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FINANCIAL REPORTING ISSUES RELATING TO REINSURANCE

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MR. THOMAS E. SKILLMAN: The three regulatory issues I would like to discuss are surplus relief regulation, security for unauthorized reinsurance, and mirror reserving. These are all accounting issues in that they impact the extent to which you may take reserve credit for reinsurance ceded, not whether you may enter a given reinsurance transaction. There are situations under which a ceding company might wish to enter a reinsurance transaction even if it does not receive a reserve credit.

The first surplus relief regulation was adopted by New York in 1985. The regulation essentially says you may not take a reserve credit except to the extent the relief will be repaid out of expected future profits. The New York Department has interpreted this regulation as requiring transfer of all material risks, including investment risk on annuities, if reserve credit is to be taken.

Texas and Washington have adopted surplus relief regulations similar to that of New York. An increasing number of other states, notably California, enforce the regulation even though they have not formally adopted it. Since it may be argued that the surplus relief regulations do not change the accounting requirements, but rather serve merely to put companies on notice that not all reinsurance agreements properly result in a reserve credit, I see no harm in enforcing the regulation without adoption. It should be noted that most states interpret surplus relief regulations more liberally than New York.

Delaware has recently issued a potentially punitive surplus relief proclamation. Most surplus relief regulations provide a grandfather clause for existing

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nonconforming agreements provided no new relief is obtained, that the existing relief is phased out over three years, and that the Department is promptly notified of the existence of the agreement and the amount of outstanding relief. If you don't notify the Department and the agreement is later determined not to meet the applicable requirements, the relief is immediately disallowed. Delaware has gone a step further and provides if reserve credit is taken for an offending agreement, except pursuant to the grandfather provision, both the ceding company and the reinsurer may be subject to loss of their Delaware license, or their charter in the case of a Delaware domiciled company.

I would now like to turn your attention to security for unauthorized reinsurance. Statutory accounting requires setting up a liability to offset any reserve credit taken for reinsurance in unauthorized companies, unless secured by acceptable security. The three generally accepted forms of security are funds held by the ceding company, funds held in trust by the reinsurer for the benefit of the ceding company, and letters of credit (LOC). Letters of credit are currently the object of regulatory scrutiny, and there has been some talk of banning their use as security for unauthorized reinsurance. I am not too close to these discussions, but my feeling is that LOCs will continue to be allowed (with some restrictions) until a bank fails to honor one.

There is also a movement afoot to prohibit recognition of LOCs guaranteed by an affiliate of the ceding company. This has a much higher probability of adoption. At least two states, New York and California, have adopted specific language requirements for acceptable LOCs. Unfortunately, a valid LOC in New York is not acceptable to California, and vice versa. Fortunately, I understand California will recognize a New York-style LOC for companies not domiciled in California.

The final regulatory background issue I would like to discuss is "mirror reserving." In spite of specific recognition in the instructions to the blue book that the reserve credit of the ceding company need not match the reserve held by the reinsurer, some regulators believe a reserve credit should not exceed the reserve set up by the reinsurer.

A few examples of why the reserve credit claimed by the ceding company may legitimately be greater than the reserve set up by the assuming company are as follow:

1. Reporting lags, such as cases where the ceding company has not reported the necessary information to the reinsurer prior to its accounting cut-off date.
2. Differences in valuation assumptions, such as cases where the ceding company holds reserves under more conservative assumptions than the reinsurer.
3. Differences in valuation methods, such as cases where the ceding company holds net level reserves while the reinsurer holds Commissioner's Reserve Valuation Method (CRVM) reserves.

Perhaps the biggest flaw in the mirror reserving theory is a shortfall in its underlying intent. The concept is presumably to ensure that the reinsurer is solvent under the valuation assumptions applicable to the ceding company. But, mirror reserving does not address the reserves held by the reinsurer on its

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other business. A Canadian company, for example, may hold reserves on its Canadian business which are substantially less than those which would be required under U.S. statutory valuation law.

New York has considered requiring what is known as "world-wide mirror image reserving" under which the reserve credit permitted to the ceding company is limited to the sum of reserves actually held by the reinsurer, its retrocessionaires, their retrocessionaires and so on. That the New York Department has not adopted this regulation is a tribute, I believe, to their integrity. They (rightly or wrongly) perceive a problem, but have attentively listened to the shortcomings of the originally proposed approach to dealing with their concerns.

I would now like to briefly touch upon a few issues from the viewpoint of a valuation actuary. These issues are being addressed currently by an Academy committee, and Diane will discuss these in more detail.

Reserves are traditionally calculated on a gross basis with the reserve offset computed separately. While I cannot point to any authority, I view this as a practical expedient to a more theoretically correct valuation of net retained liabilities. The two approaches will generally, but not always, produce similar results. (I have not looked at specific examples, so this is just a gut feeling.) Even if a Department permits recognition of a given reserve credit, I wish to remind all valuation actuaries that the actuarial opinion contains an overriding "good and sufficient" certification for the net reserve held. Even if a piece of paper says the ceding company will reduce its reserve by X and the reinsurer will set up a reserve of X, unless there is indemnification by the reinsurer consistent under statutory accounting theory with the liabilities allegedly transferred, I do not believe it is proper to claim the reserve credit.

Also in the valuation actuary area, I might note that while U.S. actuaries have relatively little guidance currently as to the treatment of reinsurance, our Canadian brethren have a Technique Paper discussing the accounting treatment of reinsurance. I might add that I find the CIA approach superior to that recently proposed for U.S. GAAP accounting.

I would now like to address a few specific accounting issues which are unclear in the annual statement instructions. I received a number of calls last January from clients asking something like, "I would like to account for the agreement like this -- is anyone else doing it that way?" My response was, "yes -- I don't know who, but someone is doing it that way, and if no one is, they would if only they'd known you would too." There are some areas where there are no right answers. In these gray areas, you must simply give it your best shot. When in doubt, I recommend using a well-labeled write-in item. I believe that, contrary to popular opinion, disclosure will serve you best in the long run.

One accounting issue goes back to the drafting of the reinsurance agreement. This is net versus gross accounting. Under the more common gross accounting, the ceding company pays a gross premium to the reinsurer and the reinsurer pays an expense allowance to the ceding company. An economically equivalent alternative, but one which produces differences in line item accounting, is for the ceding company to simply pay a net premium to the reinsurer equal to the gross premium less the expense allowance. Since this is what usually happens in practice anyway, this might be regarded as more honest accounting, but at least one regulator has objected to net accounting because surplus relief would not show up on the Insurance Regulatory Information System (IRIS) test for surplus

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relief. (The problem is in the IRIS test, not the accounting.) For technical reasons related to deficiency reserves, net accounting is typically used only in the first calendar year of an agreement. I might also note the reinsurer may prefer net accounting due to a subtle tax issue, which I won't elaborate on.

Large coinsurance deals are frequently done on a funds withheld basis to avoid transfer of large amounts of assets. Modified coinsurance may accomplish the same effect, but other considerations may in some cases dictate coinsurance with funds withheld as a better alternative. The ceding company would report the funds withheld in the appropriate asset category, offset by a write-in item for the liability (or as an amount withheld from unauthorized reinsurers, if appropriate). The ceding company would also include a write-in expense for interest on funds withheld. An alternative, I suppose, would be to treat the funds withheld as borrowed money, but this is atypical.

The reinsurer would usually show the funds withheld as a write-in asset and report the investment income thereon as a write-in component of gross investment income, which would flow into net investment income.

There is a preprinted line for the ceding company to report any modified coinsurance reserve adjustment, but not for the reinsurer. The reinsurer might reduce premium income by reserve adjustments paid or report a write-in expense item.

The experience refund under an experience rated reinsurance agreement is frequently treated as a premium adjustment by both the ceding company and the reinsurer. It might also be treated as a write-in income item by the ceding company or write-in expense item by the reinsurer.

The ceding company, the reinsurer, or both are sometimes required to fund a trust to support their obligations under a reinsurance agreement. Some states require that assets placed in trust be noted in the annual statement in Schedule D and/or on page 2. It would seem the asset should also be reported on the Special Deposit Schedule, although this is not always done.

Schedule S contains some interrogatories which must be completed in certain situations. To the best of my knowledge, no company in all history has ever completed those interrogatories in their blue book filing, so I can't be much help in giving you guidance to fill it out. Still, I hope you look at it occasionally to see if it applies.

MR. PAUL A. SCHUSTER: I plan to discuss financial reporting as it relates to traditional reinsurance reported on a self-administered basis. I will not be commenting upon individual cession business, because I believe that all reinsurers have a master file and the ability to generate GAAP and statutory reserve listings on a mainframe computer.

The area on which I will be focusing is self-administered ordinary reinsurance. I would like to add, because I believe it is a very important point, that there isn't one correct approach. I simply intend to discuss how one company attacked this problem and some of the things which we felt were important in our analysis. I think everyone would agree, most new reinsurance is reported on a self-administered basis. Electronic transfer of data for most ceding companies is years away at best. So this topic is a timely issue and one that will be with us for a while.

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I prepared those introductory comments a few weeks ago. Yesterday, I attended a workshop on self-administered reinsurance and heard a number of comments about electronic data transfer. One reinsurer indicated that nearly 50% of their business is reported that way. All I could think of was that things have changed so fast in reinsurance reporting that all of my comments are now outdated.

I think, though, that this is not the norm for most reinsurers. I also feel that obtaining an inforce listing on a magnetic tape is significantly different than true electronic data transfer in its fullest sense. I hope that all reinsurers are still struggling with self-administered reinsurance and more appropriately struggling with generating meaningful financial statements from client-provided data. I say "hope" because otherwise this presentation will find no interested parties.

Establishing appropriate reserves is more than satisfying your public accountants. It really is an issue of managing your business to a stated goal. What may be satisfactory for the public accountants, may not be enough to really be on top of your business. I will be describing how one company's approach to valuing and managing self-administered treaties became much more than a system just to establish reserves.

Until very recently, I spent three full years working for a professional risk reinsurer in the financial reporting area. The challenge which we faced was to establish statutory, tax, and GAAP reserves on over 400 self-administered treaties. These treaties ranged in size from thousands of lives and billions of inforce to treaties which may have one or two lives and \$50,000 of inforce. We had to value this business with a group of four individuals over a two-week period every quarter. For each treaty, someone spent the time during this process to review each report submitted by our client and perform some estimates and calculations to arrive at the quarterly reserve.

What developed over the years was a very elegant series of computer programs which were utilized to perform the valuation on a significant amount of both new and inforce business.

There were a number of items which defined the problem, and also pointed us in the direction we took for solving that problem. First, we had a senior management that demanded to know quarterly how we were doing by treaty. Emphasis here is on "by treaty." Secondly, the business was incredibly diverse. There was quota share and pure excess business. There was traditional YRT, coinsurance, and also coinsurance converted to YRT. Permanent plans were reinsured as well as term plans. The business itself was incredibly dynamic. New treaties were added regularly, existing treaties were amended to include new plans or revised terms, and some treaties were terminated.

Senior management was also asking questions about our ability to project this business for such things as strategic planning, cash flow projections, durational analysis, and others. We were also asked to perform recoverability analysis on all of our reinsurance. Without the ability to project, we would be unable to answer that particular question.

In addition, as diverse as the business was, the reporting by our clients was equally, if not more so, diverse. Some were very good at providing data, while others were incredibly poor.

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To briefly summarize, we felt we had to focus on the individual treaty. Trying to approximate the entire book of business just was not feasible. We were being asked not just to establish reserves but to, time and time again, revisit each treaty. We had to know both where we were and where we were going quarterly. And, we had to keep the data required to perform our work at a minimum, recognizing the current capabilities of our clients.

What developed was a very simple three-step approach. The first two steps were independent of one another, but they needed to be completed prior to step three.

Step one involved building a very detailed calendar year model of the business. We went to great lengths to develop age distribution, non-smoker or smoker distributions, plan distributions, and the like. Then, based upon the GAAP assumptions and the distributional data, one calendar year model was developed to represent a year's worth of issues under any particular treaty. From this model we were able to obtain GAAP reserves, statutory reserves, and tax reserves, as well as all cash flow elements.

Step two was the capturing of the summary data reported by the client. Here each report became an individual cohort of lives to be projected at the valuation date. The data which we captured from the clients' reports were very simple. If the client used our standard self-administered report, it contained all that we would need. We obtained first-year and renewal premium, first-year and renewal allowances, number of lives and inforce, for new business as well as existing.

Step three combined the results of one and two. Each reporting period, as I mentioned earlier, became a cohort of lives to be projected forward. The GAAP reserves and other financial reporting data were applied to an individual cohort of lives, and the computer programs projected each cohort from its original report date to the valuation date. This particular piece of the analysis was also very dynamic. It was dynamic in terms of inforce, which was adjusted to reflect the actual amount reported by the client, and it was dynamic based upon first-year allowance to first-year premium ratio. This was used to adjust the GAAP reserve in our projection.

There was some very simple elegance to this entire three-step system. At the quarter or year-end, all we needed were the summary worksheets provided by the client. In theory, you simply did not need any other detail. This accomplished a number of things and allowed primarily for a relatively small group of people to do the valuation work on these four hundred odd treaties.

The system did not develop overnight. A great deal of work and thought went into each change we made. It wasn't perfect but it worked. It required constant maintenance of the models, which was performed between the quarters. It also required constant attention to the clients' reports. This was performed by an accounting unit.

In talking about the benefits which we derived from these techniques, I am going to let some of my personal opinions and prejudices sneak into this presentation. Other than the rather obvious benefit associated with actually performing the valuation in a timely manner, we derived other benefits from our efforts.

The model itself, and more appropriately the development of the model, proved helpful. The emerging distributional data provided a solid check against our

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pricing assumptions. I know of one reinsurer who performs fairly extensive sampling on their business for valuation purposes. However, the information is never compared against pricing assumptions, and I believe that this is a major mistake.

We were able to capture in our data file the entire reporting history of the treaty. We had first-year and renewal premium, the case count and inforce for new and existing business from the inception of the treaty. These were the client's actual reported figures, all in one file.

These techniques provided much needed self-discipline. If your valuation people are sampling and modeling just a handful of treaties and then grossing them up to fit your total inforce, I would be concerned. I don't want to be misunderstood, we sampled large treaties to obtain our distributional data, but only grossed up by treaty. We did not go the one step further by grossing up the sample treaties to fit our entire inforce.

The self-discipline extended to other areas as well. I mentioned the check to pricing assumptions, which was very helpful. Everybody must be doing some grouping in their pricing. If a hypothetical quote on a set of cost of insurance rates is 100% first-year and 25% in renewals, I don't believe that each issue age for non-smokers, smokers, and perhaps even preferred non-smokers is self-supporting. You need the feedback to make sure everything is okay.

We were also able to obtain some early warning checks. Ratios of claims to premiums was one important measure. We have looked at expected and actual claim to premium ratios. Most new business was written on universal life cost of insurance rates, which was not select and ultimate in nature. These are clearly mismatched against the underlying select and ultimate mortality assumption. If you are not watching this closely, you can be bringing in income money that should be set aside to fund shortfalls as a block of business matures. The same problem can occur with the ten-year level term policies, which remain very popular.

Because our model projected all the cash flow items, we were able to perform crude mortality studies. Our expected was based upon our GAAP assumptions. Similarly, we were able to develop persistency studies, again with the expected equal to our GAAP assumptions.

The important thing through all of this was that we were working at the individual treaty level. Time and time again, clients ask to be treated individually, not grouped with all select and ultimate term accounts or universal life accounts. I think that this is a valid point. In addition, with margins where they are today, I believe you need to know regularly how you are doing; not just overall, but at the individual treaty level.

In closing this section of the panel discussion, I would like to relate three different stories, all focusing on the need for a strong, active valuation unit.

Some nine months ago, I spoke with a FSA who oversaw his company's entire reinsurance operations. In an informal discussion, he was wringing his hands and lamenting over the fact that they were having a great deal of difficulty getting their arms around their self-administered business. He said that one of his nightmares is to walk into his office on a Monday morning after the end of a quarter and find out that reserves had been underestimated by a significant

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amount. We ended up talking about the financial reporting aspects of self-administered treaties for a while. It was clear to me that they had yet to come to grips with this issue.

My second story relates to a comment made in Montreal during a workshop at the annual meeting. A reinsurance pricing actuary mentioned that his company's stated profit objective was a 15% return after tax. He then said that if in pricing he had to reduce his margin to 5% to write the business, he would quote it. Obtaining 15% was someone else's problem.

The last story relates to a conversation at a joint meeting of the Southwest and Southeast Actuaries Club. A reinsurance marketing representative was lamenting that his company's actuaries rotated through the reinsurance pricing area. He said that just when he had gotten these people to a point where he could con them, they left and he had to start again on someone new. He was very serious in his comments.

My overall point is you simply can't throw up your hands and say that it can't be done when it comes time to value self-administered treaties. In an era of unprecedented marketing influence on margins and pricing assumptions, I believe that senior management must spend the time, money, and effort to develop a very strong valuation area. Ceded reinsurance today is a profit center. It will take a great deal of time to focus at the individual treaty level, but that is what must be done. My old company learned a very valuable lesson. A great deal of new business coupled with a very aggressive deferral approach can hide a lot of sins, but only for a limited time. The issue is much more than just generating the GAAP and statutory reserves for the quarter.

Using sampling techniques for grossing up treaties may be fine for public accountants based upon a materiality issue, but in terms of managing your business, you need to do more than just make approximations. You have to know what is going on.

MR. JOHN M. COLE: For GAAP reporting, the rules for a U.S. company doing business in non-dollar currencies come under Statement of Financial Accounting Standards No. 52, which deals with foreign currency translation. International reinsurance comes under the heading of multi-currency business, so it might be helpful to outline FAS 52, even if a few of the finer points are ignored.

Consolidated statements of a reporting enterprise must reflect financial results in the functional currency of each affiliated entity. The functional currency is defined as the primary currency in which each entity conducts its business.

If an entity's functional currency is different from the reporting currency, translation adjustments will result from translating the entity's financial statements into the reporting currency. Translation adjustments are not reflected in net income but are reported separately and accumulated as a component of equity.

Foreign currency transactions are transactions denominated in a currency other than the entity's functional currency. Unlike translation adjustments, foreign currency transactions generally are reflected in net income. If the exchange rate between the foreign currency and the functional currency happens to change, thus increasing or decreasing the expected amount of functional

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currency cash flow, there is a foreign currency transaction gain or loss for the period.

At the date the transaction is recognized, each asset, liability, revenue, expense, or gain or loss arising from the transaction is measured and recorded in the functional currency at the current exchange rate. At each balance sheet date, recorded balances denominated in a foreign currency are adjusted to reflect the current exchange rate.

Likewise, the settlement of a foreign currency transaction results in a transaction gain or loss (measured from the transaction date or the most recent intervening balance sheet date, whichever is later) and is reflected in net income for the period.

The exchange rate to be used for translating foreign currency transactions is the rate at which a particular transaction could be settled. At a subsequent balance sheet date, it is the rate at which the related receivable or payable could be settled. For translating foreign currency statements, the rate applying to conversion for dividend remittances is used.

Any intercompany profits resulting from sales or transfers between affiliated entities are based on the exchange rates at the dates of the sales or transfers. The effect of subsequent changes in exchange rates on the transferred asset or the related expense is viewed as being due to changes in exchange rates rather than being attributable to intercompany profit.

The aggregate transaction gain or loss included in determining net income for the period must be disclosed. An analysis of the changes during the period in the separate component of equity for cumulative translation adjustments must also be provided.

In addition to FAS 52, we now have Exposure Draft No. 54 dealing with disclosures about financial instruments. To the extent that international reinsurance includes an element of financing, disclosure would be required as with financial instruments denominated in foreign currencies.

According to the Exposure Draft, an entity must disclose information about future contractual cash receipts and payments denominated in currencies other than the reporting currency if they are significant.

Disclosures about expected cash receipts and payments are encouraged where the expected and contractual amounts could differ. The exposure draft gives us an instrument whose future cash flows are contingent upon the occurrence of specified events that have not taken place.

The termination and recapture clauses of a reinsurance agreement would have to be examined to see if either party has the option to prepay financial assets or liabilities before their contractual maturity. If so, that fact must be disclosed.

Also, an entity must disclose information about the interest rates of financial instruments denominated in currencies other than the reporting currency if they significantly affect the entity's overall average effective interest rates.

Let's move on to statutory accounting. There is no distinction in the NAIC blank between domestic and international reinsurance. It is only through foreign

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exchange adjustments that an international arrangement might give rise to unusual accounting entries. The difference between assets and liabilities held in foreign currency appears on Page 2, Line 17, or on Page 3, Line 20. Any change during the year is shown in Exhibit 4, Line 9, Column 5. Thus all foreign exchange is run through surplus.

A U.S. company ceding to an unaffiliated reinsurer overseas is not engaged in international reinsurance because the reinsurer provides security in dollars. Under statutory accounting, the arrangement is treated the same as reinsurance ceded to a nonadmitted U.S. reinsurer, which would also have to provide security.

For a U.S. company, reinsurance becomes truly international when that company or a foreign affiliate has to obtain the approval of a regulatory authority in a different country. Reinsurance regulation is designed to maintain a framework of responsible practices. Each country has a different notion of what constitutes being responsible, but regulations everywhere are coordinated with and carry out government policy.

Some countries might see reinsurance as a means of creating foreign exchange, while others might utilize it to control foreign exchange by delaying outward remittances. Countries exposed to unusual hazards, like catastrophe, pay enlightened attention to what a reinsurance arrangement actually covers.

Where a tax treaty is in effect, reinsurance opportunities are enhanced, yet the circumstances enabling a company to take advantage of a tax treaty do not always present themselves and even when they do they are usually surrounded by pitfalls. An example is business ceded to an affiliated reinsurer domiciled in a country where the rules for matching currencies are different from U.S. statutory accounting. Although the U.S. entity and the affiliated overseas entity might each be matched, the enterprise as a whole might be exposed to a currency mismatch when common rates of exchange are applied to the balance sheets of the two affiliates.

MS. DIANA WALLACE: We've been talking about issues that affect both ceding companies and assuming companies, both statutory statements and GAAP statements. I know it's hard to keep it all straight, but I hope that at least some piece of the program is applicable to your own situation.

I'd like to finish up today with some information on current activities in the AICPA and in the American Academy of Actuaries.

The first item is a proposed statement of position by the AICPA on transfer of risk in reinsurance. The background of this statement of position begins with FAS 60, which is a general accounting guide for GAAP reporting on life insurance companies. FAS 60 categorizes reinsurance treaties into two types: those with risk transfer (the actual words in the FAS) and those that are financing. Financing transactions are generally those where the expected impact on lifetime profits is minimal with high certainty. This concept was developed to handle the property casualty type reinsurance transactions called loss-portfolio transfers.

The GAAP accounting theory generally provides that if a reinsurance agreement is expected to have little impact on the lifetime bottom line, and only the timing of income will be affected, the agreement should not be allowed to change your GAAP income statement. The accounting for financing transactions generally

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works by setting up offsetting liabilities to reinsurance premium income and offsetting assets for premium payments under the theory that these premiums will eventually be reversed through benefit payments in the opposite direction.

FAS 60 gave very little guidance on how to determine whether a particular reinsurance agreement was a risk transfer agreement or a financing agreement. So, the AICPA intends to publish a statement of position helping those preparing GAAP financial statements to determine whether a particular reinsurance agreement should be treated as a financing transaction or as a risk transfer transaction. A proposed statement of position has been recently released. The AICPA committee preparing the draft has requested comments by July 17 and I encourage all of you to take a look at it and respond.

The current draft has several highlights. First, it takes the position that risk is transferred for purposes of GAAP reporting only if underwriting risk is transferred to the reinsurer. It does not take into account any other risks of the transaction such as investment, expense, or lapse risk. Underwriting risk is the only risk that constitutes risk transfer for these purposes.

A second major position of the paper is that if the risk of economic loss to the reinsurer is remote, then there is no risk transfer for purposes of GAAP accounting.

A third major feature of the draft is a list of several provisions which, if contained in the reinsurance agreement, would be indication of lack of risk transfer. For example, a profit sharing technique built into the reinsurance agreement, such as experience rating or contingent commissions, would indicate no risk transfer for purposes of GAAP accounting. If there are cancellation provisions within the treaty that might result in a loss to the reinsured company, this would indicate no risk transfer. If the reinsurance agreement is non-cash in nature, if there are payables and receivables, this would indicate that it's a financing transaction rather than risk transfer. Recapture provisions would indicate financing as well.

The draft also contains a few other general statements. For example, if the consideration paid by the ceding company is judged to be excessive, this would be considered a financing transaction rather than a risk transfer transaction.

My personal opinion is that the draft, as it's currently written, is much more focused on property/casualty transactions and does not handle well the wide variety of life reinsurance agreements in use today. The AICPA has the admirable goal of trying to make it easy for preparers of financial statements to make objective determinations as to whether a treaty is a risk transfer treaty or a financing treaty. But, in trying to create a simple, objective categorization, the paper eliminates a lot of flexibility that preparers of financial statements need in assessing the risk transfer elements of reinsurance agreements.

The goal should really be to determine the lifetime expected impact of a particular reinsurance agreement under the scenario chosen for that particular GAAP statement. To the extent that lifetime income will be changed up or down, this impact should be spread over the years in the statement. This ought to be done whether the agreement has whole or partial risk transfer, and whether it's proportional or nonproportional risk transfer. And, the analysis should take into account all financial aspects of the reinsurance agreement. As we know,

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the true underwriting or mortality risk is a very minimal portion of the risk in our business today.

It will be interesting to see how the statement of position develops for one additional reason. It's unfortunate in my mind that we're using the word risk transfer to define a set of factors to influence our financial reporting in both GAAP and statutory statements. There are legitimate differences in the way any given reinsurance treaty should be treated for statutory versus GAAP reporting, because the premise of the statements' accounting is so different. If we use the label risk transfer to define one set of factors under statutory and one under GAAP accounting, it's easy to get confused in understanding what that label "risk transfer" really means.

I hope that all of us keep in mind that these words just describe a set of factors. The preconceived notions about what risk transfer means might not apply to a given set of factors. In particular, I think it is important to realize that there may be true economic risk transfer in an agreement, but for purposes of GAAP accounting, it is considered financing because it is expected to have very little lifetime impact on earnings.

Let's go on to the American Academy of Actuaries. As you all know, the Interim Actuarial Standards Board was formed a couple of years ago to promulgate standards of practice for the guidance of actuaries in their professional work. Several of those standards have already been promulgated. One of the items that has been on the list IASB for a long time is reinsurance accounting. The IASB recently asked the Life Financial Reporting Committee of the Academy to draft a proposed set of standards for actuaries making opinions or preparing reports on financial statements that contain material reinsurance transactions. Tom mentioned this earlier in his presentation.

Now, supposedly actuaries have considered reinsurance all along in making actuarial opinions, but these standards are intended to give an actuary a little bit more guidance in what it means to review the reinsurance in making opinions about financial statements. The standards will not be a cookbook. They will be very general reminders of what to look at in reviewing the reinsurance situation of your companies.

I expect a draft of these standards to be available for review by the actuarial profession later this year. It will be given lots of exposure and lots of time for comments. This will be a very important and sensitive issue so, again, I encourage all of you to be aware of this process and to give your input.

I'd like to give a brief review of how the standards are progressing at this point. First of all, the standards will cover all life insurance company financial reporting, including statutory and GAAP reporting. The standards will direct actuaries to consider all statement items in making opinions, not just actuarially determined liabilities. For example, the actuary would have to consider receivable assets from reinsurers in making an opinion about the sufficiency of net liabilities. The standards will suggest that a prudent actuary review all existing reinsurance as of the statement date before expressing an opinion. That would include, for example, reading material reinsurance treaties, understanding the treaty terms, and reviewing material accounting entries to make sure they are consistent with the reinsurance treaty. The actuary should review the financial security of the reinsurance agreement, either through assessing the financial condition of the reinsurers or making sure that appropriate security such as

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LOCs or trust accounts are in place. This, of course, is to make a judgment about the collectibility of the reinsurance for which credit is taken in the statement. A final aspect of the standard is most likely to be that, under certain circumstances, the actuary might choose to use cash flow testing to support the position that net liabilities make good and sufficient provision. Cash flow testing might be used for very large reinsurance transactions or transactions where the reinsurance does not parallel the underlying insurance contract.

The real guts of the standard will be an acknowledgement by the actuary that not only does the net statement liability meet all applicable laws, regulations, and rules with respect to that statement, but, in addition, that net statement liabilities make good and sufficient provision for all retained risks according to the actuary's best estimate of future experience.

These standards are intended to be the industry's assurance to regulators that an actuary has both considered reinsurance in making opinions and reports, and that the actuary believes reinsurance has been treated appropriately in the actuary's best professional judgment. I think this is a good direction for us to take as a profession. Perhaps these standards might be a model for other portions of the statement when opinions are made.

The process of developing these standards is currently in full swing. The documents should be available for review fairly soon. Those of us in the reinsurance business, both ceding companies and reinsurers, have a real obligation to create a document which helps us all in our reinsurance reporting as well as satisfies our regulators, analysts and customers.

We would now like to take questions from the audience on topics that have been covered today, as well as on any other reinsurance financial reporting topics.

MR. WILLIAM B. DANDY: I have got two questions for Mr. Skillman on the net versus gross accounting. Specifically on credit disability coverages, where the reserves carried are actually unearned premium reserves, is there different treatment when paying net reinsurance premiums versus the treatment if you pay a gross reinsurance premium and receive a ceding commission?

MR. SKILLMAN: For lines of business that are more casualty related, like the health lines, there may be some differences. It seems to me that in theory there shouldn't be, because they're economically equivalent, but because of peculiarities of PC accounting which health tends to follow, you may be right. It may be that if you pay a net premium, you may only get a credit for the unearned portion of the net rather the gross.

MR. DANDY: I also want to know how the disclosure of an LOC liability on the part of the reinsurer is handled in the annual statement or in the GAAP statement. Does the reinsurer have funds tied up behind the LOCs that are not available to our policyholders?

MR. SKILLMAN: Ceding companies are required to designate the type of security that is being used, whether that might be a trust, funds withheld, or a LOC. It wouldn't have to be disclosed in the Blue Book of the reinsurer.

MS. WALLACE: The essence of a LOC is that the ceding company may go to a bank and withdraw cash. The bank would use a variety of means to assure itself that the cash will be repaid should it be drawn. In some instances, they

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might require the reinsurer to deposit assets as security. In others, they might rely on the general credit of the particular creditor. It would vary from circumstance to circumstance.

MR. DENIS W. LORING: Should the valuation actuary examine the probability that the bank will honor its letter? You may actually have to get into the question of the bank's solvency, especially if its offshore and has a large number of letters outstanding. I've heard at least some talk of possibly discounting face values of letters to account for a small bank insolvency risk.

MS. WALLACE: The NAIC has recently revised its model regulation controlling the use of LOCs. The new model regulation specifically describes the quality of banks that will be allowed to issue acceptable LOCs for unauthorized reinsurance. Regulators were concerned that banks would be unable to honor letters, so now there are very strict quality guidelines. The banks must have certain Standard and Poor's or Moody's ratings to qualify.

MR. SKILLMAN: California and New York have both recently specified the form of an acceptable LOC. Unfortunately, the two aren't compatible. I'm told that California will recognize the New York style LOC for non-California domiciled companies. A California domiciled company with a 50-state charter, however, may have to get two LOCs.

MS. WALLACE: I have a question for Paul. Does the system that you've described to handle GAAP financial reporting have any applicability to your statutory reporting as well?

MR. SCHUSTER: The model we developed has expense and benefit reserves, statutory reserves and tax reserves all built in, so all of the elements pop right out at the time of valuation.