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Introduction to Life Reinsurance 101

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Summary: This session is designed to give an overview as to the who, what, when, why, and how of reinsurance. Topics covered range from what types of reinsurance agreements exist, how they are accounted for, and when they are used.

Mr. Denis W. Loring: Life Reinsurance 101 and 201 were first done for the NAIC in Baltimore in April 1997. So we've actually had a chance to do this program once, get some feedback, and refine it.

We're going to go over introductory concepts and go over the basic features of the life insurance agreement. We're also going to go over regulatory concepts including risk transfer. Risk transfer is the key regulatory and really substantive issue in reinsurance. It is also one of the most difficult issues to understand, and it's almost impossible to quantify, but we're going to try.

Reinsurance, at least in the eyes of the regulators, and in many people's eyes, connotes property and casualty reinsurance. It's a huge industry. Life reinsurance, in many ways, is smaller. There are very fundamental differences between life and property and casualty. For example, the risk concentration issue in life reinsurance is fairly small. Hurricane Andrew was not a very big deal in the life insurance business. If you were a property and casualty insurer doing business in southern Florida, and if you weren't properly reinsured, Hurricane Andrew may have put you out of business because of the high concentration of loss in one area.

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The term of risk is a fundamental difference. Life insurance risks are typically very long. They are lifetime risks. Property and casualty risk can be very short. There are one-year agreements, or they can be very long in what are often called long-tail agreements. A perfect example is asbestos. There are pollution risks. There are risks that were written in the 1950s that nobody really believed would be coming to claim in the 1990s, but they are.

The claim amount is what makes the mathematics very different. If you have a \$100,000 life insurance policy, and the individual dies, the odds are overwhelming that the beneficiary is going to get \$100,000. If you have a property and casualty risk, as in automobile insurance, and you crack up your Mercedes, you don't know how much you are going to get. It depends on how big the crash was. Did you total the car? Was it a fender bender? The point is the claim amount isn't known until the event takes place. That makes the mathematics of it completely different. It makes the entire approach to the risk completely different.

There are more differences. The premium rates in life are typically fixed. For a whole life contract, there's a single premium rate that is paid for all of life. Obviously, some coverages like term can increase every one year, five years, or ten years. But rates can be fixed for the life of the policy. In property and casualty, rates are typically changed every year. Reinsurance policies are written for a single year. Rates are renegotiated. Policies are renewed and replaced at the end of the year. The balance sheet focus for life used to be liabilities, but with the whole notion of immunization theory and asset/liability matching, the focus is now more often on the asset side of the risk. In the property and casualty business, the primary focus is on the liability side because that's where you really take your serious losses. Again, Hurricane Andrew is an example.

Who are the reinsurers? In the life business, the major reinsurers are typically mixed. What I mean is this: the biggest reinsurer in the country is Transamerica. Transamerica has a reinsurance division of a life company, Transamerica Life. RGA, which is the second biggest reinsurer, is a pure reinsurer, but they are 65% owned by General American, which is a life company. Lincoln National, Mike's company, has a big reinsurance division, but Lincoln National also sells directly. In property and casualty, most of the big companies, General Re, Employers Re, Munich Re, Swiss Re, or Reinsurers Only, do not sell direct business. That's a very fundamental difference.

Now let's discuss one of the sources of life reinsurance capacity in the world. In the U.S. you start out with what we'll call traditional reinsurance, which is what many of you may well think of as reinsurance. You have a million dollar policy. The ceding company holds \$250,000. It sends \$750,000 to Lincoln National on a

one-year-term basis. This is very traditional. There are also reinsurance pools, and this is done more for accident and health. These are very typically done by third-party managers, the biggest one is a company called Duncanson & Holt, purchased a few years ago by UNUM. They are managing general underwriters. They underwrite business on behalf of a number of companies, for example, my company, The Equitable. We may have 10% of an accident pool and 12% of a disability pool and 15% of a long-term-care pool. Duncanson & Holt underwrites the business and places it on a quota share or uniform basis with all the companies in the pool. That provides a nice source of capacity.

Captive reinsurers are used much more for property and casualty than for life. This is a company that is, as you might deduce from the word captive, owned by one company and used for its reinsurance programs and for others. Producer-owned reinsurance companies are a fairly new concept. You may have heard them called agent-owned companies. The idea here is that the direct company feels its agents will write better business if the agent has a financial stake in the success of that business. How do you do it? You create a reinsurance company. You let the agents own it. You reinsure some of the agents' production in the company, and then the agent can get the financial benefit of the better mortality and the better persistency because he or she owns a piece of the action. These have been quite successful.

There is non-U.S. capacity, which we sometimes refer to as naive capacity because it is not always clear that these non-U.S. companies know what they are doing. Many companies in Europe find that the U.S. is by far the best market for life reinsurance because we're the ones that are writing the big policies. They have come over and taken, or attempted to take, large pieces of U.S. business on terms that are sometimes, let's just say, extremely favorable to the ceding companies.

Then there is an entire notion of alternative risk transfer. You may have heard this called financial reinsurance.

Let's discuss surplus relief and limited risk reinsurance. These are not traditional forms of reinsurance. The primary purpose of the reinsurance may not be purely to lay off risk, but instead to have a surplus effect on the ceding company's books, to allow a growth in a market that the ceding company otherwise would want to go into, in a much more limited way. There are alternative methods of risk transfer. They tend to be more common in the property and casualty business for certain regulatory reasons. That's something Mike will go into. You really need to transfer risks fully under life reinsurance contracts but there are nontraditional ways to do that.

I'd like to discuss different types of life reinsurance. Indemnity reinsurance is the type of reinsurance that has odds that you are most familiar with. Let's go back to the million dollar policy. The ceding company keeps \$250,000 and sends \$750,000 out. Why? It wants to lessen its risk. The company simply doesn't feel comfortable keeping \$1 million dollars on a policy. Let's take aviation in the property and casualty field as an example. A fully loaded 747 might cost \$800 million on a crash. No one company wants to absorb an \$800 million risk, so that risk might be spread through pools, for example, one company will take 20% of a pool that has 20% of a risk. Now they're down to 4% and, one company may take 10% of 5% of a risk until the risk is amortized. It is broken into tiny enough pieces so no company will be very severely hurt.

Financial reinsurance, sometimes known as surplus relief, is reinsurance whose primary purpose is to affect the financial statement of a company. It's like renting surplus, for lack of a better term. This is perfectly legitimate reinsurance as long as risk is transferred. As I said in the beginning, the transfer of risk is the key issue. As long as risk is transferred, financial reinsurance is, in fact, "real" reinsurance and it's accounted for as real reinsurance.

Nonproportional reinsurance is reinsurance, as the name states, that is not set up in a proportional fashion at issue. If I reinsure \$750,000 of a \$1 million risk, I know three-quarters of the risk goes away, and one-quarter of the risk remains with me. If I have catastrophe reinsurance, which is typically defined as reinsurance of a big event that has to have a certain number of deaths, I don't know what portion of that is going out until the event actually takes place.

Stop-loss reinsurance does exactly what its name implies. It stops my loss. Let's suppose I have a block of business, and I have a target loss ratio of 80%. I may want to buy reinsurance that will cover losses over 100%. I'm willing to accept the loss ranging from 80 to 100, but I don't want to lose any more than that. I will stop my loss by reinsuring any losses over 100% to the reinsurer. We don't know what proportion of losses that represents until they actually take place. That's why it's called nonproportional.

Retrocession is a very simple word with a perfectly defined meaning. It's reinsurance of reinsurance. The Equitable is a professional retrocessionaire. We do not do business with Metropolitan Life, for example. If Metropolitan wants to reinsure business, it will send some to Lincoln or Transamerica or GA or Cologne. If Lincoln wants to send some of that risk out because it was too much even for it, it will retrocede it to The Equitable. If we want to send some out, there's no third fancy word. It's retrocession forever. So you have reinsurance until the risk is spread sufficiently.

Assumption reinsurance, by some people, isn't reinsurance at all. It is the permanent transfer of business. Unlike other forms of reinsurance, if I have a block of business that I give by assumption reinsurance to another company, I am now severed from that business. I have no dealings with the policyholder anymore. The company who has assumed it literally takes my place. That's the only type of reinsurance in which that happens. Why is it called assumption reinsurance? That's simply how the term came into being. It really is a permanent sale and divestiture of a piece of business.

From the Floor: I'm in financial reinsurance. Are there any limits on transferring a certain amount of risk?

Mr. Loring: Yes. You must transfer all the risk that there is. That doesn't say how much there has to be. It says, "If there is risk, it must be transferred." Now, in case you're wondering what that means, I'll jump ahead and give you the punch line. If the business loses money, who pays? If the reinsurer pays, you transfer the risk; the ceding company pays, if you didn't transfer the risk.

What are the reasons for reinsurance? We talked about traditional reinsurance and transferring selected risks. Perhaps it's risks that are too big for a company to absorb or, let us say, they are substandard risks. You may have all heard the term substandard shopping. A ceding company underwrites a risk. When it thinks there's a decline, it may shop it to several reinsurers who evaluate the underwriting paper. One of the reinsurers may say, "Well, I think this individual is insurable." The ceding company then issues and reinsures the risk with that reinsurer.

Another reason for reinsurance is to limit catastrophes. Again, with a catastrophe such as a hurricane, an earthquake, or an airplane going down, the risk is simply too big for one company to absorb. Reinsurance can spread that out and limit its exposure. Maybe a company wants to enter a new market. Maybe it's a market that it doesn't know too much about, but the reinsurer does. Or maybe it's a market that requires a certain minimum amount of money to enter and a certain minimum presence, but the company simply doesn't want to absorb that much risk. It may ask a reinsurer to help it underwrite a new type of business or a new product, for example. In turn, the reinsurer will be paid, not by a fee, but by getting the opportunity to share in the business.

Obviously, it's in the reinsurer's best interest to make this product or this new market as profitable as possible because the reinsurer's earnings are going to come precisely from that business.

The same thing applies in an acquisition. There have been many mergers and acquisitions. Reinsurance can be a very valuable tool in that. Perhaps there's a block of business in this company or segments being acquired that the ceding company really doesn't want, so it may lay that off and partition the business. It might keep some and give some out. The reinsurer may well have merger and acquisition expertise that the ceding company lacks. The reinsurer is to be your partner. It's not your adversary. It's not ideal for reinsurance to be a zero-sum game. You and the reinsurer should both benefit from the partnership.

An indemnity reinsurer can provide underwriting assistance and product expertise. The reinsurer may have developed the same product for seven of your competitors. Why shouldn't it help you? Reinsurers can provide tax planning, management of capital, management of surplus, and management of your risk-based capital. Perhaps you have a very heavy C-1 company, and the reinsurer has a client that's a very heavy C-2 company. With reinsurance, you can absorb some of its C-2 risk and pass some of your C-1 risk out.

There are three main types of reinsurance. The first one, YRT, is extremely simple. There's coinsurance, including something called coinsurance funds withheld. There's also something called modified coinsurance. You can combine them in various forms. The most common form is something that's called co/mod-co, (combined coinsurance/modified coinsurance), which is a combination of co-insurance and modified co-insurance. It does something fairly interesting.

With respect to life reinsurance YRT is the simplest type of reinsurance. You transfer the mortality risk and that's all. The premium typically varies year by year, for example, there is an age 35 premium, an age 36 premium, and an age 37 premium. They also vary by sex and by policy duration for a limited select period. After the select period, there's an ultimate period where rates usually vary by age, sex, and issue class only. The reinsurer will quote on a block of business. The ceding company will say, "Oh, no. That's much too much. Cut your rates by 20%." The reinsurer will say, "Well, I can cut it by 12% for the nonsmokers, but only 7% for the smokers." They haggle back and forth and agree on terms. The rates are not guaranteed for certain regulatory reasons, otherwise; the reinsurer might have to set up deficiency reserves, which it doesn't want to do. But, in practice, once a reinsurance agreement is done, the initial rates generally remain in place.

In coinsurance, everything is shared; there's a 50/50 relationship. It is as if the reinsurer issued 50% of the policy. Mortality is shared, the investment risk is shared, and the lapse risk is shared. The only thing that can't be shared perfectly or prorated are expenses because a reinsurer is not going to cut a check for 50% of the

commission to your agent. What typically happens is the reinsurer gets its share of the premium and then pays some allowances, which are negotiated, to the ceding company to cover the ceding company's agency expenses, underwriting expenses, and maintenance expenses. That way, the reinsurer pays some expense, just as the ceding company does, and the reinsurer gets its proportional share of the profit. The easiest way to think of it is to think of both companies having issued the policy and getting exactly the same treatment, except the reinsurer had to pay expenses through a formula instead of literally cutting checks for actual expenses.

The issue I mentioned before was about assumption reinsurance and how it's different from all other types of reinsurance. In all other reinsurance, there is a Chinese wall between the policyholder and the reinsurer. The reinsurer has nothing to do with the policyholder. If Prudential issues a policy and reinsures it with Lincoln, the policyholder deals with Prudential. It doesn't matter if Prudential was keeping 10% of the risk and Lincoln has 40% and Equitable has 50% retroceded by Lincoln. As far as the policyholder is concerned, The Equitable doesn't exist and Lincoln doesn't exist; only Prudential exists because it is a Prudential policy.

On the other hand, with assumption and assumption reinsurance, Prudential sells the policy to Lincoln. The person now is a Lincoln policyholder and Prudential steps out of the way. With only that one exception there is a wall between the policyholder and the reinsurer. Why? So there is consumer protection. If a consumer buys a Prudential policy, he or she wants a Prudential policy and doesn't want to worry about what happens to his or her risk down the road.

From the Floor: On coinsurance, do you also transfer the reserves?

Mr. Loring: Yes, in coinsurance you transfer the reserves. Funny you should mention that. I was just about to discuss mod-co which is just like coinsurance except you don't transfer the reserves. If you don't transfer the reserves, how do you transfer the investment risk? There is an interest credit to the reinsurer. The interest credit to the reinsurer is based on the performance of the policy. In other words, the reinsurer says, "Hey, I should have these reserves. That's \$10 million in assets. I'm not getting the interest on those assets. Therefore, ceding company, kindly pay me what my proportional share is of what you earned on those assets."

Coinsurance funds withheld is very similar to mod-co. The reserves appear on the reinsurer's books, but the assets don't. Now, this may sound like a great deal for the ceding company, but it really isn't. What happens is the ceding company says, "Here's \$1 million of reserves. Normally I should transfer 1 million of assets to you, but, my assets are liquid and I want to keep control of them. I'm not going to give you the assets. I'm going to give you an IOU instead." So the reinsurer's books stay

the same because there is a receivable (which is an asset) from the ceding company for \$1 million and reserves of \$1 million, which wiped out to zero. From a financial perspective, it's as though the reserves weren't transferred.

Why would you want to use mod-co? Suppose the reinsurer is not admitted in your jurisdiction. You can't take credit for those reserves. You don't want to have to worry about that, so you just don't give the reserves up. Most ceding companies prefer to control and invest their own assets. They don't want to give money away to the reinsurer. It's OK. With modified co-insurance, you give the experience on the assets which is the transfer of risk. You don't give the actual assets. It's the same with co-insurance funds withheld. I may keep my stocks and bonds and just hand an IOU to the reinsurer. It's no different financially, but I still get to control my own stocks and bonds.

From the Floor: Which is the most common?

Mr. Loring: They're both quite common. I'd say mod-co is somewhat more common than coinsurance funds withheld. Let's suppose you do a block of business that is part coinsurance and part modified coinsurance. Let's also suppose the allowances are 10%. Remember you have these expense allowances to cover commissions, etc. It turns out that if you do 10% coinsurance and 90% modified coinsurance, and if you do all the accounting very carefully, no cash will change hands. That's the key of co/mod-co. If you can structure a coinsurance agreement that has no cash-flow consequences, and you can even make that continue over time if the reinsurance, for example, gets paid back, by changing the percentage that is coinsurance and the percentage that is modified coinsurance, it's a very clever technique.

We talked about risk transfer. Risk transfer is the key to reinsurance. The accountants want to see it, and the regulators want to see it. If there's no risk transfer, there's no reinsurance. It is very difficult to quantify risk transfer. Some policies are very risky. Some policies aren't very risky at all. Suppose I'm with a very old line mutual company. I pay a very high dividend scale, and I do coinsurance. Suppose this block of business is for an in-force block. I have the right to reduce my dividends to zero if a block turns bad. What are the odds that block of business is going to lose money or that the experience is going to be so terrible that even if I drop my dividends to zero, I'm going to lose money? Practically speaking, it's nil. I've co-insured it to the reinsurer, so the reinsurer shares my experience, paying the same mortality and sharing the payment of dividends.

Have I transferred risk? The reinsurer virtually has no chance of losing money. Someone might say, "Gee, you haven't transferred any risk." My response is, "I transferred all there was. I cannot transfer risk that I don't have." This business is so secure; for my dividends to drop to zero, there would have to be a catastrophe. The reinsurer is in exactly the same position I am. I have transferred risk. It's not a matter of not being able to do anything else. The question is not, what's the reinsurer's absolute probability of loss? The question is, what's the reinsurer's probability of loss relative to the amount of risk that was there to begin with? You cannot transfer risk that you don't have. So if you transfer all there is, you have transferred risk. How do you define it? Take the case I just gave. Suppose the catastrophe took place? The ceding company reduced its dividends to zero and the business lost money. Would the reinsurer have to pay? If it's pure coinsurance, the answer is yes. If the answer is yes, you have transferred the risk. In the early 1980s, this sometimes wasn't the case if the reinsurance treaty were clever enough, such that even if the business lost money and the ceding company had to pay, and the reinsurer didn't have to pay, then there was no transferred risk.

The possibility of loss is not the same as the expectation of loss. No reinsurer in its right mind, with the possible exception of the naive capacity I talked about earlier, will take on a deal expecting to lose money. The reinsurer will take on a deal with the possibility of losing money because every insurance transaction has the possibility of losing money or it's not insurance. It's not risk. But to say a reinsurer must expect a loss is naive. There simply must be a possibility of loss.

From the Floor: Could you go over the difference between modified coinsurance and coinsurance funds withheld?

Mr. Loring: Yes. Assume I'm the ceding company. In modified coinsurance, I do not transfer the reserves or the assets. The reserves and the assets stay on my books because I want to control the assets. The financial experience will go to the reinsurer through the formula. On co-insurance funds withheld, I want to get the reserves off my books, for whatever reason, so I might transfer \$100 million of reserves. Now, accounting-wise, the reinsurer is \$100 million in the hole. I don't want to give him my \$100 million stock portfolio so I simply write an IOU. I withhold the stock portfolio. That's how we get the term, *funds withheld*. Then, I simply write an IOU and hand it to the reinsurance company and say, "I owe you a \$100 million." Now, the reinsurer looks at its book and says, "Let's see, I have a \$100 million liability. That's a reserve. I have a \$100 million asset in the form of an IOU." It's a perfectly good, admitted IOU from a legitimate company. The net effect on my surplus is zero—a \$100 million dollar asset, a \$100 million dollar liability.

Again, in either case, the reinsuring company would have to experience the same investment experience as the ceding company on the assets. Otherwise, you don't transfer the investment risk. That's the key. Whenever you have one of these contracts that doesn't actually move the assets, whether it's with a funds withheld or mod-co, you have to move the experience on those assets. The reinsurer must take the asset risk, the liquidity risk, and the disintermediation risk. The simplest thing to do is for the ceding company to say, "OK, here are the assets I'm holding. I'm going to monitor the experience on that asset. I know which bonds they are, I know which stocks they are, and I know which mortgages they are. I can check through the pools, and I can look at the coupons. I can also take the capital gains. The reinsurer has 40% of the business? You get 40% of whatever investment experience is." So, there's a full transfer of all that investment risk to the reinsurer, but the actual physical assets still stay with the ceding company. There's full risk transfer, but the assets didn't move.

One of the things that a ceding company has to do is decide whether its reinsurance is collectible or not. In other words, if I have this wonderful reinsurance contract, but can't collect on it, what's it worth? So the receiving company must actually evaluate the creditworthiness, so to speak, of its reinsurer. I hope that will never be a problem.

Mr. G. Michael Higgins: I have two purposes. I'm going to talk about life reinsurance agreements and then reinsurance regulation.

First, I'd like to talk about life reinsurance agreements. I think life reinsurance agreements are essentially very simple contracts. Essentially, you identify the policy forms that are being sent to the reinsurer. The primary responsibility of the ceding company is to pay the premium. The primary responsibility of the reinsurer is to pay claims. There may be other monetary amounts being transferred. A reinsurer may pay allowances, may reimburse premium taxes, but, nonetheless, the quid pro quo is fairly simple.

I thought that life reinsurance agreements were fairly simple, but the details are not necessarily so simple. In our company, we went through the process of redrafting our YRT agreement. It took us 18 months. We had actuaries, underwriters, claims people, and our account managers from law. What you find is that it does have its nuances. It can be very complex. There are knotty definitions. What is net amount at risk? How is that defined? When you read a reinsurance treaty, is the errors and omissions article one paragraph long? It can take you a long time to work through. There can be complications.

I'm going to primarily talk about the U.S. regulatory side and the U.S. reinsurance agreement side. Earlier this year, I participated in the Canadian reinsurance conference to form the reinsurance guidelines. I offered a U.S. perspective. For the most part, I see the agreement side, both in Canada and in the U.S., as somewhat similar. There are subtle differences, but they are so subtle, we wouldn't really need to address those in a conference such as this.

Let's discuss ways of binding the reinsurer. You have automatic reinsurance or facultative reinsurance. With automatic reinsurance, in advance of the issuance of any policy whatsoever, the ceding company and the reinsurer agree on certain parameters that have to be satisfied so that when the policy is issued, it is ceded automatically to the reinsurer without the reinsurer's involvement. Facultative reinsurance is where, on a case-by-case basis, the reinsurer needs to underwrite each risk and make an offer of reinsurance that needs to be accepted.

What are the general conditions that you will find in a reinsurance agreement that need to be satisfied in order for the ceding company to automatically bind its reinsurer?

The first condition is that the ceding company needs to take and keep its retention on the life. It will have predetermined the amount of risk per life that it feels comfortable bearing on its own. The retention is set by life, not by policy. So if a company issues a second or a third policy on a life, it will check what it has already retained on that life and then bind the reinsurer. The idea of retention, from a reinsurer's perspective, is that it wants the ceding company to have an economic interest in the life so that as particular claims are adjudicated, there is some pecuniary interest of the ceding company, and it will take care to process that claim with due diligence. I think that's the purpose behind the retention.

The second condition is that the risk ceded to the reinsurer has to be within what is called an automatic binding limit. Typically, that's a multiple of the retention such as four or five times the retention. The reinsurer will grant that much automatic capacity. It doesn't want to get that ratio too much out of balance or, in the ultimate scheme of things, the ceding company will not have enough pecuniary interest. That's why they have an automatic binding limit.

The third condition is that the amount applied for may not exceed the jumbo limit. It's also known as the participation limit. This is a limit where, as the application comes in, the ceding company needs to know how much insurance is in force and being applied for in all companies (not only within its own company, but within all companies). The purpose for this is because the reinsurer is interested in financial underwriting. At some point, it wants to evaluate whether there is too much

insurance on this life. A secondary purpose for this requirement is that the reinsurance capacity may already be filled up if there's that much insurance on a life. So it has this jumbo limit.

Fourth, the ceding company has to have applied its normal underwriting rules. For example, it would not be a guaranteed issue product, but rather it's underwritten according to the rules that have been previously disclosed to the reinsurer.

Next, you find a condition in the treaty where the reinsurer says, "If this policy has been sent out facultatively, you no longer have the right to bind me automatically." The purpose behind this condition is that you would want to avoid antiselection. The ceding company might see the policy and think that it might be able to send it to a number of reinsurers and get a decent premium rating on the policy. But it might fail to receive a decent offer. It would then go and send it automatically. This is antiselecting against the reinsurer. When it gets a decent rate, it will go elsewhere. When it doesn't, it will come to the reinsurer. If you send it out facultatively, you can no longer bind me automatically.

Another condition that you will find in this agreement is that it be written on a resident of the U.S. or Canada. I see that as a condition that we add to our agreements simply to ferret out where the ceding company is doing business. We know the block of business we're underwriting. If it says to us, "We happened to write some business in the Virgin Islands," or wherever, we could change this condition, but that helps us better understand the risks that we're writing.

Let's discuss a questionnaire that I've given you. What do we call the amount that XYZ Reinsurance Company refers to when it says, "You have this much capacity to automatically bind me?"

From the Floor: Is that the binding limit?

Mr. Higgins: Yes, the binding limit. The second question relates more to the amounts that are applied for and in force in all companies. That condition is known as the jumbo limit or the participation limit. Are there any questions about automatic reinsurance or the conditions in automatic reinsurance?

Next, I want to talk about facultative reinsurance. As I explained before, it's the kind of reinsurance where the reinsurer needs to underwrite each policy or each risk case by case. I'm trained as a lawyer, and if analyzed legally, it's an offer/acceptance analysis. The ceding company makes application. The reinsurer makes an offer or declines to offer reinsurance on that case. It's the ceding company that accepts the offer. There are a number of ways of accepting an offer.

It could fax a notice back to the reinsurer that it has accepted the offer, or it will simply be included on the next administrative report. That's a method of acceptance. It's important to go through that sort of offer/acceptance analysis to try to resolve cases that might come up. Let's say a policy comes in. The ceding company decides not to bind its automatic reinsurer. It wants to get an underwriting opinion. It sends that risk out to a number of reinsurers, but before the underwriting process is finished, the person dies.

The reinsurer hasn't made an offer to reinsure it, and it wouldn't, given that the applicant has died. If you have a conditional receipt or a temporary insurance agreement outstanding, you might have some additional reinsurance being provided by your reinsurer where it agrees to be bound in that limbo stage. Unless you have that, no reinsurer is bound until its offer is accepted. You might even have the underwriting process finished. A number of offers come into the ceding company and a death occurs. Then you have a different analysis. In our treaties, we say that if ours was the best offer present in your company, even though you haven't formally accepted it, we will be bound. So you have to go through an analysis of offer and acceptance.

What generally happens, on a facultative case, is the ceding company will not keep its normal retention. In a sense, you enter into a minicontract with respect to that risk. The offer/acceptance relative to that risk will be binding. Then the rest of the treaty will only apply to the extent it doesn't conflict with that offer/acceptance. So you can change your rates, and you can change your retention. Any number of things can happen on the facultative side.

Premiums have been traditionally payable annually in advance. If a policy is issued in January, a company's February statement to the reinsurer shows an annual premium for that. Then as the policy is issued, renewed, or comes to its anniversary the next January, they pay a second year's premium in February so the entire year is paid in advance. We've moved away from that a little bit, particularly with the universal life products where the cost of the insurance rate is deducted out every month. So what we find happening now is that the ceding company is paying a monthly premium for its entire block of business. That's just a shift that we've noticed over time.

The fourth question relates somewhat to this issue. Here you have a company that is ceding—ABC cedes to XYZ. The premiums are paid annually in advance. It's been issuing policies throughout the year. It stopped paying premiums, so XYZ says if you're not going to pay the premium, I'm going to terminate the reinsurance for nonpayment of premium. At the end of the notice period, there's a chance to cure that default. The reinsurer says if you pay me within the next 30 or 90 days,

everything will be fine, and we'll move on. If at the end of that cure period, the premiums have not been paid, how does reinsurance terminate if you have one of these treaties where you're paying annually in advance? If it was paying for the entire block on a monthly basis, it would all terminate wouldn't it? It has failed to pay a premium on any of its policies past a certain period. Therefore, as of that last paid-up date, it would all terminate. It's a much more complicated issue when you are paying annually in advance rather than month to month. What you failed to do was pay me, for example, your March premium for your February issues. That's not to say you haven't paid me your January premium or your December premium. It takes time to run off the termination when you're paying annually in advance. That's kind of the purpose or the point behind example four.

Again, the quid pro quo is premiums in return for claims. So the reinsurer's main responsibility is to pay claims. Typically, a reinsurer will want prompt notice of claims. If there's a failure to give notice, that's not like a breach of a condition where the reinsurer would be exonerated totally. I think the reinsurer would generally have to show prejudice for not receiving notice. For the most part, reinsurers want notice. What happens, at least with domestic reinsurers, is the claims departments will then offer counsel and advice to the ceding company. Some reinsurers see larger claims, such as claims from across the U.S. and around the world. They have an expertise that they simply want to share with the ceding company. Ultimately, the decision as to whether to pay or deny a claim is that of the ceding company. It is the ceding company that has the relationship with the policyholder, not the reinsurer. Advice and counsel is given, but it is not a mandate as to what to do.

The reinsurance contract will define the reinsurer's liability. It differs. In coinsurance and modified coinsurance the reinsurer has a percentage of the benefit that's payable under the original policy. Under yearly renewable term reinsurance, the reinsurer has a portion of the net amount at risk. That has been computed. The premiums have been based on the reinsured net amount at risk, and it will then pay the reinsured net amount at risk.

The reinsurer will typically share in certain unusual expenses (not internal administrative or employee expenses) that are incurred outside the norm. The best example of costs that would be shared proportionally would be the cost of litigation, attorneys' fees, and that sort of thing. If, in the process of the claim adjudication, there is a reduction in a policy benefit that's payable or an increase, the reduction, the increase is shared proportionally by the reinsurer and the ceding company.

The most controversial issue, or the issue that's most hotly debated as far as claims are concerned, is extracontractual damages. Extracontractual damages are liabilities that could be incurred by a direct company because of wrongful or tortuous conduct as it deals with its policyholders. What you will find is a range of positions by reinsurers. Some reinsurers write an agreement where they say nothing at all about extracontractual damages. I think that's a dangerous thing to do because the silence could be read against the reinsurer, and the reinsurer would follow the fortunes of the ceding company and have to pay.

In contrast, you will have some reinsurers deny any liability for extracontractual damages. Others will take the position of participating in extracontractual damages to the extent that they are an active party in the liability or the actual act or omission that gives rise to the liability. As you think about that last position, a reinsurer is not saying to a ceding company, "I will reimburse you for the loss that you pay for your own conduct," as much as it's saying, "If I get involved, and a portion of what you pay is attributable to my involvement, then I will hold you harmless. I will indemnify you for the liability you suffer as a result of my actions." There was a woman who was named beneficiary. She sued the direct company because she wants to receive a policy benefit, and she claims punitive damages because ABC refused to process an application to change her to be named beneficiary versus someone else. The policy has always been reinsured with a reinsurer. Since inception, it has been reinsured. In light of the explanation I gave about participation and punitive damages, would XYZ share in those punitive damages?

During the life of a policy and through the administrative changes that take place in a policy, a reinsurer is not really involved. If it's ceded, it simply gets administrative reports. It isn't involved in the processing detail. In the administrative department of the ceding company, you have errors and omissions. Maybe negligent conduct is taking place. It's not going to turn to its automatic reinsurer and receive participation in the punitive damages.

Let's discuss the agency relationship. Once again, the reinsurer is not involved in the contact between the direct company and its policyholder as far as the agent is concerned. So you're probably not going to find a reinsurer participating in punitive damages in those instances where agent conduct is involved.

Take an example of a case where, during the adjudication of a claim, the reinsurer gets involved. It concurs in the actions that are taking place in the denial of a claim. Punitive damages result in connection with that denial. A court might say, "You denied in bad faith. You wanted to hold onto your money longer. You wanted to browbeat this person or somehow reduce that claim for unjustified reasons." The reinsurer is participating in that process. This case is different than the previous

few. You find reinsurers participating. The way we define it in our agreements is on an equitable basis proportionate to the amount of involvement we've had in the actual act or omission that gives rise to the punitive damages.

From the Floor: Is it proportionate to the involvement or proportionate to the amount of the claim?

Mr. Higgins: It's proportionate to the involvement. There may be other reinsurers that do it proportionate to what they had of that policy. When the policy is first issued, you determine the proportionate share of the net amount at risk that's being reinsured. That might be at, let's say 75% to a reinsurer, 25% retained. When it comes to the claim time, the ceding company generally is the most involved in processing that claim. The ratio may be flipped. It may be 75% involved and the reinsurer may be only 25% involved. Our contract would say we will pay you 25% of the punitive, rather than 75%. I think that's an equitable position. We're holding you harmless from our involvement.

The question is, do they ever disagree? Obviously, it's ripe for disagreement. We haven't had a case where we have disagreed in that sort of thing. My opinion would be to then take it to a group of insurance executives who would serve as arbitrators and let them listen to the facts and circumstances and try to weigh the liability. We just haven't had this mature into an issue.

From the Floor: What about a property-casualty product like professional liability? Would that still apply?

Mr. Higgins: The question is, what if it were a different kind of product like professional liability? That's on the property and casualty side and not the life reinsurance side. On the property and casualty side, what you find, as far as extracontractual damages, is they have losses in excess of policy limits, and they have extracontractual obligations. On the property and casualty side, you have a professional liability. You're being insured for your conduct as an actuary up to \$100,000. I don't know if that's a reasonable amount or not. You've given a valuation opinion of a company and someone has relied on that. They sue you, as a professional, for \$500,000, which is well in excess of your limit. Assume an offer comes in to settle your liability at \$100,000, and the insurance company thinks it can do better than this. It comes to court and they are, in fact, awarded \$500,000 against you. One rationale says, the actuary pay the \$400,000 because you're only insured up to \$100,000. You're able to bring a suit against your carrier on the grounds it failed to negotiate your claim in good faith. You shouldn't be liable for the \$400,000; it should be liable." On the reinsurance side, the reinsurer says, "OK, I will pay that. I will take on losses in excess of policy limits." Those are

typically under third-party liability-type agreements. On the life insurance side, it's not a third-party liability contract. It's a first-party liability contract. So we don't have that. It essentially takes kind of a claims-related punitive damages position as I described here, as well. They will pay claims-related punitive damages.

Let's discuss administrative options. If you now have doubt about the main responsibilities of the two companies identifying the block of business, paying the premiums, or paying the claims, what do you do now? The way I think of an agreement is you start to take on those things that naturally flow from that obligation or those kinds of issues that need to be taken care of as you think about the relationship. There are a number of miscellaneous clauses, and, obviously, the business has to be administered. What you find is that the administration can be driven by the ceding company or driven by the reinsurer. There used to be a great deal of paper flow back and forth. Sessions were given to a reinsurer that generated a bill, and that bill was inspected to see whether there had been cancellations, crossouts, and so on. It was very people-intensive and expensive. So we've migrated more to a ceding-company-administered product where they will give either electronic data or they will give spreadsheets that will show the amount of the policies that are written.

When Denis was talking, we had a question here about what the reinsurance actuary can do by way of valuation or cash-flow testing. I see a downside to a ceding-company-administered business in that we get less information. We're able, for example, to do fewer and maybe less-detailed mortality studies because we're not loading the stuff into our own computers. We get kind of summary detail and so our valuation actuary, then, has to go back to the ceding company and ask for more detail so that he or she could do that analysis.

Offset, again, is a provision that you will find in an agreement. It essentially says, let's pay amounts due and payable on a new basis. So rather than cut large checks back and forth, the company that owes the balance would pay that balance. As I get into regulation, I will talk about the insolvency clause of an agreement. It's one of the few mandated clauses under the law as far as reinsurance is concerned. I wanted to mention that in relationship to the offset issue. Oftentimes, you hear the argument that because of the insolvency clause in the agreement, you're not able to offset. I don't think that is a good argument. In fact, it has been defeated in court a number of times and in a number of states. The offset provision says if the ceding company becomes insolvent, the reinsurer will pay without diminution because of the insolvency. That is what this means. Let's say the policy that's issued is a \$100 policy, and 75% of it is reinsured. Upon death the reinsurer ought to pay \$75 and the ceding company would pay \$25. But if there's an insolvency, it may be that the

ceding company doesn't have \$100; perhaps it can only pay 50 cents on a dollar so it would pay \$50 instead of \$100.

What should the reinsurer do? Should it say, "I owe 75% of \$100 or 75% of \$50?" because it's a contract of indemnity. It needs to reimburse for the economic loss, so it would say, "Well, you only paid \$50, so I'll give you 75% of \$50 rather than 75% of \$100."

That argument was successful all the way to the U.S. Supreme Court. As a result of that case, the State of New York, and nearly every other state, has said, you must base your liability on the regular benefit, in this case the \$100. So you must pay without diminution. That's the purpose of the insolvency provision. Some regulators have said, "That means you can't offset because, when you offset, you're reducing your liability." That isn't an argument that has held up. We will say, "I'm basing my liability on \$100, but unfortunately, you owe me some money, and so, as I pay you my 75%, I'm going to net it out." I just wanted to explain that, in relationship to the offset provision, it's not in conflict with the insolvency clause.

From the Floor: Is that an interpretation that you just gave us?

Mr. Higgins: Yes. I think that generally what you will find is that the courts have sustained that argument and recognize that is the right interpretation of the insolvency provision and reinsurers are permitted the right of offset. That's not a diminution of liability.

From the Floor: How often do you evaluate reinsurance premiums for profitability?

Mr. Higgins: We model agreements as we place them in force. But we have not been able to evaluate profitability as well as we would like to, and we have been trying for sometime to check a contract in its second or third or fourth year to see whether it's meeting up with expectations. We're trying to do that better. With some of our more unusual or complex deals, we will do that, but from a traditional YRT agreement, we really don't.

From the Floor: Do you think the ceding company does that?

Mr. Higgins: I don't know Denis, what would you say?

Mr. Loring: Generally not. What a ceding company might typically do is once the deal is in place, it might evaluate it two or three years in the future. If it seems that the reinsurer is making a great deal of money, the ceding company can ask for a renegotiation of terms. Or, for example, when the new block of business comes

out, it can put that block out for rebidding and expect to get better terms. In that sense, the ceding company will constantly revalue its reinsurance just to be sure it can remain on the cutting edge of whatever opportunities arise.

Mr. Higgins: I was at a meeting where our valuation actuary actually did a report for my boss and his direct reports. The valuation actuary essentially had gone into a pricing model that we had put together as we priced a deal. It's now a year-and-a-half or two later, and he's doing kind of a cross-check of that pricing. He said, for example, he got lost in the program and couldn't tell what assumptions were under each cell. He had to do a spreadsheet and said, "This is the way this contract ought to be performing." It's an exercise that's fairly difficult in some cases. We don't do it for every contract as we should or would want to.

The solvency provision kind of supports Denis's earlier analogy to the Chinese wall that exists between the policyholder and the reinsurer. There's no privity of contract between the policyholder and the reinsurer. If you think about group life or group medical, they are what are known as third-party intended beneficiary contracts. You're an employee. You didn't negotiate the agreement with the insurer. Your employer did. It's an employer/insurance company contract. You are intended to be benefitted by that contract. You could sue underneath that contract. That's not the case with indemnity reinsurance. It's a two-party contract with no intended third-party beneficiary. The policyholder and the beneficiary cannot directly sue and seek benefits from a reinsurer.

There is an exception to that. It's what is known as a cut-through endorsement. By cut-through we mean we are cutting through that wall or that barrier, and we are coming directly to become liable to the policyholder. It's a very rare provision. The ones that I've seen fall of their own weight. It becomes complicated because the reinsurer is very concerned about having to pay twice. It pays to the policyholder, and yet, the liquidator of the insolvent estate will come in and say, "Well, you should pay me. That's the way reinsurance works." Reinsurers don't want to pay twice. There are other complications. Even reserve credit complications. So it's a fairly rare phenomenon.

Let's discuss the increase in retention and recapture. This is, I think, a result of an awareness that the policy being reinsured is a very long-term policy. When you issue a life insurance policy, as long as premiums are tendered, the traditional whole life has to remain in force as long as the policyholder pays. If a guy gets it at age 20, it could stay in place 45–50 years. What happens is insurance companies mature and grow over time. Later in their corporate development, they can retain more risk. So what they will do is come in and say, "We want to increase our retention as far as new business is concerned." Then they will say, "We would like

to take back some of the reinsurance we gave you on previously issued business. We want to recapture reinsurance."

So reinsurers have approved it with some conditions. What reinsurers are saying is, "We don't want to be antiselected against. You can't just pick and choose and take the ones you want." We also have said we have expenses involved in the issuance of these products. When we quote, we quote without any premium to us in the first year. If it is a coinsurance or modified coinsurance, we pay allowances, which drive us economically into a hole. So we've priced to see when we will break even and when we will start to make a profit. We typically would put that into a reinsurance agreement, and they may not be recaptured until a certain period of time.

Typically, recapture is only done when you increase retention. So if you tell us you'd like to increase retention, we'd also like to recapture. How does the recapture program get implemented? You would have been doing business over a number of years. Some policies are in place for one year, two years, three years, or four years in all. So as you recapture, you give us a notice. You're not going to be able to get the policies that are only one year or two years if we give you a ten-year recapture. So it phases in over time as the policies mature.

Let's deal with the termination of liability. When the amount being reinsured reduces over time because of the terminal reserve, or something builds up and there is a smaller net amount at risk, it doesn't make sense to continue to reinsure it. It will automatically terminate.

Let's talk about terminating new business only. If a reinsurer could say to you, "I'm on the hook for this block of business, and I want to terminate that in-force block," you could find yourself with liability well in excess of your retention. So the reinsurer is prohibited from terminating in-force business. You would have a hard time going out and finding replacement reinsurance on these lives that have been in place. So reinsurers generally can't terminate the reinsurance on an in-force block. Ceding companies may be able to recapture that business.

We can terminate for the nonpayment of premium. Typically, as I said earlier, we will give a cure right. So if you pay back the premium within 30–90 days, everything goes along fine.

I'd like to switch to a discussion of regulation. We will be skimming the surface as we did with the agreement. I will, again, focus only on U.S. regulation of reinsurance, not Canadian. I know a little bit about Canadian reinsurance regulation, but not enough to stand here and say I could represent it as an expert.

Reinsurance has historically been unregulated. It has been thought of as the business between two sophisticated companies, each of which can negotiate on its own. So when you think about the direct policy level, it's thought to be a contract of adhesion. So they've come in and said we want to mandate certain provisions in these policies. They've taken consideration, if you will, of the policyholder and the applicants. That was not the case in the past with reinsurance because there have been sophisticated buyers and sellers. I would say that really started to change in the late 1970s throughout the 1980s. There is always a reinsurance regulatory issue that is pending at the NAIC or within the states. There are always developments. We are currently working through the codification of life reinsurance. There are issues relative to the letters of credit that are used to support reinsurance. There's always something going on.

I think of regulation as having two main purposes. Denis mentioned ensuring risk transfer. What they actually do is look at the agreement between the two companies, and they try to make sure that agreement transfers risk. We will talk about that when we talk about the Life/Health Reinsurance Agreement Regulation or what's called the Risk Transfer Regulation. The first main purpose is regulation protects the ceding company from the reinsurers' credit risk. They don't look so much at the agreement as they look at the status of the reinsurer and the creditworthiness of the reinsurer. This is regulated under what's known as the NAIC model reserve credit law. Below the law, they have a regulation. The law is fairly general in its parameters and the regulation takes and carries that through to much detail.

Michael Mackenzie mentioned that regulators are very interested in public confidence, financial security, and stability. I think that regulators say, "As you cede out that reinsurance, we want to make sure that stability and confidence is not undermined." They want to look at the reinsurer and determine whether reserve credit can be taken.

If your agreement doesn't comply with these laws or these regulations, you lose reserve credit. You may do reinsurance business with whomever you want. If your reinsurer doesn't satisfy what's known as an authorized status, or if you use unauthorized insurance and use security, you have to set up a liability, if you will. You cannot take credit for the reserves that are transferred to the reinsurer, so it becomes a surplus hit. If you're willing to bear that consequence, you may do the reinsurance. If you don't want that consequence, which companies typically do not, then they make sure that they follow the rules as far as reserve credit is concerned.

I already discussed the insolvency provision. Let me just say that there are very few provisions that are mandated as far as a reinsurance agreement is concerned. In the insolvency provision, if the ceding company wants to take reserve credit, it has to have this language about reinsurance payable without diminution.

There are a few others. For example, if you do a coinsurance or modified coinsurance agreement, it has to say that it's the entire agreement between the two parties. It can't be amended except in writing. If you cede to a non-U.S. company, that company has to agree within the agreement subject to service of suit by the domestic regulator. So there are some, but few, provisions that are mandated. For the most part, it is freedom of contract.

I will now discuss one of the two regulations that I mentioned: the NAIC Model Law on Credit for Reinsurance. It looks at the status of the reinsurer. Essentially, there are two categories—authorized or unauthorized. You can satisfy that requirement with a number of statuses. Your reinsurer could be licensed in the ceding company's state or jurisdiction. It could be accredited by your jurisdiction, which is an application process. It's not as rigorous as the process that has to be gone through to become directly licensed. The accredited reinsurer has to have \$20 million of capital and surplus. It must be licensed by and domiciled in a state with substantially similar laws as your own state. In the fourth status, and this is used more on the property and casualty side, your reinsurer has a nationwide trust agreement. It's a non-U.S. company that sets up a trust for all of its ceding companies. The U.S. Lloyds of London is really the example of that. We don't see it on the life side.

So if you satisfy four, or primarily the first three that I mentioned, you are an authorized reinsurer. The domestic regulator of the ceding company says, "I can rely on the stability of that reinsurance company. I'll give you full credit for the reinsurance ceded." It's seen the balance sheet of the reinsurer.

If you don't fall into these categories, you are unauthorized. If you cede to an unauthorized reinsurer, and if you look through Schedule S of the blue book, the statutory statement, you will have to take a liability for unauthorized reinsurance. It comes off your surplus. The way to avoid that is to get security from your reinsurer. If you want to get credit for reinsurance ceded to an unauthorized reinsurer, you must get security. You must get a clean, irrevocable, nonconditional letter of credit. You could place funds in trust. You also can withhold funds from the ceding company, or the ceding company can withhold funds. Regulators, to know if your letter of credit qualifies as being clean, irrevocable, and nonconditional, hold the prototype up to the light. They put yours on top of it. If there is an exact match between the two, they'll give you the credit. If you change a comma, a period, a

paragraph, or sequencing, or whatever, they don't like it. There is a model letter of credit in the financial examiner's handbook. If you were to want a letter of credit, go there and tell your reinsurer, "Give me this." I think you have a safe harbor as far as being able to take the credit.

If you want to take credit for all the reserves that you're taking down, you would want a letter of credit with the face amount equal to that reserve. They can be adjusted on a basis agreeable to you and your reinsurer. Perhaps it would be quarterly but it would certainly be annually. You would either top that letter of credit up or reduce it. It's seen as being kind of readily available cash. Within assets placed in trust, they have to be valued at market equal to the reserve credit. So that's the law and regulation on credit for reinsurance.

The last topic I have relates to the risk transfer regulation. It was formerly called the Life Health Reinsurance Agreement Regulation. If your agreement satisfies these kind of accounting requirements, you have transferred risk.

NAIC MODEL REGULATION ON LIFE HEALTH REINSURANCE AGENTS

- Risk transfer required for reinsurance credit
- Defines risks and risk transfer
- Chapter 24 of the accounting and procedures manual adopts this standard
- Trans-City decision accepted the regulation (Section 845b of Internal Revenue Code)

I think one of the interesting things about this regulation is it says, "i.e., you may not get reserve credit unless you transfer all the significant risk from the policy." There is a table that has been developed. Do you have morbidity, mortality, credit quality, reinvestment, or disintermediation risks? They've tried to identify that by product and they said, "If you have a star in your column, your treaty needs to transfer those risks." As Denis said, if you transfer what's there, you've transferred the risk. It may not be a great deal, but if it's there, it is passed, and you've essentially satisfied that condition. There are 11 conditions for risk transfer, but once your agreement satisfies that, you've transferred the risk.

Chapter 24 of the *Accounting Practices and Procedures Manual*, recently redrafted at the NAIC, adopts this regulation and its definitions of risk transfer. If you're very interested in reinsurance, you could read Chapter 24 of the *Accounting Practices and Procedures Manual*. Right now they are codifying statutory accounting *Issue Paper Number 74* which relates to life reinsurance. Jeremy Higgins will talk a little bit about the codification efforts and some of the controversy that surrounds that, as well.

The *Trans-City* decision accepted the regulation, Section 845b of the Internal Revenue Code, and adopted this analysis under the Risk Transfer Regulation for federal tax purposes. The regulation would have disallowed tax consequences of a reinsurance agreement if the agreement had a significant tax avoidance effect. This *Trans-City* case would have said, if you transfer risk as defined in the Risk Transfer Regulation, then that is sufficient for the analysis from a tax perspective.

Mr. Loring: There are all sorts of formulas to determine how much the ceding company keeps. There are some standard Monte Carlo-type analyses. In reality, the retention of the ceding company is the largest claim the chief executive officer could stand to see on his desk on Monday. However, there are more scientific ways to go about it.

From the Floor: What are the different options and practices used for selling a block of business? I mean like assumption reinsurance versus 100% co-insurance?

Mr. Loring: It depends. Do you want to rid yourself of the financial effects of the block? Would you want to rid yourself of the block itself? If you want to rid yourself just of the financial effects, but you don't mind continuing to have the legal responsibilities of the policyholder, 100% coinsurance is fine. If you want to get the block off your books forever, close its accounting, and never talk to the policyholder again, then the only thing you can do is assumption reinsurance.

From the Floor: Are there any problems in getting something like that approved?

Mr. Loring: Yes, there are. There is a Model Assumption Reinsurance Regulation that some states are passing, and it requires the consent of the policyholder. There's a question of whether it has to be active consent or can it be passive consent. In other words, if you send a notice to the policyholder, must the policyholder check the "yes" box, or is it sufficient for the policyholder to not check the "no" box?

Mr. Higgins: And pay premiums thereafter?

Mr. Loring: And pay premiums. That also varies from state to state. Assumption is basically a pain. If you can use 100% coinsurance with a servicing agreement, it's much easier.

From the Floor: When you set up this fund with all the reserve ceded, who puts up the AVR/IMR (asset/valuation reserve/interest maintenance reserve) or risk-based capital? The ceding company or the reinsurer?

Mr. Loring: It's currently the ceding company. There are questions going through the regulatory community and the NAIC about what is the proper treatment of risk-based capital, especially if assets have stayed in one place and the rest of the experience has moved somewhere else. It's an ongoing question. Things are changing. I believe they are talking about moving the AVR, but not the IMR. Up until now, everything stayed with the ceding company. It's now an open question, and my guess is three years from now things will be quite different. It is being debated right now.

Mr. Higgins: Denis and I, as well as Diane Wallace, are on the American Council of Life Insurance Reinsurance Committee. That's how we've come to do this. You'd have to ask Diane about risk-based capital because she feels that it didn't go quite as well as she hoped.