RECORD OF SOCIETY OF ACTUARIES
1986 VOL. 12 NO. 2

REINSURANCE FROM CEDING COMPANY'S STANDPOINT

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- Retention limits
- Administration
- Drafting of treaties
- Facultative shopping

MR. WILLIAM A. PORTER: Reinsurance has become a very important part of our business, and to the small company, reinsurance is of critical importance. Without reinsurance the small company can't compete in the markets with the larger companies and must rely on reinsurers for support in both risk taking and in other services. Reinsurers provide services to us in the form of underwriting, administrative services and, more recently, in the area of financial services. The needs of ceding companies with respect to reinsurers have changed considerably over the last few years, and the reinsurers have responded to meet those changing needs in various ways. We will examine some of the needs of the ceding companies as they are in our contemporary world and the ways that the reinsurers have responded to satisfy those needs.

MR. JOHN E. BAILEY: Despite a comment I heard about the demise of shopping programs, ours is still alive and well. I'd like to describe a little bit about it and talk about shopping programs from a more general point of view.

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We are a general agency company with captive agents; we do not write brokerage business. We have a philosophy of conservative underwriting and lowest possible cost. We also have a philosophy to pay claims whenever they are justified. Those kinds of things are pretty important for any kind of reinsurance, but particularly for a shopping program.

Our shopping program is very helpful to us. I will give you four reasons why it is good for us, and nine reasons why it is not, and let you judge which of those sets of reasons is dominant. That is a good structure to discuss the features involved in a shopping program.

Our biggest reason for shopping has to do with our field -- the retention and recruiting of agents. Before we were able to shop substandard applications, a lot of our agents went down the street because our underwriting was more conservative than that of a lot of companies. When our agents would get an occasional impaired risk, they knew they could get a better rating somewhere else, and did so. Our concern was that they might stay there. When our agents placed the business elsewhere, our General Agents got no override on that business even though they provided training and housing. We wanted to have that business at our own shop if at all possible.

A second reason, of course, is that it is better for the client. We've got to consider the client's best interest, and if we're able to get a better, lower rating for him, that is to everybody's best interest. He's going to be a better client and stick with the company rather than going somewhere else.

A third reason is that a shopping program will expand our direct business. The portion that we retain, of course, is an expansion of our business. There may be ancillary sales, which produce more premium income, spread our unit cost, and add to the benefits of increased size.

The final advantage may be unique to us. We're strictly an individual policy company, but we do write some small business situations through a guaranteed acceptance program. Typically we will agree to write coverage up to certain amounts at *some* rating. We are able to do this because we normally can get

some kind of reinsurance coverage for it. Therefore, we can offer this benefit in a group situation without any real additional cost.

Those are the advantages. Let's talk about the other side of the ledger for a minute. One of the biggest disadvantages we have seen is a shift in the quality of the business that is submitted to us. Before we had a shopping program, we emphasized our field selection very much and relied heavily on it. The agents knew if they came in with an applicant who was impaired, they were not going to get a favorable offer from us, so they didn't send it to us. With shopping, we shifted the emphasis and told our field force agents to send all their business to us so that we could shop it for them. Since the change, our doctors, have perceived a distinct difference in the quality of business being submitted. That puts an additional strain on our total underwriting operation because a much smaller proportion of our applications are clear and of quality needed for a select rating. That is what we asked for and that is what we got. It's a disadvantage and we have to live with it.

A corollary to that is the expectation of favorable ratings by our field. It gets harder and harder to make a substandard rating stick. The normal reaction, when you tell them that not even the reinsurers will not take it standard, is "Well, you'd better go and get some better reinsurers." I am sure anybody with a shopping program has heard that a few times.

The third factor that we were really concerned about was the effect on our underwriters and on our underwriting standards. A shopping program subjects your underwriters to second opinions time after time. If they underwrite to your company's underwriting manual -- your standards -- they will get undercut time after time. They have to be able to withstand that. You have to reinforce them on the reasons for your standards, whatever they are. Otherwise your underwriters may start thinking that the reinsurance shopping program rather than your own underwriting manual defines the proper standards.

Every shopping program has a threshold rating; that is, you may shop everything above your class 2 or class 6 or standard or whatever it is. Inevitably, an applicant will be just below the threshold, and the agent will want the underwriter to increase that classification so that it then qualifies for the

shopping program, and he can come back with an even better rating. An ironic result.

The fourth disadvantage is that any portion of the shopped business that you retain is an automatic loss to you, unless it is factored into the pricing. Assume you are retaining 20% of the risk. If your underwriters rate a given application at class 4, and the reinsurer says it's a standard, that means that you are taking 20% of that risk at a standard price instead of a class 4 price. If you really want your shopping program to be self-sufficient, you must consider that in the pricing for the shopping program.

Another somewhat more subtle disadvantage of shopping programs is that shopping introduces inequities into your pricing structure. There are several kinds of inequities that I have been able to identify. Obviously, the retained portion of a shopped case is inequitable in that the insured is on your books at a lower class than your underwriting standards indicate, and at a lower class than an otherwise similar individual somewhere else in your portfolio. Insureds who qualify for the program are going to be rated more favorably than those who do not. Wherever you establish the threshhold, this will happen. Some applicants just above the cutoff will be reduced several tables. Suppose the cutoff is class 2 -- anything above class 2 is shopped. Some applicants will be rated class 3, shopped, and issued standard, whereas others who are not quite bad enough to be 3 will be stuck at table 2. That's an inequity in the overall structure of your book of business. If the shopping program has an amount qualification, it will produce the same problem. Agents will apply for enough insurance to qualify for the shopping and later reduce it. That is another kind of inequity. Another more subtle one is that your shopped business is essentially nonparticipating; that is, it costs whatever the reinsurance premiums are. Yet if you're paying dividends to that business, that business will benefit from increases in dividends even though it does not really contribute to them. Another inequity inherent in shopping programs.

My next disadvantage has to do with expense and time delay. I will not spend a lot of time on that, but you can imagine that there is much expense involving additional requirements, shipping papers off to reinsurers, and so forth. It is expensive and time consuming.

Another potential disadvantage has to do with differences in claim philosophy. As I said at the outset, we have a pretty pure claim philosophy. We will pay a claim particularly in the life insurance area, if we think there is a good reason to pay that claim. There may be some reinsurers who are a little more cautious at claim time than you are as a direct writer. That's something you need to discuss at the beginning -- is your claim philosophy consistent with that of the reinsurer?

Another difficulty we have is with inability to reconsider ratings. Reconsideration is a tradition at our company. If an individual is issued a substandard policy and later improves the factor causing the rating -- blood pressure, weight, or whatever it is -- we will underwrite that individual and lower the rating if appropriate. However, if we're locked in to a reinsurance premium schedule, we cannot do that. We've made that very clear to our field, and they do not like it. Our clients often choose a retained policy at a higher classification over a reinsured issue because of the possibility of reconsideration. They know the individual situation and I expect there is some antiselection there, but it helps place the business.

The final disadvantage is actually one of the bigger ones. Our shopping program has been there for so long and has grown to such immense proportions, that the agents really take it for granted. If the time comes that we are not able to have a shopping program, it will have a traumatic effect on our field force. The agents are used to the fine ratings that they are able to get through shopping, and I personally shudder to think of the day when we will not be able to rely on it. Our underwriters are going to have to get on the phone and say to a lot of agents, "No, we cannot issue this on a standard basis; it's a class 6."

That's the end of the list of advantages and disadvantages. Every company has to weigh those for itself to determine how a shopping program will fit into the company's particular operation. Now I would like to cover a little bit about call pricing in shopping programs, and some of the mechanics of determining the parameters of a program.

The pricing really represents the balancing of the costs and benefits of the shopping program. We have a philosophy at our company that no block of business really should subsidize any other block of business, and we apply that philosophy to our substandard shopped business. It makes for some interesting decisions sometimes, but we generally have been able to maintain that requirement. Being a participating company, our basic requirement is that the dividend scale mortality charges on any block of business are sufficient to cover the reinsurance premiums on that same block of business. That's a very simple test.

When we started the shopping program about eight years ago, we used reinsurers' premium schedules. Of course, every reinsurer had a different premium schedule, and that made life very, very interesting. At that time, the basic philosophy of the reinsurers was to set a rather wide standard for "standard," that is, let the standard class include a quite large proportion of all applicants. This was very convenient; reinsurers could put a relatively high price on their standard classification, and also include a very large portion of all business. It all sounded good to the direct writers -- almost everything is "standard." When we looked at those standard costs, and compared them to our direct costs, we found that on the average we had to charge our second substandard class just to recover the reinsurance premiums for that "standard" offer. We did just that for a couple of years simply to make this block of business self-sufficient. That is, when we got a standard offer from the reinsurance shopping, we issued a class B policy. That was a competitive disadvantage because a lot of other direct writers did not do it, but later on some of them did adopt that strategy.

After a few years, we borrowed an idea that circumvented this problem and developed our own reinsurance premium schedule. That has a couple of advantages: (1) it's a lot easier to administer one reinsurance premium schedule than seven or eight, and (2) we were able to reduce those premiums to a level where a standard reinsurance offer could be issued on a standard basis. That is, the reinsurance premiums were set low enough so that our standard dividend mortality charges would cover them. We expected to get a much lower percentage of standard offers than before but were surprised that the percentage did not go down very much. With that mechanism we were able to issue a lot of business

rated at class 6, class 8, or declined according to our own underwriting standards at standard, class 1 and class 2. We were really forcing the reinsurers to price individual applications more precisely than they had been willing to do before, and we got very good acceptance from the reinsurers on this particular structure.

I want to discuss the mechanics of establishing a facultative program. Several things have to be considered at the outset. One of these is the parameters -- which applications will qualify for your program? This has to be defined precisely to avoid chaos. Do you want to include just prepaid or all applications? We include only prepaid. It really helps the placement ratio for the reinsurers, which is very critical to them. You probably want to establish some kind of minimum size; we use a $100,000 size. The reinsurers have to underwrite every application and, at $25,000, even if they get the case, it's not going to pay for their underwriting.

Which classifications to include is a very important question. We started out with table D or two times our standard. Gradually this has been lowered until it includes everything above what we call our standard smoker classification. So the program has expanded. The tendency of both your field and your underwriting department will be to want to expand the program; you have to determine as you go along whether or not expansion is appropriate costwise.

Another aspect with some programs is differentiation by particular impairment. We have never done this since we have never really been able to verify that reinsurer A is good in impairment A and reinsurer B is good in impairment B.

Another question is how much to retain. Appropriately, the reinsurers are going to want you to retain something; this is more true today than it has been in the past. Most reinsurers require that the ceding company retain at least 20% of each risk in a shopping program. As indicated before, you have to recognize that 20% as part of the reinsurance pricing since it is not issued in the appropriate class for your regular pricing.

How many reinsurers should you include in a shopping program? Keeping reinsurers is something like keeping a harem -- the more you have, the harder it is to

keep them happy. There's a very good reason for that -- reinsurers are in the business to be profitable. Typically, they want at least a 20% completion ratio; of all the cases they underwrite, they need to place at least 20%. It's not too hard to figure out that if you're sending cases to six reinsurers, not many of them are going to get 20% . Right now, we're shopping most of our business to three reinsurers and some of the business to four, and I think they are all close to that 20%. That's a big consideration for them.

A little more about pricing. If you use the reinsurer's premium schedules, you must have a way to determine which of those offers is best. They may all give you a standard offer but unless you have a solid analytical technique, you do not know which one is best. We simply use the present value of the first 20 reinsurance premiums.

Another problem is to determine which of your own pricing classes to use. If you get a standard offer, can you afford to issue a standard on a self-supporting basis?

The other option is to develop your own reinsurance premium schedule, or steal one somewhere, or require one of the reinsurer's schedules to be used by all of them. This simplifies the comparison of the offers among the various reinsurers, but of course if you do that, you're going to get common offers on many cases. That is, if three reinsurers all come back standard, you have to have a mechanism to determine which of those three reinsurers should get the coverage. We have an allocation system based on the alphabet.

There are many other costs to be considered in the pricing. I will mention only a few of them here. Some reinsurers now charge fees if your placement ratio is inadequate. Dividend additions on participating shopped business increases retained risk in a class lower than indicated by your underwriting.

Conditional receipt claims are another concern. What happens if there is a claim during the shopping period? You want to get that defined up front so everybody knows whose risk it is. We have been able to get our reinsurers to agree to share those claims with us. In fact, we have written that into our

treaty, and we are very pleased that the reinsurers are willing to participate with us on that basis.

Another aspect is the treatment of inforce substandard policies on lives that are able to qualify for standard insurance through the shopping mechanism. Our reinsurers have agreed that, if there is current evidence based on a new application, they will accept a reconsideration of inforce business on the same life. That insured and that agent are not going to ask, "How can he be standard today and class 6 on the old policy?" The field will not tolerate such inconsistencies, and you have to have some kind of mechanism to deal with then. Otherwise the business will be rewritten.

There are lots of administrative routines sending papers back and forth and keeping track of which reinsurer has the best offer on each application. And, there is what might be called post-issue support -- maintaining records of the reinsured business, making sure that the reinsurance premiums are paid and keeping the reinsurer informed of any changes that happen to reinsured policies.

Finally, I will mention what we look for in a reinsurer.

My first item is reputation and public commitment to the American reinsurance business. That probably is the best assurance we can have that a reinsurer is going to be there a decade from now. It is going to be giving good service if its name is in front of the public as a reinsurer.

A related subject is solvency of the reinsurer, claim philosophy of the reinsurer, and its willingness to accommodate your program. Every one of these programs is a little different, and it must be very difficult for the reinsurers to keep track of and to accommodate all of them, but that may be very important to the ceding company.

We now come to price. That is an important consideration, but probably not as important as many of those other ones. The last one is service. Not that service is unimportant, but in many underwriting areas, service simply is not critical to our company.

In summary, a shopping reinsurance program can be very beneficial to your company, to your field, to your clients, to your general agents, and it can operate at a minimum cost. It can be self-supporting. The field response will be very positive and if properly designed, it can operate with a minimum of disruption of your underwriting operation. Thank you.

MR. PORTER: Would either of our other two colleagues care to comment on facultative reinsurance? You might extend the comments to cover facultative as a tool as opposed to a facultative shopping program.

MR. PAUL H. PEARSON: Jack, have you done any analysis, not only as to the percentage of your total business that's coming under the program, but in addition, perhaps some of the placement or not-taken ratios with your own field force?

MR. BAILEY: Our shopping program and a related automatic program include 6 to 8% of our total face amount of business. Two or three years ago we had much better statistics than we have today, because we are developing an electronic program for these statistics. Since we did require only prepaid business in the shopping program, we were able to place about 80% of all the business for which we got some offer from at least one reinsurer. We thought that was pretty favorable.

MR. ANDREW F. BODINE: I'd like to make a comment about the administration of these shopping programs. Although it's in conflict with the basic function of providing support to the agents' efforts to place insurance, having more facultative outlets will balloon the administrative complexities because of the different records, company reports, rate schedules and so on. The total number of facultative outlets should be limited. Even though a single case might be shopped in only a few companies, the administration unit is locked into years of working with all the reinsurers.

MR. JEFFREY G. STEVENSON: I was confused on the pricing comments. You mentioned one block of business not subsidizing another, and I didn't get from your comments that you treat the shopped business alone as a separate class with its own dividends.

MR. BAILEY: Shopped business gets the same dividends and premiums as our regular business. My point was that we do not want to incur higher costs on shopped business than on retained business, recognizing that it enjoys the same price as retained business of the same type.

MR. STEVENSON: So it's really coming to the level of substandard premiums?

MR. BAILEY: We view it as a matter of classification. We classify each reinsured policy at a class that is high enough to support whatever reinsurance premium we have to pay on that particular coverage.

MR. STEVEN P. MILLER: If you received a quote from a reinsurer at, say, 200%, and you did your present value calculations and your results were that 175% of your mortality charges would satisfy the reinsurance cost, would you then give the benefit to the policyholder and give him a table 3?

MR. BAILEY: Yes, we would have done that when we were using various reinsurers' schedules. Now that we have our own schedule, that's not a possibility because the reinsurer has to name the class and that automatically indicates our issue class. If they say class 3, we will issue at class 3 and know that the costs are in balance.

MR. MARK R. WHITE: I was at John Hancock before joining The Wyatt Company and I just wanted to make an observation along the lines of what you've been talking about. The difficulty of explaining to your marketing people why something that's called standard isn't standard can often be extended to the underwriters. Sometimes even the actuaries in the actuarial department, if it's a separate group of people, will find it's probably a common occurrence that the actuarial department may not specifically be pricing for the fact that substandard business is being included in disproportionate amounts in the standard block of business. And the underwriters may not be specifically trying to deal with that lack of pricing, so there could be general uncoordination within the company as far as handling the substandard businesses flooding into the standard block. It's more of an observation than a question, but it's probably more common than a lot of people want to admit.

MR. BAILEY: I think it's really the reinsurance administrator's responsibility to make sure that that does not happen.

MR. DOUGLAS M. LANDRY: Jack, how did the actual mortality proportion you retained compare to your dividend mortality?

MR. BAILEY: We haven't actually looked at the mortality on our shopped business for a couple of years. We did look at it back in the late 1970s, and it was higher than on our retained by as much as 3 or 4 tables.

MR. PAUL E. BUELL: You mentioned six factors that you take into account in choosing a reinsurer if you're the ceding company. Five of those are essentially nonquantitative, at least on the face of it. Do you attempt to quantify those factors, and if so, how do you do it?

MR. BAILEY: We really haven't tried to quantify those up to this point. Several things that have happened this year have put a lot more emphasis on solvency, so that we are going to look more carefully at that in the future. But we have dealt with large mainline reinsurers and felt that that was our biggest safeguard, and I guess in truth it probably is.

MR. BUELL: So what you're saying is that you consider safety to be first and foremost in your own mind.

MR. BAILEY: Yes.

MR. PEARSON: I'll comment on both the selection of reinsurers as well as the determination of retention limits. A basic point is that whatever you're doing, whether it's facultative shopping or determining your retention limits or selecting reinsurers, you really need to take into account your company's overall and very broad strategic marketing direction. What's the focus? As all of us here know, reinsurance has gone well beyond the traditional role of risk sharing, into such items as tax planning, deferring first year acquisition costs, surplus relief, and supporting particular target marketing strategy. So I think the first step in determining your own retention limits is to visit with your marketing, and your underwriting department as well as senior

management. Get a good handle on what they perceive as target markets, and equally important, what they perceive reinsurance achieving in those markets. I think that's the first and a very important point.

The second factor in selecting reinsurers is in applying your traditional rules of thumb as they relate to the assets, surplus and inforce. You obviously need to take into account not only your average size policy and your company size, but more and more today a critical emerging issue for all of our companies is the geographical distribution of your business. If you're heavily concentrated in certain areas of the country, where there's a very high incidence of AIDS, it's a major factor in determining your own retention limits. Just looking at AIDS, it's the leading cause of death at ages 30 to 44 in New York City right now. So there are many factors in determining your retention limits that you really have to take a look at.

As far as selecting reinsurers is concerned, I was intrigued by Jack's observation about consistency and stability. I think that's very, very important. One of the big concerns that your company's marketing and underwriting departments have, I believe, is trying to maintain a consistent philosophy and policy of underwriting to your field force -- not one that changes from year to year, depending upon whether a particular reinsurer is trying to gain market share through cutthroat underwriting techniques. Some of the European reinsurers entering the marketplace several years ago came into that marketplace by buying substandard business, then cutting back. Many other reinsurers have periodically experimented with programs in underwriting, only to later withdraw. What that does to the direct writing company is that it leaves the company in a position of either exposing its own field force to very inconsistent underwriting policy or forcing the company to seek yet new reinsurance outlets. So it's a complex subject and one that involves many considerations, with the bottom line that for any business relationship to work at all, it needs to be mutually profitable not only for the direct writer but, equally important, for the reinsurer.

MR. BODINE: As an actuary, I have to look quite closely at reinsurance costs in the selection of reinsurers. Many years ago your automatic business went to only one reinsurer. You had just a few others, and you had facultative

outlets. Currently, each time we come up with a major new product, it seems to go out for bids on a coinsurance basis, or, at least on a coinsurance approach to determining YRT rates. We have been selecting a reinsurer for each particular product, so we don't have only a single automatic reinsurer to deal with anymore. The rate structures are often specifically designed for our own company.

I very much favor long term relations with a reinsurer and would like this competitive bidding on a product basis to end up with a reinsurer with whom we're already comfortable doing business. I find I'm swayed somewhat by the personal relationships that develop with these companies over the years of dealing with them. On the other hand, if another company comes in with a lower cost, the difference is significant, and there's no apparent reason to have the underwriters say they're uncomfortable dealing with this other reinsurer, (and that's a key factor in making a choice -- the underwriters have to be comfortable with the underwriting staff of the company), it's very hard to turn away from this more competitive bid, and thereby introduce a new automatic reinsurer. I think I'd opt not to go for a new automatic reinsurer if the price difference were small; I certainly would consider opening up facultative agreements with aggressive new reinsurers and, over a period of time, if the underwriters push for more business being sent there, they might earn their right to an automatic contract.

MR. PEARSON: Bill, I'd like to come back to one thing and ask perhaps some of the people in the audience to comment on it. It seems to me that from a direct writing company's standpoint, they have more and more been exposed not only to wild underwriting, but frankly to some wild pricing on the parts of the reinsurers. That's extremely disconcerting, yet I have no idea where they're coming from at times, and it is a critical factor in the selection of reinsurers.

MR. PORTER: I agree. I was just going to add a question along the same vein as to the extent that you feel that you're obliged to submit requests for proposals to multiple reinsurers simply because you're not very comfortable with the entire pricing structure.

MR. BODINE: Bill, as long as we're on the subject of choosing reinsurers, I've got some other items I'd like to mention briefly. Anyone might volunteer to add to these considerations which go beyond the underwriting comfort and the price competitiveness which seems to be most important.

As another cost consideration, some reinsurers offer opportunities to participate in retrocession pools. This certainly should not be ignored as a possible source of reducing reinsurance costs.

I'd like to look to my reinsurers for some help on keeping me up to date with what's going on in the insurance industry. I know they can't share specifics of product designs of competitors, but if we're unaware of a trend, they could certainly help us out. Broader awareness of what companies are doing in smoker-nonsmoker rates is an example of information I would want from reinsurers.

Sometimes the reinsurers can be like an external auditor, by providing in-formal management advice. If they are concerned about the direction in which the company is headed, a good sales rep would be able to pick this up and suggest caution, a different way of doing business, or a market to get into, or avoid.

Many smaller ceding companies might want help in training their administration staffs or their underwriting staffs if they do not have enough depth of experience in their home office. A lot of larger companies who can do this on their own are quite proud of their own underwriting capabilities, but the smaller companies may need to look for this kind of support.

If you got into a legal claim contest -- do all reinsurers have adequate legal staff to really support you in contesting the claim the way you'd like them to? Or, would they be more inclined to let you sink or swim on your own if you want to contest a claim, even though they'd be willing to pay their share of expenses? Then, what about punitive damages?

I find with new regulations coming out that I look to reinsurers for some interpretation, especially in areas where I'm not really clear on the impact on my own operations.

Policy language developments -- I'm very concerned about how to handle smoking misstatements in the smoker/nonsmoker world, and I've asked my reinsurers what they see other companies doing. I don't have any other good source as to what's going on right now with other companies.

Certainly we look to them for treaty preparation. I find treaty preparation varies quite a bit from reinsurer to reinsurer. Although the basic price and the product information is usually all right in the contract, there's a lot of language that may be inconsistent. For example, Universal Life treaties might contain references to nonforfeiture benefits that really just don't apply. As another example, we have a disability benefit with our Universal Life product that provides a specific dollar amount for the benefit. The benefit is not proportional to the Universal Life benefit because there isn't any specified premium being waived. But the reinsurance treaty has come back with the disability benefit reinsured stated as being proportional to the life benefit reinsured. So, treaty details need a defensive review by your own administrative people, your actuary, your legal departments and so on. The better job the reinsurer does, the less burden you have on your own administration people. NOTE: This does not take away from the large amount of expertise and effort which the reinsurers put into the initial draft of the treaty which could not be produced at all by most ceding companies, including my own.

The question of a reinsurer's financial strength has come up. Which reinsurers aren't licensed in all states? How acceptable are letters of credit? If they're supported by a European parent company, what happens if it significantly reduces its support? Where does that leave the direct writing company? Does it start over again to find another reinsurer for in force business? It's a concern we've had. I'm not aware of any actual negative experience of this kind as yet, but we wonder when something like this might come about.

Self-administration has come to be a practical necessity with Universal Life contracts. We're not doing the job we would like to do with our own self-administration. How tolerant are the reinsurers of accepting temporary limited self-administration until you can do a better job? How tolerant is the reinsurer of going along with you to work out problems that were unanticipated?

I've just reviewed a pretty long list, meant to be only examples of considerations which help guide the choice of who you'd like to do business with -- considerations that extend beyond the more obvious pricing and underwriting considerations.

MR. PEARSON: One thing I'd like to suggest that people might want to do when they get back home, Bill, is take a look at how many reinsurers your underwriting departments are using (if your companies are actively engaged in using reinsurance as a marketing tool). And I say that because the underwriters do not view reinsurance shopping in terms of its overall cost impact or in view of some of the critical items that Jack and Andy have indicated here. To an underwriter, it's simply a marketing device to accomplish an overall total objective. What I'm suggesting to you is that you may be shocked at the number of reinsurers that your companies are using. It may be as many as a dozen and the fact that the shopping is done not with a rifle or shotgun approach, but rather very, very indiscriminately. Done on that basis, it's not profitable for the reinsurers, obviously, but I'm suggesting it may not be profitable for you, either. You may be shocked at how many reinsurers are really being asked to quote on substandard cases. It can be shocking if you don't stay on top of it.

MR. BODINE: We have already touched on the level of retention, and I'd like to address that subject more at this time.

Here again, the obvious concern is cost to the ceding company. There should be a cost to reinsurance. The reinsurers are not in business to lose money; they're not a welfare organization any more than we are, and so any risk amount reinsured should have a cost attached to it. If the cost is about break-even for you as to whether you keep it or reinsure it, it doesn't make much difference what your retention level is. On the other hand, if it's costing quite a bit to reinsure, you want to raise your retention as much as you think you can stand to cut down those reinsurance costs. Some companies reduce their retention on a product selective basis because they're better off with reinsurance than without reinsurance. So maybe having an amount of retention that's applied in all cases throughout the company is not appropriate anymore. When

you're dealing in specialized markets, or in experimental markets, it may be appropriate to reinsure proportionally, such as 50% of all policies.

That brings up recapture interpretation. Suppose you have a standard retention of $100,000, and you reinsure on a 50-50 basis. Your treaty calls for recapture at the end of 10 years. In the meantime, your regular retention has increased to $200,000. At the end of 10 years, what amount is recapturable? Or, even if you haven't increased retention, what does a recapture clause in this treaty mean?

Beyond the cost, the claim comfort level to the Board of Directors, or to the CEO, is important. How much of a strain can they stand? There have been a few formulas attempted. I looked at a copy of a survey Dave Holland distributed in 1977. It has a broad range of responses. Just to pick some central numbers out of it, 2% of surplus seems to be a fairly common level to set retention. Alternatively, retention might be set at about 0.05% of the face amount in force or 1% of assets. Another company distributed a formula to add the company's surplus and the annual amount of life premium, reduce that sum by the amount of annual reserve increase, and set 1% of the result as the retention level. Back in the days when life insurance was stable, that might provide a nice growth rate for retention. But with the volatility going on today, I'm not really sure how practical those guidelines are.

I've had a practical (non-formula) suggestion made, and I think this originated at Lincoln National. Review your spread of risks of business with respect to your retention levels. At what point would you incur a loss to more risk exposure per policy, but not save reinsuring very many policies? If raising retention another 10% would save the administration cession work on 100 or 200 policies, that would probably be a good move. But if you'd only avoid reinsurance on 5 or 10 policies, it wouldn't be a good move at all. So its a relative administration cost guideline. If this brings you to an amount where your CEO and your Board are uncomfortable, maybe there's an educational problem. They may need to better understand why the spread of risks is reasonable at that level.

Of course, there can be other concerns such as cash flow, level of annual operations gains, etc., which cannot be ignored. There are also reasons for keeping your retention low if you need surplus. If you're growing awfully fast and you can't afford the surplus strain of new issues, then you'd want low retention so that on the major part of new business expense, you'd get surplus relief.

There are two marketing concerns that come into play which I've just recently encountered. We have a term product for which we're getting quite a few applications on large amounts that don't qualify for automatic cession, so they must be sent to the reinsurer. This can cause delays if the reinsurer wants more information, or wants to rate it higher than we feel is needed. This delay can create field force discomfort. I suggest that if you raise your retention, then your automatic binding limits go up by a multiple of that retention and there would be at least a higher level, an added layer, where you'd achieve more agent satisfaction by having your own competent home office underwriters making those decisions instead of needing to send the case to the reinsurer.

There have been some special marketing efforts in terms of policy exchanges, accepting rollovers from one policy form to another, or taking over another company's in force business on your own policy form with limited underwriting. Your reinsurer may not be comfortable with these actions. If you raise your retention, you can do more of this special marketing within your own retention, without involving the reinsurer. You probably can't do it at the levels above where you're willing to raise your retention.

I'd also like to suggest you consider different retention levels for supplemental benefits. For the accidental death benefit, why not retain nothing and take advantage of bulk reinsurance opportunities? There can be a lot of savings, because bulk ADB reinsurance rates can be very attractive compared with the price charged when it's just a supplemental benefit on a single policy. The single policy cost can be almost double the rate charged per thousand on a bulk basis. Bulk ADB administration can be pretty simple -- once a year reporting to the reinsurer in aggregate.

Consider level retention as opposed to proportional retention. With level retention, you reduce the reinsured risk by the entire amount of reserve increase in your policy; you don't use an initial ratio of the face amount of the policy whereby only the initial proportion of the risk amount is retained for the policy lifetime. For a permanent plan, this would achieve reducing your reinsurance risks and getting all reinsurance on the policy off the books sooner than with proportional retention.

Consider coordination of insured risk with other departments. Assume you have an ordinary $100,000 policy, and the Group Department has another $100,000 on the same life. Assume you've got an ADB benefits for $100,000, and also a health policy with an AD&D clause for another $50,000. If you have a $100,000 retention limit and don't coordinate, your company could have a $350,000 retained claim. I think there's a lot not being done in coordination on retention levels between the different departments within a company. For many companies just detecting multiple policies on a life in only the Ordinary department is one of the most difficult administrative problems.

This checklist of things to consider on the subject of retention shows there's a lot to think about beyond just cost, comfort level and risk fluctuation, which are the more obvious reasons for setting retention levels.

MR. BAILEY: I'd like to mention one other factor having to do with retention limits, and that's COLA products. We have introduced a couple of cost of living products recently and found that, under the right economic situation, a policy that is within retention limits initially can be 3 or 4 times the retention limit at the end of 10 or 20 years. You have to give some consideration to that in setting retention limits.

MR. JAMES R. HOREIN: Both Jack and Andy included on their list of criteria for choosing a reinsurer a comment about claims. Jack I think was saying it is important to understand the reinsurer's claim philosophy, and Andy had on his incidental list, looking at a reinsurer's ability to investigate and/or provide legal support. I was pleased to see the prominence of that particular criterion. I would be interested in what either of you or members of the audience do right up front to make an assessment. Jack, that the philosophy is

the same or compatible; Andy, that you feel you would get the support you'd need. By right up front, I mean as an early pre-agreement assessment.

MR. PEARSON: I'd like to help, Jim. For those of you who haven't seen it, you might read the February 1986 issue of the Lincoln National *Reporter*, which has a very excellent write-up on this very critical issue of the reinsurers' philosophies on claims and their whole approach to this. I agree that it's far better to find out what that philosophy is well up front in advance of a problem than to wait until after a problem occurs. But this particular issue of the Reinsurance *Reporter*, I am sure Lincoln has extra copies, is an excellent synopsis of your question, Jim.

MR. BODINE: I'm afraid there's not a specific way of investigating this question, but to the extent it's recognized and considered, reputation has a lot to do with it. To what extent do you hear scuttlebutt about reinsurers? Do your friends in other companies tell you "Gee, we've had some problems with this company or that company." I think a larger reinsurer has some strong advantages over a smaller company. It's something the smaller reinsurance companies have to find a way to overcome, because they probably can't afford the legal staff, or might not have the broad experience that the larger reinsurers would have. If you feel that there's a legal support deficiency, is that offset by price competitiveness? How are you going to make a choice? It's not clearcut. It's often very difficult to make that kind of a decision. It's hard to be negative when a smaller reinsurer looks good and is really trying to do a good job to grow and these "iffy" questions exist.

MR. BAILEY: Other than discussing it right away, you can start off with a modest shopping program, send them some facultative cases and see how it works out, before you get into a gigantic automatic program.

MR. PEARSON: I think, Jim, you brought out an excellent point. Europe has many, many more small reinsurers than we do here in the United States, and some of the very early facultative shopping programs utilized some of the very small European reinsurers. People very quickly found out that while the claims might ultimately be paid, the Europeans had a slightly different philosophy than we did as to the timing of the payment of those claims. You might find that as a

direct writer in the United States, you'd be expected to settle those claims promptly, particularly when they're building up at an inputted rate of interest that you've got to add to the proceeds. Many of the small European reinsurers look at reinsurance very differently, not so much the risk taking aspect, but as to the money aspect, and it's very important in considering who you do business with.

MS. JOHANNA B. BECKER: A couple of thoughts on what we have done regarding claims. One of the things that we have noticed is that more recently in treaties the claim language is becoming more specific, and I think that's a very good sign because it spells things out much more clearly. If a treaty isn't as detailed as we think it should be, we are asking that the necessary language be added. One of the things that our law department feels very strongly about is that we do not relinquish control over the claims so that the ultimate decision remains ours. We are certainly willing to send all the papers out, discuss the case with the reinsurer, but the final decision is ours. If we feel there is a good reason to pay the claim, we will pay the claim. And we have seen in some of our treaties that the reinsurers have language that says they will not participate in punitive damages. We agree with that in principle, but our feeling is that if they expect to share in decision making process on a claim, or say, take over the decision making process and have control over the claim, then they have to be willing to recognize that if they take control away from the ceding company, they could put us in the position of being hit with punitive damages if there were delays in payment or some other circumstances that are then beyond our control.

MR. DALE R. VOLLENWEIDER: I'd like to ask the panel members to comment on the importance of considering catastrophic reinsurance when setting the retention level.

MR. PEARSON: I might be able to help on that, Bill, because we do have at Security Mutual, in addition to participating in a catastrophic risk pool which is an Accidental Death pool, stop loss reinsurance. In our case, we happen to get it through Lloyds of London, and that's set at about 125% of the expected level of claims. We went into that approximately 15 years ago. We have a very high average size policy, we're a relatively small company, we have about $10

billion in force, but an average size business policy of close to $150,000. We also have a CEO who's a marketing person, and frankly we went into stop loss reinsurance not only in light of the particular characteristics of our company but also because of our CEO because we were looking for an executive sleeping pill. It's a great thing. Those of you who haven't looked at stop loss reinsurance might look at it, because it enables you to have some safety in increasing your retention limits particularly if you want to increase those limits for marketing reasons and retain a greater share of that risk so you have more control over a particular product line.

MR. BODINE: I'm very much in agreement with the use of the protection against catastrophic losses in order to help increase retention. I don't think we have enough of it in my own company. Maybe we need to raise the priority of that item a little bit. I might question whether that's "insurance" or "reinsurance," but anyway, catastrophic protection is certainly needed.

MR. BAILEY: I might add that we also participate in a catastrophic reinsurance pool to take care of that aspect of the risk.

MR. BODINE: We made an effort a few years ago to simplify reinsurance treaties from all of the add-ons that had been made, and we find we're back into that pattern. We've gone from generalized simplified treaty language into more and more complications. But I see the need for this added treaty language and support it because of the amount of litigation that's going on: jury awards, law suits, claim denials, smarter agents and smarter customers trying to put one over on the insurance companies, so we get more misrepresentation cases. Smoker misrepresentations are becoming a major concern. I think in the past the treaty was looked at primarily by the underwriter and the actuary, and if there was an administrative unit outside either of those departments, the administrative people were told what had to be done. There wasn't any feeling of need for others to see the treaty. It's very important for the claims and legal department to see those treaties now before they are signed so that they review the aspects of the treaties that may affect them.

In this context I also want to endorse the use of the article written by Jim Schibley at Lincoln National. Some of our attorneys who are getting more

involved with reinsurance don't have the experience, and the article is an excellent primer. It covers many different aspects of a reinsurance treaty for the novice attorney who is being handed this responsibility. It can be used as a starting point to get educated as to what should be in the treaty, and what his concerns should be. Data processing people need to look at what is needed. With respect to policy changes and policy issues, these departments need to look at the treaties so that they appreciate why the records need to be kept and when changes might be needed for reinsurance records. Too often, policy issue people and the policy change people are unaware of reinsurance. It's not part of their world and if they happen to miss noting that a policy needs reinsurance -- c'est la vie. It's a much more important activity than it ever used to be, and a lot more people should pay attention to it. I'm even thinking in terms of an area I've not yet touched in my own experience -- variable life insurance. Is there going to be a need for the investment people to start looking at reinsurance treaties to the extent that policy benefits or investments might be related to some treaty provisions?

I commented earlier on treaty drafting. It has to be accepted as being a joint effort with the reinsurer. It must be reviewed to be sure that everything fits the situation you thought had been agreed upon. I have found that when making changes and trying to negotiate details that didn't come out when the major negotiation was taking place, neither the ceding company nor the reinsurer wants to upset the agreement by being overly hardnosed about language modifications. By major negotiation I mean that the choice of reinsurer has been made and the pricing has been determined. So if either side decides it wants more protective words or a little something different, there is a lot of cooperation. I also find that for oversights or when situations come up that haven't been thought of, most reinsurers are very willing to go along with amendments to treaties and modify them as practical necessities. There's a huge emphasis on being practical with reinsurance treaties. I think working in general with this approach has been one of the pleasures of the reinsurance world because of the lack of being too nitpicky about what language could mean or not mean. Again, there's a caution with the way litigation is going recently.

I've prepared a list of things that might be negotiable within a treaty.

a. The recapture period might be something that could be negotiated after the pricing has been set, or maybe some of these are negotiated as part of the price setting process.

b. What about the maximum automatic limit or the jumbo size case reference? Some of that might depend upon what the reinsurer thinks of the ceding company's underwriting department as to how much its willing to be bound automatically. The reinsurer's retrocession limits might impact the jumbo case language.

c. Premium tax reimbursement can be negotiated a little bit. I might suggest that there's one point about which differences of opinion might exist. For coinsurance premiums most people agree premium tax is reimbursed on the whole premium, not just the net cost premium after allowances. The usual YRT schedule has no implicit "total" premium as a possible comparable tax reimbursement base. But when you devise YRT premiums in the coinsurance fashion, where you use the direct writing company's YRT rates less allowances, I think there's a lot of merit to thinking of the whole premium, not just the net YRT premium, which would be the basis for premium tax reimbursement. You might consider talking to the reinsurers along those lines. On the other hand, maybe whatever is agreed on is just reflected back on setting your allowances. It might be a wash in whichever way this question is resolved.

d. For self-administration, what has to be there and what doesn't could be a subject of negotiation. There is a lot of effort put forth in the administration effort; that's the next topic, and we'll cover a little more there, but a fairly standard set of administration information requirements has been developing in the industry.

e. Volumes of business: At least one major reinsurer has taken a position that it would volunteer to reduce costs if the volume of business was much larger than anticipated. In any event, if there's a large discrepancy in the actual amount of volume that's issued compared to a lower amount that was anticipated, the ceding company might negotiate more favorable costs

for continuations of reinsurance under that treaty. Some reinsurers might consider that good public relations and go along with it.

f. Punitive damages were touched on. I think that's an extremely important point to discuss with your reinsurers; get your legal department and your claim department involved in the negotiation. The way facultative business will be covered is another area of negotiation. Practices differ quite a bit among the reinsurers.

MR. PEARSON: The area of conditional receipts has been mentioned a couple of times. It's something that I think is of tremendous importance. In most automatic reinsurance treaties, you'll find the liability of the reinsurer commences coincident with that of the direct writing company, and so it's really not a problem when you've got a conditional receipt case. Where the conditional receipt does become a problem is when you're involved in facultative reinsurance, because typically under most facultative treaties, the liability of the reinsurer does not commence until the coverage goes to that particular reinsurer. There is a hiatus of reinsurance coverage if your company has accepted a conditional receipt or temporary insurance receipt case. This happens many times, where you are bound above the conditional receipt limit and above your company's retention limit. Very often, the underwriters will not turn that down, but rather go out and seek reinsurance. The problem is, what happens on a million or two million dollar case, if you have a death claim while you're facultatively shopping that case? Jack has indicated his company has apparently met that up front in their treaty negotiations. I'll suggest that 90% of the direct writers in this room have not addressed that in their treaties. I think that's extremely important in today's litigious climate.

MR. BODINE: I had one other comment on treaty language. If there's a complex area to cover with treaty language, it's got to be the subject of policy changes. If there are increases or decreases in risk due to policy changes, what will happen as far as proportionate changes? What if multiple reinsurers are involved, and you get involved with other policies that were issued before the current reinsured policy? What is your new retention base? I really hope that what I've seen so far continues, in that it is the one area that's kept

away from trying to be complete for treaty language. The generalized intent should be part of the treaty, that changes are treated proportionally among the insuring parties -- the various reinsurers and the direct writing company. But the details and the types of things that can happen are just enormous to contemplate. I hope that this is an area where we don't lose the gentlemen's agreement feeling, and that ceding companies will understand the need to not show bias against the reinsurer. Fairness to all parties must prevail, flavored by practicality.

MR. BODINE: This may be the biggest point I'd like to make for this session. Most of us, in one way or another, are involved with universal life. There is no way that universal life to my knowledge can be handled without some self-administration. Very few companies have received the attention needed priority-wise from their data processing resource to provide the necessary information, reports, policy changes, etc., for reinsurance self-administration support.

There are a few efforts around that I'm aware of -- a firm called PDA, originated with Francona (Kansas City), and we get mailings about that system fairly regularly. Lincoln National has given its support to a system called PULSAR that its sharing with some Lincoln clients. I understand Phoenix Mutual is working with some electronic data exchange ideas, either on tape, or floppy disks, or otherwise. There may be other efforts of which I'm unaware, but some general self-administration capability available for all companies would be excellent because of ceding companies dealing with multiple reinsurers and the reinsurers dealing with multiple ceding companies. I hope that some of these efforts prove fruitful in eventually coming up with workable data processing system support. We're certainly on the right track; a lot of good people are putting a lot of time and effort into it. If there is one biggest obstacle, it's got to be getting your main frame computer master record modified to provide 150 or so extra bytes just so you can put some reinsurance information in there. For example, some codes are needed to index tables of different reinsurance rate schedules, to identify which plans are subject to which treaty and where they appear for your annual statement reports. Reserve adjustments are needed. Your alpha index should operate, so that you're able to electronically identify multiple policies on the same life and not depend upon manual identification.

I've tried in two companies, to get the attention of the CEO to raise the level of importance of this data processing support, and I've had some moderate success, but to me it's the biggest weakness in the whole administration area.

MR. PEARSON: If you want to have more success, any of you, you ought to put a bug in the auditor's ear and have him do a report because the auditor's report goes directly to the Board of Directors.

MR. BODINE: If we don't have self-administration, consider the traditional system where the cessions are sent to the reinsurers. This is not without problems, either. The reinsurers have staffing and consistency problems of their own just like ceding companies have, and their records can be inexact; they might not pick up changes; they can be late in timely delivery of annual statement information. The converse is the reinsurer needing to look to the ceding company for annual statement information.

Reconciliation with reinsurers can be a huge job, particularly when there is a sudden growth in business, and you're just not staffed up in the many areas to cope with it.

One of the major problems being discussed now is whether or not reserves should be "mirrored" in the reinsurer and the ceding company. I have no qualms with taking the position that they should not need to be mirrored. I know that there's a lot of controversy in that area, probably two divided camps on it. As long as the reserve relief taken by the ceding company is consistent with the company's basic reserve calculation, and the reserve held by the reinsurer meets standards set up by the insurance department laws for the assumed risk, I don't see any need to have the same reserve held by the reinsurer as the amount of credit taken by the ceding company. One obvious situation would be where the reinsurer has made the 1980 CSO election and the ceding company is still on 1958 CSO basis for new business.

Multiple policies on the same life are probably one of the biggest problems, and companies may look to oversight provisions in the treaties to cover them for that. Well, oversights are fine, but the oversight provision is not meant to mean that the company doesn't need to check its other policies for multiples

on the same life. If you consistently don't perform this research activity, the reinsurer is getting a raw deal, and that's not fair. There must be a conscientious effort to set up a system where you look for multiple policies to adequately identify retention. You don't want to repeatedly have a claim and then go to the reinsurer and say, "Oh, it looks like we've got more retention than we should; we need more reimbursement for that policy." It doesn't take a genius to understand why that's not fair.

Sometimes there's not an appreciation that annual statement information requires separating your gross reinsurance premium and allowances, that just keeping accounting records on a net payment basis isn't adequate. This had come up in my experience; I don't know how widespread the problem is.

A major decision for self-administration is whether to modify the primary system or build a separate reinsurance system. I would suggest that in the long run you would be better off biting the bullet to modify the master records instead of building a separate reinsured policy data base. To go down the road having to copy changes in your master records into a separate reinsurance record can get to be very complicated and subject to an awful lot of errors. A separate reinsurance system without a separate policy data file would seem to overcome this problem.

MR. PEARSON: I'm sure some of the reinsurers can help us out on the reinsurance administration. You mentioned, Andy, about the Lincoln as well as the Phoenix doing some work with some reinsurance systems that they may make available to client companies. Could either company comment on that? The availability of that software to your clients for reinsurance administration?

MR. HOREIN: Were you asking for our commercial or just a straight answer to your question?

MR. PEARSON: Quite frankly, Jim, we need some help. I think all of us here in the room have problems with trying to administer reinsurance, and if any of the reinsurers have been farsighted enough to develop those systems and make them available to clients, I think we'd like to know about it.

MR. HOREIN: I was going to merely confirm that Andy Bodine did make a factual statement, at least relative to Lincoln National. We have endorsed a software program named PULSAR which we are making available to selected clients among our client base, which is designed to assist and we hope solve a major portion of our clients' self-administration problem.

MR. BODINE: Mark White chaired a reinsurance administration committee, and the result of that work, after several drafts, was a final version of guidelines for the reporting of self-administered reinsurance. It was sent out to the reinsurance section members of the Society with a cover letter dated February 1. The final guidelines are dated January 1, 1986. For those of you who haven't seen that, I recommend it to you.

MR. WHITE: Just a follow-up on that. It was also sent to the members of the Individual Product Development Section and to the list of computer vendors that we obtained from the *Actuarial Digest*. So computer vendors now have a copy of those guidelines, and we haven't really heard anything back from them yet, but hopefully they're pouring over it and about to incorporate all of that in their systems.