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FINANCIAL REINSURANCE

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- o A continuation of the Reinsurance Section Breakfast
- o Federal tax issues
- o State regulatory issues
- o Changing climate in reinsurance and administrative issues
- o International issues

MR. ALLAN D. GREENBERG: The topic of this session is financial reinsurance. We are quite fortunate to have such a distinguished panel to speak to us on many aspects and issues relating to financial reinsurance. I currently am Vice President and Chief Actuary of Geneve Capital Group, a holding company that has substantial interests in insurance. Over the years our insurance companies have been involved in several financial reinsurance treaties to the profit of

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our companies and to the profit of the companies with which we have done the reinsurance.

Over the past few years several things have happened in both the tax area and the regulatory area to make it more and more difficult for companies to enter into reinsurance agreements at an arms length basis in order to accomplish whatever reinsurance aims they have. With difficulty often comes opportunity, and I hope we will have a chance to consider both the areas of difficulty and the areas of opportunity. Concurrent with some of the difficulties caused by the external environment, we have also seen a change over the past ten years, and particularly over the past five years, in the relationships between reinsurers and their clients.

MR. STEVEN W. FICKES: The first thing that I want to do is to provide some definitions. First, let's define traditional reinsurance. Traditional reinsurance is a form of reinsurance on which the assuming company thinks it will make money but rarely does. Then we have financial reinsurance. This is the type of reinsurance where the greatest risk transfer is the risk that insurance will be disallowed.

The first item that I would like to talk about is the history of financial reinsurance from the beginning through about four of five years ago -- what I refer to as the tranquil period. Then the second item that I would like to discuss is the period which we are currently in which I refer to as the onslaught period -- where regulatory officials are attacking financial reinsurance transactions. Finally, the third item that I would like to talk about and probably spend the most time on is the future of financial reinsurance.

The tranquil period begins with Modco 820. This was really the genesis of financial reinsurance. There was a little surplus relief going on before Modco 820. However, by taxing life insurance companies at marginal rates in excess of 100% on investment income, the IRS spawned a tax avoidance industry in financial reinsurance. Then, following Modco 820, many of us got creative with 818(c)(2) deductions going back and forth between companies. Then we had a lot of nonpar ping pong. One company would take a big increase one year, and the decrease never counted so you could go back and forth. Then you had deficiency reserves. Deficiency reserves marked the beginning of international reinsurance as companies began to discover that these things could sink into the ocean.

Next, one of my favorites is surplus relief. During this period of time everybody was specializing in no risk transfer surplus relief. There were two forms of treaties that evolved, and I have named these tautology reinsurance and Chinese reinsurance. Tautology reinsurance is where the experience refund formula is very complex, but when you finally analyze it, you end up with one equals one. Chinese reinsurance is where the treaties are incapable of being understood.

That brings us to the onslaught period. The first item that signified the beginning of the onslaught period was the repeal of the Modco 820 election. Second, 818(c)(2) was taken away. Third, nonpar deductions were removed. Fourth, we started to get letter of credit requirements. Finally, we are beginning to get reserve requirements that may require companies to put up the reserves that they are reinsuring instead of letting them sink into the ocean. Then the biggest change that came about is 845(b), which basically gives the Internal Revenue Service the right to be fairly harsh to one party without having to be lenient to the other party in a reinsurance transaction. That brings us through the onslaught period.

Next, we have the future. I think the future for financial reinsurance first lies in international reinsurance. We have several opportunities here. First, in tax planning we have many opportunities today to reinsure business internationally where it is most appropriately taxed, or in other words, where it is most favorably taxed. We have actually done reinsurance deals where companies on both sides of the ocean get tax benefits for the same reinsurance. Also, we are beginning to see a very legitimate need for multinationals to do international tax planning and a need for international reinsurance corporaions to assist in this. It is not very good if you operate multinationally and have huge losses in Japan which you cannot offset with huge gains in, say, the U.K. So we are seeing much multinational tax planning and international reinsurance.

Another area is capital management. Most companies that have ever operated a foreign subsidiary realize that once you put money abroad it rarely comes back home. Many companies are becoming much more aware of this and are doing surplus relief deals for their foreign subsidiaries. One time I did a reinsurance treaty for a subsidiary of a U.S. company where the foreign subsidiary was buying surplus relief reinsurance at 5% while the parent company was trying to give it away at 2%. This happened because the parent company was requiring too high a rate of return on the capital that it was providing its subsidiary. There are many opportunities in capital management and going internationally. We can actually get some play on serving the differences.

A further international item is currency management. I think just the tip of the iceberg has been explored in this area. To give you an idea of how big it can be -- in 1977 Exxon took a $270 million hit to earnings because of currency fluctuations. Recently, a U.S. company attempted an acquisition of a U.K. life company for about 500 million pounds. At the time of the acquisition this would have equated to about $500 million. Since that time that acquisition would now be worth $750 million which is a gain of $250 million -- much more than you could ever make in life insurance. On the converse side, the U.S. company could have lost that much money. So when we get into financial reinsurance in the future, we have to look at ways to solve currency problems for companies that operate internationally.

Joint ventures may be the new word for coinsurance. With 845(b) many reinsurance treaties could be thrown out. However, if you were considering an extremely large reinsurance treaty, it would be possible to instead do a joint venture agreement. That would very likely accomplish the same thing that a coinsurance agreement used to accomplish and would avoid some potential IRS problems. If the deal involves many millions of dollars, this is very favorable.

Another area of interest is leveraged buyouts. Every day in the *Wall Street Journal* you notice that a new company has managed a leveraged buyout. If you do it with an insurance company, you discover that the insurance company's management cannot do what it does best (which is produce sales) because that produces losses. With losses you cannot repay your loans on a leveraged buyout. What is needed is some type of ongoing reinsurance so that you can produce as much new business as you want and so that, as you produce more, you can pay off your loan faster. I think leveraged buyouts will be a big item in financial reinsurance in the future.

Investment-oriented products really fall into financial reinsurance more than traditional reinsurance. I think you will see much more investment risk associated with life insurance products being reinsured in the future. For mortality risk, if you know what the risk is, you really do not need reinsurance. It is only when you do not know what the risk is and you want to avoid the loss that you try to hand it to a traditional reinsurer. So investment-oriented products have much potential.

Finally, I think producer-owned captives would fall into the category of financial reinsurance. This is kind of an in-between step of reinsurance companies becoming direct writers or remaining pure reinsurance companies.

These are the areas where I think you will see financial reinsurance insurance in the future. As you will notice, they are much more legitimate and much more defined than what we have seen in the past.

MR. EUGENE L. COPELAND: I will discuss some recent developments in the regulatory and federal tax areas which may affect financial reinsurance. Regulators have a legitimate and very understandable interest in surplus relief reinsurance. The sole reason for their existence is to protect the policyholders and help assure the solvency of insurance companies. Recently, there has been a thrust for more specific regulation of reinsurance transactions. Unfortunately, some aspects of the resulting measures and those now being considered are, in my opinion, an over-reaction to the perceived problems. They cast a cloud of uncertainty on many kinds of reinsurance transactions which have in the past been considered legitimate and which have not adversely affected policyholders. I believe that if these measures are widely adopted without further specificity, they will adversely affect the ability of smaller and more innovative companies to compete and grow. Competition will suffer, and members of the insurance buying public will be the ultimate losers.

The first of the new regulations on surplus relief reinsurance was Regulation 102 in New York. It became effective March 15, 1985. Although improved from original drafts, provisions requiring subjective amounts of additional risk transfer still can cause significant problems in implementing surplus relief reinsurance arrangements. As stated by the New York Insurance Department, it feels that some insurance companies enter into reinsurance agreements for the principal purpose of surplus relief which is only temporary and which transfers little or no risk to the reinsurer. To allow this, it believes, would result in a distorted picture of a ceding company's financial position and create a hazardous situation for policyholders and the people of New York state in general. The department therefore will disallow any liability credit or asset established under the reinsurance agreement by the ceding company if any of six specified conditions exist. Most of these conditions are such that the presence of any of them should rightfully result in adjustments. For example, this might be where the ceding insurer can be deprived of surplus at the reinsurer's option, or automatically upon the occurrence of some event such as the ceding insurer's insolvency, or where the ceding insurer must at specified times automatically recapture all or part of the reinsurance. However, one of the conditions, which I will call "Condition 1", is very troublesome. In abbreviated form it disallows reserves credit where "the primary effect of the agreement is to transfer deficiency reserves or excess interest reserves to the reinsurer for a *risk charge* without consistent risk transfer in the areas of mortality, morbidity or surrender benefits."

"Consistent risk transfer" is a nebulous term and as such is susceptible to subjective interpretation. It could be applied to deny reserve credit under almost any reinsurance agreement containing the other elements specified in Condition 1.

The fundamental flaw of this regulation is that it requires some unascertained amount of risk transfer. The New York regulation contains language in its preamble condemning agreements which produce surplus aid for the ceding insurer while transferring "little or no risk" to the reinsurer. "Little risk" is a relative concept necessarily susceptible to subjective interpretation. It is my understanding that New York has unfortunately used Regulation 102 to disallow credit for most financial reinsurance agreements presented to it.

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In December, 1985 the NAIC adopted a Model Regulation on Life Reinsurance Agreements. It is patterned after the New York regulation but with some improvements. The ACLI reinsurance committee had worked unsuccessfully with the NAIC to try to get a less subjective regulation. Condition 1 of the NAIC Model closely follows Condition 1 of the New York regulation. Instead of referring to "consistent risk transfer," it refers to "significant participation" in risks, which is itself a nebulous concept susceptible to subjective interpretation. The preamble of the NAIC Model condemns agreements which provide "little or no indemnification" of policy benefits. It also would disallow reserve credits taken under reinsurance agreements which provide some indemnification of policy benefits where those policy benefits are not included in the gross reserves established by the ceding company. As examples of policy benefits not so included, it cites catastrophic mortality and extraordinary survival. These terms are not defined in the regulation, and their use is confusing because all life reinsurance agreements (even yearly renewable term agreements) include catastrophic indemnification.

The ACLI recommends alternative language that would make the regulation objective and not require any significant risk transfer. The ACLI reinsurance subcommittee has taken the position that state adoption of the NAIC Model should include these changes:

- Delete the preamble altogether, or in the alternative, change "little or no indemnification" to "no indemnification."
- Restate the preamble sentence disallowing reserve credits taken under reinsurance agreements which provide some indemnity for policy benefits which are not included in the ceding company's gross reserves by deleting the "catastrophic mortality and extraordinary survival" examples of policy benefits and substituting the following objective example of the reserve credits which would be disallowed: "such as reserve credits calculated using mortality or survival assumptions more conservative than those used in establishing the ceding company's annual statement reserves."
- In Condition 1, substitute "any participation" [in risks] for "significant participation" [in risks], and include "lapse" as a distinct risk in addition to "surrender."

In other words, the ACLI takes the position that as long as you have the financial risk of solvency of the company and profitability of the subject block of business, that any surplus relief provided should qualify for reinsurance credit. In my discussions with various regulators around the country, it becomes very clear that no public policy is advanced by requiring some other significant risk transfer. Without changes, this regulation would put companies at risk in being uncertain as to what kind of reinsurance agreement will be permitted by the insurance departments.

In December of 1985 the Arizona Insurance Department produced a draft regulation similar to the NAIC Model. However, it did omit the preamble, and in Condition 1 it did not require "significant participation" in risk by the reinsurer, simply requiring some risk participation by the reinsurer. As far as I know, this draft has never been formally proposed.

Utah's new insurance code, which became effective July 1, 1986, allows credit for reinsurance only to the extent that the reinsurance contract shifts insurance policy risk from the ceding insurer to the insurer in fact and not merely in form.

The next matter of current interest is the NAIC model law regarding letters of credit and custodial accounts. In 1984 the NAIC adopted a Model Law on Credit for Reinsurance. This Model Law prescribes rules for the allowance of reserve and other credits for reinsurance. It applies only to a domestic ceding insurer and therefore is not "extraterritorial."

If its requirements are not met, credit is allowed only to the extent of specific funds held by the ceding insurer or in trust for it to secure payment of reinsurance claims. The funds must be in cash, securities approved by the NAIC Securities Valuation Office and qualifying as admitted assets, clear, irrevocable, unconditional letters of credit issued by a Federal Reserve System member bank or any other form of security approved by the Commissioner.

In 1985 Delaware, Nebraska, North Carolina and Tennessee each enacted laws on credit for reinsurance similar to the 1984 NAIC Model Law on Credit for Reinsurance. Maine enacted a law but different in form, from those of the Model.

Utah's new insurance code, effective July 1, 1986, imposes solvency standards like those of the Model. In 1986, New Hampshire enacted a new law based mostly on the Model. Kentucky enacted a law which follows the Model but applies to all authorized ceding insurers rather than only to domestic ceding insurers.

Since 1983, California, following New York's lead, has a regulatory bulletin requiring that letters of credit supporting reinsurance be evergreen, i.e., have an initial term of at least one year and be automatically extended for a time equal to the initial term unless the issuer gives 30 days notice of non-renewal during the initial term. In 1985, Kansas enacted a statute requiring that letters of credit be evergreen. New Hampshire's 1986 law also requires an evergreen clause. In 1986, Utah has been considering a regulation under its new code which would require an evergreen clause. I would think that every company would want an evergreen clause in their letters of credit in the event that some one fails to renew it in time.

Just last August, 1985, a study group in the NAIC Securities Valuation Office produced draft documents concerning standards of eligibility for issuers of letters of credit. These drafts include a Securities Valuation Office procedure for establishing a list of eligible banks, an amendment of the Examiners' Guide, and an amendment of the Model Law on Credit for Reinsurance. If all of these were in force, a letter of credit would not be acceptable as security for payment of reinsurance claims unless issued by a bank on the list. To be eligible for the list, a domestic bank would have to have either a long term debt rating equal to A or better by Moody's or Standard and Poor's, or a short term debt rating of P2/A2 from those agencies. Other standards are prescribed for U.S. branches of foreign banks.

The current proposal has a technical flaw in it because it does not address what happens if for some reason a bank's rating falls during the year. Hopefully, this issue will be considered so that a company will not be left without credit at some point simply because its bank went down a notch in the ratings. The NAIC may act on the Securities Valuation Office procedure this December, 1986, but probably not on the other measures.

The next item that I think is of serious concern to the reinsurance business is "mirror-image reserving." Starting with the 1983 annual statement form, life insurance companies have been required to list all their assumed reinsurance accounts in Schedule S, including information as to reinsurance in force, premium income and reserves established. This has given state examiners the capability of matching reserve credits taken by the ceding company with the specific reserves established by the reinsurer for the business assumed. That capability will be enhanced by the availability of the NAIC computer data base. All of this, along with general regulatory concerns with reinsurance, has given rise to pressure for "mirror-image reserving," that is, limiting the ceding company's reserve credit to the amount of specific reserve established by the reinsurer. For example, in a recent zone examination the examiners required dollar for dollar matching as a matter of examination practice, without benefit of a statute or regulation, and without consideration of anything but line item reserves.

The quantification of reserve credits under reinsurance agreements was the subject of intensive study last year by the NAIC (EX5) Reinsurance Advisory Committee chaired by Bill Zeilman. That committee reached the conclusion in its final report that the ceding company and the reinsurer would each establish reserves that satisfy minimum valuation requirements for their portions of the policy benefits. That committee's report was forwarded by John Montgomery, Chairman of the NAIC (EX5) Life and Health Actuarial Task Force, to the NAIC Standing Technical Advisory Committee. The latter committee, known as "STAC" or the Greeley committee, has produced a draft of a proposed Actuarial Guideline XV concerning the review of reinsurance in the valuation of reserves and other actuarial items. This draft does not require mirror-image reserving. I understand that it is to be considered at an NAIC Life and Actuarial Task Force meeting in conjunction with this Society of Actuaries meeting.

In my opinion the pure mirror-image reserving idea should be opposed because I think it is not needed, is impractical, is administratively burdensome, interferes with the independent judgments of the insurer and reinsurer and probably would not further the solvency of either.

Another current threat to reinsurance is the proposed "anti-fronting" regulations. In December, 1985, the New York Insurance Department proposed a regulation (Regulation 82) on "fronting," directed at certain transactions involving reinsurance with unlicensed insurers. This had been preceded by similar proposals in 1978 and 1983, which were successfully resisted by the industry. The December 1985 proposal was aired at a hearing in June, 1986 where it was vigorously opposed by industry. Later in the summer the regulation was withdrawn. I do not know whether another version will be proposed.

There were three basic objections to Regulation 82. First, there was no demonstrable need for it. Second, while it would undoubtedly have prohibited arrangements which are abusive of the company licensing laws and thus deserve to be prohibited, it would also have prohibited or discouraged a number of legitimate business arrangements, which are not abusive. Third, it would have discriminated unfairly against reinsurers which are not licensed in New York but are accredited as reinsurers.

Examples of the types of legitimate business arrangements which could have been adversely affected by Regulation 82 are agent reinsurance and various kinds of joint ventures between insurers involving pooling of portfolios and/or expertise.

In June, 1986, Florida enacted an amendment to its existing statute on fronting. The original statute had prohibited an authorized insurer from acting as a "fronting company" for an unauthorized insurer. It had defined a fronting company as an authorized company which by reinsurance or otherwise, transfers to one or more unauthorized insurers substantially the entire risk of loss under substantially all of the insurance written by it in Florida on one or more lines or from one or more agencies or from a designated geographical area. It seemed clearly to have been limited to Florida business. The new law changes the definition. "Substantially all of the entire risk of loss" becomes "more than 50%" in the case of reinsurance with one unauthorized insurer and "more than 75%" in the case of reinsurance with two or more unauthorized insurers. These percentages apply to "the entire risk of loss" but the language then becomes unclear as to whether the law applies only to Florida business or whether it applies also to business written outside of Florida by an insurer authorized in Florida. It is hoped that no extraterritorial effect is intended. The new definition also provides an exception for reinsurance with unauthorized companies which are approved reinsurers, and it allows, with prior approval of the Insurance Department, transactions which would otherwise be prohibited by the new definition.

The AICPA Task Force on Reinsurance Auditing and Accounting has proposed that fronting arrangements be accounted for as service arrangements rather than reinsurance. The proposal has not received industry support. It has the common problem of a loose subjective definition that is not workable.

One of the areas in which true fronting has been prevalent is credit life and A&H insurance. The Pennsylvania Insurance Department recently issued a notice to licensed insurers writing credit life and A&H in Pennsylvania stating that it has investigated the practice of Pennsylvania licensed insurers marketing credit insurance in conjunction with "captive reinsurance arrangements". The notice targets arrangements whereby an insurer agrees to cede business to a reinsurer owned in part or in whole by the producer of the business. It advises that these arrangements are unlawful if the dividends or other distributions to be received by the producer from the reinsurer are related to the volume or profitability of business referred by the producer to the insurer because it circumvents a statute establishing maximum compensation to credit life and A&H producers.

Another area of interest is the regulation of reinsurance in the event of an insolvency. Under indemnity reinsurance, there generally is no privity between the direct insured and the reinsurer. The policyholder or beneficiary of a reinsured life policy cannot sue the reinsurer, even where the direct insurer is insolvent. There have been limited exceptions to this, as where the reinsurer specifically obligates itself to make direct payment to the original insured. Some states have regulations that work as a cut-through. Vermont has a statute providing that when a direct insurer is insolvent and its liability on a risk becomes fixed and determined, the insured or other obligee shall have a prior lien on the amount payable by a reinsurer of the risk. The reinsurance laws of most states do not allow a ceding insurer credit for reinsurance unless, in the event of insolvency of the ceding insurer, the reinsurance is payable to the liquidator. Louisiana, which has such a law, amended it last year to also allow credit where the reinsurance contract, with the consent of the direct insured, specifically provides for payment to a payee other than the liquidator in the case of ceding insurer insolvency.

In May, 1986, in the case of *Grimes, et al. v. Crown Life Insurance Company*, a federal district court in Oklahoma upheld the validity of a "netting" provision in a coinsurance agreement. The agreement, which had been intended to provide surplus relief on A&H policies, provided for year-end settlements in which reinsurance premiums, claims, expense allowance, risk charge and experience refund would all be netted out. The agreement was executed in March, 1983, to be effective January 1, 1983. It later developed that the ceding insurer was in financial difficulty on January 1, 1983. In April, 1984 it was placed in receivership. In May the Oklahoma Commissioner and the Oklahoma Guarantee Association sued the reinsurer, Crown Life, in state court to recover benefits under the reinsurance agreement. Crown Life removed the case to Federal Court. The agreement contained a standard insolvency provision requiring payment of reinsurance benefits directly to the ceder or its receiver without diminution by reason of the ceder's insolvency. The Commissioner and the Guarantee Association contended that the insolvency provision overrode the netting provision so that the reinsurer must pay reinsurance claims to the receiver and then get in line with other creditors of the ceding insurer to collect its reinsurance premiums. The court rejected this argument, upheld the validity of the netting provision and dismissed the case. The Commissioner and the Guarantee Association appealed. In this appeal, now pending in the Tenth Circuit, they are not only submitting the basic contractual issue, but also issues as to whether the Oklahoma State Court should have exclusive jurisdiction and as to whether the reinsurer should be equitably estopped from denying liability. The Reinsurance Association of America was recently granted leave to file an amicus brief. The outcome of this case will have great significance for the entire reinsurance industry. It has been reported that in many jurisdictions, regulators and guaranty associations are endeavoring to assert that there is no right of offset after the ceding company becomes insolvent.

Among miscellaneous happenings in reinsurance, the Florida statute on filing of treaties has been changed. In 1985, the Florida Insurance Department obtained passage of a law requiring a ceding insurer to file with the Department two copies of all documents relating to the ceding of the risks. These included all preliminary documents as well as the actual treaties, and the law applied to all authorized insurers, not only those domiciled in Florida. This law must have resulted in a prodigious pile of paper. This year the law was amended to require the filing of only a summary statement of information about each treaty, with such supporting information as the commissioner might require. The law still applies to all authorized insurers, but exemptions are provided for ceding companies with over $100,000,000 of policyholder surplus and for companies with relatively small Florida direct premiums or small numbers of policyholders.

Convention blank changes are also being considered. At its June, 1986 meeting the NAIC adopted some changes to parts of Schedule F, including a new column for reinsurance contract effective dates, separation of affiliate and non-affiliate transactions and a new column in Part 3B for "Other Debits." The NAIC Life Reinsurance (EX4) Study Group continues to consider proposals for dividing page 5 of the annual statement (analysis of operation by lines of business) into separate parts for direct business, reinsurance assumed and reinsurance ceded. It is currently considering a Page 5R proposed by Mr. Montgomery of the California Insurance Department.

Some current federal income tax topics which I would like to discuss include the Section 820 Modco grandfather provision, IRC Section 845(b) and excise tax rulings. In TEFRA (1982) Congress repealed Section 820 for taxable years after 1981. It grandfathered pre-1982 Modco contracts by providing that any determination as to the qualification of a contract under Section 820 was to be made solely by reference to the terms of the contract except in case of a deficiency due to fraud with intent to evade tax. The IRS, by "Guidelines" to auditing agents, has challenged the effective dates and investment income transfer rates under pre-1982 Modco agreements. In response, the ACLI and the Health Insurance Association of America made a successful effort to secure a technical amendment in the 1986 Tax Reform Act reaffirming the scope of the grandfather clause that the Service "shall give full and complete effect to the terms of any modified coinsurance contract" and that "the terms to be given effect. . . shall include, but are not limited to, the effective date and investment income rate as stated in such contract." The conference committee report adds that "the IRS is to respect the manner in which the terms of a modified coinsurance contract have been reflected on the tax return." This is a significant success for the reinsurance industry.

There is nothing new to report on IRC Section 845(b), which was added to the Code by the Deficit Reduction Act of 1984 (DEFRA). My company, as a professional reinsurer, continues to be particularly concerned with Section 845(b), the unrelated party provision. This very unusual statute allows the Secretary of the Treasury, based on the finding that a reinsurance agreement has a "significant tax avoidance effect" on any party, to eliminate the tax avoidance effect. If an adjustment is made with respect to one party, no correlative adjustment is required as to any other party. Although the DEFRA Conference Committee Report expressly anticipated that the Treasury would provide more guidance by regulations, there are still no regulations after two years. The only guidance we have had is in the Conference Committee Report, which contains a list of items to be considered by the Secretary in determining if an agreement has a significant tax avoidance effect and a description of some safe harbor examples. As to the latter, the Report expresses the intention that any regulations inconsistent with the safe harbor examples are to have effect only prospectively. So far I have not heard of an instance where the IRS has involved Section 845(b).

IRC Section 4371 imposes a 1% excise tax on life reinsurance premiums paid to a foreign reinsurer. Private Letter Ruling 8626050, issued March, 1986 dealt with a modified coinsurance agreement between a domestic insurer and an unrelated foreign reinsurer. The ruling held that taxable premiums consist of the initial and annual reinsurance premiums and reserve adjustments paid by the ceding company to the reinsurer and that experience refunds and reserve adjustments paid by the reinsurer to the ceding company would be treated as returned premiums, which would result in a credit or refund of the excise tax paid on the taxable premiums. Since the excise tax is paid on the basis of quarterly returns, it may be possible to structure a foreign reinsurance agreement with quarterly settlements so as to net out the amount of tax owed.

There is a tax treaty with Bermuda under consideration that would waive the excise tax. This treaty has met some controversy in the Senate because Bermuda is not a taxpayer and the U.S. is giving it significant tax benefits. The treaty will likely be approved as is for security reasons and because Bermuda is giving greater access to Interal Revenue Service investigators seeking information on tax evaders.

Finally, I will discuss an income tax item with respect to overseas association captives, particularly in the Caribbean. It was aimed at the manufacturers associations' captives owned by more than ten companies to insure their own businesses. These had more than ten members in order to avoid the traditional subpart F foreign income provisions. The staff and the Congress decided that these companies were avoiding taxes in the United States because there were no taxes in places like Bermuda. They have created a special tax for association captives so that they will now be taxed under the United States Internal Revenue Service.

MR. GREENBERG: One of the things that Mr. Copeland said with which I take some issue is that no public policy is advanced by requiring some amount of mortality risk transfer. I think I am among a majority of those actuaries who follow reinsurance who feel that reinsurers must definitely accept a certain amount of mortality risk and not only a certain amount but effectively all of it. Whatever the reinsurer reinsures, I fully believe the risk should be unlimited. I think it is beyond the province of the regulator to make a subjective judgment as to whether there is a likelihood that there will ever be a loss by the reinsurer. If the business has sufficient margins and there is never a mortality loss, that is an arms length negotiation in a treaty negotiations process between the reinsurer and the ceding company. Nonetheless I do think it is an important distinction that we make with the regulators: No, we are not trying to avoid paying the mortality losses if there are indeed losses under the terms of the treaty. We will pay them to the extent that we have sufficient capital and surplus and until we are out of capital and surplus.

MS. LOUISE TURNER ZELLNER: My current interest in reinsurance is a very specialized area of mortgage insurance. In order to understand my ceding company point of view, you should know that my business is a mono-line business. If you think you have problems, you should understand that when we do reinsurance, even when it is very straightforward quota-share coinsurance with clear risk transfer, unless it is done with a mono-line company, we get no regulatory relief at all -- no reserve credit.

There is currently a wide range of issues in reinsurance, and the topic we are discussing is probably on the cutting edge from both the company's point of view and the regulator's point of view. The issue is: "What kinds of risks may be transferred and how do you properly account for them on both the ceding company's and the assuming company's balance sheet?"

One of the most difficult problems faced by regulators is the adequate oversight of reinsurance agreements. I think we only need to review the list of financially troubled companies in the last few years to realize why this is a hot and genuinely important topic. In general, regulators are concerned not only with the solvency of the company, but with whether it is operating in a financially hazardous manner, that is, it is not insolvent yet, but will be unless there are major changes very soon. To assess financial health, a number of measures and analyses are used. I am sure you are aware of most of them. Some of the obvious are: Is there surplus strain; are reserves adequate; are assets appropriately valued; and are assets appropriately matched with the liabilities?

Where there is reinsurance there are, of course, additional questions and concerns. For instance, what is the financial strength of the assuming company? The Mission case shows that which is assuming is as important as that which is ceded. Second, is the assumption contingent? What are the circumstances under which the agreement can be ended? Clearly, insolvency cannot be one of these circumstances, and most regulators require proper insolvency clauses. While there seems to be much discussion about this point, I am not sure that it is really a major issue now. It appears that most companies, whether they are ceding or assuming, agree on this point. What about other reasons for cancellation, for example, poor experience? Since many companies buy reinsurance to provide some protection from unusually adverse experience, it is clear that poor experience cannot be a reason for avoiding existing treaties or requiring recapture.

Most of these issues were fairly well negotiated in the NAIC model just adopted. I am sure that model will face further refinement as individual states move to adopt this particular regulation. Two main issues that seem to remain are: (1) Is significant risk transferred and should that matter? (2) What should the reserve credit be?

The arguments over significant risk transfer and whether such transfers must include morbidity, mortality or surrender charge risk are likely to continue. Some regulators will argue no risk transfer, no credit. Some companies will argue that if there is an absolute promise to pay, there should be full credit for the amount of the maximum possible loss, regardless of the risk. I think it is a question of what is appropriate to consider. For example, if you think of this as an expected value problem, then what you have is a range of outcomes and a distribution of probabilities associated with each possible outcome. Ceding companies argue that they want to look at the maximum value in that range, and that is what the company should be able to take reserve credit for. The regulator will want to talk about the expected loss, i.e., the sum of each outcome times the probability or frequency of the outcome's occurrence. In the end we are probably going to end up somewhere in the middle. I think that provides another perspective on how the problem might be defined and why there is this disagreement.

It seems to me that the better and the more difficult of the two questions and the one to be struggled with in the future is: "How much reserve credit?" Forget what kind of risk you might transfer to the reinsurer. Forget exactly how much risk is transferred. Instead, consider how much credit is the ceding company able to take. When we get beyond the arguments over the types of risk that can be appropriately transferred and the appropriate bases for cancellation or cessation of benefits under the contract, this becomes the issue.

In short, once it is clear who should pay under the terms of the agreement, we are back to the solvency issues. Are liabilities, in this case reserves, appropriately stated for both the ceding and the assuming companies? The work has begun on this problem, and issues such as mirror-image reserving will generate extensive debate in the future. As a former regulator I think these efforts are well spent.

MR. GREENBERG: We, as an industry, sometimes ignore the terms of the contract in reinsurance and we become theoreticians. If we were to agree that the risk transfer that goes to the assuming company is infinite, regardless of the likelihood of any loss ever occurring, then there should be no question on the part of the regulator.

I think Ms. Zellner was correct in stating that many of us ignore the possible losses, the ability of the reinsurer to pay those losses, and how they should be reflected in the reserve credit. The answers to some of these questions are not easy. I think Ms. Zellner has brought up an additional issue that has not been focused on. We have not seen major problems relative to that issue on the life side that I can recall. However, I think we have seen it on the property/casualty side.

MR. OSCAR R. SCOFIELD: Why is there so much activity in the financial reinsurance area? Why is there so much interest in financial reinsurance? Why are there so many people playing in the financial reinsurance marketplace? I think we can get a better answer to the question, "Why is there so much activity?" if we look at five different constituencies that are involved in this whole process.

First, let's look at the customer -- the person who actually buys the life insurance policy or an annuity. That person, over the last 10 to 15 years, has told our industry that he is more than willing to take some of the investment risk on the products which we offer. But we cannot let that customer take that risk because of the regulations which we deal with. Specifically, the maximum interest rate that we can use in accumulating those reserves is restricted. So, financial reinsurance has permitted companies to offer products which have an investment factor in them but which require high surplus strain.

The second constituency I think we have to keep in the picture is the investor -- the person who owns life insurance companies. That investor, over the past 10 or 15 years, has put management teams in direct writing companies and reinsurance companies under tremendous pressure to produce profits. Some of these management teams have put products on the marketplace that have very little margin for error. And when the errors happen, when things go wrong, some of these companies have had to use financial reinsurance on a retrospective basis to get themselves out of trouble.

What about the third constituency, the reinsurer? The life reinsurance industry today, and I doubt that I will find any exceptions to this statement, is a group of people and companies with their backs to the wall.

The primary companies are offering fiercely competitive products and the reinsurer has very little margin left to make a profit. So what did the reinsurer have to do in many cases? He entered the financial reinsurance marketplace, because it is an area where you can make good profits and where you take on very little risk. So, from a reinsurer's standpoint, financial reinsurance is important, but it is probably only a temporary solution to the real problem which is underlying our industry.

The fourth constituency is the lawyers, the accountants and the consulting actuaries from the outside. They are very interested in financial reinsurance because of the billings involved and often because of the contingent fees which they can realize in these transactions. For this constituency, financial reinsurance offers profits. But it may be a short-term and short-sighted solution to the overall problem.

Finally, we have the regulator. The regulator must certainly sense a threat to his role in the entire insurance process. He is concerned with maintaining the solvency of companies, and lately, as we all know, the regulator has been putting the brakes on financial reinsurance transactions. That should not come as a surprise to any of us. But putting those brakes on may not be a solution to the real problem. These are the five constituencies -- each with a different outlook on financial reinsurance: the consumer, the investor, the reinsurer, the outside consultant and the regulator.

In preparing for this presentation, I tried to find the one single circumstance which makes financial reinsurance transactions possible. I really think that it is the fact that the life insurance industry keeps its books on three different bases. And a financial reinsurance transaction has a different impact on each set of books.

Let's look at the statutory books. We are concerned with solvency. The regulator wants to take a snapshot of our balance sheet on December 31 to see what our assets and liabilities are and what our surplus is to meet our contingencies that we have taken on. On the statutory set of books, when we write a policy, all acquisition expenses must be expensed in that year. The statutory set of books takes the liabilities high and the assets low, and perhaps artificially so.

Then we have a GAAP set of books, and that is not only true now for stock companies but for some mutual companies as well. Many of the mutual companies have some form of GAAP accounting, if only for internal management reports. Now the GAAP set of books is concerned with the income statement. How are the profits emerging? How are we going to report them to the stockholders? Acquisition expenses, unlike the statutory books, are deferred over the stream of income during the life of the policy. On the GAAP books, we try to be more realistic on our assets and liabilities. We try to match those two things.

Then we have a third set of books. Our third set is our tax set of books. Washington is concerned about getting its share of the pie from the insurance industry. On the tax set of books you can use a financial reinsurance transaction to wipe out your tax liability on a cash basis, but on a GAAP basis, you are actually accruing a liability.

So this phenomenon of our industry, where we are keeping these three sets of books, allows financial deals to be done on the reinsurance side which produce high statutory benefits, have no GAAP impact other than a small profit or fee and actually reduce taxes. That is a peculiar set of circumstances for anyone who is outside of the insurance industry to see.

I think financial reinsurance transactions are bandages. I do not think they are solving our real problem. They obscure our real problem which is the underlying, unacceptable profitability level of our industry. We have to spend more time on selling our customers on the uniqueness of our product, which is the fact that we can guarantee a benefit to a person if he lives, if he dies, or if he is disabled or gets sick. We have to spend less time on selling ourselves on the concept that we must invariably provide a service at inadequate profit levels.

So I am asking you, please go back to your offices, to your computers and your tables, and try to develop new products that will protect your insureds when these bad things happen. Develop new products that will reward your owners and also build your surplus account. As an industry, we are failing to reach our customers with the products that I am talking about at terms which are realistic to the investors. And we are keeping at least three sets of books, as I have said. So we balance our statutory, our GAAP and our tax books with financial reinsurance transactions. But these are bandages. The patient, our industry, needs some new brainpower. We must direct our thoughts away from temporary financial reinsurance solutions to the problems that are underlying our industry and to begin again to think long term. I think that financial reinsurance in many instances has made substance out of nothing at all. I think that is what the investor, the regulator, and the customer is after. I was happy to hear Mr. Fickes's projection for the future that financial reinsurance will be more substantial and more meaningful. I certainly hope that happens.

MR. JOHN O. MONTGOMERY: I have learned much from responses to the NAIC's proposal, which was intended. We have problems with reserve credits on reinsurance ceded. In one example, (it seems very exaggerated but it actually did occur), there was something like $5 million in reserve credit for reinsurance ceded, and the reinsurance assuming company set up $5,000. We have problems with things like that because it appears that surplus is being generated in the ceding company when it does not belong there. This is a real problem. I realize mirror-image reserving is not the answer, but we have to find out what tolerance we can give to the differences. We have to develop rules for that. That is what I am after, and in that respect, I am going to ask the actuarial task force to ask the American Council Committee on Reinsurance to work on such rules.

The other item I want to talk about is surplus ratios. We have run solvency surveillance tests of ratios of capital and surplus plus mandatory securities reserves to total liabilities. We have found that for most of the larger companies it is running around 5%. For some of the mutual companies that have a lot tied up in very conservative reserve bases, it could go as low as 2%. For small companies it runs between 10 to 15%. For the reinsurers it is something like 0.5%. This indicates to me that there is a real lack of surplus to withstand a possible increase in claims through the AIDS epidemic that may be coming in the next 5 years. The ability of the reinsurers to handle such a catastrophe concerns us.

MR. GREENBERG: I think many of us appreciate the problems of mirror-image reserving and what it entails. I think even more of us are frustrated when this is not an issue (when the reinsurer holds the exact reserve and has the exact surplus impact of the ceding company), and somehow the legitimacy of the transaction is questioned.

For small companies, reinsurance is critical for us to survive. When certain regulations come up, particularly the proposed New York regulation on fronting, we look at these with a tremendous amount of concern. One of the things that concerned us was that this regulation seemed to say that, if a company is licensed to do business, there is no problem, but if it is licensed to do reinsurance only (but is a licensed company as far as reinsurance goes), there are all kinds of problems affecting its ability to do business. It seems that because my company is a New York company, this would cause many of us problems by limiting normal reinsurance transactions with many of our best reinsurers. That was a frustrating situation and was barely comprehensible to us because of some of the arbitrary numbers put in the proposed regulation.

More frustrating was the lack of sensitivity on the part of the people drafting the regulation. We noticed in the regulation that there were certain rules about what could be ceded and at one point the amount ceded had to be less than 50%. A group of individuals approached the department and said, "Wouldn't it make more sense to say 50% or less, so that on a very normal risk sharing reinsurance agreement of a 50/50 split, the problems that might ensue would be eliminated?" We assumed the answer to that would be, "Okay, fine." The answer was simply "No. We believe, theoretically, that you should never get up to 50%. You can approach it asymptotically, but you can never get to that point".

The problems for the ceding companies to administer the result of such a provision were totally disregarded. This is the kind of situation that can sometimes produce bad relationships between insurance companies and regulators. It was a point that had no substance relative to the purpose of the regulation, but would clearly cause much pain and grief for the direct writers.

MR. DENIS W. LORING: I would like to suggest that at least two of the issues that have been brought up here are aspects of the same fundamental question, which I would suggest is the fundamental question underlying all of the reinsurance problems. The two issues are: (1) "Should there be risk transfer?" and (2) "Should mirror-imaging of reserving be required?" The fundamental question is, "Will the policyholder get paid if there is a need for benefits? Will the reinsurer be able to provide the money if he has to?" I would say that is the underlying problem, and that should be the main interest of the regulators. They are trying to protect the policyholders; they want to be sure that the money is there when it is needed. Given the creativity of reinsurance actuaries in the past, if that energy could get harnessed to develop some set of standards and some measurement criteria by which arrangements could be examined against the grid of, "Will the policyholder get his money?" then the questions of, "Should risk be transferred? Should reserves be mirror-images?" etc., will all fade away against that much more fundamental issue.

MR. GREENBERG: I agree. But it is probably a double issue; the issue that may be so obvious that you did not mention it is: "Under the terms of the agreement is the reinsurer able and also required to pay?" I think the second half of that is the critical issue. I do believe that in a reasonable world those should be the only two questions. I think though that it is a little too idealistic to assume that the problems with the regulators will go away, at least in certain jurisdictions.

MS. DIANE WALLACE: I would like to comment on Mr. Scofield's statement that surplus relief reinsurance is a bandage. I think it is dangerous to assign labels to reinsurance. The words "surplus relief" somehow automatically connote "No good reinsurance." For many years traditional, conventional reinsurers provided reinsurance that everyone would agree was sound reinsurance, that increased the surplus of the ceding company. I would like to define surplus relief reinsurance as reinsurance that increases the surplus of the ceding company. What has developed over the last few years is that most of the traditional reinsurers do not have much surplus to spare. As a result, they have often refused to participate in reinsurance that improves the surplus of the ceding company, because it depletes their own. In response, sources outside of the traditional reinsurance industry developed to provide this surplus. As non-traditional, these alternative sources are often labeled as "bad surplus-relief reinsurance," and that is not always the case. There are many legitimate reinsurance transactions where the surplus of the ceding company is improved. That is surplus relief reinsurance, and we should not automatically assume that it is bad or a bandage.

MR. SCOFIELD: I agree with your observation. I think you have to make a distinction here between risk and loss. Everybody in the reinsurance business is taking a risk. You can show, even though this stuff is bulk reported on surplus relief, that risk was taken because claims were paid. I think the argument that the regulator has is: "Is the reinsurer ever going to have a loss on these treaties?" I think you would have a difficult time finding many reinsurers that have paid significant losses as a result of these treaties. I think that is where we are having trouble with the regulators. They cannot expect us to go into a treaty to pay a loss -- I understand that. But it is amazing to me that billions of dollars have changed hands here, and no one has ever had a loss, and everybody has come out ahead. I think that is what is absolutely stupefying and mystifying to the regulator.

MR. GREENBERG: The point is: What is the problem in that situation for the regulator? In my opinion, the issue should be, if there is a loss, (1) will it be paid (does the reinsurer have the ability to pay that loss)?; and (2) will the reinsurer be required to pay that loss? Why should surplus relief and why should so-called non-traditional reinsurance be something bad? We focus on treaties where there is a bulk method of getting surplus relief, where you take business with substantial margins and get surplus (that you need to run your business) at a very low cost, and where the reinsurer is required and has the ability to step up and pay losses if there are any. Why is this somehow bad, and why do we really have to look at it as "how much" risk gets transferred? All the risk is transferred! If the risk requires many unusual things to happen in order to have a loss, so be it. I think that these are just generic issues for reinsurance, and if the fact is that a loss is never paid, God bless us all. I would like every product we issued not to show losses. The idea has somehow developed that we are in this business to lose money, and while we are at it, we should pay a lot of taxes while we are losing this money. Were it not for the adverse financial consequences, for some in the insurance industry to buy such a philosophy is a joke!

MR. SCOFIELD: We provided real surplus relief last year in the form of claims to the tune of over $20 million. We can exhibit that we had losses on our other business.

MR. MELVILLE J. YOUNG: I agreed with most of Mr. Scofield's comments. I think we have major problems in the primary insurance business today and in the reinsurance business today in the profitability of the products that we are selling. The need for surplus relief is being generated by real losses -- companies are really losing money on what they are selling. I think it is kind to call surplus relief a bandage in that situation. I do not think that consultants or reinsurers are doing their clients a service by helping them continue that practice. If the client has a problem in the profitability of the product the company is selling, it is our obligation to point that out to them. I do think that there are many very valid reasons for financial reinsurance and surplus relief, because of statutory accounting rules. I think many regulators feel the same way. I think that as responsible people we have to work together as insurance companies, reinsurers, regulators, and consultants to find a responsible way to administer reinsurance and financial reinsurance treaties.

MR. FICKES: The real underlying issue with respect to surplus relief in the United States is redundant reserves. I see no real problem reinsuring in, say, Bermuda, if the Bermuda company sets up a realistic reserve while the reserve in the United States is horribly unrealistic and too conservative. On the other hand, by having these redundant reserves, reinsurance is being encouraged to go to a place where somebody may not exercise reasonableness.

The Bermuda actuary might set up half of a realistic reserve, and that is where you get into problems.

I like the system the U.K. has as far as reinsurance is concerned. There the actuary for the ceding company is responsible to look at his reserves and the assuming company's reserves on reinsurance, and determine the probability of getting the payment from the assuming company. If he feels that the assuming company is about to go bankrupt, he will set up zero reserve credit. On the other hand, if he feels that the assuming company is holding a realistic reserve, he is allowed to take a full reserve credit.

Maybe the best solution is to give the actuary more responsibility to determine what is realistic so that companies can function with realistic accounting.

MR. COPELAND: The quality of our industry has changed over the last ten years. I do not think it is just the insurance industry; I think it is every industry. The reinsurance industry used to be characterized by a high level of trust, integrity, and quality of agreements. I think aspects of the New York 102 regulation (even though I focused on what I consider to be a fundamental flaw that raises immense uncertainty for our business) are appropriate and address things that the industry should not have entered into. I think we have responsibilities to the industry and ultimately to the policyholders beyond cutting the next deal. We should take some responsibility to ensure that we are not creating or encouraging abuses. It is a matter of integrity and commitment.

MR. YOUNG: We too often take adversarial positions. As an industry and as regulators we forget that we should be working towards the same goal. I believe the Program Committee of the Reinsurance Section is planning to have a conference in Montreal in 1987. We would like to have a number of key regulators involved in the conference and see if we can work out the problems together in a cooperative spirit. I invite you all to attend.

MR. GREENBERG: I realize that the topic is financial reinsurance, but I think that we should focus on the fact that, from the late 1970's on, there has been a move among insurance companies to price products in what could kindly be called an irresponsible manner. This causes real problems -- the problems of profitability and deteriorating relationships between the insurer and the direct company, and problems with financial reinsurance as a bandage. I do not think that any of the arrangements that Ms. Wallace mentioned have anything wrong with them. There is nothing bad about them! They are perfectly legitimate and fine transactions. There is an underlying problem, and as a result, you have situations where ceding companies are not playing fair with their reinsurers now. They are actually, at best, being unethical. Reinsurers are reacting by enforcing terms of the contract in a literal contractual way instead of in the spirit of the gentlemen's agreement. It is very easy to be gentleman when you say, "Well, I'm willing to take a smaller profit." It is harder to be a gentleman when you have to say, "I'm going to have to take a bigger loss." That is a problem that is endemic in the industry, and I do not know what the answer is.

We can go back to our companies or clients and say what we must do now. Suddenly someone else comes up with a hot new product and you see that they cannot not make money. Your company says, "We're going to get killed if we do come up with something that is going to match this." I do not know what the answer is, but I think that everybody here has identified what the major underlying problem is.

MS. WALLACE: I understand there is a provision in the new tax law that explains what employers may take as deductions for premiums on their group insurance. This provision discusses the nature of the insurance contract including whether there is risk transferred in making that determination. It also discusses the nature of the experience rating under the insurance contract. I wonder if that provision might give us any guidance on how 845(b) issues may be interpreted by the IRS on reinsurance contracts.

MR. COPELAND: I am not familiar with that provision. I would venture an observation that I suspect it will not. There will be people who will try to use it by analogy, but the code sections are often so separate that I suspect it will not offer much.

MR. GREENBERG: The new alternative minimum tax has a very interesting provision that a dividend from a wholly owned subsidiary to a parent can be taxable as part of the minimum tax for the parent company. There are several situations in the United States where you cannot consolidate for tax purposes. Where the tax law prohibits consolidation, the dividend issue indeed becomes a punitive provision. In final adjustments to the bill, the tax writers made a fairly long list of exceptions. I have been lead to believe that every single situation where this is a problem was given a specific exemption except for the life insurance industry. We have been singled out for special generous opportunities to make additional contributions to the federal government.

MR. JAMES W. PILGRIM: I have a question relative to letters of credit. At an actuarial meeting here a couple of years ago a similar panel mentioned that, in certain situations, ceding companies were able to pull the letter of credit from the agreement and actually call it. In fact they were not calling it to recover claims or whatever from reinsurers. First, are you hearing that that is continuing to occur? Second, what can we do to protect ourselves when the provisions, for example in New York, require that you have a clean, unconditional letter of credit?

MR. COPELAND: In law school we learned that every dog is entitled to one bite. It will be very difficult for that company to get another letter of credit from anyone, and it is an invitation for a lawsuit. I have seen a thorough examination of the ability to get an injunction where a reinsured was expected to improperly exercise the letter of credit. The reinsurer concluded that it could not get the injunction. It is a very difficult situation. It gets down to the gentlemen's agreement and the high level of trust that used to exist and that seems to have become seriously tarnished in this business. There is a higher level of distrust, and that is really discouraging. In the same regard, we are seeing more recisions of reinsurance agreements. There have been serious misrepresentations as to underwriting and profitability of products. I know of an example of an abuse of table ratings, where the issuing company did not apply their underwriting standards consistently in order to get better rates from the reinsurer.

PANEL DISCUSSION

MR. FICKES: I stated about a year ago that, although reinsurance treaties have the provision that you can only remove a letter of credit if there are losses under the treaties, several companies have discovered that staple removers work fine as well. I have seen actually an increased incidence over the last year from the previous year. I now know of about five cases where it has been done. Most of the time it happens because the ceding company and the assuming company begin to squabble over something. In one case the ceding company did not like the way the assuming company was handling its statements. So the ceding company taught the assuming company a lesson. The ceding company took $2 million from the assuming company and got some attention. There is really no solution. A couple of companies have tried to escrow their letters of credit, but then that defeats everything that the state regulators want (i.e., that it be an evergreen and that it can be cashed at anytime). It is a big quandary, and maybe one solution is to try trust agreements which are a little bit more stable and less likely to be removed from the treaty.

MR. GREENBERG: Is there something in New York regulations that makes it even more of a problem for the issuer of a letter of credit? I think they use words meaning no restrictions whatsoever. People were very concerned that this meant that money could be drawn for an illegitimate purpose.

MR. COPELAND: The letter of credit certainly must be phrased that way. About the only kind of edge you can give yourself is to have a full discussion in the reinsurance agreement itself, even though the letter of credit has to be completely clean.

MR. CHARLES G. BENTZIN: In the new tax law there is a provision for an alternative minimum tax which is related to a whole hierarchical series of financial statements. Starting in 1990 we have a tax based upon so-called earnings and profit which is something very similar to GAAP profits as we know them. Would anyone on the panel care to comment on what impact, if any, this is likely to have in financial reinsurance?

MR. GREENBERG: Again, in reaching the compromises between the House and the Senate, the insurance industry was favored with an opportunity to make substantial contributions. The agreement was what the Senate wanted, and the

50% of the "earnings and profits excess" was what the House wanted. The idea was that the Senate version would apply for a few years, then the House version would apply. I have not seen it in writing, but I have been led to believe that the compromise is to change 50% to 75%. That compromise benefited the entire business community. They also added in deferred acquisition costs or something similar to them. Again, I have not seen the exact language, but I have been informed that instead of "earnings and profits" as we have expected, we will somehow be taxed on a GAAP basis now. For the insurance industry, the idea of the compromise to earnings and profits was to keep taxes on a consistent basis. Is anybody more familiar with those specific provisions?

MR. COPELAND: People will be looking at that provision for quite a while. There are at least two areas that they will be examining closely. The first is with respect to the kinds of statements that they will provide. There are companies that have options about the kinds of statements that they prepare. Second, while I expect that there are serious problems with the Alternative Minimum Tax and the taxes we will be paying, I suspect that there will be some more opportunities for reinsurers.