

# Annuity Coinsurance

By Todd Sagmoe

**R**EINSURANCE OF fixed annuities has been around a long time. Until recently, it has been viewed as primarily related to financial reinsurance transactions on in-force blocks of business. Even now, this “one and the same” view of annuity reinsurance and financial reinsurance seems to be a common perception in the life and annuity industry. Over the past few years, many direct writers of fixed annuities have had various reasons to seek reinsurance on new sales.

Coinsurance of new sales of annu-

ities can be viewed as a partnership between the direct writer and the reinsurer. Simply put, the ceding company is passing a percentage of all risks to the reinsurer. This includes all the major categories of annuity risk: investment risk, distribution risk, and lapse risk.

Until recently, annuity coinsurance arrangements could take the form of straight coinsurance or modified coinsurance. With the SEC’s heightened focus on embedded derivatives in modified coinsurance (modco) contracts, this type of transaction

has fallen out of favor due to the uncertainties surrounding the accounting of the transaction from the standpoint of both the ceding company and reinsurer.

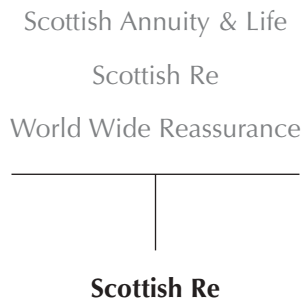
## RATIONALE

Why would a direct writer want to reinsure its fixed annuity new business? There are three primary reasons: capital management, spread enhancement, and product portfolio extension.

More often than not, direct writers of annuities are managed as a sepa-



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rate profit line of business within a corporate entity. As part of the corporate planning, the annuity line of business (LOB) is typically allocated a certain amount of capital each year. However, that capital may not be enough to meet the needs of distribution.

For example, an annuity writer may expect a distribution channel to sell \$500 million of fixed annuities. This amount of sales may translate into a \$50 million allocation of capital. However, the annuity LOB may only be allocated the use of \$25 million of new capital. Through the use of coinsurance, the company can promise to accept the full amount of the sales in order to keep distribution channels satisfied by not putting constraints on their production.

Companies also look to the reinsurer to assist them with spread enhancement. Spread enhancement is a percentage of the account value the reinsurer pays to the direct company above and beyond expense reimbursements. When determining spread requirements, a reinsurer may be able to offer spread enhancement from either the liability side (lower cost of liabilities) or from the asset side (better earned rate on assets).

Spread enhancement on the liability side is most likely available if the reinsurer has certain advantages in pricing as compared to the ceding company. Advantages reinsurance can bring include a lower cost of capital, taxation, and risk-based capital (RBC) advantages.

On the asset side, the ceding company may find that the reinsurer has some investment advantages that can translate into a higher earned rate. Investment advantages occur due to differences in investment culture between the ceding company and the reinsurance com-

pany, and differences in perception of a suitable target investment duration and risk tolerance.

To demonstrate a case study with spread enhancement on both the asset and liability side, let's examine a typical 5-year CD annuity.

#### **CEDING COMPANY (BEFORE COINSURANCE)**

- ▶ Net Earned Rate: 5.5 percent
- ▶ Pricing Spread: 2.0 percent
- ▶ Supportable Crediting Rate: 3.5 percent
- ▶ Return on investment (ROI) equals ceding company profit targets.

**PROBLEM:** Supportable crediting rate not high enough to support distribution requirements of 3.65 percent. Ceding company approaches reinsurer regarding coinsurance solution. Ceding company requests reimbursements for 50 percent of pricing expenses and commissions.

#### **REINSURANCE COMPANY**

- ▶ Net Earned Rate: 5.60 percent
- ▶ Pricing Spread: 1.80 percent
- ▶ Supportable Rate: 3.80 percent
- ▶ ROI equals reinsurance company profit targets.

**SOLUTION:** Supportable rate is higher than ceding company's target crediting rate. Reinsurer offers .15 percent reimbursement to Ceding Company.

#### **CEDING COMPANY (AFTER COINSURANCE)**

- ▶ Net Earned Rate: 5.5 percent
- ▶ Pricing Spread: 1.85 percent
- ▶ Supportable Rate: 3.65 percent

#### **REINSURANCE COMPANY**

- ▶ Net Earned Rate: 5.60 percent
- ▶ Pricing Spread: 1.95 percent
- ▶ Supportable Rate: 3.65 percent

**CONCLUSION:** ROI targets are still

Using coinsurance, the company can promise to accept the full amount of the sales and keep distribution channels satisfied by not putting constraints on their production.

met for both companies. Supportable rate is "equalized" for the both companies at desired level. Partnership is formed.

The final reason a ceding company would pursue coinsurance on new business of annuities is to minimize the risks associated with entering the fixed annuity market. Perhaps the company distribution wants an annuity product, but the company is unwilling to take the risk of starting annuity sales on their own due to lack of expertise.

Alternatively, the ceding company may want to develop a type of annuity product they have not previously sold. In these cases, the ceding company may look to pass a high percentage or even all of the risk and profits. As part of this type of arrangement, a third-party administrator may be brought in.

#### **DEVELOPMENT ISSUES**

Annuity coinsurance can be a more involved process in setting up treaties than other forms of reinsurance on new business (e.g. First Dollar Quota Share Term & Mortality YRT). The primary parties involved in negotiating the terms of the treaty are the actuarial and investment teams of the two companies involved. Once terms are decided, the legal departments and members of the executive team finalize and sign off on the treaty.

Depending on the nature of the agreement, there may be trusts to set up to manage assets. In addition, trusts may be used to alleviate con-

cerns about counter-party risk. During the negotiations, a process should be set up to involve the reinsurance company when managing the rate setting practices of the ceding company. While the ceding company still primarily determines crediting practices, there must be guidelines put in place to not harm the reinsurer by reducing spread income.

After the deals are complete and cash flows commence, it's important for both the ceding company and the reinsurance company to monitor the experience of the treaty. New policy forms can be added and spreads and reimbursements can be adjusted as the nature of the policies being sold changes through the use of amendments to the treaty. This partnership will ultimately lead to a profitable ongoing relationship for both the ceding company and the reinsurance company.

With the recent rise in consumer desire for more certainty in the annuity market, companies are looking for ways to continue to sell fixed annuities. However, with the lowest investment rates in several decades, companies have had difficulty making these products meet company profit objectives due to squeezed margins. With a properly structured reinsurance arrangement, perhaps the annuity line of business managers can meet their objectives. ■

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