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Session 5PD
Current Uses of Reinsurance

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Summary: Reinsurance has become an important part of the financial planning process for an increasing number of insurance companies. Reinsurance can provide solutions to risk management and earnings management challenges.

This session provides an overview of the current uses of reinsurance, focusing on recent developments and issues. Panelists discuss application of reinsurance to specific products and lines of business and its use as a financial management tool in:

- *Term insurance*
- *Mortality stabilization*
- *Earnings volatility stabilization*
- *Variable life and annuities and other investment-oriented products*

Generally Accepted Accounting Principles (GAAP) treatment of reinsurance (e.g., FAS 113) and due diligence issues in selecting reinsurers and maintaining reinsurance arrangements is also discussed. Finally, panelists discuss advantages of onshore and offshore reinsurance transactions.

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Chart(s) referred to in the text can be found at the end of the manuscript.

MS. YIGI S. STARR: We have a panel of reinsurance experts. First, we have Bob Reale who will talk about the overview of the reinsurance market as well as the latest developments in the life and annuity reinsurance. Bob is a senior vice president and chief underwriter at Annuity and Life Re, a Bermuda-based reinsurer. Bob has over 22 years in the insurance industry. Prior to Annuity and Life Re, Bob was a consultant at Tillinghast in 1997. From 1989 through 1996, he was the head of the marketing actuarial organization at Swiss Re.

Following Bob, Don Solow, the senior vice president at Ace Capital Re, will talk mostly about the credit risk associated with reinsurance. Given this is a valuation actuary symposium, we thought that would be a very valid topic for all of us. Don is a senior vice president at Ace Capital Re in New York where he works on life, health, and annuity reinsurance transactions. He has been involved in reinsurance for nearly ten years with an emphasis on transaction, structure, and pricing.

MR. ROBERT J. REALE: Reinsurance has seen a growth over the past several years in contrast to the direct market with regard to life products. In traditional life reinsurance, new business volume assumed by reinsurers over the past six years has grown considerably. Chart 1 is derived from the Munich American/Society of Actuaries' study on new business reinsurance. This is just the reinsurance on new business. It excludes portfolio or reinsurance of in-force business. Prior to 1994, the reinsurance market was relatively flat. There was a dramatic difference between the market then and what has been going on in the reinsurance world over the past six years.

Increasingly, companies are relying on reinsurance for mortality products. However, companies are starting to examine the amount of exposure they have to any one company. Don will talk a little bit more about the counterparty risk associated with reinsurance.

What I'm going to focus on are the relatively new reinsurance activities companies have been engaged in over the past few years. First, I'm going to start talking about mortality related life transactions, and then I'll switch to a brief discussion of annuity transactions. Mike Gabon is going to follow-up with a more in-depth review on the annuity and disability income business as well.

There are four things on the life side that I'm going to talk about. In-force mortality is yearly renewable term (YRT) transactions reinsuring the mortality element of in-force business. This is probably the most significant reinsurance activity that has been going on for the past few years. Second, I'll discuss reinsurance programs designed to help with sales practice litigation settlements, the free death benefit that is offered as part of the litigation settlement. I'll discuss what reinsurers can do. Third, I'll comment on some of the recent activities generated from the change in RBC formulas with respect to modified coinsurance (mod-co) and co-funds withheld. Finally, I'll discuss XXX issues.

In-Force Blocks

In 1994, the Munich study reported about $20 billion of portfolio reinsurance assumed. Over the next five years, about $550 billion has been reinsured, with $420 billion over the past three years alone. That is a significant increase in activity. This activity is the reinsurance of the mortality of in-force blocks of business on a YRT basis. It has been from primarily large stock companies and mutuals, but even the medium and small companies are involved in this activity.

The primary reason given why companies are looking to reinsure in-force blocks is to stabilize their earnings. They've done a lot of reinsurance on new business and now they're focusing on the in-force mortality as a way to stabilize their corporate result. Another reason is it provides an increase in surplus from the unearned premium reserve credit. There are also very favorable terms being offered by reinsurers. I'll discuss a little bit more about that. Also, the companies have a desire to shift their focus to asset-based products and reinsure the mortality component off their books.

One of the things I wanted to discuss further was the unearned premium reserve credit. It can be as high as from $2.00 to $4.00 or more per $1,000, depending upon the age of the block, so it can be rather significant. Table 1 shows the risk-based capital associated with a particular size or a block of business. The extra capital is labeled as statutory redundancy in the mortality table associated with the various tables used for the various blocks of business.

TABLE 1

In-Force Life Required Capital*

Reserve	RBC	"Extra Capital"	Total Capital per $100 Liability
GAAP	100	20	120
Statutory			
1980 CSO Table	100	195	295
1958 CSO Table	100	250	350
1941 CSO Table	100	450	550

* For every $100 of expected claim liability, required capital is comprised of two forms: risk-based capital and "extra capital" in the conservatism is the basic reserve. Statutory basic reserves for in-force business are excessively conservative. Under GAAP, total required capital is much lower.

One of the things I also wanted to touch on was how reinsurers are reinsuring this business at what appears to be aggressive prices. In-force mortality is relatively stable. Wouldn't that mean that the reinsurer has to charge to cover that mortality, plus its cost, plus its profit margin? What has happened is reinsurers are looking at the future mortality improvements and building that into their prices. So as ceding companies look at their blocks, they might consider that these blocks might have improving mortality, or they might not. The reinsurers are offering a guaranteed mortality improvement today. As a result, the YRT prices are at or below current mortality levels and that has proved quite attractive.

Let's discuss some other points on reinsurance prices. Reinsurers have a lot of access to data. That's their business. They're spending a lot of time studying where the mortality patterns are. They dissect blocks much more in-depth than I did when I was at a direct company years ago. Finally, whatever mortality fluctuations there are, reinsurers are getting pieces of business from multiple companies, so they're not subject to any one type of underwriting profile. They have numerous underwriting profiles to help absorb and mitigate the mortality fluctuations.

Sales Practice

Another area of recent activity for reinsurance has been the result of sales practice litigation settlements. Typically, it involves an offer to the policyholders impacted, such as a free death benefit for five years or more. The cost of these settlements is high. First, there is the economic value of the additional benefits. Second are the tax costs associated with the fact that the

statutory reserve might be much higher than the tax reserve. Third is the capital associated with this business. That would include both the redundant statutory reserves held for this paid-up benefit and the risk-based capital associated with it.

Chart 2 gives you a snapshot of what these capital amounts are. You can see that there's a significant amount of capital embedded in the statutory reserve over and above what I'll call the GAAP reserve or economic value of the actual benefit. So reinsurers have been able to offer reinsurance for a one-time premium payment of an amount close to the GAAP reserve. That would free up a fair amount of the statutory strain on your books.

Modified-Coinsurance (Mod-Co) Transactions

Another avenue that companies are currently looking at deals with the change in the NAIC and rating agency risk-based capital formula that now recognizes, under mod-co and co-funds withheld, that the risk has been transferred to the reinsurer. Companies are looking for low-risk blocks that the RBC formulas are overly redundant or excessive for that particular block.

One example might be the closed blocks of demutualized companies. Those blocks can be "mod-co'd" out where the emerging profits are nearly all refunded back to the company. Another example would be an investment portfolio that has a fair amount of stock exposure. A reinsurance program can reinsure the stock portfolio supporting low-risk business, and the reinsurer would refund the profits of the business and the performance of the stock back to the ceding company. Actually, programs such as these are designed to also smooth out the stock volatility.

XXX Issues

Finally, on the life side, there are the XXX issues. This is probably the biggest issue this year and probably will be for the next few years. Reinsurers have reinsured a lot of level term business and support a lot of the business. One of the techniques used by the ceding companies to handle the additional capital strain is to reinsure to offshore reinsurers or to reinsure to onshore reinsurers who, generally, retrocede it to offshore affiliates.

With XXX, there is an increasing reserve each year on the business reinsured. That's going to put a strain on the types of collateral used, primarily letters of credit. Additional new business only compounds that problem. What's going to happen if there's a shortfall on the Letters of Credit (LOC) side? What's going to happen to your reinsurer and, again, what's going to happen to you, the direct company who is looking to take credit for reinsurance? Has your reinsurer provided an adequate capital plan and shared that with you to demonstrate the support for your long-term security needs. Finally, have your reinsurers committed to any sort of capacity limits? There's not an unlimited amount of capacity in the industry, and one should recognize that there should be a commitment of how much a reinsurer can absorb.

Another issue is a change in the X factors. Let's say a change in the X factors down the road might result in additional deficiency reserves. Have your reinsurers consented to assume that additional reserve?

The final issue on XXX is the secondary guarantees associated with universal life. We've noticed product changes have been slower in 2000 than for the level term products, but we do see this as a significant area of capital usage. The reinsurance programs include forms of coinsurance, and mod-co, and a form of YRT approach on the mortality as well. Compounding this is the potential for the variable life products to be impacted by XXX.

Annuities

I want to switch over to annuities. Generally, there is a snapshot of what's going on in the annuity reinsurance business. I'll talk about variable annuities. Reinsurance capacity for reinsuring the guaranteed minimum death benefit (GMDB) and similar benefits were impacted by the withdrawal of Swiss Re and CIGNA from the market, although, AXA Re did step in. There is lower capacity out in the reinsurance markets. It has resulted in companies retaining more of these risks. There are new reinsurance companies emerging, so companies might get some relief there. Another area of reinsurance activity is on cash financing of deferred variable annuities. That activity has been going on for some time, and it is still going on.

On the fixed annuity side, we did a survey a year-and-a-half ago with Milliman and Robertson (M&R) just to find out what companies are doing on reinsurance fixed annuities, primarily single premium deferred annuities (SPDA). We found that some companies were involved in reinsurance programs, although, most were not. It's not a product that's being reinsured as frequently as life products.

This has changed recently. There's a desire to limit the kind of risks companies are assuming because of the increased annuity sales, especially those that are used to selling variable annuities and the strain associated with certain products and features.

Generally, what we're seeing in 2000 are more annuity mod-co transactions, again, because of the risk-based capital (RBC) change. Modified co-insurance offers companies the opportunity to reinsure the product and get risk-based capital relief, but still retain control of the assets. This is a full risk transfer. This is not any sort of a financial risk or a non-risk program. The reinsurer is liable for all of the asset risks.

Offshore reinsurers typically have a lower cost of capital for a variety of reasons and can return what would be deemed excess profits back to the ceding company. The higher allowances offered by some of the offshore companies have been quite attractive. The ceding company can improve its return on equity (ROE) or pass it on in the form of a higher credited rate generating further sales, leading to cover more of its overhead expenses and so on.

Another area of annuity reinsurance exists with older blocks of structured settlements, group annuities, and immediate annuities. These products were sold in a high interest rate environment. Those original assets with higher yields either have been harvested or the bonds have been called, and the performance on the assets remaining might not support the long-tail liabilities. These assets are certainly depressing ROEs. There is potentially a loss recognition looming or it has occurred.

Reinsurance has allowed companies to reinsure these blocks by potentially getting a tax credit and a release to capital to deploy in higher ROE type business. There is a potential, if the company is no longer doing this business, to book it as a discontinued operation, and any cost in reinsuring can be below the line.

Certain offshore companies use alternative assets in a coinsurance transaction and invest those assets offshore to get higher yields to support the long-term liability. There is potentially a larger counterparty risk exposure on that type of program for the direct company.

I'd like to turn it over to Don to talk about some of the credit counterparty risks.

MR. DONALD D. SOLOW: What I'm going to talk about is kind of a focused topic. I'm going to talk only about credit risk that's related to reinsurance transactions, and I'm going to focus on two types of credit risk. The way I see credit risk is you have two things to worry about. The first one is obvious, and that's the risk that your reinsurer becomes insolvent or bankrupt and just isn't able to pay amounts due under the reinsurance agreement. The second form of credit risk occurs when the reinsurer is in great financial health and just refuses to pay amounts that you think are due under the reinsurance agreement. I'm going to call the first type *default risk*. I'm going to call the second type *performance risk*.

Before I go into talking about some security devices that can be used to mitigate some of these risks, I thought it would be useful to spend some time just going over the *Financial Accounting Standard (FAS) 113* treatment for reinsurance. As you know, under *FAS 113* there's what's called the gross up, where you show your reinsurance recoverable as an asset on your balance sheet, not as a reduction to the liabilities. I think that was an interesting development, because what that said was your reinsurance reserve credit really should be viewed as an asset, and it's an asset like any other asset. This asset is shown on your GAAP balance sheet as an asset. It brings up the questions: is this a good asset, and am I going to be able to make the proper recoveries under this reinsurance agreement? This forces you to compare the size of that asset to the surplus of your company and ask, how much of my surplus is at risk under these reinsurance agreements? If, for some reason, the reinsurer couldn't pay or doesn't want to pay, what do I have at risk?

As for the default risk, which is the ability to pay risk, this comes from two primary causes. You have insolvency, which is really a statutory concept. That's when the liabilities exceed the assets. You have bankruptcy. A bankrupt entity might or might not be insolvent, but it just doesn't have the cash to pay the amounts due, so it's considered bankrupt. It can't pay.

The willingness to pay risk is a little more complicated. The willingness to pay risk comes to what I call "feet dragging." There's a reinsurance agreement. It's not going the way the reinsurer thought it would go, so the reinsurer starts to drag its feet. It wants to come in and review all the underwriting, because it says that you didn't underwrite the way you said you were going to underwrite. The reinsurer wants to do some claims audit of disability reinsurance or some kind of health reinsurance. They might come in and say, "You haven't managed the claims the way you're supposed to manage the claims. There are many administrative audits. You didn't underwrite properly, and you didn't manage claims properly." This, obviously, leads to some messy situations. You sometimes have allegations of fraud. This might lead to arbitration or even litigation, which could, in turn, lead to some reformation or even recision of the reinsurance agreement.

You might say, "How can I secure that asset? How can I be sure that these reinsurance recoverables are good assets?" There are some basic methods. You have funds withheld or modified coinsurance. You have letters of credit, and you have trust accounts. You might have parental guarantees, which I'll talk about later. You might have some kind of third party coverage or you might not have a security device at all. You might simply be relying on the regulatory framework. In that case, your reinsurer will be an admitted reinsurer in your state, and you're relying simply on the regulatory framework to ensure that it's going to be a recoverable asset.

All these methods have some pluses and minuses. If you have a funds-withheld, or a mod-co agreement, there's an obvious advantage to that. You own the assets. Those assets are titled in your name. Those are on your balance sheet. You own those assets. You have assets equal to the statutory reserves. If some amount is due, and the reinsurer can't pay or won't pay, you have the assets. You can fund those claim payments.

The problem is, what if the reserves turn out to be inadequate? Suppose the reserves on a block of business are $100 million, and you have $100 million in reserves. The block of business performs poorly. Where do you get that next dollar from? Having funds withheld is good up to the reserves, but it doesn't help you for amounts above the reserves.

For nonproportional coverages, it's hard to see how this can be useful. If you're buying a mortality stop-loss coverage, where the reinsured is obligated to pay some amounts above some attachment point, what can you withhold other than the stop-loss premium, which is going to be relatively small compared to the amount that might one day be due. So funds withheld or mod-co, generally, gives you good security for proportional coverages up to the reserves. It doesn't give you much security beyond that.

You're all familiar with how a letter of credit works. It is typically an unconditional letter of credit. Providing for credit for reinsurance is a requirement. What that means is they generally say you should bring this letter of credit to the bank. The bank will wire you the amount of money, so it's unconditional. You just have to call the bank. What is good about that is, if you have a dispute with your reinsurer, in which you say some amount is due and the reinsurer says he or she doesn't think that amount is due, you can always make a draw on that letter of credit, so that gives you some comfort in the event of performance risk. The bank is actually taking the default risk and the performance risk of the reinsurer.

The downside is similar to funds withheld. You have the letter of credit set equal to the statutory reserves. Again, what if the reserves were not adequate on that block of business? What happens if you get to a point where the reinsurer says, "I can't pay because I'm just out of business." or "I don't want to pay because there was some fraud here." You have a letter of credit up the reserves. You have no security for amounts beyond that.

Another thing that you have to think about is this: I've heard of situations where reinsurers have called their bank and said, If this company comes in to make a draw, I don't want you to give them the money." It puts the bank in an awkward spot. What will the bank do? They're supposed to honor that letter of credit without any conditions. If they think there's some kind of dispute going on, it's unclear exactly what course of action they might take.

Just like funds withheld, this might not be useful for nonproportional coverages, unless you would set the letter of credit amount equal to the limit of liability of the stop-loss agreement. You have to ask yourself whether that is commercially feasible? Is that really going to work?

The other problem with the letter of credit is if you have a block of business where the reserves are increasing, that reinsurer is supposed to true up that letter of credit every quarter. It's done by amendments, so they give you a larger LC. If your reinsurer has a failure, either an insolvency or some kind of dispute, and it occurs in between the last true-up period, and the next true up period, you have an unsecured exposure equal to that increase in reserves that hasn't been secured by the letter of credit.

Probably the most common method is a trust account. Under that structure, the trustee is responsible to the beneficiary and the trustee is supposed to act sort of as the policeman and allow withdrawals according to the terms of the trust agreement. It's having this third party, this trustee, and that should give the ceding company a lot of comfort that they can go to the trust and make withdrawals for amounts due.

One of the downsides to the trust account is this. Before a company is placed into receivership, there's a period that's usually called the confidential receivership period. It's during that time that a judge will issue an order to the trustee that says these assets are not to be moved. So if you're the ceding company, by the time you find out that your reinsurer is insolvent and you go to that trust account to make a withdrawal, the trustee is going to send you a copy of the court order and say, "I can't give you this money." That's going to produce a lot of liquidity problems for you as the ceding company. Where are you going to get the money to fund all these claims? It could take six months. An example that I'm familiar with took six months and a lot of legal expense for the ceding company to eventually get the funds out of that trust account. Those funds were just frozen.

In a dispute, it's possible that a trustee will not even honor a withdrawal request. The trust agreement sometimes has some language that says the trustee is not obligated to do anything with this money if the trustee thinks there's a dispute between the parties. If you go to make that withdrawal and the reinsurer has written to the trustee and said, "Look, we have a big dispute on

this agreement; it's going to go to litigation," odds are that trustee, depending on how your contract is written, might not allow the withdrawal. Again, you have a liquidity problem. How are you going to get the money out to pay claims?

You have some of the similar problems to what we discussed before with letter of credit and funds withheld. If you have a trust account equal to the statutory reserves, you'll have the same problem. If it's a poorly performing block of business and the reserves prove to be inadequate, there might not be enough money in that trust account.

You usually have a quarterly true up on these trust accounts. You're looking at the market value of those trust assets relative to the reserves. What happens if you have a major movement upwards in interest rates? It depresses the market value of those securities in the trust. It's time for a true up. There's a large amount due, but your reinsurer can't or won't make that payment. You potentially have just a gap in there from the market-value risk.

You could have defaults of the assets in that trust account. If it's a small trust account, it might not be well-diversified. It might have four or five securities in there and that's it. You have some credit risk there. You can have a default of one of those assets. Again, the trust is not useful for nonproportional coverages unless you're going to ask your reinsurer to fund the trust equal to the whole limit of liability of the stop-loss agreement. Again, you have to question whether that's commercially feasible and whether they'd really want to do that.

In many cases, it's possible to get a parental guarantee. What you do is you go to your reinsurer and say, "You're part of a large group of companies; I want a guarantee from the parent company." That might really help with the default risk in that the insolvency of the reinsurer might not produce a problem for you. You'll go to the parent and claim under that guarantee. It can also be useful for nonproportional coverages. If some amount is owed to you under the stop-loss agreement, and the subsidiary can't pay, you're going to go to the large parent and get some money there.

The problem is most of these parent companies are going to be holding companies, but they don't own a bunch of U.S. Treasury securities. They just own a number of other operating

companies, so they're not sitting on a big pile of cash. They might have problems paying you, and they might have to try to get money out from other operating subsidiaries. If those are domestic companies, there are all sorts of restrictions on moving capital out of the domestic subsidiaries.

A parental guarantee is not going to help you with performance risk. If the reinsurance company is alleging fraud or some sort of underwriting discrepancies, you're not going to be able to go to the parent company and collect. Obviously, they're going to support the subsidiary and say, "If there's a problem here, you can't collect from us either," so you're going to end up in court or in arbitration.

It might be possible to get some form of third party surety. This is where an unrelated party is going to guarantee the obligations of the reinsurer. Similar to the letter of credit, the surety providers take the default risk and maybe even the performance risk, depending on how the surety contract is structured. It doesn't have to be limited to the amount of the reserves. It can be an unlimited surety, so that would say, to the extent the reinsurer owes you any money and hasn't paid, you claim under the surety policy.

It can potentially be used for nonproportional coverages where the surety provider will pay the amounts due under the stop-loss agreement if the reinsurer can't or won't pay. It's not tied necessarily to any kind of reserve calculation. It's sort of an unlimited surety, so there's no quarterly true-up risk. The downside is you're introducing the default and the performance risk of the surety provider. So suppose you have a reinsurer that can't pay. You file a claim under your surety policy. The surety provider says, "I can't pay," or "I won't pay." You have that risk there. There's a very limited market there, and there are not many entities that will provide these types of third party guarantees. Depending on how it's structured, it can be very expensive. The question is, who's going to bear the expense of that.

Many reinsurance arrangements are not secured at all. They're simply a reliance on the regulatory framework. So suppose your reinsurer is an admitted reinsurer, and you've got a

coinsurance transaction. You wired hundreds of millions of dollars to another company. You have no security at all other than the hope that the regulators in their state are doing their job.

There were a number of failures of companies in Tennessee, Missouri, and Mississippi recently. I think there's a lot of evidence that the insurance regulators were not properly staffed to do an adequate job of checking out those companies. That did lead to the insolvency of one particular domestic life company. So if you're relying on the regulatory framework, my only comment there is, good luck.

I think the conclusions are relatively obvious. First, you should pay attention to the size of this reinsurance recoverable, this asset, and see what that is relative to your surplus. In the example I just mentioned, the U.S. ceding company's reserve credit to one reinsurer was larger than its surplus, so when the reinsurer couldn't pay, the company became insolvent. So you want to pay attention to the size of these reserve credits relative to the size of your surplus. You have to assess the reinsurer default risk. There must be a due diligence process. You should read what the rating agencies have said about that reinsurer.

Something much more difficult to assess is the performance risk. You can have a AAA reinsurer say, "I'm not going to pay you. I think you've committed fraud against me." How do you assess that? That's very difficult. Ask around. Get some feeling as to the reputation and the quality of management of that company. Some of them might have been around forever, and some might not have been around a long time. You might not be able to get a good history.

You should diversify your exposures just like you would in your asset portfolio. You wouldn't have one asset exceeding your surplus. You should pay attention to how you've diversified your exposures.

Clearly, you should understand the limitations and the pitfalls of all the security devices. They're better than having no security, but they all have small problems or even large problems that might put you in a position when you're looking to use them when some problem occurs if they don't work the way you thought they would work.

Relating to performance risk, as a caution, if you strike a deal with your reinsurer and that deal seems too good to be true, you should expect problems later. It's possible that the reinsurer will

come back and make some allegations of fraud or something, and you might have a problem later. If the deal seems like it's going to be a big loser for your reinsurer, there's a good chance that deal might come back to haunt you.

MS. STARR: We have heard from our panelists who have talked about the uses of reinsurance. How could you take it from a valuation actuary point of view and examine the credit risk, especially within the context of *FAS 113* and GAAP accounting? There are considerations associated with the due diligence process and advantages of offshore reinsurance and some examples. I hope you get a sense of how reinsurance can be used as a financial management tool as well as how to use it effectively for your business needs. I want to thank our panelists for giving us such a good and wide range of insight into reinsurance.

MR. WILLIAM A. KLING: If an offshore reinsurer (a U.S. taxpayer) takes a 953D election, are there any advantages or disadvantages to that person's tax position relative to a U.S. onshore reinsurer?

MR. REALE: Let me try to tackle that. I'd say, generally, no. There might even be a disadvantage if the 953D company is partner of a bigger organization. There might be problems in integrating any sort of tax losses with that 953D with the corporate. I'm not exactly a tax expert, but I know we had run into that at Swiss Re at times.

Other than that, I'm not sure from a tax perspective if there's any advantage or disadvantage. There are statutory/GAAP accounting arbitrage plays that are done with 953Ds. For financial reinsurance, it's the 953D company that provides what I'll call pure financial reinsurance, like the surplus relief for low-risk business. Non-FIT companies like mine and Mike's are generally at a disadvantage. Excise tax costs get in the way of those programs for the most part.

MS. DIANE HEIM CHUN: I'd like to know about the tax and statutory implications of using unauthorized reinsurers. I don't know much about reinsurance, and I don't really know much about unauthorized ones.

MR. SOLOW: Tax-wise, offshore reinsurers are either going to be nontaxpayers, so they don't have a permanent establishment in the United States, or they have elected to pay tax under 953D, so they might have a staff of various sorts in the United States. If it's a taxpayer that has elected to pay tax on the 953D, your reinsurance agreement won't be too much different than a reinsurance agreement you'd use with an onshore company. There's usually a section regarding the so-called deferred acquisition cost (DAC) tax, or the DAC proxy tax. You're going to have that same language with the 953D company, whereas, you probably wouldn't have that with the nontaxpaying company. Instead, you'll have a section that addresses excise tax and who pays it and who doesn't. I think those are really the only differences.

MR. REALE: The other thing on the DAC tax is that if you're dealing with a non-U.S. taxpayer, you can't transfer your DAC tax like you can to a U.S. taxpayer. What's interesting is if the cash flows are coming to you, you've added DAC tax to your books. What you need to consider in doing reinsurance with a non-U.S. taxpayer is, can that reinsurer make amends, so to speak, in some form.

Add a DAC tax provision that's different from the taxpaying reinsurers, which essentially gets the company back to where they would have been if they had reinsured to a U.S. reinsurer. That's one way of handling it. Generally, DAC tax is not a big cost, and it often results in a nonissue. Funds-withheld transactions might generate additional tax implications or potential tax implications.

CHART 1
Growth Business

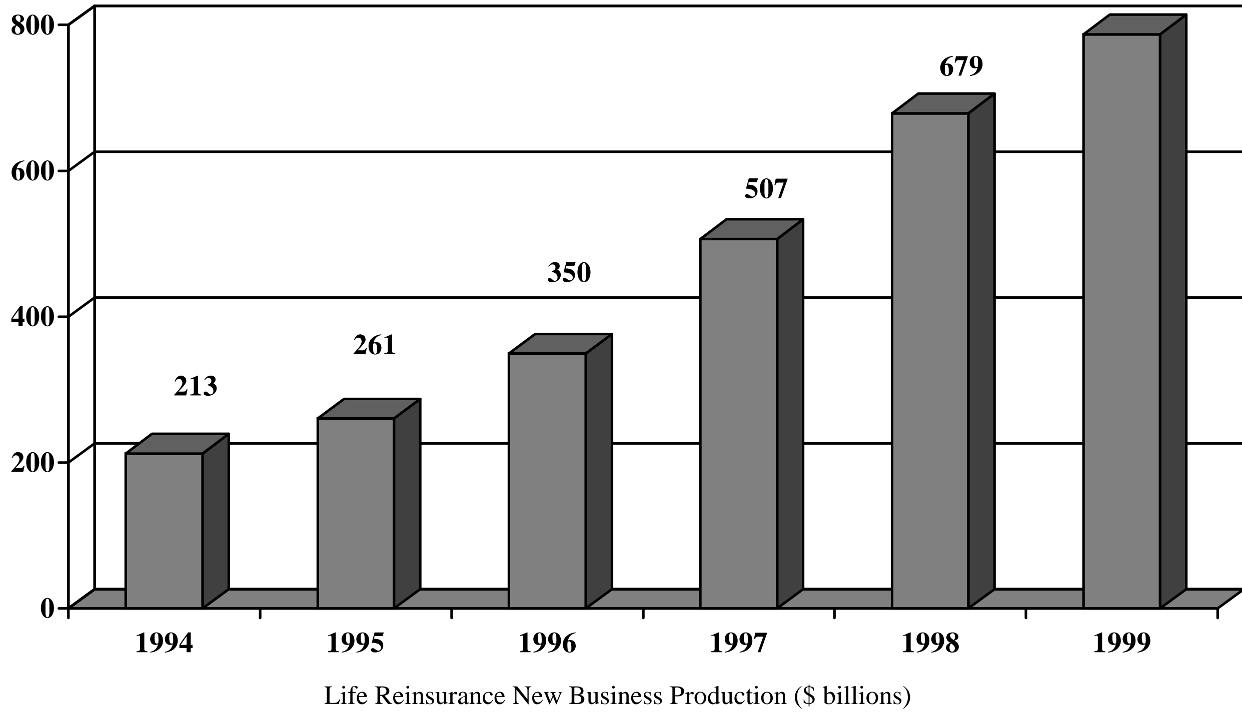

CHART 2
Required Capital Patterns