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THE PROBLEMS WITH BULK REINSURANCE

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This session will analyze various aspects of bulk or self-administered reinsurance treaties with respect to the following:

1. Certification of information on reports by an actuary.

2. Reinsurance audits of bulk accounts.

3. Format of information on bulk reports.

4. Approach to handling reinsurance of universal life.

5. Special problems of ceding facultative reinsurance under bulk agreements.

MR. JAMES HOREIN: I'll introduce the panel members in the order in which they will make their presentation. We will start off with Tim Fitch. Tim is Second Vice President and Actuary at Security-Connecticut Life Insurance Company. He will be followed by Pete Fox, who is Assistant Vice President and Assistant Actuary at Volunteer State Life Insurance Company. These two individuals have been through the process of evaluating self-administration on their reinsurance account and have the considerations and experience to share with you. They will be followed by Herman Schmit, President of NRG American Life Reinsurance, whose assignment will be to summarize and convey to you some of the problems and considerations as well as successes from a reinsurer's point of view. The final prepared remarks will come from Ron Freres. Ron is a partner and National Director of Insurance for the public accounting firm of Ernst and Whinney. We think Ron can provide us with a unique insight into an outsiders view, if you will, of a very critical area.

I think it is necessary to make a couple of observations with respect to the title of this session, "The Problems With Bulk Reinsurance." My first comment has to do with the term "bulk" reinsurance. In the world of reinsurance account administration, you can find administrative approaches ranging along a full spectrum: one end is the very traditional individual policy cession method where each policy is submitted to a reinsurer in some fashion. Record keeping, billing, etc., tend to be provided by the reinsurer. We will probably refer to that as individual policy cession form of administration. All the way to the other end of the spectrum where no individual policy detail is submitted from a ceding company to the reinsurer. This latter end of the spectrum is what we, at least at Lincoln,

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would call "bulk reinsurance," or we might call it "pure bulk reinsurance." This would be commonly used in the Group Reinsurance area. Property casualty risks are frequently submitted in a bulk or a net basis, and in the Life arena with the accidental death benefit insurance. In between the two ends of the spectrum, you can probably find a wide variety of approaches differing in the amount of information that is exchanged; but the most common of these would be grouped in the middle of this spectrum and probably called bordereau. We at Lincoln call it SPREAD, some people call it self-billing or self-administration. Under bordereau or SPREAD administration, individual policy detail is provided via a form on a monthly or quarterly fashion, typically computerized. I suspect it is this form of administration, the bordereau form, that most of us are thinking about when we refer to the term "bulk" today; and specifically, this is the form of administration that this panel intends to focus on. So, to clarify the terminology here - bordereau, self-administration or SPREAD - they are interchangeable and they are in the middle of this spectrum. If in doubt, perhaps the speaker can define where he is on this spectrum.

The second observation, with respect to the title, deals with the word "problems." There has been a growing tendency within the reinsurance industry to view bordereau or self-administration as a problem, as a negative, as something without which, frankly, we'd be better off. Why does this attitude exist? I will submit that, as an industry, the reinsurers must shoulder a major part of this responsibility for the problems which exist with self-administered reinsurance. My feeling is that we've come to view alternative administrative methods as a problem, possibly because we in reinsurance have over sold them. This has been a somewhat natural result of our marketplace over the last several years. Some even sell this approach as simplified administration. If the ceding company can do some of the administration, the reinsurer can lower the cost, the reinsurer can be more competitive and, hence, sell more business. This may have been done without the reinsurer completely explaining to the ceding company exactly what obligations they are assuming and without the reinsurer adequately evaluating whether the ceding company can provide what is expected. Perhaps it has been sold without thinking through if the business in question, which is being reinsured, can best be administered that way. Well, that's the theme of today's panel.

MR. TIMOTHY FITCH: Before I get into the meat of my talk, I think it will help to set the stage by talking a little bit about the recent history of my company, Security-Connecticut. We are a company that has grown quite a bit in the 1980's primarily as a result of our competitive term portfolio as well as our early and continued presence in the universal life market. Our primary distribution source has been the independent brokerage general agents. The ultimate success of our affiliation with these entrepreneurial types is determined by our ability to find fields left uncultivated by career agency companies and then till, plant and reap as quickly as we can.

Since we don't have any direct control over our producers, we realize that we may be subject to slightly higher lapse, and perhaps even higher mortality than some of our competitors, so controlling expenses is an especially key item for us. I think my Greyhound stub and the tent I have pitched in Temple Square are testimony to this fact. Our first involvement with bordereau self-accounting reinsurance occurred in 1978 and was prompted by our desire to find a less costly way to administer reinsurance. Our first system was capable of automatically billing renewal premiums, but all new business and policy changes, including lapses and reinstatements, had to be done manually. This worked fine for a while, but less than two years later, we were anxious to get a system that was capable of doing even more.

In the middle of 1980, we took the next step by developing an enhanced system that was capable of determining how much reinsurance, if any, was needed on all non-facultative policies, and then ceding the right amount to the right reinsurer and automatically billing us for the initial premium as well as the renewals. This system could also collect the correct premium refunds owed to us on lapses or surrenders.

We took this next step to head off what we saw as the looming specter of rising reinsurance administrative costs that would result from the healthy sales increase we were expecting in early 1980.

Our enhanced system generated quarterly inforce and premium reports to each of our automatic reinsurers. The inforce listing showed the insured's name, sex, date of birth, policy date, underwriting code, and current amount reinsured on each ceded policy that was inforce with them. The premium reports were listings of all the policies that generated premium payments or refunds for that quarter. These included policies that were first paid for in that quarter, renewed in that quarter, and those that lapsed or were reinstated in that quarter.

Each listing in this premium report had all the policy information needed for the reinsurers to verify the premium or refund amount. I'd be happy to provide more specific information on the actual output format to anyone who is interested, but, in deference to those who can't wait for me to finish, I will wait to give more detailed information until someone asks me for it.

In retrospect, our decision to go to this bulk self-accounting system was the right one.

The main reason this was such a good decision is that even though we were expecting a "healthy" sales increase during the early 80's, the actual sales increases we got would make a super-fit, non-smoker look like a Table 10 (a little insurance allusion there). Our ordinary life sales volume jumped from $1.2 billion in 1978 to $11.0 billion in 1982 for an average annual compound growth rate of almost 75% over that 4 year period. These sales increases brought along correspondingly large increases in the number of reinsurance transactions required. Fortunately, our systems enabled us to handle this large increase in reinsurance administration activity with a relatively small staffing increase.

The bottom line here is that in the past two years we have been able to process over 23,000 individual cessions equal to $5 billion of face amount and maintain our whole inforce ceded block with a reinsurance administration annual payroll of less than $90,000. These are the kind of numbers we like to see.

That's the good news. I could go on and on about all the time and money that our system has saved us, but, when Jim Horein asked me to participate on this panel, he claimed he was asking me as a representative of a company that had been using a self-accounting system for a while and, as such, he figured I could talk about some of the unforeseen problems that we've run into during the evolution of our system. Personally, I still think he asked me, since he is a vice president of Lincoln National, which just happens to be our parent-company, and he knew it would be a little tough for me to say "no." Nonetheless, I will be happy to spend a few minutes addressing the agony, as well as the ecstasy, we've experienced in living with our system. I will also touch on some of the ways we found to mitigate that agony.

Most of the pains that we've experienced with our system have been one of two types. First, there were the pains associated with growth of the system. The more it could do, the more we wanted it to do. The more we wanted to do, the more changes we had to make, and the more complex it got. I will refer to these types of pains as "growing pains." The second type of pains we felt are those which are associated with any type of large general automated system. Since we are in the age of acronyms with words like NATO, NASA, IRA's, LASER, SCUBA, and WASP all being commonplace, I'll take the liberty of using an acronym to refer to these general automated system pains -- I'll call them "GAS" pains.

The growing pains stemmed from the fact that when our system was first set up, it was very simple. We had one YRT rate scale for all our automatic reinsurance. We established a pool of 11 reinsurers, which we cleverly called "Pool A." Each of the members of the pool got a percentage of each risk. The premium and inforce reports which were sent to each reinsurer looked the same, except the ceded amounts and the premiums shown were different for each reinsurer, based on the size of their slice of the Pool A pie. Well, this was fine for a while and it was a nice, clean, simple system to work with. Then, we set up a second pool, imaginatively named Pool B, for certain special plans. This pool was made up of the same 11 reinsurers as Pool A, but with different percentages and slightly different rates than Pool A. No big deal, now we had 2 pools and 2 rate scales. Well, this was just the beginning. As we got more heavily into the term market, we realized that we had a need for a more customized YRT rate scale for our rapidly selling select and ultimate term plan. Before too long, we had separate YRT rates for each of the 5 bands of our most popular term plan and for each sex. I think you can see where I'm headed. Along came variations of our term plan, smoker/non-smoker rates, allowances that were lower when we levelized commissions on known replacements, and so on. All of these resulted in different YRT rate scales. Today, our system, which was first designed for one rate scale, is now the proud father of over 250 different rate scales!

In order to keep up with these changes and variations in the rate scales, we had to step-up our vigilance to make sure that each policy was, in fact, having the correct rate applied to it. One way we do this is by picking out policies at random from each quarterly premium report, and manually calculating the premium to see if it jibes with the one on the report. We pay particular attention to policies issued on plans or under underwriting programs where new rates were installed during the latest quarter. Sometimes these checks can't really be done on the production system's output until a year after the new rates go into effect. This happens any time the new and old rates differ only in the renewal years. In these situations, the only way we know for sure that the new rate scale is being properly applied is to check the renewal rates which are used the year after the new rate scale is put in. So, we have established a diary system to remind us to re-check the renewal rates on policies that are most apt to need testing.

Aside from the multiple rate scales, other growing pains occurred as the pool itself evolved. In 1981, we decided to increase our retention as of 1/1/82. We wanted to make sure that our best reinsurers would not see a big drop in the amount of business ceded to them. So, we cut the number of reinsurers from 11 to 7. Therefore, we had to adjust the system to produce premium and inforce reports that reflected the different percentage splits of the pool after January 1, 1982. This was no big deal, but it did require additional Data Processing work, and added to the complexity of the system.

One final example of the growing pains we've experienced is the following. As we developed special underwriting or marketing programs, and developed other reinsurance programs, we had to adapt the system to be able to consider other factors, such as, underwriting program, date of issue, and writing agent, as well as the plan code in determining who should get the reinsurance and what rates we should pay. The more we were able to get the system to do, the more confident (or maybe "cocky" is a better word) we became that the system could do anything and everything. However, our original dream of the ultra-simple system was evolving into a major system that was quite complex. A complex system, in and of itself isn't bad, but it does mean that we then had to deal with the GAS pains I mentioned earlier.

In particular, it meant that any time we wanted to make additional changes to the system, it took more and more time, and that meant more money, for the data processing area to assure themselves and us that the system was doing all the things that we want it to do and, which is sometimes more important, not doing the things we didn't want it to do. The potential for problems occurring is increased even more as the data processing department experiences turn-over, as these DP-types are wont to do. What this means is the guy who worked on the system for the last year and found all kinds of short-cuts to fool the system to get it to do what he wanted it to do is replaced by someone who doesn't know the difference between coinsurance and YRT and who thinks that an automatic cession is the daily 10 o'clock coffee break! As we became more dependent on the data processing area, we not only had to re-train when we had turnovers in the Reinsurance Department, but we also had to re-train when we got turnovers in the Data Processing area. Also, unless the short-cuts made by the first programmer were well-documented, additional changes made by the "rookie" may result in unexpected "happenings." Thus, the internal checks, such as spot-checking of policies I mentioned earlier, are doubly important.

One of the beauties of a system as automated as ours is that it can handle over 90% of all of our cessions. However, in order to do what it does, it does have to interact with other systems. This means that inter-departmental communications has to be increased so no department makes any changes to their system without consulting all the other areas, not just those that are obviously affected.

I have a recent example. Until late last year, our system could not issue a policy and make it become a paid policy on the same day. Once it was issued, it couldn't become a paid-case until the following day's cycle was run. This sometimes caused problems, since the commission payment was contingent on the policy becoming paid. As a way to get commissions paid on a more timely basis and as a way to make our processing of cash-with-app cases more efficient, we felt that it would be advantageous to be able to get our policy issued and paid on the same day. The people in the

Commissions area talked to the people in the Issue area and they worked out a solution. However, they forgot to check with our Reinsurance area. To them it didn't seem to matter. But, our reinsurance system only pays a first year premium if a master file record has a reinsurance indicator on it at the time it becomes paid. Under our old system, the reinsurance indicator was put on the day after the case was issued, but before the payment process took place. So, under the new system, any case that was being issued and paid on the same day's cycle would not have a reinsurance premium generated on it. However, since the reinsurance indicator would be on the master file record at the end of the quarter, it would show up on the inforce listing. Fortunately, we found this error before any reports were actually sent out; the way we found the error was by doing a quarterly reconciliation of the inforce reports to the premium reports. This is how it's done: The number of policies on the inforce report at the end of the latest quarter should be equal to the number inforce at the end of the previous quarter, plus any additions, less any deletions. Included in the additions would be new paid policies and reinstatements, and the deletions would include lapses, surrenders and deaths. All of these "ins and outs" are on our premium reports, so this reconciliation is fairly easy. If last quarter's inforce plus the "ins" less the "outs" doesn't equal this quarter's inforce, something is wrong. In the case I mentioned, it was obvious in doing the reconciliation that we were missing some "ins" somewhere.

As we traced it back, we found that the missing "ins" were all issued and paid on the same day. This led us to the cause of the problem. This reconciliation that I described is, I think, one of the most valuable and most cost-efficient checks that can be done to pick up policies that might otherwise "fall through the cracks," or in some cases, "fall through the chasms."

One final GAS pain that I would like to mention is the classic one of any computerized system--it lacks the flexibility of a manual system.

For example, implementing a new YRT rate scale. This is a process that is relatively easy for us to do with a manual system. But, when it involves systems changes, we now have to compete with other areas for the available data processing resources to get the new rate scale and logic implemented. The net result of this is that certain plans may have to be done manually from time to time, or, if you have an agreeable reinsurer, you may be able to get them to hold off on getting paid for new policies on a certain plan until the following quarter when the new YRT rate scales can be implemented and the back-premiums calculated and paid. In some companies, the availability of D.P. resources may not be much of a practical limitation, but in our environment, it sometimes is. Since we always push to get our product developed and on the street as quickly as possible, the mere fact that we don't yet have the reinsurance rates on the system isn't going to hold up the announcement of the product. So, we in Reinsurance Administration have to find a way to deal with that. We've been fortunate enough to have reinsurers who recognize the serious efforts we make to ensure the integrity of our records. Therefore, they have been willing to work with us to find reasonable solutions the one, or maybe it was two times, our reports have had minor errors.

This brings me to probably the most important point I can make with regard to a company that has considered going to a computerized self-accounting system. That is, no matter how carefully the system is planned, programmed, documented, checked and audited, sooner or later, errors will occur. Hopefully, you'll find most of them before the actual bills are sent out. But, sooner or later, one will slip through. In these cases, it's important to have a good working relationship with the reinsurers you will be dealing with. It's important to keep them informed as to what your system can and cannot do, and to pick their brains for ways to improve your system. They may have been through it before with another company, and you may be able to use their experience to help you avoid mistakes or to minimize the agony if mistakes do occur.

In spite of the problems I've talked to you about here--remember the statement I made earlier--i.e., in retrospect, our decision to go with our current system was the right one; we feel it has saved a lot more money than it has cost us and much of the credit has to go to our reinsurance partners.

However, even though we're happy with our system, it is not the be-all and end-all. We are tempted to continue to make enhancements to have it handle every bit of automatic reinsurance possible. But, there are certain situations that we feel are better-suited to manual processing. For instance, we still do all our facultative business on a manually billed basis, and we have been using a cross-breed of a manual and automated self-accounting to do our universal life for the last two years. When we first came out with the plan, we felt that the changes necessary to our system to get it to do universal life properly would cost more than we wanted to spend, especially, given the questionable future of universal life during its infant years. Now that we realize what a big chunk of our business this will be, we are committed to having our universal life done totally by the system as well.

All of this is to say that self-accounting can be a blessing, but is not without its drawbacks. For anyone who is thinking of using it in an area where they aren't using it now, the possible advantages are usually obvious. However, just keep your eyes open to the possible draw-backs, which often are not as apparent.

MR. PETER FOX: Universal life products seem to be well suited to bulk (or self-administered) reinsurance methods, particularly if it is possible to get adequate Electronic Data Processing (EDP) assistance. I think that, considering the volatility of the policy, self-administration is the only way to go, even though self-administration probably requires a larger initial investment, and probably a higher level of clerical worker.

The two most popular forms of reinsurance for universal life are a more or less traditional Annual Renewable Reducing Term (ARRT) format, and a monthly premium, self-administered format.

The chief appeal of the ARRT format is its similarity to the usual format of regular ordinary individual cession reinsurance. This makes it easy to integrate universal life into an already operating reinsurance administration system. When the policy is issued, five or six years of projected reserves are calculated, net amounts at risk are figured using these reserves, and standard YRT rates (or special rates, depending on the reinsurer) are applied to the net at risk. The cession is filled out as usual, and the policy takes its place among the other policies on the reinsurer's billing. It sounds simple, and is...all you have to do is set up the policy and forget it for five years. This method has special merit where an older, traditional-type product changes to a universal-type product, and the reinsurer is one to which your company is no longer actively ceding new business. It can prevent having to set up a single case contract for one or two policies. Although useful, the conventional ARRT method can be inaccurate with respect to the amounts at risk reinsured, because the net at risk can vary, within limits, pretty much according to the policyholder's whim. The prospect of explaining a large over-retention was one of the reasons which convinced me to use a method whereby more accurate net amount at risk could be reinsured. I also wanted to keep paper work within reason. Under the traditional approach, with amended cessions, I saw the potential for being buried by paper work.

The other method of reinsuring universal life business is what I call the self-administered monthly premium plan. In this type of reporting (also called bordereau), a report is sent as of the end of each month to the reinsurer, listing the pertinent information for each policy reinsured, along with a check for the reinsurance premium due the reinsurer. The reinsurance premium is based on the "cost of insurance" amount, or "risk charge amount" which is charged to the policy fund value for that month. Typically, the amount sent to the reinsurer is a percentage of that amount for the net at risk reinsured. This, too, is relatively simple in concept. Unfortunately, universal life has several aspects which really tend to confuse the issues when it comes down to the day-to-day nuts and bolts administration of reinsuring universal life.

In self-administration of any type, not just for universal life, timing differences may generate a problem between the company and the reinsurer, especially for policies ceded facultatively. Since reports are sent (probably) monthly it can take more than two or three months for a policy to show up on the reinsurance report to the reinsurer. For example, consider a policy approved by the reinsurer on January 10th, but not paid for (i.e. not in force on the computer) until February 1. This means it's not listed for the reinsurer until the report showing in force as of the end of February, and not actually sent until mid-March (or later). If the reinsurer closes its offer after 60 days, as some do, this can create a problem if they are paying attention to their bordereau business. A related problem is that some of the reinsurers, especially ones who did not have that much individual self-administered business, do not seem to have coordinated their bordereau and regular systems, and they may not have things as well under control as they seem to have on their individual cession business. This sometimes has created some misunderstandings where our own procedures and those of the reinsurer are both evolving at the same time.

It can take some time to get a format for reporting which is acceptable to all of your reinsurers. Some of the reinsurers are enlightened and say "show me what you have, and we'll try to live with it," but others have fairly well insisted on the specific information to be included. I finally solved this problem by including everything everyone wanted on one report, but when you're just starting out this problem can be a bother.

The main reason that universal life creates more problems for the ceding company than regular policies is because it has the potential to change so often, in so many ways. For example:

1. Reserves and cash values plus net at risk can vary according to the premiums paid by the insured.

2. The policy face amount may reduce if a withdrawal of cash value is effected.

3. Additional insurance can be underwritten and added to an existing policy, giving you two entirely different sets of reinsurance under the same policy number.

4. Policies may change from level death benefit (net at risk = face less cash value) to increasing death benefit (net at risk = face) and back at the policyholder's option.

   Under a self-administered system, these changes can get to the reinsurer about as fast as they can. As soon as the changes take place in the ceding company's computer, they can be reflected on the next statement sent to the reinsurer, and this is much faster than the "amended cession." The key here is "as soon as the changes take place in the computer." It sometimes takes a long time for a policy change to be effected, especially if the change is complex or of a type unanticipated by the system's designer.

   With the net at risk changing frequently, some decision must be made about how to calculate exactly how much is to be reinsured. Our system establishes a "reinsurance percentage" which is determined at issue based on the face amount and the amount reinsured. This reinsurance percentage goes along with the policy through all of its various changes in net at risk. A separate percentage must be established for each increase segment, however, just as it would for a new issue.

5. There is usually a sixty day grace period. This means that a policy can hang around for several reporting periods without any premium activity, and then have a two or three month catch-up cost of insurance premium due all at once.

6. Replacement of existing policies with universal life type policies may be allowed or encouraged. In some cases this involves the consolidation of several old policies into one new policy, possibly involving several different reinsurers.

7. Cost of insurance rates (per $1,000 risk charges charged to the insured) may change at any time depending on competitive considerations. Depending on how your treaty was written in the beginning, the reinsurer may want to re-price his allowances, since he may be getting less premium. Of course, while he's recalculating, you don't know what to pay.

8. Finally, as new generations of universal life emerge, there seems to be a rush on the part of the healthy policyholders to dump Product A for Product B or C...thus creating more and more of an administrative overload. Surrender-loaded, or back-loaded policies may slow this process down.

In handling the administration of reinsurance for universal life type products, assistance from EDP is very desirable...in fact, it is imperative. I'm sure you've all seen, at one time or other, the entertainer who spins plates on a flexible stick. He starts one plate spinning, then another, then another, and pretty soon he's madly running back and forth, keeping the plates going and adding new ones. Well, that's the way our universal life EDP system is right now. Every new product or new wrinkle is like a new plate added to the row. The trouble is, those first plates are really starting to wobble, as the "we won't have to worry about that until the policy has been in force for 3 years" philosophy begins to take its toll, just like gravity and friction working on the plates. Our systems people and programmers just don't have much time to worry about reinsurance interfaces.

We operate with what I consider to be the absolute minimum level of EDP support...I get the following information from our mainframe administration system each month:

1. A listing showing all universal life policies reinsured which are in force at the end of the month (our system has a reinsurance code carried in the master file).

2. A listing, by policy, of the end-of-month cash values for each universal life policy in force at the end of the month (this is a product of the regular reserve system).

3. A listing of the risk charges assessed against each policy's cash value during the previous month.

With these three reports and an IBM personal computer, and a considerable amount of clerical work, I produce a list each month for each different universal life contract reinsured with every different reinsurer. We currently have seven reinsurers handling four different universal life type products for a total of 28 different reports every month. The reports show, for every reinsured contract, all of the information necessary to effect coverage for each contract. When and if I am able to transfer information from the main system to the microcomputer, most of the tedious clerical work will be eliminated. After the decision of "which policy" and "how much" is made and entered, virtually everything else will be automatic...information sent to the reinsurer about the policy will follow exactly what is on our company's books.

At the risk of looking like I'm picking on the Data Processing people, the problem facing me, and anyone planning self-administration, is to make certain of the ability of your systems and procedures to produce the necessary information. Reporting monthly, as I think you should, takes twelve times the effort of conventional ARRT, because some information on each policy is reported each month.

I was fortunate in that the system I worked out was able to grow with the volume of business. We were one of the original writers of a universal life plan, so the business started as a trickle, and my system was able to grow and adapt to problems as time went on.

If you plan to start self-administration with a product that is already selling well, at the very least you need the commitment that information-gathering systems will be in place soon. If this is the case, you can survive manual reporting for a while, obviously at the cost of additional resources expended. Eventually, you must have EDP support to survive.

MR. JAMES HOREIN: I'd like to take a few minutes for questions at this point. We have heard two ceding company's experiences. The questions could be directed to them either from the floor or other panel members.

MR. MICHAEL SLATER: I'd be interested in what approach you have taken when dealing with multiple reinsurers and multiple agreements to try to identify those cases where you are going from one plan to another and to keep track of where the original reinsurance was placed and where the successor policy should be placed. Are you using a unique identifier for a given risk or how are you doing this in your system?

MR. FITCH: Are you referring to continuations?

MR. SLATER: I'm not talking about continuations per se, but I'm talking about new policies which are issued and where there were previous policies. This can be other things besides continuations that are involved, like reductions, for example. I know some of you are going to think I'm a broken record but wherever there has been a policy issued previously and you need to have some way of identifying how reinsurance should be handled as changes take place, how do you track this in your system? How do you distinguish where there was a previous policy from a new issue?

MR FITCH: Given that there are reinsurers here, I won't tell you that we don't bother with that, we do. We have to do that totally outside the system. Any policy file that goes through the policy change area has to be referred to the reinsurance area. When it comes through the reinsurance area, we look to see how reinsurance was handled on the original policy and make sure that it's handled the same way on the new policy. If the change is one that qualifies for first year rates, we put it back on the system and it handles it properly. If point-in-scale rates are in order, we have to handle these outside of the "system."

MR. SLATER: So some individual is charged with the responsibility of looking at each new case and decides whether there is some particular action to take. Then the individual decides who the reinsurer is. They are looking to match the criteria against the policy.

MR. FITCH: If it's a new policy, which came through new business, was underwritten and all that, unless it was identified in the underwriting area as an exchange, replacement or whatever, then it probably would be handled just like any other policy. But in our company, the way it works, all those should go through the policy change area and if they are identified in the underwriting area, they get referred to the policy change area and no file is allowed to be sent back to the file room until it has a stamp on it showing that it's been through the reinsurance area.

MR. FOX: It's pretty much the same way it works at our company, too. Of course when a policy is cancelled that was reinsured naturally the person who pays the reinsurance premium must be notified to take it off one list and get it on another list. I have a method of fooling my reinsurance reporting so that a new policy can be entered at point-in-scale on the allowance's schedule.

MR. SLATER: Of course that's reassuring to me to hear you say that. I was wondering if there was some sort of alpha index or a unique record that is set up on a per life basis that is independent of the policy number. I was just wondering how you coordinate this. You responded in part to that. Do you have an alpha index such that every new policy being issued is somehow matched against that?

MR. FITCH: Yes. We do have an alpha index system. Now we are looking at a way to make it more flexible. There are certain types of names that it probably should match as being the same, but it doesn't. For instance, if Robert Jones comes through and then Robert W. Jones comes through, it doesn't necessarily recognize those as being the same name. But aside from that, if two applications come up with the same name, then the system looks for that name and then assigns a number to it. It then looks for other policies on that name and prior retentions on that name to determine how much we can then retain on that life. Outside of doing that at issue we also, twice a quarter, have a program that runs through our Master file. The program knows what our retention is on various underwriting programs and various plan codes and does an audit to pick up any potential over-retained cases. We run it two weeks before the end of the quarter, so, we can clean those up before the quarter-end reports are run for the self-accounting report. Then it is run again at the end of the quarter to make sure that we picked them all up.

MR. PETER PATTERSON: Tim, we've had experience with one company system where the problem deals with the subject we were just discussing where you are trying to track that the policy has gone off and another one has come on. I think this is in the minds of many reinsurers. One scenario that we've experienced is that a company whose retention has changed, even in being able to find the right reinsurer, the old policy goes off and the new policy comes on and the system, like yours, establishes that the retention can be filled and then the retention is filled and the new policy in fact, even though it's a continuation, is completely retained because of the fact that the retention was able to be increased. Do you have facilities in terms of the calculation of your retention on these cases to ensure that that sort of thing doesn't happen as well?

MR. FITCH: Our system doesn't have any ability to do it, that's why we do all those outside the system.

MR. RUDY KARSAN: My question is to both Peter as well as Tim. You mentioned checks that you carry out to ensure that the listing that you do send the reinsurer is up to date by either tying in the movements as well as spot checking. The question I'd like to ask is do you have a system whereby you compare your reinsurance file with your directly written business? For example, a policy that has lapsed on the individual or on the direct written file is also being lapsed on the reinsured file. Do you have any sort of checks of this nature?

MR. FOX: We maintain a separate reinsurance file that is a listing of policy numbers of policies that should be reinsured. At the end of the year and at our six month valuation, we run this listing of policy numbers and get data off our mainframe for those policy numbers. Naturally if the policy number doesn't exist on the mainframe we know the policy has lapsed and our reinsurance has slipped somewhere.

MR. FITCH: One of the advantages of our system is that the reinsurance record is right on the Master file. We don't have a separate reinsurance file, so any time a policy lapses, it couldn't show up on any reinsurance report. If the policy lapses off the Master file nothing will show up when we run the listing for the self-accounting business and similarly, if a policy is issued and it has a Master file record and requires reinsurance, it will be on the quarterly reports.

MR. KARSAN: If I understand you correctly, you are saying that everything on your directly written file is identical to your reinsurance file because you just have an indicator. All movements are treated identically, for example, not takens are not takens on both files as opposed to lapses on one and not takens on the other.

MR. FITCH: As long as the correct reinsurance indicator is out there, yes.

MR. KENNETH GITTINGS: A question for both gentlemen. Have either of you approached, or have any of your reinsurers approached you on what I would call a machine-to-machine sort of transfer of data and if it has happened has there been any success?

MR. FOX: No one has approached us at all about that. I would certainly be willing to entertain any suggestions from any of our reinsurers.

MR. FITCH: Nobody has said anything to us about that either.

MR. HOREIN: I can speak for one reinsurer who has spent a great deal of time and money over the last 2 years building a very, I started to say sophisticated if not at least expensive individual cession administration system. The question you asked is leading to something I think we should all be thinking about in the future. I say at least from our point of view we think we are in a position to work with someone who would see that as advantageous. I think of it as building an automatic interface to our system then, using our system, the reinsurers system, which has been built to perform a lot of functions and then we can feed it right back to you on a timely basis. I find it a very creative idea, but we are not doing it with anyone at this point.

MR. HERMAN H. SCHMIT:

History

Ten years ago or so, bulk reporting was an infrequent phenomenon. If you asked a reinsurance company valuation actuary what he thought of bulk reporting, he would probably tell you, with some expletives deleted, that it was a scheme dreamed up by marketing people to justify more aggressive pricing. He would also add that it made his life miserable and probably cost the reinsurance company twice as much to administer as conventional business.

When I had valuation and statement responsibilities, I think I shared that negative view of bulk reporting. Much has changed in the last 10 years or so. I no longer have such negative feelings about bulk reporting. I might add I also don't have direct valuation or statement work responsibilities anymore.

A survey done among 12 reinsurers shows that approximately 60% of new business and 50% of business inforce is on a bulk basis.

Another interesting item in the survey results is that the average bulk treaty accounts for approximately 10 times as much volume as the average conventional treaty.

Nature of Bulk Reporting

What is this bulk business we are talking about? There are basically two different types of self-administered business:

1. The completely blind type of reinsurance treaty, without any information with respect to individual risks. This has been in use for a long time for bulk ADB, for credit life, and for treaties where other factors besides risk transfer (such as surplus relief or tax benefits) play a significant role.

2. The type of treaty where the client notifies the reinsurer periodically about new business and other transactions, and takes it upon himself to handle all billing and reporting functions. The reinsurance provided under this type of treaty is usually of the straight risk transfer, excess over retention business (YRT, coinsurance, modified coinsurance). The generic name for this type of business is bordereau.

It is this type of reporting and the problems it entails that are the subject of our session this afternoon.

My focus on this topic will be from the perspective of the reinsurer.

Traditional Administration

It may be helpful to briefly touch on the conventional way of administering reinsurance since most of the problems involved with bulk reporting stem from the sudden change in reporting methods that reinsurance administrators have had to cope with.

Before bulk administration methods were commonplace, most life risks were ceded on an individual cession basis. The reinsurance company was administered very much like a life insurance company in that both were individual policy (cession) oriented. Files were similar. Computer systems were different only in that the reinsurer had slightly different (more simple) jobs to perform (no agent commissions, etc.).

Also, they were very similar in the way they completed their statutory statement, the way they calculated reserves, GAAP treatment, policy exhibit, etc. The reinsurer captured its data in a similar way as a direct writer would, so that a reinsurance actuary could perform mortality and persistency studies just as his counterpart at the direct writing company. All these things provided a lot of comfort to the reinsurance actuary who often had received his training in a direct writing company.

Push Towards Bulk

A great deal of the impetus towards bulk or bordereau accounting came from the following conditions:

1. Ceding companies who ceded a large number of cases found the job of checking reinsurance cessions and bills increasingly onerous.

2. The lack of agreement between ceding companies and reinsurers' records due to processing lags, etc.

3. The basic information necessary for the proper administration of reinsurance is present in the hands of the writing company. It certainly appears like a duplication of effort to transfer this information to a reinsurer who then must process that information to produce records (cession, bills, inforce listings) which must in turn be checked by the cedent. Self-administration is simply the obvious way to administer reinsurance.

4. The impression (probably promoted by the reinsurers) that they would price to reflect expense savings if cedent would do the administration.

When Is Bulk Reinsurance Appropriate

1. Does the company have a reasonable automated capability to produce the necessary reports accurately and on a timely basis? If the company proposes to handle manually, the administration may actually be worse since with most reinsurers, even the conventional way of administering may be more efficient (e.g., automatic renewal billing).

2. Does the company have credible internal operation procedures? As I will comment on a little later, audits are an essential ingredient in a successful bulk reporting system. If an audit discloses that the operating systems of the company prohibit an accurate and timely preparation of the necessary reports, such a negative audit result will have unfavorable effect on relationship between company and reinsurer.

3. Is the company willing to make the necessary investment, both up front and on a continuing basis, to develop an adequate reporting system?

   Ideally, there would be an integration of the reinsurance reporting function and the company's issue system and other systems, so that reinsurance would be a by-product of their own administration. I do not believe that this is the case today in the majority of situations.

4. Does the company plan on ceding a large number of cessions? The up front investment necessary to develop an adequate system will not show a good cost/benefit result unless the company will definitely cede (not hopes to cede) a large number of cessions.

Also, the reinsurer can accommodate a modest number of cessions much more easily on a conventional basis than on a bulk basis because the quality of personnel needed to analyze bulk accounts is higher than that needed to process YRT or coinsurance cessions. Also, audits become prohibitively expensive.

5. Average face amounts ceded should be relatively small. If face amounts ceded are large, the reinsurer runs into a number of problems:

    a) Retrocessional problems for amounts in excess of retention.

    b) Accumulation of amounts.

    c) Quota share approaches rather than alphabet splits should be utilized.

6. The treaty should be limited to automatic business. There is little justification for including facultative business in a bulk reporting system. If a company and reinsurer can exchange entire underwriting files (including xrays and EKG) it seems silly to object to the exchange of enough information to prepare a cession.

    The handling of facultative business on a conventional basis is, I think very important. It is very difficult to develop any mortality statistics from reports provided by bulk reinsurance clients and the evaluation by the reinsurer of the financial effects of certain underwriting approaches is a very useful by product of the conventional system.

7. Terms should be kept as simple as possible. Non par YRT or coinsurance should be utilized without too many bells and whistles - production bonuses, chargebacks, experience refunds, persistency bonuses and the like.

8. Universal/Adjustable Life - This is a natural for bulk reporting because of the frequency of changes in amounts. Even certain bulk systems utilize approximations for any policy year with the premium and liability following the approximation rather than the actual amounts.

What are some of the reinsurer's problems with bulk reporting?

1. Timely Reporting - The reinsurer has to file a statutory statement just like the direct writer. He may therefore need the 4th quarter's statement no later than January 20 (approximately) to be able to include it in his statement. If not received in time, he must decide whether to accrue some amounts for the missing reports or to publish a report which, for some accounts, reflects operations from October 1 to September 30, rather than the calendar year.

2. Certifications - The reinsurer must certify to the accuracy of his reserves. If he qualifies his certification by stating that he relied on information provided by cedents, some states may object. It may become necessary for reinsurers to ask cedents on bulk

treaties to provide an actuarial certification that the reserves furnished are appropriate.

3. Over-retention due to multiple policies.

4. Completion of various exhibits in statement - Page 6 of Annual Statement, Page 15 (Policy Exhibit).

5. A need for auditing accounts regularly. This is something which hasn't always been done. Some work may need to be done to ensure that the cedent accepts the audit in the spirit that it is intended. Besides auditing what has been reported, I think it is crucial that the auditors do a thorough job of auditing what should have been ceded. Claims that occur on policies on which reinsurance was inadvertently omitted create a great deal of strain on the relationship between cedent and reinsurer. A quality audit can go a long way to instituting the kind of checks that will reduce this type of incident to a minimum.

6. Variety of reports received. We have a significant number of clients on a bulk reporting basis, but I doubt that even two of them provide us with similar reports.

I'd like to conclude my remarks by summarizing what I see as the solution to some of the reinsurer's problems referred to earlier:

1. Timeliness and Quality of Reports - Instead of reinventing the wheel each time a bulk treaty comes along, I think we need a standardized reporting form, broad enough to encompass the majority of treaties that we encounter.

   Also, standardized treaty wording would be useful, clearly stating when the various reports were due.

2. Certification - Reserves furnished the reinsurer should be accompanied by an actuarial certificate.

3. Over-retention - The reinsurer should internally recognize that it can be over-retained on any policy by a certain amount. It is counterproductive in my opinion to attempt to index each and every policy. Only policies in excess of a certain amount should be indexed. A quota share pool approach is probably the best vehicle to minimize the need for indexing retrocessions and other problems. The pool should be constructed to minimize the need for such indexing. Ideally the maximum limit of the pool and size of the various reinsurer percentages should be such that the reinsurer is only accepting up to his own retention.

   Alphabet splits should be avoided.

   Facultative business should be excluded.

4. Auditing - Auditing is expensive and time consuming. It can become a real burden if each of a half dozen reinsurers decide to audit the same account in a particular year.

> Reinsurers should engage in joint audits.
>
> My own preference would be for all (or the majority) of a company's reinsurers contract with an independent auditor to audit the account for their joint benefit (with costs shared by all participating reinsurers).

Let me conclude by saying that we have emphasized, this afternoon, the problems of bulk reinsurance. In doing so, we may have overlooked one important item. Reinsurers are looking at many more billions of dollars of reinsurance risk with little or no expansion in staff. If we can overcome some of the problems discussed this afternoon, we will have made a significant impact on the efficiency in which we administer our life reinsurance.

MR. KENT SIMMONS: Would you favor some type of statement or certification in our actuarial certification regarding Schedule S under its new expanded format? In other words, will you certify that the reinsurance ceded is correct?

MR. SCHMIT: I think I'd like to receive from every bulk account a statement when I receive their reserves at the end of each year. This statement would be that the reserves transferred or reported to us at that point in time are the correct reserves for that treaty. That's going perhaps a little bit further than saying they agree with your Schedule S.

MR. PATTERSON: I'd like to make a comment and then ask you a question on two unrelated subjects. The comment is in terms of pools which I view as a subset of bordereau or bulk arrangements. My feeling is that pools or quota share type arrangements are less preferable than alphabetic splits. I have in my mind a psychological test that was done where some people were waiting in a dentist office. First, one man was waiting alone in the dentist office. Smoke came pouring through a ventilator and the man leaped right up and ran out and got help. Then the experiment was tried with 5 or 6 people waiting in the office. When the smoke started coming out, the people sat there and they looked at each other and waited to see if the other guy noticed and nobody moved. It took 4 or 5 times as long for anyone to do anything. My own feeling is that if you have a 10% share of a pool, you look at the 90% carriers and wonder why they aren't noticing that things seem a little odd. You have less impact at claims time and binding limits rise because you start looking at your 10% as your share of the deal. You may want to comment about this, I don't know but, personally, and I think the M&G's own experience is that quota share arrangements may be a little more administratively easier. Maybe it's worth it to have a substantial amount of the risk and to be the one under the gun and have to make your own decisions. The question I particularly wanted to ask you involves the administration of these financial deals. We've been talking this afternoon about bulk as it applies to the individually administered business handled differently - items that we want to have information about and we have to get it from the ceding company. We set up a bulk department within our general policy administrative area because we thought the two were very closely related and dealt with the same kind of companies and same kind of business and everything else. But we also included in that grouping the financial deals because they were handled in a bulk type of way. We are trying to re-evaluate this in terms of the actuarial input that's required on a block deal. Maybe it's more significant to know accurate reserving figures and to fill out a year end statement type thing than on the bulk business. I wonder if you'd comment on how you would see the two, whether financial type deals where the individual cessions aren't very important should be handled in the same area as bulk or whether you would handle it in a different area.

MR. SCHMIT: I think that on the financial type transaction we do most of our analysis up front when we enter into the agreement. Once we've decided this was a good deal to enter into, we are less concerned about the exact dollar accuracy of the reserves reported on that piece of business. Generally on that type of a treaty the bottom line result is not affected in any great way by whether or not claims are off by $100,000 or reserves are off. There are a lot of offsetting factors going on generally to experience rated transactions so that as long as the experience falls within very broad parameters the bottom line results are approximately the same.

MR. PATTERSON: Where do you administer it then? Do you do it in a corporate area or is it handled where your bulk business is handled?

MR. SCHMIT: Well, we are a small company and we don't have corporate areas. Our entire company consists of 35 people. It goes directly into our controllers area once the treaty has been agreed to by our actuarial people. Reporting bypasses the normal administration and goes directly into controllers where the only activity entered is really the accounting activity. I'll comment on the other point you mentioned, that is the preference that you indicated regarding alphabetic splits over quota shares. My thrust was primarily administrative. I agree with you that that problem exists. I know of several situations where perhaps action would have been taken sooner on an account but didn't because everyone's got a small piece of the account. But of course that knife cuts both ways. Some cedents may find that attractive because a difficult claim is a lot easier to handle if 10 reinsurers have 10% of it than if it's all with one reinsurer where it could be an all or nothing fight. Disputes are usually much more easily settled, I think, between cedent and reinsurer if it's on a quota share basis.

MR. SLATER: You briefly described your view of what might be a desirable, if not an ideal, bordereau arrangement. Would that view be changed any if the AICPA audit guide were not a draft guide but were it implemented today?

MR. SCHMIT: No, I would still feel the same way about my ideal situation. I have a quota share of a certain pool of risks where each of those risks is well within my retention and where I even choose to perhaps completely accept that risk without indexing, and just accepting any possible over-retention. I believe that as long as I do my audits when I'm supposed to, checking on the various reports that are sent on both transactions and year end statements as to reserves, I don't believe I would have any difficulty with the accountants.

MR. SLATER: I was thinking particularly about the possible requirement to monitor the actual results on an account in an agreement versus those that were expected at the time you priced it. If you have this bordereau reporting arrangement that I think you were describing, I don't see the wherewithal to do that sort of monitoring exists.

MR. SCHMIT: I think I have great difficulty doing it even on an individual cession basis. We have a great many accounts where we have all the information in the world somewhere in our files and we're not comparing actual results to expected. We are, maybe because we're young enough and small enough and we didn't have a huge portfolio to contend with when we set up our system, currently getting complete operating statements on each of our treaties but that is strictly financial results by treaty. I have a problem with that regardless of the method of administration. I believe you can probably get better answers by visiting the client and auditing the results there.

MS. JOHANNA BECKER: I just wanted to point out that we have a couple of bordereau arrangements and we do have our facultative business reported on the bordereau reporting forms. What we have done is this. If it's a very simple kind of facultative case where if the amount is above a certain point then it has to go facultatively instead of being automatic, the computer system can obviously pick those up and put a facultative indicator on them. If because of previous insurance it has now become facultative and the amount itself isn't that large, we then put that on manually. Once a case is underwritten facultatively, information on all facultative cases is sent to the processing administration area and then if the indicator was not put on facultatively, it goes on manually, so we do catch all of them. This was acceptable to the reinsurers.

MR. SCHMIT: I think our interests are somewhat divergent there. I think the typical ceding company would like to submit its facultative business on the same basis because all the benefits of bulk reporting then inure to the cedent with respect to facultative business only. Coming from the reinsurers' point of view, and with large cases, I think at this point most reinsurers are not as well established to track large amounts of facultative business and track their reinsurance procedures as well when the business comes in on a facultative basis. We have a number of large facultative bulk reported cases and it concerns me greatly that something may slip between the cracks. We're finding out at claim time that we have a claim, but do we have the proper retrocessions in place and reliance on the errors of omission clause wears very thin.

MR. GITTINGS: Herman, do any of your retrocessionaires give you particular problems in your handling a bulk account where they have a question and they have to deal through you to find out what the ceding company was doing?

MR. SCHMIT: No. Our retrocessionaires have full faith and trust in us. No, we haven't had any problem in that area. I think in a number of instances we've been retroceding within our own group on original terms and there the relationship is such that there is that trust, if you like, with unrelated parties. We have not always been on an original terms retrocession basis, it may well be on a YRT basis, where it's coming in on a facultative basis.

MR. HOREIN: Thank you for your comments, Herman, and your contribution. I'd like to swing back to the question I believe Steve asked relating to administering bordereau accounts in one area, and financial or other tax driven bulk accounts in another area, and at least offer one other reinsurer's experience which was a fairly conscious decision to administer them in two separate places. The people administering the bordereau accounts tend to come from an individual cession background, and that's what we want. The very small number of people handling the financial or other bulk accounts, we find there is more variation in the arrangement and they tend to need to know the financial impact and so their training and mind set is totally different and we intend for that to be the case. We found that to be fairly successful split.

MS. MONICA HAINER: Just to add to that Jim, we hired an accountant last year. We found that administration of financial deals went more smoothly when handled by this accountant and the actuarial area rather than the regular administration section. I think administration was happier too!

MR. HOREIN: Thank you for that comment. Let's move now to our fourth speaker, who is Ron Freres, Ernst & Whinney.

MR. RONALD P. FRERES: Thank you all for the opportunity to participate in your meeting. It's been a very enjoyable two days.

I've taken a little different tact than what we've looked at. So far you have been talking about the details of administering bulk reinsurance on a ceding company and assuming company basis. I'm going to open it up to a little broader picture, and that is the internal control perspective. We need to talk about internal control needs regarding bulk reinsurance and throw out some ideas as to internal control procedures you might perform.

Looking at it from the very broadest picture, internal controls of your company have to be adequate to assure that your financial statements are fairly presented and that your assets are protected. Where do these requirements come from: They come from the Foreign Corrupt Practices Act (which affects all public reporting companies), they come from State Insurance Departments, they come from the needs of internal and external auditors and, often overlooked but most important, they come from your management's need for reliable reports to make the very important decisions they have to make on a daily, weekly, and monthly basis.

What I'd like to do today is discuss a little about the internal control characteristics of bulk reinsurance, talk about some suggested internal control procedures, talk about the AICPA statement of position (which was mentioned by Mike) and then look at the issue from the ceding company perspective. Most of my comments will be from an assuming company perspective, but those of you from a ceding company are on the other end of the procedures we are suggesting, so I think they are equally as important to you. I think there's been plenty of background information, so I won't get into what bulk reinsurance is or why there's a problem.

Some of the unique internal control characteristics that I see in this area are the following.

1. Limited information may be transmitted. We've heard different definitions of bulk reinsurance--from the concept of one letter with no detail to the bordereau concept. One thing I would throw out as being something we might look at from the internal control perspective is that if the assuming company gets bordereau information and files it in the desk drawer for future reference, I would suggest that from an internal control perspective, they are really at the other end of the spectrum (i.e. they are getting a letter or series of summary reports which they are recording in

their financial records). The fact that they are getting substantial detail is somewhat irrelevant from an internal control point of view if it is not used.

2. Accuracy of information. The question to ask ourselves in this internal control area is whether the information being received from the ceding company is accurate. The assessment of this control area encompasses both intentional and unintentional misstatements of data.

3. The third characteristic (and we have talked about this today quite a bit) is that reports are not standardized. This becomes important from an internal control point of view because it's very difficult to train staff to record information and analyze information that's coming to the reinsurer in every which way from different insurers. It takes a very talented person to deal with non-standardized reporting.

4. Another characteristic is that the accuracy of the information the assuming company receives is dependent upon the ceding company's systems and procedures. In response to a question, Jim responded positively that <u>if</u> there is an indication in the master record that this policy is reinsured, it's controlled; however, the extent to which the presence of this indicator is controlled effects the accuracy of information the assuming company receives.

5. Time lags are very important in any type of reinsurance, but I think particularly when you get into bulk reinsurance. There's a different level of importance given to bulk reinsurance by some companies because detailed submissions to the reinsurer are not required.

6. Foreign business. For those assuming companies that assume foreign business, I think the time lag becomes even greater. This results in various required accruals. You have to have some good basis for making these accruals.

7. Terminology differences. Some of the assuming companies I'm aware of will, on the individual cession basis, record the policy and apply their own reserve tables against it. Now you're going to have situations where you are getting total reserves from the ceding company and you're going to record those reserves. They may or may not be the same reserves you would have recorded on an individual cession basis. Somehow that seems to be a conceptual or philosophical issue that the assuming company has to deal with in determining its financial policies and controls. For example, the assuming company may consider something substandard, while the ceding company considers it standard.

8. The final item is that reinsurance agreements by and large are unique agreements. They all have common characteristics but each agreement may have a little quirk to it this way, or a little quirk to it that way, that makes it different. We find many errors when there is not good communications between the underwriting department and the administration or accounting department. In other words, if the accounting department has been

booking treaties a certain way, they keep booking them that way even if there may be unique aspects to a newly written agreement. The accountant may not read the treaty, he just knows that he takes information from someplace and prepares it for input to the accounting records. There may be a retro involved in the treaty and the person doing the accounting may not know that and therefore not reflect it in the accounting records. We would say that errors shouldn't happen, but I assure you we find it more often than we'd like and I'm sure you find it in your operations more often that you'd like.

From an internal control perspective, I think there are two overall questions we should ask. Can the assuming company rely on information without verification? I think the answer in today's environment is clear, "no." We have a responsibility for validating that data. Another question would be, "who has the responsibility," and I think I've already answered that (i.e. the assuming company). I think there is clear legal, regulatory, and accounting precedents (not meaning to speak for the lawyers) that would say we are somewhat defenseless if when something goes wrong and we say, "I recorded what they sent me in the letter." I think in today's environment that argument is not considered valid. So, the assuming company has some obligation to determine that the data received from the ceding company is adequate (or reasonable).

I think the comments we are making about internal controls really apply to individual cessions as well as bulk reinsurance. This can be seen if you take individual cessions as one end of a continuum and bulk insurance (bulk being where you just get one letter or summary letter) as the other end. I think these exposures and internal control requirements become more evident as you get closer to the bulk end of the continuum. However, the basic control considerations are the same even if you have individual cession agreements.

We should consider the significant potential adverse results if we don't have good internal controls.

1. Inaccurate financial statements would be one. We've talked about the importance of both internal and external financial statements. Probably the areas most likely to result in inaccuracies would be the accruals that are necessary to compensate for time lags. Once again, unless there is good communication between underwriting, administration, and accounting, we may not know exactly what to accrue. I know of one instance where the factor used in estimating reserves for a block of new business was based on a mature block of business. Needless to say the estimate of the reserve requirements was not adequate (there were some big dollars involved), and this example is not unusual (unfortunately). Another reason for inaccurate financial statements is the incorrect posting of the data once it is received. Once again, this potential applies to individual cession business as well as bulk reinsurance but I think it's exacerbated when you get to the bulk insurance.

2. Another source of potential adverse results is cash losses resulting from a ceding company providing incorrect or incomplete data. Looking at it from what you might say is a jaundiced eye,

we are familiar with several situations where a ceding company just stopped sending all the information it should. Maybe they report only half the premiums on their reports. The answer from many assuming companies normally would be, well, we're protected by our contract. We can go back, force the ceding company to pay the additional premium. Well, we all know that this is most likely to happen when the ceding company is in financial difficulty. So, they become insolvent and you have all the contractual rights in the world; however, you're a general creditor, in trying to exercise those rights. Generally, the assuming company has obligations under the reinsurance treaty for all the business that should have been reported under the reinsurance agreement. I think there is enough history in this area to suggest the reinsurance contracts are interpreted this way in a liquidation situation. I think this is a very large risk an assuming company has under bulk reinsurance, although it's also a risk for individual cession business.

3. The third potential adverse result results from negative cash flow contracts--Equity Funding type situations. To the extent the assuming company is providing the ceding company with more cash than they are receiving, you are subject to phony policies. It's advantageous to the ceding company to be generating policies that don't exist because they are getting more cash than they are sending you.

All these potential adverse effects can be addressed by internal control procedures; however, you certainly can never guarantee they won't happen. Before looking at some suggested control procedures (and these are consistent with what is in the audit guide that Mike referred to before) we might look at some present practices. I think some of the things you heard about today are actuarial certificates, and going out and auditing the ceding company's records. That's great in concept but I also have the feeling not much of that is being done. I may be wrong. Once again, I would emphasize here that we have to designate treaties as bulk and bordereau more on the basis of what's being done with the information received rather than on whether bordereau information exists in the assuming company's records.

Suggested Control Procedures

I think it's very important that the people doing the accounting or administration understand the agreement. I referred to that and I think other people have referred to that before. If they don't understand what the agreement is between the two companies, it is difficult to decide whether the accounting is correct. You have to know if there are retros and you have to know the anticipated profit. I was somewhat surprised to hear with the records that Herman's company has that he said he wasn't able to monitor profitability. I think that's one of the greatest controls. If the underwriters and actuaries who set up the program expected a certain profit to be accruing to the reinsurer, one way of identifying a problem is to be monitoring that profit to make sure it's occurring as was expected. I would suggest that monitoring profitability is a very significant control procedure that may actually mitigate doing a lot of detail testing. I'm not suggesting that we do one or all of these suggested internal control procedures in any particular case, but if you could monitor and do a lot of analytical procedures and monitoring, you may be able to minimize the actual detail auditing that's done.

Another control procedure which could be used is to obtain letters from the ceding company's internal or external auditors. These could be in the form of a single auditor letter or a letter regarding specific agreed upon procedures. The single auditor letter gives comfort on the internal controls of a given segment of the ceding company's business. You'll find there are a lot of caviats in this letter with the basic caviat being that although they tested period X and they will tell you that the controls were good and operating during that time, they will warn you that at the time you are reading the letter they are not saying anything about the procedures because they may have changed. Rather than obtaining a single audit letter, you could ask the ceding company's auditors to perform specific procedures on the balances or to test specific records relating to your account. That is not a challenge; however, you would have to work out the wording of the letter report with them. It's called an agreed upon procedures report. In this situation you and I agree (assuming the ceding company agreed we will do this) to perform certain procedures. We do the work and then say that we found something or didn't find anything, but we don't give any opinions that we believe your balances are right. We say we did what you told us to do and here's the results (i.e. we found errors or we didn't find errors in the items we tested).

Another internal control procedure would be to visit the ceding company and "audit" the ceding company's records. I think there are two different aspects you should be equally concerned about during these visits. First being operational, and second, financial. I think when you go in and audit, one thing you want to do (and I call this financial) is to make sure all the tab runs total and that everything was calculated correctly. In addition, I think you also should be looking very closely to see that you are getting the type of business you agreed to assume. Are you getting standard business when you expected standard business? Are they using the correct rate tables? You can send us auditors in and we'll find the rate table and compare it and say yes, it calculates. However, unless you tell us which table to look at and look at the underlying underwriting files, the results of our testing may not be very meaningful. I'd say we're not qualified to decide whether the risk assumed is what you thought it was when you agreed to the premium schedule. I consider this the operation part of the review.

We talked about analytical data before. I think it's important that, as an internal control procedure, you review (once again on a test basis, you won't do this on all accounts) annual statements, insurance department examinations, and internal control letters for your big risks. Once again, monitor the ceding company's activity. We can say from experience (and I'm sure you can too), that as a company's financial condition worsens the odds that the data you're getting is inaccurate or incomplete (for various reasons) increase dramatically. This particular procedure is also very important for the financing type arrangements that you talked about before. This might be the only procedure you perform for a financing contract. You certainly want to monitor the financial stability of the company you have the financing arrangement with to make sure it can meet its obligations.

I think a final internal control procedure you would want to provide would be designed to maximize the accuracy of the data recorded on the financial statements. Once again, this is something you can do in your own shop. One aspect of this area of control is to be sure you have procedures to ensure that the agreements are being recorded (i.e. data is being recorded) in accordance with the substance of the agreements. I think this requires consulting and communication with underwriting personnel.

I talked about actuarial certificates. I think that's a rather good control procedure.

An interesting control procedure we chatted about at lunch is that even with bulk reporting, assuming companies apparently continue to pay significant attention to claims. In fact they go so far as to (at least when there's a bordereau) trace claims back to the bordereau as sort of an inforce test. What I really perceive here (and this is just a little aside) is that there's a great urge to go to bulk reporting but we don't want to give up all benefits of individual cessions. So we have bulk reporting and then we find a claim and sort through tons of data trying to find out if the policy supporting that claim actually was inforce. I think this has a lot of merit to it and from an internal control aspect you are accomplishing two things when you do that. You obviously are supporting the claim and I think equally as important you are supporting the fact that the inforce data you are receiving is accurate and you are receiving premiums on all policies. I've heard of several cases, and I don't want to overemphasize the importance of this, where you go to the data file to support a claim and lo and behold the policy isn't there. You then call the ceding company and they say "that's right, we forgot to cede that particular policy to you. We're sorry. Here's $25 (or whatever) to cover that one." I would say (and I'm not suggesting that anyone overreact because there certainly are random errors) that I would look very hard to convince myself that this is an isolated case and not an indication that half of the policies haven't been reported to you. As I said, errors do happen, but also, anytime you have one of those missing inforce records I think there is a danger signal. If you get more than one or two from a ceding company, I would be very, very concerned.

Special considerations. We have already talked about the importance of solvency, cash flow characteristics of the agreement (and if there is negative cash flow there is cause for more internal control procedures).

Also, in a lot of our discussions it appears that one concern is that the assuming companies have difficulty calculating reserves or accruing balances because they don't have enough detail coming in under these bulk agreements. That's not as much of a control problem as an accounting problem. You need to go to the ceding company and tell them, give us more data, we need it. Not to be too naive about it, I understand there is competition and what your competitors are doing dictates whether you can enforce reporting requirements or not.

Trained personnel in the bulk reinsurance area I think are also very important. I think that while Jim said that they transfer people from the individual cession department into bordereau and that's the best approach, I would say that additional training is needed. It's sort of like when I was in a mutual company de-mutualization session this morning and there was a lot of discussion among the mutual people about the mutual company mind set. They are not sure that even if they become stock companies it would change that mind set and allow them to "think like stock people." That's sort of irrelevant here, but I think the same thing is true if you have people in individual cession or "thinking" individual cession and you move them into bordereau. I think you have to change their mind set as well as give them a different desk and a different set of procedures.

The AICPA statement of position. There is a group in the AICPA that is charged with audit responsibilities and standards which have various subcommittees--one of which is a reinsurance task force. That task force has put together a document ("exposure draft") which contains most of the internal control procedures we talked about before (and a few more) and which dictates what the requirements are for an external auditor in auditing reinsurance transactions of a life insurance company. They are very important to you. The casualty business has gone through the process of implementing a similar audit guide and found it somewhat concerning because they had to change some of their operating procedures. This is a very unique situation in accounting because you can go through 99.9% of the accounting dictums that come out and very few of them actually change your operations. This particular one borders on changing your operations. I might sort of refer to that before we ask any questions. It is my hope that you won't change your operation because of an auditing requirement. However, you might change significantly your documentation and internal control system. The exposure draft is not printed yet; however, it will be out on the street very shortly. You can get a copy from the AICPA. It's titled "Proposed Statement of Position--Auditing Life Reinsurance" and the AICPA is located at 1211 Avenue of the Americas, in New York. I would think most of you at this session probably would be interested in that document. It will be applicable to all life companies. There's an exposure period in which comments are requested through July 30, 1984. No effective date has been set but I assume it probably will be for years beginning after December 31, 1984.

Ceding company considerations. I think from a ceding company's point of view, once again looking at internal controls, there are two things to look at. One, the accuracy of recording the transaction. Are your people recording the transaction accurately and do you have procedures to ensure that they will? Secondly, monitoring the financial status of the assuming company. As you are all well aware, the reinsurance agreements are only as good as the assuming company's ability to meet its obligations--certainly you should be interested in that.

In summary, I think there are many control ramifications of bulk reinsurance. These considerations become more important as we move from the individual cession business towards what I think was defined as pure bulk reinsurance. I think the responsibility for those controls and for adequate financial statements are the responsibility of the assuming company in case of an assumption treaty.

The final thought I would leave you with in terms of control would be that best effort is not equal to adequate internal control. This is a difficult concept (and it sounds like it makes sense). In practice you will find that we have difficulty understanding it and applying it. An example would be that if you get only a letter (or summary report) from a ceding company and that's what the underwriting and marketing department agreed to and then the auditor comes in and says "how do you know all those numbers are right?" You say "I don't know, let's go out and audit them." However, the ceding company says "No, we don't want you in here." Then you try other approaches; however, in the end you continue only getting the summary reports. We are then tempted to say, "we've done everything we can, we must be okay." I'd say that from an internal control point of view the fact that you've done everything you can doesn't necessarily mean you have adequate internal controls.

I realize there are practical limitations to implementing the suggested procedures we talked about (I think I referred to them) such as competition. If your competition is not requiring detailed information, competitively, you may not be able to do that. If you're a smaller reinsurer, maybe that's what you have over the large Lincoln's. Maybe the Lincoln can beat people on the head and tell them they want substantial detail; however, the way the smaller reinsurer gets its business might be by saying "I don't want all that detail, just send me the money." It may be a little risky but it may be a good business strategy.

Another practical limitation is cost. Anytime you do an internal control procedure you are cutting into your profit margin (i.e. the "designed" profit margin--if we ignore errors and frauds and what not).

Sampling. Once again, the procedures we talked about you would many times just do for a sample. Mike brought up a question before where Herman was going to do a detail audit and Mike said well there's another procedure you have to do--monitoring. I don't think the audit guide really says that, the audit guide suggests some procedures you might do. You wouldn't have to do all of them. Maybe if you were doing detailed auditing you wouldn't worry about monitoring or maybe if you were monitoring you wouldn't do detailed auditing. There's no specific requirement as to what you have to do.

Where do you get help if you're looking for help in establishing your control procedures? I would think your internal or external auditors would be the logical place to start because you have to work with them in addressing this situation. If all else fails, call Ernst & Whinney.

MS. BECKER: What's involved specifically in an EDP audit versus a non-EDP audit? We've had auditors come in and it wasn't an EDP audit so what do we have to look forward to?

MR. FRERES: Is this in addition to getting audited financial statements, Johanna? I'm not quite sure I know.

MS. BECKER: I can think of a couple of different situations. We have our own internal audit department and every three or four years they come down and audit reinsurance, but they now also have their own special group of EDP auditors and they haven't come to see us.

MR. FRERES: Generally, assuming it's part of the financial audit (there are very specific EDP audits you can do for safeguards and continuation of business), the EDP audit helps implement the concept of auditing requiring that you look at all the controls and test those controls. Traditionally, the CPA firms have done what's called "auditing around the computer." You audit up to where information goes in and then you catch up with it when it comes out. You then draw a link to determine the computer did what it was supposed to do. That goes back quite a few years. The approach now is that you should look at the computer controls, look at what the computer is doing. We generally find that this approach causes much less aggravation on the client's part in terms of people's time and also permits us to do a much more efficient and therefore less costly audit. I don't know exactly what you have to look forward to. It depends on how they approach it and how good your procedures are. It's not that much different than the normal internal audit--it's just that they are going to address a different aspect of your operation.

MR. CARL WRIGHT: My question's a bit of an unusual one because of the situation I'm faced with. I'm a ceding company and like most ceding companies who don't have a huge reinsurance volume, I have a reinsurance unit which handles all the work. The question I'm faced with, and it may or may not have something to do with internal control, and that's the question, is reinsurance such an unusual animal that reinsurance administration can only be performed under the direct direction of the actuarial department or can it just as well be performed under say, the Policyholder Services Department or even the comptroller's function? I recognize it's not a factual kind of thing, it's an opinion kind of thing.

MR. FRERES: I guess I could comment that we find it under all those departments you talked about. But I'm not sure that says where it should or shouldn't be. I would emphasize that when a direct writer gets into a few reinsurance contracts, they have to know why they are doing it and how it is being controlled. For example, under Herman's scenario, if you're taking 5% of a treaty that his company is controlling and he's doing all the internal auditing work and data, I guess you can sit back and say I'm relying on what he's doing. However, if what you're involved in is a cocktail agreement between your president and someone who told him he should take 5% of this treaty, I guess you are at risk. In summary, unless you know what the controls are, you've shot the dice. That statement may be a little unfair because our business is a people business so you rely on people as a basis for entering into agreements. However, from any factual basis, when you enter into one agreement and it appears you don't have the horses to provide internal controls, you are gambling to a certain extent.

MR. HOREIN: You asked for an opinion answer and Lincoln National would think of several facets. But the one in particular that jumps out would be the distance, organizationally and floor space distance, between the point in the organization where let's say treaty negotiations take place and the point in the organization where the treaty is administered, the greater that distance the greater the risk from a reinsurer or auditing point of view of satisfactory and reliable transmission of information. So, if it's the actuary that negotiates the agreement, our opinion would be placed as close to that office organization as you can. If it's the underwriter, place it as close to that organization as you can.

MR. GITTINGS: Without destroying the simplicity motif of bulk reinsurance, how do the auditors view the following: which are my expenses as a reinsurer, not the expenses of the ceding company - my interest earnings are not their interest earnings. How do you come up with GAAP reserves without tearing apart these bulk listings that you get and have to do them all over?

MR. FRERES: That's really a good question. It really relates to the one comment I had about whether you have sufficient detail. I am convinced personally (I haven't tried to apply it yet) that with some innovativeness the actuaries and accountants of the assuming companies can come up with some methodologies for getting sufficient data on a ceded block of business that they can apply some overall factors to get GAAP earnings. On the other hand, if you are not getting inforce data or detail on inforce data and your underwriting file doesn't show enough detail that you can make some assumptions, you really can't get credible GAAP data. You can't make a silk purse out of a sows ear. But I do think there is a bit of a mind set in some companies that says if we don't have the PYA cells detailed in a computer there's no way we can get reserves. I would suggest that we all become more innovative and try to develop ratios and averages using all the information available (underwriting file, data that's submitted, etc.), and I bet we can come up with some reasonable GAAP earnings. I know that wasn't a specific answer but I don't have one.

MR. HOREIN: I could add, in Herman's comments he made reference to the survey that was conducted amongst 12 reinsurers by a member of this comparable panel in Atlanta and I have a copy of that. One of the questions was, "for what percentage of bulk treaties do you use these methods for GAAP valuation?" Most of the questions were very simple responses. The response to this one took a chart, which I think speaks to the variation. There are five categories. The first category is "no GAAP revaluation." Five of the twelve do no GAAP revaluation on all of their accounts. Three of the twelve do no GAAP revaluation on a portion of their accounts. The second category is "use the ceding company valuation." One of the reinsurers does that 100% of the time. The third category is "use a factor method involving individual records." Two of the reinsurers do that on a portion of their accounts. The next category is "use a factor method involving grouped records." One reinsurer does that on 100% of their bulk accounts and another reinsurer does it on a small percentage of their bulk accounts. And the final category is "other." There are four reinsurers applying that method to a portion of their accounts.

MR. JAMES HOUSEHOLDER: We've seen how our external auditors react to estimates in statutory and GAAP reserves, but how do you think the IRS is going to view this, especially in view of the new tax reserves that are going to be coming upon us next year, or maybe the end of this year?

MR. FRERES: I would propose that they certainly accept estimates in the casualty industry. I'm not sure that you are more interested in the deductibility of that reserve or whether it's going to cause some disqualification as a life company--which does not have all of its advantages anymore. I really don't know how they will look at it.

MR. HOUSEHOLDER: I'm not so concerned about the disqualification as the fact that the whole basis of calculating statutory reserves is going to change this year. Where we could previously take the ceding company's reserves and virtually use those in our annual statements, now the burden is going to be on the ceding company to provide us with tax reserves because we can't calculate them ourselves.

MR. HOREIN: In fact, we need three reserves from a ceding company: statutory, GAAP, and tax in certain situations.

MR. FRERES: I just find this great conflict between bulk reporting which is what everyone is trying to get to and then these detail needs--under true bulk reporting you wouldn't get that detail. You'd get a number, they would tell you what it is.

MR. HOREIN: Of course, we say to the IRS that we have the right to audit the client.

MR. HOREIN: I want to first thank the panel for a fine contribution. To each and all of you, especially Ron our guest, we were delighted to have you with us. Thanks to you for your contributions as well.