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REINSURANCE—SELECTED TOPICS

Moderator: JOHN E. TILLER, JR. Panelists: SUE ANN COLLINS, WILLIAM K. TYLER, MELVILLE J. YOUNG. Recorder: SUE ANN COLLINS

1. NAIC regulation of reinsurance.

2. Problems of reinsurance coverage on internal replacements and rewrites.

3. A short Reinsurance Section business report.

4. Other current topics.

MR. JOHN E. TILLER, JR.: I would like to begin by introducing the members of the panel. First, Sue Collins, Actuary from General Reassurance, will give a report on the business transactions and affairs of the Reinsurance Section for the past year. She is also going to serve as the recorder. Sue will be followed by William Tyler, Senior Vice President from Lincoln National, who will discuss recent NAIC regulatory movement in the reinsurance area. We will then hear from Melville Young, Senior Vice President from General Reassurance, who will present some of the problems inherent in today's reinsurance marketplace, especially problems surrounding the movement of reinsurance from one policy form to another and one carrier to another.

MS. SUE A. COLLINS: First, I have the results of the recent election of three new Council members. This election was conducted by the newly formed Election Committee of the Reinsurance Section with considerable help from the Society's office. 395 ballots were mailed to Fellows of the Section and 225 were returned; this means that 57% of those eligible to vote, did so. I would like to thank those who voted and especially those people who consented to appear on the ballot. We had a fine group of candidates.

Elected to three-year terms were Monica Hainer, Bob Johnson, and Mike Winn. Irwin Vanderhoof resigned from the Council as of October 7th. Randy Mire, the fourth place finisher in the election, will serve Irwin's remaining term.

New officers of the Council for the year 1983-84 were also elected. Mel Young will serve as Chairman; Dave Holland will serve as Vice Chairman; John Tiller as Secretary; and Mike Winn as Treasurer.

Over the past year the Reinsurance Section has laid the ground work for being able to respond to concerns and items of interest to Reinsurance Section members. Seven committees were formed and have been staffed. They are Program, Elections, Reinsurance Administration, Reinsurance Coverages and Areas of Special Interest, Treaty Provisions, Education and Statistical Research. Each committee is now in the process of preparing its action plans and setting its goals and objectives. Once these are completed, the Committees will proceed in their stated directions.

Soon after this meeting, an updated list of Section members, Council members, Council officers and Committee members will be published. This list will then be forwarded to all members of the Reinsurance Section.

In order to get timely and useful information to our Section members, several meetings were held over the past year. A joint meeting was held in conjunction with the Individual Life Insurance and Annuity Product Development Section prior to the Society's Chicago meeting last spring. A full day's program was presented on the subject of special products for the large term market. This meeting was well attended and, by most accounts, was very successful. The Section also presented various programs at regular meetings of the Society.

For the upcoming year, the Section has another special meeting planned. On the day before the Society's spring meeting in Salt Lake City, the Committee on Treaty Provisions will present a full day's program. This meeting is still in the planning stages, but the primary topic will be suggested treaty provisions and reinsurance administration as it relates to the treaty. We plan to encourage underwriters and claims' personnel, as well as actuaries, to attend this meeting since this is an extremely important subject. The possibility of presenting an abbreviated version of this program at an underwriters' meeting in 1984 is also under consideration. The Reinsurance Section will also continue to present either pannel discussions or workshops during the regular meetings of the Society in 1984.

MR. STEPHEN R. RADCLIFFE: During the twin meetings next spring, we are planning an unnumbered session and hope that it will make it into the program. It will probably be a workshop, sponsored by the Reinsurance Section. The discussion will be on the administration of bulk, self-reporting and self-billing accounts. I would like to take this opportunity to ask any of you who may have some interest or knowledge in this topic to please give me a call to help us put this session together.

Mr. MELVILLE J. YOUNG: I have an addition to Sue Collins' report. Court Smith, the Section's outgoing Treasurer, has prepared a financial report for the Section. We were left with a fund balance of $5,145.07. If any one wants a copy of this report, it is available from the Council. Another comment I have is on the programs we plan to present. I want to stress the importance of the Salt Lake City meeting. All of us in reinsurance, reinsurers and ceding companies, know that there have been many problems with the interpretation of reinsurance treaties. This meeting will give us an opportunity to spend a day clarifying some of these problems that have entered our new complex world. We urge you all to attend.

MR. WILLIAM K. TYLER: My comments will address the current interest and direction of the regulators with respect to regulating the insurance business. There has been increased interest on the part of regulators in both regulating and understanding the current reinsurance activity among the companies that they regulate. Lincoln National has had a Government Relations Department in the Corporation for many years which deals with state insurance departments. The Lincoln has observed that it was very unusual for the state departments to get heavily involved in activities that related to the reinsurance business. We have seen a big change in that in the last year. The regulators' concern stems primarily from their overriding interest in protecting the solvency of the companies they regulate. As a result, the financial security of reinsurers and the financial security and accounting procedures of reinsurance intermediaries have become issues for many of these regulators.

The publicity that has surrounded the Baldwin-United problems and problems that preceded Baldwin-United with respect to the property and casualty side of the business has been one source which has raised the regulators' awareness about the problems they need to face. This has also raised their sensitivity regarding the need for them to know more about reinsurance transactions and the impact they have on the companies that they are examining. In addition to publicity, the substantial increase in the past few years on the part of ceding companies in using reinsurance for financial and tax planning purposes has increased the interest of regulators. They are interested because of the increasing number of companies involved in reinsurance transactions that are of a somewhat unusual character, at least compared to prior years, and because they don't understand some of the techniques being used. They are concerned that they don't know how to regulate these activities. Furthermore, many companies are making expanded use of offshore reinsurers for one purpose or another, and this has caused concern among regulators. They are concerned that companies domiciled or conducting business in their state of jurisdiction are able to circumvent the rules and regulations of their state - rules which were designed to protect the solvency of the companies. All of these factors have increased the interest of the regulators in attempting to deal with the reinsurance questions that they see.

Regulators have many problems because historically state insurance departments have been understaffed and have not dealt specifically with reinsurance matters. There is a big educational process that needs to take place before they can effectively determine how to regulate this business. It is important for all of us, reinsurer and ceding company alike, to be interested in providing and facilitating this educational process because rules and regulations that are promulgated by people who are knowledgeable in a given area tend to be more reasonable than those promulgated by people who are not knowledgeable. The general reaction of a regulator in reviewing a transaction that he does not understand is to find some way to outlaw it. This is not necessarily the right approach for the types of things that are occurring in the reinsurance arena.

Specific activity that has taken place in the last twelve months includes activity at the NAIC level as well as activity at various state insurance departments. Early in the year the NAIC got involved in reviewing an expansion to Schedule S that would be required for any company who is accepting business as a reinsurer. The recommendations of the committee of the NAIC that was involved in this activity have been approved. Beginning with the 1983 annual statements, any company who has accepted business as a reinsurer will be required to report in Schedule S the ceding company and the corresponding amount of business by inforce and premium volume. The deadline for completion of this expanded Schedule S is somewhat later than the March 1 date for annual statements. I believe April 1 may be the date that was settled upon.

In addition, at the recent meeting of the NAIC in Tampa, the Reinsurance and Anti-Fraud Task Force, chaired by Lyndon Olson, the Texas Commissioner and former Chairman of the NAIC, formed, or indicated an intention to form, three working groups to review various areas of reinsurance activity. The first would review reinsurance and financial activities as they relate to reserve credits, allowances, reporting for surplus relief, etc. The second task force will deal with reinsurance in foreign companies; this task force would review unlicensed and alien reinsurance companies and look at the possibility of creating some sort of international treaty to assist in the investigation of reinsurance fraud involving offshore companies, Lloyds, etc. The third working group will address the problems related to reinsurance intermediaries. This is of particular interest on the property-casualty side where there have been some real problems in the last few years. The regulators want to find ways to exert some control over reinsurance intermediaries. These groups are expected to develop some interim findings and report back to the NAIC at the December meeting. The current plan is for final action to be proposed at the March, 1984 meeting of the NAIC.

There is some difference of opinion as to whether or not there is a real ground swell of interest on the part of the NAIC in dealing with these issues. From our perspective, we think the interest is there, even if the resources are not, to pursue some of these items vigorously over the months ahead. As a large company which has been involved in the reinsurance business for many years, and which is also a direct writing company, we're interested in what happens in this area from at least both of these angles. We are taking the interest of the NAIC very seriously and are attempting to be as helpful as we can in providing them with guidance, education, assistance and comments on the approaches they may be proposing. Along with this, the ACLI has been requested to increase their involvment in following reinsurance regulatory activities. On an informal basis, the ACLI, as I understand, has agreed to attempt to broaden their knowledge for the purpose of being able to effectively monitor activity and participate in discussions at the December NAIC meeting.

At the state level there have also been a couple of things of note. Early in the year, or perhaps late last year, the New York Insurance Department issued a proposed fronting regulation which was aimed at a number of practices that impact on reinsurance. There was a hearing in New York in the early part of the year, and at that point, a task force was formed. The activity of that task force has been fairly slow paced this year. Secondly, I understand New York is looking at developing a model letter of credit regulation for a circular bulletin that will be distributed to companies domiciled in New York and perhaps to companies who operate in New York. This may have some impact on those who are involved in programs that require the use of letters of credit to provide for allowing reserve credits or for other purposes. In addition, the California Insurance Department formed and staffed a reinsurance unit within the last twelve months. That group has sent out a request for information to a number of companies. I do not know how broadly that request was distributed. As far as I know, that group is still in its formative stages; it is trying to determine what it is it should be doing and how it should go about doing it. Finally, the State of Utah is engaged in a project of updating all of their insurance laws, and one aspect of that is looking at reserve credit laws and other regulations that have some impact on reinsurance business.

To conclude, there is a great deal of interest in reinsurance by regulators. This is particularly apparent when viewed from the historical perspective when previously very little reinsurance activity was occurring in the states or the NAIC. There is a real charge for all of us to find effective ways to participate in this process in order that we get good regulation where regulation is necessary.

MR. TILLER: Bill, you said the ACLI is getting more active in reinsurance matters. Who is in charge of that effort?

MR. TYLER: I am not certain how the ACLI process works, but a request was made at the September Board meeting of the ACLI for the ACLI to become more involved and perhaps to allocate staff, or perhaps to develop staff, to deal with the activity in the reinsurance area. It is my understanding that the Board informally approved that activity and planned to refer the question to one of their committees. I believe the commitment that has been made at this point is that certain individuals at the ACLI will be identified to talk with reinsurers, particularly those who are knowledgeable on current activities, in order that they be able to attend the NAIC meetings and involve themselves in some of the discussions. The ACLI will be at the December meeting in any event; it is just a matter of individuals being prepared to discuss the topics and issues. This is still in its formative stages,and there has not been formal approval of the request. Our feeling at the Lincoln is that the ACLI is a very good forum for this type of activity. This is not by any means only a reinsurer's concern; it is of concern to all companies since many companies are involved with reinsurance at least peripherally.

MR. YOUNG: Policy changes, rewrites, reversions, all these things by different types names - we like to think of these as the old fashion policy change and conversion. Those are the two animals that have been haunting all of us, primary company and reinsurer alike, in recent years. They have been haunting us because what used to be a very infrequent type of activity, which was handled routinely, now has become a very common place activity. This type of policy change and conversion represents a large percentage of our overall home office activity today.

Twenty years ago when a policy change was an infrequent activity, it generally got handled properly. Most companies had a policy change manual, either in a policyholder service department or an actuarial department, and when a policy change was requested, perhaps once or twice a week, a manual was pulled out to see what the proper course of action was. Now that this type of activity represents 40% to 50% of our daily work, or maybe 10%, this manual is no longer used.

What has brought the surge of activity in this area? Frequent changes in term rates was one of the first items that caused it. Companies that used to change their term rates every three to five years found themselves changing their rates every six months to stay up with the competition. Many companies that were involved in this product market came to the conclusion that, in order to protect their own business, they had to change their inforce business over to the new lower rate or at least had to encourage this kind of activity. This led to many companies adopting programs that encouraged the twisting of their own business. The second event was the introduction of interest-sensitive permanent products and the rush by many companies to have their existing term policies, as well as permanent, converted to universal life or similar types of policies. The third event that created the activity was the advent of the non-smoker or preferred class; many companies were besieged with policy change requests from people who wanted to go from the old standard class to the new higher smoker rates.

Many companies that I have spoken with never prepared a model office which studied all the different facets behind a decision to go from one rate basis to another to see if it made sense. We have discussed with our clients and encouraged them to prepare model offices when they are about to make this decision. We have encouraged them to look at the expenses involved and look at the class of business involved. A renewable term portfolio that is five or six years old is generally involved, and the class of business is generally substandard. If the standard lives are removed from this block of business and moved to a lower rate, the remaining block is even more substandard.

What improvement in lapse rates has to happen in order to justify the premium reduction and these other expenses? Many companies, after they performed model office studies, found that the improvement in the lapse rate necessary to make this work was unachieveable, and those companies decided not to move standard lives to a lower rate scale. But many companies have done it and that has created a lot of change activity.

Many companies who have had exchange programs did not think through the consequences to the existing reinsurance; they were either ignorant of the potential problems or were aware of the problems but lacked solutions. These companies have felt that it is impractical for them to handle these policy changes for reinsurance in the way that the treaties and tradition have warranted. Their administration departments are treating the reinsurance on these changed policies as lapses and new issues. This approach is wrong and can lead to disturbing results for all parties in the transaction.

From the reinsurer's standpoint, the old reinsurer who thought that some business had been paid for and who had expensed high up front costs, with the expectation of getting renewal premiums, has suddenly had an upsurge in lapses. Some of these are due to this type of policy change and are not lapses at all. The new reinsurer is now collecting reinsurance premiums based on the cost of a new issue which reflects new underwriting, and there has not been any new underwriting. The new reinsurer is now in the position of having a bloc of business that is perhaps, five years old, and the premium they are collecting reflects first year underwritten business. The new reinsurer is probably not going to do well either.

The ceding companies, although it was expeditious to do what they have done, have found that at the point of claim, that they did not have reinsurance at all. There are at least six claims that I am aware of where the insured died after one of these policy change activities occurred and the reinsurer was changed in the process. On these cases the ceding companies are having a great deal of difficulty in collecting the reinsurance coverage they thought they had. In some cases they are not collecting the benefits.

Let's take a look at what gives rise to these policy change situations. The first type of situation, the cleanest, is a term to permanent conversion with permanent including universal life. Most underwriting departments understand the contractual nature of this arrangement and seek no new underwriting upon conversion. The existing reinsurance treaty protects the ceding company in the event this happens. This change was anticipated when the treaty was written and both parties recognized that there would be some adverse selection upon conversion. The reinsurance treaty reflected this and provided that there would be a continuation of coverage with the existing reinsurer; the ceding company would generally be paying point-in-scale YRT rates on the converted business. Continuation of the reinsurance in this example was already in effect.

Another easy situation occurs if the ceding company has treated it as a lapse and a new issue and has reinsured it with the new reinsurer that is reinsuring the current policy form. At the point of claim, assuming the new reinsurer has an alert claims department, the policy will be identified as not a risk of the new reinsurer. The company then will in effect recapture all of the business that was treated this way and cede it back to the proper reinsurer. All that has happened here is that company has had an extra expense because it has had to go through this cession and recession process, and the original reinsurer properly should have been on the risk. In all the cases like this of which I am aware, the original reinsurer has stepped up to the claim.

In another type of situation, a policy change, as opposed to a conversion, where the policy moves from a term to term rate or permanent to permanent rate and where there is no new underwriting, underwriting departments treat this transaction as a contractual change. Tradition has called for this to be treated in the same manner as a conversion. For amounts up to the original issue amount the reinsurance would stay with the original reinsurer again on a point-in-scale basis. In some cases because its impractical to take a policy from a coinsurance to a YRT form, companies have spoken to their reinsurers in advance and arranged for renegotiated terms, so that the new case could be handled on a coinsurance basis as well. There are many companies that are not handling their reinsurance in this way and are treating this policy change as a lapse and a new issue. At point of claim there is the same problem as existed with conversions, but it is a little stickier because in this situation, contracts are not as clear and companies have to rely on tradition.

The worst situation is where there has been a contractual change or a non-contractual change and the underwriting department has taken some new evidence of insurability, not complete new evidence, but some new evidence of insurability. There are a number of claims currently being contested where this type of change has occurred and both reinsurers have denied liability. The argument goes like this. The new reinsurer, when it is notified of the claim, will say: "We have an agreement; we have underwriting guidelines that you have submitted to us which have been jointly agreed upon; the business that you submit to us is supposed to follow these guidelines and in this case it does not follow these guidelines. Hence, this case clearly is not reinsured under the existing reinsurance treaty and perhaps this case should be reinsured with your old reinsurer." At this point the companies involved have turned to their old reinsurer, who had been notified of termination of their reinsurance agreement, for claim reimbursement. The argument by the original reinsurer, in addition to being based on having received notice of treaty termination, is based on the fact that a new contract was made with the policyholder, and new underwriting had been secured. Therefore, the old contract doesn't exist, and therefore, we, the original reinsurer, do not have the reinsurance. This type of situation could result in the ceding company paying the entire claim itself. Usually there is some discussion and the ceding company does not pay the entire claim, but I submit that technically there is no reinsurance in effect in this situation. Many companies today have created this atmosphere and are not aware of it.

I have a copy of the General Re program describing how it feels about these various situations. If anyone would like a copy, please give me a call.

MR. LARRY WARREN: On internal conversions, little or no underwriting is typically required, and it would seem to me that the errors and omissions section in the reinsurance treaties covers this. Shouldn't the ceding company be protected in one way or another?

MR. YOUNG: If it is a contractual change, any underwriting that the company does is irrelevant. If it is clearly a conversion situation, where the company is complying with its policy provisions, it is covered by the reinsurance treaty. The fact that there has been some new underwriting is irrelevant as far as the reinsurance coverage is concerned. My point is simply in this type of situation many companies have ceded this case to another reinsurer, and the only effect, if everyone is alert to this situation, is that all those cases that are ceded in this way have to be undone and sent to the original reinsurer; there is coverage. If there is a non-contractual change where additional underwriting has been taken, a problem has been created if this hasn't been discussed in advance with the reinsurers involved. At General Re we have taken a strong position in this area. We will not knowingly replace another reinsurer's business without a written signoff from that reinsurer that it doesn't want to be the reinsurer anymore. After receiving this, we will consider it.

MR. PETER PATTERSON: On the same subject of the contractual change, it seems to me that the presumption that you can, in fact, adjust the premiums after the claim has occurred which has brought the problem to light, is based on a presumption that you get an early claim. If time goes by, or if it is a small block of business or if you are a facultative reinsurer, and a claim doesn't arise for a number of years, will you take this claim five years later because its a contractual change? In the area of limited underwriting or perhaps no underwriting where policies are issued to replace policies of another carrier, there seems to be some lack of consistency on the part of reinsurers between being concerned about poor persistency and being involved in programs to easily replace business of a nature that I am describing.

MR. YOUNG: There were a couple of specialty companies that had been carrying on this practice for the last couple of years. Since they had very limited retentions and since they had difficulty finding domestic reinsurance, the programs did not do well. More recently, a number of larger companies have introduced this type of program which has put the reinsurers in an uncomfortable position. We are opposed to this in concept. However, we are in a position where many of our small clients are faced with a large competitor who perhaps has a million dollar retention and who is raiding their business. They would like to be able to react in some way. As a result of this, General Re has an internal program, which, when it is approached by a good client with this type of problem it will discuss with them. This program is not as ambitious as many of the programs currently being marketed because it restricts the types of situations where General Re will become involved. The restrictions are: 1) term to permanent; 2) General Re will not be involved in guaranteed issue programs; non-medical underwriting must be involved; and 3) the original policy must have been issued standard within the last five years by a company whose underwriting is compatible with ours, etc. The reaction to this program has been one of non-interest by our clients. They are interested in a guaranteed issue program since that is what other major companies are doing.

MR. TYLER: Our position at Lincoln is quite similar to General Re's. We understand the problems with these types of programs, but it is too easy to fall back into the position of saying we simply will not reinsure them. This response is not a very tenable answer, at least as a general practice. We do attempt to look very carefully at the type of program that the client is structuring. We have restrictions on the underwriting aspects of the program, on the amount of coverage that can be brought in under the program and on the type of conversion that can occur. We are interested in making sure we have some controls in the program and that it is reasonably put together. Our other concern is being very certain that the reinsurance program we offer to the specialty company who has this type of exchange program is no more favorable to that specialty company than the reinsurance program we would offer to the companies being raided who might attempt to conserve their business. I think this somewhat addresses Mr. Patterson's comment about talking out of both sides of our mouth with respect to the lapse problems while at the same time supporting these programs. We have attempted to look at the reinsurance price and facility that is available to the original writing company so that the original writing company can keep the business inforce effectively. Our goal is to eliminate reinsurance price from being a determinant as to which company gets to write the case.

MR. TILLER: We are in an industry which has become much too price competitive on our one unique product. We have turned it into a commodity rather than a real product. These types of programs are designed to move from poor persistency products based on price alone to products that will eventually have longer term, better persistency. I think we have some short term problems in the industry. Persistency is decreased if these policies are moved. However, if these term products are moved to a product which has some incentive to keep it inforce, persistency will improve. I submit that the majority of the policies being moved under these programs would have been moved anyhow and that rather than being moved from term to cheaper term, they are being moved to something more viable. This is not a comfortable situation. This is not a decision that was made in any sort of capricious way by any of the companies in this market. It is an attempt to improve long term persistency and to change the attitude of the industry and the agents, in particular, to sell something with a little more profitability.

Transamerica Occidental does have such a program on the direct side. It will issue and fully retain up to $1 million. If it is an internal replacement, any existing reinsurance will be maintained with the original reinsurer. The reinsurance line at Occidental has a program available to clients which is very similar to those outlined by Mr. Young and Mr. Tyler. However, our program is restricted to situations where term products are moved to interest-sensitive products. We have found that the majority of our clients are not interested in guaranteed issue programs but do want to put in some limit on the length of time the product has been inforce in order to have better control on mortality.

MR. YOUNG: What do you think about the mortality anti-selection in these programs? Most replacements are agent-motivated, and if these types of replacements are also agent motivated, what is the anti-selection involved if a program involves limited underwriting and also less than full commissions? Also, what are the long term effects on our companies of having untaught our people, our marketing people, how to market? Basically we have been giving them ways to sell our product off of a pushcart. The select term is that type of a sale.

MR. WALTER N. MILLER: I am very glad that the discussion has taken this turn with the emphasis on marketing considerations in this type of situation. I would like to agree with Mr. Young and others who have suggested that when you are looking at this situation, it is really critical not only to examine it from the standpoints of the ceding company or the reinsurer but the other important player in the game who is the agent. I do not agree on the basis of our own experience with our own agents that what we're discussing is having these programs utilized in situations where the business was going to move anyhow. I believe that what's really happening is that opportunities are being created to set up situations where business is moved and once it has moved for the first time, it is much more likely to be moved again. This is the beginning of the downward spiral. I do not know if there is a good answer to this other than companies, both ceding companies and reinsurers, taking all sorts of concerted action which is probably unrealistic and almost certainly in violation of anti-trust laws. If it is out there, somebody is going to grab the opportunity. I think the seeds of big troubles are being sewn in companies where the prevailing official attitude is "it was going to happen anyway, so let's make a few nickles off of it."

MR. TILLER: I do not mean to say that all business would be of that nature. Where we participate in reinsurance programs, we insist that the conversion be from a term product to a higher premium, interest-sensitive product. I do not believe persistency problems on univeral life plans will be as bad as on term plans. Instead of the 40% lapse rates on many term plans, we will see 15%-20% lapse rates on universal life. This is an improvement. Asset shares would have to run to see if better presistency actually improves the position of the company involved. I share your concerns about these programs. We do not encourage them in the reinsurance line but will participate if the client has a good program. Another aspect is that this has not been a major selling program on the direct side at Occidental. The program was originally designed as an update of our own term policies and as an alternative to Trendsetter 20 and some of the other products.

MR. DENIS W. LORING: I invite the panel to comment on the following possibility. Miniscule Mutual offers its non-competitive life plan, securing reinsurance coverage involving some fairly heavy front-end allowances. The reinsurer prices it to breakeven after five years and make a profit down the road. Two years later Miniscule Mutual decides to introduce a super competitive life plan, obviously a far better seller. It secures other reinsurance coverage, perhaps a pool of several reinsurers, and encourages all its agents to encourage its policyholders to switch from non-competitive life to super competitive life. Of course, the reinsurance moves because super competitive life is reinsured by different people. This leaves the original reinsurer with heavy first year allowances and a nice negative profit. Even though they do not get the claims down the road, they do not get the premium either.

MR. TYLER: One important point you did not comment on in your case was the amount of underwriting that was associated with the issue of the new policy. I think there would be no new underwriting. The principles that Mr. Young discussed would apply here. The reinsurance coverage ought to continue with the original resinsurer. That is a simple answer but that is often not happening. The reason it is not happening is because of the various points that Mr. Young has made including the fact that this has not been an issue that has been discussed upfront between the reinsurer and the ceding company when the original reinsurance program was put together. The reinsurance agreement includes provisions dealing with these types of activities but not necessarily in a complete or precise way. Therefore, it is a difficult problem, and I think there is some room for disagreement between reasonable people when dealing with a specific case as to what is a reasonable solution. The real solution is to make sure we understand that the problem exists and, at least prospectively, frame our reinsurance treaties and agreements on a basis where we do deal with this type of activity and know how it is to be handled.

MR. LORING: Super competitive life, the second product, is also super competitive as far as the reinsurance is concerned. The reinsurer on the first product doesn't want to participate at the required reinsurance premiums on the second product.

MR. TYLER: That problem should have been discussed two years ago when the original plan was written. The difficulty is that two years ago there wasn't much thought given to the fact that the company might introduce a newer product, lower priced, and encourage agents to internally replace that business. This is a fairly recent phenomenon that hasn't been discussed which makes it difficult to deal with that situation.

MR. YOUNG: This is an area we are becoming more aware of, and it is area that we reinsurers are trying to make our clients more aware of. Mr. David Holland did a study last year as part of one of the reinsurance meetings on the history of premiums, claims and commissions on reinsurance over a period of years. All the numbers made sense until the last year or two, and then the charts started looking unusual. Basically what happened was that there was a sharp reduction in the amount of renewal premium that the reinsurers were receiving. These renewal premiums were not paid for a number of reasons. I submit that at least one of the major reasons was this phenomenon we are now discussing. We have been correcting the problem; it is not five years later, maybe two, but we have been correcting the problem. Certainly we are correcting it going forward. Sometimes the audit trail has gone cold on inforce business, but we are trying to correct that as well. We are attempting to go back in time and collect the premiums that should have been paid to the proper reinsurer.

MR. TYLER: An additional comment that I would like to make is to change the emphasis a bit. It seems to me that the emphasis in dealing with these matters is not what the emerging financial experience of the ceding company or the reinsurer is likely to be, but the real emphasis is dealing with the changed circumstances. There is now another issue that has to be negotiated at the time a reinsurance treaty is put in place. It is: How will conversions and how will policy changes occur; what will happen down the road if something unforeseen of this nature does happen? I think it is important to determine what is going to happen upfront and to determine at what price it is going to happen. This does not preclude the two companies from getting together two years later and changing those provisions prospectively, but at least there was something in place initially to deal with this type of activity which is currently very common. The emphasis is dealing with the contractual terms and not the reinsurer's or the ceding company's profit position.

MR. TILLER: Let's go back to Miniscule Life. We are currently dealing with a situation where we reinsured a term product that was a 10 year select and ultimate plan with a 10 year re-entry provision. We allowed 100% first year allowance and 50% second year allowance. After the treaty was signed, the company decided to add a non-contractual change that would allow re-entry at the end of the first year. What premium does the reinsurer charge and what allowance do they give on it? The ceding company contends that all the treaty says is that the reinsurer will give these allowances based on the premium that the ceding company charges. Hence, the ceding company wants a 50% allowance based on a new first year premium. We, the reinsurer, have said that if they get another first year premium, the allowance should be 12%. This is a significant difference of opinion. These concerns must be tied down. We are trying, and all reinsurers are trying, to tighten the treaties to be much clearer upfront, and to face these issues. Now what you will find is that reinsurance negotiations take much longer than before. There are many more loose ends to tie down.

MR. WARREN: I want to make three points: 1) I feel the change in the reversionary period clearly changes the design of the product and that the ceding company would have to resolve this with the reinsurer and renegotiate allowances; 2) I feel that the reinsurance contract itself specifies a set of YRT rates which would be used upon conversion or policy change unless coinsurance or mod-co were decided upon later; 3) my third comment is on replacement programs. It seems that most companies have limited underwriting, some no underwriting, with various issue amount limits. But the one common denominator is that the program is being made available to only standard issues of other companies. In that regard the New York Insurance Department has taken a firm position that any program that is available only to standard lives of other companies is clearly discriminatory and illegal. William Penn has a reinsurance arrangement which would enable us to be involved in this type of replacement program fairly successfully, but we are unable to do so because of the New York Insurance Department. There are a handful of companies doing business in New York with programs that are only available to standard issues, and I think there is a legal problem here. I would like to know to what extent the reinsurers are aware that they're reinsuring those companies that are in violation of the law?

MR. YOUNG: I was not aware of it.

MR. TYLER: Your comment is news to me; maybe this is a recent ruling.

MR YOUNG: We reinsurers have taken a strong position as being opposed to this type of program. Even those of us who have reacted in some way to it, feel it is bad for the industry and would like to see the program disappear.

MR. MICHAEL R. WINN: I wondered, in light of Mr. Warren's comments, if the panelists are going to rethink their position on external replacements? I think each one indicated that a non-medical application would be utilized for the external replacement programs. What would you do if, as a result of the non-medical application, you determine that this insured, who was issued a policy five years ago, is no longer standard? Would you secure medical information?

MR. YOUNG: I am going to use the information that Mr. Warren has made us aware of to alert those companies that come to us with requests for these types of programs. I would advise them of the fact that the New York Department is taking this type of action and that they might want to look into it.

MR. TILLER: We are constantly reviewing our program. If new underwriting was secured and the non-medical part showed that the individual was no longer standard, the policy would be declined. Most of these are accept or decline programs.

MR. WINN: Has the Reinsurance Section given any consideration to exploring Mr. Tyler's comments further and perhaps aligning the Reinsurance Section with some of these other regulatory bodies that are pursuing reinsurance regulations?

MR. YOUNG: This is an excellent idea which we will explore.

MR. JAMES D. MAUGHN: Would any of the panelists comment, in light of mentioning the pushcart type sale, on whether or not serious consideration is being given to limiting first year allowances on these programs?

MR. TILLER: Our program is designed around a YRT approach only.

MR. TYLER: I think most of the major reinsurers have taken some steps to try to protect themselves against the early lapse risk on these replacement program policies. We have introduced a couple of programs aimed at that, and I know some of our competitors have done the same.

MR. GORDON GIBBINS: If you submit your modified underwriting on replacements to the reinsurers on your new product, is this enough to switch the obligation in the eyes of the reinsurers from the old one to the new one? I do not mean in those situations where replacements are encouraged but rather when they are specified in the application as being an internal replacement.

MR. TILLER: When some type of additional evidence for the new policy is secured, then it becomes a matter of individual judgment. I think that the majority of the reinsurers would prefer that something be negotiated for the reinsurance to stay with the original carrier on internal replacements. But if the program has the same evidence required on internal as well as on external replacements, you have a pretty good chance of getting the new reinsurer to take it.

MR. YOUNG: I suggest you go back to your actuarial department and review your policy change manual. I think you will find that this situation is covered in there. It will direct you to renegotiate this with your existing reinsurer.