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Session 7PD
Reinsurance Treaty Issues

Track: Reinsurance

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Summary: Over the past 20 years, reinsurance treaties have gone from gentlemen's agreements to detailed legal documents. This session covers current issues in reinsurance treaty wording, including:

- *Claims wording: follow the fortunes, binding authority, opting out, and punitive damages*
- *Insolvency wording of the direct company and of the reinsurer*
- *Are the reinsurer rates guaranteed?*
- *Does the treaty follow the NAIC model regulation?*

Mr. Denis W. Loring: We'll have three speakers, and I'll introduce them as they speak. We are going to be talking about reinsurance treaties. For those of you who are old enough to remember, a reinsurance treaty used to be what we called a gentleman's agreement. In fact, reinsurance used to be called the last handshake business. There was an old maxim that said, "If you don't trust the handshake, don't trust the contract."

Unfortunately, life has gotten more complex, the stakes have gotten a lot higher, and if you read the papers, you see such things as: "Unicover—many companies avoiding contracts;" "Spiral—many companies avoiding contracts." Contracts aren't quite the gentlemen's agreements that they used to be. There also used to be, and we hope still is, a principle in reinsurance called uberrime fides, which means utmost good faith. Again, if everything operated under utmost good faith, perhaps you wouldn't need to be so careful about dotting the i's and crossing the t's of a contract, the way you do now.

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We are going to discuss some reinsurance treaties, show you some ways in which we think that perhaps a treaty can be used to get back to the way reinsurance used to be, and perhaps some ways that you can advance that cause.

I have been very lucky to recruit a really extraordinary panel. Among the three panelists, we have the former head of the Guidelines Working Group of the Reinsurance Committee of the American Council of Life Insurance (ACLI), the current head of the Guidelines Working Group of the Reinsurance Committee of the ACLI, and an individual who is both a CPA and an attorney.

Our first speaker is Connie Walker. Connie is vice president, life marketing, for Swiss Re. She has 18 years of experience in life reinsurance. She is a member of the ACLI Reinsurance Committee and she is currently chair of the Guidelines Working Group.

Ms. Connie Walker: I think reinsurance treaties are a really crucial part of the reinsurance relationship. As Denis indicated, they've changed a lot over the years and are becoming a lot more high profile than they used to be.

The purpose of my talk is to give you an introduction to the ACLI sample life reinsurance treaty, which is a part of a new manual we are going to call "The Life Reinsurance Treaty Source Book." I'll give you some background as to how and why this project got started and why there is an interest in the development of guidelines for reinsurance treaty language. I'll also give you a description of some of the main features of the sample treaty, what phase we are at now, and what some of our next steps will be.

The treaty manual has been the main focus of the Guidelines Working Group, which is a subcommittee of the overall ACLI Reinsurance Committee. It has come out of the working group's overall mission, which is to help develop ideas that will bring greater efficiencies to the business of reinsurance.

To get started, the first project that was completed was a reinsurance quote checklist. That checklist is really not part of the treaty, although a lot of the information that would be gathered there would ultimately end up in a treaty. It is an inventory of the usual information that a reinsurer would want from a direct writer in order to complete a life reinsurance quote.

After we completed the checklist, we moved on to the much larger project, which was to complete the treaty manual, including complete sample articles. We put together a group of experts representing both direct and reinsurance companies. These were the companies that were involved in the drafting of the treaty language.

When we started out, what did we see in the current environment and in the recent past with respect to reinsurance treaties? If you have worked with reinsurance treaties in the past, you are probably aware that traditionally the reinsurer most often wrote them. Thirty, 40, or more years ago, as Denis indicated, the concept of a gentleman's agreement was alive and well. Products and reinsurance agreements were both simpler than they are today. Typically they were YRT agreements covering a broad range of plans with fewer reinsurers, and they changed less frequently.

If the reinsurer and the direct writer had a difference of opinion on the intent of the agreement, there weren't very many places that you could look for guidelines.

In today's environment, it is still probably most common for the treaties to be written by the reinsurers, but the balance of direct writers that are choosing to take care of this themselves is much higher than it used to be. This shift, I think, is very consistent with other changes that we've seen towards more quota-share reinsurance and almost exclusively self-administered business.

Products are more complicated than they were many years ago. Product cycles are shorter. Reinsurance agreements are therefore changing more frequently, and they are less generic and more specific to the products involved. As you all know, the workplace has changed a lot in many industries, not just ours. With mergers and players changing companies more frequently, it is a lot harder to rely on people's good memories. These are also factors that contribute to the need for treaties to be well written and to clearly state the intent of both parties.

Regulations have reinforced the importance of proper documentation with the introduction in the last ten years of things like the entire agreement clause, which Johanna will be talking a little bit about.

The industry has also recognized the need for more reference materials. I don't know if you saw the SOA discussion paper on reinsurance treaty provisions that was published in 1994. I think Johanna was on that committee, along with several others. It has some really good background. If you haven't already seen it, I would really encourage you to get a copy of it.

Our Guidelines Working Group took on the task of developing this treaty manual. If you haven't read any good treaties in the last several years, we're really hoping this will be one that will be really helpful. It will include a full sample treaty, as well as some reference material, like the 1994 SOA paper.

It is important that I tell you that this sample treaty that we've written is not intended to be a mandated standard; it is a guideline. While we hope that people will feel that it is an excellent base, and they will feel they can adopt some of the wording, it's really up to the parties involved to make sure that their treaties say exactly what they should say for their own situation.

The other thing I want to clarify is that we had to narrow our scope somewhat, so we chose traditional life only. We haven't written a treaty for disability or other lines of business, and it is appropriate for YRT or coinsurance agreements. We did add in a summary for joint life products, since they crop up pretty regularly in individual life agreements.

Our working group has been in place for the last couple of years. As Denis indicated, Johanna started the leadership of the group. I've been doing it for the last year-and-a-half or so. It has been fun and really interesting working with such experts, but as you can appreciate, trying to write treaty language and agree on not just the content, but also the semantics and punctuation, can be a really long and lengthy process, but it has been a good one.

For each article we drafted, we started with current industry examples as a base. From those examples, we would prepare one starting point for discussion, and then work through weekly or biweekly conference calls until we could come to agreement on what we hoped would be a final version of that article.

I was really hoping that I could bring some pieces of that draft for you, but we decided it has to go through the exposure draft process first. That is something that will happen this summer. Just to give you a general idea of the format, we have written article-by-article sample wording. We've included drafting notes whenever we felt that additional explanation would help the people using the manual.

For a lot of articles, there might also be optional wording or optional explanations just to cover some common alternatives that might crop up. As an example, we have written a sample reserves article with some explanatory notes. It has some optional wording that might apply to some other agreements and situations (for instance, if a letter of credit applies).

We've also tried to consider what's new in the environment for reinsurance treaties, as well as what's tried and true and already well established in practice. As much as possible, we try to make the treaty complete in addressing new areas, or areas that have undergone a lot of changes in recent years. For example, we decided that we would add a mediation clause, in addition to the standard arbitration clause.

There were members of the group that took a really close look at the rate guarantee wording and features specifically related to quota-share agreements, like recapture. As I said before, this sample treaty will ultimately be part of an overall manual that will be published through the ACLI. It will contain this sample treaty, as well as the reinsurance quote checklist. It will include a glossary of terms. The 1994 SOA discussion paper will also be included, as will some of the relevant regulatory information for life reinsurance.

Where are we now in this process? We have finished drafting all articles just this week. We finally had our last conference call to decide on what the actual draft wording should be. Now, our group is going to go through the entire document again, and make sure it includes everything that we think is needed. We'll double check it and make sure it's in good shape for an exposure draft.

Then, we hope it will be released as an exposure draft in the summer of 2000 to, what we hope will be**,** a good cross-section of professionals, including actuaries, legal, and other technical representatives at various companies. It will be circulated through the ACLI Reinsurance Committee and/or members of the team that wrote the 1994 SOA paper, and other companies that haven't yet been involved in the drafting process. Once we've received all comments and made any necessary changes, we want to have the final manual ready for everyone by the end of 2000.

As it goes through the exposure draft process, we would like to see some good critique to make it a final document, so please review it and give us your comments.

Mr. Loring: We are unusually privileged to have for our next speaker. Johanna Becker's official title is second vice president and actuary with New England Financial. All she really does is head all individual life reinsurance for New England and the Met. She was the original chair of the Guidelines Working Group. Her other activities in reinsurance would take much too long to mention.

Ms. Johanna B. Becker: I took a look at the list of those who are preregistered for this session, and it was evident to me that almost anyone in this audience could probably give my presentation. I think we have a lot of very knowledgeable people here.

My goal is to cover two items on the program. One is the NAIC Model Regulation on Life and Health Reinsurance Agreements, and the second is to talk about YRT rate guarantees, or maybe more properly, the lack of guarantees in YRT treaties, and what some people think about that. Because of the knowledge level of the people in the audience for the most part, what I will be doing, is just more of a refresher on the NAIC Model Regulation on Life and Health Agreements and the provisions that apply to reinsurance treaties.
For those of you who are new to reinsurance, or are not familiar with the model regulation, there should be enough basic information so that, hopefully, you will run out and get your own copy and curl up with it some evening.

The model regulation is aimed at ceding companies and their ability to obtain credit for a reinsurance agreement in their statutory statement. The model regulations state that it is "improper for a licensed insurer, in the capacity of the ceding insurer, to enter into reinsurance agreements for the principal purpose of producing significant surplus aid for the ceding insurer, typically, on a temporary basis, while not transferring all of the significant risks inherent in the business being reinsured."

I heard Denis speak on the model regulation. He stressed the fact that, if you come away with only one thing from this session, come away with the fact that you have to transfer all of the significant risks. I would echo that, so that from a treaty standpoint, you have to make sure that your treaties have covered all of the significant risks in the product.

This regulation covers life and health insurers, and property and casualty (P&C) insurers with respect to their A&H business. It is aimed at domestic insurers and those other insurers who do not have a similar regulation in their domiciliary state. It applies to coinsurance and modified coinsurance, and it excludes YRT reinsurance, assumption reinsurance, and certain nonproportional reinsurance, such as stop-loss or catastrophe.

I would like to spend one moment on YRT reinsurance. Even though the model regulation specifically excludes YRT, you are not really off **s**cot-free, because Chapter 24 of the *NAIC Accounting Practices and Procedures Manual* refers to many of the provisions in the model regulation as guidance for YRT reinsurance. You are going to find that on that side, that is what is being used to determine legitimate YRT agreements.

The model regulation has a number of accounting requirements, and these are related to getting credit for the reinsurance agreement. If certain conditions exist, credit will not be allowed. The accounting requirements state that you cannot get credit, reduce any liability, or establish any asset in a statutory statement for the insurer:

- First, if renewal expense allowances in any accounting period do not cover anticipated allocable renewal expenses on the portion of the business being reinsured.

- Second, if the ceding insurer can be deprived of surplus or assets at the reinsurer's option or automatically upon the occurrence of some event. This excludes termination by the reinsurer for nonpayment of premiums.

- Third, if the ceding insurer is required to reimburse the reinsurer for negative experience. The only time that is okay is upon voluntary termination by the ceding company. Voluntary termination doesn't include unreasonable provisions which allow the reinsurer to reduce its risk under the agreement. I'll talk about that a little bit more later.

- Fourth, if the ceding insurer must, at specific points in time, terminate or automatically recapture all or part of the reinsurance. I had this come up in conversation with a reinsurer. We had asked to include wording in an agreement that allowed us to recapture if there was a reduction in the reinsurer's rating. The comment that I got back was that it seemed like it would be only fair that the reinsurer could recapture if our rating was reduced. My answer to that was that I thought that we would not be able to get credit under the NAIC model regulation, because that would be a unilateral right of recapture by the reinsurer, triggered by an event. That would be something that we could not put into the treaty.

- Fifth, if the reinsurance agreement involves possible payment by the ceding company of amounts other than from realized income from the reinsured policy, such as fees being greater than premiums

- Sixth, the treaty does not transfer all of the significant risk inherent in the business being reinsured.

- Seventh, if the C-1 or C-3 risk is significant and the ceding insurer does not transfer the underlying assets or legally segregate such assets. There's much more detail in the model regulation to deal with from the treaty standpoint.

- Eighth, if settlements are made less frequently than quarterly, or payments are not made in cash within 90 days of the settlement date.

The next two concerns have to do with representations and warranties. The first is, if there are any representations or warranties in the treaty that are not related reasonably to the business being reinsured. The second is about the future performance of the business being reinsured.

The second is if the reinsurance agreement is entered into for the principal purpose of producing significant surplus aid, while not transferring all of the significant risk inherent in the business reinsured, with the effect that essentially the insurer's risk remains unchanged.

There are other things that apply to reinsurance treaties, as well. One is that, if a ceding company fails to meet all of the requirements for credit, it can still get credit if it gets prior approval of the insurance commissioner. Another is, if you reinsure a block of in–force business, the ceding company is required to file the treaty and any subsequent amendments. This is not really treaty-related, but the model does include procedures for accounting for any increase in surplus, if you have a block of in-force reinsured business.

With respect to execution of the agreement, you cannot get credit unless the agreement or the amendment is signed by the "as of" date of the financial statement, or there is a binding letter of intent in place. If a ceding company uses a letter of intent, then the agreement must be executed within 90 days of the letter of intent.

There must be an entire agreement provision in the agreement that states there are no understandings outside of this agreement, and that changes are null and void unless made by amendment. I appreciate the spirit of this, but I do have some concerns about the practicalities of how detailed you really have to be.

I've heard various people remark differently on this. Some say if it is important, you really should have it in your treaty, or in an amendment. Others say there are too many administrative things, and other little things that go on, that you just can't burden a treaty with. Again, it is something to think about as you are making various agreements on specific cases or procedures. Is it something that really should be recorded for posterity as an amendment?

Existing agreements don't get off the hook, either. If you have older reinsurance agreements, the model does cover them, so it would behoove you to go back and take a look at your old agreements.

I would like to get into YRT rate guarantees. Why is this on today's program? I have found, in the last couple of years, this is something that is being discussed quite a bit. As Denis has already stated, reinsurance isn't what it used to be; it is not the gentleman's agreement.

The arrangements are changing. Ceding companies change reinsurers more frequently so that the demise of long-term relationships has certainly affected ceding companies' and reinsurers' attitudes about the fact that YRT rates can be increased. The competitiveness of today's marketplace certainly affects that. That is what is causing ceding companies, to change reinsurers and to change or renegotiate their pools so frequently. One of our pricing actuaries said: "We ought to be going out every year." There is an attitude that we should constantly be trying to improve what we are doing.

There is dependence on first-dollar reinsurance in pricing now that direct rates have been tied to the reinsurance premiums. If that reinsurance rate isn't guaranteed, then that is cause for uncertainty about what might happen in the future.

Denis mentioned the mergers and acquisitions in the industry. From a ceding company perspective, we see the changes in management, and wonder how they will affect relationships and understandings that we have all had. How safe are we from increases in YRT rates?

Direct pricing actuaries are taking notice. That doesn't mean that direct pricing actuaries weren't taking notice prior to this. But my own company, a few years ago, all we were doing was excess retention and some facultative reinsurance for things like substandard shopping. Back then, pricing actuaries never thought about reinsurance.

And then it was a real wake-up call for some of them, when we started doing first-dollar quota share. They are saying, "You mean YRT rates aren't guaranteed?" One pricing actuary, every time we go out for a new quote, says, "Are you doing something to assure that rates won't be raised on us?" They really do have it on their minds because they realize that it is affecting pricing.

I'm not here to provide you with all the answers to this issue. My goal was to get you thinking about it, and thinking about what's going on in some of the discussion**s** Think about what the options are**.**

I had to chuckle at what Denis was saying, because I had said that my guiding principle is partnership and that really is an old-fashioned idea in today's marketplace. That really has fallen by the wayside in many cases. Many of us, as we grew up in the reinsurance world, cut our teeth on the gentleman's agreement concept. Newer actuaries who become involved in reinsurance don't have that background.

While I think new reinsurers and ceding companies are committed to fairness and partnership, to a certain extent, as Denis said, the stakes have changed. People are looking at things differently, and that's just a reality.

Historically, rates have not been guaranteed because the reinsurer would have to set up deficiency reserves since the reinsurance rates typically are less than the valuation rates. The exact wording in treaties determines statutory accounting and valuation treatment. Some treaties might give a guaranteed maximum, and other treaties might be silent.

With respect to increasing rates, there is the attitude that the reinsurer took the risk, so why should the ceding company have to pay? As we've seen with the model regulation, the whole emphasis is that the ceding company has to transfer all the significant risk. There is this whole emphasis on risk transfer to the reinsurer, and trying to understand if or when there are any legitimate circumstances that a rate increase for YRT might be appropriate.

What I'd like to do is just go over some scenarios; it is not meant to be all encompassing, but just some things to get you thinking a bit further about this issue. The first one is that the ceding company raises direct premium rates. Should the reinsurer be able to do the same? My answer would be "Yes, if it were related to the risk transferred." If mortality experience had deteriorated to the point that the ceding company is raising rates, then certainly it seems that, in fairness, in a YRT agreement that should be passed along to the reinsurer. If there is some other reason that they raised rates, it doesn't necessarily mean that there should be a passthrough.

There is a thornier situation. The ceding company should or could raise rates but doesn't, because so much of its business is reinsured. Then what? That gets back to "Well, we transferred the risk to the reinsurer, so it has the risk. We reinsured 90% of it, so we shouldn't have to do anything."

I would get back to what's really the fair thing to do here. I would say there are other considerations. A reinsurer shouldn't just look at the experience; it must consider what is the overall effect on the ceding company. If the reinsurer raises rates, to an extent that basically forces the ceding company to raise its rates it could have serious repercussions on its policyholders, persistency, field force, and image in the marketplace, depending on how much business is involved, and what the business is. There are other issues. Whether to raise rates and how high to raise them is not a simple decision.

The third scenario is that the ceding company's experience is good, but the reinsurer's experience isn't. I don't think this is going to happen too often on your YRT first-dollar quota share agreements. It is more likely to happen on excess retention or facultative agreements that are covering things like substandard shopping.

Another question is, should it make any difference if it is automatic or facultative reinsurance? Again, you could say with facultative reinsurance, the reinsurers underwrote all the risk, so it wasn't something that they didn't go into without having their eyes open.

There has been a lot of discussion on treaty limitation wording. One of the key things to remember is that the wording cannot be so onerous that the reinsurer must establish deficiency reserves. The ceding company wants protection, but it doesn't want to put the reinsurer or the agreement over the edge because you are requiring deficiency reserves.

One option is to have wording that says that the reinsurer will not raise the rates in this agreement, unless it raises the YRT rates for all of its clients. A variation on that theme would be to raise rates for a certain class of business. Another would be to raise rates only if direct rates are not guaranteed on the underlying business, so that again, if the reinsurer raises rates, the ceding company could pass that through. Yet another variation would be to tie the increase to an outside indexed mortality.

Somewhat related to this is recapture. Also creeping into agreements is a provision giving the ceding company the right to recapture if rates are increased. This isn't perfect because the ceding company would do that only if it felt that experience was better than the reinsurer did, so it would be better off without the rate increase.

The second two options that allow the reinsurer to raise rates on all YRT business or YRT business of a certain class offer pretty good security to a ceding company. It is not a full guarantee, but it's essentially suicide for a reinsurer to do that. A reinsurer is not going to do it unless it is in financial straits and needs to.

There is one cautionary note that I would make. That is, what if a reinsurer wants to get out of a particular marketplace? For example, if it's reinsuring disability income and says, "Hey, I don't want to be in this marketplace anymore. I'm going to raise the rates on all my clients to get them to recapture their treaties."

There is one thing I would mention here; it sort of ties back to the model regulation. The model regulation does give an example that the right to raise charges to excessive levels and force the ceding companies to prematurely terminate the agreement might be somewhat of a safeguard for those extreme situations, such as the disability income example that I was speaking of.

What's next? I think that ceding companies think about protection and comfort level. The world is changing for reinsurers. They need to establish a policy with respect to the various requests that they will receive from ceding companies. Ask for treaty wording. Know what your position is.

Mr. Loring: I would not want to say that we have necessarily saved our best speaker for last, but he is certainly our most unusual. Monte Lightner is second vice president and director of agreements and taxation for Lincoln Re. When I say he is our most unusual, Monte is both an attorney and a CPA, and he is an attorney who views his job as helping us create and complete agreements as opposed to standing in their way.

Mr. Monte J. Lightner: I'm going to talk about two specific articles or clauses within a reinsurance treaty that you should be aware of as you are working on or reviewing agreements.

We are first going to talk about insolvency clauses for both the ceding company and the reinsurer, with either of them becoming insolvent. Then, we will also spend a little time talking about punitive damage clauses.

We will go into the insolvency clause and talk about the insolvency of a ceding company. Most states require that this clause be included. They also, as part of this clause, have three requirements.

First, they require that the reinsurer must be on the hook for the entire risk. The amount can't be diminished just because the ceding company has become insolvent and won't be able to pay the full claim. This requirement stems from a court case where the reinsurer argued that since the ceding company wasn't obligated, or couldn't pay the full risk to the policyholder, then the reinsurer shouldn't have to pay either. That prompted this requirement by the states.

Second, the language in the treaty has to require that the payment can go to the liquidator. It doesn't have to go to the ceding company directly. Most states don't want payment going directly to the insured or to a guaranty fund, but they do want the liquidator to be eligible to receive the funds.

Finally, a liquidator has to give the reinsurer notice of any claims that are pending. The reinsurer has the right to investigate. California requires direct payment on demand, so there is a little controversy there on how the reinsurer would have the right to investigate. There is a timing issue there. These three clauses are required in a reinsurance treaty.

States want to be assured that the policyholders won't suffer if the direct company becomes insolvent. Generally, there is no limit on offset, even though the ceding company is in insolvency. The reinsurer should be allowed to offset payments due and just pay out the net payment.

Let's discuss cut-through provisions, where payment is made to a third party. Many states don't allow this. Some states will allow it, especially payments to a mortgagee, but you have to give consideration there. We're always a little bit leery about doing that. If the provision isn't drafted correctly, or if it is interpreted incorrectly, the reinsurer could possibly be on the hook twice. After making the payment to the third party, the ceding company with which the reinsurer has the contractual obligation might make a claim as well. That is not likely to happen, but it is a possibility.

Now, let's talk about insolvency of the reinsurer. What does insolvency really mean? I guess it could be interpreted differently. It could be if the state takes control. If a reinsurer has gone into receivership or actual bankruptcy or liquidation, maybe that's when this clause might come into play.. The language needs to be clear here. You need to make sure that both parties know exactly what is going to trigger this clause.

What happens if the reinsurer does meet this definition of insolvency? Should it be complete termination of the agreement? That should be the ceding company's option. You don't want to give the ceding company the opportunity to terminate parts of the business and not all of the business because they might decide to just bring the good stuff back, and leave the bad business with the reinsurer. You shouldn't allow that to happen. That would result in the reinsurer ending up in a worse position than it was in to begin with.

There should be a termination charge, even though the agreement is terminated because of the insolvency of the reinsurer. The reinsurer should be eligible for a termination charge, just as if the ceding company had terminated for some other reason, because the reinsurer has taken the risk. There should be some reimbursement or some compensation for that.

There is something else I wanted to talk about. These are not necessarily insolvency provisions, but other reasons a ceding company might want to terminate; things that need to be considered. There are other termination triggers. One would be a change in risk-based capital (RBC) level. There could be a provision in the agreement that if the RBC level drops to a certain point, the ceding company has the option to terminate. Obviously, the reinsurer doesn't necessarily want any of these provisions in the agreement, but they have been included. I've seen them in agreements, and a lot of ceding companies are asking for these provisions.

Another trigger would be a deterioration in ratings. If the ratings of the reinsurer or its parent company drop below a certain level, that might give the ceding company the opportunity to terminate the agreement.

Another trigger would be change of control. Some agreements might say that if the control of the reinsuring company changes or a certain percentage changes hands, then the ceding company would have the right to terminate.

In any of these termination triggers, one thing that the reinsurer should request as part of the agreement is that not only does the trigger have to be tripped, but the reinsurer also has to demonstrate that there's failure to meet the obligations. There has to be some distress shown. The ceding company obviously won't like that. The ceding company doesn't want to wait that long to show actual distress. But there are times when some of these triggers can be tripped for other reasons; it could be for reasons that don't actually impact the financial stability of the reinsurer. We try to avoid these when we can and include a provision where there has to be failure to meet obligations.

Rather than looking to termination, if a ceding company insists on having some of these triggers, we look to see what else can we do instead of allowing the ceding company to terminate? One would be to provide for a clean-up period. If the trigger is tripped, the reinsurer has a period of time to clean up whatever happened. For example if the ratings dropped**,** there should be a period of time to get the ratings back up, or, if the RBC level is too low, to get that level up.

One way to mollify the ceding company would be possibly a reduction or an elimination of any termination charge, if the triggers are still tripped after the clean-up period**.** That might be acceptable to the ceding company.

There is another weird thing that I've seen, although it's not going to happen too often, and the ceding companies might not accept anyway. This would be a comfort letter from the regulators saying that they realize that certain financial formulas haven't been met, but they are comfortable in investigating the company. They are comfortable that the reinsurer is strong enough to pay claims. As I said, that is highly unlikely, but that is one alternative. Something that I think has some possibilities is a letter of credit. If the trigger is tripped, the reinsurer agrees to fund a letter of credit for a portion of the amount of risk or the full amount of risk. This would be done just to give the ceding company comfort that the claims will be paid, and that it is not going to be on the hook.

Let's talk a little bit about punitive damages clauses. Punitive damages clauses are part of extracontractual obligations clauses. Extracontractual obligations clauses are common worldwide, but punitive damages aren't. Punitive damages are more common in the U.S. Therefore, in the extra contractual obligations clauses, you are likely to see punitive damages clauses in an agreement with a U.S. company, rather than a European company. However, punitive damages are becoming more prevalent outside the U.S., as well.

Obviously, ceding companies want this. They want to be able to be reimbursed for punitive damages that they incur, especially if they feel that the reinsurer was directly or indirectly responsible for a portion of the punitive damages. Punitive damages are less common in life treaties, but you do see them, usually in market conduct issues or claims handling issues.

One question you might ask is, if there is a punitive damages clause in the agreement, what's the extent of the coverage? Will the reinsurer reinsure all punitive damages that are assessed on the ceding company with regard to the block that is being reinsured? What's more likely is the reinsurer might agree to a clause in which it will share or pay for punitive damages that are imposed as a result of the reinsurer's direct action. That is, it might be an area in which it actually had some part in whatever took place that caused the punitive damages to be imposed.

Another question is, what is the equitable share? What piece of this punitive damage should the reinsurer be responsible for paying? Is it a quota share? If the reinsurer is quota sharing 30% of the business, should it pay 30% of the punitive damages?
Or, is it the level of participation? If the reinsurer was not involved in whatever happened to cause these punitives, then maybe the reinsurer shouldn't be responsible for any of the punitive damages. If the reinsurer really pushed to have a claim not paid, or something like that, you could say the reinsurer is 100%

responsible for that, or participated in 100% of it. ? Then the reinsurer should be responsible for the full punitive damage.

One of the problems with punitive damages clauses is it is very hard to price that into the reinsurance premium. What do you look at? What's the likelihood that there are going to be punitive damages? You hope that there are none. Nobody really anticipates that there are going to be punitive damages, but if there's a clause in there, it should be at least considered when you are pricing the product. Do you look at the ceding company's history with punitives? You look at your own company's history with participating in activities that have resulted in punitive damages. This is a very difficult thing to do.

Several states don't allow punitive damages clauses within reinsurance treaties. It is a public-policy issue. They say that punitive damages have been imposed because the direct company has done something wrong, and they want them to be punished. If someone else is going to reimburse them or directly pay those punitive damages, then there is really no punishment there. Many states have difficulties with these agreements.

There is a question of enforceability of the coverage, even if it is included. There is an old Hartford fire case in which the home state didn't allow punitive damages. This was a reinsurance treaty with a Lloyd's of London syndicate. Lloyd's, the reinsurer, took the position that since the home state didn't allow punitives, it shouldn't have to pay, even though it was in the agreement.

In that case, the court ruled in favor of the ceding company and required reimbursement of the punitive damages. That dealt with international treaty issues, as well. That's not saying that this is going to actually happen on a domestic treaty.

The issue on punitive damages is, has the reinsurer participated in the activity that has caused the punitive damages? One way to avoid that would be with a commonly used bailout feature, in which the reinsurer can say, "I am not going to participate in contesting this particular claim. I'll pay my share and get out of it." That would keep the reinsurer out of any extracontractual obligation payments for that particular claim. One problem with that is, if you don't bail out, you are implicitly agreeing with whatever action is taken. Is that enough to say that that's 100% participation? I don't know. That's an issue. Having the bailout feature is great; you want to include that. But if you don't act on it, then are you agreeing with what is going to happen? Another concern is if you have a major piece of this block, are you actually pushing the direct writer to take whatever position it is taking?

There is a privity of contract issue with these also. If you sign off on a claims decision, you might say that the only punitive damages that you’ll participate in are those that you've taken direct action in. Direct action, in our case, would mean that we actually sign off on whatever decision is made. We're real uncomfortable with that because if you sign off on something, and you've taken a position that the direct company is going to follow, there is a possibility that you are going to lose the privity of contract defense, if the policyholder tries to sue you directly. Normally, you can say, "I don't have a contractual relationship with you the policyholder. The ceding company is in the middle." If you are taking these direct actions, there is a risk that the policyholder could successfully argue that because you are taking that direct action, and because the ceding company is following whatever you say to do, there is a direct contractual relationship there, and you could be liable for a suit directly from the policyholder.

Finally, on the issue of punitives, something that I hadn't really considered until we looked at this issue more closely is the type of coverage. Punitive damage is not a life risk. It is more akin to a P&C risk. Does your company's charter allow you to reinsure P&C risks? It could be argued that paying punitives is a form of directly insuring the ceding company on some P&C risk. Is it within your company's charter?

If not, then that opens up a whole other avenue of problems that you could get into. If the ceding company requires a punitive damage clause, some companies will try to bifurcate the risks and insure all the extra-contractual obligations through a P&C company, while doing only the life risk through the life company.

Mr. Loring: I'd like to leave you with a final thought, before we go to the questions and answers. An unscrupulous negotiator, even an unscrupulous actuary if there are any, can find a loophole in any contract, no matter how well drafted or well negotiated. Or, an unscrupulous negotiator can simply choose to ignore a contract, and say, "Yes, we have a treaty, but I simply refuse to perform. Go arbitrate or sue me."

In the end, reinsurance transactions are dependent, as are all transactions, on the good faith of the parties. The more that reinsurance practitioners adhere to the notions of uberrime fides, of utmost good faith, the better it will be for the business. Having said that, a well-drafted, well-thought-out, reinsurance treaty cannot help but make the agreement between the parties a better one. Remember the words of a very famous professional gambler: Trust your mother, but cut the cards.

Mr. James Tomer Ward: If you have a reinsurance agreement between a direct writer and a reinsurer, and a retrocession on a same block of business between the same companies back to the direct writer, for the purposes of complying with the model regulation, are those viewed as a single contract, or are those viewed as independent contracts?

Ms. Becker: I would think each would have to stand on its own. I would ask for other comments.

Mr. Loring: I think each treaty would have to be viewed separately, but then don't be surprised if a regulator looks at the combination of treaties to say, "Is something going on in this entire transaction, embodied by both treaties, that shouldn't be going on?"

In other words, are there two separate treaties moving business back and forth for a good business purpose, to accomplish a legitimate end? Or, is that particular construction designed to circumvent something in the regulation? I think those would be the questions asked.

Ms. Becker: I would echo what Denis is saying. We get back to the whole idea of risk transfer. If you haven't met the risk transfer requirements in the end, after the retrocession, then I think a regulator is going to take a very dim view of it.

Mr. Edward F. McKernan: I have a couple of comments and questions. First, Mr. Lightner, I appreciate that you thought of the punitive damages issue, as it related to your charter. Now, I have something to think about, too. I have a comment on the increases in rates and what type of provisions you might have. Basically, we have followed a redetermination policy type of provision that's somewhat related to the pricing. I think that kind of goes back to the good faith nature of the agreements.

I have a question related to that: Could that impact deficiency reserve considerations if you are basically following the specific experience of the business, but you do have that safe harbor provision? One reason why we do have that provision is because the ceding company has a lot of other margins it can look to in covering its total profitability, but as a reinsurer, we are living and dying by the mortality risk.

Ms. Becker: I'm not sure I want to answer that one or have an answer. Yeah, it's a good point. I think that there are a lot of issues that are just being thought out now, in relation to what is appropriate for increasing rates.

Mr. Loring: I think, at this point, the whole issue of premium guarantees and rate increases is a work in progress. I do not think there is any sort of industry consensus, and I don’t even think there is a subindustry consensus, in a sense of the ceding companies tend to think A, and all the reinsurers tend to think B. I think there's a lot more discussion yet to go on.

Mr. McKernan: I have another question on the requirement of filing agreements on in-force business. Is that applicable to YRT as well?

Ms. Becker: No, because the model regulation applies only to coinsurance (co) and modified coinsurance (modco).

Mr. McKernan: Okay, so that is specific to co and modco.

Ms. Becker: Right.

Mr. McKernan: Does "in force" mean, business placed in force prior to a letter of intent?

Ms. Becker: Yes, there is business that is in force prior to the effective date of the reinsurance agreement.

Mr. McKernan: If you're reinsuring business from January 1, 2000, you execute the agreement in June. That's considered in force?

Ms. Becker: No, it's not based on the execution date of the reinsurance agreement. It's based on the effective date. You could have an effective date of January 1, and execute a treaty two, three, or six months later. Hopefully, it is not six months for co-insurance or modco though.

Mr. Joseph F. Kolodney[*]: I am very interested in Johanna's presentation and also Monte's presentation. I've been doing this for about 34 years, and not being a technical person I tend to take a very basic view of some of these provisions. In talking about the deficiency reserve issue on YRT, I find that it is very clear that reinsurers have the right to raise YRT premiums. The question is, under what circumstances, in talking about Denis' comment about utmost good faith. I think that such an action cannot be arbitrary, it has to be justified, has to be done in a way that can be objectively viewed as a sound measure and not onerous or arbitrary on the part of the reinsurer just because it wants to get out of an agreement.

Denis alluded very briefly, in his concluding remarks, to the arbitration provision in the contract. I think that that is definitely a remedy because one of the provisions in the contract says that this is not a contract. This is a gentleman's agreement and should be interpreted in the context of the intent of the parties. I think that that is a very valuable provision and actually kind of a safeguard to prevent either party from acting in an arbitrary, capricious way. There are ways to cure this.

On punitive damages, Monte raised a good point. Is it within the charter of a life insurance carrier to be able to provide what essentially is casualty insurance coverage? I think it is certainly within the context of the relationship between ceding company and reinsurer to determine, in advance, the respective liabilities of each party in a given situation.

I negotiate aggressively on behalf of my clients, but there is a reality involved in how far anyone can go in asking for the moon. I think that that's something else. I think there is definite bifurcation between the ceding company's liability versus the reinsurer's liability. If the ceding company is going out and doing misconduct or misselling, and the reinsurer is unaware of it and happens to be on the risk for that business, I think it's really the ceding company's problem. As long as the reinsurer has not touched any part of the transaction.

If, on the other hand, a ceding company goes to a reinsurer and asks, "What do you think about this claim?" The reinsurer has two choices. It says, "We have no opinion. You do what you want," or it says, "We really think you should contest

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[*] Mr. Kolodney, not a member of the sponsoring organizations is Senior Vice President at Aon Re Worldwide in Stamford, CT.

this." If it is contested, and the ceding company loses, and there is a punitive damage levied, then I think the reinsurer has to participate.

There is a lot of common sense involved in all of these things, and if professionals are dealing with professionals, there should be a way to resolve these issues. I hope that we don't get so obsessed with reducing everything to language that we start vitiating some of the common sense practices inherent in a reinsurance transaction, that have been conducted pretty much successfully for the last 50 years.

Mr. Loring: In order to tempt you to spend a little time looking at this model treaty when it comes out, the model treaty does in fact include clauses on punitive and extracontractual damages that were worked on quite extensively by the Guidelines Working Group. It also includes not only a model arbitration clause, as Joe alluded to, but in an attempt to get back more toward the gentleman's agreement, it includes a model clause called mediation, which is a much more simplified, shorter procedure, designed to head off a full-blown arbitration. You might find all of those clauses of interest when you get your hands on a model treaty.

Mr. Melville J. Young: I have a question for Monte on the punitive damage issue, and a comment on the guarantee and on mediation. If the parties are both participating in the action that leads to the punitive damage award, and the reinsurer is merely saying that if it is some action on my part that causes this claim, and I'm going to pay my share of that because we are partners in this and we are both participating, and both are responsible, is that a reinsurance issue, or is it just two parties stepping up to their legal obligation? It would seem to me that participation to that extent, in the punitive damage award, is not a separate insurance cover. It's just two parties in a transaction, living up to their legal responsibilities.

Mr. Lightner: I think that is true, but the party that is actually being hit with the punitives is the ceding company, so there has to be some contractual relationship between the ceding company and the reinsurer, related to those punitive damages, in order for the reinsurer to be affected at all. The concern is, what is that contractual relationship? It could be just a gentleman's agreement, I agree, but it could be interpreted as insurance.

Despite what has happened as far as the agreements, and whether the claim will be paid or not, the fear is that the regulators could say that you are insuring the ceding company against any punitive damages. I'm not saying that that's what's going to happen, but that's the fear, and we just want to protect ourselves from that.

Mr. Young: On the mediation I would just say, like Denis, I participated in lots of arbitrations and a few mediations. For those of you who have a choice, I support the mediation effort, because you don't realize, sometimes, the extent, of arbitrations especially if you get lawyers involved. It seems like more arbitrations nowadays have lawyers participating. The legal costs in the arbitrations I've participated in recently are so immense that nobody wins.

Mr. Lightner: The lawyers do.

Mr. Young: Yes. If you can end up with a mediation proceeding with a party that you have faith in, I think you can get a much better answer, at a much lower cost. It is a much lower cost from a relationship standpoint as well.

On the guarantee issue, some of you may have been in Hawaii last year and seen the debate that we had on this issue. John Tiller and I participated and, though I have strong feelings about this, my feelings about this may or may not be **those** of my current employer. I think that they are.

As Denis said, it's an issue that certainly there isn't unanimity on as far as reinsurers or ceding companies are concerned. I think ceding companies tend to be more unanimous than reinsurers. Because of my involvement in that particular arbitration, and in that debate that followed it, I did have a chance to talk to lots of reinsurers. I think that it's an issue that there's more agreement on by reinsurers than perhaps some of you have been led to believe.

The whole issue started perhaps 25 years ago. There was a chief actuary at the New York Insurance Department by the name of Bob Callahan. Twenty-five years ago, Mr. Callahan came up with the idea to look at reinsurance YRT rates. He said, "These things are deficient; we need to do something about that." As a result, we have the language, perhaps not well thought out, that we're currently living with—in YRT reinsurance treaties.

I have participated in many presentations in marketing reinsurance, involving lots of different reinsurers. During my long reinsurance career, I have heard most often in those presentations, reinsurance marketers guaranteeing verbally, by saying, "Oh don't worry, we will never raise these rates."

It is my position that for a company to change rates, even if its particular people haven't made that promise, it has to make a formal announcement. This is established industry practice.

As a result of an arbitration that I participated in a few years ago, perhaps 20-30 witnesses with long reinsurance corporate memories, including people on both sides of this issue, were asked by a retired judge, "Are you aware of a single instance where reinsurance rates were unilaterally raised by a reinsurer?" No one in the room could come up with a single instance where that ever happened.

I believe for us to change that practice as an industry, a company would have to make a prospective announcement for new business. I believe there is too much water under the bridge for reinsurers now to suddenly say, "These rates are not guaranteed." I understand the reserving issues, and we could debate that as John and I tried to do last year. I just think that for a reinsurance company to change that, they really have to make a formal announcement from this point forward, you can't count on our rates being guaranteed.

Mr. Kolodney: I believe that there is a technical right of the reinsurer to raise YRT rates, but Mel is absolutely correct. The representations that have been made over the years and the language of the older treaties have, in effect, said, "because of technical reasons related to deficiency reserves, we can't guarantee these rates."

If I were a ceding company and a reinsurer attempted to raise the YRT rates on my treaty, and could not demonstrate sufficient cause, then I would have a very good argument to take that reinsurer to arbitration.
You can have a technical right to raise rates, but the issue then becomes do you have a commercial right to do so, in the context of your relationship with the ceding company? I think that has to be demonstrated by the reinsurer, unequivocally.

Monte, I understand what you are saying about punitive damages, but I would take the view that says that a reinsurer is not providing casualty insurance coverage for punitive damages, if in fact it is a party to the action that created the damage. Then, it is really just saying to the ceding company, "We're acknowledging our joint liability with you because we shared in that decision that created the punitive damage."

Mr. Lightner: I agree. I still think there's the issue that the punitives aren't imposed upon you as the reinsurer; they're imposed upon the ceding company.

Mr. Kolodney: Absolutely. There is nothing to preclude you as the reinsurer from saying, "Even though they're imposed upon you, since we made this decision jointly, we're prepared to kick in for our proportional share, or whatever."

Mr. Gordon A. Gibbins: I would like to make a few comments regarding Canada. For a long time, there have been Canadian reinsurance conference guidelines that deal with the issues that Connie was talking about, although, not necessarily all the NAIC guidelines. It would be interesting to contrast them when you get them out. I congratulate your committee on the work it is doing.

Second, another interesting Canadian perspective, is the fact that capital requirements in Canada depend on rate guarantees in treaties and will affect any company that is consolidating its results back to a Canadian basis. If you are right, Mel, then I can't be sure that companies are actually holding their capital correctly in Canada.

Finally, I have a couple of observations. One is from my last year in the A&H business. Along with the responsibility that a reinsurer has in guaranteeing rates and treating things as gentlemen's agreements, and in the spirit of common sense, it comes on both sides. With 90/10 agreements and with the underwriting being done at the automatic levels that we have today by ceding companies and the claims paying practices, we didn't talk about the claims clauses, but I suspect the authority largely rests with the ceding companies. The mortality result is still going to flow from the ceding company's actions.

In the A&H business, there has been a lack of people who having a real investment in the results, taking actions that are inconsistent with what the reinsurers certainly would have liked to see. On the common sense side, I would hope to see clauses interpreted to the extent of following the fortunes.

I have seen requests in the last two months for reinsurers to participate in punitive damages without any right to review the claim. Right now, I have a request to pay twice on a case where the wrong beneficiary was paid without our having had any involvement.