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REINSURANCE FROM THE CEDING COMPANY'S VIEW

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Recorder: MARK ANTHONY HUG

- o What is the view of the reinsurance market as seen by the ceding company?
- o Has the market tightened?
- o Is it still a "gentleman's agreement?"

MR. MARK ANTHONY HUG: I'm Vice President and Associate Actuary at Transamerica Occidental Life, and I'm the moderator. We're going to talk about reinsurance, but all the views will be expressed from a ceding company's view as opposed to an assuming company's view.

I'm very lucky to have a distinguished set of panelists to give the topics. Combined, they have over 66 years of industry experience, and I think each one will have a very interesting talk to give. Jack Bailey is a Senior Actuary at Northwestern Mutual Company, and Jack will bring a perspective to us from a large mutual's point of view, and I think we'll hear some interesting things from Jack. He has 26 years in the business.

Our second speaker will be Ron Colligan. Ron has 20 years in the business. Ron is not an actuary. He's an underwriter. So, he'll bring a very different perspective. Ron is the Vice President of Underwriting Research and Development at Transamerica Occidental Life. He has been on both sides of the fence, so to speak. Ron originally was on the side of the reinsurer and, of course, now deals from the ceded company's side. He deals a lot with our reinsurers.

Our last speaker is John Tiller. John has 20 years of experience and is currently a principal of Tillinghast. John has been with reinsurance in many regards, both from a ceding company's view and from an assuming company's view. John is currently co-authoring a book with his wife, Denise Fagerberg. The specialty topic is reinsurance from a life and health point of view. I think that book will be coming out later this fall. We'll all be anxious to read that.

We'll talk about general reinsurance, and each one of the panelists will have certain specialties to discuss. We'll also talk about a couple of specifics in your program. One is, "Has the market tightened up?" and you'll hear it from our point of view. Also, is reinsurance still a "Gentleman's Agreement"? I think we can all speak on that subject.

* Mr. Colligan, not a member of sponsoring organizations, is Vice President of Underwriting, Research and Development at Transamerica Life Company in Los Angeles, California.

PANEL DISCUSSION

Some of the ideas presented may be controversial, but, please, they're intended to encourage discussion. We would like your views, especially from the reinsurers. We'd like to hear some your feedback. Without any further delay, Jack, would you like to start?

MR. JOHN E. BAILEY: It's an honor to have an opportunity to speak on this panel. I note that I am the only panelist without a Transamerica Occidental connection.

I'd like to indicate that reinsurance has really become a large and integral part of our operation. Even as a very large mutual company, we've come to use reinsurance a great deal in the past few years, and it's been a very interesting time for me, at least personally. We have most of the kinds of reinsurance that you're all familiar with. We have a large term coinsurance program. We have two substandard programs, an automatic and a facultative substandard program. We do some excess reinsurance. We have joint life and various other kinds.

We find reinsurance to be very advantageous for us. It helps us provide more competitive products to our field and to our clients and increases our capacity, but the biggest benefit that I see is that it maintains our field force loyalty. We have a captive field force, and they demand lots of things which reinsurance often is able to provide. As a matter of fact, whenever any problem comes up, the first solution that anybody ever poses is, "Can we do it through reinsurance?" Sometimes we can, and sometimes we can't.

Because of this support that we get from the reinsurers, we believe that the reinsurers are entitled to a profit, and we want to see them make a profit. That's why they're there, and that's the only way they're going to continue to be there. And so we support that very much. But standing up and saying that reinsurers are great wouldn't make a very exciting session. We do have some concerns. I want to describe some of those concerns . . . not in any particular order.

FINANCIAL STABILITY

The first concern has to do with financial stability of reinsurers. Even though we deal only with "first tier" reinsurers, we've had major financial changes in three of our primary reinsurers in the last two years. I don't want to get into any of the specifics. None of these changes have resulted in outcomes that we view as being particularly troublesome to us, but it's a matter of considerable concern when you see your reinsurer up for sale.

As a result, we want to spend more time and look more carefully at the financial status of our reinsurers. This certainly is not limited to reinsurance; the financial press is paying a lot of attention to that sort of thing. For example, we don't know enough about securitization arrangements. We were somewhat surprised at year-end when we were doing our Regulation 20 reserve information to find that some of the reinsurers had quite different valuation standards than we might have expected. We don't know a great deal about how much commitment a foreign parent or a foreign company that's associated with the U.S. company has, in supporting the operation of the U.S. company. We've started collecting additional data on reinsurers, and we encourage them to give us all they can. We're starting to look at reports by Moody's, Duff & Phelps, and other

services to learn all we can about the financial stability of our reinsurers. We have learned that every reinsurer is structured differently and that surplus and profitability numbers cannot be compared like gold or bowling scores.

The message to the reinsurer is tell us all you can; the message to the ceding companies is to ask for and review your reinsurer's financial information.

SALE OF REINSURED BUSINESS

The next general concern has to do with sales of blocks of business. This was not even in our consciousness until a year or two ago when one of our major reinsurers offered its entire block of reinsured business for sale. And you can believe that we found out about that very quickly from a number of different sources. We really hadn't considered the implications of this before; the main concern is that this block of business could be sold to a reinsurer that didn't have the financial stability that the original reinsurer had. What if it was sold to a company that couldn't administer the business as well as the original reinsurer could? Are we going to have trouble getting them to pay claims? What kind of service could we get from a new company that would have our block of business without our approval?

For ongoing business, of course, we could change the arrangement, but for inforce business we couldn't, and that was a matter of some concern to us. We take the position that if the new company can't perform, we can look back to the original reinsurer for performance on the contract. As a matter of fact, we're going to talk about the issue in future reinsurance negotiations and look for either the right to approve a sale like this or a treaty provision that will guarantee that the original reinsurer will make good on this kind of commitment.

EXTRACONTRACTUAL DAMAGES

The next concern I would like to discuss is extracontractual damages. This is easily the most difficult treaty provision to complete. I'm not an expert in this field and hope I never have the opportunity, but I would like to propose some general principles having to do with damages. First of all, if the damages really are produced by the ceding company's investigator harassing the beneficiary or something like that, we pretty much agree that the ceding company should bear the damages. But in most other situations I think it's probably appropriate for some kind of sharing. Certainly, if the reinsurer makes the decision to deny, we think that it should have a share in the damages. Particularly in situations where a large proportion of the insurance is reinsured, the reinsurer and the ceding company can get in very different positions. If the reinsurer is not going to share in damages, it has a great incentive to deny a claim, whereas the ceding company in that same situation has a great incentive to pay the claim. We can avoid having the partners in different positions by defining the extracontractual damages provisions more clearly in the treaty, and that's really our objective. Many treaties give the reinsurer the right to pay in its share of the claim and avoid any further involvement with a questionable claim. We take the position that in a situation like that, if they do not make that payment, they are saying the claim should be denied and therefore should have some involvement in extracontractual damages. In fact, we prefer that reinsurers not have that right in situations where they have no right to recommend or approve a claim.

CLAIMS PRACTICES

Most of our reinsurers have been very cooperative in claim situations. I want to relate a claim that we had last year. It was a relatively large claim that should have gone facultatively to the reinsurer because of its size. We failed to do that. When we got the claim we admitted to the reinsurer that we forgot to do it. They asked for the underwriting papers, which we sent, and within a couple of days they had agreed that they would have taken the risk had we sent the papers originally. The claim was paid, and I slept a lot better after that. As a result of this we have added a number of edits in the hope of avoiding future claims of this nature, but, despite our best efforts, some will slip through. Reinsurance is "paperwork" for the underwriter, whose main job is to evaluate risks.

I'd like to talk about some other claim situations that haven't turned out quite as well from our perspective. These involve an automatic agreement that requires that we do not submit anything that has been shopped facultatively before. Unfortunately, a couple of ineligible issues did slide through, and the reinsurer doesn't want to pay the claim.

We certainly can understand that business of this type is not the same in character as business that has not been shopped before, and we're completely in agreement with the theory. But it's very troublesome to the ceding company for several reasons. Had we discovered this situation at the time of issue or at the time of application, we could have shopped the case somewhere else or we could have declined the application. But at the time of claim, of course, that option is not open. You can try to apply the errors and omissions clause, but it just doesn't work. You cannot put the ceding company back in the same position it would have held if the error had not occurred. So, I don't think that clause really operates very well. As a ceding company, we've relied on the reinsurance, and now it comes to claim time, and we find it's not there. Maybe that's all right for one or two claims, but pretty soon management begins to wonder "Do you really have reinsurance or don't you?" It's a very, very awkward situation at best.

Another consideration is that the reinsurer has been accepting premiums in this situation. If we accept retail premiums for a couple of years, we are precluded from denying a claim on any basis. I'm not saying that two years is necessarily the right answer for the reinsurance market, but perhaps we can work out something that will lock in the reinsurance protection after a certain period of time.

We have the same concern about the situation where the dispute involves an underwriting error or perhaps a difference in opinion on the underwriting and the ceding company has relied on the reinsurance. We've paid the premiums. We have no other options at the time of claim. We would like to see those claims covered in some manner.

How do we resolve this? I have a few suggestions that certainly don't cover the entire situation. Obviously, the first thing you can do is discuss these things before they happen. How are you going to handle them? How can you avoid them? I think both the ceding company and the reinsurer should be auditing these cases as much as possible. I would like to see the reinsurers underwrite these claims as they come along, and if they would have taken the risk in the normal course of events, pay the claim. If not, the claim would be denied. Basically, we need to avoid getting into differences of

opinion about claims. We're concerned about our relationships with our reinsurers when we do have to differ with them over a claim.

INTERNAL PRICING AND PRODUCT DECISIONS

The next point I'd like to make has to do with the impact that reinsurance has on our company's internal pricing and product decisions. The reinsurer really is our partner, and it's fairly easy for those of us who spend all of our work time involved with reinsurance to understand that, but it's a little more difficult to get some of the other members of the management team to agree. I have a couple of examples.

We have a large coinsurance program for an indeterminate premium term product. That's our biggest reinsurance operation. Because it's indeterminate premium, theoretically we can change those current premiums to reflect the experience as it unfolds. But that has to be a joint decision with the reinsurer because an increase or decrease in that premium is going to have a big effect on the reinsurer. An increase in the premium likely will increase the lapses, reduce their expense recovery, perhaps cause some of the better lives to lapse and impair the ongoing mortality. The same question works in reverse. If the reinsurer wants to see an increase in premium because of high mortality or whatever reason, it will have an impact on our own experience and on our field operations. And so the two operations really are closely intertwined.

In the same situation, what if the ceding company wanted to introduce a new lower-premium term product to be competitive? Internal replacement can be expected whether a formal program is established or not. Must the ceding company compensate the old reinsurer because of the likely increase in lapses? Or, must the ceding company identify all "continuations" and continue to reinsure them with the original reinsurer on the original pricing basis? Is the ceding company precluded from establishing an internal replacement program, either with or without underwriting? This should be negotiated with the reinsurer. What is the appropriate price if the replacement is with underwriting?

Our company is somewhat unusual in that it recaptures the risk at the time of conversion. The reinsurers have relied on our stated lapse and conversion experience in establishing their pricing. Are we precluded from offering conversion credits or other incentives to convert to boost our agents' commissions? This really should be negotiated before hand -- as we have done.

Our conditional receipt requires us to underwrite the applicant solely on the basis of his or her health on the underwriting date. Yet the underwriting and reinsurance processes often take a long time to complete, and some reinsurers ask for a statement of health at the time of delivery. Must we change our conditional receipt, which we view as important protection to our applicants and a favorable marketing factor? Or, must we give the client a less favorable classification through reinsurance because we will not ask for this requirement?

What do we do with the request for conversion of a facultative substandard term contract to a joint life product if that reinsurer does not reinsure joint life? Must we

retain this risk at a rate more favorable than our own underwriting evaluation, or must we take away the right of such insured to convert to this product?

These examples illustrate some of the ways in which reinsurance becomes an important factor in internal management decisions. There is no simple way to avoid these complications. The reinsurers should understand our need to make pricing and marketing decisions -- as I believe they do.

REPLACEMENTS AND CONTINUATIONS

I want to talk about what might be called replacements and continuations. What is the ceding company's obligation if the insurance is replaced internally? This occurs frequently with the further development of additional lower premium term products. Internal replacement can take place either formally with a defined program or informally where the agent just writes the new product and later drops the earlier one. Replacement may not be known to the ceding company. The new coverage is underwritten and the old policy dropped at different times in different departments so that there is not necessarily a known connection between the two. The reinsurer has agreed to reinsure this business with some assumptions about mortality and persistency. The views of the reinsurer and the ceding company are very different in this situation.

The reinsurer does not want to give another 100% (or whatever percent) first-year allowance on the continuation of the same block of business, nor does the reinsurer want to lose that particular piece of business to another reinsurer if it is not involved in the new product. If it's a facultative situation, that reinsurer may have to undergo the expense of underwriting that same block of business a second time. It may be that the reinsurer has to get additional retrocession coverage on that same life, and, of course, this kind of replacement deteriorates the mortality and the persistency of the ongoing block of business. For formal replacement programs, the agent's commission may be reduced -- which is another evidence from the reinsurer's perspective that this is a continuation and not really new business.

On the other hand, the ceding company looks at this question very differently. Often there is full evidence of insurability, particularly if it's a formal program. In the ceding company's view, this is a new issue. We've taken an application. We've underwritten it. What's your problem? Often the suicide and contestability provisions will run again. If it's an increase in coverage, that may be just on the increase, but that is a difference. Our direct pricing certainly assumes that we will get a new first-year allowance in the reinsurance. The fact that there is a reduced agent's commission should serve to discourage replacement -- which we would view as a positive in terms of keeping that old block of business in force. The new product may have benefits and features that were not present in the old product, making it seem more like a different product.

One of the biggest concerns is that we don't have the administrative capacity to continue the old reinsurer on the new product. We're now looking at ways to do that, and I hope we will be able to do it in the near future, but up to this time, we really haven't focused on how you can continue the original reinsurer in a replacement situation. It's very difficult to identify replacements if they're not through a formal program. If the agent

just applies for new coverage and then drops the old, we don't necessarily know about it. So, this leaves the ceding company and the reinsurer in a different position.

We think the most important factors are new evidence of insurability, the need for retrocession coverage and administrative considerations. As a ceding company, we really would like to be able to treat as a continuation any change for which the reinsurer has to reunderwrite or get new retrocession coverage, and is willing to bill us on an individual basis. We would like to treat the other reissues as new business. I'm not sure that we're going to be successful in that, but that certainly would be the most convenient for us from an administrative point of view. As I said before, we are exploring systems changes that will allow some form of continuation of the prior reinsurer's coverage on a new product.

REFORMATION OF PRICING

What should we do when a reinsurer asks to change the pricing on an existing reinsurance agreement? Our temptation is to say that, "Well, we've made that agreement, and isn't that nice?" But in view of the concept of a "Gentleman's Agreement," we really want to look at that situation. Basically, we ask, "Is the experience as we had represented it?" And if it is, we prefer to continue the pricing as it was. But, there may be things that are different than we had represented it. It may be that the average policy size is different. It may be that there is a higher proportion of very large policies requiring retrocession coverage than had been anticipated it. And, of course, it may be that the mortality is not working out as we had anticipated it.

In these situations, we do try to make some kind of an adjustment. If the change is from a purely unexpected, external factor -- AIDS is probably the best example -- we don't think that the ceding company really should have to make a change. That is, we don't view the reinsurance agreement as a cost-plus contract. If a reinsurer has been aggressive, then they should bear the consequences. But we really do look to our own company's best long-term interest. We want to continue to maintain our presence in the reinsurance marketplace, and we will certainly seek to keep whatever reputation we have alive and well.

EXCESS RISKS ON INDEXED PRODUCTS

The final concern that I want to bring to you has to do with excess risks on indexed products. This is not really a reinsurance problem at all; it's a much broader problem, but it comes up in the context of reinsurance and retention limits. We all have to be more aware of this than we have been. The ceding company is in the position of having the knowledge because they've developed the product. They have the records. They know how the product works and should be able to identify whether or not they will wake up in 1999 with $3 million in excess of both their own retention and whatever reinsurance facility they have. We need to design our products and our reinsurance agreements to avoid this kind of situation. It's probably come home most to me in the last year or so on our joint life, last-to-die product, where the projections out to age 99 can get pretty astronomical. I would say to the reinsurers, "keep us on our toes," so that we don't end up with a large claim way out there, and nobody knows whose risk it really is. That shouldn't happen.

Those are our primary concerns with reinsurance. I also have some suggestions. The only difference between a concern and a suggestion is that suggestions are more of a "wish list," -- things that we would like to see available in the reinsurance marketplace as a ceding company.

NEED FOR MORE CAPACITY

Larger amounts. How can a very large mutual company still need to have more capacity? Well, believe me, there are times when we really would like to have it, maybe not appropriately, but we certainly would like to have it. We often get requests for additional coverage from wealthy individuals who may already have $20 million or $50 million of coverage. These are people who get their own way, and they want to buy another $20 million. Maybe it's appropriate, and maybe it isn't. If it isn't appropriate, of course, we don't want to put it on the books. But where it is appropriate, we would like to be able to obtain the additional coverage. This is a very time-consuming process for our underwriters, for our field, and certainly for the reinsurers as well. The small number of very large cases that we see receive attention out of proportion to their relative volume because these are the agents who call the President and say, "The underwriting department isn't helping me out." So, this is a place where we can use help when it's appropriate.

Older ages. We've all read about the graying of America and how the average age is increasing. More older people are wealthier today than they ever have been before, and they're asking for insurance coverage. Our shop is very reluctant to offer coverage at ages over 75. Our doctors say they can't underwrite at those ages. I would put this down as an opportunity for a reinsurer. You could corner the market pretty fast. I don't know how profitable it is, but I think it's a market that's coming, and we certainly could use some reinsurance help. This is maybe a case where a reinsurer could pool coverage from a number of companies and get a more stable base of coverage than any individual company could get.

Highly substandard situations. This, again, is a real time consumer. A wealthy individual who wants to have coverage, and who is highly rated will say, "Tell me the price." In our experience, most reinsurers are interested in substandard underwriting but only up to about 300%. Beyond that, most of them say they are not interested. I can't really criticize them for that because the highly substandard business takes a lot of time to underwrite. The premiums are high. The placement ratio is low. There's not a broad enough base of experience to get a statistically predictable result. So, there are lots of reasons for not being in this market. But this is an area where we really could use some additional help.

Those are our three greatest capacity needs, and we put them all together in one product and call it joint life, last-to-die, where we really need additional reinsurance help. Not many reinsurers have been too much involved in this product up to this date and for good reason. Not only are there large amounts, older ages, and highly substandard lives involved in this market, it's also a more complicated product. The premiums are very low, and there is not a good spread of risk. But, again, it's a need that we have.

AUDITS

My final suggestion has to do with audits, and, again, I want to say that the reinsurers are usually very helpful. I don't say that we jump for joy when we hear that a reinsurer is coming in to audit us, but we do welcome them. Over the years we've learned some things about our administrative system through the audit process. An audit certainly focuses management attention on reinsurance administration, which is not terribly high in management's consciousness most of the time. It helps us understand underwriting differences between our company and the reinsurers, and the audit provides us some assurance that things really are being done appropriately.

I do have a couple of suggestions about audits. We really appreciate getting the policy numbers that are going to be audited at least three weeks ahead of time. It takes time to get death claim folders and policy change folders and that sort of thing ready for the auditors, and when we're able to do that, the audits usually go pretty smoothly. In a recent audit, we got the policy numbers just a couple of days ahead of time. We weren't able to get all that information, and it was a tense week because the auditors were always asking for the information. We've also had audits of the same reinsurance program by two different reinsurers in consecutive weeks, which takes a lot of our time. Is it possible for reinsurers who are reinsuring the same company on the same program to conduct a joint audit? It would save a lot of our time. I know there are confidentiality questions that have to be resolved, but we would like to see that happen where more than one reinsurer is involved in the same program.

While I've presented a number of concerns, a few suggestions, I haven't given a lot of answers. I want to say again that the reinsurers really help us to serve our public and our field force. Our goal is to communicate better with our reinsurers so that both of us understand where the other stands, and what's going to happen in certain situations.

MR. RONALD A. COLLIGAN: I speak at a number of multidisciplinary meetings in the insurance business. I've spoken at ALIMDA (the Association of Life Insurance Medical Directors' of America) about underwriter/medical director relationships, and at quite a few marketing meetings, and I've spoken at one other actuarial meeting. I think it's extremely important that the actuaries, the underwriters and the marketing people develop a kind of symbiotic relationship if a company is to succeed with both their marketing objectives as well as their profitability goals.

What we're speaking about, to a large degree, is perception. What do we think of the reinsurance market? Is it what we think it is? And sometimes things aren't necessarily what they seem. I'm reminded of the story of the CIA agent who was stationed in Lima, Peru. CIA agents, as most of us know, are very hard-drinking, hard-loving, hard-working guys, and this fellow was in a particularly good diplomatic post in Lima, Peru. He was at his third cocktail reception of the evening one Friday night, and he was on his third drink at the third reception when the band started playing. He looked across the room, and he saw a vision of loveliness in a crimson gown, and he staggered over and asked to dance. This vision of loveliness in the crimson gown looked at him and said, well, no, for three reasons. (1). You're obviously drunk. (2). The band is playing the Peruvian National Anthem. (3). I'm the Archbishop of Lima. So, things are not always necessarily what they seem.

A little bit about my background is going to help you understand better what I'm saying. Mark chatted a little bit about my experience in the reinsurance business, and I did spend 19 years there, 16 of them in reinsurance underwriting and then three in reinsurance marketing. Those of you in the reinsurance business know that sometimes those two disciplines on the reinsurance side are a dichotomy, and so I can bring a little bit of the perspective of what it's like trying to sell it, and then what it's like trying to put the business on the books in a profitable way. For the last 15 months, I've been Vice President of Underwriting Research and Development at Transamerica Occidental Life. My job involves setting underwriting policy -- basically responsible with Mark and the actuaries for product performance, in knowing what mortality assumptions he and his people set on various products and then making certain that our underwriting reflects that in trying to bring Transamerica to the levels of profitability we expect. To do that I have to work very closely with the reinsurers from a ceding company's point of view.

Everyone recognizes, as Jack said, that without the reinsurance business our industry couldn't succeed the way it has, and what we're trying to do, as Mark said, is just bring some new perspective into what we feel needs to be done to bring the relationship back to one which we think is going to serve us both a little bit better.

I'd like first to answer, from Transamerica's view, and my own view perhaps more than that, the three basic questions that we're addressing. What's our view of the reinsurance marketplace today? And our view of the reinsurance marketplace today is that it has gone back a little bit in the last few years in terms of being a more open and competitive marketplace. It has tightened up primarily from the underwriting standpoint, and I'm going to chat a little bit more about that later. It has tightened up significantly, and I think that has caused us some concern, and we've examined why we think it has tightened up, and I'll go into that a little bit more later on.

Is the reinsurance treaty still a "Gentleman's Agreement?" I think we would like to think that it is, and I think it is when it is carried out in the spirit in which it is written. I think from a realistic point of view we've got to recognize that in more and more situations it's not, and that in a ceding company the agreement ought to be very, very well-scrutinized by every discipline involving itself in the reinsurance process: the financial people, the actuarial people and the underwriting people. We have got to know and you have got to know as reinsurers that we're doing the job that you expect us to do, and we've got to know as a client company that if we do the job you expect us to do, that you're going to pay claims.

One of the things I'd advise as ceding companies is that more attention be placed on is facultative situations where a case is sent out to multiple reinsurers. You should have in your treaty some kind of a scheme as to where the reinsurance is going to be placed. There's nothing worse for a primary company or reinsurer than to have a case sent out to three people, have somebody die in the interim, and not know where the insurance is going to be ceded. If you can develop a trail and a procedure, preferably in the treaty, that says where this claim is going to be paid if the individual dies during underwriting, you're going to avoid a lot of conflict at claim time. One of the most important things we can do administratively and in underwriting, quite frankly, is to avoid conflict at claim time.

I'd like to address first what I feel is the appropriateness of underwriting involvement in the reinsurance process. Traditionally, underwriters have not gotten very involved in selecting who a company's automatic reinsurers are going to be. We used to say in the reinsurance business that the underwriting VP couldn't say where the automatic was going to go, but in most circumstances he could say where it's not going to go. I think this is somewhat changing now in progressive companies, because the actuaries responsible for determining where reinsurance goes recognize that it is we in the underwriting trenches that have to live with those agreements. Underwriting philosophies have got to be very compatible and should be discussed right up-front.

At Transamerica, we in the underwriting area play a very integral part in reinsurance negotiations and discussions, and I think we're better off, and our reinsurers are probably better off, for that happening. I'd encourage you, as actuaries on the primary side, to get your underwriters involved in this process, and, naturally, you on the reinsurance side, to get your reinsurance underwriters involved in treaty negotiations. Many times it can be a little bit of a favorable mortality assumption that goes into your coinsurance pricing, based on some input from an underwriter at the reinsurance company who knows a little bit about my shop or somebody else's shop, that's going to mean the difference between you getting an automatic client and not getting an automatic client. And by input I don't mean an underwriter picking up Best's and looking at it and saying, well, the mortality generally appears favorable. I've known some companies that price that way. What I mean is getting your underwriters out more, sitting down with the underwriters in the primary business, talking about product, market, and agency force and thrust, and developing a confidence level in us so that it can be communicated to your pricing actuaries and, hopefully, give the companies that are doing the kind of underwriting that you want done a little bit of a break in their pricing.

Underwriters are also very close to the market. We are probably, on the primary side, other than the marketing department itself, in more direct contact with our producers than any other discipline in the industry. We know what they need. We know what they want. We know what they're not getting. And we can bring an awful lot to bear on what a reinsurer can do to help us serve our producers, and, quite frankly, everything that we do in the primary business is geared to making more and profitable sales. This kind of thing can be very important in determining which reinsurer or reinsurers can best help us achieve those profit objectives.

Another reason for underwriting involvement in reinsurance negotiations is that we are developing more and more underwriting-intensive products in the 1990s. Jack chatted a little bit about last-to-die products, and these things are extremely underwriting intensive as far as what degree of substandard severity you're going to accept on one or two lives, and whether or not you're going to issue uninsurables. What basic mortality limit are you going to put in there? Is there a split option? Does your split option require underwriting or is it guaranteed? These types of things that underwriters are getting involved in will help them serve you better in playing a part in determining where reinsurance should go. So I would encourage all of you in the primary business to chat with your underwriting officers, and get them more involved in reinsurer selection, and you in the reinsurance business to get your reinsurance underwriters more involved in picking the companies that you want to price aggressively for. It's extremely important

because, as I said, product performance is the major responsibility of the underwriting department. Whenever I talk with underwriters I like to point out that we are actually producing a product. An underwriter thinks of their job too many times as an abstract thing, but it's not. We're laying something out before our public, who are the producers of the company, and that product that we're laying out is a policy. Hopefully, a policy that is underwritten in such a way that it is going to be a benefit to the consumer, profitable for the agent relative to his commissions and persistency bonuses, and help us meet our profit objectives as companies. So, let us play a part in managing the product that is reinsurance, because reinsurance, as you know, is certainly a product also.

Service is what we require in underwriting from a reinsurer. Once the treaty is negotiated, we have to live with it, and the services that we live with are what determines whether or not that reinsurer is doing their job for a primary company. We need market familiarity. We need people underwriting our business that know what the contemporary issues are in the direct insurance marketing arena of today. We need them to know what's new in the estate planning area. We need them to know that we can't evaluate a business when we're looking at it for a buy-sell agreement based on book value. We need to have reinsurance underwriters that are amenable to looking into market value, that are amenable to talking with their financial people, and if they can't determine from an annual statement how much this business is worth, that they're going to go to their financial people who can.

One of the things that I've said quite frequently lately to reinsurers on the phone, and this is not meant as a criticism, it's meant as something that I think might help, is that in too many circumstances reinsurance underwriters have not been in the real world for the last 15 or 20 years. I feel like I can say that because up until 15 months ago, I hadn't been in the real world for 15 or 20 years. We need a dialogue with reinsurance underwriters that includes, for example, when they come to visit our offices, time spent with our actuaries and, maybe more important than that, time spent with our marketing people. I want the people that underwrite my business at Transamerica to know who my big producers are, and to know what kind of business they produce. If some producer's persistency hasn't been all that good over a period of years, and if I've got a $15 million case on my desk that I've got any little question about persistency on, I want to be able to talk with this guy up-front about it. That's because, believe it or not, primary companies lose just as much when a case goes off the books as reinsurers do, and we're as interested in persistency as people in the reinsurance business are. So this is very important to us, and I'd like to have that kind of relationship with the people that underwrite my large cases, so that I can be very blunt with them on persistency. I'd also like to have the kind of flexibility with them that enables me, when I see that I've got a risk that might potentially prevent me from collecting a lot of money for persistency reasons, to be able to do some negotiating on that risk.

If I've got a risk for $10 million that I know is likely to stay on the books for only four or five years, I've got an insurable event, but I don't have it on the primary basis, on a full commission or full compensation schedule, and the reinsurance company doesn't have it on a full coinsurance allowance schedule. I'd like the opportunity to negotiate with the reinsurance underwriter as I bring my commissions down, in conjunction with Mark and some of our marketing people, to get you to participate on the risk if you also bring your

levels of compensation down. This is something that we've done at Transamerica quite frequently recently. Some of our reinsurers have been very helpful in that area, and some of them haven't. It's a fact of life that if we have a contract out there that's a keyman contract, and it's going to last for four or five years, somebody's going to write it. We want to write it profitably, and if we know we're only going to break even if that product stays in force for seven or eight years, we've got to be able to do something to compensation. We need reinsurance support in allowing us to do that. That's what I mean by being close to the market. I also need a reinsurance underwriter who is close to the market when it comes to being able to recognize that the most important thing I can do for a producer is help to issue a case as applied for -- the borderline or Table 2 case, that we have some sound reason to take standard. I need their help in doing that.

Contrary to what Jack is saying, and I know highly rated cases are important, and they might be important for an individual producer some of the time, what I need more than anything else is the ability in the low to moderate substandard area where we know more about mortality in underwriting -- I need the ability to help place that case in the best possible light for the company and for the producer. I would like to be able to call my reinsurance underwriters and basically say this is a Table 2. I know it's a Table 2. This agent basically produces $150,000 in commissions a year. I need some help on this. Rest assured as reinsurers, that when I do this I recognize from my dialogue with Mark that I don't have a whole lot to play with when it comes to underwriting on a lot of my products, and that we're doing this on an individual basis because in our minds, the business decision on that case is an extremely important one.

Trust is the other thing we need in our reinsurance underwriters. They need to recognize that we in the primary business are not unsophisticated, unfamiliar with medical mortality, and not at all familiar with financial underwriting. You know, there were a lot of times when reinsurance people, and I did it myself, sat in an ivory tower and decided that most underwriters in the primary business didn't know what they were doing. That's just not the case. They do, and I think that's got to be recognized. You have to trust our business judgment as long as we haven't burned you. If we're making bad decisions, you're going to know about it quickly enough, and I think that's when we talk about lack of trust.

There were primary company underwriters, when I was in the reinsurance business, that I'd take $5 million from on a phone call. Then there were underwriters that I wouldn't take five cents from on a phone call. It's a reinsurance underwriter's job to know which underwriters do, and which don't, deserve that kind of trust. What I'm asking you to do is, if we have not shown you any reason why you should not trust us, recognize us as being able to manage our business. We're the ones that basically know our mortality objectives and our producers' needs better than anyone. If you in the reinsurance business let us, we can guide your underwriters a little bit in the direction that will help them react in a way that's going to be more profitable to you and to us. As I said before, I would also like them to have some more familiarity with our products and producers.

One of the things I was chatting about at dinner last night was perhaps the opportunity for some significant reinsurer participation in agency meetings, at conventions, and just

sitting down over a drink and talking with our producers to recognize that these guys know what they're doing. I think that's an excellent idea. I speak quite a bit at agency meetings around the country, and I would love to have a representative of the reinsurance industry with me, because one of the biggest questions I get whenever I speak is, "Who are your reinsurers?"

It used to be that it was taboo for a primary company to talk about who it reinsures with. Reinsurance was a deep, dark secret that was not to be known to the producer. Those days are gone. They know who we reinsure with. They have a right to know who we reinsure with, and, quite frankly, at Transamerica we're proud to tell them, because we, as Jack and Northwestern Mutual, make certain that the companies that we do business with have a great degree of financial strength because we want our policyholders protected as much as Jack's and any other company does. So, we're proud of our reinsurers, and we'll talk about that. If the reinsurers were represented at these meetings, I think we could make an awful lot more points as to why we've chosen these reinsurers. So, I'd encourage you to talk with your client companies about perhaps getting involved in something like this.

The second thing we need is innovativeness and ability to respond to producer needs. We're seeing a lot of companies getting into a market now with a kind of hybrid product between group and ordinary, where we're going in on an employer basis, not necessarily payroll deduction, but voluntary group types of products. And AIDS has kind of put a crimp in this because we've realized the antiselection that can occur there, but I think what we've got to do is get more reinsurers involved in helping us design these products. If we can put together a scheme developing ways of utilizing participation limits, ties to salary and a little bit of modified underwriting, I think our mortality is going to be good, and we're going to be reaching a segment of the marketplace that's only reachable in that way.

I heard it said once that perhaps 90% of the agents concentrate on the top 20% of the social-economic group, the debit agents concentrate on the lower 10%, and the 70% in the middle is not really contacted at all other than through their employers. This is a market that we think is out there, and it's a market that we'd like the reinsurers to help us respond to. We need some of your expertise in that area, and we'd sure like some more activity on the part of reinsurers in helping us deal with that.

The third area is flexibility. We need in this business to be very flexible if we're going to produce a product that's going to achieve its goals. I tell underwriters when I'm training them, and when I'm working with them, that the underwriting decision is made up of three basic parts: the medical decision, the financial decision, and the business decision. Those three in sum total make the underwriting decision, and the good underwriter has the judgment to know in which percentage those three decisions need to be applied in each particular case. As far as the business decision goes, he is the one, or she is the one, in the primary company that knows best where that comes in. We need flexibility on the part of the reinsurance companies to understand that if I've got an agency that's producing $6 million a year in premium, of which my reinsurers are getting a significant share, that I've got to treat that agent a little bit differently than I do from an agent that's just starting with me or producing $50,000 a year in premium. That's a fact of life,

and it's a fact of life that the reinsurance community needs to get involved to help us meet our objectives.

I want to chat a little bit about facultative reinsurance and shopping programs and what happened. I like to call the period of the late 1970s and early 1980s the facultative feeding frenzy. Everybody wanted more market share. When automatic market share could not be increased through aggressive pricing, companies decided they were going to do some things with their facultative books of business, and there was a period of time when reinsurance actuaries were pricing coinsurance at 50% of 65-70 Select and Ultimate, and then underwriters were automatically cutting four tables off the same products. This just doesn't work. The reinsurance actuaries and the reinsurance underwriters probably did not know what each other were doing. Well, what happened was that primary company underwriters had to take advantage of this facultative feeding frenzy because the marketplace found out about it. Some reinsurers went out to the marketing people and talked about their appetite for facultative business. Naturally, the marketing people came back in and told us what we had to do. So, what we had was facultative cases going out perhaps to six or seven different reinsurers.

Primary company underwriters saw the offers that were coming in and they had to accept those offers, because their marketing department demanded it. But they said, "Hey, there's no way I'm retaining anything on this piece of business." So, they ceded 100% facultatively. Well, lo and behold, the reinsurers found out that their mortality on nonretention, facultative business was awful. Then they started to blame primary company underwriters for selecting against them and started instituting forced retention programs on facultative business and started raising prices significantly on facultative business. From my perspective, it was done because of mistakes that were made on the reinsurance level, not at the primary company level. As a matter of fact, I think the primary underwriters were the smart ones when they said, "Hey, I don't want a piece of this thing." It wasn't because they were selecting against you. It was simply because your underwriting had gotten to the point where it was ridiculous.

What we're finding now is that reinsurers, in my point of view, have reacted to that bad mortality and pulled back too far, and we find them from the underwriting standpoint now more conservative than they ever have been, and more conservative than we would like them to be based on what we think is the improving mortality both in our book of business, and in their book of business. There's no question in my mind that mortality has improved on the reinsurance side, and I think it's improved because of what's been done both to your pricing and to your underwriting.

The underwriting losses happened because reinsurance underwriters, as I said, combined aggressive mortality assumptions with table cutting. I don't think we in the primary business want to be blamed for that, and I think we would like to see you go back towards middle-of-the-road underwriting. There's a difference between very, very liberal underwriting that's going to cost you money, and it did cost you a lot of money, and then responsive underwriting that's reacting to today's mortality trends.

I'd like to talk about some of the things we need in the older-age marketplace. This is an emerging marketplace, and it's one that goes along with everything else that's been

happening in the world. People are living longer. Anybody that takes a look at the 75-80 mortality study, and compares it to the 65-70 mortality study and analyzes what's happening, is going say things like, "Let's get some products out there that we can issue with the older ages, and let's institute some lifestyle underwriting at the younger ages." Accident mortality at the younger ages is a problem. We've got to do something about that and be active about that, and we are at Transamerica. We also have to be active in going after that market segment where we see mortality leveling off and coming down, and where disposable income is at an all-time high. I have written, or tried to write, several very large cases recently where individuals are over age 80. Some of my reinsurers have helped me. Some of them have made blanket statements that, "We don't reinsure any lives over age 80." That needs to change. You need to do it carefully, but you need to recognize that these are buyers that are probably going to provide us with a significant premium income, and I think buyers in whom mortality is going to be acceptable enough for us to make significant profit margins.

I'd like to talk about rehabilitation. Jack discussed some books of business -- select and ultimate basis and other kinds of term generic type of format -- where there's a lot of internal replacement going on, internal and external. Transamerica certainly was one of the players in the large-term market as were several other ceding companies. It's very important that you as reinsurers work with us in trying to rehabilitate those blocks of business. We need some creativity and helpful ideas on how we can handle internal replacements on a profitable basis to us and to you and not have "churning," as went on in the mid-1970s and early 1980s, continue to go on in our blocks of term business. We'd like activity in that area.

One thing I'd like to leave you with is, be you on the reinsurance side or on the direct side, get your underwriters involved in making some decisions. They're really pretty smart, and I think they can provide some good input into the areas that you want to be aggressive in, and in the areas that you don't want to be.

MR. JOHN E. TILLER, JR.: It's difficult in a group like this, I think, to follow an outstanding speaker like Ron who comes from a different point of view and has underwriting expertise. I think both Ron and Jack have done excellent jobs of presenting a number of views, and I want to say that I enjoy speaking to underwriting groups, too, Ron, because they listen to somebody different, too. I agree that we need to have more joint activities with these groups.

I will try not to repeat the comments of the other panelists except where I feel some additional emphasis is needed. In general, I agree with their comments. I was asked by Mark to represent the small company point of view. As I looked through the material that the others put together and saw who they represented, I decided I'd expand that to cover the medium company because I don't think either one of their companies fits in the category of small or medium.

The small company and the medium company have basically the same needs for reinsurance that the large companies do. The priorities and the mix of products and services may vary, just as I think you've discovered they vary between a Transamerica and a Northwestern Mutual, but the basic needs are the same. Perhaps the primary

difference is that the small company typically will not have as much inhouse staff or expertise to deal with certain problems, and they're probably more dependent upon the reinsurer to help them in certain areas. Quite frankly, I suspect that Transamerica, or Northwestern Mutual, and many of the large companies, could probably do anything they want on their own, with the possible exception of placing a $50 million case. The small company may actually need the reinsurance to survive or to be competitive.

I want to first address the three questions in the program, and then talk about a few other topics. I've chosen to address these in reverse order, probably because of my own perverse nature.

Is the reinsurance treaty a "Gentleman's Agreement," a handshake, a way that you do business, and you don't really need this piece of paper? No!! It's my opinion, and I think the rest of the panel agree with that.

There are still some elements of a gentleman's agreement that you must deal with and you should try to deal with. This is still largely a business of people, of contacts, and of trust, and I think both of these guys have brought that out. But the profit margins are too low to ask many favors of the reinsurer or ask them to "help me on this one, and we'll make it up in the future with some more business." That doesn't happen.

Part of that is the fault of the reinsurer. Part of that is the fault of the buyers. Part of that is just a function of life. Profit margins are too low today to allow for that type of business decision on an ongoing, every day basis. In negotiating a treaty, and I think Jack emphasized this, define every possible element upfront, everything that you can think of. There will still be some unforeseen events that you'll have to deal with. Treaties negotiated 10 years ago didn't foresee internal replacements, for example, and that's something that has to be dealt with today. The more that you can document today, the more situations you can think of that you can provide for in the treaty, the more it will give a guideline as to how things should be handled in 5, 10, or 20 years. After all, as we've already heard, one party or the other to this agreement may go out of business or change ownership or change direction, and, on top of that, the people doing the negotiating, the people doing the handshakes, change jobs, they retire, they die. Things happen that lead you to need documentation in the treaty of what's going on, and I don't think I can emphasize that enough.

Reinsurers and reinsured companies both are much more prone today to go to arbitration or to take legal action where there's a difference of opinion. It seems that almost on a weekly basis, at least a monthly basis, I now hear about an arbitration that would not have happened before, a legal case that would have been settled previously. We have addressed the denial of claims earlier in this session. One reinsurer last week had said it had settled a claim for 60% of the face amount because the underwriting wasn't up to the agreed upon standard and there was a lot of documentation in the files as to what that underwriting was intended to be. The ceding company had not continued that underwriting, and therefore got 60% of what they could have. Quite frankly, had the case gone to court, the reinsurer might not have paid a penny.

Think about that a little bit, some of you that are on the ceding side. Nearly every one of the cases that I've seen involving legal action or arbitration was the result of poor management or lack of attention to detail. In some instances, there's a problem with an unforeseen event such as an internal replacement and the continuation of coverage, but most of that actually could have been dealt with if people had thought through what was actually happening and what should happen in the reinsurance market and the reinsurance transaction at the time they took the actions that led to the disagreement. On top of that, some reinsurers are contemplating raising rates on in-force treaties where experience is bad. Most of the treaties, YRT treaties in particular, give reinsurers the right to raise rates.

So, basically, you no longer have a gentleman's agreement. I think you should treat the treaty as a legal agreement with obligations outlined for both parties, but deal only with those parties that you trust. A reinsurer has no business dealing with a ceding company it does not trust any more than a ceding company should deal with a reinsurer it does not trust, or does not believe it can deal with.

Try to negotiate reasonably in any settlement. Neither party is going to gain in stature or reputation, and probably not too much economically, from a fight. Despite the "follow the fortunes" philosophy that many reinsurers have adopted and on which many ceding companies depend, the economic and other interests of a ceding company and a reinsurer may diverge in the future even though they are consistent today. And then finally, as I said earlier, document everything that you can. That may help you avoid a misunderstanding later.

Question #2. Has the market tightened? Well, to answer that I think we need to go back into a little history and maybe talk about the era of the feeding frenzy that Ron referred to. Let's try to look back to the era that I believe set the psychological expectations of most ceding companies with respect to the reinsurer, say the era of 1980-1985. You could broaden that to 1975-85, but somewhere around the early 1980s. There are two sub-eras in there. The years 1980 through 1983 were marked by the term wars, where everybody was increasing market share on both the direct side and the reinsurance side by lower and lower cost term, nonsmoker policies, and mortality improvements. To some degree, that was also fueled by the fact that there was a nice "golden goose" of tax-motivated and tax-driven reinsurance for some companies. Market share was the name of the game. We were all going to make a bunch of money.

The years 1983-1985 saw a shakedown -- a kind of a shock treatment. All of a sudden, people realized that certain individuals were moving policies every year. The classic story is a policy on an individual which was moved every year for nine years. Seven of the nine years the same reinsurer had it as a new, automatic case from a different carrier, each time paying a 100% allowance. That was even worse than Ron's story. It wasn't one year of no premium, it was seven years of no premium. The case finally stopped moving, incidentally, when the owner became uninsurable, and the ceding company had to pay a renewal reinsurance cost higher than its direct cost, and didn't understand why the reinsurer didn't have any sympathy.

A number of carriers moved out of the term business in particular and there was a wind-down in this particular era of competition. From 1985-1990, there was a refocusing of the reinsurance business, and a workout of the marketplace. So, it's my belief that the early 1980s formed for many people and many companies the current concepts of reinsurance, basically including the idea of the reinsurer being the ultimate risk-bearer. In 1990, I think it's important that we realize, as both Jack and Ron have stated, that there is a need for both parties to make a profit.

So, has the market tightened? Yes. I'd like to discuss it a little more deeply, though, by dividing it into two separate market segments, the financial and the traditional marketplaces. Financial reinsurance is the normal surplus relief, noncash flow reinsurance used to support certain blocks of business or improve the balance sheet. That market has gotten somewhat tighter. Pressure from regulators and the IRS has put the reinsurers in a position that they can no longer rely on the terms of the treaty to provide protection. They have to underwrite the block of business and the company involved. They must do that much more carefully. Some of the suppliers of the surplus relief reinsurance will directly reinsure or deal with only Best's A or A+ rated carriers. Some will deal with other companies only by bringing it through a third party reinsurer who has to take some sort of risk. Less supply, which is what this means, implies a higher cost, or less availability of the coverages.

Now, this is an interesting marketplace in that there seems to be a continual flow of new entrants and of companies exiting the market. The Colonial American decision from the Supreme Court last year effectively moved some carriers out of the marketplace, but we see other new carriers coming into that marketplace. So, that's a fairly healthy market, which is a little bit tighter, but I think it's a healthy tightening.

And the traditional marketplace appears to me, as an independent outside observer, i.e., a consultant, to be somewhat tighter than it was in 1985 and definitely tighter than it was in 1982. Last week one of my partners and I were visiting with a major reinsurer. In the course of dinner conversation, we identified seven, and only seven, reinsurers that we felt were truly active on a broad scale in the excess automatic and facultative reinsurance marketplaces. No names. You make your own list because my seven didn't happen to agree with their seven, but we all came up with seven.

Many other reinsurers have focused onto specific, and typically relatively small, specialty or niche markets. The reasons for this have been gone over, but just to hit them again quickly: Persistency, especially on the term business. Poor experience, people got out, just what they should have done. The AIDS hazard has definitely impaired some companies and made them more concerned about the marketplace than they might otherwise have been. Expenses -- acquisition expenses, especially in the facultative market -- can be horrendous. And finally, overall profitability. Is there enough return in this business to make it worthwhile?

The results of all these concerns is that there is somewhat less supply in the reinsurance marketplace. Strangely enough, I don't hear any buyers complaining that they can't get reinsurance. As someone pointed out, fewer competitors does not necessarily mean less competition. There always seems to be an active price leader on every account, on every

quote that comes up for bid. However, it is true that the reinsurers are more focused on profit than they have been in the past, and much less on market share. Prices are still relatively low, but the price of reinsurance is still a fair buy on a broad basis. Some reinsurers have exited. Some are in the process of exiting. There are few, if any, new entrants. Certainly in the last couple of years, there have been no major new entrants into the reinsurance marketplace for excess automatic business, or for facultative business.

Overall, I believe that these trends mean a tighter but healthier marketplace; healthier in that there will be more stability, and the companies won't be entering or exiting marketplaces. They'll be able to make a proposal and a deal that they can support. Better chances of profits for everyone due to better discipline, and that should help everybody down the road.

In fact, based upon my informal survey and dinner conversations, my opinion is that the aggregate profits of the reinsurers is probably at an all-time high. Now, before all of you that are working for the ceding companies go out of and start pounding on your reinsurers to get better quotes, and before the reinsurance people want to put cyanide in my lunch, let me qualify that statement. Aggregate profits are probably at an all-time high, but a lot of that is because we have an all-time high in volume, and also because there's been a cutback. Reinsurers are reaping renewal profits without investing as much or as hazardously or as ridiculously in new business. I think there are still significant questions about whether most of the reinsurers are receiving appropriate return on investment results, or getting appropriate rewards for the risks that they are taking. From an investor's point of view, I would question the validity of going into or expanding this market. So, basically I think you have a commodity market that's fairly tight, but the prices seem to be relatively fair now. If you were judging this market on a value-added basis as an investor, you would have some significant questions.

What is the view of the reinsurance market? Let's go back and look at that from a small to medium-sized company point of view. I did have some doubts about my qualifications to speak on this topic, having worked basically for a large company and consulted for large companies, but I've also consulted for small companies, and as Mark pointed out earlier, I do have 20 years' experience. This sounded impressive until one of my associates asked, "Well, is that 20 years or is that one year 20 times?" So, draw your own conclusions.

First of all, as I said, the needs of the small to medium sized company are very similar to those of the large company, and those needs have been very eloquently put forth. Capacity on large risks and underwriting are of paramount importance to these companies. Surplus may also be a need; the capacity to produce business on an economic scale that allows them to cover some expenses and make a profit. Probably the primary need for reinsurance in the small to medium companies is to allow them to compete with the big boys. As I said earlier, a lot of the big companies can do just about anything on their own. Reinsurance is probably essential for the small company, in particular, to compete. Many large companies have similar needs, of course, especially in the area of surplus. So, nothing we're saying here is really unique to smaller companies other than that crucial aspect.

Smaller companies may be more reliant upon the technical staff of the reinsurer, especially the underwriter. Ron has gone through those uses very well. I'm going to disagree with something that Ron had in his notes and that was the statement, or at least the implication, that the expertise in the underwriting business now resides with the direct carriers rather than the reinsurers. That may be true in the companies with large underwriting staffs, but for smaller companies that have very limited underwriting staffs of one, two, or five individuals, or maybe even 10, the situation is different. The ceding company, or direct writer, has to look to its reinsurers for information on trends and products. They also may provide actuarial advice, but the need for training programs, seminars, and underwriting manuals is very important. Underwriting audits that you heard about earlier are also extremely important to help keep them both current and competitive -- to let them know the market hasn't passed them by as to how they should be underwriting, but also to verify that they haven't gone too far off the deep end. I think too often the audit focuses on, "Are you guys conservative enough?" and not often enough on keeping up with the marketplace and what a company should be doing. Proper underwriting audits also help avoid the conflicts at claim time that Jack Bailey described. A review of facultative procedures and administrative procedures during underwriting and administrative audits can also save a lot of trouble about, "Whose claim is this?" down the road.

Other areas of service? The smaller companies are perhaps reliant on reinsurers for general information; you might call it gossip, but it is more product trends. They look to the reinsurer to provide advice or to act as a sounding board not only in underwriting matters, but in actuarial and marketing matters. Often these companies cannot take on a new venture or a new product or enter a new market, without assistance from the reinsurer. In essence, the reinsurer is a true partner in the venture. The ceding company needs help, as Ron stated, in things like rehabilitating select and ultimate term portfolios. Administrative audits, especially for self-insured business, can be terribly important to a small company. Jack emphasized that importance at Northwestern Mutual. I contend that it's even more important at the small company. NML has a $10 million retention. Quite frankly, as you said yourself, a million dollars isn't going to affect your dividend scale much. How many companies in this country could take even an extra $100,000 risk on an insured, let alone a million. It is vital to the small companies that they have good administration, and I think it is vital that the reinsurer help with it. If the reinsurer wants good claims and good administration, then they should provide some guidance as to how to go about it.

Let me just echo Jack's comment on joint audits. I don't see why more joint audits can't be done on both administration and underwriting. I think most of the companies would be glad to see reinsurers come in once, and do it thoroughly and do it right together, than to have consecutive meetings costing both time and distraction. I know there may be some concern over the issue of antitrust, but I believe that the attorneys are smart enough to work out a way to do that.

Ceding companies must realize that all these services and protections cost money. Reinsurance should not be bought just on a matter of price. When I was in the reinsurance accepted business I often saw proposals turned down because we were two-cents-per-thousand present value of profit or five-cents-a-thousand or ten-cents-a-thousand

present value of profit different from somebody else. And somebody says, "That's a big difference." If you're looking at $20-30 million of ceded volume per year, what does that total? Five cents a thousand on 20 million of volume, present value spread over 20 years, is a thousand dollars. I take a lot of pride in my actuarial skills, and most of you do, too, but I don't know anybody that can price that precisely -- not even close. So buyers, look at what you're getting, not just at the bottom line numbers. Consider Jack's criteria for choosing a company and add a few of your own. Services necessary for small and medium sized companies may have a different mix than for the big boys, but I'm not convinced that that's necessarily a reason to make them more expensive. Price them appropriately.

I have two other areas I would like to cover. The first is a coming or a growing trend called joint ventures. So far the comments of the panelists have all been focused on the relationships for the normal uses and normal suppliers of reinsurance, including my little foray off into the financial reinsurance marketplace. I think we need to spend some time focused on what may be the most important use of reinsurance in the next decade -- joint ventures.

Joint ventures mean different things to different people. But, very simplistically, define it as a relationship where one party provides distribution and the other party provides a manufacturing capability. This is really a reallocation or a redeployment of resources. Reinsurance has always done that. One of the good things about reinsurance is it allows you to bring capital and capacity to different marketplaces without having to go through a lot of legal rigmarole of minority stock or any sort of investments like that.

Why do we need some reallocation? Why would anybody want to enter into a joint venture? Well, first is the high cost of systems support and product development which may be a barrier to many companies, and definitely to some companies, in entering into a new product or a new market. The time required to introduce a new, revised product can be prohibitive. How can you respond to a marketplace which is basically commodity-driven if it takes a year and a half to change your system and bring out a new product? Very few, if any, direct insurers, can attempt to offer all products to all people.

A major problem in most companies is expenses, and they can often be alleviated by more production. We've all laughed about make-it-up-on-volume theories, but it really can happen. If you can truly increase your marginal premiums faster than your relative marginal expenses, you can get ahead of the game. More production can help. Lower cost of introduction of products and quicker introduction are ways to lower expenses and increase production. Companies with distribution systems frequently lack the proper products, services and systems. I call those the distributors in my new environment. Companies with products and systems may have extra capacity for sales and marketing. How many of you that have a good system that is servicing your marketplace could look at it and say, "Yeah, we could take 20%, 50%, maybe 100% more business, with no real strain on our capabilities?" Those are the manufacturers.

A joint venture allows you to provide the manufacturer's product and support to the distributor's agents. They typically take one of two paths. The first of these is for the ceding company to act as a brokerage agency for the manufacturing company and to

control a lot of the brokerage and shopping that is already occurring and to collect an override. A second path is a private labeling on the distributor's paper. This sort of joint venture is transparent to the agents and to the public and usually, in either of these, the reinsurer or the manufacturer will modify the product to suit the individual characteristics of the direct writing company. Typically, the manufacturer wants not only an administrative fee, but also a part of the underwriting risk and profits. In most cases I've seen, they require that the distributor also participate in the underwriting risks and profits. The sharing, the terms of the sharing, the allowances, and the premium sharing, are all negotiated.

Advantages to the distributor include faster and probably cheaper introduction of products, a wider range of products for the portfolio for their agents, and a chance to introduce a proven product, one that's probably been tested in a similar marketplace. They know how the market reacts and who buys, so fewer assumptions are "up in the air." This allows the management to focus their efforts and resources on its core business. Typically, these products are in side lines, not into the core business. So, if the distributing company can focus its own efforts, its own systems, and its own management, on the core products, the joint venture partner will manage the ancillary products.

Advantages to the manufacturer include increased production and a lower cost of acquiring production and distribution capability (or agents, in other words) than by doing it directly. Their expenses can be spread over a wider base.

Disadvantages, and, yes, there are some, to the distributor, are that they lose some control over plan design and management of the in-force. That is important to a lot of people, but what is more important: absolute control or survival? For the manufacturer, a disadvantage is that the distribution source may not be loyal or dedicated, and it can disappear at the end of a contract period.

This is going to be a major marketplace. The players in this so far have not been the traditional reinsurers, but the potential is great. One of our clients that is active in this market advises that in 1990 it expects to receive between $50 and $60 million of premium. How many reinsurers do that much? Now, of course, this premium is direct premium that carries commissions and expenses with it, but it is real. Several companies, both large and small, are considering joint ventures. Amazingly enough, they're considering both sides. Some companies are willing to be the manufacturer in one case and the distributor in another. As I said, joint ventures primarily are for products other than the core products. I think one area where we will see tremendous growth is in the long-term care which takes a large systems investment, a specialized underwriting capability, and an investment management capability. Another boon area potentially is annuities. Everybody writes a little bit of annuities, but how many write enough to really be effective? Another possibility is payroll deduction which requires unique types of systems. Some smaller companies, however, and at least one large company, are actively looking at this for their main line of business. The potential is very great.

The final opportunity for reinsurance that I'd like to bring up formally is probably aimed more at the medium- and small-sized company, but it could certainly be aimed at the larger company, and that is support in the event of an acquisition. As many of you

know, there's quite a bit of consolidation and specialization occurring in companies today. Many companies have found that they cannot be all things to all people, and, therefore, they're divesting in-force blocks of business. Perhaps this is an individual health line or disability income line. Perhaps this is an old par or nonpar whole life line because the company wants to focus strictly on modern, interest sensitive lines. By paring down the number of lines that the company administers and focusing on its core, the economics of the expenses can improve dramatically. It costs a lot to support a hobby business, and none of us can afford to be in a hobby business anymore. So, some companies are selling off or divesting of these old, closed blocks or small blocks. Sometimes this goes into a joint venture, allowing management to focus on the core business, and generally creating a profit that allows additional capital for that core business.

On the other side, some companies are looking to acquire matching blocks of business. They can spread their overhead, system expenses, administration, whatever, and maybe improve their market share. Sometimes you could acquire a small distribution force, or even a large distribution force. I am aware of at least one debit company, fairly sizable, that was sold through a reinsurance arrangement rather than selling the company. They just sold off that line of business, including the agents.

Many of the buyers of these small blocks of business are relatively small companies themselves, and don't have enough surplus or capacity to carry off the arrangement alone. They can look to the reinsurance marketplace to fill that need. This is different from the typical surplus relief in that it is matched to a certain acquisition and growth strategy. It is sometimes on a real cash basis, and probably is a long-term arrangement. It's also typically put in place before the final acquisition deal is signed. Reinsurance of this nature will come both from traditional sources and from new sources that are used to assist in these efforts.

In conclusion, the needs of the small- to medium-sized companies are very similar to large companies. The priorities, the emphasis and the product mix may change. Reinsurance, however, is much more crucial to the survival, the prosperity, and the long-term growth of the small- to medium-sized companies than for the big boys.

MR. HUG: Let me quickly summarize, and then we'll go to questions. First, I think the panel discussed the need for both parties to make a profit. The parties may be a ceding company and an accepting company or a distributor and manufacturer, as John pointed out earlier. We want to do this through increased communication, through a service-intensive environment, and through higher trust levels. These items are the same, the needs are the same, whether it be a small company or a large company. It's just that they manifest themselves differently depending upon the size of the company.

The market has tightened, we believe, especially in underwriting, but it has also tightened in price. We think this is because reinsurers tend to be more profit focused, which is probably necessary for the long term, and because the 1980s frenzy has probably caused somewhat of a turnback in the market for the 1990s. Reinsurance is no longer a purely "Gentlemen's Agreement." Now, because of more litigation, we need to have clearer contracts. The contracts need to be set up in such a manner to try to anticipate

what is currently not anticipated, and that's very difficult, and that means more time and energy spent at the beginning of the process as opposed to during the claims processing and litigation. That's about all we covered today, in a nut shell.

MR. ANDREW C. BOYER: Mr. Bailey made the point that when an indeterminate premium plan is coinsured, the reinsurer should have some input in the decision to raise premiums because its profits would be affected by higher lapses, for example. Would you extend that idea to reinsurance on a YRT basis? And, if so, why not extend it even further to universal life cost of insurance charges and interest credited? And what effect should the reinsurer's right to raise YRT premiums have on the repricing decision?

MR. BAILEY: Yes, I would extend this to other forms of reinsurance. I think about it mostly in terms of coinsurance because that's where we have large volumes. Most of our YRT is excess, and if you have half of 1% of your block reinsured, you don't necessarily think of involving the reinsurer in a pricing change of that nature. But conceptually I think the idea is the same, especially where the reinsurer has a significant part of that risk.

MR. TILLER: The question that occurred to me is why not extend this concept to changes in dividend scales also? But we may not want to discuss that at this point. As a practical matter, I don't see how the reinsurer can be involved in every change in an interest sensitive product, especially in credited rates which might change monthly or even more frequently. What is important and could be done is for the reinsurer and the ceding company to discuss the interest crediting and cost of insurance strategies up-front, so that the reinsurer has an idea how the company is going to respond to change in the environment. As long as the company is responding in that general manner, the reinsurer has bought into the strategies and should be willing to accept the results.

Most of us have heard stories of somebody wanting to buy a block of business and then drop the interest rates down to the bare minimum guarantees, because there is immediate profit due to surrender charges, for example. That would be a case where the reinsurer has a very legitimate gripe against what's going to happen, even on a YRT basis.

MR. COURTLAND C. SMITH: I'm with a reinsurer, a start-up actually, one of the new ones. Before I took that position I asked them seriously if they really knew what they were doing, and they said they did. I'd like to ask John Tiller a question with just a brief preamble. I am still hearing horror stories of some of the things that are going on in some reinsurance shops which represent faulty communications, in some cases non-communication, between the underwriting side of the shop and the actuaries, actuaries pricing on a certain basis, underwriters apparently still giving away tables as they did in the glory days -- not quite as many tables, not quite as often, but still doing it. I don't think the margins are there, and I don't think the margins are there on the direct side, but I'm wondering what John thinks, because I really don't think we're going to get the kind of health that we need back into this business until there are adequate margins to run the business properly. What do you think, John?

MR. TILLER: I'd like to quote one of my partners who was a very senior officer at a direct writing company that was sold a couple of times. When I asked him about the new owner of the company, and the price paid, he said, "Well, I stayed around to negotiate the sale, and then I went to consulting." I think that reflects the attitude many of us have. Frankly, Court, I don't think the margins are there. The industry is terribly unhealthy. I don't think it has enough discipline. Mortality protection and, to a lesser degree, in my opinion, tax free accumulation are the two things that this industry has to offer the public, and I've been saying for eight or ten years that we're selling those too cheaply, especially the mortality aspect.

Yes, I question whether or not the margins are there. I think it's going to be a very thin margin business for a fairly long period of time. I think it's very important to price carefully, to know with whom you're dealing, and to underwrite carefully. I've not heard too many reinsurance horror stories recently, but it wouldn't surprise me. I don't think anybody has as effective communication system as they can.

Agreeing with Ron, and I think Jack brought the point up too, any reinsurer that doesn't have the underwriters and the actuaries talking before they're setting assumptions and trying to categorize the company is setting itself up for a major problem. Some reinsurers are doing that, and they're going to be able to underwrite more effectively. But I don't think the situation is as bad as it was seven years ago at this time when there was a seminar on term insurance and everybody got together and bemoaned all the problems. There are profit margins available, but they're very thin, and I think it's very difficult to get a proper return, and almost impossible to get the return necessary to support the real risk in this business. It's going to be interesting to see what happens with the future of something such as AIDS, for example, which is definitely causing an increase in claims.

MR. COLLIGAN: I'd like to make a comment on that. We still make it a practice at Transamerica, if we send a case out facultatively and one or two offers are way out of line, too liberal, of calling the reinsurer and giving him another chance to look at it. That happens much less frequently now than it used to, and we're finding the reinsurers a lot more thankful and not saying, "Well, we know what we're doing," and not taking the attitude of, "Well, who do you think you are, calling us up to get us to change an offer." So, I think a lot of that has stopped. One thing I'd like to say about the need for business decisions, as we talked about before, even in a thin-margined product, the underwriter does need to have a little bit of flexibility when he or she is making a very informed business decision, if we're going to be able to compete in the marketplace today. When I talked about business decisions and table-cutting and that kind of thing, they're the exception rather than the rule, but we can't have all of the flexibility and competitiveness of the company on the pricing side. As I said before, underwriting is a marketing tool, too, and reinsurance underwriters, as well as primary underwriters, do have to have some flexibility to react to the competitive environment they find themselves in. As far as the horror stories go, though, I really don't know of any, and I stay fairly close to the reinsurance marketplace.

MR. MICHAEL PALACE: I hope Transamerica won't be accused of monopolizing this, since I also work at Transamerica. One of the more very prosaic concerns that I have, as an actuary responsible for a lot of the reserving that goes on our direct business, is

one of our obligations to our reinsurers to ensure that they have adequate and appropriate information to fill out their annual statements and their tax forms, specifically the reserve components of them. We at Transamerica have tried very hard recently to help our reinsurance partners get some of that information. Whether or how successful we are is something we will know as time goes on. Specifically, Jack, I was just curious as to whether you have any concerns from the ceding company perspective as to whether in general, we are providing good information to reinsurers.

MR. BAILEY: You're asking if the ceding company is providing adequate information to the reinsurer?

MR. PALACE: We have groped with this question, reserving issues. A lot of it is done on the back of an envelope. We've tried to improve that situation. I was just wondering how you feel you've been able to cope with that at Northwestern Mutual.

MR. BAILEY: I guess we really haven't perceived any problems. We indicate our reserve basis and our underwriting basis to our reinsurers, and we're available for consultation but haven't perceived that as being a problem.

MR. ROBERT J. TIESSEN: I'd like to get a comment, especially from Jack Bailey, about the reinsurer's role in claims approval. I recently got a treaty where the direct writing company wanted complete claims approval, but also the reinsurer to participate in punitive damages, which seemed perhaps self-exclusive, and I'd just like to know what the panel's opinion is of where the reinsurers should come into the claims approval process.

MR. BAILEY: Well, I agree with you. If the ceding company has complete control, then there should be no extracontractual damages, and as a matter of fact, we have some agreements of that nature.

MR. TILLER: By and large, I think that the ceding companies are wise if they at least discuss some questionable claims with their reinsurers. Quite frequently, the reinsurer will have some other information or a different point of view that should be taken into account. You settle the extracontractual damages issue, I think Jack outlined a pretty fair procedure, that if the reinsurer participates in an activity and that activity leads to the damages, they pay. There are a number of issues which influence the amount of extracontractual damages. They're often based upon the surplus, or the penalty, or the punitive amount necessary to hurt the direct writer, and maybe the reinsurer should not be participating in that. If the reinsurer doesn't participate in the decision, and has no claims or review authority, I don't think they should participate in the damages.

MR. COLLIGAN: I think there needs to be, in this area, a little bit more communication, too. I think probably in the case of most reinsurers when they're reinsuring a large company, as far as potential for punitive damages go state-by-state, the primary company probably has a bit more information on that. There needs to be more consultation in that area. I think facultative cases where a ceding company has less than 50% of the risk is generally when you require consultation. Is that true? I think that's probably fairly standard, and that's what most of us are doing.

PANEL DISCUSSION

MR. JOSEPH F. KOLODNEY*: On the item of punitive damages, some attorney once told me that you can't deny liability for that for which you are responsible, and you can't accept liability for that for which you're not. You can't have liability forced on you. And I think in the area of punitive damages, you're seeing a big trend at least in the commercial sector, where courts are now holding routinely that companies cannot recover extracontractual damages through insurance coverage, because it's against public policy to do so. For those companies that have clauses in their agreement and think they have extracontractual damages covered, unless the reinsurer has in fact cooperated in the settlement of the claim or had an action which resulted in a punitive damage action which is sustained in the courts, I really don't see that a ceding company has a lot of recourse to obtain recovery on that basis.

* Mr. Kolodney, not a member of the sponsoring organizations, is Senior Vice President with Thomas A. Greene in New York, New York.