



SOCIETY OF ACTUARIES

Article from:

Reinsurance News

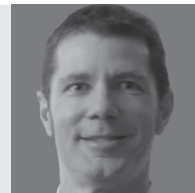
July 2013 – Issue 76

Life Reinsurance Treaty Construction: A Preview

By Steve Stockman and Tim Cardinal



Steve Stockman, ASA, MAAA, is principal with Actuarial Compass. Steve can be contacted at sstockman@actuarialcompass.com.



Tim Cardinal, FSA, CERA, MAAA, MBA, is principal with Actuarial Compass. Tim can be contacted at tcardinal@actuarialcompass.com.

Procuring reinsurance and negotiating rates and treaty provisions are often an integral component of the life product development process. Reinsurance bears directly on the product's risk management, the product's competitiveness, and the long-term profitability of the block. The Society of Actuaries (SOA), the Reinsurance Section and the Committee on Life Insurance Research sponsored a report on "Life Reinsurance Treaty Construction." The report is based on questionnaire responses, telephone interviews, participant research assignments, follow-up email correspondence and an in-person roundtable discussion. The report documents participants' points, counterpoints, counter-counterpoints and insights distilling dozens of hours of discussions into 300 participant comments.

The report's purpose is to increase awareness of the importance of many reinsurance treaty terms/provisions; identify common treaty structures, practices and/or solutions in reinsurance treaty construction and negotiation; and illustrate how treaty terms have evolved over time. The report appendix contains samples of past language and current language to illustrate how provisions have evolved and we hope will prove to be a valuable reference.

Shared knowledge may facilitate the success of future reinsurance treaty negotiations to the mutual benefit of reinsurers and direct companies. Lessons shared may enable both sides to reach better solutions more efficiently, enhancing current processes and treaty language, reducing the length of time needed to complete negotiations, and improving the administration and execution of treaties.

The report presents underlying themes followed by highlights on contentious provisions and issues including cedants cherry-picking recaptures, reinsurers raising premium rates, cedants' administrative and reporting weaknesses impacting reinsurers' financial statements through errors and omissions (E&O), reinsurers denying coverage on claims, and both cedants and reinsurers exceeding tolerance risk limits.

BEHIND THE SCENES

A questionnaire was used to identify contentious issues and provide talking points for the telephone inter-

views with each participant. Fourteen interviews were conducted in a span of eight days with questions and follow-up questions. On one call, we would hear clearly articulated reasons and stories why their position and perspective on an issue was right and the other side's position was untenable, unreasonable and unfair; and the other side should be more accepting or willing to change their position or move along the spectrum. Later the same day, on the next call, we would hear the exact opposite alongside an equally passionate and persuasive story. Our reactions were we couldn't wait to see what would transpire during the roundtable discussions.

Participant comments provided through the questionnaire and interviews were useful and insightful, and allowed participants to see the thought process of other treaty negotiators. However, the rich exploration of issues was only possible through engaging dialogue and debate. A non-pressure, non-negotiation setting allowed participants to share and listen to other perspectives without the need to compromise, negotiate or persuade. The roundtable discussions alternated between describing, explaining, debating, clarifying, expounding, disagreeing, defending, developing, supporting, brainstorming and laughing. The authors used a documentary approach to capture these dynamics. Some issues provoked strong disagreements on the nature and intent of the provision. Throughout the roundtable, these differences were constructive and met with professional respect.

PERSPECTIVES

The report's centerpiece is *Section 5, Perspectives: Treaty Provisions*, which documents participants' comments and authors' observations. The following provisions are presented documentary style:

1. Facultative Reinsurance
2. Reinsured Risk Amount
3. Late Reporting
4. Claims
5. Reductions, Terminations and Changes
6. Changes of Plan (Conversion, Exchanges, Replacements)
7. Premium Accounting
8. Recapture
9. Change in Legal Control
10. Errors and Omissions (E&O)

//IT'S NOT AS IF WE'VE BEEN BRILLIANT WITH FORESIGHT IN ANTICIPATING FUTURE ISSUES; WE MOSTLY REACT TO BAD SITUATIONS.//

11. Change in Rating/Financial Control
12. Offsetting/Netting Provisions
13. Automatic Binding Limits
14. Miscellaneous Provisions

We encourage readers to see the report for an interesting read.

OBSERVATIONS

Central themes emerged during the interviews and roundtable dialogues. A few of the report's observations follow.

The business of treaties and the nature and degree of the reasons for the departure from the gentlemen's agreement and trust era underlie the evolutionary forces impacting the construction process. Provisions have been evolving, and reinsurance arrangements are increasing in complexity. The consequence has been an increase in operational risk. A result has been diverging viewpoints by ceding companies and reinsurers on existing E&O clauses. The importance of building and nurturing their relationships was stressed as being good business.

The pendulum swings back and forth between guidelines and rules based on developing experiences. Precise legal language can provide clarity to protect one's interests. Guidelines can provide flexibility when rules do not anticipate or address the instance precisely. Precision can imbue clarity while removing ambiguity when the "letter" of the contract rather than the "intent" is enforced. Not every issue can be anticipated in advance. If the rules approach does not address the instance precisely, then each party decides exactly what it means. These interpretations likely do not coincide. One interviewee said, "You want to be loose and flexible but then it is difficult to figure out how it applies to a specific case or dispute, so you want to tighten that up."

Contention can occur during the negotiation process or long after the treaty's consummation. Some contentious issues have everything to do with treaty language and some have everything to do with business operations and practices. Regarding treaty evolution, one participant commented, "It's not as if we've been brilliant with



foresight in anticipating future issues; we mostly react to bad situations."

All roads may lead to Rome; however, all treaty provisions lead to E&O. The basic question is: Does E&O narrowly apply to specific types of errors under certain conditions with limitations (the preferred reinsurer interpretation), or is it all inclusive (the preferred direct writer interpretation)? During the interviews and the roundtable, discussion on numerous articles and provisions led to a digression on E&O. Both sides are passionately firm in both their business interests and in their positions. Both sides acknowledge various points of the other side but remain opposed on the intent, scope and application of E&O.

CONCLUSION

A reinsurance treaty's long-term nature challenges both parties during the construction process to negotiate intent and then translate and formulate intent into language that pulls together rules, clarity, guidelines and flexibility to pass the test of time. Twenty years ago, reinsurers did not necessarily anticipate the operational risk created from business and administrative practices.

CONTINUED ON **PAGE 28**

United States Secretary of Defense, Donald Rumsfeld said, “There are also unknown unknowns—the ones we don’t know we don’t know.” If intent, language, interpretations, time, practices and known errors cost companies on both sides millions, what about the unknowns? Treaty provisions have evolved as a means to address the known and the unknowns.

Each side agreed there was room for improvement regarding operations and business practices as well as meeting/serving industry needs. Suggestions included facultative notification, more effective audit reviews to address and fix back office and administrative errors, consistency between treaty language and requirements with business practice, a repository to address autobind and jumbo limit compliance, and E&O categories.

The direct company/reinsurer/retro relationship may not be a partnership, but there is no denying the three sides have built strong business relationships. The friendships and the respect each side has for each other were evident prior to and during the in-person roundtable discussion. It is because of the respect and friendships the three sides have for each other that we have no doubt reinsurance treaties will evolve to the mutual benefit of the life insurance industry. ■

REFERENCES

Stockman, Steve, and Tim Cardinal. 2013. Life Reinsurance Treaty Construction. Society of Actuaries.