RECORD OF SOCIETY OF ACTUARIES
1987 VOL. 13 NO. 3

REINSURANCE REGULATION

Moderator: SUE ANN COLLINS
Panelists: KENNETH J. CLARK
JOSEPH D. COOK*
JOHN O. MONTGOMERY
Recorder: HUBERT B. MUELLER

- o Recent insurance department activity
- o Current American Institute of Certified Public Accountants Issues
- o Challenges to insolvency provisions (offset, cut through, etc.)

MS. SUE ANN COLLINS: We have with us three panelists who represent a different segment and perspective of the life reinsurance industry. Joseph D. Cook is Senior Audit Manager of Deloitte, Haskins and Sells in New York. John O. Montgomery is Chief Actuary and Deputy Insurance Commissioner of the Department of Insurance in California and Kenneth J. Clark is a Vice President at Lincoln National.

MR. JOSEPH D. COOK: The first thing I'd like to address is GAAP, generally accepted accounting principles. As the acronym implies, they are basically pervasive accounting practices that have been promulgated, for the most part, by the recognized body established expressly for that purpose. Since the early 1970s that body has been the Financial Accounting Standards Board, or FASB. The FASB is comprised of seven members who work full time in this capacity. Three of these members may be non-CPAs; the others are all Certified Public Accountants. All of the members of the FASB are compensated at a very high rate to ensure that they maintain their independence. Any of them that have previously worked in the industry, or in any of the accounting firms, has to sever all ties to ensure that their decisions will be unbiased.

* Mr. Cook, not a member of the Society, is Senior Audit Manager of Deloitte, Haskins and Sells in New York, New York.

Prior to the establishment of the FASB, however, GAAP was promulgated by the AICPA itself. The FASB was created through a decision by the AICPA Council and is completely independent of the AICPA. The Accounting Research Board and its successor, the Accounting Principles' Board, were the predecessors to the FASB. These two Boards were comprised of AICPA members; they functioned generally on an ad-hoc basis; members served part-time and had other interests. With the creation of the FASB, we now have a body that does nothing but deliberate on GAAP issues.

Since its formation in the 1970s, the FASB has issued almost 100 Statements of Financial Accounting Standards. These statements are considered the ultimate authoritative literature for defining GAAP.

In addition the FASB can issue two other types of documents. They have issued about half as many Interpretations. The interpretations serve to clarify a previously issued statement, in the following way: "Remember FASB number 13 issued two years ago, it meant that you do this in that situation," and they take it from there. The other type of document that they can issue is called a Technical Bulletin. Basically, this explains how the existing GAAP is to be applied in a specific situation.

Other authoritative literature can still arise within the AICPA itself. For example, the AICPA is charged with developing industry accounting and auditing guides, and it also issues Statements of Position (SOPs). The industry guides provide fairly detailed information, not only on existing GAAP and various alternatives within existing GAAP, but they also identify transaction cycles in a typical company within that industry, flows of documentation and transactions, internal accounting controls, and devote a substantial portion to suggested auditing procedures to help in examinations of these companies. Statements of Position represent pronouncements which, while they don't carry the weight of an FASB statement, nonetheless, are a secondary promulgation of GAAP. Generally these SOPs relate to topics that are not pervasive, and therefore do not merit an FASB statement.

Within the AICPA various committees have been established. These committees can have one of two focuses. They can either be an industry designated committee, or an issues designated committee. An example of the latter is the

Relations with Actuaries Committee. The industry designated committees are charged with the responsibility of identifying, addressing and reacting to accounting and auditing issues within a specific industry.

One of these industry designated committees is the Insurance Companies Committee. This committee is comprised of Certified Public Accountants having extensive involvement in various aspects of the insurance industry. It can be expertise with life companies, property and casualty companies, agents and brokers, or reinsurance. This committee in turn, has established several task forces to both ease its workload, and to provide more specific expertise. For example, there is a large task force established to deal with agents and brokers. It has about sixteen members and is comprised not only of CPAs practicing public accountancy, but also an equal number of industry representatives. Most of the major brokerage houses have a representative sitting on that task force.

Another is the Reinsurance Task Force which consists of eight members. Coincidentally, each of those members represent one of the big eight accounting firms and these individuals all specialize in reinsurance. The Reinsurance Task Force authored two pronouncements back in the early 1980s, which were ultimately released as AICPA Statements of Position entitled Auditing Property and Liability Reinsurance and Auditing Life Reinsurance. Given the timing of their release, and the subsequent rash of insolvency of reinsurers, these SOPs were perhaps the most timely papers that the AICPA had ever issued. What is unique about these SOPs is that while they were issued as audit guides or audit papers, they also document both general and specific procedures that cedents and reinsurers should be applying in evaluating these companies. Prior to those papers there was no authoritative literature as far as what a company should do to evaluate a potential ceding or assuming company.

Later issues that have been addressed by the Reinsurance Task Force and submitted upward to the Insurance Companies Committee have included papers on loss portfolio transfers, on accounting for foreign reinsurance and on fronting. All three of these papers have been approved by the Insurance Companies Committee and have been submitted to the next layer of review which is the AICPA's Accounting Standards Executive Committee.

The Accounting Standards Executive Committee is not comprised of industry specialists; therefore, they rely heavily upon the deliberation of the Insurance Companies Committee for addressing the propriety of these papers. Basically, if the papers are passed by the Insurance Companies Committee and are specifically related to insurance industry issues, the Accounting Standards Executive Committee will rely on that committee as to the propriety of the papers. If there is a more generic item within those papers, they may challenge it. As you may note, these papers primarily address property and casualty reinsurance issues, because members of the Reinsurance Task Force, the AICPA and the SEC believe that the property/casualty issues are more critical at this time.

The Reinsurance Task Force's Insurance Companies Committee and various authoritative bodies are generally reactionary in nature. They react to a problem or react to a suggestion by another body to look into a matter, rather than trying to take a pro-active stance and identify an issue long before it is on the horizon. The most recent issue on the Task Force agenda is risk transfer. The Task Force has been asked by the Insurance Companies Committee, which was prodded by the SEC, to define what is meant by risk transfer. Currently, FASB statement number 60 is our most authoritative GAAP literature for insurance companies. The section in it that deals with risk transfer generally says that if an agreement does not provide for the transfer of risk, the transaction will be accounted for as a deposit. That's all it says. They do not define risk transfer. Therefore, there have been a lot of abuses, potential abuses and very liberal interpretations of what constitutes risk transfer. This topic right now is in the early stages of deliberation and again the primary focus of this paper is property/casualty. But, given the subject matter, it is not unreasonable for the final paper, or perhaps a companion paper like the auditing SOPs, to dwell upon similar issues for life reinsurers.

Like the recently approved fronting paper, this issue is guaranteed to spark some controversy within the industry. The fronting paper was deliberated upon within the Reinsurance Task Force for close to 18 months. A draft of that paper was issued for industry comment and it was torn apart. The Task Force had to go back, consider all the comments, make adjustments as appropriate and reissue the paper. The industry is still not thrilled with the risk transfer paper as it is drafted; however, it has received the approval of all of the Task

Force members and the Insurance Companies Committee. I would expect a similar timeframe and reaction to this risk transfer paper.

In closing, I wish that I could say that we have many more items on the agenda that deal with property/casualty issues. In some respects this is a good sign since we tend to react to problems, so maybe that means we don't have any problems in life reinsurance. However, my fellow panelists may assist me in bringing some attention to this segment of the industry and identifying some of these problems.

MR. JOHN O. MONTGOMERY: At a meeting March 18, 1987 attended by representatives for five state insurance departments (California, Illinois, New York, Texas and Wisconsin) and four representatives from the reinsurance industry, ten problem areas with respect to life and health insurance company reinsurance agreements were identified.

1. What constitutes a legitimate reinsurance transaction? (Should there be requirement for a "significant transfer of risk"?)

2. What restrictions are needed in the acceptance of letters of credit associated with reserve credits allowed for reinsurance ceded to non-admitted reinsurers, including off-shore reinsurers?

3. What reinsurance reserve credits should be allowed? (Is "mirror imaging" possible?)

4. Should a statement be required summarizing the essential terms of each reinsurance treaty?

5. Should treaties be subject to prior approval by the appropriate regulatory authority?

6. With respect to reinsurance ceded to an affiliate company reinsurer, should there be a consolidated life insurance company financial reporting blank?

7. How may the lack of clarity in many reinsurance treaties be resolved?

8. Should there be a standard definition (or standard definitions) of what constitutes a reinsurance treaty? (How should treaties be categorized, defining each category?)

9. How should situations be resolved where the administrative procedures of the parties are inconsistent one to the other and/or inconsistent with the written agreement?

10. What forms of fronting are allowable and what forms should be scrutinized carefully? (Is "fronting" a pejorative term?)

I will begin by going over the NAIC task forces where work is being done. The Actuarial Task Force did have a committee headed by William W. Zeilman (known as the Zeilman Committee) which was disbanded one year ago. In connection with these ten issues that have been identified, we feel that we will have to form another committee at a later date. The other area where reinsurance has been discussed is in the Accounting Practices and Procedures Task Force, where proposals were made for adding a separate set of pages to the annual statement with regard to reinsurance ceded and assumed. Work is proceeding on this. We initially picked out just those areas that could be directly obtained from the statutory statement blank, but then it was decided at one of our meetings to make it a complete statement of reinsurance items and not just a partial statement. The reinsurers volunteered to do this. This research is currently proceeding. The other area where reinsurance is being reviewed is in the Liquidation Task Force of the NAIC, where they have a separate reinsurance working group concentrating primarily on property and casualty reinsurance.

I couldn't possibly comment on all ten of the problem areas of reinsurance agreements, so I'm going to cover in some detail the first two, and then in lesser detail the third and fourth. The discussion on the first two topics will indirectly include some of the other topics.

Concerning legitimate reinsurance contracts, the NAIC adopted a model regulation at its December 1985 meeting regarding surplus relief contracts. Paragraph (a) of Section 4 of that model regulation stated specifically:

> No life insurer subject to this Regulation shall, for reinsurance ceded, reduce any liability or establish any asset in any financial statement

filed with the Department if, by the terms of the reinsurance agreement, in substance or effect, any of the following conditions exist:

1. The primary effect of the reinsurance agreement is to transfer deficiency reserves or excess interest reserves to the books of the reinsurer for a "risk charge" and the agreement does not provide for significant participation by the reinsurer in one or more of the following risks: mortality, morbidity, investment or surrender benefit;

2. The reserve credit taken by the ceding insurer is not in compliance with the Insurance Law, Rules or Regulations, including actuarial interpretations or standards adopted by the Department;

3. The reserve credit taken by the ceding insurer is greater than the underlying reserve of the ceding company supporting the policy obligations transferred under the reinsurance agreement;

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

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

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

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

8. The reinsurance agreement involves the possible payment by the ceding insurer to the reinsurer of amounts other than from income reasonable expected from the reinsured policies.

One way for an insurance company to demonstrate that the reinsurance agreement does provide for an identifiable risk, is to provide projections of the effect of the agreement under various scenarios of adverse conditions, as well as under the original pricing assumptions, on the progress of statutory results. In other words, we are going to use the valuation actuary approach to verify the validity

of risk transfer in a reinsurance contract. Such projections should demonstrate the relationship of the amounts payable by the reinsurer under the different scenarios to the operations of the ceding company to determine if the transfer of risk is meaningful. We are currently testing this in California in our review of various insurance companies. As most of you know, we do have some problems with reinsurance with certain companies in California. This is one way that seems to generate results which help us. Of course, we'll seek assistance in developing this approach, but it is a possible objective way of measuring whether or not a risk is potentially being transferred.

There are several approaches to structuring reinsurance agreements that provide surplus relief. The most direct is straight coinsurance; but under that type of contract the assets are transferred to the reinsurers. The ceding company may not wish to do this even though there is little doubt about what reserve credit would be appropriate.

A second form would be a coinsurance agreement with the funds withheld so that the assets remain with the ceding company. Here there may be some doubt as to what reserve credit to allow. Some regulators may say that no credit should be allowed since the reserves have not been physically transferred to the assuming reinsurer in the form of assets supporting those reserves.

A third form is the traditional modified coinsurance agreement with an amounts receivable asset for the commission and expense allowances due. Some regulators may require an actual transfer of assets to the ceding company by the reinsurer if the amounts receivable asset is to be considered an admissible asset. This controversy among regulators has yet to be resolved.

A fourth form now being considered is a combination of coinsurance and modified coinsurance involving the formation of a segregated asset account whose assets are acceptable to the regulator, such as cash and investment grade bonds. The segregated asset account is set up for 100% of the block of business involved, not just the quota share involved. This provides an incentive for the ceding insurer to manage the assets properly. This is a very complex contract and is being considered for surplus relief reinsurance contracts where the investment practices are an additional factor. I think you can read into this some of the

current problems with reinsurance with companies that have a high percentage of their portfolio in junk bonds.

This situation with "excess reserves" is much like the New York City garbage scow that wandered all over the Atlantic Ocean looking for a place to be dumped. And, like that situation, it may have to come back home to be resolved. It's true that the capacity for life and health reinsurance may not be adequate to cover risks which may be on the horizon, such as those which may be expanding because of Acquired Imune Deficiency Syndrome, or AIDS.

The California Department is currently considering the issuance of a bulletin entitled Credit in Accounting and Financial Statements on Account of Reinsurance Ceded to a Non-Admitted Foreign or Alien Reinsurer: Letters of Credit Issued Pursuant to the Insurance Code Sections 922.4 and 922.5. From the current draft copy of such a proposed bulletin are several passages worth quoting:

> Section 922.4: Credit in accounting and financial statements on account of reinsurance ceded to a non-admitted reinsurer other than an alien reinsurer shall be allowed only:
>
> (c) *To the extent that the amount of* a clean and irrevocable letter of credit issued for a term of one year conforming to the requirements set forth below, is a substitute for advances for claims, unearned premium, and all other policy and contract liabilities and reserve obligations to be made by a foreign reinsurer in connection with its liability under a specific reinsurance agreement. The requirements are that such a clean and irrevocable letter of credit shall be issued and maintained under arrangements satisfactory to the commissioner as constituting security to the ceding insurer substantially equal to that of a deposit under subdivision (b) and that it shall be: (1) issued or confirmed by a banking institution which is a member of the Federal Reserve System and of financial standing satisfactory to the commissioner, or (2) issued by a California State chartered bank which is insured by the Federal Deposit Insurance Corporation and meets the conditions established by the commissioner. For purposes of this subdivision, a confirming bank undertakes the identical terms and obligations of the issuer including those set forth herein. The changes enacted to this subdivision at the 1982 Regular Session shall apply only to life insurers.

Furthermore:

> When a letter of credit is utilized pursuant to the California Insurance Code Section 922.4 (c) or Section 922.5 (c), the letter of credit must be in full compliance with the requirements set forth in this Bulletin or

there will be a disallowance of statement credit for any reinsurance contract or treaty entered into with the nonadmitted reinsurer which is supported by an unacceptable letter of credit. The following requirements must be satisfied in order that there be full compliance.

A. The letter of credit must be issued or confirmed by a bank which is a member of the Federal Reserve System. The letter of credit also may be issued by a California state chartered bank even though it is not a member of the Federal Reserve System as long as it is insured by the FDIC. A bank which is not a member of the Federal Reserve System may not act as a confirming bank. Irrespective of whether the bank is the issuing or confirming bank, it must maintain a financial standing satisfactory to the Insurance Commissioner.

B. The substance of the following conditions must be reflected on the face of the letter of credit.

(1) It must be an unconditional letter of credit requiring no documentation whatsoever, and it must vest in the beneficiary/ceding insurer an unconditional right to recover thereon (i.e., the beneficiary must be able to realize the funds simply by drawing a draft under the credit, limited only by the amount available, as set forth in the letter of credit); and

(2) It must expressly provide that it is clean and irrevocable and that it cannot be modified or revoked without the consent of the bank or the beneficiary, once the beneficiary is established; and

(3) It must contain an "evergreen clause" which prevents expiration of the letter of credit without some affirmative action by the issuer; the letter must be for a term of not less than one year and must provide that it will be automatically extended for the period of time stated in the original letter unless, prior to the end of the term, the issuer has given the ceding insurer/beneficiary and the reinsurer/accountholder not less than 30 days due notice of nonrenewal by certified mail, registered mail, telegram, telex or hand delivery; and

(4) It must contain a statement to the effect that the obligation of the bank under the letter of credit is in no way contingent upon reimbursement with respect thereto; and

(5) Only one beneficiary may be named on the letter of credit; and

(6) Only one amount may appear on the face of the letter; and

(7) The expiration date must be clearly noted on the face of the letter and must set forth a specific month, day and year on which the letter will expire; and

(8) Only the expiration date may appear on the face of the letter; and

(9) It must be issued or confirmed (if that confirmation is necessary) on or before the "as of" date of the financial statement in order to secure credit for non-admitted reinsurance; and

(10) A letter of credit must specifically state that in the event of insolvency of the beneficiary, the letter of credit shall be for the benefit of the beneficiary's conservator, liquidator or statutory successor.

C. If the letter is made subject to the Uniform Customs and Practice for Documentary Credits International Chamber of Commerce Publication No. 400, the letter must specifically address and make provision for an extension of time to draw against the letter in the event that one of the occurrences specified in Article 19 of Publication No. 400 occurs.

D. No schedule of periodic payments shall appear on the face of the letter.

E. The amount of a letter of credit issued in conjunction with a reinsurance contract is expected to cover advances for claims, unearned premiums and all other policy contract liabilities and reserve obligations due from the nonadmitted reinsurer. Unless specifically excluded under the underlying reinsurance contract, the letter of credit amount shall cover the "Incurred But Not Reported" reserves; otherwise a surplus penalty is applicable for such amount.

F. Neither the beneficiary and the reinsurer, nor the beneficiary and the applicant/accountholder may be members of the same ultimate holding company system.

G. If a letter of credit is confirmed by a member of the Federal Reserve System, the following requirements must be met:

(1) The letter of credit that is being confirmed must comply in substance and in form with Exhibit A.

(2) The confirmation letter must contain an "evergreen clause" which prevents expiration of the confirmation letter without some affirmative action by the issuer; its term must coincide with the term of the letter of credit which it is confirming and must provide that it will be automatically extended for a like term unless, prior to the end of the stated term, the confirming bank has given the ceding insurer/beneficiary, the reinsurer/accountholder and the issuing bank not less than 45 days due notice of non-renewal by certified mail, registered mail, etc.

(3) The confirmation must comply in form and substance with Exhibit B; and

EXHIBIT A

LETTER OF CREDIT FORM
(Bank Name and Address)

For Internal Identification Purposes Only

Date: ________	Our No. ________	Issuing Bank No.	________
Clean, Irrevocable, and Unconditional Letter of Credit	________	Accountholder	________
		Reinsurer	________
________ Issuing Bank	________		________
________ Beneficiary	(Reinsured)	Amount	________
Expiry	________		

Irrevocable Clean
Letter of Credit No. ________ Date ________

To Beneficiary: (Name and Address)

We have established this clean, irrevocable, and unconditional letter of credit in your favor for drawing up to U.S. $________ effective immediately and expiring at (bank address) with our close of business on ________. Except when the amount of this letter of credit is increased, this credit cannot be modified or revoked without your consent.

We hereby undertake to promptly honor your sight draft(s) drawn on us, indicating our credit no. ________, for all or any part of this credit upon presentation of your draft drawn on us at our offices prior to the expiration date hereof or any automatically extended date.

In the event of insolvency of the beneficiary, a drawing against this letter of credit shall be honored upon presentation by the domiciliary conservator, liquidator or statutory successor of the beneficiary.

This letter of credit expires on ________, but automatically will extend for an additional one-year period unless the reinsurer and the beneficiary have not received by certified mail, registered mail, telegram, telex, or hand delivery, notification of our intention not to renew 30 days prior to the original expiry date and each subsequent expiry date.

The obligation of the bank under this letter of credit is unconditional and is not dependent on the ability of the bank to perfect a lien, security interest, or any other reimbursement.

This letter of credit is subject to the Uniform Customs and Practice for Documentary Credits (1983 Revision), International Chamber of Commerce Publication No. 400. Notwithstanding Article 19 of said Publication, if this credit expires during an interruption of business as described in Article 19, the bank hereby specifically agrees to effect payment if the letter is presented for draw within 30 days after the resumption of business.

____
Authorized Name (typed)

____
Signature

EXHIBIT B

LETTER OF CREDIT CONFIRMATION

Date ________

Issuing Bank # _______	Confirming Bank No. ______	
Issuing Bank _______	Confirming Bank ________	Reinsurer __________
Address ____________	Address ______________	Address ___________
____________________	______________________	___________________

To: Beneficiary(ies)

At the request of the issuing bank indicated above, we are enclosing their letter(s) of credit and amendments thereto, if any, established in your favor.

We hereby confirm this letter of credit in the amount of $______________ and hereby undertake to pay on sight all drafts, subject to the same terms specified in the letter of credit, which are presented to this bank on or before the close of business on ______________ or any automatically extended date of the letter(s) of credit for an additional one-year period unless the issuing bank, the reinsurer and at least one of the beneficiary(ies) have not received due notice of nonrenewal by certified mail, registered mail, telegram, telex, or hand delivered, notification of our intention not to renew 60 days prior to the original expiry date and each subsequent expiry date.

This confirmation letter is to be presented for payment at our United States address shown herein.

This confirmation letter will be honored notwithstanding that it was not presented by the expiry date shown herein provided the letter of credit was timely presented to the issuing bank on or before its expiry date or any extension of time in fact occurring and for which provision is contained in the letter of credit.

Except as stated herein, this undertaking is not subject to any condition or qualification. Our obligation under this confirmation shall be our individual obligation, and in no way contingent upon reimbursement with respect thereto. Except when the amount of the letter(s) of credit is increased, this confirmation cannot be modified or revoked without the consent of the beneficiary(ies).

____
Authorized Name (typed)

____
Signature

(4) The issuing bank must formally designate the confirming bank as its agent for the receipt and payment of any drafts drawn, and specifically state that payments are to be made at the U.S. office of the confirming bank; such designations must appear on the face of the letter of credit and must set forth the complete name and street address of the U.S. office; and

(5) The confirming bank must comply with I below.

H. The financial institution which issues or confirms a letter of credit cannot be a member of the same ultimate holding system of which the beneficiary is a member.

I. The aggregate of all letters of credit issued or confirmed to any one ceding insurer by one bank on behalf of any one reinsurer must not exceed 5% of the bank's capital and surplus as shown in its annual report as of the end of its preceding fiscal year and as filed with the California State Banking Department or appropriate Federal banking regulatory agency. Further, the bank must be in satisfactory compliance with all banking regulatory rules and regulations and upon request, to provide the Insurance Commissioner satisfactory documentation to this effect from such banking authorities.

J. Foreign branches of banks that are members of the Federal Reserve System may issue letters of credit, and such letters of credit will be acceptable if the face of the letter clearly shows that the letter of credit may be drawn down at a U.S. office of the bank and specifically lists the street address of that office. Similarly, foreign branches of banks that are members of the Federal Reserve System may confirm letters of credit, and such confirmation letter will be acceptable if the face of the confirmation letter clearly shows that the letter of credit may be drawn at a U.S. office of the confirming bank and specifically lists the street address of that office.

K. In the event of nonrenewal of the letter of credit under the reinsurance agreement between the ceding insurer and reinsurer, the ceding insurer must not be precluded from withdrawing the balance of the letter of credit and placing such sums in trust to secure continuing obligations under the reinsurance contract until an acceptable renewal letter of credit or acceptable substitution in lieu thereof has been received.

Many states have laws, regulations or bulletins like this. It is doubtful that letters of credit from foreign banks will be acceptable unless they have U.S. branches which are members of the Federal Reserve System. The Securities Valuation Office of the NAIC maintains a register of branches of foreign banks that are members of the U.S. Federal Reserve System. However, the list is difficult to maintain, and it is suggested that the use of letters of credit from any such branch be accompanied by documented verification that the branch is a

member of the U.S. Federal Reserve System. Continuing confirmation each year may be also needed.

Many regulators are struggling with the problem of "mirror imaging" where the timing of items in transit makes exact mirroring an unlikely possibility. We do have problems in establishing the total reserve credit that should be allowed, and I think some rules need to be developed. Robert Callahan of the New York Department has suggested that reinsurance credit allowed for the ceding insurer be limited to the lower of: (1) The reserve the ceding insurer would have set up had it retained the business; and (2) The reserve set up by the assuming insurer, with allowances for any item in transit. Mr. Callahan has also suggested that reinsurance credit allowed for the ceding insurer be subject to exceptions specifically approved by the regulator in charge where the bases of computing (1) and (2) differ, but each is in accordance with standards approved by such regulatory authority.

They recognize that there is a problem there. The Actuarial Task Force, through its advisory committee, is going to have to come up with some guidelines in this area.

The other item that I wanted to mention is the summarization statement. This would list all of the essential features of the contract and would greatly facilitate analysis of a reinsurance contract by a regulator if such statement were available.

In conclusion, reinsurance is obviously undergoing a metamorphosis which all of us are are trying to comprehend.

MR. KENNETH J. CLARK: My assignment here is to comment on all of the things that can go wrong or can unexpectedly happen at the time of insolvency with a reinsurance agreement. I sometimes think that the whole area of insolvency is the dismal side of reinsurance; it's a little bit morbid to be talking about what happens upon the death of a client. The areas that I will comment on are offset; the insolvency provision; arbitration; cut-through provisions; guarantee funds (and their involvement with companies); the simple collectability of the reinsurance; letters of credit and trust funds.

The offset provision is one in which there is the biggest risk currently. The topic is discussed by regulators and rehabilitators and is being actively litigated in a number of cases. One can make a strong case that the entire offset subject should be a non-subject. Under common laws, under federal bankruptcy laws, under numerous Supreme Court decisions in non-insurance cases, it has been held that the setting off, or the offsetting of amounts due to or due from two parties in the event of insolvency, are not discriminatory, do not create a voidable preference and are really deemed to be an appropriate, equitable practice that facilitates commercial activity. There are numerous cases going back over hundreds of years that establish this principle in non-insurance areas. As I said, the Supreme Court cases on this issue do involve non-insurance cases, but what is there about reinsurance or insurance that requires a different conclusion?

A number of people think that a different conclusion is warranted. For example, the rehabilitators and receivers of insolvent insurance companies have attempted to deny reinsurers the right of offset. But their position is that they're trying to maximize the residual value for the benefit of the policyholders and, under the deep pocket approach, they go after the money wherever it might be and let the court decide whether they are right or wrong. But, some state insurance departments have sided with the rehabilitators in attempting to deny the right of offset, the most recent cases of this nature being a property/casualty case in Ohio, and a life case in Oklahoma. The Oklahoma case was won by the reinsurer. However, the case will probably be appealed.

The good thing about the case in Oklahoma is that it is one of the rare examples where the ACLI worked with the Reinsurance Association of America (RAA) in filing a joint brief on behalf and in support of the right of offset. I should mention an earlier Illinois case that was also won by the reinsurers. That case was upheld at a circuit court level. Reinsurers, though, should be alert to efforts by some ceding companies to get the ACLI to either reverse its position (which was in support of the right of offset) or at least to take a neutral position in future cases. I think the insurance company opposition has been led by certain large, strong companies that and feel that they should not pay the large guarantee fund assessments that result from insolvencies and, if reinsurers didn't have the right of offset, there would be smaller amounts that would be assessed to those strong, large companies.

There were early drafts of a 1986 Utah Insurance Code that included a prohibition of offset but fortunately, that was dropped from the final version and there is no mention of limitation on offset in Utah's Insurance Code. The only prior attempt, that I'm aware of, to legislate a prohibition of offset was back in 1973 in Wisconsin and that was also defeated. So, at this point the reinsurers could say they're batting 1000. I guess we can expect the rehabilitators and regulators, joined sometimes by ceding companies, to try to get legislation or NAIC model language to either prohibit or somehow limit the reinsurer's right of offset. In fact, just two months ago at a recent meeting of the Rehabilitators and Liquidators Task Force, they had asked their law and legislative study group (which does have industry participation) to review model language involving offset and recommend any possible changes or at least to advise them as to whether any changes were appropriate. Anyone who wants to volunteer to serve on that group, or knows of someone who might want to, should contact Jerry Service at the Florida Insurance Department.

If you look at the statutes on offset and at the regulations, you would feel that there really isn't any problem here, but you do have 50 states to review. The problem is that the courts aren't necessarily bound to follow those regulations and laws because of the conflicts between state and federal laws, and you have to be concerned about the property/casualty industry today. It is the developments and the insolvencies in the property/casualty industry that have driven the concern by life companies and regulators of life companies about what will happen in the event of insolvency. The Mission insolvency and the Beneficial problems with some of its subsidiaries have really focused everyone's concern about what's going to happen in the event of insolvency. Of course, Lincoln, being a very large reinsurer, enters into very large reinsurance transactions. To date we have always won the right of offset. However, the millions, and even billions that are exposed under this issue indicate that it is an important issue and one that we cannot ignore. They said that in the Oklahoma case, the life industry and the professional corporation (P/C) interests coincided, but I don't know whether this will be the case in the future. I can give several examples where the interests have not coincided, where the P/C group has gone off on its own and the life reinsurers didn't have a focused representation. The life reinsurers do not have their own association and are not members of RAA.

Again focusing on what can happen at the state level, even though there are clear laws in Colorado where there are no statutory or regulatory limitations on offset and where federal law should govern, the Colorado commissioner has taken the position that for there to be absolute transfer of risk (as their law does require) there can be no right of offset, in effect no contingencies upon full payment. We've argued this issue without success with the Department and, I guess, the courts will have to decide the issue in view of the absence of any regulation or legislation defending the position. Colorado has also taken the position that the mean reserve adjustment within modified coinsurance treaties aren't affected by limitations on offset. This is a halfway position. I guess that supports the view that there is less offset risk under a modified coinsurance treaty than under a coinsurance treaty with funds withheld, even though the financial bottom line effect is identical under both of these treaties.

We have a situation where we've always batted 1,000; we've got large amounts of risk; and we need to know what can we do to protect ourselves. We'll have to take the view, regardless of what we think the state position may be, or what the department's position might be, that in the event of an insolvency one simply has to take the right of offset and litigate. Even in Colorado, for example, or other states that might have some limitations to the right of offset, I think we can litigate regardless of what those views might be or have been in the past. The amounts at stake are just too large. The New York Department has taken a compromise position. Whereas under common law the two parties have a right to offset all amounts due between the two parties under all contracts between the two parties, the New York position is that offset can only be applied to amounts that are due within a single treaty; if there are other treaties between the two parties the amounts can't be combined to obtain one net amount due.

Several issues have been raised in the course of resolving insolvencies that may lead to a change in insolvency statutes and hence to insolvency provisions. For example, the model insurance laws and many state insurance laws are in conflict with the federal government with respect to the priority of the IRS to the assets of the insolvent company. Under insurance laws, the IRS comes after the rights of policyholders, but under federal law the IRS would come before the rights of policyholders. Most experts agree that the IRS is probably right, and that it would take a change in federal law to uphold the states' views that the policyholder comes before the IRS.

California has required the use of the words "payable on demand" in the insolvency provision. These are the amounts that are payable to the rehabilitators on demand. For example, under typical quarterly or annual accounting of a financial reinsurance transaction which provides for offset, the transaction involving offset may not be due at the instant when the rehabilitators demand payment. Is it a right to, in effect, postpone that payment or take into account offset at some time other than the normal accounting date under a bulk treaty? Will this, in effect, negate the right of offset? We know for a fact that a prior California commissioner interpreted "on demand" to mean within one year, which is a reasonable position. We're not certain what the current commissioner's view is on this.

A cut-through provision is a form of a contingent automatic assumption reinsurance provision that is triggered by the insolvency of the ceding company, where upon the insolvency the reinsurer becomes directly obligated to the policyholder. With the increased threat of life insurance company insolvencies there has been a large increase in the number of requests from ceding companies and/or large corporate policyholders to get cut-through provisions in life insurance and annuity treaties. In the past these provisions were more common in property/casualty contracts but rarely seen or considered for life or annuity reinsurance contracts. Unfortunately, the reserve credit and the insolvency laws of a number of states make cut-through provisions impractical; they simply won't work.

There was a case in Puerto Rico decided at the Supreme Court level several years ago that did void a contractual cut through. I don't know of any other cases in any U.S. jurisdictions that have voided a cut through. On the other side of the coin, there were a couple of recent cases involving P/C business fronting operations, where, in effect, the reinsurer and the policyholder were related parties. The parties sued upon the insolvency of the direct writing company, asking the courts to force a cut through, and to let the reinsurer make the payments directly to the policyholder. They argued that this was really the intent of the transaction. Unfortunately in a recent Texas case, it was decided that the reinsurance treaty and the direct policy constituted a single contract and the parties pleading for that kind of treatment for cut through got it. The proceeds were payable directly to the policyholder bypassing the insurance company and the rehabilitators, even though there was no

cut-through provision in the reinsurance contract or the direct policy. Hopefully, this will not set a pattern.

The arbitration provision made this list because of a recent case that established that an insolvent company does not have to arbitrate a reinsurance dispute. We would have thought, historically, that the arbitrators would be required on behalf of the insolvent company, to arbitrate a reinsurance dispute. This case in New York ruled just the opposite.

One thing that has happened as more companies become insolvent, on the P/C side anyway, is that reinsurers are looking for any possible way to negate the contract and not pay the claim. You would not expect this except perhaps in the case of an insolvent reinsurer. However, we have a number of cases in court involving Mission and the Beneficial subsidiary where the reinsurers are looking for any way they can to reduce their losses and not pay the claims.

Regarding letters of credit, these should be clean, irrevocable, payable on demand, etc. We're aware of at least one case where the rehabilitator was able to get an injunction and the company, in effect, could not draw the letter of credit and had to sue to get its money. That can happen. Also, in the Baldwin-United case, the Arkansas Department stepped in and, even though the funds were held in trust on behalf of a non-Arkansas company, froze those funds when under the terms of the treaty they should have passed immediately to the Indiana company. This should provide a flavor for the things that can go wrong in reinsurance treaties at time of insolvency. We are typically dealing in very large amounts. It is true that the risk of one of these bad events occurring may be small, but they're multiplied by, in many cases, some very large amounts.

MR. WILLIAM J. SCHREINER: I have a question for John Montgomery. Can you sort out in some reasonable fashion the activities relative to reinsurance at the NAIC level? I know there's a study group working on additional disclosure in the annual statement with respect to reinsurance. Your Actuarial Task Force asked the American Academy of Actuaries through the interim Actuarial Standards Board to look at the question of actuaries establishing reserves for reinsurance ceded. The American Council of Life Insurance has been asked to work on red flags for the regulators, and the group that was working on letters of

credit has just prepared a report. You apparently are now planning to establish another group. Can you put these groups in context with the other groups, and what do you expect this group to accomplish?

MR. MONTGOMERY: I pointed out ten issues identified by regulators in New Orleans. We will ask this other group to consider these ten issues and to help in obtaining some answers. Actuaries at state insurance departments are concerned with all of these items; hence all will be topics for consideration by the Actuarial Task Force.

MR. SCHREINER: Do you feel there is any duplication of effort going on in all these efforts?

MR. MONTGOMERY: There may be indirectly but I don't think there is directly. We may find that out in the course of our discussions with the Task Force at a later date. If there are areas of duplication and of some of these ten issues are being addressed elsewhere, we will not reinvent the wheel.

MR. JAMES W. PILGRIM: In your list of requirements for letters of credit acceptable to the California Department, what provisions are there to preclude the occurrence of a ceding company separating a letter of credit from the reinsurance agreement and calling it for any purpose whatsoever? This has occurred in prior years in certain situations because of the requirements for acceptable letters of credit. Is there any provision that will protect the reinsurer from the ceding company just cashing the letter of credit to meet payroll, to pay bills or whatever?

MR. MONTGOMERY: This letter of credit bulletin only applies to those associated with reinsurance contracts and does not address other letters of credit. I don't even know whether the Department would consider such letters of credit. There's no provision in our statute for letters of credit other than those associated with reinsurance contracts.

MR. PILGRIM: If I were a ceding company with a letter of credit associated with a reinsurance contract and I had a financial problem that I needed to meet, is there anything to prevent me from pulling the letter of credit and cashing it at the bank?

MR. MONTGOMERY: This may be in another part of the statute or the code. I'm sure that it isn't totally ignored. I just don't know the research. I'm sure it's something that has been reviewed.

MR. PILGRIM: A couple of years ago there was a provision in the Louisiana legislature saying acceptable reinsurance agreements had to have cut-through provisions included. What's happened to that?

MR. CLARK: That wasn't part of the final law.

MR. RICHARD S. MILLER: The Zielman Committee very clearly came out against a position of mirror imaging as a necessary item in considering the reserve credit. By raising the question again, you imply that your group rejects that. If that is the position, then why is it even being presented to another advisory group?

MR. MONTGOMERY: We've had numerous discussions on mirror imaging and there is a consensus among regulators to reject it. However, we need some guidelines on what can be done about this because we do not just want to say there's no such thing as mirror imaging. We do want to have some form of relationship between ceded reserve credits and assumed reserved credits. We still have a problem in this area.

MR. MILLER: The proposal that Robert Callahan has quoted is fairly reasonable. It recognizes in transit as part of the problem.

MR. MONTGOMERY: Yes, that's one problem and we don't know what is a *reasonable difference*. You can get a wide variation of opinions among the various departments so we are trying to come up with some general rule and that's the reason why this is still a topic.

MR. R. NEIL VANCE: I'm concerned with the ongoing solvency of life insurance companies. I'm a little bit bothered by the fact that, apparently, letters of credit can be cancelled with appropriate notice. What sort of worry am I supposed to have about a company that has a letter of credit this year, who might not have it next year, but presumably, still has the liabilities that have been transferred to the offshore reinsurers?

MR. MONTGOMERY: That's one of the problems we're concerned with too. If letters of credit are not replaced at the end of the year and companies do not find alternative solutions, then they do not get the reserve credit. It's as simple as that; they could have a problem.

MR. VANCE: There is one other option of course Under the Evergreen clause, upon notice of termination of the letter of credit, that it's not being renewed, the ceding company can take the money.