RECORD OF SOCIETY OF ACTUARIES
1985 VOL. 11 NO. 2

REINSURANCE - CURRENT FINANCIAL REPORTING TOPICS

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Topics of current interest in the United States and Canada from the perspective of the reinsurer and the ceding company.

- o Update of American Institute of Certified Public Accountants (AICPA) activities, including AICPA audit guide.
- o Current generally accepted accounting principles (GAAP) standards for reinsurance ceded and assumed.
- o National Association of Insurance Commissioners (NAIC) activities.
- o Life insurance tax law.

MR. FRANK W. KLINZMAN: In the early 1970s, life reinsurance began to be sold more frequently to assist companies in their financial planning. Using life reinsurance as a financial planning device continued to increase during the 1970s and probably hit its peak in the early 1980s when, due to what many felt was an inequitable tax law, a number of companies entered into modified coinsurance agreements with an election of Section 820 under the Tax Code. This lead to desired changes of the Life Insurance Company Tax Law with special consideration being given to reinsurance agreements in certain instances. This activity also led to increased interest in reinsurance by various state regulatory officials and the AICPA.

In spite of all this activity and interest in the tax and state regulatory areas concerning reinsurance, there has been little change, if any, in the application of GAAP to reinsurance since the American Academy of Actuaries adopted Recommendation 4 and Interpretation 4A in its Financial Reporting Recommendations and Interpretations.

MR. JAMES L. SWEENEY: Individual state insurance departments, the NAIC, and the AICPA all have moved to close some of the perceived abuses of reinsurance treaties. These developments will affect how we as reinsurers and ceding companies conduct our reinsurance relationships. These regulatory authorities are wrestling with the question of the transfer of risk, the business purpose of certain reinsurance, and the substance rather than the form of reinsurance

contracts. The regulatory authorities want to institute safeguards for the financial stability of both reinsurers and ceding companies and want reinsurance to be accounted for appropriately. In 1983, the NAIC changed Schedule S of the annual statement to get much more detail of how reinsurance arrangements actually work. Some of these earlier versions of Schedule S required that commission allowances be given for every reinsurance contract. These, of course, were not included in the final form. This additional information given to regulators on Schedule S may have promoted the idea of mirror imaging of reserves. Also in conducting routine examinations, the states have been concerned with some financial reinsurance treaties. A California Department Proposed Bulletin reads:

> The California Insurance Department has become aware of an increasing number of life reinsurance contracts which are entered into for the primary purpose of providing only temporary surplus relief to a ceding company. The terms of these contracts do not effectively provide for any reasonable transfer of risk to the reinsurer or provide for any reasonable indemnification to the ceding company.

Again and again you will hear the words "transfer of risk" from the regulators. It is also the basis of the AICPA's "Statement of Position on Auditing Life Reinsurance."

In 1979, the Securities and Exchange Commission (SEC) issued a complaint to the AICPA dealing with the audit practices of certain aspects of reinsurance transactions. They wanted the AICPA to address the contingencies associated with reinsurance -- generally, reinsurance transactions in which unusual risk may exist and which the reinsurer is unable to fulfill and also reinsurance transactions entered into principally to increase statutory surplus where actual risk of loss does not pass through to the reinsurer. The SEC had already commenced proceedings in two cases where the inadequate disclosure of reinsurance had materially affected those companies' 10 K's. In both cases, the SEC wanted those companies to amend the 10 K's for all the years for which reinsurance was involved. Following the SEC complaint, the AICPA established a task force, and in November of 1984, a statement of position was issued. The statement of position applies both to reinsurers and the ceding company. Any AICPA member may have to justify any departures from these recommendations. Further, the statement is applicable for the year 1985 and beyond.

The AICPA wants the auditor to examine the level of internal controls that the insurance company may have established for its reinsurance. The auditor will examine the extent to which the reinsurer or ceding company has determined that the other is financially sound. In particular, the auditor will examine the interal controls of the ceding company to (a) evaluate the financial responsibility and stability of the assuming company and (b) to provide reasonable assurance of the accuracy and reliability of information reported to the assuming company in amounts due to or from the assuming company. In evaluating the reinsurer, there are seven items that the ceding company may consider, contained in that statement of position. The ceding company is not

required to gather all of the information but must have a means of verifying the stability of its major reinsurers.

A ceding company must review its internal controls relating to the accuracy and reliability of the information that has been given to the reinsurer. Are there cases that should be reinsured that have slipped through the cracks? If it's a self-administered account, are the premiums being billed correctly? If a policy lapses, is there a mechanism to make sure the reinsurance policy also lapses, and finally, are there controls that give reinsurance to the right reinsurer? These are the types of internal controls that the AICPA is addressing. For reinsurers, the AICPA position is similar. The assuming company must institute internal controls and procedures for assessing the accuracy and reliability of data provided by the ceding company. There are four procedures suggested by the statement of position that the reinsurers should consider. As a result of this statement of position, our auditors have strongly recommended that we institute some of these controls. While we had informally instituted many of them, we now have formalized them. We have established a job position to collect, analyze, and file the data. If the analysis requires some action, the person in that position is to notify management.

While the AICPA statement of position affects all reinsurance conducted through the audit process, the states are enacting legislation that regulates reinsurance directly. The NAIC has a model bill on reserve credits, and the examiners handbook is being revised so it agrees with the model law. There is also a NAIC Model Holding Company system Regulatory Act that applies to intercorporate transactions between members of a holding company. The NAIC also has a surplus relief task force advisory committee set up under John O. Montgomery. There's also a working group on reinsurance under the Accounting Practices and Procedures Task Force at the NAIC level.

The model bill on reserve credit is regarded as a minimum standard to allow a ceding company to take a reserve credit. In order for a company to take a reserve credit, the reinsurer must be licensed in the ceding company's state of domicile or in at least one state with similar standards regarding reserve credits, or the reinsurer must establish a trust fund in a U.S. bank or trust company. The reinsurer must also file an annual report with the Director of Insurance and the Director will then determine the sufficiency of the trust fund. The trust surplus must be $20 million if there is a single reinsurer or $100 million if it is a group of two or more. If the reinsurer is not licensed in the ceding company's state of domicile, a reserve credit cannot be taken unless the reinsurer will agree to litigation if it fails to meet its obligations. The litigation provision does not override the arbitration clause found in most reinsurance treaties. Finally, no reserve credits can be allowed if any payments or obligations are reduced by the insolvency of the ceding company. This model bill on reserve credits has been adopted by the NAIC and has been introduced in various states.

In addition to the activities of the NAIC, individual states have proceeded with regulation of reinsurance. Most notably is Regulation 102 that was issued by the state of New York in March 1985. The New

York regulation disallows reserve credits for certain types of reinsurance. In October 1984, the department held a formal hearing on what was then a proposed 102. It was a standing room only crowd with about twenty people scheduled to speak. It was quickly apparent that 102 was overkill and work was begun on what was called "Son of 102." With some industry input, Regulation 102 became effective in March.

The regulation begins:

> The insurance department recognizes that life insurers routinely enter into reinsurance agreements that yield legitimate relief to the ceding insurer from strain to surplus. However, the department has become aware that some licensed insurers in the capacity of ceding insurer have at times entered into reinsurance arrangements for the principle purpose of producing significant surplus aid while transferring little or no risk to the reinsurer. In substance of in fact, the expected potential liability to the ceding insurer remains basically unchanged by the reinsurance transaction not withstanding certain risk elements, such as catastrophic mortality or catastrophic survival.

At the October hearing, the department wanted to know business reasons for reinsurance other than surplus aid; what the reinsurer does for its money; and how the reinsurer's fee is determined. The regulation as adopted disallows a reserve credit or establishment of an asset if any of the following conditions exist:

1. The primary effect is to transfer deficiency reserves or excess interest reserves for a risk charge.

2. The reserve credit taken is in excess of the reserve necessary to support the policy obligations transferred.

3. The ceding company is required to reimburse the reinsurer for negative experience. It is permissible to offset current year experience with prior year losses, that is, you can have a loss carry forward provision in your experience refund formulas.

4. The reinsurer has the right to terminate the agreement and deprive the ceding company of surplus, the ceding company cannot take a reserve credit. Provisions such as an automatic termination upon the insolvency of the ceding company are also prohibited. The reinsurance contract, however, can be terminated for non-payment of premium.

5. According to the treaty, if the ceding company must recapture or terminate all or part of the reinsurance at specific points in time, then the reserve credits are disallowed.

6. If there is no cash payment due through the lifetime of the agreement prior to termination, or if all settlements that are made prior to the termination date are made into a reinsurance account, then the reserve credits are disallowed.

Regulation 102 applies to existing agreements as well as new ones. However, existing agreements may be allowed to continue to take reserve credits if there is no new business ceded under the agreement; if the deduction of the liability or the asset established is reduced to zero by December 1988; and if the agreement is otherwise permissible, and if the New York Department is notified of the existence of such an agreement by May 15 and of the reserve credits taken in the 1984 annual statement.

The California Department has asked for comments on its version of Regulation 102. In most cases, it's identical to the New York Regulation, but it does not allow for any grandfathering. The California Department expects all insurers affected by the bulletin to correct their accounting and reporting for such contracts prior to December 31, 1984. The contract affected are essentially the same as those by New York Regulation 102.

Similarly, the Illinois Insurance Department made a staff report on surplus relief and the transfer of risk. This staff report questions the bonafide agreement to transfer risk in some surplus relief treaties. The report goes on to state that the surplus of some companies may be overstated. They examined a number of single premium deferred annuity (SPDA) modified coinsurance treaty wordings, and they also discovered a similar problem with ordinary life reinsurance treaties. They suspected that such treaties also exist for accident and health (A&H) business, but they did not find any. The conclusion of the staff report was that "a position be developed by the NAIC so that uniform treatment and financial quality of surplus relief can be asserted."

The State of Florida also has proposed legislation that would affect all companies licensed to do business there. In this proposed legislation, in order to apply for a certificate of authority, a company must provide its corporate charter, the articles of incorporation, a copy of the most recent examination by the public official having supervision of insurance, and copies of any existing or proposed nonfacultative reinsurance treaties. Additionally, any company having a certificate of authority must provide the department with a copy of any nonfacultative reinsurance treaty within thirty days of its execution. Further, the department may employ consultants at the expense of the ceding company for the purpose of reviewing and reporting to the department findings on the nature, protection, and adequacy of the reinsurance treaty. I'm not aware that this legislation has been enacted in the law, but it will give you an idea of what some of the state insurance departments are thinking about.

There's also some talk about setting up guarantee funds for reinsurers, and some states are requiring that companies assuming reinsurance have higher minimum capital and surplus requirements. I think Illinois has enacted some legislation to do this, and I know Georgia has contemplated this, too.

Another subject that is getting a lot of attention recently is the idea of "mirror imaging" the reserves. This prevents a ceding company from

taking a reserve credit for any more than the reinsurer has established. An example of mirror imaging would be to suppose 100 percent of a policy is reinsured, and the policy reserve is $1,000 on the reserve standards of the ceding company. If the reinsurer has chosen a more liberal reserve basis, then the reinsured reserve is calculated to be $900. Under the idea of mirror imaging, the ceding company must hold a $100 reserve on a policy that is fully reinsured. It sets up the $1,000 reserve but is only allowed to take a $900 reserve credit, leaving it with a reserve and no risk. One actuary has described mirror imaging as "an ill-conceived solution to a dimly perceived problem."

Mirror imaging, in one case, has produced the conclusion that regardless of which company is responsible for a claimed reserve credit exceeding a reinsurers reserve, the ceding company's surplus will be penalized by a mirror image adjustment." By applying the mirror imaging concept this way, any company with a significant amount of reinsurance should find our what its reinsurer is holding as reserves. You may be in for a real shock if your reserve standards are higher than the statutory minimum, and you do your own valuation for the reinsured portion of your portfolio.

I can only speculate on the rationale behind mirror imaging. With the availability of the NAIC database, regulators can easily compare a company's reserve credits with the reserves established by the reinsurer. When a tool is available, there is often an impetus to use it. There is also a precedent set for mirror imaging reserves for property and casualty reinsurance. Loss portfolio transfers are used by property and casualty companies to transfer to a reinsurer loss-payment obligations already incurred. The consideration paid to the reinsurer is usually the discounted value of those loss payments plus a margin for the reinsurer. Thus, when a company makes a loss portfolio transfer with a consideration that is less than the loss reserves, then the company will show an underwriting profit. The profit is the difference between the loss reserve and the consideration.

New York has Regulation 108 that says a loss portfolio transfer cannot have a surplus effect. Thus, the ceding company cannot take a reserve credit for reserves that the reinsurer has not established. Regulators may be applying that same logic used in loss portfolio transfers to come up with mirror-imaging reserving.

The industry is generally opposed to mirror imaging for several reasons. First, there are practical problems of mirror imaging. There are also timing problems. The normal course of events is a delay in reporting and processing of reinsurance. Therefore, a reinsurer may not be aware of new business or terminations in process. Second, many companies use approximations for ancillary benefits such as accidental death benefit (ADB) or waiver of premium. Reserves for table-rated business are often based on many approaches. Continuous and curtate factors can cause reserves to be different between ceding company and reinsurer even if the reserve standards are otherwise the same. Third, the premium mode may be different between what the ceding company receives and what is paid to the reinsurer; therefore, it is impractical for reserves to match.

The industry is also opposed to mirror imaging because there is no statutory or actuarial role that the gross policy reserve be established by the sum of the reinsured reserve and the net retained reserve of the ceding company. In fact, the 1984 annual statement instructions read as follows:

> Reserves should be computed on a gross basis, i.e., direct and reinsurance combined. Then deductions for reinsurance should be computed using the same valuation method but reflecting the actual mode of reinsurance. If the assuming reinsurer uses different valuation assumptions or methods, then deductions for reinsurance ceded will not necessarily equal the reserves established by the assuming company.

A final reason for the opposition to mirror imaging is philosophical. There is discussion about the importance of the professional opinion of the valuation actuary. The idea of mirror imaging is a contradiction to that concept. The reinsurance company's valuation actuary will establish reserves based upon its block of business and its characteristics. These characteristics may not be anything like the block of business written by his client. The reinsured block may have different product design, for instance, to insure only the mortality risk on a universal life policy. Finally, there is no mirror imaging of reserves in the tax law. GAAP valuations do not require mirror imaging. Why should we have it then in statutory requirements?

MR. GILBERT W. HART: The biggest thing in the 1984 Tax Act is the new Section 845, giving the Secretary of the Treasury authority to reallocate amounts in a reinsurance agreement. This appeared in the conference bill in its final form nine months after the house bill had been introduced and with no time for any hearings and no real time for involved parties to comment on the proposed legislation. The bombshell was Section 845B, which, for the first time, provided for reallocation between unrelated parties in a reinsurance agreement. Section 845A, which provides for reallocation between related parties, was similar to the old section 818H, which came in under TEFRA and which, in turn, probably didn't give the Internal Revenue Service (IRS) a lot more authority then it had under Section 482, which allows the IRS to make reallocations among related taxpayers in noninsurance as well as insurance transactions. A tax on captive reinsurers has been going on for some time with the IRS, at least recently, winning these battles. The tone and the thrust of Section 845A seems logically to stop short of the IRS's court position that within an economic unit, there can't really be any transfer of risk. The IRS's position in court is that reinsurance between a company and its subsidiary is, by definition, impossible.

All the horrors that I will describe as applying to reinsurance between unrelated parties would also apply to reinsurance between related parties. You can't avoid any of these horrors by doing business with your cousin. The difference between related and unrelated party reinsurance, as far as reallocation is concerned, is that to make a reallocation between unrelated parties, the IRS has to demonstrate a significant tax avoidance effect. If it can do that, it can make an adjustment to one or both parties. It doesn't have to push one up and

the other down; it can make the adjustment to just one of the parties if that seems appropriate. It can, after arriving at a tax avoidance effect, assume that the agreement is terminated on December 31 and then reinstated on January 1.

In deciding whether there has been a significant tax avoidance effect, the IRS does not have to go into the motivation of the parties for entering into the reinsurance agreement. A valid business purpose, as stated in the committee report, is not relevant. All of this information comes from the conference committee report; Section 845 itself it two or three sentences long. The committee report says that the fact that the agreement is negotiated at arms length is not relevant.

Tax avoidance, the committee report says, is when there is artificial reduction in various tax elements, such as the company's equity; or if there is a change in the source of an item; or if the agreement has the effect of deferring tax; or if it extends a loss carryover period; and finally, perhaps most significantly, if it switches income from one bracket taxpayer to another bracket taxpayer. It is spelled out later in the committee report that a small company and a large company are in different tax brackets; that a loss company and a company that is making money are in different tax brackets; and that a life insurance company is in a different tax bracket from a casualty company. So reinsurance between these elements is the sort of thing the IRS would be looking at, with, of course, the implication that reinsurance between two life insurance companies, each paying tax at 36.8 percent, perhaps has a leg up, in that those companies have not done anything so far to attract the IRS's attention.

A significant tax avoidance is when the effect on your taxes is disproportionate to what somebody would expect with the risk transferred. In an important sentence, the IRS says there would be no significant tax avoidance if the reinsurer had the same gain or loss it would have had if it had written the block of business directly. The committee report lists seven items that it would expect to be examined to see whether significant tax avoidance effect had occurred.

The first item is the duration of the block of business reinsured, where the committee feels that new business is less likely to have been used for manipulative purposes than old business. The committee also rather confusingly states that "new business has the risk of lapse which old business doesn't." We've seen some old business disappearing in some way or other. I am not quite sure why, just because a block of business does not have any significant lapse risk left, that there is still not a valid transfer of risk that could be reinsured. The IRS would examine the mode of reinsurance. It appears to be comfortable with yearly renewable term (YRT) and uncomfortable with coinsurance. It would look at the experience rating formula and might say that coinsurance, where the experience rating formula, if it gives a coinsurance agreement, only gives a risk charge to the reinsurer, might be considered to be YRT plus a financing arrangement.

The IRS would look at the duration of the reinsurance agreement. New agreements might have trouble whereas old automatic agreements ought

to be fine. Under termination rights of the parties, recapture fees may be allowed where there is an upfront commission, which has not been recovered, but the IRS does not like provisions allowing the reinsurer to recover losses. Finally, the IRS would look at the financial situation of the parties. Surplus relief would be allowed if there is real insolvency, but otherwise, the IRS would wonder why the surplus was moving from one company to another.

The committee report goes on, giving four "safe harbors." It recognizes that this is new that there are no regulations, and that the parties are entitled to know something about what might be allowed because the Section seems to leave it up to the imagination of the IRS as to how far it can go. YRT reinsurance without expense allowances seems to not involve any significant tax avoidance. Coinsurance of a ceding company's annual renewable term (ART) business would be allowed because there is no transfer of long-term reserves. Coinsurance of new business is allowed providing the expenses are handled on a pro rata allocation where the company has to be able to show that the expense allowances were appropriate in relation to the expenses of the block reinsured. Block of old business can be transferred if the ceding commission can be shown to reasonably reflect the ceding company's unamortized expenses and the anticipated profits on the block of business to the reinsurer.

The American Council of Life Insurers (ACLI) has had task forces dealing with all the Sections of the 1984 Act that affect life insurance companies, examining where those companies need regulatory help. There has been a task force dealing with Section 845 working on the problem. I understand that there is some difference of opinion within the industry as to whether we want to push ahead with requesting regulations and submitting to the Treasury drafts of such regulations. Mr. David Garlock who is a member of the Treasury Department, speaking to the ACLI several months ago said that he would not expect to see regulations put out under Section 845 for six or seven years. To some people, that was a disaster. How could we live through six or seven years not knowing what kind of agreements will be accepted and what kinds will not? The other side says no news is good news and that they would not push ahead to get regulations where there is an indication that regulation will be a long way off. So I would say we should not look to find any regulatory assistance in this area soon.

Section 845 is not the only place in the ACT where reinsurance is mentioned. Considerable attention was paid to reinsurance agreements written after September 27, 1983, when the first draft of the house bill was made public. Essentially, three things happened. The so-called fresh start for life insurance reserves is not available for reinsurers' reserves on contracts entered into after September 27, 1983. There is also a provision that says the small company and 20 percent deductions will not apply to income attributable to expenses transferred in the last quarter of 1983 agreements. A bombshell occurred again in the conference report; in their 1983 returns, there would be no nonparticipating deductions or special group and A&H deduction for contracts entered into after September 27, 1983. This provision first came out three months after the due date of the 1983 returns, when we were still being

told how those returns should be filled out. In the Technical Corrections Act, which was introduced in just the last month or two and has not been passed yet, there is a provision that for fiscal-year reinsurers, the last quarter of 1983 does not end on December 31 but extends until the beginning of your first taxable year after December 31, 1983. That last provision closes a loophole that you could have driven a truck through unless, like most of us, all you had were calendar-year "trucks."

Finally, there is a provision for reinsurance agreements entered into in 1982 and 1983 that when they are recaptured, the reinsurer must share with the ceding company any of the fresh-start benefits received at December 31, 1983, on the reserves held. Another item in the Technical Corrections Act is a provision that says companies, which use net level premium basis for valuing noncancelable A&H, may use that basis for valuing their noncancelable tax reserves. This is only available to direct writers; nobody seems to like reinsurers. Those were the specific provisions in the act.

A big problem, of course, that arose out of the Act is the revaluation of the reserves and the problem that reinsurers have on self-administered business in arriving at the amounts of these reserves. The Tax Equity and Fiscal Responsibility Act (TEFRA) item that occurred on the handling of reimbursed dividends in the tax return was where dividends are an expense deduction to the reinsurer and income to the ceding company and then a dividend deduction to the ceding company. This was retained in the 1984 Act, although the loophole closed in TEFRA had disappeared with the elimination of phases.

A couple of items that are current events and that are outside the 1984 Act will be eligible topics for conversation later. The first is the questions arising under the examination of companies that have Section 820 Mod-Co agreements prior to 1982. It seems to be a characteristic of life insurance company taxes that nothing ever seems to be finally settled. The repeal of Section 820 with a grandfather provision stating that the terms of the contract would govern agreements prior to then, unless the treasury could demonstrate fraud, seemed to give a settled state. The calm did not last long, and agents were raising a number of questions without seeming to raise any question of fraud. They have questioned the effective date of contracts, when those contracts were executed at a date considerably later than the effective date. They have questioned the interest rate involved in the Mod-Co reserve adjustment, when it is based on new-money rates or rates considerably higher than the ceding company's portfolio rate. They have been unhappy with provisions in some of those agreements providing for the return of some portion of the risk premium if the ceding company did not obtain the federal income tax result anticipated from the agreement. Finally, they have made general attacks on whether there is any transfer of risk or business purpose in these agreements.

The ACLI has made some effort to head this attack off at the pass, but as far as I know, they have not been successful. There seems to have been a retreat on the questions of business purpose and risk transfer and federal income tax recovery provisions, but it seems to be a

standard audit procedure to set up adjustments where there is a discrepancy between the execution date and the effective date of where there seems to be an excess amount of investment income moved by selecting a high interest rate.

The other item outside the 1984 Act is the question that has come up on acquisitions under 334B2 or Section 338. The Treasury has taken a position that the company being liquidated in these arrangements received income in the amount that the acquiring company was setting up as an amortizable amount paid for the new business. The tax position of the acquiring company is not being challenged, but the Treasury is suddenly using something like assumption reinsurance arguments and saying that the liquidating company is stuck with this income. And since the same company owns both the acquiring company and the company that is being liquidated, the bottom has fallen out of that particular approach. Our understanding is that the Treasury seems willing to grandfather the older agreements, picking a date like August 1, 1983. The Treasury would not challenge those agreements but there is, where the company is concerned, considerable strife going on as to whether the company can move that grandfather date up. I understand that if the companies involved could get a grandfather date of today, they would happy and not look for those benefits into the future.

MR. JOHN E. TILLER, JR.: Any historical research into the methodology, the challenges, and the opportunities of dealing with GAAP as it applies to reinsurance, either accepted or ceded, generally starts with two papers that were published in Volume XXVII of the Transactions of the Society of Actuaries in 1975. These two papers were entitled, "GAAP Accounting for Reinsurance Accepted" and "GAAP Accounting for Reinsurance Ceded," both by Richard S. Robertson.

These papers and their discussions fairly well address the basic concerns and techniques involved in reinsurance GAAP. It is possible to be much more refined in the way that these procedures and techniques are applied today, but that is true in any area of GAAP. I will not spend much time today in resetting those principles and certainly wouldn't even try to duplicate the extensive formulas used. Rather I would like to take the time to talk about some of the practical problems that are not specifically discussed in these articles.

Robertson's papers appear to have implicitly assumed that reinsurance would be conducted on an individual cession basis and that traditional products with predictable amounts at risk would be reinsured. That was an accurate description of the world in 1975, but since then, we have seen major shifts in the directly written life insurance products and in the forms and applications of reinsurance. Those shifts have brought about the concerns of the state regulators, the AICPA, the IRS, and many others.

The reasons for those changes are part of a separate discussion for another time and place, but presumably all of us can agree that those changes have occurred. The ideas of 1975 are still valid; the practical implications and the application challenges have changed.

What are the changes that have specifically impacted reinsurance? First, reinsurance is more important proportionately to ceding companies than it was in 1975. In general, a larger portion of the business is being ceded. The cost of reinsurance has become a more important issue. The ceded-reinsurance, financial impacts are now "significant" requiring more attention be paid to the concepts and to detail. Auditors are paying more attention to reinsurance. My former employer was a fairly large reinsurer and was one of the first companies to implement GAAP, but for years we did not use GAAP for reinsurance. We ceded large volumes, and most of both ceded and accepted reinsurance was on a YRT basis, so everything netted out. In the mid-1970s, coinsurance became dominant and set up a deferred acquisition asset. By 1980, benefit reserve adjustments were needed because even if the business where to stay in balance (which it did not) between accepted and ceded, the characteristics of those businesses were vastly different. Line-of-business financial reporting also increased some of these pressures.

A second change and major shift has occurred from YRT, or in deference to Mr. Robertson, risk premium reinsurance (RPR), which was the mechanism by which most reinsurance occurred prior to 1975. Reinsurance was done on YRT scales with an established rate basis. Today, coinsurance is used on nearly all products or else a tailor-made RPR scale which is the equivalent of coinsurance from a financial point of view.

The reinsurers are those companies that accept the business. They now have more sales to deal with, and each account becomes, in essence, and individual sale. Before, one rate scale could be assumed to have a general set of GAAP assumptions and margins, the more individualized assumption make it more difficult to categorize the accounts for GAAP assumptions. To give an example, in reviewing products I priced over the past few years, the mortality assumptions and the gross premiums varied so greatly that for a given age, duration, and underwriting standard, the mortality assumption could have varied by as much as 100 percent from one to another. Lapse assumptions may have been three times as great on one product compared to another. Obviously, the same GAAP assumptions are not suitable for all those products; in 1975, you could probably use one set of assumptions. Although one must provide for different assumptions, one must face the question of what is practical in timely reporting without undue expense versus the accuracy of detail reporting.

Many reinsurers express a profit objective as a percent of premium, and a wrongly categorized product can lead to strange profit emergence situations. GAAP terminal reserves may be higher for a given amount than the gross premium for another one despite superficial similarities.

For ceding companies, the YRT approach does not necessarily impact the deferred acquisition cost (DAC). Coinsurance, however, must impact the DAC. In some cases, ceding on a coinsurance basis creates a first-year statutory profit. In this case, ceding reinsurance has a different impact than that of normal GAAP. Under normal GAAP, the GAAP adjustments are used to accelerate income and defer expenses.

The challenge of ceded coinsurance is, instead, to defer profits and accelerate expenses. A ceding company will find that its allowances and the DAC amortization factors should vary from plan to plan, and age to age. The commissions and allowances offered by the reinsurer will almost never match those used by the ceding company for GAAP-expense assumptions.

A third change is that there is much more facultative business today than there was in 1975. Whether placed on either a coinsurance or a YRT basis, this may produce mortality and persistency results which are vastly different from that of automatic business. Both ceding companies and reinsurers must look at their portfolio to determine if they need to set up separate scales for facultative business. Again, this could be fine tuned to the point where you have individual cells for each policy; so practicality is important.

The fourth and perhaps most important change is that universal life and other interest-sensitive products have been developed and demand attention. Most reinsurance of these products today is on a tailor-made YRT scale, generally with no first-year premium. There are some unique challenges in that. Basically, all the problems, which exist with a direct writer, plus a few more exist in reinsurance, also.

Surplus relief and tax-driven types of treaties, or nontraditional treaties in general, and bulk, or self-administered treaties are a special challenge and require a model for the entire block of business as opposed to an individual policy-cell factor approach for GAAP. Under normal GAAP models, policy forms are assigned to categories which are somewhat standardized and include central age assumptions, some expense assumptions, and persistency assumptions. This models the entire in-force business of a reinsurance treaty and applies some form of GAAP modeling to that totality as opposed to the individual policy details. Therefore, the bulk accounts require assumptions for basic distributions which are to be applied to the entire account. Incidentally, these observations are based on my own financial reporting experience plus consulting experience with a number of operations. I have never seen a bad approach, but I have never seen an approach that I consider really smooth either. Most probably using GAAP for reinsurance cannot be done smoothly for bulk accounts.

The GAAP objectives and the theoretical mechanics involving bulk and nontraditional reinsurance are the same as those encountered in applying GAAP to more traditional lines. Most, if not all reinsurers have found the reliable, consistent application of GAAP to bulk accounts to be much more difficult than to individual cessions. While the "problem" in the "individual" cession area may be described as an overabundance of detail (age, underwriting classification, duration, sex, amount at risk, plan code, and so on), the challenge of bulk accounting centers around a total lack of data. Any approach to using GAAP for accounts without individual detail requires that a delicate balance be established between simplicity of reporting and validation of results. Since different types of business require different GAAP approaches, the rest of this discussion is divided into bulk YRT and coinsurance accounts and nontraditional accounts.

The purpose of bulk accounting is to simplify administration for both the reinsurer and the reinsured, minimizing the volume of data which must be transferred from one party to the other, often using existing reports which produce reinsurance accounting information as a by-product. Many of these systems are designed to produce only the bare essentials -- face amount, premium, claims, and allowances -- usually split between new issues and renewals. Attempts to get more data can be made, but there are realistic limitations to any such efforts. Since it is self-defeating for bulk accounting to add a layer of more detailed reporting on to the existing accounting, a model approach becomes necessary. If it is possible to get annual data (volume and premium) reissues, age distribution and smoking classification of new issues, age distribution of in-force business, and issue-year distribution of in-force business, then a reliable model can be constructed. When less data is present, a reasonable result can be obtained, but validation is more difficult.

The actual construction of a model and development of factors for benefit reserves and DAC is the same as that for the individual cession business. The steps involved include:

1. Selection of the various model segments.

   Criteria for selection can be based on the degree of similarity between the various accounts' products. Some bulk accounts will include only one plan and some will include several. Ideally, each plan would be an individual segment. Since that is impractical, plans with similar characteristics should be assigned to a given model cell based on one predominant plan of that type.

   Where it is applicable and practical there should be subsegments based on smoker/nonsmoker status. New segments will need to be established as new products and clients are brought into production. GAAP accounting will probably require more segments than will statutory accounting. GAAP-era, issue-year groupings should be considered, but these will be of little value due to the short life cycle of most modern products and reinsurance agreements.

2. Selection of assumptions.

   Assumptions need to be selected for each of the cells. These can be based on the pricing assumption or another standard, as appropriate. Three issue-age groups per plan should prove adequate.

3. Development of the new issue projections.

   A project of new issues should be developed for each segment, and factors then produced relating to in-force volume, in-force premium, or in-force statutory reserves. The appropriate measure may vary between segments depending on the characteristics of the underlying data, the basic reports, and the validation criteria.

4. Application of factors.

Factors would be applied to some summary or summaries of in-force business, consistent with the factor development, on each valuation data.

5. Deferrable expenses.

   The company would have to determine the amounts of expenses deferrable in each year, just as with individual cession reinsurance.

The biggest single difference between using models for individual cessions and for bulk accounts is in the validation process. Persistency assumptions provide the most difficulty in checking. If a distribution of the in-force business by issue age within issue year is available, then a model with that actually reported will demonstrate the approximate reliability of the model. If other or less data is available, then other tests must be devised. Comparisons should always be made of the aggregate statutory reserves, volume, and premium produced by the model, with that reported by the reinsured. A comparison of premium per unit of the model, with that reported, can also identify problem areas.

The purpose of the model validation is to determine the accuracy of the results. For example, if all assumptions, such as mortality and persistency, except issue-age distribution are correct, the model can produce some extremely inaccurate results. Validation of the model, while never perfect, can allow reasonable reliance on the results, in effect permitting the substitution of a "per account" factor in place of a "per $1000" factor. Absolute validation is usually possible only if the ceding company will furnish statistics on the business it has ceded. Although this is unlikely, any information produced by the ceding company should be reviewed and considered. Data on the ceding company's total ceded reinsurance, its gross directly written business, or even its net retained in-force business may be useful, depending on the applicability of the data to the reinsurance placed with the reinsurer.

Recoverability and loss-recognition criteria are similar for bulk and for individual cession reinsurance. The model office projections approach already described provides a convenient and simple way to perform these tests. The projections can also be used in earnings projections for business or profit plans, with sensitivity analyses possibly incorporated.

A few practical points should be noticed:

1. There is seldom any special data available regarding facultative cessions and most bulk cessions are automatic. To the extent that facultative business is present and cannot economically be separately identified, the assumptions for that plan or segment should reflect this fact.

2. Most bulk accounts represent single products. If more than one plan is involved, the model must be adjusted accordingly. This may be done in great detail or via the assumptions, depending on the situation involved.

3. Substandard data is often missing or unclear on bulk accounts. The assumptions and the validation process should include reference to expected substandard ratings for both premiums and mortality.

4. The majority of bulk accounts report activity at some point after the appropriate valuation date has passed. Some reinsurers accept this and allow their books to always be one reporting period behind for such clients. Others attempt to project both statutory and GAAP results to the end of the reporting period. If the latter, more technically correct, approach is chosen, extreme care must be taken that earnings are not distorted. Techniques, which produce conservative statutory results, may lead to a reporting of excessive GAAP gains. This result is not only misleading about the performances of the company; it also creates management problems since those earnings must be "made up" later.

5. Tailor-made YRT reinsurance for universal life plans also present a new challenge in GAAP. The typical first-year premium is zero, so the choice of benefit reserve and DAC factors is somewhat unclear. It is mathematically possible to recognize the zero premium, establish no DAC, and create a negative GAAP benefit reserve. On the other hand some reinsurers, equally correct, are inputing first-year premiums equal to the direct cost of insurance, inputing allowances in equal amounts, and establishing DAC and GAAP benefit reserve factors as through the YRT reinsurance were coinsurance of the cost of the insurance. The second approach probably is more correct in theory, but requires more work and is susceptible to error if the bases for the DAC and the benefit reserve are not identical. Done properly, the result should be the same under either method.

The nontraditional accounts theoretically should be handled in a manner consistent with the bulk accounts. However, the nature of the reinsurance and the accounting information provided does not always allow even that level of analysis, nor is such effort always necessary. For purposes of this presentation, nontraditional accounts are meant to include those which originated for surplus relief or primarily for tax-related concerns. Each of these accounts should be handled individually in GAAP, but a common procedure needs to be established.

As part of that common procedure, remember that the basic purpose of GAAP is to recognize income as it is earned. Therefore, the real economic impact of an agreement must be considered. In a typical surplus relief agreement (without significant cash transfers), it is expected that the cash flow will be toward the reinsurer and equal in amount and timing to the "fees" earned. In this situation, the fees represent the economic result of the treaty and should be the only items recognized in GAAP earnings. All other items should be "reversed out" for GAAP purposes. There should be an adjustment to both benefit reserves and to DACs to bring about the desired results. The allocation of adjustments between these two items is based on the terms of the treaty involved. Some reinsurers make the entire adjustment in the benefit reserve and some make it entirely in the DAC.

Either can yield an acceptable earnings result, but may elicit criticism from the auditors.

The best method is to develop a model at the point the agreement is priced and signed. This model would then project future premium flows and relate any expected fees to this. Reserve and DAC adjustments would then be related to this model. Care must be exercised to avoid both too much acceleration and too much deferral in recognition of fee income.

Reasonable approximation on "forcing" of the result has generally been accepted. It is usually accepted as undesirable to grossly distort basic income or earnings reports due to the magnitude of these few treaties. Again, the basic idea is to report the true economic results, not the cosmetics. Recoverability of surplus committed is the most important practical concern.

MR. KERRY A. KRANTZ: Our company has some reinsurance agreements wherein, for the benefit reserve which we report to the reinsurer, we simply apply a factor such as 50 percent to our seriatim calculation, if it is for a plan we share fifty-fifty. That works on a historic basis. However our company was purchased last year, and we have the up-coming administrative burden of doing our GAAP benefit reserves on a purchase basis and doing the reinsurance on a historic basis.

MR. TILLER: Some companies do provide the benefit reserves. The problem with that is that it is rare that a reinsurer would use the same assumptions or would have the same expense patterns. Sometimes it happens or sometimes the reinsurer is willing to take the ceding companies reserves as a close approximation.

MR. KRANTZ: We are just reporting the benefit side, they are doing their own deferred policy acquisition cost (DPAC).

MR. TILLER: Even there I seldom found that the assumptions were the same, but sometimes it is easier to live with reserves reported by the ceding company.

MR. FRANKLIN C. CLAPPER, JR.: Mirror reserving simply doesn't work. It doesn't achieve its intended purpose. The ability of a reinsurer to pay its obligations depends on its overall solvency, so what good does it do to ask the reinsurer to hold a higher reserve on a little piece of its business? It doesn't do anything to increase the reinsurer's solvency. If a reinsurer is authorized, then there is a presumption that the reinsurer will be able to pay its obligations and that a proportional credit to the ceding company should be allowed, regardless of the reserves held by the reinsurer. If the reinsurer is not authorized, then some other instrument, such as a trust fund or a letter of credit, is used to support the reserve credit taken, and this enhances the solvency of the ceding company directly, in the event that the reinsurer is unable to pay. So, either way, whether the reinsurer is authorized or not, mirror-reserve requirements do not achieve any beneficial effect.

MR. SWEENEY: Thank you, Mr. Clapper, for amplifying further; I agree with you on those points.

MR. KLINZMAN: I agree also. It seems to me that a company, as long as the reinsurer is an authorized reinsurer, should be required to establish reserves on its net retained liabilities. The reserve credit it would take for the portion reinsured would be based upon the assumptions it uses in its reserving process and won't necessarily be equal to the reserve established by the assuming company.

MR. TILLER: In general I agree, but I have seen enough situations where there is abuse of regulatory differences on reserves. Specifically, I have seen deficiency reserves disappear in going from one state which required them on an ART plan to another state which didn't. The regulators have valid concerns. There is a lot of smoke, and they may be putting water on the wrong fire. But, it is incumbent upon us to help come up with realistic solutions. The establishment of trust between us and the regulators and better regulation of the total scenario is important. I have seen situations where literally 90 percent of the reserves disappear. Whether or not you believe in deficiency reserves is not important, it is the fact that those reserves are required and the state has a right to be concerned about them disappearing, that is important.

MR. CLAPPER: I think those reserves are required because they are supposed to be a measure of solvency. I contend that if the reinsurer is able to pay, it doesn't matter what the reinsurer's reserves are.

MR. TILLER: But there have been substantial reinsurers who, if they set up deficiency reserves on the level that Texas has required for example, would have been insolvent and, therefore, by Texas law were insolvent. That is a specific example where I think there is room for valid concern, but I think the regulators are getting at the wrong issue. I hope in five to ten years, when the valuation actuary has some sort of control, and we have a totally new valuation system, that some of these things will go away. But until then, you have to deal with these states that regulate with strict constructionalism in some of these issues.

It is a bit of a sham to have these reserves totally disappear without an asset being set up. Now if a letter of credit is set up, that's valid. I agree that they are probably attacking it wrong. I agree that it is totally impractical to use mirror reserves, which are utterly ludicrous just for the timing differences. But we need to look at the other side and agree that there are some valid issues here.

States have had a number of companies involved in reinsurance which became insolvent, mostly on the casualty side, and they have had some big problems. I was in a situation a few years back, where we had two California companies both of whom wrote business in Texas. Neither of these companies was required to set up Texas deficiency reserves by California. Texas required them, and I actually had to put up a scenario where business was written in one company and reinsured in the other and it disappeared. The California Department said it didn't

require me to set them up but the other guy can't take credit unless I do. The mirror imaging is probably ridiculous, but there is some principle here that makes sense.

MR. LEE R. LAMBERT: One of the tests that the IRS applies to reinsurance contracts is what the industry considers them to be. How do we look at them? If we are to get any tax benefit from future reinsurance arrangements, then when we apply GAAP, we need to show what we think those arrangements are. If we collapse them and try to show that there is some kind of a risk transfer, we need to show that also when we apply GAAP.

MR. TILLER: I agree totally and apologize for not mentioning that earlier. That is a very valid point.

MR. KLINZMAN: Is there anybody in the audience who might have another view on mirror imaging of reserves?

The ACLI formed a subcommittee on reinsurance and then formed a task force that is developing seminars to be given to the various state insurance departments. The purpose of these seminars is to be better educate the departments about reinsurance. I would like to see that task force include in their seminars, something about taking reserve credit on business that has been reinsured. Maybe all that is needed is to include, in the reinsurance educational process, something about how to determine appropriate reinsurance reserve credits.

MR. TILLER: I don't believe in the statutory reserving system as it was applied in 1970, where every company has the same statutory reserves regardless of experience and so on. We are moving in a much better direction, and as we do that, we will be able to get to the point where the reinsurers do not have to set up exactly the same type of reserves. Right now, we are in a dollar for dollar world, and that's probably what we have to live with.

In regard to surplus issues, I was recently visiting with the Chief Examiner of the State of Arizona. A small company that was going insolvent had about $14,000,000 in liabilities and about $5,000,000 of assets. My client was interested in bailing the company out and buying it until we spent a couple of hours there and decided that my client could probably spend his time and money much better elsewhere. There was about $1,500,000 of reserve credits on surplus relief that was sitting there in that company, and the state totally disallowed them on the 1984 statement. The state felt there was no risk transfer, and they could not be evoked. It meant nothing in a liquidation situation.

That is part of what the regulators are trying to get to. There was nothing but a piece of paper there instead of hard assets supporting this company. Reinsurance has been used to abuse the system. Something must be done about it, and I think is being done, and what we have to do is work to make sure they don't throw out the baby along with the bathwater, because the bathwater is definitely being thrown out.

I am working on another situation where the outstanding surplus relief through these transactions provided via reinsurance is 100-300 percent of the capital and surplus of the company. In other words, the entire solvency of the company rests with its reinsurers -- often involving paper transactions. If you were a state examiner or official, you would want to make sure that there was something solid backing that up. That is where a lot of this is coming from. It isn't being generated just to cause problems. These educational tours are going to be quite helpful in working out something. I have talked to the Commissioner of California, and he does not have an objection to letters of credit, to trusts, or to any sort of reasonable protective device, but he has to be assured that when it comes down to the bottom line, there is some real money to be drawn on. That is what New York very rightly went after, and we just have to work with them and educate them on our own.