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Session 2PD
Reinsurance Credit Exposure

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This session articulates the considerations in performing due diligence on a reinsurance partner and the impact, if any, of deteriorating credit quality. The session includes the following topics: letters of credit, arbitration and disputes, impact of mergers and acquisitions, offshore reinsurance and NAIC issues. At the conclusion, attendees have a better understanding of reinsurance credit risk.

MR. JAMES W. DALLAS: This morning our topic is reinsurance credit exposure. First we will have Ed Betteto; he is currently senior vice president and chief actuary of Max Re Ltd. and has been in the reinsurance industry for about 10 years. Prior to Max Re, he served as senior vice president and senior life and annuity underwriter for Lehman Re, where he was one of the individuals instrumental in launching the investment banker into the reinsurance business. He has authored papers on securitization within the life insurance marketplace.

Prior to joining Lehman, Ed was vice president of structured reinsurance at ManuLife Financial. At Max Re, Ed underwrites life and annuity reinsurance programs and was one of its first employees when it opened in 2000. Ed is an FSA, a member of the American Academy of Actuaries and a member of the Canadian Institute of Actuaries. He's going to cover letters of credit and offshore discussions.

Next we have Mark Rouck. Mark is the director at Fitch Ratings' North American Insurance Rating Group. He has coverage responsibilities in the property and casualty (P&C) industry and for insurance-linked securitizations. He is a member of the insurance ratings committee for Fitch. Mark was an assistant vice president and

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performed a similar role at Duff & Phelps prior to the merger of Duff & Phelps and Fitch IBCA in June 2000. He joined Duff & Phelps in 1997 as an analyst in the insurance rating group. Previously Mark spent seven years as a member of Allstate Insurance Company's corporate finance stuff; his experience includes financial statement preparation and analysis, acquisition due diligence, competitor analysis and accounting research. He holds the chartered financial analyst designation and is a certified public accountant. Mark is going to cover rating agency perspective on reinsurance credit exposure today, as well as discuss the impact of mergers and acquisitions.

Speaking last is a good friend of mine, Dana Wiele. Dana has been practicing law in the areas of insurance regulation and reinsurance for more than 15 years. His practice, which is primarily transaction-oriented, includes life and health insurance, as well as P&C insurance matters. Having served as both inside and outside counsel to the insurance arms of several Fortune 100 financial companies, including Capital Holding and ITT Financial, Dana has gained particular experience in financial reinsurance transactions, regulatory compliance and regulations and agent and intermediary relationships. He has successfully represented firms and their dealings with insurance regulators in most states and in more than half a dozen countries. Dana received his juris doctorate degree from St. Louis University in 1987, and he is also an FLMI. His firm, Wiele & Rutterer, based in St. Louis, is currently celebrating 10 years of service to the insurance industry. Dana is going to speak with us today about enforcement of terms, arbitration issues and NAIC matters.

MR. EDWARD BETTETO: I'm going to be spending a little bit of time on what a letter of credit actually is. I made the presumption that some members of the audience don't have much practical experience with letters of credit, which have gotten a lot of notoriety in the last years, so I'll spend a little bit of time on what a letter of credit is and what it is not, then a small amount of time on the regulations governing their use. Letters of credit are used primarily, at least within the life insurance industry, to support reinsurance credit engagements and transactions with non-U.S. regulated reinsurance transactions. There are also applications in the reinsurance market. I'm going to spend a little time with comparisons with other forms of security and then spend most of my time in terms of practical limitations and some of the turmoil that has happened within the industry.

I think the best way for me to describe a letter of credit is to say it's an immediate and unconditional demand for cash from an accredited U.S. bank. When I say accredited, I mean an NAIC-accredited bank. It's irrevocable by anybody other than the beneficiary. It's for a specified amount, so it doesn't go up and down like a set of assets supporting reserves. The beneficiary is in complete control, a topic that I'll spend a little more time on.

One of the most important conditions of a letter of credit is to fulfill the requirement known as an evergreen clause. Regardless of the duration of the letter of credit, which almost always is one year, there is an extension feature: in other words, the

bank needs to provide 30 days notice if they're not going to renew the contract for a further 12 months. They're typically effective January 1, the full calendar year, so by December 1, if the bank does not provide notice to the beneficiary that it's going to withdraw or not renew, then it's automatically renewed for a further 12-month period. I'm going to spend a little time on what that means from the practical point of view to a ceding company that has entered into one of the transactions.

I think while the technical duration is one year, the evergreen feature in effect tailors the duration to the duration of the contracts. So if a reinsurance contract typically is a very long-term—30, 40 or 50 years—some would argue that the duration of a letter of credit is only one year and therefore there is a mismatch, and there are risks associated with the letter of credit. What I'm going to want to demonstrate here is those risks are not borne by the ceding company. They're in fact borne by a combination of the bank and a reinsurance company.

In order for a ceding company to take reserve credit, when it enters into a reinsurance transaction with an offshore reinsurance company (these regulations first came in 1991, I think), a letter of credit together with assets in trust are the two main methods of providing collateral. Collateral up to the full amount of the statutory reserve is part of every transaction.

The bank must be on an NAIC-accredited list, which is published on a regular basis. I'm not going to spend time going through all of the options or the issues in terms of the regulations, but it must be irrevocable by the bank, and again, technically, it's irrevocable for the 12-month period, together with the evergreen clause.

Occasionally there are discussions from a couple of regulators about the mismatch risk trying to remove letters of credit as one of the possible options in terms of providing collateral. I know those who have used letters of credit in the past don't quite understand where that goes. There are CFOs and chief actuaries of ceding companies who enter into transactions on a regular basis, using offshore reinsurance, who prefer the letter of credit to assets and trusts. And I can spend a little bit of time in terms of the comparisons of collateral to explain why that is.

The document is usually delivered directly by the bank to the treasurer or to the treasury department of the ceding company. It does not pass through the reinsurance company. The reinsurance company enters into and pays the fees to the bank for the letter of credit, but it's a contract between the bank and the ceding company, which is the beneficiary of the letter of credit.

Occasionally the document is actually held within a trust. Some states, including New York, do not allow that provision; the treasury department of the insurance company has to hold the instrument. The only reason that this occasionally takes place is some reinsurance companies believe that this is a little bit more protection against the ceding company actually withdrawing the letter of credit, when in fact the reinsurance contract is still being honored in full faith. I don't think that this

actually happens very often. In my experience the letter of credit is held directly by the treasurer of the ceding company.

The reserve credit, of course, is limited to the face amount of the letter of credit. In practice, each quarter, under those treaties where the reserve credit goes up, and we'll just spend a fair amount of time on that, the letter of credit gets adjusted quarterly. Technically the test is a continuous test, but in practice it's done either monthly or (in almost all cases) quarterly by the end of the quarter. So if the reserve goes up, related to the reinsurance transaction, from the beginning of the quarter, or the end of the previous quarter to the end of the next quarter, the ceding company notifies the reinsurer to increase the amount of the letter of credit.

There may be one or more banks. These days, for large amounts, letters of credit tend to be syndicated, so if it's, say, a $100 million letter of credit, it would tend not to come from one bank, with that bank then syndicating behind it. Often the letter of credit would have what's known as side-by-side risk. So if there are two or three or four big banks on one letter of credit, that's a fairly common practice these days.

There are several methods of security for a ceding company entering into a transaction with a reinsurance company: assets in trust, of course; a letter of credit; funds withheld or modco (modified coinsurance) agreements—I'm not sure there are going to be many modco deals happening these days, with the new SEC-sponsored regulations. Occasionally a parent company or a third party may guarantee a transaction when the reinsurance company is a weaker credit or is not regulated. This is more common when the reinsurance company is a lightly capitalized subsidiary of a larger domestic organization. And then, of course, if the reinsurer has NAIC accreditation or is in fact a domestic reinsurer, then no collateral, of course, is provided, and the reserve credit comes automatically.

Letters of credit are often compared to assets in trust as a form of collateral. As I said earlier, many CFOs prefer letters of credit to assets in trust. For one thing, there's asset performance risk in the trust account. The reinsurer, of course, is responsible for that asset performance risk, and if interest rates go up dramatically, or if there are credit problems in that portfolio, the reinsurer is responsible for topping up the trust or redeeming some of the assets with other assets. But that means potentially a new risk for the ceding company and that is credit risk should the reinsurer not be able to fulfill its obligations. A letter of credit is for a fixed amount, that doesn't go up and down with performance of assets.

Another issue is size. If a deal is smaller than, say, perhaps $25 million in terms of reserves, it gets very difficult in an asset account to diversify those assets in any practical manner. A lot of letters of credit are provided just simply because the size of the reserve credit is too small for an asset portfolio.

When trouble happens—and this is, I think, one of the reasons that this session was created as there has been some turmoil lately — is when a bank notifies that it is canceling a letter of credit. As I mentioned, the cancellation window for a calendar year letter of credit is prior to December 1. If the bank notifies the beneficiary it's not going to renew the letter of credit, then one of two things could happen. It's fairly common for bank relationships with reinsurance companies to change over time. Most of the time a cancellation is just simply business as normal, switching from say Citibank to Bank of America or whatever, but well before prior to December 31, the ceding company would receive a letter of credit from the new bank prior to the end of that year.

However, if the bank is providing a cancellation notice, because they're worried about the credit risk of the reinsurer, then the reinsurer may not be able to find another bank to issue a new letter of credit. Now, this is where the risks associated with a possible mismatch exist. On one hand, the legal duration of a letter of credit is one year; on the other hand, the duration of the liabilities could be 30, 40 or 50 years. In this case, where the reinsurer is credit challenged, the ceding company then makes a demand on the first bank to cash in the letter of credit. So if it's a $100 million letter of credit, and the ceding company is concerned that the letter of credit will not be in place for the following period, it actually redeems the letter of credit, and it's unconditional. There are no questions to ask. That's part of the NAIC-approved definition of the letter of credit. That's the evergreen clause.

Now, the bank has recourse rights to the reinsurance company. So the bank now has a $100 million loan, if you will, outstanding from the reinsurance company. The original ceding company now has cash to support its reserve product. Now, there is an execution issue here in effect. There is a presumption that a ceding company does have some experience with the structure, particularly with a letter of credit, because if the treasurer forgets or somebody doesn't pay attention, then there is a possible risk that by December 31 there is no support for the reserve. I've never heard of an occurrence, however. In addition, there is a reluctance issue because the banks providing the letters of credit are Citibank, Bank of America, Fleet—the large banks in the United States. So there is still a sense of reluctance to go to the bank because the letter of credit exists supposedly just as support. The theory behind the structure is it's never to be used if everything is copacetic. But I would submit that for this structure to work properly, the ceding company should not have any regrets about going to the bank and making sure its security is intact when the reinsurance company is in clear duress.

Next I'll talk about secured versus unsecured letters of credit. I was talking with a senior officer at one of the big banks—and I'll be going to go into some of the industry capacity issues a little later on—and he pointed out that 80 percent of the letters of credit are supported by full security. So typically if a bank gives $100 million letter of credit capacity to a reinsurance company, and that's actually a fairly small amount for some of the bigger companies, that is typically supported by actually a little bit over $100 million of very high-quality bonds or Treasuries to

support that letter of credit. The bank in that case doesn't have any collateral issues, and in fact, most letters of credit are fully supported.

Unsecured letters of credit tend to go only to reinsurance companies with very high credit ratings. Today that's probably AA. About two years ago, when credit was a little bit easier to obtain, single A reinsurance companies were able to get some unsecured letters of credit, but I don't think that's true any more. And you might ask, does this matter? I would submit that the ceding company doesn't have much risk in certain situations. It really depends on whether the reserve in a transaction is projected to go up or it's projected to go down or be stable. If it is projected to go up, then I think whether a letter of credit is fully secured or not there are risks to consider.

Let's just talk about that for a moment. If there's a $100 million deal, and let's say it's a closed block and the reserves are projected to go down and never to go up, under almost any scenario, and there's a letter of credit there, backing those reserves, I would submit that the ceding company really doesn't have any credit risk associated with that transaction. If the reserves are projected to go up, however, while the $100 million current reserve is fully secured, one does need to go past that and think about where the future collateral is going to come from. Are there risks for the provision of future collateral to support the reserve increases going forward?

This is a hypothetical example. I'm going to compare two blocks here. One is a closed mature block. There's no new business going in, and at the point of the transaction from the ceding company to the reinsurance company, let's say the reserve is about $250 million and let's say it's further supported by a $250 million letter of credit. And the statutory reserve for that block is projected to go down immediately as the block matures. Let's compare that with another situation of $100 billion face amount of 10-year term, written after the XXX regulations come into place.

Now, before people pick away at this, this is a little simplistic. This is $100 billion issued all at once to 40-year-olds, if I recall correctly, and let's say that that block of business moved from the ceding company to reinsurance company at duration 2, which moves $250 million in reserves to an offshore reinsurance company, supported by letters of credit. But, three years later, the $250 million goes toward $450 million, and this is without any new business. This is just simply a single transaction at one point in time for simplicity's sake. So the reinsurance company then would need to come up with another $200+ million in collateral. Now, there may have been some naiveté in terms of the industry that letters of credit were easy to come by; the capacity issues are pretty challenging right now. This is an entirely different matter than a closed block where the liability is going down. Here I would also submit that the collateral for the first $250 million is not in jeopardy, but there's no assurance whatsoever as to where the next $200 and some million of collateral is going to come from.

In terms of counterparty amounts, about $2 billion is the upper amount that any single reinsurance company is able to get these days. To get to this amount you'd have to be AA and you'd have to have long-established relationships with the banks. I would also submit that it would be very difficult to increase one's capacity in today's climate. It's a low-margin product for the bank; they're really only providing it as a service to big customers. And banks, of course, also have internal limits in terms of their total aggregate capacity.

There are, of course, significant pressures on bank capacity now mostly due to the tremendous increase in demand according to XXX. There are industry experts who are expecting that the future needs just for the humpback reserves on the 10- and 20- and 30-year term other guaranteed premium products are going to grow to be in the tens of billions of dollars. The entire banking industry capacity will not be able to support this.

The bank officer whom I talked to phrased it this way: they're projecting the demand curve to be incredibly steep, while the supply curve is going the other way. Some of the banks have merged. Banks are reducing capacity because there have been certain transactions that have not been favorable to them at all. They've taken some losses. They've done some internal reviews that have shown the risk-reward ratio to be skewed, which means even if capacity is going to be made available, the prices are going to go up dramatically. The banks have learned through these experiences that the relationships they entered, while technically bilateral, are really trilateral. So they're now more concerned about whom they're providing the letter of credit to, in terms of who the beneficiaries are. He estimated the current total bank capacity to be about $50 billion, and as I said earlier, about 20 percent is unsecured. And that's projected to go down. Not only are the banks expecting to support the increased demand, they're projecting their capacity to go down. He also said, "Bank capital used to be given away; we won't be doing that in the future." Now, the bank officers are looking for other solutions as to how to do this. So they're scrambling for the solutions, but I don't think it's going to come in traditional letters of credit.

The capital markets are being looked to for solutions. But the prices are going to be dramatic. When I proposed to him 150 basis points a year, for example—I'm not sure how many of you have experience with letters of credit, but that's a multiple of current price—his immediate response was "that's cheap, that's a cheap source of capital." So this is going to be an interesting crunch going forward. It seems to me that both the insurance industry and the reinsurance industry assumed that the letters of credit were an easy solution to the XXX-reserving increase. Many now predict that this is going to be a huge problem for the industry going forward.

I'm just going to quickly go through offshore reinsurance. Offshore reinsurance is included in this program primarily because they are the primary grantors of letters of credit. Up until about five years ago, virtually all of the offshore companies that were in the life business were small, undercapitalized subsidiaries of very large

companies, and they provided the security through letters of credit and other forms of collateral. There have been new entrants in the last few years, most of them in Bermuda, that are highly capitalized and publicly traded.

The differences between accredited reinsurance, it seems to me, is there is no NAIC supervision, there's full collateral for the current statutory reserves, whereas, of course, an accredited reinsurer doesn't need to provide the collateral. The new offshore reinsurers have less operating history than the domestics, of course.

The similarities are: a) very experienced reinsurance professionals in terms of implementing transactions and understanding the regulations, b) they are highly capitalized and publicly traded, or in the case of the former insurance companies they are subsidiaries of very large organizations, c) I think most importantly, many of the stakeholders are common—the SEC, the rating agencies, and an audit partner from one of the Big Four are all stakeholders, all watching this transaction. So in terms of decision points, in terms of reinsurance, are you better off going offshore and taking the collateral or better off staying domestic and hanging your hat on NAIC supervision?

Is there residual credit risk? If there isn't—in other words, if reserve credits are not projected to go up—then you have to look at the collateral as a strong positive, not the only factor, but a strong positive. If the reserves are projected to increase significantly, then I think you're going to need to do further credit analysis. Some states require regulatory approval for transactions between a domestic U.S. insurance company and an offshore reinsurance company. And if that approval is required, how does that sit? Often insurance companies get that approval even if the state doesn't require it.

How do the rating agencies view this transaction? Internally, is there a financial officer with experience?

Together the insurance industry and the reinsurance industry have moved virtually all of the new term reserves offshore. Are there going to be ramifications going forward? I'm going to leave that as a question, rather than try to answer that right now. The projections range from $60 billion to $100 billion of further reserve increases. I don't know whether that includes new business going in there, or if that's just the projection for the business already sold. Given the current level of the industry's statutory surplus, these future liabilities will be challenging to absorb. It's going to be interesting going forward.

MR. MARK ROUCK: What I'm going to talk about really are essentially three topics. I approach this from the standpoint of what the audience might be interested in from a ceding company's perspective, what types of things they should be looking for in terms of the credit risk they might be facing. And I'm coming at it from a rating agency standpoint, so I guess I kind of viewed it as to some extent that, if I'm a ceding company, you're looking at a lot of the same

credit risks, obviously, or hopefully, that a rating agency is looking at. So I thought I'd talk about how to avoid excessive risk concentrations and essentially how to manage your exposure to your reinsurers.

I'm going to talk a little bit about specifically Annuity and Life Re, and I don't mean to single them out for any other reason than they've been in the news quite a bit recently with regards to things like letters of credit and credit risk. So I think we can kind of cover some of the things that Fitch thinks impacted them and overlay it on some of the other things that we're talking about. And then I'm going to talk briefly on the impact of mergers and acquisitions and how we see that impacting the credit quality of the reinsurers that are out there.

First of all, from some background perspective, I'm primarily a P&C analyst. I previously did have a lot of life coverage, but for the last year and a half roughly I've been focusing on P&C companies. So when I started preparing for this presentation, one of the first thoughts I was trying to remember was how exposed the life industry is relative to the P&C industry that I was used to looking at more at this point. And our general view is that in the life and annuity sectors' credit exposure to reinsurance risk is really manageable. I kind of did some rough numbers based off year-end 2000 data, and when you look at ratios of recoverable to surplus, which is kind of a basic measure of how to look at credit risk to the reinsurance industry, the life and annuity industry, that ratio is only 6.6 percent. Now, I did a run of companies on a by-company basis, and you know more about this than I do, but in terms of the highs, the lows, the ranges and the mix of all that, there's a wide variation, a wide variability between the companies. So although in aggregate the industry's exposure is relatively low and certainly manageable, the results vary widely by company. And they're often material: the credit risk is often material at the individual company level. To put this in perspective, getting back to the P&C industry, the ratio of reinsurance recoverables—the surplus there is about 87 percent. So it's a much higher number, and I think we can probably agree that the P&C industry is a lot more volatile and perhaps buys more reinsurance for that reason.

Avoiding excessive risk concentrations: here I'm really defining risk in a couple of ways, and the most obvious one is your inability to collect your recoverables from your reinsurance partner. That's pretty straightforward, pretty obvious. Also there are situations where the ceding company may be in a situation where they're essentially forced to recapture some of their business. And that's because perhaps the reinsurance partner is in some type of financial distress situation. Connected to that is that can cause a change in your business plan and your capital requirements. Obviously, one of the big reasons reinsurance is used is to help manage capital, and to the extent that you see business to reinsure and then downstream or a few years later you have to recapture that business, that can cause you to adjust things like your business plan, your retention rates, your capital plan, that type of thing. So really that's how I'm defining risk when I'm talking about risk concentrations here.

When you look at avoiding risk concentrations, the first thing that jumps to mind is just diversify. Our view there is that really that's more important than it's ever been at this point. We think that for a variety of reasons, and I'll get into those a little bit later, the reinsurance market is more volatile, financial results are more volatile, and as a result we think that having a diversified portfolio of reinsurers is probably more important than it's ever been.

Another way to avoid excessive risk concentrations: you can look at it in two ways. Number one is just having a concentration with a few or one or two specific reinsurers. You can also manage that risk if you do have a concentration, but it's with a rock solid reinsurer, obviously, you're less concerned about it. So having an effective reinsurance security review process is really important.

The catchall to all of this is if everything else goes wrong and you need to raise some capital, if you had the financial flexibility to do that, at reasonable terms, that can be a key factor in managing these risk concentrations. The tricky thing there, and we'll get into it a little bit later on, is you have to manage that within the context of what's going on in the capital markets. And in some ways that can be influenced very heavily by factors that are beyond your control or the company's control. So that's a little bit tricky in terms of managing that risk.

Diversification, the basic idea behind managing your risk concentrations: we feel that it's more difficult perhaps than it has been in the past, just because there have been some consolidation and contraction in the reinsurance industry. And in specific market segments it can be difficult to find enough quality reinsurance to really diversify the risk that you face. Another reason why we think that diversification is increasing in importance is that financial results have become more volatile than they were over the last several years, and I think investment losses, product mispricing, things like unit cover, all of those factors, as a result of things like that, the financial results and the financial stability of companies have become more volatile. I think, as a result, our general view is that the average financial strength rating of the reinsurance industry has declined over the last 12–24 months. I think that's been reflected in ratings, and when you look at some of the really large reinsurers that have suffered rating downgrades, they carry a fairly large part of the capacity of the industry. So when we look at kind of the relative credit quality of the industry, we think it has declined.

The other thing I would say is in response to these more volatile financial results, rapid changes in capital market conditions, things like that, that the rating cycles' duration has shortened and stability of ratings has declined somewhat. The rating outlook we assign to a company is designed to cover a 12- to 18-month period. I think, in general, the factors that are impacting the company over that time period have just accelerated, and as a result, the duration shortened. When you put all this together, from our perspective, we think it's made rating agencies' jobs a little more difficult. We also think if you're a ceding company, and you're out there

evaluating your reinsurance partners, it's made things more difficult for you, as well. That leads to just a heightened need for effective due diligence and security processes when you're evaluating your reinsurers.

I came up with several things when I was thinking about what you need to have an effective security review process. Here I'm talking about what you do or what you look at when you sit down and you evaluate the credit quality of your potential reinsurers. One thing that came to mind—and you'd actually be surprised, although this sounds relatively easy, there are a lot of companies that don't do this—but you really need to set industry-wide exposure limits, and you need to look at credit risk you face from a reinsurer, both in terms of the recoverables that your reinsurance contracts might generate, and then in terms on the asset side of the balance sheet, any credit exposure you might have from either that company or more likely one of that company's affiliates. You can have exposure in your investment portfolio to the bonds of that company or an affiliate, or even stock of that company or that company's affiliates. So that's one thing that I think needs to be managed.

The other thing—and this is something that always kind of strikes us—is we have companies all the time that say, "Oh, this isn't material, it's one-quarter's worth of earnings and it's a very small part of the assets of our company." Well, we tend to look at those exposures relative to the surplus base of the company. Depending on the leverage of the company, you can have something be a fairly small part of your assets or fairly small part of your earnings, but it can represent a material part of the capital of the surpluses. So I think when you're evaluating what type of recoverables a potential contract might generate with the reinsurer, you might have a CEO who is always worried about what it is going to potentially do to earnings the next quarter, but you really need to evaluate it relative to the capital base of your company.

You should establish an effective due diligence and a monitoring system. There you really need to focus on both the ability and the willingness or the incentives to pay, and I think everybody has a pretty good idea of what I'm talking about in terms of the ability to pay. What's the fundamental quality of that company, and how do you arrive at your opinion of that? But what we think has become even more important recently are the willingness and the incentive issues. Is this potential reinsurance partner that you're evaluating committed to this business? Is this partner committed to this line of business? And that's an important factor because if they're out of the business at some point in time, their need to service you as a client declines. The cash-flow dynamics of who is sending cash to whom and how promptly it gets exchanged can change dramatically too if they decide to get out of the business at some point in time and not accept new business on a go-forward basis. So I think that's something that should be evaluated.

The last one is understanding rating agencies' processes and hot buttons, and hopefully I can give you an idea of what those are. In terms of hot buttons, I'll touch a little bit on this more later, but I think these include things like liquidity,

optionality and contracts, rating triggers and the kind of leverage that's embedded in the insurance contracts. Those are, to some extent, some of the less traditional types of things that we would look at, and I would say they're things that we at Fitch at least are focusing on heavily right now.

Now, if you were designing a due diligence process or security review process, I'd suggest a kind of a boilerplate, a really high-level way we look at evaluating our companies that we rate. Under industry review, we're really looking at what the level of competition is in an industry for a particular line of business. How orderly has it been in time? In other words, have companies gotten in and out at a very fast rate? We're looking for things like what do you need to form a competitive advantage? Is it scale? Is it specific underwriting expertise? What are the entry barriers in that particular line for that risk? Because those can have a big influence on the extent that companies get in or out of the business, and that's an important thing. And then we're looking at basic industry fundamentals: things that impact pricing and costs and distribution costs, you know, interest rate levels, all the typical types of things that I'm sure you look at when you're evaluating a product or pricing or things like that.

Operational review: we're looking for distribution capabilities in the mix, and that's very important in the life insurance industry—all kinds of the warm, fuzzy things like market share, position and growth. What are the franchise value and the brand quality of the company? The product mix of the company is critical. And understanding the product mix, how it's changed recently, how it's likely to change going forward: that can have a huge impact on our view as a company.

Organizational review: there we're really looking more at where the specific insurance entities sit within the overall organization. What are the cash flows that are perhaps dividended between companies? Is it a holding company? Are there shareholder requirements, things like that?

Management review: there you're looking for things like appetite for risk. I would think this would be something that, as a ceding company looking at a reinsurance partner, you'd get a fairly good view of, like what's their credibility? What's their track record? Have they been able to perform as they said they have in the past? That's something that we look at pretty heavily, and I think it's something that, as a ceding company, you'd be interested in.

Financial review: there we're looking at all the standard things like return on equity, return on surplus, what's the return on assets? What's the source of the profits of the company, and how volatile have they been? Obviously, your kind of catchall is looking at capital strength and capital levels.

That's kind of a very high-level boilerplate look at what we do, when we go out and we look at a company and we assign a rating. And to the extent that we're interested in the credit quality of a reinsurer, and to the extent that you're

interested in the credit quality of a reinsurer, those seem like things that you might want to consider from my perspective.

Traditional red flags: when we go through our rating process, these are fairly straightforward. Rapid growth—it's difficult to explain or understand where it's coming from. Aggressive pricing terms or investment strategy, unexpected reserve charges and then, obviously, negative capital trends: that's as basic as it gets, whether it be from operations or investments.

These nontraditional red flags tie in to some extent with those hot button issues that I talked about earlier. And here we're looking at things like what's the credit default market telling us? You know, if all the hedge funds are saying the spread should be wider than the rating agencies, why is that? That's something that we look at. Bond price anomalies are kind of the same thing. What's the market saying relative to what we're saying? And then equity market deterioration, what's happened to the company's stock price? That can be an indicator as well.

So I would say the mechanics of our rating process are generally unchanged from what they've historically been, but on the heels of Enron, WorldCom, all those issues, we're weighing these factors a little more heavily, and those are the things I talked about earlier: liquidity, financial flexibility, confidence, sensitivity, accounting transparency and management quality—those are some of the nontraditional issues that I think we are spending a little more time evaluating these days.

Annuity and Life Re: as I said, I'm not really trying to single them out for any other reason other than they have been in the news quite a bit, and a lot of these issues that I'm talking about I think had an impact on them, as well as some of the things that Ed brought up with letters of credit. We actually withdrew our rating on August 29, but essentially from February 2002, which is when we had it rated A, it ended up being rated C, when we withdrew the rating.

I'm sure a lot of you are familiar with what's going on there, and in terms of what they've said publicly, but these are just some comments that have come out of SEC filings. Essentially, they're in a situation where they've disclosed that they've ceased writing new business, are not accepting new business on existing treaties under existing terms, and they were really looking at ways to reduce their collateral requirements by recapturing, retroceding or novating certain reinsurance agreements. And then ultimately if some of those strategies weren't successful, they'd be required to liquidate different parts of the business.

If we're talking here about credit risk, you can obviously say, "Well, what happened there? In Fitch's view, what went wrong?" From our perspective, it's a convergence of several factors, and I wouldn't say these are necessarily exclusive to offshore companies, although the fact that they were an offshore company did have some impact on what happened. But number one, they were a relatively young company. I think the company was started in December 1997, and so from December 1997 to

2002 the company is about 5 years old. They did have concentrated blocks of business, and it grew rapidly. Rapid growth is always something that's difficult for any company to manage.

That's one thing that might have contributed to some of the problems that led to their ceasing to write new business, etc. Some of the other things that happened: there were some pricing assumptions that turned out to be materially inaccurate, things on surrender assumptions, assumed investment returns, things like that. They ran into some U.S. regulatory issues and capital market conditions, and I think they were essentially in a situation where in 2002 they were looking to raise some capital, bring some outside capital into the company, and that was a very dicey time in the capital markets, the bond markets. You had situations where people were concerned about the amount of commercial paper that General Electric had outstanding. So when that's getting bantered about in the market, you know it's a pretty dicey time in the credit markets. I think that impacted them.

Operating leverage built in the portions of the long-term agreements: I think that that to some extent ties in a little bit with what Ed was talking about in terms of some of the mismatch of the duration. They had a lot of long-term contracts, and they were supported or backed up by letters of credit that, in this case, had a much shorter duration, and those letters of credit were potentially going away. So that was an issue. The offshore domicile generated large collateral requirements, and that ties in with what Ed said earlier.

So you put all that together, and what happened, well, it really resulted in a liquidity crunch, and investors refused to provide funds for additional collateral. The balance sheet became increasingly encumbered. I have some statistics here: as of the first quarter of 2003, if you looked at the cash and the fixed-income investments, which were a huge portion of their investment portfolio, three-quarters of it had been pledged as collateral for letters of credit, or placed in trust for the cedants' benefit, and they also had a huge funds-withheld balance. The balance sheet, in our view at least, had become increasingly encumbered at that point in time.

I'm going to quickly touch on mergers and acquisitions' impact on credit quality, and it's the last topic I'm going to talk about. I think we'd always kind of viewed it as a dual-edged sword. You know, companies that had been acquired typically were acquired by stronger companies. They were bringing something to the table that the acquired company lacked, whether it was product capabilities, scale, something that was making that company perhaps less competitive. So, in our view, I think essentially what typically happened is you had a stronger company buying a weaker company, and that's good for reinsurance credit quality. The flip side of that is it results in a more concentrated industry. And I think those are the mechanics of what happens in that situation, and that's been coupled with some fairly large and strong companies deciding that maybe reinsurance is not as core a business for

them as it had been in the past. And so, I guess these points speak to a contraction to some extent in the life and reinsurance industry in terms of capacity.

I think something else contributed to that contraction. Some of the large reinsurers write both life and P&C business—and the terms of the P&C business have been very favorable over the last couple of years—so I think there's probably been a desire to commit more of their capital to that than perhaps the life industry.

Mergers and acquisitions activity has been light over the last several years. I think companies have been focusing on and coping with a difficult environment in terms of a low-interest-rate environment, and there have been a lot of credit problems. The equity markets up until this year have had three straight years of decline. You put all that together, and I think companies were a little bit more worried about managing their own business than acquiring someone else's. Right now, if you look at the stock market, that's come back quite a bit this year, and it looks like things are improving there. With credit problems, our view is generally that the credit cycle has bottomed out, and we're coming out of a credit problem, kind of a trough with that cycle. Interest rates have picked up over the last month or two months, and I think the general view there is they couldn't go much lower. So you put all that together, and I think that we believe that the mergers and acquisitions market is likely to pick up certainly from where it has been over the last couple of years.

MR. DANA WIELE: My topic is the more rigorous enforcement of treaty terms. I think a lot of what I say is really an outgrowth of maturity in the life reinsurance market because that drives a lot of these factors, and it drives a lot of the difference that I've seen. I'm sure, looking at the audience, that many of you have seen the differences in the way ceding companies and reinsurers deal with each other. But I've been in the industry long enough to remember when so many things were done on the handshake. And so we begin with that was then, and I say once upon a time, reinsurance was characterized by personal relationships and understandings between a few representatives of each party.

It really wasn't that many years ago when we didn't even have a regulation requiring life reinsurance agreements to be in writing. When a lawyer looks at that, they would say, well, you'd be crazy not to put it in writing. I can remember working inside a P&C company at one time, and if a reinsurance question came up, there were a few individuals who knew, and at some point the contracts would catch up. I see people nodding their heads. The contracts would catch up with the administration, because an arrangement would be struck, the deal would be put in place, but if Ms. Smith or Mr. Jones who had negotiated the deal were on vacation or something, you literally had to wait until they got back to know exactly what happened in a given situation. And it sounded very disturbing to me as a young lawyer, but I was told that's just the way things were and to get used it.

So I'd say handshakes rather than written contracts completed the deal, and there was little regulation of treaty terms. But that was then, and there were few lawyers

involved. When I first started practicing privately, or becoming involved in reinsurance, people said, "Why would you want to do that?" Yes, when there's a dispute, they need you, and they will need you in a big way, and these things have been going on for ages. But it doesn't really sound like anything that you could put food on the table consistently for the family with. But that's proven not to be the case, fortunately.

But this is now. Today we have written contracts. We review treaty terms more often than not by multiple disciplines within the ceding company and the reinsurer. Handshakes are replaced with representations and warranties, one of my favorite topics, and we have longer treaty documents, but we have more disputes. So maybe I'm wrong about putting it down in writing and things are better.

I can remember being questioned for the length of treaty documents, many times. "Oh, our ceding companies will never buy into that", our client reinsurers would say. "It's 50 pages; they don't want to read that. They don't want to read 30 pages. Our competitor is doing it with less." And in the last five years, I can't remember a single time when the ceding company, or hearing through a client or from a ceding company, that they've complained about the length of the documents. They're beginning to ask for more language in the documents. So I think that's a complete flip-flop.

Why? Some of this has nothing to do with law, this is just me putting on an economics hat, but let's explore this. Mature reinsurance markets: I think when you have mature markets in any industry and certainly in ours, you see a concentration of the players; you see the big and strong acquiring the little. You see new entrants coming in, when prices go up as a result of that. But they have to be more and more aggressive all the time to get a smaller piece of the pie that's available in smaller margins. You have companies willing to take risks that maybe the long tried-and-true companies would not take. Narrow profit margins, merger mania create fewer suppliers, fewer service providers, and price competition is fierce. Mark just talked about that a little bit when he addressed Annuity and Life Re, and Ed touched on that as well.

More desire for diversifications: today I think there's a "don't put all your eggs in one basket" ceding. If you had a relationship as a ceding company with one reinsurer, and it was a relationship that grew out of the old handshake days or good long-term dealing, today we'd stop and look at that. Clients say, "Yes, I want to keep a treaty or treaties in place with reinsurer A, but I want someone else in there, because I don't want to be overexposed to reinsurer A." I never heard that in the past. In the last eight to 10 years, that's a bigger thing. But as a result, the old relationship is a little bit abrogated, because you're going out for financial reasons to involve more parties.

Continued globalization and increased regulation of terms: you know, it wasn't until 1985 that New York had the first bulletin in life reinsurance, which told us what you

had to put in your treaty, if you wanted the hope of having an adequate risk passage. And before that, all we really needed coast to coast was an insolvency clause, and we needed to discuss a few other things and needed to have things in writing maybe. But all that's changed.

So, as a result, the age of the handshake reinsurance transaction draws to an end; there is increased adversarial posturing between cedant and reinsurer and a potential decline in old-line loyalty and commitment to work through differences. Good faith and fair dealing are the underpinning of any reinsurance relationship, but what we see today is, yes, we'll work with you, one side the other, but not at the expense of thin profits. More lawyers are involved in reinsurance. There are more disputes, not just more arbitrations, but more litigations than we've had in the past.

So what should a reinsurance counsel advise its clients? What I'm saying I think really comes along and looks at a lot of the things Mark addressed from a different perspective. From the lawyers' approach, I want to urge clients to adopt a methodical approach in evaluating, negotiating and entering into reinsurance transactions. Involve multiple disciplines in your company upfront, work through these things, evaluate the client and evaluate the transaction. If reinsurance is a regular activity in your enterprise, develop or adopt standard treaty articles. And review the same annually to accommodate changes in regulation and legal interpretations.

Once my reinsurance clients are on standardized language, it doesn't mean they never deviate or should never deviate from that. It just means we want an orderly system to make sure that all these highlights I'm about to get to somehow were addressed upfront and worked through, with the aim to minimizing the amount of disputes that could rise later.

The multidisciplined approach: I spoke about a gentleman in the P&C company that, if he was on vacation, you had to wait until he came back to find out what the terms were going to be for reinsurance recovery on a certain claim. That obviously wasn't a multidisciplined approach. He or she may have checked with one other person in the company and negotiated the reinsurance cover, and that was about it. A multidisciplined approach is involving a team of people from a reinsurer, a team of people from a ceding company, dealing with issues during the treaty-drafting stage rather than after the treaty is signed. Yes, that makes the document longer, but the document then embodies the intent of the parties. And it provides for binding arbitration of disputes in the treaties.

If the cedant is to make representations as to the condition of due diligence materials—and it really should—and warrant facts to the reinsurer, let's make sure the specific references are there in the treaty for these things. A reinsurer today doesn't have the option to just walk away from a life reinsurance agreement. We know that's true, unless they don't get paid something they're owed. So it's a very

serious point for a reinsurer, essentially, that if it has to do its homework upfront, it has to know that the materials it was given to review are good and accurate, and there's nothing misleading or incomplete. And it doesn't mean they can go in a closet and not look and ask obvious questions. It has to do that. Of course, it has to rely on this information, so that needs to be in the treaty.

If you, as an actuary of a company, as a reinsurer reviewed a list of materials, but you don't refer to those in the treaty, how are you ever going to fare in a dispute and say this was represented to me, I relied on this? If it's a phone call, reference the phone call in a list of ceding company data. If it's an e-mail, make reference to that. Because these are the kinds of things that you'll have to rely on to either resolve a dispute and keep the dispute from getting to a confrontational stage, or ultimately hang your hat on to win, should there be a confrontation in an organized resolution.

This speaks to reinsurers: avoid taking risks that can't be quantified. I see this a lot, and I saw this in a company we were just speaking about a little while ago, when I had an opportunity to review many of their contracts for someone who is interested. It's amazing; everybody wants to complete a deal if you're the reinsurer. But you should not be accepting risks that you cannot quantify. What are those risks? Extra-contractual obligations, risks for ex gratia payments, all these are risks that you should look at. How in the world would you price for that? And then monitor the treaty and preserve your rights. That's the team approach again. What do reinsurance clients request from counsel? They didn't request a whole lot 15 years ago. Today I think they request a lot more. At least I get a lot of calls.

Methodical approach: establish reasonable criteria for underwriting and treaty terms. We talked about standard terms. If somebody decides to make an intelligent decision to accept the risks they can't quantify, I'm not calling him a dunce. I'm just saying: exercise discipline and maybe you won't get there. But I say avoid deviations without careful deliberation. If you're going to take a risk you normally don't, and you're going to negotiate a provision, an arrangement you normally do not, then appreciate and know what you're doing. You'd be surprised how often in a dispute, it comes out that they just wanted to get it done, and they really didn't work through it.

Standard treaty terms do not mean boilerplate, though—rather, reasonable provisions designed to fit your company's needs. In the treaty terms, there are certain terms which should always be in there. That doesn't mean in each and every treaty that the same language should be used again. The starting point, yes, your standard language which you would work with can be used again. But make the language fit the deal that you've negotiated.

More standard treaty articles: this has become kind of a hot one. Will the reinsurer follow the fortunes of the ceding company? You know, follow the fortunes is kind of an age-old concept. Everybody knows what I'm talking about, and many times now

when people talk about follow the fortunes, they're actually talking about follow the settlements, which is somewhat similar. Follow the fortunes scares me, because from representing a reinsurer, many times when you start talking to the ceding company, they intend it to be much broader than it probably is. And the reinsurer many times just means, you do the underwriting, or you make the decisions or you pay the claims. I'd like to suggest to you it's broader than that. If you're going to accept it in a treaty, talk to your other party about it and know what you're getting into.

How will changes in the law or regulation or subsequent regulatory orders impact the reinsurance? As reinsurer, when you get into the deal, you can't get out of it. So many times I like to take the approach to preserve the status quo. As reinsurer, when you bought this business, when you bought into this treaty, you did modeling and you made certain assumptions. So how do we make sure those are good? Well, we can't have a moving target. We have an obligation and a commitment to work through problems and to deal with things when they come up, but give yourself an out, if you will; the party should essentially force them back to the table if something unforeseen comes up. And work through it that way, as opposed to, "The treaty says this, this has happened. We paid this, now it's your obligation. The other side says this, but that's not what we bought into, that's not what we priced for." This is the day when the handshake is gone. This is the day when there are thinner margins. Competition is fierce, and this is the day when there are likely to be disputes, versus working something out, so prepare for it in advance.

Extra-contractual payments of the direct writer: this scares lawyers because we always assume that our clients really haven't gotten a handle on what that means. The reinsurer's perspective is very difficult, because the reinsurer will say, "We have to know that risk as well as the ceding company." They always tell me that. And the ceding company, I look at it and I say, "You're never going to know that risk as well as the ceding company. You don't know those agents. You don't know who wrote that. You don't know how it's really been administered and how things have been handled. You've done a very good due diligence." So be very careful in the risk you're accepting, and if you intend to accept certain risks for business reasons, or to make a transaction, be very clear. Just avoid using the boilerplate on something like that.

What about ex gratia payments? Does everybody know what an ex gratia payment is? That's a payment where life reinsurance contracts say: if you die, you get this; if you surrender, you get this. If a circumstance arises for a business reason, the ceding company says they don't really qualify for this payment. They don't qualify for that, but this is a good case here, a good agent. We're going to make payments anyway. Maybe there's a regulatory problem now come up. It's unpopular. There's a problem with our contract language, even though it was approved. We will make a payment. They make the payment. They turn to the reinsurer, and the reinsurer says, "Gosh, why are claims so high this quarter?" The ceding company comes back and says, "Oh, that's related to these cases." "How is that covered under the

contract?" the reinsurer asks. And the ceding company says, "Well, it isn't but you're following our fortunes and we're making these payments." You know, there are age-old ways and results given in the law as to how ex gratia payments are generally handled, but does anybody really know what they are? Is anybody comfortable with what they are? If you intend to cover that, and you may well, make a very logical decision and do that. Know what you're getting into or maybe put some limit on it. Talk to your ceding company, but do it before the treaty is in place.

Who sets the crediting rate, if you have that type of business? How is it done? I saw a treaty recently where a reinsurer was complaining about the way the ceding company behaved and how it prejudiced its ability to make any money and dumped all the risk on it. I looked at the treaty, and basically the treaty turned all the keys, left all the controls, everything with the ceding company. It had no checks and balances, no incentive. Gosh, what a great deal for the ceding company. I would have made that one too. Can we really complain about it as reinsurer? Secondarily, there are regulatory limits. If you're accepting all the risks as reinsurer inherent in that business, how far can you reach your hands into that ceding company? It's a regulatory question.

A similar question: who manages the assets if it's that type of a transaction? And what protections do you have if you're the ceding company; what are you giving up, if you're the reinsurer; what protections do you have?

Carefully and specifically define what is being reinsured. Describe the business: well, that's a very common thing for disputes. Was that covered? Was that not covered? Obviously in hindsight they wish they would have been more specific. And then other things have come up.

We've talked about the multidisciplined approach involving various disciplines from each company, and negotiating and completing the treaty. We've talked about dealing with issues during the drafting process. This flushes out many of the things that we've been talking about. Avoid deferring treatment of thorny issues until post-treaty execution.

Arbitration: reinsurers generally fare better in arbitration. Ceding companies generally fare a little bit less better in arbitrations than they do in litigation. But arbitration is typically historically the way we handle disputes after 75 years of the presence of federal arbitration acts. It's generally accepted pretty well, however, and you have to be careful because sometimes one size doesn't fit all, to pun an expression. Many times, rather than using a boilerplate arbitration clause, you should discuss this between the ceding company and the reinsurer. What disputes are to be arbitrated? Who will decide the arbitration? What rules will you follow? If you say you're going to follow certain procedures, but then you begin in your clause to talk about other procedures, make sure that you trump those procedures in the contract then to get what you intend.

Will there be any review? I recommend foreclosing a review by the courts. That's the reason you're in arbitration, unless there's been some serious misbehavior on the part of the arbitrators. But that's not to say that there shouldn't be enforcement of the award by the courts. And then what court is going to enforce it? Address all these types of things. Timeframes: keep it moving. That's very, very important. Many times, that's the one thing regulators will question. How long is this going to take? We need an answer.

Some people like negotiation clauses. I'm not a big fan of those, because I think the parties would have already worked it out and tried before they got their arbitration. The problem I see as a lawyer with the negotiation clause is it talks about everything coming on the table, and once arbitration starts, there will be rules established for discovery and getting documents and disclosure. During a negotiation stage, there are no such rules typically. You could draft something up, I guess, to agree. The difficulty I see with that is one party could be very insincere in their desire to work something out and use that negotiation to basically rape the other party of documents and information that they would not have a right to get in a formal trial or formal arbitration. So be very careful.

Representations and warranties: I talked about those a minute ago, and I said they're very critical because this reinsurer can't get out of a ceding company. You want to make sure that you're not representing something that you yourself do not have confidence in. So that's very important. The NAIC will let us, under the regs, make representations in the life reinsurance contract, as long as those representations are reasonably related to business we reinsure and as long as they don't go to the future performance of the business.

I thought I'd throw a quick little quiz in. Which of the items I'm going to mention are proper and which are inappropriate, that would disqualify for reserve credit? I just said you can't go to the future performance of the business, you can't warrant that. And it has to be reasonably related to the business reinsurer. So we look at each of these, and if these were stated in ceding company data or somehow represented in the treaty, would any of them cause the ceding company's credit to be put in question? Well, no other reinsurance on the block, does that sound like a problem? Lapses have historically been 7–10 percent per year. The policy forms themselves, always get those represented. Profits for the next five years are expected to be X percent: that one sounds a little questionable. The product is priced to achieve a 12 percent return on investment: some could argue about that; I think that's perfectly fine. It doesn't say it's going to get a 12; it says what we believe. The ceding company's annual statement: very common, but does that violate the reg? Is there stuff in there not reasonably related to the business reinsured? Probably. The ceding company is a corporation in good standing: it seems perfectly logical. They're signing the document. That violates the reg bill.

Here's a bonus question. Why are representations and warranties so important to the reinsurer? Here's the answer. Under current regulation, the reinsurer may not get out of the reinsurance agreement as its own option, except in fraud, material misrepresentation or nonpayment of premiums. The reinsurer has to do its homework as due diligence upfront. And it's only as good as the information it was provided. I'm a firm believer that we have to have very good reps and warranties for the sake of both parties.

I talked already about this: be careful taking risks that can't be quantified. And if you're going to take those risks for one reason or another, be careful how you discuss it and make sure you flush it out on the treaty.

Monitor the treaty: we talked about these—communications, evidence decisions in writing. Since the handshake is gone, we've talked about arbitrations, and there are many, many more arbitrations. I saw a survey recently; when I looked at the survey itself, I could really say, "Gee, it doesn't look like anything's really changed in the last so many years. The numbers look consistent." And then I read the commentary, and the commentator himself said, "I don't really believe this is accurate. I think they're not reporting it." No one likes to talk about arbitrations they're in, but there are more now. You see it in the news that there are more now than ever. And there are more disputes in courts regarding reinsurance. But good data are hard to find on arbitrations.

I talked about the enforceability. Courts still become hostile toward arbitration. Somehow they don't trust a process when there's money or rights involved. They don't trust a process where there are not strict rules on discovery. They don't trust the process where a panel makes decisions. And so if you give a court a chance, they will likely look for a way to throw your arbitration out. If you want arbitration, make it very clear in your contract that you want arbitration, arbitration of what disputes, and that you want it to be binding.

Enforceability: this is addressing being comprehensive in your arbitration. Spend some extra time looking at that in your treaty.

What's going on at the NAIC? I'm heading from here to the Chicago meeting of the NAIC; perhaps I'll see some of you there. In the last few years, a two-year process has been going on that's very interested in reinsurance. The NAIC rehabilitation and liquidation model act is being revised to conform to the Uniform Receivership Law. There are many areas of interest to insurers and reinsurers regarding that, as well as guarantee associations. It's been a very complex process. It was slated to take less than two years, perhaps 18 months. It's gone on longer for a variety of reasons, but it's drawing to a close. So we will see some changes to the insolvency law, and that will impact what happens in the horrible situation where there's an insolvency.

The other thing is that the foreign reinsurance syndicates continue to seek relaxation of standards for credit, given the domestic cedants for sessions to their companies. Funding a multibeneficiary reinsurance trust can now be done with letters of credit. The bad news about that is there is already a crunch on letter of credit capacity, and I think this is going to escalate that. And they're looking for a relaxation of stringent reporting requirements. Why? Because we have a hungry demand for reinsurance cover in the U.S. market, but the supply is shaky, and the collateralization is a problem. So this is being identified by the reinsurance committee; it's being talked about. There's constant pressure, but will we see a relaxation of standards? I don't think that's the answer, because I think it flies in the face of what we've been talking about this morning about the protections.

MR. FRANK CLAPPER: I have a question for Mark. You showed first the evolution of Fitch's rating over the course of the year on Annuity and Life Re, and then you cited all the conditions. Weren't some of those conditions known before the rating changed? And if so, I'm not really picking on you, and I don't mean to criticize Fitch, but this is the thing that happens with ratings. And what I'm getting at is, if we want to decide whether or not to do business with Annuity and Life Re or some other company, I think we need to know more about their risk three or four years before this happens, instead of six months.

MR. ROUCK: Believe it or not, I anticipated I might get a question on this. It's a perfectly appropriate question. If you look at kind of where those ratings were, there was one point where the rating fell several notches, and I think it was like November 2002. Four or five ticks the rating went down. So you know, the question is, why so far and why so fast? Other than that, it was somewhat of a logical lock step down, and you're right, some of the things that I cited, you know, it was a young company, and it grew fast and it had concentrated blocks. Those are all things that we knew and in theory are incorporated in the rating. I think the one thing that in retrospect we didn't do as good a job on as we probably should have was understanding the individual contracts and understanding the leverage component embedded in those.

I think what it points out is liquidity, and to some extent, when you're relying on external capital, that's very fleeting. I was talking about that we were trying to incorporate—not incorporate, but maybe weigh more heavily—nontraditional things like liquidity, access to external capital, capital market access, embedded leverage—those are the things that I think a situation like Annuity and Life Re points out that we should have obviously weighed much more heavily. I don't have any better explanation than to say that those are lessons that I think we learned, and there are things that we have to look at more heavily going forward. But you're exactly right.