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REINSURANCE IN THE NEWS

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As reinsurance is used more frequently in major joint ventures and capital raising deals, it comes under increased public scrutiny from regulators, rating agencies and the press. The Federal Government also has been investigating the role of reinsurance in connection with the financial health of insurers. This session will help reinsurance actuaries prepare to give testimony and interviews, and to become proactive in explaining the needs and proper uses for reinsurance.

MS. DIANE WALLACE: Our session is "Reinsurance in the News." I was asked to undertake this assignment about six months ago with no further instructions besides the title. Thus, the only tie among our illustrious, but disparate speakers is that they will entertain us about reinsurance topics currently in the news. I think you'll find that our speakers have very interesting and thought-provoking comments to share with us.

Many both favorable and unfavorable comments have appeared recently in the industry trade press and in the general business press. Therefore, actuaries are being questioned about complicated reinsurance transactions -- questioned by our managements, by our agents, and even on occasion by our neighbors. The goal of this session is to make us more familiar with reinsurance topics that have been in the news recently, so that we can better respond to questions.

When I think about reinsurance in the news, I think about something I call the airplane test. Over the years, when the person sitting next to me on an airplane has asked how I make a living, I have tried to figure out how to respond so people will have some inkling of what it is that I do. I used to just say that I'm in the insurance business. Then I'd immediately get questions about why auto insurance is so expensive. That didn't work very well. Then I started to tell people I was an actuary. That didn't work either, because all I got was blank stares. Then we were named the best profession in the world (or whatever it was), and now everyone knows what an actuary is. So I decided I could give a more complicated response. I've been testing out the answer that I work in reinsurance. Lo and behold, people have heard of reinsurance. Therefore, I know that it's been in the news. People on airplanes now know what I mean when I say reinsurance, or at least they think they do.

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Now I'd like to introduce our panelists, and tell you about their backgrounds. Our first speaker is Allan Greenberg. Allan is chairman of Greenberg & Fickes, a consulting, reinsurance brokerage, and acquisition team. Allan has had considerable experience in the reinsurance field, particularly in using reinsurance to finance acquisitions. As you know, financial or surplus relief reinsurance has been in the press recently. An example is a headline in the May 10, 1991, *The Wall Street Journal*. "California regulators issue new rule that bans reinsurance agreements." Allan will give us some background about this type of controversial reinsurance and explain how it is used. Prior to forming Greenberg & Fickes, Allan worked for Standard Security Life. He also spent five years in public practice as a consulting actuary and eight years at the Prudential.

Our second speaker is Lavonne Paden. Lavonne is a CPA, and she is currently an Accounting Fellow with the U.S. General Accounting Office. She is on loan to the House Oversight and Investigations Committee chaired by Representative John Dingell. Lavonne is concentrating on insurance industry issues, primarily with respect to solvency. Lavonne previously had six years experience with Ernst & Young in public practice and before that she was controller of the Acacia Group in Washington, D.C. She is eminently qualified to bring us both the insurance industry and the government perspective on this high profile issue. A recent *National Underwriter* edition headline reads "Dingell Initiative Seeks Federal Accreditation of State Departments." The article also reports on proposals that reinsurance and surplus lines be subject to federal regulation. Lavonne will tell us about the thinking behind Representative Dingell's call for federal regulation of reinsurance.

Our third speaker, with a totally different topic, is Joseph Belth. Dr. Belth is professor of insurance at Indiana University, and perhaps more known to us as editor of *The Insurance Forum*, in which Joe frequently vents his displeasure at the life insurance industry. Joe has been an active writer about reinsurance issues. In a recent issue of *The Insurance Forum*, you will read an article titled "The Weakening of the Financial Standards Applied to Life Insurance Companies – The Assault on Statutory Accounting Principles," containing, among other things, information about reinsurance agreements. Joe has written recently about assumption reinsurance, where he makes such mild statements as "transferring policies to unlicensed companies is an abhorrent idea." I think we'll hear some interesting comments from Joe.

Dr. Belth has received numerous awards for his contributions to insurance literature. He has previously worked as a life insurance agent, and he's been profiled in many general press publications, most recently in *The New York Times* in 1990.

MR. ALLAN D. GREENBERG: As background to my remarks about financial reinsurance in general, it's worthwhile to talk a bit about what has happened at Executive Life and the response by the California Department of Insurance. One of the reasons given for the failure of Executive Life is the proliferation of reinsurance treaties at Executive Life. I would like to touch just briefly on one aspect of this reinsurance -- the fact that Executive Life was basically reinsuring annuities. The overwhelming majority of its business has been annuities. The annuity reinsurance essentially passed the mortality risk and the lapse risk, but virtually no reinsurance on the annuities has passed the investment risk.

If you took an anonymous survey of everyone at this session, over 90% would say that the major risk factor to an insurance company in issuing annuities is the investment risk. Yet, that element of the contracts at Executive Life was not protected by the reinsurance contract. I don't want to get into the pluses and minuses of the way reinsurance has been done. However, on annuity contracts I think we're going to see differences in the future.

I found it interesting that the response of the Department of Insurance was to look at the contractual form used in these particular reinsurance agreements and to come to the conclusion that this contract form was a bad form and shouldn't be allowed. As most of you are aware, that form is a combination of modified coinsurance and coinsurance. I visited the Department of Insurance and asked why this prohibition applies to life and health insurance, where the major risks are persistency and mortality or morbidity. The response I got was a sympathetic, "That's the way it is."

I have a great deal of fear that because of the circumstances and events surrounding Executive Life, we will see a lot of misguided regulation regarding reinsurance. I don't necessarily think the intent of the regulation or the legislation is wrong. However, I think the results achieved may be very different from what is anticipated by the regulators and legislators.

I would like to give three examples of reinsurance where any restriction other than tightening up of security requirements (with respect to reinsurer performance under the terms of the contract) would be misguided. The classic example is one we all learned as actuarial trainees in "Reinsurance 101." A small growing company does not have sufficient statutory surplus to support its new business writings because of the nature of statutory insurance accounting. The common method to solve this problem was to set up a coinsurance agreement for a substantial portion of the insurance issued. This resulted in a mitigation of the risk, and because of the allowances provided by the reinsurer to offset the acquisition cost, the insurance company was able to continue writing policies. Before too long, some companies thought about this and said, "Wait a second!" We all remember from "Risk Theory 101" that the highest risk parameters on insurance policies are at issue. That's when the exposure to lapse, the exposure to improper underwriting, and the exposure to bad mortality/morbidity is greatest. As the years pass, the risks become more and more known. Although substantial risk still exists, the risk of adverse deviation is reduced. Someone then suggested that if we instead reinsure business that's two or three years old, we could probably get a better price from the reinsurer and keep more of the business. If we're wrong, we pay out more claims. If we're right, we make more profit and can write more business. This marketing area was filled by some reinsurers that could afford to charge less for reinsurance because the risks were less. Effectively, financial reinsurance was formed to enable a new company to expand at much less cost.

Let me give you a second example of the use of financial reinsurance. An established company writing one or two lines of business has sufficient surplus to finance most or all of its new business. It then decides to go into a new line of business. It can try a few things to raise capital. I'd like to see an insurance company try to raise equity capital. The second thing it could do, if it has a rich parent, is to receive contributed capital from its parent. Because of the difficulty of getting capital out of

insurance companies after the contribution is made, a lot of companies are reluctant to make the necessary contributions. And, in today's economic environment, a lot of companies don't have the resources upstream to do it. Another possibility is to raise necessary capital by reinsuring existing blocks of business. The surplus generated by this reinsurance can be used to finance the move into new lines of business.

Finally, stockholders may feel that they have a better use for capital than to leave it in the insurance business. Instead of borrowing money or raising capital outside the insurance company, financial reinsurance is a method for these companies to raise capital within the insurance company and to use that capital for other purposes outside the insurance company.

In all of those instances there is one critical factor. Are the reinsurance disbursements truly payable to the company in the event of adverse experience? If there are losses, will the reinsurer pay? It is not superfluous and redundant, maybe not even applicable at all, to ask if "enough" risk is transferred or if the reinsurer is "likely to lose" money? I think there should be only one question. Will the reinsurer pay when there are losses? Or, rephrased, does the reinsurance agreement truly guarantee the surplus provided by the financial reinsurer?

Those of us in the room who have a vested interest in the health and capacity of the insurance business should try to get the regulators and the legislators to focus on that question. Otherwise, when the answer comes, it means decreased capacity in the insurance industry.

MS. M. LAVONNE PADEN: I appreciate the opportunity to speak to the Society of Actuaries on the role that Congress is playing in the world of reinsurance. Indeed, reinsurance is in the news. First, I'd like to give some background on the subcommittee's work.

The Subcommittee on Oversight and Investigations of the House Energy & Commerce Committee under Chairman John Dingell has been holding insurance insolvency hearings for almost three years. During about 14 hearings, they've explored some major insurance company insolvencies and have issued the report *Failed Promises*. *Failed Promises* examines the failures of Mission, Transit and Integrity insurance companies. These failures have been the largest property/casualty insurance company failures in U.S. history, and by latest estimates, they will cost the American public about $5 billion.

In addition, based on repeated rumors and criticism surrounding First Executive, the subcommittee was prompted to hold a hearing on that company in June 1990. The recent takeover of First Executive's insurance company by California and New York has only heightened Congress' concern. Coming on the heels of a $500 billion S&L bailout, those insolvencies have, needless to say, gained some attention in Congress. As the press, the insurance trade groups, and the public have become more jittery, Congress has justifiably turned its attention to these insolvency issues. While I can say the subcommittee hasn't reached any conclusions yet on the financial stability of the industry, I think that it has documented some very serious weaknesses in insurance solvency regulation.

Against that background, we can now talk more specifically about reinsurance. No one single factor led to the downfall in the insolvencies that the subcommittee has examined. Instead, insolvency was caused by a very complicated set of factors. In all of the insolvencies, reinsurance did at least play a key role. In fact, the subcommittee dubbed reinsurance as the black hole of insurance solvency regulation.

Reinsurance is seemingly a very straightforward concept of transferring risk among insurance companies, but in practice it embodies many complex concepts and practices. Reinsurance involves not only underwriting risk and the related letters of credit, past-due reinsurance and fronting, but also the different aspects of financial reinsurance as a separate issue. Reinsurance uses fancy terms: loss portfolio transfers, time-and-distance policies, prospective aggregates, retrospective aggregates. You can understand why congressmen are confused.

In the cases of Mission, Transit and Integrity, the reinsurance system broke down entirely through a very complicated set of reinsurance agreements. Those companies were transferring risks on extremely unprofitable business to reinsurers all over the world. When the massive claims began to come in as, of course, they must, the reinsurers yelled fraud and misrepresentation. They refused to pay or they were unable to pay because of their own insolvency. Ultimately, Mission, Transit and Integrity were all forced into bankruptcy.

Let's look at Transit specifically as an example of how an insurer can use reinsurance to take a very fast ride into insolvency. Transit decided to outrun the soft market of the 1980s by using reinsurance. It decided to get into risky lines of business, medical malpractice, liquor liability, toxic waste, and satellite launches to generate new business. The company had traditionally written 500-800 policies a year using 200 agents, but by 1981 it was using 17 managing general agents (MGAs), 1,000 agents, and were attempting to write 37,000 policies in that year. The company thought it had 450 reinsurers, but the Transit receiver has already uncovered 1,700 reinsurers and the count is going up. In his last report to the subcommittee, the receiver had recovered only 70% of the records, which Transit didn't have in its possession when it went under. Those records are now eight feet high and cover 20,000 square feet in a warehouse in California.

Transit basically was used as a front by its MGAs, and it very clearly was intending to reinsure almost 100% of that business out the back door. With a top rating from A.M. Best, it seemed perfectly suited to pursue its aggressive plan of business. The company only had $44 million of capital, but it wrote enormous amounts of business.

The receiver is now trying to recover $400-800 million from reinsurers all over the world. The letters of credit that supposedly backed up the reinsurance were woefully inadequate. Not only were loss reserves understated, but also a lot of the issuing banks wouldn't honor the letters of credit. The initially sound concept of reinsurance and risk spreading degenerated into reckless fronting, uncollectible letters of credit, and massive past-due reinsurance.

I've heard *Failed Promises* criticized for being too anecdotal. The critics point out that it's not representative of the industry, and that the problems observed by the

subcommittee were very isolated. Well, I can say that so far no one in Congress is convinced that's true.

Let me mention another case. The problems with junk bonds at First Executive are very well-known. What's less well-known or less well-understood is the problems that Executive Life of California and New York had with reinsurance. In the subcommittee's hearing last summer, quite a few questions were directed at Mr. Fred Carr on his reinsurance dealings. As early as 1986 he had taken about $180 million credit for reinsurance with an alien insurer. These were supposedly backed up by six letters of credit. When the California Department took a closer look, those six letters of credit were nonexistent, and the Department disallowed the reinsurance credit.

Unfortunately, at the end of 1989 the company persisted in such dealings. It took a $523 million credit for surplus relief reinsurance with an affiliated company. The reinsurance apparently didn't comply with the California regulations. But the amount was more than Executive Life's surplus, so the options available to California at that point weren't very pleasant. Another isolated instance? I'm not sure.

One of the basic issues that I keep hearing and reading about is the massive buildup of past-due reinsurance in the industry. Exacerbating this has been a record level of catastrophe losses in the last couple years. As concern and criticism began to mount, the NAIC moved a couple of years ago to modify the annual statement. It required a 20% charge against an insurer's surplus for reinsurance 90 days or more past due. The NAIC intended this to be a very proactive step to penalize insurers that had past-due reinsurance. Ironically, it may have backfired and not achieved what was wanted.

Some credible analysts say that $10-20 billion of reinsurance in the industry may not be collectible, but in 1989 when the penalty went into effect, property/ casualty insurers only recorded a $543 million penalty. Most of that, unbelievably, was recorded by one company. In fact, under the 20% rule a lot of major insurers actually decreased their allowance for uncollectible reinsurance. Based on recent analyses, an estimated 34% of all reinsurance is past due.

Even more scary, 20% of all reinsurance is more than 180 days past due and collectibility is very doubtful.

Even though the NAIC debated and ultimately settled on the 20% penalty, the other 80% may or may not be collectible. The top 50 reinsurers in the United States only have an allowance of 4% of their reinsurance recoverables as uncollectible. I read that the industry exposure overall could be up to 95% of the industry's surplus if you count reinsurance due from affiliates. It's obviously not a small issue, in any case. And, it's one that is not likely to go away.

As companies continue to come under more capital and profit pressures, a lot of them are turning to the practice of fronting. I've heard arguments that fronting is conceptually different from reinsurance, but the two really do work hand-in-hand. In fact, New York regulators told the subcommittee in summer 1990 that fronting was abusive reinsurance. Fronting is advantageous to the insurer that gets a fronting fee and also advantageous to an unlicensed or lower rated reinsurer which otherwise

couldn't write the business. Unfortunately, the original insurer is exposed to an enormous risk if the reinsurer can't make good on those contracts.

At the moment, very few states prohibit fronting. Last fall, the NAIC started to draft model regulations on fronting. Fronting is disallowed if more than 50% of the business is reinsured. A 50% rule does have some precedent in the United Kingdom. The solvency margin calculation permits no more than a 50% credit against reserves for reinsurance. The NAIC model, as it was drafted, had some flaws and came under substantial criticism. The NAIC, at least for the moment, backed down. Like most other things that we're talking about, the concept isn't bad. It's just that we need proper disclosure and accounting, and at some point we've got to make an assessment on how these free market activities really impact our industry's solvency. For example, the AICPA has begun discussions recently about requiring additional disclosures on fronting.

Perhaps even more than past-due reinsurance and fronting, financial reinsurance has been in the news. As I understand it, financial reinsurance was developed in the early 1980s as a surplus relief mechanism. Some people have said that it artificially increases surplus; that it's not real surplus. Insurance, accounting and regulatory experts are currently in debate on how to define it, but maybe it can be defined simply. It's really a transfer of risk other than underwriting risk, such as investment yield risk, credit risk or expense risk. Even though it's very complex, a basic tenet of this kind of reinsurance is it's utilization of discounting where the original insurer can't discount in its financial statements. The original insurer accomplishes the same thing through financial reinsurance.

In fact, a financial reinsurer recently gave three reasons for the utilization of this type of mechanism, which are probably also three good reasons why the regulators and auditors should look more closely at the agreements: (1) this mechanism permits discounting that otherwise wouldn't be permitted; (2) it demonstrates coverage to regulators, alluding that it wasn't truly coverage; and, (3) earnings could be realized by transferring current losses. I maintain that surplus generated by that type of economic situation is really an illusion. Financial reinsurance itself isn't bad. It just should be accounted for as a financing mechanism.

I agree that companies have capital constraints. But capital constraints that are artificially relieved are just that -- artificially relieved. The bending of accounting and regulatory rules hasn't changed the reality of the situation. It's just changed the perception of the reality. For an unknowing reader of a financial statement, that's not a good situation. Even though the NAIC guidelines say that underwriting risk must be passed, a lot of states don't follow those guidelines. And a lot of states have made exceptions for troubled insurers. Such exceptions are not a very comforting thought for a policyholder doing business with a troubled company.

Some financial reinsurers smugly point out that the regulators just need a good education. It's probably not an education that's needed, but courage to develop consistent and coherent regulations for everyone to follow.

The AICPA and the FASB have taken some recent steps. The AICPA has issued several statements of position that would limit current gain recognition or surplus

enhancement due to either financial or foreign reinsurance. In April 1991, the FASB told the subcommittee that it planned to look at three aspects of reinsurance. One is the netting of reinsurance in financial statements, two is current recognition of gain or loss, and three is appropriate footnote disclosures.

The ramifications of this type of surplus enhancement in the industry are sobering, to say the least. Even more disturbing is that regulators and auditors admit a lack of ability to distinguish true reinsurance from financial reinsurance. I don't think anyone really knows the extent of our industry surplus. In summary, past-due reinsurance, inadequate letters of credit, indiscriminate fronting, and generous surplus enhancement through financial reinsurance all come under the umbrella of reinsurance. All of these are of concern to the subcommittee. Although the issues differ on each, the end result may be the same. Through clever leveraging techniques to create additional capacity, either an unscrupulous insurer or one that's very desperate can boost its surplus and lead itself on the path to insolvency. I think the subcommittee intends to address these issues.

The subcommittee recognizes that reinsurance is an essential function of the marketplace for spreading risk and for expanding capacity. Yet, it has received more complaints and requests from state legislators, regulators and, surprisingly, even companies on the topic of reinsurance. The complaints range from insufficient jurisdiction of the states, improper activities, inadequate information, and poor capitalization. All of these threaten the very fragile system that links our insurers to our reinsurers and our reinsurers to our insurers.

In fact, the reinsurance community itself has surfaced quite a few suggestions for consideration by the subcommittee in its deliberations. These range from federal licensing and regulation of reinsurers to a comprehensive white list process. Some have even suggested that limitations should be put on the extent to which reinsurance can reduce reserves. That would prohibit companies with very little capital from expanding aggressively.

Do I expect the Energy and Commerce Committee to legislate every little detail about the insurance or reinsurance industry? Probably not. This legislation is not going to look like the very detailed legislation for the S&Ls. Do I expect it to put some sort of a federal mechanism in place to deal with some of the issues? Probably so, as insurance and reinsurance is going to continue in the spotlight until there is some satisfactory resolution in the congressmen's minds to some of these issues. I think it's really time for all of us to work together -- not only Congress, but also the regulators, companies, actuaries, and accountants. We need to be clear-headed and realistic, and we should not be afraid to face the truth. The bending or the lack of regulations or accounting rules in some of these areas allowed the savings and loan industry to hide the truth from the public, the regulators and, in some cases, even from itself. The end result was disastrous.

I'd really like to see us not follow down that same path. Let's not allow manipulation of the rules for financial disclosures just because we don't like what the economics tell us.

MS. WALLACE: You said things some of us would rather not have heard, but we appreciate your comments.

DR. JOSEPH M. BELTH: Reinsurance is an essential part of the insurance industry. Without reinsurance, it would be difficult if not impossible for any but the largest companies to engage effectively in the business of insurance.

I think the title of this session is correct. Reinsurance is indeed in the news these days, largely because some creative uses of reinsurance have had the effect of circumventing a variety of laws, regulations, and accounting principles. I will mention several examples.

In 1978, five big mutuals -- Equitable of New York, John Hancock, Metropolitan, Northwestern Mutual, and Prudential -- incurred a total of about $1 billion in federal income taxes. In 1979, the figure was about $1.1 billion. In 1980, the figure was about $500 million.

It's my understanding that the main reason for the $600 million decline was the creative use of modified coinsurance. At the time no one gave me a business reason, other than to reduce income taxes, for those huge modified coinsurance agreements. I think they were a tax dodge.

I was not surprised when Congress closed the loophole. What did surprise me was that the companies that had taken advantage of the loophole were allowed to get away with their raid on the U.S. Treasury.

Executive Life's problems with junk bonds have been legendary. Not so well known have been the company's problems with surplus relief reinsurance.

In 1985, the California Department filed an exam report on Executive Life. According to the examiners, Executive Life had taken credit at the end of 1983 for $188 million of surplus relief reinsurance that did not transfer risk sufficiently to justify the credit. If the unacceptable reinsurance had been disallowed, Executive Life would have been insolvent as of the end of 1983.

The California Department did not disallow the reinsurance. Instead, the report said, "Sufficient time will be allowed for an orderly accounting transition acceptable to the Department." When I asked why the Department did not disallow the unacceptable reinsurance, a Department official said:

> All things being equal, and in an otherwise healthy financial environment, this Department prefers its methodology of deferred surplus impact over a period of time, as distinguished from a one-time heavy charge thereto. In addition, this method reduces the number of inquiries from concerned policyholders, producers, and newspaper types who might otherwise require assorted assurances, hand-holding, explanations, and justifications for a situation which can as easily be remedied in a less drastic yet nevertheless completely satisfactory fashion.

First Capital Life's problems with junk bonds have been in the news lately. What has not been mentioned is that the company has also had problems with surplus relief reinsurance.

In 1985, the California Department filed an exam report on First Capital Life, which was then E.F. Hutton Life. The examiners found a substantial amount of surplus relief reinsurance that did not transfer risk sufficiently to justify the credit the company had taken.

Again, the California Department did not disallow the reinsurance. The matter was handled the same way as the Executive Life situation.

In March 1987 the New York Department filed an exam report on Executive Life of New York. The Department disallowed $150 million of unacceptable surplus relief reinsurance. The company admitted violating eight sections of the New York law, was required to obtain a surplus infusion of $150 million, and paid a $250,000 fine.

Some of the reinsurance did not transfer risk sufficiently to justify the credit the company had taken. Some of the reinsurance was supported by letters of credit that did not conform to the Department's rules. Some of the letters of credit were executed after the "as of" date of the annual statement. Some of the reinsurance agreements were never executed, some were executed after the "as of" date of the annual statement, some were canceled before the "as of" date of the annual statement, and some provided for less credit than was taken in the annual statement.

The problems were so serious that the New York Department entered into what was supposed to be a secret agreement with First Executive. One provision of the agreement was that three senior officers of Executive Life of New York, who also were senior officers of the California company, would not sign the 1986 annual statement of Executive Life of New York. I do not know whether officials of the California Department were aware of the agreement before it was made public by First Executive in an amended 10-K filing with the SEC.

In November 1987, the California Department disallowed $180 million of surplus relief reinsurance for which credit had been taken by Executive Life in its 1986 statement. The California Department required the company to file an amended statement in other states, and the company did not file the amended statement in other states. The disallowance received little publicity even though it wiped out 66% of the company's statutory net worth.

In 1988, the California Department filed an exam report on Executive Life. According to the examiners, various letters of credit supporting the company's surplus relief reinsurance agreements with unauthorized reinsurers were guaranteed by First Executive. The department did not say whether it took any action with regard to such arrangements.

I think it is unacceptable for an insurance company to take credit for reinsurance supported by letters of credit that are guaranteed by the insurance company's parent. Now that First Executive has filed for bankruptcy, perhaps we will find out the value of such guarantees.

Much of the credit taken by Executive Life has been because of reinsurance with affiliated companies. The largest amounts have been with First Stratford Life, which is owned in part by a firm controlled by Michael Milken. There have been suggestions in public documents that there are problems with the First Stratford reinsurance, but I do not know the nature of those problems.

In the mid-1980s, Lincoln National Life entered into a reinsurance agreement with a Bermuda affiliate. The reinsurance was supported by letters of credit that were guaranteed by Lincoln's parent. As indicated earlier, I think it is unacceptable for an insurance company to take credit for reinsurance supported by letters of credit that are guaranteed by the insurance company's parent. As far as I know, the department in Indiana, where Lincoln is domiciled, did nothing about the situation.

In the 1970s, Prudential, which was the carrier for the group life insurance program at Cargill, reinsured part of the coverage with Summit National Life, which at the time was a subsidiary of Cargill. I think the arrangement was a rebate. As far as I know, the department in New Jersey, where Prudential is domiciled, did nothing about the situation.

In the mid-1980s, Prudential, which was the carrier for the credit life insurance program of the Indiana National Bank (INB), reinsured a portion of the coverage with Monument Life, an Arizona affiliate of INB. I think the arrangement had the effect of circumventing Indiana's regulation that limits the compensation paid to the lender by the insurance company. As far as I know, the Indiana Department did nothing about the situation.

A couple of years ago, General American Life and Washington National entered into surplus relief transactions with Citibank. The companies described those transactions as the sale to Citibank of the future premium loadings on certain existing blocks of business. I think that the transactions were loans, that the companies should have established liabilities, and that no surplus relief should have been taken.

The NAIC, after reviewing those transactions, concluded they were inconsistent with statutory accounting principles. But the departments in Missouri and Illinois, where the companies are domiciled, ignored the NAIC. I have not heard of any new such transactions.

A couple of years ago Massachusetts Indemnity and Life Insurance Company (MILICO) entered into a surplus relief transaction with a consortium of banks headed by Chase Manhattan. The key to the transaction was the formation of a paper entity called Mapleleaf -- not Figleaf, Mapleleaf. Mapleleaf pays agents' commissions, receives fees from MILICO that are smaller than the first-year commissions paid by Mapleleaf, and borrows from the banks to make up the difference. I think the arrangement is a sham. The NAIC, after reviewing the arrangement, concluded it was inconsistent with statutory accounting principles. But the department in Massachusetts, where MILICO is domiciled, ignored the NAIC. I have not heard of any new such transactions.

Finally, although assumption reinsurance is not reinsurance, I told Diane the only way she could stop me from talking about that subject was to arrange for a power failure.

I am referring to the type of situation in which an insurance company transfers a block of business to another insurance company, intending that the acquiring company will take over the liabilities and that the liabilities of the transferring company will be extinguished. In these comments, I will use the word "transfers" rather than the phrase "assumption reinsurance."

Insurance companies have often made such transfers without the consent of the affected policyowners. Incredibly, the transferring companies in such cases apparently thought they could thereby extricate themselves from their obligations to their policyowners.

Suppose I enter into an agreement with Diane under which she assumes some of my obligations. Try to imagine the reaction of a creditor who receives this letter from me:

> Dear Creditor: Effective immediately, my obligations to you have been assumed by Diane Wallace. She's a fine person; I know you'll like her. To anticipate your question, you have no recourse to me in the event of Diane's bankruptcy or failure to meet her obligations to you. Sincerely yours, Joseph Belth.

If I wrote a letter like that to my banker, I wouldn't want to be in the room when he read it. But that is precisely what insurance companies say when they inform policyowners that coverage has been transferred to another company. It seems to me the transfers should not be permitted without the informed, positive consent of the policyowners.

Here is a case in point. Many individuals bought single-premium deferred annuities from First Pyramid Life, an Arkansas company. A block of these annuities was transferred three times. The first transfer was to Security Benefit Life, a Kansas company with an A+ rating from A.M. Best. Two transfers later, the annuities wound up in Diamond Benefits Life, an Arizona company which shortly thereafter was declared insolvent. The question of whether the last of the transfers was valid is the subject of protracted litigation, and may not be resolved for several more years. The affected annuitants have been in limbo for more than two years.

Here is another case in point. The death claim on a $100,000 life insurance policy is in limbo. The insured's policy was transferred twice, and wound up in Mutual Security Life. The insured died last summer at about the time Mutual Security was placed under the supervision of Indiana's insurance commissioner. At present there is a moratorium on the payment of death claims, and there is no telling how long the insured's widow is going to have to wait before she receives the policy's death benefit.

Cases such as these prompted the NAIC to appoint a study group to consider transfers. The study group, chaired by Jim Hanson of the Illinois Department, appointed an advisory committee. I volunteered to serve on the advisory

committee. Initially I was turned down, but later I was appointed to the advisory committee.

The advisory committee has submitted to the NAIC study group a report and a proposed model act. I disagree with certain fundamental positions taken by the other members of the advisory committee. For that reason I submitted a minority report and a proposed model act of my own.

The most important question in the deliberations of the advisory committee was what type of policyowner consent should be required. Although some transfers have been made without the consent of the affected policyowners, the advisory committee recognized that consent is needed.

The other members of the advisory committee concluded that negative consent is adequate for a valid transfer to be consummated. Under negative consent, the policyowner who does not respond to the notice of transfer within a specified period is deemed to have consented to the transfer.

I support positive consent under which the transfer is effective only if the policyowner gives his or her written consent. The policyowner who does not respond to the notice of transfer within a specified period is deemed to have rejected the transfer.

Another major question that arose in the deliberations of the advisory committee involved transfers to companies not licensed in some of the states in which affected policyowners reside. The other members of the advisory committee concluded that such transfers should be allowed, provided the policyowners are given a list of states in which the acquiring company is licensed and told there might be problems with regulatory recourse and guaranty association coverage. I think transfers to unlicensed companies should be prohibited.

A third major question was what information should be provided to the policy-owner concerning the proposed transfer. The other members of the advisory committee concluded that policyowners should be given the first three pages of the most recent statutory annual statement of the acquiring company. I think the policyowners should be given information about the ratings of the transferring company and the acquiring company issued by the nationally recognized rating agencies.

The NAIC study group has met twice recently. It plans to have a proposed model act ready for the June 1991 meeting of the NAIC.

Although reinsurance is a legitimate and essential activity, I think there have been many abuses in the area. I am not surprised that the New York Department has tightened up considerably on surplus relief transactions. Nor am I surprised by the California Department's recent announcement of its intention to tighten the rules governing surplus relief transactions.

As for transfers through so-called assumption reinsurance, the NAIC is working on a model act. I hope the model act will require the informed, positive consent of the affected policyowners.

MS. WALLACE: Folks, I need your help now. I only consented to lead this session because I felt confident you would help me with some counter-arguments to remarks that are in conflict with a lot of what we believe. So please, do we have any questions for the panelists?

MR. MELVILLE J. YOUNG: I have no comments on Mr. Greenberg's presentation. I'd like to say our industry is not trouble-free. Many people have been diligently working for some years to improve practices and regulations. One helpful step would be to remember that we are the life insurance industry. We shouldn't be confused with the property/casualty industry. Its problems shouldn't be attributed to us. We have enough problems of our own.

Unfortunately, Executive Life is part of the life insurance industry. We've all heard some of the alleged abuses at First Executive, and perhaps some of us have seen evidence. But I believe the First Executive problems were problems with the driver and not the vehicle. Perhaps that's why it was headed by Mr. Carr. If Mr. Carr owned a Volvo, it probably would have become a Pinto overnight. If Fred Carr drank a lot of milk, would we be discussing the prudence or legality of overdrinking milk? If one were to list the hundred biggest problems at First Executive, I believe reinsurance would rank somewhere around 82. Financial reinsurance, as we use it in the life insurance industry, is very different from what is used in the casualty insurance industry. There are some very effective regulations for reinsurance in general, and they are widely used by most of the states, even if they haven't been adopted.

I disagree with the definition that Lavonne gave of financial reinsurance. I think most of us would say that, although risk passage is a necessary ingredient for all legitimate reinsurance, financial reinsurance arrangements are distinguished by a financial motivation. This doesn't mean there isn't full risk passage. Most reinsurance arrangements -- financial and otherwise -- are very legitimate arrangements with legitimate companies.

As Allan discussed, when companies write business, they typically have an expectation of future profit stream. But if they're growing rapidly, they have surplus strain in the early years of writing that business. They buy financial reinsurance at a lower cost than traditional reinsurance by, in effect, selling a right to part of the future profit stream of the business they've written. It's no sleight of hand. They have an asset in hand, and they realize part of the value of that asset today rather than waiting for the future. There's no monkey business.

Now, as far as modified coinsurance 820 treaties, are we to say that all the people who have bought municipal bonds should be thrown in jail for tax evasion? Because of a tax law that just stopped working and because Congress wasn't able to act soon enough, mutual companies were being overtaxed during the late 1970s. It was widely recognized, even at the IRS. It was not until mutual companies were being taxed at an extremely high percentage of their earnings that they took advantage of something that had been in the code for 20 years in order to bring their tax rate down to a more reasonable level.

You, I, and most people in this room would do the same thing with our own taxes if there was some legitimate vehicle in the tax law. I don't think there's anything wrong with that.

I would like to say one thing about assumption reinsurance to Mr. Belth. I also have been working on that task force. Many of the points you've raised during those task force meetings have been correct. That doesn't mean everything you're saying is correct. Most of us disagree with the positive consent issue. Assumption reinsurance is vital in the insurance business if a company wants to get out of a particular line of business. Positive consent would kill assumption reinsurance. There has to be another solution, and I hope that you have an open mind and that you continue working with us.

MS. WALLACE: I'd like to ask Lavonne first if she has any responses to Mel's comments.

MS. PADEN: I just have one response on the financial reinsurance comments. I guess what's instructive to me is that even GAAP disallows the recognition of financial reinsurance as an enhancement to capital in companies' financial statements. And, the AICPA and the FASB are both working to tighten that restriction even further. It creates a real question in my mind any time a statutory accounting principle is less conservative than GAAP. The S&Ls went through the same thing. Statutory or regulatory guidelines were more lenient than GAAP. The regulators learned the hard way to take a real close look at that.

MR. GREENBERG: If GAAP accounting were addressing the issue of capital and surplus as opposed to presentation, the GAAP accounting treatment of financial reinsurance would be exactly the same as statutory. There are several thousand insurance companies, and there are a lot of CPAs who have a very good understanding of insurance and many who don't. Using negative deferred acquisition costs on financial reinsurance to appropriately reflect it on GAAP was just too much of a complication. If GAAP did not preclude accounting for financial reinsurance, the impact on the surplus of companies would be zero anyway. Therefore, the AICPA, in the original audit guide, chose to ignore it perhaps because it was too complicated to reflect on a GAAP basis.

MR. KIN K. GEE: On a GAAP basis, you're allowed to set up certain deferred policy acquisition expense assets. On a statutory basis, you are not permitted to recognize the stream of future profits. You can't take one element of GAAP accounting and try to apply it to statutory or take one element of statutory and apply it to GAAP. On the life side, it's true that we collapse under GAAP, so there is no impact except for the fee on the transaction. On the property/casualty side, at least until the AICPA finalizes the exposure draft on transfer of risk, financial reinsurance is reflected on a GAAP basis. It is not correct to say that certain elements of surplus shouldn't be recognized on a statutory basis because it is not recognized on a GAAP basis. That's because on a GAAP basis, acquisition costs are set up as the asset.

MR. JAY M. JAFFE: I'm concerned that we look at this with a holistic point of view. As I've heard here and understood from my own experience, reinsurance is often driven by the requirements of statutory accounting. Perhaps the requirements of

statutory accounting have to be changed. There are certain areas where statutory accounting is too stringent as compared to the actuarial reserves required. Is the panel approaching this from just one point of view or would the panel look at the whole picture and help us put it in perspective?

DR. BELTH: Statutory accounting principles, whatever they are, have evolved over a period of time. Although I didn't say it, there was a premise in my remarks. Statutory accounting principles exist and should be followed until such time as they are modified, eliminated, weakened, or changed. The problem that I've had with certain reinsurance arrangements is that they amount to a circumvention of those rules. In other words, I've taken it as a given that the rules exist. I'm not saying that I agree with the rules.

Several years ago, I confronted a prominent actuary, who's also a CEO of a large company, and asked him whether he thought it would be possible to revise statutory accounting principles significantly to bring them closer to GAAP. This was, by the way, several years ago and therefore before the savings and loan crisis. At that time, he felt that it was not politically feasible to significantly alter the statutory accounting rules. He was implying that as long as it's not politically feasible to alter the rules, it is necessary to do an end run around the rules.

I don't know what he would say about the political feasibility, but I can just imagine proposing that statutory accounting principles be significantly weakened now. Given all the problems that we've had lately in the insurance business, is this the time to weaken the accounting rules? You can imagine the kind of political reaction that would engender. So what we're going to have is circumvention, and a lot of people disagree with me whether circumvention should be allowed. I happen to think that the rules should be followed, but there are those who feel that if the rules are not reasonable, we should do an end run.

MS. WALLACE: I'm a big believer that our business is so complex that it is very difficult to create laws and regulations that work over any extended period of time on every type of transaction. Instead, we should work towards making regulators and the public more comfortable with relying on actuarial opinions. Actuaries need to take responsibility and be accountable for making such opinions, and reviewing the accounting treatment on all balance sheet items to make sure that a sound and accurate picture is given of the financial condition. That's the direction we ought to be headed rather than trying to create new, more liberal or more conservative accounting rules.

MR. JOSEPH F. KOLODNEY*: This whole scenario that's been posited by Joe and Lavonne is very complex. I think one of the root problems is that we're trying to focus on a company and a vehicle that has been perceived to have been abused. We should try to look at the total package. One aspect of the total package is that the states collect a lot of premium taxes. An insufficient amount of those premium taxes is dedicated to making sure that regulations are properly enforced. Most of the insurance commissioners will tell you that they have totally inadequate budgets to

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carry out their mandates. We know some regulators who said that they couldn't come to NAIC meetings because their insurance departments didn't have money in the budget to send them, and they were short staffed. The regulations are there. We live with them every day, but the insurance departments are not properly staffed to look with more frequency at whether or not these regulations are followed.

Let's talk about Executive Life. What you really have is a company that embarked on an investment policy to build assets and drive earnings in an inappropriate way. There was an inadequate response on the part of the regulatory authorities to observe closely what was going on and to take proper action. No doubt there were some political issues involved. Another part of the problem was the perception of internal management trying to generate schemes that avoid the requirements of statutory accounting and circumvent the intent of the regulations. The record speaks for itself on that.

A secondary factor applies to both Executive Life and First Capital. Good news does not sell newspapers. Nobody writes articles about how solvent companies are. This drumbeat of negative publicity drives the policyholder to accelerate policy redemptions and surrenders, which creates a self-fulfilling prophecy of collapse. There is not one single, solitary financial institution in this country, including the U.S. government, that can stand a run on a bank where all its liabilities are called on to be drawn down immediately.

We should look at the situations that have evolved, the genesis of how they're created and being handled, and try to come up with more appropriate and realistic measures to deal with them. To take a microcosm and say all these insolvencies are the fault of inappropriate reinsurance just isn't true. The majority of reinsurance transactions involve very responsible people who are trying, through due diligence, to accomplish legitimate financial transactions between ceding companies and reinsurers.

As an intermediary, we at my company are very conscious of our responsibility, even though we do not let the perfume of the brokerage obscure the odor of the risk. I think that we should be a little more thoughtful about how we approach some of these issues rather than just latch onto one aspect and beat it to death.

MR. GREENBERG: Much of what Joe Belth said is very, very important for us as an industry to listen to, but unfortunately I must say that I disagree with Joe's perspective. I am diametrically opposed to the idea that when someone enters into a reinsurance agreement, that this circumvents regulatory or statutory accounting.

I'm sure that the idea of federal regulation of reinsurance or new reinsurance regulations coming out of California is not worrying Bob Winters up on the 24th floor of the Plaza Building in Newark, New Jersey. The Prudential will not have to cut back sales because it can't get enough surplus relief reinsurance. When you have several billion dollars of surplus, you probably don't worry as much about that. When you're a growing company which has to finance growth through various methods, one is to immediately share the risk up-front. That's fine. But why should a company be precluded from finding another way to finance its growth? If it reinsures some of its business to acquire surplus, there's nothing evil about that. The only time something can be wrong is, if at the other end, the reinsurer does not pay.

Everything that was said about bad reinsurance represents someone at the other end not paying. When you talk about the problems with Executive Life and First Capital -- and there are a couple more companies that many of us can think about who are going to have similar problems regarding their viability -- how can anyone say that those are not asset problems as opposed to liability problems? Take a look at the amount of assets that are in trouble and take a look at the reinsurance. Pay all that reinsurance and then see how those companies are doing. They're still dead in the water if their assets are 40% under water.

I don't think we need a plethora of regulations right now in response to Executive Life. That will strangle some small companies. The regulation may effectively put a lot of companies out of business.

MR. GLENN R. SWANICK: I've heard some criticisms of letters of credit (LOCs) from this panel and from others. One criticism that came up was that loss reserves were inadequate. As Mel observed, that is a property/casualty concept. It doesn't really apply to life insurance. This time around I've been in this business just a couple of years, and the letters of credit I'm familiar with are New York standard. They're very, very unconditional and I find that type of letter of credit hard to criticize. All you have to do is identify yourself, contact the bank, and it pays.

I had to think about the concept that letters of credit guaranteed by a parent was a problem. If I'm a little company and I draw a letter of credit on a bank that's guaranteed by my parent, I guess they fire me. So I suppose that can be an issue. But, the bank pays. The guarantor of the bank seems to be an irrelevancy, in my mind.

Dr. Belth commented on positive consent for assumption reinsurance, which I would view as impossible. I have, experience where negative consent worked rather effectively in blocking an assumption. It didn't take very many active people to involve the media. Probably 0.5% of the people who were petitioned said no, and they were quite active in getting the media and others involved. It blocked a $200 million assumption.

DR. BELTH: Well, the only comment I'd like to make on positive consent is that I do have an open mind. I'm willing to listen. The problem is, that my orientation is the point of view of the consumer. I find it objectionable for the consumer to be deemed to have agreed to a very, very important alteration of his rights if he should throw a piece of mail into the wastebasket. It just bothers me. I have actually received some comments from people, who don't want to be identified, who insist that the only solution is to prohibit transfers altogether. I'm talking about thoughtful knowledgeable people.

The point is that there are more extreme positions than mine. Mine is a very simple position. If a company wants to extricate itself from its liabilities to a policyowner, the policyowner simply has to positively consent to that transfer. It's unfortunate if you think that will kill assumption reinsurance. I hope it won't.

MS. PADEN: I just have a comment about letters of credit guaranteed by parent companies. I don't think this practice is any coincidence in a lot of these failures.

You've got a very complicated holding company structure with all kinds of non-insurance affiliates, and it's very much of a shell game. The parent may be following GAAP rules. The insurance subsidiaries may be following statutory. It's very complex, and a lot of companies have figured it out and can use it to their advantage.

New York found out in the case of First Executive that it's fictitious to think that you can wall off one company in a holding company group which goes down and keep the other company afloat. I think the banks and the S&Ls both learned their lessons. It's not just banks or savings and loans that are regulated. It's also their holding companies. We very quickly have to get to that point with insurance company holding groups.