Larger Than Life

Primarily because of changes in the reinsurance market, putting together a jumbo life insurance package for a wealthy individual has become a colossal challenge

Gregory Taggart

TIME WAS THAT IF YOUR CLIENT needed large amounts of life insurance—say, a jumbo policy of $50 million or more—it could be cobbled together fairly easily. In 1999, Michael Gallop, president of the Broker's Network in Camarillo, Calif., arranged coverage of more than $350 million for a couple in just two weeks. But these days, arranging such policies is much more difficult. Not only have the events of September 11, 2001, changed forever the way life insurers perceive risk but the all-important reinsurance landscape has also been dramatically altered. According to Gallop, clients can still acquire supersize life insurance policies. But "the way a case is presented to the insurer and reinsurer, the way it's packaged and communicated, the way the whole thing is put together is very important."

The typical buyer of a jumbo life insurance policy is in his late 60s and has an estate in excess of $100 million. Advisers interested in helping such clients plan their estates need to understand how large amounts of life insurance are packaged. To begin, an insurer's retention level—that is, its financial capacity and stomach for risk—depends largely on its size. Only a handful of the big players—Prudential Financial and New York Life Insurance, for example—can handle risks between $20 million and $50 million, depending on the type of policy. Smaller carriers like Union Central Life Insurance will generally sign on for only $1 million of a permanent insurance risk. And the risk capacity of individual reinsurers—those that assume risks direct insurers can't handle or don't want (see "Mumbo Jumbo" on page 36)—tends to be less than that of their direct insurer counterparts. Consequently, a mammoth case may require lining up 10 or more carriers. Gallop had to use about 20 carriers to pull off his $350 million case, and that was in 1999. "We were able to get $210 million put together with 12 direct carriers and did the balance in the reinsurance market," he says.

These days, even the reinsurers often sell or cede some of their risk to their own reinsurers—called retrocessionaires—who may, in turn, cede a portion of the risk to their own reinsurers. The process can become very convoluted. "All the carriers basically go to the same reinsurers to get capacity," Gallop says. "There's a tremendous amount of overlap."

The overlap sometimes leads to problems. For example, Nat Perlmutter, chief executive officer at Forest Hills Financial Group in New York, a Guardian Life Insurance agency, was working on a $90 million term case with an agent who also sent the case to MassMutual Financial Group. Now, Guardian has a maximum exposure on any policy of $5 million, and it routinely reinsures 90 percent of every term insurance case. So the firm needed all the reinsurance capacity it could get to place the case. But as it happened, MassMutual and Guardian share the same reinsurers. And guess what? MassMutual was the first one to put the case out to reinsurance. "They took all of our capacity," Perlmutter reports. (He later got the case, but that was only after the insured told MassMutual that he would do business only with Guardian.)

Interestingly, capacity, not price, is the dominant issue

Illustrations by Katy Lemay

Only a handful of the big players—Prudential Financial and New York Life Insurance, for example—can handle risks between $20 million and $50 million

in the large-case marketplace. And it's shrinking. During the past four or five years, the insurance industry has experienced a perfect storm of sorts. "I don't think anybody could have imagined what has happened in the past couple of years," says Paul Rutledge, president of Transamerica Reinsurance in Charlotte, N.C.

The events of September 11, 2001, presented perhaps the most startling wake-up call. Suddenly, insurers were concerned as never before about a large number of insured lives concentrated in a single location. It was an exposure that in the past underwriters hadn't recognized as a likely catastrophic risk. One insurer had coverage on three major employers in the World Trade Center and had to pay claims on close to 1,800 lives. Fortunately, "they happened to have a catastrophic reinsurance program in place," explains Carl Friedrich, a consulting actuary with Milliman in Chicago. "So in the end, the company's out-of-pocket was modest, but the amount picked up by the reinsurance community was around a couple of hundred million." Not surprisingly, capacity shrank as insurers retrenched.

But even before the terrorist attacks, reinsurance capacity had been tightening up as the industry consolidated. Over the past five years, Swiss Reinsurance has gobbled up Lincoln Re (once one of the largest reinsurers), Life Re, Cigna Re, and some others. GE's Employers Reinsurance, the world's fourth-largest reinsurer, purchased the reinsurance business of Phoenix Home Life Mutual Insurance in 1999 and of American United Life Insurance in 2002 and then left the life reinsurance market in the United States altogether last year. By some estimates, such consolidation has cut life reinsurance capacity by as much as half. Today, the pool of reinsurers numbers only about a dozen firms, including Swiss Re, Transamerica Reinsurance, ING Group, and Reinsurance Group of America.

And the story doesn't end there. The retrocessionaire market is a subset of the reinsurance market, including many of the same players as well as direct carriers, such as Manufacturers Life Insurance and Sun Life Financial. The same issues that influence the reinsurance market affect that subset.

What's more, as Rutledge notes, bond defaults, lower interest rates, and the volatility in the equity markets have all had a negative impact on insurers' balance sheets and, by extension, their credit ratings. As insurers' credit ratings decline, their relative cost of debt financing increases, which in turn affects available capacity. In addition, ever since the National Association of Insurance Commissioners adopted Regulation XXX in March 1995, insurers have had to increase their reserves for certain life insurance products, creating more demand for capital. Going forward, "the cost of capital and capital equivalents—letters of credit and reserve credit trusts—is going to be driving the capacity issue more than anything else," Rutledge says.

In the meantime, though, the effects of the industry's demutualization are still being felt. In order to more easily raise capital and facilitate acquisitions, many mutual insurers have reorganized into stock companies over the past few years. The change has come with a price: Prior to reorganization, their financial statements meant little to anybody but the most eagle-eyed insurance examiner. But as a stock company, if a carrier takes a $50 million hit, Wall

Street takes notice. In fact, Gallop says that when Prudential demutualized in December 2001, it reduced its retention level from $50 million on a second-to-die policy to $10 million in an effort to manage earnings volatility. "The thinking was that they felt very comfortable taking on a $50 million risk, but they were concerned about how Wall Street would react if the risk actually hit their income statement," he says. The company later returned to the $50 million level on second-to-die policies and $30 million on single-life policies to prove that it was still in the large-case market. "It's a perfect example of how sensitive insurance companies are to how the market looks at their financial statements," Gallop says. "Other companies look at it the same way. They don't want to take the big hit."

To avoid getting walloped, Prudential and others have begun using so-called first-dollar quota share (FDQS) reinsurance to minimize their risk. Under FDQS, direct carriers accept only a percentage of each dollar of any risk instead of accepting all risk up to their retention limit and ceding the remainder to reinsurance. Assume, for instance, that a carrier with a $10 million retention limit is considering a $15 million case. Under the conventional "excess of loss" retention method, the direct carrier would assume $10 million of the risk and cede $5 million to reinsurance. But with a 20 percent FDQS retention policy, the carrier will accept only $3 million, or 20 percent, of the total and cede the remaining $12 million to reinsurance.

Direct insurers now even offer some products that are completely reinsured. "As a result, carriers are really relying on reinsurance more than they did five or 10 years ago, even as the market is contracting," Gallop says. "It used to be if I had a $100 million survivorship case, I could go to Prudential for $50 million and New York Life for $30 million and someone else for $20 million—three or four carriers to do the whole thing. Now, if I bring New York Life in, they might reinsure the whole thing or do first-dollar quota and keep $6 million. The vast majority of the carriers are doing that, and that clogs up the reinsurance market."

That's the bad news. The good news is that there are still ways to navigate the capacity issue and address most, or maybe even all, of your wealthiest clients' life insurance needs. You just need to tread carefully. "A common mistake that people make is to just throw a case out to the reinsurance market and see what comes back," Gallop

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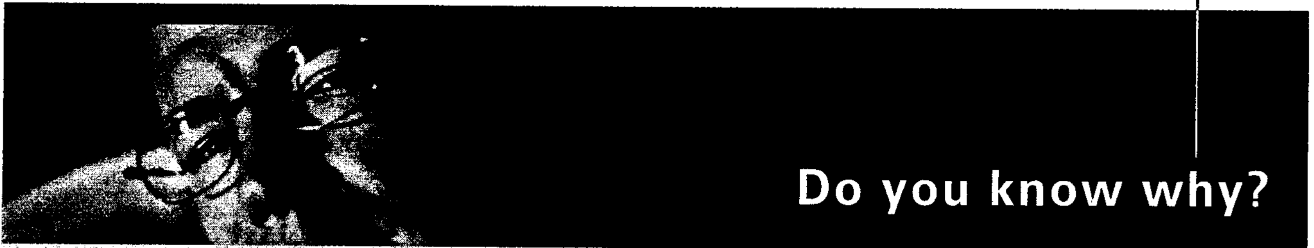

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MUMBO JUMBO

If you're an adviser with a client who needs large amounts of life insurance, you'll discover that reinsurance terminology is even more arcane than insurance jargon in general. Worse, there are more players. Here's a quick guide to help you through the maze.

Three types of carriers get involved in the jumbo life insurance process—direct carriers, reinsurers, and retrocessionaires (who reinsure the reinsurers). They all contract with one another to make sure your clients get the insurance they need. Called treaties, those contracts come in two basic varieties:

- Automatic treaties, which require reinsurers to accept insurance risks up to a defined maximum dollar amount.
- Facultative treaties, under which the insurers conduct business one transaction at a time.

In the reinsurance business, the so-called jumbo limit—not to be confused with a jumbo policy—can also come into play. No matter what treaty is in place, if in any particular instance, the insurance applied for plus the insurance already in force with any and all insurers exceeds the direct insurer's jumbo limit—typically in the $35 million to $50 million range—the reinsurance process defaults to a facultative treaty so the reinsurer can assess whether it wants to assume a particular risk.

There are also two basic forms of reinsurance: proportional and nonproportional. Under nonproportional, the direct insurer assumes all risk up to its retention limit, and the reinsurer pays the rest. With proportional—often called first-dollar quota share—both the direct insurer and the reinsurer pay a predetermined percentage of each claim. First-dollar quota share is becoming increasingly common. —*GT*

explains. "They don't realize that the reinsurance market is an area that requires close management and control."

For example, some of the tricks of the small-case market simply won't work in the large-case market. Savvy agents don't send large cases to multiple carriers to get the best price or rating, because given the way the reinsurance market overlaps, sending a $50 million case to four companies can make it look like a $200 million case to a reinsurer that serves all four. Furthermore, underwriters look at both the health and financials of the proposed insured and are suspicious of overinsurance and of clients who shop for ratings. "They say, 'Wait a second. This guy went to four companies. Maybe he wants to see who thinks the pain in his kidneys is not serious,'" Perlmutter notes.

This is why many experts recommend that advisers give one agent exclusive control of a large case from the start. "People who think that they're going to be smart and shop megacases among two or three agents and let them compete with each other may hurt their chances. For sure, they'll make the case more difficult, because it confuses the market," Perlmutter says.

To avoid such difficulties, seasoned large-case agents will first gather all the relevant medical and financial records and arrange the necessary exams, then look at each important detail with the eyes of an underwriter to discover what the issues will be. If the valuation on a house or business seems over the top, they'll call an appraiser and get it right. If the insured's medical history raises red flags, they'll see if the attending physician will write a letter clarifying the situation. "We know what the issues are and where the problem areas are, and we devise a strategy for how we're going to handle those issues before the companies even know the case exists," Gallop explains.

Some industry experts suggest that clients are better-off giving the package to a lead company—instead of a large-case agent—and letting the underwriter take it from there. Gallop, not surprisingly, disagrees. As he sees it, an agent or general agent experienced in the jumbo-case market is financially motivated to make the thing work. "That agent is a salesperson," he says. "He or she knows how to package the case and how to present it to get the best result. Many times we have to negotiate hard to get the result we want, and sometimes underwriters may not be in a position to do that. Besides, after September 11, an insurance company is not going to rock the boat with its reinsurers."

Before Gallop approaches a company, he maps out the case and identifies which insurer and reinsurers can best meet his client's needs. For example, if his client has a history of cancer, he'll take the case to carriers that are comfortable with cancer risks. He tells each carrier what the requirements are, how much of the pie it will get, and who else is participating. The key, he says, is communicating with all interested parties.

Just how much insurance can be patched together in today's market? According to Gallop, anywhere from $125 million to $150 million on a single-life case and up to $200 million on a survivorship case. But to land that big a package, he notes, "you have got to make sure you're doing each step right." Take the wrong step, and a jumbo case may turn into a jumbo headache.

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