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# In the Middle: Role of a Reinsurance Intermediary

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Picture yourself attending a social event, one not related to the insurance industry. We've all been there. Someone approaches you, introduces himself, and you do likewise. Then he asks the dreaded question, "What do you do for a living?" You proudly say, "I'm an actuary by training." Now unless you live in Hartford (CT that is; and I lived there in the early 1990s) where non-insurance industry individuals know what an actuary is, in most other places the person stares at you with a glassy look in their eyes and nods politely. You think to yourself, *Should I go to the next step and say, "I'm a reinsurance intermediary" or try to explain what an actuary is?* It's obvious that the person in front of you has no clue about either of them.

Since this article is appearing in a section newsletter for the Society of Actuaries (SOA), you will have an adequate understanding of the first statement, "I am an actuary by training." However, you may or may not be clear on the second, "I am a reinsurance intermediary." In either event, please read on to come to a better understanding of what reinsurance intermediaries do and what services they offer.

> The roll of a reinsurance intermediary is to allow the company actuary to sleep easy at night by transferring the "mystique" of reinsurance to a professional.

## WHAT REINSURANCE INTERMEDIARIES DO

A reinsurance intermediary can be compared to the real estate agent who works on your behalf to sell your house, brings in prospective buyers, and is compensated by the buyer of the property. Incidentally, the said compensation is part of the negotiated price the buyer pays for the house; the amount is disclosed in the settlement documents detailing the terms of the transaction.

Essentially, a reinsurance intermediary—aka, "intermediary" or "broker"—represents a ceding company in need of capital to support liabilities on their balance sheet. The intermediary finds and brings in sources of capital who are willing to assume risks by purchasing the liabilities for a price—the negotiated reinsurance premium. The premium includes the intermediary's compensation and is disclosed in the settlement documents (or "reinsurance treaty") detailing the terms of the transaction. Just like the real estate agent, the reinsurance intermediary "earns" compensation by bringing the two parties together.

But that's not the only service the intermediary offers. In property/casualty reinsurance transactions, intermediaries actually receive the premium payments from the ceding company and remit them to the reinsurer; likewise, intermediaries receive the benefit payments from the reinsurer and remit them to the ceding company. The use of the intermediary relieves the ceding company of dealing directly with and/or negotiating terms of the reinsurance treaty. This places the intermediary in a significant need for liability insurance as he or she is responsible for any mix-ups in the reconciliation of payments, understanding of terms, and so on.

Unlike in property/casualty reinsurance transactions, in life insurance (including annuities) reinsurance transactions, the two parties handle settlement of payments directly; the intermediary receives compensation (initial and renewal, if any) from the reinsurer. In health insurance reinsurance transactions, either practice may be used based on the wishes of the ceding company.

One of the reasons, if not THE MAIN reason, why life reinsurance intermediaries are not involved in collecting/distributing cash flows is the extremely expensive and limiting availability of liability coverage. It is not uncommon for the premium for $1 million of liability coverage to range between $10,000 and $15,000 annually. If, through negligence, the reinsurance intermediary is at fault and is sued, the harmed entity would want to extract more than $1 million in damages. Therefore, life reinsurance intermediaries choose to be LLCs (limited liability companies) and maintain "lean" bank accounts. On the flip side, many PC intermediaries are housed inside large corporations for which the liability coverage is folded into their normal E & O coverage.

## WHAT IS THE PURPOSE FOR REINSURANCE?

Before going into detail about the services provided by reinsurance intermediaries, let's spend some time discussing what reinsurance is and why companies use it. Simply put, reinsurance is insurance purchased by an insurance company to cover all or part of certain risks on policies the company issued. Reinsurance is a financial solution allowing a company to market, solicit and sell policies of any size, regardless of the company's surplus position.

Actuaries determine the appropriate retention level for policies issued by the company in relationship to its surplus. For example, suppose the actuary at ABC Life Insurance Company determines its surplus is sufficient to assume $200,000 of risk on any policy sold by the company on any life. What happens when the agent for the company sells a $1,000,000 life insurance policy? ABC retains the $200,000 of death benefit and sells $800,000 of death benefit to XYZ Reinsurance Company. This transaction is seamless to the insured. ABC needs to rely heavily on XYZ to live up to its agreed part of the transaction if and when the insured dies.

Reinsurance doesn't involve just one policy; it involves blocks of many policies sold by ABC. Without reinsurance, ABC would be insolvent because it would need to hold enough surplus to cover all the potential death claims on the policies it sells. Therefore, the main purpose of reinsurance is the transfer of risks ABC doesn't want to retain. In exchange for the transfer of risks to XYZ, ABC doesn't need to hold the full reserve (liability) for the amount of death claims in excess of their retention. ABC therefore is allowed a reserve credit for the portion of the risk transferred to XYZ, and XYZ is required to hold the appropriate reserve for the risk it assumes.

## WHAT ABOUT THIS TRANSFER OF RISK AND RESERVE CREDIT?

Let's look more closely at the financial implications of reinsurance on the ceding company (ABC) and the reinsurer (XYZ). We all know insurance is a highly regulated industry. Insurance regulators are concerned with protecting the consumers within their jurisdictions to be sure insurance companies live up to the promises they make when selling policies.

Since part of the risk assumed by insurance company ABC is transferred to reinsurer XYZ in exchange for the reserve credit on ABC's balance sheet, regulators want to be sure the risks transferred comply with certain rules before ABC is allowed to take the reserve credit (a reduction in liabilities and an increase in surplus).

*Risk transfer* is the equitable transfer of all significant risks and responsibility for payment of future benefits, from the ceding company ABC in exchange for reserve credit, to the reinsurer XYZ in exchange for compensation (reinsurance premium). Eleven risk transfer rules apply to coinsurance reinsurance transactions. *Coinsurance* is a form of reinsurance whereby ABC and XYZ share an equitable "partnership" in proportion to the premiums paid by the insured: the benefits provided by the policies and the expenses incurred in administrating the policies. Other forms of coinsurance are modified coinsurance and coinsurance funds withheld. When *coinsurance* appears in the title of any form of reinsurance, the ceding company and reinsurer retain their respective "partnership" relationship.

If the reinsurance is defined as *yearly renewable term* (YRT), only 7 of the 11 rules apply. YRT is a form of reinsurance whereby XYZ determines the reinsurance premium to be paid by ABC; each company is responsible for its respective proportion of benefits provided by the policies.

As long as the relevant risk transfer rules are followed, the ceding company ABC will be entitled to reserve credit because XYZ holds reserves for its proportion of the risks assumed. Just as there are rules for risk transfer, there are also rules governing the reserve credit allowed to ABC and the collateral required to be held by XYZ. These rules emphasize the consumer protection imposed by the regulators to be sure ABC and XYZ are financially secure and can pay benefits.

## WHAT SERVICES DO REINSURANCE INTERMEDIARIES PROVIDE?

Now let's turn to the services intermediaries provide to ceding companies. Since insurance and reinsurance are highly regulated, the services provided by intermediaries coincide with being sure the regulations are followed so that ABC can transfer risks and receive reserve credit. These services include, but are not limited to, the following:

- Adhere to the ceding company's (client's) instructions and written standards
  - Identify the client's need for capital and the purpose for reinsurance
    - o Determine if ceding company-owned captive is an alternative; if so, assist in all facets of captive formation
    - o Advantages/disadvantages of on-shore versus off-shore jurisdiction
    - o Determine if traditional third-party reinsurer is an alternative
  - Identify what risks are to be transferred; in-force block of policies or new business policies as they are issued
  - Assist in the financial analysis of potential blocks of policies to be reinsured
    - o Review experience assumptions
    - o Review cash-flow analysis
    - o Include pre- and post-reinsurance analysis
  - Assist in preparation of requests for proposal (RFPs) to solicit potential reinsurance sources
  - Obtain written permission from the client before negotiating reinsurance terms
  - Disclose any relationship with potential sources of solutions (such as banks, other insurance companies and/or reinsurers) to the client
- Solicit potential reinsurance solutions from reliable sources
  - Obtain financial strength and solvency ratings of potential sources
- Assist in the review and analysis of proposed reinsurance solutions from all interested sources
- Facilitate the negotiation of terms and conditions for potential reinsurance solutions between the client and potential sources
  - Do not accept any terms or conditions on behalf of the client
  - Provide only the data the client has authorized for exchange
- Do not accept any allowance, proceeds or other settlements or instructions from any of the potential sources on behalf of the client

Just as regulations govern the actions of ceding companies and reinsurers, intermediaries must be licensed by the state in which they are located and operate. It is generally agreed that each state provides a reciprocal agreement eliminating the necessity of being licensed in all jurisdictions in which the intermediary may practice.

## WHAT ABOUT THE FINANCIAL SIZE OF THE CLIENT?

Clients may consider the intermediary as an extension of their staff. The intermediary's purpose is to remove the burden of reinsurance solicitation and negotiation from their plates to allow them to concentrate on their everyday responsibilities. Reinsurance is an infrequent activity, not something a company actuary does on a regular basis. The need for reinsurance arises with the development of new products or an expressed need to raise capital embedded in a block of policies or to acquire a block of policies from another company.

Reinsurance activity is something with which intermediaries are involved on an almost daily basis. Their role is to allow the company actuary to sleep easy at night by transferring the "mystique" of reinsurance to a professional. Here are some examples of client engagements an intermediary may have:

- Performing cash-flow projections of future profitability to determine appropriate quota share proportions of a block to be reinsured
  - Helping clients to evaluate appropriate levels of economic reserves for potential XXX/AXXX reserve redundancy financing solutions
  - Helping clients to form captive reinsurance companies for the purpose of securing XXX/AXXX redundant reserve financing solutions

- Assisting clients in securing financing solutions for XXX/AXXX redundant reserves

- Helping clients to understand reserve requirements under VM-20, AG 48 and PBR

- Helping clients to recapture blocks of reinsured policies due to an increase in their retention limit
- Helping clients to understand complex reinsurance structures for transferring variable annuity living benefit rider risks
- Helping clients to understand how special banking transactions can overcome the high minimum guaranteed credited interest requirements in legacy fixed annuity blocks of policies
- Assisting clients in preparing request for proposals (RFPs) to evaluate and select mortality risk reinsurance partners for term insurance products
- Representing clients in the role of expert witness to testify at arbitration or mediation proceedings

The degree of assistance depends on the size of the company. Many large clients have existing relationships with the same sources as the intermediary. Thus, they may be reluctant to incur the extra expense of intermediary compensation, which will be a factor in the price of the reinsurance solution. However, the intermediary may be able to complete the transaction in a much shorter time frame; he or she may know the right decision makers at the potential source company to complete the transaction; and his or her dedicated effort can free up internal resources for other more important tasks. Intermediary compensation is also immaterial for the client compared to the cost of the solution.

With medium and small companies, the intermediary's expertise and knowledge play more important roles. He or she can open doors to potential sources with which the client has no previous contact, and using the intermediary as an extension of the client's staff allows the reinsurance transaction to take prominence over other internal projects.

This has turned into a long explanation of what a reinsurance intermediary does. Back to that social event. At the end of your conversation, you exchange business cards. I like this part, because mine says, "Securing financial solutions to improve the bottom line," to which my new acquaintance usually says, "Oh, that's what you do!"

Until next time, may all your experiences be profitable ones!

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