results. It is a guaranteed product. There is not much you can do about it after you put the business on the books.

In the last few years, our organization returned to the life insurance business. It has amazed me how the profitability tends to vary by a lot of factors, including the reinsurance allowances, especially now with XXX coming on board effective January 1. It seems like the reinsurance allowances will probably be the main driver of profitability for the direct companies. The key profit drivers need to reflect how the business managers view their business. If they do not have buy-in and if these are the four or five main profit drivers of their business, then you are calculating a bunch of numbers and ratios and tracking things.

Looking back over the past five years, there have been some new designs where there are some unknowns in terms of the reserving, or the RBC impact of some new products. For small companies in particular, some of these types of products might be a bit dicey in terms of getting into a new product line and finding out two years later that the reserving or the RBC requirements are significantly different than anticipated.

Many medium (and even some large) companies have used reinsurers to lay off some of the risk of equity-indexed annuities, as well as some of the enhanced designs on some variable-annuity products. This results in a shift of business risk to a reinsurer who is willing to take that risk. That is a good way to manage your capital in light of uncertainty around product design reserving and RBC implications. Reinsurance is definitely a way to enhance returns.

One thing our organization considered starting in 2000 as a way to handle XXX is offshore captive. We have decided to not pursue this right now, but there are other possibilities in using offshore captives to manage your capital, and therefore your returns.

I am also going to talk about buying blocks of business. We just got back into the life insurance business within the last two years, so we do not have much of an in-force block buildup. One thing we will probably be doing is starting to look at blocks of business to buy and to spread that infrastructure cost over leveraging operational capacity. There are some regulatory changes coming along XXX. We will be entering some new lines of business toward the end of 1999 and into 2000 so that the financial forecasts line up with the business forecasts. You have to have your business managers assess where they are, what they do well, and what they do not do well. Actuaries can play a key role in making sure that the financial forecast really lines up with business planning or business forecast, and informing management of your best guess in terms of the financial results.

One change this year in GAAP accounting is the change with respect to capitalizing and amortizing start-up costs. This is one problem our organization is still struggling with because we still want to invest in new start-ups. We were entering a new line of business this quarter and then into next year, and it definitely costs a noticeable amount of money. With the GAAP treatment change, you can expense that money rather than capitalizing and amortizing it over a three- to five-year period. Let us say this is one of the forecasting and capital management issues we were still dealing with. What is the best way to handle that?

For about a year and a half, we have been spending a fair amount of money to enter a new line of business. We have been talking with some reinsurers about sharing some of that business on a pure coinsurance basis. Then a thought occurred to me. I would love to be in a business where a direct company spends millions of dollars in start-up, and then I come along and start getting the business on a coinsurance basis, not having to share in those start-up costs. We were asking our reinsurers, if they wanted to share in some of their coinsurance, to reimburse us for some of the start-up costs, and on a proportional basis.

I think this is new for a lot of reinsurance companies to consider; at least, this is what we have been told by the two companies we were talking with. It has not been warmly received on their part. From a business perspective, we have spent the capital to get into the line of business, and if we were just letting off a little portion of the risk on a coinsurance basis, we were diluting our overall inception to date and return on capital without some type of reimbursement from the reinsurers. I think one of the reasons it has not been warmly received is that we brought up this idea with the reinsurers late in the process. On a go-forward basis, we will have these discussions more up front, in the planning process, and hopefully get some buy-in that way.

The main business challenges are distribution, operation systems, and regulations—our company entered new lines of business. We entered the variable annuity business just a few years ago, which is a big operational change in terms of systems, platforms, organizational changes, regulation changes, and reserving on new product types. In the business and financial forecasting process, another change we were implementing this year was trying to get a good feel on what returns we were getting on business that we were putting on the books today, both on an internal rate of return (IRR) basis and a GAAP ROE.

GAP ROE tends to be diluted in the early years compared with IRR. But if you are shooting for a certain return on capital long term, it is good to have an honest assessment of what returns on capital you are getting today. That can vary quite a bit by product. Since we have acquired a few companies in the past few years, we definitely want to understand that in terms of purchase GAAP (PGAAP).

When we buy a company, we know what long-term return to expect. The PGAAP modeling we do in our due-diligence phase, before we agree on a price with a company, is to ensure that we understand the initial GAAP ROE, which is usually below your long-term hurdle. Two or three years down the road, if we spend $100 million to buy this company, what is our actual return versus our expected return at point of purchase. The impact on key profit drivers is that there are a few things we start tracking, primarily on the expense side: actual to pricing, actual to the plan or forecast, and mortality.

We track mortality, actually pre- and after-reinsurance, because you can get different impacts if you have an axis-of-retention type of YRT arrangement. You need to look at the mortality results before reinsurance to compare your underlying pricing assumptions. In terms of your bottom line, you need to take into account the reinsurance impact. In the forecasting process, if there are certain key drivers, such as expenses if it is health business or some of your loss ratios, what specific steps are you going to take next year or over the next planning cycle to get those ratios back in line?

It is definitely an art of capital management. As part of the planning process, the management team has to make a determination about the business plan. Is it really compelling, especially in terms of startup activities? Are you trying to get into new types of lines?? Are the returns going to be at the levels you want? Or flipping the question around, what do you need to do better to make those returns what you want them to be? If you can't accomplish this, what can you do?

There are reinsurance alternatives, namely, buying blocks to spread out some of your fixed costs. There are ways to return excess cash (dividends) to a parent through management fees. All these examples are legal, as long as you are charging a market rate on your management fees, your information services fees, or your corporate services. One thing we do is if we have excess capital, rather than keep it in the life insurance companies, we dividend it up to the parent and avoid the C-1 charge on those assets. Over the past five years, we have had excess capital sent up to the parent. This also leverages our returns.

Mr. Wade: Our last presenter is Buddy Maughn, who has spent 20 years with Employers Reassurance. He will cover some of the subjects connected with how the reinsurers might help out with some of the capital dilemmas that might occur with his expansion programs.

Mr. James D. Maughn: I would like to cover a few reinsurance applications and talk about the benefits of reinsurance in managing your capital, as well as give you some suitably masked examples of a couple of transactions that should illustrate these items. I will finish with some reasons why you should use reinsurance to manage capital.

The applications are numerous. In today's world, we see an awful lot of acquisition and divestiture activity, even in small blocks and in small companies. Reinsurance can be frequently utilized to assist in those transactions that are perhaps larger than you might otherwise consider. The additional application of improving your capital position from a variety of angles is through new business, surplus strain, RBC relief, disfavored assets being divested, and commission financing, that is, cash and/or noncash.

The ability is to improve your statutory IRR and GAAP ROE, smooth your statutory earnings results, and transfer capital or shift income period to period. Some of the benefits of these applications include:

- Obtaining relief from redundant statutory reserves
- Establishing capital requirements a little closer to a level of risk equity by financing the difference between statutory and GAAP reserves at a lower cost of capital and achieving more favorable returns on equity and IRRs
- Increasing investment flexibility and actually enhancing yields
- Freeing up cash or liquidity for acquisitions and/or lowering your cost of capital for an acquisition
- Getting RBC relief from investing in high-RBC assets
- Being flexible in statutory earnings management

This is a nice laundry list of potential benefits, but until you have actually done a transaction to see these benefits, they may or may not seem reasonable to achieve.

The four examples I would like us to walk through briefly start with a hypothetical acquisition, where the reinsurer is one of three parties (Table 1). In this first example, the reinsurer is between the seller and the ultimate buyer and participates in a percentage of the risk on a permanent basis. In addition, the reinsurer provides support for the ultimate buyer through financial reinsurance to minimize the statutory strain on the business. In this example, if you look to the IRR on a simple two-party arrangement where the seller transacts with the buyer, that produces a statutory return of 9.5% with a GAAP ROE of 11.4%. These are after-tax illustrative numbers.

TABLE 1
HYPOTHETICAL ACQUISITION (000's)

Initial Statutory Reserves 495,520
Ceding Commission 118,925
RBC 14,866

	Traditional Acquisition				Reinsurance Partnership			
Year	Stat Profits	Stat IRR (%)	GAAP Income	GAAP ROE (%)	Stat Profits	Stat IRR (%)	GAAP Income	GAAP ROE (%)
0	(102,077)	-	0	-	(3,469)	-	0	-
1	13,761	-	8,663	11.5	(513)	-	1,104	21.7
5	12,116	-	7,752	11.7	(207)	-	2,442	19.0
10	9,475	4.4	6,377	11.8	5,852	1.1	5,889	17.2
15	7,217	8.3	5,074	11.7	5,111	17.8	3,510	17.1
20	5,334	9.5	3,527	11.4	3,780	19.9	2,439	18.3

Through a reinsurance partnership, the substantial statutory strain is significantly minimized. Although it continues slightly in the early years of the transaction, by the time you progress 20 years, you can see the IRR has improved rather dramatically, from 9.5% to almost 20%. The GAAP ROE is also substantially increased, from just over 11% to about 18%.

The reinsurer is retaining 30% of the risk on a permanent basis and is providing assistance on the other 70% of the modified coinsurance transaction. It is always useful to look at reinsurance as being utilized by the ceding company. Please also look at why the reinsurer would be interested. This transaction produces a certain return on a GAAP and statutory basis. If you look through the minor differences, because some effects of RBC are attributable to the difference in size and makeup of the companies, you have a zero-sum game. What is happening here is the reinsured's returns are increasing, and the reinsurer probably has a lower return.

The question might be, Why would the reinsurer be interested in doing this? Trying to understand the motivation of the reinsurer, as well as thinking through the ramifications from the way the rating agencies and the regulatory folks will look at the transaction, is always useful with respect to any potential transaction. As in this case, the reinsurer is effectively benefiting from the ceding company's locating a transaction—essentially its marketing effort—and attracting the business to it. This is one reason it might be willing to accept a little bit lower return, plus it is also deploying capital that might not otherwise be utilized. There are potential tax benefits associated with this as well, although I do not want to suggest what tax benefits should be.

The next transaction example is one that is contemplated as an asset transfer (Table 2). The basic business being considered is a block of annuities. This concept is the quota share, 50% of the business, not on an original-terms basis. We will digress for a moment and suggest that any time there is a block of business to be considered, there is a wide array of ways to look at the variety of risks that are inherent in the book of business. The ability to share the risk between the two parties can be divided in a large array of ways as well.

TABLE 2
ASSET TRANSFER

Hypothetical RBC Relief/Yield
Enhancement Reinsurance of Annuity Block
Quota Share 50%

Premium	500,000
Initial Reserves	526,701
RBC	21,068

Retailed Portion Reins Cash Flows Net after Reins

Yr	Distr Cash	Distr Profits	Distr Cash	Distr Profits	Exper Refunds	Interest Bonus	Distr Cash	Distr Profits
0	0	(40,455)	0	(22,861)	0	0	0	(22,861)
1	0	5,877	0	2,985	0	401	401	3,385
5	0	5,824	0	2,978	0	379	379	3,357
10	3,989	5,515	1,995	2,847	1,938	324	4,257	5,109
15	3,395	4,842	1,697	2,526	1,655	245	3,597	4,425
20	2,561	11,204	1,281	5,704	1,254	159	2,693	7,117
IRR		12.76%		11.18%				16.34%

Let's think back to the reference of the utilization of a reinsurer. Trying to support new business and having the reinsurer participate in some of the start-up costs are very logical and reasonable things to contemplate. Is this an appropriate and reasonable thing to consider? It is also very much of a partnership when the reinsurer is being asked to participate from the ground up. The way you can split up this wide array of risks that exist is multifold. In the instance where you want the reinsurer to participate from the onset of contemplation and development of a product and to support the actual capital associated with the start-up of the line of business or product, you might need to involve your partner completely and thoroughly from the beginning. So it is a very differently contemplated relationship than what you might consider if you were strictly looking at yearly renewal term on an excess basis of some portion of your term portfolio.

The concept is to reinsure a portion of the portfolio, 50% in this example, into another company that has the ability to perhaps not weather the effect of the RBC as significantly. They may not even be a rated entity and hence not concerned with RBC. With respect to the assets transferred associated with the liabilities, a willingness to allow investment in higher-RBC assets would be the basis for the enhanced yield. Specifically, equities are utilized for a portion of the liabilities; it is 20% with respect to the reinsurer.

I would caution that this does not make sense for many liabilities. In this particular example, we were talking about very long tailed liabilities, perhaps in excess of 40–50 years, with 30–40% of the liabilities on a present-value basis. Equities might be a very reasonable alternative to consider for a portion of the assets as a basis for additional participation with respect to risk and enhancement of yield. The experience refund column is essentially a kind of profit return, since the reinsurer is not necessarily participating in much risk in this example, and the interest bonus is the consequence of an assumption of a yield pickup of about 150 basis points. The IRR does increase rather significantly, from about 12.75% to 16%. It is very possible this example can happen.

Let's discuss dealing with disfavored assets, I have an example where we have combined the actual sale of mortgages that may have been underperforming for the impact on your RBC or rating. I have coupled that with a transaction where a portion of business is reinsured to create some surplus relief or financial reinsurance-type transaction to minimize the impact of taking the loss on a statutory basis (Table 3). It is essentially a package of financial reinsurance with the sale of some assets.

TABLE 3
DEALING WITH DISFAVORED ASSETS

	Before Action	Sale of Mortgages (1)	Reinsurance (2)
Mortgages	200	50	50
Other Assets	800	920	800
Total	1,000	970	850
Liabilities	920	920	770
Capital & Surplus	80	50	80
Total	1,000	970	850
Net Income	-	(30)	0
RBC	62	55	47
RBC Ratio	128%	90%	170%
Mortgages to Surplus	250%	100%	62.5%

(1) Sales of 150 Mortgages at 80% MV to BV
(2) Coinsurance of 150 of Reserves; Transfer of 150 Mortgages at 80% MV to BV

Why would a reinsurer want to even consider such a transaction? It is an opportunity for it to deploy capital and get a fee income, as well as some potential tax benefits. The reinsured, on the other hand, gets some RBC benefit plus the elimination of the disfavored assets without affecting its statutory result. The reinsurer does come into play by providing additional capital at risk, so the rating agencies and regulators would look at this transaction favorably in that it protects future statutory profitability and smoothes it, as well as reducing the required capital.

This last table is a new-product example (Table 4). It is a single-premium product illustrating both a 40% and an 80% quota share. This is a quota-share transaction with respect to the risk, not necessarily with respect to all of the expenses. Because the reinsurer is not participating 100% on all the expenses, the reinsurer does not necessarily expect a return consistent with what the direct company is going to see. You can see the increase improvement in the IRR again by looking at the bottom line, the larger quota share. This is intended to be an example of reduced-risk participation on the part of the reinsurer.

TABLE 4
IMPROVE NEW PRODUCT IRR

	STAT Projection for Hypothetical SP Product				40% Quota Share Reinsurance			Additional 40% Quota Share	
Yr.	Premium	Net Stat Gain	Allocated Surplus	Distr Profits	Unamrt Ceding Comm	Net Stat. Benefit	Profits after Reins	Net Stat Benefit	Profits after Reins
0	100,000	(7,500)	5,640	(13,140)	4,000	2,688	(10,452)	2,688	(7,764)
1	0	1,200	3,786	3,054	3,600	(385)	2,670	(385)	2,285
5	0	1,500	4,514	1,306	2,000	(338)	967	(338)	629
10	0	2,000	5,626	1,758	0	0	1,758	0	1,758
15	0	2,800	7,011	2,498	0	0	2,498	0	2,498
20	0	3,800	0	11,800	0	0	11,800	0	11,800
IRR				12.6%			14.0%		15.4%

Reinsurance is one of multiple alternatives you have with respect to capital raising. Why use it if your circumstances are such that debt is a possibility, or capital is being raised in the equity market surplus notes and debentures? It is worthwhile to use careful management in contemplating all of these sources, but specifically reinsurance benefits (both asset and liability classes), as well as income. You can achieve debtlike cost with equity-like benefits, and it is easier and more flexible to put in place than other possibilities. Premature asset sales may be undesirable; you can utilize reinsurance to avoid that, as well as reinsurance protecting the statutory earnings of the company. However, reinsurance does reduce risk in most instances.

While you do have other options, one of the real advantages of reinsurance is that it basically reduces risk for the enterprise, whereas the other options tend to increase risk for the enterprise. In conclusion, I would like to encourage small companies to think big and contemplate transactions where they can utilize a partner through reinsurance to achieve the results they are seeking.

Mr. Paul H. LeFevre: Mike, you indicated that in your holding company you keep the capital levels at your optimal or required level and then you dividend up cash to the holding company. How do you manage that cash at the holding company? Do you invest it differently than you would if it were down at the company?

Mr. O'Connor: We invest a little bit differently. With the cash of the parent, there are a couple of asset classes we tend to specialize in, so we might have a little bit higher allocation to those classes. The main advantage there is the lack of a C-1 charge to drag down your returns. We generally do not get into any new asset classes. There are a couple classes we think we know well and that we can operate well in. Instead of being 25–30% of the assets in the life company, they might be 50%.

Another thing we do with the cash of the parent is to maintain the same amount of liquidity with that cash, because if an acquisition came along six months later and that is what the cash were for, we would want to maintain those assets as liquid. For instance, we would probably not do commercial mortgages and real estate, but other liquid investments are things we would do.

Mr. R. Dale Hall: I am trying to link Richard's and Buddy's presentations together. In the RBC and the BCAR types of calculations, there seem to be some charges for the amount of claims reinsurers have. I am curious to hear from Richard. How much impact on your actual A.M. Best rating does the reinsurer have?

Mr. Kirk: We were always looking for what we call *quality reinsurers*. When I first started with the company, we had a tangible list of preferred reinsurers to deal with. To expand this list in the modern era, we would use companies that we consider to be highly favorably rated, and we have been able to sustain that position over a period of time. We do look at that as far as who the partner is and who the counterparty is. Over the hundreds of reinsurance contracts I have reviewed, we look to see if the reinsurer would evaporate and also at the quality of reinsurers.

From the Floor: I have a couple questions for Mike. The first one is that you say you look at GAAP ROE as a target. What sort of hurdle do you benchmark against that? When you attribute capital to a line of business shown in your formula, what kind of thinking process goes into that formula, and would you ever look at the volatility or riskiness of the earnings of that line?

Mr. O'Connor: In terms of return hurdles, we were in the double-digit range. It tends to vary for new business. There are more hurdles for acquisitions, depending on how good a fit it is with us. In terms of the variability of earnings, at this stage we do not do that. We use whatever rating formula is driving our capital at any point in time or that we expect to be driving our capital. Currently, it is not the NAIC formula. It is one of the other rating agency's models that we would use for the required surplus formula. We want to make sure that in the breakdown of our GAAP equity, we were reflecting the actual required surplus or capital on a statutory basis that we were holding.

Right now, our formula for capital holding is being driven by one rating agency in particular. We have considered, and are considering, developing our own formulas. This is probably a project for next year, trying to look at the variability of earnings across product lines. The difficulty is in trying to get as close as we can to an apples-and-apples basis. What is interesting is that you tend to perceive the product lines as being at one level of risk. The new product lines that might be in the rest of the industry are perceived as having a much higher level of risk. Trying to get these measures on an apples-to-apples basis is very, very difficult.

Otherwise, in terms of variability, how do you compare a long-term-care policy to a payroll deduction for a flex annuity sold to teachers in the K–12 market?? This is a very difficult question to answer. On the forecasting side for new lines of business, the variability of earnings two or three years out is definitely going to be greater for new lines of business.

Mr. Richard B. Pitbladdo: This is related to issues brought up by Buddy, but I will direct my question to Richard. Much of your activity is focused on how much capital ought to be held on top of NAIC reserves, yet much of Buddy's activity is how to help companies with onerous redundancy in the underlying reserves. What is your approach to the issue of reserve redundancy? Do you build any quantitative models with respect to that, or do you just use it in your qualitative analysis?

Mr. Kirk: Internally, it is a qualitative issue that we try to quantify with some documentation. Nine out of ten companies (or probably ten out of ten) say that they compete based on their quality of service, the line of business, and the underlying exposure. However, everybody comes in and tells us that they have a cushion as regards reserves. Whether that is for the tax collector or not is something we try to factor in. We inherently acknowledge these or apply these in the equation. If the relative capitalization position is short, that becomes more of an issue. Then we will ask for additional documentation and probably additional outside valuation of the true excess of that reserve and will then factor it back into our model. Only very rarely do we give a dollar-for-dollar credit based on that research.

Mr. Pitbladdo: My question really did not focus on practices in between individual companies but rather on differences across the different products. To make the question tangible, what are you going to do about XXX when all of a sudden the underlying reserve standards are going from one level to something completely different? Are you going to track the new products as having XXX so that we will be more favorable toward them because they have higher underlying reserves?

Mr. Kirk: I will handle the first part and then turn the second part over to Buddy. First of all, what we had witnessed through many of the existing term riders—large term riders or the wanna-be term riders—is that there is going to be a fire sale on term insurance. Some Internet services, such as SelectQuote or Quotesmith, give you a weekly array of insurance cost for the same amount of insurance per thousand that continues to drop, depending on the age and no change in the health status. Things we look at within our review that will continue to be factored into our process are the following: How are we going to treat that as far as a block of product under the existing code, and, how is this going to change in the new millennium? We have heard about XXX on and off over the last 18 months with different levels of intensity. People are rushing up to the plate with some opinions and various states behind them, and then they are receding. This has been an ongoing phenomenon for us.

Mr. Maughn: I will put out an additional comment with respect to XXX. I think reinsurers in general need to focus on more extensive communication with each other and internally within companies. I am trying to suggest that pricing and valuation people need to talk with each other. Also, the expected potential use of reinsurance should involve up-front conversations with your reinsurer. For those of you who have worked at pricing new products for XXX and have an appreciation for an increase in the reserve and capital, it is imperative for us to understand each other at the beginning in terms of what is expected in the way of reserve credits. Because of the overwhelming nature and magnitude of this, it is very important to have rather extensive dialogue at the onset.

Mr. Wade: With regard to XXX and other things of that nature, how much analysis do you see A.M. Best doing on the actual profitability of products that are being written now? How much do you see that growing in the future as a part of the analysis?

Mr. Kirk: I do not know how many of you are familiar with *Best Policy Reports*, but we routinely survey companies on a myriad of topics from term through variable annuity. This year we added index annuity, for example, long-term care. Basically, we try to look at the historical performance of those products as stated to us and how that translates into reality. This supports our existing peer database and analysis of companies. It is also a continuation of what we have been asking through our questionnaires relative to types of product and distribution system, i.e., what is your first-year statutory gain on this as simplistic to the GAAP profit? We will continue to look at the actual results versus the assumptions the companies lay out for us.