2002 Valuation Actuary Symposium
September 19–20, 2002
Lake Buena Vista, Florida

Session 3PD
How Safe Is Your Reinsurance Credit?

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Summary: The panelists discuss regulatory and accounting issues that can cause the loss of reinsurance credit; how rating agencies evaluate the quality of reinsurance; what state examiners look for when reviewing reserve credits; how to perform due diligence on reinsurers; how to structure transactions to provide maximum security and special issues associated with international reinsurance.

MR. HENRY K. SULIKOWSKI: When we were asked to put together a presentation on reinsurance some time ago, we thought we'd do something a little bit different. Over the past few years at SOA meetings, we've had panels on uses of reinsurance in a risk and capital management role, problem solving with financial reinsurance, current uses of reinsurance, and subjects like that. These are all important. These topics reflect the growth of the importance of reinsurance at all of our companies. We'd like to discuss how we, as ceding companies (and we're all ceding companies—even reinsurers) can evaluate the security and safety of our ceded reinsurance programs.

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Let's take a look at some statistics. According to NAIC Exhibit 8 and Schedule S data, the average life insurance company today has more than 25 reinsurance treaties in force with more than $55 million of reserve credit. This is both life insurance and annuity reserve credit. The average life reinsurance company has a variety of treaty structures in place, including yearly renewable term reinsurance (YRT), coinsurance, modified coinsurance (modco), and treaties with multiple reinsurers. You likely have reinsurance with professional reinsurers. You may also have reinsurance with other director writers and perhaps even affiliates. Finally, it's likely that some of your treaties from a bygone era display names of companies that younger actuaries at your company wouldn't even recognize. Your newer treaties might reflect reinsurers in exotic locations such as Barbados, Bermuda, or Ireland, and these are reinsurance transactions that your predecessors probably couldn't have imagined. Suffice it to say, reinsurance has dramatically changed over the past 10 years.

I think we're all aware that the amount of life and annuity reinsurance ceded for new policies issued and in-force business has been dramatically increasing for some time now, but take a look at these statistics. They're pretty dramatic. In 1996, life companies took an aggregate statutory reserve credit of $47 billion against gross Exhibit 8 reserves of $1.3 trillion. By 2001, only five years later, reserve credit has more than doubled to $118 billion. During this period, gross Exhibit 8 life and annuity reserves increased by $240 billion industry-wide, with an amazing $71 billion or nearly 30% of this amount reinsured. This is a pretty dramatic number just in the last five years.

Another way to gain a perspective on how significant reinsurance has become is to compare it to capital and surplus. In 1996, the reserve credit of $47 billion equaled 32% of the industry's aggregate capital and surplus. Reserve credit for 2001 has grown to nearly 60% of aggregate capital and surplus, and this number appears to be growing. Remember, this is Exhibit 8 reserve credit only, which doesn't include liabilities from modified coinsurance or other arrangements that do not directly reduce your liabilities. Clearly, given the magnitude of these numbers, the quality of our reinsurance programs has become very important.

I think it's also important to remember that we, as direct writers, remain liable to policyholders regardless of whether amounts recoverable from reinsurance are actually collected. As a result, you need to assess the collectability of future amounts that you expect reinsurers to pay. You also need to assess the degree to which you will be allowed to reflect these future payables on your balance sheet, either in terms of a reduction of your statutory liabilities or an increase in statutory admitted assets. To do so, you will need to perform periodic due diligence on your reinsurers, and you need to assess compliance with applicable regulations, accounting requirements and rating agency standards.

We're very fortunate to have a panel that's well versed in all these areas, and I think we have a good program for you. Our first speaker is Bob Garofalo. Bob is a managing senior financial analyst in the global financial services division of A.M. Best Company. Bob is a member of a team of analysts that specializes in monitoring and evaluating the emerging and complex financial institutions marketplace both domestically and internationally. In addition, Bob covers professional reinsurers. He also oversees and produces A.M. Best analytical reports on companies' financial strength and debt capacity. Bob has written and co-authored articles that have appeared in A.M. Best periodicals and industry journals. Prior to joining Best in December of 1997, Bob was the director of reinsurance for the MONY group.

MR. ROBERT GAROFALO: On behalf of the A.M. Best Company, I'm delighted to participate in this important forum discussing how A.M. Best evaluates reinsurance companies and current issues facing the reinsurance industry. I've divided my presentation into four parts: the application of the A.M. Best rating, the value of the rating, the rating process (which will probably be the top I'll spend the most time on) and market trends.

Over the past decade, and more recently, within the last few years, numerous economic and financial market events have resulted in dramatic and unprecedented attention to the soundness of the world's financial institutions. The insurance industry has been no exception. Whether resulting from specific catastrophe losses or economic events within a country or a region or due to global events like the tragedy of September 11, everyone has become increasingly concerned about the impact that events can have on the financial stability of insurance companies. Given the unique role that they hold in the global economy and given the ever-growing complexity of the financial marketplace, scrutiny about the stability of the reinsurers will only increase.

Although I'll concentrate my comments on the application of our evaluation process, it's important to understand that all the ratings issued by A.M. Best are assigned in accordance with our corporate mission, which is to prevent and detect insurance insolvency. Our perspective is not entirely different from regulators since the focus of our ratings is on the security offered to policyholders. It's also important to understand what a rating is intended to be. A rating is an independent opinion of a company's financial strength and its ability to meet its ongoing obligations. Our focus is clearly on the security of the policyholder.

Let's discuss a 10-year period. There has been a migration of the superior rating, which is the A+ and the A++ ratings. Collectively, the overall financial strength of the industry has moved down, and now it lies within the A/A- range. We currently have a negative outlook on that.

As a result of our ratings coverage, A.M. Best has tried to leverage this information to provide better insights about insurance company financial security to the marketplace. Since we are a rating agency, one of the major factors we evaluate is the predictive value of our ratings. The company impairments follow a similar distribution to what you would expect to see with corporate bond defaults. Companies receiving our highest ratings have a much lower incident of insolvency than companies at the lower end of the scale.

One interesting point is that the companies that do not participate in the rating process have a much higher rate of failure than companies who do. This is not a public service announcement. It just seems to be reality from what the data says. In fact, the failure rate of companies that do not have ratings is consistent with that of our vulnerable rating classifications or noninvestment grade. In addition, as we've updated the study, we don't find the cause of insolvencies materially different from year to year.

Let's get into the reasons for some of the insolvencies. What is more interesting to everyone is the nature or the causes of these insolvencies. Although we could probably argue that any insolvency can simply be blamed on the failure of management to execute, there are common causes of insurance company failures, and I'll just try to highlight one or two of them. Deficiency in reserving or inadequate pricing seems to be the leading cause. That's kind of what the data indicates. This factor is much more common in non-life companies than in life, but clearly the issue about pricing the business adequately is front and center. In the U.S., companies that do not participate in the rating process account for the second-highest proportion of failures, and that's also represented under miscellaneous as well. This might be more appropriately interpreted that companies that do not provide transparency or full disclosure are at a high risk, and that's really what I want to focus on. You should have an A.M. Best rating, but it's really about transparency.

What and why? What is reinsurance? It's a great tool to help you manage risk. It's something that has really gained a lot more interest. It's being utilized a lot more frequently over the last five years. Basically it plays an essential role in spreading risk and provides insurers varying degrees of financial stability and flexibility. At A.M. Best, the evaluation approach of reinsurers is analogous to reviewing a derivative contract. Thus, the reinsurer must enter into a reinsurance program or swap that is appropriate relative to its risk/reward profile. The most important part of my presentation that I'm going to focus on is how we evaluate professional reinsurers, and that's clearly what I'm talking about when I talk about how we evaluate reinsurers. These are professional reinsurers, special purpose companies, or reinsurers that focus in on block deals, financial reinsurers, retrocessionaires, companies that are joint ventures, and affiliates.

Recognizing that reinsurance is clearly a global business, the process at A.M. Best starts by considering the company's level of disclosure, the accounting environment that it operates in, and its financial reporting. Sovereign risk refers to the regulatory environment that it operates in, and the overall macro environmental conditions in that marketplace. It's a real challenge. The market leaders, Swiss Re and Munich, are not U.S. companies; they're European companies. It's a real challenge to make sure you understand the different accounting standards that are utilized,

and one of our greatest challenges or hurdles to overcome is the differences. We have people who really try to understand the different standards and try to interpret what they mean.
The evaluation process involves both a top-down and bottom-up analysis of financial strength, operating performance, and any other factors that could affect an organization's ability to provide security to its policyholders. This involves a comprehensive review of all significant operating units as well as an enterprise analysis of the entire organization and/or holding company structure. So it's not just an operating company focus. The analysis is conducted by teams focused on specific industry segments and geographic regions. Financial results are compared to or benchmarked against appropriate peers. The interactive process is exactly that. One of the most important things that we value is that all of our ratings are interactive and involve an ongoing interactive dialogue with the managements of companies we rate. Ultimately, the process is based on multiple quantitative and qualitative variables. So it's not just black box with quantitative ratios and statistics. It's really about what they all tell you when you bring them all together. They do tell a story. One of the valuable aspects of our job is that we can see the whole industry.

The most general way to explain the analytical process is that it begins with an assessment of balance sheet strength. This is essentially a balance sheet oriented analysis designed to identify how volatile an organization's net worth might be. We see the potential changes on either side of the balance sheet with the assets and liabilities. We use operating performance as a second way to look at companies or an analysis process. It is much more of a profit and loss orientation or a going-concern analysis. It focuses on sources and volatility of earnings and capital generation. Finally, the third leg of the stool, as we like to call it at A.M. Best, is business profile. This is more of a qualitative assessment of any number of factors that could affect an organization's future performance and financial strength. Over time, as we progress through the rating scale, these elements tend to differentiate rating categories.

In order to provide a sound basis for our analysis, the process requires a significant amount of information to digest. We rely on public and private information, and it involves extensive interactions with senior management. As a rating agency, we are not regulators or auditors. However, we make extensive use of financial documents filed in accordance with regulatory guidelines. It is validated by external parties and auditors. We also utilize reserve adequacy reports and documents prepared by outside actuaries and consultants. I'm sure everyone is familiar with our supplemental rating questionnaire (SRQ). It's kind of painful for some and not so painful for others. It's a valuable tool. It gathers a lot of information that gets plugged into our capital model, and it's used in our analysis.

Let's discuss uses of reinsurance. Reinsurance is such a flexible tool. There are many ways to manage risk and spread risk. The management of risk is a crucial need for insurers and reinsurers. Therefore, A.M. Best focuses on the application of reinsurance and how much risk is accumulated in the various programs. There is financial, risk transfer, nonproportional, retrocession, and assumption, but our analysis begins with discussing and understanding a reinsurer, its cedents, where the reinsurer is getting business from, any retros that it's ceding business to, and how it's getting the business. Structure of risk is probably where we spend a lot of time. We're trying to understand the structure of the risk and how it's being managed. We also look at underwriting controls and data. How accurate, valid, and current are the data that they're getting from the ceding companies that they're utilizing?

Financial reinsurance is a versatile tool, and the application of it is almost endless. At least that's how we see it. You can be very creative. It's probably the hardest structure to analyze at A.M. Best when it comes to reinsurance. I used a continuum to assess where the risk is on the capacity that's being provided with it. Some of the problems include that it's used to help companies manage internal rates of return, prove GAAP return on capital, relieve acquisition strain, mitigate RBC strain for capital allocation, and for mergers and acquisitions. Thus, we usually ask reinsurers to provide information on the risk characteristics of the capital capacity being provided.

I'd like to give you insights into the key measures we use to analyze reinsurers. We look at operating performance in many ways. We place a great deal of emphasis on understanding the overall business risks written by the company, as well as each line of business. We divide it into the different groups: life, annuity, and accident and health. That's generally the approach we take when we try to understand the structures that are involved there. In life insurance, we review mortality performance, actual versus projected, and persistency to see how that's emerging. We look at the results and what it's saying. We try to also understand whether it's quota share, excessive loss, and the structure. For annuity reinsurance or asset base, we look at spreads or guarantees. If it's on a funds-withheld basis, we review the asset manager that's managing the funds. We try to look through the structure, and observe the asset quality and the application to an underwriting policy statement?

In A&H, we look at typical things like combined ratios and how it's sourced. Any number of breakouts provide insights into the sources and stability of underwriting profits. Most reinsurers, or at least those that are not in the traditional risk transfer business, look at underwriting performance to be the core source of earnings. We look at underwriting to be the core source of earnings and capital generation, including the evaluation of investment performance. Other measures of profitability also include pre-tax earnings to net premiums, which is more for A&H companies and those with a PC focus. There is return on capital shown as a total and by line of business. Most importantly, we like to see earnings that are consistent with pricing objectives and whether these earnings are volatile, stable or improving.

Capitalization holds a critical role in the rating process. We conduct a comprehensive review of capital adequacy using our best capital adequacy ratio (BCAR) or our proprietary capital adequacy model. While our model provides insights into capitalization at an operating level, we also review financial leverage that exists at any level of the organization, including holding companies and intermediate holding companies. Our evaluation of current capitalization and potential volatility of capital in the future does account for the use of retrocessional reinsurance in order to manage risk. However, we also factor in the quality of the companies providing retrocessional coverage as well as dependency on retrocessional programs to provide capacity as part of this evaluation.

Liquidity is probably the other issue that's extremely important. You might call it potential calls on liquidity. That's really our approach, and we try to understand how it can have a major impact on capital and, therefore, financial stability. In this area, we analyze the composition and quality of a company's asset portfolio, liability structure, stability of cash flows, and potential calls on cash and any other internal sources of liquidity, including collateral. An additional consideration is whether there is any parental support, especially since many large reinsurers are global and a part of larger PC organizations as well.

Business profile. As mentioned, our analysis cannot focus only on past performance. We need to consider future stability. As a result, we evaluate a number of factors that might influence the level of stability of future earnings and capital generation. This includes the company's competitive position, legal and regulatory environment, mix of business, economic conditions, and risk management practices.

In addition to some of the key issues already mentioned, our rating analysis of reinsurance also considers the client relationships, namely the quality and diversification of its primary clients, the contract terms and conditions associated with coverages, and, what is most important, the risk management practices, including the control environment, the modeling capabilities, the underwriting standards, and generally the way one thinks about risk within the organization and how that person monitors potential exposures. Finally is the strength and diversification of distribution sources and the alignment of interest between the company and its sources of business. Recognize that the majority of the business and the life reinsurance is sourced directly by the companies and is not a distribution channel, but there can be brokers.

Reinsurance is a global business, as I alluded to earlier. As a result, A.M. Best continues to incorporate other techniques into the rating process. Your static ratio analysis starts there. We have our proprietary capital model, which is a risk-based capital approach. We also look at cash-flow analysis, value at risk, simulation, and any simulation testing that's done in a dynamic financial analysis (DFA). So we're really trying to continue to broaden our analysis. We aren't just trying to focus in on statutory data. We look at a whole host of information.

What are the characteristics of highly rated reinsurers? It's reinsurers that tend to offer the greatest stability to policyholders. Since this really is an institutional business, you could also say this about the ceding companies. Those that are highly rated achieve and maintain our highest ratings. They are those that demonstrate vision and leadership, maintain appropriate financial strength and flexibility, and have demonstrated a performance track record that establishes a strong franchise and brand, that operates efficiently and effectively, and that focus in on risk management and profitability. Probably *the* most important issue today is risk management and profitability.

I'll conclude my presentation with a couple of thoughts about the value of ratings and some industry observations. At A.M. Best, we believe very strongly in the regulatory process. We also believe that our services can be of value to the marketplace in general and to regulators in particular. Best ratings differ from the regulatory perspective in that they provide an independent opinion of an insurance company's relative financial strength. Ratings should not be interpreted as an indication of whether policies sold by insurers are good or bad or are suitable for a particular purchaser. Rather, our ratings indicate that A.M. Best has examined and will closely monitor the major areas that affect policyholder security. Over the decades, ratings have proven a useful indicator of pending problems. Companies receiving low or no ratings have a much higher incidence of future problems than companies that value transparency.

As for the future outlook, current market trends should continue to provide reinsurers with opportunities. Given the current state of what's happening with primary companies, they continue to outsource underwriting risk, and they focus in on distribution and asset management. That has been the key throughout most of the 1990s, and it seems to continue today. Frankly, I don't know if companies can return back to taking on more of the risk. We wonder whether there is a chance of turning back. As a result, the current life reinsurance landscape will be impacted by several things, which I'm going to try to highlight here. There is slower organic growth evidenced by flat session rates, which you saw in the SOA survey, when you look at 2000 versus 2001. The industry's digesting a lot of acquisitions. Swiss Re, ERC, ING, Munich and even SCOR has entered the picture. So there's a lot of digestion of acquisitions in the U.S. as companies try to gain more market share and economies of scale.

Merger and acquisition (M&A) activity will be a little bit slower as companies continue to digest these acquisitions. There will be price hardening in the property/casualty market, but the life reinsurance market really hasn't been impacted too much. What might happen is that capital resources are going to be a little bit harder to come by in larger global reinsurance groups. The primary market demand for reinsurance and alternative risk transfer mechanisms will likely put pressure on reinsurance capacity as primary companies evaluate capital management solutions to increase returns. One of the key issues going forward will be companies looking to better manage their risk and look for alternative risk transfer mechanisms because they realize they're exposed. They use modified coinsurance (modco) or structures that are going to be exposed to the reinsurance credit. I think you're going to see a movement towards some alternative risk structures because there's only a finite amount of capital reinsurers.

Finally, the historical trend of profitability of the core life and health businesses with five market leaders are generally sustained, and that would include Swiss Re, Munich, ERC, AEGON, RGA and ING. While the immediate impact of 9-11 was manageable for these companies and the industry (with costs ranging near $1 billion), the lingering aftereffects and the changes in the economic conditions will remain a drag on the industry as a whole. My focus, as one of the lead people analyzing the life reinsurance industry is to focus in on operating performance and where that's going. There are a lot more downgrades than upgrades that you're seeing. You can also lump in that there are more negative outlooks than stable outlooks. Therefore, we have a negative outlook overall on the segment.

MR. SULIKOWSKI: Our next presenter, Hugh McCormick, is a partner in the New York office of LeBoeuf, Lamb, Greene, and MacRae. Hugh advises U.S. and foreign insurance and reinsurance companies on tax, regulatory and corporate matters arising in connection with mergers and acquisitions, demutualization, reinsurance transactions, and insurance products. Hugh is an officer and director of the Insurance Tax Conference and is a member of the board of advisors and contributors to the *Journal of Taxation of Investments*. Huge received his B.A. from the University of Michigan, his J.D. from Rutgers University School of Law, and an L.L.M. in taxation from Georgetown. Hugh, I understand you're currently interested in taking actuarial exams, so I'm sure you can get some good advice from this group.

MR. HUGH T. MCCORMICK: We all came to this meeting to listen to Colin Devine for the purpose of determining whether or not it was worth staying around for the rest of the program. If he said the industry was dead, we were just all going to go home. Fortunately, he gave a much brighter outlook than I think some of us had feared.

I'm going to talk about reinsurance credits from a lawyer's perspective. I'm going to try to talk about issues. We've tried to figure out the level at which we should be approaching this. Is it a sophisticated group or a beginner's group? We came to the conclusion that probably a moderate level of presentation would be appropriate. I'm going to try not to dwell too much on real basics.

We're going to talk about the NAIC credit for reinsurance model law and regulations, and I will deviate into New York law and some other laws from time to time, as appropriate. New York, as you're all aware, is the most difficult and the most aggressive in terms of regulations. So you do have to be familiar with New York law. I'm not going to talk about these other laws, but you should be aware that they exist. We are going to talk later about the life and health reinsurance regulation because there is a specific regulation in effect in 49 of the 50 states that governs the terms of life and health reinsurance regulations. There are also NAIC model laws on reinsurance intermediaries, on assumption reinsurance, and then on securitization vehicles. This is a relatively new law that has been implemented to facilitate this relatively new concept of securitization of blocks of business.

The credit for reinsurance rules play a significant role in the regulation of the insurance industry. For the most part, states doing business laws exempt reinsurers from licensing requirements. If you look at the laws in the various states, you will find a specific exemption for reinsurers in most states. New York and a handful of other states take a somewhat different approach, and I think this might come as a surprise to some of you. In New York, an unlicensed reinsurer is allowed to operate in the state only under the mail order rules. You are not supposed to physically come into the state to solicit, negotiate, and so on. This applies, incidentally, to accredited reinsurers. Accreditation, under New York law, only gives the ceding company the ability to take credit for reinsurance. It does not allow the unauthorized (which is the term in New York) reinsurance company to actually come into the state other than through the mail.

The New York Insurance Department has also taken the position that when they talk about the mail, they're talking about toddling down to the local post office and dropping a letter in the box and waiting the two or three weeks for it to get lost and then misdelivered. They will tell you there is at least one opinion that the Internet, faxes, and things like that are not considered mail. I think it's silly, but that's what the rule says.

I mentioned the Bermuda Triangle issue. You might have heard about this as a tax issue. There has been a movement, particularly in the property/casualty world, for companies to re-domesticate or otherwise set up operations in Bermuda, the Cayman Islands or other offshore jurisdictions because they've discovered the newest "loophole." In Washington, it's a little like the movie *Casablanca:* in which they are shocked that there's gambling going on. They're shocked that you can go to Bermuda and not pay tax. This has been the law probably since Bermuda was created by a volcano millions of years ago. It is not a recent phenomenon. There has been a real drive of U.S.-based insurance and reinsurance operations moving to Bermuda because of the tax advantages.

There are a lot of proposals in Washington right now that they call the antiinversion legislative proposals, but none of them have been implemented as yet. We have seen life reinsurers created in Bermuda and the Cayman Islands. Hank can probably speak to at least one of them. Hampton Re is a Bermuda company. Again, the offshore companies are not subject to any kind of a U.S. regulatory oversight, and if they operate properly, they're generally not subject to the jurisdiction of U.S. courts. They're subject to the jurisdiction of the offshore courts. In this case, the credit for reinsurance rules really are the primary source of regulation of this business.

MR. SULIKOWSKI: Hugh, I would just like to say we have not inverted.

MR. MCCORMICK: I don't think any of the life companies have inverted. Some life companies, if I can mention names like Hampton Re and Scottish and Life & Annuity, were created originally offshore, so they are technically not inverted companies. If you read some of this legislation carefully, you will see that if any of it is implemented, some of the provisions might pick up companies that were not inverted. So you do have to watch the legislation carefully.

Let's discuss the means of obtaining financial statement credit. The NAIC credit for reinsurance rules lay out certain means of a ceding U.S. domestic insurer to obtain credit on its statutory financial statements for reinsurance with various reinsurance companies. If the reinsurer is licensed in the state in which the ceding insurer is licensed, there generally is no problem. That automatically provides credit for reinsurance. Similarly, companies can become accredited as reinsurers in various states without actually subjecting themselves to licensing requirements. The accreditation procedure is a fair amount simpler than becoming licensed. New York makes it fairly painful, but then New York makes everything fairly painful.

If your reinsurer is not licensed or accredited, there is a rule in the credit for reinsurance rules primarily aimed at offshore foreign companies. This is primarily for property/casualty type business. The reinsurer maintains a trust fund that is equal to liabilities of its U.S. ceding insurers plus $20 million. It's $100 million in the case of Lloyd's and other unincorporated pools that there are. There are also rules about submission to the jurisdiction at the U.S. courts and designation of the insurance department as agent for service of process. Lloyd's, for example, which is a huge reinsurer in this market, maintains an enormous trust fund called the Lloyd's American Trust Fund, which we at LeBoeuf actually help administer. I'm not sure how large it is, but it has millions of dollars. These trust funds are used to secure the insurances and the reinsurances that Lloyd's has placed with the U.S. market. I'm not aware of any life companies operating under this particular rule.

A ceding company can cede reinsurance to other unlicensed or accredited reinsurers as long as certain requirements are met. Generally speaking, if the treaty is structured as modco or funds withheld, the ceding company gets credit for reinsurance for the modco reserves or for the amount of funds withheld by the ceding insurer. Those are ways of securing your reinsurance credits kind of on a self-help basis. The other standard way to do it is for the reinsurer to post security in the form of a trust or a letter of credit. The credit is generally the amount equal to the amount secured, and this can get into some things that I've been wrestling within the last few days about different forms of reinsurance and what assets can be maintained at book value and what assets can be maintained at market value.

The NAIC credit for reinsurance requirements focus on market value, whereas if a ceding insurer just held the assets and the liabilities, they can maintain assets at book value. I would suspect in this world of guaranteed minimum death benefit (GMDB) liabilities and in the area of crashing asset values, that there might be some timing issues as to the difference between book and market values. This might create some interesting kinds of timing issues between the reinsurer and the ceding insurer.

Regulation 114 is the New York regulation that basically created this whole world of credit for reinsurance trusts. The NAIC rules are fairly similar to Regulation 114. There are some minor differences but probably nothing of great materiality. There is one place where I have noticed some differences over the years. Regulation 114 lists certain types of assets that could be held in a Regulation 114 trust. We have been told by the New York Insurance Department that, unlike the rules that apply to a general account of an insurance company, the assets that could be held in Regulation 114 trusts are listed as assets permitted under certain provisions of Section 1404, which is a provision that governs property/casualty companies.

Even if it's a life agreement, you're still looking to the legal investment laws applicable to property/casualty companies. Within those classes of assets are generally equities, preferred stock, debt obligations, and governments, and a couple of other types of obligations or investments, all of which are issued by A-rated or better issuers. I believe the NAIC model just talks about cash, CDs, and Standard Valuation Office (SVO) rated admitted assets. Over the years, we've discovered that you can actually do some things in New York that you can't do in other states with assets held by the trust.

The trust must be held by a qualified U.S. financial institution, and the assets are to be held in the United States.

This just goes quickly through some of the terms of the reinsurance trust. We don't need to dwell on these. There are a couple of points that get interesting, though. You raise some interesting questions. You note that the beneficiary has the right to withdraw assets at any time without notice to the grantor. The beneficiary is the ceding insurer. Under the terms of the trust agreement, the ceding insurer has to have the right to pull the assets out of the trust.

There are slightly different rules for life and health agreements and property/casualty type agreements. We're focusing on the rules for life and health agreements. Under the current state of the NAIC regulation, the trust agreement must give the ceding insurer the right to pull the assets, the trust, and the reinsurance agreement together and then put some limitations on the right of the ceding insurer so that the ceding insurer can only pull the assets for the following purposes: to reimburse the ceding insurer for the reinsurer's share of the returned premium, surrenders, benefits, and losses; to pay the assuming insurer for amounts not needed to secure the reinsurance credit (i.e., to pay the reinsurer the excess of amounts in the trust over the required amounts to secure the reinsurance credit); and, to fund unpaid liabilities on termination.

The life and health reinsurance agreement must include all these provisions. In a property/casualty agreement, they can be in the trust. In a life and health agreement, they have to be in the reinsurance agreement. Why the distinction? It's just historic to Regulation 114 or to the New York rules. They don't make much sense to me, but that is the way things have been done since Bermuda was a volcano.

The reinsurer can request substitution of assets or can request withdrawal assets not in excess of 102% of reserves. The ceding insurer is not supposed to unreasonably withhold its consent to such withdrawals. You have to keep the trust on a quarterly basis marked to at least 102% of reserves if money is going in and out. The reinsurer can be allowed to take money out of trust with the consent of the ceding insurer to the extent that the trust is, in essence, overfunded. It's important to keep in mind that this is a market-value analysis; it is market value of assets compared to the stated value of liabilities.

There's an interesting wrinkle, though, in some of the states. New York and some of these states have a fourth withdrawal. I said earlier that they had those three conditions under which the ceding insurer can withdraw the assets. In New York and in certain other states, the tag line to those rules is to pay any other amounts the ceding insurer claims are due. This is where you look at the rights of the ceding insurer or, worse yet, the ceding insurer's rehabilitator or liquidator and say, when can he get the money out of trust? You look at a provision in the following way. Whatever can a rogue rehabilitator look to pull assets out of trust? Paying any other amounts the ceding insurer claims are due is, in my opinion, a hunting license for a regulation rehabilitator. It's something you need to be thoughtful about. The various parties do a reinsurance agreement. When are these assets drawable? When are these assets secure? What can a state insurance department do to get to assets?

Reinsurance credit can also be funded with letters of credit issued by qualified U.S. financial institutions. The letters of credit have to meet certain requirements. Again, it's a market value. The letter of credit is pegged to the market value of the liability or, if you will, the stated value of the liability.

In order to qualify, reinsurance agreements have to meet certain other requirements. They must have the standard insolvency clause that payments, in the event of an insolvency of the ceding insurer, will be made to the rehabilitator, the ceding insurer, or the liquidator without diminution because of the inability of the ceding insurer to pay its underlying claims. This actually goes back to a New York case in the 1930s in which a reinsurance company successfully argued that my cedant was insolvent. It didn't pay anything. Therefore, mine's a contract of indemnity. I don't have to pay anything. The courts said, gee, you're right. That's the way the contract works and off you go. I've forgotten the name of the case, but it was very interesting. As a result, I believe all 50 state insurance laws state that the reinsurer must pay without diminution because of the insolvency of the ceding insurer.

Under the NAIC rules, the reinsurer must also submit to a jurisdiction of a court or of an arbitration panel and contractually agree to comply with the judgment of the panel. That is not a uniform rule in all states, and some offshore reinsurers have taken the position, over the years, that they cannot submit to jurisdiction because it would raise a tax issue; that is whether they are engaged in a trade or business in the United States. It might give the Internal Revenue Service a claim that they're doing business in the United States for tax purposes. We, at LeBoeuf, have taken the position that that's just not a valid concern, but other firms say that it is.

Rights in insolvency. State insurance laws are paramount. The federal bankruptcy laws do not apply to insurance companies. Insurance companies are, if you will, defined out of the term debtor, and only debtors are eligible for reorganization or liquidation under the U.S. bankruptcy code. What this does is it throws the insolvency of an insurance company back into the laws of the state in which the company is domiciled. The state insurance regulator has the right, under local law, to impose supervision, conservation, rehabilitation, and liquidation as the situation requires. Many states have laws that are just supervision or conservation as an administrative procedure, and they do not have to go into court. It's kind of a consent agreement with the insurance company. It's step one in the process of taking over a company that the state insurance department believes is impaired. You will see this arise when there is a noninsurance parent that goes into insolvency. I'm reminded of the Baldwin/United situation of the early 1980s, but it has happened periodically since then.

When a parent company goes into federal bankruptcy, the state insurance department has the right to step in and impose an order of supervision. The federal bankruptcy court has no jurisdiction over the insurance company, and even though the bankruptcy of the parent might not have a significant financial impact on the subsidiary, the state has the right to step in. Again, it's a consent order, but it's really imposed. The consent is given after the thumbscrews are applied. It controls things like dividend payments and things between the insurance company and other members of its control group. Then the insurance department can prevent payment of dividends and perhaps limit payments on surplus notes. They cannot restructure policies. They can't limit payments to policyholders or those kinds of things. That can only be done after there is an implementation of an order of supervision. There can be a temporary freeze on things like that under a supervision, but you really have to affect the rights of a policyholder or of a counterparty to a reinsurance agreement. The state insurance department would have to go into court, obtain a court order of rehabilitation, liquidation, or whatever is appropriate.

Can a receiver terminate agreements unilaterally? There is case law to support that a reinsurer has certain rights. When the insolvency begins, they can either agree to abide by the contract and take it with its benefits and burdens or they can reject the contract. There is case law that supports that concept. Can the receiver amend the contract? We litigated that on behalf of Guardian in the Crawford vs. Guardian Life case in Oklahoma many years ago. The lower courts in Oklahoma were receptive to many strange views, but the Supreme Court of Oklahoma ruled that a receiver cannot just willy-nilly amend a reinsurance contract to read out offset clauses and provisions like that.

Can a ceding insurer terminate a treaty with an insolvent reinsurer? Generally, yes. You have to look to the terms of the treaty, but, generally it can. Under risk transfer rules, a reinsurer can terminate only if there is a breach of the agreement. A reinsurer is not unilaterally allowed to terminate a treaty. The next speaker will talk a little bit more about some of those rules.

When can a ceding insurer draw trust assets from the reinsurance trust? That goes back to any other claim the rehabilitator can come up with. Can a draw be blocked by a receiver of the reinsurer? There has been some litigation in this area, and there have been a handful of courts that have been willing to issue orders forcing assets to be left in the trust until the purpose for withdrawing the assets can be established. Do offset or recruitment rights apply? This can be important both to a reinsurer and to a ceding insurer.

In the case of insolvency, the broader rule is that if the contract has offset rights, net accounting rights, or recoupment rights, those will be upheld. I mentioned Midland Insurance Company. There’s case law in New York, case law in California, federal case law in Illinois, and cases in a number of other states that support offset rights without limitation. There is one case at the Pennsylvania Supreme Court level, the Mutual Fire, Marine, and Indemnity Insurance Company case, in which the courts basically said the receiver has a fairly free hand to do what he considers to be just and equal.

What is an insurer to do? You look at the various forms of the treaty under the various state laws, and you try to figure out what your rights are under these different forms of treaties. What are your offset rights? What are your protections? What is your security? Is it modco or co-modco where the ceding commission is provided by coinsurance, and the rest of the treaty is modco? If you're the reinsurer, you have to look at what your relative rights are on the insolvency of the ceding insurer. I'll also go back to a point I think that Hank raised earlier. The important thing is perform due diligence on your counterparty. It's important to know with whom you're going into business. The security devices are wonderful; they work fairly well, but they're not necessarily foolproof. You really do need to know with whom you're doing business.

As a final note, I don't know how far to go with securitization versus traditional reinsurance. The developing world of securitization is a very, very interesting world. There have been a couple of transactions. The MONY closed block and the Prudential closed block securitization transactions allow for monitization of embedded values. It may very well be that investment bankers are now in the process of telling some of their clients that securitization might be a more efficient way to monitize your assets. Going to the capital markets with the value of an in-force book of business as opposed to going to the reinsurance market with a book of in-force business, might be a more efficient way to raise capital right now. It's a developing world, and it's something that at least the investment bankers like. I've been working with Goldman recently on some securitization ideas, and they think that there is real value there. On that note, I will turn it over, and we're going to talk about some more regulatory issues.

MR. SULIKOWSKI: When we put together the concept for this panel we thought it was very important to have someone from the regulatory community participate, and we're very lucky to have Laurie Pleus with us. Laurie has been a reinsurance examiner with the Missouri Department of Insurance since December of 1993. She is responsible for the review of reinsurance contracts and material transactions, and she provides assistance to Missouri field examiners as they work on insurance company examinations. Prior to joining the Missouri Insurance Department, Laurie was a senior reinsurance analyst with the ITT Lyndon Insurance Group in St. Louis where she was involved in financial reporting and planning roles related to their reinsurance operations. She's a member of the American Institute of Certified Public Accountants and also the Missouri State Society of CPAs.

MS. LAURIE PLEUS: I appreciate the opportunity to speak to the Society of Actuaries on what state examiners look for when reviewing reinsurance credits. The specific items that I'll be covering today are the NAIC credit for reinsurance model law, the NAIC life and health reinsurance agreements model regulation, including Appendix A-791, and the life reinsurance examination procedures contained in the NAIC Financial Examiner's Handbook.

Hugh has covered the credit for reinsurance model law in quite a bit of detail, so I won't spend a lot of time on it, but this model law is perhaps the most significant way in which reinsurance is regulated because it restricts when and to what extent a ceding company may take financial statement credit for reinsurance. It looks at the licensing status of the reinsurer and the ceding company's state of domicile. If the reinsurer is licensed or accredited as a reinsurer, it is considered to be authorized. If it doesn't satisfy this authorized status, the reinsurer must agree in the reinsurance contract to provide security to the ceding company in order for the ceding company to recognize the financial benefit of the reinsurance. When the reinsurance company is unauthorized, the reinsurance contract must also contain a service of suit provision whereby the reinsurer agrees to submit to the jurisdiction of a U.S. court, and it must agree to designate the director as its agent for service process.

As a condition for credit for reinsurance, state examiners also review reinsurance contracts to determine the existence of a proper insolvency clause. This clause basically defines what the reinsurer's obligations are to the insolvent ceding company's estate when it becomes financially impaired or insolvent. The regulator with principal interest in the wording of this clause is the domestic regulator of the ceding company. Each state might have their own variation of this wording, but the general requirement, as Hugh mentioned, is that the reinsurance proceeds must be payable to the insolvent ceding company or its statutory successor on the basis of liability of the ceding company without diminution because of the ceding company's insolvency.

The underlying intent of the life and health reinsurance agreements regulation is to ensure that a company's financial condition is appropriately stated and is not distorted by artificially enhancing surplus through reinsurance arrangements that do not fully transfer risk to the reinsurer. This model was developed or first adopted by the NAIC in 1985, and an updated version was adopted in 1992. Since it's an NAIC accreditation requirement, I believe almost all states have adopted this model. The evaluation of risk transfer in life reinsurance is quite different than it is for property and casualty (P&C) reinsurance. The term is used to define whether and to what extent a particular reinsurance transaction should result in a reduction of the ceding company's liability or the establishment of an asset in its statutory financial statements.

The model defines transfer of risk in terms of all of the significant risk inherent in the business reinsured and does not address probability of loss to the reinsurer as is done in P&C reinsurance. The important concept is whether the ceding company is establishing a liability net of reinsurance credit appropriate to its future obligations net of reinsurance recoveries. The model defines significant risk with reference to a table of risk and contract types. Any contracts that do not contain any of the conditions described are allowed reinsurance accounting treatment.

The life and health reinsurance agreements model regulation applies to all life and health indemnity reinsurance agreements, but it excludes yearly renewable term (YRT), nonproportional, and assumption transactions because these types of arrangements do not typically result in significant surplus aid to the ceding company. The regulation requires the ceding company to make a post-execution notification filing requirement of any contract that involves the reinsurance of a business issued prior to the effective date of the contract. Such contracts reinsuring in-force business must be filed with the ceding company's domestic regulator within 30 days of their execution. The regulation imposes standards on ceding companies only and gives authority to the ceding company's regulator to deny credit for any noncompliant agreements. Both parties must sign the contract by the "as-of" date on the financial statement, and in the case of a letter of intent, a reinsurance agreement must be executed within a reasonable period of time, not exceeding 90 days from the execution date of the letter of intent, in order for the ceding company to take financial statement credit.

The regulation also requires that life reinsurance agreements contain an entire agreement clause stating that there are no understandings between the parties other than those expressed in the agreement. The regulation specifically prohibits side agreements. Section (4)C(2) of the model mandates a specific accounting and reporting requirement that applies to the reinsurance of in-force blocks of business. Any statutory gain resulting from the reinsurance of in-force business at the inception of the contract is not to be reflected in the income statement. Instead, the increase in surplus is posted as an adjustment to the balance sheet at the inception of the contract, and the income statement impact is amortized over future years as profits emerge on the reinsurance block. This is sometimes referred to as below-the-line accounting treatment because the surplus enhancement on the ceding company's books is shown on an after-tax basis in its income statement. The model provides an example of how this accounting treatment is to be reported in the ceding company's financial statement.

Section 4A of this model sets out the risk transfer rules. During the Financial Reporting for Reinsurance Seminar held in conjunction with this symposium, these requirements were referred to as the 11 Commandments or the Thou Shalt Nots of Reinsurance, which I think is a very good description. Contracts that do not contain any of these conditions described in this section are allowed reinsurance accounting treatment. The first requirement is that the renewal expense allowances paid by the reinsurer to the ceding company must be sufficient to cover the actual expenses incurred by the ceding company in producing the business. This requirement implements the purpose of the regulation by providing credit for reinsurance where the ceding company is afforded a large ceding commission at inception of the contract only to have that surplus increase drained away in future periods because the reinsurer is not paying the ceding company sufficient renewal expense allowances. These expenses include commissions, underwriting cost, premium taxes, and the cost of administering the business. If all of the expenses the ceding company used in pricing the product are included within the terms of the reinsurance agreement, this will generally be acceptable and be considered to meet this requirement.

The second accounting requirement provides that the ceding company cannot be deprived of surplus at the reinsurer's option or automatically upon the occurrence of some event such as the insolvency of the ceding company. What this means is that the reinsurance must be permanent or within the control of the ceding company to keep permanent. The usual effect of this requirement is that the reinsurer should have no right to terminate the agreement other than for nonpayment of premiums or other amounts due to the reinsurer. A reinsurance agreement cannot contain a provision, for example, that says the agreement will terminate in the event that the ceding company becomes insolvent.

Under the third accounting requirement, the ceding company cannot be required to reimburse the reinsurer for a negative experience refund. However, if the ceding company wants to voluntarily terminate the in-force business, offsetting experience refunds against current and prior losses and the payment by the ceding company to the reinsurer of that amount are not considered to be a violation of this requirement. Voluntary termination does not include situations where the termination occurs because of unreasonable provisions in the reinsurance agreement that allow the reinsurer to reduce its risk. An example of this is the right of the reinsurer to increase reinsurance premiums or expense and risk charges to excessive levels forcing the ceding company to prematurely terminate the agreement.

The fourth accounting requirement says that the ceding company cannot be required to terminate or automatically recapture, at specific points in time that are scheduled in the agreement, all or part of the reinsurance. The next requirement prohibits the ceding company from making payments to the reinsurer other than from income realized from the reinsured policies. What this means is that the reinsurance agreement cannot contain any provisions that would require the ceding company to make payments for which it is not fully reimbursed. An example of this would be an instance where the contract could not contain a provision that forces the ceding company to pay a larger interest rate under a modco agreement than what the ceding company actually earns on those assets. Another situation would be when a ceding company would be required to pay reinsurance premiums, which are greater than the direct premiums that were collected by the ceding company. That would be considered to be a violation of that requirement.

Accounting Requirement (4)A(6) of the regulation contains a product matrix table, which is very important in terms of identification of the risk related to certain products. Section (4)A(7) says that credit for reinsurance of investment-oriented products is permitted only if investment risk is transferred to the reinsurer. This is accomplished by coinsurance whereby assets are physically transferred to the reinsurance company. Alternatively, funds may be retained by the ceding company under modco or funds-withheld structures. However, there is a formula included in this section of the regulation that must be followed in determining the reinsurer's investment earnings on those assets retained by the ceding company. If a fixed premium or permanent life insurance product is being reinsured, however, the regulation says that investment risk is still significant, but the risk or investment risk transfer requirement may still be satisfied by using that portfolio rate, including capital gains and losses of the ceding company. The model defines how that portfolio rate is to be calculated.

The eighth accounting requirement says that cash settlements between the ceding company and the reinsurer must be made at least on a quarterly basis. Any amounts received from the reinsurance company are nonadmitted if not paid within 90 days. Sections (4)A(9) and (4)A(10) of the regulation provide that the ceding company cannot be required to make representations about the future of the business reinsured. For example, a reinsurance agreement could not contain a provision that says if, after 10 years, the annual lapse experience on the block is worse than 10% per year, the ceding company will somehow reimburse the reinsurer for that poor experience. These requirements don't prohibit any types of disclosures or sharing of information between the ceding company and the reinsurer, but they do prevent the ceding company from guaranteeing any of the experience on the block of business.

Appendix A-791 is a question-and-answer document that was developed by the Life and Health Actuarial Task Force Reinsurance Working Group. For some background information on this document, a set of questions and answers (Q&As) were developed by the Life and Health Actuarial Task Force, which I believe was referred to as Actuarial Guideline JJJ. It was developed in 1995, but was never adopted because of some controversial items such as, segregation of assets, conversion to coinsurance, YRT exemption, and modco funds withheld. These Q&As were revised in 1999, and they were adopted as Appendix A-791 in the year 2001. If anyone has any specific questions about this appendix, we can take questions at the end of the session.

The next thing that I'm going to talk about is the life reinsurance examination procedures contained in the NAIC financial examiner's handbook. We utilize these procedures in Missouri, but we do tailor them to address specific statutory requirements in our state. Overall, the handbook provides a guide to assist state insurance departments in establishing and operating an effective examination system. The basic purpose of an examination system is to detect, as early as possible, those insurers in financial trouble and/or those who are engaging in unlawful and improper activities. It's purpose is also to develop the information needed for timely, appropriate, regulatory action.

The audit objective of an exam of a company's financial statement accounts that are affected by reinsurance is to determine that reinsurance contracts effectively transfer risk and contain provisions that are mandated by regulation. Another objective is that reinsurance assumed is properly authorized, valued, and recorded, and that amounts of reinsurance ceded are properly reflected in the financial statements. As part of the examiner's overall risk assessment of a company's reinsurance program, an evaluation of the likelihood of a material adjustment to surplus based on the following criteria (rated as high, medium, or low) is made for significant financial statement line items of the ceding company's balance sheet and income statement that are affected by reinsurance. These include amounts recoverable from reinsurers, reinsurance in unauthorized companies, commission and expense allowances due, and funds held under reinsurance treaties.

The examination procedures included in the handbook include examples of procedures commonly used. It is important to note, though, that the actual procedures selected to be performed is a matter of considerable judgment for the examiner. Such judgment includes, among many other factors, the application of those principles and concepts to exams of small companies, specialized insurers, and multiple company groups within consolidated accounting systems. To the extent that the examiner judgmentally determines whether it is appropriate to use these procedures, that selection is documented by checking the space next to such procedure with modifications noted in the margin, if any. The examiner might also determine that alternative or additional procedures are required.

General procedures regarding a company's reinsurance program include the examiner's documentation of the company's maximum reinsurance coverage provided by the ceding program, the maximum retained liability, pricing and ceding commission information, and anticipated loss ratios under the contracts. An examiner will look at all significant assumed and ceded reinsurance treaties to detect any unusual features that might affect a company's financial condition or that are in violation of state laws, regulations, or NAIC accounting practices and procedures. Things we also look at include cut-through endorsements. These are endorsements to a policy that are referred to in a reinsurance agreement, which says that in the event of the ceding company's insolvency, the reinsurer will directly pay to the policyholder any loss covered under the agreement.

Prior to this year, due to a law change in Missouri, cut-through provisions in an insolvency clause in a reinsurance contract were not permitted because our insolvency clause wording in our credit for reinsurance law did not permit the payment of reinsurance proceeds to anyone other than the liquidator. We also had a provision in our insolvency code that said, regardless of any provision in a reinsurance contract, the amount recoverable by the liquidator shall not be reduced. This caused Missouri to be designated as the double jeopardy state, and I believe reinsurers were very cautious about the issuance of cut-throughs to their Missouri clients because of this wording. Our law has since changed, and the existence of a cut-through provision in a reinsurance contract is now permitted.

With respect to fronting arrangements, things that we look at include whether the company has evaluated the financial strength of the fronted company and whether they have actually reviewed the business that they are fronting and have decided that they could live with it in the event that the reinsurance company becomes financially troubled. We like to see that they've evaluated the entire package and not just think about the commission or other fronting fees they're receiving for letting another company write on their paper. Excessive risk assumed under a treaty and a large portfolio of reinsurance executed during the last three months of any calendar year are also considered. We look at significant or unexpected changes in the entity's reinsurance program, such as significant changes in retention levels or the form of reinsurance. We also identify any contracts under which excessively high reinsurance commissions are received.

With regard to ceded reinsurance, we review the contracts to determine that risk transfer requirements are met and that the overall accounting treatment complies with the guidelines in Statutory Accounting Practices (SAP) 61 of the NAIC Accounting Practices and Procedures Manual. We will obtain financial information of all significant reinsurers to determine the financial strength of the reinsurers to which the company cedes its business. With regard to amounts recoverable from reinsurers, we look at the aging of these recoverables to identify anything that's over 90 days old, and we will discuss with management the collectability of any amounts over 90 days old to ascertain their collectability. Reinsurance recoverables are agreed to a valid reinsurance contract and might be directly confirmed with the assuming company. We also will determine the recoverables written off or disputed recoverables have been properly disclosed in accordance with the guidance in SAP 61.

With regard to commission and expense allowances due, we also obtain a schedule detailing this account by the reinsurance company. We'll recalculate these commissions and expense (C&E) allowances by utilizing percentages and amounts specified in the reinsurance contracts. We also might confirm directly with the reinsurer significant C&E allowances. We also verify that commission and expense allowances due have been recorded in accordance with the guidance in SAP 61. There is guidance on excess commissions there, and also on renewal expense allowances paid by a reinsurer to the ceding company. In accordance with the NAIC life and health reinsurance model regulation, SAP 61 requires that the funeral expense allowances paid to the ceding company by the reinsurer must be sufficient to cover the ceding company's anticipated allocable renewal expenses.

With regard to assumed reinsurance, we want to see documentation that evidences management's review and approval of reinsurance assumed contracts. We also want to determine that the company has complied with the underwriting guidelines that are preestablished by the company. Also, financial information of all significant ceding companies is obtained to determine the financial strength of the ceding companies from which the company assumes its business. We also verify that the reserves for reinsurance assumed are in accordance with the guidance of Paragraph 38 of 61, which says that they must be equal to the required reserves calculated using the same methodology and assumptions that would be used if the reinsurer had written the risk directly.

There are some other procedures that we perform that are not included in the handbook. We run a report against the NAIC database on Schedule S, and we will look at the credits taken by a Missouri ceding company and compare that to the reserve liabilities established by that reinsurance company. If there are significant differences, we'll ask the company to explain why, but we do acknowledge that there are valid reasons for such differences.

The point I want to make is, with regard to risk-based capital, what do you do if you have modco instead of coinsurance? If there's coinsurance, you transfer the assets. When you do your concentration factor, those assets aren't in there to do the calculation. Currently, the Life Risk-Based Capital Task Force is looking into actually when you segregate those assets. The ceding company would not take those into account in its RBC calculations, and they would have to report those to the reinsurer. The reinsurer would have to take those into account. I think that's an evolving process, though. I don't think that it has been put into practice.

MS. PLEUS: One of the speakers at the Financial Reporting for Reinsurance Seminar made the comment that that was a Larry Gorski hot button that had just been talked about at the New Orleans meeting.

MR. SULIKOWSKI: I guess the other issue that came up at the New Orleans meeting was just an understanding, in general, that if a reinsurance transaction has the effect of transferring risk-based capital (RBC) from a ceding company to a reinsurer, that regulators understand that this is actually occurring. There is a movement in the early stages to try to figure out exactly how to go about establishing that the RBC is being posted on someone else's books.

MR. GAROFALO: I mean we try to query the insurance companies to give us that data, and then we would adjust our model for that. It's really up to the companies to disclose it to the rating agencies.