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Emerging Issues in Quota Share Reinsurance

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Moderator: CRAIG M. BALDWIN
Panelists: CRAIG M. BALDWIN
JOHANNA B. BECKER
MICHAEL S. STEIN

Summary: A panel of reinsurers discusses recent issues surrounding quota share reinsurance, including limits in the capital market, XXX reserves, letter of credit funding and costs, recapture provisions and arbitration.

MR. CRAIG M. BALDWIN: Over the last few years, quota-share reinsurance has become the norm for most direct writers. With this development, the nature of the client relationship has changed in scope for reinsurers and ceding companies. The heavy reliance of the market on reinsurers' financial capacity has forced many new issues to the forefront. We will discuss how those issues are addressed today.

Let me first address some of the global aspects. The first graph presented is of U.S. life sales that have taken place over the last few years (Chart 1). If you notice, there was a little "bump" in 2000. That increase is often associated with what is called by many the fire sale of 2000. If you look at normalizing the curve to take that out, the sales in the life insurance industry have been more or less flat. A slide later on in this presentation can lead you to believe that those sales are going to be flat for the foreseeable future, unless we find some other way to break into markets that the industry is not getting to right now.

At the same time that that level of growth has been occurring in the direct side, the reinsurers have been experiencing dramatic growth; sometimes two to three times the growth rate of the direct side (Charts 2 and 3). Again, you see the bump in 2000 for reinsurers. What's interesting is the percentage of direct companies' business reinsured by professional reinsurers is almost at 60 percent right now. We don't have the data yet for 2002 direct sales production. But I speculate that when you factor in what occurred in 2002 and the fact that there were a couple of large direct carriers who increased their retention and are doing excess reinsurance instead of quota share, my expectation is that the number will be reasonably flat and still close to 60 percent.

If you look at the recently published 2002 Munich Survey, there are some interesting things going on in the reinsurance market (Chart 4). There is quite a concentration of risk occurring, which is becoming an issue for some of the direct carriers. If the published discussions of the possible purchase of ERC by Swiss Re actually takes place, there will be a fairly large concentration of mortality risk with Swiss Re. Whether the direct carriers will allow Swiss Re to maintain that market share, only time will tell. My guess is, since the first five carriers on this list control, depending on what number you look at, about 63-66 percent of the new business market right now, there's going to be some movement of that new business between those carriers and the other players further down the list.

If you look at these next slides it is interesting to see what the direct side is anticipating as far as additional term production for the future (Charts 5 and 6). These statistics from the Life Insurance Marketing and Research Association (LIMRA) show that the companies themselves are much more optimistic about their potential to grow the business than they are about the industry's ability to grow.

An additional statistic, which will segue into the next slide, is what the distribution of business looks like right now (Chart 7). This is very typical of the distribution reinsurers are seeing because of the quota-share relationship. The really interesting thing that follows from this is if you look at the letter of credit (LOC) demand based on that growth expectation and distribution of business, the demand for LOCs, or their financial equivalent, will increase approximately tenfold over the next five to six years. That's an interesting phenomenon, which would lead a lot of people to think about who is going to provide that capacity, or who is going to be the 800-pound gorilla at the trough to get first call on LOCs. There is an additional question as to what the banks are going to do as far as pricing LOCs given this demand curve. There is little doubt that there are some interesting things going on in this marketplace.

MS. JOHANNA B. BECKER: Today I will be covering two specific areas that were identified in the program. One is recapture; the second is arbitration, but I've thrown in a bonus for you, and that is what I'm calling miscellaneous items—treaties and administration.

Historically, I think we all recognize that quota share was not eligible for recapture. And the recapture wording in quota-share treaties typically followed the old increase in retention limit wording that applied to excess treaties. What has happened in the last few years is that some companies started requesting recapture, and this was due, in part, to the large volume of business that they were reinsuring. This was also due to a feeling that they needed to be prudent about safeguarding themselves against the future financial stability and condition of their reinsurers.

In the past, ceding companies were asking for recapture after a certain number of years, which was very similar to what was in excess retention types of treaties. Sometimes the recapture was based on an increase in quota share, and this might be tied to a retention limit increase, but in other situations it was not. Sometimes it was tied to the level term period if it dealt with level term products. Ceding companies were also beginning to ask for recapture if there was a rate increase, again, because of so much business being reinsured. A number of direct writers were feeling very vulnerable about the potential of someone else having the right to raise reinsurance rates that had been built into their market pricing.

Additionally, direct writers were concerned about the financial condition of their reinsurers and were starting to place financial triggers in their treaties. These could be based on the reinsurer's rating, such as A.M. Best, or Standard & Poor's (S&P), the authorized control level of risk-based capital (RBC) maintained by the reinsurer, or simply if the reinsurer was insolvent the ceding company would have the right to recapture to protect its interests.

When these early requests started coming in, reinsurers were agreeing, saying, "Sure, you can recapture. Our ratings are never going down. These events are never going to happen to us, so what the heck. If you want it, we'll put it in there." And the ones that were concerned about recapture said, "It's not widespread so we'll go ahead, we'll allow it. But we do have a concern that if this does become widespread in the industry, we'll have to rethink our position." And, in many instances, I don't think that these early requests by ceding companies and the related agreement by reinsurers were necessarily well thought out.

What's emerging now is that more ceding companies are requesting recapture provisions of various forms, and reinsurers are beginning to rethink their positions on recapture. The responses of the reinsurers are varying depending on whether recapture is just because of an increase in quota-share percentage retention or whether it's based on the impaired financial condition of the reinsurer.

So what is the impact of these emerging issues?? I'm seeing more recapture fees now, whereas before reinsurers never discussed a recapture fee when it was requested. The treaties are becoming much more detailed regarding the terms of recapture.

Ceding companies are also targeting the return of the reserves backed by LOCs, or having some kind of alternative financial security, again, because there had been nothing in earlier treaties dealing with these issues. In response, reinsurers are saying on coinsurance treaties, "Fine, you can recapture, but we're not returning reserves." Yet, at the same time, from the reinsurer's perspective, they more than likely are not holding the full statutory reserve because the business is going offshore and the reserve credit is backed by an LOC. The concern, of course, is the equity involved in negotiating such a recapture. Additionally, if the reinsurer is inclined to return the reserve, what reserve are they going to return?

Reinsurers are also beginning to push back on rating triggers. In some instances, they're saying that whatever the trigger point had been, it has to be lower because a lot of reinsurers are finding that they have been downgraded for various reasons, or there's this potential for downgrading that they never contemplated. Some are saying that they don't want a trigger tied to ratings at all. They feel that is something outside of their control and don't want the rating agency community having that kind of power. As a result, parties are looking for non-subjective triggers, if recapture is going to be allowed. Others are searching for alternative solutions that may involve putting money in trust for the ceding company in certain circumstances, or possibly selling the block of business to another reinsurer to maintain the economics of the transaction. The overall goal is to satisfy the ceding company's requirements for financial security while again maintaining equity.

Consistent with my introductory remarks, I would next like to address arbitration. Arbitrations, and their outcome, aren't something that the industry routinely hears a lot about. After discussing this issue with an acquaintance familiar with arbitrations, this person pointed to two specific emerging issues. The first is ceding companies are asking for trouble if they do not disclose material information in the quote process, even if not specifically asked for the information by the reinsurer." Essentially, it behooves all ceding companies to not try to second guess what a reinsurer might need, but provide all of the relevant information that they have. The second issue was for reinsurers, and the advice was: "Absent egregious behavior on the part of the ceding company, the presumption that the reinsurer must follow the fortunes of the ceding company is difficult to overcome." This appears to be sage advice as reinsurers look at situations where they see the potential for a dispute. The overall question has to be: What is the likelihood of really prevailing in an arbitration?

The history of arbitration in the U.S. has predominantly centered on underwriting and claims issues. These areas are continuing to be a concern, with a little different twist as things emerge. Reinsurers are concerned about the lack of underwriting diligence on the part of direct writers. They are also concerned that ceding companies are making more and more business decisions that fall outside the guidelines that the reinsurers expected when they priced the business.
In addition, there can be third-party administrators (TPAs) doing the company's underwriting on a contract basis, and those administrators may not have the same standards for underwriting as the ceding company. And, again, there can be a disconnect between what the reinsurer is using in pricing versus what the administrator is actually doing in practice.

The same concerns apply regarding diligence in the claims investigation process. Again, if the direct writer takes the stand that it's reinsured so they don't have to do as thorough a job as they would have in the past, there are going to be more disputes resulting in possible arbitration.

Another issue that I think is just beginning to emerge is lead reinsurer liability. Some quota share pools have a lead reinsurer for claims so that the ceding company doesn't have to go to every single reinsurer for claims adjudication. This role also applies equally to having lead reinsurers on the underwriting front. Related to this, a comment was made that if reinsurers don't agree with what the lead reinsurer has done, they don't have an arbitration process to resolve disputes since they don't have treaties between them. Traditionally, the responsibilities of lead reinsurers are not routinely discussed or defined as thoroughly as they should be. I believe we need to pay more attention to this in the future.

Conversions and continuations are probably the next likely emerging issue, although dealing with them is not really a new item. They have been talked about in the industry for quite some time, but the possible issue is the theoretical treaty wording versus the more realistic administration procedures. Things that used to work in the much "simpler" excess-of retention, smaller-volume days, just don't work in a large-volume, quota-share environment.

Even within MetLife we have three major franchises, each with its own direct systems and related reinsurance system. Connectivity between the systems varies in determining the original policy's issue age and date, and the original reinsurer who is supposed to be receiving point-in-scale rates. The processing and understanding of its nuances need to be understood by all involved at the treaty's inception. There is another possible emerging issue dealing with possible arbitrations in pool situations. The overriding concern has to be the mechanics behind an arbitration in such an environment. The question becomes: Will there be single arbitrations with each of the pool members that have this issue, or do the reinsurers of the ceding company decide that one arbitration will be used to settle it all? Multiple arbitrations can become very time-consuming and costly. But if you have multiple arbitrations, will the outcome of the first arbitration influence subsequent arbitrations on the same dispute topic?

On the treaties and amendments front, more of this is generated because of quota share, and I believe that neither the ceding companies nor the reinsurers have the staffing to keep up with the volume. Consequently, the various parties' understandings really do not get codified in an executed document for quite some time. Timing is becoming more of an issue as everyone struggles to keep up with the volume. It especially becomes an issue since the regulators are paying more attention to the process.

In some situations, reinsurers are using claims adjudication as leverage in getting treaties signed. The problem then arises that because the ceding company has been paying premiums under the assumed agreement the reinsurer is potentially in violation of the treaty. What the reinsurer should possibly be doing is giving 90 days' notice that they are not going to take any new business until the treaty is executed.

Another possible position has been heard that unless the treaty is executed within the 90-day time frame, the treaty is considered null and void. Since this is not considered to be normal industry practice, this needs to be clear to all parties during the quoting process.

Many are familiar with the NAIC model regulation on life and health agreements and its requirements for obtaining statutory credit. But I feel people aren't putting enough emphasis on complying with it. I believe more effort should be made at the time quotes are accepted wherein the ceding company and the reinsurer agree on a reasonable timeframe for executing the agreement. I also believe there could be more use of letters of intent (LOIs) to clearly define the intent of the parties' agreement. The LOI then provides the basis for drafting the treaty. Lastly, I think a solution for timely execution would be adoption by the industry of the ACLI common treaty template. Then, at least, there would be a common starting point for negotiating the particular details associated with the agreements.

On the administration front, I believe it has become more complex because quota share has thrown new wrinkles into the equation. Pools get continually re-priced. There are new reinsurers and new shares so that you have different pool configurations coming on line for the same or similar products. Identifying the plans and the appropriate shares can become a daunting problem. In the process, treaties can become very ambiguous and difficult to manage, creating issues for the future.

Along with all of these issues there need to be tighter time frames for financial reporting. The reinsurers are likely dealing with retrocession issues out the back door that could be putting them at risk for the same things the ceding company and the direct writer are trying to address in the normal course of business. As far as emerging issues are concerned in the aggregate, I think things are going to continue to change. There are new wrinkles coming out the more we talk about all of this. There can be no doubt that these are interesting times. We all need to stay tuned for what happens in the future.

MR. MICHAEL S. STEIN: I've broken down my presentation into a few different categories. The main topics will deal with emerging issues from quota share reinsurance, emerging issues from Guideline XXX and finally emerging issues from world events, including capacity issues in a post-September 11 environment.

The growth of what I call the in-force mortality reinsurance risk has generated a large number of problems. For those of you who may not be familiar with these sorts of transactions, they generically are the transfer of just the mortality risk, usually on a YRT basis, but coinsurance has also become a little bit more common on term products for policies issued in the past. Unlike new business agreements, there are issues that you must consider on these agreements that just don't come up on new business contracts.

Companies are entering into these agreements for the same reason they're looking at new business reinsurance treaties. One reason that I point to is just the competitive environment for reinsurance today. Ceding companies are obtaining favorable terms on their new business quotes, and attempt to lock in similar terms on their in-force contracts as well. They also can avoid some of the fluctuations that they have been seeing from claims, and they free up capital. Other companies may look at a potentially favorable GAAP impact on universal life (UL) contracts if there's a change in the pattern of expected gross profits.

The ceding companies have to look at their existing agreements to verify that they're allowed under their contracts to reinsure what was originally intended to be retained. Also, if they're recapturing business with the intent of reinsuring it, they may look to their original treaties to verify that it's allowed.

When the reinsurer prices in-force blocks, they rely on data that's provided to them. Typically, a substantial amount of information is exchanged, and arbitration is something that's always hanging over somebody's head. The reinsurer is relying on a seriatim file of what the purported exposures are going to be, and it's important that those are the exposures that are going to be reinsured ultimately. The mortality and persistency studies are usually developed more precisely than you might expect on a new business quote. For in-force business, there's a very good indication of what the mortality experience has been, and it's heavily relied upon. Those representations from the clients are also relied upon for underwriting standards, where the business came from, and any changes in the distribution channels that have developed during the time that the business was issued.

On occasion these contracts are backdated to the beginning of the year, so there are already known claims out there for the business that's in place. It's important that those claims are identified and communicated to the reinsurer so there's no misunderstanding about who knew about what claims when the treaty was entered into.

Preparing for administration has its own nightmares for in-force blocks. I believe the reinsurance administrative systems that are in place today for new business are pretty good. You probably have some administrative people out there that are saying, "Well, they're not good enough," but they're, overall, pretty good. A lot of the business that was placed, say, in the 1980s and earlier never envisioned the magnitude of reinsurance that's being pushed through it today. They may be on legacy administrative systems that simply cannot handle the demands placed on them for reinsurance. That should be considered ahead of time. There are just simple administrative issues that come up about the existing reinsurance and how it's going to interact with the new reinsurance, and it has to be considered ahead of time. After all of this administration is cleared up, you need to make sure that the initial exposure that was developed for the reinsurer to base his pricing on is roughly the same, and any differences are communicated in advance.

It's important that the reinsurer and the ceding company understand and agree ahead of time on what the reporting demands are going to be. In an ideal world, the ceding company will understand this before the contract is entered into. Unfortunately, sometimes the administration lags behind the creativity of the actuaries who are developing the reinsurance structures.

On the regulatory front, there was some uncertainty originally regarding how the in-force transaction should be reported; whether it can go through current gain from operations or whether it needs to run through surplus. Strictly interpreted, a coinsurance agreement is clear that if it includes business issued prior to the effective date of the agreement, then it must be a surplus transaction. YRT was less clear. It's now clear that initial gains must be deferred through surplus and not immediately put through the gains from operation.

The NAIC is currently examining whether agreements with business that's issued in the current year where the treaty is backdated to the beginning of the year should be treated as an in-force agreement. The NAIC is also considering whether the surplus resulting from these in-force transactions must be appropriated, which limits the ability for the ceding company who's taking these gains to actually use those gains for some other purpose. This stems from the property and casualty (P&C) industry's accounting for these types of transactions. There are enough differences between the life transactions and the P&C transactions to at least create debate.

Recapture and the definition of recapture have changed since the original premise was developed. It used to be simply that if there's an increase in retention you can get the business back after some point in time. So everything was time-specific and understood, and the likelihood of recapture was also understood. It's evolved now to something substantially different where the time horizon is not defined because business can be recaptured before anything occurs, such as a result of rating triggers, or a change in capital positions. When a ceding company may recapture without a triggering event, how does the reinsurer control this risk? And all of this has an impact on the terms that the reinsurer can offer. Also, if the pricing horizon is shortened up enough, the terms become less and less attractive for the ceding company, which comes back to the possibility of just expanding the length of time before recapture is available.

Johanna asked what to do about the ceded reserves, particularly on level-term business, and that's an issue that has to be addressed ahead of time. I don't think any reinsurer out there can realistically expect a return of the reserves to the ceding company in the event of an early recapture, but there can be some middle ground. And the time to discuss those things is not when it gets triggered, but at the time the treaty is executed.

Some table-shaving programs have probably been around for quite a while, but they're becoming more and more prevalent today in the competitive marketplace. I believe that it's becoming more prevalent and getting more reinsurance attention simply as a result of companies no longer retaining these risks. In the past, as the companies retained the risks from table-shaving programs, they didn't have to involve the reinsurer, so they could pretty much manage the risk themselves.

A typical table-shaving program, for those who may be curious, will allow substandard risks, usually from Table 2 to Table 4, to be placed as standard cases. The reinsurer will typically provide rates that load up the standard risk class for these additional substandard risks, or may just provide the same rates that they're currently charging for all substandard risks. As a reinsurer, I'd rather continue getting the same rates as before and ask the ceding company to pay Table 2 or Table 4 as underwritten, but that's not generally the case.

Fortunately, these programs have certain limits. Usually they're permanent products only—with a maximum age, maximum amount and limits as to the types of impairments allowed. Generally, impairments giving rise to a flat extra are not allowed in these programs.

One thing needs to be made clear. These programs assume from the get-go that underwriting discipline will be maintained. Without it, these programs will fail, and hard feelings will be the result.

In pricing these programs, the reinsurer has to make an assumption as to how many Table two, three and four applicants there are going to be. Generally there's some historical information about what there's been in the past for each of these companies, and the companies will often provide those statistics. But depending upon how aggressively these programs are marketed, you could see some dramatic increases in the substandard risks that are being pushed into the standard classes, and these need to be monitored.

What happens if the program does bring in more table threes and fours than originally envisioned? What's the recourse for the reinsurer? Based on the original understanding, the reinsurers only recourse is to reprice for new business, unless a bookmark has been left in the treaty to allow the reinsurer to reprice based on the actual distribution.

And finally, what's important is how the ceding company administers this program. There are a number of companies out there that are unable to identify the substandard risks that they pushed into the program. We'd audit these programs with some regularity in order to understand the risks that are going into them. We ask that the ceding company code these risks to allow us to validate our assumptions.

Reinsurance of term conversions today are being handled a little bit differently from what I've been seeing in the past. Typically, these are reinsured point-in-scale—if you convert the risks with the original reinsurer. There are occasions where the ceding company recaptures conversions, or some companies may choose to ask the reinsurer to continue reinsuring the contract under the permanent scale at new business rates. This does raise pricing issues, as you can well imagine. When you price these conversions for new business rates, the reinsurer will provide lower allowances for the underlying term product to compensate for this extra mortality.

The first question you need to answer is whether the risk stays with the original reinsurer, or with the reinsurer of the new contract. I would assume that the reinsurer of the new contract has no expectation that it is getting conversions. I would argue that the industry standard is that the risk does stay with the original reinsurer. But how do you price for that extra mortality when the control of the amount of conversions, in many respects, is in the hands of the ceding company? The ceding company's and the reinsurer's interests become misaligned as a result of this because they're going to want the conversions moved into permanent products, and the reinsurers have a cost for that. So, again, agreeing ahead of time what the expectations are for these things and putting them into the treaty would be a good idea.

I'd like to touch on some of the limitations on reinsurance capacity that are emerging today. The limitations that we're seeing started before the events of September 11. Some of it came from consolidation in the retrocession market. One of the most notable consolidations is the Clarica and Sun merger, but there were also a number of consolidations in the European market. All of these things were a precursor to what happened after September 11.

Our retrocessionaires have to somehow get a handle on the risks that are coming to them through the back door. Due to the administrative problems that are out there, both with the direct companies and the reinsurers, these retrocessionaires are getting these risks as late as three years from the date the risks are placed. Their ability to manage their own retention is really limited and, as a result, they have to scale back on the amount of capacity that they can offer your friendly reinsurer.

Also, as I pointed out, after September 11, the European retrocession market pretty much dried up for our retrocessionaires. They've had to pull back. What this meant for just RGA, in particular, was that our own internal capacity was cut 20 percent.

This created an interesting dilemma, and I can say it's interesting because we didn't get hurt, in that we had made offers toward the end of the year for risks that could have been higher than what the capacity would have been if those risks were placed in 2003. The corporate owned and bank owned life insurance (COLI-BOLI) market was also affected by the events of September 11. After September11, reinsurers and direct writers alike began to focus more attention on what their geographic concentration of risk had become. Now, all of a sudden, companies are asking, "Well, where are these employees located?" I didn't hear a lot of those questions before and, as a result, since the questions weren't being asked, the data wasn't being accumulated. We, as reinsurers, and probably the direct writers alike, have a lot of concentration already in place related to geography that we don't know about. Managing our own catastrophe cover is an issue, and there are new limits being placed on a zip-code level, or even on a building level that weren't in place before. And all these limits are exacerbated by the unavailability of relevant data.

Now, it would be unrealistic for me to expect that the in-force business will ever get cleaned up. It would be an ideal world where we can start managing these exposures and understanding where our concentrations lie. So, again, if there's anything that can be done out there to help us out, let me know.

Next is the issue of mirroring of XXX deficiency reserves. As we all know, some states mandate that reinsurers mirror the reserves in order for the ceding company to get a reserve credit. All this is just another regulatory hurdle we must deal with, but it hadn't been as much of an issue in the past simply because everybody knew ahead of time what the prescribed reserves were going to be. By that I mean that everybody knew the interest rates that were to be used on the underlying mortality. Under the new world of X-factors under XXX, that's a little different. We can state what those X-factors are going to be at issue, but they can change. The question becomes, should the reinsurer be obligated to mirror the reserves in the future that the ceding companies have now established as a result of increases in X-factors?

This may also be linked to mortality and a worsening of the underlying experience. If the direct writer is experiencing worse than anticipated mortality, certainly the reinsurer would also see the same experience, and they would need to increase their X-factors. It's not always that simple. The reinsurer may be assuming that only portions of the risk going into the experience are being identified by the ceding company. The poor experience may come from products that the reinsurer is not reinsuring, but still may be asked to share in the increase in reserves in order for the ceding company to get its reserve credit. Again, this issue should be discussed and negotiated up front. There should be an understanding under what circumstances the reinsurer will be required to handle those additional reserves as a result of changes in X-factors, and what recourse the reinsurer may have to change rates to handle the cost.

My final topic is the distribution of business risk. I touched on this as it related to conversions, as well as table-shaving programs. The reinsurers are more and more frequently being asked to help support their clients in terms of giving them customized allowances that support certain cells that are less profitable than others. Well, if those cells are less profitable to the direct writer, they're going to be less profitable to the reinsurer as well. If they're less profitable to the reinsurer via higher allowances, it's going to make it even worse.

How does the reinsurer handle this risk? Again, there are a lot of ways to handle it. But getting quick data to the reinsurer to understand where the distributions are emerging helps. They can then understand when they reprice the product using these assumptions where the distribution has changed. There have been a number of situations where we've come out with higher rates from one period to the next because of changes in distribution.

It has historically not been a situation where there's been any difference of opinion over how we feel about the underlying expectations of that company's business; it's simply been a change in the distribution that was different from what we had originally expected. We need the information of how these mixes change over time. If possible, we may even put something in the treaty to control our exposure depending on the level of the risk.

MR. JOSEPH F. KOLODNEY: I'd just like to make a couple of comments on some of the issues that Johanna, Craig and Mike have brought up. For those of you who are not aware of our presence, we (AON) are life reinsurance intermediaries. We don't accept risk. We make sure it's properly ceded.

In the Munich study that Craig put forward, this concentration of risk issue has been one of our concerns in general because we believe that ceding companies really need effective diversification to manage risk. A continuing problem that you run into is that there are a shrinking number of reinsurance markets available, and there is the fact that ceding companies are almost forced into aggregating their exposure to fewer and fewer companies. Then you have to wonder what happens when Swiss Re, as well financed and as historically strong as it's been, runs into a problem. It has a 53 percent market share, and something happens.

From a more parochial point of view, it gives certain reinsurers a lot more leverage on imposing terms and conditions because of their overall presence in the market. The ceding company may actually have little recourse.

Let me go back for just a minute to the aggregation of risk. In approximately the last five years, eight life reinsurers have more or less evaporated from the marketplace. Never mind the retrocessional issue, especially since the Europeans now look at the coming of North American business into Europe like Dracula looks at a silver cross. If you just trace back to what has happened, Swiss Re used to have a couple of autonomous entities that operated, while owned by Swiss Re, with their own retentions and own markets in the industry. They lost Union Re, and the Bavarian Re folded into Swiss Re. Life Re and Lincoln were acquired by Swiss Re. ERC acquired Phoenix Mutual and AUL's reinsurance operation. Munich acquired CNA Life Re's operation. So a lot of retrocessional capacity between the companies has evaporated, and I'm getting calls from reinsurers to find out where to go for retrocessional capacity. Frankly, a lot of it just isn't out there. That's a definite cause of concern.

One of the issues Craig talked about earlier, is if LOC demands go up, there's going to be, what they call in the P&C business, a gross-line limit that any one bank is going to have for issuing LOCs to reinsurers. That's going to create a capacity crunch, and bankers aren't stupid. They're going to start squeezing the price and, eventually, somebody is going to run out of gas in the market.

You talked about catastrophe cover requirements by zip code. Even so the life catastrophe cover market has substantially strengthened on pricing. As a matter of fact, as a reaction to September 11, everybody was running for the exits. If you had to buy a life catastrophe cover after that event, there were tremendous prices being asked for it, not to mention new items like terrorism exclusions and nuclear, biological or chemical conditions. I think that has eased a little bit simply because some of the non-life reinsurers who are providing catastrophe cover are seeing that they are no longer able to get the same pricing for their P&C business. They're coming down on their hurdle rate, so there may be some remedial action there.

You talked about the retrocession market and quota-share recapture. When a reinsurer prices on a quota-share basis and does offer a period of recapture, I think the ceding company is entitled to assume that, at that point in time, when the recapture can be triggered, there should be no penalty. So I think that some of these issues about surrender charges or recapture charges are irrelevant, from the ceding company's point of view.

We have negotiated a treaty on behalf of a ceding company, which had a quota-share recapture in it. We simply said, "Look, you're pricing for a certain goal, and you're saying that a 10-year recapture is acceptable. So we have to really believe what you're telling us is that at the end of 10 years, if we want to take this business back, we're going to take it back. We shouldn't pay any penalty for doing so."

Now, as far as how that comports with an increase in retention, there has to be a de facto increase in retention because if you ceded 90 percent of the risk, where are you going to put it if you don't have the retention to absorb it? And, therefore, you can still recapture up to your overall gross published retention, and anything over that would stay with the reinsurer. Do you have any response on the question of why there should be a charge for recapturing on a quota share?

MS. BECKER: I agree with you. I think it's coming up more so when the company is financially impaired. So it's not based on a period of time. It is more likely to be a result of a ratings trigger.

MR. KOLODNEY: Regarding insolvency, are you going to be at odds with the regulator's interest in rehabilitating the company? Do they want you to come in and be able to take back a flow of business that's producing profits for the rehabilitated company?

MR. BALDWIN: Just because there's a provision doesn't necessarily mean that you'll be able to take it back.

MR. KOLODNEY: Exactly.

MR. STEIN: And I think that's your point, isn't it?

MR. KOLODNEY: Exactly.

MS. BECKER: I think that's why ceding companies also don't want to wait until the reinsurer is insolvent. They want an earlier ratings trigger so they can get in before the regulators do.

MR. ROBERT J. TIESSEN: I'd like to talk about three things; one is treaties. I think a lot of what people have said is basically, "Oh, the treaty doesn't cover this. The treaty doesn't cover that. We don't know what happens on conversions. We don't know if there's reserve transfer on recapture." Well, there's a spot to do all these things, and it should be in the treaty. I think one thing that might happen is that if you exchange treaties at the time of negotiation rather than three months afterwards, you could solve a lot of these problems.

In the past, no one would have negotiated a reinsurance treaty without knowing what the underwriting rules are, but now they're willing to quote a price without knowing the treaty terms, and I think that's going to have to change. I think people should start exchanging treaty provisions at the beginning of a process and not down the road.

At the Canadian Reinsurance Conference, there was an interesting slide presented. It was very much like Craig's second slide, which demonstrated the percentage of business reinsured. It was actually the average number of pages in a reinsurance treaty. That had quite a nice slope to it as well, and I believe someone said that the average reinsurance treaty was three times the size it was 10 or 15 years ago.

One additional item that hasn't been mentioned, which I think might be a ticking time bomb for some people, is the possible use of time limitations on the use of errors and omission (E&O) clauses.

There was a situation earlier this year that involved a number of companies. There was a joint-life, last-survivor treaty that had the usual kind of joint-life, last-survivor rates starting out in the minimum 10- to 20-cent per thousand at-risk range. Someone, unfortunately, assumed that those were monthly rates and was paying those rates every month for 10 to 20 years before the error was discovered. When this error was discovered, the financial impact was a very large number. So you have to ask the question as to whether this should not have been discovered long ago. I don't think there is any question about whose fault it was.

The issue becomes whether there should be a limit on invoking E&O. How far back can you go? And is there something that you might want to put in your agreement to have some sort of limit on this? I would think that auditors or other people might be quite interested in this. If there is to be a material hit to both parties' income statements, how do you deal with it? The P&C industry has had this problem with issues raising their heads after many, many years. My opinion is that there likely needs to be a statute of limitations on invoking E&O.

The third thing that I'd like to bring up is that reinsurance concentration of risk is certainly an issue. In Canada, the basic industry has consolidated a huge amount, and the reinsurance industry has also done the same. I believe this is the first year that reinsurers have gotten into serious enough trouble that people are actually looking at the solvency of their reinsurers. People need to look at their concentration of risk and insolvency risk a lot more than they might have in the past.

MR. ARNOLD A. DICKE: The concentration of risk issue isn't limited to COLI-BOLI situations. There was a concentration risk involved in September 11, and it didn't involve COLI-BOLI. It's an interesting thing that somewhere in the future we need to think about that in another context besides just COLI-BOLI.

Finally, you dropped the issue that was brought up about pricing for recapture when there isn't financial impairment involved. But what recapture amounts to is an option, and all options have prices. The price can be big or small, but what you want to avoid is anything where you're trying to negotiate too large of what I would call an "uncertainty premium." If you have an option where you really don't know how it's going to play out, then the price of that option has to be set at something that's close to the upper end of the scale of what it will cost.

The real reason for trying to put some limitations, or penalties, into your treaties is to cut down on that uncertainty premium so that the reinsurer has a better idea of what the cost will be. The reinsurer can then produce a price where the expected value and/or the expected value plus some deviation are close to one another. You don't have to build in too much of a premium margin.

MR. MELVILLE J. YOUNG: I want everybody in the room to remember that Denise and John Tiller wrote a reinsurance book. That book cites ways that things should be done. A lot of people walk away after reading that book feeling they now understand how things are supposed to be done. Hopefully, they will understand that there is a wide spectrum of ways of doing things. All we have to do between us is decide what the right way is and memorialize it in an agreement. There isn't one way that's always correct.

That gets to the broader issue that I wanted to raise. I participated, because of my earlier consulting career, in many arbitrations. I don't remember one off-hand where one party was completely innocent and the other party was obviously guilty. In every one that I can think of, both parties shared the guilt. One way to try to minimize the chance that there's an arbitration in the future is to completely communicate up front each party's understanding and intent under the agreement. Poor communication is generally what results in arbitration.

I am familiar with that multiple arbitration pool situation mentioned earlier. I'm also familiar with another one where the ceding company, as it was working its way through to the arbitration process, went back and re-negotiated with various reinsurers to try to avoid an arbitration with those parties. I think there is a lesson to be learned from this approach. Given that most arbitrations end in some form of a compromise, why not try to get there before you incur all of the angst of arbitration?

One of the things that was mentioned earlier was the need to provide all of the information available during the quote process. I think the word relevant wasn't mentioned. I believe you simply want to make sure you give your reinsurer every piece of **relevant** information that's available.

I'd also like to discuss the third-party administrator (TPA) underwriting audit situation. One of the things to keep in mind if you're in a situation where you have a TPA is it should be clear as to which of the two parties, the reinsurer or the cedent, is responsible for auditing that TPA. And, whoever has that role is communicating with the other.

Lastly, I'd like to address the continuation issue. While I was in consulting, I did a lot of arbitration surveys over the years. I became familiar with a lot of the issues that resulted in arbitration, and one of the most frequent issues is the continuation provision. I'm not familiar with one single situation where the reinsurer that was originally on the risk continue to be on the risk. You're hiding your head in the sand if you don't think that that's the way it's going to turn out. If it's really a difficult administrative issue for you to deal with, you need to get it covered up front.

MS. BECKER: I would like to make a follow-up comment on Mel's remark about providing relevant information to reinsurers for quotes. I agree that it shouldn't be the kitchen sink. It should be what's relevant. But, again, based on what I'm hearing in the market, it is important to err on the conservative side.

MR. YOUNG: One other arbitration I've been in recently dealt with something that came up in this discussion today involving material reserves on recapture. In this particular situation, the reinsurance treaty was completely clear that there were no reserves to be returned. The arbitration panel, two out of the three arbitrators, felt that the cedent was not sophisticated enough to understand that even though the treaty was completely clear. Two of the three panelists said that this was an unsophisticated buyer and even though the treaty said nothing and was going to be returned, they voted to return the reserve anyway.

MR. CARL MEIER: I'd like to comment on one of the things that Mel Young said about arbitration. It seems like you never run into a situation where one party's hands are completely clean and the other is 100 percent guilty. I think that harkens back to this idea of whether or not there should there be a time limit on E&Os. The example that was given that—if the reinsurer did not notice for all those years that they were being wildly overpaid, it seems to me that that cuts both ways. Certainly, if somebody was paying me 12 times what I should have been expecting, I should have been able to notice that. That's a reason why I would say no to a time limit if that's the example we're going to use as to why there ought to be one.

MR. KOLODNEY: Has the relationship between reinsurers and the direct writers changed lately? Can you talk to where the relationship stands today?

MR. STEIN: I think the relationship is more stressed than it has been in the past. The market continues to be extremely competitive. Preferred risks are priced razor thin. There's an expectation we'll attain profitability, but there's also an expectation that when the ceding company commits to underwriting to a certain set of guidelines, those guidelines are going to be followed to the letter. There is little to no room for error and it builds very high performance expectations into the relationships.

MS. BECKER: I would add that I believe the relationship between direct writers and reinsurers remains good overall. There is some stress because of the constant repricing of pools and, as has been said at previous Society meetings , the long-term relationship that was anticipated before is no longer there. The players keep changing and it's difficult to establish a solid working relationship. The market appears to be firming up price wise and the direct writers can no longer anticipate constantly lower reinsurance rates. The relationship is changing due to the harsh realities of the marketplace.

MR. TIESSEN: I'd like to clarify my comment on the time limit for E&O usage.. It wasn't based solely on one example. I was also involved in a situation where 10-year-old claims were presented for payment, but the company could not recreate the related premium payments. This to me creates an untenable situation. This again underlines the needs for reasonable limits on E&O issues.

MR. BALDWIN: Issues like that underline the further need for communication and an understanding of each party's expectations from the get-go. If you can agree that an error that comes up maybe three years after we sign this agreement is not going to be covered, it at least forces people to push for tighter controls.

MR. TIESSEN: Seven years is a time limit that frequently occurs in law. A limit consistent with that could probably work.

MR. BALDWIN: We talked a bit earlier about LOCs. In preparing for this session, I tried to do a thumbnail survey on LOC capacity in the bank market.. From the earlier chart I put up, TARe's estimate, based on projections of business written subject to XXX, about $10 billion dollars of LOC capacity was used at the end of 2002. An estimate derived from my survey was that current capacity is about $25 billion, but this amount is shrinking due to line limitations being placed on customers.

The price of LOCs went up about 30 percent at the end of 2002. Based on the current demand curve, it is very likely we will see another 30 percent increase in 2003. Where the market goes from here is anybody's guess.

MR. GORDON A. GIBBINS: This talk about LOC capacity makes me think there should be a rush of insurance companies to buy banks. That may take care of your LOC problem.

As an additional comment, we talked about the payment or non-payment of the reserves upon recapture. The definition of what reserve is involved is important If it's to be settled on a GAAP basis, it could be a negative reserve. In that case, we're talking about money flowing the other way, so the possible lack of understanding could be even more important.

I would also like to comment on treaty claim clauses. There is quite a bit of variation in the rights and non-rights of reinsurers in claims decisions that have been worded very differently by a number of players. This situation is somewhat recognized in all the options provided for in the ACLI "standard" wording. Unfortunately, it is very difficult to accurately pinpoint a true "standard." This is also true of the roles of the parties in claims litigation.

Lastly, I'd like to comment on the importance of data. Almost all reinsurers have a greater requirement for data today than they did in the past. Because of this, we have moved to giving the reinsurers seriatim valuation. In terms of risk management and more accurate valuation this move recognizes the need for ceding companies provide in-force tapes to the reinsurer.

MS. MARY J. BAHNA-NOLAN: I've heard in several different forums that, due to the increase in the amount of first-dollar quota share and the associated business risk transferred, reinsurers want to have more direct involvement in a company's front-end business practices. With this possible desire on the part of reinsurers, don't you see the possibility that the market may seek to limit the amount of reinsurance they place in the future.

MR. BALDWIN: I don't think that that type of involvement by reinsurers is practical. There has to be a great deal of trust in today's quota-share relationships. I don't believe that reinsurers have the resources to be that involved in overseeing your business practices.

MR. STEIN: I echo that statement. However, there is a tacit understanding that any changes in business practices that influence the pricing environment should be communicated to the reinsurer. I can't see it going any deeper than that.

MR. YOUNG: The one place where I think that type of reinsurer involvement would be justified is in annuity reinsurance. Here you have a situation that dictates a closer business relationship. The setting of interest rates and investment guidelines makes it necessary.

MR. JESSE M. SCHWARTZ: I know the topic of discussion is emerging issues, but I've been listening to the conversation about limitations on lines of credit and the impact of XXX reserves, and I have to wonder why this hasn't been an issue for quite some time. I find it hard to believe that companies had not contemplated the need to be sure that capacity is available and if something should happen, they should nail down from the start an alternative method for securing their reserve credit. Additionally, with the nature of XXX reserve solutions being what they are, a company should realistically expect to see a recapture charge in place if they want the business back, even under adverse conditions.

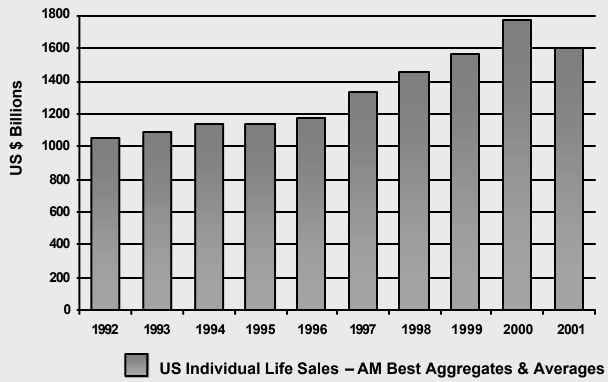
MS. BECKER: I would say that there are some emerging issues as to whether to offer recapture at all. The industry is examining viable alternatives to ratings triggers, as well as workable methods to effect equitable recapture terms.

MR. STEIN: As an aside, reinsurers and direct writers alike, are looking for alternative solutions to LOCs to deal with what may be a looming problem. They are all beginning to recognize that LOCs are only out there for a year, and the risk of growing reserve credits are 20 or 30 years long. So simply relying on LOCs is really short-sighted. Alternatives are being aggressively examined.

MR. BALDWIN: Since the drive for alternatives has only recently begun, the market has no clear feel for how much alternative capacity can be created. Stay tuned for future developments.

Chart 1

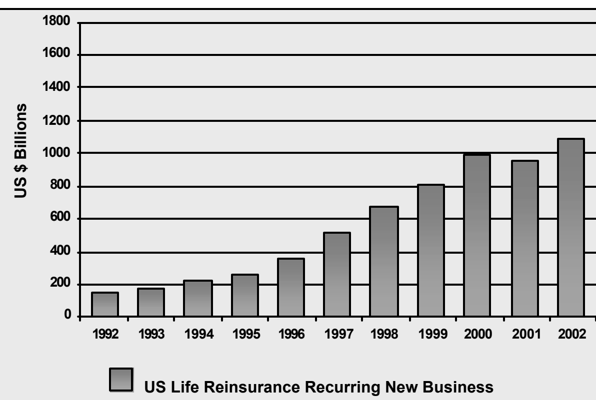
U.S. Life Insurance Sales by Face



- Slight gains year-over-year until 2001
- 2002: AM Best new sales up slightly; LIMRA up 14% thru Q3, 2002

Chart 2

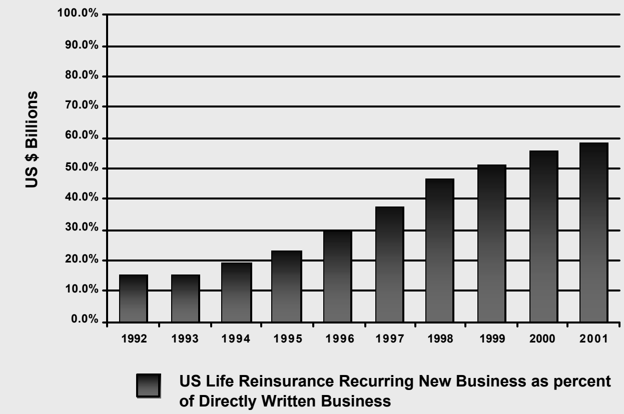
Growth in Recurring Life Reinsurance Market



- 2002 volume almost seven times 1992 volume
- 22% CAGR

Chart 3

Growth in the Life Reinsurance Market



- Percent reinsured continues to grow
- Growth rate slowed after 1998

Chart 4

Munich Re Survey Ranking

Source: Munich Re Survey

		2002					2001				
	Company	Recur.	Port.	Retro.	Total	Market Share	Recur.	Port.	Retro.	Total	Market Share
1	Swiss Re*	265,491	9,225	0	274,716	21.0%	246,466	493,335	0	739,801	48.4%
2	Employers/ERC*	58,483	141,568	0	200,051	15.3%	50,448	29,359	0	79,807	5.2%
3	ING Re	129,340	14,858	7	144,205	11.0%	93,584	0	4	93,588	6.1%
4	RGA	116,491	21,852	0	138,343	10.6%	112,746	20,682	0	133,428	8.7%
5	Transamerica Re	110,219	0	0	110,219	8.4%	85,662	0	0	85,662	5.6%
6	Munich American Re	80,076	10,398	176	90,650	6.9%	103,679	6,122	680	110,481	7.2%
7	BMA	74,255	0	0	74,255	5.7%	39,003	985	0	39,988	2.6%
8	Allianz	54,749	0	7	54,756	4.2%	43,711	0	2	43,713	2.9%
9	Scottish Re (US)	34,339	2,962	0	37,301	2.9%	26,045	319	0	26,364	1.7%
10	SCOR Life Re	21,888	292	0	22,180	1.7%	2,923	292	0	3,215	NA
	TOP 10 TOTALS	**945,331**	**201,155**	**190**	**1,146,676**	**87.8%**	**804,267**	**551,094**	**686**	**1,356,047**	**88.7%**
	MARKET TOTALS	**1,078,262**	**204,495**	**23,989**	**1,306,746**	**100.0%**	**947,169**	**569,358**	**25,141**	**1,528,468**	**100.0%**

***2002 ERC portfolio and recurring includes significant volume assumed from AUL**
***2001 Ordinary portfolio amount includes $470,093 assumed from Lincoln Re**

Chart 5

Expected Growth in Term Sales
Average Annual Rate over Next 5 yrs

	No. of Companies	
	Industry	Own Company
< 5%	19%	16%
5 – 10%	69	41
11 –15%	12	37
>15%	0	6
	100%	100%
Avg Ann Growth	8%	10%

Source: LIMRA International

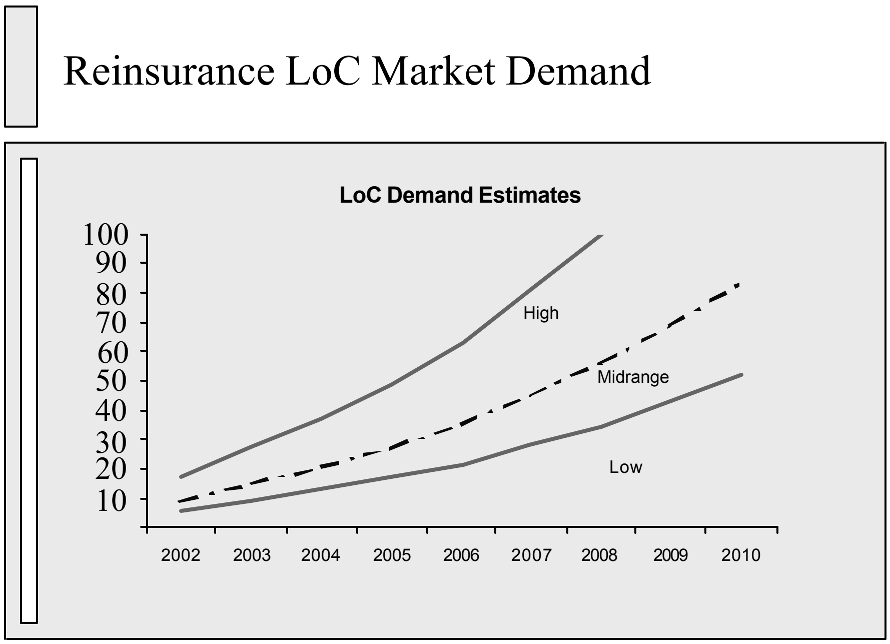
Chart 6

Sales by Premium Period
2001 Results

	Policies	Ann. Premium
5 year	12%	8%
10 year	23	28
15 year	7	10
20 year	35	37
30 year	9	8
YRT	9	8
Other (incl ART)	5	1
	100%	100%

Source: LIMRA International

Chart 7


Reinsurance LoC Market Demand
LoC Demand Estimates
100
90
80
70
60
50
40
30
20
10
2002
2003
2004
2005
2006
2007
2008
2009
2010
High
Midrange
Low