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REINSURANCE FROM THE CEDING COMPANY'S POINT OF VIEW

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This panel will explore the changing nature of the relationship between the ceding company and the reinsurer. How do ceding companies use reinsurance? Has this relationship changed? Are there different issues for smaller insurers?

MR. JEFFREY STANTON KATZ: The name of the session says it all. There's not much that I can add to it and there's not much I can add from the ceding company's point of view, because I'm giving the reinsurer's point of view. The session will be worthwhile from both the ceding company's viewpoint and the reinsurer's viewpoint. You will learn what our customers are looking for in terms of reinsurance and also what some other companies, some of your peer companies, do from the standpoint of pursuing reinsurance when they need it.

Our first speaker, Johanna B. Becker, is a Fellow of the Society of Actuaries. Johanna is an associate actuary with The New England. Johanna's responsibilities for reinsurance include treaty negotiations, financial reporting, and much of the reinsurance administration done at The New England. Johanna will represent reinsurance from the point of view of a larger ceding company.

Our second speaker is William J. Casill. Bill is also an FSA and is a vice president and actuary with Security-Connecticut Life Insurance Company. Bill's reinsurance responsibilities include negotiation of reinsurance arrangements and reinsurance administration at Security-Connecticut. Bill will represent reinsurance from the point of view of a smaller ceding company. Security-Connecticut is by no means a tiny insurance company, but it's certainly a good deal smaller than The New England and has different considerations when it's looking for reinsurance.

Our third and final speaker is John E. Bailey, also an FSA. Jack is senior actuary with Northwestern Mutual Life, and his reinsurance responsibilities include designing reinsurance programs, negotiating reinsurance arrangements, and reinsurance administration at Northwestern Mutual. Jack was a panelist three years ago when we had a similar session, and he will comment on changes during the past few years in considerations for ceding companies as they seek both reinsurance and reinsurers.

MS. JOHANNA B. BECKER: I would like to expand on Jeff's introduction and start by giving you some basic information regarding our company to set the stage for my large-company perspective. New England Life has a $5 million retention limit for both single-life and survivorship products, with the exception of our single-life variable product for which we keep a $3 million retention limit. We have treaties in force with 16 different reinsurers for the individual-life line, and we currently do business with seven reinsurers. That doesn't include special situations, such as agent-owned reinsurance arrangements.

As I'm sure you are aware, New England Life and Metropolitan have announced plans to merge. New England will continue to operate independently as a stock subsidiary here in Boston offering a full line of products, and we anticipate having ongoing reinsurance needs. I cannot comment on those needs specifically at this point in time, but we do not expect our philosophy regarding reinsurance to change significantly.

I intend to cover the following topics: the three main reasons why we reinsure; three important factors in the reinsurance process and how they relate to our reasons for reinsuring; and how we select reinsurers.

Our primary reasons for reinsuring are for excess retention purposes, for our substandard shopping program, which is a facultative-only program, and for products pricing. Our profit objective reasons are usually accomplished through a quota share reinsurance arrangement, and I will just refer to this as quota share reinsurance.

This year I have received several calls from marketing research firms that were hired by reinsurers to do surveys to find out what we think of our reinsurers and what we're looking for in relation to reinsurance. Most of these surveys were multiple choice in nature. I was asked to qualify something in terms of most important to least important or most significant to least significant, and I learned that it's very difficult to answer in such a rigid structure. I wanted to say, it depends. I'm going to discuss some of those areas that were targeted in these surveys.

I think this sums up my feeling about the surveys: nothing is ever simple, this is really pertinent to the view that reinsurers seem to have, they could just have us categorize things very easily in multiple-choice buckets, and this is the way we always felt about a particular issue. I intend to illustrate that by discussing my views on the factors that we consider important and how they relate to our reasons for reinsuring. Three very important factors in our process are costs, facultative underwriting, and capacity. Cost is always a consideration, but it's not necessarily the most important factor. Its relative importance depends upon which reinsurance need is being met. With excess retention and substandard shopping programs, cost is a factor, but as you may well imagine, it is the most important factor with quota share reinsurance. I'd like to take a closer look at each of our reasons for reinsuring in relation to cost.

With excess retention, if all things were equal we would decide based on cost. But we find that things are never equal in that sense and, therefore, we tend to look at other factors such as capacity, automatic binding limits, jumbo limits, facultative underwriting, and so forth, in addition to cost to help us make a decision. With our substandard shopping program, we do not have a uniform rate scale for that program, so it is important to us to have rates that are reasonably close.

Some of you may wonder why we don't have a uniform rate scale. Doesn't everybody do that these days? We have heard stories and seen situations in the marketplace among some of our peer companies in which reinsurers are bobbing in and out of their programs, depending on what the rates are at that time, and we don't believe that frequent churning of our reinsurers is in our best interest. We believe that stability counts for a lot in relation to having reasonable rates as well. We believe that there is something to be gained by dealing with reinsurers long enough for us to get to

know them and for them to get to know us, so from a cost prospective we try to minimize our rate differences but not have rates that are all the same.

With high-volume automatic reinsurance, such as quota share, cost is the overriding factor. The other services that a reinsurer could offer usually would involve or cover only a small percentage of the business being reinsured. Our purpose is to be able to price a product more competitively or to lock in mortality profits.

The next important factor that we consider is facultative underwriting. The underwriting aspects of facultative submission is a key factor in decisions regarding excess retention and substandard shopping. With excess retention, some cases do not always meet the criteria for automatic and must be submitted facultatively. Having a reinsurer whose philosophy is similar to ours is very important. If we find that a reinsurer's underwriters are more conservative than ours, or are inconsistent or are inflexible in their decisions, then they're not going to meet our needs on a facultative basis. In addition, it is important for reinsurers to be sensitive to the needs of our field force. Reinsurance underwriters who have never experienced working in a direct operation sometimes do not appreciate the needs and pressures on a direct writer. It is our goal to help our field force place business.

We respect legitimate differences of opinion between ourselves and our reinsurers' underwriters on specific cases, but the prospect of continued problems on this front will eliminate a reinsurer from consideration no matter how low its cost is. For our substandard shopping program, because all business is submitted facultatively, reinsurers must make competitive offers. It is our policy to take the lowest offer and to settle ties based on time service. If a reinsurer cannot win enough of the cases, then it is not a good arrangement for either us or that reinsurer.

With respect to facultative in general, we have found that reinsurers get the opportunity to know our underwriters and gain confidence in how we underwrite. I have had more than one reinsurer say to me that our underwriters have done an in-depth analysis of the case before sending it out to be reinsured. We believe that the recognition of the professionalism of our underwriters builds confidence and trust in our underwriting judgment by our reinsurers, thus making them more willing to make business decisions and help us with cases.

Capacity is an important consideration in excess retention reinsurance. In general, having a reinsurer that has significant capacity has always been a consideration. There have been some ups and downs in the market in the last few years, on things such as case splitting, that have affected our capacity needs, but in general it is something that we do think about. If an automatic reinsurer cannot handle very large cases on a facultative basis, then we may find that we have to turn to a facultative-only outlet to meet needs that we would expect an automatic reinsurer to meet on its own.

Another aspect of capacity has to do with obtaining coverage when a reinsurer cannot meet all our needs for capacity because it already has some business on that particular life. Occasionally, and it doesn't happen too often, we find situations in which we may have to go to a second or a third reinsurer to get all the capacity that we need on a particular case. Something that we find helpful in expediting this process is if the first reinsurer will tell us which retrocession outlets it approached. That way, the

second reinsurer doesn't waste its time going to the same outlets. We have had reinsurers that have refused to share with us the information regarding whom they have approached for retrocession, and our underwriters take a very dim view of this and don't consider this as being very cooperative in the process. We do have a reinsurer that has been cooperative in these situations, and this has helped enhance our relationship over the years with that reinsurer. You keep adding all the little things together, and this is just one more thing that makes a good relationship with that company.

In determining who to ask to quote, it depends on whether we are seeking to replace an existing arrangement and the reason for the reinsurance. Again, is it excess retention, substandard shopping, or a quota share arrangement that we are seeking a reinsurer for? The annual survey of reinsurers conducted by Munich American, which is published in the Reinsurance Section newsletter, shows that more than 20 reinsurers are active in the U.S. marketplace. Every reinsurer that we encounter hopes to get a piece of our business or increase its share of the business it already receives. Practically, we cannot give everyone who comes to see us or who would like to quote the opportunity to quote, no matter how good the company is. If an existing or a new reinsurer was given the opportunity to quote more than once in the last few years and the offer wasn't reasonably competitive, chances are we won't ask the company to quote anytime soon, because there's no need to waste our time; we've formed an opinion of that reinsurer.

If we do have a long-term relationship with a particular reinsurer, we will give the people there a courtesy call and say that we don't think this is their thing, or we don't think they would be interested, or they haven't been competitive in the past, but would they want to quote? Usually we'll come to some sort of an agreement as to whether they will quote, but we will give a long-standing reinsurer that opportunity. In general, we try to feel out reinsurers to find out who may be interested in quoting before we go through the formal process of putting the packages together and sending the letters out.

If we hear in actuarial or underwriting circles that a reinsurer is competitive or gives good service, or we hear other factors about how it operates, we are much more likely to give that company the opportunity to quote more than one that we've heard nothing about. "Nothing about" could be anything from the sales representatives never coming to visit us, or the only thing we've heard about the company is from the sales representative, and naturally the sales representative is going to tell us how wonderful the company is. We like to have something independent to go on.

Over the years, our auditors have asked me how we select our reinsurers. My answer always was that we choose professional reinsurers that are well known in the marketplace. I think that's basically the way we still choose our reinsurers. We want reinsurers that have good ratings—they don't have to be triple A—that are financially secure, that are in reinsurance for the long haul, that have a good reputation, and that are focused. By focused I mean that they have found their niche, they know their target market, and they are established in it. They're not newcomers in a market and we don't have to feel that maybe they're unknown and we're a little uncomfortable dealing with them in that particular area of reinsurance.

Excess retention reinsurance needs usually involve replacement of an existing reinsurer. We may be more inclined to go to a facultative outlet that we've used for capacity because we're already familiar with the company and it meets our needs regarding knowledge of the market or product. Substandard shopping, again, usually involves replacement of an existing reinsurer rather than expanding to including additional reinsurers. We want to ensure that, based upon our paid-for ratio, each reinsurer has the opportunity to get a reasonable share of our business, thus the need to limit the number of reinsurers.

Not all reinsurers are interested in substandard shopping programs, especially ones such as ours. Our first step is to determine what company might be interested and would like to quote and whether it would be a good fit. Good underwriting may be determined by the reinsurer's reputation, or by having reinsurers review our sample cases for us so we get a feel for how they underwrite, and conversations with their underwriters and medical staff on specific impairments and how they handle them. In the final analysis, we are looking for a combination of reasonable rates and good underwriting. With quota share, because our primary goal is low cost, this is the easiest place to test the waters and ask new reinsurers to quote. If all reinsurers that we ask to quote have the same offer, then it really gets down to tiebreakers. If the offers are very close, so that maybe with some minor changes we can say they're all the same, then we start looking for other factors to decide which one or ones we are going to select. Some of those tiebreakers could be automatic binding capacity, other services they might be able to provide for the small number of cases that would fall into that category, or just in general the kinds of services they can provide. Those will be used to help us make a decision.

Some of these tiebreakers are subjective. For example, when dealing with a new reinsurer, does it come across favorably, what kind of service does it provide, do the people seem to be knowledgeable when we're dealing with them? First impressions mean a lot; they can make or break a reinsurer's opportunity on a particular quote if some of these subjective factors come into play, and we thought that things didn't seem to go as well when dealing with them.

Reinsurer expertise plays a part in our decision process. Having knowledgeable reinsurers with a marketplace perspective is very important. This is something that we feel in actuarial and I've heard time and again from our chief underwriter. We're a big company and we think that we know a lot. Reinsurers deal with many different companies and they see a lot of different things. Having that perspective, we find this important. Some of the myriad of questions that were on these surveys that I answered earlier this year had to do with the importance of various aspects of reinsurer expertise. Sometimes this is a factor in our selection process. I happened to think of a few things as I was putting together my talk. I do have mixed feelings about telling reinsurers that they must be all things to all clients. I'm not sure any reinsurer can do that successfully. It would be nice for us as a ceding company to have one-stop shopping, yet at the same time, we operate successfully by recognizing the strengths and areas of expertise of specific reinsurers and seeking out those reinsurers.

Starting with my first item, products, as an example, I would say that in recent years there have been more complicated products. Products with more twists and wrinkles or unusual products are on the market nowadays. We are all selling.

If a reinsurer has dealt with that product in the past or has some familiarity with it, we're more likely to ask that reinsurer to quote than we are one who seems to have very little knowledge or experience working with the product. Going back a number of years, an example that comes to mind is variable life. I remember calling reinsurers, when we first wanted to reinsure our variable product, and I found a difference in the responses I received as to how much of a handle they had on what they wanted and needed in the way of information.

Regarding foreign nationals, we recently had a situation in which we wanted to cover U.S. citizens traveling to a certain foreign country and residents of that foreign country who had U.S. business connections. When calling reinsurers, we found that some were more knowledgeable than others in this area.

We contacted several reinsurers earlier this year to have discussions about the older-age market and to gain more information. One reinsurer sent in its chief underwriter to make a presentation to our underwriters. Another reinsurer sent in its medical director. Yet, a couple reinsurers said they had very little expertise in this area and were just beginning to think about it.

The next two areas, product development and claims, are areas where we find that we rarely feel a need for reinsurer expertise. Product development seems to be an area right now where reinsurers are coming on strong and are trying to market their skills as helping ceding companies to develop new products. When reinsurers come to me with these proposals, I have taken them to the head of our pricing area and find there's very little interest. Sometimes we may give a reinsurer a courtesy visit, but I find that there's no interest in pursuing this, because we think that our actuarial staff is large enough and competent enough to handle product development.

With respect to claims, our claims department is well versed in investigating claims. It is supported by our underwriters, our medical department, and our law department. With respect to research, we have great respect for reinsurers that do research and statistical analysis, and we look upon this as an asset and source of information we can tap if we select that reinsurer.

Last, with respect to regulation, whether it be state, federal, or a professional body such as the AICPA, we expect our reinsurers to be up on what's going on and be able to advise us. We find great variation among reinsurers. The first example I would mention is New York Regulation 147. As a company licensed in New York, we had to comply in 1994 and had questions regarding a YRT reinsurance exemption. Some of the reinsurers we called told us that they didn't have to comply until 1995 and hadn't started thinking about it. Yet, we as a company licensed in New York had questions too early for what they were prepared to deal with.

Second, with regard to deferred acquisition cost (DAC) tax consideration, we found this year when reporting and trying to come to agreement on what those net considerations were with our reinsurers—we don't try to nickel-and-dime our reinsurers and get everything down to the penny—if we have wide differences we try to discover what the reason is and resolve those. A couple reinsurers told us, when we questioned the net consideration they had provided, that we could just use our numbers on our tax return and they'd use their numbers on their tax return. It obviously had

not filtered down to their administrative staff that there has to be a meeting of the minds on this issue and what was in our reinsurance treaty. One reinsurer told us that this was a directive from its tax department. We asked the person to go back to the tax department and quote chapter and verse. He came back with a different answer.

Third is section 113, which requires demonstration of risk transfer under reasonably probable conditions for GAAP reporting. Everyone, not just reinsurers we had spoken to, agrees that section 113 is directed to property and casualty companies and is not appropriate for life insurance and it's difficult to apply it. We've begun having some discussions with some reinsurers and have found that we're all in the same boat on this, but there is a willingness to try to come to grips with some of the issues.

In summary, our reasons for reinsuring are not simple. They cannot be reduced to buckets in a multiple-choice questionnaire. They depend upon our reason—excess retention, shopping, or quota share—and the impact of the primary factors of cost, facultative underwriting, and capacity on the reason. Our reason for reinsuring and, in turn, the factors we consider important, influence our decision regarding which reinsurers to ask to quote.

MR. WILLIAM J. CASILL: I have been asked to present the perspective of the smaller company. Security-Connecticut, as many of you know, is not what I would consider a small company, but I do think our uses of reinsurance are more akin to that of a smaller company than that of a larger company. Some companies view reinsurance as a necessary evil or a cost of doing business. Others attempt to make reinsurance a profit center. We at Security-Connecticut prefer to consider reinsurance as an opportunity to develop strategic business alliances in which the ceding company and the reinsurer can work as partners to improve the value of both companies. The partnership concept, from our perspective, is the key to making reinsurance work for the smaller company.

I'd like to talk about three different aspects of reinsurance from the smaller company's perspective. First is why smaller companies use reinsurance and what type of benefits a partnership approach can bring. Second includes some of the issues to consider when developing reinsurance partnerships. Finally, I'd like to give you some insight into the selection process that we use at Security-Connecticut.

Why do companies use reinsurance? From a textbook perspective it's quite simple. You use reinsurance to manage risk and to enable you to write business that you otherwise wouldn't be able to do on a financially prudent basis. The classic purpose of reinsurance is basically to hedge against the risk that a single claim would jeopardize the financial security or solvency of the insurance company. This is indeed true, but I view reinsurance more as a tool for managing earning fluctuations. This function is important for a small company and even more so for a company that's publicly traded or owned by a noninsurance parent.

Many reasons we use reinsurance are comparable with those of a large company (cost, underwriting), but there are many other considerations from the smaller company's perspective. For example, small companies are often presented with opportunities in which their managements may be either not knowledgeable or not comfortable with the risks they're being asked to assume. This can come from new marketing

opportunities, new product lines, or specific individual cases. Strong reinsurance relationships frequently enable the company to write this business or enter this new market by sharing or transferring the risk to one of its reinsurance partners who may be more knowledgeable or comfortable assuming that type of risk. With regard to underwriting assistance, facultative underwriting is important in any of the reinsurance relationships, but, again, from a small company's perspective, there are other issues.

For example, most small companies do not have the resources to devote to establishing and maintaining detailed underwriting criteria. Many reinsurers can provide support in this effort by allowing access to their underwriting manual and their research expertise. In addition, reinsurers can also provide training programs and facultative support. Here a partnership approach is crucial to the small company because to change reinsurers on a frequent basis may involve changing underwriting manuals. As anyone who has gone through the process understands, changing underwriting manuals is a time-consuming process from the home office perspective and a very disruptive process from the field perspective.

Strong reinsurance relationships can also provide benefit in managing financial results, be they from a statutory perspective, a tax perspective, and even a GAAP perspective. For example, surplus today is becoming a scarce commodity. Companies use a significant amount of surplus either to service debt, to pay dividends, to maintain ratings, or just to grow new business. Strong reinsurance alliances can help in this regard, because reinsurers that are confident that they are going to be around year in and year out will be more willing to provide allowances in excess of 100% the first year. They're more willing to be flexible in structuring quota share arrangements, and they're more willing to be creative in coming up with other funding mechanisms.

It's also helpful to have a partner to consult with when you're faced with issues that you have not seen in the past or are not completely comfortable with. This can range anywhere from trying to underwrite the elderly to trying to design a new product that you haven't sold before. Reinsurers can provide a lot of support in this effort by either providing you with the results of their expertise and research or providing you with an insight into standard industry practices.

What types of things should you consider when looking to form your reinsurance partnership? We like to start off by viewing the entire universe of potential reinsurers—those 20 or 22 companies that are actively writing new business in the marketplace today—and then quickly go through a process of elimination based on the issues that are important to us. First off, being that we look to form long-term business relationships, not just on the in-force side, but also on the new business side, we must be convinced of the reinsurer's financial stability and its long-term commitment to the reinsurance marketplace. We also look to find a reinsurer that has business strategies comparable with our own. It's important that your reinsurance partner be willing and able to support your efforts.

Directly related to this is the risk assessment capability of your reinsurer. Does it provide access to its underwriting manual? Will it provide training programs for your underwriters? Is it experienced in the large-case market? How does it handle highly substandard business? Again, you need to define your needs and make sure that your reinsurance partners can support those needs. You then need to look at whether the

reinsurer is easy to do business with. Is it willing to entertain creative ideas and novel approaches to doing business, or is it frequently presenting obstacles and challenges in your efforts to write new business? Many reinsurers provide value-added services.

Last but not least is price. You must consider whether the price of the reinsurance fits in with the pricing of your products, how much price elasticity you have in your products. Can you increase your premiums and provide your company with some of the benefits that a reinsurer can provide?

Value-added services are something that I believe a smaller company will take advantage of more so than a larger company, because the smaller company doesn't have the capability of providing many of these things. For example, reinsurers frequently have expertise in areas that you lack. They can provide significant expertise in new product ideas and designs, regulatory issues, or underwriting issues. Some reinsurers will periodically audit your underwriting process and also your administrative process for processing reinsurance. This can provide valuable insight to your senior management and act as an early warning system for the things that may not be going right.

Recently, some reinsurers are providing more extensive consulting services, and many will act as a sounding board for your actuarial department or your underwriting department, again getting into areas that they're not familiar with or not comfortable in. More and more reinsurers are also providing access to other opportunities. Some reinsurers offer turnkey packages to help a company get into a variable product line on a cost-efficient basis. Some provide access to expert underwriting systems, and others provide access to state-of-the-art administrative systems, issues that frequently are more applicable to a smaller company.

Security-Connecticut recently went through an extensive process of reevaluating its reinsurance relationships. Currently, we do business with six different reinsurers on an automatic basis, and the average period of time that we've been doing business with those reinsurers is in excess of 20 years. We go through our analysis to consider whether those relationships should continue or be changed on a three- to five-year time frame.

It's crucial that you know your reinsurers when going through the reinsurance selection process. Know who you're dealing with, know what their strengths and weaknesses are, and know what benefits they can bring to the table. Equally as important, they must know who you are. They must know how you do business, why you do business, and what you're looking for in a reinsurance relationship. You then need to internally define the selection criteria. Again, know what your needs are, determine what your capabilities are, and find reinsurers that can fill these gaps. Some of the significant selection criteria that we utilize include risk assessment in the large-case and in the highly substandard marketplace. We do not have our own underwriting manual, so that is a significant issue for Security-Connecticut.

We're also looking for an efficient source of capital, a company that can help us meet the changes and challenges of day-to-day business operations. As everyone else, we look for appropriate and consistent pricing.

We also consider whether companies provide help in financial planning and access to new programs, new ideas, new marketing opportunities. We then go about providing them with an extensive amount of detail. We provide them with an overview of what we're doing from a corporate perspective. We provide them with details of what we're looking for specifically from our reinsurance arrangements. We give them specific, detailed product information, including, rates, specifications, policy forms, and underwriting criteria. We also provide them with recent experience studies, from a mortality and persistency perspective and from a distribution-of-business perspective, so they know exactly what they are getting into. We then specify the information that we are requesting.

Here is something that we had requested in that process. From reinsurers who we were not then currently doing business with, our underwriting department put together 12–15 sample cases of a variety of underwriting issues that they faced on a day-to-day basis, cases that we had actually underwritten and placed. We presented those cases to our new reinsurers for their specific actions that they would take on that case. We also requested ratings from all the different agencies, as well as their blue book and other financial statements if we didn't already have them. We looked for detailed information on their retrosectionive capacity and an outline of their other value-added services, to the extent that we were not already familiar with them. We also requested information on their most competitive rates on several different bases to help us design our reinsurance arrangements on a most cost-efficient basis. We then go through what I would consider an open auction process in which we disclose in general, without using names, the cost and benefits that are being offered by the other reinsurers and the value that we, as a company, place on each of those items. We give them an opportunity to reevaluate their proposals and we are fairly consistent about giving our then current reinsurers a last opportunity or a last look at our decision-making process.

In conclusion, we have found that joining forces with strong reinsurance companies in partnership arrangements have provided benefits to our company and enable us to obtain services and access to markets that we cannot get elsewhere on a cost-efficient basis.

MR. JOHN E. BAILEY: Northwestern Mutual is a little larger than The New England but not as large as the combination with Metropolitan. You've already heard an overview of the approach that companies take when selecting reinsurers and uses for reinsurance. I'd like to get into some very specific reinsurance problems that we have experienced. Jeff has also asked me to concentrate on changes that we've seen in the reinsurance process. I'm going to talk primarily about some of those changes.

The first change has to do with increasing government regulation. This includes regulations on credit for reinsurance and life and health reinsurance agreements. We've seen New York's Regulation 20 and New York's Regulation 102. We all have to deal with the DAC tax requirements. There is the "entire agreement" requirement for reinsurance agreements, and the list goes on and on. Most of these have valid reasons for being and we, like most other companies, probably believe the reasons do not apply to us, but we have to comply because somebody else is doing something that's foolish.

The important points to make here are that all these regulations do make it more burdensome to engage in reinsurance activity. It takes a lot of time and study to comply with these regulations. I do want to acknowledge the efforts of some who work with the regulators on these regulations and make them more user-friendly and reasonable. Denis Loring, Diane Wallace, Jeremy Starr, and Mike Higgins come particularly to mind. They are always in the forefront of regulation activity, trying to make regulations more reasonable.

The second change that we have seen in reinsurance activity involves automation. This applies both to the acquisition of reinsurance and to the administration of in-force reinsurance. This has been driven both by the availability of new technology and volume. We're seeing a very large volume of reinsurance at our company and it has become mandatory that the administration be automated.

In the last two years we've had a fairly extensive project to modify our underwriting system. We have a case management system in underwriting, and we have made a number of changes to facilitate the reinsurance process. The underwriter now can indicate the need for reinsurance on his or her personal computer. For facultative reinsurance, he or she has the opportunity to see all the facultative offers on a screen and select among those offers just by pressing a few keys.

That system also includes extensive reinsurance edits so that we can be sure that all the applications get into the right reinsurance program. We have about seven or eight reinsurance programs, each of which has differing requirements with respect to plan, age, classification, and a number of other factors, making it complicated for our underwriters to remember. This system gives us some assurance that all policies will be ceded to the appropriate reinsurance program.

At the moment, we receive facultative offers by facsimile from the reinsurers, and someone has to key that information into the system. We are working on a system so that this will come electronically through the use of electronic data interchange (EDI) from our facultative reinsurers. We hope to have that in place with some reinsurers by next year.

Speed is not the real reason for this. We believe that the reinsurers' turnaround times are already good, particularly for a large facultative case. Some will be in our shop as long as five or six weeks before we send them to the reinsurers—who turn them around in about two days. We think that's quite acceptable. The real reason for this automation is accuracy and efficiency. By transmitting the data electronically, we reduce the need for inputting both in our company and at the reinsurers, and this should reduce the possibility of input errors as well as reduce the cost of inputting.

This system also will serve as a beginning point for our ability to analyze reinsurance offers. We have a fairly large facultative substandard program, and we've never been able to analyze whether reinsurer A is better than reinsurer B regarding impairment C, but we now will be able to do that. We'll also be able to analyze time service, how often each reinsurer requires additional underwriting information, what kind of restrictions it puts on reconsiderations, and other factors that apply to facultative offers.

This same system also will feed not only our policy issue process and our mainline accounting process but also our reinsurance administrative process, so that we now can automatically self-administer most of our facultative and automatic reinsurance. The only exceptions we'll have are the very large cases, which often go to several reinsurers and just don't fit into that mode. This is another efficiency that we've been able to build into our reinsurance administrative process through automation. A group of six people administers our in-force reinsurance. This is the same size group we had 20 years ago when the number of policies we reinsured was 10% of what we have today.

These changes, both the new-issue process and the in-force administration process, require a great deal of cooperation from the reinsurers to establish formats and agree on rules. If several reinsurers are involved, we really need to have the same rules in place for all of them, and we've received excellent cooperation in accomplishing that goal.

The next change I'd like to discuss has to do with the management of increasing risk patterns. This is something we've recognized over the years and have not really done very much about. I hope we're not typical there, but I suspect that we are. There has been a progression in the form of increasing risk patterns. Historically, the only increase in risk involved dividend additions for participating business. Then in the 1970s, we introduced cost-of-living products in which the amount of risk could increase. The typical corporate-owned life insurance (COLI) product had a cap. Ours was 8% a year, not to exceed the CPI increase, and it ran for ten years. So we could define the maximum risk amount that would result from that particular product, and it wasn't difficult to indicate that to your reinsurer and figure out how to split that risk.

The next development at our company was additional premiums, also called dump-ins or additional deposits. There is a base product and additional premiums that buy paid-up additions. Because the relationship between the base premium and the additional premium is variable, suddenly the relationship between the initial risk amount and the ultimate risk amount became even broader. That increased the possibility of getting risk amounts that were both beyond our capacity and beyond the capacity of the reinsurer, and it made it difficult for the reinsurer to know when to seek retrocession. Even so, it was possible to define the risk, because the amount of additional premium is known. Because the policyholder cannot add any more without further underwriting, a policy illustration will indicate the risk pattern so that it is at least manageable.

The next phase of that progression involves variable life. With variable life, three factors combine to preclude any reasonable limitation on the risk amount. Those factors include additional premiums, as we already had for our fixed-dollar products, and the ability of the policyholder to invest these policy values in any of a number of different funds. We happen to have nine funds, and they can switch among any six of those nine at any time. That means that an astute policyholder who knows when to shift his or her funds can earn a yield rate that is higher than what any of the funds earn simply by shifting back and forth at the right time. As a result, there is no real limit on the earnings rate that the policyholder can achieve. Most policyholders, myself included, wouldn't outperform the funds, but it certainly is possible, and it's something that we need to consider.

The third factor is what we call the corridor provision. This ensures that the policy always will qualify as life insurance. No matter how large the invested assets in the policy grow, the total death benefit will increase in proportion so that the policy will qualify as life insurance. Divide the policy assets by the net single premium to get the death benefit. Because the invested assets can increase almost without limit, the amount of risk will increase in a proportionate manner, and it's very hard to define what the maximum risk pattern is going to be.

I tried to find out what other companies were doing about this risk, without much success. We looked at the risk patterns in our product and concluded quickly that the total risk is much more related to that annual premium than to anything else. As a result, our company has a dual retention limit on variable products: one related to the ongoing annual premium, the other to the initial face amount. We use these limits for our own retention and also for limiting the amount of risk that we will put into our automatic reinsurance programs. That maximum premium increases very steeply by age, simply because younger people have a much longer time to accumulate assets and are assessed smaller risk charges.

The next two items I'd like to talk about are related. They arise out of our company's coinsurance program for indeterminate premium term. The first one is the treatment of policyholder dividends. We're a mutual company and our goal, which we take seriously, is to provide insurance protection at a cost to our policyholders. Even though we have an indeterminate premium form, we believe that this is best done through dividends. It's easier to declare a dividend than it is to get approval for a change in indeterminate premium premiums and, more importantly, we're a lot more familiar with the dividend process. No reinsurer is going to agree to allow a ceding company the full right of determination of dividends if it is going to participate in that dividend. We've found that to be true. The result is that although we can negotiate favorable terms on a coinsured term block at the time of issue, if the mortality improves over time, the reinsurers, rather than our policyholders, benefit from improvement in mortality.

The reinsurers may have anticipated this improvement in mortality. They may be a lot smarter than we are in predicting future mortality, but that's not what our policyholders and our agents expect from us regarding improving the cost to reflect mortality improvements.

Our solution for this, which we do quite frequently, is to introduce a new series of term products. If the mortality has improved, we'll get better reinsurance pricing for the next series, but that doesn't help the in-force policyholders. If they want to enjoy the benefits of the new series, they have to go through an exchange program. Exchange programs are becoming a big business. The whole system is not very efficient because of the effort required for the policyholders to get the benefit of the improved mortality. We have to get and pay for more medical exams, and the agents have to take a new application. It's a large administrative job to reunderwrite all that business. These folks have been underwritten recently, and we know most of them are in good shape. The whole structure is simply inefficient.

New York's Regulation 102, which requires the reinsurers to participate in dividends, is another factor that makes this more difficult. We have considered experience refund

reinsurance arrangements but never have done so. The concern, of course, is who gets to control the pricing changes. The reinsurer will not give us the full authority to do that, and we don't want to give the reinsurers the full authority to do so. Even though we have a large volume of business, the experience on any one specific block may not be credible enough to form the basis of an experience refund formula. It would not give us a smooth pattern of dividends. This is something to work on between series to be ready for the next change.

One response to this problem is a continuation program. When we change to a new series, we offer our policyholders the opportunity to change an in-force policy into the new series and keep the same reinsurers on that block of business. Typically, we have a distribution of four or five reinsurers in every individual cell. This time we're suggesting that we do not even ask for additional underwriting evidence for the exchange. We think that is a benefit to everybody. It allows the "old reinsurer" to continue the business. It has given us 100% allowance in the first year, fairly recently, and deserves to keep that business. The insureds are the same people and are not going to die any faster simply because they have a new policy. Most of our reinsurers have been very accommodating in this approach.

Our marketing people would like to be able to increase the face amount. They want to keep the same retail premium and agent's commission and give the agents a reason to see their policyholders again. In our current, new series, we have been able to get our reinsurers to agree to a modest increase in face amount on this basis. This program does have some limitations. We're going to put a sunset date on it, so all the business included has been recently underwritten. This new development makes our home office administrative people happy because it reduces costs and work effort. Again, it's a way in which the reinsurers have been helpful to us in achieving our objectives.

The last area I want to discuss has to do with financial strength of reinsurers. This is far from a new topic. It's not a change, but it is something that we view as being very important. As a ceding company, we take the financial strength of the reinsurers as a very serious matter. This has become more evident today than in the past, as we've seen some companies merge and some companies fail. The financial strength of our reinsurers affects our policyholders, who are our first priority.

I have to put in my usual plug that there is no contractual relationship between a reinsurer and a direct policyholder, so if a reinsurer fails, that loss is spread over all our policyholders, not just those holding the reinsured policies. That makes it even more important for us. Another reason that we view financial strength as being important is that our own rating agency evaluations are critical to our marketing operation. The rating agencies haven't investigated our reinsurance operations yet, but I'm sure they soon will because of the volume.

We do have investment managers who review the financial strength of our reinsurers. We keep very much on top of their rating agency evaluations. We review their annual statements and other financial material. Some of our recent reinsurance agreements included financial protection provisions that allow us to receive this material and in the event of certain well-defined conditions, specify a series of steps that we can take with the reinsurer. These start with a face-to-face review with its chief financial officer and lead to the establishment of assets to protect the reserves on our reinsured business.

FROM THE FLOOR: Johanna, you spoke most extensively about facultative shopping. I'm wondering if you could also comment on your practices with respect to what your own retention is on facultative shopped business, whether you keep nothing or keep your normal retention and how you make that decision if it's not always the same.

MS. BECKER: What retention do we keep on facultative shopped business? Zero. That's the way the program is set up. If you want to participate as a reinsurer it has to be on that basis. We have had a variation on this theme since the late 1970s, and I guess it even goes back further than that. Originally, it was just declined cases or above table P, and then by the early 1980s, it was expanded down to lower table ratings, but we retained the zero retention approach and have found reinsurers that are willing to participate on that basis.

MR. ROBERT A. GABRIEL: It gave me many good ideas. I hope ours is not the only company that has come into the 1990s and not automated the reinsurance system, but we haven't and we're thinking about it still, slowly but surely. Can anyone give me any hints as to what to look for in a reinsurance system?

MS. BECKER: The Reinsurance Section has published a document on uniform standards. Some of it has to do with electronic data transfer but, again, I think that some of the basic ideas or the kind of information that you need to collect are in that. Stop and think, even on an individual-session basis, what you are providing for your reinsurer—name, date, policy number, risk. Those are things that you're going to have to automate, and that information will be needed for its annual statement as well. You could have one program that just does the automated billing portion and do the valuation separately, or you could have them all together. Some software packages, some companies, do specialize in providing reinsurance administration. I'd say that most of what we do in our company is on our own home-grown mainframe computer systems that we feel very comfortable with. It seems to work with every insurer.

MR. CASILL: There are two sides to that: one is the acquisition side and the other is administration of in-force business. With respect to the acquisition side, this is an excellent opportunity to make a plug for the American National Standards Institute (ANSI), which is actively working and has been working for the last two or three years on developing standards for transmission of data between ceding companies and reinsurers. Our company is very involved in this. I know Lincoln National is very much involved and probably some of the rest of you are. The group meets about six times a year and is making some good progress in defining exactly what data should be transmitted back and forth, particularly for the facultative situation.

With respect to administration of in-force business, you're on your own. The biggest thing is to try to integrate that with your accounting system so that your accounting system can bring you the data you need to do the administration of the reinsurance. We have a fairly innovative system, and that has proved to be very helpful in being able to automate our reinsurance programs. Almost all of them will be self-administered within a year or so.