The Future of Producer-Owned Reinsurance … is Now!

A Life Insurance Perspective

How the Right Business Structure Can Align Incentives
and
Create Wealth

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This paper describes the benefits of producer-owned reinsurance, and key issues participants in producer-owned reinsurance need to consider. To put these issues in context, the paper also presents a brief history of reinsurance and its fundamental principles. The paper is not intended to provide legal, accounting, actuarial, or tax advice. Competent professional advisors should be retained to provide advice on these issues.

The author has made reasonable efforts to check the accuracy of the information in this paper, however there is a possibility of errors, and the author cannot be responsible for any damages that may be caused by reliance on information in this paper.

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Producer-owned reinsurance is of growing importance in the insurance market, for producers and insurance companies focused on establishing long-term value. As life insurance producers consider the possibility of their involvement with reinsurance, there has been no single resource that covers the many facets of this decision. This paper is designed to fill that need. This paper has been produced under the sponsorship of Global Preferred Solutions, Inc. to outline the important issues that life insurance and annuity producers, and their advisors, need to consider when deciding whether and how to become participants in producer-owned reinsurance

Executive Overview

Producer-owned reinsurance can benefit consumers, producers, and insurance companies by aligning the interests of these three groups. During the last twenty years producer-owned reinsurance has become a way for leading insurance producers to share in the profits of the business they produce, creating wealth by becoming financial partners with the insurance companies whose products they sell. Producer-owned reinsurance creates a strong incentive for agents to produce quality business with high persistency, thus aligning the interests of consumers, producers, and companies in the life insurance business.

When insurance producers examine the business of reinsurance, it can seem overwhelming. Producers may be concerned about entering a technically complex business for which they do not have an adequate background. This paper shows how producers can overcome the barriers to entry and benefit from the long-term value that they create. There is a lot to consider, but existing service providers have opened the path to entry.

Why Do It?

Why would a producer want to get involved with reinsurance? The answers are clear from the experience of top producers who have already gone down this path. The most obvious reason is that reinsurance can create substantial wealth, even exceeding the producer's commission income. This is illustrated in Charts 1 and 2 (see pages 8-9), which show the leverage created through

participation in the profitability of business written and reinsured. Essentially, the producer is enabled to continue benefiting from transaction based commissions through the traditional sales relationship and increase his/her net worth through participation in the business reinsured.

Perhaps equally important, however, is the ability of the reinsurance arrangement to transform the nature of the producer's job. Instead of a totally transaction-based incentive system the producer now has the direct incentive to produce quality business, and the satisfaction of benefiting from the long-term value of the business produced. Sharing in the economic results, the producer is often empowered to influence or even create products that cater specifically to his or her market.

Marketing of life insurance products has traditionally had a short-term focus, with the producer earning most of his or her income at the time of sale. The producer's incentives have not been tied to the long-term profitability of the business, so the company's and the producer's objectives have been different, or even in conflict. Insurance companies and producers have seen producer-owned reinsurance as a way for both parties to benefit from the long-term profitability of the business. The insurance company and the producer then have similar incentives. The resulting symbiotic feeling of partnership benefits both companies and producers. Consumers also benefit from a marketing structure that is more efficient, with the potential for more accurate pricing, and from the long-term relationships that are encouraged between producers and insurance companies.

Basic Structure

For producers with a substantial volume of business there should not be much difficulty in participating in a producer-owned reinsurance venture. Depending on the type of reinsurance structure, minimum entry points for participation may vary from as little as $50,000 to as much as $5 million, or more, of annual commissions on whole life or annuity policies sold.

As a practical matter, the biggest decision for the producer is the selection of a service provider, and deciding the amount of the initial investment. The investment required of the producer is determined by the types of products reinsured, the nature of the reinsurance contract, economies of scale, and leverage created through financial partners. As illustrated in Chart 3 (see page 17), a significant initial

investment will allow the producer to receive earlier profit distributions, and perhaps, greater returns on the investment. Producers who do not want to make an investment of this magnitude can still participate, but it may take longer to start receiving significant profit distributions (see Chart 4 on page 18).

There are four possible routes of entry into reinsurance:

- Establish an independent reinsurance company
- Participate in a reinsurance company owned by a group of producers
- Participate in a reinsurance company controlled by an insurance company
- Contract with an independent, turnkey reinsurance provider

Owning an independent reinsurance company provides the ultimate in flexibility and control, but is expensive, requires substantial management effort, and may fail to take advantage of economies of scale. Few producers will choose this option, and those who do will need extensive professional advice from attorneys, accountants, actuaries, and experts in the chosen domicile. There are much more efficient ways to get the benefits of participating in reinsurance.

Most producers will choose to participate in an existing reinsurance entity, either a reinsurance company owned by a producer group or one controlled by an insurance company, or contract an independent, turnkey reinsurance provider.

- A reinsurance company controlled by an insurance company (i.e., an insurance company "captive" reinsurer) will typically have lower volume requirements for entry, and may have lower capital requirements. This option will generally limit the source of business to only those policies of the sponsoring company, and may introduce other conflicts, as the reinsurance company tries to satisfy both its owner and the producers. The insurance company's bargaining power with the producer is certainly greater when the insurance company provides the reinsurance as well as the products.

- The producer-group "captive" reinsurance company has the advantage that the producer is dealing with his or her peers, and generally will have more flexibility in the business placed with the reinsurer. On the other hand, while this may be preferred to

the dependency on an insurance company relationship, it in turn creates a dependency through producer group affiliation.

- The option to contract with an independent, turnkey reinsurance provider can offer the most flexibility in relation to the products reinsured, and avoids potential conflicts of dealing with the insurance company's own captive reinsurer. This is a structure offered in offshore domiciles, including Bermuda, which recently enacted legislation to provide for the establishment of "segregated account companies", also known as "protected cell companies." This structure creates a sanctioned method for offshore reinsurers to legally segment business from one producer to the next. This combination of features allows producers the important benefits of owning an independent reinsurance company without excessive cost and administrative burdens.

Companies see producer-owned reinsurance arrangements as a means to attract more productive producers, improve mortality and persistency experience, develop longer-term relationships with producers and customers, and reduce marketing expenses. Producers are attracted by the prospect of increased earnings, wealth creation, a more effective role in product design, and a way to participate more broadly in the results of the business written.

On the other hand, companies may be concerned about increasing the bargaining power of producers, and potential dilution of the companies' profits. The bargaining power of the producers involved in any type of reinsurance arrangement, in relation to a particular insurance company, depends on the volume of business written, or potentially written, by the participants in the reinsurer.

What to Consider

Producers who want to participate in a reinsurance arrangement will have to consider the costs and benefits of participation, the steps to entry, and their exit strategy. Most producers will decide to participate in an existing reinsurance company, either one sponsored by an insurance company or one owned by an independent group of producers, or contract with an independent turnkey reinsurance provider. In any case, they and their advisors will need to consider the types of business accepted, the costs of participation, the method

for distributing profits, the interaction of their business risks with those of other producers, and the exit process.

Whether you are creating an independent company, choosing a producer group, contracting with a turnkey reinsurance provider, or deciding whether to participate in an insurance company's captive, you will have to consider the following key issues:

- Formation
- Structure
- Management

Each of these areas is discussed later in this paper, along with some other issues that will depend on the type of structure that is being considered.

Perhaps for the first time producers will be directly concerned about the profitability of the products they are selling. The profit of a block of business comes from a combination of the inherent profitability of the product, the quality of the specific block, and a random element caused by the risk aspects of insurance. The producer has control over the first two of these elements, the first by selecting the products that he or she sells, and the company represented, and the second by producing business with good underwriting quality and high persistency. The projected long-term profitability of the business is the essential element in the decision to enter a producer-owned reinsurance arrangement.

The Foundation of Producer-Owned Reinsurance

Background

Reinsurance is an insurance transaction between insurance companies in which an insurance company transfers all or part of a risk by entering into a contract with another insurance company. When it does this, it creates a reinsurance transaction. The company that reduces its risk, typically by paying a fee, is called the ceding company, and the company that takes on the risk is called the assuming company.

The origin of reinsurance is in transactions that relieve the ceding company of risks that would exceed its risk tolerance, thus transferring a portion of its risk to larger companies, or to groups of companies. This type of transaction allows insurance companies to offer customers larger amounts of coverage than would otherwise be feasible. As an example, suppose that a life insurer decided that it can accept the risk of up to $100,000 loss on any single life, but has a potential customer who wants a $1,000,000 policy. If the company can accept the risk, but cede $900,000 of the risk to another company, it can maintain its relationship with its customer and producer, while protecting its financial strength. This type of transaction is carried out every day in companies around the world.

Historical Perspective

Since its beginning as a basic risk sharing process, reinsurance has evolved to include transactions that involve every aspect of the financial operation of an insurance company. Among these are transactions that allow insurance producers to share in the financial results of the coverage that they write. This paper focuses on issues related to producer-owned reinsurance, but is not intended to cover the myriad of other aspects of the reinsurance business.

The origins of reinsurance go back to the fourteenth century in the reinsurance of ocean marine risks. Initially, the purpose of reinsurance was exclusively to spread risk among insuring entities, or to protect the insured against the insolvency of the insurer. During the 18th century, problems arose in England from policies that were reinsured for fronting companies in Europe. These problems resulted

in reinsurance essentially being banned in England for over 100 years. This encouraged the development of private underwriters at Lloyds.

In other countries, the increasing demand for reinsurance gave rise to the development of specialized reinsurance companies, including life reinsurance companies, starting in the 18th century. Up until this time reinsurance agreements were always written on an individual risk basis. It was not until early in the 19th century that the modern concept of a reinsurance treaty developed, and in 1842, the first professional reinsurance company, Cologne Re, was established. It was during this period the first reinsurance subsidiaries were established by insurers, greatly increasing the availability of reinsurance. At this stage, virtually all of the reinsurance companies were based in Europe. There were no significant independent reinsurance companies in the United States until after 1900.

Early in the twentieth century, a few companies with substantial casualty risks created insurance companies to handle only the risks of the owner. These were the first captive insurance companies. The concept of a captive has evolved into its current definition as an insurance company whose insurance business is primarily controlled by its owners. Captives generally have a small number of owners, who have direct influence on the operation of the company. The number of captives has been growing at about an 8% rate for many years. There are an estimated 4,500 captives operating today, most of them so-called "offshore" captives based outside the United States. Less than 10% of these 4,500 companies may underwrite life risks, but this small number of captives is exerting an important influence on the development of the life insurance business today.

Basis in Economic Theory

The use of a producer-owned reinsurance entity has the potential to benefit customers, producers, and insurance companies by improving the quality of business written, the quality of information, and the quality of service. This combination can result in better prices for customers, while the primary insurance company's profits and producer compensation are increased.

Chart 1 illustrates the traditional commission paradigm, whereby the marketing organization may realize a net profit margin equal to 1% of the present value of total policy revenues. The illustration is characteristic of a typical individual insurance product, but may differ

depending upon the particular circumstances. It is clear, however, that the total transaction based profit margins realized by a marketing organization represent a small fraction of the total policy revenues.

Chart 1

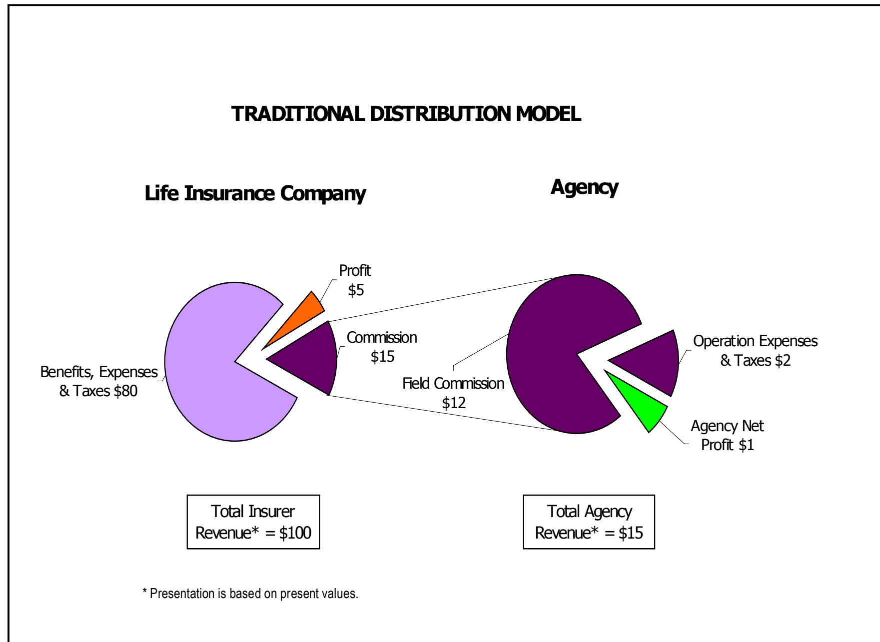
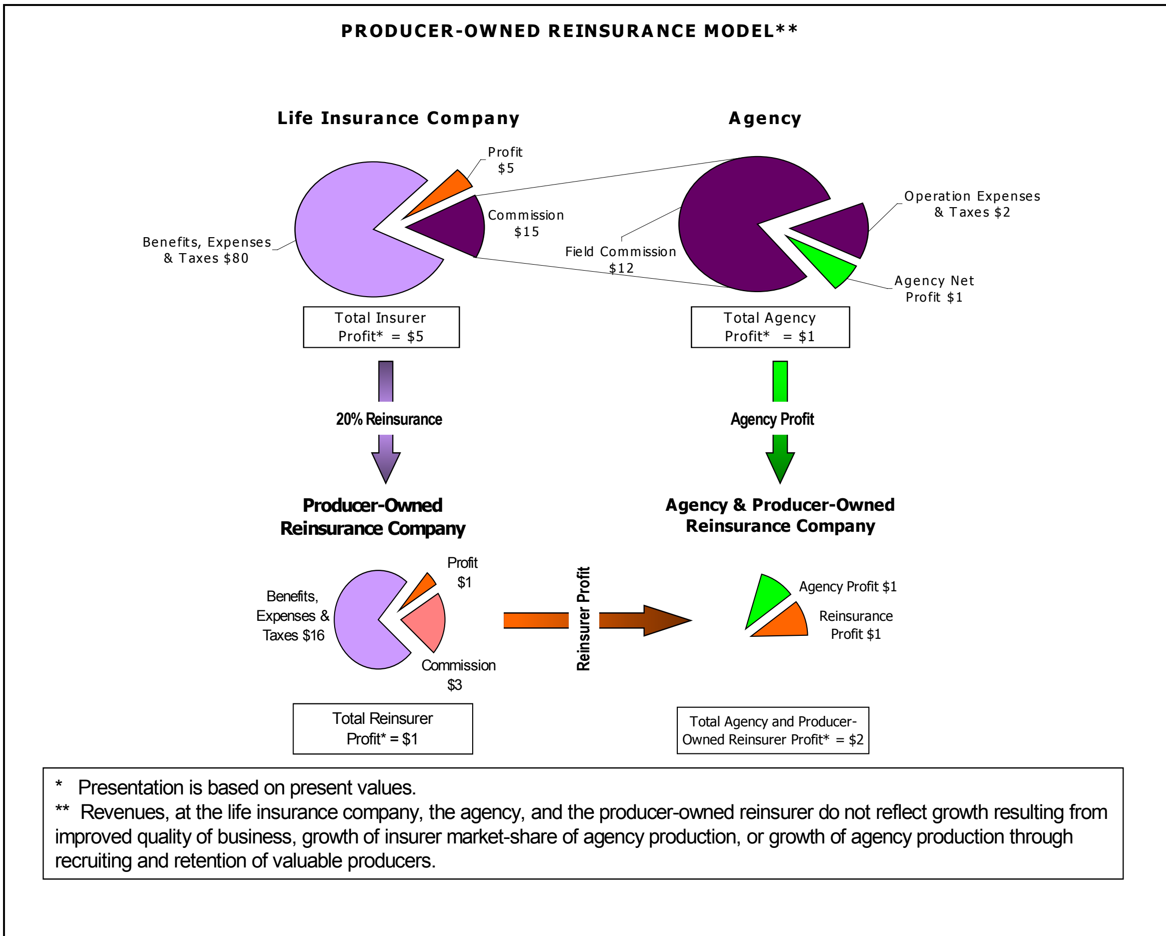


Chart 2 illustrates the benefits of producer-owned reinsurance to the marketing organization. Again, using a typical individual insurance product, target profit margins may be as much as 5% of total policy revenues. Assuming the producer-owned reinsurer provides 20% reinsurance coverage, a net profit margin is realized equal to 1% (20% x 5%) of policy revenues. As can be seen, significant leverage is created through the producer-owned reinsurance structure. The value of the marketing organization can potentially double – through current cash flows under the traditional transaction-based relationship and the long-term value created through the producer-owned reinsurance structure.

Chart 2



The illustrations in Chart 2, above, do not show the increase of total available policy revenues that are expected to result from the producer-owned reinsurance relationship. Increases in persistency, market share of business resulting from the marketing organization, organic growth of the marketing organization and increased efficiencies all serve to enhance the total revenues available to the insurer and agency. The combination of these drivers can easily result in even greater profitability to the primary insurer, after giving effect to the producer-owned reinsurance relationship. This increased profitability may, in turn, be of advantage to the consumer through decreases in policy costs.

These benefits flow from the increased efficiency and reduced risk of the pricing process that results from a better flow information in the marketplace, and the improvements in customer service as a result of more effective incentives for producers.

The economic benefit of the improved flow of information in the insurance marketplace is clearly supported in economic theory. For example, the work of Akerlof shows that information is a key element of efficient pricing. Without quality underwriting information it is impossible for insurance companies to establish a price that efficiently reflects the policy risk, resulting in higher prices and lower profit. Rothschild and Stiglitz have also shown how imperfect information can result in inefficiencies in the insurance market. Producer owned reinsurance adds value by eliminating many of these inefficiencies.

The incentives to producers should be aimed at the points where they can improve the financial success of the business. The producer has a key role in maintaining the quality of business written, facilitating the flow of information between the customer and the insurance company, and in conserving business. Points at which producers can have an important influence include the selection of methods to solicit business, communication between the producer and client, and between the producer and insurance company, and in servicing the business after the sale. The reinsurance relationship can help to enhance profitability of the business in each of these areas.

In the absence of information, the insurance company must set its price on the basis of potential worst-case scenarios. The insurance company will be forced to price for the most adverse risks that can flow through the underwriting process. This results in higher prices, which discourage the best risks from purchasing the insurance product. To solve this problem, producers can participate in the selection process through their marketing approach and improve the flow of information to the insurance company.

The financial results of these improvements in selection could be passed back to the producers in the form of commissions, if the company could develop clear evidence of the future improvement in profitability. Generally, this improvement is impossible to demonstrate at the time of sale, precisely because of the inequality of information between the producer and the company. The reinsurance mechanism allows the producer to benefit from the improved quality of business as favorable experience emerges. At the same time, this mechanism permits sharing of the favorable profitability with the primary insurance company. The reinsurance company, as the facilitator of this improvement, also benefits by an increased volume of profitable business. All participants in the transaction benefit – producers, insurance companies, and customers.

Incentive Structure

The incentive structures of the reinsurance contracts and the ownership arrangements play a vital role in motivating each of the participants in the reinsurance transaction to perform at their best. The incentives should reflect the degree of control that each participant has over the various aspects of the success of the block of business. As an example, producers can have a significant impact on persistency, both in the solicitation and in conservation of business, while they would have virtually no influence over the administrative expenses of the insurance company. Both producers and the insurance company can influence selection and classification of mortality risks. These considerations would lead to a reinsurance structure that provides a major portion of the benefit of persistency to producers, sharing of mortality gains between the producer and the insurance company, and incentives related to administrative costs left with the insurance company. Favorable persistency of a block of business reduces investment risk, and expands the investment choices available to the insurance company. Some producer-owned reinsurance arrangements include participation in investment profits, a feature that can share the favorable investment results available on more persistent business.

An important element in the efficiency of this system is educating the producer about the importance of low lapse rates in the profitability of the business. Similarly, a low mortality rate is important for the profitability and competitive pricing of life insurance, and the producer can contribute by focusing on business that is motivated by long-term needs, with a significant savings element. This is even of greater importance for annuity business since the retention of funds with the insurer is a key to profitability. Again, the producer can contribute by emphasizing tax benefits and a long-term investment strategy, rather than focusing on customers who wish to add a few basis points to the return on their investment in the short run.

Formula of Success

The benefits of producer-owned reinsurance to consumers, producers, and insurance companies arise from improved efficiency of the insurance transaction resulting from a better flow of information. These benefits are realized through incentives, to both producers and insurance companies, to work together as partners in producing quality business.

The Future of Producer-Owned Reinsurance

When producer-owned reinsurance companies were first formed in the life insurance business, they were formed to reinsure credit life insurance. In this case, the producers were typically banks or retailers of major consumer items such as automobiles.

Producers of life insurance and annuities started to develop producer-owned reinsurance companies in the mid-1970s, but the number of producer reinsurance companies was small until the late 1980s, when stock life insurance companies began to support the formation of producer-owned reinsurance companies. This development was pushed forward by the growth of independent agency systems.

Events of recent years have dramatically changed the life insurance distribution process. Through the 1970's, mutual life insurance companies dominated the life insurance industry, selling through captive producers. Convergence of financial services created pressure on the mutual companies, causing almost all of the major mutual companies to migrate to some form of stock company structure. At the same time many of the captive agency plants were virtually abandoned, leading to a greater role for independent producers.

Historically, only the largest independent producers that had a sufficient volume of business could justify the start-up and administrative costs of establishing a stand-alone producer-owned reinsurer. As a rough estimate, sales generating commissions in the range of $1 million to $5 million per year would be a minimum starting point for the development of a stand-alone producer-owned reinsurer to be feasible. This creates a substantial barrier to entry, but alternatives are now available that allow producers to participate in reinsurance with virtually all of the benefits of a stand-alone reinsurer at a fraction of the cost. By sharing the cost, independent producers can enter producer-owned reinsurance arrangements with annual commissions as low as $50,000. As a practical matter, most producers will participate in reinsurance by choosing one of the three structures that permit cost sharing – the insurer captive, the producer-group captive, or the independent turnkey reinsurance provider.

The substantial barriers to entry into the reinsurance business have motivated a number of insurance companies to establish reinsurance captives for their producers. This arrangement can provide many of the benefits of producer-owned reinsurance, but the benefits will be

totally dependant on the specific terms established by the insurance company. The participants in such an arrangement would not have the leverage or realize all the benefits of a producer who has an independent reinsurance entity.

Producers who would like to participate in the insurance of the business that they produce, but do not wish to reinsure their business with a captive of the insurer, have two options available. These are through the producer group captive or the independent, turnkey reinsurance provider. Within the category of producer group captives, some companies have many classes of stock as a means to identify the specific interests of various producers. Organizations that have started reinsurance companies with producer participation include producers' groups, banks, broker-dealers, and independent marketing organizations. The independent, turnkey reinsurance provider can establish protected cells to give producers results of their own production and greater flexibility concerning the amount of capital the producer needs to be able to participate.

Growth Potential

Producers who can benefit from participation in producer-owned reinsurance are those who have a critical mass of production. As an example, there are 14,000 members of the Million Dollar Round Table in the United States today, representing producers who exceed $65,000 in annual commissions. Most of these producers could benefit from participation in producer-owned reinsurance. Among this group is the elite "Top of the Table" group, consisting of some 1,300 producers who have exceeded a commission target of about $400,000 per year. Virtually all of the producers at this level could benefit from producer-owned reinsurance. These figures do not represent the agents who belong to producer groups that command greater volumes of production on a collective basis. At this time, the participation of these groups in producer-owned reinsurance appears to be a small fraction of the number that could benefit. One reason for this low participation may be the lack of published information about producer-owned reinsurance and the perception of high entry barriers. This paper is intended to provide the basic information that producers need when they first consider producer-owned reinsurance.

Establishing a Reinsurance Company

Establishing a reinsurance company is a complex process, with many barriers to entry. Each of these barriers can be overcome, however, and the rewards of entry justify the effort. Through the efforts of pioneering producers and insurance companies, the path to entry has now been charted, and high quality producers can follow that path to participate in producer-owned reinsurance.

Paths to Entry

The most direct way to obtain the financial benefits of a reinsurance transaction is to own the reinsurance company. The essential ingredient is commitment to the success of the producer-owned reinsurer on the part of both the insurance company and the producer. An insurance company is willing to give up a portion of the future profits on a block of business because they believe they will actually increase their total profit in the long run by retaining an interest in a better, longer-term block of business, and by developing a more solid, continuing source of future business. The reinsurance company changes the nature of the relationship between the insurance company and the producer to a long-term strategic relationship, rather than a short-term relationship based on individual transactions.

Owning and operating a stand-alone reinsurance company may cost a producer in the neighborhood of $100,000 per year, or more, just for maintenance. This does not cover the capitalization, nor does it include the start-up costs of selecting a domicile, incorporation, and development of the initial reinsurance contracts, each of which could be substantial. As a result, almost all producers will seek a structure that allows them to use already established facilities, or to share services with other producers.

Rather than establish a reinsurance company, in the past a small number of producers established insurance companies to write the business that they sold. In other words, they started their own, closely held insurance companies. There do not seem to be a significant number of these, nor do they appear, in general, to have been very successful. The issues involved in managing a primary company would certainly create a serious diversion of talent on the part of the producer, away from his or her successful marketing efforts into a number of unrelated areas. While there have been a few

examples where this has been done successfully, the producer-owned reinsurer seems to be a better way for most producers to enjoy the profitability of their business without diverting too much of their attention from their marketing efforts.

The effort involved in establishing and maintaining a producer-owned reinsurance company can only be justified if it adds significantly to the producer's wealth. The long-term, tax favored incentives of the producer-owned reinsurer have succeeded in creating a substantial asset for many top producers. In addition to the direct profits realized through reinsurance, producer groups have also successfully enhanced the growth of their organizations by offering the opportunity of participating in the benefits of reinsurance to quality producers. For some the wealth that has built up in the producer-owned reinsurance company is far more important to their financial success than the transaction-based incentives of sales commissions.

The technical issues involved in establishing or acquiring a reinsurance company require sophisticated expertise, but these issues can be dealt with if all parties are committed to the success of the venture. The following sections identify the major issues involved in the establishment and management of the producer-owned reinsurer.

Domicile

The vast majority of captive reinsurance companies have been established in locations that specifically favor their development. The domicile of the reinsurance company is its legal corporate location. Because of the advantages of locations that cater to the reinsurance industry, the domicile of the reinsurance company is rarely the same as that of the insurance company or the producer. The choice of a domicile is a complex decision that must take into account a number of financial and business issues.

The number of popular domiciles for producer-owned reinsurance companies continues to grow. *Best's Captive Directory* lists 24 overseas domiciles and 20 U.S. states and territories that have been used as domiciles for captives. Within the United States, there has been favorable legislation in Vermont, South Carolina, Colorado, Hawaii, and Arizona. Internationally there are about 10 domiciles, referred to as offshore domiciles, that have numerous captives, including Bermuda, Barbados, the Cayman Islands, Guernsey, Ireland, the Isle of Man, Luxembourg, Singapore, Turks & Caicos, and the

(British) Virgin Islands. Selection of a domicile should include a review of the regulatory and tax framework, stability, and reputation, as well as transportation and the availability of local services. Another critical issue is the potential for currency fluctuations.

Among the key regulatory issues to be considered in selecting a domicile are the following:

- Minimum required capital
- Licensing or other fees at establishment
- Annual fees
- Existence and nature of a tax treaty with the United States
- Local income and other taxes
- Restrictions on the type or source of business written
- Expected amount of time needed for regulatory approval
- Policy reserve requirements
- Investment restrictions
- Regulatory reporting requirements, such as financial and audit reports
- Local office requirements
- Currency restrictions

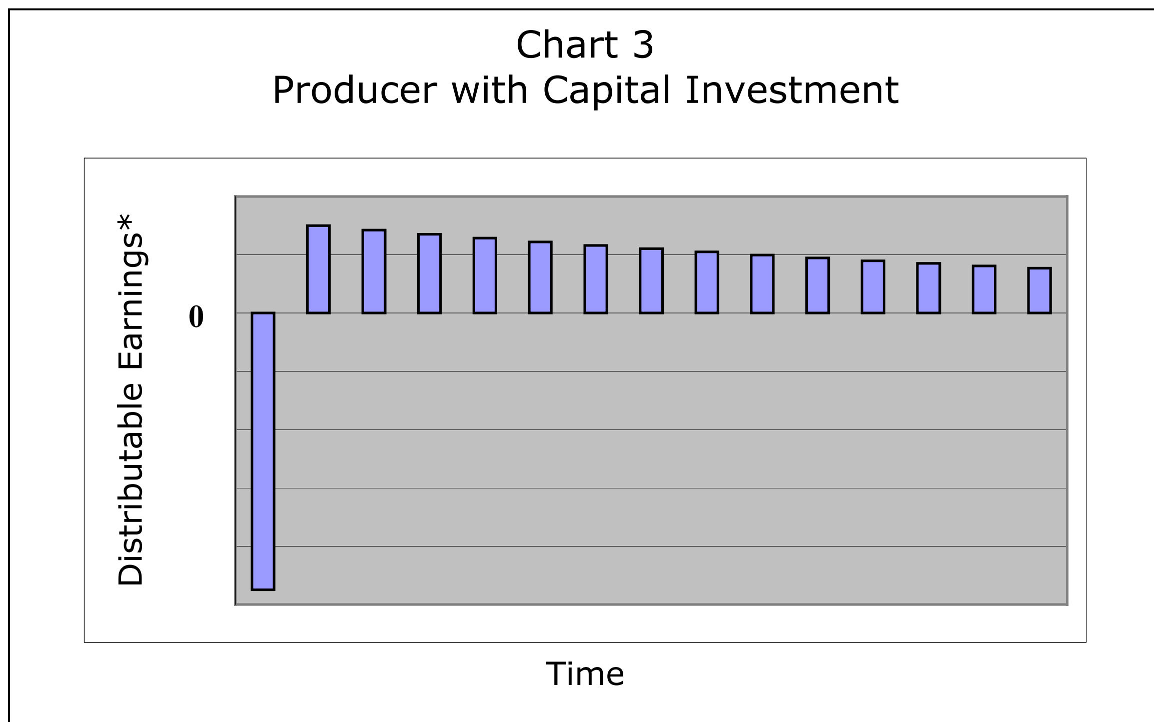
While the choice of a domicile from the many alternatives available today would be a complex task, in many cases the producer will be using the services of a reinsurance organization that has already gone through this analysis and made the decision as to domicile. Reinsurance companies with a history of successful operation have demonstrated that they made a good choice of domicile.

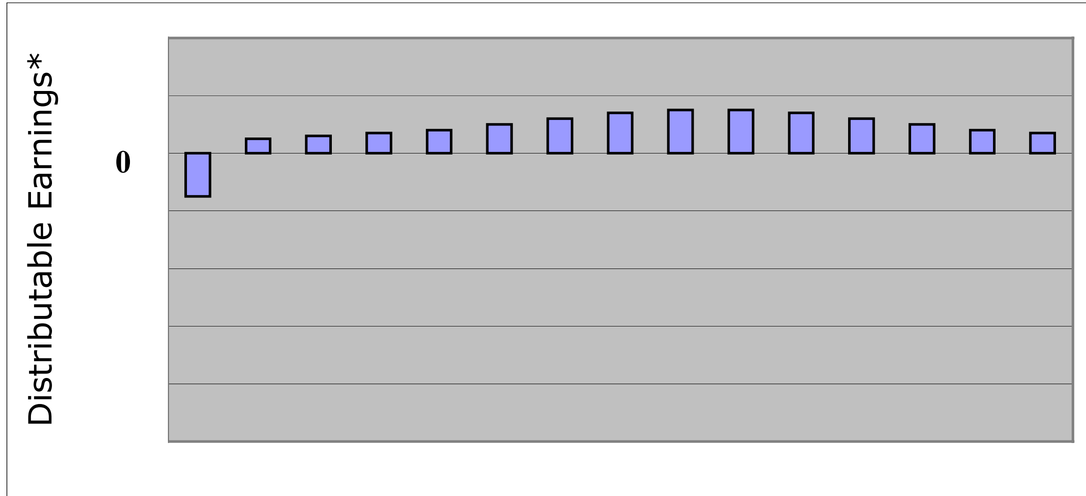
Capital Requirements

Operation of an insurance company (including a reinsurance company) requires some form of licensing in every jurisdiction. Licensing is the process by which a corporation gains the authority to legally accept insurance risks. An insurance license is the one absolute requirement for a company to be able to conduct an insurance business. The complexity of the licensing process varies tremendously from one jurisdiction to another.

One universal component of the licensing requirements is that companies must have at least a specified minimum amount of capital under the regulations of the domicile. Currently the amount of capital required ranges as low as $83,000 in The Isle of Man up to $1,200,000 in Luxembourg. Once capital has been contributed to the insurance company, there are strong regulatory constraints on the ability to take these funds out of the company, as long as the company retains insurance liabilities. Restrictions on equity distributions may make it difficult to find external sources of capital.

Initial capital requirements for producers to participate in a producer-owned reinsurer may range as low as $25,000 for participation in a company sponsored by an insurance company, up to hundreds of thousands of dollars. This can create a barrier to the entry of individual producers into an existing entity, but the entity's need for capital requires commitment of capital by those who stand to benefit from its success. Some organizations allow a trade-off between current capital investment and the timing of profit distributions. As illustrated in Charts 3 and 4, a producer can participate with little or no capital in exchange for a less rapid emergence of significant profits.





* **Distributable earnings**: The earnings that can be distributed to the owners of the company, taking into account not only basic cash flows and solvency reserves, but also required capital. When distributable earnings are negative, they represent an amount that the owners must contribute to the company or allocate to a line of business.

Additional capital is required as the volume of business grows. While prudent reinsurers will establish their own capital targets, some jurisdictions have minimum risk-based capital requirements. These are regulations that define the amount of capital required to support various components of risk arising from insurance and investment operations. These regulations may increase the level of capital otherwise required by virtue of adding insurance risks.

Reserve Credit

When an insurance company reinsures one of its policies, it pays a premium to the reinsurance company. In order for reinsurance to be financially feasible, this cost must be offset by a reduction of the insurance company's reserves, which are its provision for the future costs of insurance benefits. In addition to the expenses associated with the placing the business, life insurance requires substantial reserves, which creates a need for capital. Consequently, a vital part

of the reinsurance transaction is the benefit that comes from reducing reserves in proportion to the risks transferred out of the company. When an insurance company transfers risks to a reinsurer, the requirement for reserves on these risks is eliminated only when appropriate regulatory requirements are met. Regulations governing the reserves of the ceding company must be carefully considered.

The ability of the ceding company to reduce its reserves for ceded risks depends on the financial reporting regulations that apply to the ceding company, the structure of the reinsurance agreement, and, possibly, the financial condition and domicile of the reinsurance company. Since it is critical that the ceding company receive reserve credit, these issues must be appropriately handled. If the reinsurance ceded to the producer-owned reinsurer will come from a single insurance company, the rules of the state of domicile of that insurance company should be considered, so that any capital required in the reinsurance company will translate into appropriate reserve credit in the insurance company.

A reinsurance company established offshore will likely be considered an "unauthorized" reinsurer for state regulatory purposes. This means that the ceding company cannot take credit for the reserves of the reinsurer unless additional steps are taken to comply with the security requirements of the state of domicile of the insurance company.

Specific approaches to make sure that the insurance company receives a reserve credit include modified coinsurance, funds-withheld coinsurance, trusts, and letters of credit. Under modified coinsurance, most of the reserves and related assets remain with the insurance company. The use of a trust involves holding assets related to the reinsured block of business in a trust that is controlled jointly by the insurance company and the producer-owned reinsurer. This arrangement can be awkward, especially in relation to the management of the assets in the trust. Finally, a letter of credit in favor of the insurance company can ensure reserve credit. Such letters of credit are subject to stringent regulatory requirements, and may be costly.

Established producer-owned reinsurance companies generally have solved the problem of reserve credit, since the arrangement may not be economically viable unless reserve credit is obtained.

Currency

The risk of exchange rate fluctuations should be considered for any offshore domicile. The currency of the domicile and the history of its exchange rate fluctuations will provide an indication of domiciles for which the stability of the currency is a serious concern.

The possibility of currency restrictions is a critical issue for an offshore domicile. Profits that are earned offshore are of little significance if they cannot be re-domesticated from the offshore domicile. Most of the popular domiciles have currency that can be freely converted into U. S. dollars, and can be freely imported and exported. Throughout the world, however, many countries have very restrictive rules about currency transfer. Unfavorable economic conditions can cause currency rules to be made more restrictive. In view of the vital importance of the ability to repatriate profits and investment, the history of a domicile's currency rules should be carefully considered.

The most popular domiciles, such as Bermuda, either have their own very stable currency, or use one of the major currencies, such as the U.S. Dollar, the Euro, or the U.K. Pound.

Knowledge and Talent

The organizational structure of a typical insurance company will include the following departments:

- Accounting
- Actuarial Pricing and Reserving
- Claims
- Investment
- Marketing
- Regulatory Compliance
- Risk Management
- Treasury & Banking Services

The insurance company will provide many of these functions, so that the producer-owned reinsurance company will not need them, but the potential for conflicts of interest should be considered.

Regardless of domicile, one essential element of the reinsurance company's operations is regulatory compliance. In addition to regulatory compliance, there may also be a need for expertise in at least the accounting, actuarial, investment, risk management, and treasury areas. The need for outside expertise in these areas will influence the structure and domicile of the reinsurance entity. Many popular domiciles, such as Bermuda, provide a choice of competent providers of these services. A reinsurance company needs various banking services, including international fund transfers, so the maturity of the banking system in the domicile should be considered.

Time to Completion

The process of establishing a producer-owned company from scratch can be extremely time-consuming. A recent article by Barbara Morris cited, as an example of the successful establishment of a captive, a case that took two years of development before the captive was ready to accept its first business. This experience should not be a deterrent; a much shorter horizon can be accomplished, perhaps in as little as two months, by using an existing structure with the guidance of professionals who are experienced in reinsurance company formation.

Structural and Management Issues

An important issue in deciding whether to establish a separate reinsurance company or to establish an arrangement within an existing company is how the owner will monitor the performance of management. A producer may not have the background or interest to manage the technical aspects of the business, and may conclude that management of the technical aspects of the business is not the best use of the producer's talents. By participating in an existing entity, the need to monitor performance of the business can be shared with other owners.

Investment Restrictions

Many domiciles regulate the types of investments that can be made by reinsurance companies under their supervision. These regulations may govern the types of assets, such as bonds, common stocks or real estate, the amount invested in a single entity, and the quality of investments. Frequently there are restrictions on investments in related entities. Some jurisdictions require that a certain proportion of the assets be invested in assets located in the domicile. A further issue is the possibility that a portion of the assets may need to be placed in a trust controlled by the domicile. This requirement can create complications when the owners want to repatriate their assets.

Certain foreign domiciles, such as Bermuda, have few restrictions on investments. However, when the domiciliary location does not restrict investments, the types of investments will be limited by the need to be, and perceived to be, financially strong, so that full reserve credit will be available to the ceding company.

Taxation

Tax issues include not only the tax structure of the domicile, but also U.S. tax treatment of transactions with the reinsurer. Normally, the income of a company based outside the United States with U.S. shareholders is not taxed until the income is brought back to the United States. However, in the case of a company classified as a controlled foreign corporation (CFC), U.S. taxes can include a tax on "Subpart F" income, which is similar to U.S. income tax on the corporation. Special rules apply to a CFC that is an insurance

company. Certain elections by a taxpayer under §953(d) of the Internal Revenue Code may allow Subpart F income tax to be avoided by causing the CFC to be treated as a domestic company for U.S. tax purposes, but tax advice is needed to navigate this complex part of the tax law.

The taxation of life insurance companies in the United States provides, in §806 of the Internal Revenue Code, for a "small life insurance company deduction." Recently the Internal Revenue Service issued a Notice (Notice 2002-70), which, among other things, states restrictions and record-keeping and reporting requirements related to §806 for certain producer-owned reinsurance companies, typically those with little or no assumption of risk. A tax advisor should be consulted about whether these requirements would apply to a specific company.

There is an excise tax on premiums paid to a foreign insurer for a U.S. risk, including reinsurance premiums on a life risk insured in the U.S. The excise tax is subject to treaty arrangements, which vary by domicile, and are subject to change. The excise tax does not apply to companies that elect under §953(d) to be taxed as U.S. domestic companies.

A further issue is the possibility of a 30% U.S. withholding tax on U.S. investment income earned in the offshore company. In practice, this withholding tax may be difficult to recover, so it has the practical effect of an actual tax. This tax is subject to treaty arrangements between the United States and the domicile.

While many popular domiciles are tax havens with little or no income tax, there may be licensing costs and fees of several thousand dollars per year.

Complex tax considerations are an entry barrier for new companies, but existing companies have developed ways to deal with current tax issues. The producer will need professional advice to deal with his or her own personal tax situation as it relates to the emergence of wealth in the producer-owned reinsurance company.

Economies of Scale

The impact of economies of scale on many of the functions of an insurance company can be substantial. Areas such as accounting,

compliance, and investment have the potential for significant savings. The potential for economies of scale is important when considering whether to establish an independent company, or to participate in an existing company through a mechanism such as a protected cell. Functions such as regulatory compliance, banking services, and accounting, while vitally necessary, add little value. When they are provided by a larger organization, the producer's costs are reduced with little or no reduction in profit potential.

At the level of the insurance company, the complexity and variety of products can have a major influence on economy of scale, and an overly diverse a range of product features can defeat the potential for administrative economies. On the other hand, the producer-owned reinsurance company will generally not be involved in policy administration, but will rely on the insurance company for these functions. Administrative aspects of the reinsurance contracts should be carefully controlled, so that the administrative management of the producer-owned reinsurance company can be kept very efficient. Several different forms of producer-owned reinsurance companies have emerged and, within these forms, there are virtually as many detailed arrangements as there are companies.

Structural Issues

The owners of the reinsurer can be an individual producer, a group of producers, an insurance company, or an independent manager. In cases with more than one owner, there can be either a single class of stock or multiple classes with different rights. The choice of capital structure has a fundamental effect on the relationships among company and owners.

Another key issue is how the profit experience of the company will be shared. At one extreme all owners share in the profits in proportion to their share of ownership. At the other extreme, each producer's business is accounted for separately and each producer receives profits only from his or her own experience. The issue of how profits should be shared among owners of the reinsurance company is a decision that should be carefully thought out, as it involves trade-offs between stability of the profits and the direct linkage of a producer's profits to the quality of his/her own business.

In the case of mortality, while a profit may be expected over the long term, mortality losses are possible on a small block of business over

short periods of time. As an example, suppose 1,000 policies are issued with an expected annual claim level of three claims per year, priced to break even at five claims. Even if the expected claim level is exactly right, the actual number of claims in any year can be expected to exceed three claims 35% of the time, and will exceed five claims 8% of the time. The smaller the mortality margin the higher the probability of a loss in a given year. For this reason, many producer-owned companies retain only a small portion of the mortality risk, or pool the mortality experience of different producers in the company.

Exit Strategy

Life insurance contracts, including related settlement options, can last for a lifetime. One study showed that some policies remained in force for 80 years from the date of issue. This implies the same potential for the related reinsurance contracts. Thus, the producer-owned reinsurance arrangement must be designed to provide an exit option, since the producer may wish to exit the business on retirement, or at another limited duration.

The sale of a small block of reinsured business may be difficult to negotiate on favorable terms, because the cost of due diligence in relation to the size of the block may be prohibitive. In addition, the same issues regarding information about the quality of business that may have motivated the formation of the reinsurance arrangement can make a favorable sale difficult to negotiate. It is important to consider the exit strategy at the outset of the reinsurance arrangement for these reasons.

Exit may be provided on a contract-by-contract or entity level. In other words, the individual agreements can be designed with an option for the ceding company (primary) to terminate the contract. This is referred to as a recapture clause. Unfortunately, an option for the assuming company to initiate recapture is not feasible, as it would create problems with reserve credit in the ceding company, which is essential to the financial operation of the reinsurance arrangement.

Alternatively, there can be an agreement to transfer ownership of the reinsurance entity under pre-determined terms. At least one existing producer-owned reinsurer provides that those who exit individually will receive their share of the statutory equity of the company. The conservatism of statutory accounting means that this will almost certainly not recognize the bulk of the value built up in the company.

On the other hand, even this level of payout has the potential for depleting the company's capital below an acceptable level. Any more generous arrangement would certainly raise questions about the stability of the company in the event of substantial defections of its owners.

The potential tax, regulatory, and management issues must be considered for these or other exit strategies. Generally, with careful planning, it is possible to obtain capital gains treatment of the value built up in the block of business. This is a major advantage of ownership that must be preserved. Quantification of and compensation for the value of future profits in the reinsurance arrangement can be considered at the inception of the business, when it may be easier to determine an objective basis for valuing the business. Issues related to exit strategy can be complex, and require legal and business advice.

Another facet of the exit strategy is the possible need for an involuntary exit mechanism. In an entity with multiple owners all contributing business to the company, a producer who either does not contribute an adequate level of business, or whose business does not meet the required level of profitability, will tend to reduce the value created for all owners. This possibility needs to be considered, and some mechanism must be provided to monitor the contributions of all owners, and to correct any problems that may arise. Initially this may involve communicating with producers who are not performing at an acceptable level, and helping them to overcome problems that they may have encountered. Ultimately it may involve a process of involuntary separation of the producer from the reinsurer. Careful advance planning for this contingency will help to avoid a highly contentious situation at the time of separation.

Generally, the established reinsurers have already developed exit strategies. A large producer-owned reinsurer with an active program of adding new producers will have more flexibility in providing for exit than a company with a small number of owners and no new entrants.

Risk Management

The producer-owned reinsurance company presents some unique risk-management issues. Because it will tend to be much smaller than the typical life insurance company, its ability to absorb random fluctuations in experience is limited. In addition, a small group of

producers may experience a concentration of risk in terms of geographic area, employment, or product type that exaggerates certain risks, such as the risk of catastrophic claims.

These factors require the producer-owned reinsurer to have a detailed and effective risk management program, which may include the need for the reinsurer to purchase reinsurance itself. A retention of $5,000 of mortality risk per life would not be unusual, while such a low retention level would not be seen in an insurance company. There may be different levels of risk sharing for different components, such as mortality risk, persistency risk, and investment risk. As an example, because the producer has such a tremendous influence over persistency, the producer might retain the full benefit or risk of profit or loss due to persistency experience. On the other hand, the fact that producers have little direct influence on investment results implies that it would be best for investment results to be shared by all owners.

Product Development

The producer-owned reinsurance arrangement presents the producer with a new challenge – determining whether an insurance product is expected to be profitable. Typically, a producer does not need to be concerned about the profitability of the products he or she sells, provided that, over all, the insurance company is financially sound. Other things being equal, a low price and valuable contract features make the product easier to sell. A new dimension is added when the producer participates in the profit generated by the insurance product. Now the marketing benefits of low price and valuable contract features must be balanced with their effect on profitability.

Large marketing organizations may participate in the product development process. Development of insurance products is time consuming and expensive, and can only be justified by a substantial volume of sales. Since generic products will be available from the insurance company, the marketing organization can only justify an investment in product development if the new products will serve a clearly defined market, or are significantly differentiated from other products in the market, and will create a major increase in sales. Marketing organizations with a niche market may decide that the development of their own products is justified by the sales generated by a specifically tailored product. This can include organizations marketing to the high-end estate market, the employee group market, and the corporate-owned market.

Regardless of the product development process, and whether the producer-owned reinsurer is reinsuring a generic product of the insurance company or one of its own design, it is paramount the producer-owned reinsurer properly assess the expected profitability of the reinsurance. Generally, actuaries are engaged to support this process and are often instrumental in negotiating the reinsurance structure as well.

Experience Analyses

Once the marketing organization decides to develop its own products, the organization may benefit from conducting its own experience analyses. This is because an insurer's experience on existing products may not be relevant to products tailored for the specific needs of the marketing organization. The value of developing experience specific to the marketing organization can be instrumental in managing the profitability of its reinsurance, securing increased commissions, or both. This need can require the skills of consulting actuaries or actuaries on the staff of the reinsurance company.

In addition to experience analysis, actuaries are also often best qualified to perform projections of mortality experience, the timing and amount of cash flows, investment returns, expenses, and persistency. All of these functions serve to assist in better managing the profitability of the producer-owned reinsurance company and capital management processes.

Producer Education

The value of participation in the producer-owned reinsurance entity will need to be continually communicated and reinforced. In addition, for producers to become true partners with the insurance company and the producer-owned reinsurer, they will need training to understand the financial reports of the reinsurance company, and to understand the processes by which long-term value is created. This includes some understanding of insurance company financial statements, mortality risks, and the benefits of persistency.

The Quality of Life Insurance Business

In considering the quality of business it is useful to distinguish those issues that are almost completely within the control of the primary insurance company from those for which the producer has substantial influence.

Issues determined by company:

- Administrative complexity of the policy
- Expense and cost-of-insurance margins
- Underwriting process
- Expense management
- Investment management
- Claims management

Issues with significant producer influence:

- Volume of business
- Persistency
- Underwriting quality

The "quality" of a group of reinsured policies refers to the profitability of the policies over the life of the group of policies. While the level of claims might seem to be the crucial element of quality for life insurance policies, this is typically not the case. In fact, the most important determinant of profitability is often the persistency of the policies. Except in unusual circumstances the average death claims on a large group of life insurance policies can be expected to fall in a narrow range. On the other hand, persistency can vary greatly from one group of policies to another.

Conclusion

Producer-owned reinsurance redefines the relationship between insurance producers and insurance companies. In the past, the producer was stuck with short-term incentives that produced short-term results. Life insurance is a long-term product, so short-term incentives are inconsistent with the needs of insurance companies and their customers. The producer-owned reinsurance company provides a way for the producer to have long-term participation in the business. This aligns the incentives of the producer with the interests of the company and the customer, to the benefit of all three.

Insurance companies have shown that they recognize the value in producer-owned reinsurance by actively supporting the growth of this segment of the industry. Producers have benefited from the opportunity to expand the growth of their business and build substantial wealth. Customers have benefited from low lapse rates and niche products suited to their specific needs, thereby increasing the value of the products they purchase. Insurance regulators in many states have also shown that they recognize the value in this development by creating friendly environments for the creation of captive insurers.

To seize this opportunity the producer will need to overcome complex reinsurance regulation, taxation, and management challenges, that might, at first, seem daunting. We hope that this paper has provided an introduction that opens the path to participation in producer-owned reinsurance. The pioneering efforts of a small number of companies and individuals have overcome the obstacles to entry, so that high quality producers now have a clear course for entry into this rewarding endeavor.

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