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Reinsurance and Tax Developments

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REINSURANCE AND TAX DEVELOPMENTS

MR. MARK M. HOPFINGER: I will address three tax issues within this paper. While these are somewhat technical, they may have a measurable effect on the level of taxes companies will pay. Some of these issues may arise under audit.

The Deficit Reduction Act (DEFRA) of 1984 substantially altered the way life insurance companies are taxed. The three issues I will discuss follow from this Act. A 1987 modification to the code brought us the applicable federal rate (AFR). The AFR compounds the effects of several provisions of DEFRA, increasing the cost of several long-term insurance products. It also compounds the effects of the issues I will discuss.

First I will look at a couple of ways to reflect the cost-of-living adjustment (COLA) benefit in the disabled life reserve calculation. Where COLA benefits are tied to an external index, I recommend that you reflect the COLA assumption as a spread from the valuation interest rate. This has the desirable effect of reducing the excess of statutory over tax reserves.

I will then discuss approaches for recognizing reinsurance in the tax reserve computation, particularly as it relates to individual life insurance contracts.

Finally, I will discuss alternatives for adjusting for deferred and uncollected premiums, with a more lengthy analysis of how it applies to individual life insurance contracts.

COLA Benefits for Disabled Lives

New within the 1984 Act is the requirement to recompute your reserves under rules prescribed in section 807 of the Internal Revenue code. For disability income contracts, this is simply the present value of future payments. With a typical COLA benefit, these future payments increase with the change in the CPI or some other index. There are generally maximum

benefits under these contracts, with both annual and lifetime limits. Guaranteed minimum increases are also found in many contracts.

I see two approaches for projecting future benefit increases. The first is the constant inflation rate assumption. Under this approach, assume the CPI (or other outside index) increases at the same rate for all contracts.

Under the second approach, the inflation rate is a function of the valuation interest rate. The simplest relation to assume is that the inflation rate is the valuation interest rate less a constant spread (the spread approach). This is consistent with the principle underlying much of cash-flow testing that interest rates and inflation rates are related. An important point to recall is that the valuation interest rate is a proxy for the actual earned rate. As such, this assumption better reflects the ability to earn more than inflation.

Regardless of the approach taken, the actual current level of payments should be used as the starting point in making future projections. Contractual minimums and maximums must also be recognized in making reserve calculations.

The description of the approach is important because in computing tax reserves you are supposed to start with your statutory reserves, and make adjustments to reflect the changes in interest rate, morbidity table, and reserve method. If projected benefits are a function of the valuation interest rate, then projected benefits under the federally prescribed reserve (FPR) rules will also be a function of the valuation interest rate. Since disabled life reserves use the interest rate for life insurance contracts, the AFR is generally greater. Thus, under the spread approach, the projected benefit payments for the FPR calculation may be greater than those assumed for the calculation of statutory reserves. (See Mutual Benefit Life Ins. Co. v. Comm., 448 F.2d 1101, 33 AFTR 2d 74-406 (3rd Cir. 1973), cert, den. 419 U.S. 882. In this case, the Court approved the use of additional information in setting reserve levels. Special thanks to Charles Friedstat for pointing this out during the session.)

As an example, consider a $1,000 monthly disability income contract with these COLA benefit provisions. COLA increases are effective on the anniversary of the date of disability. The minimum benefit payable is the original benefit payable at the time of disability increased with 4% interest (compounded annually). The maximum benefit is based on an 8% interest rate. In addition, the lifetime maximum benefit is twice the original benefit, in this case $2,000. COLA increases cease after age 65.

Assume a male with the above contract provisions was disabled October 31, 1990 at age 40. At December 31, 1992, monthly benefit payments are $1,100. The statutory reserve is computed using a 5.5% interest rate while the FPR uses an interest rate of 8.37%. Both reserves are computed using the 1985 Commissioners Individual Disability Table A (CIDA). The tax reserve is the lesser of these amounts, and in this example will equal the FPR. Table 1 shows the reserves computed using both a constant 5% inflation rate and the valuation rate less 2.5%:

TABLE 1

COLA Rate	5.5% Statutory Reserve	8.37% Tax Reserve	Excess Statutory Reserve
5%	$167,059	$129,261	$37,798
2.5% Spread	152,302	132,719	19,583

It should be noted that under the spread approach, the statutory payments assumed quickly approach the minimum required, resulting in an actual spread of only 1.5%. Even so, note the substantial reduction this has on the excess of statutory over tax reserves.

Recognizing Reinsurance in the Tax Reserve Calculation

There are three general approaches for approaching reinsurance reserve credits in the tax reserve process. These are the seriatim, the aggregate, and the separate contract approach.

Under the seriatim, each contract's statutory reserve, FPR, and cash-surrender value is computed recognizing the effect of the reinsurance agreement on each item.

Under the aggregate approach, the tax reserve credit for reinsurance ceded is a function of the statutory reserve credit. This can be based on the ratio of tax to statutory direct reserves, or simply be the actual statutory reinsurance reserve.

Finally, you can treat the reinsurance ceded as a separate life insurance contract, and compute the tax reserve as if you were the assuming company.

DEFRA provides that a comparison be made between three different items before computing the tax reserve under a life insurance contract. Section 807(d)(1) states:

> For purposes of this part (other than section 816), the amount of the life insurance reserves for any contract shall be the greater of:
> (A) the net surrender value of such contract, or
> (B) the reserve determined under paragraph (2).
>
> In no event shall the reserve determined under the preceding sentence for any contract as of any time exceed the amount which would be taken into account with respect to such contract as of such time in determining statutory reserves (as defined in section 809(b)(4)(B).

The reserve determined under paragraph (2) is the FPR. The statutory reserve is the amount set forth in the annual statement, and hence is the net amount after reinsurance reserve credits. The committee reports indicate that consistent assumptions must be used in computing these amounts. Thus, since the statutory reserve is adjusted for reinsurance reserve credits, the contract's FPR must also be reduced by a reserve credit. This credit is computed using the FPR mortality table, interest rate, and method.

The committee reports allow for a certain amount of grouping to be done. Moreover, it may not be a material amount for several companies, and approximate methods such as the aggregate approach should not significantly distort income. Likewise, separate treatment works well in

many cases, especially where there is only one insurance coverage per contract and it is coinsured. However, a strict interpretation of section 807 implies that the seriatim method be used.

The reinsurance treaty types common today are yearly renewable term (YRT) reinsurance, which can be on either a calendar- or policy-year basis, coinsurance, and modified coinsurance. I am ignoring reinsurance treaties such as stop loss that do not reinsure specific mortality risks, but pay off in the event a certain overall mortality level or catastrophic event occurs. These agreements do not result in specific reserve credits against individual contracts. Hence, no reserve adjustment is necessary to reflect these agreements.

Calendar-year YRT treaties do not generate reserve credits. Under modified coinsurance, the ceding company keeps the reserves and takes no reserve credit in the annual statement. Since no statutory reserve credit is taken, no reserve adjustment is required under either of these treaty types.

Policy-year YRT agreements transfer mortality risk under the contract. These treaties generate statutory reserve credits, usually 50% of the YRT net premium computed using the mortality table and interest rate used to compute the direct reserve. In computing the FPR, a similar credit is taken, but using a YRT net premium computed on the basis of the same mortality/morbidity table and interest rate used to recompute the direct reserve. The effect of the agreement on the cash-surrender value must also be considered. Lapse risk is not transferred under YRT treaties. If no part of the reinsurance premium is refundable on lapse of the reinsured contract, then the cash-value floor is unaffected by this amount. Otherwise, reduce the cash-value floor by the amount refundable on lapse.

Under coinsurance agreements, a percentage of both the mortality and lapse risk is transferred under the coverage reinsured. The statutory reserve credit is the direct statutory reserve times the coinsurance percentage of the coverage. The FPR and cash-value floor are also reduced using this same percentage.

Uncollected and Deferred (U&D) Premium Reserve Adjustments

DEFRA added several provisions that govern the level of tax reserves a company may establish. Code section 807(d)(1) referred to previously stated that the tax reserve could not exceed the statutory reserve. In addition, the committee reports make it clear that consistent assumptions must be used in computing the statutory reserve and FPR, which are to be compared. Code section 809(b)(4)(B)(i) provides this definition of statutory reserve:

> Statutory Reserves. -- The term "statutory reserves" means the aggregate amount set forth in the annual statement with respect to items described in section 807(c). Such term does not include any reserve attributable to a deferred and uncollected premium if the establishment of such reserve is not permitted under section 811(c).

Code section 811(c) provides:

> No Double Counting. -- Nothing in this part shall permit a reserve to be established for any item unless the gross amount of premiums or other consideration attributable to such item are required to be included in life insurance gross income.

In the case of life insurance reserves to which the statutory ceiling applies, the ceiling is not the amount shown in the annual statement, but rather that amount adjusted to eliminate reserves associated with premiums excluded from gross income.

The first question to ask is whether an adjustment is required under section 811(c). The committee report states:

> Thus, because deferred and uncollected premiums for a contract do not accrue until paid, the contractual liability related to those premiums may not be recognized until the premiums are taken into income.

This is certainly the case for individual insurance contracts. These contracts have specific provisions that govern nonpayment of scheduled premiums. These contracts actually represent a series of options provided by the insurance company to its policyholders.

Consider the case where the ceding company has collected the direct premiums but has not yet made payment to the reinsurer. The ceding company does not, by the terms of the reinsurance treaty, have the option of not paying the reinsurer. The reinsurer could go to court to compel specific performance according to the terms of the agreement. This differs substantially from the effective option granted to direct purchasers of individual insurance contracts. The ceding company is entitled to a deduction for amounts owed the reinsurer, and no reserve adjustment is required for the unpaid ceded premium. Likewise, the reinsurer must record the due and unpaid premium as income. All events have occurred that fix the reinsurer's right to collect the premium.

A deferred premium on reinsurance ceded would in general not be accruable. The premium is not yet due, and will only be due if the contract is in force on some future date. As of the end of taxable year all events have not yet occurred that fix the reinsurer's right to collect the premium.

Before making an adjustment, it must first be decided whether or not the premium is accruable. In the case of reinsurance, where uncollected premiums refer to amounts owed between companies, the answer depends upon the terms of the reinsurance agreement. In general, these amounts are true receivables and are reported as premium income on the reinsurer's tax return and deducted from the premium income of the ceding company.

U&D Adjustments for Health Insurance

Note that the adjustment to be made is for the reserve attributable to the uncollected or deferred premium. While the premium income adjustment is for the gross amount, assuming the amount is not accruable, the reserve adjustment is not necessarily the corresponding net U&D premium asset.

Let us first consider individual health insurance products, and suppose the reserve held equals the midterminal reserve plus 50% of the modal gross premium. There are no deferred premiums in this case. Whether or not the given modal premium is paid, the midterminal

reserve remains the same. (If more than one modal premium is unpaid, it is possible that the contract's paid-to date falls in the previous calendar year.) The reserve adjustment should be 50% of the modal uncollected premiums removed from statutory income (assuming that no contract has more than one uncollected premium).

For example, suppose a contract is issued September 10, 1992, and has a quarterly premium of $200. At year-end, the December 10 premium is still unpaid. The unearned premium reserve established on the annual statement would be $100. Under two-year full preliminary term, the midterminal reserve would be zero. Thus, by including the $200 in premium income, the statutory income statement shows $100 of net income related to this contract. When computing premium income for the tax return, the $200 uncollected premium is eliminated. The corresponding reserve adjustment should be for only $100, which is the reserve amount established. The tax return will show no income from this contract. This is the same answer that would have occurred had the contract been terminated at year-end, which is clearly the correct answer.

Consider group health insurance, and suppose that reserves are established as the anticipated loss ratio times the gross uncollected premium. Similar to the preceding individual insurance example, the reserve adjustment should be the anticipated loss ratio times the uncollected premium. When the service performs runoff analyses to test for redundant claim reserves on audit, this business and the associated future claims should both be excluded from the analysis.

Unearned premium and unpaid loss reserves are not life insurance reserves within the meaning of 807(c)(1) and hence are not subject to the statutory ceiling requirement. Traditional life insurance contracts, those with guaranteed premiums and cash-value schedules, are subject to the statutory ceiling of 807(d)(1). There are several approaches available for these contracts. Throughout this discussion, assume the company is holding mean reserves for its traditional life contracts.

Seriatim Approaches

As noted earlier, a strict interpretation of 807(d)(1) implies that a seriatim approach be used. The committee reports require that consistent assumptions be used in computing the statutory reserve, FPR, and cash-surrender value. For example, the same paid-to date must be used for all three calculations, and if continuous assumptions are used for statutory reserves, they must also be used for calculating federally prescribed reserves.

Deduct U&D Premium -- One seriatim approach is to deduct the net U&D premium asset from the annual statement statutory reserve. Consistency requires that the associated U&D net premium, computed using the FPR assumptions, be deducted from the mean FPR. Likewise, the mean cash value would be reduced by the corresponding U&D gross premium, if mean cash values are computed using gross premiums. If the mean cash value is computed using the nonforfeiture premium, then the U&D nonforfeiture premium should be deducted from the mean cash value.

A problem with this approach is that the computed values adjusted for U&D premiums can be negative. Consider a one-year term contract issued December 10 with an $11 gross monthly premium. Suppose the statutory and FPR net premiums are $120, or $10 on a monthly basis. The statutory mean reserve will be $60. Eleven monthly premiums are deferred as of year-end, so the statutory deferred net premiums are $110. The adjusted statutory reserve under this method would be negative $50. A negative reserve is not a reasonable answer.

On the other hand, this produces a reasonable answer for other types of traditional insurance contracts. Consider a one-pay whole life insurance contract for $1,000 for which the net single premium is $444 at the beginning of the policy year and $456 at the end. The company allows monthly premiums to be paid of $45. (Another example would be a premium addition rider). For simplicity, assume that the FPR basis is the same as the statutory basis. Also assume that cash values are computed on a mean basis using the gross premiums.

A contract is issued December 10 paying monthly premiums. The prior terminal reserve is 0, the current-year terminal reserve is $456, and the net premium for the year is $444. The end-of-year cash value equals the terminal reserve, and the current-year gross premium equals $540 (12 * $45). At year-end, the deferred net premium for eleven months is $407 (11/12 of $444) and the deferred gross premium is $495 (11 * $45). Table 2 below summarizes the results:

TABLE 2

Mean Reserve	$450	$450	$498
U&D Premium	407	407	495
Adjusted Reserve	43	43	3

The final tax reserve is $43. The net premium collected by year-end is $37. This slightly overstates the reserve for this contract, but is substantially closer than the one-year term example above.

Redefine the Statutory Reserve

In these cases, adjustments for U&D premiums are made by redefining the statutory reserve calculation. The goal is to more closely approximate the true liability on a contract-by-contract basis, and to eliminate negative reserves.

One approach is to recompute the statutory reserve ceiling and the FPR as the midterminal reserve plus one-half of the modal net premium. This approach basically copies the noncancelable accident and health approach, but uses net premiums instead of gross. The cash value is similarly computed using either the modal gross or nonforfeiture premium. When the contract has uncollected premiums, do not add one-half of the modal premium.

This approach has several advantages. First, the computed reserve and cash-surrender values are never negative. Second, for annual premium contracts that have no uncollected premiums, the recomputed statutory reserve ceiling equals the statutory mean reserve reported in the annual statement. Finally, these amounts are relatively easy to calculate.

An approach very similar to the above is to compute the statutory reserve and FPR as interpolated terminal reserves plus the unearned net premium. If there are uncollected premiums on the contract, this computation would be done as of the paid-to date of the contract rather than year-end. The cash value would be computed on an interpolated basis also. This approach has several advantages, also. Again, the statutory reserve ceiling is never negative. The cash-value floor reflects the true surrender value, and the calculated values more accurately reflect the risk on a contract-by-contract basis.

Uncollected Premium Alternative

An alternative for treating contracts with uncollected premiums is to assume conversion to a nonforfeiture option, either reduced paid-up or extended insurance. The maximum of the reserves computed under both nonforfeiture options is another variation that has merit. The arguments are very strong for this approach if the contract is beyond the grace period. A benefit of assuming the reduced paid-up option is that cash values and reserves are equal, eliminating the need to recalculate values on the FPR basis. For permanent business, cash values under the reduced paid-up option continue to increase, resulting in a greater reserves than computing the reserve at the paid-to date would. Finally, it does not produce negative values.

If there is no nonforfeiture value, establish a term reserve for the remaining part of the grace period. You should still be able to establish a reserve for benefits payable should death occur within the grace period.

Aggregate Approaches

Under aggregate approaches, tax reserves are computed assuming all contracts are paid to their next anniversary. From these an aggregate amount is subtracted to adjust for the effect of U&D premiums in the reserve calculation.

One option is to subtract the statutory net U&D premiums. This is the simplest approach. Since statutory net premiums almost always exceed FPR net premiums, the adjusted reserves do not exceed those calculated under more exact methods.

Another approach is subtract the FPR basis U&D net premiums. This approach has less validity since the introduction of the AFR. Tax reserves are seldom equal to the FPR reserves on permanent business. This approach has the effect of overstating adjusted reserves when compared with more exact methods.

A third approach is to compute the ratio of tax to statutory reserves before the U&D premium adjustment. Tax reserves are then reduced by this ratio times the statutory net U&D premiums. This approach has the advantage of reflecting the relationship between statutory and tax reserves.

A fourth option is to split the computed tax reserves into three nonoverlapping groups. The first group would be where the tax reserve equaled the statutory reserve. To get the adjusted tax reserve for this group, subtract the statutory net U&D premium. The second group is where the tax reserve equals the FPR. Subtract the recomputed net U&D premium to get the adjusted tax reserve. The remaining contracts are those with the tax reserve equal to the cash value. For this group, deduct the gross U&D premium (or U&D nonforfeiture premium).

I do not care for any of these aggregate methods, nor for the seriatim approach of subtracting the net U&D premium from the mean reserve. These adjustments subtract the U&D premium, rather than the reserve attributable to the U&D premium. The other seriatim approaches do a better job of eliminating the reserve effect. My preference is for the interpolated terminal plus unearned premium approach. It more accurately reflects the actual risk on a contract-by-contract basis. However, any method that gives rise to a different statutory reserve when there are no U&D premiums will certainly be questioned on audit.

The IRS is just now having to face the statutory reserve ceiling issue in audit. Adjustments for U&D premiums are not the only issue. Reinsurance reserve credits are another issue. So is the incorrect computation of statutory reserves, as well as failure to report reserves. The issue is this: Is the statutory ceiling simply a dollar limitation, or is it intended to be the amount, properly computed, which should have been held? This question will not be answered any time soon.

REINSURANCE AND TAX DEVELOPMENTS

MR. W. DENNIS PEPE: I have been involved in the reinsurance business in one phase or another almost entirely for the last 12 years. I thought that I was fairly expert. Four years ago I would have been afraid to stand before a collection of experts like yourselves and give this talk regarding reinsurance fundamentals; however, the past few years have given me new insights that I want to share. I have been involved with regulators, rehabilitators, liquidators, attorneys, arbitrators, actuaries, and any number of insurance people attempting to solve a variety of reinsurance problems during this time. It is those experiences on which I will report. The "boiler plate" of a treaty is the first consideration.

The reinsurance contract is a contract between equals, and no matter how sincere your intentions, the fact that the other side led you astray is not a defense. If your deal is not clearly documented in writing, the arbitrators will probably find against you.

There have been few regulatory constraints until the last few years about the terms and conditions of a treaty or with whom a treaty may be executed. This is undergoing major change.

Attorneys are frequently aghast when reviewing a "reinsurance contract" because it is typically an outline of an agreement that stipulates that industry practice will prevail. Unfortunately, industry practice is surprisingly diverse, and your heartfelt opinions about practice can be contradicted by another competent source. The Canadian Reinsurance Conference has published a set of standards for reinsurance practices that is an excellent source; but, to do this in the U.S. could be restraint of trade. There are simple steps that can be taken to avoid much of this problem.

Most treaties agree to be bound by arbitration. Interestingly, arbitration is not necessarily a simple or straightforward procedure and can involve as much discovery and formalism as a

court proceeding. Further, if it is in the interest of one party to delay the procedure, not picking an arbitrator is an excellent ploy. Drafting a thoughtful arbitration clause is in all parties' best interest.

Treaties are intended to survive insolvency; however, treaties frequently do not contemplate the insolvency of the reinsurer. Also, the right of offset is increasingly under attack as are rights under trusts and funds on deposit. Every treaty should contain a bilateral offset clause. Further, consider carefully the site of trusts. The conservator in an insolvency is going to first collect any assets available and then consider equity and discharging liabilities.
There are a significant number of legal precedents affecting reinsurance and a good legal counsel is important. The concept of a "gentlemen's agreement" is nice but does not bear serious scrutiny in today's environment.

Until recently, reinsurance contracts could be consummated with anyone with the only concern being that credit for the agreement might be disallowed. Today, things are different as we shall see.

We once could pull risks apart in most any fashion and sell parts to interested parties, even when the industry was arguing that a life insurance contract could not be divided into mortality and savings portions. With an evolving reinsurance market where reinsurance is being considered a commodity, with the Chicago Board of Trade entering the medical reinsurance market, and with a peril like AIDS threatening the industry, flexibility in covering various risks or portions thereof would seem a boon. When the ACLI Sub-Committee on Reinsurance was founded about eight years ago, its first task was to try to educate regulators about life reinsurance. The effort was valiant but not very successful. The conclusion then and now is that the regulators do not understand this business and are fearful that we are pulling one over on them, and so we are facing limitations on our flexibility in setting treaty terms.

Reinsurance in the U.S. has been transacted for at least a century, and the European reinsurers were among the first in the market. Because of this, security for reinsurance was an early issue, and funds withheld and letters of credit were commonly used. They persist today.

The regulators typically only rejected "Credit for Reinsurance" in the case of an unsatisfactory reinsurer and the rules reflected that concern.

The regulators are confused and concerned. Further, there were some deals done in the 1980s that were probably loans rather than reinsurance. We are now "paying the piper" for those excesses.

There is frequent and significant new regulation aimed at stopping a perceived abuse in a short time frame and frequently causing more turmoil than good. As an example, coinsurance/ modified coinsurance treaties have come under attack in the last few years. The real problem the regulators were addressing was elsewhere, but a general misunderstanding caused these treaties to be attacked causing substantial difficulty, uncertainty, and expense for insurers.

Terms of a treaty had never been regulated but now they are being dictated; in fact, intent is sometimes under regulation.

Some states want preapproval of some or all treaties. This process is frequently conducted informally and due process is difficult to obtain.

The valuation actuary's role, as I understand it, could take the place of much of the current regulation. Allowing the proper credit for reinsurance using sound actuarial principals is the goal of most of the regulation and would solve most of the problems. For a ceding company, the valuation actuary should only take credit for liabilities actually transferred. For an assuming company, the valuation actuary should set up the full assumed liabilities. For both, the valuation actuary should assure that the premium is adequate to cover both risk and expenses.

The first regulations were about requirements on the reinsurer so that the insurer could take credit for reinsurance in a state. Being licensed in the state will do it. Being accredited in the state will also do it. The process is more frequent (annually, in some states) but a little less involved than obtaining a license, and some states will not license a company to do reinsurance only.

The word sounds awful but "submission" usually means agreeing that a competent court in the state can have jurisdiction (without giving up rights of appeal or change of jurisdiction) over payment of policy proceeds and that the commissioner or other can accept service of suit. Connecticut has a form in its reinsurance regulation that is both enlightening and helpful on this issue.

The state must have the right to investigate the company's financial status and in a time and place acceptable to it. This is a reasonable requirement.

The company must be licensed in at least one state and file an annual statement and audited statement. These are both reasonable requirements.

At least we know what the NAIC views as a serious amount of cash to be in the reinsurance business. It is $20,000,000 of surplus or approval. The Commissioner keeps a significant amount of authority here.

If accreditation is current, due process is in place, and a notice and a hearing are required before accreditation is pulled. Do not let a clerk forget to file an annual update if one is required because states are reviewing more carefully, and oversights can cause a lot of distractions when they come up.

If a company is subject to "substantially similar regulations" in another state, has enough surplus to be considered serious, and agrees to submit information, the company is reasonably admitted.

Approved by trust is frequently used to admit "foreign reinsurers" including Lloyd's Names. If you are curious about how Lloyd's can write its own policies on a direct basis, review the surplus lines regulations. In any case, these rules are sufficiently arcane as to deserve little mention except that a pool of existing insurers entering the U.S. market must have all been in business for three years. A single insurer is not required to have any experience. I am also curious if the Chicago Board of Trade, upon establishing a $100,000 trust and solvency of its purchasers, could begin trading reinsurance options to individuals using this section.

Since various funds and pools are mandated by law and regulation, such as various assigned risk pools and guarantee funds, credit for participation is allowed under this section.

This is a section that is under scrutiny because a number of off-shore reinsurers are using it. Funds withheld and fund in trust seem acceptable as the funds are visible and, as a trust may be layered with various beneficiaries, it would appear easier than some other approaches. The letter of credit has been in use for centuries but is frequently under review by the state. Unfortunately, when called, some banks have denied payment because the letters were "fraudulently obtained." This has caused the states no little concern.

The rules of trusts are fairly clear. The basic issue is that, if an organization is enabled to act as a fiduciary of a trust, it cannot default on its obligations even in bankruptcy unless it has violated its fiduciary duty and despoiled the trust. I understand that this is a fraud. Hence, the states are relatively liberal in these regulations.

The most important comment about letters of credit is that the number of banks that can provide acceptable letters (see the NAIC list) is very large. If your organization has some banking relationships with non-U.S. banks, sometimes they will provide reasonable cost letters because of the relationship and the reserving requirements to which they are subject. Make sure that your letters are in hand when you file your statement and that they are effective on the "as of date" of your filing.

The question of who is an intermediary used to only be an issue in New York, but the regulations are spreading. There are two categories with very broad definitions, brokers and managers -- the former represent the ceding company (even though frequently compensated by the reinsurer assuming the risk), and the latter accept risk for the reinsurer. There is then a laundry list of who is not an intermediary. This regulation is presently a registration requirement, but it does require the intermediary to be a licensed insurance agent and of good character. It also requires that the intermediary agreements be in writing and minimum contract requirements are stipulated in the regulation. The regulations concerning contractual agreements involving managers are substantial. There are substantial recordkeeping requirements for the intermediary as well as limitations as to how long the intermediary may hold money. All parties to an unauthorized "intermediation" are subject to fine, and if an unauthorized intermediary is handling money, there can be substantial problems if the cash should go astray.

Life and health reinsurance regulation is the outgrowth of California's Regulation 91-10, and it significantly affects all reinsurance agreements with the exceptions stated in this section. While exempting these types of agreements, it does not lessen the valuation actuary's responsibilities in truly stating the company's liabilities before and after reinsurance.

The new words for credit for reinsurance are, "reduce any liability or establish any asset."

This is a laundry list of the conditions under which credit is denied:

1. Inadequate renewal expenses;
2. Reinsurer can take back surplus or assets at own option or upon certain events except termination;
3. Insurer cannot pay back losses except from present and future profits;
4. The contract must remain in place for the duration of the business;
5. All reinsurance premium must come from direct premium;
6. All risks of a contract must transfer, as specified in the regulation;

7. There are significant investment risks (as specified in the regulation) and funds are not transferred to reinsurer or segregated by the insurer;
8. The insurer is holding unsegregated funds for the reinsurer for products other than the following:
    a. Health Insurance (LTC & LTD);
    b. Traditional Permanent (Par and Non-Par);
    c. Adjustable or Indeterminate Premium Permanent; and,
    d. Fixed Premium UL (no dump in); or, the "transfer rate" does not consider actual investment earnings and all realized and unrealized gains and losses;
9. Settlements are not made at least quarterly;
10. Unreasonable representations and warranties; or,
11. The intent or effect is to supply surplus relief on a temporary basis without transferring liabilities.

I will only comment on a few. Regarding item 2, I was taught that if the reinsurer allowed the insurer to retain funds, that was a privilege that could be revoked. This regulation makes it a right, once granted. Item 3 is not unreasonable; the insurer cannot be forced to repay losses except from future profits. I do not understand item 5: the reinsurer cannot require commissions or other unrelated payments from the insurer, but policy fees, underwriting fees, recoveries, and a variety of other "nonpremiums" are equitably shared. I do not believe that the intent is to exclude this. For item 6, the regulation is very specific as to what risks must transfer. In item 7, funds must transfer or be segregated in most cases. In case of a trust, make sure that the beneficiary has rights of approval over transactions in the trust. Many trusts in this context are custodial in nature and the grantor can add, trade, or remove assets from the trust without notice or permission of the beneficiary. The beneficiary is now responsible for gains or losses in the trust. As to item 8, modified coinsurance (and its relatives) is still acceptable for some specified products but the reinsurer must participate in capital gains (or losses) and the "modified coinsurance" transfer rate must be reasonably related to the rate earned by the insurer. The Exhibit II rate including capital gains and losses is given as an example of an acceptable formula. For item 10, representations and warranties are still

important as the industry standard on "due diligence" is substantially less than for an assumption or purchase. Assertions of fact at the time of the effective date as to mortality or morbidity rates, lapse rates, volumes of business in force, status of the assets, etc. still seem to be allowed. Any promises about the future are excluded. An unusual amount of time in discovering inconsistencies, in particular in the face of evidence of inconsistencies, could waive this defense in the case of difficulties. Item 11 seems to be another "intent" regulation, and I do not know what it means.

Statement entries and amendments are so new and broad as to be unclear. The intent seems to require the insurer to explain the effects of any changes and to report it differently in the statement when making the required changes to existing treaties as well as to new treaties involving "old business" (i.e., prior to the effective date of the regulation). Amending an old coinsurance treaty to implement a conversion YRT scale with lower rates could require an explanation and possible special treatment in the statement. Hopefully, if this model is passed in September 1992, its implications will be explained.

The NAIC will probably pass this model regulation in 1992, and states are already rushing to pass regulations about assumptions. It is an area where regulation was needed.

If the company that assumed a block of business from your company is in financial difficulty, in light of a number of court cases, the effectiveness of the transfer could be in doubt. This regulation will help clarify the effectiveness of such transfers but at a significant price. That is that the policyholder has the right to reject the change. For policyholders that reject the change, a reinsurance arrangement ceding all the risks to the assuming company and a "hold harmless" agreement allowing the assuming company to do the administration are possible and will solve most of the day-to-day problems. Unfortunately, the ceding company must still report on the business and remain a party to the policy with all of the incumbent liabilities.

There are now fairly elaborate informational requirements to the policyholder so that an informed decision can be made. As presently drafted, a policyholder has to be informed at least twice, but unless the policyholder says no, the assumption can be made.

The issue gets sticky when there is a policyholder in a state where the assuming company is not licensed. The policyholder is regulated by the state of present residence, so given any block, policyholders are widely dispersed over time. In addition to general regulatory concerns, which should be manageable with "substantially similar" regulation or submission to the rules of the state in question, the issue of coverage by a guarantee fund arises and is not easily resolved.

This draft of a regulation has been around for a while and is a good example of why regulating "intent" is so difficult. There is a perception that companies are willing to lease their licenses to "unlicensed reinsurers" and that is a bad thing. With each draft, the list of exceptions grows. At present, the draft includes reinsuring more than 50% or 75% of a block of business or allowing the reinsurer to underwrite, pay claims, or set reserves as "fronting." The NAIC had intended to enact this draft but encountered such a negative response from the industry that it is being redrafted with a new draft expected this month. In my experience, an insurer who leases its license and pays no more attention to the business it is writing runs substantial risk as case after case demonstrates. However, two parties entering into a joint venture where one party is bringing expertise and another insurance resource is, in my opinion, a good thing. This is one way that product innovations can occur; it is a way that a carrier can issue risks that it normally would reject; and it is a way that the smaller insurers, who must be "niche players" can expand their markets without making a large and speculative investment. Joint ventures should be encouraged because, in my view, they are good for the industry. If the intent of the regulation is to discourage bad management decisions, that is a noble goal but not a feasible outcome.

I hope for some stability and uniformity in the future regulatory environment as hopes for a minimum of regulation is naive; but, I fear that we will see more and more regulations with

continued attempts to regulate our "intent." With federal regulation as highly probable, I suspect that we are in for an even more regulated future.