



Insights and Commentary on the Reinsurance and Insurance Markets
from Ruark Consulting LLC and Ruark Insurance Advisors, Inc.

July, 2005

Famous or Not So Famous Quote:

I love deadlines. I like the whooshing sound they make as they fly by.

Douglas Adams



Standing Tall on Full Disclosure

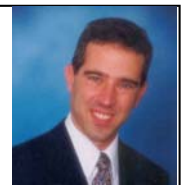
By Tim Ruark, FSA

RIA is a reinsurance intermediary company and we frequently act as reinsurance brokers. Normally, a reinsurance broker functions behind the scenes, but recent legal action has brought greater broker scrutiny. First, some brokers were accused of submitting false bids, in order to create the impression of competition where there really was none. Second, brokers have collected extra compensation by directing deals to certain companies, even if those companies were not best suited for the transaction. Much of this activity relates to brokering insurance, not reinsurance, but that subtlety is lost on most people.

Yet with all the negative publicity lately about brokers, RIA finds itself standing a little taller. Why? Since we began operations in 1998, we have always disclosed our role and our compensation. To us, if we aren't creating value for our clients to justify our involvement, we prefer to step aside. New reinsurance professionals often find it surprising that brokers do not disclose their fees, while old timers accept it as the way business is done.

But if the ceding company doesn't understand the broker's compensation, how can the cedant

Continued on page 3



Can Index Annuities and Variable Annuities Complement Each Other?

by Rich Tucker, FSA

Proponents of index annuities and variable annuities are typically mutually exclusive. Strongly held beliefs are found among distributors of each camp and these beliefs tend to migrate upwards to the insurance company manufacturers. The results are insurers that focus only on their particular world of variable annuities or carriers seeing only their own universe of index annuities. However, a look at possible synergies from a broad perspective and joint management of index annuities and variable annuities can create cost savings.

On the one side you have carriers creating variable annuities. Variable annuities are being enhanced to offer additional guaranteed benefits such as guaranteed minimum death benefits, guaranteed minimum income benefits, and guaranteed minimum withdrawal benefits.

All of these guaranteed benefits are "put-based" benefits, meaning they produce value if the underlying funds decline. Insurance companies typically use reinsurance or hedging strategies to manage the financial risks of these variable annuity guaranteed benefits.

Continued on page 2

Complementing Annuities from page 1

On the other side you have insurance companies manufacturing index annuities using “call-based” derivatives to manage the index participation formula. Call-based means they produce value if the index increases.

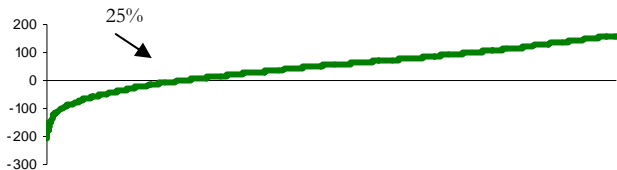
I did some calculations of the expected cash flow to the insurance company of a put-based variable annuity guaranteed benefit, in this case a guaranteed minimum withdrawal benefit. The insurance company makes money through 95% of the stochastic scenarios generated, but can lose significant money (\$30 million for each \$1 billion of sales) the remaining 5% of the time.

Chart 1
\$1 Billion GMWB Only
Present Value of Cash Flows (\$ Millions)



Index annuities, being call-based, have the opposite effect. Benefit costs to the insurance company arise when the underlying index increases. When I calculated the expected cash flow to the insurance company with the index annuity under the same stochastic scenarios used previously the shape of the curve is reversed, indicating that indexed annuity participation is high when variable annuity benefits are low, and vice versa.

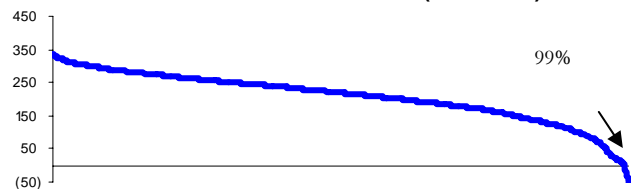
Chart 2
\$1 Billion Index Annuity Only
Present Value of Cash Flows (\$ Millions)



What happens if an insurance company can combine the index annuity call-based participation formula and the variable annuity put-based guaranteed benefits?

When I combined \$5 billion of GMWB with \$1 billion of index annuity the probability of a loss decreased by four-fifths, from 5% in the GMWB only scenario to only 1% in the GMWB-Index Annuity combination. **The worst case loss has declined 86%, from \$350 million to only \$50 million!**

Chart 3
\$5 Billion GMWB + \$1 Billion Index Annuity
Present Value of Cash Flows (\$ Millions)



An insurance company that can create this type of combination should be able to significantly reduce hedging costs. Although there are not many companies that currently have significant blocks of both index annuities and variable annuities, this may change over time if companies evolve to create balanced product offerings of indexed annuities, variable annuities, and fixed annuities.

Reinsurance can be a mechanism to create this balance immediately. Companies with a heavy concentration in indexed annuities could assume reinsurance of variable annuity benefits, or companies with a heavy concentration in variable annuities could assume reinsurance of index annuities. I have found that this powerful risk management technique is not being utilized by the insurance industry today and could provide a win-win scenario for both variable and index annuity manufacturers.

* * * * *

Standing Tall from page 1

evaluate whether the broker is valuable, or merely dead weight? So from the beginning RIA's policy has been one of full disclosure.



We suspect some brokers were reluctant to disclose their fees because they may have seemed out of line with the services performed. This has never been a concern to us. We are very involved in every treaty from the RFP stage and throughout its term.

In preparing RFPs, we first work with the ceding company to analyze their needs and design a reinsurance structure that satisfies them. We perform our own pricing analysis to ensure the ceding company has reasonable expectations as to the likely cost of the reinsurance program. This is beneficial to all parties. Reinsurers know they are not wasting time with an unrealistic buyer and therefore are more willing to invest the effort to verify RIA's structure and pricing. This is particularly important with variable annuity reinsurance where considerable time is required to price the reinsurance. In addition, the cedant can more quickly determine if a reinsurance program is likely to work for them and avoid the inefficiency of evaluating a treaty that is not viable.



Once an agreement is reached on the terms, we spearhead the drafting of the letter of intent and treaty, as well as any amendments over the treaty term. Since we've done treaties with half a dozen reinsurers and twice as many cedants, we are quite knowledgeable on what the parties are looking for in treaty language. In addition, a few of us have been experts and/or witnesses in reinsurance arbitrations (not involving RIA treaties). Although arbitrations are universally unpleasant, we try to use the experience to help us educate our clients on areas of potential conflict.

We also set up and run the monthly administration process to determine the reinsurance premium and to track treaty values such as claim limits, deductibles, and sales limits. This involves receiving monthly seriatim files on active contracts and claim files, reviewing the data for reasonableness, and preparing the reinsurance statements.

Unlike most brokers, RIA does not seek a float. Brokers often collect premiums from cedants and hold the money for several months before passing it on to the reinsurer. They'll do the same for claims in the other direction. This activity is legal but unscrupulous. Since the broker is not a party to the transaction, what right do they have to collect interest on other people's money? Again, RIA has always required that funds be transferred directly between the parties to the treaty.



RIA has also avoided contingent fee arrangements. We feel it is in the best interest of our client if we are compensated for the services we perform rather than the profitability of the programs we place. Generally, the profitability of the treaties we source will be outside of the control of either party. For example, a GMDB treaty may lose money if the SPX drops 50%, but neither party can control changes in the SPX. In the future, there certainly could be a contingent fee arrangement that makes sense for RIA and our client, but we would seek our client's approval for any compensation that is not already outlined in the broker letter.

Last, RIA performs periodic book of business reviews to gauge each reinsurance program's progress relative to expectations and to highlight emerging experience and demographic trends. Our goal is to ensure the long term health of the reinsurance agreement, and we use our book of business reviews to establish a framework for renewing programs to the satisfaction of both parties. Again, it's our commitment to disclosure that guides our actions.



RCL recently completed the 2004 Dental PPO Network Survey - In the next issue of Ruark Reports, Ruth Ann Woodley will provide an overview of this competitive analysis of dental discounts from 11 major carriers by geographic area.

Rich Tucker to speak at 2005 annual NAVA meeting in New York City - On October 23 Rich will provide the latest information on Index Annuity Market Trends.

RIA hosted its third Reinsurance Conference at the of April - A variety of topics were covered at our well-attended 3-day conference in Bermuda, including an update on the latest VA valuation proposals, a comparison of real world and arbitrage-free pricing techniques for variable annuities, and the results of RIA's studies of VA mortality experience and contract holder behavior. Rich's presentation on synergies between variable and indexed annuities is included in this issue. It was also included in the Index Compendium, June 2005, published by Advantage Compendium.

Ruth Ann is part of the AAA Disease Management workgroup - Their report was discussed in the June 17 National Underwriter article titled "Actuaries Unsure About Effects Of Disease Management". (We assure you Ruth Ann is rarely unsure about anything.) The report highlights the difficulties in quantifying Disease Management's impacts, and the group is developing practice standards to address the issues.

Rich presented on Annuity Reinsurance Management at the SOA Reinsurance in Depth seminar, on June 28th in Rosemont, Illinois.

New baby on the way at RIA—Sally and Alan Osit are expecting their fourth child at the end of August, making the Osits the most prolific of all RIA/RCL families.

2005 Tournament - The Osits once again helped organize this event which raised almost \$46,000 in the **fight against childhood cancer** and brought the 3 year total to over \$120,000!! For more information or to make a donation, go to www.golfforethekids.com.



RIA/RCL Team:

Actuaries:

Peter Gourley	Sally Osit
Inger Harrington	Timothy Ruark
Michael Loftus	Richard Tucker
Susan Murray	Ruth Ann Woodley

Office Manager:

Judy Mason

Editor:

Inger Harrington

**Ruark Consulting LLC &
Ruark Insurance Advisors, Inc.**
730 Hopmeadow Street
Simsbury, CT 06070
(860) 651-3744
www.ruarkonline.com