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REINSURANCE FROM THE REGULATOR'S POINT OF VIEW

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- o Surplus relief -- Balancing legitimate need with regulatory concern
- o Mirror reserving -- What is the "right" reserve credit?
- o Offshore reinsurance
- o Credit for reinsurance

MR. MELVILLE J. YOUNG: The idea for this session grew from a meeting about a year ago in which John O. Montgomery and I chatted after another reinsurance session. We thought it would be a good idea to begin a process of defusing some of the adversarial aspects of the atmosphere that exists occasionally in relationships between the industry and the regulators. It was clear to us that, for the most part, people on both sides of the fence were trying to do the right and upstanding thing, but somehow they weren't communicating with each other. We began a series of meetings at which a number of industry people and a number of regulators began to discuss a series of issues as areas of concern which the regulators-participants had put on the table.

MR. LARRY M. GORSKI: I'm going to discuss how I feel about reinsurance, as a regulator, and why I feel that way.

I have been with the Illinois Department of Insurance for over 14 years and have come to understand the commitment to monitoring financial solvency that our department has made. We view our role in monitoring financial solvency as a key element in protecting the insurance consumer. My presentation could be an academic one, but I would give some real life situations.

My first exposure to a real abuse of reinsurance was with respect to the financial demise of Iowa State Travelers. My understanding of that situation was that reinsurance was used as a way of convincing people that a proposed venture into small group accident and health insurance administered by a third party was a safe undertaking. I was not involved in the Iowa State Travelers' problem until after the demise, but I learned that you have to really dig beneath the surface to understand a financial transaction. The lesson that I learned there was that, "You can't believe everything that you hear." My next exposure to reinsurance abuse took place closer to home. A former Illinois domestic insurer was in the process of being acquired. I was asked to review the projections supporting the ability to repay the financing arrangement.

The company in question was a long-time member of our problem company list. I carried out my assignment by building a model of the company's operations and setting the parameters based on a review of the company's experience. Try as I might, my statutory balance sheet projections indicated a net worth of $1-$2 million less than projected by the company, and for a company of this size, a $1-$2 million difference was important. My immediate reaction was that there was something wrong with my model. However, after several weeks of close scrutiny by myself and others, we decided that the problem was at the other end. I visited the company again and started a small scale financial examination. I finally determined that the company was accounting for the impact of a surplus relief treaty in a different fashion than my model was accounting for the treaty and, in fact, in a different fashion from the assuming company. This difference in accounting explained the $1-$2 million difference.

The ceding company claimed the existence of an amendment to the reinsurance treaty. This amendment would support the ceding company's method of accounting. However, no amendment was ever produced. This incident really soured me on reinsurance, and in particular, financial reinsurance. The lesson that I learned here was, "Things are not always the way they appear."

These two incidents made the rest of the Illinois Department of Insurance and me very careful and thorough in our review of reinsurance transactions. This review does not always start with a filing of a new treaty. It often begins with our review of a financial statement. As regulators, we are very interested in the statutory net worth, and anything that might lower the quality of net worth. We perceive reinsurance as a mechanism that might cause such a deterioration.

When reinsurance is involved, we check to see whether reserve credits equal assumed reserves. This is what we often find. This difference cannot be explained by timing differences. Other times, when the assuming company is an unauthorized reinsurer, we look to Schedule S, Part 3B, reinsurance in unauthorized companies. This is what we sometimes find. Many regulators are interested in reserve credits supported by letters of credit. Note that there is no identification as to the support for the reserve credits, such as a letter of credit or a trust agreement. It is very difficult to assess the value of the support for a reserve credit when the identity of the support is not disclosed. While it is impossible to infer a motive for the lack of disclosure, it does make a regulator wonder. After obtaining a revised Schedule S, Part 3B, from the ceding company, and depending on the amount of the reserve credits, we might ask to see the letter of credit or trust agreement supporting the reserve credit. This is the kind of answer we sometimes get. Note the statement regarding the lack of obtaining a letter of credit.

None of these situations make reinsurance a trusted financial arrangement with insurance department personnel. However, there is still more to come. There are times when after our annual statement review and all of our correspondence, we still feel like we need to review the actual treaty. While this is not a typical response to our request for a treaty, it still occurs all too frequently. Note the lack of a finalized treaty six months after the accounting date. How can a regulator evaluate the strength of an insurance based on an annual statement when key transactions are not in place?

Once we get our hands on a reinsurance treaty, what do we look for? It is my responsibility to review the treaty for a transfer of risk. The big question, however, is what is meant by a Transfer of Risk. Guidance can be found in the NAIC model regulation. However, the NAIC regulation only indicates a situation wherein a transfer or sharing of risk does not occur. Very simplistically, I understand the concept to mean, "If the direct writer loses money on the business, then the assuming company should also." This doesn't mean that the reinsurer has to lose money on the treaty, but it should "Share" in the losses that the direct writer experiences. In the case of deferred annuity business, capital losses should be shared between the direct writer and reinsurer.

This brings up another situation which makes me question the legitimacy of reinsurance in some cases. The Illinois Department had a situation in which the parent of an Illinois domiciled company wrote some deferred annuity business and then entered into a treaty with the Illinois domiciled company. The Illinois domiciled company reinsured it elsewhere. I chose my words carefully, because the treaty between the parent and the Illinois company was one that I would recommend for disapproval if the Illinois company had been the ceding company. However, our authority over such transactions is limited. Once the Illinois company "Assumed" the business via the treaty, the reinsurance treaty between the Illinois company and the ultimate assuming company could not be criticized for lack of transfer of the capital loss because the Illinois company never had that risk in the first place.

An interesting side effect of our demand for a "Sharing of Risk" is a concern over the financial soundness of the reinsurer. As regulators, we can't overlook the fact that if we require a "Sharing of Risk" in a reinsurance treaty, then we had better be sure of the ability of the reinsurer to make good on its obligations. It doesn't do much good to replace receivables for a commission and expense allowance on a reinsurance treaty that is, in fact, a loan with receivables for unpaid claims from a reinsurer that is financially shaky.

The evaluation of risk transfer or risk sharing is made difficult in many situations because of complex or ambiguous treaty language. I want to present some of the language from a treaty that I recently reviewed for risk transfer. The treaty appeared to meet the standards of the NAIC model regulation until I read the following phrase:

> And such negative amount shall be carried forward as a deficit carry forward in the calculation of experience refunds for subsequent quarters until recovered in full by the reinsurer.

This phrase appeared to eliminate any risk sharing. After some discussion with the company and the reinsurer, the language was clarified.

In summary, how do my cohorts and I view reinsurance? We find it to be:

1. Inconsistently reported from ceding company to assuming company;
2. Inadequately reported;
3. Complex and confusing; and
4. Sometimes abused.

How can we be persuaded to feel differently about reinsurance? One thing that can be done is for assuming companies and ceding companies to work together to strive for consistent presentation of reinsurance transactions, or at least notify the regulators up-front of differences that exist. Secondly, up-front disclosure of the mechanics of a treaty should be made with a demonstration of any risk sharing that is an inherent contract provision that might be the way to settle problems concerning missing amendments or administration different from the treaty situations involving a substantial sharing of risk. I am in the process of working with an actuarial consulting firm in an attempt to address the issue of standards.

With all of the problems that I have identified, one might think that I am making a case for the prior approval of reinsurance treaties. In Illinois, we have a limited prior approval law. Because of the statute, we see most treaties that generate surplus relief for ceding companies. The statute causes us to devote substantial time to do as we have. However, our efforts are directed only toward domestic companies.

MR. YOUNG: Hopefully, some of us are beginning to understand some of the regulators problems, thanks to Mr. Gorski's examples. The next speaker I've mentioned before is Ted Becker, who is going to be talking to us about Mirror Reserving.

MR. TED BECKER: One of the subtopics listed for this session is "Mirror Reserving -- What is the Right Reserve Credit?" I plan to concentrate on this subtopic. First, I will define *mirror reserving*, and *quasi mirror reserving*, which is an expression that I have coined especially for this presentation. Second, I will briefly describe what has been our traditional position at the Texas State Board of Insurance.

Third, I will comment on two recent papers, which have challenged our traditional position. Both of these papers are professionally done, and they include work by very competent actuaries. These two papers have not been widely distributed as yet, but they merit close attention and review. One of these two papers is a report from the American Council of Life Insurance Subcommittee on Reinsurance. This report is on the specific subject of mirror reserving. I will call this document the ACLI Subcommittee Report in my presentation. Mr. Wayne Bidelman, of Security Life of Denver, furnished me with a copy; and I very much appreciate his kindness in doing this.

The other paper that has challenged our traditional position is a report from a special Reinsurance Advisory Committee to our NAIC Life and Health Actuarial Task Force, dated December 5, 1985. The Chairman of this Reinsurance Advisory Committee was William W. Zeilman, of General Reassurance Corporation, and I will refer to this document as the Zeilman Committee Report. I am a member of the parent NAIC Actuarial Task Force, and I had a copy of the Zeilman Committee Report in my files. The Reinsurance Advisory Committee is no longer active, but a new Advisory Committee is now being organized. Fourth, I will make a proposal for an idea which the NAIC Actuarial Task Force and the reorganized Advisory Committee may want to explore.

DEFINITIONS

We need to start with a definition of *mirror reserving*. The ACLI Subcommittee Report contains the following definition: Mirror Reserving, sometimes called mirror image reserving, is an expression created to describe a financial accounting concept which would require that the reinsurers reserve for its portion of a risk "mirror," the ceding company's reserve credit. Stated another way, the ceding company's reserve credit could not exceed the reinsurer's reserve, nor could the reinsurer's reserve exceed the credit taken by the ceding company.

This comes close to my definition of mirror reserving, but I would like to add the further requirement that the assuming company would be permitted to use a stronger reserve standard than the ceding company. However, the ceding company would not take reserve credit on a stronger standard than it had used in setting up its gross reserves. By a stronger reserve standard I refer to a standard (mortality table, interest rate and reserve method) which produces higher reserves per $1,000 face amount, than those reserves which had been set up by the ceding company in establishing its gross liability. It is also possible that the assuming company would have to set up a deficiency reserve on account of low gross premium rates, and that the ceding company did not need to establish such a reserve. I would also consider such a case as using a stronger reserve standard. Without this further requirement, the ceding company would obtain too much reserve credit as an offset on its ceded block of business, and the balance of its business would be underreserved.

I will define *quasi mirror reserving* to refer to a different accounting concept wherein the assuming company and the ceding company are both required to use the same mortality table and interest rate in computing reserves. However, they would not necessarily have to use the same reserve method.

Once again, we will be concerned that the balance of the business left with the ceding company not be underreserved. The assuming company would be allowed to set up its reserve on a stronger standard than that which had been used by the ceding company, but the ceding company's reserve credit would always be limited to the standard which it had originally used in setting up its gross reserve liability before reinsurance.

As a straightforward example of quasi mirror reserving, let us consider a company, which is the direct writer of a block of ten-year term business, with reserves set up on the 1958 CSO Mortality Table at 3.5% interest, using the net level method. These policies do not have cash values. This business is then ceded to another company. The quasi mirror reserving concept would allow this ceding company to take credit against its gross reserves on the same standard, including the net level method, even though the assuming company was setting up reserves on the reinsured block of business on the same mortality table and interest rate but on the commissioner's reserve valuation method.

Thus, the quasi mirror reserving allows cases where the total reserves set up by the two companies, after the reinsurance transaction, are less than the gross reserve set up the ceding company prior to the reinsurance.

The definition of mirror reserving did not necessarily require the two companies to use the same mortality table and interest rate for reinsurance credit purposes as the ceding company had used for gross reserve purposes, although some limits are imposed because the ceding company cannot take credit on a stronger reserve standard than that which it used in setting up its gross reserves. However, the definition of quasi mirror reserving does impose the requirement that the two companies use the same mortality table and interest rates.

TRADITIONAL POSITION IN TEXAS

Historically, the Texas State Board of Insurance staff has been the most comfortable with the mirror reserving concept. This concept seems to fit in naturally with annual statement blank accounting, which shows both gross reserves and net reserves for the ceding company. This concept also seems to fit in naturally with the doctrine of conservative accounting for insurance companies, under which liabilities should be overstated if there is any question as to their proper amount. The net reserve remaining, after the reinsurance credit is taken off, is a liability item for the ceding company.

There is something which may be instinctively unsettling to regulators when liability can vanish due to reinsurance. The mirror reserving concept, whatever its faults may be, does not seem to permit any liability to slip down between the cracks in the floor, with neither the assuming company nor the ceding company setting it up.

One well-known reference book in our actuarial library, *Life Insurance Accounting*, by Noback, states specifically that the combined reserve set up by the assuming and ceding companies, after reinsurance, should not be less that the gross reserve which the ceding company had set up. Thus, this book would seem to call for mirror reserving. That book was published in 1969.

Two other well-known reference books seem to allow for quasi mirror reserving. These are *Life Insurance Statements and Accounts*, by E.C. Wightman, published in 1952, and a much more recent book *Life Company Annual Statement Handbook*, by Booke and Company, 1986 version. I do not interpret these books as allowing for any other exception to mirror reserving than quasi mirror reserving.

The quasi mirror reserving concept does allow liability to slip between the cracks in the floor, but only within certain specific limits. This concept has the blessing of these two books, and I believe we would accept it as a general rule. However, the liability for paying cash surrender values under the reinsured policies must be kept in mind, and be properly set up.

Suppose that a block of whole life policies has cash values equal to net level reserves, and this block of business is reinsured. If the obligations of the assuming company under the reinsurance agreement do not require that company to ever pay more than the commissioner's reserve method in a case of cash surrender, then the assuming company could set up reserves using that method. However, the ceding company should not be entitled to offset its liability using net level reserves, because its obligation to provide the cash values has not been covered.

There are certain other reference materials which I consulted, in addition to the three books I mentioned. However, these other materials did not give any specific assistance in determining the proper reserve credits. The applicable statute in Chapter 3 of the Texas Insurance Code is in this category, as is the Reinsurance Section of the *NAIC Financial Condition Examiners Handbook.* (The *NAIC Handbook* does clearly state that the reserve on ceded business should not be offset by the ceding company on a stronger standard than that on which the gross reserves had been set up.) Also, in this category is the new Texas Board Order No. 50350, dated March 27, 1987, which contains language similar to that originally developed by the New York Department. This Board Order contains language tying the proper reserve credit to rules or regulations, including actuarial interpretations or standards, adopted by the State Board of Insurance. But so far nothing of that kind has been adopted. The Board Order leaves open the possibility that the Board may do this in the future.

When I speak of our traditional position in Texas, I want to emphasize that this is what I understand we have been trying to follow. I am sure that cases exist where matters were not cross-checked, and reinsurance credits which did not comply with this position were left unchanged. We have had a number of different field actuaries over the years, and at the present time we have six of them at our agency. They have generally been good and competent employees, but I would be surprised if there were not some inconsistencies along the way in our review of reinsurance transactions.

One traditional concern of regulators, in Texas and elsewhere, has been that reinsurance should not be used to avoid the Standard Valuation Law. There is a provision in the model Standard Valuation Law which permits an insurance company currently holding reserves on a higher valuation standard than the minimum standard to reduce its reserves to a lower standard, at least equal to the minimum standard, but only with the approval of the appropriate state regulatory authorities. I do not see how mirror reserving could be used to reduce reserves and avoid this requirement. However, quasi mirror reserving would be a way of avoiding this requirement of approval by regulatory authorities through transfer of the business to another company via reinsurance. Because quasi mirror reserving requires the ceding company and the assuming company to use the same mortality rate and interest rate, the reserve reduction which could be implemented would be rather limited.

TWO RECENT DOCUMENTS

The ACLI Subcommittee Report defines mirror reserving, as I have already mentioned. The report takes the position that the mirror reserving concept should be rejected. Four reasons are listed for this position, and there is a short conclusion consistent with that position. The report includes a number of relevant footnotes, but none of these footnotes relate specifically to Texas. These footnotes do indicate careful research by the authors of the report on the laws in a number of other states and the District of Columbia. I will refer back to one of these footnotes later.

For the present, let us list the four reasons for recommending rejection of the mirror reserving concept, as given in the ACLI Subcommittee Report.

1. "Mirror Reserving is Based on a False Premise." The report goes on to identify this false premise as the concept that all states and jurisdictions have the same minimum reserve requirements.

2. "Existing NAIC Rules Reject the 'Mirror Reserving' Concept." Here, the report is referring to the "NAIC Instructions for the Life and Accident and Health Annual Statement," and more specifically to the Instructions for Exhibit 8 "Aggregate Reserve for Life Policies and Contracts." The language cited here would certainly support quasi mirror reserving. It is

not clear to me whether these instructions intend to authorize any other exceptions to mirror reserving.

3. "The Existing Statutory System for Allowance of Reinsurance Reserve Credits Satisfactorily Addresses the Issue of Reserve Capacity." The report makes the point that mirror reserving is not specifically listed as a requirement in most states. Some regulators in various states might argue that the existing system is not really satisfactory. However, they would not necessarily agree that mirror reserving is the answer to making the environment satisfactory.

4. "There Is No Problem That Mirror Reserving Would Solve." The report states that no ceding insured is known to have failed or became impaired because its reserve credits were larger than the corresponding line item reserves of its reinsurers. As far as I know, this point is well taken. The Conclusion to the ACLI Subcommittee Report contains this sentence referring to mirror reserving:

    > Moreover, it can be expected to generate significant administrative burdens and costs for ceding companies and reinsurers without enhancing the solvency of either.

    The report is rather brief, and it does not elaborate on this sentence. But this statement should be investigated and studied further. Are there sufficient benefits to regulators to justify these administrative burdens and costs for the ceding company?

The Zeilman Committee Report is also concerned with reinsurance accounting, but it is not specifically written in response to the mirror reserving concept.

However, it is quite clear that this report does not support the mirror reserving concept. The net reserve section of this report contains a sentence as follows:

> A consequence of a proper calculation of retained reserves is that an algebraic relationship such as the one between benefits, need not hold true for reserves with respect to policy benefits. When a policy is reinsured, the net reserves held by the ceding company plus the reserves held by the reinsurer may be more or less than the reserves that would have been held had the ceding company not reinsured any of the policy benefits.

The Zeilman Committee Report had previously defined a net benefit (or retained benefit), which represents the remainder of the benefit left with the ceding company after reinsurance. The report takes the position that the net reserve should be based on this net benefit, but that the ceding company may have to hold a higher net reserve on account of reinsurance provisions which diminish indemnification, or on account of certain additional liabilities as described in the report.

The Zeilman Committee Report goes on to list four examples, where business might be reserved differently by the ceding and assuming companies. The first two examples relate to cases where the assuming company is required to set up deficiency reserves, which are not needed by the ceding company and which should not be allowed as a credit. These two examples are cases where the assuming company uses a stronger reserve standard than the ceding company, even though the deficiency reserve is needed in order for the assuming company to meet minimum reserve requirements.

The third of the four examples reads as follows:

> A ceding company and a reinsurer may establish different valuation bases, which is appropriate as long as both satisfy minimum valuation requirements.

No further details are given in connection with this example in the Zeilman Committee Report.

The fourth and last example reads as follows:

> A reinsurer may rate a facultative case at a different substandard table than the ceding company and therefore establish reserves on a different valuation basis than the ceding company.

Presumably, the rerating could produce either stronger or weaker reserves being held by the assuming company, and the judgment of the assuming company is substituted for that of the ceding company. If the assuming company does set up weaker reserves, then we have a case where neither mirror reserving or quasi mirror reserving concepts are met.

In fairness to the Zeilman Committee Report, it assumed that the Interim Actuarial Standards Board of the American Academy of Actuaries would develop actuarial standards in regard to reinsurance. The Interim Actuarial Standards Board is to become the Actuarial Standards Board, but this project is still being studied. So, at the present time, these standards for reinsurance have not been developed; and in some cases actuaries may not know what the minimum standards actually are. Thus, there could be disagreement as to whether the assuming company and the ceding company are both meeting minimum reserve standards as required under the third example listed in this document.

One question which might arise concerns the proper mortality table to be used in computing minimum reserves for a life insurance policy issued under an obsolete mortality table, but not ceded until quite recently. Could the minimum reserves for the ceding company be based on the American Experience Table, and the minimum reserves for the assuming company on the same block of business be based on the 1980 CSO Tables?

A still more difficult question is identifying the minimum reserves for a life insurance policy with a fixed and relatively high schedule of cash surrender values. Several years ago, the NAIC Actuarial Task Force and its Standing Technical Actuarial Committee agonized over the question of whether such cash values need to be prefunded in computing minimum reserves, in a manner somewhat like the Commissioners Annuity Reserve Method. Now, the American Academy of Actuaries will have to address this same question.

PROPOSAL FOR STUDY

The above two documents have merit, and much additional work needs to be done. On the other hand, the mirror reserving concept still seems to me to be an appropriate norm or starting point. I feel it is reasonable to ask the companies for an explanation when the mirror reserving concept is not met. The explanation could then be reviewed on an individual basis by the appropriate regulators.

One of the footnotes to the ACLI Subcommittee Report reads as follows:

> The California Department of Insurance has indicated an interest in discovering cases where material differences exist between ceding company's reserve credit and the reinsurer's reserve. In "Reinsurance Survey 1984," dated December 31, 1984, and directed to "All Admitted Insurers," Question 10 reads as follows: "On assumed business have you established liabilities at least equal to the

> reinsurance credits taken by the ceding insurers after adjusting for any reporting lag? If not, please explain and provide names of ceding insurers where material differences exist."

The NAIC Actuarial Task Force and the reorganized Advisory Committee could explore requiring such a statement, on either a temporary or a permanent basis. I propose that this idea be studied, for possible future implementation in all states.

MR. YOUNG: I want to point out that mirror reserving is an issue that is been written about and spoken about quite a bit, and is obviously an area of disagreement. I appreciate the citations for the 1950s and the 1960s; the reinsurance industry has its own unofficial historian, Thomas G. Kabele, of the Guardian Life, and I'm confident that we're about to hear a citation from the early 18th century on the subject.

MR. THOMAS KIRK HARTMAN: Robert J. Callahan has noted to me that at times he expresses views in an attempt to either revise Department policy or to set Department policy. He has further noted that sometimes Department policy is not revised and at times new policy is set which is other than he has advocated. Accordingly, Callahan wants it fully understood that his prepared remarks represent his personal views. Also any remarks I make during the question and answer period represent my personal views, although I may not have any. Herewith are Mr. Callahan's prepared remarks.

Years ago reinsurance was truly used as a means to spread the risk, whether that be a mortality risk, an expense risk or an interest rate risk. The three common forms of reinsurance: (1) yearly renewable term for the net amount of risk, (2) coinsurance, and (3) modified coinsurance and the use of excess amounts and quota share were well understood as means of sharing the risks.

In some cases, some insurers, in particular new insurers, used the underwriting expertise of the reinsurer having the right to reject certain cases. These seem to be laudable objectives.

How then did something go wrong to the extent that today I have identified reinsurance as the biggest concern in the valuation process, the knife that cuts the hole in the bottom of the bag of statutory reserves, and the thorn that may influence me to withdraw any further support for the valuation actuary?

Unless otherwise specified, my remarks pertain to life insurers and life insurance and annuities and not to property and casualty insurers and insurance.

Life insurance and annuities had once been considered rather stable, unexciting products. However, today we have a new ball game with interest sensitive products, and either tax qualified or tax deferred products and with companies looking for surplus to grow. Reinsurance accounting has evolved into a device to show surplus.

Some of the problems are with the current accounting procedures and regulations. Procedures can become out of tune either with the procedures over time having evolved to a stage not originally contemplated, or with the procedures being used with new products in ways not originally contemplated and in having effects not anticipated.

A parallel can be made with reference to the 1959 income tax law for life insurers. The procedures therein worked for a while under stable circumstances but then as interest rates rose, the approximate formula for adjusting tax reserves resulted in harsh taxes. Companies then sought means to reduce taxes by taking advantage of certain loopholes.

Two examples are: (1) creation of a modified premium whole life policy with a long premium grading benefit and using the approximate adjustment from Commissioner reserve valuation method to the net level method, and (2) by use of modified coinsurance treaties to obtain unlimited deduction of policyholder dividends. Obviously the federal government had to close these loopholes as part of the revision of the tax laws in trying to reach a satisfactory tax procedure for a rather complicated industry. The basic point is that once the loopholes were discovered, the tax laws were revised to close such loopholes.

The accounting for yearly renewable term and coinsurance may seem relatively simple. The accounting for modified coinsurance is not relatively simple and may mask some problems. For example, in the summary of operations on a net of reinsurance basis, the entries for coinsurance may affect each line. Whereas the entries for modified coinsurance may be lumped together in one or two lines. I have worked in the New York Insurance Department long enough to remember when, in the case of life insurers, the reinsurance credit for reinsurance that was ceded to an unauthorized reinsurer was not permitted as a deduction from reserves unless either funds were withheld, or there was a trust fund under control of the ceding insurer. The increase in net reserves affected the gains from operation. A decision was made to change the accounting procedures so that the disallowance of such reserves did not adversely affect the gains from operations. Now the accounting calls for the deduction from reserves whether the reinsurance is with an authorized or unauthorized reinsurer, but the ceding insurer has to set up a liability for any excess for reserve credit taken over funds withheld. This revised procedure directly impacts on surplus.

In the first few years after a change in accounting procedures, the reserve credit taken, funds withheld, and excess were first set forth on page 3 of the annual statement, thereafter only the excess on page 3, with a worksheet in the separate instructions, and subsequently the latter was replaced by Schedule S Part 3B format, instruction and footnotes. Many regulators and rating organizations tend not to get involved in the details of the schedules, but rather focus on the asset, liability, surplus and summary of operations on pages 2-4 of the annual statement.

At one time many mutual life insurers chose reserve bases and special reserves so as to control the incidence of earnings and the incidence and amount of dividends. Low valuation interest rates tend to produce higher reserves, and produce greater excess interest earnings in later policy years thereby producing much higher dividends in later policy years. A mutual insurer having a very low surplus percentage, but conservative reserves, may be far more stable and solid that a stock insurer with a high surplus percentage, but low reserves. Today with interest sensitive products and the competition with other financial institutions and mutuals issuing guaranteed interest contracts with no expectation of policyholder dividends, we find some mutual and some stock life insurers attempting to show more statutory surplus by setting up lower reserves through the use of less conservative reserve standards, through surplus relief reinsurance, and through legitimate reinsurance but with unauthorized reinsurers, and a letter of credit backing the reinsurance.

The New York Insurance Department has annually issued complaint ratios. Recently the federal aviation agency has issued complaint ratios for airline passengers to help guide them in choosing an airline. The New York Insurance Department has published cost comparison figures for typical policies and representative ages. In turn it is easy for a reader to rank the insurers by cost.

However, the New York Insurance Department has not issued rankings or grading of companies by claims' paying ability or by financial stability. We now have various investment services ranking some insurers by claims' rating ability. Some of these investment services appear to be dealing more with appearances that substance and giving high marks to those insurers showing high surplus, even though such surpluses may have been created by low reserves and by questionable reinsurance.

Where reserves are redundant there is a tendency to reinsure such business for a premium less than the reserves. If the reinsurer is a licensed insurer of an accredited reinsurer, then the reinsurer must abide by the same reserve standards as the ceding insurer.

In some cases, the reinsurance has been on a combination modified coinsurance and a coinsurance basis, with the reinsurance premium set basically equal to the modified coinsurance reserve, and for a small risk charge, the balance of the reserve was ceded on a coinsurance basis. In case of business where the principal risk was the investment risk with the ceding insurer retaining such risk on the modified coinsurance portion, the ceding insurer received a very large credit for the coinsurance portion, and yet little or no risk was being transferred. In some cases the assuming insurer set up and retained the full reserve for the coinsurance piece, as for example, if the ceding insurer had sufficient surplus and if there were tax savings. Some assuming insurers, although licensed or accredited, claimed lower reserves based on the standards and interpretations of their state of domicile. We advised such insurers that our standards and interpretations applied to all their business, both direct and assumed. Some assuming insurers sought to retrocede such business, in many cases to an unauthorized reinsurer.

In recent years, the New York Legislature has enacted laws and the Insurance Department has issued regulations for annuities and guaranteed interest contracts for an actuarial opinion and memorandum, as to the adequacy of assets supporting liabilities and with the imposition of penalty reserves in the event that there is no acceptable opinion and memorandum. Obviously, if an insurer could cede the extra reserves for a very small premium, it may decide not to do the cash flow testing, and appear to be on a sound net of reinsurance basis, but if the reinsurer has not assumed the investment risk, the ceding insurer might be in financial difficulty.

New York's Regulation 102 Reinsurance Transactions By Licensed Insurers dated February 15, 1985 was designed to limit the credit taken by the ceding insurer where there has not been a true transfer of risk. In turn, in December 1985 the NAIC adopted a Model Regulation on Surplus Relief similar to New York's Regulation 102.

For structured settlements involving a substantial investment and reinvestment risk, our Department has recently approved a combination modified coinsurance and coinsurance treaty. This treaty is on a percentage of the total risks assumed where the ceding insurer retains identified assets in a segregated asset portfolio, which is at least as great as the asset supporting the modified coinsurance as if the combination modified coinsurance and coinsurance were for 100% of the total risks. The reinsurers sets up the coinsurance reserves based on the percentage of the total risks reinsured and taking into the part on the modified coinsurance basis. The assuming insurer insists that the ceding insurer retains a portion of the total risk and that the assets in the segregated asset portfolio be sufficient for the total risk. Assets going into the portfolio are subject to the approval of the reinsurer. If assets are replaced, the ceding insurer must demonstrate compliance with a cash flow test set forth in the treaty.

The reinsurer participates in capital losses at maturity but not before. Obviously the asset portfolio is less than the statutory reserve, or surplus relief would not be effected. We concluded there is a true transfer of the reinvestment risk. We urge all assuming insurers considering a similar treaty to carefully examine the quality, coupon, maturity and call provisions of the assets as well as the magnitude and length of the benefit obligations.

Now, for the sake of simplicity let us consider reinsuring 100% of the risk on a coinsurance basis such that it appears that 100% of the risk is truly transferred. If the reserves are in fact redundant, the reinsurance premium may be less than the reserves. In case of such insurance with an authorized insurer and a transfer of monies to the reinsurer, the ceding insurer is effectively receiving immediately a portion of the present value of future profits; the reinsurer obviously anticipates receiving some profit in the future. The assuming insurer must put up the full reserve. The ability of the assuming insurer to do so is limited by the amount of surplus the assuming insurer can afford to use. This in turn means the number of insurers able to assume such business is limited.

The law was intended to give licensed insurers, and accredited reinsurers meeting the same solvency standards as licensed insurers, an advantage over unauthorized reinsurers by restricting the credit taken by the ceding insurer to the lesser of the reserve the ceding insurer would have set up if it retained the risks and the amount of funds withheld by the ceding insurer. However, the groundwork for turning the disadvantage for unauthorized insurers into an advantage was laid in 1961 when the Superintendent of Insurance, on the basis of an Office of General Counsel Opinion, declared a letter of credit to be a fund withheld in considering the situation of an unauthorized property and casualty insurer (a viable insurer) and a list of outstanding claims.

Today this has evolved to where, in the life annual statement blank Schedule S Part 3B of the ceding insurer's statement, a letter of credit is given the same weight as true funds withheld and trust agreements for supporting the credit taken in case of unauthorized reinsurers for both term reserves and for unpaid claims.

Thus the effect is that as long as the assuming insurer can get a letter of credit to furnish the ceding insurer, whether the assuming insurer be a viable insurer or only a shell, the assuming insurer's surplus is not affected if the jurisdiction supervising the insurer has either very loose or no reserve standard.

There is of course a charge for the letter of credit which in turn is reflected in the reinsurance costs. However, such cost is insignificant in comparison to the amount of reduction in reserves. The bank issuing the letter of credit should check the credit of the reinsurer buying the letter of credit. In some cases the holding company is guaranteeing repayment in event the letter is drawn down even though the biggest asset of the holding company is the ceding company. The bank should assess the financial condition of the reinsurer and whether the reserves set up are sufficient, and whether the letter of credit together with all other letters of credit do not exceed the surplus of the reinsurer. It is doubtful that most banks issuing letters of credit perform this credit analysis with the result that insurance risks are being transferred to the banking industry.

In 1983 the New York Insurance Department issued a circular letter indirectly placing restrictions on the banks issuing such letters of credit by requiring that the letters of credit be evergreen and be able to be drawn down by the ceding insurer, thereby limiting the total outstanding letters of credit as a percentage of the capital and surplus of the issuing bank, and requiring that the issuing bank or the bank guaranteeing the letter of credit of the issuing bank be a member of the federal reserve bank or be a New York chartered bank. This circular was composed jointly by representatives of the Property and Casualty Bureau and of the Life Bureau.

In May 1986 when an NAIC study group met with an advisory group on letters of credit, the Chief of the Life Bureau, Mr. Terence Lennon, asked me to substitute for him as the Department representative. We both wondered why the Department had someone from the Life Bureau, rather than the Property and Casualty Bureau, be the representative as we thought that letters of credit were primarily used in the Property and Casualty area. We subsequently discovered that while some ceding insurers did reinsure with a viable unauthorized reinsurer which furnished a letter of credit, a few life insurers have made extensive use of letters of credit in the life insurance and annuity area. They have done this with generally offshore and European insurance companies subject to little or no reserve standards, however, at times with a legitimate reinsurer in the United States but which in turn retroceded to an offshore captive. Somehow these unauthorized reinsurers have furnished letters of credit, or so the claim is.

Much has been published in the past year and a half by an insurance consumer advocate as to reinsurance in unauthorized reinsurers and the use of letters of credit.

REINSURANCE FROM THE REGULATOR'S POINT OF VIEW

In a recently filed examination report, it was noted that in some cases the reinsurance treaties and/or the letters of credit were not in force on the valuation date, and that in some cases, the parent of the ceding insurer was responsible to make repayment in event the letter of credit was drawn on. How could we have reached this stage without having detected the problems sooner? While New York has prior approval of policy forms, it puts the stress on the policy provisions of individual policy forms on the basis that insurance is a complicated and/or technical product and the Department looks after the interests of the man on the street.

More leeway is allowed for group policyholders, in particular for large policyholders, with guidelines for binding cases, collecting premiums, and administering claims before formal approval of the forms on the basis that large group policyholders are either sophisticated and knowledgeable or have access to insurance and annuity consultants for expert advice. In the case of reinsurance, it is generally assumed that both the ceding insurer and the assuming insurer are knowledgeable and expert and do not need the Insurance Department to protect either one. While the Department has laws and regulations on reinsurance, except for transactions between affiliated companies (parent and subsidiary), it does not have prior approval on reinsurance treaties. Previously, I referred to the Department's approval of a surplus relief treaty, but such was at the request of the parties in order to avoid criticism later on. If the Department were to require prior approval for all reinsurance treaties, the Department would need to hire more people.

By law insurance companies must be examined every 5 years, but except for the giant companies, the examination is every 3 years, with examiners sent in from 1 to 12 months after the December 31 examination date. While the average examination may only take a few months, it is customary for the report to be reviewed by the examiner's supervisor and by the company, and to have any problems resolved between the company and the Department before the report is formalized and filed as a public document. In the meantime the findings are kept confidential, frequently from other interested parties within the Insurance Department.

Thus, in the case of a recently highly publicized examination report, the date of examination was December 31, 1983 with the bulk of the work completed during

1984, but with the problems, and the agreement with the company not being resolved until February 27, 1987.

The report, dated January 28, 1987, has some updating for the 1984 and 1985 annual statements and refers to the February 27, 1987 agreement.

What can be done to correct the problems? Regulation 102 pertaining to surplus relief reinsurance is only a partial solution. We are currently working on revising Regulation 20 Credit for Reinsurance to require modified mirror reserving by limiting the credit taken by the ceding life insurer to the lesser of the amount of reserve it would have set up in absence of reinsurance and the amount of reserve set up by the unauthorized reinsurer. We have been working with an advisory group and we may make some concessions for true funds withheld and for trust agreements. However, if an unauthorized reinsurer does set up the same reserve as the ceding insurer, how can we prevent the reinsurer from underreserving a different block of business?

The Department is also working on a regulation governing letters of credit. It is my opinion that the modified mirror reserving is not sufficient, and that we need to prohibit the reduction of reserve credit for reinsurance into an unauthorized reinsurer where a letter of credit is substituted for funds withheld. I also think that no letter of credit should be recognized where there is any common management or ownership between any of the ceding insurer, the assuming insurer and bank issuing the letter of credit.

I also think that full public disclosure should be made in the annual statement. While I have input to the revision of Regulation 20 and the development of a regulation on letters of credit, others within the Department have the primary responsibility. A public hearing will be held on November 16, 1987 on a proposed regulation on letters of credit.

Perhaps one may say that we should reduce the need for surplus relief reinsurance by making the reserve standards more realistic and less redundant. I have urged revisions of the statutory standards to make them more realistic, but I contend that in some cases today, in particular for business issued in 1982 and later, the statutory standards may even be inadequate unless the assets are appropriate for the liabilities.

I have continually urged the cash flow analysis for annuities and guaranteed interest contracts, and the setting up of additional reserves if so indicated by the analysis, but I have steadfastly maintained that we need to retain an objective test using a statutory formulae's approach, perhaps market value of assets and market value of liabilities. We cannot permit the use of reinsurance to undercut the statutory formula's reserves.

No one state can solve the problems alone. The states must unite. Currently we have some states inviting both insurance and non-insurance companies to set up captive reinsurers by very low requirements of capital and surplus for insurance companies doing only a reinsurance business.

Also there is tremendous diversity in practice in regulating and enforcing reserve requirements, partly due to the lack of technical help by some states and partly due to the fact that reasonable people can reasonably differ in both interpretation and the way regulations should be carried out. There is a need to make more efficient use of the present regulatory talent and to strive for more uniformity whether by smaller states using the expertise of the larger states, through the creation of an actuarial staff in the NAIC central office, or by federal regulation of solvency. A central and uniform national policy will in turn facilitate and control the international insurance market rising today.

MR. YOUNG: Our next and last speaker is John O. Montgomery, from the California Department.

MR. JOHN O. MONTGOMERY: I'm going to discuss views on various reinsurance and related topics and then talk about some actions that are going on. Reinsurance has already been pointed out by some of the other speakers as a way to avoid reserve requirements mandated by the Standard Valuation Law, and should not be allowed. The process of retroceding business to offshore reinsurers whether they are affiliated or not, and is a subterfuge commonly used to escape such requirements. Most states allow such business to be supported by letters of credit. In fact, in California legislation exists specifically providing for this. Such letters of credit may not, however, be allowed if they are guaranteed by affiliates of the original ceding company.

The whole problem of letters of credit is a very political one. Such a technique was originally devised for supporting reinsurance agreements on coverages lasting no more than a year, such as is the case with many coverages in the property, casualty liability insurance areas. Despite the inclusion of an *evergreen* clause in connection with letters of credit for consecutive one-year period associated with reinsurance agreements lasting more than one year. I believe such arrangements are very weak and dangerous propositions. The evergreen clause is likely to turn brown under the acid rain of adverse conditions. We've already experienced some of that in connection with the casualty company.

In this day of tumultuous economic conditions and high competition for the consumer dollar, letters of credit supporting longer term reinsurance contracts may prove to be the greatest folly of this generation.

To me, mirror imaging is a secondary issue relative to the weakening of our reserving system. Rules are needed to govern the tolerances between reserve credit reported by the ceding company and that reported by the accepting company.

Concerning the asset "Reinsurance Ceded: amount recoverable from reinsurers," which is Line 11.1 in the 1987 Blank, Page 2, only amounts to be recovered before the next annual statement should be admissible. Any other amounts purported to be recoverable should be non-admissible.

For the purpose of surplus relief the California Insurance Department has allowed a form of coinsurance and modified coinsurance agreement with a decreasing percentage of coinsurance in the recent past. It would probably require in the future that the coinsurance percentage remain constant throughout the term of the agreement so as to strengthen the fact that the contract is intended as a reinsurance contract and not a repayment of a loan.

Another form of surplus relief being considered by California is a form of coinsurance contract with funds withheld by the ceding company and with such funds been placed in a segregated asset account over which the assuming company may have or may not have some rights with respect to the types of assets maintained.

It has been noted that attempts have been made to net out the initial expense allowance in the payment of initial premium by the ceding company to the reinsurer. This involves some tax considerations. If this practice becomes widespread, it could totally invalidate several NAIC, IRIS tests and is considered as a form of misrepresentation in the Annual Statement Blank. If there are tax considerations they should be handled in some other way in the terms of the reinsurance agreement.

Cash flow projections can be useful in demonstrating that a risk is being transferred. However, when the most adverse scenario possible demonstrated a negative cash flow not remotely related to the reserve credit sought for reinsurance ceded, the validity of such a reserve credit must be questioned. This procedure is going to take considerable study with the possibility that some rules on reserve credits for reinsurance may need change.

There is no doubt that there is a need to expand the capital market beyond the United States. Some form of international agreement is needed to allow this but not destroy the validity of the Standard Valuation Law. However, the Standard Valuation Law may have to be modified to accommodate this agreement by removing some possible redundancies. Then again the inevitable effect of the Valuation Law on life insurance company taxation adds another dimension to the problem. Obviously, consideration of reinsurance, world capital markets and taxation are all going to have to play important roles in the drafting of a new valuation law.

Now let's look at regulatory actions. I think in Bob's write-up he already mentioned that the NAIC adopted a model regulation at its December 1985 meeting regarding surplus relief contracts stating specifically the conditions under which reserve credit or asset establishment would be allowed. That's in the *NAIC Proceeding* 1986 Vol. I, p. 243. This is an important reference.

The NAIC Life and Health Actuarial Task Force has appointed a Reinsurance Advisory Committee (RAC) to study and recommend a practical regulatory approach to the problems in five areas:

1. Mirror imaging.
2. Unauthorized reinsurers.

3. Letters of credit.

4. Nonproportional and/or stop loss reinsurance.

5. Surplus relief insurance.

The RAC is in a way a successor to the Zeilman Committee of a few years ago. The charge will be further refined in the meeting in Phoenix. That's on Saturday, December 5 for anybody that wants to attend.

The California Department of Insurance has scheduled reinsurance hearings for Life, Accident and Health Insurers on Tuesday, November 24, 1987 at 9:30 a.m. at the State Office Building in San Francisco and on Friday, December 4 at the Los Angeles State Office Building. Notices have been sent to all companies and persons on the mailing list of the Department. Testimony is going to be called from representatives of insurance and reinsurance companies, reinsurance intermediaries, agents and brokers, representatives from state and federal government agencies, business and trade associations and other interested parties in nine areas of interest:

1. The need for new state laws and regulations to provide the insurance commissioner with additional jurisdiction over reinsurance contracts and arrangements.

2. Credit for reinsurance from unauthorized reinsurers.

3. Adequacy of existing reinsurance accounting and disclosure requirements.

4. Criteria for reinsurance contracts.

5. Adoption of mandatory provisions in reinsurance contracts to require prior and periodic inspection of the underwriting and accounting records of a ceding insurer by a reinsurer or independent certified public accountant.

6. Requirement that a lead reinsurer be designated in any multiple reinsurer contract and that participating reinsurers agree to be bound by lead reinsurer's actions and decisions.

7. Need to license and regulate persons engaged in reinsurance transactions including reinsurance intermediaries, managing general agents, syndicates, pools and associations.

8. Withholding of reinsurance trust funds, possible adoption of the NAIC Model Act on Credit for Reinsurance, and uniformity between states in recognizing various methods.

9. Need for regulations to prohibit or limit fronting arrangements.

On October 1, 1987 the California Department of Insurance issued Bulletin 87-10 and on October 5, 1987 an additional Bulletin 87-10A which both title "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 Insurance Code Sections 922.4 and 922.5." The supplemental bulletin merely extended the compliance date for the first bulletin.

The bulletins cover six pages of rather complicated legalese and spells out specific requirements for credit in accounting and financial statements on account of reinsurance ceded to a non admitted reinsurer other than an alien reinsurer under Section 922.4, and similar requirements for non admitted alien reinsurers under that section. This is very similar to what New York had in 1983. They also have attached to that bulletin, illustrations of acceptable letter credit forms.

MR. PETER S. KRUETER: I hope the fact that my being from the department doesn't mean that we're still having a one way dialogue. However, I would like to expand very briefly on Mr. Gorski's analysis of certain treaty provisions. I wonder, Larry, can we talk about the experience rating refund provision. In the N.Y. department we certainly agree with Larry's view that reinsurance would be expected to involve risk sharing, and that if a loss occurs on the reinsured business the reinsurer would bear that loss. Of course, this view might have to be appropriately modified for non-proportional reinsurance or for example modified coinsurance where the loss was solely from investment income not being adequate to support the interest needed for the contract. Nevertheless, any treaty provision that explicitly reimburses the reinsurer for the loss for what is otherwise sustained, in the event there is a loss on the reinsured business would be viewed with the greatest suspicion. The provision that Mr. Gorski questioned was resolved as being, I think, an ambiguity in treaty language. I interpret that provision to mean that the reinsurer is to be repaid out of future profits under the business when and if they emerged; and the New York Department would have no problem with that type of arrangement. However, if you backed up about two sentences you'll notice that the direct company is required to reimburse the reinsurer for losses up to 5% of that year's premiums, together with any previous experience rating refunds that have already being recognized.

At the Department, you would have a great problem with that type of provision because that provision says that the reinsurer does not have to bear the loss unless it exceeds 5% of that year's premiums, plus the previous experience rating refunds. I feel very confident that that type of provision would not pass if it was submitted under a Regulation 102 filing.

MR. YOUNG: I would suspect, Mr. Gorski, that that particular treaty predated Regulation 102. I haven't seen that kind of language since 102 was passed.

MR. GORSKI: This treaty was filed probably five or six years ago. And, the point of this was just to show that in order to understand the reinsurance, really you have to go paragraph by paragraph. When in one point you seem to be sharing a risk, you are transferring risk which can be taken right back again in another paragraph.

MR. CLAUDE Y. PAQUIN: I was interested in Larry Gorski's comments, illustrations and suggestion early on, that sometimes an insurance department might welcome being notified informally about some of the goings on, and this is what drew my interest the most because in essence there was a suggestion of whistle blowing in that.

In the United States we're reasonably familiar that the fact that the federal government has sought to protect whistle blowers. The thing that I look back to is the Equity Funding scandal and how in those days one individual sought to get the attention of the regulators and had gotten absolutely nowhere. Eventually he got the attention of the *Wall Street Journal*, and for his efforts, ended up being prosecuted by the Securities and Exchange Commission.

It seems to me that there is a tradition in the United States, and I suppose in Canada as well, that whistle blowing just isn't nice. If the regulators want to be informed about some of the things that go on, that people who work for companies are aware of and don't say a word about, they should encourage the information to come up. Quite possibly they could adopt some sort of regulation that requires certain things to be reported to them. As of now, there is no legal department for anybody to report anything, so why should anybody volunteer anything to any insurance department?

Actuaries do see things once in a while. If there is no requirement to report it, you have to face the fact that in a future assignment if the actuary is known as being the type of person that might report things to insurance departments, companies might be exposed to defamation suits for liable or slander with respect to some of the people or some of the companies involved. They might be submitted to no end of legal problems.

One thing that I've observed is that when actuaries resign their positions, it seems that insurance regulators never ask any question and never make any inquiries. At least I'm not aware of any resigning actuary who's ever been asked by regulators, "Why did you really resign?" Also, there's never been, to my knowledge, any disbarment or action ordered against actuaries, or any other person involved in, the insurance industry in the United States who has been disciplined in any way by insurance departments. If actuaries, as professionals, who are trying to help in a way the regulators could be integrated into the regulatory process the same way accountants are often integrated into the regulatory process, I think, better use could be made of actuaries, and better use was made of the professional mechanisms that exists.

If insurance departments induced people to report things that should be reported by providing for a regulation safeguarding confidentiality of what is reported to the insurance department, perhaps they could be helped more by using the profession than just by trying to resolve the problems all by themselves.

MR. MONTGOMERY: I happened to work on Equity Funding, and there is a lot more to that story than has ever been publicly revealed. I really can't tell you anything more except that we had advance warning quite a bit before it happened, and a number of employees secretly, and under threat of severe harm, came to the department.

MR. GORSKI: I've been involved with NAIC work for quite a while, and one of the major topics under discussion for the last several years has been the valuation actuary. Part of the valuation actuary concept is increased responsibility for the actuaries actions. I liked the idea but I was always somewhat skeptical as to whether an actuary would actually indicate that reserves were inadequate or reserves had to be strengthened or what have you. This past year we had an incident in Illinois which makes me have a stronger feeling and support of the valuation actuary concept. We had an HMO that after filling its annual statement sent us a letter asking us to have the statement recalled because the accountant who had filled it out had supposedly intentionally misrepresented the financial position of the company. The actuary had signed an opinion that claim reserves were adequate, but the accountant had supplied him with false information. Afterward, the actuary went back into the company to find the true financial picture of the company, and the actuary, while under no obligation to us, was very honest and forthcoming in his opinions to us prior to any formal presentation to the plan's management. So I believe there can be a dialogue between professional valuation actuaries and regulators to help solve some of these problems.

MR. JOHN E. TILLER, JR.: On the valuation actuary issue in certifying the statement, you have six points that you are required to comment on, and you don't have to comment positively on all of them. One of my colleagues once sent in a statement noting that the assets and the liabilities, where properly calculated and footnoted on the statement, showed the liabilities exceeding the assets again this year. As far as I know the company is still in business, but I don't know how.

Mr. Montgomery, you had some very legitimate concerns about letters of credit that you've raised -- namely, the issue of not allowing letters of credit that were in some way guaranteed by or involving an affiliate, if I understood you correctly. Is that a general guideline, or if the bank is willing to make the guarantee on a letter of credit and assume there is an appropriate use of credit, what is wrong with allowing the affiliate to be the guarantor as long as the bank will pay up some day?

MR. MONTGOMERY: We don't view that as being really a guarantor independently related to the ceding company.

MR. TILLER: But doesn't this tieback to whether the bank is ultimately responsible? I'm trying to separate here the issue of affiliation and the banks' responsibility from the issue of whether the letter of credit is appropriate for liability 20 years from now.

MR. MONTGOMERY: I'm not quite sure as to what you're getting at.

MR. TILLER: I just would like to make a point, I guess, being an affiliate is not necessarily bad.

MR. MONTGOMERY: As far as we are concerned if the guarantor is an affiliate of the ceding company we're not going to recognize them.

MR. TILLER: Ok, that is a hard and fast rule and there is no room.

MR. MONTGOMERY: As far as California is concerned.

MR. TILLER: Fine.

MR. YOUNG: I just like to say that James Schibley is chairing the CX5 Reinsurance Advisory Committee that's been formed.

MR. JAMES V. SCHIBLEY*: Maybe I can just make a comment or two. I spent a lot of time thinking about the issue of reinsurance this morning, so I hate to waste all that preparation. From a general industry point of view I think we would be the first to agree, and I think other professional reinsurers would agree, that we all have a lot of work to do; we being the reinsurance industry, the ceding companies and the regulators. We are dealing with an area that was virtually unregulated few years ago. When I first started doing reinsurance law, I was told by the general counsel, "Jim, you're going to love it. There aren't any laws. There aren't any regulations. You can make it up as you go along; it's the easiest job you'll ever see." Some day I will get even with him

* Mr. Schibley, not a member of the Society, is Associate General Counsel with the Lincoln National Corporation in Fort Wayne, Indiana.

for having told me that, but, from our point of view, in the industry, let me talk very briefly about what I think the right way to regulate reinsurance is, and then give various examples of the wrong way.

I think there should be an emphasis, number one on the collectability of reinsurance. That means the solvency of the reinsurer. That's addressed currently in the NAIC model law in which it is required that the reinsurer either be licensed in the state of domicile of the ceding company, (and there are some other exceptions I won't get into) or if its not licensed in the state of domicile of the ceding company, it must provide an acceptable asset. The typical assets that are used, and the ones that are provided for in the NAIC model law, are funds withheld by the ceding company, funds held in trust (and these would be funds of the reinsurer put in trust for the sole benefit of the ceding company) and letters of credit.

For some reason the letters of credit are the most controversial though from the legal point of view, I am not sure that should be the case. However, the collectability of reinsurance is a critical 'issue, and we should all be concerned about how that's going to be addressed.

The second issue that I think it's perfectly legitimate is whether the reinsurance transaction is a real reinsurance transaction, or an illusory transaction. That is what efforts like New York's Regulation 102 have been directed to. Once again, the NAIC has acted and has enacted, as has been referred to here, a model regulation with respect to surplus relief reinsurance although that is not what it is called. The crux of the matter is to try to determine if there are contractual provisions in a reinsurance agreement that negate the transfer of risk to the reinsurer that make this paper transaction, in fact, not result in indemnification of benefits by the reinsurer to the ceding company. There certainly are those kinds of contracts out there and they should not be allowed. If they're being done, there should be no reserve credit permitted for them if they aren't a true, real reinsurance contract. More work certainly needs to be done in this area.

A third way which I think reinsurance should be regulated is with respect to a full and accurate accounting disclosure on the reinsurance transaction. If these guys can't rely on the numbers they see in the blue book, then they are in real trouble, and if reinsurance can be used to make the numbers in the blue book appear to be other then they are in the real world there is problem. So, there has to be full disclosure and the annual statement currently doesn't have enough information with respect to reinsurance in it.

Let me just briefly mention that I think a few ways reinsurance should not be regulated, though from time to time some of these areas are proposed. Number one there should be no prohibition on particular kinds of reinsurance. The two parties negotiating a reinsurance contract are big boys. They're sophisticated. They should be able to use what is a very creative tool, reinsurance, for whatever purposes are permitted as long that it involves a real reinsurance contract and they are properly accounting for it.

I've heard from time to time some regulators say, for example, that modified coinsurance should simply be prohibited. I think that's as much as anything because there are some regulators who don't understand how modified coinsurance works. It's no solution to any problem to simply prohibit certain kinds of reinsurance. I also don't think it's any solution to prohibit certain types of securities for reinsurance transaction. We should not simply outlaw letters of credit; I think letters of credit are very legitimate security device. These certainly have to be done properly and there are limitations on the ability to use them, and a lot of work is being done to determine what those limitations should be.

I don't think it would be useful to mandate reinsurance agreements to say that they are standard forms that have to be used for reinsurance transactions. The biggest problem with that is that it eliminates a great deal of the usefulness, the creativity, and the flexibility of entering into reinsurance transactions. I don't think any of us want to see the day when there are three standard reinsurance agreements, a standard coinsurance -- namely, a standard modified coinsurance, and a standard YRT -- and all we can do is pull one of those off the shelf.

There is a great deal that has been accomplished by reinsurance actuaries in devising new ways of doing reinsurance for new direct products; they're absolutely essential and we do not want to cut that off and so we don't want to mandate particular kinds of reinsurance agreements. Also, no solution will be found in prior approval of all the reinsurance agreements. That has been tried, for example, by the state of Florida and it failed. There aren't enough actuaries in the world to read all the reinsurance treaties entered into, understand them and analyze them. It simply is not going to be done in that fashion.

Finally, from an industry point of view, a plea to the regulators that one thing we do not need in our reinsurance regulation is uncertainty.

We have to know if the reinsurance agreement is acceptable or not. There are many situations, for example, with respect New York's Regulation 102, where the New York Department has done an admirable job of devoting time and resources to sitting down with us (the industry) looking at a specific reinsurance transaction and telling us how it should be accounted for and what the ultimate result of that transaction is going to be. However, there are too many other instances where the wording is ambiguous and where the regulators aren't sure what they are trying to accomplish. They simply know there is something out there and it should be prohibited, and we have to wait for years after the financial statements have been filed, and it's too late to do anything about the transaction, and there's is an examination of the company and, at that time, the company may discover whether it's solvent, and that's far too late. These regulations have got to be clear. We've all got to understand them so that we can all work with them. That is sort of a theme that I would propose to the regulators concerning the direction we should be going and the direction that we should not be going.

MR. YOUNG: Historically speaking, we're engaging in very new ground and I think you might agree that in many of the comments today, there is obviously a great deal of agreement on both side about the facts. We can agree on much of what each of the regulators has talked about. We might find different ways of accomplishing certain things. We may not agree on everything that needs to be done, but I think both sides are willing to talk and certainly that's a big step forward.

MR. KENT M. SIMMONS: We had a situation where a company was moved from one state to another when it was purchased, and all communication stopped. We had an existing reinsurance treaty. Our regular officers tried through regular channels and could get absolutely no information. Fortunately, I was able to call two or three people with an insurance department. They did confirm that the company was in trouble and certain things were going on, and for one thing we immediately changed our position of determining all that reinsurance, to sort of keeping it in force until the state and the company that was taking over all this business could work the problems out. I mean you normally don't go two and half years without accepting premium. So, I would like to point out that there could be some improved communication that way as well, and here's a real concern of policyholders who may be paying premiums and not know who has the coverage.

MR. PAQUIN: I think I'm in a position where I could endorse virtually everything that Mr. Schibley stated. There is one point that I would particularly wish to emphasize with respect to letters of credit. Letters of credit are an ideal tool whenever you have an international reinsurance transaction and that the foreign reinsurer is not compelled to purchase securities which are dollar denominated at the time for safe keeping in the U.S. It avoids currency exchange transaction and some of the currency risk for the foreign reinsurer. I bring this up because the U.S. Department of Commerce and the International Section of the ACLI are concerned about some of the international aspects of what we do in the United States. We have a huge trade deficit and it's a deficit with respect to goods, and what the U.S. Department of Commerce would like the U.S. to do is to start exporting services abroad to make up for the deficit that we may have in importing goods.

I realize that when we export reinsurance abroad that we're exporting services while we are importing services in a way, but there are some retaliatory provisions that come into play when we try to persuade the Europeans, for instance, to be more liberal in accepting insurers from the United States who wish to do business in their country. It's important to keep the gates open and to have a kind of open mind and not be so self-centered as to eliminate all normal and easy means of international commerce. So, I would like to add my own plea, if you will, for letters of credit in that they are a great vehicle whenever an international reinsurance transaction takes place. I realized that foreign reinsurers can cause some problems for the regulators, but there are foreign insurers or reinsurers of demonstrated capacity and great solvency with which the regulator need have no fear, but I don't think we should impose upon them the burden of having to run currency risks in addition to reinsurance risk because then we box ourselves in, and we box ourselves out because they keep us out if we keep them out.

The other comment I would make would be on standard forms. Here we might have a little bit more of a difference of opinion or more things to talk about between Mr. Schibley and me in that I would favor the use of standard forms or standard clauses in reinsurance contracts. However, I think it would be desirable to keep them as safe harbors rather as mandatory provisions. In other words, if the company used a certain clause that would be almost recommended by the insurance department, it would never run into problems with respect to that preapproved clause with the insurance department. However, the creativity of the insurer and reinsurers should not be stifled by imposing clauses that could cause them problems.

MR. GORSKI: Everyone agrees that in order to have a valid reinsurance treaty either a transfer or sharing of risk is needed. That seems to be a common ground. Mr. Schibley seems to indicate that there is a desire not to require any kind of standard forms. Also, that it be very difficult, if not impossible to have prior approval of all reinsurance treaties. So, as long as there is creativity out there in the reinsurance world, a new treaty is being developed, and we only have, let's say, objective standard to gauge these, I guess, in terms of transfer or sharing of risk. We're really in a dilemma because new language or some creative language may be introduced into a treaty, which might seem to circumvent our objective standards, the NAIC regulation, or the New York regulation, and we don't have prior approval of that reinsurance treaty. That causes substantial uncertainty because that treaty is not going to be looked at possibly for two or three years. So, we've got a really difficult situation that we're all trying to solve; and I hope something comes out of this meeting and future meetings.

MR. THOMAS G. KABELE: As I understand it, California no longer allows modified coinsurance where the reinsurer withholds funds. However, that treaty is algebraically equivalent to coinsurance funds held by the ceding company. Does California allow treaties where the funds held liability exceeds the reserve, which would do the same thing as setting up an asset?

Well, let's consider a treaty where there is a $100 million of reserves and a $10 million allowance. There are three ways you can do it; there are all algebraically equivalent. One way would be to do a modified coinsurance where the reinsurer sets up a $10 million. Another way would be do a co-modified coinsurance where $10 million of reserve is coinsured, the balance is modified coinsurance and there is a $10 million allowance. Another way would be coinsurance with funds withheld where there's $100 million reserve credit and $90 million funds withheld.

MR. MONTGOMERY: There are certain provisions in there that really change the effect of the contact, then we're going to have problems.