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REGULATION OF REINSURANCE

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- o New state and National Association of Insurance Commissioners (NAIC) regulation of surplus relief reinsurance
- o Generally Accepted Accounting Principles (GAAP) treatment of reinsurance
- o Taxation of reinsurance under Section 845 of the 1984 Tax Law

MR. MELVILLE J. YOUNG: The reinsurance world has been the focus of a lot of interest in recent years. The U.S. Congress and Treasury had their interests peaked when a seldom-used provision of the 1959 Tax Act suddenly became popular. The special interest shown by the state insurance departments can probably be traced to the Baldwin-United debacle.

I find both of these situations interesting. The industry virtually ignored the existence of Section 820 of the 1959 Tax Act until it simply stopped working as it was meant to, and the Baldwin-United situation involved no reinsurance contracts outside of the Baldwin- United family.

The two most notable consequences of all this interest to date are a section of the Tax Reform Act of 1984 (TRA 84)--Section 845--designed to strengthen the hand of the IRS when dealing with reinsurance agreements it believes create significant tax-avoidance effects, and New York Regulation 102 designed to give state regulators a tool to help identify and eliminate reinsurance treaties they perceive to be abusive.

I believe that the establishment of reasonable standards and guidelines for reinsurance agreements is, potentially, a healthy development for our industry so long as the regulators can focus on the transactions needing attention while retaining the flexibility necessary to insure the continued life, health and development of the life insurance business.

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PANEL DISCUSSION

MRS. DIANE WALLACE: As mentioned, the U.S. Congress and Treasury became interested in reinsurance agreements about two years ago as a result of the large reductions in life insurance tax bills accomplished through the modified coinsurance transactions with Section 820 elections. Recently, surplus relief agreements have received attention because they so obviously move income from one party to another and then back again. If one party to a transaction is taxed at a different rate than the other party, their combined tax bill may be lower after the reinsurance transaction, and reduced tax dollars receive attention from Congress in today's environment.

This perceived reinsurance problem has been attacked by Congress in a very broad way. The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) eliminated the Section 820 elections on modified coinsurance. These are now history, except for the audit issues that have been arising.

TEFRA also contained a provision allowing the IRS to reallocate income among parties to a reinsurance agreement if the parties were in the same controlled business group. In fact, the TRA 84 expanded this authority to allow allocation among unrelated parties as well. In short, if a reinsurance agreement moves income from one party to another, the IRS may disregard the movement in computing either party's tax. This is stated in Internal Revenue Code Section 845 (b), the subject of my talk today.

The code section reads, in part:

> If the secretary determines that any reinsurance contract has a significant tax-avoidance effect, the secretary may make proper adjustment to eliminate such tax-avoidance effect.

This provision is effective for risks reinsured in 1985 or later, so current, new and ongoing agreements under which new business is reinsured are subject to this new tax law.

Congress and the Treasury have, so far, provided very little guidance on how to interpret the law. The key words, of course, are "significant tax-avoidance effect." If the secretary determines that any reinsurance contract has a significant tax-avoidance effect then income may be adjusted.

The kicker is that any reinsurance agreement, even old yearly renewable term (YRT) or coinsurance treaties on risks in excess of retention, is likely to move income from one party to another. After all, one of the major reasons ceding companies buy reinsurance on new business is to get the reinsurer to help finance acquisition costs. This moves the first-year loss from the ceding company to the reinsurer. If the ceding company is paying little or no tax, and the reinsurer has other income against which to offset this loss, taxes are at least temporarily avoided. It seems quite likely, though, that Congress did not intend for this new law to apply to this common and traditional practice.

The question, then, is about how the tax law affects our every-day reinsurance decisions. The only source of guidance, at this point, is the Blue Book prepared by the staff of the Joint Congressional Committee on Taxation. It gives an explanation of TRA 84. It is clear in this document that Congress intended Treasury to write regulations to interpret the legislation. However, Treasury has shown no interest to date in promulgating regulations for this section of the Act or any other, for that matter.

Both the American Council of Life Insurance and the NAIC have made some attempt to prepare proposed regulations for the government; however, no formal proposals have been made at this time due to a number of factors. These include lack of interest on the part of the Treasury and industry disagreement. Recently all industry effort seems to be diverted to influencing the 1985 tax legislation, so efforts to obtain interpretations for the 1984 legislation seem to be slow.

Therefore, at this point, we are stuck with our own personal interpretations of the Blue Book in making reinsurance decisions. The Blue Book explanation first provides a definition of significant tax-avoidance effect. Part I says,

> A tax-avoidance effect is significant if the transaction is designed so that the tax benefits enjoyed by one or both parties to the contract are disproportionate to the risk transferred between the parties.

In other words, there must be risk transfer in any reinsurance agreement or there may be a significant tax-avoidance effect.

Part II of the definition says,

> There is no significant tax-avoidance effect for a reinsurer, however, merely because a tax reduction arises from a loss on the reinsurance, if the loss was no greater than if the reinsurer had written the business directly.

The bill in effect says we should not create artificial losses from our reinsurance agreement. The major points, therefore, are risk transfer and no artificial loss.

The explanation then goes on to provide several factors that the Secretary of the Treasury should consider in determining whether or not a reinsurance transaction has significant tax-avoidance effect. One item discussed is the age or duration of the block of business reinsured. Reinsurance on new business is more likely to pass a significant amount of risk to the reinsurer than reinsurance on an old block. Consequently, reinsurance on new business is less likely to draw attention than reinsurance on an old block.

The explanation also addresses the structure of the agreement. A pure financing agreement would be an indicator of possible tax-avoidance effect whereas true sharing of the risk and profits will not.

The Blue Book also addresses the duration and termination provisions in the reinsurance agreement. Automatic treaties and long-term treaties are better than short-duration financing schemes.

Other items discussed in the Blue Book include the character of the business reinsured and the relative tax and financial positions of the two parties to the agreement. For example, surplus relief to an otherwise insolvent company is not an indication that the treaty was entered into for a tax-avoiding purpose.

Finally, the explanation gives three examples of transactions that will generally not be adjusted. These have come to be known as safe harbors.

- YRT reinsurance is probably acceptable.
- Coinsurance of annual renewable term life insurance is probably acceptable since it does not require transferring large amounts of reserves.
- Coinsurance which allocates expenses and income between the insurer and the reinsurer in the same proportion as the allocation of risk is probably acceptable.

Let's see if we can use this advice from Congress to talk about some of the changes the companies have been making in their reinsurance agreements to better protect the intended tax consequence.

I'd like to concentrate on traditional surplus relief reinsurance agreements since these are the transactions that will most likely attract Treasury attention. Any concepts we talk about with respect to surplus relief agreements may also be applied to other reinsurance transactions.

Let's quickly review what happens in a traditional surplus relief agreement. Initially, a block of business is transferred by the ceding company to the reinsurer. Liabilities associated with the block are therefore transferred to the reinsurer. Usually, some type of asset is also transferred to support the liability, but in an amount that is smaller than the liability transferred.

In more familiar terms, a premium is paid at the inception of the agreement, typically equal to the current reserve liability. The reinsurer in turn pays a ceding allowance or ceding commission to the company so the net amount of the assets due the reinsurer is equal to the amount of the reserves less the ceding allowance. And since more liabilities are passed than assets, a gain is created on the books of the ceding company.

The ceding company essentially gets a portion of the present value of future profits on the block now, instead of waiting for the profits to emerge later. The reinsurer, of course, suffers a corresponding loss initially to both its income statement and its balance sheet.

In exchange, the reinsurer has the right to future profits until the surplus relief is repaid. The reinsurer also gets a risk fee to cover the risk that profits will be insufficient to repay the surplus relief. At that point, typically, additional profits are returned to the ceding company through an experience refund. Ultimately, the block is usually returned to the ceding company through a recapture provision, and then the agreement is terminated.

There are, of course, many variations to this basic description. The terminology: mod-co, funds withheld, co/mod-co, and the like, is well known. But these variations do not change the basic substance of the traditional agreement. The ceding company receives a gain and the reinsurer suffers a loss which, over time, reverse themselves.

Now how does Section 845 (b) affect these transactions? My first suggestion is for those who have been counting on tax deductions when providing surplus relief reinsurance: Don't. Consider alternative ways to invest your taxable surplus. Direct new business ventures or joint ventures will help eliminate the tax risks associated with reinsurance as of this point. Appropriate tax deduction on most reinsurance deals is uncertain.

Those ceding companies and reinsurers who do wish to enter a statutory surplus relief agreement, but do not wish to suffer great uncertainties concerning tax issues, should consider instead a treaty that provides nontax deductible relief. This type of arrangement considerably limits the amount of relief that can be provided on a block of business, but it does help avoid most tax questions. The approach is to create a bottom-line effect on statutory books that has no effect on tax books. This can be accomplished by reinsuring a block of business with higher statutory reserves than tax reserves. The ceding company passes the entire statutory liability to the reinsurer. It also passes assets equal to the lower tax reserve liability. On the tax books, the liabilities passed are exactly equal to the assets passed, so there is no tax effect. However, on the statutory books, the liabilities passed are greater than the assets passed, so the intended statutory surplus relief is accomplished. This is the way many surplus relief agreements are being structured this year. Non-tax-deductible surplus relief has also been called excess interest or deficiency reserve relief.

Now let's talk about those situations where more traditional surplus agreements are desired, those that will have an effect on tax books. For those agreements that do have an effect on taxable income, what can be done to help insure that the tax effects will not be overturned by the IRS? I emphasize that no one at this point can be sure what will happen. We have no guidance and no precedents on which to rely on. However, many companies have changed their treaties in fairly obvious ways to reduce their risk of unintended tax effects.

Remember, the key issues seem to be proper risk transfer and proper allocation of expense between the parties. One definition of risk transfer is that there must be a risk of economic loss to the reinsurer. Of course a loss does not have to be expected under normal circumstances or the reinsurer would not enter the agreement. However, it must be

possible under the terms of the agreement for the reinsurer to lose money. This is the most basic requirement for a new treaty. It must must be possible for the reinsurer to lose money under the agreement in the event of bad experience.

Some companies believe that in order to show that risk has been transferred, a treaty must be nonrefunding. Most traditional treaties do provide for refunding excess profits to the ceding company, but in a nonrefunding treaty all future profits would belong to the reinsurer and there would be no experience refund clause. This approach creates a surplus relief treaty that looks just like a typical coinsurance treaty. Of course, to be acceptable to the ceding company, the amount of surplus relief given initially must be pretty close to the total expected future profits. Normally, surplus relief treaties provide a great deal of margin in the expected future profit over the amount of surplus relief provided. This protects the reinsurer against adverse experience and therefore the price of surplus relief can be at a fairly low level--something that is affordable to the ceding company. The ceding company is protected on the other hand against losing too much if profits are greater than expected through the operation of the experience refund formula. Without an experience refund clause, the upside is more clearly transferred to the reinsurer, and therefore more analysis required. It must be fine-tuned a great deal and, most likely, the cost or risk fee for the reinsurance will be greater as well.

One variation to this approach is to have no experience refund, but to allow a fairly early recapture in the treaty at the option of the ceding company. Under this type of agreement, the reinsurer would live by the profits of the underlying block up to the point of recapture but no further. If profits to that point are in excess of the amount of surplus relief originally provided then the reinsurer would gain, and if profits are insufficient to repay the surplus relief, the reinsurer would lose.

A less extreme modification of the traditional treaty is to keep the experience provision but create a formula that refunds less than 100 percent of excess profits to the ceding company. This would be done in exchange for more built-in risk of loss to the reinsurer. Expected profits, in other words, would just barely be in excess of the amount of the initial surplus relief.

Some definitions of risk transfer, particularly at the state level, address whether or not the reinsurer is enough at risk for each of the insured benefits. It is possible that the IRS will take a similar approach. Surplus relief on deferred annuities, in particular, has tended in the past to put the reinsurer at risk, but only for some of the insured benefits and not others. For example, a commonly-used annuity treaty passes risk only on the annuitization benefit and then only if annuitization occurs at the rates guaranteed in the contract. No lapse or investment risk is passed. Some companies have decided that additional risk passage might be necessary on these treaties to avoid unexpected tax results.

How can we increase the risk transfer on such treaties? First, we can expand the mortality risk transfer by making the reinsurer cover the

annuity payout whenever annuitization occurs at current rates, not just the guaranteed rate.

Second, we can transfer risk on the surrender benefits by having the reinsurer pay in the bail-out risk or any other risks associated with the surrender charge.

Another approach is to have the reinsurer participate in the investment risk. One way is to have the reinsurer actually receive and invest the funds backing the deferred annuity. This is pretty difficult to control, though, because the reinsurer is investing the money and the ceding company is setting the crediting rate. You can imagine all the complications that that would create. So, an alternative is to have the reinsurer agree to accept investment income on the withheld assets at a rate that is equal to whatever the ceding company actually earns rather than the traditional approach of having the rate contractually set in a reinsurance agreement.

All of these ideas strengthen the position that risk has actually been transferred. Each company is going to have to use its own judgment to decide at which point on the spectrum the IRS will decide that enough risk has been transferred.

After risk transfer, the second point of guidance in the Blue Book is that expenses must be allocated properly between the parties. How can this be accomplished? In the past, the amount of surplus relief to be provided on a block of business was limited to the value of future profits that could be recouped by the reinsurer on the block of business to repay the surplus relief. Under the new law, most companies believe that this amount is now changed and is limited to the current loss position of the writing company. What does that mean? If surplus relief is provided on new business, the reinsurer should not suffer a loss (at the inception of the transaction) that is any greater than the loss suffered by the ceding company when it originally wrote the business. And if the reinsurance covers an old in-force block, the loss to the reinsurer should be no greater than the ceding company's current unamortized acquisition expense. This limit to the reinsurer's loss, of course, is the corresponding limit to the amount of surplus relief that should be given to the ceding company on the transaction.

This type of analysis is also directly applicable to normal excess of retention coinsurance. Ceding allowances should, probably, not be in excess of the writing company's true acquisition costs or you may have tax troubles on your hands.

We have covered the two primary concerns pointed out by Congress in its explanation of Section 845 (b)--risk transfer and allocation of expenses. Some companies have taken other steps to improve their chances of maintaining the intended tax consequences of their reinsurance transactions. For example, whenever there is a choice, or wherever possible, reinsure new business rather than old blocks of business. This point is specifically addressed in the Blue Book.

Another idea is to set risk fees that are a percentage of profits or some other term in the treaty, and certainly not set them as a percentage of the outstanding surplus relief. Also, do not back date treaties. This issue is not mentioned at all in Section 845 (b) nor is it mentioned in the Blue Book's explanation of Section 845 (b), but it has created a lot of attention in mod-co 820 audits. So I think that back dating will be a "red flag" that will cause the IRS to look at transactions, whether or not they have to do with mod-co 820. Also, one could make the argument that if you are back dating, your treaty risk cannot be transferred because you already know what happened.

Finally, some companies believe that obtaining approval to enter a reinsurance transaction from their state insurance departments improves their chances that the IRS will recognize risk transfer. Most states require that risk be transferred in an agreement in order for the ceding company to take credit for the reinsurance; therefore, getting state approval or nonobjection is added documentation that risk has indeed been transferred.

Unfortunately, we must all go on in our day-to-day decisions with a great deal of uncertainty regarding our tax status, but I believe if we all behave rationally and make conscious efforts to comply with the spirit of the recent legislation, we can still accomplish our business goals and reduce our risks.

MR. ROBERT J. CALLAHAN: First, I must state that what I say later is not to be attributed to the New York Insurance Department nor to any other individual in the New York Insurance Department, nor to the Society of Actuaries, nor to any other entity.

As chief of the Actuarial Valuation Bureau checking the Annual Statement Exhibit 8 reserves of domestic life insurers, I do have an interest in the net amount of reserves certified to by the superintendent. I participated in the public hearing and in a department task force, and have worked on the NAIC Annuity Writers Study Group. I am also a member of the NAIC Life and Health Actuarial Task Force which is also meeting this week. This task force, under the chairmanship of Mr. John Montgomery, Chief Actuary and Deputy Insurance Commissioner of the California Insurance Department, is also studying reinsurance, but has a longer range and broader goal.

In the Actuarial Valuation Bureau annual check, we primarily look at methods, procedures, bases and arithmetic. It is up to the field examiners during the triennial, quadrennial and quinquennial examinations to spot-check the accuracy of the basic records and review the procedures used to derive the annual year-end in-force figures. The field examiners may also spot-review the approved contracts against those issued to ascertain whether or not the in-force business is properly classified and various provisions are appropriately reserved for. These field examiners may also spot-review reinsurance contracts to ascertain whether or not the reserve credit is appropriate for the contract provisions and risk transferred.

REGULATION OF REINSURANCE

Unlike direct-issue contracts, reinsurance contracts have not been subject to prior review and approval unless the reinsurance contract was between affiliated insurers under a holding company set-up, or between a parent and its subsidiary. Where the reinsurance contracts were subject to prior review, Messrs. Meyer Baruch and Jerry Connelly of the Life Bureau advise me that they have seen each of the six conditions addressed by New York Regulation 102 and enumerated in subdivision A of Section 127.2.

Regulation 102 was occasioned by the first two conditions which are:

1. The primary effect of the reinsurance agreement is to transfer deficiency reserves or excess interest reserves to the books of the reinsurer for a risk charge and the agreement does not provide for mortality, morbidity, or surrender benefit participation by the reinsurer consistent with its participation in the deficiency or excess-interest portion of the policies reinsured.

2 The reserve credit taken by the ceding insurer is in excess of the actuarial reserve necessary under New York Insurance Law, Rules or Regulations, including actuarial interpretations or standards adopted by the department, to support the policy obligations transferred under the reinsurance agreement.

It should be clear that reserve credit should be denied or restricted for conditions 3 through 6:

3. The ceding insurer is required to reimburse the reinsurer for its negative experience under the reinsurance agreement, except that neither offsetting experience refunds against prior years' losses nor payment by the ceding insurer of an amount equal to prior years' losses upon voluntary termination of in-force reinsurance by that ceding insurer shall be considered such a reimbursement to the reinsurer for negative experience.

4. The ceding insurer can be deprived of surplus at the reinsurer's option or automatically upon the occurrence of some event such as the insolvency of the ceding insurer, except that termination of the reinsurance agreement by the reinsurer for nonpayment of reinsurance premiums shall not be considered to be such a deprivation of surplus.

5. The ceding insurer must, at specific points in the time scheduled in the agreement, terminate or automatically recapture all or part of the reinsurance ceded.

6. No cash payment is due from the reinsurer throughout the lifetime of the reinsurance agreement with all settlements prior to the termination date of the agreement made only in a reinsurance account, and no funds in such account are available for the payment of claims.

How did the conditions addressed by Regulation 102 arise? Unlike many other commodities where, upon sale, profits are realized immediately,

in the case of life insurance and annuities, the high initial expenses and first-year reserves are frequently greater than the considerations received, such that the higher the new sales the greater the surplus strain. Of course, gains in renewal years should be such that overall, upon sale of the contract, there is an expectation of profits over the life of the policy.

Under statutory accounting, there can be a drain on surplus as new business is written, whether premium-paying or single-premium. A moderate amount of surplus strain may well result in restraining an insurer from writing more new business than it can handle administratively or that it could handle financially in an event of mass surrenders. If statutory reserve requirements are overly conservative in the mortality and interest factors, the surplus strain may be such that an insurer may seek surplus relief so that it may write more new business. Such surplus strain is greatest in the early years of a new product and will get even greater until the earnings of renewal years are sufficient to overcome the surplus strain of writing the new business.

The traditional forms of life reinsurance such as YRT, coinsurance and modified coinsurance with the various combinations of the basic plans of reinsurance and of excess amounts and of percentage reinsured have played and do play legitimate roles of spreading risk which an insurer might otherwise have to decline, and do afford legitimate surplus relief in some situations. There is one product in particular that caught the regulators' attention in occasioning the regulation. This product is the single premium deferred annuity (SPDA) product with accumulation of the full consideration at a guaranteed low, long-term rate of interest with periodic declaration of high interest rates, usually for a year at a time, and with cash surrender available at all times with a surrender charge grading down from a typical 7 percent in the first year to 0 percent at the end of seven to ten years.

For years, the deferred annuity product did not generate much business. The typical deferred annuity product was a fixed annual premium contract with percentages of the premium accumulated at fairly low rates of interest and with a guaranteed annuity income based on conservative purchase rates per $1,000 of cash value on the annuity commencement date. The death benefit was generally the greater of the sum of the premiums and of the cash value. The excess of the sum of the premiums over the cash value was a decreasing amount extending over ten to thirteen years. Reserves were generally set equal to cash values. No excess interest was credited on nonpar policies.

Then, in the mid 1970s a number of things happened. With inflation, more individuals were paying high income-tax rates, making tax-exempt and tax-deferred products such as a deferred annuity with tax deferral of the inside build-up more favorable to a vast number of individuals. The 1974 Employee Retirement Income Security Act, the IRA, the deferred compensation program and the HR-10 Programs created new interest in deferred annuities. Furthermore, states permitted additional interest credits under nonparticipating contracts.

In 1976 the NAIC adopted, *for the first time*, a model standard nonforfeiture law for deferred annuities. This took the form of a retrospective formula with maximum charges against the gross premium and minimum interest rates to be credited. It also provided for surrender charges approximately equal to 1 percent for each year remaining to the annuity commencement date, provided the resulting value did not fall below a stated minimum value. This surrender charge was to enable insurers to invest in long-term securities and have a hedge against asset depreciation at time of surrender.

The feature that became the most popular was the accumulation of a full consideration at competitive new money rates with a declining surrender charge; that is, with the surrender charge being used to recoup expenses rather than as a hedge against asset depreciation.

As new money rates continued upward, the valuation interest rates for deferred annuities did not keep pace, despite their being increased by the NAIC from 3.5 percent to 4 percent in December, 1972 and to 6 percent in December, 1976 and then according to an index in December, 1980. Consequently, many insurers chose to declare a high interest rate only for a short time such as one year so as to reduce the year-end annual statement liability. An interest declaration on a policy-year basis might result in requiring provision for a one-half year's excess interest but on a calendar year basis, with the periodically-declared interest terminating on December 31, the reserve strain for excess interest could be eliminated from the annual statement.

However, to give policyholders some assurance that the company would continue to pay high interest rates during renewal years, many insurers included a bail-out provision that in the event the insurer ever failed to credit a specified interest rate (for example 1 percent lower than that in the first year), the insured could surrender his contract without charge during a specified time interval. Obviously, if an insurer could invest into ten-year coupon bonds at 10 percent, the insurer may feel it could credit at least 7.5 percent on the accumulation.

From a reserve standpoint, the big question was whether reserves should be based on the full accumulation amount (that is, no reduction for the surrender charge), or on the cash surrender value. In New York, we chose to use the full accumulation value since that was the value on which interest was credited, the basis of the death benefit and the basis of any current annuity purchase rates. Further, we felt that in any excess interest contract the valuation interest rate should be the lesser of the guaranteed rate and of the maximum valuation interest rate. This also had the effect of not allowing any reduction in reserves for the surrender charge.

Direct-writing insurers then found some insurers or reinsurers to mod-co the basic reserves and to coinsure any excess interest reserves and any surrender charges for a relatively low fee. In many instances, the reinsurer was willing to set up the reserve for the surrender charge if it had sufficient surplus and if it resulted in a favorable tax treatment.

As interest rates rose in 1979, 1980 and 1981, the so-called C-3 risk drew everyone's attention. This is the risk of loss due to variations in the level of interest rates, affecting both the value of the underlying assets and the incentive for policyholders to pour in more money or to take money out. For an SPDA contract with cash surrender available at all times with only a modest surrender charge, if any insurer invests long and interest rates increase, some policyholders might find it advantageous to suffer a small surrender charge and invest elsewhere. Depending on the length of the underlying assets, and the spread between the coupon rate and new money rate, the asset depreciation could be in the neighborhood of 30 percent with little offset by the surrender charge. If assets were invested short, and interest rates fell, the insurer might have to pierce the bail-out rate and pay the full accumulation value upon surrender without being able to realize any capital gain to offset the waiving of the surrender charge.

Thus, at a time when we regulators in New York were considering lowering our reserve requirements to allow reduction for the surrender charge, we became convinced of the need for some cushion. After analyzing the problem further, we chose to reaffirm our position in Circular Letter 18 dated October 6, 1983.

The troubles with Baldwin-United in 1983 highlighted bad investments, the C-3 risk and the bail-out provision. The troubles with Baldwin-United and with the Charter Holding Company in 1983 and 1984 had an adverse impact on the Charter Life Insurance Companies which had written a large amount of SPDAs. At the end of 1983 and early in 1984, several states reacted by prohibiting the bail-out and by prohibiting any deferred asset charge or any reduction in reserves for the surrender charge, generally over a short transition period. The NAIC Life and Health Actuarial Task Force in October 1983 recommended reserves be based on the full accumulation value wherever a bail-out provision was present, but the guideline was not ready for adoption by NAIC until December 1984. At that time, due to the effects of the new tax law, action was put off by the NAIC until this past June at which time a guideline on reserves for bail-out provision was adopted.

In the case of SPDAs, the greatest risk is the C-3 risk with the asset liability matching. In many of the combination reinsurance arrangements with mod-co for the basic amount and coinsurance for the surrender charge, the C-3 risk was not reinsured but remained with the ceding insurer. In some arrangements, the waiving of the surrender charge in event of piercing the bail-out rate was not reinsured. Regulation 102 was aimed primarily at this situation. This problem came to light during the latter half of 1983 and was then addressed. As noted above, the final regulation was dated February 15, 1985.

Most states other than New York generally only required reserves equal to the cash surrender value but with the discussions of disallowing credit for the surrender charge where there was a bail-out, surplus relief reinsurance treaties could be attractive and practical for insurers not licensed in New York. To ward this off, the NAIC Annuity Writers Study Group prepared a draft of a model regulation, Life Reinsurance

Agreements, in June of this year, revised it in September and hopes to have it adopted this December.

Perhaps you may say the real answer is to make the reserve standards appropriate in the first place. While we have had since 1982 a legal requirement as to an actuarial opinion and memorandum to demonstrate the adequacy of assets supporting liabilities for use of the higher set of valuation interest rates, legislation enacted this year has expanded the requirement and, at the same time, recognized some reduction in reserves for surrender charges to the extent justified by the actuarial opinion and memorandum. This legislation also permits insurers to restrict the availability of cash values and to make market value adjustments. In some cases, the cash flow analysis may indicate the need for higher reserves. Advisory groups are now working on regulations to implement this legislation.

There are situations where annual premium life insurance policies have had to be reserved at conservative mortality and interest rates such that premium deficiency reserves occur. Such reserves are greatest at policy issue. Some insurers have ceded such business with basic reserves on a mod-co basis and the premium deficiency reserve on a coinsurance basis. Such contracts have to be reviewed carefully to see whether or not there is a real transfer of risk. However, there are other ways to alleviate the premium deficiency reserves for life insurance, such as the adoption of the 1980 Commissioners Standard Ordinary table and dynamic valuation interest rates, the use of indeterminate premiums with the maximum gross premium high enough to cover valuation net premiums and the use of universal life policies with conservative long-term guarantees but periodic declarations of more favorable interest and mortality.

Hopefully the new reserve requirements for analysis of cash flows under various interest rate scenarios for annuities and guaranteed interest contracts will be extended to the life insurance area and the C-3 risk appropriately provided for. Many people feel that the C-3 risk can be reinsured only on a coinsurance basis and not on a modified coinsurance basis. However, if the reinsurer can effectively control the investments of the ceding insurer, it may be possible to transfer such risk on the mod-co basis.

At present the New York Department Examiners are reviewing many reinsurance contracts to ascertain whether or not there has been a transfer of risk to justify the extent of the reinsurance credit.

MR. JOHN MEYER: It has been my experience that company reinsurance departments tended, more often than not, to be left to themselves and to operate rather autonomously. They had their own language and subculture, both of which probably assisted greatly in maintaining the departments' autonomy.

Unfortunately, this autonomy contributed to a lack of auditing and accounting guidance leaving the auditor faced with entering this "nether world" unarmed. This led to ineffective audits in some cases.

Soon we auditors started to hear about failed companies, doomed because of reliance upon "gentleman's agreements." Some gentlemen began to fold their tents while their associates were left holding the bag. Or, fictitious reinsurance transactions built up a house of cards that inevitably had to tumble.

The Securities and Exchange Commission (SEC), no stranger to controversy and never shy about questioning the adequacy of auditing standards, became increasingly concerned about these failures resulting from reinsurance agreements. In 1979, Mr. Clarence Sampson of the SEC sent a letter to the American Institute of Certified Public Accountants (AICPA) outlining problems and proposed solutions to a number of reinsurance problems. Mr. Sampson also cited "an absence of appropriate guidance in the auditing literature."

The AICPA responded by forming the Reinsurance Auditing and Accounting Task Force, still in existence today. The objectives of the Task Force are to

> ...develop an auditing statement of position on auditing reinsurance for all types of insurance companies and develop an issue paper on accounting and disclosure of reinsurance transactions.

The most significant output from the Task Force to date has been two papers on auditing reinsurance. One paper, issued several years ago, was for the property-liability industry. The second paper, issued in November, 1984 and effective for the first time as of December 31, 1985 is for the life industry. The two papers (called Statements of Position or SOP) are very similar, both addressing internal controls over reinsurance transactions at both a ceding company and an assuming company.

The SOP is designed to be a guidance document for both companies and auditors. It is not designed as a checklist of procedures that an auditor must complete before reaching conclusions on the reasonableness of reinsurance amounts. Rather, it is directed to the industry. It is a discussion of internal control mechanisms as illustrative procedures. It is not required that every one of those procedures be in place.

The worst-case scenario for a company will be that, based on the external audit, conclusions are reached that material weaknesses exist in the reinsurance cycle. The auditor's responsibility then becomes either to satisfy himself through the use of other procedures that the reinsurance accounts are reasonably stated or, if he can't satisfy himself, qualify or disclaim his opinion.

From the perspective of the ceding company the paper focuses on two general areas. First is the financial viability of the assuming company. The auditor is concerned about this because liabilities have been passed on to the assuming company that the ceding company is ultimately liable for. Such transferred liabilities are therefore a receivable of sorts in the eyes of the auditor, and he is looking to see whether or not that receivable will eventually be collectable.

The second focus is on the accuracy and reliability of the financial information sent to the reinsurer and of the amounts that are due to or from the reinsurer. The auditor must have some assurance, as should the companies, that the information being assembled with respect to reinsurance premiums, claims, and so on, is reliable and accurate.

Some control procedures for ceding companies suggested by this paper are outlined in Table 1. With regard to item #2 in that table, many assuming companies may develop prepared packages of information. When the property-liability SOP was issued several years ago, many reinsurers developed such packages, knowing they were going to receive requests for this type of information.

Controls should also be maintained at the assuming company to assure the accuracy and reliability of the data received from the ceding company. Some assuming-company control procedures suggested by the SOP are outlined in Table 2.

One should be prepared for the auditor to perform the following procedures in auditing a reinsurance program:

- He will read and summarize the reinsurance agreement.
- He will inquire as to the business purpose of the treaty and the reason for selecting the particular reinsurer.
- He will perform a test check of the transactions underlying the treaty.
- Finally, and this is the hardest part of his job, he will determine whether there is any risk sharing under the treaty.

The basic rule, first brought out in the Stock Life Insurance Company Audit Guide, reinforced by Financial Accounting Standard No. 5 and again reinforced by Financial Accounting Standard No. 60, is that if the reinsurance contract does not provide indemnification to the ceding company, then the premiums paid by the ceding company less the amount thereof to be kept by the assuming company equals a deposit on the ceding company's books. Thus, in a financing agreement where there is no indemnification because all amounts paid out by the reinsurer must eventually be returned to it, whether through experience refunds, retrorating or any other mechanism, one cannot account for the effects of such a treaty on the income statement. Such an arrangement is in reality a loan, and under GAAP it must be recorded as a loan on the ceding company's books. Any expected income effects would be removed from the profit and loss statement. The same rule has been in effect since 1972.

Tables 3 and 4 show a simplified example of what we are talking about. The direct writing company sustains a $60.00 first-year loss on certain business for which it desires surplus relief. If the treaty provides for genuine indemnification by the reinsurer, then the ceding's income statement may be as shown in the "With Risk" column of Table 4. However, if there is an experience refund provision requiring that the

TABLE 1

Illustrative Control Procedures Of Ceding Company

1. Obtain/Analyse Recent Financial Information Related To Assuming Company

2. Obtain/Review Available Sources Of Information Related To Assuming Company

   - Industry Reporting And Rating Services
   - Insurance Department Exam Reports
   - Letters Regarding Adequacy Of Internal Control Sent To Regulators

3. Inquire About Assuming Company's Retrocessional Practices

4. Inquire About General Business Reputation Of Assuming Company-- Background Of Owners and Management

5. Consider Need For And Evaluate Adequacy Of Collateral From Reinsurer

TABLE 2

Illustrative Control Procedures Of Assuming Company

- Maintain Information Regarding Business Reasons For Entering Into Contract And Anticipated Results Of Contract
    - Actuarial Studies Of Business Assumed
    - Expected Profitability
    - Expected Termination Rates
    - Prior Experience With Ceding Company
    - Assuming Company Experience On Similar Business
    - Information Regarding Pricing And Commissions
    - Frequency And Content Of Reports From Ceding Company
- Monitor/Document/Follow-up Actual Results Against Expectations
- Visit Ceding Company And Review/Evaluate Sales, Underwriting, Benefits Processing, Actuarial Policies
- Obtain From Ceding Company The Special Purpose Report On Internal Controls Over Ceded Reinsurance Issued By C.P.A.
- Review Financial And Other Information On Ceding Company And Its Management

TABLE 3

Coinsurance Treaty
Where Risk is Transferred

Amounts Reinsured

	Yr.1	Yr.2	Yr.3	Yr.4	Yr.5
Premiums	$100	90	85	80	75
Acquis. Cost	(100)	(9)	(9)	(8)	(8)
Claims/Reserve	(50)	(50)	(50)	(50)	(50)
Maint. Expenses	(10)	(9)	(9)	(8)	(8)
Profit (Loss)	$(60)	$22	$17	$14	$9

Ceding Company Income Statement

Premiums-Direct		$500
-Ceded		(100)
		400
Aquis.Cost-Direct	200	
-Ceded	100	100
Claims/Reserve-Direct	250	
-Ceded	50	200
Maint. Exp.-Direct	50	
-Ceded	10	40
Net Income		60

TABLE 4

Risk Removed Via Experience Refund

Experience Refund

After Year 3, Assuming Company Made Whole (Effectively Assuming Company Held Harmless). Service Fee = $15.

Ceding Company Income Statement

		With Risk	Without Risk
Premiums-Direct		$500	$500
-Ceded		(100)	
		400	
Acquis.Cost-Direct	200		200
-Ceded	100	100	
Claims/Reserve-Direct	250		250
-Ceded	50	200	
Maint.Exp.-Direct	50		50
-Ceded	10	40	
-Svc.Fee		15	15
Net Income (Loss)		$45	$(15)

Dr. Income	60	
Cr. Deposit (Loan)		60

However, if there is an experience refund provision requiring that the assuming company be made whole as of the end of year 3 of the agreement then the ceding company's income statement must be completed as shown in the "Without Risk" column of Table 4. The only effect of reinsurance that appears in the income statement in this case is the $15.00 service fee.

If the auditor finds, in such a case, that the ceding company has included the full effect of the reinsurance in its income statement, he will debit the income statement as shown at the bottom of Table 4.

It is difficult for auditors to understand these treaties and to see that in many cases what is being discussed in the experience refund section is merely a repayment of everything that was paid out by the reinsurer in the past. But auditors are becoming more and more sensitive to financing arrangements. They may more often be asking you to demonstrate to them how a particular treaty transfers risk, and if you can't demonstrate that, they may speak to other people in the company about how to proceed.

Finally, we'll take a look at some current developments. One of the topics the AICPA Reinsurance Task Force is now discussing is risk assessment. What is the risk? Is it underwriting risk? Investment risk? Expense Risk? And how much risk must be transferred in order to have reinsurance instead of a financing arrangement? These issues were on the agenda as long ago as 1980, and I am told an exposure draft may be available by the end of this year.

Another item this task force will discuss is fronting fees and income recognition. How should a fronting company account for the service fees it receives in a fronting arrangement? Two possibilities are to recognize such fees in income immediately and to amortize them over the life of the contract. A temporary conclusion is that if the fronting company is not responsible for any servicing of the business--if it is only attaching its name to the business--then it can recognize all the income on the day the deal is consummated. The company can front-end the income because the only thing it is required to do under the contract is to supply its name, so its services have been completed and the full income can be recognized. If the fronting company is required to supply any services under the contract, however, it must amortize the income over the period of the contract.

About a year ago, the NAIC Reinsurance Companies Committee forwarded a paper on loss portfolio transactions to the Financial Accounting Standards Board, which has not yet acted on it. This probably has more relevance to the casualty business. Transactions occur where an ultimate-cost reserve or full-value reserve is ceded for a discounted premium. The paper addresses the risk transfer question. If risk is transferred, the difference between the discounted premium and the full-value reserve is allowed to be recognized in income. However, if there is no risk transfer, the difference between the premium and the ultimate reserve must be deferred and amortized through investment income over the period of the treaty. The paper addresses the issue of

how much risk must be transferred in qualitative terms; it says that "substantial risk" has to be transferred. I suspect you may see that kind of wording as well in the risk assessment paper to be produced by the AICPA Reinsurance Task Force.

MR. JOHN O. MONTGOMERY: I do want to congratulate the panel on excellent presentations. One guideline Mr. Meyer described is in the process of becoming a requirement in California: a demonstration that the contract is transferring risk. We on the NAIC Task Force have elaborated on this idea a little but basically speaking, that's exactly what we are asking for. A company must provide a demonstration of scenarios on how this contract expects to handle whatever risk is supposed to be transferred. For instance, the pure financing of deferred acquisition costs is the equivalent of a loan, and does not constitute reinsurance.

If there is a risk that the acquisition cost is not going to be amortized as expected, that does constitute reinsurance. The company must demonstrate the conditions under which the assuming company is going to be returning to the ceding company amounts such that the ceding company will not have a loss in surplus due to the operation of the reinsurance contract. Basically, it can demonstrate that the contract is a reinsurance contract through scenarios in which the reinsurer is going to have to pay the ceding company certain amounts to make up for deficits in case events do not occur as expected as drafted in the contract. The NAIC expects to adopt a model regulation on this subject this December.

Another point is that the valuation actuary is going to have to consider both the reinsurance contracts and the financial condition of the reinsurers. This could be a critical item over the next few years if there is a catastrophe in mortality due to age.

MR. J. ALAN LAUER: I'd like to observe that I also think that it has been a very good discussion. In my work as a regulator, I am dealing with a lot of first-grade problems.

I was recently asked by my Bureau of Examinations to review a reinsurance treaty between a Company A of Pennsylvania domicile and a Company B. It appears that in Schedule S of the Annual Statement, Company A had taken a $3 million reserve credit on the basis of this treaty, which was labeled in Schedule S as a coinsurance treaty.

First of all, both the cover page and the first words in the body of the treaty stated that this was a "modified coinsurance reinsurance" treaty. How can there be a $3 million reserve credit on a modified coinsurance treaty?

Then I read further and analyzed a little mathematical formula in Appendix II of the treaty to discover that each year Company A would pay Company B a fee for the treaty. Otherwise, no cash or any other consideration of any value would ever change hands. No money would ever change hands except the fee. Is that a reinsurance treaty? It did not look like one to me.

Much to the disgrace of the actuarial profession, the company's CPA firm disallowed this treaty for GAAP purposes.

Unfortunately, this is not an isolated incident. There is too much of this going on. I want to ask all the people in the audience today to think of this question: What do you think of the professional conduct of the actuary who signed a Statement of Actuarial Opinion that the reserves of this company were correctly stated and in accordance with all legal standards? In my opinion, he did not act in a professional manner.

MR. YOUNG: Not having seen the contract, the only thing I can say is thanks to the efforts of a lot of people in the industry, we have begun establishing some standards and guidelines for reinsurance agreements and, at least from what I have been able to see so far today, I think the reinsurance community has been responsive to those guidelines. Hopefully, you will see an improvement in the types of reinsurance agreements that are signed in the future.