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REINSURANCE REGULATIONS

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- o Security of Reinsurance Arrangements (NY 102)
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- o Trends in state regulation of reinsurance
- o Impact of regulation on reinsurer/reinsured relationship

MR. WAYNE D. BIDELMAN: I am Senior Vice President of Reinsurance at Security Life of Denver. I have been in the reinsurance line of business for about 12 years now and am responsible for both the ceded and assumed reinsurance functions at Security Life.

I thought that, as we start this session today, we should concentrate on the reinsurance transaction itself. Remind yourselves that the reinsurance transaction is not just *a* tool for reinsurance companies, but it is absolutely a *necessary* tool to the survival of the insurance industry. Only through the reinsurance process can the resources that exist within the industry be put to maximum utility, enabling an open yet fair marketplace in which we can all participate. There are external tools available to us, such as further capitalization, merger, acquisition and even the idea of avoiding risk entirely by getting out of the insurance business; however, reinsurance is the only tool to obtain lacking resources without dramatically changing one's corporate financial structure and while still retaining the ability to compete freely and equally in the marketplace.

Reinsurance has allowed an insurance company to offer a wide variety of risk-taking contracts to the insurance agent for sale to the public -- even if that insurance company doesn't have the resources to absorb all of that risk. Reinsurance allows a company that does not have the resources to absorb all of the risks to transfer part or all of that risk to another company that is willing to absorb it. A surplus-weak company through reinsurance can obtain surplus from a company willing to share its financial resources. Again, reinsurance allows all the resources within the industry to be put to maximum utility.

Today we find an increasingly tense regulatory environment within which to try to implement reinsurance transactions. The federal government has become concerned that it may not receive fair tax income due to reinsurance transactions. Accounting and auditing authorities are concerned that the accounting representation of the reinsurance transaction is not an accurate one for the company's investors or that the reinsurance transaction has not truly provided the protection intended. The state regulatory authorities are concerned that the statutory accounting treatment of some reinsurance transactions does not provide the accurate solvency picture of an insurance company, fearing a lack of protection for the buying company.

I believe it is a true statement to say that the current regulatory thrust threatens the legitimate use of reinsurance transactions. It is also an equally true statement, however, to say that the intent of the current regulatory thrust is legitimate and necessary for all of us to have the guidance for properly structuring and accounting for reinsurance transactions.

The purpose of this panel is to first of all educate you on the current regulatory environment and, secondly, to provide an open forum of discussion of viewpoints for both the industry and the regulators. The first panelist is Karen MacDonald, F.S.A. Karen has been with Transamerica Occidental since 1980. Prior to that, she spent five years at the Equitable. Her current title is Director of Asset Liability Management and Acquisition, which she tells me also includes financial and specialty reinsurance ventures, both ceded and assumed. Karen will start out with a brief look at the federal regulatory environment.

MS. KAREN OLSEN MACDONALD: For those of you who don't know, Section 845 was a last minute introduction to the DEFRA tax bill enacted during 1984. It gives the Secretary of the Treasury broad powers to reallocate amounts in a reinsurance agreement for tax accounting purposes. It has two sections. Section 845A applies specifically to transactions between related parties; it is similar to provisions that existed under prior tax laws. Section 845B, on the other hand, applies to transactions between unrelated parties; it is entirely new with the 1984 act. It is the Section 845B provision that I am going to talk about.

As far as I know, no clarifying regulations or instructions on 845B have been issued by the Treasury since the Blue Book came out early in 1985, nor are any releases expected in the foreseeable future. As a result, there is not a whole lot I can report on in the way of new news. What I will do is give a quick summary of the specifics of Section 845B for those of you who are not familiar with it. Then, I will offer some observations on how the industry has learned to live with it so far. Finally, I will make a few guesses about the future. For those of you who would like more detail on this, I suggest that you refer back to relevant entries that appear in various 1985 editions of the Record which go into a lot more detail than I am presenting today.

Section 845B specifically and simply reads that "if the Secretary determines that any reinsurance contract has a significant tax avoidance effect on any party to such contract, then the Secretary may make proper adjustment with respect to such party to eliminate such tax avoidance." There are several important things to note about this section. First, it apparently gives the IRS the power to make adjustments to one party in the transaction, without making a reflective adjustment to the other. Second, it leaves the term "significant tax avoidance effect" completely undefined.

The committee reports and the Blue Book shed only a little light on what the term "significant tax avoidance effect" is supposed to mean. For example, they make clear that the motivation for entering the transaction should be considered irrelevant in making the determination of a "significant tax avoidance effect." Several characteristics that will potentially be viewed as red flags by the IRS are also identified. Among these are newly negotiated treaties,

treaties between parties with different tax rates, treaties with experience refunds or automatic recapture provisions, and surplus relief treaties in general.

Several limited safe harbors are identified, including YRT and so-called "clean" coinsurance treaties. However, even these forms should be utilized with caution, because there are apparent inconsistencies and conflicts about what is safe even within the limited sources of information that we have.

So given all this ambiguity, what are companies doing? From what I have seen, during 1985 companies were generally kind of cautious about entering new agreements with an 845B risk. While deals did get done, they were significantly fewer in number than in the past. This of course was not entirely due to Section 845B; the state regulatory environment was also going through a turbulent period of deciding what to do about surplus relief during 1985. Now that we are midway into 1986, I have noticed an increased level of activity in the special reinsurance treaty area. More companies seem willing to enter treaties that have some perceived amount of residual 845B risk. These include treaties playing on the difference between statutory and tax reserves. Also, more mutual companies seem to be willing to take the tax risk on non-tax neutral surplus relief treaties.

As far as the future, I expect to see this trend continue. This is especially likely to happen if the states continue to move to clarify the regulatory situation with respect to reinsurance treaties.

One final word on 845B. It may give you some comfort, if you are with a company planning to enter treaties that could raise this issue, that there are a lot of very competent professionals in the legal and tax areas across the country who believe that the section would have a lot of trouble standing up in tax court, if challenged. As a result, if your company can realistically live with the idea of going to tax court, if necessary, then the potential 845B risk may not be a real one for you.

MR. BIDELMAN: The next panelist, James Jones, is an ASA and has the title of Attorney with the Illinois Department of Insurance. He is a former actuary with the Michigan Insurance Bureau, former Chief Actuary to the Colorado Insurance Department and has his law degree from the University of Denver's College of Law. I have asked him to discuss some of the state regulatory concerns relating to reinsurance business.

MR. JAMES D. JONES: Most of you have learned to live with regulation; in the insurance industry, regulation and regulators are facts of life. For the next few minutes I would ask you to place yourselves in the shoes of the regulator. You must be concerned with not just one, but with hundreds of insurance companies. As one regulator said it, "regulating reinsurance is like setting a speed limit for the wind."

It is important to draw lessons from history. Remember that the 1974 Equity Funding scandal was based upon a reinsurance scheme. I am not suggesting to you that we compare the current reinsurance practices with the fraud that was practiced at Equity Funding. I am suggesting, however, that the regulation of reinsurance is serious business and suggesting that a mistake by regulators may have serious consequences for both the consumer and the industry. We should not forget that the regulators were severely criticized for their role in the Equity Funding affair.

A number of current reinsurance problems plague today's insurance regulator. Lack of clarity in the wording of reinsurance contracts can cause headaches for the regulator who is charged with deciphering overly complex or vague contracts. The regulator worries about the effect of a reinsurer's insolvency on the ceding company and, at the same time, worries about the effect of a ceding company's insolvency on the reinsurer. Illinois regulators are especially concerned that the use of well established reinsurance products may be severely mismatched with the types of risks associated with the relatively new interest sensitive insurance contracts.

Reinsurance contracts which are drafted today often are classified by their wording into two extremes: either the contract is so vague in its terms and definitions that regulators are uncertain of its meaning, or the contract is too complex and sophisticated, producing precision in meaning but confusion in application. In either case, it is not uncommon for regulators to find that such reinsurance contracts are interpreted one way by the ceding company, another way by the assuming company, and still a third way by the insurance department. Often the drafters of these contracts forget that the purpose for writing a reinsurance agreement is to clarify the intent of the parties. Reinsurance statutes of the state of Illinois are primarily focused on the domestic insurer as the ceding company. Historically, with the exception of surplus relief reinsurance, the Illinois Department has restricted its review of reinsurance treaties to domestic companies. Only under limited circumstances, such as acquisitions, admissions, and companies experiencing financial difficulties, has the department deviated from this practice. Other states operate in a similar fashion.

Generally, a foreign insurer may choose any reinsurer, regardless of whether such a reinsurer is licensed in the state of Illinois. However, with increasing frequency, foreign ceding companies in Illinois are attempting to move a block of Illinois policies to nonadmitted reinsurers by using assumption reinsurance agreements. The certificate of assumption in these cases typically is worded to absolve the ceding company of liability for future claims on the policy that is being ceded and purports to establish the reinsurer as the substitute for the ceding company whenever the policy refers to the ceding company. This establishes a new contract between the policyholders and the nonadmitted reinsurance company. In Illinois, this arrangement will be viewed as conducting an unauthorized insurance business, and appropriate regulatory action will be taken against the reinsurer.

Reinsurer insolvency often poses a serious problem to the financial health of the direct writers. When Illinois does not regulate the reinsurer directly, the question of the reinsurer's solvency cannot be answered in a way that will make the regulators comfortable. Regulators check the collectibility of balances whenever reinsurer solvency is questioned. Regulators may require the reinsurer to deposit reserves with the domestic ceding company if credit is to be permitted on the annual statement.

Surplus relief reinsurance is now being used in an increasingly complex, financially oriented insurance market. The risks faced today by insurance companies writing interest sensitive products were unknown to life insurance companies 15 years ago. Adapted to these risks are old tools such as surplus relief reinsurance.

The Illinois department considers the regulation of surplus relief reinsurance a very important issue because so many of our regulatory decisions are based on reported surplus, and because the end result of surplus relief treaties is the improvement of the surplus position of the ceding company. Surplus, the funds available to meet those unanticipated deviations in operating results, must actually be enhanced by these treaties. Too often surplus relief treaties merely enhance the complexion of the annual statement without supplying any substantive change in the ceding company's financial position. The need for some minimum level of surplus as a buffer against risk fluctuations is so essential to the financial health of the company that it is a key component in determining a company's *Best's* rating. If the surplus of the company becomes too low, the Illinois Insurance Director will suspend or revoke the certificate of authority to do business in the state or, if it is a domestic company, will place the company in receivership.

The regulator is at times accused of being inconsistent because he or she has disapproved a treaty which was drafted with wording similar to an already approved reinsurance treaty. The critics often ignore the special facts surrounding the disapproved treaty. Regulators readily acknowledge that the intended use of a reinsurance contract colors the regulator's perception of the treaty. When a ceding company insures a very predictable risk, then a reinsurance contract may cover little or no risk. Under such circumstances, where only a negligible risk is transferred to the reinsurer, a surplus relief reinsurance agreement will be disapproved.

Companies using surplus relief reinsurance as a financial tool are ceding business that would normally be retained. Surplus relief is merely a financial strategy to generate additional statutory surplus for the ceding company; it is a means of trading surplus with the reinsurer.

There are various reasons for seeking surplus relief reinsurance. A company having a distribution system which is capable of producing more business than can be retained on its books with the attendant surplus drain will seek surplus relief. In many cases, reinsurance is a justifiable solution to a temporary problem. But with some companies -- and these are the ones that ultimately concern regulators -- the temporary infusion of surplus serves only to disguise a very serious financial problem. The job of the regulator is to first determine which companies have sought surplus relief and, once those companies have been identified, to determine their motivation for seeking surplus relief.

Beyond the inappropriate use of reinsurance, occasionally agreements are "reinsurance" in name only, as there is no transfer of risk to the reinsurers. The elimination of risk is accomplished by a number of subtle devices, often including an experience refund formula requiring the ceding company to repay any deficits.

Regulators have come to believe that some in the industry no longer support the concept of risk transfer in reinsurance contracts; that some look to surplus relief reinsurance as an artificial means to leverage their company through use of accounting manipulations. Although single premium deferred annuities have commanded center stage in this respect, regulators conceive that such abuses also exist for ordinary life and accident and health insurance.

The litany of abuses of surplus relief reinsurance would not be complete without also including companies that back-date treaties into prior years without a pre-signed letter of intent, companies that report surplus relief when the relief reported significantly exceeds the value of the risk transferred, and companies that are so highly leveraged by surplus relief reinsurance that they have seen huge gains from high risk investment policy.

This latter abuse could occur because, under a modified coinsurance treaty, a ceding company is capable of accumulating a high ratio of assets relative to its equity in the company. Regulators are told by reinsurers not to fear the possibility of such a situation since they -- the reinsurers -- have an interest in monitoring the ceding company's asset management. The fears of the regulators are not so easily allayed, however, since the department has seen examples where the unacceptable did occur despite the reinsurer's monitoring. When the value of the risk transferred to the reinsurer is small in comparison to the cost of monitoring the ceding company, the reinsurer may lose its incentive to review the ceding company's investment policy.

The business of the insurance industry is insurance; so also is it a simple truism that the purpose of a state insurance department is the regulation of the insurance business. But regulation is not business, nor can the industry's self-policing substitute for regulators; the public would not accept that situation. Because our roles differ, regulators at times may see reinsurance from a different perspective than members of the industry. This should not mean that an adversarial relationship is the norm; two points of view may inspire a truly three-dimensional understanding of reinsurance problems.

MR. BIDELMAN: We would like to look at some of the specific things that are going on in the state regulatory area, which brings me to our third panelist. Bill is a Senior Vice President with Lincoln National and has been involved with reinsurance for 17 years. Bill is going to discuss current developments in the state regulatory area.

MR. WILLIAM K. TYLER: While the life insurance industry has been very highly regulated throughout the 20th century, the reinsurance industry has basically been unregulated. It has only been during the last 10 years or so that the insurance regulator has begun to focus increased attention on the area of reinsurance regulation. This shift in focus originally developed because of problems in the property-casualty side of the business; for example, the fraud encountered in Kenilworth, which was a result of unscrupulous reinsurance intermediaries, and the insolvencies of a lot of property-casualty companies over recent years. More recently, the collapse of Baldwin United has tainted the reputation of life reinsurance because of the way reinsurance was used to transfer assets between affiliated companies in that situation.

One of the most significant and well known regulatory initiatives in recent years was the adoption in March 1985 of New York Regulation 102 by the New York Insurance Department. This regulation prohibits life insurers licensed in New York from reducing any liability or establishing any asset for reinsurance ceded if the reinsurance agreement contains any of a list of prohibited provisions. All new agreements entered into subsequent to March 1985 must comply with these requirements. Companies may continue to take reserve credit for existing reinsurance agreements that are not in compliance if those agreements were provided to the department within 60 days of the effective date of the act. I think several companies did provide agreements to the New York Insurance Department under this provision.

The treaty provisions that are specifically outlined in Regulation 102, which if present in a reinsurance agreement would deny reserve credit to the ceding company, include such provisions as the following:

1. The ceding company is required to reimburse the reinsurer for negative experience under the reinsurance agreement.

2. The ceding company can be deprived of surplus at the reinsurer's unilateral option or automatically upon the occurrence of some specific events such as the insolvency of the ceding company.

3. Any provision that would require the ceding company, at some specific point in time, to terminate the reinsurance agreement.

For the most part, the reinsurance programs that I am familiar with do not violate these particular provisions. Structuring a reinsurance program that meets these objective criteria as outlined in Regulation 102 is possible.

The problem with Regulation 102 is that it goes on and focuses on another aspect of surplus relief transaction wherein the concern or area of interest is how the reserve that the ceding company is taking under the reinsurance agreement compares with the risk that is transferred. The problem with this particular area is that no objective tests are provided. This is a subjective area. This regulatory concern for reasonable risk transfer and a relationship between risk transfer and the reserve credit has found itself expressed in this regulation and in an NAIC model regulation, which was developed subsequent to New York's Regulation 102. The preamble of Regulation 102 states that the department views as a violation of New York law all reinsurance agreements entered into for the primary purpose of producing significant surplus aid to the ceding company while at the same time transferring little or no risk to the reinsurer.

It goes on to state that the department is concerned with reinsurance agreements under which the expected potential liability of the ceding insurer remains basically unchanged, notwithstanding certain risk elements in the agreements, such as catastrophic mortality or survival risk.

Two provisions in the body of Regulation 102 also express this concern. One of these conditions deals specifically with the agreements which transfer deficiency reserves or excess interest reserves to the reinsurer and requires that the reinsurer participate in the mortality, morbidity or surrender benefits under the contract in the same proportion as it participates in the excess interest or deficiency reserves. The problem that the industry has with this aspect of Regulation 102, and indeed with the NAIC Model Regulation, is that there are no standards set forth; there is simply no way to know in advance whether a specific treaty is going to meet the test that New York or some other state might apply to a specific treaty.

What has happened in other states? Arizona, California, and Florida have all been mentioned as states that are close to, or at least are considering, adopting similar regulations. Last year, Connecticut sent out special statement instructions addressing reinsurance reserve credits.

That is a quick summary of just what the provisions of this regulation are and its current status. I find it ironic that at the same time that the state insurance departments are so very concerned about the capital shortage on the property-casualty side of the business, they view surplus relief transactions on the life reinsurance side as abusive -- and some are. There are some of you seeing transactions being done; there is no question about that. Surplus relief is a very effective capital transfer mechanism. There needs to be a basis for the industry and the insurance regulators to be able to exchange views on this topic and come up with regulation that curbs the abuses but allows the mechanism to work.

MR. BIDELMAN: We want to try to cover some other state regulatory issues, and one of the key ones is the appropriate reserve credit to take on reinsurance transactions. There has been some activity in this area.

MS. MACDONALD: Reinsurance reserve credits are another subject where most of the items that I have to talk about are somewhat old news. I had hoped that something new might have come out of the NAIC meeting held at Boston this week. Yesterday, I called one of my associates who had attended that meeting for an update, but all I could come up with were a few small items.

First, he reported that an unusual series of separate seminars open only to examiners had been held at that meeting specifically to go over actuarial, accounting, administrative and legal issues associated with life reinsurance arrangements. This points to a continued high level of interest in reinsurance amongst the regulators.

Second, my associate told me that a new subgroup to the accounting procedures task force has been created to study annual statement blank issues associated with life reinsurance arrangements. Brad Gile of the Wisconsin Department is chairing this group, and an industry advisory group has also been appointed, headed up by Peter Storm of the Travelers. They aim to have a report ready for the September NAIC meeting to be held in Des Moines.

Getting back to older news, I would like to give you a quick summary of work in the reinsurance reserve credit area, completed last year by the EX5 reinsurance advisory committee on which both Bill Tyler and I served.

The reinsurance advisory committee was created by the NAIC EX5 committee and was given the charge of coming up with a way of quantifying the appropriate amount of reserve credit under all types of reinsurance arrangements. Presumably, it was felt by the regulators that this type of work would be particularly helpful to them in their assessment of the appropriate reserve credits that companies were taking on surplus release treaties. As Bill mentioned earlier, they were looking for some specifics to help them in this very subjective area. However, because of the shortcomings of the existing statutory accounting framework, this turned out to be a virtually impossible task for the advisory committee to complete to the degree that had been contemplated by the charge. In fact, there was quite a lot of disagreement among members of our own group about how to proceed with it. The approach that we finally decided on was to establish only a basic set of principles for determining the reserve credits. In addition, we compiled a list of issues about specific standards of practice that we thought needed a much broader exposure among other actuaries before any kind of recommendation could be made.

Getting down to specifics, the basic conclusions that we came up with were something like the following:

1. First of all, we decided that when a policy is reinsured it should be recognized that only those benefits which are recognized in the ceding company's gross reserve and which are indemnified by a reinsurer should result in a reserve credit.

2. Second, the ceding company and the reinsurer should then each establish reserves that satisfy the minimum valuation standards for their portion of the policy benefits. Note that under this definition the sum of the retained reserve plus the reserve held by the reinsurer need not necessarily equal the gross reserve that would have been held, had all benefit responsibilities been retained by the ceding company. This is true because of differences in statutory minimums between states and differences in standards that individual companies actually choose to use.

3. Third, our committee concluded that any provisions in reinsurance agreements which diminish or nullify the payment responsibility of the reinsurer should be reflected in the reserve credit taken. Presumably, these provisions would have the effect of reducing the credit.

4. Finally, our committee recognized that treaty provisions themselves may sometimes create situations where additional reserves may be required as a result of the reinsurance. For example, this could happen if the treaty specifies a schedule of premiums that the ceding is obligated to pay the reinsurer that exceeds the gross premiums being charged to the policyholder.

Obviously the four items I just outlined are a pretty crudely developed set of principles. Our advisory committee recommended back to the NAIC EX5 committee in December that it should refer the matter to the American Academy of

Actuaries for further development and exposure before any part of these guidelines are put into practice. Since then, the Greeley committee of the NAIC has been looking into the matter. From a conversation that I had with Bill Carroll of ACLI, it sounds like the Greeley committee has decided to go along with our committee's recommendation. Specifically, the Greeley committee is thinking in terms of recommending that the NAIC come out with a very general guideline actuarial statement about reinsurance reserve credits. This would be signed by the actuary as part of the annual valuation statement. In addition, the plan is to recommend that the job of developing standards of practice should be referred to the American Academy.

The other thing I would like to touch on briefly is mirror reserving. This is supposed to refer to a condition where the reserve credit is taken by the ceding company with respect to specific reserves, matching those established by the reinsurer on a dollar-for-dollar basis. With the availability of the NAIC database, more and more regulators seem to be latching onto this idea. In fact, I believe that there are a few states that actually require that ceding company reserve credits not exceed the reserve established by the reinsurer under coinsurance arrangements.

I think that this is an unfortunate development. Both from a theoretical and an industry standpoint, mirror reserving just simply does not make sense, for a number of reasons.

1. First of all, statutory minimums vary by state, which means that the credit of a reinsurance reserve need not be the same if, in fact, the ceding company and the reinsurer are on different standards.

2. Second, there are oftentimes approximations used in reserve computations that could make a dollar-for-dollar match between the approximation used by the ceding company on the one hand and the reinsurer on the other hand absolutely impossible to achieve.

3. Third, reinsurance is often on an annual premium mode rather than on a modal mix that the direct writer actually used, which would imply that

your reserve credit won't match the reinsurer's reserve in almost any case because of the modal differences.

4. Fourth, there may be timing problems in coordinating statement preparation between the affected companies, which might make reserves impossible to match. For example, oftentimes I believe that the reinsurer has to work with an estimate, while the cedent is able to get a more exact number because it has a few more days before it has to print.

5. Finally, and this is the area where I have the most concern, a requirement for mirror reserving could have the effect of undermining the role of actuarial judgment in setting reserves. With all the subjectivities out there about what is needed for appropriate reserves, I hate to replace a good actuarial judgment by any type of formula standard.

It is interesting to note on this that the principles developed by the reinsurance advisory committee that I went to above would also argue against mirror reserving. I think we all need to monitor and work closely to influence developments in this area in coming months.

MR. BIDELMAN: Our purpose here is to give some opinions on both sides of the issues, so I would like to ask Jim to come back up and make some comments from the state regulators' viewpoints on the subjects that Bill and Karen just discussed.

MR. JONES: Before I actually get into the area of surplus relief, I caution you to not really draw any comparison between casualty companies and their problems and the surplus relief question. Casualty problems are based on many different events that occurred for years, and some of these problems are based upon cash flow underwriting that was accomplished eight years ago. I don't believe that, if you translated the surplus relief over into the casualty area, it would solve many of these problems.

In the area of valuation of risk that is transferred under surplus relief, I think the term that was used was "subjective" area. I think, from what I have heard so far, that is probably true. There is an effort being made to quantify the area, but we still do have differences. One difference that I think popped up in this area is when we were talking about mirror images. There were five reasons listed by Karen as to why mirror imaging might not be a good idea. Most of them don't appear to be a real problem for the regulators. As for the different standards by state, I think regulators realize this problem, and those differences can be accommodated. The approximations are going to be used in most accounting-type transactions, and you can't expect always a dollar-for-dollar result. However, I would say that a dollar-for-dollar offset has the appeal of being simple, and that is something that should concern you. If you make a solution unworkable, a simple solution may be grabbed.

There is no problem with premium mode being used, but Karen's last statement about undermining the role of the actuary's judgment, which seems to advocate replacing the form of the standard, seems to be throwing the area valuation of risk back into the subjective area. Actuaries do differ in their judgments, and I think that a good actuarial judgment is a good tool in determining the financial position of a company. However, it cannot be a substitute for a precise standard, which the regulator can look to in determining the status of the company. Regulation of a financial institution is very important, particularly since we are now engaging in more and more sophisticated and complicated financial transactions in the insurance industry. I think it would probably be a good idea to turn away from such subjective thought, replacing actuarial judgment with good hard analysis, and taking the surplus relief question and analyzing it in terms of a question that can be answered in terms of precise numbers.

MR. BIDELMAN: I wanted Bill Tyler to spend some time discussing some of the other state regulatory items that are going on, such as fronting bills, filing requirements, etc.

MR. TYLER: New York circulated a draft of Regulation 82 late last year. The regulation is designed to prohibit life insurance companies licensed in New York from entering into transactions with life insurance companies not licensed in New York, where those transactions are deemed to be fronting. The regulation would apply even in those situations where the unlicensed insurance company is an accredited reinsurer and recognized as such by the state of New York.

REINSURANCE REGULATIONS

After several meetings with the ACLI, the New York Life Companies Association, and individual companies including Lincoln National, New York revised its draft regulation and recirculated it in late April of this year. Hearings were held in New York on June 5. I was not personally at the meeting. If anyone here at this meeting was there, we would be interested in hearing your account of what took place at that hearing. What I have heard is that there were a lot of people at the hearing. The ACLI, Lincoln National, and several other companies made presentations at the hearing. The New York bankers were there as well. All who spoke from the industry except one, I am told, opposed the regulation, at least in its current form.

This is a déjà vu experience. This is the third time New York has published or circulated a fronting regulation. Each of the two prior times, the regulation has been dropped. At this date, it is not clear what New York will do. It appreciated all of the industry interest; it indicated that it will take the comments under advisement. What it will do next, though, is not clear. It obviously can drop the whole thing, it can modify it substantially, or it can press ahead with its current draft.

The basic problem with the fronting regulation from the industry standpoint is that its definition of fronting is simply too broad. It defines fronting in a way that not only would curtail abusive transactions, which we might all agree should not be permitted, but would also cover many transactions which should not be prohibited.

An example is a life insurance company ceding portions of the policies it writes to a reinsurer owned by the agents who write the business (ceding to agent-owned reinsurance companies). This kind of transaction would be prohibited under the regulation. Regardless of how you feel about agent-owned reinsurance companies, it would be my view that the fronting regulation is not the place to capture that type of transaction and to prohibit it.

There are many joint marketing ventures that involve two or more insurance companies, where one company writes the business and shares it with the other partners in the venture. These types of transactions would also be violations of Regulation 82.

Reinsurance transactions in which the reinsurer performs any one of several functions for the ceding company (i.e., marketing, underwriting, claims processing, and/or product development) would be prohibited. Our view, from an industry standpoint, is that the definition of fronting will capture all kinds of transactions that simply should not be prohibited transactions.

A second issue is the way the regulation is drafted. There is a real presumption of illegality on any transaction that even looks like it might be fronting under this very broad definition. The burden of proof that the transaction should be acceptable is on the company itself. The insurance department does not have this burden of proof.

It is our understanding that Florida is also considering fronting regulation, but I have not seen the specifics on that.

On another front, the AICPA, through its Reinsurance Accounting and Auditing Task Force, is looking at fronting transactions and attempting to propose what type of GAAP accounting is appropriate for these transactions. Basically, in the early drafts of its work, it was coming down on the side that a fronting transaction should be accounted for as a service agreement, not as a reinsurance transaction. One of the difficulties with the approach the AICPA is taking, from my perspective, is that it tends to equate the concept of fronting with the concept of reinsurance, which is ridiculous. The two concepts are not equivalent by any means. So that is where the fronting initiatives stand at this point.

As has been mentioned, there has been a lot of activity in the area of reinsurance regulation. One way the industry has dealt with this increasing attention is by increasing the staff support and the focus within the ACLI. The ACLI formed a Reinsurance Subcommittee in February of 1984. Since that time, that Subcommittee has been active with these various actions that have been coming out of the NAIC and various states. In addition, as Karen mentioned, the NAIC has several committees and task forces either on a standing basis or on an ad hoc basis that are looking at a variety of reinsurance issues. Our hope, I would say from an industry standpoint, is that the cooperation and communication between the NAIC and the ACLI Reinsurance Subcommittee can increase so that there is a more organized approach toward dealing with the various regulatory initiatives which affect reinsurance.

Another area that I would like to mention briefly is the development within the statutory annual statement blank itself. As most of you know, there have been many additions to the annual statement blank that help regulators get a better handle on the kinds of reinsurance activities in which the company is involved. Several years ago, Schedule S was substantially expanded to include additional information on business assumed. Even prior to that time, there had been several additions made to the annual statement to separately identify specific reinsurance transactions on the summary of operations, the balance sheet, or elsewhere in the statement. Again, these changes were made just to give some disclosure to the regulatory authorities. In addition, some interrogatories deal specifically with surplus relief programs.

More recently, the ACLI looked at a proposal for expanded reinsurance disclosure on pages 5 and 7 of the annual statement. I don't know if that particular proposal will develop and go forward at this point, but certainly it represents continuing interest on the part of the regulatory community to get a better understanding of the reinsurance transactions in which its companies are engaged.

Finally, I will just comment briefly on a filing regulation that the Florida Insurance Department passed last year. It required all licensed companies to file all reinsurance treaties. There was some lobbying by the ACLI to try to reduce the scope of that requirement, but it met with little success. All companies doing business in the state of Florida are required to file all reinsurance treaties under which they are ceding new business. I assume Florida has received a ton of paper since last October.

I haven't seen any indication that any action has been taken on this to date -- I would be surprised if there were. The Florida requirement is not a very useful way to deal with reinsurance regulation. It provides a lot of paper, but it is not focusing the department's attention in any particular area where it has concern. It is not really clear what this filing requirement is intended to accomplish for this insurance department. Again, I think that this is just another manifestation of the need for an improved dialogue between the ACLI, the NAIC, and the various insurance departments on this matter of reinsurance.

MS. VICTORIA L. BAILEY: I look at mirror reserving from the perspective of a casualty actuary. We do reinsurance of some health business, and we do our reserving especially for what we call IBNR (you probably call it something else), using the large numbers from combining all of our clients. We have high-layered business, large deductible, major medical -- that type of thing. We really believe that we get a better answer for what we have to ultimately pay out on all our clients' business if we combine them all, rather than having each client project what it thinks its two or three largest claims would be and trying to sum that all together. So it is hard for me to understand what you are talking about in the mirror reserving. Is it that there should be some formula that each ceding company could use so that I could sum them all up and get as accurate a number as I'd have got if I had access to a larger statistical base -- working with all of our ceding companies combined? You are saying that this would be less subjective and less judgmental. It sounds to me like it would be much more subjective, because I am giving up the whole advantage of having a large data base. Am I missing something because the life side is so very different?

MR. TYLER: I agree with your basic comment -- it supports the idea that mirror reserving isn't always appropriate, certainly in a situation where a company is taking the excess risk only on some kinds of programs. The morbidity or mortality level on the excess side of the business is likely to be far different than it is on the total block of business written by the client company. So in that case, it doesn't make any sense for the ceding company to take a reserve credit that is equivalent to what you are setting up for your business. That would be taking too much of a credit. To require mirror reserving in that case would be very unconservative and counter-productive to what I feel the insurance companies generally want to accomplish when they focus on this concept of mirror reserving. I think generally the mirror reserving concept is not well defined, and you know different people have different definitions in mind. I think that generally people are talking in terms of conventional quota share types of coverage, where a given percentage of all the benefits written by a ceding company is passed over to a reinsurer. In that case, there should be some comparability between the reserve credit, the reserves that the client is taking, and the reserves that the reinsurer is taking.

MR. JONES: I think, Ms. Bailey, if I understood your question, you are also looking at IBNR calculations. I think that the IBNR calculations that you would use in the casualty line of insurance are significantly different, in that the type of formulas you would use to approach the valuation is different from the types of formulas we're talking about here in the mirror image. The IBNR calculations are not something that you would probably get any two actuaries to agree on. They are highly statistical, and the techniques even vary by company. I believe here that we are talking about something a little less volatile.

MR. JAMES W. PILGRIM: I believe, Bill, that Florida also said in its requirement that it wants to see all the papers that lead up to the agreement so that it can see the line of reasoning that went along and then see the final agreement as well. I don't know how many companies were filing their papers as well as the agreement, but I think that it was one of the requirements. I have a question in regard to a bill that was in the Louisiana legislature, having to do with imposing cut-through agreements in the event that a ceding company goes insolvent. The bill would have made it so that a policyholder could go directly to the reinsurer to obtain benefits. Do you know what happened to that?

MR. TYLER: I am familiar with that case, or the situation, but I don't know what the status is. The only thing I do know is that the ACLI attempted to discuss the issue with the Louisiana Department and met with no success in terms of changing its opinion. I think, from a reinsurance perspective, this represents a very serious concern; even though the issue is one of focus in Louisiana (in the property-casualty business), it is obviously a situation that is of great concern to all reinsurers, whether they are life or property casualty. The idea that the reinsurer is dealing only with the ceding company and has no responsibility on through to the policyholder is a very basic concept. It is not one that should be cut into without a lot of thought. It is really a basic concept that has been inherent in the life reinsurance business for a long time.

MR. ROY GOLDMAN: I attended the hearing on Regulation 82 last week and, in fact, testified on behalf of the Prudential against the regulation. I'd like to make some further comments about it. First, I don't think it is the case in New York that the regulators don't understand the reinsurance business. I think they do understand the reinsurance business, and the hearing officers (none of whom were involved with the drafting of the regulation) claim that what they are really after is a definition of fronting. They challenged several of the individuals who testified to come up with a better definition of fronting than they already had.

I think the hearing officials would concede that the regulation is too broad in the way it is drafted now, and they will probably redraft it to narrow the types of business that they are really trying to eliminate. In fact, one of those who testified said that fronting is like pornography. You know it when you see it, but you can't define it.

The hearing officers said that one of their aims is to try to regulate a New York statute which says that a licensed New York carrier should not aid unlicensed carriers to do business in New York. One of the things they are very concerned with are those unlicensed carriers who are trying to circumvent the licensing process that New York has. They commented several times about the futility of having a licensing procedure that is easily circumvented by unlicensed companies. For example, a carrier that is unlicensed in New York had put together a product, done all the marketing of the product, done all the claims work and simply needed a licensed fronting company. The second situation, I think, is in the area of credit insurance, where you have a large financial institution forming captives that are certainly very small insurance companies (the very large insurance companies are ceding business to these captives).

I think another question as to what is going to happen is tied up in whether New York feels that it can win any kind of court action. It seems this might be difficult, because several attorneys testified (including attorneys on behalf of the American Banks' Association), claiming that the New York Insurance Department has no statutory authority to pass this regulation. Indeed, this was the reason that prior regulation, which I guess was proposed in 1978, never came to pass. That regulation was even more sweeping than this. It applied to property and casualty as well as to life insurance. In fact, Al Lewis, former Superintendent of the New York Insurance Department, testified on behalf of large banks such as Chase Manhattan and Key Bank. He claimed that it was illegal for the insurance department to pass the regulation. I really think New York believes that it wants to regulate some of the situations. The question is whether it can define these well enough to avoid a court challenge.

MR. BIDELMAN: Jim, is Illinois looking at anything in the fronting area at all?

MR. JONES: Not to my knowledge. I don't believe that we have anything that is current in the fronting area. We are aware, of course, of the New York Regulation 82 and have made some analyses of the situation, but I don't think anything is current right now.

I would like to make a comment now on issues such as this of fronting, or any other issue that is put before regulators. I think that you, Bill, made the statement that informed regulation is certainly preferred, and that is true. First of all, all regulators (even in New York) can use a little bit more information and a little more knowledge on any subject, no matter how well they be versed. However, the education of regulators oftentimes consists of simply hearing preferences and then hearing those preferences defined. That is not really very useful for the regulator, and I am not sure that it is useful for the industry either. It would be better, I think, if the insurance industry were able to explain reinsurance to the regulators in a fashion that would be more of a true dialogue, as opposed to their simply stating a preference.

The other point I want to make is that a lot of times actuaries, because of their training, want to study an issue for a few years before anything comes of it. In regulation and regulatory settings, you do not have the time to study an issue to death. Issues become popular at a certain time, and they generally die their own deaths rather than deaths by new regulations. Those issues which the industry would probably consider dead are simply not adopted for regulation. You have to use the time table of the insurance departments. It is important that, if you want to have a voice in whatever regulation finally comes from a state like New York or Illinois, you meet the time table with the regulators.

MR. BIDELMAN: Jim, you told me earlier that you were concerned because you didn't think there was enough industry input on some of these reinsurance regulatory issues. Do you have a suggestion on what could be done better, other than what you have already commented on?

MR. JONES: I am certain that others would have a different opinion as to what can be done than I would. Personally, I would prefer that members of the Society who are particularly knowledgeable in this area spend more time explaining to regulators exactly what a particular reinsurance contract is intended to accomplish -- i.e., what the financial significance is and why certain things are done the way they are. If the regulator expresses some opinions, those opinions should be taken into account. There seems to be an effort now, and a good effort at the high levels, to improve communication and dialogue between the industry and regulators, but on a day to day working basis there is perhaps not enough effort.

MR. LARRY M. GORSKI: I have been very active in reinsurance the last couple of years, and it is a fascinating field. I think that the comments concerning the ACLI educational efforts have been helpful in getting some type of exchange started between the regulators and industries, and I would like to see that continue to happen.

MR. TYLER: James, regarding your comments on how the industry should approach regulators when the industry has an issue to deal with, I imagine that some of the same concepts that Loren Belker discussed in Business and Luncheon Session 14, in terms of approaching the Senate, probably apply here too. Basically, the regulators, although it is obviously a different forum than we are dealing with here, are dealing with people who have a job to do and don't have enough staff to get everything done with the degree of analysis they would like. So, it is very useful not only to approach them in an effective manner, wherein they can understand what your position is and what the logic of that position is, but also to discuss with them what the counterpositions might be so that they don't get blind-sided either.

The New York fronting focus has been on trying to figure out how to define fronting, and I think my argument would be that New York doesn't need the regulation to start with. It can deal with the problems that it is concerned about with its existing authority. Obviously, New York doesn't agree with that, or it wouldn't be pressing forward. I think there is a basic difference of opinion about what is really needed to give New York the tools it needs to deal with the problem.