SOCIETY OF ACTUARIES

Reinsurance News

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newsletter for members of the reinsurance section

"AREN'T YOU GOING TO STOP AND ASK FOR DIRECTIONS?" A ROADMAP FOR REINSURANCE DEDUCTIBLE SELECTION

by Mark R. Troutman

Each health plan is unique, and different factors must be considered when making a decision regarding reinsurance deductibles. This overview offers considerations when selecting a medical excess deductible for commercial, Medicare and Medicaid programs. It is more applicable for large payers, such as HMOs, rather than self-funded employers because there's usually not enough claims data to warrant such analysis on any given employer group.

When selecting reinsurance, program managers should review national excess claim data, one's own plan data, and perhaps data from similar plans. One important consideration: not all plans require the same reinsurance deductible; each plan looks at reinsurance for different reasons.

A key consideration in selecting a reinsurance deductible level is the number of expected claims. Table 1 on page five can be used to review expected frequency and severity of claims at various deductibles. These are only estimates, and plan variations can be expected due to random fluctuation. A plan should usually select a deductible level, that is expected to generate no more than five to 15 reinsurance claims per year. Otherwise, a higher number of claims begin to approach a predictable level. Specific stop-loss reinsurance is designed to cover unpredictable losses. Furthermore, there is always an additional cost to reinsurance represented by the expenses and profit charge of the reinsurer. Conversely, if the deductible level chosen is too low, the client pays margins needlessly on essentially predictable claims.

Table 1 is an illustrative claim distribution.

Based on the projections of expected claims (Table 1), and the suggested guideline of targeting five to 15 claims per year, a 100,000-member plan selecting comprehensive coverage should probably choose a deductible of $250,000, all other considerations being equal, since it will result in roughly 10 expected claims. A plan selecting hospital-only coverage may wish to select a lower deductible of roughly $150,000 to cover a similar number of expected claims. Certain types of covered services demonstrate more variability in costs. For instance, hospital services

continued on page 4

CONTENTS

COMMUNICATION AND SOLUTION-FINDING

by Michael E. Gabon

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Communication, participation and solution-finding are among the ingredients required in the industry and profession. "Can we talk? … We're in this together" is this Corner's theme applied to reinsurance agreements and our professional community activities.

Can we talk? … We're in this together – Part I

Reinsurance is often described as a partnership. Partnerships have been described as the lifeblood of a supply chain. In the insurance industry supply chain, reinsurers have provided risk mitigation, financing and assistance with manufacturing and distribution.

Reinsurance was once conducted as a gentlemen's agreement often with informal clauses, regardless of intended short- or long-term duration of the agreement. More recently, situations have arisen causing older, long-duration arrangements to be reviewed, resulting in the partners having different understandings/interpretations and prior unstated expectations, causing some disappointment amongst the partners and disputes.

What is the magnitude today of these misunderstandings created through such historical partnership operating methods? How do the various insurance industry stakeholders, the media and other industry professionals see the insurance industry and our profession? Will the fans of the industry begin to lose confidence and interest similar to that occurring, for example, in the sports world? Will alternative providers encroach further on the traditional reinsurer and insurer markets, as we do not resolve our differences in expectations?

Nowadays, the partners recognize the need to clearly state their expectations upfront, often with disagreements. The process is consuming significant time and resources. What is the opportunity cost to the industry of unresolved differences going forward? Perhaps a solution/product to meet market needs not offered? What are the issues anyway? What are the challenges to finding solutions? How might the issues be resolved?
Here are a couple of education-resolution avenues:

- The Mr. Re article presents an in-force situation commonly experienced today
- For new business reinsurance quotes, provide a menu of contract terms and price alternatives, including the terms requested.

Another educational avenue is participating in the Treaty Negotiation seminar at the spring meetings, where some of the issues will be discussed in case study format. In this seminar you will be asked to don the hat of a decision-maker representing of one of the parties…beware of the possibility of locked doors as an incentive to identify solutions and reach agreement within the time allotted.

Can we talk? … We're in this together – Part II

The Reinsurance Section is a nonprofit educational and research community whose members are primarily from the actuarial profession. The community's activities are provided on a volunteer basis and, in order to thrive, is dependent on a balance between membership feedback on issues/needs and participation to implement programs to address such issues/needs.

The expressions "you've come a long way" and "you ain't seen nothing yet" are both fitting to the activities of the community. Since November 2004, significant progress has been made on the section's transformation, yet there is much more to do. Visit the section's Web page, review the activities and strategy for the year ahead along with the membership survey, and give us a call to find out how you may get involved …we're in this together.

Volunteer Spotlight

I would like to take a moment to spotlight four highly active, engaged and empowered individuals along with their companies, who have been most instrumental in the section's transformation to date.

- **Richard Jennings** (non-actuary; non-council member). As team leader of the Communications and Publications Committee, the section's electronic newsletter *Re-News!* could not have been launched without Richard's dedicated efforts. Richard is also active in the Web page redesign and is editor of the print newsletter.
- **Mark Troutman** (Summit Re; council member) is leading efforts to bring the news and views of the Accident and Health Reinsurance community, who have traditionally been underserved to the broader Reinsurance Section. Mark is active on a number of fronts including developing A&H training and education programs to support the Section.
- **Graham Mackay** (Milliman USA; non-council member). Although not a council member, Graham has continued to provide support since the previous Section year, and has undertaken coordination of Spring Meetings, the Valuation Actuary Symposium and has been very active in raising issues on Section Council calls.
- **Craig Baldwin** (Transamerica Re; Council member) having previously served on the council, brings resinurance breadth and depth. Craig is leading what is traditionally our greatest area of activity (Continuing Education) and taking it beyond... to nontraditional venues and formats, and alternative educational delivery mechanisms such as webcasts. Craig is not only managing, but doing, all of which has been a tremendous help. ✹

DEAR MS. RE

by Mr. Re

This issue marks the introduction of a new "Letters to the Editor" feature where a unique or timely topic is discussed in case study fashion. If you would like to write a letter to the editor for publication in this section, please address your letters to "Ms. Re," signed "Mr. Re."

Dear Ms. Re:

In 1993 we entered into a 90/10 first-dollar, quota-share agreement with one of our principal reinsurance partners. The treaty we negotiated had a 10-year recapture provision in it with standard wording as to each party's rights upon recapture by the ceding company. Specifically, the language allowed for the ceding company to recapture up to its now-current retention after the 10th anniversary of the business in force.

Based on direction from the CFO of our company, and as follow-up to a Board resolution, my company has increased its quota-share retention to 50 percent. With this in hand, I have notified my reinsurer that we wish to recapture up to our current quota-share retention as of the 10th anniversary of the agreement. I was surprised to receive a response from my reinsurer acknowledging the correspondence, but also taking exception to my interpretation of the recapture article, saying that that was not the intent of the agreement.

Question: Can you explain to me where they may be coming from in their argument for denying recapture, and what possible recourse I may have?

Signed,

Mr. Re

Ms. Re responds:

Dear Mr. Re:

How often over the last few years have you said or heard others say, "What happened to the partnership relationship in reinsurance" or "Why have our reinsurance agreements become burdened with so much legalese?"

Reinsurance once was conducted on a gentleman's agreement basis, often on a handshake with no formal treaty. Reinsurers once made ex-gratia claims payments when there existed significant doubt concerning their liability.

When I first entered the reinsurance business some 35 years ago, reinsurers' profit margins were often higher than today's reinsurance premiums. Quota-share agreements were rare, and reinsurance relationships lasted a lifetime, i.e. there was no free agency, and players stayed with the same team for their whole career.

Whether we like it or not, our world has changed. Unfortunately, early versions of quota-share reinsurance agreements were often written in the pre-modern era format. That is, many provisions, including the recapture provision, were not as well-spelled out as they could have been.

Mr. Re seems to be suffering from the Rip Van Winkle syndrome. Having been asleep for the last 20 years he suddenly finds himself awake in 2005. Although the recapture provision they are working with may be unclear, one would hope that there is other documentation in their files that better explains the understanding of the parties dealing with recapture. Many first-dollar quota-share agreements written in the past had language originally constructed for excess agreements, affording the ceding company the right to recapture in the event that the cedent raised its retention. Although Mr. Re believes that the definition in the recapture provision in their treaty is unclear, the intent at the time of contract, historical precedent and the clarity of how it was communicated are important factors in resolving the confusion.

As a general rule, reinsurers historically tied recapture provisions to a change in the maximum retention limit of the ceding company, and not their client's quota share retention. Under the standard provision, recapture was only eligible on those lives on which the company retained its maximum dollar retention at issue. Reinsurers priced these agreements with long-term persistency consistent with these considerations. This was generally true unless the cedent specifically stated their desire to have a recapture option based on an increase in their quota share retention and it was negotiated at the treaty's inception. In those circumstances the reinsurance was priced accordingly.

Despite this history, some cedents assume they have rights to recapture based on an increase in the quota share percentage. As a result of the different interpretations of the recapture provision, disagreements have begun to occur.

Hopefully, a review of both parties' files and cordial conversations in a partnership atmosphere can resolve these differences. If not, there may very well be some arbitrations in the future over these issues.

Cordially signed,

Ms. Re ✺

Ms. Re extends her thanks to Mel Young, for without him, she could not have articulated such an answer.

"Aren't You Going to Stop..." from page 1

show much more variability than professional (physician or surgeon) services. This is why many health plans choose to obtain only reinsurance for hospital services.

Individual Plan Considerations

Important considerations in deductible selection are:

- **Geographic location and provider contracts**—higher-cost locations and provider contracts will have more claims at various deductibles.
- **The provider-contracting strategy**—capitated services require no reinsurance protection unless the plan passes through the protection to the capitated providers.
- **The risk profile of a plan's membership**—higher-risk individuals will have more claims at various deductibles.

- **The amount one is willing to pay for reinsurance coverage**—a reinsurance premium is an expense item subject to limited financial resources and a value proposition like anything else in business.
- **Risk tolerance**—this is perhaps the most important variable. Each person responsible for plan reinsurance purchasing must determine his or her own plan's risk tolerance.

Risk tolerance is a function of many things:

- **Plan size**—smaller plans require more reinsurance initially since statistical variability is higher.
- **Coverage type**—claim types vary among commercial, Medicare and Medicaid populations. Medicaid plans, for example, are subject to higher neonatal risk than transplant risk.
- **The number of years that the product or managed-care program has been in existence**—as a plan matures, its risk tolerance typically increases, regardless of the size of the population. Maturity also allows the risk tolerance to become more comfortable with the plan's operations.
- **The plan's targeted and actual underwriting margin**—the plan's capital base and profit prospects are important to protect with an appropriate specific stop-loss level.
- **The plan mission, financial strength and backing by parent, if any**—the larger the capital base and/or access to capital, the less reinsurance is usually purchased. Most publicly traded "chains" do not buy external reinsurance. Most small provider-owned plans do purchase reinsurance.
- **Individual attitude to risk and its consequences**—are you risk averse or not?

Commercial vs. Government Risk

The following are brief guidelines for catastrophic deductible selection based on various lines of business. Commercial members have a wide array of diagnoses making up their catastrophic claims given that this group represents all demographic segments of the population. However, government programs tend to produce populations with differing, but predicable, risk profiles due to consistent demographic and socioeconomic characteristics. The Medicare population tends to have a higher usage of medical resources and a higher frequency of claims at lower deductible levels. There's a possibility, however, of a diminished incidence of claims at higher deductibles due to the absence of high-cost situations such as premature infants and most transplants. A plan must factor

Table 1—

Comprehensive Coverage – All Services

Deductible	Expected Number of Claims/1,000	Average Claim Size
$10,000	N/A	N/A
$15,000	N/A	N/A
$20,000	N/A	N/A
$25,000	12.9	$31,000
$50,000	4.1	$53,000
$75,000	1.8	$69,000
$100,000	0.9	$90,000
$125,000	0.6	$103,000
$150,000	0.4	$115,000
$200,000	0.2	$144,000
$250,000	0.1	$156,000

these considerations in the higher per-member revenue associated with Medicare members when considering deductible selection.

Medicaid populations vary greatly by state, so the first step for a plan in this arena is to fully understand the nature of catastrophic risk based on Medicaid enrollment criteria and state risk-retention programs. Some states retain certain categories of risk to assist plans participating in its programs.

Consider the following examples:

- New York takes back neonatal risk for births under 1,200 grams.
- Florida takes back neonatal risk when the hospital stay extends beyond 45 days.
- Michigan has a program that allows the managed care plan to petition the state to take back the risk. The member actually has to request this, but there are advantages to the managed care plan and the member. The program is not specifically targeted for transplants, neonatal risk or other catastrophic injuries, but may include any of the above.
- Texas also offers a program to have certain risks returned to the state.
- California takes back almost all catastrophic conditions for Medicaid members.

For a health plan participating in multiple lines of business, it is necessary to choose between a deductible based on the total block of members and deductibles for each individual segment. This decision should be driven by management expectations for each individual business segment. If each segment is expected to perform within certain boundaries on its own, then each will need a lower deductible selected for its particular membership size and type as opposed to looking at the entire risk pool.

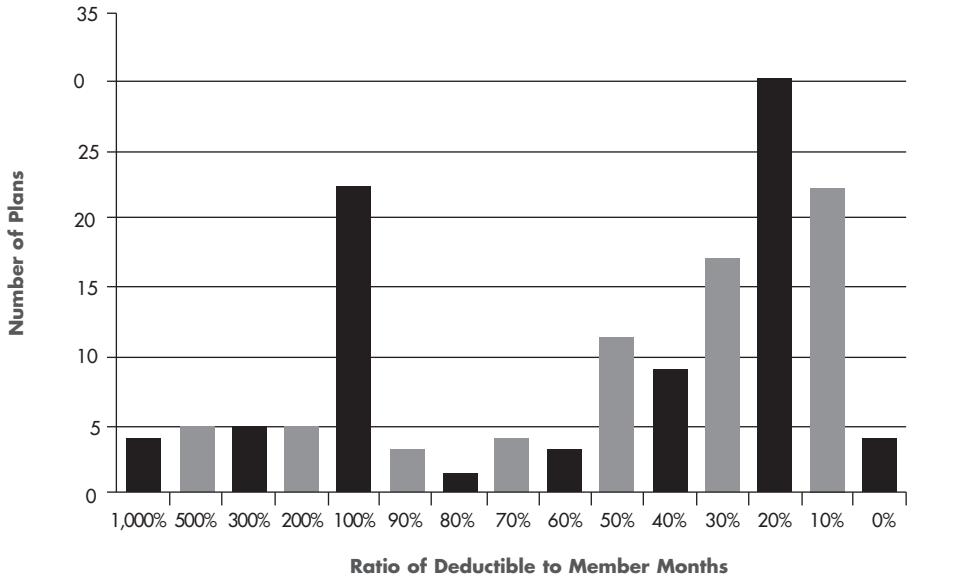
ANOTHER USEFUL TOOL IS TO MODEL THE REINSURANCE COVERAGES BEING CONSIDERED RELATIVE TO THE PLAN'S OWN EXPERIENCE OVER THE LAST TWO TO THREE YEARS.

continued on page 6

"Aren't You Going to Stop..." from page 5

Table 2—

"Keeping up with the Joneses"–Most Frequent Deductible Ratios



Modeling Individual Plan Experience

Another useful tool is to model the reinsurance coverages being considered relative to the plan's own experience over the last two to three years. Model a number of scenarios to learn the impact of different coverages upon financial results. Then choose the coverage that seems to optimize the balance between cost and stabilization of results.

In reviewing one's own plan experience; it is helpful to examine it graphically. This model focuses on a plan's own claim experience rather than on a theoretical distribution from broader actuarial data. An average daily maximum (ADM) is a per diem limit by the reinsurer to incent the plan to control hospital contracts and manage care within the network as much as possible. Review of one's plan experience over three years indicates that a deductible of $175,000 may be appropriate for this plan. It is helpful to see the frequency and severity of claims to determine what level of deductible will cover a reasonable amount of the "peaks and valleys," neither too high to provide too little coverage nor too low to trade dollars with the reinsurer, but "just right," as Goldilocks would say.

When selecting a deductible level, it may be beneficial to see how other plans have gone through the selection process. Table 2 above is based upon the ratio of the deductible selected to the number of annual member months for the plan. There are many different types of members, geographical locations and coverage parameters selected, so it is expected that there will be some natural variation in this relationship, not to mention the individual risk tolerance positions of each client. Although this is a simplistic view of deductible selection, it is valuable for providing a general idea of the level of deductibles selected by a large number of HMOs.

It should be noted that most of the activity on the chart at 100 percent or greater is composed of

continued on page 28

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SECURITIZATION OF LIFE INSURANCE

by Dr. J. David Cummins

Editor's Note: This article appeared previously in the December 2004 issue of The Forecaster *and is reprinted with kind permission from Transamerica Reinsurance.*

Briefly describe the ideal situation or company business suitable for securitization.

The ideal business situations for securitization would be those where a company faces significant risks or has significant growth opportunities and where conventional sources of risk hedging or financing are not available or are too expensive. Ultimately, securitization should be able to provide hedging and/or financing that is more effective and less expensive than the alternatives.

For example, a life insurer with significant growth opportunities may find securitization appealing in comparison with more conventional financing techniques such as issuing equity capital, because securitization may have more favorable effects on the insurer's leverage, cost of capital and financial ratings.

Briefly discuss the primary differences between life and P/C Securitization.

In principle, securitization can accomplish the same objectives for both life and P/C insurance companies. However, to date most life and P/C securitization deals have served different purposes.

Most P/C securitizations have been focused on hedging the risks of property catastrophes such as hurricanes and earthquakes.

In contrast, most life insurance securitizations to date have been financing transactions rather than risk-hedging transactions, and many have been motivated by regulatory requirements. One important class of life insurance securitization has involved the financing of acquisition costs. Insurers that are growing rapidly due to new business incur upfront policy acquisition costs that can place a strain on statutory surplus. Through securitization, insurers can sell off the emerging profits from a block of policies to recover the acquisition costs and realize future profits which otherwise would take many years to recover.

The transaction thus can improve the insurer's leverage position and provide cash to finance additional growth.

Another class of life insurance transaction has been associated with demutualizations. For example, Prudential Financial executed a so-called "closed block" securitization in connection with its demutualization in 2001.

The transaction raised $1.75 billion by issuing notes to investors, with repayment of the notes to be funded by the emerging profits from Prudential's participating life insurance business.

The deal provided cash to be used by Prudential in expanding its other businesses.

Recently, at least one major life insurance securitization has taken place to provide reserve relief under the National Association of Insurance Commissioners regulation Triple-X requirement, and the first mortality-index bond was issued in December 2003.

The mortality-index bond was structured similarly to a P/C CAT bond but is designed to protect against adverse mortality trends.

continued on page 8

Securitization of Life Insurance from page 7

For both life and P/C insurance, most securitizations to date have been fully funded, i.e. they have involved the issuance of asset-backed securities. However, there have been a few transactions that involve call or put options which are not funded in advance. It remains to be seen whether the volume of option transactions will increase in the future or whether insurance securitizations will continue to be mainly asset-backed transactions.

What risks, in your view, are ideal to try to securitize? Which risks will prove to be more difficult to securitize?

The risks that are ideal to securitize are those that are relatively easy to quantify and also are transparent to investors. Catastrophic property risk falls into this category because there have been major advances in catastrophe modeling over the past 15 years that have enabled modelers to quantify the risk.

Life insurance mortality and longevity risks also are ideal for securitization. However, it is generally the case that transparency for investors is enhanced when the securitized risks are based on a readily observable index rather than on the results for any specific insurer. But basing the results on an index means that the payoff from the securitized instrument is not perfectly correlated with the underwriting results of the issuing insurer, creating a type of risk known as "basis risk."

ONE OF THE CHALLENGES IN FUTURE SECURITIZATIONS WILL BE TO CREATE SECURITIES THAT ARE TRANSPARENT TO INVESTORS...

One of the challenges in future securitizations will be to create securities that are transparent to investors and reduce the basis risk inherent in indexed securitizations. This is an area where reinsurers can play an important role by creating portfolios of reinsurance policies from primary insurers and using securitization to transfer risk to the capital markets and manage the basis risk.

With life insurance products becoming more complex, and hence riskier, how do you manage the growing number of risks?

The asset-backed securities market in general has proven to be very efficient in dealing with complex transactions such as commercial mortgage cash flows that are subject to various types of economic risks. Insurance transactions are in principle no more complicated than many other asset-backed securitizations. One way to deal with complex products is through tranching, i.e. the creating of different classes of securities with varying degrees of seniority and risk exposure. Tranching has not yet been fully exploited in the insurance securitization market.

How have regulatory changes or interpretations affected securitization possibilities?

One of the most important regulatory decisions affecting securitization is the decision to allow reinsurance accounting treatment for indemnity securitizations. Indemnity securitizations are those that pay off based on the insurer's own loss experience rather than on an index. At least one recent life insurance securitization involving Triple-X reserves has been given reinsurance treatment by the regulators. Although the NAIC is studying the possibility of giving reinsurance treatment for indexed securitizations, currently it is uncertain whether such transactions will be treated as reinsurance for regulatory purposes.

What could hinder further development of the market?

Adverse regulatory, accounting or tax rulings are the principal threats to the securitization market. For example, denial by regulators of reinsurance accounting treatment could create serious problems for securitization. Accounting rule changes requiring the consolidation of special purpose reinsurers (SPRs) for GAAP accounting purposes also would hinder the market as would any adverse rulings involving the taxation of special purpose

reinsurers or the deductibility of risk premiums paid by insurers to SPRs.

How do you factor the lack of pricing transparency into the securitization?

Clearly, achieving pricing transparency is one of the challenges that must be overcome if securitization is to continue to grow. However, it is worth keeping in mind that there have been some very successful transactions that have been quite complex, including Prudential's closed block transaction and a recent transaction involving insurance subsidiaries of Barclay's Bank.

In such cases, the lack of transparency is often overcome by using credit enhancement mechanisms to provide further guarantees to investors. These can involve third-party credit wraps or internal credit enhancements such as over-collateralization. These mechanisms also have been used successfully in other complex securitizations involving other types of asset-backed securities. It is also possible to use tranching to create classes of securities that have high transparency and relatively low risk to appeal to conservative investors while creating other tranches of securities with low transparency and higher risk that appeal to investors who have informational advantages enabling them to undertake the higher risk classes of investment.

What is required to make securitization a successful risk transfer option?

Continued evolution of the insurance-linked securities market will require insurers and investors to gain more familiarity with insurance-linked securities. Insurers need to develop confidence that securitization has an important role to play as part of their risk management and hedging strategies and to develop more experience in working with insurance-linked securities. Investors too will need time to become familiar with these relatively new investment vehicles. Continued innovation by reinsurers and investment bankers to create transparent securities with lower transaction costs also will be important to the future development of the market.

How do securitization transactions affect the income statement and balance sheet? What kind of revenue recognition do these deals receive?

Properly structured securitization transactions can have favorable effects on the balance sheet by reducing required reserves and enabling insurers to recover prepaid expenses and emerging profits. Such transactions thus have the potential to reduce leverage by decreasing liabilities and increasing equity capital. Risk premiums paid to special purpose reinsurers and expenses incurred in structuring securitized transactions are deductible for tax purposes.

In the case of risk hedging transactions such as CAT risk and mortality risk bonds, the release of funds from the SPR on the occurrence of the covered event provides funds needed to pay losses and thus prevents financial dislocations and potential ratings downgrades.

Securitization thus has significant potential to maintain and enhance the financial health of the issuing insurer. ✹

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PROPERLY STRUCTURED SECURITIZATION TRANSACTIONS CAN HAVE FAVORABLE EFFECTS ON THE BALANCE SHEET BY REDUCING REQUIRED RESERVES AND ENABLING INSURERS TO RECOVER PREPAID EXPENSES AND EMERGING BENEFITS.

LIFE REINSURANCE – A VIEW THROUGH THE REAR VIEW WINDOW

by Melville J. Young

I remember a time before iced tea lunches, a time of reinsurance suites, a time of Runyonesque characters, a time before politically correct had anything to do with the New York governor's race, a time before New York 102, XXX and the model act for reinsurance, a time when experts actually had the benefit of expertise, a time before P&C edicts were automatically (and in some cases idiotically) applied to life reinsurance, a time of the gentleman's agreement, four-page treaties that were not always signed, a time of business men rather than lawyers directing the business, a time when people were guided by doing the morally right thing rather than the contractually required thing, a simpler time, a fun time, "ah yes, I remember it well."

Since I spend so much of my time thinking about past events, I've come to recognize how far back my past goes. Your editor, recognizing that I have probably served the last term I'm going to serve as your chairperson and that I have been around the life reinsurance

world A VERY LONG TIME, has asked me to pen some anecdotes concerning my career. Though 45 years may seem like an eternity, it seems to have taken about the same amount of time that Superman typically spent in a telephone booth. Telephone booths, remember them? That's proof of how long it's been and how much the life reinsurance world has changed.

In 1971 Herman Schmit and Frank Klinzman, two of the nicest human beings I've had the honor of knowing, took a chance on a young actuary with a very spotty record. In 1971, the market share of my new employer, General Reassurance Life, when rounded, appeared in the charts as zero. We began 1971 with premiums under $10 million. Soon thereafter, I took over the pricing function and was told that I had pretty much free rein, except that we did not do modified coinsurance. That edict was of no consequence since very little modified coinsurance was written in the marketplace at that time. The life reinsurance business was primarily a YRT business done on an excess of retention basis. Most ceding companies did business with either one or two automatic reinsurers and possibly one or two facultative reinsurers and there were 25 to 30 reinsurers to choose from. The profit margin, which was embedded in those YRT rates, was larger than the 10-year term gross premiums charged by many term writers today for a significant percentage of issue ages. Needless to say, direct companies' term rates were not very aggressive and coinsurance of term was rare.

In the early 1970s we at Gen Re realized that for our market share to ever round to a whole number we had to do something dramatic. We introduced a pricing regimen with significantly reduced embedded profit margins and a marketing plan designed to convince potential customers that carving out their term products from their regular automatic reinsurance program would save them a good deal of money and not harm their 40-50 year reinsurance relationships. Our new pricing allowed those companies who decided to do business with us to significantly reduce the premiums they charged on their term policies. The resulting revolution created a business that would be unrecognizable to anyone around in preceding years. So now you and Paul Harvey know the rest of the story…and you know whom to blame for the term wars that may eventually replace the 100-year war in longevity.

I made reference earlier to Runyonesque characters; there is no better way of describing people marketing life reinsurance 30, 40 and 50 years ago. Some of my fondest professional memories involve joint marketing trips with some of these crazy, lovable, talented reinsurance professionals. The names that come immediately to mind are Charlie Frydenborg, Hass Savard and the indomitable Oscar Scofield. I learned a great deal at their respective knees and had more fun than anyone's entitled to during a working lifetime.

In 1971, there were no regulations governing reinsurance and the IRS had not yet realized reinsurance existed. Despite that, financial reinsurance transactions were rare. This all changed dramatically during the late '70s when the three-phase system which governed life insurance company taxation, failed to fairly tax life insurance companies. High interest rates caused the Menge formula to fail. This resulted in unreasonably high taxes imposed on many life insurers. Since the problem proved to be to the advantage of the IRS, corrective action did not occur. This led to the widespread use of Section 820 of the Internal Revenue Code. This section, which had been in existence since the code had been last revised in 1959, had been virtually ignored by the industry until the problem I cited earlier became untenable. What followed over a period of three to four years was a series of modified coinsurance agreements, designed to fully utilize Section 820, resulting in a significant reduction in

life insurance taxation. The IRS does not like to hear it, but this did not happen until our industry was strangled by an extremely unfair tax regimen, with no relief in sight.

During this same time period, companies began to be burdened by excessively conservative statutory reserve requirements, which in some cases created unreasonably high deficiency reserves. This, like the burdensome tax situation I mentioned before, led to a sharp increase in the use of various forms of financial reinsurance. Generally, insurers and their reinsurers were responsible in their use of these reinsurance instruments, but there were a handful of abusive situations, which ultimately led to reinsurance regulations. It's my opinion that a more reasonable reserve regimen would have resulted in a significantly reduced use of financial reinsurance.

The frenzy of activity that was spawned in the late '70s and early '80s led to the rapid evolution of new reinsurance vehicles. Terms like "Co/Modco" and "Co Funds Withheld" leapt into our lexicon. Co/Modco was born when Steve Smith of First Colony called with a surplus strain problem caused by their entry into the structured settlement annuity market. He needed surplus relief, but was unwilling to pay the 'usurious' rate I charged for Gen Re's cash. He forced me to develop a "cashless" alternative.

Tax-free Co/Modco was spawned soon thereafter when Denis Loring became a buyer, on a large scale, of surplus relief and was upset at the resulting tax implications. A simple modification of the original design made the transaction tax neutral for all parties.

I haven't talked about the birth of the Reinsurance Section yet. The section was formed in 1982. About two years earlier, the E&E Committee called and asked me to form a task force to review the life reinsurance literature that was then used as part of our exam process. I twisted some arms and a 12-person task force was formed. We decided early on that there were so many holes, it required an effort that reached beyond the exam syllabus. In the ensuing two years, our group wrote a series of white papers on subjects as diverse as the reinsurance treaty and reinsurance law (Tom Heaphy, a guy too smart to be an actuary was the principal author); life reinsurance underwriting (Bill Tyler being the principal author); and reinsurance pricing (the late Mike Winn being the principal author). Mike was a dear friend and is sorely missed. Although we all took part in editing, Denis Loring was the principal editor and grammarian. The SOA incorporated portions of our collective labor into the syllabus, but more importantly these white papers formed the basis of what has become a rich body of literature. This was eventually replaced by a text entitled *Life Reinsurance*, co-written by the first chairperson of the section's Education Committee and her husband (Fagerburg and Tiller). Soon after the conclusion of our effort, the section was formed. Your first officer group was Irwin Vanderhoff, chairman; Mel Young, vice-chairman; and Denis Loring, secretary/treasurer. Unfortunately, due to changing job responsibilities, Irwin stepped down and I served out his term before beginning my own. Irwin, too, has passed on. He was perhaps one of the brightest people to sit for our exams, a dear friend who enriched the profession and all of us who were fortunate to have known him.

I've learned along the way that you can never have too many friends. You can't always count on regulators or tax folks to do the right thing. In excess of 99 percent of the people that I've met in the life insurance industry are well-meaning folks who care about our industry and its customers. This is particularly true of the people that I've come to know in the life reinsurance industry. While competition in life reinsurance continues to be fierce, it has not impacted the respect and strong friendships that have developed among those of us fortunate to have spent our professional lives in this most stimulating and fascinating business.

I would be remiss if I didn't mention the two people I consider mentors: Joe Kolodney, my best friend, and Ron Ferguson. Joe is the guy who took me to Acacia Mutual on my first sales call. Just before walking into their grand building in D.C., Joe stopped and imparted a life's lesson I have always remembered; "We're not here to make a sale today. We're here to build relationships. Reinsurance is a long-term, relationship business." This is one of many life lessons I have learned from this true reinsurance professional.

One of these relationships began over 20 years ago. During my first Tillinghast assignment, I met with Greig Woodring of RGA (General American Re at the time). In the years preceding my time at RGA I traveled with Greig, David Atkinson and other members of the management team on client visits. Some of these trips deserve an article of their own. In my opinion, Greig is the finest CEO of any reinsurance company and he has assembled an awesome group of professionals around him.

When I reached the ripe old age of 13, my rabbi told me "Today you are a man." I believe this really happened the day Ron Ferguson, a giant of a man, told me that I had gained his respect and that I had earned the 'pen' of General Re. Earning Ron's confidence proved to be the pivotal turning point in my career.

By the time I retire, I will have spent almost 40 years working in three great organizations. Gen Re, Tillinghast and RGA have each been blessed by an extraordinary array of insurance people — people who enjoy their jobs, recognize the long-term nature of the business and who are committed to keeping their promises. When I think of working at these three companies the lyrics from a Dean Martin song come to mind: "How Lucky Can One Guy Get".

I suspect that I know many, if not most, of the people reading this article. I'd like you to know that I've enjoyed our professional relationship and I'm honored to have had the opportunity to serve you through your Reinsurance Section Council. ✹

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OBESITY: THE NEXT SMOKING?

by Ernest Eng and Ronald L. Klein

Editor's Note: This article is based on a feature which previously appeared in the July 2004 issue of Reinsurance Magazine. *It is reprinted with permission.*

Swiss Re Investigates the parallels between public and (re)insurance industry responses to obesity and smoking.

Obesity is poised to overtake smoking as the leading preventable cause of death. What parallels can be drawn between public and (re)insurance industry responses to these two lifestyle choices? Swiss Re investigates.

The last 30 years has seen a sustained decline in heart-disease mortality in the United States and across the developed world. These mortality improvements should not, however, be taken for granted. Rising obesity, if allowed to continue, now threatens to attenuate these positive gains in the future. As Figure 1 shows, obesity is currently more prevalent than smoking in the United States.

The U.S. Centers for Disease Control and Prevention (CDC) has estimated that smoking accounts for 435,000 deaths annually, with deaths arising from poor dietary habits and physical inactivity — the two factors most closely associated with obesity — not far behind at 400,000. Assuming that current trends continue, obesity is poised to overtake smoking as the leading preventable cause of death.

Table 1 illustrates how obesity is also catching up with smoking in terms of the strain it places on total medical costs. This is especially true in the United States, where these costs are already considered to be on par with those related to smoking. According to one report, obesity is associated with even more chronic conditions than those linked to smoking[1].

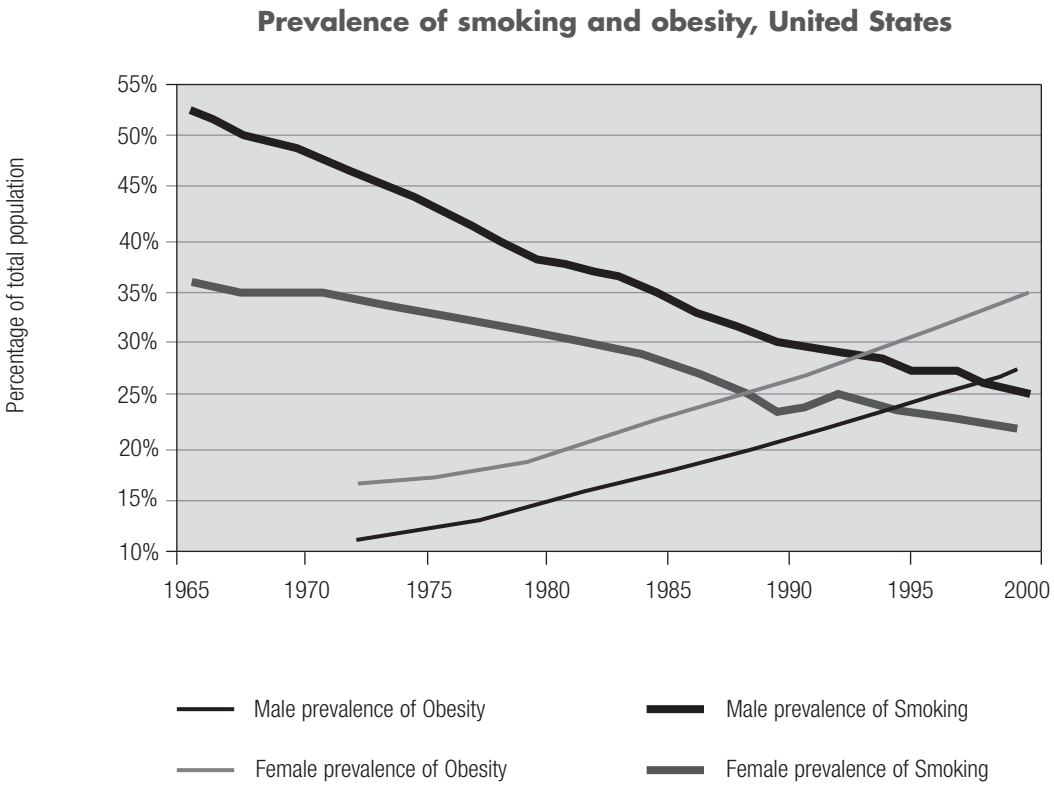

Figure 1
Prevalence of smoking and obesity, United States
Source: Centers for Disease Control and Prevention (U.S.)

Like smoking, the origins of obesity are usually heavily rooted in lifestyle choices. The last 20 years have seen a fall in the prevalence of physical activity, coupled with an increase in unbalanced diets. It is, of course, possible that some of the rise in obesity may be linked to a change in dietary habits when people give up smoking. Similarities between smoking and obesity suggest that a combination of public and private-sector responses may be required to adequately address the risks associated with obesity.

A brief history of smoking

Between the 1920s and the mid-1960s, cigarette smoking was

Estimated costs as a percentage of total medical spending		
	Smoking	Obesity (BMI > 30)
United States	6.0% - 8.0%	5.3% -5.7%
United Kingdom	5.1%	1.5%
France	3.5%	2.0%
Canada	4.0%	2.4%

Table 1
Estimated costs as a percentage of total medical spending, selected countries
Source: Various

regarded as a lifestyle choice rather than a health problem. In the United States, cigarette consumption increased markedly during the two World Wars, largely because of the increased availability of tobacco products to men of military age. Anti-smoking movements did exist in the early 20th century, but were unsuccessful in achieving large-scale changes in attitudes towards the habit. During this period, the U.S. government was largely ambivalent towards the health impact of smoking. It was not until 1964, when the Surgeon General published 15 years' worth of definitive medical research linking smoking and its detrimental impact on lung cancer, that trends began to reverse. Even then, it took yet another decade for cigarette smoking to begin its sustained decline, up to the present day. Figure 2 illustrates these trends.

The decline in smoking over the last 30 years highlights the scale of resources needed to reduce cigarette consumption. Despite the efforts of government policies, anti-smoking groups and further medical research confirming its associated health hazards, the prevalence of smoking still remains stubbornly high, particularly amongst the lower socioeconomic groups. According to one set of U.S. data, more than 30 percent of American adults who had not completed high school were smokers, compared with 10 percent of those with graduate degrees or higher[2].

A similar trend for obesity?

All of this might suggest that any future decline in the prevalence of obesity may take a long time to achieve — decades rather than years. There was a strong lobby against smoking, partly because of the impact on nonsmokers and unborn children; the response to obesity is likely to be weaker. There are also indications that the current situation might get worse before it gets better. It is worth remembering that today's concerns over obesity relate not only to adults but to children and adolescents, too. By contrast, obesity is already more prevalent in children and adolescents today than smoking was 30 or 40 years ago.

Furthermore, the longer-term health implications of obesity largely remain to be felt. A parallel might be drawn from the delayed effects of lung cancer mortality, which, in men, as Figure 3 demonstrates, did not reach its peak until 1990, nearly 30 years after the corresponding highs in cigarette consumption. A recent study[3] has suggested that there may be

continued on page 14

Obesity: the next smoking? from page 13

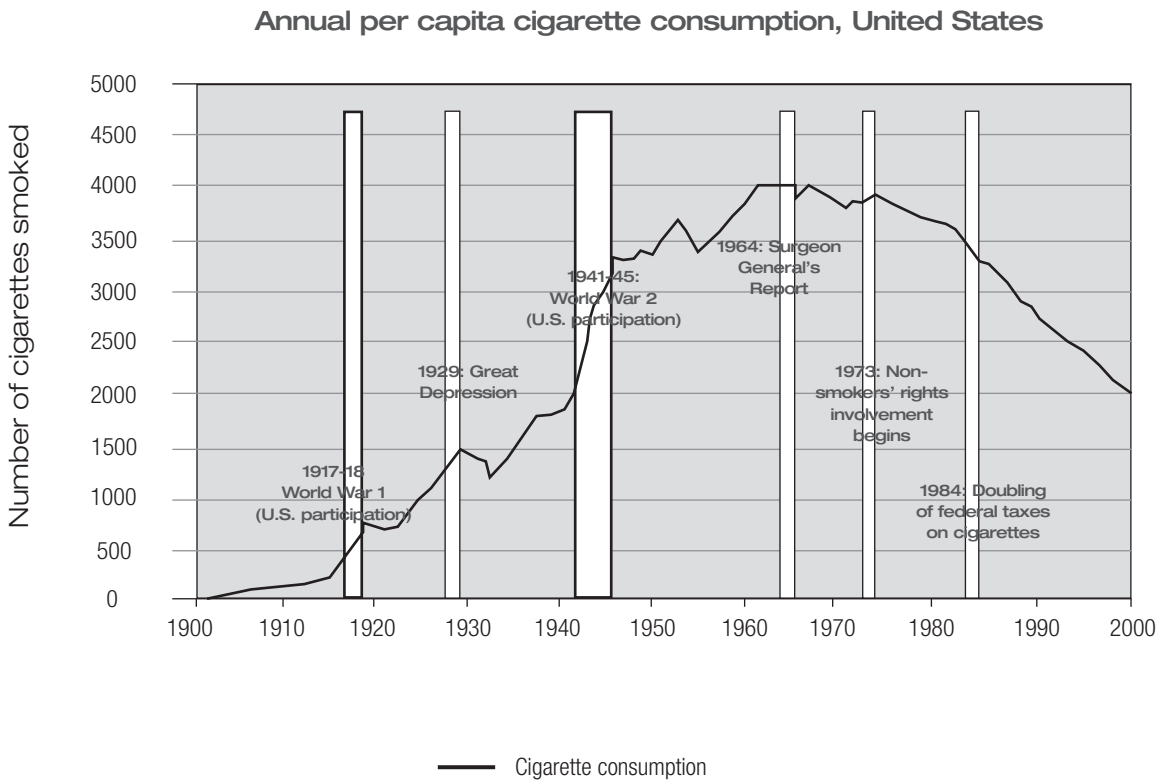

Figure 2
Per capita cigarette consumption, United States
Source: Department of Health and Human Services (U.S.)

a similar lag between diet and future heart-disease mortality, and it is therefore plausible that a similar pattern could emerge in the case of obesity.

Will obesity go the same way as smoking? Using the United States as an example, Table 2 illustrates some of the similarities in how government, businesses and society at large have responded following increased consumer awareness of the risks associated with these two health hazards.

Taking responsibility for our actions

Governments understand that the efforts required to tackle obesity require the participation of all sectors of society. It will not be sufficient to place the onus solely on businesses through regulation, taxation or litigation. Consumers must rethink the 'find someone else to blame' culture and start accepting more responsibility for their own actions.

Signs of such a shift in thinking are perhaps already starting to appear, at least in government circles. According to Dr. William H. Dietz, director of the division of nutrition and physical activity at the CDC: "No single company or agency can solve the problem of obesity on its own." In March 2004, the U.S. House of Representatives ruled that customers are no longer allowed to take legal action against fast-food restaurants for making them obese.

In the case of smoking, governments took the lead in educating women on the dangers to foetuses

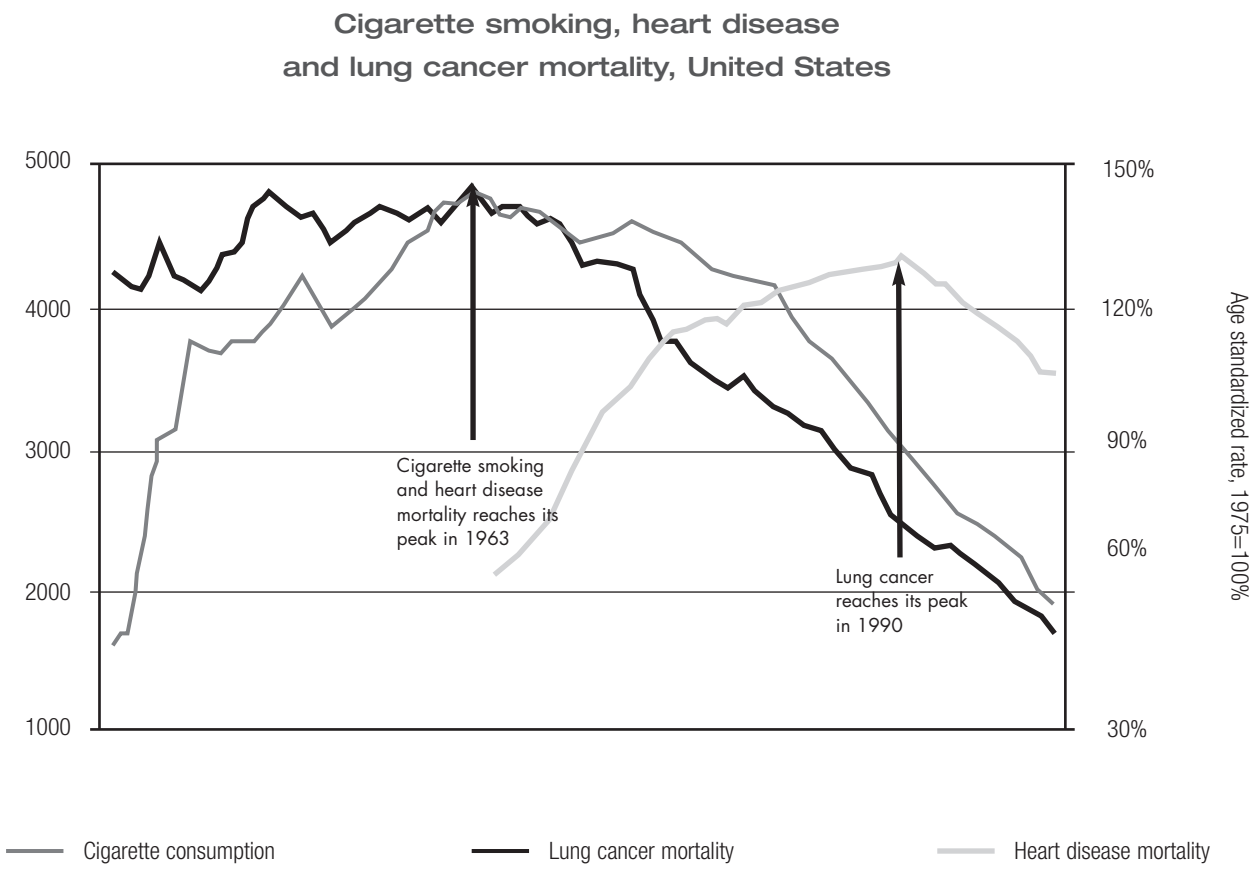

Figure 3
Cigarette smoking, heart disease and lung cancer mortality, United States
Sources: Department of Health and Human Services (U.S.), Centers for Disease Control and Prevention (U.S.)

of smoking during pregnancy. Likewise with obesity, governments have started to promote the importance of healthy diets and physical exercise — efforts which require the active participation of the population. Some countries have gone further to bring home the anti-smoking message in more graphic terms. For instance, countries like the United Kingdom, Canada and Singapore have used televised health warnings showing dissected body parts of smokers to warn against the dangers of smoking. These shock tactics are similar to earlier, apparently effective, awareness campaigns in the United Kingdom addressing the problems of AIDS and driving under the influence of alcohol. It will be interesting to see if the same approach will be adopted to discourage obesity in future.

Fortunately, many people seem to understand the importance of a healthy lifestyle. According to one report, Americans with health and fitness club memberships visited their clubs an average of 92 days per year in 2002, an increase of 10 percent over 1997. At the same time, membership of these clubs also grew by more than 7 percent to 36 million last year[6]. Similar trends have been reported in Germany and the United Kingdom.

Governments, corporations and insurance companies might also be able to do more to influence attitudes amongst the public than might be expected. A recent survey[7] found that, among the U.S. population:

- Three in five people believe that the U.S. Congress should do more to tackle obesity;

continued on page 16

Obesity: the next smoking? from page 15

	Smoking	Obesity
Product choice	Tobacco companies introduced 'low tar' and 'lights' cigarettes, accompanied by claims to be less addictive[4] or harmful to health[5] because of a lower tar or nicotine concentration.	Food & beverage companies have introduced 'low-fat' or 'slim' versions of their products. In fast-food restaurants, choices of salads and fruits are available. McDonald's no longer offers 'super-sized' meals.
Legal action	During the 1980s, the public began to sue tobacco companies for cigarette smoking-related effects on health.	A lawsuit that accused McDonald's of contributing to young customers' obesity was filed in 2002. In 2004, the U.S. House of Reps. approved a bill to ban lawsuits by obese customers claiming to have become overweight by eating at fast-food restaurants.
Advertising	Tobacco advertising was restricted in 1964 following the Surgeon General's report on health and smoking, leading to a complete ban on TV and radio advertising of cigarettes in 1970.	In Feb. 2004, Commercial Alert, a nonprofit organization, called for the World Health Organization to impose a global ban on the marketing of 'junk food' to children.
Product labeling	Mandatory health warnings on all cigarette packaging were introduced in 1965. The warnings were strengthened in 1970 and, again, in 1984.	In August 2003, the U.S. Food and Drug Administration set up a working group to examine food labeling and packaging requirements as part of its campaign against obesity.
Life insurance	In 1964, State Mutual Life Assurance Company of America became the first company to offer lower premiums to nonsmokers, a change which was soon adopted by most other companies.	The life insurance industry applies ratings to applicants who are above 'normal' weight. Height-weight tables were first introduced by life insurance companies in 1908. These were replaced by Body Mass Index (BMI) during the late 1990s.

Table 2
U.S. Responses to smoking and obesity following increased consumer awareness of the associated risks
Sources: Various

- Two-thirds feel that the costs of providing health club memberships should be a tax-deductible expense for their employers; and

- Three-quarters of respondents would agree to undergo a regime of regular physical exercise in return for a lower health insurance premium.

Financial incentives: lose weight or pay more

There is clearly more scope for improvement. Insurers, particularly those in the providing health and disability insurance, are beginning to take obesity seriously — unsurprisingly perhaps. BUPA, Britain's largest private health insurance company, has reported that a growing proportion of its clientele is obese[8], while UNUM Provident, a large insurer operating in the United States, has recently reported a ten-fold increase in obesity-related, short-term disability claims over the past decade[9].

The total cost of obesity to American companies has been estimated at USD 13 billion annually, of which USD 8 billion and USD 1.8 billion was attributed to health and life insurance costs respectively[10]. In this respect, employers have a stake in encouraging a healthy workforce.

The insurance sector can also play its part in encouraging consumers to help themselves. In addition to other risk factors, such as blood pressure and cholesterol levels of the applicant, life and health insurers typically apply ratings according to the Body Mass Index (BMI). However, there may be scope for BMI to be applied in a manner more obvious to the consumer when life insurance premiums are quoted, using ratings supported by medical evidence. Certainly, this is the case with smoker-differentiated rates, which are not only already well accepted, but are now a common feature of automated insurance quote systems. This stems from the 1960s, when life insurance companies in the United States introduced smoking-differentiated rates after the Surgeon General's report on tobacco use was published, bringing the cost of increased premiums directly to the attention of smokers. Under this 'carrot and stick' approach, consumers will take more notice when discounts on premiums are offered to those who maintain 'normal' weight and/or exercise regularly, or when insurance becomes increasingly difficult for obese people to obtain. As Swiss Re has warned in its own report on this topic[11], if obesity continues to rise, fewer people will be able to purchase life insurance at standard rates and those who are overweight will ultimately have to bear the costs of higher premiums.

Facing the future: tough action all around

Like smoking, obesity is linked to cardiovascular disease and many types of cancer. It has also become a major public health concern world wide on a similar scale. Looking ahead, the life insurance industry must tackle the likely increase in obesity by ensuring that the associated risks are accurately assessed and rated, and that consumers are charged an appropriate premium to reflect the risk they present. This, however, presents challenges for underwriters and actuaries in an increasingly competitive environment. For existing life insurance cover, the detrimental effects of increasing obesity will be offset, to an extent, by the wider mortality improvements that have been driven by progress in medical treatment, reductions in heart disease and declining tobacco use.

Society has dealt with smoking through a variety of measures including education and persuasion. Confronting obesity is now an equally pressing task, calling for a combined and determined effort from all parties. Governments, the medical profession, food manufacturers and consumers — particularly parents — need to be alert to obesity and to play a role in confronting this emerging risk. ✹

Footnotes

1) Sturm R, Rand Health Research Highlights: *Obesity and Disability*, 2002

2) Center for Disease Control, National Center for Health Statistics

continued on page 19

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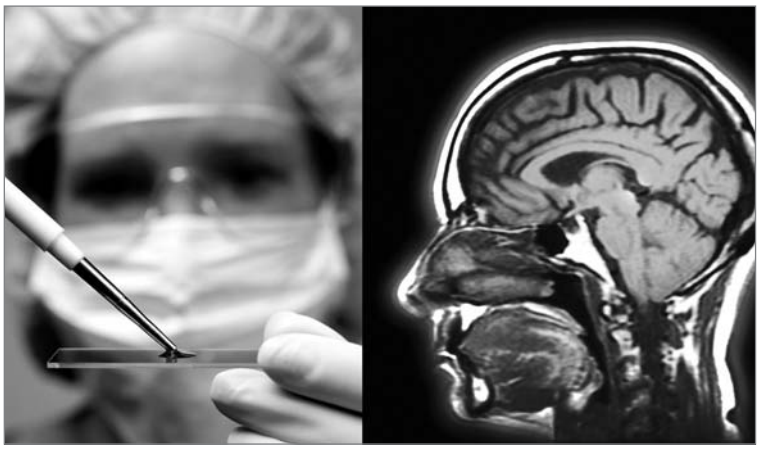
FOUNTAIN OF YOUTH VS. SUPER SIZE ME

by Dr. Lawrence Segel, M.D.

Man's yearning for immortality is arguably a noble endeavour. What isn't arguable is the ever-increasing average life expectancy throughout the ages, that is, if one ignores the blip of Adam, Seth, Noah, Methuselah and their like living 930, 912, 950 and 969 years respectively. Cavemen had a life expectancy of 33 years, while the average Romans fared a little better at 40 years. By the nineteenth century, men were living well into their 50s. Women, for a long time didn't fare as well, because of the perils of pregnancy and childbirth. Yet, today they have leaped ahead of men by about seven or eight years. But can this life expanding trend continue indefinitely?

The genetic limiting lifespan of man has been postulated to be about 120 years. In the real world,



few individuals ever attain this gift. Animals have disease, accidents and predation to blame. Similarly, man has disease, accidents and predation, better known as homicide and war. Efforts to combat aging and extend life date back as far as 3500 BC. Legendary figures such as Alexander the Great and Ponce de Leon all got into the act by searching for the Fountain of Youth, and came up empty. However, there are areas in the world where humans purportedly live well into their 150s and 160s. These areas include Vilacumba, Ecuador; Hunza, Pakistan; and the Caucasus in Russia. Still, no freaks of longevity have ever been objectively documented, and there are reasons to doubt their existence. For instance, the Caucasus was the birthplace of Stalin. Myths of super vitality flowed from this region like butter over popcorn to stroke Stalin's superman ego, not to mention a forged birth date was an excellent way to avoid conscription into the "longevity demoting" Russian army. The oldest well documented human was Jeanne Louise Calment who lived into her 120s, before passing a few years ago. Contrary to conventional wisdom, she smoked until 100, but gave it up once she couldn't light her own cigarettes.

The chance of becoming a centenarian from birth in an industrialized nation is approximately 1/20,000. But, the odds seem to be getting better. The number of people older than 100 years in the United States has been increasing by more than 7 percent per year since the 1950s. The number of U.S. centenarians is expected to reach almost one million by 2050. And if that isn't food for thought, the fastest growing group of drivers in Florida is over 85 years of age (Note to self: call travel agent today and rebook Florida trip to Mexico).

Throwing a monkey wrench into the idea of ever-increasing life expectancy is a population expert, Dr. Jay Olshansky. Olshansky, a demographer from the University of Chicago, gives new meaning to the term Super Size me. He believes that the trend toward longer life will level off in the coming years and may even turn downward. He blames the future downturn in life expectancy on the epidemic of obesity "creeping through all ages like a human tsunami," as well as the emergence of deadly infectious disease. It seems difficult to believe. Till now, things looked pretty rosy. A baby born today compared to one in 1900 lives on average about 30 years longer, thanks to modern medicine and public health improvements. Still, one cannot summarily discount Olshansky's prophecy. More than 30 percent of Americans are classified as obese. According to the Rand Corporation, if Americans keep getting fatter at current rates, by 2020, one in five healthcare dollars will be spent on people aged 50-69 due to the complications of obesity. Also, one has only to look at regions of sub-Saharan Africa to see how

infectious diseases such as AIDS can dramatically alter population life expectancy. If you think industrialized countries are immune, think again. Russians now live seven years less since the collapse of the Soviet Union in 1991.

Olshansky believes the effect of obesity on longevity is currently equivalent to the overall effect of cancer mortality. In other words, if we found "the cure" for cancer, overall average life expectancy would increase by about 3-3.5 years. Further, he feels the effect of the obesity epidemic will double or triple in the future shortening lives by 7-12 years. As for infectious disease, higher rates of drug resistance, air travel, and an aging population will all take its toll. Just look at Asia where a highly virulent strain of influenza is raging through bird populations and killing scores of people. The World Health Organization has warned that it is only a matter of time before this lethal flu strain (H5N1) more easily spreads and infects humans. That development could spark a global flu catastrophe. And, need we remind you of Stanley Prusiner's Nobel prizewinning prionic disease discovery, best exemplified as "Mad Cow Disease" to the lay public.

For those of you with a sporting interest in aging, the Methuselah Mouse Challenge with a prize of $10,000 is available for anyone gifted or crazy enough to vie for developing the longest living laboratory mouse. Typically, a mouse lives about two years. Currently, the record is 1,819 days held by a mouse named GHR-KO11C. Sadly, I must report that he is no longer with us, but will never be forgotten. In the interest of fairness, I have disqualified myself from the competition since I am owned by a black feline who has a particular fondness for rodent flesh. Olshansky, himself, has placed a bet on his predictions. He has wagered $500 million that no 150-year-old person will be alive and in good health by the year 2150. The bet is in the form of a $150 endowment to a trust fund that with the magic of compound interest will be worth millions in about 150 years.

So, will medical technology such as organ replacement, gene manipulation and cloning continue to lead to boundless increases in longevity? Or, will man's predilection for an unhealthy lifestyle, destruction of the environment and emerging infectious disease outpace his science? I'll let you know in 50 years, but don't bet on it! ✺

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Obesity: the next smoking? from page 17

3) Law and Wald, *British Medical Journal*, Vol.318, May 1999

4) Hyland A et al, *Nicotine and Tobacco Research* Vol. 5, October 2003

5) Harris JE et al, *British Medical Journal* Vol. 328, January 2004

6) International Health, Racquet and Sportsclub Association (IHRSA) *Trend Report* Vol. 11, No. 2, April 2004

7) IHRSA op cit

8) *The Guardian*, 29 March 2003

9) UnumProvident press release, 17 February 2004

10) Department for Health and Human Services (US), *Prevention Makes Common Cents: Estimated Economic Costs of Obesity to US Business*, 2003

11)Too big to ignore: the impact of obesity on mortality trends, 6 April 2004

RATE CHANGES UNDER YEARLY RENEWABLE TERM REINSURANCE CONTRACTS – AN EMERGING ISSUE

by James A. Shanman

That many of the traditional principles, customs and practices of reinsurance have been subject to serious attack over the past few years will come as a surprise to almost no one. Even those industry participants fortunate enough to avoid actual disputes need look no further than the host of "emerging issues" discussed in industry periodicals and at industry gatherings to see that the reinsurance traditions which were considered sacrosanct perhaps as little as a decade ago are now fair game for attack. One of these emerging issues which has received relatively little attention so far concerns the ability of reinsurers to raise premium rates under yearly renewable term (YRT) life reinsurance contracts and the propriety of such rate increases.

As is the case with many reinsurance issues, this one arises from a contradiction between contract wording and industry practice. YRT reinsurance contracts typically permit the reinsurer to raise premium rates, at least to some extent. The reason is that, as a regulatory matter, if the reinsurer were to guarantee rates, it might be required to put up deficiency reserves, which, of course, no reinsurer wants to do. There are a variety of these rate change provisions. For example, some YRT contracts simply state that the reinsurance premium rates are not guaranteed and that the reinsurer reserves the right to change them. A second common form of provision permits the reinsurer to increase rates up to a certain limit, often linked to the 1980 CSO Mortality Table. Both of these types of provisions may include a statement to the effect that although the reinsurer may raise rates, it does not anticipate doing so. A third type of provision permits the reinsurer to raise rates for a particular cedent only if and to the extent it raises rates for all cedents from which it assumes similar business. These are, of course, only general illustrations of the types of rate change clauses commonly seen in YRT reinsurance contracts; the actual wording of particular clauses varies widely.

Despite express contractual language permitting reinsurers to raise rates, however, many in the industry believe, some very strongly, that reinsurers cannot and should not do so under any circumstances. Moreover, as a matter of actual practice, rate increases under YRT reinsurance contracts are extremely rate. A number of reasons are cited for this belief. First, it is argued that once the reinsurer sets its rates initially, in fairness it should be bound to live with the profitability or unprofitability of its decision. A second argument is that if the reinsurer has the right to increase its rates freely, there has been no transfer of risk from the cedent to the reinsurer and, thus, the resulting arrangement is simply not reinsurance as it is commonly understood. A third view draws upon the tradition that reinsurance is really a "gentlemen's" or "handshake" agreement. Thus, according to this line of thought, no matter what the contract may say as a matter of regulatory boilerplate, there is a firm and binding understanding between cedent and reinsurer that rates will not be raised. Finally, some participants in the industry take the position that given the widespread understanding that rates are not to be raised, any attempt to do so may constitute a breach of good faith.

As noted above, despite increasing discussion of this issue within industry circles, there appear to have been few actual disputes. There is no reported case law on this subject, and there appear to have been at most only a few arbitrations. Nonetheless, given the poor results of a substantial number of life reinsurance treaties, together with the marked increase in the number and contentiousness of life reinsurance disputes, over the last few years the emergence of rate changes under YRT contracts as a more frequently disputed issue seems very likely. This is borne out by anecdotal evidence.

In the absence of a substantial body of case law or arbitration experience, it is difficult to predict reliably how disputed rate change issues might be resolved. Having said that, however, there are a number of factors which should almost certainly be considered in analyzing these issues, and these are discussed briefly below.

First, it is important to keep in mind that most rate-change issues will be resolved in arbitration rather than litigation. This is of particular importance because virtually every rate change provision we have seen is unambiguous on its face and would almost certainly be enforced by a court. What an arbitration panel would do, however, is much less certain. A very large proportion of arbitration clauses in reinsurance contracts provide in words or substance that the arbitrators need not follow strict rules of law or the literal language of the contract. Many go further and provide that the contract will be viewed as an "honorable engagement." These provisions, of course, support the "gentlemen's agreement" rationale relied upon by many of those who argue that rate change provisions should not be literally enforceable. More broadly, because arbitrators have very wide discretion in shaping awards by virtue of both the typical arbitration clause wording and well established arbitration practice, there is always a real possibility that a panel will look beyond the rate change wording in a YRT contract to what it is persuaded is the industry custom with regard to rate changes and decline to enforce the literal wording. Obviously, however, the decision in any particular case will depend upon the composition and views of the particular panel as well as the circumstances involved.

A second factor that must be considered is the contract language itself. All things being equal, a rate change is much more likely to stand under a contract which provides simply that rates are not guaranteed, as opposed to a contract that limits the magnitude of rate increases or subjects the reinsurer's ability to impose such increases to express conditions. The impact of language to the effect that the reinsurer does not anticipate raising rates may well depend upon the circumstances. For example, if the rate increase at issue comes a relatively short time after the inception of the contract, the ceding company may have a stronger argument than it would 10 years after the inception of the contract. A panel may also look at evidence relating to the negotiation of the rate change provision to try to determine the parties' intent. However, this may be difficult since in many cases the rate change provisions, if not precisely boilerplate, are not intensely negotiated, and the evidence may be sparse if it exists at all.

To the extent a panel is inclined to construe the contract strictly, i.e. to enforce the literal language and some arbitrators, are strict constructionists, it may be important whether the contract contains an integration clause providing that it constitutes the entire agreement between the parties. Clearly, the inclusion of such a clause makes it much more difficult to argue that a provision permitting the reinsurer to raise premium rates is subject to an unwritten understanding, which nullifies or limits its effect.

In short, the precise wording of the rate change provision in a YRT reinsurance contract will be a key factor in determining the enforceability of that provision. It is, of course, important to keep this in mind not only in viewing potential disputes, but also in negotiating such provisions in the first place. The ability of either party to prevail in a dispute over a rate change may well be enhanced by the care and precision employed by that party in negotiating the rate change provision and by contemporaneous documentation of the negotiations.

Based upon discussion within the industry, another issue which may well arise in connection with rate change disputes, is the occasion for and reasonableness of such increases. For example, assuming a rate change provision, which imposes no restrictions, can a reinsurer impose a rate change merely because treaty results have been poor? Similarly, and again in the absence of any restrictions, can a reinsurer raise rates 100 percent? Or 500 percent? These are obviously very difficult questions to answer; however, a few thoughts may be helpful.

A VERY LARGE PROPORTION OF ARBITRATION CLAUSES IN REINSURANCE CONTRACTS PROVIDE IN WORDS OR SUBSTANCE THAT THE ARBITRATORS NEED NOT FOLLOW STRICT RULES OF LAW...

First, it seems likely that an arbitration panel would require a reinsurer to comply with some rule of reasonableness. Hypothetically, a panel might have a very different view of a situation in which a reinsurer was attempting to raise rates in order to break even or achieve a reasonable profit going forward on a treaty which had been performing poorly, as opposed to a situation in which the reinsurer was attempting to enhance the profitability of a

continued on page 25

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"GETTING TO WOE SOME"

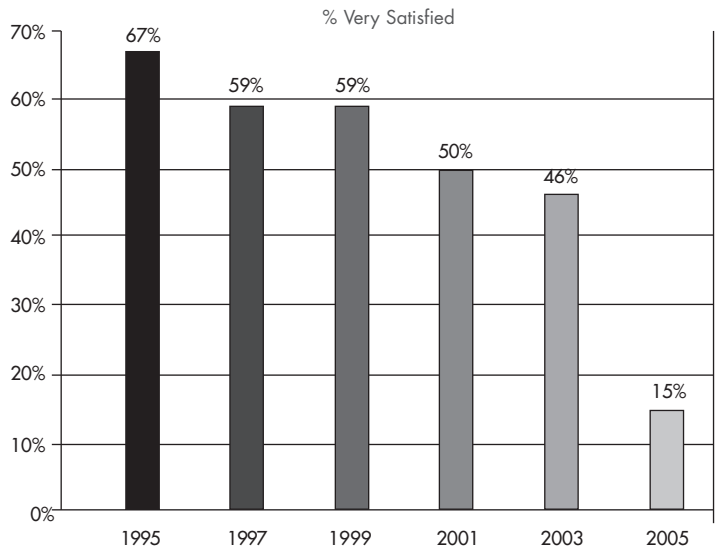
by Rick Flaspöhler and Richard Jennings

Editor's Note: Rick Flaspöhler is President of The Flaspöhler Research Group, who have been conducting the biennial survey of ceding life company attitudes about life reinsurance and reinsurers since 1993. The results of these surveys are used by major life reinsurers to develop marketing and service strategies.

"Getting to Woe Some" is a thought-provoking title for Rick Flaspöhler's recent presentation to the ACLI Reinsurance Executive Round Table in March 2005. Flaspöhler presented the high-level findings of the biennial reinsurance survey, and in his words this industry has gone from "bad to worse." The reinsurance industry now finds itself in a unique and difficult situation that will require dramatic steps to improve things going forward.

When Flaspöhler first began working with reinsurers there were about 30 different companies, and now there are only eight to nine principal players. Of the 10 best reinsurers rated by ceding companies ten years ago, six are no longer here. Flaspöhler says this reminds him of what he has seen on the P&C side. Since 1995, there is only one reinsurer still operating with the same name in that market. Certainly if things don't improve, there could be a lot of new and/or different names on the life side a few years from now.

cedent Satisfaction With Life Reinsurers Serving North America Since 1995



cedents "Can't get no … satisfaction"

In his 25 years working with varied industries and business sectors around the globe, Flaspöhler has never seen any industry sink to such a low level of satisfaction with its clients. Sixty-two percent of ceding companies rated that their relationships with reinsurers, overall, were declining, and only 16 percent of cedents were "very satisfied." Any client relationship manager will tell you that when a client is only "somewhat satisfied" with their supplier, they are 20 times more likely to move their business somewhere else, and 50 percent of cedents are "somewhat satisfied." Perhaps more disturbing is that 18 percent of ceding companies are "somewhat dissatisfied" and 4 percent are "very dissatisfied."

Ceding companies that rated themselves "very satisfied" have consistently dropped from 67 percent in 1995 to 46 percent in 2003, but in the last two years this level has dramatically reduced to 15 percent, unheard of in other service-orientated industries. When this satisfaction rating fell below 50 percent, this should have been setting off alarm bells. Instead it is now "beyond bad and become awful." Certainly reinsurers have their work cut out for them.

Impact of Reinsurer Consolidation on Direct Writers

When asked, "What were the most critical issues facing Direct Writers?" the number one issue was "Reinsurer Consolidation." Other important issues also noted were "Preferred Criteria and U/W Exceptions," and "Treaty Terms and Conditions."

It's not so much the fact that the reinsurance market has consolidated, but more the impact the consolidation has had on the remaining reinsurers and the sense that they can take advantage of this less-competitive market. Reinsurers are responding to

the consolidation by strengthening rates and tightening terms and conditions. It is the impact of this change in the ways of doing business that is being so strongly felt by direct writers. Here are some verbatim responses that highlight their concerns:

"It seems that the 'gentlemen's agreement' approach to doing business is being quickly replaced with the new contractual provisions which seem to protect the reinsurer at the expense of the ceding company. This appears to be driven by a belief that the ceding company is no longer as trustworthy."

"The rules have changed without warning, e.g. claims on cases underwritten years ago denied that would not have been denied in the past. Audited cases charged higher premiums. No difference of opinion accepted. No judgement allowed in underwriting. Rules, not guidelines, apply in all areas."

"Based on my experience, over the last year, the reinsurers have become reluctant to help me when I need an exception. I've actually had one reinsurer tell me we have been instructed 'no exceptions'. Keep in mind these are reinsurance underwriters but it is obvious they have been told to either be very careful if they make an exception, or not to make any exceptions...a major issue for me is the decline in overall reinsurance capacity. I understand the reasons for the decline, but it is an issue for me."

"As a direct writer, we have found that there is less compromise with reinsurers. The feeling is that there is much less flexibility or willingness to discuss options for obtaining the same information. It boils down to reinsurers being more black and white and less willing to consider positive factors of a risk as a way to offset negatives. I believe the reason is that there is far less competition between reinsurers."

"In the past reinsurers were willing to partner with direct companies to handle exceptions or disagreements on mortality evaluations. Today, they dictate terms and if direct writers deviate, they run the risk of paying 100 percent of a claim. Reinsurers used to be more flexible and willing to compromise, that is no longer the case."

At the same time that the reinsurers have been tightening up terms and conditions, ceding companies feel that there has been a decline in the level of trust and civility that used to exist in their relationships with reinsurers. Here again are some verbatim responses to the "loss of trust/civility" issue:

"...seems to be less trust. The treaty historically was used as a final resort to settle disputes. Now it seems more iron-clad and restrictive. [...] less flexibility in regard to business practices, and much more control exerted over activities. Repricing pools because of poor internal results, likely due to overly aggressive internal pricing. Any change to underwriting standards, no matter how minor, can be used as the rationale for repricing the pool."

AS A DIRECT WRITER, WE HAVE FOUND THAT THERE IS LESS COMPROMISE WITH REINSURERS.

"Reinsurance over the past 20 years was truly a partnership concept, based on general principles rather than a reading of the treaty terms as a strictly legal document. [now...] too many lawyers involved in treaty composition. Reinsurers are increasingly inflexible regarding treaty terms and provisions. Additionally, reinsurers reluctance to trust and participate in underwriting flexibility adds an additional layer of complexity to the direct carrier's day-to-day operations."

"Reinsurance is no longer a partnership relationship. The environment is now dictated by financial people, not risk selection professionals. Trust underwriting is no longer allowed, and guidelines have become rules. Also, the quality of the underwriting staffs within the reinsurers has sunk to a new low of inexperience and lack of ability to make decisions."

continued on page 24

"Getting to Woe Some" from page 23

"Much less flexibility and lack of overall cooperation. We realize it's a tough market but treat us with a bit more respect."

Relationships are a two-way street and not everything is the fault of the reinsurers. Ceding companies themselves admit that their own ways of doing business need to change as well. Some, not all, ceding companies may have abused the system and been too aggressive on price or pushing through too many exceptions. Other direct writers feel that they are paying the (higher) price, and that the reinsurers are increasing prices across the board because of some direct writer's experience.

REINSURERS NEED TO TALK CONSISTENTLY ABOUT UNDERWRITING QUALITY ISSUES, NOT JUST WHEN THE GOING GETS TOUGH.

"I believe that the direct carriers are no longer treated as clients by the reinsurance community. It is no secret that a handful of direct life carriers have taken advantage of their quota-share arrangements...had hoped that the frequent use of reinsurance audits would help to stabilize the aggressive nature of these renegade companies. Unfortunately, many of our reinsurance partners have decided that it would be best to treat all their clients as if they were involved in the great conspiracy against the reinsurance community. Years of valued relationships appear to have been thrown out the window. It is truly unfortunate and unfair."

"Rates increasing, underwriting becoming more conservative, due to reinsurance consolidation, reinsurers trying to take advantage of the situation and increase profitability, and some direct companies continuing to make exceptions to their own and reinsurer guidelines, spoiling the situation for the rest of us."

What Solutions are available?

When client companies are becoming increasingly frustrated and their suppliers are raising prices, even if they are only trying to get back to a 'reasonable' level, it would appear that new entrants will sense an opportunity and enter the market. This process has already begun.

"The reinsurers will have to take a few losses in court before they see the error of their ways. New entrants in the reinsurance marketplace with a more reasonable approach to doing business could take market share and hasten the healing."

"First, reinsurers must recognize that the problems they face did not occur overnight, and the solution can not be implemented overnight. They need to work with cedents, not against them, to correct the problems. Most underwriters are professionals who take pride in their work and have high ethical standards. The reinsurers do not recognize this and increasingly treat us as the enemy, with no respect. In my 30 years in this business, this is the most poisonous environment I have ever seen."

Are the 80 percent and 90 percent quota-share deals a thing of the past? Retentions are increasing, and treaties are shifting to excess of retention with higher attachment points. As this continues, direct writers will get back into the business of risk retention and risk management. This will induce them to behave in more sensible fashion with regard to the abuses of before. Also "what goes around, comes around," and reinsurers will be reminded of that when they go to negotiate their next round of renewals.

"Direct companies do need to restore integrity to risk selection. But reinsurers contributed to the problem with laxity in their own underwriting and audit standards in the '90s. We need to get away from the high percentage quota-share arrangements. Reinsurers need to talk consistently about underwriting quality issues, not just when the going gets tough. We need to get back to thinking of each other as partners. And let's not add language to the treaties, as at least one major reinsurer is doing, that gives reinsurers lots of ways to avoid automatic liability if they disagree with the underwriting."

Perhaps reinsurers should go back and reread Dale Carnegie's book, *How To Win Friends and Influence People*, which taught a simple lesson. Sometimes how you deliver the message is almost as important as the content of the message. Reinsurers need to remember this when revising their terms and conditions. In order to maintain their relationships, they need to work with their clients to come up with a way to do business that is mutually beneficial, not one-sided in favour of themselves.

"It would set a much better atmosphere if the reinsurers would explain why they are suddenly changing the wording, length of provisions and general tone of their agreements. Also, some of the new provisions are too one-sided. Finally, the reinsurers seem to feel that they are now able to dictate terms, as opposed to seeking compromises."

Some reinsurers will suffer because they won't figure it out. Others that continue to work with their customers, in a true sense of partnership, will build stronger and healthier franchises.

Conclusion – Flaspöhler's Thoughts

To the Direct Writers:
Accept the fact that you played a role in creating the problems faced today. Direct writers:

- Continued to demand low price, even when not justifiable
- Believed that it was easier to fight the reinsurer than the field
- Allowed too many exceptions in underwriting

To the Reinsurers:
Accept the fact that (some) reinsurers played a role in creating the problems faced today:

- Remember "what goes around, comes around"
- Let profitability and results be your driving factors
- Don't forget to treat especially well those who have performed
- Don't forget the "small" writer
- Communicate
- Communicate some more ✺

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Rate Changes under Yearly Renewable... from page 21

treaty that was already breaking even or performing well. Moreover, in the former situation, a panel might look to how carefully the reinsurer had underwritten the business in the first place and the completeness and accuracy of the underwriting information furnished by the cedent. In the same vein, a panel might take an entirely different view of a situation in which the reinsurer was simply attempting to achieve a reasonable profit going forward as opposed to a situation where it was attempting to convert past losses into profits. And, in any case, a panel would probably look at least to some extent for guidance from the actual contract language as well as any evidence concerning the negotiation of the rate change provision.

None of this is meant to predict what a panel might actually do in a particular situation, but rather, simply to indicate the kind of questions that might be raised in a dispute of this type and how a panel might choose to approach those questions. Given the relative lack of dispute experience in this area, there are few actual signposts to follow. It seems likely, however, that the experience of the next few years will furnish more. ✺

A FOND FAREWELL TO OUR EDITOR

(AN INTERVIEW BY RONALD L. KLEIN)

Dean S. Abbott, FSA, MAAA, is vice president and actuary with ING Re in Minneapolis, Minn. He can be reached at *dean.abbott@ing-re.com*.

There are currently 18 Sections of the Society of actuaries with over 36,000 members according to the Society of Actuaries Web site. Each of these 18 Sections publishes a high-quality newsletter that is distributed to its membership.

The Reinsurance Section of the Society of Actuaries currently has over 2,400 members which ranks it sixth amongst all sections. I do not know of any section that is more pleased with the quality of its newsletter than the Reinsurance Section — all thanks to Dean Abbott.

After more than four years of dedicated service in making 2,402 actuaries happy (a daunting task in and of itself) and an additional 40 non-actuaries happy, Dean has decided to step aside in his role as editor. I felt that it would not be fitting to let him go without asking him a few questions. I had the opportunity to catch up with Dean recently. Here is what he said:

Q: What were you responsible for during the past four years?

A: Most of my time was spent editing the Reinsurance Section newsletter and also as Web site Liaison for the section.

Q: I didn't know that you were the Web site liaison. What was your biggest accomplishment?

A: My biggest accomplishment clearly was creating the advertisement for my successor. I obviously did a great job since Richard Jennings volunteered for the position and he is doing a fantastic job!

Q: Tell us more about the newsletter. How many did you send out? What was your longest issue?

A: In all, I edited nine newsletters during my tenure. Supposedly, in successive issues a couple years ago, I had the longest Reinsurance News *ever and followed it up with the longest section newsletter ever (of all the sections). It was not my goal to do that, instead my goal was to have more articles committed to than I ultimately needed, figuring that a number of them would not materialize. However, I was fortunate in that I always had a high "articles actually submitted to articles committed to" ratio.*

Q: I am sure that being the editor had its good times. What was the best part of the job?

A: I love dealing with people and this position afforded me the opportunity to work with a large and diverse group of people while preparing each issue. It was also interesting to think of ideas for articles that the membership would enjoy reading. I would often sit back and think "what is it that I really want to know about what's going on in reinsurance" and then I would try to find people to write articles on those issues. I got more questions answered that way.

Q: Being an editor had to have its tough days too. Would you like to discuss some of these days?

A: I generally don't like to complain and I would have to name names — and that would just get me into trouble! If any of the readers are really interested in my struggles, please give me a call.

Q: Are there any humorous stories that you would like to share with us?

A: Graham Bancroft asked me to volunteer for the position of newsletter editor while he was chairperson of the Reinsurance Section Council. At that time, I

had been in reinsurance for barely one year. How could I possibly take the position without an in-depth knowledge of the reinsurance industry? How could I get volunteers to write articles when I did not have any contacts? These were just some of the questions that I posed to Graham even though I was excited about the opportunity. Of course, Graham assured me that as chairperson he would be able to make up for my shortcomings — no problem (for those of you who do not know Graham he has this way of making you feel more comfortable when you have a concern). Based on Graham's assurances, I signed on as Reinsurance News *editor. My first official assignment was to attend the Reinsurance Section Council meeting not two weeks after speaking with Graham. At the meeting, the first order of business was to thank Graham for his term as Chairperson and to wish him well as he was leaving the council! So much for assurances! I will never let him forget that. In fact, I hope he is reading this article now.*

Q: Do you have any final comments as outgoing Editor?

A: I very much enjoyed being the reinsurance section newsletter editor and I would like to again thank the many contributors to the newsletter. I would also like to thank the staff at the Society of Actuaries for assisting me every step of the way. Meeting so many good people and learning so much made this a great experience. I highly recommend it.

I hope that you will all join me in thanking Dean for his exemplary service to our section and wish him well in his future endeavors. ✺

REINSURANCE

NEWSLETTER OF THE REINSURANCE SECTION

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This newsletter is free to section members. A subscription is $15.00 for non-members. Current-year issues are available from the Publications Orders Department. Back issues of section newsletters have been placed in the Society library, and are on the SOA Web site, *www.soa.org*. Photocopies of back issues may be requested for a nominal fee.

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SOCIETY OF ACTUARIES

"Aren't You Going to Stop..." from page 6

small plans or small segments of larger plans. Deductible levels were set higher than normal either because of current size and anticipated growth or due to other larger blocks of business with the same entity.

The data on the right side of the table are more representative of where HMO plans are selecting deductibles. Most of the activity is grouped from ratios of 10 percent to 30 percent. This means that the ratio of deductible to annual member months falls in this range. For example, a 50,000-member plan would have 600,000 annual member months and might be selecting a deductible of around $120,000 or 20 percent of the number of member months. These observations are based primarily on hospital inpatient-only coverage and represent a mixture of commercial, Medicaid and some Medicare HMO business.

Although the deductible is a significant out-of-pocket cost, coverage should also be selected with other important criteria in mind. A properly structured reinsurance program will result in a high "coverage-efficiency ratio" of actual reimbursed claims relative to expected reimbursed claims (i.e. few "surprises"). This creates the most cost-effective benefit program by providing the best value for the premium. Key considerations include:

- Desire for hospital inpatient versus comprehensive cover
- Artificial per diem limitations such as an ADM cost limitation
- In-network versus out-of-network utilization issues

A PROPERLY STRUCTURED REINSURANCE PROGRAM WILL RESULT IN A HIGH "COVERAGE-EFFICIENCY RATIO" OF ACTUAL REIMBURSED CLAIMS.

- Outpatient and step-down facilities
- The contractual definitions of acute care, medical necessity and experimental procedures, which can lead to significant out-of-pocket costs if not structured appropriately. It is highly desirable to select a reinsurance treaty that has no separate definitions for these items, but rather follows the form of the medical plan.

In conclusion, the following considerations can be drawn regarding deductible selection:

1. The best analysis for each deductible selection should take into consideration individual plan experience as well as a national claim distribution manual.
2. There are numerous individual plan considerations in selecting an HMO excess of loss deductible, such as type of membership (commercial or government program), geographical cost, plan-risk tolerance as well as plan size, ownership and budgetary considerations.
3. Most plans end up selecting a deductible that results in a deductible divided by annual member month's ratio of 10 percent to 30 percent.

This roadmap was designed to assist with reinsurance deductible selection criteria. If you use some of these simple guidelines, you'll definitely be in the driver's seat! ✹