RECORD, Volume 24, No. 1*

Maui I Spring Meeting
June 15–17, 1998

Session 8D
Do Reinsurers Have the Right to Raise Rates Under YRT Treaties?

Track: Reinsurance
Key words: Reinsurance

Moderator: RONALD L. KLEIN
Debaters: JOHN E. TILLER, JR.
MELVILLE J. YOUNG
Recorder: RONALD L. KLEIN

Summary: Typical YRT treaties have a clause which states: "For technical reasons relating to the uncertain status of deficiency reserve requirements by various state insurance departments, the life reinsurance rates cannot be guaranteed for more than one year. On all reinsurance ceded utilizing these rates, however, the reinsurer anticipates continuing to accept premiums on the basis of the rates shown." This or similar wording can be found in treaties over 30 years old. Exactly which rights does this give the reinsurer? Under what circumstances can the reinsurer raise rates? This hotly contested issue will be debated by experts in treaty interpretation.

Mr. Ronald L. Klein: I work for Life Reassurance Corporation of America. For technical reasons relating to the uncertain status of deficiency reserve requirements by various state insurance departments, the life reinsurance rates cannot be guaranteed for more than one year. Renewal rates will be guaranteed to the greater of the rates in the treaty or the 1980 CSO on all reinsurance ceded at these rates. However, the reinsurer doesn't anticipate raising rates. That's basically the wording you see in YRT treaties. Some are a little different.

What does this mean? It is complicated wording for an actuary. It is probable that a bunch of marketing guys put it together. We're going to debate what this really means. We have two speakers. On the pro side—the reinsurer does have the right to raise rates under this wording—is John Tiller. John actually started off as a life insurance agent, so, I don't know if we can trust him at all. He worked at Transamerica after that for several years. He also was a principal at Tillinghast.

John is currently at KPMG Peat Marwick in New York as the national director of insurance consulting. If any of you have taken actuarial exams, you know that John was the co-author of *Life, Health, & Annuity Reinsurance,* by John E. Tiller, Jr. and Denise F. Tiller, 1995, Actex Publications, Winsted, CT.

Mel's a principal at Tillinghast, and his secretary sent me a 15-page fax with his biography. He's in reinsurance and he's a principal at Tillinghast. I'll leave it at that.

The pro side is that the reinsurer has the right to raise rates under this wording. I know it's not a clear picture, but what I'm going to do is I'm going to start off with a poll. How many people think under this wording that the reinsurer has the right to raise rates for the ceding company? Seventy people say they do, which shows you there's a bunch of reinsurers in the audience. How many think they don't have the right to raise rates? There's eight people. I don't know if there's any truth to the rumor that the direct companies didn't send anybody to this expensive meeting and only reinsurers attended. So it's 70 to 8.

The way we're going to run the debate is John's going to start off. He's going to present his side of the story. Then Mel will present his side of the story, not to rebut or refute anything that John said. Then we're going to go back and have a rebuttal. Mel will start the rebuttal, and then John will come back with his rebuttal. We'll have a closing argument, and then we're going to open the discussion up to the floor.

Mr. John E. Tiller, Jr.: I actually was kind of wondering why Mel and I were picked. I thought they might get somebody a little more outspoken and willing to go out on a limb.

I'd like to start off with a couple of caveats. One, these comments are mine and not my firm's. I don't know if Mel wants to make the same statement or not. The specific facts of each treaty may lead to a different interpretation, but, having said all that, I have talked to some of our accounting partners that deal with reinsurance a lot and got a little guidance from them on this.

I don't even know why we're here. I think the language is very clear. It says the right cannot be guaranteed beyond one year. What could be clearer than that? Except for the rules of this debate, I'd sit down now and make Mel prove the opposite case. The issue, therefore, is very straightforward and simply stated. Do the words in the reinsurance treaty have meaning and integrity? Are they merely a screen to deceive, to, in effect, defraud the public and the regulators by modifying our accounting system? If the words have meaning, then the reinsurer has the right to raise rates. If they don't have meaning, then the reinsurer must establish deficiency reserves on YRT contracts.

To reach that conclusion, I have four, basic assumptions. First, in the absence of such language, the reinsurer will have to establish additional reserves. In effect, for this discussion I'm discounting the flowery language that says something about the uncertain status of deficiency reserve requirements. If the industry truly believed that there was an uncertain status, I believe that they, somewhere in the last 30–40 years, would have gone to the regulators and come up with some sort of interpretation. Granted, there may be some difference in interpretation from state to state, but by and large, I believe it should be interpreted that the reinsurer will have to set up deficiency reserves if there is no right to raise rates. If not, let's change the language and forget about it, and we won't have any further debate.

It should be noted also that this language or similar language pre-dates the advent of nonguaranteed premium elements other than dividends. So nonguaranteed premiums, interest credits, variable cost of insurance (COI), and variable expense credits all came after this language was introduced into treaties.

The second assumption is that there is no intention to defraud or mislead the regulatory system. While it clearly is an intention that the reinsurer should not have to establish deficiency reserves, nobody wants to do it so as to defraud or deceive. Twenty years ago, a common treaty provision in surplus relief treaties said that this reinsurance is null and void from inception if the ceding company becomes insolvent. That didn't do the regulators much good. I think that was a form of deception. I don't think that's what we're trying to do here. I think we're trying to legitimately establish rights for both parties.

Third, the issue becomes one of capital. How much capital is required to write reinsurance premiums? Additional reserves is another way of saying you have to allocate more capital to YRT business. Therefore, for most companies and most reinsurers, there's a cost associated with that capital. This boils down to a cost of capital which, in normal circumstances, will translate into a cost of reinsurance. In the third assumption, we are really talking about the price of reinsurance.

Four, there's some debate in the industry as to whether a reinsurance treaty is a full, legal contract, enforceable under law or whether it is a gentlemen's agreement, where we all know what it means, and we'll all get together over cocktails and napkins and work it out some day. In that disagreement, I come down very solidly on the side that it is a legal agreement enforceable in court, just as any other legal agreement. Terms such as a gentlemen's agreement may be meaningful in terms of establishing some of the context of it, but the words of the treaty must prevail over other types of practices. If we don't have words in the treaty that mean something and that we follow, then how is anybody going to know how to deal with this 50 years from now when all of us are retired?

There's another provision that sometimes gets overlooked. I believe under the model law, it's required for co-insurance and modified co-insurance that a treaty contain a provision that's called the Entire Treaty Provision or Entire Agreement Provision. It basically says that there are no side agreements, no handshakes, no oral agreements or winks or nods that override the words in the treaty. Therefore, even though a reinsurer may sit down with somebody and say our plan and our honest intention is that we want to live with these rates forever these entire treaty provisions mean that the reinsurer is not committed and still has the right to increase those rates.

Accounting principles. That particular thought is clearly in contrast to the gentlemen's agreement school of processing as to what a reinsurance agreement is. If we look at accounting principles, per our accountants, if there's no intention to take an action or no ability to take an action, then you cannot rely on that action for accounting purposes. I'm sure a number of you have run across this in GAAP where you use your best assumptions of future interest rates, crediting, COI, and expenses, and it sometimes causes a problem with loss recognition. This is a similar issue. What is the intention here? What is the ability? If there's no ability to raise rates, then there can be no intention to raise rates, and accounting principles say you must fall back on the fact that you cannot raise rates and do your accounting that way.

Now, there's a trade-off to the ceding company in that the ceding company avoids higher premiums. In short, I contend that the ceding company can get guaranteed rates. They're just going to have to pay more for it. The confusion in all this comes around the last sentence where we say language to the effect that the reinsurer anticipates continuing to accept premiums on a current basis. What is meant by *anticipates*? That's a statement that the reinsurer's intentions are honorable and he or she intends to use these rates in other situations, circumstances being equal. However, it is not a guarantee. For example, after a very long day of traveling from New York yesterday, I was scheduled to arrive in the airport at 6:15. The airline delivered me at 7:30. I believe the airline had good intentions of delivering me here at 6:15, but the plane was late. It did deliver on its basic guarantee, and that was to get me here safely within some reasonable amount of time. But it did not get me here when it said it would. I pay an added cost, which is an hour and a quarter of extra discomfort and frustration. I accept the risk of tardiness, frustration, and even safety every time I fly, but there is a cost associated with that. I do not have a guarantee that they will get there. I have an intended or anticipated time of arrival.

Anticipation and intentions are honorable statements, but they're not guarantees. If there were a guarantee, this language would read something like the reinsurer will continue to accept premiums on a basis of the rates shown in Schedule C for the duration of this agreement. This is simple language and very easily written. You don't even need all the rest of this junk.

There is an analogy to direct undetermined and unguaranteed premium elements that I think we need to talk about briefly. Some ceding companies say (and I'll overdramatize this), "Please, please, please, Mr. Reinsurer, you can't possibly not guarantee our rates. I must have a guaranteed rate." But they don't give that to their policyholders, do they? Very little business today is sold with a guarantee. You have universal life and term insurance with nonguaranteed premiums. You have universal life with nonguaranteed elements around interest, mortality charges, and expense charges. Participating whole life says you have a nonguaranteed dividend. There may be formulas. There may be rules around how this is done, but if a ceding company or a direct writer can deal with unsophisticated Joe Lunchbucket on an undetermined nonguaranteed basis, why can't a sophisticated buyer such as an insurer deal with the reinsurer on the same basis?

There are other discussions we can go through on alternatives and market considerations, but, in the interest of time, I'm going to stop there and just say that my basic position is the words that are written down in the four corners of the treaty and the legal agreement are what must apply. The right to raise rates is allowed, and unless both parties are willing to admit to an intention to deceive the regulators and basically commit fraud in accounting, then the reinsurer has the right to raise rates.

Mr. Melville J. Young: I, like John, will give the same caveat. I'm speaking for myself and not for anyone else. I have not asked my brethren at Towers Perrin for their position. Over the years, I have had quite a number of conversations, including discussions with people at this meeting, about their position. I'm astounded at the vote. We'll get into that later.

Commitments. Like John Tiller, I grew up in an industry justly proud of a rich history of keeping its commitments. For a segment of the life insurance industry, the life reinsurance industry, keeping promises has been more than a tradition. It has been the number one product. I did my apprenticeship at General Reassurance, and John did his at Transamerica. We're both schooled in the importance of keeping our corporate as well as our individual promises. This tenet was drummed into my head along with the notion that not keeping commitments was far costlier than stepping up to the cost of our mistakes. During my 38 years in the life insurance industry, a significant period of time has been devoted to the life reinsurance industry. Companies I have worked for, with, and competed against have tirelessly tried to build a reputation amongst their clientele that they could be depended upon. There being no shortage of capacity in the market, building a reputation for integrity was viewed as a critical success factor.

For almost 40 years, YRT reinsurance treaties have contained language providing less-than-complete rate guarantees. This language was designed to protect the reinsurer from the costly potential of having to maintain deficiency reserves. Perhaps, during the rebuttal, we could talk about the origins of the language. Unfortunately, I've been around long enough to know history. The cost of reinsurance is an important competitive factor of the reinsurance contract and guaranteed cost is an often promised ingredient when choosing between nonrefund and experience refund rates. In fact this guarantee has often been stressed by those marketing nonrefund YRT programs, and since the YRT program could easily be reconfigured, which John seems to have ignored up to now, as a nondeficient rate coupled with the ceding commission. Structured as it was for the convenience of the reinsurer, cedents have not spent much time worrying about the technical reason language contained in their YRT treaties, at least until now.

Then there is custom and practice. At a recent arbitration hearing on this subject, experts on both sides of this issue were asked to cite a single instance where a reinsurer exercised a unilateral right to increase rates. No one, amongst a very large contingency of experts, could cite a single example. A handful of rate changes involving situations where the cedent was not living up to its contractual commitments were cited, but no one could cite an example of a unilateral rate increase by a reinsurer. Through their words and their actions reinsurers have made a commitment to maintain these YRT rates. Shouldn't a change of position be clearly announced to one's existing and prospective clients before being implemented? Shouldn't this change apply solely to future business?

Since reinsurers can reconfigure their agreements to achieve the results they desire, and since a 40-year history of guaranteed YRT rates has been established, it's my view that a literal interpretation of the language (forgetting about what the lawyers and the accountants are trying to tell us), that allows a unilateral right to raise rates, is not only wrong but is bad business. It's a bad business practice for a company interested in maintaining itself as a participant in the traditional reinsurance business.

Those on the other side of this issue have been known to say, as John did earlier, the words speak for themselves. How else can a reinsurer avoid deficiency reserves? The words don't speak for themselves when the contracts are called guaranteed cost, and those delivering them say, "Don't worry, we have no intention of ever changing these rates." As far as a reinsurer's right to raise rates unilaterally on a company-by-company basis, there are sufficient alternative interpretations to the technical reasons language to argue against the necessity for deficiency reserves. For example, if a reinsurer were to clarify his position stating that any change would apply across the board to all its clients, its cedents might not like this new interpretation, but might accept it because the cedent would recognize that such an across-the-board change would so negatively impact the reinsurer that this interpretation would be tantamount to a guarantee.

Reinsurers, like insurers, are in a risk assumption business. Structuring or interpreting treaties to eliminate risk brings into question the efficacy of the life reinsurance business itself. An unfettered right to raise rates should certainly bring the concept of risk passage into question. In the arbitration proceeding I referred to earlier, one consultant taking the position counter to mine acknowledged that, in his opinion, the reinsurer could raise rates to any level, even to a level which exceeded the death benefit. Hopefully we could all agree that this is a ludicrous interpretation, but the words speak for themselves.

It is typical that YRT reinsurance treaties cover mortality risks associated with noncancellable life insurance policies. The cedent cannot cancel, and its right to change rates is usually prohibited or closely regulated. Over the years product development actuaries have been encouraged by reinsurance actuaries to factor guaranteed cost nonrefund YRT rates into their pricing models. These rates were sold as one certainty in a very uncertain environment. Ceding companies have been encouraged by their reinsurers to purchase more reinsurance than they theoretically need so as to gain the advantage of this certainty. Can the reinsurance industry, in good conscience, back off from this commitment? Most reinsurers I've spoken to have answered that question emphatically no. Ron Klein was giving the opposite impression.

Reinsurer participation in a cedent's rate increases on indeterminate premium policies is justified and should be provided for in the reinsurance treaty. But I don't think there should be unilateral rate increases. This debate should not be occurring. I agree with John on that point. After 40 years of clearly established precedent within our industry, a company wishing to change the rate should have to clearly announce that change to existing and prospective clients. Tillinghast has conducted surveys which show that ceding companies choose their reinsurers based on price, service, relationships, and financial strength. Integrity is never mentioned. It's a given, and it is a reinsurer's most important asset. It shouldn't be discarded thoughtlessly. I suspect that if a reinsurer announced to its clients that it intends to interpret the technical reason language as giving it the right to unilaterally raise YRT rates, that reinsurer would experience a dramatic flight of its clients. I wonder if any reinsurers present have made such an announcement. If not, I wonder why a reinsurer intending to oppose this interpretation has not made such an announcement.

Mr. Klein: We are ready for your rebuttal.

Mr. Young: If somebody's interested in some history, I think 40 years ago, an actuary at the New York Insurance Department that I've spoken to on the subject, was asked whether or not deficiency reserves even apply to YRT rates, and he struggled with that for quite a number of years. There was a great deal of debate in the industry. This whole issue as to whether it applies has never been fully documented. Whether it's a subterfuge or not, it was with the assistance of the then chief actuary of the New York Insurance Department who had raised the issue to begin with. This was an approach that was accepted. I have alluded to some approaches. There are other things that people can do to avoid deficiency reserves as a reinsurer if they're uncomfortable with the current status quo. He said that some of the examples I gave earlier certainly would avoid deficiency reserves.

As a result of all this and as a result of some recent questions about this language, we, at Tillinghast, have begun advising clients to ask their reinsurers about their position on this and, if there is a question, they should ask for a change in the agreement. John indicated that there's only one way for the reinsurer to avoid deficiency reserves and that would be for there to be a nonguaranteed rate. If there's a guaranteed rate, that would inherently involve added cost. Now that's just not true, and he knows it. You can have a guaranteed rate that's not deficient and an allowance equal to the difference between the old rate and the guaranteed rate which is not deficient. That voids deficiency reserves. If those companies in the room that are cedents have any question as to whether your reinsurer will ever exercise this unilaterally against you, I strongly advise you to have them change their treaties and use that approach.

Mr. Tiller: I didn't mean to imply that was the only one. I actually have eight alternatives here.

Mr. Young: That was my point. There are lots of alternatives.

Mr. Klein: Now John will give his rebuttal.

Mr. Tiller: Let's go back to the situation that Mel was describing from last year where a supposed expert said that there was an unlimited right to raise rates beyond the level death benefits. I was that supposed expert, to be perfectly honest. The wording was different. That particular treaty had nothing about a guaranteed rate. It just had the language that rates can be raised, and it had some other modifying language that we don't want to go into right now, but it didn't have anything in there about a cap.

Let's talk about alternatives. In that case, in the answer of the attorney from the other side, the ceding company said it can raise rates. There was nothing in the treaty that stops that. There is, however, market consideration. Mel talked an awful lot about integrity, and I think integrity is extremely important in this. In our era of more conservative, market-oriented philosophies in the U.S. and the rest of the world, I think we'd have to say something about the invisible hand of the market doing some controlling around this; that should not be ignored. Mel referred to how a company would start losing business if it went out and without justification arbitrarily started increasing rates. I happen to believe that's absolutely true. I think there is a very strong market control on this. I think it's the same control that the direct writer has on its rates, and, in many instances, it is why they do or not raise rates. Why doesn't a direct writer raise rates or change rates more frequently? Each of us knows that there may be a formula, targets, and guidelines, but, deep down, most insurance companies set their rates on renewals for universal life policies. They set their dividends on participating life based upon what they think the market, including agents, policyholders, and competitors, will tolerate. So it's not a purely scientific situation.

We talked a lot about unilateral. I talked about the unilateral right to raise rates. As far as I know, I agree with Mel. Nobody has ever unilaterally increased rates, partly because there's a second phrase in the language that often floats around that says the ceding company doesn't pay the rates, and they don't get any benefits. Both companies have a bit of advantage over the other one. What normally happens in these situations is the reinsurer comes in and says, "I need a rate increase. They propose something and sit down and negotiate." In Mel's school of thought, that is no longer unilateral. So, it's true. There are very rare, if any, circumstances where a unilateral rate increase has been imposed because the other party has the right to fight this; it can go to arbitration, go to court, and refuse to pay payments. These things are normally settled. I think we should forget about the sophistry of unilateral and talk about how you continue to be protected in the business world. I don't mean to imply that there will be unilateral increases. I think there is the reinsurer's unilateral right to raise rates, and then there are consequences from that.

Mel, you talked about your survey and why people buy reinsurance—price, service, relationships, financial strength. I think those reasons are all true, and, to me, integrity is a part of that. I think it is a very important one. It's so important that I just can't believe a reinsurer would not suffer and be aware of those market consequences in asking for rate increases. Last year there was an article by Joanna Becker in *The Reinsurance Reporter,* and I think it was titled, "Are Your YRT Rates Safe?" There were three responses given to that article later in the year: one of those was by Jack Bailey of Northwestern Mutual who takes a pretty strong position on this. One of Jack's points, as a ceding company representative, was that word will travel. Bad news travels fast. Sophisticated buyers of reinsurance are aware of the fact that they do have a bit of a club. A reinsurer cannot arbitrarily do this without ruining themselves in the marketplace.

I have eight alternatives. I'm sure there could be others if we stopped and thought about them. Recapture was discussed in some of those articles. I believe the possibility of recapture was mentioned in response to Joanna's Becker's article. There's a problem with recapture. If you, Mr. Reinsurer, increase my rates, I have the right to recapture the reinsurance. That might take care of that particular problem, but presumably you had a reason you wanted to reinsure that business. You're stuck with a bunch of old underwritten business for which you must find another reinsurer. It may or may not be a legitimate alternative.

This has the limit of putting a cap on the rates, valuation, mortality, and interest. It's still high relative to the normal marketplace. It's very advisable to have this language, and I tell all my clients that they ought to have it in there, but it doesn't solve the whole problem.

We could go back to experience refund treaties like they had in the 1940s and 1950s, but to avoid the deficiency reserve problem, you have to set the reserve for the YRT premium up at the valuation level. What you're doing is agreeing to split profits in some way, shape, or form. I think there is a serious question in some of these about how much risk you've actually transferred. Under YRT, that's not normally a big issue. It doesn't even fall under the model regulation dealing with this risk transfer.

There is a problem if YRT rates get too high. There are interpretations that will say if the ceding company's YRT rate is higher than the rate its collecting, such as a COI rate or a term rate, you have to establish a reserve for the present value of the future deficiencies on that reinsurance cost. We ran across that 25 years ago in California at Transamerica. So each alternative has its own problems.

Mel mentioned the possibility of what I would call an entire class or rate scale restrictions. For example, everybody on a certain rate scale gets increased. That may work in the old days on certain business where there is a common rate scale; most of the business that is being ceded today is on a tailor-made rate scale. The class is that individual company's block of business. I don't know of any reinsurer that would really want to say all their YRT business would be viewed together. Frankly, I don't think they should. If you're going to do that, bring in the co-insurance and bring in everything. You have to have it down to a manageable block of business. Direct writers look at individual classes of business and not at all their business at once.

My favorite is the one that Mel referred to which involves setting up the rates at the valuation level and giving an allowance. That takes care of net cash flow, but you're back into the possible deficiency for the ceding company. You can set up a formula as to how the rates can be increased driving off of experience. I advise you talk very seriously to your regulator about that because that may actually take the control out, and if the ceding company or the reinsurer doesn't have the right to change a rates barring experience, they may be back in a deficiency reserve situation because they don't have unilateral control over it. You can co-insure the business with appropriate terms.

The final option is to get a reinsurer that will guarantee the rates. Capital is relatively cheap. The reinsurer's cost of capital, including its retrocession cost, may be far cheaper than the direct writers. Maybe you could get somebody to guarantee the rates. If I was advising a reinsurer today, I would tell him or her to take a look at that. I don't know exactly what I'd charge for it, but if you're really concerned about this, you could, as the reinsurer, give a quote on a nonguaranteed basis and another on a guaranteed basis. Let them choose. I don't see anything wrong with that.

Mr. Young: There probably shouldn't be any *XXX* discussion then, John, given that capital's so cheap.

Mr. Tiller: But each of these carries problems, so there are alternatives.

Mr. Klein: We've had our opening arguments and rebuttals. Have people in the audience changed their minds as to which side of the fence they're sitting on?

Mr. Henry B. Ramsey, III: I think you're asking the wrong question. The response was 70 to 8 when you asked whether reinsurers have the right to raise rates. If we asked the same group the question— would raising rates be very detrimental to reinsurers, effectively withdrawing them from the reinsurance marketplace—you'd perhaps get the opposite answer.

Mr. Young: Or, of the ceding companies, how many of would cease doing business with the reinsurer that you're doing business with if they put through a significant rate increase?

Mr. Tiller: On their company or on another company?

Mr. Young: On your company.

Mr. Tiller: It depends on which ox is getting gored.

Mr. Young: Do you want to ask?

Mr. Klein: OK. We have a question posed. Hank said that maybe our question is a little off. I think there's a difference between the questions, do you have the right to raise rates and will you raise rates? Under what circumstances will you raise rates?

I'll just give you two ends of the spectrum. You have one ceding company that gave you all mortality studies and all the information that they had and continually discussed it with you. The business experience started turning poor. The ceding company called the reinsurer up and said we're doing everything possible to manage this block of business. We're losing money on it, too. Here's what we're doing, and here's the plan. Then there's another company at the other end of the spectrum where the block of business turns bad. You call the ceding company, and you say, "What's going on here?" You realize that there were mortality studies they never sent you and all sorts of programs that they never told you about. They're not managing the block of business. They're earning extra money on the business even though you're losing money. You're not on the same risk. You never knew that. You might say, "If I'm doing business with that reinsurer, I want them to raise rates on that lying ceding company so my rates aren't hampered in the future." On the other side, you would say, "I don't want them to raise rates. The experience is bad. There's some risk involved." I think that there's more than just the question of whether you would raise rates. The question simply is do you have the right to raise rates if you need to under some circumstances? So I think that's where we were going.

Ms. Sue Ann Collins: When I read this, I believe it says the reinsurer absolutely has the right to raise rates, but there's an implied reason as to why they can raise rates. I would guess that the implied reason has to do with deficiency reserves. It doesn't have to do with experience deteriorating or with misinformation on the part of a ceding company sending information to a reinsurer. I think it has to do with technical reasons relating to deficiency reserves. Is this any different than some of the experience the direct companies have had with raising COI rates, when there has been policy contracts that say we will only increase the COI rates if mortality experience deteriorates? We've seen a lot of market conduct lawsuits that have, for the most part, been settled, but some of those lawsuits have been driven because someone believed that COI rates have been increased for reasons other than mortality deterioration. An example was the deferred acquisition cost (DAC) tax. I question whether this is any different than that scenario. If the reinsurer really wants to be able to raise rates if mortality experience deteriorates, I would suggest that they put that language in the reinsurance treaty.

Mr. Klein: I think we have two questions, and I'd like an answer on both of them. The first question is a little difficult in my opinion. It says nothing about mortality experience. It says there's something to the technical reasons for deficiency reserves. So, why don't we hit that one first, and then we'll go to the COI. The question is, when can you raise rates? What are the technical reasons for deficiency? What does that mean?

Mr. Young: I absolutely agree with Sue. I think it's very clear. It says nothing about experience. I would like to ask how many ceding companies, since there are 70 people that disagree with me, have had discussions on this subject with your reinsurer where they've clearly stated their position that if experience turns bad, they're going to raise your rates. Have they said they have the right to do that? How many ceding companies have had this discussion with their reinsurers? Have they come to you and said, "By the way, we could raise your rates?" I don't see one hand in the room. Of the 70 people that feel that the reinsurer has a right to raise rates, how many of you have had that discussion? How many reinsurers have said to your clients, "We know this language is crystal clear (obviously 90% of the smart people agree with it), but in case you don't understand, we want to tell you that this means something other than deficiency reserves." If you get a 10% increase in mortality experience, we're going to raise your rates? How many reinsurers have had that discussion with your clients? If not, why not?

Mr. Tiller: I think he raises some good points. I don't like this language. I think it's imprecise language. I've been involved in somewhere between one and two dozen situations where I've been an expert witness, and Mel has been in some of those on the same side as I was and sometimes he was on the other side. Most of those cases boil down to poorly written treaties. Being precise about what you mean in the treaty is one of the cleanest ways to avoid a future problem. I don't think this language is very good. I think it starts off with a reason as to why the rates can't be guaranteed, and then it says there's a cap on them, and then it says we don't expect to change them. However, it leaves open when, where, and how they can change. It has no logical meaning unless you can raise the rates. If it said you can raise them because of the mortality experience, that would be clear. Joanna's article cited some language that she had received in a draft treaty. "The reinsurance premium rates are not guaranteed. The reinsurer reserves the right to change rates at any time. If the reinsurer changes the rates, it will give the ceding company 90 days prior written notice of the change. Any change applies on the reinsurance premiums due after the expiration of this notice period." Most of you wouldn't like that language, but I think it's a lot clearer than what we talked about. It very clearly says reinsurers have a right to change rates.

Mr. Young: If you really intend to be able to raise rates for reasons other than deficiency reserves, then why have you not changed your treaty language, and why have you not had this conversation with your clients?

I have talked to most of the reinsurers in the industry about this issue, and I have found a very large percentage of the reinsurers believe that they don't have the right to raise rates. So, I'm absolutely astounded that 90% of the people disagree with that point of view.

From the Floor: It does say you can raise rates.

Mr. Klein: Let's just get into the technical reason for deficiency reserves. Let's ask—what are deficiency reserves for? Why would this wording mention anything about deficiency reserves? Why doesn't it just say experience? How are deficiency reserves and experience tied together?

Mr. Young: Well, I have had a strong position myself for many, many years (for more years than most people have been working). I think the whole concept of deficiency reserves is ludicrous. I think it's a ridiculous concept. I understand the accounting, and I understand a valuation actuary's point of view. I think it's a ludicrous concept. It's there because, theoretically, there may not be enough premium to meet benefits, but there's no connection between statutory premiums and reserves and real-life premiums and reserves. I think the concept is crazy, and I think that, unfortunately, as I said earlier, accountants and lawyers are ruling the world, and so we end up with this concept.

I just don't like the concept. We talked about the origins of this. I think that the former chief actuary of the New York Insurance Department was the first guy to require this, and he took a long time to come up with his position. He sort of agreed with my position. There has been a question in his mind, and lots of other regulators' minds over the years, as to whether deficiency reserves should even apply to YRT reinsurance.

Mr. Tiller: I talked to the chief actuaries in Texas and California over the years, and they think they are right. We have a statutory valuation system that dictates the minimum mortality you can use.

If you don't collect the premium at that guaranteed level, then you have to set aside surplus for it because that's the way a statutory valuation system is built. It's not GAAP. It might not be good, and it might not be bad. It's just the way it is, and it's what we have to live with.

Mr. Young: I understand what Sue said earlier. My position has always been that many of the YRT contracts we're talking about are labeled guaranteed cost. I suspect there are a number of reinsurance marketing people who may not want to get up and admit that they have said to their clients, "Don't worry, we're not going to change your rates." They don't want to admit it because their companies have taken different positions. I don't care what the words say. I don't know what the position of John Montgomery of the California Department would be. I'll just tell you that if you go to a court of law, and your reinsurance salesperson has delivered that thing that says guaranteed cost, and has told you not to worry because he will not change your rates, you're going to win in court.

From the Floor: I want to make a comment and then ask your observations. I think you are finding more differences than there really are here. This language is anachronistic. It has absolutely very little application to the current kind of reinsurance contracts that are being written. The current kind of reinsurance contracts being written have more of an indeterminate nature. There less of a partnership aspect between the ceding company and the accepting company than there used to be. Ron Klein was talking about two different types of companies. I think we're seeing, in product development areas, a definite inclusion of the reinsurance aspect into the profitability of the contract, and that's not a shared concept at this point. I agree with you, Mel. If you apply this anachronistic language to the kinds of situations that are coming up today, you're going to have tension. Reinsurers are being a little more than disingenuous when they say they have no intention of raising your rates because they have no idea what the rates are going to be.

Mr. James D. Atkins: First, I'd like to offer a bit of rebuttal on Mel's behalf to John. John said that there isn't much in the way of guarantees anymore on the direct side anyway. I take real strong exception to that. There are extremely long guarantees in term insurance—20–30 years is prevalent today. In universal life policies, several companies in many states have long secondary guarantees which have the long-term effect of having a guarantee that's not on a year-to-year basis. I just wanted to make that one point.

Mr. Young: Good point.

Mr. Atkins: I'd like to pose a question to the two of you. If the valuation rules change so that we got rid of the concept of deficiency reserves and leave the responsibility for setting reserve levels up to the valuation actuary, who would use his own best professional judgment (i.e., there would be no more deficiency reserve rule), would this language have any future effect?

Mr. Young: I'd ask you whether you would, in a one-year term contract that you were issuing to the public, establish any deficiency reserves. You obviously feel the rate is sufficient. If I was the valuation actuary back in my General Reinsurance days, based on that set of circumstances, I would set up no deficiency reserves. I assume you would do the same thing. You would set up a set of rates that you think would be sufficient.

Mr. Atkins: Speaking as the product development actuary, and not the valuation actuary, I would say that I would never price a product that would need a deficiency reserve because it would be underpriced.

Mr. Young: That is exactly my point.

Mr. Tiller: Let me pose a slightly different answer. I tend to agree with Mel that most reinsurers do not plan to raise rates except under certain circumstances.

Mr. Young: That's not what I said, John. I said they emphatically say they will not raise rates. They said they will not change their rates.

Mr. Tiller: I believe, however, that most reinsurers, deep down, do believe that they have the right to raise rates, even when they say they're not going to. There are always these dire circumstances. The fact that they can raise rates ultimately does assist them a little in their pricing. I think the same is true on the direct writer. You may not intend to raise those term rates or anything, but the fact that you can gives you a little bit of an out and allows you to be a little bit more competitive. Jim, to answer your question, I think if deficiency reserves went away in the valuation system, I think the reinsurers would still look to something. I don't know whether it would actually quantify itself into a higher premium or a nonguaranteed element. If I were advising on a pure theory basis, I would say that there is a right to raise rates under some conditions (for example, if AIDS had been as bad as we thought it would be). It gives the reinsurer an out that they want and there is a price break in there for that. I can't quantify it. Every company would have to look at it individually.

Mr. Young: I agree with what John said. I'd advise reinsurers to look at raising your rates. Based on this language, if there were no chance of raising rates, and if the rates were truly guaranteed, I bet that no reinsurer would change their rates today if an edict came down and said, no, this language says you're not going to raise rates because of experience. I bet you nobody would change rates by one-tenth.

Mr. Robert J. Thiessen: As someone who has drafted this wording and used a variety of variations to make ceding companies happier, I think the one thing that reinsurers have been trying to do is be in the same position as the ceding company. Many reinsurers have different regulatory constraints, and reinsurers operate in New York and ceding companies don't. There are other things like that. In order to price on a method that's appropriate to the ceding companies, they want to be in the same position as a ceding company. If the ceding company isn't setting up deficiency reserves, they definitely do not want to set up deficiency reserves themselves. I think that's some of the genesis of some of this really convoluted wording.

I think it's sort of an outgrowth of a valuation system that's based on a very old idea. I think some of the ideas underlying the valuation system that create deficiency reserves have done their job and should be replaced by others. As long as that old valuation system is there, people will develop this convoluted wording to try to avoid some of the harsher aspects of the valuation system, especially if they think they're irrelevant.

Mr. Young: Did you give your opinion, though?

From the Floor: I voted with you, Mel.

Mr. Lee A. Zinzow: I have a question for the reinsurers and for the ceding companies. I think John has established that, in his opinion, the main reason you haven't seen anything or might not see any changes would be a fear of market consequences. I'm wondering if we haven't seen increases in rates due to a feeling on the part of reinsurers that they cannot do it. Has there been a feeling among the reinsurers suggesting that they would do it, but they don't feel that they can because of contractual wording? Or has there been a belief that it just hasn't been necessary because we haven't had any experience deterioration such that it would be required? I'd like some sort of response on those two points from the reinsurer. From the ceding company's perspective, I'd be curious to know whether anybody has seriously considered the possibility of a reinsurer increasing their rates. I think that if that were a serious consideration among ceding companies, they conceivably would be exploring other alternatives such as guaranteed rates or whatever. I wonder if the reason that hasn't been done is because there's a perception that the reinsurer really isn't going to change rates and would not change rates.

Mr. Klein: What would happen if noninsurance people took over an insurance company to run it off and said, "We want to get as much money out of this company as possible? We have the right to raise rates to the 1980 CSO table. Let's raise all the contracts to the 1980 CSO table. We don't have any relationships with these ceding companies. We don't care about them. We took it over, and we're going to strip the company." Would they have the right to do it? That gets right to the answer. Now there's no more gentlemen's agreement because there are no more gentlemen. They came in there. They're here to rape and pillage.

Mr. Young: I think I answered your question earlier. You're talking about an action that's going to be in a court of law. Are you going to get into that he-said/she-said kind of thing? If the former or current employees of the reinsurer are honest people, they might very well say, "We told these ceding companies we're not going to change rates," if they go into a court of law, and if that can be proven, I think, hands down, the reinsurer loses regardless of who the management is.

Mr. Klein: Let's ask the question. You wanted to know whether the reinsurers would raise rates.

Mr. Zinzow: Nobody has come up with a situation where they have raised rates.

Mr. Tiller: What we've established, I think, is that reinsurers have requested rate increases and negotiated them.

Mr. Klein: You don't hear about that.

Mr. Tiller: We don't know of any case in which it is done fairly frequently. What we've not established is any case where a reinsurer has prevailed in saying I want a rate increase. The ceding company says no, and they still get the rate increase.

Mr. Zinzow: My question is, could the reason they didn't unilaterally increase the rates be due to a feeling that they could not because of the language or perhaps a belief that there was no reason to because of the experience?

Mr. Klein: This is for reinsurers. Have you ever been on an account where you felt that you needed to raise rates, but you didn't do it because you felt you could not do it? Has that ever occurred?

From the Floor: Do you mean that we could not do it from a legal perspective?

Mr. Tiller: Yes.

Mr. Klein: Yes, let's say you could not do it from a legal perspective or a treaty perspective. How many felt they could not do it from a marketing perspective?

From the Floor: From an experience perspective.

Mr. Klein: We'll get to that. There are a couple of people who felt that there was a bad treaty, and would like to raise rates, but, from a marketing perspective, it is not worth it. I think it's the same question if you say that from an experience perspective. Would they want to raise it from an experience perspective? That is sort of the same question that I just asked. The same people will raise their hand.

Mr. Tiller: As Mel pointed out, relationships are important. A reinsurer might go to a ceding company and say, "I'm not doing too well in this block of business." The ceding company may not be doing well, and it might be able to change its rates, and the reinsurer may participate. Another thing that often happens is the ceding company will say, "I can't help you on that one, but I'll give you this other block of business, and maybe the terms will be little bit more favorable or something. We'll make it up to you." There has been a lot of that over the years, especially back in the 1960s, 1970s, and early 1980s. We're talking about mortality experience under normal circumstances, and mortality has, for the past 40 years, basically improved every year overall. There hasn't been a major experience issue in the industry as a whole. The issue of experience might apply to one particular block that was underwritten differently or something, but there's generally a way to float around it. In the life insurance industry, we have not faced the issues that have been faced in portions of the health insurance industry or in the property/casualty industry where you had these cycles and experience goes off the charts. We've been blessed with overall improving, underlying mortality, and that has been one reason that it hasn't come up.

Mr. Young: But John and I both were smart enough to live through the 1970s and 1980s, the last time there was, what some might consider, a crazy reinsurance pricing cycle. John and I wrote some agreements that lost our companies a lot of money.

Mr. Tiller: I beg your pardon.

Mr. Young: During that time period.

Mr. Tiller: My company never wrote off a single penny.

Mr. Young: We're now going through another such cycle. During that previous cycle, I was at General Reassurance and I went to a number of my major clients, hat in hand, and said, "I've made some mistakes. I'm losing money. Can you help me out?" That is not what we're talking about here. I didn't go to them and say, "I need a 30% rate increase, it is hereby imposed." That's not what I said. That's not what we're talking about today.

One of the questions asked earlier was, of the 70 people that represent reinsurers, have you discussed this with your clients? I would like to have somebody address that issue. If you feel you have the right to raise rates, and you think it is so clear that you don't need to discuss it with your clients, come up and explain to me why you haven't addressed it. Ninety percent of you feel that you can raise rates, and I'd like one reinsurer and tell me why you haven't had the discussion.

From the Floor: I work in a different environment. I work in Asia, and when we write our contracts we do have explicit wording in there that says, "if experience mortality warrants." In Asia, different clients have different practices with regard to their reinsurance treaties, and we've seen a lot of treaties that explicitly say that at the time that the experience warrants, there will be a discussion as to what level to go to. The reinsurer cannot say, "I'm going 30%." The reinsurer comes in and says, there's a problem; we have to look at things. We decide that we need a rate change together. Part of that might be because the client is also raising the direct rates for its market.

Mr. Young: Is anybody in the room curious at all why not one reinsurer is willing to address this matter?

Mr. Klein: As a reinsurer, even though I'm the moderator, I will say there are a lot of things that you don't discuss. When you hire someone at your company, you don't say, "Down the road, we might fire you, and we may not give you a severance package, and we may just pack you on your way right when you need us most." You might think that, but that's not something that's usually discussed. There are a lot of things that people don't discuss.

Mr. Young: What you're saying is what's being discussed in your companies is we're going to be dishonest with our clients. If you feel that way, why don't you take the opposing position and explain to me why?

Mr. Tiller: Mel, those 70 people were not all reinsurers. Some of them are starting to get offended by you saying that. Second, every time you go out and accept engagements, do you tell the client, "Here is the exact number of dollars per hour and the exact number of hours I'm going to work." Or do you say, "I will send you a bill?" Do you every time put down every possible implication that could affect that bill? That's what you're saying.

Mr. Young: I'll tell you exactly what I tell my clients, John. I tell them, "You're going to get a bill from me, and if you don't want to pay it, I'm not going to sue you. I might never do business with you again, but if I haven't performed to your satisfaction, and you don't pay my bill, I'm not going to sue you about it because I work real hard to make sure that my clients are satisfied with the work that I do for them."

Mr. Klein: Lee, you're still looking for a question to be answered.

Mr. Zinzow: The second question that I had was from a ceding company perspective. For those who are direct writers, why have you not sought protection against rate increases? It was suggested earlier that reinsurers would agree to provide this sort of guarantee if it were sought. I'm wondering if the reason it's not sought is because the ceding companies don't anticipate rate increases and would not attach enough value to that guarantee such that they would not seek that sort of thing out.

Mr. Klein: Let's ask it as a yes/no question. Jim Atkins got up and said he had a 30-year guarantee on his 30-year level term plan. Do the ones that have YRT plans and don't have guarantees feel that the reinsurer is not going to raise rates? For the slight chance that they do, it's not worth any extra cost? Is that the reason? I'm getting yes nods. That seems to be the answer.

Mr. Young: Maybe we should have changed our question then. Were you one of the 70?

From the Floor: Yes. I think they can change the rates.

Mr. Young: For deficiency reserve purposes, and not because of experience?

From the Floor: Right.

Mr. Young: How many of the other 70 feel that same way? Sue said that earlier. Do the other 70 that said the reinsurer can change rates feel that the reinsurer couldn't change it for experience? Can he only change it for deficiency reserves? There's only one other hand?

Mr. Klein: What does "for deficiency reserve purposes" mean to you? Do you mean that if a regulator came in and said, "You have to hold deficiency reserves, so now you could raise rates?" I don't understand what that means. I really don't understand this wording. That's why I said a marketing guy probably wrote it.

Mr. Young: An attorney.

Mr. Klein: Yes. I think it's a difficult question. Have any audience members changed their minds.

From the Floor: What would be the difference between a change for deficiency reserve purposes versus a deterioration in experience. If you had a deterioration in experience, wouldn't you have a deficiency reserve?

Mr. Tiller: Not under U.S. statutory accounting. In the U.S. you are governed by your gross premiums.

From the Floor: In theory, you could move the treaty to a separate company and analyze it on its own merits. It would then require more reserves because, in the aggregate, that company would not have sufficient reserves.

Mr. Tiller: If that were the only block of business in a company, you would have to set up additional reserves.

From the Floor: I'm speaking for me, not my company.

Mr. Tiller: Is anybody speaking for a company or are we all speaking for ourselves?

From the Floor: Does that mean that if there is a kind of pervasive deterioration in mortality experience that this deficiency wording would apply?

Mr. Tiller: It probably would not apply under normal interpretations of U.S. statutory accounting, but if you get to the point that under cash-flow testing you had to establish additional reserves, then you've got something. The deficiency reserves is the language here. That's not what you're setting up. You're setting up additional reserves because of the deficiency, but that is not what they're talking about here. Now you're talking about something that didn't exist in the 1950s and 1960s.

From the Floor: I think 30 years ago rates had lots of margins. If there were additional claims to be paid, there really was no argument because reinsurers were making so much money or there was a trading of business. There were handshakes and good relationships. What has happened in the last ten years is basically the profit margins have become much smaller. In fact, profits are in the low single digits now. Second, there are companies that I would say are outsourcing the mortality risk. They keep very little, if any at all, which means that now they price their product assuming that their insurance rates is their cost. Then they build up on the acquisition cost, and that's their rate. So these companies probably consider the mortality cost to be guaranteed. There are going to be new products coming up. I think of annuities with those guarantees when the market goes up. So, if there's one thing that I would consider very important it is to make the reinsurance contract much clearer than that sentence. Otherwise, there's going to be problems. With such low margins, some companies are not going to be able to afford to lose money unless the contract clearly states what the two parties have agreed to.

Mr. Tiller: I'll put that in perspective. In the 1970s, when I was with Transamerica, we had treaties dating back to the 1940s and 1950s. They were generating over $2 profit per thousand of in-force business per year. The CEO was an actuary that had priced a lot of those and dealt with them in the 1940s and 1950s. Every year we had a review of our various lines of business, and the question that the CEO asked me every year was, "John, are we still getting the dollar a thousand profit?" I remember the first time I had to say no. A few years later it went from a dollar per thousand per year to a dollar present value to less. So, you're right. Rate increases have not come up with regard to a lot of old business because the margins were so fat, but they're not there anymore.

From the Floor: I just want to make a final comment. I think this language is unclear, but, to me, it doesn't talk about deterioration in mortality experience as a reason to raise rates. If that's what the reinsurers intend, I would suggest that they change the wording in the treaty. I think over the last 25 years there have been cycles in the reinsurance YRT marketplace where the reinsurer's perspective on future mortality has differed from the ceding company's perspective.

Ceding companies have found that it is favorable to reinsure large amounts of their business in those situations. If the reinsurer is taking a different bet from day one, and he finds out his bet is wrong, and doesn't say, up front, "If our bet is wrong and the mortality doesn't turn out as we expect it will, we're going to increase rates." I think it is misleading to use this language to increase the rates.

Mr. William J. Briggs: I have a question for both speakers. If, during the next 10–15 years, professional reinsurers begin to unilaterally try to raise rates, will the ensuing litigation be more or less extensive than the market conduct litigation going on now?

Mr. Tiller: How about the advisers who are advising them to raise rates? Does your question include that?

Mr. Briggs: All kinds of litigation coming out of this.

Mr. Klein: Mel, do you think that it'll be less expensive or more expensive than the market conduct?

Mr. Young: No, I said before I don't think rates are going to change because I don't think reinsurers are planning to change rates. I haven't found a reinsurer that's willing to say they're going to do that. That's curious. So many people feel that they can raise them. No, I don't think that there will be any increase in rates because I don't think that the reinsurers are going to raise rates. I do think if this issue comes to court, the reinsurers are going to lose it.

Mr. Tiller: If it comes to court, I don't think they're necessarily going to lose, but I don't think there's going to be a wide scale rate increase either. I think it could happen in certain selected areas where the reinsurers believe they were misled, or, for some reason things are radically different. By and large, the reinsurer will stick to the rates that are out there. Having the right to do it doesn't mean that they will do it.

Mr. Klein: I learned that even though most of you thought that the reinsurer does have the right, under the wording, to raise rates, they may not do it. I think everybody agrees that the wording's not clear. Even if reinsurers have the right, what are the reasons for the right? Maybe we should change the wording and maybe we shouldn't, but it is something to think about.