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REINSURANCE NEWS

NEWSLETTER OF THE REINSURANCE SECTION

Is Regulation Driving Competition?

by Carolyn Cobb

"Most of the change we think we see in life is due to truths being in and out of favor."

— Robert Frost, *The Black Cottage* (1914)

In the last "Reinsurance News," three prominent life reinsurer CEOs predicted the near-term future of the life reinsurance industry, each from a slightly different perspective. My perspective is a regulatory one. Reinsurance regulation is changing rapidly on every level—internationally, federally and at the NAIC. I see these oncoming changes shaping the future of the industry and determining the migration of capital and talent. In my opinion, now is the time for us to shape that regulation and our own future.

My argument is this: The reinsurance industry competes for capital. To do so effectively, it must pay investors a competitive return. If regulation—national, international or state—imposes frictional costs on reinsurers higher than those imposed on other financial sector participants, reinsurers will find it harder to pay a competitive return to investors and harder to attract capital over the long term. Since reinsurers' product is a form of capital, reinsurers must act forcefully—individually and collectively—to maintain the ability to win that competition by advocating regulation that lowers the frictional costs of regulation.

OVERVIEW

Cost of Capital: The Driver

According to the FDIC, the new Basel II capital requirements would let the most sophisticated banks recognize significant savings over their current capital requirements. Their current capital rules require all banks to hold $8 in capital for every $100 of commercial loans, regardless of the credit risk. Under Basel II, banks using the most advanced internal ratings system could hold between $0.37 and $4.45 of capital for each $100 of AAA-rated loans, between $1 and $14 for BBB-rated loans and between $4 and $42 for B loans. Basel II will be finalized this year and enforced starting in 2007.

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Generalized Mortality Table Analysis

by Larry Warren

Editor's note: This article is a continuation of Larry Warren's previous article, "The Relationship of Mortality Projections and The Underlying Mortality Tables Used" ("Reinsurance News," Number 50, June 2002). If after reading this article, and/or after having reviewed the previous article, if you have any additional thoughts or comments, either in support of or with a differing point of view, no matter how long or short, please respond to me for possible inclusion in the next Reinsurance News. *Comments need to be completed and sent to dean_abbott@allianzlife.com by May 31, 2003, to be included in the next newsletter. (The June 2002 newsletter with Larry's previous article may be found in the Reinsurance Section of the Society of Actuaries' Web site, www.soa.org.)*

In this article, we discuss the need to search for alternative mortality tables (other than the 1975-80 and 1990-95 tables), which may be more appropriate for a particular company or specific products. It must be recognized that differences or variations from company to company can exist in the following areas which impact future mortality patterns:

A. Underwriting Rules/Guidelines/Practices

Variations in underwriting rules/guidelines/and practices obviously impact future mortality patterns. While underwriting guidelines vary from company to company, the degree to which the underwriters adhere to these guidelines (i.e., are underwriting exceptions often made?) must also be considered.

B. Average Size of Policy (Face Amount)

The average face amount per life insured plays a dramatic role in the overall underwriting screening process. For example, two companies may have identical stringent underwriting guidelines, yet one company (Company A) may be writing policies with average face amounts in excess of $500,000, while another company (Company B) may be writing policies with face amounts averaging $100,000. Thus, the actual underwriting requirements being obtained from Company B would be very limited relative to Company A.

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The theory behind Basel II is that the current formulaic, one-size-fits-all capital standard in Basel I is insufficiently sensitive to credit-risk differentiation. Banks have assumed increasing credit risks—for example, the notional value of derivatives contracts they hold has risen from $7 trillion in 1990 to $45 trillion in 2001—and the blunt instrument of Basel I has allowed banks significant latitude for capital arbitrage. At the same time, the banking industry has consolidated, consolidating growing risks as well. These factors have led the developed world's central bankers to agree to harness two additional tools to assure capital adequacy: risk metrics used by banks themselves and market discipline.

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These are the now famous "three pillars" of the new regulatory paradigm:

I. Minimum capital requirements based on a refined measurement framework;
II. Supervisory review of the insurer's internal assessment procedures; and
III. Market discipline through disclosure.

As we will see below, it is apparent that reinsurers will be subject to increasing scrutiny and regulation, perhaps nationally and certainly internationally. Basel II and its three pillars will be the measure of our success in reducing the frictional capital costs of our regulation.

Cost of U.S. Regulation: The Impediment?

By comparison, U.S. insurance regulation for solvency has been a blunt instrument that has driven up the cost of capital for both direct and assuming insurers. As financial products have become more fungible, as financial institutions have consolidated and as global flow of capital and information has accelerated, U.S. statutory accounting has made the life insurance market here into a capital sink. That has benefited the U.S. life reinsurance industry greatly over the last few years, but few think that growth trend can continue.

Meanwhile, the NAIC pushes to limit and segregate the statutory surplus to be gained from reinsurance. It also continues to oppose any form of federal regulation or licensing of even U.S. life reinsurers. It is also exporting to developing markets the U.S. form of reinsurance regulation, including trusteed assets as collateralization.

Transnational non governmental organizations—such as the World Bank and the International Monetary Fund (IMF)—now view reinsurance as a significant risk to global financial stability. These institutions and other "global guardians" are attempting to apply Basel II-type principles to the global reinsurance industry to control that risk. While they are more sophisticated in finance and economics than U.S. insurance regulators, they don't know much about reinsurance—and even less about life reinsurance. I recommend that all reinsurers follow this work closely.

How to Measure

You have all heard the fair value debate, no doubt. The proponent of fair-value—the International Accounting Standards Board (IASB)—and the FASB signed an agreement this fall to "make their existing financial reporting standards full compatible as soon as practicable...." Known as the Norwalk Agreement—named after the location of the meeting—it has been widely heralded as a commitment to convergence. Whether and how that will come to pass for insurance contracts—and what that might mean for cost of capital—are unknown and very fluid.

In addition, the IASB has proposed that insurance contracts be "unbundled" if the cash flows from the insurance component do not affect the cash flows from the deposit-like component. It is also considering bifurcating derivatives embedded in insurance contracts without regard to the current "closely related" test. These discussions—together with the SEC's new recommendation to bifurcate the "derivative embedded" in modco contracts—has caused substantial confusion and concern. It's hard to make money when the rules keep changing.

DEVELOPING INTERNATIONAL STANDARDS

Accounting

The IASB is a privately funded, self-appointed international accounting standard setter based in London that cooperates with national standard setters, such as FASB and the SEC. Its efforts became internationally pivotal because the EU, Canada and Australia have announced they will implement the IASB's standards as of 2005. When the IASB proposed to adopt a fair value standard for insurance liabilities as well as assets, a whirlwind of controversy erupted internationally. The IASB then recognized that "it would not be realistic to expect implementation of a full recognition and measurement standard for insurance contracts by 2005." It announced that instead it would complete these parts by 2005:

- Presentation and disclosure, including how insurers might give disclosures about measurement assumptions;
- Application of IAS 39 Financial Instruments: Recognition And Measurement to some contracts issued by insurers that do not qualify as insurance contracts for accounting purposes;
- Elimination of some practices that are incompatible with the IASB's principles, such as the elimination of reserves that do not represent liabilities and the offsetting of reinsurance;and
- A review of how other standards would apply to insurers, absent an insurance-specific pronouncement.

The biggest snag in that timetable to date has been the IASB's proposed revision of IAS 32's and 39's definition of an insurance contract. IASB has proposed that insurance contracts—and therefore reinsurance contracts as well—be "unbundled." It determined that if the cash flows on the insured risk and the investment component do not interact significantly, then the investment component must be "unbundled" and accounted for as a financial instrument. For this and related reasons, the EU has declined to endorse—at least so far—this portion of the project. The German, Japanese and U.S. life insurance trade associations are also objecting. As of this writing, it's not at all clear what will happen next.

Reinsurance

The Financial Stability Forum (FSF) is one of the "global guardians." It coordinates the central bankers and financial regulators of the developed countries to promote international financial stability, reduce systemic risks and improve market functioning. The U.S. participants are the Treasury, Federal Reserve Board and SEC. The World Bank, IMF and OECD also participate.

The FSF has recently directed the International Association of Insurance Supervisors (IAIS) to create the Task Force on Enhancing Transparency and Disclosure in the Reinsurance Sector and charged it with:

- Defining the aggregated information that would shed light on the structure and resiliency of the global reinsurance market;
- Creating arrangements to produce that data regularly; and
- Stipulating the forward-looking, risk-oriented information that should be made available for insurance and financial risk exposures, for how reinsurers are managing those risks, and for the capital and reserves reinsurers are holding against those risks.

The task force must have recommendations finalized by September 2003, and it plans to meet monthly through June to meet that timetable. One U.S. regulator is on the task force—Superintendent Alessandro Iuppa of Maine. He expects to be accompanied to each meeting by one life and one property/casualty reinsurance executive. The Denmark insurance regulator is chairing the task force, and other members are Bermuda, France, Germany, Netherlands, Switzerland and the United Kingdom.

Supervisory Regimes

The World Bank and the International Monetary Fund (IMF) administer a program to promote minimum standards for macroeconomic financial stability. It is the Financial Sector Assessment Program (FSAP). FSAP's goals are

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to identify the strengths and vulnerabilities of a country's entire financial system; to determine how key sources of systemic risk are being managed; to ascertain the sector's developmental and technical assistance needs; and to help prioritize policy responses.

The IAIS creates the FSAP standards for insurance regulation. This program has benefited both direct and assuming insurers by creating new markets. It bears close watching, however, since the process of creating the standards is neither transparent nor open.

The foundation of the FSAP standards for the insurance sector is the Insurance Core Principles (ICP). They address—at a very high level—fundamental "best practices" that each jurisdiction can implement to meet its own needs. The IAIS is substantially revising the ICP currently to address, among other things, reinsurance, internal controls, derivatives and off-balance-sheet items.

The IAIS added detail to the original ICP in a Methodology that explains each principle and its elements and prescribes over 200 assessment criteria. The IAIS has, in other documents, elaborated on related principles, including supervising international conglomerates and Internet activity and regulating market conduct, capital adequacy and solvency. The IAIS has also authored various standards and guidance papers, each focused on a particular issue and elaborating on best practices with respect to that issue. Some prescribe practices for regulatory authorities, and others describe practices that a well-managed insurer should be expected to follow.

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The World Bank and IMF use the IAIS guidance to identify gaps in insurance-sector regulation in their macroeconomic stability assessments. Their assessments—reports known as ROSCs—summarize countries' observance of all international financial standards. They help sharpen regulators' discussions with their own national authorities, assist the private sector to assess risk and reveal potential systemic risks to financial stability.

The World Bank and the IMF staff believe that the importance of the insurance sector will continue to increase and that more work must be done on "the linkages between the macroeconomy and the insurance sector." They see the insurance industry changing rapidly, but in their view appropriate regulatory standards have not yet evolved. This lag exposes the entire financial system to systemic risk. They have stressed that the insurance sector's most important potential vulnerabilities are (1) "weakness in the supervisory coordination among insurance, banking and securities supervisors," and (2) "lack of effective cross-sectoral systems for identifying and managing risks within financial groups."

Reinsurers' Supervision

An IAIS subcommittee has proposed to accredit reinsurers' supervisors. The proposal is a draft entitled "Standard on Supervision of Reinsurers," dated December 2002. I expect the IAIS to adopt it or very similar minimum standards for regulating reinsurers in October 2003. This means that it will become an FSAP standard for new markets and current ones.

The premise of the draft Standard is that non domestic regulators can cede jurisdiction over a multinational reinsurer to its home supervisor only if the domiciliary regulation meets certain minimum standards. This Standard proposes those minimum requirements; they include:

- For the supervisor—"adequate powers and resources" and a mandate to share information with other regulators internationally; and
- For the multinational reinsurer—investment and capital standards, solvency standards and an investment-grade rating.

The IAIS subcommittee has not discussed the many questions about an accreditation program that we've experienced in the U.S. These include who would accredit national supervisors, what would the home jurisdiction of a true multinational be, who would set and maintain the standards for accreditation, what that process would be, who could participate in it, or what would happen if an accreditation were withdrawn. The subcommittee will meet again in February 2003.

Solvency Generally

The IAIS has adopted three papers on solvency. One reviews methods used to quantify insurance liabilities. Another offers guidance on using actuaries as part of a regulatory regime. A third gives guidance on solvency control levels.

The IAIS paper on quantifying liabilities addresses reinsurance particularly, advising that:

- Liabilities should be reported to the regulator on gross and net-of-reinsurance bases;
- Adequacy and extent of risk transfer is material to determining whether allowance should be made for reinsurance arrangements; and
- Alternative risk transfer products involve additional risks, such as legal, documentation and basis risk.

The IAIS paper on requiring insurers to use an actuary with responsibilities to the supervisory authority reviews different countries' practices. From this review, the drafters drew conclusions on how to decide whether to use a responsible actuary in an official capacity as part of the supervisory model and on how to implement that decision. Their conclusions closely track current practice in the United States and U.K.

The IAIS paper on solvency control levels elaborates on two principles already endorsed by IAIS. One principle requires the supervisory regime to set a minimum level of capital. The other requires a regulatory regime to establish one or more levels of capital above the minimum that trigger regulatory intervention when capital drops below that level; these trigger points are called control levels. The guidance paper implies that the supervisor would set each insurer's control levels individually, and it discusses factors the supervisor should consider in doing so. These include the insurance sector's competitive position, the quality of an insurer's management and other operational risk factors, existence of a guaranty fund and the length of time the insurer has been operating or whether it is assuming new types of risks.

The Guidance On Control Levels describes powers that the supervisory authority could exercise once a control level is breached. The powers are similar to those a U.S. regulator has currently, except that it proposes that supervisory regimes might confer benefits—such as streamlined approvals and reduced reporting—on insurers operating well above the solvency controls. Finally, it discusses, but does not resolve whether each insurer's actual control levels should be disclosed.

The International Actuarial Association (IAA) has formed a Risk-Based Capital Solvency Structure Working Party to prepare a paper on

risk-based capital for consideration by the IAIS. It is expected to complete its report in May 2003. Its current direction is that a "multi-pillar approach" is necessary and that, among other things, solvency assessment should reflect "the specific characteristics of the individual insurer and the markets in which it operates" and be "principles-based."

Cross-Sectoral Comparisons

The Joint Forum is a multidisciplinary group of technical experts from 13 countries—the United States, the EU and Japan. It develops best practices in areas common to insurance, banking and securities to prevent regulatory arbitrage. In a recent study it found that one of the most significant differences among the sectors was capital treatment of similar risks.

In another recent study it analyzed and compared capital regulation among the three sectors. It concluded that regulators will likely be facing a rising and fundamental tension between sectoral approaches to capital regulation based

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on traditional business activities on the one hand, and consolidations and convergence on the other. "To the extent that …convergence increases, supervisors [must] re-evaluate their sectoral regimes for capital and [reserves] to ensure that they provide an appropriate means of evaluating the capital held by firms in relation to their activities."

The Joint Forum is continuing its work, focusing on:

- Risk aggregation, by studying approaches that firms use to manage and aggregate risks across multiple businesses and risk categories (e.g., credit, market, insurance and operational risks) and methods that supervisors use to address conglomerates (e.g., capital distribution in groups);
- Operational risk management, by studying how firms address operational risks in their global businesses and how they control transferred operational risks;
- Credit risk management and transfer, by promoting the sharing of supervisory information on credit risk transfer, risk aggregation and regulatory arbitrage;
- Aggregate risk disclosure, by considering how to express vulnerability to risk concentrations and by developing risk assessment concepts and methods; and

- Effective supervision of financial conglomerates, by assessing the appropriateness of group-wide methods of supervision.

This work has increased interest in preventing what is known as "double-gearing," particularly within groups that include a reinsurer and a bank. Double or multiple gearing is the practice of counting the same capital more than once. Japanese banks and life insurance companies, for example, are providing each other reciprocal capital. The work has also concentrated regulatory attention on reinsurers' knowledge and management of their intra-group credit and market risks.

Databases on Reinsurers

Both the Organization for Economic Development and Cooperation (OECD) and the IAIS are compiling databases on reinsurers. Both are populated by regulators and are available only to them. Currently, the databases contain only public information on fraud, insolvency and limitations of activities. Both IAIS and OECD acknowledge that individual regulators can provide that information only subject to confidential restrictions in their own jurisdictions.

IAIS Medium-Term Plan

The IAIS has released its Medium-Term Working Plan, outlining its goals and budgets from 2004 through 2006. Founded in 1994, its projected budget in 2006 is US$2.134 million. It will fund that with dues from members, to be assessed based on the size of each country's insurance market and its 2001 GDP per capita, and with fees imposed on nonmembers to observe such IAIS activities as may be open. The United States would pay by far the largest amount under that formula and would receive only 15 member votes.

During the period, the IAIS expects to participate in WTO and GATS trade talks and work with the OECD to set standards for insurance, pensions and other "contractual savings." It also plans to:

- Draft a global solvency standard;
- Create a "more effective and coherent approach to reinsurance supervision"
- Adopt standards on acceptable forms of capital; and

- Issue guidance on asset valuation and on asset/liability matching.

The IAIS has solicited comments on its plan by February 28. It expects to adopt it in October 2003.

OPTIONAL FEDERAL CHARTER

No federal legislation proposing an optional federal charter has been introduced yet. It is expected early in this session. The effectiveness and efficiency of state insurance regulation will be debated in several contexts during this session of Congress, as will reinsurance itself.

The perceived effectiveness of state insurance regulation will be front-and-center as the NAIC, the state departments and the U.S. Treasury work to implement the new Terrorism Risk Insurance Act of 2002 (TRIA). Critics of state regulation will argue that it is failing the test that TRIA imposed. Others will view the states' implementation as effective.

The impending sunset of the Fair Credit Reporting Act's preemption of state laws on sharing credit information among affiliates will also trigger debate about whether state insurance regulators have adequately or uniformly protected personal medical and financial information.

Finally the Treasury will be reporting to Congress on its study of the availability of reinsurance for group life.

RECENT NAIC ACTIVITY

Pending

Adjusting TAC for Reinsured Dividend Liability

The AAA has recommended to the NAIC that the dividends used in the total adjusted capital (TAC) calculation should be reduced or increased to the extent that liability for policyholder dividends is ceded or assumed under modified coinsurance, coinsurance with funds withheld and any other agreements. If the NAIC's Life RBC Working Group adopts this recommendation in March 2003, as expected, it will be effective immediately.

Segregating Surplus Due to 'Retroactive Reinsurance'

The NAIC deferred until March 2003 adoption of a requirement to segregate surplus due to retroactive reinsurance. This "nonsubstantive" interpretation of SSAP No. 72—Surplus and Quasi-reorganizations, would require that "surplus resulting from reinsurance of in-force business of life insurers must be recorded as an appropriation of surplus by the ceding company." The proposal contains no definition of 'retroactive' reinsurance and might also include assumption reinsurance and nonproportional reinsurance. This issue has been referred, only until the March 2003 meeting, to the Reinsurance Subgroup of the Statutory Accounting Principles Working Group. If adopted in March 2003, it would be effective immediately.

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Definition of 'Existing' or 'In-force' Business

The NAIC is still considering whether to amend Appendix 785 to define all policies or contracts issued prior to the beginning of the quarter in which a binding letter of intent or reinsurance agreement is executed as in-force or existing business. The effect would be to allow gain to be deferred only if clients sign letters of intent for new business in Q1. The issue was deferred in June 2002 pending clarification of the underlying problem by NAIC staff. If staff presents that information in March 2003, the 'non-substantive' interpretation could be adopted at once and might be effective in June 2003.

Workers Comp Carve-Out and RBC Factors

The NAIC will finally adopt its issues paper on workers comp carve-out in March 2003, as well as the RBC factors recommended by the AAA. Those factors closely resemble property casualty RBC factors.

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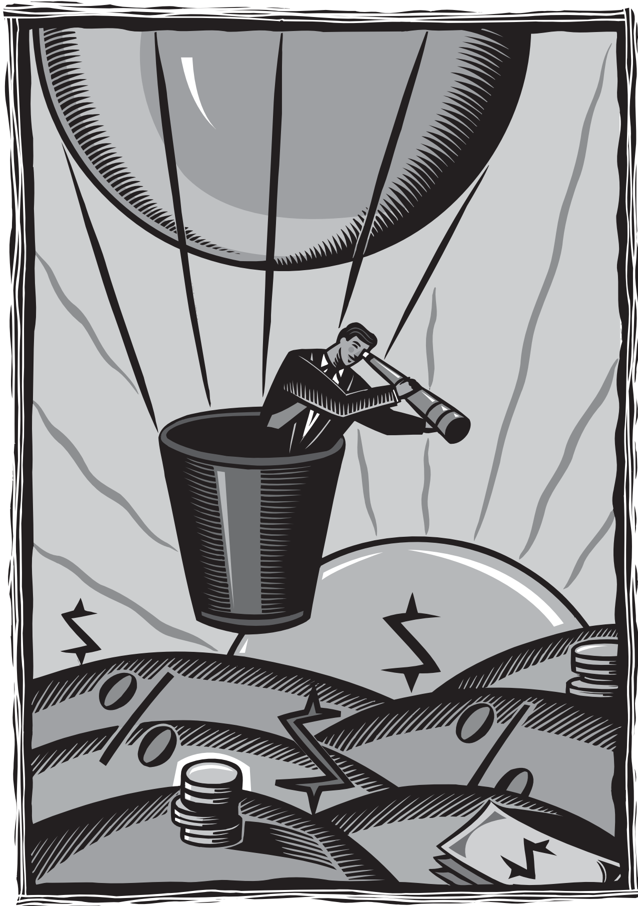

Follow-up issues will include:

- Requiring an actuarial opinion on the pool's business and giving regulators access to the actuary's work papers, the pool actuary's work papers and the member companies' audits and actuarial reviews.
- Subjecting pools and associations to the Model Audit Rule and requiring them to file an independent statutory audit opinion.
- Amending Schedule S to require comprehensive disclosure of interaffiliate pooling, in compliance with SSAP No. 63.
- Revising the NAIC application process to list pools and associations, to assign identification numbers to pool transactions and to provide due diligence.

Ongoing

Statutory Accounting: Evaluating Inconsistencies Between Life and PC

The Statutory Accounting Principles Working Group formed a reinsurance subgroup in fall 2002. The subgroup has both regulatory and industry members; regulatory members are California, New York and Wisconsin.

The subgroup's generic task is "evaluating the inconsistencies between life and health and property and casualty reinsurance and determining whether those inconsistencies are valid and or [sic] whether the accounting rules should be consistent." These inconsistencies include the 90-day non admission and experience rating refunds.

The subgroup is now also charged with addressing, before March 2003, whether "retroactive" reinsurance must be segregated in surplus. If the NAIC's tentative decision is affirmed at the March 2003 meeting, it will be effective immediately.

RBC: Evaluating Inconsistencies and Effectiveness

The NAIC formed an ad hoc RBC Task Force in late 2002. The task force was originally charged with evaluating the inconsistencies among all three RBC formulas, as had been detailed in a AAA report. The task force has since determined that it will address those issues only as specifically directed by its parent committee and will instead focus on evaluating the effectiveness of the risk-based capital formulas in identifying troubled companies.

This task force is sometimes known as the "Wisconsin Letter" group, since it is following up on a letter from the Wisconsin Department to the NAIC pointing out that the current RBC analysis was not flagging troubled companies. The task force is meeting in closed sessions.

Alien Collateralization

The NAIC continues its consideration of proposals to reduce the collateralization required of alien reinsurers. At present it is studying the regulatory regimes of Bermuda, France, Germany, Switzerland and the UK. Debate is likely to continue for some time.

New Initiatives

Interest Expense on Funds Held Reinsurance

The NAIC has exposed for comment a non substantive interpretation of SSAP 61. The interpretation is that interest credited to the cedent under a funds—held treaty should be reported "a component of aggregate write-ins for miscellaneous income" by both the ceding and assuming insurer. In the health blank, both should report it "as a component of

aggregate write-ins for other income and expense." If the tentative interpretation is endorsed at the March 2003 meeting, it will be effective immediately.

More Statement Disclosure of ART
The 2003 charges of the Property and Casualty Reinsurance Study Group include monitoring the development of alternative risk transfer mechanisms and considering whether broader annual statement disclosure might be appropriate. The study group's discussions often affect life reinsurers.

Risk Assessment
The Risk Assessment (E) Working Group is developing a proposed prioritization outline similar to the banking industry's CAMEL methodology, but is including "items related to reserves and reinsurance." The 2003 charges to this working group include:

- Enhancing the utilization of risk assessment, including the review of risk management practices used by insurers, in the regulation of financial solvency;
- Addressing the challenges of incorporating the assessment of risk and of risk management in the financial solvency oversight role; and
- Proposing modifications, as appropriate, to the NAIC's financial examination and financial analysis processes.

[Bank supervisors in the United States rate each bank on its capital adequacy, asset quality, management, earnings, liquidity (hence "CAMEL") and since 1997, its sensitivity to market risk. Examiners assign a rating for each component on a scale from one to five, with one being the highest rating, as well as a composite rating for the bank's overall condition and performance. A bank's CAMEL rating is highly confidential. Though CAMEL ratings are not a comprehensive indicator of all the supervisory information gathered during a full-scope exam, they serve bank supervisors as a convenient summary analysis. This is analogous to what the Risk Assessment Group is constructing.]

SUMMARY

There's an old saying that if the only tool you have is a hammer, then everything looks like a nail. I'm an insurance regulatory lawyer—that's my tool. It's not really surprising then that I see all these developments and want to hammer these nascent regulatory regimes into ones that will help my clients compete—not just today but long into the future.

Having made full disclosure, here's what I think. I think that the past few years have been very good for life reinsurers. Everybody's been very busy, and the future has looked, well, far away. And in all that time, the tide of regulation has been rising for reinsurers. Growth is now slowing, and that tide is rising faster and higher. That tide is the frictional capital cost of regulation compared to institutions with other types of charters.

There are many good effects of that rising tide. The FSAP opens new markets, for example. It is also true that many features of the international regime are sophisticated and thoughtful and will benefit markets and flows of capital.

Just remember the Basel II numbers. ✍

Carolyn Cobb is the principal in Cobb Law Office, which serves life insurance and life reinsurance clients on regulatory issues nationally and internationally. She can be reached at ccobb@cobblawoffice.com.