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Session 49 OF
Pool Reinsurance

Track: Reinsurance

Moderator: Jeffrey A. Leitz

Panelists: Jonathan Beerman[†]
Kieron Farrelly[††]

Summary: Pooling of risk is Actuarial Science 101. Insurance and reinsurance companies have sought to pool their risks with others as a means of sharing risk as well as reducing volatility. Unfortunately, participating in a pool oftentimes results in surprises and exposure to liabilities never anticipated. This session discusses why many of these surprises have occurred, reviews some actual case studies and discusses what companies and reinsurers are doing to reduce and/or eliminate any mistakes of this nature going forward.

MR. JEFFREY A. LEITZ: I'm a Towers Perrin financial services consultant in Hartford, Conn., and I'll be your moderator. Today we have two speakers who have prepared remarks on the origins of pool reinsurance in the United States, what has gone right over the years, what has not, and how we can avoid those pitfalls in the future.

Now I'd like to introduce our first speaker. His name is Kieron Farrelly. Mr. Farrelly has over 23 years of experience in the accident and health (A&H) reinsurance industry. This past April, Mr. Farrelly joined ZON Re USA as executive vice president for excess loss treaty reinsurance programs. Previously he held the position of senior vice president of AON Re's Global Life Accident and Health Insurance Division headquartered in New York City. Kieron is also a former senior vice president and

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field manager of the Duncanson & Holt (D&H) Group, where he served for over 15 years.

MR. KIERON FARRELLY: I did spend 15 years with D&H. D&H was in fact the pool manager. I do have some unique insight and experience in the pool management area. I got involved in it in the early stages. It moved along and then in some ways advanced and in other ways declined. I do have a fairly good insight to it, and I'm hoping to pass that along to you today.

I'd like to give you a little history of what pool reinsurance is about and how it got started. Up until probably about 1970, the late 1960s perhaps, virtually all A&H reinsurance was done in Lloyd's in the London market. There was really no U.S. A&H facility that provided reinsurance. That was fine and dandy for a lot of years. But as we got into the 1970s, a couple of things were changing. The first thing was that benefits, limits and things along those lines were increasing significantly.

The other change had to do with London. This was in the days before e-mail; there weren't even faxes at this time. In dealing with London, it was cumbersome. It was long. You could send information over there, but you did it by telex. It was a cumbersome process. You might not get quotes back for a couple of days or a couple of weeks. There started to be thoughts that there was an opportunity out there for a U.S. A&H reinsurance facility; there was a great opportunity there to get into this business, to work with Lloyd's and not against them necessarily. There was a need for more capacity. Benefits and limits were going up. People were buying more reinsurance. Insurance companies, particularly life companies, had the need for more capacity. So there was a nice fit there. A few people saw the opportunity and went for it.

My experience, as I said, was with D&H. A lot of what I will discuss today is in relationship to my experiences there. At D&H, there were two men, Todd Duncanson and Bill Holt. They spent probably two years going around the United States and talking to the large, financially stable insurance companies. They presented the concept to them of what the opportunity was and the fact that they could make some money. They knocked on doors and went through this whole process. Ultimately, they formed what was called the American Accident Reinsurance Group. It was a facility that was made up of about 25 to 30 life companies primarily, who all shared in the risk. That was really the genesis of it. While Todd Duncanson and Bill Holt were doing it, there were other people out there that had the same idea and were doing the exact same thing.

What they were applying was a very similar approach to Lloyd's. Lloyd's of London operates on a spread of risk. Individual names at that time gave money to syndicates or managing underwriters. They went out and wrote on their behalf, so they shared in the profits and losses. They took the exact same idea and instead of using the individual names, they did it with insurance companies. The funny thing is when you look at Lloyd's today, that's sort of what Lloyd's is now. The individual

names have gone away, and insurance companies now are providing the capital and taking on the risk that Lloyd's does. In a strange way, what happened in the United States became a forerunner of what Lloyd's was ultimately going to become, and that's, as I said, taking individual companies and spreading the risk among the companies.

The pool members shared the underwriting profits, and the managing underwriters were the ones that were responsible for the underwriting results of the facility. The key point of the approach is that there were "several, not joint" liabilities. This is very important. If you had a pool of 50 members and one of them fell out, it wasn't the other pool members' responsibility to take on that member's liability. In fact, there was a hole there in the reinsurance, so it was extremely important that any members you brought into the pool had the financial wherewithal to sustain the losses, whatever had happened. They had to be able to be responsible for their liabilities in that pool. This did become an issue with Mutual Benefit Life. Mutual Benefit Life did participate in a number of pools, and when Mutual Benefit Life went into supervision, that did create a gap, an uncollectable part of the reinsurance for the pools that they were on. It became an issue. But as I said, "several, not joint" is important, so for members, companies that you were soliciting to come into the pool, you had to be very cautious and make sure that they had the financial strength to last.

In the early days, D&H was probably the biggest. But there were other very well-run facilities at the time: IOA Re out of Philadelphia; Lockwood, Dipple and Green (LDG), which was up in the Boston area; and then Reinsurance Management Services (RMS), which was a spin-off of D&H. These were the main pool managers at the time. There were four different facilities. They all had pools of the insurance companies that made up these facilities. Strangely enough, what does become a problem later on, as you'll see, was that the pools were very similar. There was commonality to them. Several companies, if they participated in D&H, were also in IOA. They may have been in LDG. I'm not saying they were in all four, but they may have been in two or three, and some were in four.

So there was commonality to it, which works as long as you're making money. But if you're not making money, then it does become a problem. The combined capacity of those facilities was about $200 million, which means on any one risk, any kind of catastrophic reinsurance protection that was being provided, you could probably get about $200 million in the market of reinsurance, which is a pretty sizable amount. Frankly, today in the United States you couldn't get that. Of course 9/11 had more of an effect than anything else. But that was a lot of money, and it did provide an adequate amount. It did provide a good amount of capacity so that companies could go out and get reinsurance. Again, get $200 million, but spread it among many companies, and it was a good concept.

There were mono-product facilities. The primary ones were accident, medical and disability. Because these products do have different financials in the way they

develop, the claims lag, etc., they were always kept distinct. The accident business was with the accident pool, medical with medical and disability with disability. They tried to keep them separate. The idea was that most pool managers didn't want the companies to cherry pick. In other words, they would say, "That accident business is turning off a nice profit. I don't want any other things." We tried to encourage companies to take a spread across all the pools. It didn't have to be the same amount, but at least to have them involved in some manner in the other pools as well. It would be easy to get everyone in the accident business because it was turning a lot of profits, and there would have been a lack of interest in the other ones.

Income for pool managers was produced through management fees and profit commission. It's a very important point. The way the deal was set up with the companies was the pool managers operated on a management fee. The management fee kept the lights on, paid the salaries, bought the computers and all the different things that kept you in business. Then the profit commission was where your bonuses and extras came from. There had to be a healthy balance between the two. You can't just have a management fee as your only source of income. If you're getting a profit commission, you're doing the right things because you don't pay a profit commission until all the pools got what they wanted. The client companies got their profits before the profit commission was paid. That becomes a big issue; the idea of underwriting and producing a profit was really the key to it. That was where the lucrative part of the business would come in for the pool manager. As long as the companies in the pools made their money, there was profit commission paid and everybody was happy.

The era from 1970 to 1995 I refer to as the "halcyon years." These were the best years for the pool reinsurance world. You could debate whether the market had changed by 1995; it probably had to a degree, but there still were some profits out there. People were doing the right things. There were a variety of aspects of it that made it successful. There was a lot of reinsurance capacity. It wasn't an overabundance; it was a healthy amount. There was still underwriting done, but the rate wasn't the decisive point in why people bought reinsurance. As I said, it was a healthy amount, so the market stayed fairly firm in terms of pricing.

There was an emphasis on underwriting for profitability. That's a very important part of it. It wasn't cash flow; they weren't just writing to generate management fees or underwriting for profit. That was the core of it. So again, premium growth was done on a responsible basis. There weren't enormous leaps in premium where suddenly word got out, and someone who has been in the business for three years has $1 billion of reinsurance under management.

Over the 15 years I was there, D&H had quite stable growth. I think after 15 years in the accident pool in general we managed maybe $100 million, and that took us 15 years to create, slowly but surely growing the book, but doing it in a responsible fashion.

We focused on our core products. We focused only on products that we knew we understood the dynamics of and had a lot of experience on. That was a very important part of it. As you will see later on, when things go awry in this world, it's because people ventured into things they didn't know. They got into products that were accident in some manner, but weren't the core products that the underwriters understood.

With a healthy balance between management fees and profit commission, it worked well. We got our fees, and we also got our profit commissions. As I said, it was indicative that people were making money on it. Every year the pool reconstituted itself very easily. We had people lining up to get into the pools, and the people that were in the pools were actually looking to increase their line because it was profit. They saw a very good profit in this business. Our biggest problem was trying to keep people satisfied—the in-force members who wanted to increase their line and also the new people who were knocking on the door, saying, "I'd like to get in."

We did over the years try to do that. We expanded our limits. That was a way of keeping people happy or bringing new people in, expanding people that were in the pool. We were able to do that. As time went on we were able to utilize that, grow our limits more and provide more capacity.

Another important aspect was that there was the general understanding that our ultimate responsibility was to produce profits for our pool members. That permeated how we did business. The underlying responsibility we had was to keep our pool members happy and make profits for them, and everything else would fall into place. That was the ethic by which we lived.

Around 1995 (the mid-1990s anyway), all the things that I listed stopped happening. This resulted in the decline and demise. What took probably 25 to 30 years to create was undone, unfortunately, in a fairly quick period for a variety of reasons. The abundance of reinsurance capacity became a problem. There was just too much reinsurance capacity out there. There were too many people that had gotten into the business. As I said, the business had been very profitable and therefore, it became very attractive to a lot of other people who ventured into it. Some had a faint idea of what they were doing; some had no idea of what they were doing. The amount of reinsurance capacity then became unhealthy on both a direct and a retro basis. A retro basis refers to the ability of reinsurance companies to get reinsurance. When that happens, it just drives pricing down and down and down.

A lot of the capacity that came in was what would be described as naive capacity. They really didn't understand the business. All they knew was that people were making money in it, and they wanted to make money in it too. Another important point was liberal interpretation of underwriting authority by pool managers. When people got into it, they went in with an understanding that the pool managers were going to be writing certain lines of business. As I said, it could be accident, medical

or disability business. Accident in particular took on a broader aspect than what most people thought. Most people thought of the accident business as traditional group travel accident or voluntary AD&Ds. You can write CAT programs for life. What happened was that accident business became workers' comp. Accident business became aviation carve-out. They started venturing into areas that they had no idea of what the product was, what they were taking on in terms of risk or how this product was going to develop. That was a big problem. A lot of it was driven by the need to grow your book, to look for other avenues of premium. With so much competition, people started looking elsewhere for growth. That is a very important point that got a lot of people into trouble.

Another reason for the decline was involvement in the London market. London is a huge market. They have as many reinsurance opportunities as we do in the United States, and a lot of different product lines. Unfortunately, the way London views its business—how they do business and how they view exposures—is different. There were a lot of managers, as well as direct writers, from North American companies who decided to go over and see what they had in London. London had opportunities. Unfortunately, as people were writing this business, they didn't understand how these things developed. You've probably all heard of the spiral. Quite frankly, I've been in the business a long time, and if someone asked me to try to explain all the details of it, I couldn't. I think you'd need Galileo or someone like that to explain it, because it is extremely complicated.

People started again going over to London and seeing opportunities. It's fun to go to London. I've been there a few times. It's a great city, and people have a great time there. The London brokers are the nicest guys in the world. But it's an inside game. The Lloyd's people understood it, but the North American capacity didn't, and they rued the day.

The last thing was a lack of due diligence. Because these pools had made money for so many years, people got complacent. There was absolutely no due diligence or audits going on. None of the companies were sending in representatives to sit down with the pool managers to look through risks, to look at what they were writing, what the portfolio looked like, etc. We only had your periodic pool meetings, where all the guys would sit around in a room like this. They would show the numbers. They looked good, and we'd all go to the bar. That's what happened in a nutshell. Nobody was digging in and really looking at the portfolio, how they were pricing things and what business they were writing. With the liberal interpretation of the underwriting authority, these books were now starting to change. The exposures were changing. Things like the traditional accident were becoming less of a force than workers' comp or aviation. All these things started becoming bigger than the actual core business. No one knew it. No one was asking the right questions or doing the due diligence that was required to get a handle on it.

Too much capacity put downward pressure on pricing and profits. Some companies supported multiple, competing facilities. When everything was going well, that

worked, but as more and more people came in, it seemed like it was the same people who were backing them. There could be companies that were involved in seven, eight or maybe 10 different facilities. It's self-destructive. It doesn't make sense—you're competing against yourself. At some point in time it makes no sense at all. That became a very big issue.

Jonathan will talk a little later. He has a whole career based on this right now with companies who have run off on all these facilities that will go on forever. They had huge portfolios. The one thing that they could do is put a huge book of accident reinsurance business together through this concept, with one or two people managing it. The underwriters were doing the underwriting in these facilities, so you could put together a large premium base of this business with very little manpower or investment. You just signed up for the pool. Unfortunately, it got a little out of hand.

The retro allowed underwriters to retain smaller risk positions, in terms of the reinsurance managers. Particularly common in London, you could buy down, down and down, and just buy more and more reinsurance to a point where you could basically arbitrage what you were doing. That became a big problem as well. People had bought so much reinsurance and they had so little risk retention that whatever they wrote, it didn't matter. They guaranteed themselves a profit by being able to buy enough reinsurance and put themselves in a position that they could write and write and write. Then who would get killed? It would be the retro writers. The people that were on the program were going to lose the money, but yet they were still able to do it year after year. This took the grass-roots underwriting out of the equation. People could not underwrite, just put business on the books and guarantee themselves a profit through a reinsurance program. It was a very short-lived kind of mentality. But it did in fact happen.

They used to put out a little periodical in Lloyd's in particular where it showed what the different underwriting managers paid in reinsurance and what they collected. It was a very interesting thing. People would buy $40-$50 million of reinsurance and inevitably would collect $60, $70 or $80 million of recoverables. The same guys did this for years. How they were able to do it I will never know. But they were still able, year after year, to reconstitute that reinsurance program, to go out and do the same thing. It worked for them. There was just too much capacity, not only on a direct reinsurance basis, but on a retro basis, which obviously caused problems for the market.

As I said earlier, in terms of the accident business, it became a broader and broader umbrella. A lot of the people who had gotten into these pools never viewed them writing these kinds of lines. It became workers' comp; it became aviation carve-out. Aviation carve-out was disguising aviation liability coverage as accident business. The same thing happened with marine; marine bodily injury carve-out was the exact same thing.

The people in these lines of business—the comp brokers, the aviation brokers, the marine broker—weren't dummies. These were smart people and they knew that by putting these programs together with the accident insurance world, the people that were going to be buying it, the underwriters of these product lines, were going to have a field day on it. They were definitely going to make a lot more than they were going to spend on it. The A&H, the accident reinsured, didn't understand these products. They were basically playing an away game. The underwriters and the brokers that were taking these product lines to the A&H world knew darn well that at the end of the day they were going to be successful in collecting a lot more in recoverable than they were going to pay out in reinsurance. It became a big issue. A lot of these management agreements that were written with the pools were very broad. Accident business was not defined perhaps as tightly as it should have been, and as a result they moved into these other lines.

With A&H, there was little experience or expertise in these areas. They never understood how to price it. The other key point is that they didn't understand the reserving, particularly workers' comp. Everyone thought they were making a fortune on some of these, particularly when you got into per-person excesses and things like that. They didn't realize the tail on it was a lot longer than they ever anticipated. While they are collecting and thinking they have profits, they in fact don't. As the losses started coming in, they had to give profits back, and it did change the results significantly. No one was successful—if you took all three of those lines I don't think anyone ever made any money on a combined basis. For certain aspects of workers' comp you could make money, but, in general, all three of those lines of business caused problems and losses.

In the Lloyd's market, there was a lack of understanding of the intricacies of the Lloyd's risks. The underwriters were unaware of actual exposures. We don't have time to have a long conversation today about the spiral. But people didn't quite understand in Lloyd's how things work. I still grapple with the idea that a reinsurer can write a CAT program—excess of $5 million per occurrence is a perfect example. A $500,000 individual one loss can hit that layer. Now think about that. That is in fact what happened, and the way Lloyd's operates. Because people had so little risk in what they wrote and had bought reinsurance down so low, when it came into an underwriter he would pay his $5,000 or $10,000 per person amount, and he'd send it off to his reinsurer. The reinsurer would pay his $5,000 or $10,000 loss, and it would go on to his reinsurer. It would just spin around the market until it came back to that original guy. He had already paid his $5,000, so what do you think he does with it again? He passes it on. This thing starts spinning up through the marketplace and ultimately it's like playing Old Maid. Someone gets the Old Maid, and it is generally whoever is at the top of the reinsurance. So literally a one-person loss for $250,000 or $500,000 can, through the intricacies of Lloyd's, end up hitting a layer where someone is writing excess of $5 million on a per occurrence basis. If you didn't have a life warranty in it, that in fact happened. No one understood that going in. None of these underwriters who were writing this business in North America understood that until it happened. Then it was too late.

You saw a lot of that kind of thing happen, and it was a huge problem. It was mostly U.S. and Canadian companies that were hit with it, and they lost a lot of money in Lloyd's because of that. They felt they were writing very clean, very traditional high excess business. Unfortunately, based on how Lloyd's operates, it didn't work.

A big problem was the lack of due diligence. They were too generous with the capacity. They were marginally involved in the risk they were reinsuring. There were very few audits. Their self-destructive strategy supported too many facilities. As I said, if they had been auditing, they would have been aware that these portfolios, these pool managers, the books of business they were managing and their underwriting were changing dramatically. They just hadn't done it. They had taken it for granted that it was the same business and everything was running well.

The last example is of what I think of as the "perfect storm." You're probably all fairly aware of the Unicover situation that occurred. Things like Unicover don't happen unless the market conditions exist for them to happen. That's the only way they can happen. The pool reinsurance and the people involved in it were walking right into this thing. As you're probably aware, Unicover was basically a workers' comp facility that was set up. It's a pretty complicated situation, but Unicover itself was an underwriting manager that was based in New Jersey. They were going to write workers' comp reinsurance. They were able, again, to go out to mostly A&H or life companies and form a pool of reinsurers that were taking on this risk. We talked about responsible premium growth. Within a year or two, they had $2 billion or more of workers' comp reinsurance that was flowing through to a pile of life companies primarily.

It became obvious that this business was woefully underpriced. It wasn't even close. Unicover itself as an entity was making a fortune. They were getting an enormous amount of management fees that were coming in through the writings of this business. But the life companies that were taking on the risk were like sitting ducks. It's still somewhere mired in the legal process. I don't know when it's all said and done, because this business has a long way to develop, but the losses will probably be in the hundreds of millions of dollars. That's a good case scenario, put it that way. But it was exactly that. All the conditions were right. These guys at Unicover got this facility behind them, and they went out with a vengeance and started writing workers' comp.

Every major broker that was out there that had workers' comp clients that needed reinsurance was banging on the door to talk to these guys to get business on the books, because if they didn't do it, their competitors would do it. I think all the things that were bad about what had happened in pool reinsurance came to their pinnacle with Unicover, and that was the fatal blow for pool reinsurance. After Unicover I think every CEO of every major insurance company sent e-mails out to their managers saying, "Are we in a facility like this? If we are, we're getting out. If we're not, we're not ever going to do this." It was all over the press. I was at AON

at the time, and AON was quite involved in it, so it had a big effect on our organization and distracted a lot of our attention away from what we should have been doing. But in any event, once Unicover hit, pool reinsurance at that point was, for all intents and purposes, dead. It was very hard to ever recruit a company into giving underwriting authority to a pool manager. In the reinsurance world, there aren't any real pool operations right now. There are some relationships, but a lot of it is done on a submit basis. Companies have to call the company; they have to submit the risk, so there's an enormous amount of control that goes into anyone who's giving the pen out to anybody anymore. There's no more free-for-all.

It's unfortunate, as I said, because at the end of the day the companies in Unicover lose a ton of money. They went in with the right idea. They went in thinking that they were going to make money on this. As a result, Unicover as an organization made a fortune and everyone else lost a fortune. That's unfortunate. But that is what happened. In any event, it's a sin where it went, because in general the pool concept made a lot of sense. You were able to gather a lot of capacity and spread the risk among many companies, and it did work. It's just unfortunate that it went off track as time went on. Whether it will ever come back into the basis of what it was I don't know.

MR. LEITZ: Our next speaker today is Jonathan Beerman. Mr. Beerman has over 20 years of experience in managing reinsurance treaty and pool business. He's a chartered property/casualty underwriter (CPCU) and also holds the designation of associate in reinsurance and associate in risk management. Jonathan is a summa cum laude graduate from the College of Insurance with a BBA degree in insurance and risk management. He is vice president of Global Resource Managers, where he specializes in reinsurance, consulting, auditing and runoff management.

MR. JONATHAN BEERMAN: Kieron went through all the problems with the pools. People come to us to try to find out what's in their pools and what they can do about it. In our world, the first thing we look at is risk. To someone like me, and to someone who is a pool member, risk is not the possibility of a loss or the probability of a loss. It's not the insured subject matter. Risk is the uncertainty inherent in the pool composition. As we explained, pools involve signing your line and managing it, usually with two or three people who can be managing $100 million in premium from five different pool managers, and they often don't know what's in that. As they've found out in later years, they don't know what's in there. We try to help them analyze the risk, which is: What's in the pool? What constitutes the pool? We then help them figure out how to manage those liabilities, which ultimately comes down to the company and not to the pool manager.

The higher the uncertainty, the greater the risk. That goes without saying. What are some of the implications of this uncertainty inherent in the pool structure? Number one is higher premiums. Most people don't see that as a problem. But the higher the uncertainty, the more likely it is you're going to peg your premiums high. A company that pegs its premiums too high suffers the risk of adverse

selection. The good risks will go elsewhere, and you'll be stuck with the mediocre risks.

Inadequate reserves and/or overly conservative reserves (playing it safe) are problems that hit on bottom lines as well. Companies try to assess their reserves. If they don't have enough information, they may peg them too low. They may peg them too high. In both cases, it's going to lead to volatility and swings in earnings, and in today's environment, CEOs and CFOs don't like to see that.

So where are the pools? The pools are grouping together a lot of insureds and reinsureds. The essence is that—as we go through these processes and in audits we see this a lot—the type of business that people put together in pools is not always the same. We think it is. They said they were going to write ABCD, and then we come in and see there's a lot of spread of attachment points and different types of risks. There are a lot of different terms and conditions, especially in London. I don't know if any of you write London business or see London business, but a lot of London contracts, as Kieron mentioned, are very vague as to what the risk is. A lot of them will say, "All business written by the reinsured's property unit," or "All business written by the personal accident unit of the reinsured." That gives them a lot of latitude. Anything they want to classify as personal accident is going to come into the pool. Most U.S. pool managers don't know that.

The pool in its entirety is the risk. The pool managers are looking at individual risks. By the time it comes to the pool member, the risk is the pool itself. To a large extent, the risk of being insured is the pool managers' underwriters.

One of the biggest problems in the pool process are the managing general underwriters (MGUs). MGUs work on an underwriting fee, which is a percentage of the premium, and they also work on a profit-sharing basis. The profit sharing is supposed to try to get them to write good business only, obviously. But they, in order to generate more premium compared to the market and to get more capacity for themselves, started to write business that they did not know.

We have a pool; we know there are problems inherent in this process. How can an audit help? An audit can include an on-site review and generally get boots on the ground to see things that you don't otherwise see. Most companies have management information systems (MIS), underwriting systems and claim systems. Not everything is captured in a computer system. Anything that's not captured does not come on a report to pool members and doesn't go to the financials, but these are things that you can find out when you're in the office itself. Getting on-site helps a lot.

We talk to pool managers and conduct personnel interviews. We look at operations. We talk to people. We see the level of expertise. Are you dealing with people that have 20 years of experience in the business? Or are you dealing with a couple of kids who have two or three years and are overworked? You walk around and you

see how many claim files there are per claim examiner. These are things you can't do unless you're on-site.

When talking with people about their work, when you're doing your pool interviews, you realize they have pride in their work like anyone else. They try to explain to you the more complicated situations they have, the kinds of cases that don't really fit in the computer system so they are called something else. They may have written some sort of open line slip, but they don't have that in their computer system so they call it a quarter share and throw it in there. The reports come to pool members and to reserve people who are trying to do reserves, and they think it's a quarter share because that's the way the MIS system shows it. When we're talking to people, we can sit down and go over cases and understand that this has special handling; this is not exactly what the underwriters thought it was. It's a way of getting around some of those issues that otherwise you'd never find out.

I like to think of the audit as answering types of questions. The "what" questions are one of the types of questions we answer. What does the underwriter pool risk look like? We've gone into places where, as Kieron said, there have been all sorts of risks—aviation carve-out and marine carve-out. We've found cases where sports business was loaded into the pool, where it was supposed to be incidental only. It was just one of the major items in there. We found places where they wrote kidnap and ransom risks and put them into a personal accident pool. There has been London spiral business in pools. There is all this stuff that wasn't really revealed when the pool began its operation.

The lines of business, types of contracts, limits and attachment points, exclusions and contract terms are all very important because they enable us to put a fence around what's written and what's not. You find out what's excluded. Once you start going to the audit cases individually, knowing what's excluded and knowing what the underwriters wanted to write is a very important part of the process. We saved one client over $5 million because there was excluded business that happened to creep into the pool and flowed through the pool members. No one paid attention to it.

Information available during the initial underwriting and placement is also important if we find things that are out of line or things that we believe the underwriters did not foresee or did not intend to write. The information that was available at placement is certainly a key point at which to look. The question is: Were you in fact warned of this stuff? Did you go in with your eyes open? Is it the underwriters, the pool manager? Who's at fault that this business was accepted?

Then there are the "how" questions, which are the flip side of it. How does the MGU go about doing its business? How do they price their product? Are they competitive? Are they cash-flow underwriting? Are they pricing in order to bring in business? Are they pricing in order to maintain market share? Are they pricing to grow or pricing for profitability? How do they monitor their claims? You wouldn't believe how many

MGUs we've run into that have no claims department at all. They simply ask two or three people in the accounting area to look at claims, pay them and pass them on to pool members.

There's enough information that they can determine their liabilities and their exposures. Are their accounting methods up to snuff? Do they follow GAAP? Do they follow STAT? What do they do with notices of loss? Do they reserve? Do they monitor them? Is there anywhere they record the initial notices? Often pool members are put at a disadvantage when their loss is settled because although the initial notice was given to the MGU, it never flowed to the pool members. Later on, it's too late to contain that loss. A lot of contracts have clauses that require reporting, but if the reporting stops at the MGU level, you're simply not going to get the information you need to do your reserving correctly at the company level.

The types of audits we do are designed to answer those two sets of questions. The book composition audit and the underwriting compliance audit focus more on the composition of the book and what was written, what should have been written and whether there were any deviations. The accounting and transactional audit, the claims audit, and the operational audit talk more to the operational side. What are they doing? How are they allocating the risks, etc.?

The first two (book composition audit and underwriting compliance audit) will really go to try to understand what the exposure is. We're usually sent in when something has gone wrong or when a company wants to renew its participation, and they want to know what their true exposure is. Often the initial estimates of a pool year are optimistic. Pool managers are going to be a little underreserving, simply because that affects their profit and loss ratio, and therefore their profit commission. In later years, as the results deteriorate, they may be giving money back, but in the meantime they usually do show fewer reserves than are warranted, in our experience. One of the things we'll do in these compositions is at least try to give actuaries and the claim people who have hired us an idea of what's in there so they can make their own estimates. They can determine their own reserving. Is there a lot of business that tends to be long tail?

When we go to look at book composition, we'll find out what comprises the book. Is it mostly fact risks or individual risks? Is it treated risk? Are there open slips? Is London business excluded? What's the split? What's the ratio between domestic, Canadian, United States and international? What types of lines of business are in there? We'll get the list of risks, and from our experience there are certain names that will appear. Anytime you see people's initials or Lloyd's Syndicate, you're probably going to want to look at that one. Often by going through and seeing these lists of risks that they've written, you'll start finding out the intertwinings of how, even on a limited level, there's an internal spiral.

As Kieron mentioned, a lot of companies are members of several different pools. What he didn't mention is that these pools write other pools. Often you'll go into

one pool and you'll see that they're reinsuring five or six other pools that your client is already on. Now your client participates in these pools twice—once as a member and once through the other pool manager who wrote the CAT cover or the retro cover for that pool. These little internal spirals are completely hidden unless you go in and break down these pools into individual risks, which is what we do.

As I said, there are retrocession spirals. "Open covers" and "line slips" are London terminology that most people don't know and don't understand when they see it. When you have an MGU that is writing a London slip, you've given the MGU authority, and often that agreement will not allow them to delegate to someone else any underwriting authority. Yet an open cover and a line slip are simply a process where a broker will write risks on an open basis. Your MGU, who thought he was controlling the underwriting, has no control whatsoever of what's written. Now you have a retrocession of a retrocession of a complete open cover for anyone to write whatever they want. These open covers are where we find a lot of the hidden London risks that sneak in.

Once we have a composition of the book, then we start comparing that to what was expected. This is the compliance audit. What did we expect the composition to be? We know everything. We have a list of risks. We've actually opened up 50 or 100 of them and seen in detail what the contract is. Is this what we expected to see? We look at placement information. We look at the information that was given to the pool members and to the MGU before the participation was determined. We say okay, what did we expect to write? The duration is a key issue here. Often companies going in expect that the risks are going to be of a short-tail nature—12 months or 18 months incidental is normal language. There were years where London was writing 36-month personal accident policies, and five-year policies were not unknown, especially on high-level, high-dollar policies.

A perfect example is a pro sports policy, where a Mike Piazza will sign a contract for $90 million. There will be a 10-year disability contract. Some London sports facility will write that and cede that back into some pool. The question is: Are they ceding it every year to a new pool, or is one pool getting nine years? If you're getting nine years' worth of liability there, or you're on for nine years and you didn't know that, that's something you'd want to know when you do your reserving. When you compound that by sports franchises, sport teams and college sports, there are a whole lot of durations there. They're not 12 months and 18 months incidental.

Aviation and marine risks are of the same nature. There can be marine carve-out risks that you're taking on that go on for years simply by endorsement. They add on month after month; every voyage is another endorsement. You're on until the contract is over and that could be five or six years. These are risks that normally underwriters don't understand when they write this business. It's our job to go and find that and say, "Hey, you have some tail here. Don't reserve for two years, reserve for six or seven." Of course, I don't know how to reserve. I'm just an auditor. But our actuaries like to get that information.

The emphasis on warranties, exclusions and representations is where we usually find our bang for the buck. Often there will be a breach of warranty; there will be exclusions that weren't paid attention to. That's where we can come up and give a lot of value, where it's not actually something that can be reserved but something to be presented to the MGU as "Hey, this should not be ceded to us." Often we can get off the risk and negotiate a commutation at very favorable terms simply by concentrating on those itty-bitty details. We did that for one client with a London contact where there was a complex wording that had both an interlocking clause and an aggregate extension clause. They were ceding a lot of individual risks, at $500,000 a pop, into this cover. The combination of the two should have been interpreted as they can only cede one $500,000 pop into the cover spread out over every year. Every year they should have one hit at $500,000, and they were taking multiple hits every year. It was a big case. There were threats of litigation, and we commuted it. People don't want this to get out; it was commuted for a savings of about $4 million. The reason they commuted with us is because if they would have litigated it, every other reinsurer on their program would have found out about it, and they would have asked for the same type of reallocation.

The more you find out in doing the audit and the compliance, the more you can then look at individual cases. Breach of warranty is generally refined. There are pro-life warranties; there are warranties that kidnap and ransom won't be more than 10 percent in the business. Things like that that are warranted both before the placement and in the contract itself. We find a lot of that.

The transactional claims and operational audits are to ascertain what happens there. Underwriters can write the best program in the world, and they can design a very nice retro in a pool facility, but often the people on the ground doing the accounting don't understand how the program works. They may not understand, if there's a quarter share of surplus, two excess covers and a CAT cover, which comes first. It may be the CAT cover protects certain things, but certain things aren't covered. It may be that the excess comes first, and then the quarter share kicks in. There may be a lot of different problems in how they actually do their transactional processing.

We found that MGUs with hundreds of millions of dollars of premium were working this thing up until very recently on simple Lotus worksheets or Excel spreadsheets. Formulas get copied year to year, and someone makes a mistake. That mistake permeates throughout the system. We find cash unapplied. Cash comes in, it doesn't get applied and therefore it doesn't go out to the retros. We find just typing errors, miscalculations or whole series of contracts that somehow never got to the pool or vice versa. The claim got into the pool, but the premium never got there. These are simple; these are not ground-shaking things. By going in and looking at these things, we can get a good flavor immediately for whether the pool is well-run and well-managed. As Kieron said, a lot of pools are a runoff now. We tend to find these types of problems a lot more simply because they're cutting staff. There's not enough premium income to keep it going. A lot of them are not converting to

robust systems simply because they're a runoff. Their accounting systems are still just Excel worksheets where every month they plug in more numbers. There are problems with that.

Another problem that we find is not in their accounting, but in their accounting to the retrocession and to the pools. Again, they have a risk that may be a 24-month risk, a two-year risk or a three-year risk. How is it accounted? How are the losses accounted? Are they accounting them per year of account, meanwhile the premium was accounted all to one year? There are problems.

The average pool accounting unit is not very well trained. I won't say they're not good at what they do, but they're not good at handling cases that they are not familiar with, and they are not good at handling the theoretical. If they've been told to do something by the underwriters year after year, that's what they do. If the terms of the underlying contracts change, they don't always pick up on them. They don't always have access to those contracts.

In these transactional audits and accounting audits, we'll review the processes and procedures. That's important for us. We go in and say, "Do you have any procedures? Do you have any written instructions on how you do what you do? How do you take a risk and allocate it?" A lot of MGUs have more than one pool. They have a couple of pools running. They may have a foreign pool and a domestic pool. They may have a pool that took the excess of the capacity after the first pool died out or couldn't take up to $50 million, and everything in excess went to another pool. So the first thing to ask the employees is, "Do you know what you're doing? Is there any sort of process and procedures that you follow? When the premium or losses come in, how do you book them? Are there lags in reporting or backlogs?" We find that to be the case and that affects reserving to a very large extent. If there are a lot of accounts sitting around that aren't being processed into the system and pool members don't know about them, they certainly can't reserve for them.

Are there accruals going on? How do they do their accruals? These are financial transactions ultimately. We don't think they get the focus that they should. In most shops you're going to find the underwriters are the top guys—they run the business. The MGU is always the first guy, the president, and the underwriting staff is always coming up from the underwriting side. The accounting is critical though, because, as pool members, what you get and what you see is the result of the accounting, not the result of the underwriting. You get quarterly reports, and at the end of the year you'll get some sort of yearly summary. If the figures are wrong, or if they are underrepresented for some reason or another, that's what goes on your financials and that's what you guys start crunching your numbers based on.

Again there are companies out there that bought protection, that bought some sort of reinsurance on an individual basis for some risks, and the accounting people don't know about it. They don't take it into account when they do their accounting. We've found some areas where pools did improve their accounting in that area as well. These audits are there in order to track the trail of the premium and losses and to make sure that everything that you're getting, even if it's going bad, is at least what you're supposed to be getting.

Some of the more important parts of the claims audit include review of the claims handling practices and procedures. A lot, but not all, of the MGUs do not have a dedicated claims unit. Some of them do. Some of them do a very good job. I have to say that I'm not trying to present everyone as the same. Some of the MGUs and pool managers we go to have a very good claims unit and receive good scores. Others don't. Others have a couple of the accounting people who simply look at the claim. They bring it to the underwriter and the underwriter is supposed to look at it, according to their procedures. The underwriter is not a claims person. He's an underwriter, and he's geared to please the client more than looking at claims. These claims just get paid and passed through to pool members. Pool members don't do a lot of due diligence either on this.

One of the things that affects the book as a whole is the reserving methodology. Do they actually reserve for these things? Do they investigate the claim and put up reserves, or do they simply pass on the documents and whatever the original reserve being reported is, that's the reserve that goes on the books? What kinds of techniques are used for the small claims? Are they doing some sort of modeling? Do they do some sort of reserving for underreporting? Is there some sort of methodology they use? Do they send $500 on first notice? Do they send $1,000? Do they send $1.00? Do they send nothing?

The accounting time lags here are key. If you try to build triangles, gaps or lags in the reporting are crucial to trying to understand this business. Often on pool business you will see spikes and valleys because of these lags and because of the constant catch-up that they play.

Dollar value of loss is not subjected to a high level of scrutiny. We've found that pools will say, "If it's $100,000 or more, we'll look at it. If it's under $100,000, the accounting people have the authority to pay it." But it turns out you may have 3,000 or 4,000 claims of $90,000, $80,000 or $70,000. These are not small dollar amounts in the aggregate. Due to the lack of resources or the lack of a dedicated claims department claims unit, the MGU's claims units won't really look at anything except for the big-dollar ones. Those are the ones they know you're going to have questions about.

The operational audit is where we look at the pool manager overall. We don't look at individual cases now. Now we're looking more at how they operate. What kind of an operation is it? Are things neat? Are things followed up? Is there some sort of an

organization? We go in sometimes and they are very organized. They are very top-level. They have monthly meetings or quarterly meetings, and their staff goes out on audits. Their staff feels free to come in to the underwriter and ask questions. In other places it's more haphazard. Let's write the business and who cares how it gets on the books. Those are the kinds of places where you'll find gaps in correspondence and gaps in coverage.

Some of them are aggressive in disputing coverage. They do want to look out for the bottom line. They want to look out for their pool members. Others do not take such an aggressive stance.

Is the staff trained? Again, in the old days, when the top four were doing all the work and a lot of the business fell to them, these were all very good shops. D&H and the others were well-trained. They were well-staffed, and they were good. That was back in the 1970s and well into the 1980s. In the beginning of the 1990s, as the business got more competitive, a lot more shops opened up. A lot of the people that founded these original ones and the people they had trained went to set up their own shops and took some staff with them. The level of staff got diluted. The level of knowledge got diluted. The staff became more of, "Let's get it onto that spreadsheet and get the account out to the pool managers." There was not the level of scrutiny that should be in this business. Again, we're trying to minimize the amount of underwriting that the company does, trusting that the pool managers are doing the underwriting and claims managing. If they're not and the company is not, this is the recipe for disaster.

Do they have someone who is a claims vice president? Do they have an actuary on staff? These are all questions we ask. We sit down with the pool managers themselves or the people running the shop and ask, "Okay, how do you do this? How are you protecting our client's interest here?"

I'm going to take you through the process fairly quickly. The process that we've devised that works well for us is a three-step process: pre-audit, on-site and post-audit. The pre-audit review is one of the most important parts of the audit because that's where we do our planning. We obtain a bordereaux, or a list of risks, which is the book composition. We review all documents. We do all this work before going on-site. This is because we don't want to waste our time on-site doing it, and there's a lot more time to discuss this with the client. We take a look at the placement documents, the MGU agreements, the claims, the risks, the submission and everything that we can get our hands on. We review it, and then we talk to our actual client. We talk to the claims staff there, the actuaries and the underwriters. We ask, "What's key to you? What do you want us to look at?" We can do a file selection at random, but random is going to give you a random chance of success. We circle stuff and say that these are the ones we want to look at. They are either high-dollar, names that we know or companies that we're involved in, in things that we've already known from previous audits. We're not allowed to divulge that, but we certainly can look at them. We can use our knowledge, even though we can't

divulge it to our clients. We know certain companies were involved in London more than others. We know certain companies were involved in Unicover or Webb; certain companies have certain involvements in workers' comp. Our clients' needs are what we want to meet. If they have a fear that their workers' comp exposure is getting larger or was too large, that's something we'll look into. If they are more concerned with London, we'll pick on those. If they just want an overall audit, we'll just do a random sample.

We'll communicate the file selection to the target. We usually set aside a week or two. We'll go in and look at the file reviews. The first thing we'll do is try to set up interviews with the people. Normally we'll be auditing three or four people; one or two of us will do interviews with the staff while the others start the file review.

The interviews are twofold. The vice president or the guy managing is the guy that you'll sit down with first and interview. We try to get permission to interview some of the other staff as well to assess the level of competence, to assess their ability to handle the work load, the claims people and the accounting people. We just like to talk to these people. Often those would be informal interviews. They bring a file over. We'll ask if they can sit down and explain this to us, just have them talk to see what they know about their own business. This onsite review lets us take a look at backlogs and at the workflow. How does the operation work?

One thing that we find interesting is something that you normally will never get from a client beforehand because they don't keep records of it. But they do normally have a file in house of their declinations. How many risks did they decline in the time that they were writing the business? This is a very key issue. It's under the radar, but it does show you whether or not they were out there trying to write a good blend of business or whether they were writing everything that was coming in the door. That's something that they never have on their MIS system. You'll never get the client to give you a computer run ahead of time. But often there will be a file cabinet stuffed with declinations (well, we hope to find it stuffed with declinations and not just one little folder).

In the post-audit review, we'll thank them for the help. We'll go back home, sit down and do our math and start looking at the results. When we're on-site, we'll just plug things into a database. We've developed a very easy and efficient way of doing the work. We have certain key questions that we ask on every file. These get plugged in. Certain documents we'll tag for copying. We try to do a lot of the work out of the office when we get home. It's just a lot easier. We can cross-fertilize and talk among ourselves and bring in the client again. Normally there will be a list of follow-up questions and a request for document production. The follow-up questions are normally things they couldn't answer on-site. You start asking questions about any exclusion or warrant, and they usually say they'll have to look into that, which is standard. We'll get those follow-up questions answered, hopefully in writing, and we'll produce a report for our client.

The audit should reduce uncertainty in the book by giving our actuaries and our claims people the breakdown of what the book is composed of, what types of underlying risks there are and terms and conditions in those risks and attachment points. Is the book mostly CAT? Is it mostly first-dollar? Is it mostly group travel? Does it exclude group travel? There are just endless amounts of things that you can put together from the composition of the book that differ to a large extent from what you thought, if you just take a look at the placing information or the placement slip for it.

We'll add information that can assist in assessing future development. Are there processing problems? Do the accounting people know what they are doing? Is there a big gap? Is there a big backlog? Are there unprocessed accounts? Are they reserving correctly? Do they have their own incurred-but-not-reported (IBNR) methods? Do they have an actuary who reviewed it? There are accounting issues and timing issues. It will pinpoint areas of concern that could be isolated or reserved for separately. For instance, you may find that they have a large exposure to kidnap or ransom; a large sports exposure; a certain area, like they have a workers' comp carrier that's in the news, that they wrote a lot of; or there's a certain feeling that the reinsurance that they were banking on is not collectable, because the retros are falling apart and going into liquidation. If those retros fall apart, the pool is going to retain much more of the risk than was originally assumed. These are all types of things that you can take back to your client, and you can then set some sort of strategy going forward.

FROM THE FLOOR: What types of risks are currently being written in the pools right now? Is there a possibility to use pools to reinsure maybe variable annuity guarantees where there's a lack of reinsurance capacity right now?

MR. FARRELLY: Right now there's not much business being written in pools because there are not that many pools around anymore, for the most part. I would say that what's being written outside of the pools in the traditional reinsurance A&H market is a lot more focused on the core business that was written years ago.

In terms of pool structures right now, there's really no one out there. There's no facility that I would describe as a pool. There are a lot of managing underwriters. They have authority to write on behalf of a certain company. In many cases, it's submitted case by case. They are literally submitting the account; they are submitting their pricing and getting the stamp of approval before they can even quote it. Right now there's not a lot of it. Whatever is being written is traditional. A&H reinsurance has gotten away from the aviation business, the workers' comp, the marine and all that kind of stuff and now focuses on the primary products.

I'm not sure about the annuity business. My background is not in that area, so I don't know. You would have to get by the whole idea of someone putting a pool together and writing. I imagine in that business you could put together an enormous amount of premium quickly because, like you said, there's probably a

void in the market right now for that. Could it be done? Sure, but I think you'd have to be playing a lot of what Jonathan brought up in terms of putting together a contract, agreements, etc., that would be focused primarily on that business. If you employed a lot of the things that Jonathan discussed you probably could do it if there is a big need in the marketplace. But again, it would have to be under pretty tight controls.

MR. BEERMAN: What we are finding is that a lot more control is being written into the contracts themselves. There are a lot more exclusions. A lot of companies now will exclude London, which tends to cut the spiral off. There will be a lot more due diligence on the part of the companies entering into this. There will be mandated audits twice a year on a lot of these MGUs. In fact, some state laws now require that if you're an MGU, the fronting company has to audit you twice a year. There has been an attempt to at least control the risk and make more of the audit process and more of the discovery process up front. I think both parties benefit from it. The last thing an MGU wants is three or four years down the line to find out there are problems and disagreements. So I think that up front, the fronting carrier cedes out general reinsurance rather than a pool. It has the same effect. I think that there's a lot more cooperation. There's a lot less independence given to the MGU without oversight. It's a good thing for both parties.

FROM THE FLOOR: Would you be able to explain what aviation carve-out and marine carve-out are, in terms of how that's accident?

MR. FARRELLY: Basically what they did in the aviation in particular was commercial aviation. These are underwriters who write commercial liability. On the liability portion of it, you put in more of a seat accident kind of basis where you would put in $250,000 a seat, or a fatality or whatever onto commercial airlines, that would be payable not so much to the airline itself, but to the aviation underwriter. This could be a Lloyd's underwriter; it could be a U.S. facility. It was a cheap way of them offsetting their loss by getting recoverables or reinsurance or retro coverage from the A&H marketplace. Unfortunately, what happened with those, when they went out to some of these A&H underwriters who were willing to do it, shortly afterward (it was only a month or two into some of these deals), China Air happened. They had 300 people that were killed on it. The liability or the amount of loss that could be paid on this thing was astronomical.

That's what they did. They were really just taking that liability portion of it and they were buying, in fact, accident business. They were capping at a certain amount per life, but really as I said it was just offsetting that liability loss.

The same thing was going on with the marine. They were taking the accident part of the medical or accident/medical for these people on ships that would have accidents. It's a very volatile piece of business. People have horrific occupational accidents on these. They took it to the accident market that was willing to do it at a far cheaper price than the marine people. Laying off that risk, they would reimburse

the facility as opposed to the company. They weren't directly writing direct reinsurance contracts. They were in fact writing a retro to that underwriter. Carving out certain accident aspects of it, getting a very cheap price from the market and just using that to help their book is what happened. It was just taking these different product lines, carving out what they felt was accident and going to the market. Unfortunately, most of the times they did it it was underpriced. They didn't know the liability on it. The aviation marine people made a lot of money on it, in terms of what the losses were.

MR. LEITZ: That's a good question. In addition to aviation, I think things became even more exotic when they started to insure satellites and satellite launches, future launches and in-orbit risks. Jonathan has a few stories, I'm sure, about the Boeing 702 satellites. I believe the company knew that they would probably fail, but once they were launched into orbit it was the reinsurance pool's problem.

MR. BEERMAN: I think one of the most amazing things for me is how a life and health company gets involved in aviation and satellite risks to begin with. You talked about the carve-outs. The workers' comp carve-out is another big line where these companies had no business dabbling, but it was a premium income, it was available, it was marketed to them and it was definitely attractive.

Satellite coverage is something they just snuck in on the back of aviation. A lot of business in the world, a lot of aviation contracts when satellites first started to become insurable and became commercially viable, had no cover. They just piggybacked on aviation covers. They wrote the same types of risks. It's up in the air and it's like a plane, so we'll cover it. Nobody understood the risk; nobody now understands the risk involved. Satellite coverage is one of these things where there's a cabal of about five expert engineers who assess all the risk. All the other companies in the market take their word. It's also a very non-competitive market, in terms of the number of companies writing it and the number of companies actually making satellites. The producers of satellites have been able to get away with a lot of favorable terms in their contracts, terms that in other areas would be product liability cases. Their contracts basically absolve them from any liability once their product is launched into space.

I think in some cases they were misled, and in other cases they joined it willingly, thinking that it was presented as good business. It was presented as very profitable. The satellite business for years was profitable, though again I don't know how they even thought that they could write this, even if it's profitable. If it's not your area of expertise, if it's not your core business, you shouldn't be involved in it.

MR. FARRELLY: One of the ways they got into it as well was that some of the companies invested money in Lloyd's. They put some capital into the Lloyd's market and invested in several syndicates. A lot of these were primarily accident writers, but they also had other portfolios in there that were hidden. They were taking on aviation, and they were taking on the satellite. It's interesting with satellite. There

are basically two pieces of it that you cover. The first is launch, and the other one is referred to as "life." I guess in some way you could say you're writing life, but it wasn't involving people; that was the only difference. The life is when it's in orbit. A lot of these will take out a four-, five- or six-year contract, and while it's in orbit and as long as it's functional you don't pay. Unfortunately you do pay when something goes awry. I think it's amusing that they did refer to it as "life," and so in some manner there was a connection.

FROM THE FLOOR: I imagine that some of the pool participants would love to get rid of the business.

MR. FARRELLY: Yes.

FROM THE FLOOR: There are some ways to do it, but I imagine people aren't looking to buy those blocks at the moment.

MR. FARRELLY: Not the pools, no.

MR. BEERMAN: If we go in and find enough suspicious activity or if we find any underwriting violations, our clients then use that as leverage to try to commute the business. It's very difficult as a pool member. Unlike a reinsurer, you have given a lot of authority over to the MGU and to the pool operator. But certainly certain blocks of business can be carved out. You can band together with other pool members and move against your pool operator if you have to, although it's rare. Most of the time, we'll try just to commute some risk or settle them at less than their value and close off some lines of business or some contracts. But it is a problem in the industry. A lot of companies are going to be saddled with these losses for a long time, even if they are not writing them now. In 1995 or 1996 a lot got out. The rest got out after 9/11. They're going to be carrying this stuff on their balance sheets and working on these pools for a good five or six years to come. That's if there are no long-tail liabilities.

FROM THE FLOOR: Is Lloyd's the only source of CAT coverage right now?

MR. FARRELLY: No, actually right now they are less of a source. The primary source right now is Bermuda. After 9/11, the U.S. CAT market sort of fell apart. Many people that were in it got out. The capacity of the ones that were in it was significantly reduced. Bermuda really went over there to write property CAT business but were willing to look at the life business. Right now they are the ones that are doing most of the life CAT, particularly if you want full terrorism. There is some capacity in the United States and London, but if you need extremely large limits ($100 million plus), you'd have to go to Bermuda. If you can live with $50,000 or at least under $100,000, you can probably get it done in the United States. If you're willing to write it without a nuclear, chemical and biological cover, use that as an exclusion, you can get enough cover in the United States and London to do it.

The problem with Bermuda is they have the capacity, but they are also very expensive. They are a risk-based-capital kind of underwriter. They base their formula on that. It's a rate online; the use of their capital is really what they are applying. They don't underwrite it as much as they might in the United States and London. That's where it is today. I think there is a bit of a growing U.S. market.

I work for ZON Re. We're a new facility. We opened up less than a year ago, and we don't have a lot of capacity. We do have 10 million. We'll write life CAT, and we can do it with full terror. We're new into the market, so hopefully you'll see a few people become less dependent on Bermuda. With all due respect to the Bermuda operations (they are good underwriters), there is a whiff of piracy about what they are doing, quite honestly. They know they are the only game in town, and were for a while, and they were leveraging that price-wise. I think they forced a lot of people not to buy, to go net on their book as opposed to buying CAT, and we'd like to get them back in buying. Hopefully that will happen.

Right now there's virtually no retro market to speak of in the marketplace. That was more driven by 9/11. When 9/11 occurred, most of that loss that was absorbed in the A&H market was in the retro markets in London or in North America, so that market is pretty much deteriorated. There's very little retro now. In one regard it's healthy; there's a lot more underwriting going on. People are managing their aggregates a lot better. It's not a free-for-all anymore. That whole structure as we talked about earlier with the ability to buy down significantly in terms of retro protection does not exist anymore, here or in London. The London underwriters are of a completely different world now. They have to underwrite. They retain a significant amount of risk, and they live by what their portfolio is, so that whole model has gone right now. As I said, most reinsurers are retaining what they write. Ergo the limits have reduced significantly.