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 U.S.
Plan

Ford Parts & Service Division / American Road



Note: In considering this business opportunity, you must realize that the business of reinsurance involves some element of risk. Profits, therefore, cannot be guaranteed. Any financial information provided in this brochure is for example, and should not be interpreted as a guarantee of results.

■ Introduction

In February of 1985, Ford Parts and Service Division and The American Road Insurance Company (American Road) combined resources to convert the Extended Service Plan to a dealer service contract administered by Ford Parts and Service Division and insured by American Road. Under this program, American Road will insure Ford, Lincoln-Mercury, and Merkur dealership contractual liability under any and all ESP or ESC service contracts.

Our sensitivity to current business trends has revealed that other business opportunities exist related to service contracts that some dealers may find attractive. These are in a complex but rewarding field called reinsurance. Using the resources and experience of American Road, we have thoroughly investigated the potentials of this industry. Our investigations indicate that there is an element of risk. However, this may be offset by income and tax advantages which dealers must evaluate with respect to their own financial situation. This booklet discusses the various aspects of reinsurance in general, and a special "Offer To Reinsure" as it relates to the Extended Service Plan contracts presently insured by American Road.

■ What Is Reinsurance?

Simply stated, reinsurance is insuring the insurer. As it applies to this discussion, reinsurance is the business of one insurer assuming all or part of a risk originally undertaken by another insurer. For assuming this risk, the reinsurer is paid a premium. Reinsurers only deal with other insurance entities, never the general public.

Reinsurance is used by insurance companies to spread their risks. They do this for a variety of reasons, including freeing reserves for greater capacity, stabilizing operating results or to improve their competitive posture. According to the Reinsurance Association of America, about 20 percent of the reinsurance business is written by primary insurers through a wholly-owned reinsurance subsidiary. Another 55 percent is written by professional reinsurers. The remaining 25 percent is written by unlicensed foreign or offshore reinsurers.

■ Reinsurance Terminology

Just as certain words and phrases in the automobile business are unique, so too, are some accepted reinsurance terms. We have attempted to keep this discussion relatively free of such references. However, in the interest of clarity, you will find a few that may require further explanation. To assist you in clarifying any such terms, we have included a **Glossary of Terms** at the back of this publication.

■ Reinsurance and the Service Contract Business

The service contract industry has grown considerably in the past five years. In 1980, it represented about 12 percent of new car sales. Today, it represents more than 21 percent of new car sales and is continuing to expand. As a result of this growth and a corresponding reduction of warranty claims because of manufacturer product quality actions, many dealers have been offered reinsurance investment opportunities to achieve a higher return on the service contracts they sell and to take advantage of tax-deferred income potentials.

TYPES OF SERVICE CONTRACT REINSURERS—

There are several different methods of establishing a reinsurance entity. One method is the **Foreign or Offshore Reinsurance** entity, also referred to as **Alien Reinsurers**. Principally based in such locations as Bermuda, the Caymans and Bahamas, Offshore Reinsurers are neither regulated nor licensed by U.S. authorities. These plans promised their investors unique financial advantages although the risk level was high. On the other hand, there are **Domestic Reinsurers**, all of whom are subject to government regulations. Many of the Domestic Reinsurance entities are located in Arizona where regulatory agencies have created an advantageous business environment.

OFFSHORE VERSUS DOMESTIC REINSURERS—

Because of changes occasioned by the Tax Reform Act of 1984, the promise of tax exempt earnings from Offshore Reinsurers is being seriously questioned. And, now, there is a question of whether there are any tax advantages whatsoever. Since the offshore locale is foreign, there is also a risk of political instability.

There are also risks associated with Domestic Reinsurers. However, these entities are U.S. regulated. In most cases, business expenses are provable, and Domestic Reinsurance companies still offer tax-deferred income advantages. Since Domestic Reinsurers are located in the United States, judgments can be obtained on any legal disputes. As U.S. corporations, disclosures must be filed, and become public records. Today, the **Domestic Reinsurance** entity is thought to be a far superior investment by many of the dealers with whom we have reviewed this program.

■ 1984 Tax Reform and Reinsurance

The Tax Reform Act of 1984 targeted U.S. tax avoidance reinsurance schemes. Also, laws existing before 1984 caused investors in Offshore Reinsurance entities a significant risk when these companies do not file U.S. income tax returns. In this situation, investors, if challenged by the IRS, may pay taxes on their income as well as find it difficult to declare normal business expenses associated with Offshore companies. Advantages in tax-deferred or sheltered profits from Offshore Reinsurance operations are uncertain.

TAX REFORM ACT OF 1984

[Sec. 845 (a)]

(a) **ALLOCATION IN CASE OF REINSURANCE AGREEMENT INVOLVING TAX AVOIDANCE OR EVASION**—In the case of two or more related persons (within the meaning of section 482) who are parties to a reinsurance agreement (or where one of the parties to a reinsurance agreement is, with respect to any contract covered by the agreement, in effect an agent of another party to such agreement or a conduit between related persons), the Secretary may—

- (1) allocate between or among such persons income (whether investment income, premium, or otherwise), deductions, assets, reserves, credits, and other items related to such agreement.
- (2) recharacterize any such items, or
- (3) make any other adjustment,

if he determines that such allocation, recharacterization, or adjustment is necessary to reflect the proper source and character of the taxable income (or any item described in paragraph (1) relating to such taxable income) of each such person.

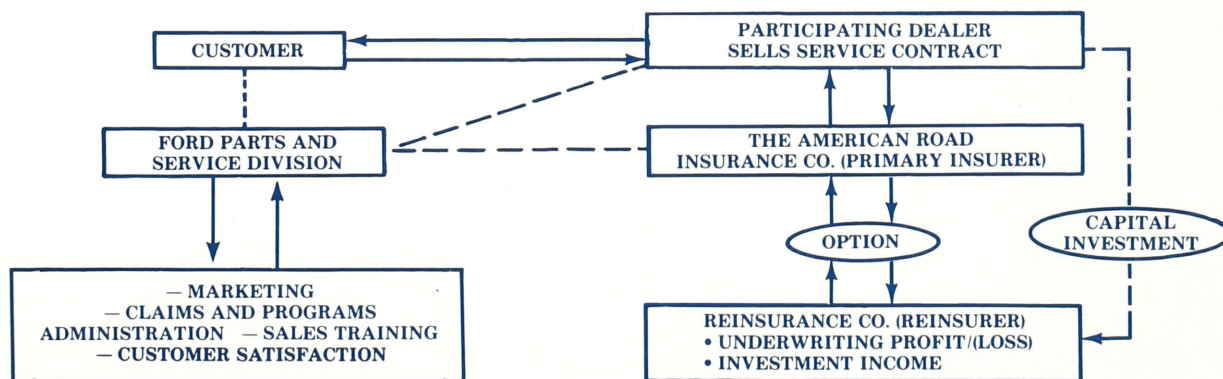
[Sec. 845 (b)]

(b) **REINSURANCE CONTRACT HAVING SIGNIFICANT TAX AVOIDANCE EFFECT**—If the Secretary determines that any reinsurance contract has a significant tax avoidance effect on any party to such contract, the Secretary may make proper adjustments with respect to such party to eliminate such tax avoidance effect (including treating such contract with respect to such party as terminated on December 31 of each year and reinstated on January 1 of the next year).

On the other hand, it can be said that Domestic Reinsurers, because of regulatory considerations and provable business expenses, usually will find taxes less burdensome while minimizing the concern of being challenged by the IRS. As you can appreciate, from the wording of the law, any significant indication by any reinsurance plan . . . Offshore or Domestic . . . that has the effect of tax avoidance may lead to IRS scrutiny.

■ How Reinsurance Works

Fundamentally, reinsurance is a risk venture that bases its higher profit potential on the supposition that fully earned premiums will always exceed the sum total of all expenses and individual claims. The chart below traces the steps of a typical reinsurance transaction as it might develop for a service contract. The dealer has sold a contract to a customer. The dealer, (the "primary insured") pays the "premium" (dealer cost) to the "primary insurer" also referred to as the "ceding company." This covers dealer losses for any claims under that contract. The "primary insurer" then cedes a portion of the premium to a reinsurance company in which Ford, Lincoln-Mercury and Merkur dealer principals participate. Over the period of the reinsurance "treaty," this coverage will earn premiums for the participating dealer less, of course, any claims against the coverage. As premiums are earned, the excess over actual losses can be either reinvested to broaden the investment base or can be paid out as future dividends.



■ Risk Exposure

A participating dealer's exposure to risk is the principal deterrent to reinsurance investments. If a participating dealer is selling a high number of service contracts, the risk is spread over a wider base, thus minimizing the effect of individual claims. Conversely, small volume participating dealers would be at a higher risk, and therefore are discouraged from participating. In a "worst case" situation, however, if claims against a participating dealer's account exceed the account's "claims reserve," the difference is charged to the participating dealer's principal investment. If claims continue unchecked, it's possible that a participating dealer's entire investment could be wiped out. Of course, there are controls the participating dealer can implement to contain these claims, since, in most cases, the claims will originate in his own dealership.

■ Extended Service Plan Profits

There is no question that Extended Service Plan contracts are profitable. The national average retail price of an ESP contract is \$414. Deducting the national average dealer cost of \$268, leaves a gross profit of \$146. If you add the ESP Bonus Program payback of \$20 to \$40 per contract, you have substantial ESP profits without any risk whatsoever. However, for dealers who are interested, there is the ESP/U.S. Plan reinsurance investment option.

REINSURANCE PROFITS—

There are several different roads to profit under participation in a reinsurance program. Essentially, these can be categorized under **Direct Underwriting Profits . . . Investment Profits . . . and Retained Profits**. Let's consider **Underwriting Profits** first.

Let's make an assumption that in a given transaction we start with a "Net Written Premium" of \$100. From this is deducted the company service fee, including any state premium tax. In our example the service fee would be \$32. We must also set aside a reserve figure for claims. In our example it happens to be \$50. However, this figure is usually based on prior experience of the average claims against the participant's individual account. If there is no prior experience, this figure is based on average claims for dealer participants within that participant's class. The resulting total after all deductions is called the "**Underwriting Performance**". This is the anticipated direct profit from a single given transaction before the allocation of fixed costs and tax.

UNDERWRITING PROFITS

EXAMPLE

Net Written Premium	\$100
Service Fee	(\$32)
Ceded Premium	\$68
Claims (Est.)	\$50
Underwriting Performance or Profit	\$18

"Investment Income" can be realized through three different sources:

- **Investment Income from the Initial Investment**—These are funds realized by the initial capital investment.
- **Investment Income from Premium and Loss Reserves**—These are the funds earned as a result of investing that portion of the "Net Written Premium" set aside as claims reserve.
- **Retained Profits**—Those funds earned but not distributed. These also are reinvested to continue to earn until they are distributed.

REINSURANCE PLAN TAX ADVANTAGES—

The present dealer ESP Bonus Program provides \$20 to \$40 per qualifying contract. This is considered taxable income at the time it is issued. For dealers participating in the ESP/U.S. Plan reinsurance program, the ESP Dealer Bonus Program will no longer apply. However, a reinsurance investment could show returns of up to twice the bonus potential per contract in **tax-deferred income outside the dealer participant's financial statement**.

■ ESP/U.S. Plan... Your Reinsurance Connection

Your reinsurance connection could be the ESP/U.S. Plan, or another company formed by an individual dealer or group of dealers. The ESP/U.S. Plan will probably be incorporated as an Arizona mechanical reimbursement reinsurance company. Arizona is usually chosen because the state regulatory agencies have created an advantageous business climate for reinsurance companies. As a U.S. corporation it will be subject to Federal and state laws, regulations and procedures. Reinsurance of dealers' Offshore companies may be considered, if they file U.S. income tax returns.

AMERICAN ROAD INVOLVEMENT—

American Road plans to provide the necessary experience and expertise in organizing a Ford subsidiary reinsurance entity. They will also be responsible for the initial capitalization and surplus requirements. The Ford Parts and Service Division will continue to be responsible for ESP program administration.

DEALER PARTICIPATION—

It is anticipated that Ford, Lincoln-Mercury and Merkur dealer principals will be offered an exclusive opportunity to participate at the time the new reinsurance entity is formed. This will be accomplished through an offer of one series of stock per dealer. Under this type of arrangement, each participating dealer's series will reflect, over time, underwriting and investment profits or losses related to ESP contracts the dealer sells and services rendered anywhere in the United States or Canada, as determined by the program administrator, Ford Parts and Service Division.

CUSTOMER SATISFACTION AND DEALER CLAIMS COST CONTROL—

Our combined dedication to the principles of Quality Care and the individual customer service and satisfaction are well known. The Extended Service Plan contracts are extensions of this dedication, and offer the most complete and effective customer relations tools at our disposal. In order to maintain a degree of claims cost control, participating dealers can exercise control of ESP repairs performed at their dealership. However, this control should be exercised with care and concern for each customer's satisfaction in order to maintain the Quality Care image projected by the Ford Motor Company and each and every Ford, Lincoln-Mercury and Merkur dealer.

■ General Reinsurance Company Provisions

The following are general provisions regarding ceding company and reinsurance company procedures. These are not necessarily the systems that will be implemented by our proposed ESP Reinsurance company when it is incorporated. They are provided for your general information about mechanical reimbursement reinsurance companies as a whole.

INFORMATION REGARDING INVESTMENTS—

Each participant in the reinsurance entity receives periodic underwriting performance reports. These will show the condition of claims reserves, number of "Net Written Premiums" applied to the account since the last report, an ongoing tally of expenses, and claims charged to the account.

DIVIDENDS—

It is usually the practice with new reinsurance companies to refrain from declaring dividends resulting from reinvestment of capital until each participant's initial premium on insurance contracts have had time to earn out. This practice normally covers a time span of about five years.

REINSURANCE PREMIUMS—PRORATED—

Most insurance companies cede reinsurance premiums on a prorated basis over the life of the insurance contract (for example, 50 percent of the premium as it is written with the 50-percent balance ceded as earned).

EXPENSES—

As outlined earlier, most reinsurers treat service fees as legitimate reinsurance expenses. As such, they are charged to each participant's account series. These, when added to claims reserves and deducted from "Net Written Premiums," result in a residual called "Underwriting Performance" which, if profitable, increases future reserves being held.

SERVICE FEES—

Service fees charged to reinsurance company participants' individual series accounts usually include all administrative charges and all ceding commissions paid to the insured's ceding company. Generally speaking, these fees vary depending on the total service contracts written. A high dollar volume in a given period, therefore, might accrue a lower percentage service fee than a lower dollar volume over the same period.

■ The Offer To Reinsure

The "Offer To Reinsure" facilitates your entry into the reinsurance business. It gives us the ability to offer reinsurance now. The terms of the "Offer" are relatively simple:

First, American Road agrees to reinsure 100 percent of the unexpired liability and cede the unearned premium relating thereto on all eligible Extended Service Plan service contract contractual liability insurance business (the "Business") written by American Road for the dealer on or after the effective date of the Offer To Reinsure, on the terms and conditions stated in the offer. All ESP Offers To Reinsure will become effective on the first day of a calendar quarter—January 1, April 1, July 1 or October 1.

Second, American Road will reinsure the Business with a reinsurance company formed by American Road or an affiliate of American Road or with another reinsurance company that is acceptable to the participating dealer and American Road.

Third, the participating dealer may request American Road to reinsure the Business at any time within the twelve-month period after the effective date specified on the Offer To Reinsure. American Road automatically extends this offer to reinsure from year to year, but such reinsurance will include only the unexpired liability and the unearned premium relating thereto on all Business written in the twelve months prior to the date the participating dealer requests American Road to reinsure.

Fourth, the reinsurance agreement will be negotiated on mutually satisfactory terms between American Road and the designated reinsurance company, and will provide for a retention percentage by American Road to cover all expenses of American Road and its administrator (Ford Motor Company, Ford Parts and Service Division) in the direct Business, other acquisition expense, premium taxes, and claims administration expense.

Fifth, the Offer To Reinsure and any reinsurance agreement will be subject to any and all rules, regulations and laws of any state or Insurance Department having jurisdiction over this Business.

And lastly, the Offer To Reinsure will remain open until withdrawn by American Road, provided, however, that American Road may not withdraw this Offer To Reinsure during the first twelve months after the effective date of the Offer To Reinsure.

TIMETABLE—

Upon execution of an ESP/U.S. Plan Offer To Reinsure, we agree to begin to warehouse ESP premiums on the first day of a calendar quarter (January 1, April 1, July 1 or October 1) so that at some future date the unearned amount may be transferred to a reinsurance company you select. If you select the reinsurance company to be formed by American Road, our legal counsel advises that the formation may take up to one year or more, since we must secure all the proper documentation through the various governmental agencies. You should note that bonus payments for contracts sold after the effective date of the Offer To Reinsure will cease. In the event you cancel, the bonus payments will be restored retroactive to the date of your signing the Offer To Reinsure.

■ Some Questions & Answers

- Q. Doesn't reduced claims expense result, ultimately, in lower ESP dealer prices and subsequent lower profit potential?**
- A.** Yes, but it's really not that simple. Good claims cost control leads to improvements in underwriting performance. That's an immediate benefit for your present reinsurance investment. Normally, lower claims costs would result in future decreases in ESP dealer prices. That would appear to lower investment potential. But, at the same time, lower prices raise the sales volume potential. Therefore, lower prices can really help achieve a much larger investment universe.
- Q. What can dealers who have invested in competitive reinsurance plans do?**
- A.** If a dealer already has significant retained profits, he may be reluctant to withdraw. In this case, the dealer can begin selling ESP and participate with any reinsurance company if acceptable to American Road; or withdraw and begin to participate with the ESP/U.S. Plan.
- Q. What are the tax advantages to reinsurance investments?**
- A.** There are distinct advantages from a tax viewpoint to insurance investments. Tax sheltering and a high retained income are just two. If, as we expect, the IRS challenges Offshore Reinsurance company business expense claims, Offshore Reinsurance tax advantages will be jeopardized. This leaves only Domestic Reinsurance companies as the alternative for tax-sheltered investment purposes.
- Q. What risk will I be exposed to in warehousing with American Road?**
- A.** There is no risk to signing this agreement because the company has not been formed and a dealer is absorbing no risk, American Road is absorbing the risk.
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■ Glossary of Terms

Benefits Paid: (Also "Claims Paid") The expenditure made to cover claims of policyholders.

Cede: To transfer to a reinsurer all or part of the insurance or reinsurance written by an insurance or reinsurance entity.

Ceding Company: (Usually "Primary Insurer") The entity transferring all or part of its risks to a reinsurance entity.

Ceding Commission: The portion of the insurance or reinsurance premium that is paid by the reinsurer to the ceding company as compensation for ceding the business.

Claims Experience: The amount of benefits paid by the reinsurance company during the applicable period with respect to policies written for individual dealer participants.

Earn Out: Total of Net Written Premiums applicable to insurance coverage completed for the period of the contract.

Earned Premiums: The portion of Net Written Premiums applied to insurance coverage provided during the policy period that has expired.

Insurance Underwriting: The process by which an entity agrees to accept a risk of loss for a consideration.

Maximum Exposure: The aggregate liability of an insurance or reinsurance entity either on an individual risk or a group of risks.

Net Written Premiums: The portion of total insurance or reinsurance premiums retained by an insurer or reinsurer for insurance coverage, and not ceded, less cancellation refunds.

Primary Insurer: An insurance entity that writes policies directly for individual insureds.

Reinsurance: A transaction where an insurance or reinsurance entity transfers all or part of its risks to another reinsurance entity for an agreed consideration for the purposes of relieving itself of the liability.

Reinsured: (Usually "Primary Insurer") The entity transferring all or part of its risks to a reinsurer.

Reinsurer: The reinsurance entity that assumes all or part of the liability attached to risks underwritten by a ceding company for a consideration.

Retention: That portion of the liability kept by the insured or reinsured for its own account and not subject to further reduction by reinsurance or otherwise.

Surplus: The excess of an insurance entity's assets over its liabilities.

Treaty Reinsurance: Reinsurance covering a specified portion of a specified class or classes of risks.

Unearned Premium: The portion of the Net Written Premium applicable to insurance coverage to be provided during a future period.

