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REINSURANCE ACCOUNTING FOR LIFE AND HEALTH INSURERS

Moderator:	DONALD F. BEHAN
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Recorder:	DONALD F. BEHAN

- Statutory developments
  - National Association of Insurance Commissioners (NAIC) model regulation
  - California requirement
  - New York requirement
  - Other state requirements
- Generally Accepted Accounting Principles (GAAP) developments
  - *Statement of Financial Accounting Standards No. 113*
  - EITF issues

MR. DONALD F. BEHAN: We are fortunate to have on the panel three individuals who are not only knowledgeable about the subject but also directly involved in currently emerging issues in this area. I can't think of another time when there was as much activity as there is now in reinsurance accounting, and this is true for both statutory and GAAP. Our panelists are Calvert A. Jared, Albert J. Reznicek, and William K. Tyler.

We'll start the discussion with Cal Jared, who will talk about the NAIC model regulation and some of the specific state issues, including New York and California. Al Reznicek will then discuss GAAP issues, including financial reporting under *Financial Accounting Standard (FAS) 113,* and fronting issues. Then Bill Tyler will speak on reinsurance issues as they relate to risk-based capital (RBC), mark-to-market, the deferred acquisition cost (DAC) tax, and will give some examples of the use of reinsurance in capital management.

Calvert A. Jared is senior vice president of ITT Lyndon Reinsurance and is assistant director of reinsurance operations. Cal is an FSA and a Fellow of the Life Management Institute. Cal has 25 years of experience in the insurance industry, including chief executive positions with the life insurance subsidiary of Citibank and with Poly-Systems, a computer software and service firm. He also served as vice president of The Equitable, and was a senior manager at a major public accounting firm. Cal has numerous papers to his credit, including a significant paper on marginal tax rates in *Transactions* of the Society of Actuaries. He is also studying for his MBA and expects to get his degree in May 1994.

MR. CALVERT A. JARED II: There is a session on reinsurance tax and regulatory issues, and so I'm going to give you the highlights of the NAIC model regulation, but not go into all the details because it's been covered before in other sessions.

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In September 1992, the NAIC adopted a new reinsurance model regulation. It applies to domestics and other licensed insurance companies that aren't subject to substantially similar legislation by their state of domicile. We will come back to that later because that is going to be important in what we have to say, particularly about accounting and filing. It is important to understand that ceding companies and assuming companies can continue to execute whatever treaties they want. What this regulation states is that ceding companies can't reduce liabilities or establish assets in regard to the reinsurance treaty unless it complies with the new model regulation. This applies to all reinsurance, not just surplus relief or financial reinsurance; there is no mention of that in the regulation. This regulation applies to all types of reinsurance except yearly renewable term (YRT), assumption and certain nonproportional, like stop-loss, and catastrophe. It applies to the ceding companies and to many assuming companies, if they do any retrocessions. Even if you retrocede within your own group, or even if you are a professional reinsurer who has been doing normal excess of retention YRT and you are ceding off some of the risk that you have been taking, then you are going to have to comply with the NAIC model regulation as a ceding reinsurer on that business. It basically applies to all life, annuity, and health products. It also applies to health products of property and casualty companies.

Probably the major difference in this regulation versus the old regulation is that you have to transfer all significant risks. What that means is that for interest-sensitive products, you have to transfer investment risk. You either have to transfer the assets if you are doing coinsurance, or if you are doing modified coinsurance, you can segregate assets, but the reinsurer has to live and die by the performance of those assets. On many of the traditional products there is still some transfer of investment risk, because you may use the company's overall Exhibit 2 and Exhibit 4 rate, meaning that you use a net investment income plus realized gains and losses, plus unrealized gains and losses. There is typically a grandfather provision in the regulation that allows existing agreements to be brought into compliance over some period of time, rather than all at once.

In the NAIC model regulation, there is an accounting example that we'll discuss later that applies only to ceding companies. If you start a reinsurance agreement on new business, in other words, prospectively the same rules that always applied to reinsurance accounting still apply. Any gain or loss on execution of the treaty for the ceding company continues to go through income and of course hits surplus. However, if you are reinsuring in-force business, then new rules apply. At inception you can only take the surplus impact, and you won't have any impact on gain from operations. Also, as part of the regulation, if you're reinsuring in-force business, within 30 days after execution you have to file the treaty with either your state of domicile, if it has adopted the new regulation, or if it hasn't, then with some of the other states that have adopted the new regulation.

So who has adopted the new regulation? If your state of domicile has adopted the new regulation or even if it hasn't, you're probably going to have to comply with these states if you're licensed and doing business in these states for new contracts. For existing contracts, you'll have to comply with whatever the grandfather date is in each state. California came out with a bulletin in late 1992 that was similar to the NAIC model regulation. There were some differences, but from an accounting perspective, nothing significant. Colorado has adopted it, but it applies only to domestics. Illinois and Pennsylvania are both trying to adopt it this year. I believe that they will, but they haven't yet. Missouri and Georgia have both adopted the new model regulation. At year-end 1992, California was the only state that had the new model regulation. So virtually every ceding company that entered into a new reinsurance agreement during 1992 that was licensed in California had to file its reinsurance agreements with the State of California. Virtually everybody that I know that's filed that has had a continuing dialogue that lasted anywhere from six to nine months, if not longer, discussing what terms and provisions California would accept, such that it would allow reserve credit to be taken under its bulletin.

New York, as is very common, has an extraterritorial provision, which is not common in the other NAIC model regulation adoptions. Basically, it says that it applies to every authorized insurer. It also says that you have to reimburse 100% of the dividends on participating policies and crediting rates on interest-sensitive products, which is different than the other NAIC model regulation adoptions. The New York department also says that the reinsurer can have no voice in establishing the dividend level or the crediting rates. So the New York department wants the reinsurer to take 100% of the risk, but it doesn't want them to have a say in establishing those amounts. Contracts that were entered into by December 31, 1992, and have not been amended subsequently, have until December 31, 1995 to come into compliance with this dividend- and interest-crediting provision. All other contracts have to conform by December 31, 1993 in New York. The New York version also makes it clear that health insurance, other than long-term care and long-term disability, must also use the Exhibits 2 and 4 rates. In the NAIC model regulation, it wasn't clear that you had to use those rates, because they showed that contracts like that have no investment risk, and some reinsurers interpreted that to mean that you didn't have to pass investment risk if there was no investment risk inherent in the product.

New Jersey's rule is also a bit different. New Jersey adopted an emergency rule, which I understand expired on October 15; by then, it expected to make the rule permanent. I'm assuming that it is now permanent. It does not exclude YRT and nonproportional, as all the others do. It states that on nonproportional, you do not have to reimburse renewal expenses on the product reinsured. It's all right to have some form of automatic termination or recapture provision in the contract; you don't have to pass all significant risks, and you don't have to pass investment risk. All these make sense and one would think that the same four items wouldn't apply to YRT, but the New Jersey regulation states that for YRT, you do have to reimburse renewal expenses appropriate for the portion of the risk reinsured. I think this means that you have to reimburse some percentage of the cost of paying death claims.

I've seen a notice that says that Tennessee has adopted the new model regulation on an emergency basis. I haven't seen the regulation, so I don't know whether there's anything unique about it.

So with all these states adopting the new regulation, one would think that if we can get some of these differences taken care of, the rules would be well set on how you write reinsurance. But a curious thing has happened. Assuming that Massachusetts adopts the old model this year, five states will have already adopted the old, reinsurance model regulation this year. There are a number of others that had adopted the old model regulation in the past. But why would five states adopt it this year? Why are they adopting the old one when the new one's out there? It's the accreditation process. These states are trying to be accredited by December 31, 1993, and the NAIC states that you have to pass the old reinsurance model regulation as well as a whole host of others. The new reinsurance model regulation doesn't have to be adopted until January 1, 1995. The substantially similar regulation in the state-of-domicile clause becomes important because, if your state has adopted either the old model regulation or no model regulation, California, New York and New Jersey are almost certain to say that you are not subject to substantially similar legislation. And if that's true, then you have to comply with all the seven states that have adopted the new one even though your state of domicile either has not adopted anything or has adopted the old regulation.

That gives rise to several accounting choices for the ceding company. If the state of domicile has not adopted the new regulation, the company can comply with the new regulation anyway regarding both the terms and the accounting treatment, or it can file separate statements in those states and comply with their domestic accounting treatment. Last, you could assume that your state's legislation is substantially similar, and if you comply in your state of domicile, you comply in the others.

Now let's look at a simple example for an in-force block (Table 1). The example is described in words in the NAIC model regulation. I assumed that there's a block of business that in 1994 would throw off $4 million of profits. At a 35% tax rate, that generates net income of $2.6 million, which flows right through to surplus, with no reinsurance.

TABLE 1
In-force Accounting Example – Old Regulation

	Before Reinsurance 1994	Reinsurance – Old Regulation	
		December 31, 1993	1994
Gain from Operations			
Profit	4,000	0	0
Allowances	0	20,000	0
Experience Refund	0	0	1,000
Federal Income Tax	(1,400)	(7,000)	(350)
Net Income	2,600	13,000	650
Surplus Analysis			
Write-In	0	0	0
Net Income	2,600	13,000	650
Surplus	2,600	13,000	13,650

If we wrote a reinsurance deal on December 31, 1993 (surplus relief, financial reinsurance, or true coinsurance with full-risk passage), I've assumed that there's a $20-million allowance paid at inception. After tax, there is a $13-million increase in net income, which again goes to surplus. This is the historic accounting method for these kinds of transactions. During 1994, obviously some of the profits are going to be used to pay back the relief if this were a surplus relief agreement. I've assumed that there was also an experience refund given to the ceding company, and that the experience refund is also taxed, so only $650,000 is the net income in this case. Added to the $13 million that was there the year before nets a total of $13,650,000. That's the same method that would currently be used on new business. Again, this method relates to the ceding company. There's a question on to whether the assuming company follows the old rules or the new rules, and later we'll see why that's important.

I'm trying to work through a calculation that needs to be done in order to make the accounting work under the new rules, so this is just a short-cut description. The profit as I described before would have been $4 million before reinsurance. The experience refund that has been given is $1 million. The risk fee, if you assume that this is a surplus relief deal with a 2% fee on the $20 million, is $400,000, so that gives you a net of $2.6 million. The after-tax impact on net gain from operations is $1,690,000.

TABLE 2
In-force Accounting Example -- 1994 Allowance
New Regulation

Profit	4,000
Less: Experience Refund	(1,000)
Risk Fee	(400)
	2,600
Federal Income Tax	(910)
Allowance	1,690

Under the new accounting rules, instead of $20 million showing up as an allowance at inception, you're only going to show $7 million, which is the tax impact. So you bring $7 million into income and show $7 million of taxes, which produces no net income. Meanwhile, the $20-million allowance that was paid minus the $7 million in tax as is a write-in item in surplus. That increases surplus by $13 million, which is the same increase as under the old accounting method, but you now have no gain-from-operations impact. In 1994, we show the $1,690,000 in net income that I just generated in the example, which is net after taxes. You also show the experience refund and the tax on the experience refund, which produces a net income of $2,340,000. If you go back and look, the company would have made $2.6 million in 1994 if it hadn't written the reinsurance deal. The difference is the $400,000 risk fee tax of 35%. So the $2,340,000 carries down into surplus as net income. The $1,690,000 that you brought into income is already in surplus and you can't bring it in twice. So you have to write down your write-in-surplus item by $1,690,000, producing surplus at the end of the period of $13,650,000, which is the same amount you would have had in surplus under the old accounting basis.

If a company has done a retrocession, what rules apply? The best example to illustrate this would be that the ceding company enters into a surplus-relief agreement with the assuming company, just as we've described here; but then the assuming company passes on 100% of the entire transaction to someone else.

TABLE 3
In-force Accounting Example – New Regulation

	Reinsurance – New Regulation	
	December 31, 1993	1994
Gain from Operations		
Profit	0	0
Allowances	7,000	1,690
Experience Refund	0	1,000
Federal Income Tax	(7,000)	(350)
Net Income	0	2,340
Surplus Analysis		
Write-In	13,000	(1,690)
Net Income	0	2,340
Surplus	13,000	13,650

The ceding company needs to comply with the new regulation. The assuming company may still be accounting for this under the old rules, because the NAIC model regulation doesn't specify that the assuming company has to comply with the new accounting rules. But when the assuming company cedes the business, it is now a ceding company, and it would then have to use the new rules as a ceding company for ceding it off. Are assuming companies going to have to use the exact same accounting treatment as the ceding companies to avoid distortions?

MR. BEHAN: I would like to introduce our next speaker, Albert J. Reznicek. Al is a certified public accountant (CPA), and he is a partner in the New York office of Deloitte and Touche. His clients have included the largest life insurance companies in New York, and he currently directs the services of Deloitte and Touche to life insurance companies that are demutualizing. Al is a member of the American Institute of Certified Public Accountants (AICPA) insurance companies committee. That is the group that develops policies for the accounting profession related to insurance company financial reporting. Al is also active with the NAIC, including membership on the invested assets technical resource group, and the NAIC AICPA working group. Al graduated from the University of Texas at Austin with a bachelor's degree in business administration, majoring in accounting.

MR. ALBERT J. REZNICEK: My subject is *FAS 113*, reinsurance accounting under GAAP accounting principles. I want to touch on some of the highlights of *FAS 113* and give you some background on what companies are required to do in their GAAP financial statements. The FASB adopted *FAS 113* in December 1992. It is applicable for 1993 and provides for amendments to three statements: *FAS 5*, "Accounting for Contingencies"; *FAS 60*, "Accounting and Reporting by Insurance Companies"; and *FAS 97*, "Accounting and Reporting for Certain Long-Term Duration Contracts." Over the years, the AICPA insurance companies committee was working on a statement of position that would address reinsurance accounting, specifically the transfer of risk under these contracts. The proposed statement of position (SOP) was formal when the FASB adopted *FAS 113*.

The statement is applicable to all enterprises that are subject to *FAS 60*, which is actually all insurance enterprises. The statement indicates that it is also applicable to fronting arrangements. There was a question about the appropriate accounting for fronting transactions by reinsurance companies. The statement will provide guidance on the appropriate recognition of fronting arrangements in the financial statements of fronting companies. The statement is applicable to any transaction that indemnifies an insurer against loss from insurance risk. This statement is directed more to accounting by ceding companies rather than the assuming companies, although it does contain some provisions for additional disclosures and guidance on indemnification for an assuming company. The statement has four major provisions. The first is the elimination of netting of reinsurance transactions in the financial statements. Second, it establishes criteria and provides guidelines for determining whether or not there has been a transfer of risk under the reinsurance transaction. Third, it prescribes specific accounting recognition and reporting standards. Finally, it has a section that deals with required insurance company disclosures of the nature and the effects of the reinsurance transaction.

In the area of netting, when the AICPA adopted the audit guides for the property and casualty companies and the life and health providers, they adopted the provisions that were essentially in statutory accounting, which provided for the netting of reinsurance in the financial statements. The Accounting Principles Board (APB) issued an opinion that indicated that offsetting of amounts in financial statements of assets against liabilities was appropriate only in those instances in which a right of offset existed. Recently, the FASB issued Interpretation No. 39, which states that offset accounting is appropriate only when there is a legal right to set off. Considering those opinions, when the FASB was addressing reinsurance accounting it concluded that it would be inappropriate to do netting. Therefore, the statement provides for disclosure of information on reinsurance transactions on a broad basis in the financial statements. The belief is that a gross presentation will more clearly reflect the activity of the company as well as provide additional financial information on the solvency of the company and its commitments.

The statement is broken into two distinct segments, one addressing short-duration contracts and another addressing long-duration contracts. A short-term or short-duration contract is one that is for a fixed period of short duration, with the contract being cancelable or having provisions that would allow for the adjustment of the terms of the contract at the end of any contract period. To allow a transfer of risk under a short-duration contract, two conditions must be met. First, the reinsurer that is assuming the business must assume significant insurance risk. Second when the reinsurer does take on that risk, there must be a reasonable possibility that the reinsurer may realize a significant loss under the transaction.

The statement also indicates that there are certain instances or types of transactions that clearly do not transfer risk. One type is a contract in which the probability of a significant variation in the timing or the amount of payments to be made by the reinsurer is remote. Therefore there is not an assumption of risk. Another instance is a provision in the contract that provides for the delay of timely reimbursement to the ceding company of the losses incurred. Such a contract does not transfer risk, because the contract can be structured so that the assuming company knows what losses or costs are going to be incurred.

A transfer of significant risk of loss under the contract has to exist for there to be a transfer of risk. The statement provides guidance for determining transfer of significant risk. The determination is made by taking the present value of the amounts paid by the reinsurer under reasonable possible scenarios and comparing that amount to the present value of amounts that are paid to the reinsurer. If under the reasonable scenarios there is a reasonable possibility that the assuming company would sustain a significant loss, then there has been a transfer of risk. If not, then there hasn't been a transfer of risk, and the contract would not be viewed as a reinsurance transaction for purposes of reflecting the effects in the financial statements. There is one general exception that has been included; a transaction whereby nearly all the insurance risks related to the product are transferred, that is, a straight-quota-share-type contract, is considered reinsurance. Under such a contract, there does not necessarily have to be a reasonable possibility of a loss to have a transfer of risk.

As indicated earlier, there are two types of contracts, the short duration and the long duration. Long-duration contracts are generally those contracts that are not subject to unilateral change, are not cancelable, or have guaranteed renewable provisions that cover an extended period of time. *FAS 60* and *FAS 97*, which deal with insurance products for insurance enterprises, contain provisions for insurance risk transfers. The calculation of the present value, etc., for risk transfer under long-duration contracts is similar to that of short-duration contracts. Again, for long-duration contracts, the present-value calculations would have to indicate a reasonable possibility of a significant loss from insurance risk. Certain products that insurance companies issue are captured under the provisions of *FAS 97*. Some of these insurance contracts do not necessarily pass morbidity or mortality risks and are considered to be investment-type contracts. If a product is classified as an investment contract, it is not subject to reinsurance accounting. In determining whether there are morbidity or mortality risks, it must be determined whether the payments are dependent upon the death or disability of the insured. If there is no transfer of morbidity or mortality risk, the contract would be viewed as an investment contract. Some contracts, such as structured annuities, might contain provisions for a transfer of mortality risk, but in substance, the life-contingent payment is remote, or the present value of those life-contingent payments relative to the total present value of all payments is insignificant. If those conditions are present, there may not be a transfer of risk for GAAP reporting purposes.

The recognition of revenues and costs in GAAP financial statements under *FAS 113* depends upon the type of contract. Recognition is different depending upon whether the contract is a short-duration or a long-duration contract, and whether the contract is dealing with prospective events or retroactive events. If the reinsurance contract does not transfer risk, it is accounted for as a deposit in the financial statements on a GAAP basis. The statement indicates that if there is a reinsurance transaction that results in a gain, then the gain cannot be recognized immediately in the financial statements unless there is a legal replacement of the issuer by the reinsurer through an assumption agreement or novation. Questions have existed in the past on whether or not a reinsurance contract could result in a GAAP gain. Clearly, *FAS 113* states that gains cannot be recognized unless the gain is related to an assumption-reinsurance agreement.

As indicated, the recognition of revenues and costs is dependent upon whether the transaction is a prospective or retroactive contract. The prospective reinsurance contract covers losses under contracts for future insurable events. Retroactive contracts deal with losses that have already occurred. What is unique is that, as you would expect, there are a number of contracts that are a combination of prospective and retroactive. The guidance in this area would be an attempt to bifurcate the contract and account for its parts. A number of individuals believe you can bifurcate a contract, while others believe you cannot. Combination contracts present an interesting, yet problematic practical application issue in GAAP accounting.

What is the appropriate accounting for a prospective reinsurance contract dealing with short-duration contracts? The amounts paid by the ceding company to the assuming company become prepaid insurance. Prepaid reinsurance is an asset that needs to be recognized as a cost. The amount would be amortized into income over the remaining contract period in proportion to the amount of the reinsurance protection provided. The costs of long-duration contracts would be amortized into income over the remaining life of the underlying contracts. Assumptions that are used to amortize the cost would be similar to the assumptions that are used to calculate the liabilities under the contracts that have been reinsured.

On retroactive short-term contracts, the amounts that are paid are reported as reinsurance receivables to the extent that the amount paid does not exceed the underlying liabilities that have been reinsured. If the underlying liabilities do exceed the amounts paid, there is a deferred gain, which would be amortized into the income over the remaining period of the contract or the settlement period. In those instances in which the amount paid to the reinsurer exceeds the underlying liability for GAAP purposes, there would be a loss, which loss would have to be recognized currently in income.

FAS 113 also addresses presentation of data in the income statement. Information needs to be disclosed on the amounts of ceded premiums and the amounts that have been recovered under the reinsurance contract. The statement provides that companies have three alternative methods of presenting this information. They can present it as a separate line item; they may place it parenthetically in the caption within the financial statements; or, alternatively, they may disclose it in the footnotes to the financial statements. This is an area where there will not be significant revisions except possibly in the extent of disclosures. The disclosure requirements of financial statements force companies to disclose the nature of the transaction and its effects on the insurance company. The statement also indicates that a ceding company has the primary obligation and the legal obligation under the reinsured contract. The amounts that need to be disclosed are the amounts of the premiums earned for direct business, reinsurance assumed, and reinsurance ceded. Property and casualty companies are required to disclose premiums both on a written and on an earned basis. The footnotes to the financial statements have to disclose the methods that have been utilized to amortize amounts into income, such as the interest method or the prorated method, over the period of the contracts.

FAS 113 is applicable to 1993. The statement appears in most contracts that have a 1993 anniversary date and is applied to those contracts as of January 1, 1993. The statement is a prospective-type statement, providing that the income statements or the effects of reinsurance contracts shall not be reflected by retroactive restatement of prior-year financial statements.

One implementation issue to be considered is that risk transfer must be evaluated at the inception of the insurance contract, recognizing any modifications or amendments that may have been made to that contract subsequent to its initial issuance. The standpoint and determination of balances has to be completed by January 1, 1993.

The application of the statement to the life and health industry to date has not resulted in any significant issues or questions. Most of the questions to date relate to short-duration contracts in the property and casualty business, catastrophe-reserve-type calculations, and whether a transfer of risk has occurred. In the life industry, most companies have already recognized that a surplus-relief reinsurance transaction did not transfer risk, and they are using the deposit approach of accounting. From a statutory perspective, the NAIC has started addressing the question on appropriate statutory accounting. The NAIC is currently revising Chapter 22 of the NAIC Property and Casualty Industry Accounting Manual. The NAIC had indicated that it will incorporate most of the provisions of *FAS 113* on risk transfer. However, the gross presentations probably will not be implemented.

I anticipate that Chapter 22 will be effective January 1, 1995, so there is some reprieve from a statutory perspective. However, the draft chapter contains a provision stating that contracts entered into after June 20, 1993 will be subject to the provisions of the new NAIC guidance.

MR. BEHAN: Our final speaker is William K. Tyler. Bill Tyler is a senior vice president of Lincoln National Reinsurance Companies, where he serves as chief financial officer. Bill joined Lincoln National in 1969 and served in various management positions within Lincoln National's reinsurance operation. He also serves as senior vice president and director of several Lincoln National affiliates, including Lincoln National Life Reinsurance, Lincoln National Health and Casualty, Lincoln National Reassurance Company, and Lincoln National Intermediaries. Bill graduated from the California Institute of Technology with a bachelor's degree in economics. He is an FSA and a member of the American Academy of Actuaries.

MR. WILLIAM K. TYLER: I'm very pleased to be here to talk to you about reinsurance accounting. I want to cover four topics. First, I'd like to discuss disclosure, reporting, and accounting developments in a very general way. Second, I will discuss the role of reinsurance as one of several financial and capital management solutions available to the management of insurance companies. Third, I will describe a few business applications that flow out of the current accounting developments. And last, I will draw a few conclusions.

Regarding disclosure, reporting, and accounting developments, it is important to look at all the accounting models that are important to the insurance company: GAAP, statutory, and tax. Over the last 15 years, reinsurance transactions have changed from largely unregulated transactions to transactions for which the accounting treatment is highly prescribed.

With respect to GAAP developments, Al has discussed *FAS 113*, but also important, at least in an indirect way, is *FAS 114*, which deals with the accounting of certain mortgage loans that may need to be written down, even though they're not currently delinquent but are in danger of becoming impaired. Also, *FAS 115*, which deals with mark-to-market issues, may create some opportunities or applications for reinsurance solutions. Mr. Reznicek referred to the property/casualty side of the business where accounting methods for funded covers is under discussion. The Emerging Issues Task Force recently issued a bulletin describing how those programs should be accounted for. There may be some application for that within the life and health area, although it's not clear where that application might be.

On the statutory side, we have two major developments: First, the NAIC implementation of RBC requirements for life and health insurance companies, and second, the NAIC accreditation process, which Cal talked about and which is an important ongoing activity. As many of you may know, there are several model laws and regulations that directly affect reinsurance in that package. Regarding the credit for reinsurance model law and model regulation as well as the reinsurance life and health agreement regulation, certain portions of the model company holding act also have a direct impact on the structure of reinsurance programs.

On the tax side, the IRS has recently labeled reinsurance as a significant industry issue for field examiners. From my perspective, reinsurance has always received a fair amount of attention on the part of the IRS, but this labeling of reinsurance as a major industry issue certainly further heightens that profile. We are aware that some of our clients have undergone what I think of as Section 845 audits, which is probably an outgrowth of this heightened profile by the IRS. The other tax issue of interest has been the DAC tax provisions, which Congress passed in 1991, and the key impact is the need for ongoing coordination between the ceding company and the reinsurer on DAC tax administration.

Finally, as a catch-all category, there are other activities that have an impact on the types of reinsurance transactions that can be implemented. A number of federal initiatives over the last few years have been discussed. Rating agencies have their view of reinsurance, and those views are changing in ways that make more sense from the perspective of those of us attempting to meet specific company-planning needs. Finally, agents and public concern, relative to the use of reinsurance by insurance companies, is an important development.

Having quickly surveyed these developments, I'd like to step back and review what reinsurance really is. In addition to being a risk-transfer mechanism, reinsurance has also always been a financial and capital management tool, only one of several tools available to insurance company management. The array of management tools available to all of us, in terms of dealing with our companies' financial needs, include: raising equity capital, debt financing, merger/restructuring activity, assumption reinsurance, product design and pricing, investment policy, conventional reinsurance, and financial reinsurance. All these tools are available to most of our companies, and they are in our toolkit to help our companies achieve business objectives and financial goals. The important thing to remember in the use of any of these tools, and certainly this is very true for reinsurance, is that the use of the tool needs to be coordinated after considering all the implications of a given transaction. You need to understand the GAAP, the statutory, and the tax impacts of any transaction that's being designed, the cash-flow attributes of the transaction, as well as the impact of the transaction on various leveraging ratios. All are important. As the rules for accounting for reinsurance transactions have become more prescribed, it's even more important to understand how the transaction will have to be handled up front before the transaction is concluded. In the past, you were able to choose from several possible treatments relative to either GAAP or statutory consideration, and you could often get the results you wanted because the guidance wasn't quite so prescribed for us.

I would like to discuss possible applications for reinsurance and link them to some of the accounting developments we've been talking about. With respect to an *FAS 113*-type application, consider reinsuring a block of in force business. What do you want from a GAAP standpoint, to have the gain or loss from that transaction immediately recognized in your income statement? In the past, it was possible to come to the conclusion that, for GAAP purposes, the initial impact of the transaction could be reflected in the income statement on day one. Under *FAS 113*, that's no longer possible under an indemnity program. On the other hand, one can use assumption reinsurance in order to get the immediate impact on day one of the transaction. The mechanics of implementing an assumption reinsurance transaction are far more difficult than most indemnity programs. The point is that the ceding company needs to be clear on its objectives and requirements in the transaction in order to determine what result and outcome it's looking for. That will then determine the best approach.

Here is another example, this time dealing with *FAS 114*. Basically *FAS 114* talks about certain mortgage loans that, prior to this statement, could be carried at amortized cost until they defaulted. Under *FAS 114*, loans that have a high possibility of going into default also need to be written down. This provides an opportunity, if you can find a reinsurer who's willing to reinsure a block of business on a coinsurance basis, to pass those specific assets over to the reinsurer. Then the ceding company can avoid having to go through the disclosure and the accounting treatment required by *FAS 114*. The way they're doing that is by passing the assets off to the reinsurer, and now the reinsurer has the problem. In some cases, the reinsurer may be interested in covering the transaction, even though they have to write down the assets. They may not be subject to *FAS 114*, or they may not be as sensitive to the impact of *FAS 114* on their balance sheets. So this is a potential opportunity for companies that are looking at implementation of *FAS 114*.

With respect to *FAS 115*, which deals with mark-to-market issues, there's a lot of potential for reinsurance to be a possible solution for companies that are looking at blocks of business that are very highly leveraged relative to interest rate changes. Certainly under *FAS 115*, without the corresponding adjustment to liabilities, companies will see substantial variations in their surplus levels, due to the interest rates. Certainly reinsurance is one solution for trying to deal with the impact of moving interest rates on especially *long-tail* business, where that interest rate leverage is important.

As a reinsurer, one area of reinsurance we thought would interest our clients was the RBC formula. Frankly we have not seen as much activity in this area as we projected a year ago. We thought that companies would be looking to use reinsurance as well as other techniques to effectively manage their RBC ratios. There are several reasons why we've not seen a lot of activity here, not the least of which is that the RBC formula has just recently been enacted. More fundamentally, the insurance industry is a fairly well-capitalized industry in 1993. We have experienced a strong equity market and a strong bond market that have improved the balance sheets of many of our companies. The need for companies to aggressively think about how to manage their risk profile under the new RBC rules is something that companies are willing to think about more carefully and analyze on a long-term basis.

While we have not seen as much activity as we would have expected, we think this is an important area in which reinsurance can be used to help manage the leverage ratios. For example, certainly quota-sharing business on a basis in which assets, premiums and reserves are all pushed out to a reinsurance company adjusts leverage ratios, whether RBC or rating-agency-leverage ratios. Reinsurance can be used very effectively in this area.

The basic conclusion I draw from all the recent regulatory and accounting activity is that despite all of the attention that's been given to reinsurance, reinsurance has emerged over the last 20 years as a very powerful financial planning tool. Reinsurance will continue to be an important tool in the toolkit of our company management. Probably the most significant impact of all the accounting and regulatory developments of the last few years is that the character of the reinsurance transaction and the use of reinsurance needs to change. It is not prudent for companies to use reinsurance transactions from a tactical, short-range or opportunistic perspective. Certainly that has been done in the past, and no doubt there will be situations in which that can be done in the future. Fundamentally, reinsurance programs need to be structured from a perspective that is a strategically orientated, long-range plan on the part of the ceding company, with an eye toward integrating this financial and capital management tool with all the other capital management tools in our toolkit.

MR. DAVID B. ATKINSON: That really does clarify it, and I wonder if I could have a summary of your speech? The question I have which you pointed out and was the most significant, is that a lot of this was done for property and casualty business and does not have a big impact on our life reinsurance business. Does it have an impact at all, for example, with an annual premium YRT contract? Do we now have prepaid reinsurance assets on our books or not?

MR. REZNICEK: I indicated that it seemed to be more applicable to the property and casualty industry. All the issues that I've seen to this point seem to have concentrated on property and casualty issues, primarily the short-term reinsurance risks. I haven't really focused personally upon the YRT issue or the effect on the financials. YRT does not reduce reserves in that case, but rather results in making what I call a term premium payment. I can't think of a required impact on the financial statements of a life company. Maybe someone else in the audience has faced this issue and has come up with a different view. If so, I would like to know about it as well.

MR. ATKINSON: The funny thing about our business is that we tend to take the total premium as earned the day it's due. If it's due June 30, then 100% of the premium is earned on June 30. *FAS 113* might imply that you only recognize 1/365 of the premium each day of the year. I don't know whether or not we were getting into that.

MR. BEHAN: I think that this might have been the situation already. Usually this is not going to be so material that it would make a big difference, but I think that there would have been a prepaid expense in any case. Al, does that sound right?

MR. REZNICEK: That sounds correct to me.

MR. BEHAN: I have a question for Al. You mentioned that the accounting aspects of *FAS 113* don't apply to reinsurance assumed. Does the transfer-of-risk content of *FAS 113* apply to reinsurance assumed?

MR. REZNICEK: Let me expand or clarify that. *FAS 113* was really written from the standpoint of the ceding company. It does carry provisions indicating that the statement does not change. It addresses the accounting for assuming companies other than the area of disclosures and an indemnification provision, and it provides some guidance on the indemnification against loss or liability relating to insurance risks and some of the disclosure requirements. But as far as changing the actual accounting, I don't think there's any change in the accounting for assuming companies. There are measurement criteria that have been expanded from the standpoint of whether there has been risk transfer.