RECORD OF SOCIETY OF ACTUARIES
1993 VOL. 19 NO. 4A

REINSURANCE AND RATING AGENCIES

Moderator: DIANE WALLACE
Panelists: MICHAEL L. ALBANESE*
JULIE A. BURKE†
Recorder: PERRY L. WISEBLATT

- How do various rating agencies view reinsurance?
- How do new risk-based capital (RBC) standards impact rating agencies' views regarding reinsurance?
- To what extent do ceding companies factor in rating agency concerns in their reinsurance decision making?

MS. DIANE WALLACE: We have a couple of great guest speakers here who are bravely facing a roomful of antagonists to defend their rating analysis practices. We, as actuaries, need to learn that other disciplines might perceive the same information in a different light than we do. For example, I enjoyed the story about the government employee who, in tight times, asked for a $50,000 raise, and was granted a $25,000 raise instead, and the information published was, "We had a $25,000 savings." That reminded me of the actuary who decided that the life insurance premium for 99-year-olds should be less than the life insurance premium for 35-year-olds, because many fewer 99-year-olds die than 35-year-olds. Hopefully, we'll achieve the goal of reaching the same conclusions as our ratings analysts when looking at the same set of facts.

Julie Burke is vice president of Duff & Phelps in the Insurance Ratings Group. She specializes in life insurance company claim-paying ratings. Her previous experience includes working as a high-yield analyst with Duff & Phelps and in the Trust Department of American National Bank & Trust Company in Chicago. She's a certified public accountant (CPA) and a graduate of Northern Illinois University and Northwestern University. Following Julie, we'll hear from Mike Albanese. Mike is assistant vice president of A.M. Best. He's been with A.M. Best since 1986 and leads an analytical team rating approximately 300 life and health insurance companies. Mike is a frequent industry author and speaker and has a degree in economics from Boston University. Also, I'd like to introduce our recorder, Perry Wiseblatt. Perry is reinsurance pricing actuary at the Equitable. I'm a reinsurance intermediary and consultant, specializing in financial reinsurance.

MS. JULIE A. BURKE: We welcome the opportunity to discuss our role in rating life insurance companies, and how reinsurance plays into the ultimate rating decision. This presentation will provide a general background on some of the factors driving the industry's risk profile, how we view life, health and annuity reinsurance in this context, and some elements we look at when analyzing a reinsurance transaction.

* Mr. Albanese, not a member of the Society, is Assistant Vice President of A.M. Best Company in Oldwick, New Jersey.

† Ms. Burke, not a member of the Society, is Vice President of Duff & Phelps Credit Rating Company in Chicago, Illinois.

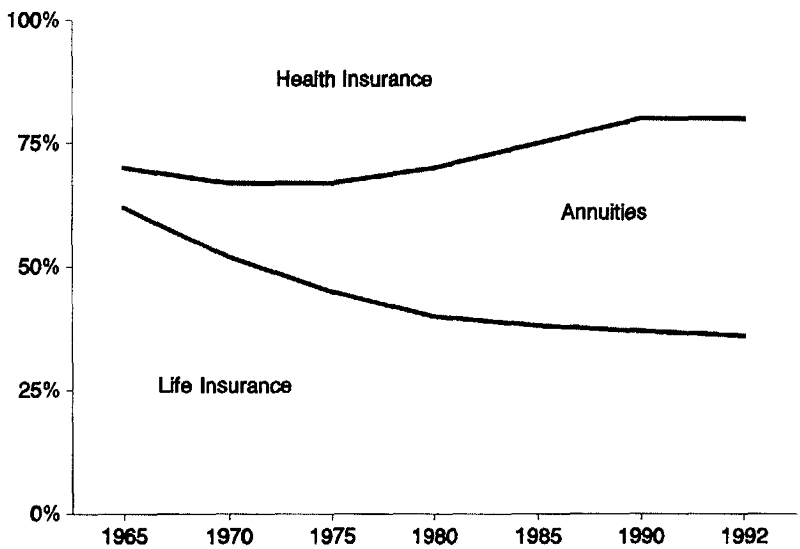
We all know that the life insurance industry has changed dramatically in the last decade or so. Chart 1 illustrates a trend toward annuity production and away from risk businesses such as life and health insurance. As you can see, this trend accelerated during the 1980s.

The competitive pressures affecting the industry have led some companies to increase their risk profile. Most of the incremental risk has come in the area of investment risk. The reach for yield has come in the form of below-investment-grade securities, commercial real estate lending and equity investments such as common stock, real estate and partnerships. At Duff & Phelps, we recognize that life insurers, like any company in any industry, must take risks to generate profit. For many years, mortality risk was the primary risk assumed by companies, followed by credit quality risk. Now companies are moving away from high levels of asset risk and their negative connotations, and moving toward other types of risks, most notably, interest rate risk.

We are most interested, not in the type of risk incurred, but in the magnitude and the management of risk throughout the organization.

CHART 1

Company Income by Product Type



Source: American Council of Life Insurance Fact Book, 1993

When we look at property and casualty (P&C) companies, reinsurance is almost always a critical issue in the rating process. Reinsurance risks we focus on include dispute risk, credit quality risk and availability risk. These risks are either not relevant or not material to most life, health and annuity reinsurance transactions. For instance, with mortality reinsurance, the reinsurer is insuring death benefits and death is typically not disputable. But on the P&C side, asbestos problems, environmental clean-up and corporate officers' negligence are issues open to dispute over coverage.

With regard to credit risk, P&C insurers are much more exposed to catastrophe and concentration risks than are life reinsurers. And availability problems have surfaced from time to time. Even if coverage is available to primary companies, the price is often too high for many.

We have found that risk reinsurance is seldom a critical rating issue with life, health and annuity companies. Risk reinsurance is reinsurance where there is a real risk transfer, not financial reinsurance, which is usually a financing mechanism. The reason risk reinsurance is not usually a critical rating issue is because of the shift in the industry's risk profile. Risk reinsurance has traditionally been related to mortality and morbidity risk, and as we saw in the chart, the industry has been moving away from these risks. Credit quality risk and interest rate risk are more prevalent, and these traditionally have not been included with reinsurance transactions. We believe the key rating issues over the next several years will not be real estate or below-investment-grade securities or the RBC formula. We believe the key rating issue will lead back to the fundamentals: the company's ability to compete on the basis of product, distribution and expenses. These also are areas where reinsurance has traditionally not played a role.

A claims paying ability (CPA) rating is an independent evaluation of an insurance company's ability to meet its future obligations under the contracts and products it sells. In essence, a CPA rating is a rating assessment of the company's credit worthiness.

When we look at a company from a credit perspective, whether we're looking at a CPA rating or a debt rating, we look for many different things, but one of the best signs of credit quality is a company that earns an attractive, sustainable risk-adjusted rate of return. When you find this company, you will find a company with not only the ability to pay policyholder obligations, but also the ability to attract capital.

Now what does all this have to do with life reinsurance? Well, when we look at a company's particular business line, or a specific transaction, we also are looking for the same thing: How does this affect the company's ability to generate attractive, sustainable risk-adjusted rates of return?

Three key issues we look at when assessing a reinsurance transaction are: Why is the company entering into the transaction? How is the transaction put together? And who's on the other side of the transaction? These three questions all get to the heart of the insurer's ability to use reinsurance to generate good risk-adjusted returns.

The answer to the core question of why the insurer is entering into a transaction is often as telling as all the documentation and details of the transaction itself. Motive is always an important issue to us. We also are interested in trying to determine how this transaction fits into the larger corporate strategy. Reinsurance should be part of a larger scheme, and not simply one or more independent stand-alone agreements.

A basic motive is often the flexibility to write additional business, whether it be a larger face value on a life policy than would be prudent given the company's capital base, or the ability to produce more annuity business. These seem to be reasonable motives to us. One concern we have is in cases of fast growth. That always sends up a red flag to a rating agency. A concern we have with regard to fast growth is that even though the company may be passing the risk, they are probably still administering the business. We want to ascertain that the company has the resources to properly service its ceded business, especially with small companies.

Another reason an insurer might enter into a reinsurance transaction is to gain a skill or to enter a new business where the reinsurer has a particular expertise. The insurer can learn a skill or a new business while passing the risk to the reinsurer. And even without reinsurance transactions, some reinsurers are providing underwriting and product development training on a fee-for-service basis. From a rating perspective, using reinsurance is a low-risk way for a company to gain or grow core competencies. In these situations, we want to hear that the insurer has thought through the strategy, knows what it's getting into and has done its homework. Because, as you know, any new venture should be approached with prudence and diligence.

A third motive we often see for using reinsurance is in lieu of a direct capital contribution from the company's parent. This is a situation that can be interpreted either as a positive or a negative from the rating perspective. Let me give you a couple of examples. A positive situation we encountered was a mortality reinsurance agreement whereby the large parent assumed all adverse mortality from its small subsidiary. When positive mortality occurred, the parent passed a refund back to the subsidiary. So, in essence, adverse mortality was passed and positive mortality was retained. From our perspective, this was a positive event for the subsidiary. Of course, we would always view a direct capital contribution as being even more positive -- but we were happy with the transaction.

A negative circumstance was a situation where a large industrial parent had supported its annuity subsidiary for years with large capital contributions. The annuity subsidiary was a fast-growing company that required consistent infusions of capital, therefore, the strength of the parent was a key rating factor. One day we received a call from the small subsidiary, informing us that they were going to enter into a reinsurance agreement to cede excess annuity production to an unaffiliated reinsurer. We interpreted this transaction as evidence that the large industrial parent probably didn't want to be in the annuity business anymore. Sure enough, within 18 months, that annuity company was sold.

A fourth reason for entering into a reinsurance transaction is to exit a business. This often has very positive rating implications, because when an insurer makes a complete exit from a business, it's typically a business that hasn't been very successful. Usually this occurs when the business line has had years of operating losses, when management has spent an inordinate amount of its time, and the insurer has experienced a great deal of internal turmoil with regard to this line. In these cases, we prefer to see the reinsurance structured as a clean break with no recourse whatsoever. We also want to be sure that the marketing effects have been taken into consideration. We want to know how the insurer will replace the business line.

These exits are often from lines, such as disability or other specialty lines, where the agents and the policyholders have come to depend on the product.

A fifth reason is to use reinsurance as a financing vehicle. Whether it be pure surplus relief reinsurance, or reinsurance to fund the cash-flow needs of variable annuity production; again, the motive is an interesting question to us.

A quote I recently ran across in a reinsurance textbook, *Life, Health and Annuity Reinsurance (Tiller and Fagerberg, 1990)*, said that surplus relief is used if "the company desires to improve or maintain its rating with A.M. Best, Moody, Standard & Poor's, or other insurance rating agencies." I think the authors are trying to say that surplus relief can be used to fool the rating agencies. Well, they didn't mention Duff & Phelps by name, and I'm not sure if that's a compliment or an insult, but we recognize surplus relief for what it is: financial reinsurance with nominal risk transfer. We do, however, feel that financial reinsurance does make sense in some instances; in fact, you could compare financial reinsurance to junk bonds because both have become pejorative terms. Both have a place in the industry when used in moderation, and both have been abused by some insurers.

How the actual reinsurance agreement works also is of great interest to us. There's no doubt in my mind that the transactions have gotten more complex recently, and if not more complex, certainly more verbose. We get more and more paper. This may be a function of the growth of lawyers and an increased need for complexity. As a rating agency, we must get comfortable with the details of the transaction. Once again, our motive is to understand how this complex transaction affects the risk profile of the company. We request a copy of the actual agreement, along with term sheets and other related documentation. We want to see how the agreement is structured. For instance, who manages the investment portfolio? Who determines crediting rates? How are disputes resolved? Is there any recourse? How are expense charges calculated? In cases where the transaction has significant rating implications, the insurer will often be in contact with us throughout the negotiation period. And since we likely rate the reinsurance company, we have the added advantage of seeing both sides of the transaction.

We also want to see how the agreement affects the financial statements. As you know, reinsurance transactions can hide real operating results. Therefore, we request that the company send us financial statements, both including and excluding the transaction. This helps us determine how material the transaction is, and obtain a sense of comparable operating results from prior periods. When we do encounter pure financial reinsurance, we will reverse the transaction when we calculate our financial ratios; therefore, we can compare the insurer to peers on an apples-to-apples basis.

We feel that *FAS 113* has much more of an effect on P&C companies than on life companies. It basically says that if a ceding company cannot prove the transfer of the legal obligation, then the ceding company has to gross up its balance sheet to include the reinsurance ceded. Like so many FASB pronouncements, *FAS 113* does not really change any of the economic realities. It's simply a bookkeeping event, much like *FAS 106* is. Furthermore, for now, *FAS 113* is a generally accepted accounting principles (GAAP) event and our CPA ratings are based primarily on statutory results. For these reasons, we don't believe that our rating analysis will be significantly affected by *FAS 113.*

The use of assumption reinsurance has become somewhat controversial in recent years. Some critics have said that assumption reinsurance is unfair to the policyholder. Well, rating agencies rate financial strength and not the consumer friendliness of the companies and sometimes it's the companies with the higher ratings that are less consumer friendly (although not in all cases).

We believe that assumption reinsurance is a very tidy way to transfer a block of business. It tends to be a clean break with no loose ends. So, from that point of view, we think it's an effective mechanism. However, we do share some of the critics' concerns. The lack of information to and consent from the policyholder is troublesome to us. We think this has and could cause ill will toward the company and toward the industry generally. Negative reactions have come, not just from policyholders, but from the media, from regulators, and from legislators.

Who the company does business with also is an important consideration. One of the key issues here is the financial strength of the reinsurer. We have rating relationships with most of the large, major life reinsurance companies. Therefore, we already have an opinion on their financial strength. For those companies with whom we do not have a rating relationship, we keep tabs on their performance through publicly available information, and for some, have developed internal ratings.

One of our goals is to bring all the reinsurers into our published universe of companies. We do not believe that ceding companies should use only reinsurers that are rated AAA. We also are comfortable with any reinsurer rated in any of the AA categories, including plus or minus. As you may know, we define AA-rated companies as having very high CPA.

A related topic is one of due diligence. We're always interested in how a company assesses and addresses risk, not just on the reinsurance side, but throughout the company. Therefore, we ask for a full description of their due diligence process. We want to know who was involved, and what was reviewed? How long did it take? What was discovered? Were there any surprises? And how will the reinsurer be monitored going forward?

Because the insurance industry is a "people" business, we look at the quality of the company's relationships with its agents, its employees, its regulators, and other constituent groups. The relationship with the reinsurer is no exception. Many reinsurance relationships are long-term alliances. I guess you could have called them strategic alliances, before anyone knew that that's what they were.

An insurer's relationship gives us a sense of how the company conducts business. For instance, does it manage for the short-term or the long-term? Why has reinsured turnover been so high or so low? Does the insurer give the reinsured too much of its business or too little of its business? Does the reinsurer consistently make money from the relationship? These are some of the questions we ask to get a sense of the dynamics of the relationship between the insurer and the reinsurer.

Another dynamic is the state of the reinsurance industry itself. We believe that fundamentally the life reinsurance industry is a mature business. Reinsurers have traditionally supported the growth of young insurance companies, and now the industry is in a consolidation mode, instead of a growth mode. In this slow-growth environment, a key issue will be the temptation to pull capital out of the reinsurance industry. This is especially relevant with reinsurance departments of larger, multiline companies. Management might feel it wise to reallocate capital from the reinsurance line to other lines of business with better growth prospects. In addition, some reinsurance lines have become commodities. Over the long term price wars will hurt any industry. Just ask the airlines.

In conclusion, I have a few remarks. Insurance companies must take risks to generate returns for their policyholders and stockholders. Generating these returns helps attract and retain business and helps attract and retain capital. As a rating agency, it's our job to determine the company's risk profile. Reinsurance is a means to pass risk to another entity. It's also a means to pass return to another entity. We're sometimes concerned that companies pass too much return to reinsurance companies. We think that a company should have a reinsurance program that fits with its overall corporate strategy, and that strategy and the reinsurance agreement should be reviewed on a regular basis.

Finally, a life insurance company is not likely to become insolvent as a result of reinsurance. But reinsurance will affect the company's incremental profit and incremental risk, and we believe that it's the smaller, incremental decisions that will drive the insurance industry over the next several years.

MR. MICHAEL L. ALBANESE: Certainly, we at A.M. Best appreciate the opportunity to be here as well. Addressing a topic as technical as the reinsurance issue is as daunting a task as trying to get into Manhattan, but I made it through some bumps in that journey, so let's see if I can do the same with this presentation.

Due to many of the reporting and accounting conventions that exist, in some cases, the only parties that are truly able to assess all the nuances and technicalities involved with the risk transfer, earnings and recoverability issues of reinsurance are the actuaries and the lawyers who have put together the contracts. I don't want to attempt to convince anybody here that we, as a rating agency, or any outside party for that matter, can truly assess every single element involved with every reinsurance contract. I would, however, like to cover some of the larger aspects of the way reinsurance fits into our overall rating framework.

Looking at reinsurance from a rating agency perspective reminds me of Clint Eastwood movie: you've got the good, the bad and the ugly implications of reinsurance, and I'll touch on a few examples of each of these classifications. Also, I want to talk about some of the explicit impacts that reinsurance might have on our qualitative or quantitative assessment of insurance companies and how that relates to our rating of a particular company. I also want to touch on how we're viewing capital adequacy, and some of the explicit items to be aware of when you review your company's reinsurance practices and the potential impact that they might have on our assessment of your company's capital needs.

Now, it's perhaps appropriate to preface my comments by taking a step back and mentioning that any of our comments, whether we talk about reinsurance, investments, or capital adequacy, are always made from the larger context of meeting the objective of Best ratings. For us, the objective of Best ratings is to provide an independent opinion on the financial position and operating results of an insurance company. This is based on our opinion of the company's relative ability to meet its obligations to its policyholders, which is based on a comprehensive evaluation and integration of all quantitative and qualitative aspects that affect the company's overall operating performance and its financial strength. Now, our view of reinsurance must fit into that context, particularly how reinsurance might affect our view of a company's financial strength, and that's relative to where it has been historically, relative to its peers, and also relative to standards that we would supply for various rating classifications.

There are many purposes that reinsurance can serve, and many of those are consistent with prudent and conservative business practices. Reinsurance can also serve some less conservative practices and certainly has been utilized in the past to foster abusive practices. Consequently, I think it would be inappropriate for us as an outside party to take a single view towards reinsurance. Each situation has to be evaluated with regard to the specific motivation, financial impact and magnitude that it would have on a company's operations.

Reinsurance can have some very favorable influences on a company's activities. Consequently, we might view certain instances favorably under our rating analysis. Risk management of a company can be met through reinsurance. We wouldn't necessarily take a negative view of a company's reinsurance practices if it seeks to reduce earnings volatility, or transfer risks through reinsurance, even if the result is to modestly weaken or reduce current income in doing so. We've also seen reinsurance as a very effective means of capital management. Companies that do not have redundant capital available to them on a stand-alone basis, companies that don't have a parent company with very deep pockets, or who simply choose not to tie up their capital when particular business opportunities are presented, might use reinsurance as a good means to manage their capitalization. One example of this is the increased number of joint ventures currently taking place in the development of new products or marketing programs.

Also in terms of good implications, it seems that just about every industry segment is faced with several common critical areas, and distribution costs are certainly at the top of this list, notwithstanding some of the recent movements (particularly at the NAIC), to place increased constraints around assumption reinsurance. We have seen assumption reinsurance agreements prove very favorable in providing a method for companies to acquire blocks of business that strategically fit in organizations at a lower-cost basis than would be available through traditional distribution methods. Using the assumption reinsurance mechanism as a way for companies to make strategic exits of lines of business, or to reduce their exposures to marginally performing businesses, is also viewed positively.

Now beyond just the acquisition or exits from business, reinsurance can be successfully utilized to reposition businesses among various members of a group. This might be sought to provide greater management control over the overall activities of the organization. We have seen a couple of organizations essentially pull business within the group, and they have been able to effectively administer the business better than they had prior to such arrangements. Some companies might even do this to achieve economies of scale in other critical areas of their operations, for example, investing in larger blocks of assets than under the legal entity approach.

We look very positively on reinsurance that's provided by a strong parent organization to a downstream subsidiary, where the downstream subsidiary may not have the recognition in the marketplace. We think that this is very favorable in locking in the strategic commitment of a parent organization to its downstream subsidiaries.

Entry into new product lines or businesses can be facilitated through reinsurance. We find this particularly true for companies that don't have resources available on their own to participate in an emerging market or product line. For example, the substantially larger policy limits that are associated with survivorship contracts, would make it impractical or dangerous for smaller companies to be involved with retaining all the risks associated with this line of business.

We also look positively on the fact that reinsurance can provide an alternative source of funding for transactions or purchases of companies where there was limited or no access to the financial markets otherwise. We feel that such activities could be viewed positively on our rating analysis if it enables a company to consummate a transaction that is in the organization's long-term strategic interest; however, there are obviously some caveats to this statement, which I will touch on shortly.

Finally, reinsurance can be helpful in many functional areas for companies. We have found in some instances that relationships with high-quality and professional reinsurers have favorably influenced company behavior or forced an additional level of due diligence on companies that might have lacked appropriate skills or expertise or management controls to ensure that they were going about the underwriting, pricing and spread management of their businesses appropriately.

Now, as I mentioned, there are also some less favorable impacts that reinsurance can have on a company's activities. We've seen all too frequently that financial distortions which might be caused by reinsurance can mask a company's underlying problems with its businesses. An outside party, such as a rating agency, would have difficulty in assessing a company's true profitability solely from the financial statements, and might likely draw incomplete or inappropriate conclusions about a company's operating performance. Now this impact from an outside party's standpoint is clearly less of an issue than managements that are making inappropriate or incomplete decisions based on illusory financial results that they might see generated from reinsurance. We have witnessed situations where profitability of businesses that have been solely reliant on ceding commissions turn bad as the reinsurance contracts have gone through changes over the years, or as the actual performance of the companies' businesses fell well behind inappropriate pricing assumptions. The assuming companies have been left holding very large and unprofitable books of business.

Also, poor quality reinsurers can be problematic. From our perspective, the quality of reinsurance is only as good as the companies with which you engage in reinsurance activities. If the reinsurers encounter difficulty in terms of their own financial positions, then liquidity, capitalization and profitability may be substantially impacted. In addition, in this environment with all of the media attention that the industry is getting, the negative publicity that can arise from a company that is substantially engaged in activities with an impaired company might present its own set of challenges that go beyond any of the other financial impacts due to problem reinsurers.

The topic of surplus relief, or financial reinsurance, remains a very controversial issue. As a rating agency, we believe that the topic of surplus relief remains an issue of definition. Despite some of the recent regulatory attempts to curb the use of financial reinsurance, we believe that reinsurance can still have inflationary effects on a company's reported results. Consequently, we would view more negatively programs that exist solely to support excessive levels of business activity that would be utilized to support and fund its distribution activities. For example, a company that has little or no control over its distribution mechanisms and relies on financial reinsurance to support a level of writings that it otherwise could not, or probably should not conduct, definitely would be viewed negatively under our rating analysis. We've found over the years that there are many common threads with problem companies and one of those common threads is excessive or uncontrolled growth. So the favorable effect that might be produced through reinsurance, even if there is an element of risk transfer under the new regulations, might distract management from focusing on the need for appropriate controls over their distribution channels.

We also feel that reinsurance can be habit-forming. From time to time, companies have become reliant on reinsurance activities to fund their growth. A company that chooses to continue to do so to support its growth objectives might be viewed negatively, especially when substantial calls on previously placed business are placed on the company, for example, when the payback period starts and the company needs to go out to the reinsurance markets to get more additional capital to support growth objectives and pay back existing reinsurance.

Now, although I mentioned that we sometimes view the use of reinsurance to fund acquisitions positively, we might view this negatively in some circumstances. We've found companies funding acquisitions through reinsurance. These companies have substantial cash flow requirements which place a burden on their ability to generate earnings and increase their surplus in the future. Where there are substantial obligations associated with paying back reinsurance to fund those acquisitions, we might view that in a very similar manner to how we would view significant fixed payment obligations that would arise with publicly or privately financed, highly leveraged transactions.

Now there's one final point about how we might view reinsurance negatively. It's the approach we take with companies who utilize reinsurance solely to circumvent the capital adequacy requirements, whether it's those of the NAIC or those that are imposed under our proprietary model to support particular rating classifications. Essentially, we feel that reinsurance practices that are of little economic benefit to a company or inconsistent with its long-term strategic interests should have a negative connotation on our rating of a company.

In the extreme, reinsurance can have some very ugly consequences. Over the years, we've seen substantial problems arise when companies become overly dependent on reinsurance as the primary source of capital. Problems are particularly acute for companies that engage in reinsurance with poor quality reinsurers that may run into financial difficulties. We support the fact that you can find comfort in safeguards implemented to protect companies from potential problems of reinsurers. Trust funds, or letters of credit, for example, are of great benefit in insulating companies from the financial difficulties that their reinsurers may run into. But we still believe that it is appropriate to question these arrangements and not appropriate to develop a false sense of security when these arrangements exist.

We have seen recoverability problems arise in certain cases, where there have been assets that were held in trust or backed by letters of credit. Although it wasn't a major failure, Andrew Jackson Life's failure presented some recoverability problems for a couple of companies that were specifically involved with their rating discussions.

In addition, the existence of trust funds is not necessarily a guarantee that appropriate or properly valued assets exist to support the business transferred through reinsurance. Also, in connection with recoverability risk, or the failure or impairment of reinsurance, we do feel that this can be contagious. It's definitely a larger issue for the P&C segment, where many failures of reinsurers have played a role in the failures of direct writing companies. But we have seen the failure of some life companies that have been caused by the failures of reinsurers.

Also, in the rapidly changing environment that we've seen all companies operate within, we can't ignore the significance of potential changes in regulation or accounting practices. Examples in this regard include some of the more recent NAIC regulations regarding risk transfer and reinsurance. Such modification in certain companies has caused them to restructure previously executed reinsurance transactions and maybe even take some financial impacts. Although the *FAS 113* pronouncements really are not an issue on the life/health side, it is presenting a specific set of challenges for many P&C companies.

With regard to the impact that regulatory or accounting changes might have, it's been our experience that changes in regulatory conditions are generally of less significance for companies that maintain a focus on pursuing prudent business practices, rather than those companies that are making decisions based on their desires to circumvent holes or deficiencies in the accounting or regulatory environments. Unfortunately, it can be expected that, in a competitive environment with close to 2,000 life/health insurance companies, not all participants are motivated in the same manner towards their decision making.

Finally, in some situations, we have seen reinsurance utilized essentially as a life support mechanism. And it's obviously appropriate to look through the window dressing impacts that might cloud what are really desperate situations.

These comments have a tone of cynicism but are based largely on our experiences over the years. The larger or high-profile failures that occurred, particularly in the 1990-91 time period, definitely deserve the attention that they've received. But, at A.M. Best we also feel it's very important to consider the issues that have accounted for and continue to account for the greatest number of life/health insurance company insolvencies and impairments. Many of you might be aware that we've published a comprehensive study on all failures and impairments that have occurred in the 15-year period between 1976-91. We have updated this to September 30, 1993. In doing so, we've identified approximately 306 life/health failures and impairments.

In doing so, we've isolated six situations where reinsurance failure was directly cited as the primary cause of insolvency (Table 1). The companies that were involved generally had very high levels of reinsurance or transacted reinsurance with lower quality companies, and were generally rated very low, or assigned one of our "not assigned" designations under our rating system.

Now on Table 2, there are an additional five companies that we've identified as having reinsurance as the secondary cause of their insolvency. Again, these companies had very high levels of reinsurance, and were not favorably rated by us or were assigned one of our "not assigned" designations.

TABLE 1
Failure Due to Reinsurance
Primary Cause of Failure

Company	3 Years Prior	At Failure	Year Failed	Reason
Old Security Life	NA-7	NA-7	1977	Affil Reins
California Life	NA-7	NA-7	1986	Affil Reins
Southern National Life	N/R	N/F	1989	Offshore Reins
Security Southwest	C+	N/F	1989	Affil Reins
New Jersey Life	B+	NA-4	1991	Surplus Relief
AMS Life	B	NA-7	1992	Unaffil Reins

TABLE 2
Failure Due to Reinsurance
Secondary Cause of Failure

Company	3 Years Prior	At Failure	Year Failed	Reason
Knickerbocker Life	B+	NA-7	1988	Affil Reins
United Republic Life	NA-5	NA-2	1990	Affil Reins
Fidelity Life and Sunbelt Life	NA-2 NA-2	N/F N/F	1991 1991	Affil Reins & Fraud*
World Life & Health	NA-7	NA-7	1991	Offshore Reins and Fraud*

*Alleged

The failure or impairments of only these 11 companies out of the 306 failures might suggest that it's not a widespread problem. But we have found approximately 60 additional companies that have failed due to mismanagement, alleged fraud, or affiliated problems, and we believe that tends to understate our findings of primary or secondary causes of insolvencies because we believe there was some element of reinsurance within the overall conditions that led to the failure of many of these 60 companies.

Now, given my preceding comments about the different perspectives that we might take towards reinsurance, I'd like to tie this in with how it factors into our overall rating process. First, our analysis of reinsurance is aimed at evaluating the purpose, quality, magnitude, provisions and financial impacts that reinsurance activities might have.

It's also important to note that reinsurance might be approached from a couple of different aspects in our rating analysis. Because we have the most comprehensive reporting in the industry, we are familiar with, report on and rate just about all companies of any significance with whom reinsurance is transacted. Therefore, we believe that we can make appropriate assessments as to the overall quality of a company's reinsurers.

Also, because of our scope of coverage, oftentimes we have talked, and where significant, we will talk to both parties involved in the transaction. I think this gives us some unique insights into the provisions, the purpose and financial impacts that might arise through reinsurance transactions. Also, remember that reinsurance transactions can have as much bearing on the rating of an assuming company as they do on a ceding company, so we generally are able to get a good idea from talking to both parties to a significant transaction as to what the true implications may be.

As already alluded to, reinsurance might have a positive or negative effect on our analysis. It also affects our quantitative, as well as qualitative analysis of companies. Quantitatively, reinsurance might explicitly impact our review of a company's profitability, its capitalization (its leverage position), or its liquidity. Qualitative considerations to bear in mind include the quality of earnings and surplus, strategic implications and regulatory issues.

Financial statements alone don't begin to address many of the issues associated with reinsurance. In order to overcome these deficiencies and better understand some of the quantitative issues that are involved, particularly with regard to specific provisions of the contract, we solicit supplemental materials relative to all companies' reinsurance practices. For example, understanding what a company's maximum net retention is on its major product lines might be of significant importance to us in understanding some of the purposes behind a company's reinsurance programs. We also inquire about the specifics, in terms of outstanding letters of credit (issuing bank, assuming company, type of business, reserve credit), funds held (assuming company, type of business, reserve credit, amount held, market value of fund assets, fund administrator) and financial reinsurance (assuming company, year entered into, face amount, reserves, net relief, repayment schedule). But in addition to some of this broader-based information that we request from companies, where reinsurance activities are significant, we also request copies of the actual contracts, trust agreements and letters of credit.

Some of the more specific items that might be factored into our analysis of reinsurance would be broken down into our familiar profitability leverage and liquidity format: a company's adjusted surplus relief to their earnings or revenue might be viewed both post- and prereinsurance, and their returns on equity and returns on assets viewed as both post- and prereinsurance. We'd also tend to look at this by a company's lines of business, by new versus renewal profit results. Also, we'd factor in specific adjustments in terms of liquidity. In this regard, we might look at the level of reinsurance ceded, relative to company surplus or assets, and the reinsurance recoverables relative to their surplus. Their adjusted quick and current liquidity measures might provide some flags to us in terms of company's liquidity positions -- there might be excessive exposures to reinsurance. Capitalization considerations include surplus relief relative to capital and surplus, our net leverage that we would view both post and prereinsurance that would have a bearing on the company's insurance risks, and also, Best's capital adequacy ratio (BCAR).

Now, over the last two years or so, we've been asked to comment extensively on our treatment of companies' capital positions. I could spend an entire session doing that, but what I want to do is narrowly focus on only those elements that regard reinsurance and how that might affect our review of the company's capital adequacy.

In terms of balance sheet treatments, you'll find that the default charges might be the same as those used under the NAIC requirements, for example. Items that are below the invested asset line may get a 0.5% charge. We're not inclined to reduce that. In fact, if we feel that there are not significant securities protecting the assets or the book of business being transferred, or we suspect the valuations and type of assets that are utilized, we may change those requirements to be more consistent with the assets that would be supporting the transaction.

In terms of insurance risk, we're concerned with the in-force and reserve components that will be calculated on a gross basis, which would give no credit for any reinsurance, and on a net basis, which would give complete credit for reinsurance. If we felt that there was a significant enough spread between the two on a best and worst-case scenario, we would then look at an adjusted basis, where we would give credit for quality reinsurance, as well as for reinsurance that we felt had adequate security provisions in place. Our treatment of C-3 risk is similar to that of C-2: we use both a best and worst-case scenario of annuity reserves calculated on a gross, net and adjusted basis, again, looking at the quality and security provisions of particular contracts.

The last area of our capital assessment is for C-4 or miscellaneous risk and it's a catchall for us as it is for any other model. But I think this might have some more significant bearings on our assessments of reinsurance. For example, we might make explicit adjustments to surplus because of reliance on reinsurance with lower quality companies. We might stress test a company's capital position to account for various levels of nonrecoverability. We also might take a discounted approach toward the recognition of what a company's true or permanent capitalization may be – capitalization that might otherwise be inflated by reinsurance, particularly financial reinsurance.

We might make other adjustments based on the purpose of the reinsurance activities. For example, even if there is risk transfer with a high-quality company, but we really feel that it is done for window dressing purposes, we may give little or no recognition for that. Essentially we're going to run various scenarios to assess what a company's capital range may be. Also, we might factor in any payback schedules in terms of the effect on future capital needs; for example, if the company is scheduled to pay back a significant amount of reinsurance the following year, we would stress that during the current year's capitalization. The last thing that I want to touch on, which is more qualitative in nature, is reinsurance activities that might be excessive in magnitude. If a company has an exceptional level of reinsurance that it's conducting, we may find that there's no Best capital adequacy ratio that we would feel comfortable using to assign one of our higher rating classifications.

There is one last point that I want to leave with you from a rating agency standpoint. It's necessary that we apply some standard approaches toward our assessment of insurance company operating performance and financial strength. Unfortunately, because of abuses that have occurred in the past, the starting points for many of our analytical processes are very conservative in nature. We believe that credible ratings must be based on a thorough understanding of a company's operations and this is only accomplished through a complete and open dialogue between us and insurance companies' managements. We've tried to pride ourselves on playing a constructive role in the industry, but I caution that being constructive shouldn't be confused with giving out lenient ratings. What we're more concerned with than obtaining any distribution of ratings is having appropriate and proper ratings for all companies, regardless of the way the distribution turns out. We find that the open exchange of information is beneficial for us and the company to understand the company's operations. This is the approach we might take when viewing unusual or extraordinary circumstances. Because our business is as much an art as it is a science, we have a much greater level of comfort with situations that we've discussed with management as to what the impacts might be, rather than solely reacting to developments in which we've had very little communication, and therefore, are very suspect as to the motivation of potential impacts that might arise.

MS. WALLACE: I'd like to give you a few insights on the rating agency process from the outside looking in. I'm going to cover a lot of concepts similar to what Julie and Mike have discussed, but from a slightly different perspective. Like them, I will divide my comments into the quantitative and qualitative issues of how reinsurance affects the ratings analysis.

As far as quantitative issues, I want to describe how rating agencies look at reinsurance capital based on my experience. Most of the financial ratios used to assess the financial condition of a life insurance company involve some permutation of looking at net worth, or capital, divided by reserve liabilities. The quantitative issues affect how reinsurance is treated in both the numerator and denominator of that formula.

I'm often asked why rating agencies do not take into account the numerator of the formula, the net worth, or the capital, related to reinsurance transactions. I have to say that I agree with the rating agencies on this point. Reinsurance capital, by my definition, is essentially leverage, meaning, capital that has a planned period of repayment. For example, debt infused as equity has a planned period of repayment to the bank. Likewise, reinsurance has a planned period of repayment, that period being in accordance with the flow of future profits on the block reinsured. And this is true for most reinsurance, whether conventional or financial. It is expected that, over a period of time, the ceding company will repay that reinsurance capital. Since the long-term net worth from that transaction alone is not essentially improved through the reinsurance transaction, it is understandable to me that, from that very narrow perspective, the reinsurance capital would not be counted in the numerator of the formula I've described.

I think it is important to count the reinsurance in the denominator of that formula (the liabilities associated with the insurance company). The only reason to reduce liabilities on account of reinsurance is because of the collectability of that reinsurance. Is the reinsurer good for its obligations? Another way to ask that is, how secure is the security? Of course, reinsurers domiciled in the United States are given complete credibility with respect to their security without any actual funds pledged. If the reinsurance is with a company outside the United States, security is required for the ceding company to take a reduction in their reserves on account of the reinsurance.

That leads to an ironic situation where sometimes reinsurance with non U.S. companies is actually more secure than reinsurance with U.S. companies. I find that rating agencies routinely discount the credit for reinsurance on account of security issues. I'm glad to hear Mike say that the discount is considered similar to asset default rates. In my experience, the discount has been much greater and I believe that large discounts are inappropriate if the transaction is fully secured. We were fortunate to hear from two analysts who specialize in the life insurance industry. I find that analysts often confuse P&C issues and life issues on this point. When P&C reinsurance reserves are fully secured, that security may not be sufficient to cover the future claims on that business. The fluctuations in claims as they mature in relation to reserves on P&C business are much greater than they are on life insurance. And the reserve may turn out to be only half adequate to cover future claims, whereas in life insurance, the fluctuations are much more modest and it is very unusual for an amount of assets equal to reserves to be insufficient to cover future claims on a life insurance block.

So I have found the contribution of reinsurance to the denominator of the net worth to liability formula to be inappropriately handled by many ratings agencies, as compared to the numerator.

With regard to the qualitative issues, first, I would say that the basic issue is whether the reinsurance transaction is going to stabilize the company and create an environment for the company to have profitable growth and ultimately increase its net worth. If this holds true, then it is good for the company. In other words, the company must have a good business plan, they must understand the strategic purpose of their reinsurance and be able to explain to themselves and to others why the reinsurance will ultimately increase their net worth.

One reason is smoothing capacity. It is a very difficult situation for companies to have to turn off agents; that has negative implications with respect to covering new business expenses, for example. It has negative implications with respect to persistency, and companies can't always judge how new products will sell in the marketplace. Reinsurance can be used to smooth that capacity without creating dislocations in the marketplace.

Another important reason to use reinsurance is to time a company's entry into the capital markets. Everybody loves equity capital, but unfortunately, it's not always a good time to obtain equity capital. Using reinsurance allows a company to make effective use of cycles for raising equity capital, i.e., using reinsurance in the interim until it is judged favorable to enter the capital markets.

A corollary to that is that often a reinsurer can obtain capital more cheaply than a prospective ceding company. Using reinsurance to make use of a reinsurer's lower cost of capital is very effective.

Finally, in spite of what I've heard about using reinsurance to cover problems, I think there are times when ratings should be positively impacted by reinsurance, even when it's being used to cover problems. One circumstance would be when it is important to create a perception among publics of financial stability after a problem has been discovered, dealt with and is on its way to recovery. I'll give you an example. I worked on a reinsurance transaction once for a health insurance organization that had been poorly managed. The rate increase process had deteriorated and the company was on the brink of disaster. The company subsequently obtained management that brought it back to financial health and got the underwriting and rate increase process under control, but they were facing a few more periods of unsatisfactory results, which was going to end up hurting their persistency. Reinsurance, with regulators' involvement, was a useful way to bridge the gap, to carry the company through the bad time until the positive actions they had taken were given time to succeed.

There are definitely bad reasons for using reinsurance and these reasons should be recognized by ratings agencies and analysts when considering the financial condition of companies and I think our other panelists have enumerated those well: for example, delaying recognition of a problem without any plan of action to correct it and growing too quickly.

I would now like to talk about some foolish decisions by ratings agencies that I have seen. I think in general, if you try to understand yourself, your reinsurance transaction and the strategic implications of it, and you communicate those effectively to your ratings agency, you will, for the most part, agree with the decisions from the ratings analysis. However, I have had the opportunity to see decisions that I just couldn't understand, and I think a lot of that is due to lack of communication. I will enumerate some examples of that.

First, I think there's a tendency sometimes on the part of analysts to consider reinsurance negatively, when at worst, it should be neutral. Certainly there are situations where it is negative. For example, I had a client with a reinsurance agreement that absolutely protected its downside risk on 100% of its in-force business. It was a mono-line company, which was not able to lose money as long as this reinsurance agreement was in effect. The portion of their capital that came from this reinsurance transaction was modest and their pledge of future profits from this reinsurance agreement to the reinsurer was modest. The reinsurance was also with a solidly rated, secure reinsurer. Yet, my client was told by their analyst that it was preferable from the ratings perspective for this company to replace that reinsurance capital with debt capital in the holding company, i.e., debt infused as equity. This made absolutely no sense to me, and I think that it is an example of a phenomenon in some minds that reinsurance is bad and "I don't want to hear about it." I think that's changing, but I caution you on that point.

Another problem I've seen is unrealistic requirements for capital structure. Of course, everybody would prefer equity capital, but there are certainly instances when leverage is appropriate and where reinsurance in particular, as a form of leverage, can minimize fluctuations, and limit downside risk.

Finally, another nemesis of companies working with their analysts is that the analysts often have frequently changing preferences and requirements. For example, another client of mine routinely visited their analyst and was given an idea of the ratios and capital structures that would be necessary to obtain the rating they sought. Every visit they met the previous requirements and were given a new hurdle to reach. This was extremely frustrating. Again, I feel that this is often due to a learning curve, but I would encourage analysts to be careful not to change their requirements too frequently.

Last, I'd like to address some practical ceding company issues when dealing with your rating agencies as you consider a reinsurance transaction. As I said earlier, the first goal that a ceding company should have, if they wish to get appropriate rating agency treatment for their reinsurance, is to understand themselves, the long-term strategic goals of their transaction and how it will help them achieve profitable growth. The company also should be very aware and conscious of the security concerns. Julie pointed out how important it was to her to understand a company's own due diligence process. That is another important issue: do your homework.

I would also suggest that ceding companies learn the quantitative methods of their rating agencies and test the transaction against those formulas and methods. Finally, please don't hide. Explain your transaction clearly, concisely and completely to your analysts. This not only creates an environment of trust, but you are the one who understands that transaction best and it's the tendency of any human being faced with not understanding something to back off and say no. Teach your analysts what you're doing, and why, and you'll probably have good results.

Ask for input from the analysts, but do not always expect them to give you definitive conclusions. Nonetheless, you should follow your best judgment if you have done your homework, and go ahead.

MS. BURKE: I'd like to talk a little bit about what Diane just said. We are always very happy to serve as a sounding board for clients, or to let you send off test balloons. And we often will receive ideas from companies who are thinking about doing something and want to know how this will affect their rating. We're always happy to respond to those types of questions.

MR. ARNOLD A. DICKE: We have only the most plain vanilla kind of risk reinsurance transactions, but our financial people have asked my area, which is responsible for the treaties, to do due diligence on them, and Julie mentioned that due diligence was an important part of what companies ought to be doing. In doing our due diligence, naturally we would probably look at the ratings that you give to the reinsurers. What I'd like to ask is, to what extent are your CPA ratings appropriate for doing due diligence on reinsurers, and what other sort of information is obtainable and would be the most useful that might help us do this?

MS. BURKE: If you're thinking of entering into a transaction with someone, they should probably be happy to give you the information you're interested in. I don't know if that's what you've found out there.

MR. DICKE: I'm thinking of a situation where we have many treaties in place with many companies and we need to do a due diligence once a year on these companies as part of the general financial process. Obviously, we don't have time to do too much in-depth analysis of the financial, although we have all that information. If you are already rating those companies, to what extent can we rely on your ratings for this purpose? If that's not appropriate, is there other information, reports and things you publish about the company that is appropriate? I know of the report that Duff & Phelps publishes, and Best also produces some; we're able to get some of the data from the companies. Do you think those are helpful? What would you look at?

MS. BURKE: I think you could probably use the ratings as a starting point. You know, we feel ratings are one tool, whether you're an agent selling business or a customer buying business. You're certainly not going to enter into a reinsurance transaction with a great company if it's not economic for you to do so. Ratings are just one factor. You might pick up the reports and see what the key issues were that we identified, and then go into the companies and talk about those key issues. Many times it's asset issues, and you can get additional information from the companies directly.

MR. ALBANESE: I would agree to use the ratings as a starting point, but also try and understand why the rating is what it is. You know, when we look at professional reinsurers, there are certain issues being exposed in that marketplace that are going to dictate ratings there, so I would be careful about setting an arbitrary rating assignment; I'd generally stick to the higher-rated companies. Also, try to find out why the company has been rated the way it is. Hopefully, if we're doing our job, we're going to try to at least put the major issues in our reports. You could also call the analyst if you have questions about a particular company. Maybe you haven't heard of them, maybe we have a higher rating on them, or maybe you want to know a little bit more about our views. Obviously, anything that we talk about is limited to public information that we publish, but we do field calls like that every day. The other thing is, we've seen companies go to an extreme, and I think it's probably a good due diligence habit to get into, if you have the staff and the resources available to do so. It's compiling your own statistical compilations. We have a lot of electronic types of service and products that many people utilize. It's really the trend in financial performance of those companies over time. Ultimately that should be factored into the trend in ratings over time.

MS. WALLACE: I must add that I have found all of the ratings agencies very open and willing to take questions and to share the information that they have. So, if I can say it for you, don't be afraid to call.

MS. BURKE: Absolutely.

MR. BARRY L. SHEMIN: A question about assumption reinsurance. It is sometimes the case that the ceding company must retain potential liability because of the requirements of an insurance department. Depending on what window emerges from the NAIC process, would you comment on how you will view the existence of that liability in evaluating a ceding company?

MS. BURKE: We absolutely look at all contingencies. Earlier, I made a general statement that assumption reinsurance tends to be a clean break and to some extent it is. But we certainly look at each transaction on an individual basis. In addition to regulatory issues, we have found that the assuming company often doesn't want to take the asset risk that goes along with the block of business; therefore, they may require significant indemnifications from the ceding company. These are all issues that we have to look at and we are always very concerned about contingent liabilities -- things that don't show up on the balance sheet per se.

MR. ALBANESE: We would pick up any contingent liability, whether it's a guarantee regarding an assumption reinsurance transaction, or if it's a guarantee to an affiliate or a subsidiary, or even if it's a forward commitment on mortgage or real estate investments. We would probably use varying assumptions in our capital adequacy test and factor in at various levels how that might impact a company's capitalization. My comments about assumption reinsurance were also on the basis that there was a clean break, but whether it's assumption reinsurance or any other tie that a company has that doesn't appear on its balance sheet, it would be picked up and factored into our process.

MS. BURKE: Yeah, we're currently looking at a situation where the vehicle is assumption reinsurance and it's a sale of a block of business. There are just so many contingencies and indemnifications required, it's almost not like an assumption reinsurance.

MS. WALLACE: How do you find the information?

MS. BURKE: We request copies of the contract. When you think about it, reinsurance is a legal contract, so we request copies of the contracts and we talk in great detail with both the ceding company and the assuming company. And you know, both of them tend to tell you the positive aspects of their transaction; however, the positive for one side usually is the negative for the other. So you can get a sense of the pluses and the minuses. But again, as Diane mentioned, communication is really a key issue.

MR. ALBANESE: For us it would be very much the same. If there was any significant transaction of any sort, it's probably in their best interest to be in contact with us beforehand, and if it is large in magnitude, as I mentioned, we're not going to talk only to the ceding company, because if there are contingencies, we want to understand it from the assuming company's standpoint as well. For example, the ceding company may tell us how it reduces their risk, while the assuming company might say they have negligible risk as well, because the ceding company is guaranteeing a certain element of that. So we try to corroborate the stories that we hear in the management discussions.

MR. FORREST A. RICHEN: You say it's a good idea to discuss the particulars of a reinsurance transaction, particularly if it's of some magnitude. How long does it take you to review those things? I understand that these things often develop fairly late in the year and maybe with fairly tight schedules.

MR. ALBANESE: We've tried to be as accommodating as we possibly can. You might have trouble getting through to us in December, when everybody is executing their reinsurance arrangements. But if we are given an indication by the company of when they need to have a decision, we'll try to be as responsive as we possibly can.

MS. BURKE: Yeah, I would agree. We try and work off your timetable.

MS. WALLACE: They try to create a continuing relationship with the analysts on all issues. It's easier if you know the person and have discussed issues in the past.