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Session 8 Seminar
Treaty Negotiation for Life Reinsurance: Part 1

Track: Reinsurance

Moderator: MICHAEL E. GABON

Panelists: MICHAEL S. STEIN
NICHOLAS M. SIMONELLI

Summary: This seminar focuses on the nonactuarial features of a reinsurance agreement, including underwriting, administrations, claims and audit. The following topics are covered: review of evolution of reinsurance treaties, insurer and reinsurer positions on key treaty features highlighted and hands-on resolution of contentious issues in reinsurance agreements.

MR. MICHAEL E. GABON: This is an embedded seminar on treaty negotiations for life reinsurance. We're going to spend about 30 minutes giving an overview and setting the stage. Then we'll break up into small groups.

We realize that there are several issues out there these days. We've decided to focus on four through collective efforts, and we hope that this discussion and process will help you in the future, shorten time to market through negotiations in an ever-competitive marketplace and improve business processes. With that, I have a caveat: the views here today, at least of our presenters, are representing *a* reinsurer and *an* insurer. Their personal views are not necessarily views of their companies. You'll probably hear them say that multiple times to emphasize the point.

With that, today from the reinsurer's view is Mike Stein, senior vice president from RGA in Chesterfield, Mo. Representing the insurer's view is Nick Simonelli, vice

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Note: The chart(s) referred to in the text can be downloaded at: http://handouts.soa.org/conted/cearchive/NewOrleans-May05/008_bk.pdf.

president and actuary from Prudential in Newark, N.J. With that, I'm going turn it over to Nick and Mike to set the stage of each person's viewpoint.

MR. NICHOLAS M. SIMONELLI: The first topic that we're going to cover is underwriting, and we'll begin with whether or not to put the rules in the treaties. We prefer not to put our underwriting rules in our treaties mainly because of the sheer volume of the rules and because regular changes in our rules would require frequent amendments. Examples of rules that would require frequent amendments include our foreign risk, country classification list and impaired-risk guidelines. We prefer that the treaty simply state that we will provide the reinsurer with copies of the rules upon request. As it is, we typically provide copies of our rules in our request for proposal and during the Q&A process, which are prior to entering into the deal.

What about notifying the reinsurer and obtaining approval from the reinsurer when we want to change the rules? We do not want to provide notification and obtain approval for every change. We're willing to do this for changes that we consider significant. Examples include changes in our age and amount requirements, our preferred underwriting criteria and any other change that is expected to cause a measurable impact on mortality. To avoid a delay in implementation of a change in the rules, we would like the reinsurer to let us know if it's a valuation within a reasonable period of time, such as 15 business days. This is because we need time to make the changes in our underwriting systems. We have to schedule these changes for a specific systems release, and we have to do so reasonably in advance.

What about exceptions in judgment? In general we would agree that the ceding company's underwriting rules should be followed for a policy to be included in automatic reinsurance. However, some exceptions should be allowed. True underwriting exceptions are those situations where the underwriter recognizes that the risk belongs in one rating class but makes the decision to place the risk in a better class for some business reason. Reasons for doing this include being competitive on a case or because the case is one of several related cases that are good risks.

In addition, exercising judgment is part of the art of underwriting. It should be allowed. For example, while rules and guidelines tell our underwriters when to order tests and attending physicians' statements (APSs), the underwriter may have good reasons to do something different. These reasons might be the information may not be available, something else may be just as good and can't be substituted or there are special circumstances about the case that may lead the underwriter to waive the requirement.

Another example of using judgment would be where the applicant just misses on one of our preferred criteria, but the underwriter decides that the risk belongs in the better class based on the total merits of the case. In underwriting not every

case fits the mold. There are nuances, and the underwriter must exercise judgment. Examples of areas that require a lot of judgment are older-age underwriting and financial underwriting. Exercising sound judgment should not preclude a policy from being reinsured under automatic reinsurance. As long as the incidence and severity of making exceptions and exercising judgment fall within a reasonable range, these cases should not be excluded from automatic reinsurance.

MR. MICHAEL S. STEIN: Thanks, Nick. I'm going provide a quick caveat here. I have the sales guy out there in the audience, and he said to make sure none of these points of view are attributed to RGA. What we tried to do was develop some polarizing points of view. I can be a pretty nice guy, but for the purposes of this discussion, we tried to come up with points of view that would generate some decent discussion out there at the tables. Mike said that these are personal points of view. Not really, but they do represent points of view that a reinsurer can be taking, and I think some of them are fairly well-reasoned.

As far as underwriting goes, Nick touched on some of the issues related to putting rules in the treaty. It's impossible to put the entire underwriting manual in the treaty, but that should be referenced, and the reference should be done at the time the pricing is done. There's a general understanding of what the underwriting is that the company's going be applying to, and those elements should be reviewed and shared in advance and as of the effective date of the agreement. All those things should be known up front and should be agreed upon.

Regarding changes in underwriting, Nick pointed out that there should be a reasonable effort to get the reinsurer to approve them, but I think the reinsurer should have some options on what it does, and there should be enough time to change so that if the reinsurer doesn't want to accept the new rules, it doesn't have to. Some companies might say that if they're not material, they don't need to be reviewed by the reinsurer. However, the reinsurer should be the final arbiter of what's material or not, and it should be able to have those opinions heard. If it doesn't want to take the risk under these new underwriting guidelines, it shouldn't have to.

When the ceding company isn't following the rules, and I've heard them called everything, including exceptions, judgment, business decision, wiggle room, errors, mistakes and deviations, it means that the ceding company didn't follow the rules that were understood at the time the pricing was done. These shouldn't be the reinsurer's risk. It sounds reasonable to say that if they're infrequent and not severe, the reinsurer will take them, and that typically has been the case where the reinsurer will take them extra-contractually, but it needs to be understood that it's not obligated to take them because there's no point where you can truly draw the line and say, "If it's one, maybe so. If it's five, okay. If it's 10, if it's 20, if it's 50 or if they're putting impaired risks into the pool and calling them preferred, and it's a mistake," if the contract states that they're not covered, they're not covered, and

the ceding company should make the extra effort to make sure that its underwriting is appropriate.

If an exception is warranted, as Nick mentioned, where you look at the whole case, and it should be preferred, but one of the guidelines doesn't fit, you have a few choices. You could retain the case, you can submit it facultatively or you can again pay the reinsurer the tabled rate. It's not a question of the reinsurer's being unreasonable. The reinsurer simply wants the rules to be applied as it originally priced them.

MR. SIMONELLI: The next topic is claims, and we'll ask whether the reinsurer should be participating in the decision on contestable claims. We want to minimize the disruption in our claims process. Our examiners want to make a decision and communicate it to the claimant. In addition, state unfair claim settlement practices laws require us to communicate our decision within a specific period of time. The SEC seven-day rule does the same for registered products. We prefer to limit the situations where the reinsurer advises us as to whether we should pay or deny the claim to cases where the reinsurer's share of the claim is at least $1 million. If the reinsurer's share is greater, we must limit the amount of time that the reinsurer has to provide advice. I want to emphasize that this applies to advice and not to a decision about opting out of a contest of a claim. We would allow the reinsurer more time to decide whether to opt out of a contest of a claim. If the reinsurer participates in a contest of a claim and therefore can benefit from the positive outcome, it should share in the legal expenses, damages and awards in the event of a negative outcome. I have a brief word about claim proofs. We prefer to limit the situations where we must provide claim proofs to those cases where the reinsurer's share is greater than or equal to $1 million.

MR. STEIN: Reinsurers are looking at claim files not just to make sure that the claim should be paid properly but to also make sure that the coverage is theirs. Examples where the case is submitted to the reinsurer inaccurately include a continuation from a prior cover where the case was somebody else's, from an original term contract, for example, converted to a permanent product that should stay with the original term writers. You can get that information only when you request all the information related to the insured. In addition, the reinsurer may be looking at the underwriting to make sure that it was compliant with the original terms that were in place when the agreement was entered into. The reinsurer must be able to review all the claim and policyholder information to determine the eligibility.

Furthermore, and this is important, the reinsurer frequently has the larger share of the death benefit than the underlying company. With the advent of first-dollar quote share agreements some years ago, it's often the case that the ceding company has a minority share of the claim. The reinsurer has the right to review and advise the ceding company, and I emphasize advise, as Nick did, as to whether the claim is appropriate to be paid or should be contested. However, the reinsurer

isn't making the final decision. As a result of that, it shouldn't have the liability for extra-contractual obligations since it was only advising and not deciding the claim.

As far as the time frames go, we agree it should be allowable by law, but 15 days? If you put it a regular mail, it might not be the right amount of time for the reinsurer to make the determination of whether it's an appropriate claim or not.

MR. SIMONELLI: The next subject is errors and omissions (E&O), and we'll begin by covering the mistakes that should be corrected, at least from the ceding company's point of view. Certain mistakes made by the ceding company in the course of issuing and administering the business should be allowed to be corrected under the E&O provision in the treaty. These include mistakes made by employees and following procedures and systems errors. Specifically, policies erroneously included in or excluded from automatic reinsurance should be allowed to be corrected upon discovery of the error. Mistakes in reinsurance rates that are unrelated to the rating classification of the reinsured policy itself also should be corrected. After a ceding company has identified a problem, sufficient time should be allowed for it to correct the flaw in its systems and procedures. Even after the ceding company has attempted to correct its systems and procedures, sometimes a small percentage of errors might remain. If the ceding company has made a good-faith effort to correct the problems, residual errors should be allowed to be corrected under the E&O provision.

There are some mistakes that I don't think should be corrected. Mistakes in reinsurance rates that are related to the rating classification of the reinsured policy itself should not be corrected. These errors would arise as a result of a mistake made in underwriting. In these cases the error in the policy rating classification cannot be corrected, and we want to keep the reinsurance rating classification consistent with the policy rating classification. Furthermore, it is my view that some underwriting mistakes are going to happen. To the extent that all companies make an occasional mistake, those mistakes are reflected in the experience of the reinsurer and therefore its pricing. Such underwriting mistakes should not be corrected under the E&O provision unless the incidence and severity of the mistakes are beyond an acceptable level.

MR. STEIN: The E&O provision was always intended only to cover reinsurance administrative mistakes. It's not intended to cover errors in underwriting, errors in policyholder administration, errors from acts of agents or late-reported policies and terminations. The intent of it was if one party is harmed, and another party gains an advantage between the parties, the parties should be put back into the place where they would have been otherwise. However, what we found is some companies view change of errors in policyholder administration to be situations where a case was put in inadvertently by an agent, for example, into a standard class, and it should have been a substandard class. There's a situation where both parties are harmed, but you can't correct the error and get both parties back into the position they should have been in. Those sorts of errors shouldn't be covered

under E&O, but I've heard that the follow-the-fortunes provision or whatever that might be says that if the ceding company winds up in this position, the reinsurer should have to go along with it. That's just not the purpose of E&O.

As far as late-reported policies, this is a situation where the reinsurer's doing its best to manage its retention. It's expected that the ceding company would report the sessions within a reasonable time frame. After a period of time the capacity may no longer be available out there. This is a situation where if you wait three years, and you still haven't been notified of a risk, and all of the sudden it pops up, you may have already offered up your capacity to some other insurance companies. While you can offer the capacity on a facultative obligatory basis as a reinsurer, if you don't have the capacity, you just don't have the capacity. In addition, there has to be a time limitation on what the obligations are for the reinsurer to refund premiums on late-notice terminations. Is it reasonable that a reinsurer should have these liabilities outstanding for years as a result of weak administration of the ceding company? I would argue that there should be some limitation, and what's placed here is a three-year limitation for refunds of premiums.

MR. SIMONELLI: Our final topic is recapture, and we'll start with impaired financial strength of the reinsurer. When a ceding company enters into a deal with a reinsurer, it does so in the belief that the reinsurer will meet its obligations over the lifetime of the treaty. It bases this belief on the financial strength of the reinsurer. When a reinsurer enters into a deal with a ceding company, it says to the ceding company that it can count on the reinsurer to meet its future obligations, and it points to its financial strength as a basis for the trust. Just as we would not enter into a deal with a reinsurer with impaired financial strength, we want to be able to get out of a deal if a reinsurer starts out strong and then suffers a significant deterioration in its strength. Significant changes in ratings and surplus are signs that something is wrong and that the reinsurer might not be able to meet all its promises in the future. Waiting until a reinsurer defaults would probably mean the default on several claims and not just one, and this could result in a sizable loss to the ceding company. Therefore, the ceding company should be able to recapture when the reinsurer experiences a significant deterioration in its ratings or surplus.

Regarding change of ownership or control, when we enter into a deal, it is with the expectation that the specific reinsurer will continue to be the reinsurer for the duration of the treaty. We don't want to find ourselves in a situation where our reinsurer is replaced by another company that we would not want to have as a reinsurer in the first place. In addition to a replacement reinsurer that is a significantly weaker counterparty, an example of a change in ownership and control that would concern us would be one to whom we already are overexposed. The ceding company should be able to recapture if it is unwilling to have the replacement reinsurer as a counterparty.

What about misrepresentation, material breach and nonpayment of claims? These issues go to the heart of both parties acting in good faith. In general

misrepresentation and material breach are bases for terminating a contract if the problem can't be remedied. Termination for misrepresentation is more protection for the reinsurer than the ceding company. It is the ceding company that makes the greater share of representations before the deal, things such as product features, underwriting rules and claim practices. It is only fair for the ceding company to have the same right. Recapture for nonpayment of claims is similar to recapture because of a significant deterioration in financial strength ratings and surplus, except that the default is actually occurring. Furthermore, it is the flip side of the provision that allows the reinsurer to terminate reinsurance for nonpayment of premiums by the ceding company.

MR. STEIN: Here's another situation where the ceding company likes to change the rules midstream. Under the current regulatory rules the provision for recapture has to be one way. The reinsurer can't take and exercise an option to force the business back. The recapture would tend to happen only at the worst time and typically would occur only on profitable business from the reinsurer's perspective. I would imagine there'd be a bit of a reluctance to take back the unprofitable business before it's right. It is a long-term relationship. The pricing actuary develops a horizon that's many years out there. If it has an option to recapture early on, the likelihood of recovering acquisition costs can't occur. It's like when you buy a long-term bond. If the ratings of the company change or there's some other change in the financial condition, you cannot expect that the company's going to say you can have your money back because something changed. It's not the way it occurs. You do your underwriting of the reinsurer at the time you enter into the contract, and then you stick with it.

Having changes in the financial condition doesn't mean that the reinsurer hasn't fulfilled any of the obligations. It simply means that there's been a change. It doesn't mean that you have the right to take back the profitable business. Once the reinsurer isn't accommodating the treaties and paying the claims, that's an entirely different issue, but the change in financial condition doesn't in and of itself mean that there's been a default.

Again, the reinsurer cannot force the recapture on these. If it tries to, it means that the treaty isn't compliant, and you don't get a reserve credit. This is going to go one way. In addition, it's important to remember in difficult times a recapture is the last thing a reinsurer wants to do. There might be situations where it's going to have to pay out reserves in cash, and there could be liquidity issues associated with not wanting to do that or not being able to do it. You're simply exaggerating the problems by creating almost a run-on-the bank situation. Furthermore, the reinsurer isn't the last line for a lot of this business. It frequently has some of this business ceded to a retrocessionaire behind it. The reinsurer needs to protect the interests of its retrocessionaire partners in addition to its own.

As far as a material breach or other misrepresentation, I agree that these things should be discussed, and if there is a material breach on the part of a reinsurer—for

example, it's not paying the claims on a timely basis—damages should be awarded. Recapture only coincidentally would be the damages for that breach. It isn't right that future profit is the provision that you have to give up if one claim is perhaps delayed in processing. It seems to be a heavy club. Furthermore, if the business is unprofitable, it's not necessarily in the interest of the ceding company, or of any value, to be taking back the business if the claim isn't paying. That's not much of a club at all at that point. But if there are any material breaches, the parties should get together and discuss them, and these are the situations that our arbitration is supposed to handle. What is the best remedy for damages? Recapture may or may not be it. Rescission may or may not be the proper provision. But simply a recapture club for some sort of a nonpayment of claim isn't appropriate.