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RESERVE CREDITS FOR REINSURANCE

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o No prior knowledge of the subject is required of the registrant. To encourage a lively discussion, part of the presentation will involve panelists debating conflicting proposals as to how best to overhaul regulations governing reserve credits for reinsurance. Between the debate and other presentations, the panelists will address the following subjects and current issues:
  -- Reinsurance reserve credits -- variations by state
    o Current Model Law on Credit for Reinsurance
    o New York Regulation 102
    o Limitations on proportion reinsured
    o Other limitations
  -- Mirror reserving
    o Alternative definitions
    o Practical difficulties
    o Fifth amendment to New York Regulation 20
    o What it is and why it was promulgated?
    o Industry response
    o Outlook for the future
  -- Reserve credits involving unauthorized reinsurers
    o Letters of credit
    o Trust funds
    o Funds withheld
    o Licensed in another state with similar solvency standards
  -- Proposed revisions to the NAIC Model Law on Credit for Reinsurance
    o What is proposed?
    o Industry reaction
    o Current status

MR. DAVID B. ATKINSON: Let me give you a brief overview of what the different speakers are going to talk about. Mel will start out first and give you an overview of all the things that are going on. Tom will follow and go into more depth on mirror reserving, New York Regulation 20, and also some of his thoughts on some other new developments. Finally, Wayne Bidelman will conclude with a reinsurer's view of mirror reserving and New York Regulation 20.

Our mission is to use this occasion to our advantage to talk about all these current issues. It is not often we get a chance to get together like this and share opinions and thoughts. I strongly encourage your participation. We have a lot of controversial issues to talk about.

MR. MELVILLE J. YOUNG: As David said, my primary task is to give you a bit of an overview of what has happened in the last couple of years to reinsurance regulations. We are going to talk first about the New York's Regulation 102 and subsequent activity involving the model regulation which follows, give you a little history of that, and then we are going to talk a little bit about the mirror reserving and New York Regulation 20, and then finish up with a bit of potpourri of some other things that have been happening recently in reinsurance regulations.

In 1984, the New York Insurance Department issued the first draft of its proposed Regulation 102. It stopped short of declaring reinsurance a capital offense -- just short. During the public hearing that followed 100 or so industry representatives presented a series of persuasive arguments that convinced the New York Insurance Department that some redesign was called for.

A half dozen or so working sessions followed. These were attended by three industry representatives and the four most senior New York Insurance Department officials concerned with life reinsurance. The result of all this effort was a compromise regulation, of which no one was completely satisfied. Those present did feel that there was mutual understanding though. Unfortunately the interpretation of the language has changed considerably since the day it was written and, to the cynical, it might seem as if the regulation is reinterpreted on a daily basis.

New York Regulation 102 was followed by the passage at the NAIC of an almost identical model regulation. A handful of states (Texas, Washington, Oklahoma, Alabama, Delaware and California Draft Proposal) have formally adopted their version of the model. In each case, the state added its own stamp. For example, supposedly Delaware's Bulletin 88-1 will be interpreted to conform with the model regulation, but it specifically provides for a phased unwinding of a treaty, which creates an immediate surplus impact and potential disallowance if the reinsured were insolvent without the treaty. This would tend to make it more difficult for a company and its regulators to resolve the company's financial difficulties (the Delaware department's logic escapes me).

Oklahoma's version effectively eliminates the offset provision for treaties that the state determines do not meet the standards of their statute. Reinsurers will certainly pause before offering any form of coinsurance to an Oklahoma domiciled company.

Mississippi domiciles will also find some difficulty in trying to obtain coinsurance, this due to a recent court case involving Gerling Global Life. The court interpreted coinsurance to mean co insurance, and therefore permitted a direct cut through from the policyholder to the reinsurer.

California has issued a draft bulletin with its version of the model regulation. If it is issued as proposed it will cause some considerable discomfort, particularly if it is ultimately interpreted to apply to all reinsurance treaties. Among the more troublesome provisions are the following:

1. A provision requiring that administrative expenses be covered by the terms of the agreement in addition to commissions and premium taxes. It seems that this provision, if it remains, should be limited to require coverage of marginal, variable administrative expenses.

2. A provision that would require the establishment of what could be a staggering deficiency reserve if the modified coinsurance reserve adjustment interest rate is fixed at a level greater than the valuation rate and guaranteed for more than one year. The same paragraph of the regulation would allow the California Department to determine if a formula rate is "reasonable in the opinion of the Department."

3. A provision calling for a valuation actuary's opinion on the agreement, to include language which could be interpreted to give the California commissioner the power to review reinsurance risk charges and impose a potentially onerous reserve in the event the commissioner deems the risk charge to be "significant."

It might be useful to review the original objectives of these regulations:

1. Reinsurance should not be used (or abused) to distort a company's true financial position.
2. Surplus created through reinsurance would be paid back only to the extent of future profits on the business reinsured.
3. The reinsurer should not take unilateral action to deprive the company of the surplus created.
4. Reinsurance should not be used to hamper the regulator's already difficult task.
5. Where possible, the availability of reinsurance should be viewed by all concerned parties as a positive contribution to the industry.

I believe the model regulation for surplus relief was a good starting point. It seems to me that almost all reinsurance agreements entered into embody certain characteristics which the model regulation encouraged. These include the following:

1. The agreements provide for full passage of mortality and/or morbidity risk commensurate with the portion of the policy reinsured. And, for a coinsurance type agreement (i.e., Coinsurance Funds; Coinsurance Funds Withheld; Modified Coinsurance Funds; Mod Co Funds Withheld) full passage is provided of the persistency risk created by the payment of

the surrender value on the portion of the policy reinsured, plus the additional persistency risk associated with the payment of high first-year allowances when new business is covered.

2. For coinsurance agreements, if the reinsurer is admitted in the original life company's state of domicile (OL SOD) the reinsurer holds a reserve not less than the minimum reserve required by the OL SOD. Therefore, hopefully there should be no question about the ceding company taking full reserve credit (based on the ceding company's reserve standard) on the portion of the policy coinsured, provided risk passage as described in paragraph 1 has occurred. This matter will be addressed again when I discuss New York Regulation 20.

3. Other than for the reasons provided for in the model regulation, reinsurance agreements can no longer be structured to require payback of losses by the ceding company to the reinsurer, and the reinsurer is denied the right to reduce or terminate in-force reinsurance. Surplus relief can be paid back only as result of the realization of profits on the business reinsured.

4. The agreements must provide for cash payments to the ceding company by the reinsurer when experience poorer than anticipated results in losses being realized on the policies reinsured, creating negative cash flows. For agreements where the ceding company is withholding some of the reinsurer's funds, those funds are available for the payment of benefits. When those funds are dissipated, the reinsurer is required to provide additional cash payments to the extent experience on the block dictates.

5. The agreements must provide that the reinsurer's income be no greater than the income reasonably expected to be received by the ceding company from the reinsured policies.

6. The reinsurance treaties are detailed and agreed to in final form or in a letter of intent sometime during the year they take effect, and if the latter is the case, the treaty must be executed no later than 90 days from the execution date of the letter of intent.

With this much behind us, some of the burning issues remaining involve investment risk passage on interest-sensitive policies; disclosure of significant reinsurance transactions; and the use of cash flow illustrations to demonstrate the workings of the treaty.

Investment risk passage has been "required" administratively by the New York Insurance Department on certain annuity agreements and on interest-sensitive single premium contracts. Whether this is appropriate and how it should be addressed are important topics of conversation.

Two topics being addressed by the surplus relief task force of the EX-5 committee of the NAIC are whether there is adequate disclosure of reinsurance contracts and providing regulators sample cash flow illustrations at the time treaties are being reviewed by them.

Mirror reserving has recently been a much discussed topic. New York again was first to address this difficult subject through its recently promulgated Regulation 20. Regulation 20 evidenced the New York Insurance Department's concern with offshore reinsurance and their belief that many companies with thinly priced products and already insufficient capital were further endangering their solvency by entering into bogus reinsurance transactions, secured by letters of credit, with offshore companies that were not holding sufficient reserves.

This regulation is rather difficult to read but my understanding of some of its more salient features includes the following:

1. The effective date is December 23, 1988. All reinsurance agreements entered into after this date or to which new business is added after December 31, 1988, are affected.

2. Purpose: "To prevent authorized life insurers from circumventing reserving requirements through reinsurance with unauthorized insurers and prevent a ceding insurer electing credit under section 125.4 (f) of this part from thereafter being eligible to elect credit under subdivision (e) of this section."

3. Regulation 20 has no impact if a ceding company's reinsurer and all its reinsurer's retrocessionaires are licensed in New York. Very few reinsurers are so licensed.

4. If the reinsurer is licensed but its retrocessionaires are not, only the reinsurer needs to file the required reports.

5. If a company is an admitted reinsurer in New York, it must, as before, continue to hold at least New York's minimum required reserve. It must also provide its clients (except as discussed below) with substantiation quarterly that it, and all its retrocessionaires, and their retrocessionaires, are holding New York's minimum required reserve.

6. If a company is not admitted as a reinsurer in New York, it need hold no reserve so long as it has deposited with the ceding company funds sufficient to cover the New York reserve or has funds on deposit in New York, under a New York 114 Trust agreement, equal to the New York reserve. If a letter of credit is used as security, the reinsurer needs to attest it is holding the New York reserve.

7. The Superintendent will accept in lieu of the quarterly reports a "plan of compliance, submitted to the Superintendent by an accredited reinsurer, which would permit a certification to be attached to a reinsurance agreement with a ceding company complying with this subdivision, in lieu of obtaining the individual reports required by the subdivision."

A number of reinsurers have filed proposed plans of compliance. The New York Department as of this date is still considering its response.

Clearly without such an approved plan the administrative problems created by Regulation 20 are mind boggling. Unlike Regulation 102, Regulation 20 is probably not a regulation that will receive widespread industry support.

Since my presentation is already too verbose, I will attempt only brief mention of other developments which have impacted reinsurance transactions, or threaten to do so in the near future.:

1. Draft Statement of Position of the AICPA entitled "Transfer of Risk in Reinsurance Contracts"
   Among the items discussed therein are an implied taboo of experience refund provisions and a test of reasonableness between the consideration paid and the amount of risk transferred. The points and others included in the document suggest that at least some of its authors lack an understanding of both insurance and reinsurance contracts.

   It is widely acknowledged that the presence of an experience refund provision in a reinsurance treaty limits the reinsurer's upside potential while doing nothing to the downside. Most people would agree that the result is an increase in risk to the reinsurer. It can also be clearly shown that if there is a correlation between the consideration paid and risk transferred it is a negative correlation. A reinsurer would normally be much more comfortable with a $40/thousand endowment premium than a $50/thousand term premium. Obviously, an uproar followed the issuance of the last draft and all has been quiet since.

2. New York and California "compromise of letter of credit form"
   Until New York and California agreed to this compromise it was impossible to have a letter of credit that was in compliance in both states simultaneously. The compromise created three letters of credit forms: one to be used in California if New York was not involved, one for New York if California was involved, and a third to be used if both states were involved. In the future, scorecards will be necessary for those entering into reinsurance agreements.

3. Excise Taxes
   The Reinsurance Association of America is seeking federal legislation to increase the federal excise taxes for property and casualty (P&C) premiums ceded to foreign insurers from 1-4%. This is to correct a perceived competitive advantage gained by foreign reinsurers as a result of recent federal income tax changes. The life reinsurance industry generally disagrees with the need and some efforts are being made to prevent this tax from applying to life reinsurance.

4. The NAIC has circulated a questionnaire on public policy issues involving the right of offset. Although the courts have continued to recognize that the right of offset is a fair and

equitable common law right and despite persuasive arguments that the right of offset is necessary to maintain a stable affordable reinsurance market, a few people continue to contest offset, particularly when a ceding insurer's insolvency makes it expedient. A majority of regulators appear to support the right of offset. However, it remains important for everyone with an interest in this subject to stay informed and to inform others of its importance.

5. NAIC Model Law on Credit for Reinsurance
   There is a proposed amendment to the NAIC Model Law on credit for Reinsurance. I will quote from ACLI General Bulletin #4023. "Under the current Model, reserve credit is available to domestic ceding companies if the reinsurer is licensed in their domicile, licensed in another state with similar solvency standards, or puts up some form of security acceptable to the ceding company's domicile. Under the proposed amendments, a domestic ceding company could take reserve credit if the reinsurer was licensed in its domicile, accredited in its domicile, or put up some form of security acceptable to the ceding company's domicile. The major difference is that, under the proposed amendments, unlicensed reinsurers that do not put up a form of acceptable security must be accredited in order for the ceding company to obtain reserve credit.

   "The proposed amendments establish standards for accreditation. The most visible proposed standard would be a minimum policyholder surplus of $20 million. To be accredited, a reinsurer must also submit to the authority of the ceding company's domiciliary commissioner to examine the reinsurer's books and records. The proposed minimum $20 million policyholder surplus would not apply to reinsurance ceded and assumed pursuant to pooling arrangements among reinsurers under common control."

   Those concerned about this amendment cite its potential negative impact on the credit insurance market, agent reinsurance agreements, and other types of joint ventures.

   Those in favor are concerned about insufficiently capitalized reinsurers accepting risk beyond their capabilities.

6. Other areas of interest include recent uses of the RICO Law in connection with reinsurance transactions, the New York Junk Bond regulation, New York Regulation 126 requiring asset/liability matching for certain interest sensitive products, and the attempt by the IRS to force amortization of ceding commissions in connection with indemnity reinsurance treaties.

MR. THOMAS G. KABELE: I will discuss two topics: mirror reserving and the magnifying glass problems. Again, these are not fictional fairy tales but real terms applied to some real problems.

First, I will talk about mirror reserving. There is what is called "full mirror reserving" where the reinsurer is supposed to hold the reserve the ceding company would have held had it retained the business. The problem is this is not always well defined because the reinsurer could theoretically destrengthen its reserves on ceded business and would end up with the same reserve credit. Most states apply what Ted Becker of Texas calls "quasi mirror reserving" and that is the reinsurer should hold the minimum reserves required in the ceding company's state of domicile. The reserve here is presumably of the liability shown on page three less due and deferred premiums and other offsetting assets shown on page two of the annual statement.

What are some of the problems mirror reserving was designed to solve? Mel Young mentioned a few of them. Perhaps the most important one was to prevent reserve dumping into the Atlantic Ocean. I understand that some companies are now looking to the Pacific as well. The regulation also forces the reinsurer and the ceding company to discuss their liabilities. There have been cases, for example in A. M. Best, particularly in the P&C side, where one company claims that they have a $5 million receivable from the reinsurer and you see no corresponding payable for the ceding company. The regulation also levels the playing field between domestic and alien reinsurers. New York was somewhat concerned that most reinsurers would move offshore where they couldn't be monitored.

As a simple example of reserve dumping, the assets are $40 million, say liabilities are $60 million, the surplus strain is $20 million, perhaps on a new block of whole life policies. The company cedes off the block and reports net liability and assets are both zero. However, on the reinsurer's

side, the surplus strain just simply disappears. It is just simply not set up. It could be deficiency reserves, or it could be virtually anything. In certain jurisdictions, the annual statements are secret, so the New York Department had trouble finding if these companies even existed, let alone what was on their balance sheet.

The effect in New York seemed to be rather minor. The fact is that initially very few New York companies were very much concerned with it. Part of the reason is that many of the New York companies are very old, very large companies, they have very large retention, and very often they are subsidiaries of other large companies. So mirror reserving has relatively little impact on yearly renewable term (YRT) reinsurance simply because the reserves are so small. Besides that, most reinsurers are, in fact, U.S. companies and they follow NAIC standards and NAIC standards are reasonably similar among all states. They may have some greater impact as mirror reserving moves across the land, if in fact it does. Another reason that there may be relatively little impact on mirror reserving is that you can obtain both risk transfer and reserve relief without really worrying about mirror reserving. By using one of the following methods, one can use stop loss reinsurance with Lloyds of London or other alien companies. You can use calendar quarter YRT where within the quarter there are no reserves at all, it disappears. You can use modified coinsurance with a cash allowance that is if the alien reinsurer is willing to pay you cash dollars, there is no mirror reserving problem. You could also use coinsurance with a trust. New York has added a fifth method, that is coinsurance with mirror reserving.

Alien reinsurers can also do business in New York provided they are bonafide companies. For example, many alien companies have in fact set up U.S. branches or U.S. subsidiaries many years ago. It is also possible, and apparently it has actually happened on the P&C side to become directly accredited in New York, and apparently a number of Canadian companies are directly accredited in New York. Also, alien reinsurers can do risk transfer and surplus relief without worrying about the mirror reserving requirement. Nonetheless, there are certain technical problems with mirror reserving. For example, there is a timing problem. The reinsurer may have to close the statement a couple of weeks before the ceding company can get all its results together, and because of that, there may be slight differences in the reserves. It seems reasonable also that there should be an exception for what I call $1/2\ c_x$ reserves. These are reserves generally under YRT reinsurance, and coinsurance of term plans. The reserves are small, and almost all bonafide reinsurers in the world would hold some reasonable type of reserve. The other problem is the difference between "quasi mirror reserving" and full mirror reserving. As Mel Young mentioned it appears that New York is going to apply the "quasi mirror reserve" concept. The final draft had a distinction between an accredited and an unlicensed reinsurer that many of us weren't aware of until we read the final draft the second time. It should be noted that New York had pretty well agreed to the first three exceptions, but after about a year's discussion with them, they had agreed that there would be some provision for timing, there would be an exception for $1/2\ c_x$ reserves, and there would be "quasi mirror reserving," but apparently certain industry groups kept arguing with them. When the final draft came out, all the exceptions were deleted. A couple of pages were added to the draft and it was also applied to the P&C companies. It seems like at a certain point in time, it would be a good idea just to tell the Department "sold," write it up and have no more discussion. Because of the continuing discussion, the first three are somewhat uncertain at this point.

Besides Exhibit 8 reserves and Exhibit 9A reserves, there are other places where there should be mirror reserving; these are short-term liabilities; I don't think anybody would question that these obviously should be mirrored. For Exhibit 9A claim liabilities, there should be some reasonable mirroring. The face amounts should be reasonably in agreement again, except for timing problems. There should be agreement on payables and receivables, such as premiums, experience refunds, allowances, and surrender benefits. Again, it is embarrassing if the reinsurer puts up a small liability and the ceding company takes credit for a larger one.

Mirror reserving is a requirement to New York Regulation 20. It is actually the fifth amendment to Regulation 20. Several state insurance departments are also applying mirror reserving, particularly when they are doing the examinations. They send us letters asking us what the exact dollar amount of reserves and credit we are taking and what the ceding company is taking credit for. The Big Eight accounting firms also seem to like the mirror reserving concept. Apparently they want to make sure that there is a bonafide agreement and that the parties are in reasonable agreement on the terms, more than just the New York state regulatory authorities that are using this concept. I am not sure just what would happen if we sent back letters giving them much

lower liabilities than the ceding companies are taking credit for. Generally, we work very hard ourselves to make sure we mirror the reserves.

It is very important to the New York Department that they preserve the sanctity and integrity of the U.S. legal reserve system. That was the most often given reason. A lot of people debated with them saying that we don't really need a mirror reserving, but that was one of their most important reasons: they wanted to preserve the U.S. legal reserve system. It encourages communication between the ceding company and the reinsurer to make sure that there is reasonable agreement, not only on Exhibit 8 reserves, but also on the other types of reserves, liabilities, and assets. It also provides a level playing field between U.S. and alien companies. If alien companies had been able to provide a dumping ground in the Atlantic or Pacific for reserves, a large part of the reserves would move in those two oceans. It also gives the U.S. regulators more information and more control and makes the audits easier. I think it makes the audits easier also for the Big Eight accounting firms. That is why they are sending out all of these letters.

Another thing it would tend to prevent is actuarial auctions. You could imagine that a president of a company gets ten actuaries in a room and asks them what reserves each would set up, and the reserves would end up in the places where they were the smallest.

Also, it protects state guaranty funds by requiring reasonable reserves to be set up.

The final thing is that it prevents some losses that might otherwise be caused by letters of credit. In very recent court cases, the courts have decided that letters of credit may be voidable preferences. Upon insolvency, a reinsurer may not have to pay the letter of credit, so that the horror stories that the Department kept telling us through the years, in fact, have turned out even worse. There was a Compton case, an air-conditioning case, and a trust capital case. There were also two insurance cases, one involving Universal Marine and the other one involving Mutual Fire in the last couple of years.

There have been a number of cases, I believe, where mirror reserving may have prevented losses. There was one case involving a pool that assumed business from a Delaware company and then ceded it off to an Irish company, and, of course, there was no mirror reserving. The Irish company was a paper entity and went bankrupt and the Delaware commissioner suited the pool for RICO fraud. When my chairman got this suit for RICO fraud he was not too pleased about it, and we had to work quite hard, and after six to eight months we were finally able to settle the case for a total payment of about $9 million. There have been numerous other cases involving insolvencies of Bermuda or Barbados companies and other offshore companies that I believe may have been prevented by something like mirror reserving.

There are problems, however, with mirror reserving. One thing is it only seems to look at the page 3 side of the balance sheet, and it doesn't look at the asset side. There were potential abuses where companies supposedly have mirror reserves and then set up a letter of credit as an asset or some other bogus assets.

The other solution may be no credit, period. In other words, if you are not licensed or authorized in New York as a reinsurer, you get no credit. I think this is a reasonable alternative to mirror reserving, because ceding companies can obtain risk transfer and surplus relief without using coinsurance with a Letter of Credit. As a matter of fact, coinsurance and a letter of credit seem to be most used in case of reserve dumping. Also, the alien companies can form branches or subsidiaries and become directly accredited in New York. The other reason for a no credit period approach would be because it is difficult to audit some of the unaccredited companies. In some cases their statements are secret. The fact is that mirror reserving in some cases may be regarded as liberalization. One nice thing about Regulation 20, and very important, is it did provide very liberal grandfathering, and I think if this is adopted in other states, hopefully there will be very extensive and liberal grandfathering just as was provided in New York in the fifth amendment to Regulation 20. That's all on mirror reserving.

The next topic is what I call the magnifying glass problem. Now this could affect traditional reinsurance and affect all ceding and assuming companies. It seems to be an attempt to extend the strange deficiency reserve concept to reinsured business. In fact in January 1989, the American Academy of Actuaries proposed that the ceding company may have to hold deficiency reserves if the reinsurer does not guarantee the premiums. Now, the fact is that in most cases the reinsurers

do not guarantee premiums in order to avoid holding deficiency reserves. On the other hand, the March 27, 1989 XXX NAIC proposal said that the reinsurer in certain cases may have to hold deficiency reserves. I am hoping that the mirror reserving concept may be applied here so that if we mirror that will be the end of it. There won't be any additional reserves. In other words, mirror reserving is far from being an enemy, but it may be a friend to prevent additional reserves. It is conceivable that even if the direct product is not deficient, both the reinsurer and the ceding company may have to post deficiency reserves if both of those proposals from the American Academy and NAIC become a regulation. In fact, you take an example where the direct policy used 1980 CSO nonsmoker select and ultimate rates, and let's suppose the reinsurer's maximum rates, if it had any, were 1980 CSO, but for the first three or four years, it guaranteed a lower rate than the direct policy. Now typically, the reinsurer's rates are lower than the direct policy rates. Well, then the reinsurer might have to post deficiency reserves in the first few years, and the ceding company may have to post deficiency reserves thereafter.

Another problem with deficiency reserves is that they are often not realistic. That is, they can produce unrealistically high numbers. For example, deficiency reserves often ignore select mortality and they ignore lapse rates. They assume that everybody is going to persist. If the product were actually deficient on a realistic GAAP basis, the assumption of zero lapse may not be too unreasonable, but in most cases the products are fairly sound on a GAAP basis. Also, the computation of the deficiency reserves provides direct benefits in that it ignores payments that really have to be made, namely commissions and premium taxes and even policyholder's dividends. Although Schedule S seems to take into account commissions and premium taxes, if they are not reimbursed by the reinsurer, perhaps they will be scheduled as deficiency reserves required. However, the schedules as deficiency reserves are not very well documented in any of the literature. Again, the deficiency reserves can be quite sizeable.

On the direct side, the deficiency reserves tend to be reduced because there is a margin in the premium for commissions and premium taxes and policyholder dividends and home office expenses. In reinsurance cases you may not reimburse policyholder dividends, there is no margin in the reinsurance premiums to cover them, and the home office expenses may be rather small. In certain cases, there is no margin for commissions and premium taxes, which for example on YRT reinsurance may not be reimbursed.

In order to get around the problems about guarantees, in many cases some companies in the past have been giving side letters to the ceding company that say that the reinsurer does not intend to raise premium rates in order to assure the client that the rate that is quoted, which may be built into the pricing formulas, is going to be a reasonable rate.

The problem with the side letters is if states find these side letters, they may decide they require reserves, depending on the wording of the side letter. Another problem is new management comes into the reinsurance company or new owners, and they forget about the side letter, and the rates go up. In particular, this could happen on the insolvency of a reinsurer.

If the reinsurer reserves the right to raise rates on a class basis to all ceding companies, then everybody who deals with that reinsurer may have to worry about his rates going up. One partial solution to this may be to renegotiate your reinsurance contract. However, that is a lot of work. Another possibility would be to have the reinsurer give his lowest guarantee that would be possible. However, certain states have different deficiency reserves. One state may allow the 1980 CSO smoker/nonsmoker and another may not. Another possibility would be to try to get the reinsurer to meet the deficiency reserve rates. Another possibility may be to try to use participating or indeterminate premium reinsurance. These are only partial solutions. Suppose, for example, the experience is bad and the reinsurer does raise the rates. The fact is that is likely when they would raise the rates. If the reinsurer's new rates exceed the ceding company's gross rates, the results could be very sizeable deficiency reserves forcing a sort of domino-type insolvency. One potential answer would be to try to do the best you can with the guarantees and another would be to try to throw the American Academy and any NAIC proposals into a round basket. This would help both reinsurers and ceding companies. In other words, the idea is we don't need deficiency reserves, we have mirror reserving.

MR. WAYNE D. BIDELMAN: I think part of my job here is to provide a little philosophical relief to this whole discussion. I think Mel has done a good job of giving a technical overview of what's going on, and Tom has likewise given his viewpoint on a couple of specific issues.

I am purposely going to take a bit of a stronger view. We tried to have a regulator on the panel. I guess it is their fault they can't defend themselves. I will be discussing primarily the state regulatory side, and believe me, I think that the regulators have an impossible task. Again, however, my viewpoint here is from the reinsurer's. One of the things I think is often forgotten is the very viable role that the reinsurer plays in our marketplace. Despite the obvious that we are all in the business of trying to make a profit, reinsurers are truly also in the business of trying to be of service to life insurance companies. Regulators also tend to forget that reinsurers help provide and distribute the resources that exist within our marketplace. In other words, reinsurance helps small companies become large. They transfer risk from one company to another, from a company that can't take it all to one that can help take that risk. On the surplus side, you can transfer surplus from the "haves" to the "have nots." So, reinsurance serves to make maximum use of the resources that exist within our industry. Without reinsurance, in fact, we might end up with only a few very large and rich companies in existence.

So how do we think the regulators view their role? I think most of you could answer this as well as I. First of all, they view it as a necessity that there exist very conservative accounting rules. In conjunction with that, they are highly solvency oriented. Their motivation is to make sure that insurance companies, in fact, are solvent under conservative assumptions. Finally, the most important thing, of course, is to protect the policyholders. We see them trying to come up with some very rigid requirements. So what kind of interaction exists in marketplace? Whenever you have rigid specific rules in a dynamic marketplace, as I mentioned before, the regulators are always going to be behind, and they are always going to be trying to catch up. It is almost an impossible job. The more specific the rules, the more there may exist the luxury of defining what's black and what's white. But as soon as you start defining specific rules that make some things black and white, you end up with a very large gray area, which makes things very unclear.

In a competitive overcapacity market, unfortunately, there is immense pressure on the part of the insurance company to strip off the conservatism that exists inside the accounting process. For example, deficiency reserves are often considered redundant reserves; there is great pressure to try to get rid of those in whatever fashion is possible. Securitization to some extent might be looked at as a method for stripping off some of the conservatism; some types of securitization at least give you an opportunity to book some of the future profit loads. Again there is immense pressure for insurance companies to try to strip off some of this conservatism in order to survive. Many of you will say that that's the time for the regulators to step up and be more firm. I don't know that I disagree with that, but I think it is very important that, rather than getting more rigid rules, existing rules should be made more practical.

One of the things that I see of regulators is an overzealous attempt to throw large blankets over very specific, in some cases, small perceived problems. I see P&C issues inappropriately applied to our life insurance business. I see way too much inconsistency between the regulatory environment of different states. I don't know if anyone has stopped to think what it costs your company to comply with as many as 52 different regulatory jurisdictions, if you want to throw in the federal government. We must comply with all of these jurisdictions and the expense of doing this is immense, including some of the lobbying issues that Mel and Tom mentioned. It is taking a great deal of time to deal with the regulators, and particularly once the regulations are passed, to try to comply with all of them. Unfortunately, I also see too often the phrase "inconsistent with statutory accounting" really meaning nothing more than realistic accounting.

I would really like to see the regulators view the overall health of the insurance industry just as important as the protection of the policyholders. I think ultimately they go hand in hand. The workings of the direct and indirect markets are not allowed to function freely. Competition could be destroyed leaving only large company monopolies. You may have some unending dilemmas here. You have conservative statutory accounting versus the cutthroat competitive marketplace. You have increased regulation of reinsurance at a time when its use as a financial planning tool is more important than ever to the industry.

There was a session on securitization. The only pleasing thing about securitization is that it is probably tending to divert some of the regulatory attention from financial reinsurance to the banks; perhaps there is a positive in everything!

If anyone knows me, I can't sit down without giving my shot at mirror reserving. I think you have heard the definitions here. I have been fairly outspoken that the concept of mirror

reserving, at least as it is applied, is not a good one. I have a real problem with the concept in a lot of ways. Not only is it terribly impractical, but I am not even sure it necessarily solves any problem. I am not even sure it is even real in theory. In other words, a lot of regulations have good theory behind them and then become impractical. I am not sure this even has good theory behind it. I think it is a dangerous concept, particularly the way it is being applied. Presumably the ultimate intention is that the appropriate net liability be held for the risks that are being retained. Unfortunately, you can have a real mismatch between the reserve credit and the reserve the reinsurer is holding and end up with perfectly adequate reserves to cover the risk that the company is actually on. By the same token, you can have absolute matching between the reserve credit and reserve that the reinsurers hold but not ensure that the right liability is being held for the risk. So one might ask, "What does this really solve?"

We heard about New York Regulation 20 as amended, referring to nonlicensed New York reinsurers, and I agree that the main intent is to keep reserves or risks from being ceded offshore, and the ultimate reserve is not held by that foreign reinsurer. The difficulty here is that there aren't any exclusions by types of reinsurance, which makes it extremely impractical. Also, when you are dealing with foreign reinsurers you might be able to determine that they are, in fact, posting the gross reserve, but unless you can look at their entire balance sheet, you don't know what this means since their entire accounting system may be different. Therefore, the fact that you have a mirror reserve doesn't necessarily mean that there exists protection for the ceding company or ultimately the policyholder.

I won't belabor the practical problems much more except to say that the timing problems that we hear about are not just words, they are very real. We may say that YRT reserves are small and, therefore, unimportant. However, if you are a small company and/or if volumes start getting large, YRT reserves can become very significant -- not only for facultative YRT but also for automatic YRT. I like the approach that has been discussed that what should be excluded is reinsurance or insurance where the reserves are only 1/2 c_x. I think that would solve a lot of the practical problems. There are built-in time lags, unfortunately, in the reinsurance process. Cut-off dates are a very serious problem. There used to be some reinsurers that would close their books in mid-December and the ceding companies possibly wouldn't close their books until mid-February. There is just no way, even if you close your books at the same time, that your accounts are going to be the same, as you all recognize. It may seem like a small problem, but if you are required to verify every difference cent for cent, ultimately it is a major problem.

Reinsurance is a worldwide capacity business; obviously providing mirror reserving and proving this for all ultimate retrocessionaires all over the world is virtually impossible. We could all sit here and in about five minutes come up with a list as long as your arm of differences that can occur in calculation methods for reserves. There are different calculations of reserves for nonlife benefits such as premium waiver, or there are mean reserves versus mid-terminal, male/female distinctions, substandard and preferred risk classifications -- you could go on and on. There are a lot of viable reasons why you could end up with reserves that are different.

The consensus of industry advisory committees is usually quite fair and thoughtful. I think there are a lot of examples of this. So far, to my knowledge, there has not been one industry advisory committee that supported the mirror reserve concept. Included in this is the ACLI Reinsurance Subcommittee, the Reinsurance Advisory Committee of the NAIC, and the Bill Zeilman Committee that at one time was formed to help define net reinsurance reserves after reinsurance credits; even the recent interpretation of the draft of the Actuarial Standards of Practice for the Treatment of Reinsurance Transactions did not support the mirror reserving concept. I don't think anyone minds a legitimate practical approach to a serious problem, particularly if mirror reserving would solve some kind of problem. We would be willing to work on it if we could make it practical. Looking at my obtuse position once again, what's wrong with the reinsurer posting a 5% Commissioners Reserve Valuation Method (CRVM) reserve and the ceding company taking a credit for a 4 1/2% net level (if that is their calculation method). I guess this gets into the "quasi mirror reserving," but so far that's never been defined in the words of any regulation.

The biggest problem of all, of course, is the way the mirror reserving concept is applied. Unfortunately, my company has some clear examples of this. Several years ago the actuarial examiner wanted to use the mirror reserving concept in its review of our company. He was looking at reinsurance transactions where we were the ceding company. If we took a reserve credit higher than the reserve the reinsurer had, they wanted us to reduce the reinsurance reserve

credit. Maybe that step in itself is what one might expect. Unfortunately, we are both a direct writer and a reinsurer. So on the reinsurance side, if we held a reserve that was lower than the reserve credit that the ceding company took, they wanted us to boost our reserve. There was never any discussion as to what the reasons might be as to why there was a difference. That's one of the problems with Schedule S these days; it is supposed to be specific. So this is called "ding the examinee." They're dinging the one that is being examined. This is the risk of agreeing or even suggesting that there is some real good theoretical advantage to this type of rule, since it is usually applied in an impractical way.

All I can say is "heaven help us" if this particular regulation ends up being an NAIC model.

MR. KABELE: I have a question for Mel. You have some results from your survey of the 50 states. Could you give that in a little more detail?

MR. YOUNG: We have a task force that both Tom and I are members of. They asked me to write to 50 commissioners. We actually wrote to several others. We included Guam, the Virgin Islands, and the District of Columbia. We have received replies from 31 states so far. The question was: "Had they adopted the model regulation for reinsurance? If not, what was their practice?" Just to summarize the 31 states, there are six that had passed a version of the model. There are three that have a draft proposed version: California, Alaska and North Dakota. There are ten that say that they are following the model in principle. There are three that review reinsurance transactions on an individual case bases. Many others cite requirements for risk passage and other nebulous kinds of things. Ten others said that financial reinsurance wasn't a real important issue to them.

MR. KABELE: Are there any states that say they don't like financial reinsurance period?

MR. YOUNG: Not any that responded.

MR. MARVIN D. FINEMAN: I would just like to make a comment that might help in future discussions of this nature. I think our colleagues in Europe and in Canada are looking with a great deal of amusement at the situation that we are involved in with the statutory accounting system we work under. The system was designed in the 19th century. It has been maintained steadfastly through the first three quarters of this century, mainly because of the enormous tax benefits that went with it. Lately, however, we find the conservatism built into this system has been reinsured away and the tax benefits have pretty much reformed away. It is perhaps time that we should consider throwing over the system entirely and going with a system more similar to the European or the Canadian system of valuation.

MR. YOUNG: Marv, aren't there multiple European systems? You say European as if there is a single system there -- I assume you mean the U.K.

MR. FINEMAN: I was referring more to the U.K. type of system, but my feeling is that all of them are going to be converging as 1992 approaches and passes.

MR. IRWIN T. VANDERHOOF: The thing about this that bothers me is that the mirror reserving seems to be a method of selecting reinsurers that will lie. It seems exactly designed to find a way to funnel business to the least honest reinsurers you can find. It seems to me that shouldn't be the objective of regulations. If you are going to try and find a way to move regulatory capital into this country, which reinsuring outside the U.S. does and I think has salutary benefits, then you should find a way to try and encourage the most honest and the most reputable reinsurers to do it, and you have done the reverse.

MR. YOUNG: I think, Irwin, most people would agree with what you said and would say that the fundamental issue was: Are the death benefits going to be paid by the ceding company and by its reinsurers? Are benefits going to be paid and is there security and an assurance that is going to happen? I am sure there are some regulators that would disagree with this, but the fact that one reserve level or another is being held is not necessarily assurance that benefits are going to be paid.

Just to go over Regulation 20 quickly again, if the various things that have been discussed do come to pass, and we get away from the term reinsurance as being inconsequential, New York may at least verbally agree to ignore the timing differences that Wayne has discussed. We'll see what

guidelines they come out with concerning the plan of compliance. If these prove practical, many of the problems that the reinsurers see with the regulations go away, but then as you just pointed out, what you are left with may not be as onerous, but there are so many loopholes that there is virtually no purpose to the regulation. It hasn't accomplished anything.

MR. BIDELMAN: Irwin, I agree 100%. I agree with you too Mel. One situation we've had with a New York domestic company on this already put us in a very uncomfortable position with a relatively new client. It was a self-administered account, so they actually reported to us the reserves that we were supposed to hold on this business. They checked with us and asked what reserves we held. We told them and they said that it wasn't right -- that it should be higher. Although our financial statement had already been closed effectively for the first quarter, they were trying to get us to write a letter saying we had actually held a higher amount, where in fact all we had done was post exactly what they had reported to us. I suppose that points out an advantage that Tom mentioned that it does force talk between the ceding companies and the reinsurers; however, I would like to find a different way to force that other than this type of situation.

MR. KABELE: There are really two types of reinsurance. One is the reinsurance of term plans where the reserves are typically $1/2\ c_x$ and the reinsurer may actually be calculating the reserve. In this case it is very hard to mirror the reserve, because the reinsurers may have slightly different computers and it may be rounding errors. However, for most of the surplus relief treaties that involve coinsurance, the reserves actually come directly from the ceding company. These are the types of treaties that involve reserve dumping, and mirror reserves being proposed by New York, in fact, do solve the problem of dumping.

MR. YOUNG: You pointed out that doesn't do anything about the asset side of the balance sheet. There are ways that you yourself have pointed out to the Department that a company could be holding no reserve at all in theory and play some games as Irwin alluded to before on both sides of the balance sheet. The reinsurer ends up being able to say that they were holding the full reserve when they might be holding considerably less.

MR. VANDERHOOF: What bothers me is that there may be an insurance company in Germany named Joe that has no sense of honor. They'll send a letter saying they posted the mirror reserve. Allianz or Munich wouldn't do that. The case Mr. Bidelman just mentioned is a direct writing company looking for an insurance company in Germany named Joe. They will eventually find it. The business will be diverted to the weakest company. It doesn't sound as if anybody has really thought of that. I don't know how the New York Insurance Department is going to examine all the companies in Germany.

MR. KABELE: As you know, my own proposal was no credit, period. So in other words, unless the German company files a New York statement, there is just no credit. That would solve your problem.

MR.VANDERHOOF: That would solve that problem but it is also a question of international capital, and you're not letting them into this country.