RECORD OF SOCIETY OF ACTUARIES
1985 VOL. 11 NO. 3

GUIDELINES FOR THE REPORTING OF SELF-ADMINISTERED REINSURANCE

Moderator: MARK R. WHITE
Panelists: TIMOTHY FITCH
MICHAEL F. MAGSIG*
BARRY RAPOPORT**
Recorder: DAVID N. WYLDE

"Guidelines for the Reporting of Self-Administered Reinsurance" Exposure Draft which covers: administrative reporting, statutory and generally accepted accounting principles (GAAP) statement reporting, actuarial certification of reports, and reporting required for mortality and statistical studies.

- o What are the proposed guidelines?
- o Why are they necessary?
- o How will ceding companies be affected?
- o What is the impact of recent auditing and U.S. tax law developments?

MR. MARK R. WHITE: The exposure draft of the "Guidelines for the Reporting of Self-Administered Reinsurance" was developed by the Reinsurance Administration Committee of the Reinsurance Section throughout the past year. In an effort to broaden the diversity of the group contributing to the Guidelines, each draft was also circulated for comments to about 20 companies other than those represented on the Committee. A particular emphasis was placed on obtaining the input of ceding companies. After going through these drafts, which incorporated most of the comments received, the exposure draft was prepared for circulation to the entire Reinsurance Section.

The primary purpose of the Guidelines is educational. They can be used by ceding companies and reinsurers in negotiating treaties, in

* Mr. Magsig, not a member of the Society, is Second Vice President at Lincoln National Life Insurance Company.

** Mr. Rapoport, not a member of the Society, is Manager at Ernst & Whinney.

deciding whether to move to a self-administered arrangement, or in implementing a self-administration system. The Guidelines will assist ceding companies in understanding the needs of reinsurers in various areas of reporting. Reinsurers often know what they need from ceding companies that self-administer, but they haven't always done a good job of making these needs known to the ceding companies.

There are several sections which can serve as useful checklists to ceding companies and vendors of reinsurance systems. These checklists do not represent items that must be included in self-administration systems. They are simply items that the ceding company and reinsurer may wish to consider using in their system.

A secondary purpose of the Guidelines is to encourage discussion on the topic of self-administration.

These Guidelines are intended to be impartial. The Committee has tried to develop them to be neither pro-reinsurer nor pro-ceding company.

The major thrust of the exposure draft is that ceding companies and reinsurers should think about what self-administration entails ahead of time and should negotiate on it just as they negotiate on price.

The "Thoughts on Systems Development" section contains a list of questions and issues that should be considered when evaluating self-administration systems. There are many options available, and of course, there is not one right way of doing things. The ceding company should be in a position to make these decisions before it implements a self-administration system. Reinsurers should advise their clients as to the trade-offs of various options.

The "Transmission of Information" section covers such matters as the mode of transfer, timing and format of reports, and how much detailed information is needed. In areas such as these, particularly when we get into a discussion of electronic transfers, it is even more clear that there is no single, correct method. There has been some interest among reinsurers and ceding companies in coming up with a standardized format and core set of data to facilitate electronic transfers.

The "Guidelines for Administrative Reporting" section consists mainly of lists of details that are frequently reported in self-administration situations.

The "Guidelines for Statement Reporting" section consists of a list of statutory information normally required. It takes the approach that the ceding company is responsible for providing the reinsurer with accurate and timely statutory information or else sufficient backup detail to enable the reinsurer to calculate it. If the ceding company calculates tax reserves on a different basis than it does the statutory reserves, that information would normally be made available to the reinsurer as well. Beyond that, however, items which the ceding company would not normally calculate and which would create a lot of extra work for the ceding company, such as GAAP reserves on the reinsurer's reserve basis, should be negotiated.

An additional topic of this section is actuarial certification. A ceding company actuary signing such a certification for a reinsurer would be providing the reinsurer with a statement of the reasonableness of various statutory numbers. This would allow the reinsurer to satisfy its own auditors as to the validity of numbers being reported to it by self-administering ceding companies. It is important that the ceding company and reinsurer jointly negotiate any such certification. The sample in the exposure draft is just that, a sample.

The section on "Guidelines for Statistical Reporting" deals with two situations: (1) where an individual reinsurer is monitoring an individual ceding company, and (2) where the ceding company data is to be included in a larger multicompany study sponsored by a group such as the Reinsurance Section. The information to be provided under this section is completely negotiable.

The concept of the Guidelines generally has been well-received thus far. There has been some legitimate concern that they should not be presented as requirements. This could create real restraint-of-trade problems.

The most controversial parts of the Guidelines are apparently those concerning actuarial certification and statistical reporting. Some actuaries have had problems with the certification because they object to the implied existence of the standards of performance. They also suggest that it is not within the scope of the Reinsurance Section to produce an actuarial certification. The best response to these criticisms is to note that the certification is not required to be completed and that it is only a method of formalizing and consolidating information which would be transmitted anyway. The reinsurer would be looking for some assurance that the ceding company actuary has used his or her normal professional standards in calculating the transmitted information.

Statistical reporting is controversial because many self-administration agreements have currently made no provision for it. From the reinsurer's point of view, this is probably the greatest weakness of self-administration. However, from the ceding company point of view, unanticipated statistical reporting is an extra expense burden, particularly if some of the requested information, such as impairment, is not on the ceding company's system. Depending on the relationship between ceding company and reinsurer, the ceding company may not have seen the results of any statistical studies in the past and may wonder why the reinsurer is suddenly so interested in statistical studies now that the ceding company is supposed to be doing the work.

We at John Hancock had three reasons for considering self-administration. First, historically we had always had a major role in our own reinsurance administration. Second, reinsurance costs are supposedly lower for ceding companies that do their own work. Of course, this can be offset by the increased expenses of the ceding company. Third, we have control over the processing. We are most comfortable in that position because we feel our information is more likely to be right and up-to-date than the reinsurer's.

John Hancock has recently undergone a great deal of reinsurance systems development. We were forced to update our antiquated punch-card system for self-administering our modified coinsurance. We also introduced variable life and universal life products several years ago which we decided to reinsurance on a yearly renewable term (YRT) basis. This was new for us at the time. We chose to self-administer partly because we needed a mechanism to handle reinsurance between our variable life subsidiary and the parent company. If we were going to self-administer that, we might as well do it for the whole program.

Like many companies, we faced a problem in obtaining sufficient electronic data processing (EDP) resources to accomplish all of the needed systems work. Fortunately, we were able to arrange a rotation of a high level programmer into the Reinsurance Department. After a start up period of about six months, we found that this arrangement resulted in high productivity and good interaction between the programmer and the reinsurance staff. We think that we achieved far more for our money through this method than we would have by going through either our EDP department or an outside vendor.

Looking back, we could have used these Guidelines to cut weeks off our developmental time, not because they provide answers, but because they provide questions. We agonized over many decisions that others could have advised us on, but we were reluctant to put too much faith in our reinsurers due to their vested interest. It would have been helpful to have this sort of an impartial reference as a guide. We ended up developing our own approach based more on what we wanted than on any understanding of what the reinsurer's needs were.

As a result of not having the Guidelines, we ran into some problems that could have been avoided; we missed some details; and worse still, we missed some shortcuts. The information that we did get from our reinsurers was not particularly consistent, and they sometimes used different terminology. An impartial and fairly complete treatment, such as the Guidelines, would have been preferable.

We had a tendency to make expedient decisions to move the systems development along which might have been made differently if the matters had come up earlier. This was mostly due to not having a clear idea of all of the matters discussed in the Guidelines well before the development started.

In making the decision to self-administer, I agree with the Guidelines that both the reinsurer and ceding company should carefully explore the pros and cons before signing any agreements. It would be smart to get the administrative people involved up front. A primary task of any negotiation today should be determining who has responsibility for the various areas discussed in the Guidelines. That way a ceding company won't be surprised.

When negotiating a treaty, the ceding company has a right to get some pricing information from the reinsurer. At the very least, the reinsurer should be in a position to give some assistance in determining reinsurance price reductions. Additionally, the ceding company might be able to use the reinsurer's expertise to help estimate what the additional expense burden will be for self-administration.

I do not have a problem with the idea of an actuarial certification, but I agree strongly with the Guidelines that it should be negotiated. I also think that reasonable statistical reporting is acceptable, but only under two conditions: (1) that it is reasonably important to study the area involved, and (2) that the study results will be made available to all ceding company participants.

MR. MICHAEL F. MAGSIG: I hope that my years of experience in reinsurance sales and in general management will provide an additional perspective to this issue which has taken on heightened prominence within our industry in the last few years, thanks principally to the efforts of the Society and the American Institute of Certified Public Accountants (AICPA).

Several factors led reinsurers to propagate self-administration as a means of reporting reinsurance in the late 1970s and the early 1980s. That period could be characterized as one of extreme competition in the reinsurance marketplace. Profit margins had been driven down to break even points and below, and reinsurers were looking for ways to differentiate themselves from the competition on a basis which would be price attractive to large ceding companies. Due to the rapid growth in the amount of reinsurance ceded with the advent of low-cost term market, reinsurers found themselves with significant administrative backlogs to the extent that business could not be processed on a timely and accurate basis. In an effort to resolve this problem and gain a better reading on their total reinsurance costs, certain ceding companies were driven to assume the responsibility for administration and to apply the reduced reinsurer's expense in administering business to lowered reinsurance rates. Ceding companies also found this information flow useful in that it eliminated much of the transfer of paper back and forth between the ceding company and the reinsurer.

The influx of interest-sensitive products into the direct marketplace accelerated the growth of self-administration as the unbundled nature of universal life business and its monthly cost of insurance deductions required more frequent reinsurance reporting of the net amount at risk.

Today, Lincoln National processes business from 791 different domestic life companies. Of those, 232 are presently reporting on some form of self-administered reinsurance. Over 65 percent of our new business volume and nearly 50 percent of our in-force business is reported on a self-administered basis.

Over the last three years, there have been many examples in which reinsurers have requested and/or required more specific detailed information from companies reporting in a self-administered mode. Much of this trend can be attributed to the inadequacy of ceding company reinsurance administrative systems prior to the advent of the self-administered method. Perhaps some of us reinsurers were "living off the fat of the land." In the mid to late 1970s, we were able to realize adequate rates of return on investment without making substantial expenditures in the management and control of our information. However, in the early years of this recent self-administration phenomenon, the marketplace may have led reinsurers to take whatever information a ceding company would supply in order to make the sale. In many of those instances, the reinsureds were not prepared to provide detailed information without significantly increasing the size of their manually-oriented clerical work systems or more realistically, replacing them with a greater technological investment.

An interesting aspect of the reinsurance decision-making process comes into play here. Historically, the company actuary and/or the vice president of underwriting served as the principal reinsurance decision maker[s] within the ceding company. Reinsurance decisions were made basically on the basis of price, level of service, and the nature of the reinsurance relationship between a ceding company and the reinsurer. As direct pricing margins narrowed, more emphasis was placed upon the pricing component in the reinsurance decision. Little consideration, if any, was given to the cost to the ceding company of providing self-administered reinsurance information in a manner acceptable to reinsurers. While at the onset of this self-reporting phenomenon such a cost evaluation was not important, it became considerably more critical as the reinsurance results began to deteriorate. Reinsurers began to realize that the amount of data being supplied on a self-administered basis did not permit them to manage this business in a fashion acceptable to top management.

As audits of Lincoln National's self-administered reinsurance business were made, further requests for more detailed, specific information arose. The reinsurer's loss of control of information in an environment where such control was becoming more critical led to some major changes in the self-reporting requirements, including the needs for ceding companies to:

1. supply accurate information for the reinsurer's general ledger and for its policy exhibit;

2. permit reinsurers to spot check policies, alpha index, and so on;

3. provide information for the reinsurer's annual statement and other regulatory requirements; and

4. provide information for internal reinsurance management purposes.

Internal audits principally led to greater reporting detail with respect to the reinsurance transaction and the need for assuring that the clients were reporting adequate information for retrocession purposes. External audits of reinsurers resulted in the requests for more statement reporting detail such as summary level information with regard to reserves, due and unpaid adjustments, and policy exhibits. This loss of data control by the reinsurer and the subsequent demand for additional data to be supplied by the reinsured may create an advantage for both companies. It may provide a similar approach to managing reinsured business and a common basis for future negotiations.

GUIDELINES FOR REPORTING OF SELF-ADMINISTERED REINSURANCE

With nearly 30 different reinsurers doing business in North America, the need for developing some guidelines for self-reporting has become apparent. It is to the credit of the Society that it has taken a leadership role in bringing this issue to a head.

As a major reinsurer, we find that the proposed Guidelines provide adequate information for us to manage our business. We would consider the Guidelines to be a basic management tool. They can serve as the basis for negotiations with ceding companies. Deviation from those Guidelines concerning the additional information that we feel we may need and concerning the extent to which that additional information or certain other requirements cannot be supplied by a ceding company would be negotiated. We also believe that the Guidelines will provide a good basis of understanding between the ceding company and the reinsurer as to the needs and capabilities of each party.

We can envision several common problems, which ceding companies may have, in complying with these Guidelines:

1. Many ceding companies find it particularly difficult to split policy detail information between retained and ceded business. (Such expense, for example, may more than outweigh the benefits derived by the ceding company from self-reporting.)

2. If the reinsurer requires the data more frequently than the ceding company requires for its financial management, this can produce additional strain on the ceding company's data processing systems and resources.

3. We find that ceding companies are having particular difficulty in providing policy activity on a durational basis, by underwriting impairment codes, and by underwriting basis.

4. The summary reports alluded to in the Guidelines are also difficult for many companies to supply from their automated system, and in many instances, this information is compiled manually.

In order to resolve some of these differences, negotiations between the ceding company and its reinsurer should focus more directly on the information which both companies are going to need in order to adequately manage the business. Such mutual understanding will lead to a greater sharing of results and experience analysis that can be beneficial to both companies and can work to the benefit of each in creating a stable reinsurance relationship. Reinsureds are developing a greater awareness of the total cost of administering reinsurance business. We are beginning to see that the chief administrative officer in ceding companies is becoming a key player in the reinsurance decision.

I see the following implications in adopting the self-administered guidelines:

1. Greater dialogue between the reinsurer and the ceding company on reinsurance administration of the business to be ceded and management control thereof.

2. A greater awareness of and attention to the reinsurance costs associated with the supplying of that information.

3. A greater emphasis upon auditing to the extent that new reinsurance administration systems will be developed that will reduce the amount of human intervention in the process of reinsurance administration.

4. Greater management attention and creativity must be focused on the concept of low-cost production while finding ways to better manage its business.

Reinsurers and ceding companies may advocate the self-administration concept to different degrees. We must accept the fact that while self-administration may be modified, it probably will not got away; therefore, we must seek ways to manage such business to the mutual advantage of both companies. It is only in this setting that the life insurance business will be able to grow so that both direct writing companies and reinsurers can meet the needs of their clients on a profitable and healthy basis.

MR. TIMOTHY FITCH: My company, Security-Connecticut, first experimented with bordereau self-accounting reinsurance in 1978. This was prompted primarily by our desire to find a less costly way to administer reinsurance. Since that time, our mainframe system has continually evolved and now handles all of our reinsurance except our facultative cessions on fixed-premium products, which we continue to do on an individual cession basis, and certain point-in-scale exchanges, which we handle on a separate minisystem. Our system has enabled us to process over 30,000 individual cessions over the last three years with an annual reinsurance administration payroll of under $100,000.

I give Mr. White and the others involved a lot of credit for putting together a paper which can serve as a handbook for ceding companies either already involved in or considering self-administration. This handbook does an excellent job of identifying the various matters which should be examined by ceding companies before making that fateful decision as to how much, if any, of the ceded business should be self-administered. The advantages of self-administration are often a lot easier to see than the potential pitfalls. This paper does a good job of identifying those pitfalls and putting both the ceding company and the reinsurer in a better position to make an informed decision. Rather than going through the entire paper, I'd like to pick out a few of the issues addressed and expand on them a little more from a ceding company's point of view.

The first of the areas I want to discuss involves the responsibilities of the ceding and assuming companies in developing and implementing a self-accounting agreement. More often than not, the reinsurer is more familiar with the concept of self-accounting than the ceding company. They've been through it before and probably have more expertise in the area. Additionally, if a self-accounting agreement is implemented, the reinsurer will depend on the ceding company to provide the reinsurer with the reports that enable it to generate the general management information, financial statements, and statistical studies. For these two reasons, I feel the reinsurer should be responsible for making it perfectly clear to the ceding company what reports the reinsurer needs and when it needs them.

The reinsurer should also make sure that the client understands that the list of required reports may grow. For example, as a result of the recent tax law change, some ceding companies may have to calculate reinsurers' tax reserves. This will involve creating a report that was not foreseen when the treaty was first signed. These Guidelines and the Statement of Position (SOP) on Auditing Life Reinsurance may also eventually force the ceding company to produce reports not envisioned when it made the decision to go to self-accounting. The additional burdens placed on the ceding company can make for some interesting discussions between reinsurance partners as to who is responsible for the cost of reports that are needed only by the reinsurer but which can be produced only by the ceding company. For those direct writers to whom self-accounting is new, I feel that the reinsurer also has a special obligation to educate them as to what really is involved. I feel professional reinsurers should caution against self-accounting in those cases where the necessary elements are lacking, even if it means presenting an offer which has higher rates.

Especially in the early days of bordereau accounting, it is not much of an exaggeration to say that reinsurance partners often agreed on a set of rates which would apply if the ceding company self-administered the business, without ever really discussing what self-administration meant. Therefore, in making the decision, the ceding companies knew what the savings in rates would be without knowing or understanding the quid pro quo. It is my biased opinion (as a member of the ceding company community) that when the reinsurer explains the rate-savings for going to self-administration, it must also be sure that the ceding company is aware of its new responsibilities.

These Guidelines can do a lot to enlighten both parties to the agreement as to what specifics should be discussed. The ceding company can then more accurately weigh the potential rate savings against the system's development and maintenance costs in deciding for or against self-accounting.

This brings me to my next area, that of errors and omissions. The Guidelines state that when applied to a self-accounting arrangement, this treaty provision is "not intended to cover situations where the system is known to be deficient when it is put into production," but would cover "incorrect cessions caused by undiscovered design and programming errors." There is sometimes a fine line between what was "known to be deficient" and what was an "undiscovered design error." Let me give you an example. In determining whether a new policy requires reinsurance, our system searches for prior policies on the same life to figure out what we had previously retained on that life. In doing that check, our alpha index system looks for all priors on individuals with the same first eight letters of the last name, first four letters of the first name, middle initial, date of birth, and sex. What this means is that an application on Mary J. Jones would not be recognized as being on the same individual as in an application on Mary Jones, without a middle initial. Therefore, the following could occur: On January 1, 1984, an application on Mary J. Jones is received for $500,000, which is our normal retention. That policy gets issued and paid for, and we fully retain the $500,000. On January 1, 1985, the same individual applies again, but this time, as Mary Jones, without a middle initial. This application is for an additional $500,000. Once again, we issue the policy and fully retain the $500,000. Now, if and when Mary dies, we'll be overretained. The question is whether or not that is a known deficiency in our system, or a design error. Almost regardless of the system used, this type of possibility exists. If Mary dies, would our automatic reinsurers step in and pick up the second $500,000 policy? On this specific issue, our system is not quite as rigid as I'm portraying it, but this type of overretention could occur. We handled the possible confusion by making sure our automatic reinsurers knew how our alpha index system worked. We were assured that should an overrention situation result, we would be covered. But again, because of the gray areas, our reinsurers told me to make sure that all you ceding companies understand the importance of developing long-term relationships with your reinsurers.

Actually though, as in many phases of a reinsurance relationship, good communication and understanding between partners is crucial. No matter how diligent both parties are in setting up all the reporting procedures, something will fall between the cracks. With computers often doing the work, we are pretty much insulated from the random error to which humans are subject. However, we are more subject to the errors in the system which can cause a certain type of policy to be consistently handled improperly. If the error goes undetected for several years, it's always nicer to have a reinsurer with whom you've had an ongoing relationship, to help you work out a way to correct the problem prospectively and make any appropriate retrospective premium adjustments.

If the error is the type where the reinsurer has been notified of all its risks properly, but it has just been underpaid, we've had success in getting our reinsurers to agree on a method for approximating the size of the underpayment rather than going back and reconstructing the technically correct adjustment on a cession by cession basis. It's even more important to have a good relationship when the system error is the type that results in some lives not getting the proper amount of reinsurance, especially if the error is discovered at the time of a claim on which the reinsurer is asked to pay more than it ever knew it was on the hook for.

The next area I'd like to comment on is the decision to either set up a separate reinsurance master file or to build all the necessary reinsurance information into a trailer on the policy master file. We use trailers on our policy master file on all policies whether they be self-administered or cession-based to help us produce the reserve and in-force listings we need, as well as to help us calculate the premiums for most of our automatic reinsurance. As mentioned in the Guidelines, the primary advantage of using this approach is that we avoid the additional complication of making sure that our two systems are in sync.

However, for companies just entering self-accounting, one of the biggest considerations in making this decision should be how much control you have over your data processing resources. If all the reinsurance processing is done on your mainframe, and you are vying for those always scarce data processing resources with other areas, you may need an extremely understanding and patient reinsurer to put up with the kind of delays you can run into. We've been able to overcome some of the drawbacks of using the mainframe system two ways. First, the Actuarial Department, which includes the Reinsurance area, is allocated a certain number of data processing bodies. Therefore, in competing for resources, we're only competing with the rest of the Actuarial Department, and I have a little more control over that than I would if I were fighting for resources with the rest of the company. When we do run into delays due to more pressing needs in the Actuarial Department, we have been able to take advantage of some of the modern data base management techniques by purchasing a report-generating software package which enables us to manipulate our master file. This allows us to generate ad hoc in-force and premium reports to get us by until the mainframe system for a new product or series is ready to go.

Now I'd like to discuss the need and desire for gathering data for statistical studies. Since I once worked as an actuary for a professional reinsurer, I understand how frustrating it must be to be deprived of all that great data which used to make experience evaluation easier. From a ceding company's point of view, I must admit it's nice to be able to control the amount of information that the reinsurers have. But, in the long run, we have to find a way to get all the data to the reinsurers so they can do their own studies. The Guidelines cite the advantage for the ceding company's ability to assemble and distribute these data for others to analyze. This ability allows the ceding company to get some studies that it otherwise may not be able to get and to assist the industry in being able to assemble data on intercompany studies.

In order for the whole thing to work, however, there must be a single format for reporting data. If every reinsurer develops its own required format, it will just delay the day when the reinsurers can once again determine lapse and mortality figures on an industry level. I hope this uniform format will be one of the eventual by-products of these Guidelines.

As the number of self-accounting clients grows, and with the publication of the AICPA Statement of Position on auditing life reinsurance, it is inevitable and prudent that the reinsurers step up their level of audits on their reinsurance clients. However, each audit involves quite a time drain on the ceding company's administrative areas, and we've tried a couple of different techniques to keep that time investment on our part to a minimum.

First, since all our automatic reinsurers are in a pool, and their business is all processed on the same system, there is no need for each individual pool member to audit us. So, when we have been audited, we've shared the results of those audits with the other pool members. Second, before a reinsurer comes in, we ask for a reasonable outline of what reports or files they'll want to see. We can then assemble all of this ahead of time. We've found our reinsurers cooperative in scheduling audits around our "bad times," and they have been good at completing their audits within the promised time frame.

In conclusion, I think bordereau self-accounting, in our case, has been a salvation. The headaches it has caused us would have been dwarfed by the migraines that would have been created by sticking with individual cessions. I think these Guidelines put both ceding companies and reinsurers in a much better position to judge for themselves which type of administration best fits a given situation. And for that, the subcommittee is to be commended.

MR. BARRY RAPOPORT: It's always encouraging to see an attempt made to improve the level and quality of data being submitted to reinsurers, which is always helpful to an auditor like myself. I'd like to give some background about the overall problems of the auditor in the reinsurance area and how the accounting profession has addressed some of those problems. Specifically, I want to deal with the Statements of Position in both the property and casualty and life areas in the last couple of years and also make a point about the Federal Accounting Standards Board (FASB) Statement on Auditing Standards No. 44 which prescribes a mechanism for communicating between external auditors on the ceding side and external auditors on the reinsuring side.

The environment in both the property and casualty and life reinsurance areas has been quite volatile over the last few years. On the property and casualty side, inadequate pricing of direct insurance and reinsurance and inadequate and untimely information coming from the direct writers and the reinsurers, has caused two problems: (1) on the ceding side, an increasing problem with knowing the security of your reinsurers, and (2) on the reinsurer's side, as an auditor, being able to determine whether or not the financial statements of the reinsurer make any sense at all. The life side has not been nearly as bad, probably because reinsurance is not quite as pervasive on the life side, and the quality of information has been better overall. There have been, as on the property and casualty side, some pricing problems over the last couple of years, but these are probably clearing up now. This shift toward self-administration has caused auditors some concern. The problem for the auditors is not unlike the problem for the reinsurer's management. There's generally less information available at the reinsurer (I'm talking about auditing the reinsurer now, not the ceding company), and it's not easy to report that information in a way that might be useful for analytical or audit purposes. The second problem at the reinsurer's side of the audit is that the ceding company's controls become increasingly important in the self-administration situation. Two potential problems are that (1) the business may not be quite as important to the ceding company as it is to the assuming company so the ceding company may not place as much emphasis on internal controls in relation to that business, and that (2) even if the controls are good, it's difficult, if you're auditing the assuming reinsurer, to determine what those controls are and whether or not they're functioning as prescribed. So it becomes a communication and a logistics problem. The auditing profession has faced that situation and has come up with ideas on those problems.

Basically, you need more flexibility in auditing under a self-administered reinsurance agreement. You have to understand the business aspects probably better than you do the processing arrangements and have a better feel as to where problems may arise. The concept of materiality becomes more important because you can't go running around to every ceding company and audit its books.

The auditing profession is concerned about these problems. Auditors got very nervous about five or six years ago when they realized there may be some opinions on both ceding companies and assuming companies that aren't justified by the evidence gathered. So the AICPA issued the SOP on Property and Casualty Insurance effective for 1983 and has recently issued, as you are aware, the AICPA SOP on Auditing Life Reinsurance effective for 1985.

The SOP serves a number of functions. First and most importantly, it educates auditors as to the kinds of things that ceding and assuming companies should be doing and the kinds of procedures they might want to do in auditing reinsurance. It represents good practice, so it serves as a standard against which you can measure the performance of the company which you are auditing and your own performance. And most importantly, it represents authoritative literature. The SOP will be a bit different from these Guidelines when they become nonexposure draft and go final in that an AICPA member would have to justify departures from the requirements of the SOP in such situations as litigation or regulatory review of his papers.

In summary, the SOP is common sense. I don't think there's anything tremendously exciting in it. It says that the ceding company ought to know something about the security of the assuming companies they are doing business with--something probably most ceding companies who are doing the job do anyway. And on the assuming company's side, the SOP says that you probably ought to know something about the nature of the business you are getting into. You should have the means to determine that either the ceding company is controlling that business adequately, or you should have your own procedures to control that business and determine that the information you receive to make business decisions and to put numbers in your financial statements is adequate and accurate.

The wording of the SOP is authoritative, and therefore, it's intentionally vague. One gets the feeling after reading it of "So what?" It's written legalistically as any of the standards on auditing statements are written, primarily because of the authoritative status. So it leaves open a lot of room for flexibility on the audit side. It makes suggestions as to which controls may be useful but doesn't say that if a company doesn't have a specific control, you've got a problem. So there's a great deal of judgment in applying those procedures to a given audit situation.

The SOP mentions that, in certain cases, it may be useful for the assuming company or the assuming company's auditor to report an internal control from the ceding company's auditor. Specifically, Statement No. 44 is mentioned. This is a new statement of auditing standards, which coincidentally came out about the time of the SOP but probably had less to do with the insurance business than it did with the data processing business and the third party administration type business we're seeing in lots of industries even outside of insurance. This is where someone else controls your information flow, and your auditor has no way of determining whether or not the controls over that information are any good. In that situation, the ceding company's auditor could apply specific procedures and controls at the ceding company and give a report to the assuming company's auditor on those controls, which presumably would obviate the need for either the assuming company's internal audit or management staff or the assuming company's auditors to go to the ceding company and test those same controls. I haven't seen too many of these reports, but I think it's an area which could be fruitful in the future.

Probably the reason we haven't seen too many of these No. 44 reports is that they can be a costly exercise, and they're probably not cost-justified in most situations in which you have a relatively immaterial treaty. Where the treaty is significant to either the assuming company or the ceding company, this type of report from the ceding company's auditors could be significant.

My specific comments on the exposure draft overall are very positive. It serves as a good educational tool to the reinsurer and the ceding company. And specifically in the audit environment, it serves auditors as a good educational tool and a good checklist when they're looking at self-administered reinsurance. The Guidelines stress the importance of controls and adequate systems of the ceding company, which are critical to getting accurate information.

I've seen specific situations of such problems in the last year or two at a couple of my client ceding companies in which they just were not in the position to get into a self-administered reinsurance agreement. They were starting up new lines of business. The lines grew rapidly and of course, the data processing systems development effort concentrated more on marketing the business and getting it on the books than worrying about the information needs of the reinsurer.

If the information suggested in the Guidelines was complied with in every self-administered reinsurance arrangement, I think that would be more than adequate to any external auditor.

The role of the external auditing environment is given more importance or power in the exposure draft than actually exists in practice. Maybe I'm a bit skeptical, but I don't believe that most of my clients look to see what the auditors want before they design their systems. But if they do and if the Society believes that the auditing environment is important and should control the reporting and information process, then maybe a bit more explicit recognition of the criteria in the SOP should be mentioned in the audit guide. For example, if it would be useful to get a ceding company report on internal controls, or a report from the ceding company's auditors on internal controls with respect to the processing of a significant treaty, then possibly the negotiation process should explicitly take that into account. And the cost of doing that should be taken into account because some of these internal control reviews can be costly. But with this information, the companies could reduce the overall cost of administering the agreement for the combined ceding and assuming company.

In reading the exposure draft as a nonreinsurer ceding-company person, I got the feeling that the systems area was written from the point of view of what the reinsurers would like the ceding companies to think about before they get into self-administration. My feeling was that it's the reinsurer's responsibility to tell the ceding company precisely what the reinsurer needs in terms of systems. It may be possible to reduce overall cost to the ceding and assuming company by having an assuming-company EDP person consult with ceding-company EDP personnel with regard to information system requirements.

The last item I had a specific point on was the actuarial certification. As an auditor of an assuming company, I certainly would like to get copies of that actuarial certification. On the other hand, I'm not quite sure I could lend as much credibility to the certification as the guide suggests. The ceding company actuary, of course, would not necessarily be considered independent of the company about which he's reporting. The specific auditing literature that would apply in this situation would allow me, as the auditor of the assuming company, to make use of his certification but in a less meaningful fashion than if he were independent, let's say a consulting actuary. I would have to consider his relationship to the company and probably have to test some of the calculations that went into his certification rather than totally relying on it without any further testing. Of course, I would still encourage the certification because of the professional standards that the Society of Actuaries has.

One point I would like to mention is that the SOP seems to be causing some changes in practice. We found in a couple of places where, although the controls suggested in the SOP existed, they (1) weren't documented very well, and (2) may have been disbursed throughout the organization. There was no single person in the organization who could say they did the four things that the SOP suggests, even though the assuming company did them. So we found that several companies have undertaken a project to get a team together to document what they are doing with respect to these controls and to make one person responsible for the relationship with the auditors in that situation. I've also found that some companies are actually moving toward more visits to ceding companies, more audits of ceding companies, and more importantly improving the in-house information systems to monitor the business to determine how it actually is performing in relation to what the reinsurers expected when they got into the agreements. I'm not sure that the SOP was the impetus for that. My feeling is that the business environment was just as much of an impetus, and the SOP just happened to come along at the same time because auditors were getting extremely nervous with the business environment.

The experience on the property/casualty side, since the SOP has been in place for two years, has been pretty good. The biggest impact was on the ceding company's side. I've noticed a trend that ceding companies are paying a lot more attention to the quality of the security and also documenting what they do to determine what kind of quality there is before getting into agreements. On the assuming side, I've seen less emphasis on the SOP, primarily over the last couple of years, probably because of the extreme price competition. Reinsurers haven't had the luxury of really dictating terms to the ceding companies. I think that will turn around now that the environment is improving a bit.

MR. PAUL BRAZILLER*: Mr. Fitch, you mentioned that you are in a pool. Do all of your pool members accept the one report that you might generate?

MR. FITCH: Yes. Right now we have, I think, seven members of the pool, and they all accept the same premium and in-force reports. Up to now, that's been one of the conditions if you wanted into the pool. Whenever any new member was taken in, we laid out what reports we had, and for the most part, we haven't had any problems with them accepting those formats.

MR. BRAZILLER: Mr. Magsig, you mentioned 232 companies are on self-administration. Do you ask them all to try to come close to the report that Lincoln wants? And if they don't, doesn't it complicate matters even more than single cessions when maybe 100 or 200 companies of those 232 have a different self-administering form to use?

MR. MAGSIG: Yes. In the last year in working with our internal auditors, we have categorized our self-administered accounts into one of three groups. The first is those whose reports are satisfactory, in terms of our being able to obtain minimum acceptable information so that we can look at the statements and track the changes on that business. The second would be those companies who are progressing satisfactorily toward reaching that point. We see regular improvement toward reaching a minimum standard of acceptability. The third category is companies who are progressing unsatisfactorily. And we make periodic reports to our audit committee of the board on the progress we're making in reducing that number of accounts. I believe we have nine companies in that third group. Several of those are new companies from which we haven't seen any reports. There's a core there of about five or six companies that are not progressing satisfactorily. A couple of those are grandfathered situations, and they are giving us considerable difficulty in that we may have had this agreement for eight or ten years. Their systems are such that it's extremely difficult for them to supply the additional information we need. In at least one instance, we are no longer doing any new business with that company. So their motives for wanting to make those changes for their in-force business with Lincoln are not that great. We continue to meet with them on a regular basis in hopes that we can reach a successful compromise from both of our vantage points.

*Mr. Braziller, not a member of the Society, is the Reinsurance Sales Director at Security Life of Denver.

MR. FITCH: The only objection from the pool that we had pertained to the format of the reports about a year ago. Since we have seven or eight members of the pool and we generate very large quarterly reports, we decided we were going to have those all put on microfiche and send them through as microfiche instead of hard copy paper. Some companies balked at that because some of them didn't have microfiche readers.

MR. PHILIP GOLD: Mr. Rapoport, I was surprised to hear your comment that, in the case of an in-house actuary signing the self-administered reinsurance actuarial certification, you would feel it incumbent upon yourself to go and check his calculations. Perhaps some of the actuaries on the panel might comment on that. Also, have any of you given any consideration to the Canadian environment where there isn't a statutory reserve as such and whether self-administration is appropriate under those circumstances?

MR. RAPOPORT: Although I'm not sure, U.S. auditing may be a bit different from Canadian. But normally, ignoring reinsurance, say I'm doing an audit of statutory financial statements of a life company, and the in-house actuary certifies the actuarial items in those statements. As an auditor, I simply can't accept that as is. I'll audit the in-force business, of course, and I'll audit the transactions, but I also have to test check using the U.S. auditing standards to see that the calculations of reserves are correct. Even in a statutory situation, the requirements are probably greater for an auditor in the U.S. I know in the U.K., the distinction between auditing and actuarial is a bit greater in the sense that the auditors in the U.K. (for the statutory requirements, the U.K. Department of Trade) do not check the correctness of reserves as calculated by the actuaries. It's not part of their audit of the company's financial statements. In the reinsurance area, that certification would just serve as another control which I can take into account among all the controls that exist on the business coming to the assuming reinsurer. If the assuming reinsurer also occasionally visited ceding companies and did a lot of internal analytical work, I may not have to go to the ceding company and check that actuary's calculations. If it was necessary to do some checking, we would normally have an actuary, say on our staff, go do it. But I may have to personally if it was a material treaty and if the controls of the ceding company were not as good as they should be. If there was no ceding company external auditor to give me comfort, then my only alternative would be to check. I'd probably check less in the situation where I got the certification than I would without a certification, but I still would have to check.

MR. WHITE: In general, I think that the Guidelines are equally appropriate for Canadian and U.S. reinsurers since they are meant to simply touch on information that would be needed. Obviously, the specific statutory information that's in there is peculiar to the U.S., and you would have to use the actual Canadian blank to get real Canadian information. But that would be more a matter of just substituting one format for the other. The general philosophy behind the Guidelines and the types of information generally required for adequate control by the reinsurer are certainly going to be comparable in both countries.

To the extent that you have a U.S. client and a Canadian reinsurer or vice versa, you have the additional complexity that the reinsurer may be reporting on a different basis than the ceding company. In that circumstance, I suspect that it's only fair to the ceding company that the differences in reporting be one of the negotiated items in setting up the treaty.

MR. BRUCE E. NICKERSON: There is, I believe, a presumption in the auditing profession that independence in terms of making certain certifications is an important control. At the level which, I believe, the reports are generated, which is the ceding versus assuming company, the practical reality is that the assuming company would, in most circumstances, feel far more comfortable with a certification from a full time company actuary and not from somebody who was in and out and less familiar with all the things that could fall between the cracks, as in a consulting situation. This is just one of the points that often causes confusion and some disconcerting reactions because of the difference in perspective. The auditor has to place great emphasis (as it is done at least in the U.S. in the Securities and Exchange Commission (SEC) context for example) on this independence whereas, I think the proper concern of the assuming company is competence and quality and familiarity, all of which are in reality weakened when the person making this certification is independent of the actual operation.

MR. RAPOPORT: That's a good point. I don't want to overemphasize the independence idea. If you look at the specific auditing literature on the question of using a specialist in your work as an auditor, one of specialists specifically mentioned in that section of the auditing requirements is actuarial. It is also specifically mentioned in there that even if the person is not technically independent, as long as he works for the company, you can still use that work as part of your audit. I think the level of checking would be substantially reduced with an actuarial certification. The other point is the cost. The actuary, in that situation, is a member of an accredited professional group and subscribes to a high level of professionalism. That's a judgmental factor that an auditor would certainly take into account. So I think all the information has to be considered. There may be instances where I may not be so worried about the accuracy of the information as long as the surplus is adequate. I may put a little more emphasis on that kind of a certification whereas I doubt it would be much help in the GAAP situation. I don't know what the intent is with GAAP, but in a situation where it's a public company, I would be a little more careful in relying on somebody's opinion who is a member of management of the ceding company.

MR. MICHAEL R. WINN: Mr. Magsig, now that Lincoln has had a chance to review the exposure draft, what steps does Lincoln plan to take in working with its self-administered clients? And, Mr. Fitch, it sounds like you've got a great system that's been working for some time, but how does it comply with the Guidelines?

MR. MAGSIG: Our intent initially would be, once the exposure draft becomes final, to share it in depth with our sales staff and to review what changes we can make to the present reinsurance negotiation process. We would want not only to inform the new clients of this draft when we're negotiating self-reporting with them, but also we might want to bring in the administrative officer more directly and earlier into those negotiations. On existing arrangements, we're going to focus more directly on those category two and three groups I mentioned where the data isn't sufficient for us to book and track that business. It would be our intent to share the Guidelines with those companies and ask for their reactions (principally from the actuaries) on what we can do to improve the level of detail. We're already doing that with the unsatisfactorily progressing category. But I think we'll focus more on the middle category as well.

MR. FITCH: In terms of assessing how our system complies with the Guidelines, I think we have all the types of reports that are shown in the Guidelines, but we have just slightly different formats. The one that we haven't done anything with yet is the reporting of the statistical data to the reinsurers in a usable format either in a tape system or other media. That issue may lead to other things in that if the industry can develop a uniform format where that statistical data can be transmitted to the reinsurer, it will be basically back in the position in which it has all the data it needs to do the administration. Originally, I think, when self-administration started, this was because it was considered folly to have two companies set up identical records and go through the same type of administration in order to do the billing. There's a real potential there, depending on what happens to the technology, if we can agree on a uniform format. We are now sending the reinsurers all the data they need to do the studies. They also have all the data they need to do the billing and the administration. So a lot of this may just fall by the wayside, but I think that's a way off.

MR. CARL J. STRUNK: We have several clients from the reinsurance side who have universal life with us, and we have yet to run into any good system that handles it. I would ask if anyone in the room knows of a good commercially available system?

MR. FITCH: Offhand, I don't. Originally we had intended our mainframe system to handle universal life. We ran into one of those situations where we had other things more pressing in the Actuarial Department, and it forced us to do it on a minisystem for about a year or a year and a half before we actually put it on the mainframe. In that time, we learned a lot. One of the things in particular that we learned was that we made many simplifications over what we had envisioned originally. For instance, we don't pass our whole universal life master file through the system every month to calculate the new fund balance and the new net amount at risk. We only do that annually. As a matter of fact, on a group of policies, all we do is project net amounts at risk and then true up after five years. There are things that we would have done originally in order to try to take advantage of all the information that is potentially on the system, but we backed off because the cost savings didn't seem significant enough. There are things like that that can be done to save money. But I personally don't know of any other commercially available system that does it well.

MR. MAGSIG: I'd like to add that we're in the process of doing two test installations on a system which is being run against the master policy record file in the ceding company. Therefore, the data for administering reinsurance are only going to be input once--at the time of issue at the ceding company. The structure of that system is such that it will meet the Guidelines and will meet our mandatory reporting items. We will have those two tests evaluated by the first of September. They are being presently installed so it's a little bit premature for me to say that the whole thing is working fine. We feel confident about the prospects; we're able to say that we may have a viable approach yet this year.