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Impact of Changing Accounting and Regulatory Regimes on Reinsurance

Track: Reinsurance

Moderator: GRAHAM W.G. MACKAY

Panelists: RICK HODGDON[†]
DONNA R. JARVIS
STEVEN D. LASH

Summary: This session provides an overview of the impact of changing operating environments affecting reinsurance transactions due to emerging International Accounting Standards (IAS) and changing reinsurance regulations in the United States and Europe. Participants in this session improve their understanding of the impact of IAS on reinsurance transactions, changing federal and state insurance regulations impacting reinsurance and emerging European regulations related to reinsurance.

MR. GRAHAM W.G. MACKAY: The idea behind this session, from a reinsurance council perspective, was to make this a regular activity. We realize that the issues affecting reinsurance are changing very rapidly. In preparing for our presentations, we found that the PowerPoint presentations put together by a couple of our speakers are already out of date, so there will be a little bit of dancing up front. If you've been following any of these issues, you should come to the conclusion that it's just about impossible these days to keep in touch with what's going on. People need to specialize, or you need to find ways of acquiring knowledge or getting some coaching on where you can find information that's going to be important to you. That's part of the brief on which I've asked the speakers today to focus. They're going to focus on certain issues. They're going to tell you why it's important, and

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[†] Mr. Rick Hodgdon, not a member of the sponsoring organizations, is executive managing director at Transamerica International Reinsurance Company in Ireland.

they're going to tell you how you can get more information.

We have broken our presentation into three main parts. We're going to look at a number of the key U.S. regulations. We're going to hear about the hot issues in Europe right now, and we're going to follow up with an update on some accounting-related issues that are also affecting reinsurance. We have our experts, our three presenters. Donna Jarvis is from Hartford. She has worked in the reinsurance area for nine years, on both the assuming and the ceding sides. Currently she's assistant vice president at Hartford Life, where she's in charge of corporate reinsurance risk management. She has been a member of the ACLI Reinsurance Committee for a year and a half. The mission of this committee is policy development and advocacy of the NAIC state and federal levels and the active monitoring of relevant international activities pertaining to reinsurance. She has also taken a leadership role in the effort to modernize the NAIC risk transfer regulations, so in the United States, Donna is at "ground zero," and hopefully she will be able to share a number of her insights in addition to what is more publicly available.

Rick Hodgdon is the executive managing director of Transamerica International Reinsurance Company in Ireland. He's also vice chair of DIMA, the Dublin International Management Association. DIMA is the industry lobbying body that represents the industry and deals with insurance regulators on finance issues. He's the chairman of the Life Reinsurance Subcommittee and a sitting member on the Solvency II Committee. Rick is one of the more vocal people in the life reinsurance industry in Ireland in terms of identifying some of the issues and some of the bumps that proposed language can have on our sector. He has been very active in helping educate the regulators and the Irish finance people on how to present their industry and negotiate positions that are attractive to us in the European Union. He'll be talking to us about some of the activities that are going on in Ireland.

Steve Lash, our last presenter, is from Ernst & Young. He has been a partner in their offices in New York for the last nine years. He has been involved in numerous actuarial consulting assignments with a particular focus on reinsurance, financial reporting and securitizations. He's a Fellow of the Society, as is Donna. Steve is also a member of a World Bank Task Force on Securitization, so he has very deep knowledge on reinsurance issues that are hot today. We're looking forward to hearing from Steve.

MS. DONNA R. JARVIS: Let me remind you of a quote that is ascribed to Robert Kennedy that says, "There's a Chinese curse which says, 'May he live in interesting times.'" Like it or not, those of us who are dealing in reinsurance regulation right now are living that curse. Usually we think that U.S. regulatory information is not all that interesting, but I do believe that there's a lot going on today of which you should all be aware, and, in fact, it is quite interesting. In fact, when I put my presentation together about a month ago, I thought I could probably rest easy for the duration. However, so much has gone on in the last month, particularly

pertaining to finite risk reinsurance, that you will see that there's a lot of information that I have to give that's not in my prepared slides. I'd like to spend the first part of my presentation talking about finite risk reinsurance and all the developments pertaining to it. I want to make sure that we're all on a level playing field as to what that means. Then I'm going to talk about some things pertaining to reinsurance that are going on at the state level, the NAIC level and also the congressional level.

First and foremost, finite risk reinsurance is a reinsurance transaction that includes limited risk transfer to the reinsurer, hence the term "finite." There can be various types of risk-limiting features in the contract, but essentially the issue is that regulators and the SEC are concerned that some companies are using these types of transactions to reduce reserves or increase capital when the economics of the transaction would indicate that true risk transfer to the reinsurer has not taken place. Just to remind you, there are some statutory and GAAP accounting differences between the life industry and the property-and-casualty (P&C) industry. In the life industry we have a different statutory risk transfer criteria than we do on GAAP, which could lead to different accounting treatments of a reinsurance transaction on both bases. On the P&C side, both our statutory and GAAP transfer criteria are the same, which is why this focus is more on finite risk in the P&C industry.

The first one out of the box is New York state. On March 29 they issued Circular Letter No. 8, which applies to all authorized insurers. Their statutory authority for this was their examination authority under the New York state law. Their concern, again, was the improper use of finite reinsurance to manipulate financial reporting results. New York is now requiring the CEO, as part of an examination, to attest with respect to all reinsurance cessions that (1) there are no separate written or oral agreements that would reduce, limit, mitigate or otherwise affect actual or potential loss to the parties under the contract; and (2) there is a treaty file for each treaty that has the proper documentation of the economic intent of the parties in entering into the transaction, including a risk transfer analysis and documenting evidence of the proper accounting treatment. Right now they don't have anything other than the attestation and part of their examination. As you well know, examinations tend to apply only to domestic companies. Right now this is only an issue for New York domestics. However, they may require increased disclosure of finite risk and, in fact, all reinsurance transactions in the annual statement, including this attestation. That would apply to licensed companies as well as domestic.

Since that time, we've received a number of clarifications. I won't read them all, but essentially, even though their concern is finite risk, New York is saying that this applies to *all* reinsurance transactions. It applies to life as well as P&C. Right now they're saying that it only applies to ceded reinsurance; they're not asking for this attestation on the assuming side. Again, as I mentioned, it applies under the context of an examination, so it would be for all companies, at this point in time,

for all unexamined years. As you all know, life insurance contracts are quite long in duration, so if you're taking reserve credit for any reinsurance transaction as of the date of the exam, that treaty would be in the scope of this attestation.

The good thing about it is that New York has said that the attestation that they drafted was not intended to be the "sum and substance" to which the CEO would ultimately attest. They didn't want to force companies to attest to something that wasn't true. They simply wanted to make themselves aware of any other arrangements that would be applicable to their review of the financial condition of the insurance company. They are working with the industry right now to develop an attestation that is reasonable and that the industry can sign. They simply want to make themselves aware of any additional considerations in an examination context. New York has also said that the CEO does not need to have personal knowledge of every contract. This is a little bit of a departure from Florida (which we'll discuss in a minute) in that they can rely on the internal controls to make the attestations. They can say that to the best of their knowledge and belief, this is true. The circular is only guidance. It's not a regulation, so it cannot be used to actually cite companies, but if someone knowingly signs a false attestation, that person would be subject to criminal perjury sanctions.

Various industry groups, including the Reinsurance Association of America (RAA), the ACLI and the Life Insurance Council of New York (LICONY), have had meetings with the New York Insurance Department to try to seek clarification and also to explain to them what some of the issues regarding complying with this regulation would mean to certain companies. We're expecting a letter to come out from the state of New York. They said the letter would come out by the end of May. It will clarify how they expect companies to comply with this. The good news is that from the life side, we have recommended a materiality threshold of 3 percent of the company's surplus. New York has said that they'd be amenable to considering a materiality threshold, so clearly if a reserve credit were above 3 percent of your surplus, then that would be in the scope of the attestation, and if not, it wouldn't. Yearly renewable term (YRT) transactions generally tend not to have material reserve credit and therefore would be outside the scope of this.

Florida followed suit very similar to New York. On May 3, the Office of Insurance Regulation filed a notice of proposed rule making. On May 10, they had a rule development workshop. They now are going to be requiring the president or the CFO to file an annual attestation under penalty of perjury, but their form right now is fixed. Unlike New York that said it doesn't want people to attest to something that's not true, the Florida form, as far as I know, is of a certain form, and the CFO and president either attest to it or not. Again, very similar to New York, there are no separate written or oral agreements that would reduce or mitigate the loss into the contract, and there's an underwriting file. The problem with the underwriting file in Florida is that not only are they asking for the objectives of the transaction and a summary of the terms, but they are asking companies to do a risk transfer analysis pursuant to Statement of Standard Accounting Practice (SSAP) 62. For

those of you familiar with this, SSAP 62 is the accounting guidance for P&C reinsurance regulation. Florida has stood up and said that no, this applies to life reinsurance transactions, but they're asking life insurers to attest to P&C accounting guidance. They're also asking for a listing of all contracts that contain certain finite risk-type features. For those contracts, they would like, in the underwriting or in the treaty file, a financial statement presentation before the effects of reinsurance, so they could view it if they wanted.

Delaware and Rhode Island have both gone to all their domestic companies in the last month and a half and requested information on various types of reinsurance agreements, particularly those with side agreements or with certain characteristics that might be indicative of finite reinsurance. They're essentially looking for many of the same things as New York and Florida: information on how the transaction would affect the income statement, the balance sheet, the surplus, etc., and whether there is an underwriting file with appropriate documentation of risk transfer. Massachusetts is reported to have plans to require the chairman of the audit committee to sign off on all finite reinsurance transactions. These are the states that I know about today. There are probably more coming down the pipe. You should certainly be aware of what's going on in your state of domicile.

On a national level we have FASB, who has added a project to their agenda to consider whether or not they need to add some additional guidance on what constitutes risk transfer in an insurance and reinsurance context. As you know, we have Financial Accounting Standard (FAS) 113, which gives the GAAP accounting guidance on reinsurance risk transfer. They are also exploring the potential bifurcation of reinsurance contracts, to the extent there's a reinsurance contract that has some risk transfer elements and some that are not. We could account for the ones with risk transfer elements with reinsurance accounting and for the rest of the contract as deposit accounting. It's pretty messy. I don't know much more about it at this point in time.

At the NAIC level, the NAIC Casualty Actuarial Task Force has asked the American Academy of Actuaries to identify risk transfer standards and to determine whether an agreement meets the requirements for reinsurance accounting. There's also a P&C Reinsurance Study Group that on May 11 exposed new annual statement disclosures, including a CEO attestation. Right now those are only going to be applicable to P&C companies, but again, we need to monitor this to make sure that it doesn't ultimately affect life at some point in time. The attestation is very similar to the New York circular letter. In fact, I think New York is driving this through the NAIC. It's expected to be adopted at the June NAIC meeting and to be in place for the 2005 annual statements for P&C companies. That's what I'm hearing. They've also revised SSAP 62 requiring bifurcation of P&C reinsurance treaties for financing components. My understanding is there are some people who aren't quite there yet with that, and most likely that won't be in place for 2005.

You may have heard in the news that we have the FBI and the SEC looking into the

insurance industry and the reinsurance industry. I don't know other than what has been reported in the press, but as I said, it's an interesting time.

What does all this mean for you? Hopefully, it means nothing. The current focus is finite risk in the P&C industry. Unfortunately, sometimes reinsurance is painted with a broad brush, and we need to be careful that regulatory reactions to stem this abuse or potential abuse makes sense for the life industry and that we're not being asked to attest that we're in compliance with P&C requirements. Obviously you should be thinking about what your state of domicile is doing. If your company is involved with industry associations, you should really get involved. The ACLI has taken a proactive approach with this. On behalf of its member companies, it's going to be going to the NAIC and it's going to be educating about the protections that the life industry already has in place. It's going to be educating as to why it's different from P&C reinsurance and making sure that what is put into place makes sense for the life industry. To the extent that you are an ACLI member company, I would urge you to get involved in that.

Back on the home front, don't wait until your regulators come looking for you. Make sure that in all your reinsurance transactions you have your I's dotted and your T's crossed. Make sure that there are no side agreements or, if there are side agreements, make sure that they're being accounted for appropriately. Make sure you have entire agreement language in all of your reinsurance treaties. Are you documenting risk transfer when you enter into a reinsurance treaty? Maybe you should consider that. Maybe you should consider doing that for in-force treaties.

I'm going to get off finite reinsurance for a little while. I have a couple of state updates. The New York Empire Project is a joint initiative of LICONY and the ACLI. The project goal is to modernize New York life reinsurance regulation. The goal is to harmonize it with the rest of the United States as far as reinsurance regulation is concerned. Currently they're focusing on five areas. The first area is assets in Regulation 114 trusts. As you may know, currently they only allow for investment-grade assets. They want to be able to use more flexible assets—all those listed as admitted assets by the Securities Valuation Office. The second area is mirror reserving. This is the only state that requires it, and it only requires it in the context of reserve credit to a non-authorized reinsurer when it's secured by a letter of credit. Unfortunately, the ceding company is supposed to chase through all the retros as well. It's a little onerous. The third area is prior approval of affiliate reinsurance transactions. Most other states have this as well, but they have a materiality threshold of 5 percent of surplus. New York has none, so for New York domestics, everything needs to be filed if you do an affiliate reinsurance transaction. As far as the fourth and fifth areas, New York also has limitations on 100 percent reinsurance and it has some non-standard definitions in its Regulation 102, which is its version of the Life and Health Reinsurance Agreements Model Regulation, which dictates statutory risk transfer. The project has been supported by our former superintendent, Greg Serio, but he's no longer there. Acting Superintendent Howard Mills appears to have support for the project, but I do think

that their efforts and their energies have been elsewhere for a little while.

What does this mean for you? If it passes, there will be improved uniformity of regulations pertaining to reinsurance for New York licensed companies, but it improves options for New York domicile companies, such as more flexibility in Regulation 114 trust assets (as a ceding company, I would ask the reinsurers if that might give me better pricing) and not having to approve all affiliate reinsurance transactions.

Here's another one that was very polarizing. Back in September 2004, California issued a draft of a credit-for-reinsurance regulation. It was a replacement of a desk-drawer bulletin that they had, but it swept in a lot of other issues that were a laundry list of California concerns that went beyond credit for reinsurance. They imposed restrictions on right of offset, specifically limiting it in the event of insolvency and to specifically itemized offset amounts. It also doesn't allow for arbitration in the event of certain large disputes. Also, regarding treatment of receivables more than 90 days due, if a reinsurer hasn't paid, let's say, one claim past 90 days, it's questionable as to whether or not you can take reinsurance reserve credit for *any* recoverable or receivable you have with that reinsurer under *any* treaty. So it's very broad and very sweeping. They're also saying that no money can go through an intermediary unless the intermediary has been reviewed by the California Division of Insurance and there is no undue risk posed to policyholders. That's new. It also imposes extraterritorial application on licensed insurers as well as domestics.

Originally, this was intended to apply to new business written on or after January 1, 2006, and then to *all* existing contracts by 2007. To the extent that you had 30-year-old contracts that did not comply, and even to the extent that you weren't a California domestic but you were licensed there, you'd have to go back and amend all your treaties to be in compliance. Well, that's difficult to do. Furthermore, nothing has really happened since September on this. I think California has also had a couple issues with which they've been dealing. We are expecting a revised draft to come out in June 2005. There was a huge public outcry in September 2004 when this was released. We hope that they're listening to our concerns, so hopefully the next one won't look as bad. If you're licensed in California, you should be looking at it.

The project that I've been working on at the ACLI is modernization of the NAIC risk transfer regulations. Our risk transfer regulation in the life industry is the Life and Health Reinsurance Agreements Model Regulation, which was adopted back in 1985 and revised in 1992. It was also included in codification through Appendix A791 as part of SSAP 61. As part of its normal course of business, the NAIC looks at older model regulations and asks if they are still relevant to the industry. That question was posed to the ACLI Reinsurance Committee back in the summer of 2004. We said that yes, you should have some kind of placeholder there, but we'd like you, the NAIC, to work with us to modernize this regulation. It was written back in 1985

and 1992 when products that we have today weren't even contemplated, so it does need modernization.

As I alluded to, there have been significant changes since the adoption of the model regulation, such as continued product innovation, the secondary guarantees, the guaranteed minimum death benefits (GMBDs), etc. There have been major changes in the reinsurance marketplace, such as consolidation and capital market solutions, and there have been advances in valuation theory and risk management. Examples are principles-based reserving and capital methodologies like C3 Phase II. It's questionable with the current regulation as to whether or not you can cede just a risk or if you have to do it on the whole product. We would like to have the flexibility to cede risks rather than products. We'd like a new principles-based approach to keep up with these changing valuation requirements. We think that a lot of disclosures and other protections that weren't existent when the regulation was drafted are here today to prevent abuse.

We're proposing a framework that would allow a ceding insurer to take appropriate reinsurance credit for reinsurance agreements under the following circumstances: that we only take credit to the extent of the risk transferred (you don't take a full reserve credit if you're only passing through part of the risk); that your remaining net liability makes sufficient provision for your obligations after the reinsurance; and that some of the protections that we have in place today, which are, in fact, some of the concerns with finite risk, are still embodied in the reinsurance agreement, mainly that the reinsurer cannot terminate the agreement arbitrarily and put the business back to the ceding company, that the reinsurer fully pays the losses, that he pays them periodically and that there are no unreasonable ceding company obligations. If we were able to do this, there would be more flexibility in transferring risks rather than products, better product management opportunities and partial reserve credit (no longer an all-or-nothing proposition). However, actuarial judgment would need to be used in determining appropriate reserve credit in this context.

I'd like to quickly touch upon two things that are happening at the congressional level that pertain to reinsurance. The State Modernization and Regulatory Transparency (SMART) Act is the federal effort for uniformity in insurance regulation. This is a step short of the optional federal charter. It touches upon such things as market conduct, insurer and producer licensing, filing of forms and rates, receivership and reinsurance, which is Title IX. This is something that has been supported by Representative Michael G. Oxley (R-OH), who is the chairman of the House Financial Services Committee. He is the one who said, "I don't think we can go to an optional federal charter at this point in time." The funny thing is that Representative Richard Hugh Baker (R-LA), who is in line for the chairmanship next year, has said, "I support an optional federal charter." I feel like we're just treading some water here, but as an industry we are responding and reacting to the SMART Act that's being put forth by Congress right now.

As far as reinsurance is concerned, the congressional draft was a little different from what we were expecting. It seemed to impose additional financial reporting requirements on reinsurers, so the ACLI and the RAA together provided some revisions that focused instead on regulating credit for reinsurance rather than reinsurer solvency. Again, this is not an optional federal charter, but if this were passed it would be better as far as uniformity in certain aspects of insurance and reinsurance regulation, and you'd have deference to state of domicile with no extraterritorial application for reinsurance regulations. That would be much easier for us all to follow.

The last thing I want to touch upon is TRIA, the Terrorism Risk Insurance Act. That was passed back in January 2002, and it expires at the end of 2005. It was a stop-gap measure put in place to insure the availability of reasonably priced P&C commercial insurance coverage without exclusions to the policyholders. As you probably know, life was never a part of that package. There has been a lot of discussion over the last several years to include group life, and there does seem to be bipartisan support for both extending TRIA and for including group life going forward. However, there are several key members of Congress who are ideologically opposed to government subsidization of private industry, so it has met with a little resistance. We don't expect much to happen anyway before at least June 2005, when the Treasury is going to report on how it has worked over the last three years.

I'd like to mention a little anecdotal bit of evidence. Two weeks ago we had that scare at the White House and the Capitol with the plane flying over the air space. Apparently TRIA hadn't been talked about for a long, long time, and as soon as Congress went back into session after that, it was brought up again. It reminded them that there are still threats, that we should keep this in mind and that it's a high priority. However, we still don't expect movement until the end of the year. They won't move unless they have to move.

Again, what does this mean to you? If we can include group life in it, maybe we can improve group life pricing and terms. As far as catastrophic cover is concerned, maybe you'll look for different types of catastrophic cover because we'd have TRIA in place.

MR. RICK HODGDON: There are some advantages to being the only non-actuary on the podium. I don't have to certify that my answers are correct. What you're going to hear on this is kind of an evolving situation. What I hope you'll get out of this presentation is that from a ceding company's perspective, your business is safe in the European Union (EU). I think that's important because you've been hearing a lot of press lately with respect to what has been going on over in Ireland specifically, because obviously it's a reinsurance mecca. Also, I'd like the reinsurers here to understand that there is regulation that's unfolding, but there is a game plan to it. Last but not least, the market stability and financial stability is something that the EU is trying to push quite strongly.

The "Draft" Reinsurance Directive is actually not a draft anymore. It has been put before Parliament. I won't bore you with all the historical accoutrements that go along, but basically it is proposed by the Council of the European Union. It amends all prior regulations, which is anything that was "reinsurance regulated" before. Obviously Ireland wasn't regulated, but the United Kingdom was, so this will take jurisdiction on that. It adds new regulations concerning reinsurance and proposes a "fast-track" solution pending Solvency II. Most of you have heard about Solvency II, which is a risk-based-capital model. What's going to happen is that it won't come into play until 2010 or 2011 because this interim Solvency I (something I'll talk about a little later) will be with us for five to six years, which is not an "interim" step any longer as far as I'm concerned.

Basically the Reinsurance Directive applies general principles of direct insurance regulation to reinsurers (other than consumer protection measures). The big thing in Europe is the Consumer Protection Act (CPA). Obviously with reinsurance it's about market and financial stability, and you need to split the two apart. Home member state (HMS) supervision is really important. The regulation will be a base. Now in some of the EU countries, the base becomes the home state, so that's where you're getting a lot of this politicking right now. In Ireland for instance, the Irish Financial Services Regulatory Authority (IFSRA) will and can put an additional layer on it. In some of the other EU states, whatever the base comes out of the EU will be the base, so that's where you're getting a lot of the interaction right now. The Reinsurance Directive harmonizes minimum levels of supervision and adds concepts of freedom of establishment and freedom of services, which is the passporting.

They tend to think the United States is harmonized, and they don't understand state-to-state and all the rest of the thing. The objective of doing this reinsurance regulation was twofold. One was to get rid of collateralization. Hence, if they got rid of collateralization and regulated the EU, they could come to the United States and say, "Let's get rid of all the collateralization—letters of credit (LOC)—since we already have other regulated environment ourselves." That was the premise behind it. The other side of the equation was to passport so that you wouldn't have to wait for periods of time when you came up with new products within the EU. If you had a product in the United Kingdom and you wanted to sell it in Italy, it wouldn't be a problem at all. Those were the two major objectives.

Article 38 is the starting point for life reinsurance capital and the requirement. Article 37 is basically saying that they're going to take the non-life solvency requirements and put it on life. Article 37 is a non-life basis. There was a lot of work done by some very good associations—the Comité Européen des Assurances (CEA) and the Association of British Insurers (ABI)—that was very technical and submitted to the EU with reasons why they could adopt the U.K. model, which most people who do business in the United Kingdom will know. But the reason that they weren't willing to do it was because going from three per mil to one per mil as a solvency standard was too easy to figure out mathematically as a 66 percent

reduction, and the politicians said, "No that's too much." The idea they were talking about at one point was going to the health rules because they figured health was more like life. At the end they decided to take the non-life.

What happens in the exceptions in this is that the HMS, again, can say it wants to do the required solvency margin or else it can go and put the non-life rules. That's where it opens it up to a little bit of debate if you're looking at, for instance, life insurance linked to investment funds in variable life. Donna used the term "bifurcate." I was told by my colleagues in Ireland that it means a totally different thing in international accounting. What they're forcing you to do now is split your contracts into two. You end up with a non-life solvency requirement on your protection business and you'd have to have that same non-life, which is 16 percent, on your investment risk. That could be quite severe to a reinsurer with respect to the capital requirements.

Article 28 sets up the solvency standards for life insurance linked to investment funds. As I mentioned before, the HMS can either decide to put the non-life or the required solvency margin on it. On the required solvency margin, they're looking at A times your gross reserves plus B times the gross capital at risk, where A is 4 percent of the mathematical reserves and B is 0.30 percent of the sum at risk. If you're just doing an investment-type product (pure annuity, GICs or anything like that), what they're looking at right now is a situation where there is no company guarantee at all, there is no capital requirement, and they're changing that to 0.25 percent. That's based on administration expenses, and it excludes new business and commissions.

The other thing that's happening on this at the same time is that as a reinsurer, if you retroceded the business in a non-regulated environment, you got 100 percent capital and 100 percent reserve relief. With the new regulations, you're going to end up with only 15 percent of the reserve and 50 percent of capital. One of the things that we've argued quite strenuously is: How can you get 100 percent in a non-regulated environment and then a reduction in a regulated environment? Does that mean that your regulations aren't any good? That's said with tongue in cheek, but they haven't gone for that. It will create some issues on the reinsurers on the retro side on both capital and reserve relief. Ceding companies already are constrained by that, so there's no additional issue with respect to that.

The issue we're dealing with right now with the regulator in Ireland—I was talking previously about the HMS—is that they're not quite sure how all the products work. In Europe it has been a fairly traditional market. You have protection products and you've had investment products unit linked. Now they're asking about universal life with secondary guarantees. What about variable universal life (VUL) and those types of products? One of the good things that the regulators have done in Ireland, which I think could be copied here, is that they've gotten together with the companies, found out what the business issues are and asked for a paper, which we're producing for the end of June, that will outline the key products and how we

feel that they should be accounted for and reserved for.

When I was talking about the solvency margin rules, these are the non-life rules. The life actuaries out there can see how archaic that is, but that's what we are stuck with. Therefore, again, if you're looking at 18 percent on the first €50 million of premium and you have an investment component to that product, there's no way that you're going to end up with 18 percent of the capital requirements. That's where you'll have to end up splitting out your contracts.

The health wording is no longer a draft. In June, Ecofin, which is the council of the EU finance ministers, will vote to make the Reinsurance Directive a law. It then gets translated into 23 other languages and then becomes "law" in either December 2005 or January 2006. Then it's 24 months before it gets implemented. There is no grandfathering. The grandfathering is for two years, but it's not a pure grandfathering on your in-force business. You basically have two years in order to get your capital requirements up to your overall business. One of the issues that they're talking about is that there are some companies, depending on how much of a capital hit that is to them, that may decide to go into run-off and then start new companies, because the run-off doesn't require any of the regulation. I guess that where there's a will there's a way.

Another objective is to get the European reinsurance industry to compete globally. One of the issues is that you have importers and exporters, and the importers would like to protect their reinsurance business and the exporters obviously don't want concentration of risk within the EU, so the theory behind that is that they want to be able to get it global. We're saying that reinsurance is not just an EU issue; it is a global issue and we do compete globally.

The home state may set up the conditions, hopefully not having to post collateral. France is still pushing that out. The United Kingdom wants to take away collateralization a lot sooner, in 2007. France would like it pushed out to 2010. The overall consensus is that until collateralization is taken out of the EU, we can't come to the United States and tell them that we would like to no longer use collateral for business coming to the EU. There is quite a dogmatic fight going on right now.

Regarding the impact in Ireland, you have probably seen a fair amount of newspaper coverage on finite reinsurance. The good news is that IFSRA did not panic. They realized it was a deal issue; it wasn't an industry problem. They've looked at the deal as a deal-specific situation, and so the HMS has the flexibility to impose more onerous requirements on reinsurers under their supervision. One thing that they included in the directive, which they were not going to allow, were special purpose reinsurance vehicles (SPRVs) and finite reinsurance. They decided to include it but have it under the HMS' jurisdiction. The HMS will be the one that will be supervising and putting the capital requirements on it. At the last moment, somebody snuck in that the minimum capital requirement to be able to do finite reinsurance was going to be €50 million in capital. That concerned a lot of the EU.

There were a couple of fairly large life companies that wanted that in there. Their onus was that it would show that they were very serious by having the capital in place, but we also think that there was another way of keeping the market excluded.

Many finite reinsurers are in Dublin. Can this sector continue to thrive in the environment? HMS may lay down specific rules (which must be communicated to the Commission) governing the carrying on of finite reinsurance related to: mandatory contractual terms; administrative and accounting procedures, internal controls and risk management requirements; accounting, prudential and statistical information requirements; and requirements regarding technical provisions, solvency margin and minimum guarantee fund.

What is the impact on Ireland? Dublin has great growth potential as a center for SPRVs. Article 44(b) permits HMS to set its own rules (which must be communicated to the commission) regarding: scope of authorization; mandatory conditions for inclusion in contracts; qualifications and reputation of directors and management and qualifying shareholders; administration and accounting procedures, internal controls and risk management requirements; account prudential and statistical information requirements; and solvency margin requirements.

If Council fully endorses Parliament's resulting opinion, the directive will be formally adopted at the next meeting of EU Finance Ministers in early summer. In practice, it will then need to be translated into the 25 or so official languages before being entered into legislation. This is expected to take 6 months (January 2006). Member states then have 18 months to get implementing measures in place. So, the date range for full implementation is mid-2007 and possibly as late as early 2008.

MR. STEVEN D. LASH: I'd like to discuss FAS B36. There are \$55 billion in reserves that are under modified coinsurance (modco) or funds withheld that would be technically subject to FAS B36 requirements. The data for 2004 is being pulled together now. It would be very interesting to see if modco transactions and funds withheld transactions are less used, now that people have to deal with the complexities of B36. Some of the data might be a little suspect as you look company by company and your Schedule S data jumps around quite a bit, but at least on a trending basis, I think it's worthwhile.

I'll give a quick review of how people have approached the B36 and why I think it's still an important issue for folks to deal with. Generally speaking there were three ways to approach the B36 derivative in modcos and funds withheld: deem it to be a credit derivative, deem it to be a total return swap with a fixed leg or deem it to be a total return swap with a floating leg. The reality is that as people got into B36 (the reason we get into B36 is this third-party credit risk), people initially thought that to mean if it's third-party credit risk, it's only a credit derivative. As it turns

out, when you look at some of the other Derivatives Implementation Group (DIG) issues like B15, once you're in B36 land, you need to look at all your derivatives in your potential contract as subject to bifurcation. In the end, I would say that most companies realized that a credit derivative was not the appropriate answer in a modco or a funds withheld transaction; it was really a total return swap. If you were arguing that it was a credit derivative only, you could run into problems about statutory risk transfer if you're not really transferring the risk for interest-related issues as opposed to credit-related. If you look at 10-Ks and public disclosures, you'll notice that substantially all companies take a total return swap approach.

Under the total return swap approaches, when you talk about fixed leg- and floating leg-type approaches, a few controversies come into play. Let's talk about the total return swap fixed approach. I'll try to go through this somewhat quickly since some of it is probably old news to most of you. The idea of a total return swap is that the ceding company is paying you the return on the portfolio, and the reinsurance company is theoretically paying interest on what we're calling a hypothetical loan interest rate. Companies need to decide whether that hypothetical loan is a fixed-rate loan or a floating-rate loan. If you decide that it's a floating-rate loan (we'll get into this in a minute), this whole B36 thing is an easy situation to deal with. It's a very easy calculation, and you move on.

The work comes in, and the controversy somewhat comes in, if you determine it to be a fixed-rate loan. Depending on your product features you can decide whether it's a fixed-rate loan or not. You need to do a calculation that takes the unrealized gains of the assets less the unrealized gains of this hypothetical loan. That becomes your B36 derivative that you need to bifurcate. There are four components in that formula: the market value of the assets, the book value of the assets, the market value of the loan and the book value of the loan. Three of those items are very easy to figure out. You know the market value of your assets in your portfolio and you know the book value of your assets in your portfolio. That's just the unrealized gain on your portfolio, so there's no controversy there. The book value of the loan, by definition of how you do the total return swap, is equal to the statutory reserves that you've ceded under a modco or a funds withheld, so that's incontrovertible and not controversial in any way. Where the work is and where the issues come in is, how do you determine the market value of this loan piece? That's going to substantially drive the value of this derivative.

The controversy that has erupted is: How do you set the fixed rate on that loan? Do you use the asset approach or the liability approach? Depending on what approach you use, you can get substantially different answers for your B36 derivative. The asset approach tells you that this loan rate that you've come up with will change depending upon the composition of your portfolio. The liability approach says the loan rate on the hypothetical loan will change as your liabilities change.

Say we had a portfolio on a modco that had one asset—let's call it an IBM bond—

and you did your B36 calculation. Let's say you got a derivative of 10, for argument's sake. We have third-party credit risk because we have this bond that is not clearly and closely related to the insurance company. We set the fixed interest rate and then we move on. Let's say that a year from now we sell that bond. We record our realized gain or loss, whatever that happens to be. Under the asset approach, the B36 derivative would then reset to zero, because now you would close off that swap and enter into a new swap with a new bond. Call it a Xerox bond. The liability approach, however, would tell you that you don't do anything with the loan because the liability hasn't changed. The fact that you sold the asset is irrelevant, so the B36 derivative will stay in place. You will end up deferring on a GAAP basis that realized gain or loss on the asset that you just sold. The accounting firms have argued about this quite a bit. The conclusion we all drew was that you could do anything you want, effectively, because there's an argument to be made on any of the approaches. I think some of us have a particular view on what is the right answer, if there is a right answer in the B36 world.

Let me touch on the floating rate. I mentioned that on the floating rate side you assume that the hypothetical loan floating rate interest moves on a regular basis; it's just like a floating rate bond. When you do that, the unrealized gain or loss on the loan piece collapses to zero and therefore, the B36 derivative becomes simply the unrealized gain or loss on the portfolio. Ceding companies love that answer, because in B36 they were given what they call the FAS 115 "mulligan," where companies can move their assets into a trading account. Therefore, any unrealized gain or loss would also float through income with an opposite sign, so, in theory, if it was a 100 percent ceded deal, there's absolutely no B36 income impact to the transaction. The problem that some companies are dealing with now is what happens when you recapture that treaty if you can't then move the assets back from trading to available for sale. Then you might actually have the exact volatility you were trying to offset in the first place.

Chart 1 is a balance sheet showing B36 earnings volatility of an actual company.

Chart 1
B36 Earnings Volatility

<u>Balance Sheet</u>	<u>9/30/2003</u>	<u>12/31/2003</u>	<u>3/31/2004</u>	<u>6/30/2004</u>	<u>9/30/2004</u>	<u>12/31/2004</u>	<u>3/31/2005</u>
TR Floating	17,115,444	19,768,357	26,382,466	10,134,726	13,676,733	15,109,223	13,121,891
TR Fixed (Asset Approach)	(3,459,731)	5,568,408	3,536,797	4,902,660	(5,566,774)	1,111,767	1,288,322
 <u>Earnings</u>							
TR Floating	17,115,444	2,652,914	6,614,109	(16,247,740)	3,542,007	1,432,490	(1,987,332)
TR Fixed (Asset Approach)	(3,459,731)	9,028,139	(2,031,611)	1,365,862	(10,469,434)	6,678,542	176,555

One of the issues with B36 is the volatility of earnings. That's a huge issue. The floating approach, the asset approach with fixed and the liability approach will give you substantially different earnings. This is a real company that actually books the fixed asset approach but tracks the floating approach also as a reality check. You can see that the results are pretty volatile. In fact, at the beginning of B36 at September 30, 2003, when they booked the cumulative effect adjustment, you can see that there was a substantial difference between the floating rate approach and the fixed rate approach and how it changes over time. What concerns me, in this new world of SEC sticking its nose in and others looking at it, is that the conclusion was drawn that both sides of the transaction don't have to come up with the same answer. A ceding company might argue that it's a floating rate derivative and book a \$17 million number. You might have the assuming company say that it's a fixed rate total return swap, so it's going to book a loss of \$3.5 million. It's the exact same economics, but you have companies reporting completely different answers. The accounting world has said that it's okay with that. My worry now is that as we start digging into transactions, what is the SEC going to say when they see two companies that have the exact same transaction but completely different results? Two years ago when this came into place, the accounting firms actually approached the SEC, and the SEC said that they understood that this is not a perfect world and it won't be mirror imaging. I'm wondering if that view might change over time. You can see the volatility of earnings.

In Chart 2 there are a number of other companies.

Chart 2
B36 Earnings Volatility

Company	Derivative Value (\$millions)			
	12/31/2003	6/30/2004	9/30/2004	12/31/2004
Company A	42.7	61.7	43.1	42.8
Company B	62.1	27.7	111.5	150.7
Company C	9.3	15.3	9.8	5.2
Company D	(352.3)	(252.6)	(365.5)	(375.3)

This was taken from public information of companies that have done this approach. You can see, again, the volatility potential of some of the transactions. What we have here are companies that have done the asset approach with fixed, companies that have done the liability approach and companies that have done the floating approach (the three methods).

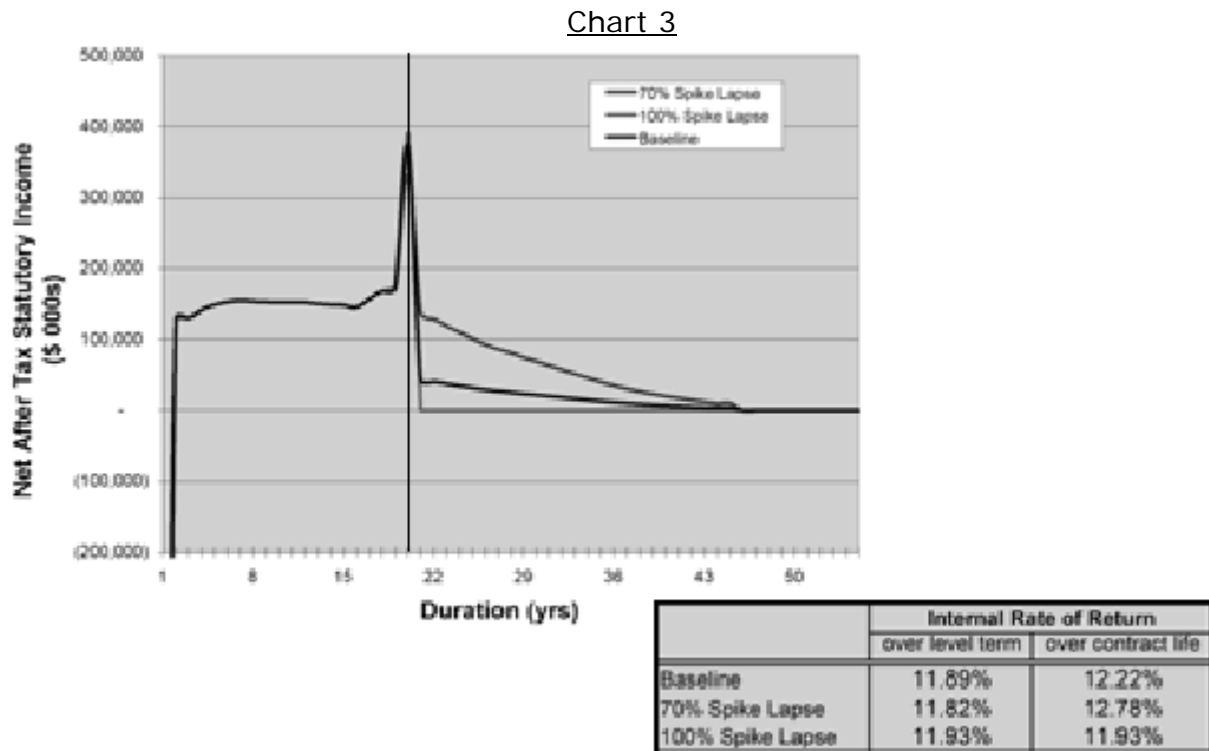
The other topic I was going to touch on that hasn't gotten a lot of press in the B36 world is how finite reinsurance dealt with B36. The comments I've made so far have been on true risk transfer from a statutory- and GAAP-basis transaction. In the finite world, people wanted to make the argument that under a finite deal, B36 doesn't apply, which is not true. It does apply, but the next argument was that on the finite reinsurance deals, the B36 derivative is zero. That is not the answer. The issue with arguing that it's zero is that if it is zero, it doesn't pass risk transfer, and then forget about statutory accounting and so forth. You don't want to make the argument that it is zero. It might be small. It might be immaterial. You might book zero for that reason, but don't say it's zero in your documentation because that will completely mess up your other accounting. Clearly the derivative can approach zero if your contract goes as you expect and you have experience refund that builds up and so on and so forth. The chance of loss for the assuming company might be minimal and therefore, the derivative might be zero the way you calculate it, but the derivative also could get large if the business doesn't perform as you expect.

The key issue here is that you want to make sure you document this correctly because if you do get one of those dreaded subpoenas and people look through your documentation and the argument is made internally that the derivative is zero, people can by extension say that if it is zero, that means you're telling me there is no risk transfer. You don't necessarily want to go down that path. The reason this is getting to be a warm issue is that it does have secondary effects on how you look

at your transactions and how the SEC might look at your transactions as the whole reinsurance world gets opened up.

The next hot topic with a number of our clients is the whole area of post level term. This was an issue that years ago when level term came into play, people didn't worry about a whole lot because when you were doing your pricing and you were looking at 20-year term, the post level term is 21 years out and you were not going to worry about that. When you price the product on a present value (PV) basis, those profits (or losses, or whatever you deal with) have an immaterial effect on your pricing exercise. Well, obviously over time the PV becomes material. You actually have earnings or projections or losses that do come into play.

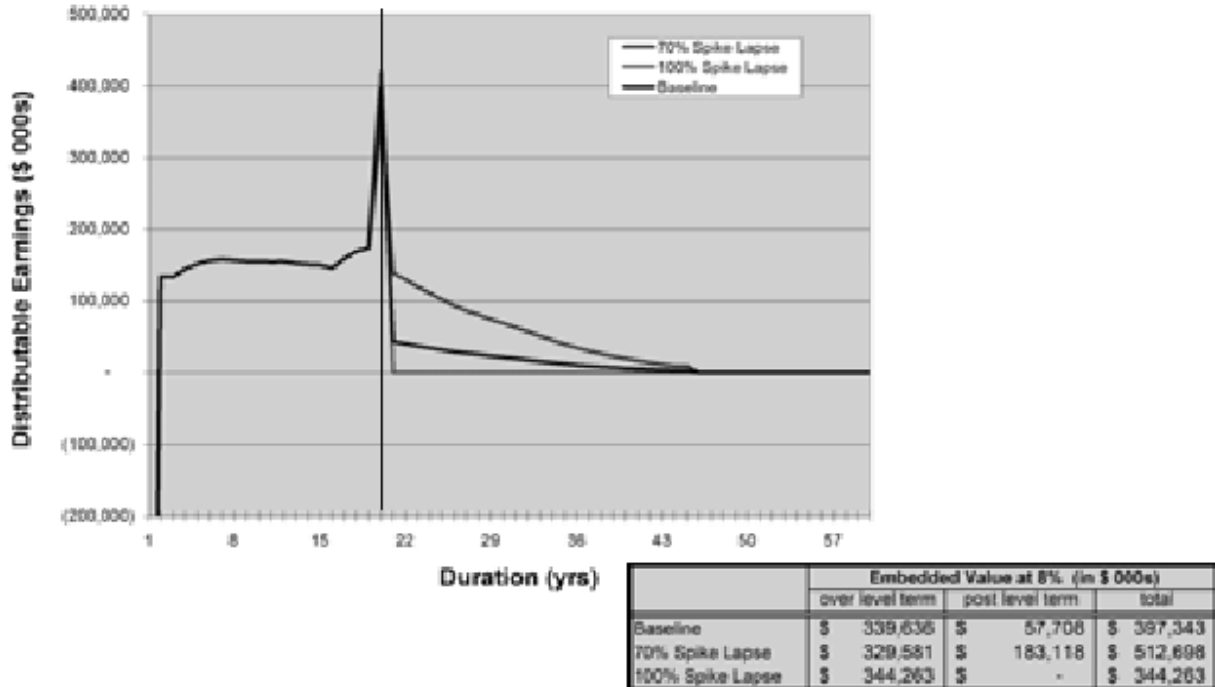
We've done a bunch of work around this issue. Chart 3 is a projection of statutory earnings under three different scenarios for a post level term product.



It's a 20-year product that we've modeled here. You can see that on a pricing basis over the level term period and over the contract life, there's not a substantial difference in the internal rate of return (IRR). The pitfall that I think a lot of us fell into was that we didn't focus on the post level term issue because on a PV basis, it didn't really have an effect on earnings.

The second way to look at it is on an embedded value (EV) basis, as shown in Chart 4.

Chart 4



In the bottom box where I have baseline assumptions, which is a 90 percent lapse rate, you can see that the percentage of post level term profits relative to the total product, depending on your spike lapse assumption and depending on the profitability you assume over the post level term, can be substantial. Again, the issue—this is all at pricing—is that if you look at the baseline with the \$57 million post level term profits, that number becomes a huge percentage of your profits over time as the product progresses. Then at the spike level, or at the end of the level term period, your spike lapses will be what they'll be and you'll have an issue to deal with of whether those profits will really materialize.

We've been thinking about this issue a lot with our clients. You have to think about what it really means or what are the scenarios or what's going to happen post level term. I'll try to tie that back to a reinsurer's perspective on what to worry about. When you get to the end of the level term period and you've sold your products, there are a few scenarios to think about. There are those who bought your product that no longer need insurance. They bought a 20-year term or a 10-year term; they bought it for that period and they no longer need it. Clearly that's a lapse; those people are going to go away. There are those people who still need insurance that will go through the re-underwriting process. I, myself, have a 20-year term policy that I bought. I didn't pay much attention to its post level term issues until I started getting into a bunch of work related to this. So a few months ago I pulled out my policy—I pay about \$1,000 a year for my insurance—and right

there in black and white, it says that in year 21 my premium goes up to \$31,000. Well, I'll tell you that I'm going to notice that. After my 20th year of insurance, I'm going to go through the re-underwriting process. Clearly my \$1,000 is going to go up to something like \$5000, but it's not going to go up to \$31,000. Hopefully, if you're in good health, you're going to go through the re-underwriting process and go into a new product. That's a lapse. It's gone; the people are gone.

Then there's the third bucket of people who will still need insurance in, say, year 21 or later, but fail re-underwriting and don't get a new policy issued, or it's substandard or whatever the case may be, and they decide that the \$31,000 is something that they're going to pay because they're very unhealthy or what have you. Then there's the fourth bucket of people who are healthy but they're going to pay the \$31,000 because it's "convenient" and they're not going to notice, or it's going to just be taken out of their checking account. When you're thinking through your lapse assumptions and your profitability, in my view those are the four areas you have to think about. When you cut through it, the bottom line is that there aren't going to be many people left at the post level term. For companies that have gone into pricing and have presumed an 80 percent lapse rate, that may not be good enough. In particular, if you presume the fourth bucket and you're going to get a decent profit margin in that post level term period, it's going to be quite small. From a reinsurance perspective (even from a ceding company's perspective, for that matter), if you believe the fourth bucket really does happen—there are some companies with which we've been working that are seeing profits in the post level term, but it takes a little time before losses kick in if the mortality is going to be adverse—and there really are substantial profits in the post level term period, then if the ceding companies are paying attention, they're going to recapture, because they're not going to keep paying that high cost of reinsurance to the reinsurance companies. So no matter how you slice it, at least in my view (the data will prove whether this is right or wrong), people need to pay attention to the post level term profit as these products are now coming closer and closer to the end of that term. It will have a substantial effect on your financials.

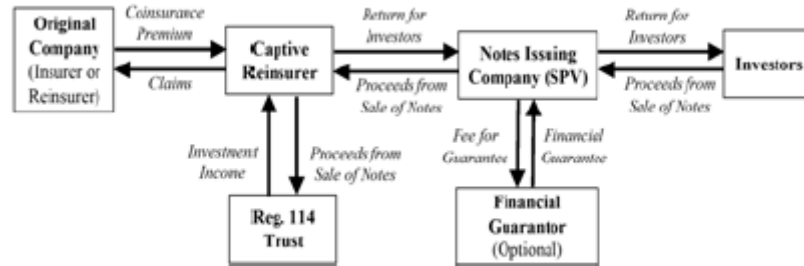
Lastly, I'd like to quickly talk about capital solutions. My comments here are in the context of XXX and AXXX, although capital solutions are broader than that. There are EV securitizations that are done and captive solutions that are done, but my comments are focused on the pending XXX. You can't go to a meeting these days where people don't talk about XXX and AXXX issues and securitization and so forth, so this session is no different. The solutions that have been talked about that are out there now are just straightforward reinsurance solutions. There's securitization, which we're going to talk a little about. There's the question about if XXX (and AXXX, but more on the XXX side) is really as redundant as everybody says it is, then let's change it. There's a concern that I have that there could be an insolvency that will blow up this issue and change the regulation. There may be other solutions to deal with this. I'll come back to some of these at the end of my comments.

The issue around capital solutions using offshore reinsurance is this whole issue about letters of credit and taking the reserve credit to get rid of the XXX or the AXXX reserves, and the fact that the reinsurer or your affiliated or unaffiliated reinsurer needs to get a letter of credit, which is a one-year term solution, generally speaking. Given that there's this \$100 billion to \$150 billion issue coming down the pipe on XXX, the common thinking is that either there won't be the capacity of letters of credit or the cost is going to get at such a level that it's going to be uneconomic to do these reinsurance transactions. In the previous financials that I showed you, those numbers assume a 50-basis-point LOC cost. At an 8 percent EV rate, that's \$70 million of cost. The EV I had in there was around \$400 million or \$500 million, so it's a substantial cost. The EV is the LOC cost in doing these transactions. Regulators have said that they don't like the short-term strategies that are out there. There are investment banks that have come up with 30-year LOC solutions. It will take time to see whether those take off and people balance the cost of those versus doing other solutions like securitization. Something needs to happen in this world because the capital needs are coming. People have turned to securitizations. I would say that there's probably not a company out there that hasn't been called on by their friendly investment bank (if not multiple investment banks) on the next greatest and latest securitization transaction. Obviously we at Ernst & Young deal with all the investment banks. We stopped counting, but at last count there were 11 investment banks working on securitization solutions, and everybody had *the* best solution. A lot of time and money and effort are being spent on this solution.

Simply stated, securitization is a non-recourse debt obligation where the payback of the capital raised in the capital markets is collateralized with the cash flows from your business. The XXX reserves are as redundant as everybody says; the capital or the cash flow from your business is more than sufficient to collateralize the cash that's raised by the investors. It's a fairly complicated transaction, and it takes a lot of time and effort by your friendly actuaries, regulators, lawyers and so forth. In one transaction that we were involved in, there were 17 different firms that were to review the documents on this transaction, so you can imagine the time and the money that's spent on these transactions. They're very complicated and very involved transactions.

Chart 5 shows how these things work.

Chart 5
Sample Securitization Structure



There are two main areas where people spend time. One is the flows between the original company and the captive reinsurer. That's where all the actuarial work of analyzing the cash flows and so forth gets done. Then there's all the work around the financial guarantor. These transactions to date have all been wrapped by financial guarantors, which effectively guarantee the return to the investors.

The question is whether those transactions will become unwrapped over time, because as we talked about the LOC capacity issues and cost, there's the same issue on the financial guarantor side. There is not enough capacity on the financial guarantor market to issue \$150 billion of potential notes (if that's the right number), so something still needs to change. There's not enough LOC capacity. There's not enough financial guarantor capacity. There is an issue with smaller companies that can't afford to do securitizations because the size of their business is too small. One of the concerns that I have, looking down the road a few years, is a company that's in a reinsurance transaction, taking its reserve credit and that reinsurer has a problem getting its LOC renewed. Let's say the LOC gets pulled. Reinsurance agreements all say that the reinsurer is going to do whatever it has to do to make sure the ceding company gets its reserve credit. If it can't, and it can't put up the collateral, you have an insolvency of the reinsurer, potentially. If that happens, now the ceding company has a problem because it can't take reserve credit any longer. There's a potential blow-up there.

It's always those types of issues that cause us as an industry to move and change regulations. If all that happens and we truly believe that these reserves are redundant, something is clearly broken and something is clearly wrong. The amount of money and time that's spent on doing X-factor opinions, doing reinsurance transactions, LOCs and now securitizations, for something that we all

say is redundant, should cause us all to pause and figure out if there's a better way to deal with these issues. If the securitization market does continue to take off, though, the other issue for reinsurers to think about is whether these securitization transactions will take away market share as companies get more and more comfortable with going to the capital markets.

I have one last comment I was going to make around securitization. I think a big opportunity for those of you reinsurers in the market is the smaller companies. A reinsurer can become a consolidator of those small company risks, and then securitize out the back end. I'd say there's a real issue with the smaller companies on how they're going to deal with this XXX issue going forward. There are a lot of complex issues to think about.

MR. TIMOTHY J. TONGSON: Thanks to the panel for a great overview. Donna, I wanted a little clarification on the New York Circular Letter No. 8. You mentioned something about reviewing treaty files for documentation of the economic intent, statutory and GAAP. Is there any guidance with regard to what documentation is needed and what would be acceptable? I didn't quite understand why the GAAP aspects would also need to be looked at.

MS. JARVIS: As far as the New York circular letter is concerned, it's supposed to release some additional guidance on how companies should comply. It's expected by the end of May, but I don't know for sure whether that's coming out or not. I don't know if they're actually going to say, "This is an acceptable format for documentation of risk transfer." You are right that they are only interested in the statutory side. What I was saying to you was that it's not just regulators that are looking at it. The SEC might be looking at it as well, and it's probably in your best interest to document statutory and GAAP risk transfer and the appropriate accounting for it. I don't think that New York is going to say what will constitute an acceptable form of risk transfer documentation; I think that is open to every company. You could go to your auditors and try to work with them to develop something that they would think is appropriate as well.

MR. TONGSON: How would Actuarial Standard of Practice (ASOP) No. 11 come into play? How do you see that fitting into this?

MS. JARVIS: I think that requires your actuary to sign off that you're in compliance with all your valuation requirements. Actually, in Regulation 102 in New York and in the Life and Health Reinsurance Agreements Model Regulation, there is a requirement that it be the entire agreement that you're talking about when you take reserve credit. As a life industry we should have already been complying, and that's why a lot of this is happening on the P&C industry, where they don't have those kinds of things in place. Nevertheless, like I said, it's being painted with a broad brush. Again, as an industry, I can't guarantee that we're all complying, but we think as an industry we're already compliant. The valuation actuaries should have been looking at all this.

MR. ALLAN W. RYAN: That was an interesting question about ASOP No. 11. I'm chairing a task force that's revising that ASOP. Some of you may have seen it. It has been out twice for exposure draft, and I think it will be released as a final in June, assuming it's approved by the Actuarial Standards Board (ASB). I don't think that there's a lot of guidance. There's an interesting issue about whether it's the actuary's obligation to make sure that net liabilities are sufficient or adequate, depending on the situation. We tried to write the standards that deal with reinsurance only. That kind of concept is probably outside the scope of it. I would encourage everyone to read it. We tried to make it general, not specific guidance. The way things are evolving, it may become out of date, but hopefully it won't.

MS. JARVIS: Does anyone know of any other states that are coming up with something pertaining to finite risk or any CEO or CFO attestations? I mentioned Delaware, Florida, New York and Massachusetts. Anyone know of any others? No. The ACLI is supposed to have all this information up on the Web site. I think it's effectively through links to the other states. Maybe Delaware and Rhode Island don't have anything on the Web site because they did in fact just send letters to their domestic companies, but the Florida proposed rule should be up online. The New York circular letter is up online. Their clarifications aren't there yet, but if you're an ACLI member company, you should be checking there frequently. It should all be up there.

FROM THE FLOOR: I have a question for Donna and Rick. I keep hearing of a blurring of distinctions between life and non-life. The life regulations or the optics that are applied to non-life transactions are now being applied to life transactions. Often life transactions will be fully compliant with the regulations at the time of the transaction. Somebody wakes up and says, "Gosh, we have a problem with it on the non-life side, so let's just take a look at it here." Is this going to be more and more common? Do you see convergence between the two, or do we need to fight to maintain separate treatment?

MS. JARVIS: Maybe I'm a little out of my element here because I wasn't around when this happened, but back in 1985 when the Life and Health Reinsurance Agreements Model Regulation was drafted, which documents risk transfer for life reinsurance transactions, there were perceived abuses at that point in time on the life side. The P&C side hadn't faced that until now. I see a convergence, but I see it coming the other way, in that the P&C side is probably going to have additional requirements as to what constitutes risk transfer on a statutory basis that will probably come more in line with ours.

MR. HODGDON: That's an interesting question you raise, because our task force considered that too. Should the scope be expanded to include P&C? The conclusion was no. We even had a casualty actuary on the task force, but we concluded no at this time. Also, I wanted to clarify something. The standard does make it clear that it's up to the actuary to be aware of all the regulation and legal requirements when they're looking at reinsurance. It's obviously incumbent on the actuary to know

about the newest guidance.

MR. LASH: I'd like to make two comments on that. One is on when it comes to P&C and SSAP 62. When you're talking about non-proportional transactions on the life side, it does guide you to SSAP 62, so in some ways life transactions get pulled in by default. The other thing I would comment on is that in this new world, all bets are off about what might be looked at. Most times, following the regulations isn't even good enough; it's the *appearance* of conflicts and the *appearance* of issues. Some of my colleagues in the accounting world might agree with me that the accounting profession has gone through that tremendously. The pendulum has swung over way too far on those issues of conflicts. All the rules that were followed correctly didn't matter, because of all these other ways to think about things. I think we have some of the same issues in the insurance world. There are a whole host of issues that potentially could be on the table that in fact are not issues, or in fact are appropriate or in fact are not conflicts, but there's an *appearance* that potentially they could be. When you're doing your analysis and doing your thinking about it, you need to think through not only did you follow the letter of the law, but how does this appear to the man on the street?

MR. HODGDON: Can I add something here that may be a little different in Europe? It's a little simpler but it's also more complex. In Europe they looked at reinsurance as being P&C; they didn't look at it as life. What happened is that they said, "We're just going to take the Third Life Directive, look at the solvency requirements, which is 3 per mil and 4 percent, and just put that on the life reinsurers." Our argument was that there's more diversification with portfolio, etc. It loses a little bit of its argument when you're starting to talk about 10/90 co-insurance deals, because at that point you really are kind of direct. We would say that under our breath, but what ended up happening is that they understood non-life. They basically said that if it's reinsurance, then it's non-life, and this is what we're going to end up doing. The problem we have in something like that is that you have an uneducated group over there that is looking for some direction. In our case, what we've done is taken regulators in under the tent and told them how our business performs, looking at our portfolio and looking at the types of products that we do, hoping that they understand that the non-life solvency requirements don't fit a life model. It's an education process. It's simple, but it's complex because they've never seen the types of products that tend to come over to Europe to be reinsured that come out of the United States.

MS. JARVIS: I'd agree with that here in the United States as well. Regulators tend to know P&C and understand P&C a lot better. Conceptually speaking, it's a lot easier to understand. It's a short-term cover. Something happens or it doesn't happen. When the ACLI and LICONY went into New York and said, "Hey, what about Regulation 102? We already have protections in place. Why are you asking us to do more?" they kind of said, "Oh, we had that?" Certain regulators drafting a circular letter may not be well-versed in what's going on in life and what protections we already have in place. They already have the protections, but they forgot.

FROM THE FLOOR: I have a couple of questions for Steve. Regarding B36, is there any upside to what has been implemented, or does the FASB just basically have a black eye in the process? The second question has to do with securitization and the financial guarantee. I'm assuming that's to get a highly rated security, by having the guarantee. How effective would a parental guarantee be in achieving a highly rated security?

MR. LASH: I'll answer the second one first. The financial guarantor gets involved to get it a AAA rating, effectively, and to give the investors comfort that they understand the risk. If the issuing company is a AAA and adds a parental guarantee, I think you'd get substantially the same effect, although that's not my expertise. I'm not sure that's an absolute answer, but the point of getting the financial guarantor is to get it AAA rated by the rating agencies so certain investors will want to invest in those notes. I think that, again, if it was unwrapped and it was a AAA entity, you'd probably get a fairly highly rated note. But I'll defer to my rating agency colleagues on that.

On B36, that's a loaded question about whether there's any upside. Theoretically there was upside because it was to give readers of financial statements more information of what was going on in transactions, since under modco as assuming company, as we know on the statutory balance sheet, there's nothing there, and there was concern that even on a GAAP basis people didn't understand what the assuming companies were taking on. Some of the history there is that I think the industry made a bit of a mistake when instead of just saying that yes, there's an issue and let's provide disclosure with a footnote, they said that no, there's no FAS 133 derivative here. They lost that fight and now we're left with B36 to do this. The intent was positive in providing more information. I think the reality is that in reading a financial statement now you don't have a clue as to what are the real earnings. I'll give you some examples of results. We had a consulting project with a client where they were looking at the three methods that I talked about, the two fixed methods, asset and liability, and floating. I'm not going to remember the numbers exactly, but under the floating approach they could have booked a \$50 million gain, under the fixed asset they could book about a \$5 million gain and then under the fixed liability they could book a \$50 million loss. Of course we wanted to get to what we thought was the right answer, but their accounting firm would have signed off on any of those methods, with the right argument. That tells you something is just not right there, if transparency is your goal.