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Session 13TS
How to Converse in Reinsurance

Track: Reinsurance

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Summary: Do you wish that you could join in when your friends talk about combined coinsurance/modified coinsurance? Do you feel out of place at parties when the discussion turns to the advantages of quota share versus excess arrangements? Then this is the session for you.

This lively session covers the basics of reinsurance, including:

- *Why do companies use reinsurance?*
- *What are the types, and when are they used?*
- *How do transactions take place (negotiation, treaties, and administration)?*

Mr. Allen M. Klein: I am vice president and senior financial officer at CNA Life Re. I am responsible for the actuarial, financial, and claims functions. Our first speaker is Donna Jarvis. She is responsible for planning, marketing, product development, and pricing of various group and individual reinsurance products. In particular, her specialty is group disability. Donna works for AXA Life Re. Next we have Jeff Poulin. Jeff has been working with London Life all of his career in reinsurance the past ten years. His responsibilities as vice president include marketing and pricing of life and annuity products. The last speaker will be Buddy Maughn. Buddy is executive vice president and chief actuary and is the North American solutions team leader responsible for the global life capital management for Employers Reinsurance Corporation (ERC). He's been with ERC for 20 years.

Now I would like to explain what we are going to do. First, Donna is going to give a history of reinsurance, as well as explain some of the reinsurance terminology. I'm going to come back on and do our first game, and then Jeff is going to talk about the structure of reinsurance. We'll play our second game, and then Buddy will finish with uses of reinsurance and some miscellaneous issues. We'll hopefully have a few minutes at the end for your questions as well.

Ms. Donna R. Jarvis: I'm going to give you a brief history of reinsurance. I don't want to dwell on it too long, because we have a lot of other important

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topics to discuss. The first reinsurance transaction that we have written record of actually occurred in 1370. And to remind you, Columbus discovered the New World in 1492, so this is about 120 years before Columbus discovered America.

In the city of Genoa, which is in the country we now know as Italy, there was a man by the name of Giovanni Sacco, and he was a merchant. He had some cargo that he needed to transport from Genoa to Flanders, which is in present-day Belgium. He decided to purchase insurance for the possible loss of cargo. The person from whom he purchased it was Guiliano Grillo. Now Guiliano was an intelligent man. Remember what the time frame was. At this time, of course, the sea was a vast unknown to the west of Spain and Portugal, and they thought there were sea monsters there or perhaps that they'd drive off the edge of the earth. The insurer decided to purchase reinsurance for the most perilous part of the journey, which was from Spain to Flanders. When we discuss different types of reinsurance transactions, you might call this transaction *excess of distance.* The reinsurer, in this particular case, was Goffredi Di Benavia. The broker in this transaction was Bartholomeo Lomellino. Unfortunately, we don't have a record of whether or not the voyage was successful or a claim was paid, but let's hope it was successful. And for those of you who enjoy reading contract language, whether it is insurance contracts or reinsurance treaties, think about this. This contract was written in Latin. Thank your lucky stars that you have what you have today.

Now I'm sure all of you have heard of Lloyd's of London. In fact, a number of people who are outside the insurance industry are familiar with Lloyd's, but I bet you didn't know that Lloyd's actually started as a coffee shop. A man by the name of Edward Lloyd founded a coffee shop in 1662, which happened to be near the docks of London. As you can imagine, it served as a meeting place for people in the shipping business. Insurance negotiations often took place there, similar to the one that we just discussed. Edward Lloyd decided to provide some great customer service to his patrons. He put a blackboard up on one of the walls of his coffee shop, which kept a status of various ships and their comings and goings at various ports of call. This actually became the foundation for the Lloyd's syndicates.

Now just a couple quick dates for you, as to reinsurance transactions in America. The earliest U.S. life reinsurance transaction that we know of occurred in 1819 and involved Aetna. It was actually an assumption reinsurance arrangement. In 1852 the first professional reinsurer, Cologne Re, began operations in the U.S. And the first U.S.-based reinsurer began operations in 1912, and it was called the First Reinsurance Company of Hartford.

Let's get into some terminology so that you have a basis for the rest of today's presentation. First the term *ceded. To cede* means to transfer risk from an issuing carrier to a reinsurer. And the opposite of ceding a risk is to *assume* a risk. A person or company that cedes risk is called a *ceding company.* A company that assumes risk is called an *assuming company* or a *reinsurer.*

There's actually a transaction where a reinsurer can purchase reinsurance, and this is called *retrocession.* When a reinsurer purchases reinsurance on its block, it retrocedes the risk. And the company that accepts that risk can be called a reinsurer, but it is more commonly called a *retrocessionaire.*

Next we have *treaty,* and as I'm sure you're all aware, a treaty is a legal contract that defines the reinsurance agreement in place between the ceding company and the assuming company. It's obviously tailored to the transaction at hand, but it also includes many standard provisions, such as what happens in the event of one company's insolvency, or what happens if the two parties disagree.

There are typically two ways that an insurer or a ceding company can report information to a reinsurer. The first is called *bordereau,* also known as *bulk reporting* or *self-administration.* As I'm sure you're all aware, obviously the best way to manage your risk is to have a lot of information about it. Bordereau is a little bit more summarized detail where the insurance company or ceding company provides summary details, total premiums earned over the period of time, total claims paid, total reserves, and whatnot. *Individual session administration* or *seriatim reporting* is actually preferable. This would give you a list of all policies covered under the transaction, possibly including, if it were individual people, their dates of birth, ages, genders, and the amount –at risk.

Next is *retention.* That's the maximum amount of coverage that an insurance company would like to keep at risk on any one life. An insurance company might want to sell large policies, because obviously it feels some pressure to do so in the marketplace to meet its clients' needs. However, it may not feel comfortable keeping all that risk itself. For instance, an insurance company might decide that it's willing to keep about $500,000 if any one person were to die. But let's say that person actually wanted to purchase a policy of $1 million. Then the issuing carrier would seek reinsurance for the excess of the amount it wanted to keep, its retention of $500,000, and cede the rest to the reinsurance company.

Capacity is what is offered by the reinsurance company to the ceding carrier. Referring to the example I just gave you, a reinsurer might be willing to offer a ceding company an additional $1 million of capacity in addition to the ceding company's retention. Using the example of the $1 million policy, $500,000 would be kept by the ceding carrier, and $500,000 would then be ceded to the reinsurer.

Recapture is actually a treaty provision. It's an option which allows the ceding company to take back some of the liability that it had already ceded to the reinsurer. It is an option, so it does not have to be utilized. It's usually done at a predetermined point in time, such as 10 to 20 years after the contract is effective, and only under certain conditions. In the example that I've been working with, if the ceding carrier decided that it could increase its retention from $500,000 to $750,000 for any one life, it could do so with the reinsurer.

The *binding limit* is the amount of risk that the ceding company can cede to the reinsurer. It's usually associated with an automatic treaty, and only if all the conditions of the reinsurance contract are met. In the example I had previously given you where the reinsurer was willing to offer $1 million of capacity, the binding limit in that case would be $1 million.

The *jumbo limit* generally occurs on automatic individual life reinsurance transactions, and it's a protective measure for reinsurers. As I'm sure you're all aware, reinsurers assume risks from various companies, and there's a chance that if people have a lot of insurance in the marketplace, the reinsurer could actually exceed its own retention, because it receives a share of risk on the same life from various carriers. This protects the reinsurer from exceeding their stated retention.

When a person applies for insurance, you add up the sum of all the insurance he or she has in force and all the new insurance he or she is looking to acquire. If this exceeds the jumbo limit, then the carrier needs to notify the reinsurer of this. It does not fall within the terms of the treaty. It's in fact submitted facultatively. And you'll find out more about that later.

An example might be about $20 million. That's a standard jumbo limit right now. If the sum of the in-force business for this particular applicant plus the new stuff that he or she is applying for exceeds $20 million, the ceding company would need to notify the reinsurer of that.

A pool is especially prevalent in the A&H market, although it's also common in the individual life reinsurance market. As I'm sure you can imagine, a *pool* is just a group of reinsurers that get together to assume risks. They each take a specified percentage or quota share of the risks that are ceded into the pool. Usually on this kind of transaction there's a lead reinsurer that sets the terms, conditions, and rates, and also performs some of the due diligence that's required in any reinsurance transaction.

Mr. Klein: Time for our first game. Before we start the game, I think we should introduce our contestants, so if you say your name and what company you work for, that would be great.

Mr. Stewart D. Lawrence: Stewart Lawrence, The Segal Company.

Mr. Rick S. Pawelski: Rick Pawelski, Health America.

Mr. John Fleming: John Fleming, Guarantee Life Insurance.

Mr. Tom Francis O'Sullivan: Tom O'Sullivan, Canada Life.

Mr. Bill McDonald: Bill McDonald, MIB.

Mr. Klein: A couple of things about how we are going to play the game. The game is going to be just like "Who Wants to Be a Millionaire?" except it's going to be called "Who Wants to be a Retrocessionaire?" To be a retrocessionaire, you have to know about reinsurance. We are going to see who knows about reinsurance. We have six questions. And even if you miss one, you are going to keep going and play all six questions. If you miss one, you are not out, as in the real game.

To figure out who is going to get to play, we have to have a quick-answer question, which I will read for you. I want you to write your answers on a sheet of paper. Just put the letters in the order you think is correct as soon as you have your answer. Put these reinsurers in the order of the founding of their U.S. operations beginning with the earliest: (a) AXA Re Life; (b) CNA Life Re; (c) ERC Life; and (d) London Life Re. Write the letters down. Who thinks he has it? Raise your hand. We have our first contestant. And you are, again?

Mr. O'Sullivan: Thomas O'Sullivan, from Canada Life.

Mr. Klein: Before we start, I want you to know that the six questions are not necessarily easiest to hardest. Also, the lifelines are as in the game, "50/50," "Ask the Audience," and "Call a Friend." What we will do for "Ask the Audience" is just do a poll of hands. For the last lifeline, "Call a Friend," you can pick anyone from the audience you want to help you other than the panel members. You will have 30 seconds to discuss your answer.

The first question is, Does the term *ceded* mean (a) the acceptance of an insurance risk by one company from another, (b) the protection against claims fluctuations, (c) the transfer of an insurance risk from one company to another, or (d) the selling of insurance protection?

Mr. O'Sullivan: OK, Regis. I don't think it's (a). Doesn't look like (b), and (d) is not it. I'm going to go for (c) as my final answer, Regis.

Mr. Klein: Final answer?

Mr. O'Sullivan: Final answer.

Mr. Klein: OK. It is (c). Congratulations. You got one right.

Mr. O'Sullivan: I would have hated to get the first one wrong.

Mr. Klein: Again, they aren't necessarily easiest to hardest. OK, second question. With respect to self-administration, which of the following is *not* true: (a) it is also known as bulk reinsurance; (b) it is also known as bordereau reinsurance; (c) the advent of modern data-processing equipment has, for the most part, moved ceding companies away from self-administration; or (d) self-administration is a reinsurance arrangement where the ceding company provides the reinsurer with periodic reports for reinsurance ceded, which show premium

in force, reserve, and other information required by the reinsurer for its financial reports?

Mr. O'Sullivan: I'm pretty sure (d) is true, so that's not it. We have a friendly audience out here. I'm going to ask the audience. Let's take a poll.

Mr. Klein: How many think it's (a)? Nobody. How many think it's (b)? Nobody again. How many think it's (c)? Looks like, computers, 88%. How many think it's (d)? OK. We have a couple.

Mr. O'Sullivan: He looks like a smart man over there. I don't know. Either that or he wants to get back to the seat and give me the wrong answer. I'm going to go with (c), Regis.

Mr. Klein: You're going to go with the audience?

Mr. O'Sullivan: I am going with the audience.

Mr. Klein: Final answer?

Mr. O'Sullivan: Final answer.

Mr. Klein: OK, (c) is correct. Donna, can you mark off that he's used "Ask the Audience"? Thanks.

Question three. You're doing great so far. With respect to retention, which of the following is true: (i) retention limits are usually calculated as a ratio of the amount ceded to the original amount insured; (ii) the retention limits may be stated as a constant amount for all risks; or (iii) the board of directors usually approves the retention limits? Is it (a) all but i, (b) all but ii, (c) all but iii, or (d) all?

Mr. O'Sullivan: Boy, I thought it was all but ii except for Sunday, but OK. I'm going to go, Regis, with (a), all but i.

Mr. Klein: Final answer?

Mr. O'Sullivan: I'm going to go with (a) as the final answer here.

Mr. Klein: OK, that's correct. Nice job.

Mr. O'Sullivan: Thank you. How many questions are there, Regis?

Mr. Klein: Six questions.

Mr. O'Sullivan: Oh, not 15?

Mr. Klein: You have three more.

Mr. O'Sullivan: OK.

Mr. Klein: Again, which of the following is *not* true: (a) the automatic binding limit is the amount of risk on a given life that the ceding company can cede automatically to the reinsurer and the reinsurer must accept if all other conditions for automatic reinsurance are met; (b) the jumbo limit is a specified amount by which the total amount of insurance in force and applied for in all companies on the individual must not be exceeded; (c) a reinsurer may be automatically bound to different maximum amounts depending on the age and substandard rating of the proposed insured; or (d) the reinsurance treaty is typically no more than five pages?

Mr. O'Sullivan: I'm going to go with (d).

Mr. Klein: That's your final answer?

Mr. O'Sullivan: That's my final answer.

Mr. Klein: Good job. I think the audience got that one, too. Two more and you still have two lifelines left! How about that?

Mr. O'Sullivan: Oh boy.

Mr. Klein: The errors and omissions clause is meant to do which of the following: (a) place the liability created by the error or oversight on the party who was primarily responsible for the error, (b) place the parties in their proper positions as if the oversight had not occurred, (c) allow for negotiation as to which party was primarily at fault, or (d) place the burden of proof on the party that created the error or oversight?

Mr. O'Sullivan: Did we go through this in the presentation? I don't remember this one.

Mr. Klein: We may not have gone through it. This is another reinsurance term. You have two lifelines and two questions left.

Mr. O'Sullivan: Oh boy. I'll go with the 50/50 here, Regis.

Mr. Klein: 50/50. OK. It is not (a) or (c).

Mr. O'Sullivan: OK, Regis, I'm going to go with (b).

Mr. Klein: Is that your final answer?

Mr. O'Sullivan: Final answer.

Mr. Klein: Yes, (b) is correct. Nice job!
Mr. O'Sullivan: One more to go and I'm a millionaire—or a retrocessionaire!

Mr. Klein: OK, number six. Under YRT reinsurance, which of the following is *not* true: (a) only the morbidity or mortality risk is transferred; (b) the ceding company retains responsibility for establishing policy reserves and payments for all surrenders, dividends, commissions, and expenses; (c) the premium rate is usually specific for a given age, duration, and sex, and it increases each year based on the attained age/duration and net amount at risk; or (d) reinsurers typically participate in policy loans under YRT? You do have one more lifeline.

Mr. O'Sullivan: Boy, it's a good one, too. Who'd like to help me out on this one? Any volunteers?

Mr. Craig R. Corrie: I'm with Scottish Annuity & Life.

Mr. O'Sullivan: I'm actually looking pretty closely at (d) there, Craig. What do you think?

Mr. Corrie: Well, I'm thinking with YRT you're probably not worried too much about policy loans. The other side of it is reinsurance.

Mr. O'Sullivan: I think you're right. We're going to go with (d). Final answer.

Mr. Klein: Final answer?

Mr. O'Sullivan: Final answer.

Mr. Klein: Yes, (d) is correct.

Mr. O'Sullivan: You get half my money for that, Craig. I couldn't have done it without you guys.

Mr. Klein: Our next speaker is Jeff Poulin.

Mr. Jean-Francois Poulin: I'm going to be talking about reinsurance structures. And it's a little less fun than the game, but I'll try to keep it entertaining. I'll talk about automatic versus facultative reinsurance, which we've addressed a little in Donna's presentation. Essentially this has to do with an ongoing treaty for new business. Then I'll talk about proportional versus nonproportional business and then the proportional structures and the nonproportional structures that are available in the marketplace.

I'll start with automatic. An automatic treaty is a treaty where essentially the reinsurer underwrites the company's underwriting. If it's happy with the way the company does business, it will agree to automatically take a share of the business that the company takes. It's either a share or a portion in excess of a specific risk. The reinsurer will typically put production limits or jumbo limits on individual cases. It will look at the underwriting and probably specify certain guidelines that it wants in the automatic treaty to make sure that the company follows those guidelines. It will preapprove the rates and the maximum

exposure that the company will cede to it. Essentially, once it's done that job, it relies on the ceding company's underwriting. Although it's willing to offer underwriting assistance to the company, the reinsurer is behind the company as far as underwriting goes.

On a facultative treaty that's a different story. Basically, each individual case is sent to the reinsurer that reviews it and decides to either take or not take it. Typically on a facultative treaty, the reinsurer always takes the risk or at least offers ratings and an opinion as to the underwriting. This is a treaty where the ceding company feels it doesn't have a lot of experience on a potentially large or difficult case, and it wants to go to the reinsurer for its underwriting expertise. Typically, reinsurers see a lot more of these harder cases to handle, or jumbo cases. They'll have the expertise that the ceding company doesn't have for these cases, whereas on the automatic treaty the reinsurer relies on the ceding company's underwriting. It's sort of the other way around for a facultative treaty.

I just wanted to note the facultative obligatory treaty is a fairly common treaty in the marketplace. Essentially it's kind of a funny name to basically say it's an automatic session, except the reinsurer has the right to turn down the risk if it's already gotten up to its retention on a particular risk. If you have a reinsurer that already has $2 million of exposure on one life and its retention is $5 million, and you present it with another $5 million on the same case, it can turn down $2 million of that $5 million. This gives the reinsurer the right to refuse if it has more exposure than it wants on a given risk.

Proportional reinsurance is essentially what we refer to as quota-share treaties. Basically, the reinsurer gets a proportion of the risk in a given block of business and shares a proportion of the benefits and the expenses in that block of business. In the marketplace you see a lot of companies going out to get reinsurance. The reason they would do proportional reinsurance is either to get out of a line of business (the quota share then would be very large—it could be up to 100%) and cede out all the risk or just to get the reinsurer's expertise or capital to help them out. That would be closer to 50% quota share where your partner would be a reinsurer going forward.

The different structures I'm going to get into more detail on are coinsurance funds withheld, coinsurance, modified coinsurance, and the combined coinsurance/modified coinsurance (co-modco). There are different ways you can account for these quota-share transactions. But the essence is the same in ceding a proportional share of the risk to the reinsurer.

On nonproportional cases, basically this is where the reinsurer is taking a different part of the risk and may get a smaller premium for a larger chunk of the risk, but that attaches at a higher level. It's typically a stop-loss or an excess cover, and typically they are on a limited-time basis. Instead of sharing the ongoing risk for the future, you limit yourself to one-year, three-year, or five-year exposure.

Again, the risk is a different risk. A good example would be a group-health portfolio where you would have a company whose expected loss ratio would be 60%, and it's comfortable with getting the 60% loss ratio and going up to 70%. Then it feels management may not be happy with a loss ratio higher than that, but since it's group health it would bounce up and down from year to year, and you want to sort of limit that.

You may want to buy a stop-loss coverage that will attach at 70%; once you get to that level, the reinsurer takes the risk. You may pay only 2–3% of your premium to get that covered. Again, the reinsurer gets a small percentage of the premium, but if you got a 120% loss ratio the reinsurer gets a large chunk of the risk.

Now I'll go into the more typical structures and YRT. I'm not sure if you can qualify it as proportional or nonproportional. I think it's a little bit of both, depending on how it's structured. It's a long-term contract, but each year there's a different rate allocated, depending on the insured's age and risk category. The reinsurer is typically liable for the exposure less the reserve—what we call the net amount-at-risk. On a life policy it would be the face amount less the reserve. If you look at different kinds of policies, it's just basically the amount being paid that year less the reserve on that amount.

You see YRT typically on mortality business, although I have seen it on some health cases from time to time and on premium refund on life policies. They're a little harder to adjust. There's minimal surplus allowance benefit to do a YRT. There's usually an allowance paid up front by the reinsurer to reimburse for certain acquisition costs; then going forward you get reserve credit, to a certain extent, for the net amount-at-risk ceded. But it's not as powerful to get the strain passed on as in a quota-share transaction. Typically when you use YRT, you're afraid of the risk that your portfolio has in excess of a certain amount.

Coinsurance is a way to do proportional transactions. The proportional structures are all very similar in terms of what you're doing on the income statement side of your statements. You're essentially going to pass on a proportionate risk to the reinsurer. The difference in these structures lies in how you handle the balance-sheet side of the statement. On a pure coinsurance transaction, what you do is transfer the assets and the reserves to the reinsurer for its proportion of the risk. If the reinsurer takes 50% of the business going forward, you're going to cede it 50% of the premium and 50% of the reserve at inception, and let it handle 50% of the risk.

In theory, if it invests in the same assets as you, it'll have the same result on the block as you do. The reinsurers participate in all aspects of the risk, and that's true for all quota-share transactions. They'll reimburse the ceding company for a portion of their expenses and for their proportion of the benefits. It's probably the easiest way to understand quota share. It's the easiest to administer. You cede 50% out, and you get 50% reserve credit going forward.

Modified coinsurance again is a proportional transaction, except in this case the assets and the reserves stay with the ceding company. However, the risk associated with the proportion of the business that is ceded is flowing through the income statement of the reinsurer. The advantage of this structure is that you're essentially ceding the risk, but you're keeping the assets and the reserve in your books so that there is less asset transfer between the reinsurer and the ceding company. If there is a loss, the reinsurers will pay the loss. If there is a profit at the end of the year, the profit flows through to the reinsurers.

The disadvantage of this structure up until recently is you wouldn't get risk-based capital (RBC) credit if you were dealing with this structure. Despite the fact that you are sharing a proportion of the risk with the reinsurer, you could not take RBC credit for these reserves because they stayed in your books. They've recently changed the law, and you now do get RBC credit for reinsurance on a modified coinsurance basis. The reason why this is a little more complicated is everything flows through a modified coinsurance adjustment, which is essentially the difference in reserve plus the investment income on the assets. It's a little harder to do the accounting for these types of transactions.

The next one is funds-withheld coinsurance. This one essentially leaves the assets with the ceding company but transfers the reserve to the reinsurer. With coinsurance you transferred both the assets and the reserve. With modified coinsurance you kept both the assets and the reserve. For funds-withheld coinsurance you cede the reserve but keep the assets.

If you're worried about the reinsurer mismanaging those assets, this could be a way to deal with your quota-share transaction. The profit and losses flow through the funds-withheld account. Obviously, if there's a loss, the reinsurer has to pay the loss in the funds-withheld account, and profits flow out of the funds-withheld account. Again, this is another way to limit asset transfer between the reinsurer and the ceding company. If you want to understand the accounting better behind all these structures, I think the best books out there are John Tiller's books on reinsurance. He's done a great job going through each of the different structures and how they're accounted for on a statutory accounting basis. And it's part of the actuarial exam syllabus.

Next up is co-modco. This is a mix of coinsurance and modified coinsurance. The reason for this type of transaction to be used, again on a quota share, is that there's a large allowance up front. If you're taking an in-force block and you want to reimburse the ceding company for its acquisition cost, you would have an acquisition cost or an acquisition allowance, which is an initial allowance in a treaty. If you wanted to limit asset transfer again, you could do the reinsurance transaction on coinsurance part modco.

And what that does is as a reinsurer, basically, you're going to assume a portion of the block on a coinsurance basis and probably not get paid for it. There wouldn't be any assets coming your way as the reinsurer, yet you'll set up the

coinsurance reserve. The remainder of the assets stay with the reinsured, and the reserve stays there also as the modified coinsurance piece.

Typically that coinsurance piece reduces over time, and the treaty becomes a full modco once the initial allowance has been paid off. This is typically why this has been used, but you can use it for different reasons. I've seen a mix of co-modco used where there's a large difference between the tax reserve and the statutory reserve. Essentially the statutory reserve minus the tax reserve becomes the coinsurance reserve when the reinsurer handles it. Maybe the reinsurer has a better tax situation than the ceding company, so it will take on the extra reserve that's not tax deductible and leave the tax-deductible reserve with the ceding company. There are reasons for using this, but this is by far the most complicated structure.

I want to talk about the stop-loss and catastrophic covers on the nonproportional side. I just wanted to add a few points. Basically on a stop-loss cover you can have it on an individual basis, so you can have it such that you cover loss in excess of x dollars per individual or on an aggregate basis. Basically that becomes your entire portfolio that is covered. Typically, your reinsurer pays claims in excess of a given attachment point, up to a specified maximum, and the attachment point is what the ceding company retains in terms of risk.

There's usually a cap on these covers. It's very unlikely to see unlimited stop-loss cover out there where the reinsurer will take unlimited risk. Again, typically they are higher attachment points and lower premium and high payout relationships, so they are slightly higher risk transactions. Although, especially in the health market, you've seen some stop-loss covers that attach at a very low level that are essentially quota-share transactions. Typically it's a one-year cover, although you can use them as spread loss to manage your business over a longer period, say five to ten years.

Mr. Klein: Before we start with the second game, I realize I forgot to tell you about the founding of the reinsurers. Let me give you some dates so you have a perspective on that. ERC's U.S. operation was founded in 1928. CNA's was in 1952. AXA Re Life was founded in January 1995, and London Life Re was founded in July 1995, just six months later, which is probably part of the reason everyone had trouble with it.

Since I know that all of you looked ahead at this and have your answers already, I'm just going to tell you what the answers to the next quick-answer quiz are, and we are going to have another question to test your speed. The original question was, "Put these reinsurers in order of their 1999 Blue Book A&H reinsurance premiums beginning with the largest." The answer is ERC Life with $495 million. That was number one, followed by CNA at $153 million, London Life Re at $48 million, and finally AXA Re Life at $12 million.

Now, let's do another quick-answer question. Put your answers on that same small sheet. Let's see who has the quickest answer. Put these reinsurers in order of their U.S. geographical location, beginning from the west. As soon as you think you have it, raise your hand. I am looking for the location of their home offices.

The most difficult one, I think, is London Life Re, which is located in Bluebell, Pennsylvania. See if that helps you. The answer is ERC, which is located in Kansas City, followed by CNA Life Re, which is located in Chicago, followed by London Life Re in Bluebell, Pennsylvania, and finally AXA Re Life in New York.

Why don't you introduce yourself?

Mr. John Fleming: John Fleming, Guarantee Life Insurance Company.

Mr. Klein: All right. Let's start with the first question. You have the same lifelines. With respect to facultative underwriting, which of the following is *not* true: (a) a reinsurer must approve each individual risk before it has any liability; (b) a reinsurer is typically given a certain time period, such as 30, 90, or 120 days, to accept in writing the ceding company's offer; (c) once a facultative submission is made, the ceding company is not obligated to cede, but it no longer has the option of automatic coverage; or (d) facultative reinsurance is submitted on a contingent basis?

Mr. Fleming: I don't think I'll be getting these all right. I think I'd like to poll the audience.

Mr. Klein: Audience, how many think it's (a)? We have two hands up. How many think it is (b)? Nobody. How many think it is (c)? Computer, that's 55%. How many think it is (d)? We have three hands up.

Mr. Fleming: I'd like to go with (c), my final answer.

Mr. Klein: That's your final answer?

Mr. Fleming: Yes.

Mr. Klein: I'm sorry but the audience didn't help you here. The answer (c) is wrong. The answer is (b), but (b) is not correct as stated. It's reversed. The reinsurer is typically given a time period such as 30, 90, or 120 days to accept in writing the ceding company's offer. This is wrong. The reinsurer makes the offer, and the ceding company accepts the reinsurer's offer. It's just backwards. The others are true. You still get to play.

Second question. Again we go back to the actuarial version. With respect to automatic reinsurance, which of the following is true: (i) the ceding company must reinsure and the reinsurer must accept all risks covered under the treaty in accordance with the terms of the treaty; (ii) the ceding company is allowed to

cede risks in excess of its retention limit, subject to certain criteria, to the reinsurer at a predetermined cost without submitting underwriting papers for approval; or (iii) automatic reinsurance generates the least amount of reinsurance of the three methods of transferring reinsurance? Is it (a) all but i, (b) all but ii, (c) all but iii, or (d) all?

Mr. Fleming: My experience is never take all. I believe the first one is true. The second one seems right, so that would mean I ought to be leaning toward (c). I will take (c), final answer.

Mr. Klein: You want to use the lifeline?

Mr. Fleming: No. The lifeline didn't help last time.

Mr. Klein: Yes, (c) is correct. Nice job.

Mr. Fleming: I knew those exams would come in handy.

Mr. Klein: Now the next few are a little shorter and more like the real questions. Not that they're easier, though. A reinsurer takes over policyholder obligations under which type of reinsurance: (a) assumption reinsurance, (b) automatic reinsurance, (c) indemnity reinsurance, or (d) YRT?

Mr. Fleming: For this one I'd like to phone a friend.

Mr. Klein: OK. Do you have someone in mind, or do you want to ask for volunteers?

Mr. Fleming: I'm looking for friends right now.

Mr. Klein: Who would like to help with this one? Who thinks he or she knows? Craig! Craig's our expert here. You want to come up?

Mr. Craig R. Corrie: I'm everybody's friend.

Mr. Klein: Thirty seconds.

Mr. Corrie: I think what they're asking here is which one will the reinsurer step in for the life insurer so automatic insurance is still between the companies?

Mr. Fleming: True.

Mr. Corrie: Indemnity—again, that's really automatic. I think it's probably a form of indemnity. YRT, we talked about this. I'm left with assumption reinsurance.

Mr. Fleming: Sounds like a good deduction on your part. Therefore, I'll take (a), my final answer.

Mr. Klein: Final answer?

Mr. Fleming: Yes.

Mr. Klein: Yes, (a) is correct. We have a real expert in the audience. Thanks, Craig.

OK, we have three more questions and one more lifeline. Question four: A ceding company's losses must exceed a predetermined amount before what type of reinsurance becomes effective: (a) facultative reinsurance, (b) nonproportional reinsurance, (c) proportional reinsurance, or (d) YRT?

Mr. Fleming: OK, let's see if we can walk through this. Proportional reinsurance is split, so that doesn't seem to be appropriate. That would actually lean toward nonproportional reinsurance. Hindsight is 20/20. I'm going to go with (b) as my final answer.

Mr. Klein: That's your final answer?

Mr. Fleming: Yes.

Mr. Klein: Good, (b) is correct. Nice job. OK, two more questions. What type of contract is most appropriate for self-funded business: (a) a combination of coinsurance and modified coinsurance contract, (b) a coinsurance contract, (c) a specific and aggregate stop-loss contract, or (d) a coinsurance funds-withheld contract?

Mr. Fleming: Is this a self-funded health plan?

Mr. Klein: Yes.

Mr. Fleming: Well, as the stop-loss actuary who does self-funded health plans, where we got beat up on specific and aggregate stop-loss contracts, I would think that the answer would be (c). Final answer.

Mr. Klein: Final answer?

Mr. Fleming: Yes.

Mr. Klein: Correct, (c). This is the last question, and you have one lifeline left. Which of the following are reasons to use reinsurance: (i) finance new business, (ii) exit a product line, or (iii) obtain underwriting assistance? Is it (a) all but i, (b) all but ii, (c) all but iii, or (d) all?

Mr. Fleming: Well, let's go ahead and use a 50/50.

Mr. Klein: It is not (a) or (b).

Mr. Fleming: I think I said earlier that very rarely is it all. However, I believe that (iii) is an advantage for getting reinsurance; it is if you're new to a market and you can get underwriting assistance. So I'm going to go all.

Mr. Klein: That means (d) is your final answer?

Mr. Fleming: Yes, final answer.

Mr. Klein: That is correct. Congratulations. Nice job. Before I forget, I would like for all of our contestants to stay afterwards. I have gifts for all of you for participating.

Mr. James Maughn: I hope you enjoyed the game. Actually, you stole a little thunder here from my introduction with that question. The uses of reinsurance include transferring insurance risks; accessing expertise and financial management, which is kind of a subset of expertise; and structuring and restructuring. Then there are other business objectives we'll cover as well. The intent isn't to suggest that we, as reinsurers, are the only ones with expertise, but it's more a matter of the ability to glean more information from a larger number of companies than typically what the average individual company can manage to do.

What are these risks transferring? The big four basics are morbidity, the lapse-surrender risk, investment risk, and expense risk. Plus, as we alluded to already, there are catastrophic and total claims. In terms of accessing expertise, underwriting is one of those. Product development is another. Again, insurance companies alone have plenty of product information available, but sometimes they don't always see the newest things coming to market, which will frequently be things that a reinsurer would be approached with. Hence, we kind of end up being an early-warning basis for new product development.

Similarly in underwriting, companies are changing their underwriting practices. Something that your underwriter might see twice a year, our underwriters might see twice a week; therefore, the opportunity to develop more information from a lot of companies exists for us as reinsurers.

Also, we have expertise around different investment classes and utilization of investments that may be a little new and different, such as capital management or surplus planning. Something we frequently run into is tax planning. Financial management, again, is a subset of this expertise. Required capital of late has been an issue that many companies need to address, at least in the recent past, as well as managing their surplus in general and tax planning. This can take on an array of different issues, including retaining your life company status or small company deduction and managing dividends of the corporation and policyholder dividends, although there are things you can do to support policyholder dividends as well.

Acquisitions typically limit the amount of dividend capability that a company will have for the owner. In terms of structuring and restructuring, reinsurers are frequently used as a fronting company, or they can put you in touch with a company that can be a fronting company. Acquisitions may allow for divestiture of additional lines of business or new product lines. Reinsurers provide acquisition assistance, in both capital assistance as well as the ability to divest of a line. If you have something that you're interested in acquiring that's inclusive of some line of business or more lines of business than you want, the reinsurance companies stand ready to assist, because there's not typically much that we won't consider reinsuring. Financing new sales allows you to finance, if you will, significant increases in production and/or to provide stockholder dividends.

Another business objective could include getting scale. If you have a small block of business, reinsurance can afford you the ability to increase volume significantly, validate expense assumptions, and of course increase profits. Another objective is increasing returns. When I mention that one, people usually don't quite understand how that's possible. It may sound a little mystical, but it's really very simple. If you think in terms of the total array of different risks involved in a book of business and you choose to reinsure only a portion of that risk, it's not likely that the effective return, with respect to each and every risk, is the same. You can reinsure off a portion of the risk, and it's very logical for the reinsurer to accept a portion of the risk it views as less risky than the average risk; thereby, your profits will be reduced in aggregate, but your returns will increase.

OK, next let's discuss the need for a signed treaty in reinsurance. I can remember in the reinsurance business when a handshake did work. But in today's world with smaller margins in the basic pricing of the agreements, because of change in personnel and so forth, it's very critical that you recognize the treaty must be a signed document today. It is a legal contract. Frequently, as you hammer out the details in the drafting of the treaty, you'll wind up changing some of the details.

But the next point, avoiding arbitration and litigation, has in recent years, I think, been a much increased level of activity for consultants. One of the employment acts for consultants has to do with their involvement in arbitrations involving agreements that were never signed. It's also very important. We have a number of companies in our group, and we find that even in related-party transactions, getting the agreement signed is a very crucial and important thing to do. Although it seems pretty straightforward, it is quite helpful when the IRS comes in or other parties, frequently even your auditors. You want to be sure you have signed documentation for your agreements.

Counter-party risk is another issue that is fairly well understood on the property and casualty (P&C) side, but it is becoming, I think, more recognized as important in life reinsurance as well, especially when you deal with transactions that involve policies that have extended durations, where these contracts will be

in force a long time. We were looking at one transaction recently where the expectation was as much as 100 years. To have an agreement that's going to cover that long a period of time, it's critical that you have someone who is stable who can look to being around for a number of years.

Financial strength to accommodate both volatility of results as well as collectability on a timely basis for many, many years into the future is key. Then for organizational vitality, clearly, with the counter-party risk that we're talking about here, it's important to have shareholder commitment behind the reinsurer, as well as confidence in management.

Mr. Klein: Before we get into the questions, I want to mention a couple things. Jeff mentioned John Tiller's book on reinsurance, which I think is an excellent resource. There is another book that I have called *Understanding Reinsurance* from the International Claim Association, which is pretty good as well.

Ms. Maria Antonieta Smith: This question is for Donna or actually any of the people on the panel. Why is there individual-cession administration nowadays compared with the bulk reporting, which I assume is the more traditional thing? For what line of business is it being used?

Ms. Donna R. Jarvis: My experience on the individual-cession administration is obviously more common on either individual life or certain individual annuity transactions. For the group lines of business, particularly disability, group life, and group health, you often don't get seriatim data, because, in fact, the insurance company doesn't have seriatim data on the groups at any one point in time. In my practice on the individual side, nine times out of ten or more, you will get the individual-cession data. On the group experience, again nine times or more out of ten, you'll get the bordereau reporting. And if anyone else wants to chime in on that one, you're welcome to.

Mr. Klein: As a reinsurer, I actually have a preference for self-administration over the individual.

Ms. Jarvis: I would disagree with that, but every reinsurer has its own preference. As I mentioned before, the more information you have on your risks, the easier it is to manage them. Obviously it's important to get as much detail as you can, although it does certainly add administrative costs as well.

Mr. Maughn: I'll just throw out that for our company about 90% of our business by premium is self-administered. Even so, today in the U.S. market, I'd submit that the predominance is bulk-reported. On the other hand, internationally that's not the case. In the U.K. and in Europe individual-session reporting is far and away the most common.

Mr. Klein: We're like Buddy; 95% of ours is self-administration as well.

Ms. Smith: Do you think there will be any tendency to go more toward the individual-cession administration? I think that nowadays with all the computers and technology, most companies will have their administrative systems up to date and including their group line of business, which makes it easier to transfer that communication.

Ms. Jarvis: I would hope that with the technology advances there would be a tendency toward the seriatim data reporting, but you would be surprised at the number of insurance companies with legacy systems that still can't manage to handle that. I think eventually we'll get there, but I don't think it's going to happen overnight.

Mr. Corrie: It seems to me that you're using bulk reinsurance, bordereau reinsurance, and self-administrated kind of the same way. I guess I would have said that you could self-administer and yet not be essentially reporting bulk. When I worked on the individual side it seemed to me that's what we did. Is that true?

Mr. Klein: Yes, that is true.

Ms. Jarvis: I took my stuff from John's book, and he lumped the three together. But yes, you can self-report and come up with summary-level information but still provide the seriatim detail.

Mr. Klein: Actually we might be mixing this up here because we have self-administration, but we do get the individual detail on it.

Mr. Poulin: I would say the same thing. I think it depends on the risk you reinsure to. A lot of reinsurers will want seriatim data even though it's self-administered. Depending on certain types of annuities or worker's compensation or claims, I think the reinsurer may want to see the seriatim data, even though it's a self-administered block.

Mr. Timothy G. Frommeyer: My question has to do with the assumptive reinsurance that was mentioned early on. I want to talk about getting into or out of the book of business, specifically, individual annuities. Let's say they are in a separate account. I wonder if anyone had any experience in that and could maybe, at a high level, walk through a transaction? If you were trying to get out of a book of variable annuities and they were individual, what would happen to the assets? How would the book be valued? It's kind of nontraditional, probably, but I wondered if anyone could comment on that.

Mr. Poulin: On a block of variable annuities the problem you have is the separate account. Nowadays to get rid of a block of business is really hard on an assumption basis because of the regulations in each state. What you can look for is a 100% indemnity transaction and then pass on the administration to the reinsurer. You're left with the risk that the administration is not done properly and that you're not comfortable with the credit risk of the reinsurer.

Therefore these are things that you want to focus on, but you can do those types of transactions.

Mr. Frommeyer: Are the assets still held in your separate accounts?

Mr. Poulin: Yes, they have to be. But you get all the RBC credit and all the risk associated with the transactions off your book.

Mr. Maughn: And aside from variable on the fixed basis, it's still very common today to use the idea of 100% reinsurance and allow for this assumption to occur over time. This reduces the difficulty of dealing with the states.

Mr. Fleming: With Unicover and the disaster that's fallen with that particular arrangement, how did it get so big? How did the losses become so big, and what is going to be the fallout in the reinsurance market?

Ms. Jarvis: I wasn't involved, but I think if we knew the answer to that question none of this would have happened. Unfortunately, I don't really know what the fallout is going to be. I mean, a number of carriers that were participants in the Unicover pool have since sold their reinsurance operation. It has had some significant fallout.

I think what happened is people just were looking the other way. I don't know if you're familiar with managing general underwriters (MGUs). MGUs are essentially people you give your pen to and allow to write business on your behalf. I think these people listened to the story they had. They probably had not put production caps in place, saying, "You can only write business up to this point in time." They allowed it to go way beyond what they really should have.

Again, I'm not totally familiar with it, but I understand that the rates were not adequate, obviously, and as a result of that they sold a lot of business. That's essentially what happened in this case. Does that answer your question?

Mr. Poulin: We don't have any Unicover exposure, but it's an interesting case for all reinsurers to look at; certainly, I think that the rates were not adequate. I think the reinsurers involved had no control over that or forgot they had control over that. And there were so many players involved between the MGUs and the brokers and the retrocessionaires. I think there was a very different understanding of the risk-retention level that was there at the first level when this was first reinsured.

I think what reinsurers are going to do in the future is ask more questions. That's what they should do. They need to understand where the risks come from and what rate it was placed at and understand who manages the risk. I think it's going to be harder for pools and MGUs to do business in the future because of that particular case.

Mr. Maughn: And one thing I'd add is the scheme. That's a fair term in the U.K. We'll use it as it's typically used in the U.S., but the scheme was extremely complicated. We didn't have any either, but we did look at the possibility of reinsuring the risk of those that had the losses. The diagram of how the risk moved was truly a piece of art because it was extraordinary.

Mr. Klein: I want to comment as well. I recently saw the latest chart. We don't have any either, but it is really complicated in terms of the fallout. It's really hard to say, because there are companies that have come in at so many different levels of this thing. It is a huge chart that shows all the different layers and pieces within it, so it's really unclear even now as to who has how much.

Ms. Jarvis: One of the fallouts has also been that a number of MGUs that aren't necessarily associated with Unicover have found it too difficult to get full capacity this year. I'm sure you'll see a number of MGUs that have been successful in the past go out of business. I think you'll see a number of companies withdraw their support of that market. I actually am one of those companies that does not support MGUs. And if people do support MGUs they're going to put extremely tight controls in place.

Mr. Maughn: The conclusion is that workmen's compensation rates are going to go up.

Mr. Pawelski: I had a question about something Jeff brought up regarding stop-loss plans and the specified policy maximum. Every study that I've seen seems to indicate that the average claim per member per month over a number, whether it be $1 million or $2 million, ends up being very small, yet it seems that everybody's afraid of unlimited max policies. A lot of companies don't want to sell them. I'm hearing you say that reinsurers don't want to accept them, and I'm having a hard time figuring out why.

Ms. Jarvis: Again, I think it's because being a reinsurer, you're looking at a block of business in total. I think that you're willing to take that risk if you have some good history on the block. But the problem is you don't want to be caught in a Unicover situation, and you want to cap your limit. Unlimited risk is very rare in the reinsurance market on excess-of-loss covers. I think if you take the reinsurance position when somebody is purchasing that cover, they know the block of business much better than you'll ever know it. You have to assume that the ceding companies have more knowledge and can get to a point where they could act against you. The best way to do that is to underwrite the block the best you can and put in some limits in case you see those types of situations.

Mr. O'Sullivan: I guess I get to move off the technical reinsurer's part into more of the buying of it. I was on the P&C side for about ten years, and I had to deal a lot with brokers. I'm just curious: is there a lot of usage of brokers in the U.S. anyway? I know in Canada there doesn't seem to be a lot on the life

side. Who actually does the buying for most companies? Is it the actuarial or financial people?
Ms. Jarvis: Well, going back to 1370, there was a broker involved, so they seem to have put themselves in the middle of transactions, and they are still there. In my personal experience I've found that there are more brokers on the A&H side, and there are not as many brokers on the individual life side.

Mr. Maughn: The preponderance of life reinsurance is without a broker if we're talking traditional life reinsurance. On the other hand, it's fairly common to involve a broker when you're dealing with finite risk.

Mr. Klein: The one exception on the life side is some of the bigger companies that had never used reinsurance until the last few years. They have gone through brokers, but on the life side it's very rare.

Mr. Poulin: In terms of who does the buying, I think it can come from either the pricing side, when you have a company that is big enough that the pricing division can make its own decisions, or the financial side. We see a lot of corporate actuaries and chief financial officers involved in those kinds of actions.

Ms. Smith: With regard to treaties that are between two parties from different countries—for example, U.S. reinsurers with companies in other countries—how does the transfer of the liabilities or reserves occur given that other countries have different guidelines? Which guidelines do you use? Not all countries are as regulated as the U.S. Some countries and certain lines of business require liability, so is it part of the contract? Who determines that?

Mr. Maughn: I'll speak for our company at least. We specify in the treaty what jurisdiction or law applies. And even within the states we'll specify typically the state law that will prevail for the treaty.

Mr. Poulin: We do the same thing. However, I'm not sure it applies to reserves. In terms of how we handle the reserve and being owned by a Canadian company, I think we try to keep the risk outside of the U.S. and into the companies where we can book it on a Canadian basis. We tried to keep the reserve on our own basis rather than on the basis of the ceding companies. I'm not sure if we're talking about South American risk, where the regulations are different. On that, we're holding the reserves under a North American basis and not under the ceding company's country's laws.

Ms. Smith: I'm talking specifically about countries in Latin America and the group-health area. Some countries and companies are not required to hold any incurred but not reported (IBNR) or claim reserves. I assume a reinsurer would like the company to have something. If they are ceding some liabilities and reserves, what basis do they use? In that case, how do you determine IBNR for a company you're taking risk for if you don't have detailed data? What do you do then?

Mr. Poulin: It's a good question, and certainly in my company we have tried to get as much data as we can, and sometimes it's closer to a guess than an appropriate reserve. As you have some data on the block of business, you get better at it.

Mr. Maughn: I'd submit you did it very carefully. What little I do know about our international operations, the lag in the reporting is at least on the life side, usually extensive enough that you don't have to worry about IBNR. On the health side, I'm not very conversant there.

Mr. Corrie: The way I understood your question, from the U.S. side, what if you're trying to take reserve credit for reinsurance ceded? What you have to do is know that the assets are collectable and available, and that is done with a trust. The assets for the reserves go into a trust or else a letter of credit. Really, the laws and the ability to review a company in a foreign country don't come into it, because the insurance departments here in the states are going to want to know what you can do without going offshore to get that money. That's how it's taken care of.