SOCIETY OF ACTUARIES

Reinsurance News

February 2007, Issue No. 59

newsletter for members of the reinsurance section

WRAPPING A LIFE INSURANCE SECURITIZATION

by Richard Leblanc and Dimitry Stambler

Life insurance securitizations have grown exponentially over the past three years. While the financing of XXX redundant reserves represent the vast majority of life insurance linked bonds, a number of embedded value, catastrophic mortality bonds and more "one-off" transactions have successfully closed. In the first 11 months of 2006, more than $4.5 billion of XXX securities have already been issued. By comparison, there were $600 million of securities issued in 2003. The chart and the table on pages 4 and 5 summarize the major "public" XXX deals closed over the past four years.

Virtually all of these securities have benefited from guarantees issued by a financial guarantor or "monoline," such as Ambac Assurance Corporation. This article explores why issuers have found it advantageous to work with financial guarantors and discusses what potential sponsors should expect from the process.

Why use a monoline?

Financial guarantors have played an important role in the insurance linked market for many of the same reasons we have helped in the evolution of most other sectors of the asset-backed market. The main reasons are:

i. lower financing costs
ii. expanded investor demand and assurance to market access
iii. greater liquidity and reduced price volatility
iv. single counterparty

When it comes to evaluating the pricing advantage, one has only to compare the cost, (measured as a spread to a reference rate, *e.g.,* LIBOR, Treasury or swap rate) at which unwrapped notes can be sold to the sum of i) the spread on the wrapped

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NEWSLETTER OF THE REINSURANCE SECTION

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SOCIETY OF ACTUARIES

CHAIRPERSON'S CORNER

Re-VIEW

by Larry Carson

When I was much younger, my father relayed to me his theory of management. He placed a bunch of spare change on the table, and carefully laid out two sets of coins. The first set was a quarter surrounded by four pennies. The second set was a penny, surrounded by four quarters. He said, "You can surround yourself with people who won't threaten you; this is the quarter surrounded by the pennies. Or, you can surround yourself with people who are smarter than you; this is the penny surrounded by the quarters." He ended by asking, rhetorically, "which is worth more?"

Well, my year as chairperson of the Reinsurance Section Council has finally concluded, and we can all be very thankful that I was surrounded by so many "quarters." Graham Mackay did an incredible job as a sounding board and coordinator, and the section will be well-served by having him as chair this year. Tim Ruark performed the often-thankless task of keeping us organized, always making sure that the materials we needed were collected and distributed in time to be of use. Jeff Burt got our financial house in order. Mark Troutman, in addition to his work liaising with the health insurance community, spearheaded the first "Who Reinsures What?" directory, among other membership value and outreach efforts. Richard Jennings continued to edit this very newsletter; Bob Diefenbacher coordinated all of our print and electronic communications, including our e-newsletters. JJ Lane Carroll got our fledgling research efforts off the ground and has positioned us for great things going forward. Last but not least, Craig Baldwin was a one-man show, coordinating our many continuing education offerings and co-chairing (with Mel Young) the inaugural ReFocus program committee.

We have built a very strong foundation to provide more and better services to our members going forward. I am personally thankful for the incredible energy and devotion this entire council brought (and continues to bring) to all of our activities. They made this "penny" look great.

See you in Lake Las Vegas for ReFocus 2007! ✹

Larry Carson, FSA, MAAA, is vice president and actuary with the Financial Markets division at RGA Reinsurance Company in Chesterfield, Mo. He can be reached at *lcarson@rgare.com*.

Re-EVALUATE

by Graham Mackay

Serving the section membership is an honor and a privilege—and quite a bit of work given the rate of change taking place in our working lives. Change is occurring at all levels and from all corners. Regulators are becoming more commercial and advisors more cautious. Banks and reinsurers compete with each other for financing solutions.

Our profession is also changing to meet these new demands. Education requirements continue to evolve and more sophisticated tools allow us to better understand the risks we are managing. The SOA has developed a strategic view of our brand, and we are now openly discussing the merits of continuing education.

Focus

So what does all of this mean to us? There is more to do than time permits, and we need to be more careful in identifying the key issues and setting priorities for our organizations. The Reinsurance Council is no exception. During the past year, we implemented team structures to bring focus to key areas of interest and raised the bar a number of times to deliver high-value services. This is to the credit of last year's chairperson, Larry Carson. He has made it easy for me to step into this role—I thank him for his tremendous efforts.

More Focus

We face many of the same issues this year. Demand continues to grow for high quality services. Our list of hot issues includes education, research, access to information and interaction with other disciplines both inside and outside of our profession. With our team structure in place, each team is staged to deliver their own high-value services to our members.

As we are expanding our organization to deliver the services you requested, we will need volunteers to support these initiatives. There are opportunities for everyone. Some projects are narrowly focused on a specific issue while others will have a broader focus and impact. The time commitments will obviously vary with the role, as do the benefits. I urge you to think about how you can help your section and participate in this process. Not only will your time bring great benefit to the section and its members, but will help you continue to grow and develop in your career. Please contact any of our council members to see how you can participate.

AS WE EXPAND OUR ORGANIZATION TO DELIVER THE SERVICES YOU REQUESTED, WE WILL NEED VOLUTEERS TO SUPPORT THESE INITIATIVES.

ReFocus

This March, the Reinsurance Council will launch ReFocus 2007, a conference dedicated to the art and science of reinsurance. It will be presented by senior reinsurance professionals for the benefit of the reinsurance community. It is a unique conference focused on life, health and annuity reinsurance and is being jointly sponsored by the SOA and the ACLI. This effort is led by Craig Baldwin and Mel Young and is supported by a strong group of reinsurance leaders. Please watch for the announcements and join us. I am looking forward to seeing you there! ✹

Graham Mackay, FSA, MAAA, is director with Navigant Consulting, Inc. in Chicago, Ill. He is also chairperson of the Reinsurance Section Council. He can be reached at *gmackay@navigantconsulting.com.*

notes plus ii) the premium payable to the monoline. In other words, one has to measure the difference in spread between wrapped and unwrapped notes. After the cost of the wrap, that difference would represent the cost saving for a sponsor for issuing a wrapped paper. While there is limited observational data, the few instances where wrapped and unwrapped pari passu notes were issued suggests this can vary between 30 basis points (bps) for a XXX transaction to over 100 bps for a mortality cat bond.

There is a relatively small population of investors that will invest the time needed to analyze unwrapped insurance linked paper. When they do these investors expect a significant "novelty" premium be built into their yield in addition to the higher spreads commanded by securities rated less than triple-A. A financial guarantee opens up virtually the entire universe of ABS investors, which is particularly useful when dealing with the more novel insurance exposures.

Certain investors will be attracted by the much greater liquidity and reduced price volatility in the secondary market of triple-A rated notes. For instance, the recent events at Scottish Re caused spreads on their unwrapped XXX related notes to widen by 50 bps or more, whereas the monoline wrapped tranches initially widened by roughly 15 bps.

Using a monoline in the transaction also allows the sponsors to avoid sharing certain proprietary information that makes them competitive in the market place such as mortality and lapse studies. By dealing with the monolines only, they limit the parties who have access to this information and do not have to disclose it to the broader investor base.

Figure 1: Regulation XXX and AXXX Growth

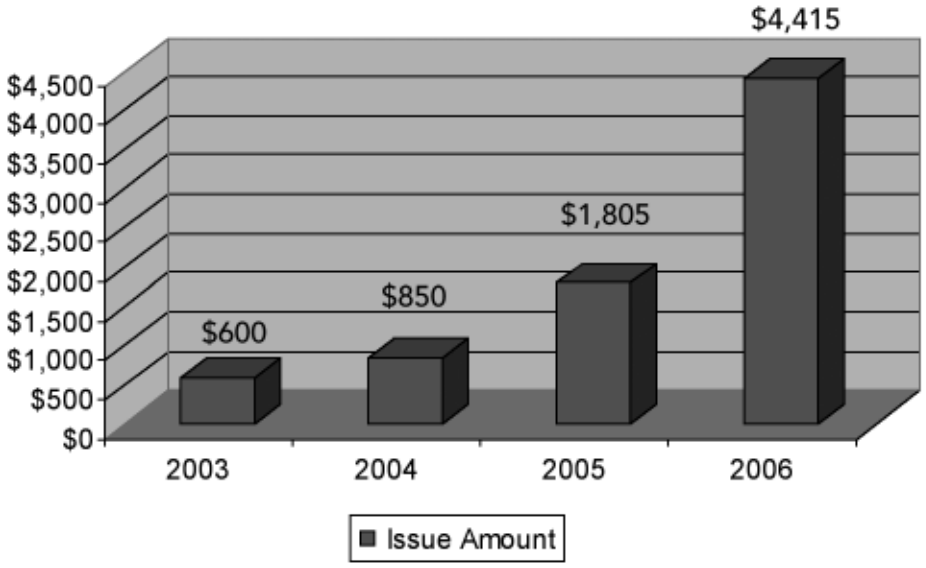

Figure 2: Regulation XXX/AXXX Securitizations

Beneficiary	Transaction	Issue Date	Issue Amount
Genworth	Rivermont (AXXX)	October 2006	$315 MM
Genworth	River Lake I (4th Issuance)	September 2006	$300 MM
Legal and General	Shenandoah	September 2006	$450 MM
RGA	Timberlake	June 2006	$850 MM
Scottish Re	Ballantyne Re	May 2006	$1,750 MM
Genworth	River Lake III (1st Issuance)	January 2006	$750 MM
Scottish Re	Orkney II	December 2005	$455 MM
Genworth	River Lake II (2nd Issuance)	October 2005	$300 MM
Genworth	River Lake I (3rd Issuance)	June 2005	$200 MM
Scottish Re	Orkney	February 2005	$850 MM
Genworth	River Lake II (1st Issuance)	December 2004	$300 MM
Legal and General	First British American	November 2004	$550 MM
Genworth	River Lake I (2nd Issuance)	December 2003	$300 MM
Genworth	River Lake I (1st Issuance)	July 2003	$300 MM

Representative Deal Structure

Statutory reserves can be split into "economic" reserves and "redundant" reserves. Economic reserves (together with the future premiums) are there to pay for policyholders' benefits while redundant reserves are not needed under most circumstances. Regulation XXX and AXXX securitization transactions offer a life insurance or reinsurance company a way to finance a portion of redundant reserves which arise from the regulations.

The diagram on page 6 is an amalgam of various deals' structures designed to finance redundant XXX reserves. While the boxes and arrows can be rearranged in many ways to meet the objectives and constraints of a particular deal, the following elements are usually present:

1. life insurance policies are reinsured to a special purpose captive reinsurer created solely for the transaction;
2. the ceding company transfers (although this can also be done on a "funds withheld" basis) to the captive its best estimate of economic reserves to discharge the expected liabilities on the policies reinsured;
3. the captive is initially funded with sufficient "first loss capital" to absorb an amount of potential adverse development based on negotiations with regulators, rating agencies and the monoline. To a certain extent, the expected profitability of the business is considered in sizing "first-loss capital;"
4. the structure may seek to insulate the captive from "event" risks and, thereby, reduce the amount of "first-loss capital" by either excluding certain liabilities or by incorporating reinsurance protections or asset hedges;
5. the captive typically issues surplus notes to finance the reserve strain;
6. surplus notes are transformed into other debt securities that are more marketable to investors;
7. the monoline issues its financial guaranty policy for the benefit of investors;
8. mechanisms are incorporated to return capital and emerging profits on the business to the sponsor or its affiliates; and
9. to maximize the tax deferral value of the XXX tax reserves, the captive usually enters into a tax sharing agreement to make these losses available to its affiliates which creates a large counterparty risk for the captive and is therefore frequently collateralized.

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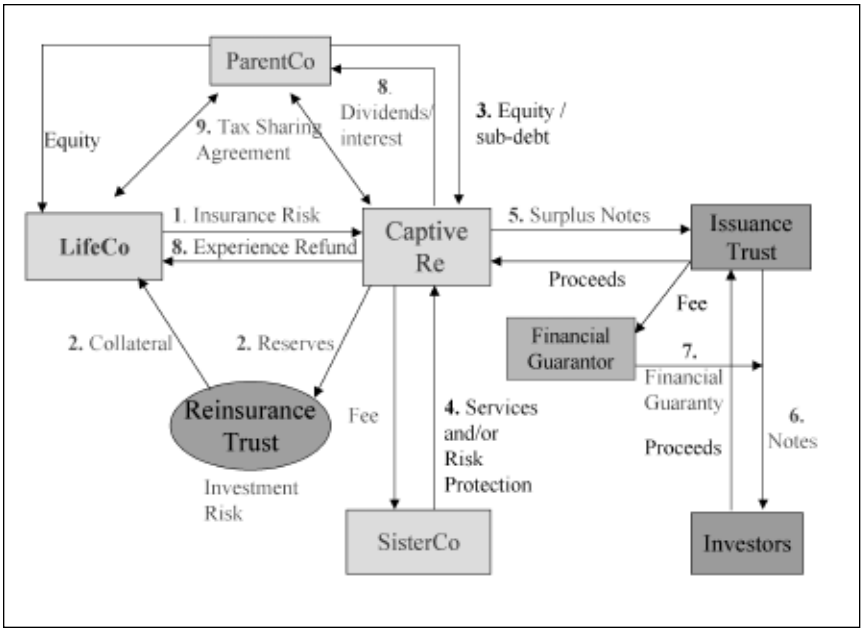
The Financial Guarantor Underwriting Process

The monoline's focus is on analyzing the amount of over-collateralization available to absorb fairly extreme sensitivities. While the transaction being evaluated can be crudely benchmarked against precedent transactions, we have found this to be of very limited value. First, each block of business has different profitability characteristics, deal structures vary considerably (e.g., capital structure, dividend and experience refund patterns and thresholds, etc.). At Ambac, decisions are made based on the professional judgment of our underwriters and scrutiny through our credit processes and not on ratios falling within pre-determined tolerances.

Great care is also given to ensuring the resilience of the structure in the event of credit deterioration of the cedant and entities' servicing of the business. Given the old adage that "time is risk" and the fact that XXX transactions can extend to 30 years, much time is spent ensuring the documentation encourages continued alignment of interests.

It is important to recognize that monolines, while knowledgeable, are not necessarily experts in the particular type of insurance product underlying the financing transaction, Therefore in addition to the typical information that needs to be provided to a traditional reinsurer, the sponsor and its investment banker should be prepared to explain the key profitability drivers and demonstrate why the proposed transaction presents a low risk of loss for the monoline. This includes details of the underlying assumptions used to price the products and experience data that supports the appropriateness of the assumptions used to value the business. In addition, the financial guarantor will want to understand the financial health of the sponsoring organization and

Figure 3: XXX / AXXX Deal Structure



how it will be able to service the business over the life of the transaction.

Monolines spend a considerable amount of time analyzing the block of business being securitized and performing comprehensive due diligence to arrive at the conclusion that, for example, the redundant reserves in a XXX deal are indeed redundant and that subordinated first loss capital and the economic reserves will be enough to cover policyholder benefits and the projected negative carry, including transaction expenses.

The analysis involves the following steps:

- on-site visit to the sponsor;
- actuarial analysis and due diligence;
- risk assessment, including actuarial, legal, structuring and other risks;
- structure analysis and risk mitigants;
- deal model review;
- negotiation and execution of deal documents.

A monoline will visit the sponsor's home office to meet the management and review the product underwriting process, pricing and reserving assumptions, claims processing, and in the case of reinsurers their ceding company audit philosophy.

The next step involves reviewing the report prepared by the sponsor's actuarial consulting firm, which prepares financial projections of the insurance block including various stress scenarios. This independent actuarial firm also comments on "reasonableness" of the base case assumptions. The findings and conclusions of this actuarial consultant are typically published in the offering memorandum to help investors evaluate the risk in the securities. Monolines retain the services of another independent actuarial consulting firm to review the work of the sponsor's actuarial consultant as well as to perform an independent analysis of the insurance risks, the appropriateness of how the model was constructed and to identify additional sensitivity testing that may be useful. The need for two levels of actuarial scrutiny is driven by a perception that the sponsor's determination of "reasonableness" may have a tendency to be at the more aggressive end of the continuum, whereas financial guarantors desire to be at the more conservative end given the limited recourse nature of such financings. One can compare the sponsor to an equity investor and the monoline to a senior debt holder. The equity investor is willing to accept more risk in the hope of benefiting from enhanced returns, whereas the senior debt holder earns a fixed spread and faces only the downside from assuming incremental risk.

Monolines perform risk assessment of the various insurance risks including any embedded guarantees and options. The major risks assessed are mortality, lapse and investment rates.

- Mortality: analysis should show that fairly extreme mortality increases, during the level premium period and after, can be absorbed by the "economic reserves" plus first loss capital;
- Lapse: analysis of lapse assumptions during and after level term period including post-level term profits estimates, shock lapse rates and post-level mortality anti-selection methodology, e.g. Dukes-McDonald method;
- Investment returns: to ensure projected current yields, reinvestment rates and asset default assumptions are appropriate given the investment guidelines applicable to the assets supporting the reserves and the first-loss capital.

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Analysis of the structure of the transaction and how it both introduces and limits risks includes careful examination of various aspects of the term sheets, accounting issues, tax issues, etc.

The deal model projects cash flows of the notes, and should include, as an input, actuarial cash flows from various stress testing scenarios and monoline payments if needed. Deal models can be quite complicated and require substantial analysis.

Negotiation and execution of transaction documents usually takes places concurrently with the other analyses. Key documents include a Coinsurance Agreement between the sponsor and the captive as well as an Insurance and Indemnity Agreement (I&I) between the monoline, the issuer of the securities, the captive and the sponsor. There are a number of other documents required to be executed, dependent on the particular structure and the jurisdictions of the deal.

Major Risk Issues

The major issues that monolines are faced with include post-level term profits, cat cover and servicing of the block, among others. Over reliance by the sponsor on post-level term profits is a particular concern to monolines due to lack of sufficient data to quantify this risk. It is addressed through stress testing, structural features and an equity cushion negotiated with the sponsor. Financial guarantors require the captive to be insulated from catastrophic losses by either excluding it from the coverage or requiring reinsurance protection. Monolines are relying on the sponsor to service the block (pay claims, collect premiums, calculate reserves, etc.), therefore the ability to perform these services becomes a significant risk factor in the transaction.

The time required to complete a life securitization transaction can range from a few months to over a year. This depends on the complexity of the structure, parties involved and the regulatory jurisdictions. By the time the transaction comes to a monoline, rating agency discussions often have taken place, "the deal model" built, actuarial work begun and detailed term sheet drafted. From that point on it can take several months to complete the deal. Possible delays include changes to the structure due to discoveries made during diligence, requests from regulators or rating agencies, as well as competing demands on the deal team. Dedicated resources are also required due to time-consuming analysis and document negotiation.

Rating Agencies

Issuers on occasion ask why their transacton needs to go through the rating agency process given that the securities will ultimately be rated AAA/Aaa by virtue of the financial guarantee? The answer is that in order to maintain AAA/Aaa ratings, a monoline's business must be completely transparent to the rating agencies. As a result, a majority of structured finance transactions need to be rated by each agency. This allows the agencies to more accurately monitor the amount of capital required to support the monoline's overall portfolio.

This rating process produces what is commonly referred to as a "shadow rating" which is meant to reflect the inherent rating of the transaction without regard to the enhancement provided by the financial guarantee. Shadow ratings influence the amount of marginal capital required to support a transaction and as such the premium rate required by the monoline. Investors on occasion ask the investment bank marketing the securities about the "shadow" rating to help differentiate and price amongst similar AAA/Aaa securities.

It is important to remember that a financial guarantor analyzes its transactions independently from the rating agencies. While, in general, many of the same factors will be considered, the monoline's diligence process tends to be more comprehensive given that it is putting its balance sheet at risk. Professional judgment is used to determine the nature and degree of sensitivities that a transaction needs to withstand, therefore, investment grade ratings from the agencies do not necessarily mean that a transaction will be acceptable to a monoline.

Supporting Private Financing Solutions

While the bulk of this article has focused on how a monoline brings value to a securitization, it is also worthwhile noting that other capital providers to the insurance industry are increasingly exploring how a financial guarantor can bring efficiency to the financings they provide. For instance, several commercial banks are starting to offer non-recourse long-term letters of credit to finance redundant XXX and AXXX reserves. Frequently, this is made possible because they are hedging the risk with a financial guarantor. Another example is the investor in unwrapped insurance linked securities who may purchase a hedge in the secondary market, frequently from the monoline which has wrapped other classes of securities in the same transaction.

Choosing a Financial Guarantor

As is the case with any insurance product, the buying experience can vary greatly depending on the provider selected. Most investment bankers recommend basing this decision on i) ability to execute, and ii) price. A solid understanding of the risks inherent in the insurance product and a proven track record of closing structured insurance transactions are keys in choosing the right monoline. This should shorten the underwriting process and make it much more predictable as the financial guarantor will know where to focus its attention and reduce the demands on advisors as well as the sponsor's staff.

Conclusion

Monolines have played an important role in the securitization of life insurance risks. Even as investors become more comfortable with insurance risks and lower rated unwrapped notes are issued in the capital markets, the advantage discussed above will lead sponsors to continue to seek access to capital markets through wrapped securities. As more new sponsors become interested in funding their more complex exposures through capital markets, monolines involvement will be critical in the process. Wrapped senior debt will continue to be an important funding source of capital for life insurance and reinsurance companies in the forseeable future. ✺

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REINSURANCE ARBITRATION VS. LITIGATION: DOES THE FORUM MATTER?

by Gail M. Goering

Most life reinsurance contracts contain clauses that provide for disputes between the parties to be resolved by private arbitration. Such clauses commonly provide for the dispute to be heard by a three-person arbitration panel whose members have experience in the life insurance or reinsurance industry. Usually each party selects a party-arbitrator, and a third arbitrator is selected by a method set forth in the contract. The details of the arbitration process itself (how much written or oral discovery is allowed, how quickly the matter proceeds, etc.) ordinarily are left to the discretion of the arbitration panel.

In recent years, disputes between reinsurers and ceding companies have become more common and the amounts at stake often are very substantial. It is not unusual for an arbitration to take a year or more before a result is reached. Thus, the arbitration process itself has come under scrutiny. Is arbitration the best forum in which to resolve life reinsurance disputes? Would court litigation be better? This article assesses both forums in four contexts: the person(s) deciding the dispute, the rules governing the process, the enforcement of applicable law in the forum, and the type and availability of the result to others.

Industry arbitrators vs. a judge

The principal benefit of using arbitrators familiar with life insurance or reinsurance is that disputes may be resolved by persons familiar with the reinsured product(s) and with industry custom and practice. This often reduces or even eliminates the need for expert evidence that may be required for a person not familiar with the business. It likewise can overcome difficulties that counsel may have in communicating complex principles to the panel. That said, it certainly is possible for a party to appoint an arbitrator who satisfies the requirements of the arbitration clause but has no experience with the subject matter of the dispute or with the arbitration process. Thus, the extent of this advantage of the arbitration forum is limited by the experience of the arbitrators that the parties select.

In the court system, it usually is not possible to select the judge that will hear a case, and thus the quality of the tribunal will depend on the person assigned to the case. Some judges are highly competent; others less so. In either case, their insurance experience often is limited. Some may have experience with property/casualty disputes but few will have had significant involvement with life business. Fewer still have had any exposure to reinsurance generally or to the actuarial principles and modeling that underlies the life insurance and reinsurance business. Educating a busy judge about what can be an extremely complex and technical area poses a formidable challenge. Judges, however, are used to having a "learning curve" on each new case they hear. Having counsel that can communicate in an effective way with the judge thus is essential.

The rules of the game

Many arbitrators are not well-equipped to handle complex disputes. Most arbitrators do not have experience with handling complex document and

deposition discovery. Thus, when disputes arise, the panel may try to make the parties work it out themselves, rather than rule on disputed matters, which results in additional delay and expense. In addition, arbitrators often are not lawyers and thus are unfamiliar with the legal principles being argued to them (and which may or may not actually be relevant to the dispute!). Arbitrator training provided by organizations like ARIAS-US can assist arbitrators in handling the arbitration process more effectively.

In contrast, most courts have experience managing complex litigation. They have procedural rules in place that are designed to move the process forward within a certain timetable. These rules include procedures by which disputes may be briefed and resolved, often within a predictable time frame (depending on the judge's case load). Judges often have staff to assist them in analyzing issues, which also can speed the process to resolution. Judges also may be more likely to exercise their powers to discipline bad behavior by lawyers.

Arbitrators are paid (usually by the hour) to resolve the disputes. Thus, it has been said that there is no financial incentive for them to move the process to a swift conclusion. Judges are not paid by the parties, and many are trying to reduce their case load by encouraging the parties to reach an agreed result or pushing the process forward rapidly, sometimes to a summary result prior to trial. Some busy judges, however, take a "hands off" approach to discovery and have little time to make significant pre-trial rulings. As a result, depending on the jurisdiction and the judge, it is possible for some cases to languish for years before going to trial.

"Honorable engagement" vs. strict rule of law

Many arbitration clauses contain language providing that the arbitrators' task is an "honorable engagement" designed to empower the arbitrators to reach a fair result consistent with industry custom and practice. The clauses therefore release the arbitrators from applying the strict rule of law so that they can fashion relief that is consistent with the parties' reasonable business expectations. In addition, the panel can consider a broad range of evidence, including the parties' oral discussions and business practices that might not be admitted as evidence in a court.

... ARBITRATORS OFTEN ARE NOT LAWYERS AND THUS ARE UNFAMILIAR WITH LEGAL PRINCIPLES BEING ARGUED TO THEM ...

While laudable in theory, such clauses lead to perhaps the most frequent criticism of the arbitration process that it leads to "baby splitting." In other words, the panel's award does not give either party all of its requested relief, even where such relief is plainly warranted by the facts and law. This most often arises where the consequences of the relief simply are considered too harsh in the circumstances, for example, where awarding the relief might cause a party to become financially impaired.

In contrast, a judge usually must follow the law, even if this has harsh consequences to a party. For this reason, litigation can yield more predictable results. Contract language often is construed in accordance with its terms, without reference to the parties' discussions or practices. Care in contract drafting thus is far more critical if disputes are to be resolved in court.

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ReFocus2007

SEE THE FUTURE FIRST

March 4-7, 2007

Loews Lake Las Vegas Resort, Spa & Casino

Las Vegas, Nevada

Dear Honored Guest,

You are personally invited to join other senior level professionals at ReFocus 2007: See the Future First, a distinctive industry conference focused solely on reinsurance. ReFocus 2007, specifically targeting life, health and annuity reinsurance, brings together top industry professionals to examine current issues, envision the future and explore strategies for success.

Interact with the who's who of industry leaders as they deliver a comprehensive view of the reinsurance world. This is the reinsurance event of the year, offering you the opportunity to gain a competitive advantage and to learn creative solutions to both global and domestic challenges.

Plan to be a part of this inaugural event. More information about ReFocus 2007 is available at www.ReFocusConference.com.

We look forward to seeing you there!

Sincerely,

Frank Keating
President
American Council of Life Insurers

Edward L. Robbins
President
Society of Actuaries

2007 Agenda

Sunday, March 4

4:00 – 6:00 p.m.	Registration
6:00 – 7:30 p.m.	Welcome Reception Insurance Legend to be chosen.

Monday, March 5

7:30 a.m. – 5:30 p.m.	Registration
7:00 – 8:00 a.m.	Continental Breakfast
8:00 – 9:45 a.m.	General Session: Reinsurers' CEO Panel
9:45 – 10:00 a.m.	Refreshment Break
10:00 – 11:15 a.m.	Concurrent Sessions A
11:30 a.m. – 12:30 p.m.	Lunch for Golfers Reflection Bay
11:30 a.m. – 1 p.m.	Lunch for Non-Golfers-Hotel
12:30 – 5:30 p.m.	Insurance Legends' Golf Classic to benefit The Actuarial Foundation
1:00 – 2:30 p.m.	CEO Roundtable Discussion (for Non-Golfers)
6:00 – 7:30 p.m.	Reception

Tuesday, March 6

7:30 a.m. – 5:30 p.m.	Registration
7:00 – 8:00 a.m.	Continental Breakfast
8:00 – 9:45 a.m.	Direct Writers' CEO Panel
9:45 – 10:00 a.m.	Refreshment Break
10:00 – 11:15 a.m.	Concurrent Sessions B
11:30 a.m. – 1:00 p.m.	Luncheon with Guest Speakers
1:15 – 2:45 p.m.	Concurrent Sessions C
2:45 – 3:00 p.m.	Refreshment Break
3:00 – 4:30 p.m.	Concurrent Sessions D
5:30 – 7:00 p.m.	Reception

Wednesday, March 7

7:15 – 8:15 a.m.	Continental Breakfast
8:15 – 9:30 a.m.	General Session with Keynote Speakers
9:30 – 10:45 a.m.	General Session
10:45 – 11:00 a.m.	Refreshment Break
11:00 a.m.–12:15 p.m.	General Session
12:15 p.m.	Adjournment

Program Committee

Mel Young, RGA Re	Co-Chairperson
Craig Baldwin, Transamerica Re	Co-Chairperson
Don Preston, ACLI	
Gail Goering, Lovells	
Richard Jennings, Manulife Reinsurance	
Joe Kolodney, Aon Re	
Chris Murumets, LOGiQ^3 Inc.	
Roland Paradis, Lincoln National	
Mark Troutman, Summit Re	

Who Should Attend

Chief executive officers, chief financial officers, chief risk officers, chief actuaries, chief underwriters, senior-level professionals responsible for reinsurance in their companies and senior management from companies that supply services to the reinsurance sector, investment bankers, rating agency staff and regulators.

Confidential award vs. public precedent

Unless the arbitration clause provides otherwise, arbitration awards are usually not "reasoned," meaning that the award sets forth the relief granted but not the reasons why. It therefore provides little guidance for any future dispute. In addition, the arbitration award (and indeed the entire arbitration process) usually is confidential, which means that the award cannot be disclosed to others without the parties' permission. Although in most cases both parties would prefer to keep their business disputes private, the lack of reasons and the confidential nature of the process can result in unfortunate consequences. For example, it may shield a party's bad conduct or allow it to pursue essentially the same dispute against other parties with the hope of reaching a different result.

In contrast, courts generally provide reasons for the decisions they render, which usually are publicly available. The decisions thus can provide precedent for future disputes. They also can deter a party's bad or recurring conduct as it will be revealed to others.

Where do we go from here?

As is apparent from the foregoing comments, there are advantages and disadvantages to both arbitration and litigation. On balance, a randomly assigned judge is unlikely to provide more efficient or predictable results than a carefully selected, experienced arbitration panel. This is particularly true in circumstances where the due diligence process underlying most reinsurance contracts is perhaps less stringent than those for other commercial arrangements, and thus the parties themselves rely more heavily on course of dealing, custom and practice than other businesses might. It is possible, however, to incorporate some of the more attractive aspects of the litigation process, e.g., a reasoned decision, into the arbitration process by careful drafting of the reinsurance treaty's arbitration clause. ✹

Gail M. Goering is a partner with Lovells in Chicago, Ill. She can be reached at *gail.goering@lovells.com*.

STOCHASTIC ANALYSIS RESEARCH PROJECT UPDATE

by JJ Lane Carroll, Art Wallace, Graham Mackay, Howard Rosen, Jeffrey Lucia, Ronora Stryker and Sheryl Kalman

Stochastic analysis has become a standard practice in the evaluation of interest rate risks. Stochastic testing is also common in non-life insurance modeling. There are situations where stochastic analysis is appropriate for evaluation of liability risks for life decrements. However, there is not the same level of sophistication in available tools and methods available in the public domain as there is for interest rate analysis or deterministic testing of liabilities. In order for actuaries to measure this type of volatility and improve on current stochastic models used in actuarial practice, a better understanding of the applicability of stochastic methods as well as the nature of the sources of volatility related to these important variables is required.

The Reinsurance Section and the Committee on Life Insurance Research are jointly sponsoring a research project to develop methodology to stochastically model mortality and lapse risk. The example used in the research will involve a multi-year life contract with an experience refunding reinsurance arrangement. The sources of volatility to be considered in the research include, but are not limited to, the following:

(1) volatility due to misestimation of the impact of underwriting practices on mortality

(2) volatility in future improvements in mortality

(3) volatility in lapse rates or cumulative impact of selective lapsation on mortality rates

(4) other sources of volatility including the risk of contagion due to environmental or man-made events such as pandemics, natural disasters and terrorism.

The research is intended to lead to more sophisticated life insurance pricing techniques and allow for determination of economic reserve and capital. Applications of the research will also have immediate benefits to analysis of risk transfer and embedded derivatives when considering GAAP accounting treatment of reinsurance contracts.

It is hoped that this initial research project will lead to future research on sources of volatility and best practices for modeling liabilities stochastically. ✹

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GOVERNMENT PROGRAM REINSURANCE MARKET UPDATE

by Brian D. Shively

This article addresses several key differences in reinsuring Medicare / Medicaid catastrophic claims versus those of a commercial population. The article begins with a description of each of the government program risks, followed by a summary of the opportunities they present.

The charts below and on page 18 profile the typical claims by diagnosis category for government and commercial populations.

Chart 1

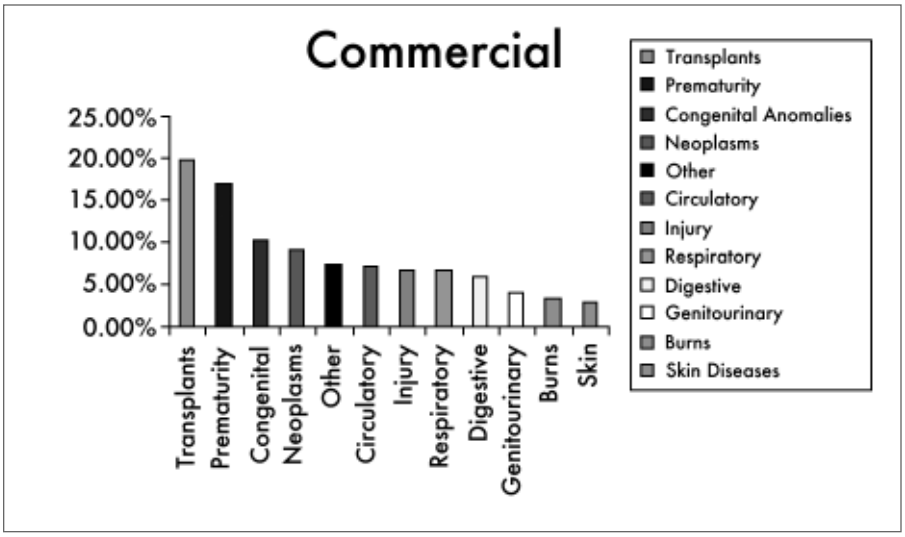
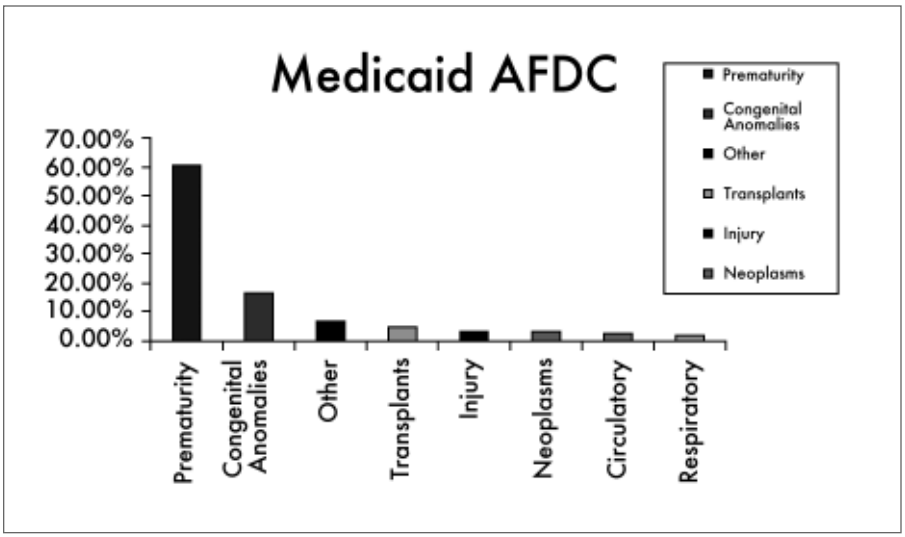


Chart 2



Medicaid

Demographic Considerations

This is a high-risk situation for catastrophic claims for several reasons. There are many younger women of child-bearing age; typical populations include Aid to Families with Dependent Children (AFDC), Temporary Assistance for Needy Families (TANF) and Aid to Dependent Children (ADC).

These covered populations are also less likely to maintain their health at an optimum level. This results from less attention to a healthy lifestyle, poor diet and higher levels of smoking or lack of information about proper health-care resources. The result is a higher prevalence of premature births and other health problems with newborn infants. Most of the additional risks associated with these populations are related to newborns.

The blind, disabled and aged populations of Medicaid have a very different risk profile from AFDC. These people are subject to more chronic illnesses. This may be due to their qualification for Medicaid SSI (Supplemental Security Income) because of disability or simply because an aged population is more likely to suffer from chronic illnesses. There are occasionally dual eligible forms, where the person is covered under both Medicare and Medicaid.

Reimbursement considerations

Medicaid reimbursement takes many different forms. State Medicaid facility reimbursement is typically DRG (Diagnosis-Related Group) based, using an expanded DRG list. A few states have maintained per diem reimbursement for hospital facilities. Others may use DRG-based reimbursement for some services and discounts for other types of service.

Catastrophic claims are most likely to follow a different reimbursement schedule. Outliers, which often pay at a discount off of billed charges, may be used either with DRGs or per diems.

One may encounter variations by facility type (e.g., teaching or children's hospitals). In addition, many Medicaid programs allow for mutual reciprocity for neighboring states (i.e. Medicaid members who receive care out of state for some reason will be reimbursed at an appropriate DRG schedule for the care received.)

It is almost universally true that state Medicaid reimbursement schedules result in a substantial discount from billed charges, and are often the lowest form of reimbursement available. Typically, Medicaid reimbursement can be less than half of billed charges. Since health care is a local jurisdiction, Medicaid allowable schedules vary greatly by state.

Program considerations

Medicaid programs have many nuances that are important to understand for an entity reinsuring them. First, how do people enroll in a plan? Are they required to pick a managed-care health plan in the area (mandatory enrollment), or are they allowed to stay with regular Medicaid fee-for-service if desired?

If members are assigned to a plan, how are they assigned? Many state programs have some form of catastrophic claim protection elements for the Medicaid contractor. These may come in the form of voluntary or mandatory stop-loss reinsurance programs. Also, many states allow AFDC cases to be re-categorized as SSI if a condition is deemed chronic. The SSI risk may then remain the financial responsibility of the state.

There are also several states that offer programs for children with various health problems. These programs may accept both Medicaid and non-Medicaid individuals; but in any case, if a risk is accepted in the program, then it's no longer the risk of the health plan. Thus, there are various opportunities for a health plan to mitigate catastrophic risk exposure through state-sponsored reinsurance programs. Understanding these programs and how a health plan uses them is critical in risk assessment. California, New York, Pennsylvania and Michigan are examples of states with some form of state-sponsored catastrophic claim protection.

CATASTROPHIC CLAIMS ARE MOST LIKELY TO FOLLOW A DIFFERENT REIMBURSEMENT SCHEDULE. OUTLIERS ... OFTEN PAY AT A DISCOUNT ...

Medicaid Extensions

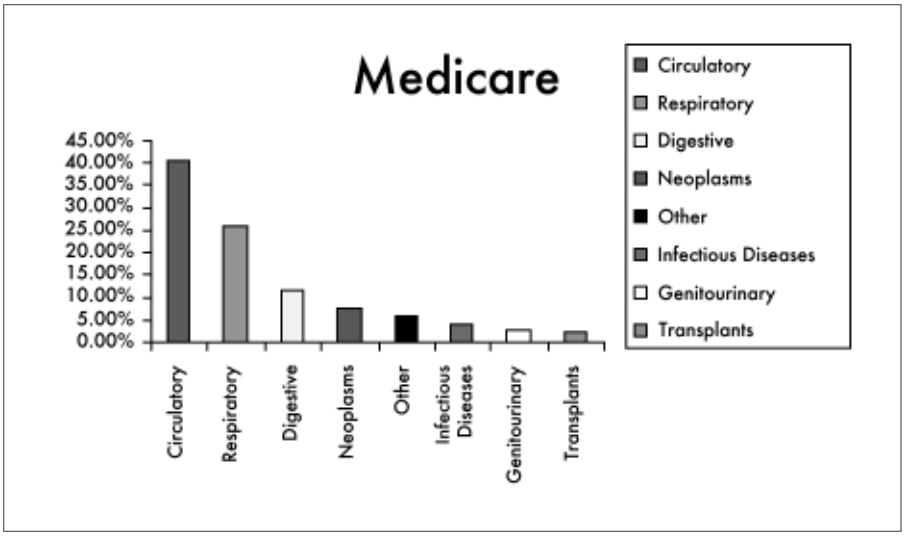
Demographic considerations

Child Health Insurance Program (CHIP) populations have proven to be one of the lowest risk segments of any of the government programs. These are basically healthy, non-infant members, often called "healthy kids," who typically range in ages from six months to 19 years, so there is no neonatal risk. CHIP programs are really political markers because they provide health-care coverage for a segment of the population that doesn't really need that much coverage.

These programs are generally not eligible for state reinsurance programs because they are not officially Medicaid members. On the other hand, the risk is very low on these members because of their demographics and health status. These programs exist in some form in most states and present a good reinsurance opportunity.

continued on page 18

Chart 3



Family Health Plus (FHP) is a set of programs that extends health-care to the parents of those qualifying for CHIP, who do not have enough income to qualify for Medicaid. This group usually presents a much better risk profile than Medicaid and are typically closer to a standard employer group risk. FHP also can also apply to the working poor without children. These individuals are typically employed in lower-paying jobs that do not offer health-care coverage. There may be some selection risk in this population because individuals are not enrolled as part of a group. Assuming they meet the requirements of this program, they would need to seek enrollment in a participating health plan. Generally, the risk for these programs is very similar to commercial employer group business.

Medicare

Demographic considerations

Typical claims include cancer treatments, heart conditions, complications from other bodily systems, or ESRD (End-Stage Renal Disease) patients qualifying so dialysis or kidney transplants are possible. There are no premature infants, few accidents and few transplants.

Reimbursement considerations

Hospitals are paid on a DRG basis with restrictive outliers (hard to reach with low payment, such as 80 percent of the estimated cost). Higher cost hospitals have lower cost-to-charge ratios and a much harder time reaching outliers. Multiple admissions in a year may contribute to larger reimbursements. Long-term acute care facilities used to receive attractive Medicare payments, but DRG reimbursement modifications have greatly modified the reimbursement for those facilities.

Medicare catastrophic claims are quite different by deductible and retention relative to a commercial or employer based population. At lower deductibles, Medicare claims are much more frequent than they are for a commercial population. At higher retentions, due to the lack of neonates and transplants, and the fact that many older patients are unable to survive extreme treatments, the frequency of catastrophic claims drops sharply.

When opportunity knocks...

The following summarizes the significant opportunities for reinsurance involving health-plan risk in government programs. Most opportunities involve reinsurance of managed-care plans, although Medicare also has Participating Provider Option (PPO) products underwritten through insurance companies. There are also specialized programs for prescription drugs and disease management.

Government program reinsurance presents an opportunity for reinsurers due to the increased privatization of Medicare and Medicaid programs. Although the larger direct writers are significant players in these government programs, the Medicare Modernization Act has created innovation and spurred newer and smaller players as well. Many health plans have identified Medicare as a growth

area for them. There are also many Medicaid health plans that are looking to preserve current dually eligible (Medicare and Medicaid eligible) members by expanding into Medicare. There are reinsurance needs associated with both of these groups as described above.

Medicaid opportunities for reinsurance are highly dependent on individual state actions. Many states have tight budgets and would like to find ways to reduce health-care expenditures. Some of those states believe health plans will help them achieve lower expenditures for these Medicaid populations. Most states promote health plans for the Medicaid populations.

However, reinsurance opportunities may not always coincide with each state's initiatives with health plans. States also institute and manage self-run reinsurance programs for the Medicaid population. States typically structure coverage in a simplified manner, but usually they are able to price with low margins resulting in rates that may be more aggressive than traditional reinsurance markets are able to match.

Sometimes, state reinsurance programs are mandatory and in other situations they are voluntary. If programs are voluntary, there is a significant chance that the program may not be designed to meet the needs of each plan. Even if the state program is aggressively priced, plans may choose to seek reinsurance elsewhere to obtain the coverage they desire. Extensions of Medicaid continue to grow. Members are enrolled in these programs on an individual basis similar to Medicaid, but these are not Medicaid programs. There are typically no state-sponsored reinsurance programs for these populations. However, the states may require that plans buy commercial reinsurance. When there is no state requirement for reinsurance, the main competition for these programs is self-insurance.

In summary, health plans have continued to experience significant growth in government program population and revenues. The risks vary due to demographics, the level (or form) of provider reimbursement and the characteristics of the state reinsurance program. Reinsurance opportunities continue to follow the growth in health plan programs, subject to the several limitations as described in this article. ✹

MEDICAID OPPORTUNITIES FOR REINSURANCE ARE HIGHLY DEPENDENT ON INDIVIDUAL STATE ACTIONS. MANY STATES HAVE TIGHT BUDGETS AND WOULD LIKE TO FIND WAYS TO REDUCE HEALTH-CARE EXPENDITURES.

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INTERVIEW WITH JOHN TILLER

by Richard Jennings

John Tiller with his wife Denise Fagerberg Tiller

John E. Tiller, Jr., a long-time veteran of the reinsurance business, is perhaps best known as the co-author, along with his wife Denise Fagerberg Tiller, of *Life, Health & Annuity Reinsurance*, the definitive book on the subject, now in its 3rd edition. Mr. Tiller, or John as he prefers, paused to reflect on his long career in reinsurance when *Reinsurance News* caught up with him at the recent SOA Annual Meeting held in Chicago.

John first entered the life insurance business as an agent during his senior year at Harvey Mudd College in Claremont, Calif. A friend of his was recruiting college students for Pacific Mutual Life to sell life insurance on campus. Since they paid significantly more than the $1/hour he was making working in the science library, he became a part-time life insurance agent. He continued with the life insurance sales business for 15 months after his graduation with a B.S. degree in mathematics, but eventually "saw the light" (that is, he made so much money as an agent that he had to become an actuary). He was hired into the actuarial program of Transamerica Occidental Life Insurance Company (then in Los Angeles) and his first assignment was in actuarial systems. This proved to be a fortuitous assignment, as he was able to see all parts of the company and its businesses in a short period.

After three years in actuarial systems, he moved into reinsurance where he rose to become vice president and actuary. As he put it, "I was fortunate that the reinsurance business at Transamerica grew as I grew and there were always new responsibilities as I was ready for them." During his reinsurance career with Transamerica, John was responsible for product development and pricing, valuation and financial reporting, underwriting, contracts, sales and marketing, and strategic planning. He was also involved in corporate efforts regarding tax planning and surplus allocation and management.

Under John's leadership, Transamerica's reinsurance team developed client specific pricing assumptions and achieved great accuracy in persistency and mortality projections. They were also able to leverage Transamerica's primary business' product expertise and innovation. Later experiences proved to John that other reinsurers were not as thorough in selecting and differentiating assumptions by customer. In 1983, it appeared that every reinsurer except Transamerica had to make major revisions in their assumptions and pricing. Mr. Tiller stressed his good luck in having some good mentors during this time, in particular singling out Fred Morrow and Irwin Vanderhoff as two individuals who were significant influences.

Mod-co reinsurance became very popular during the 1980s when ceding companies could affect significant tax benefits by reinsuring business and applying the terms of Section 820 of the 1959 Tax Act as it applied to life insurers. John remembers many trips to New York and elsewhere to put together some very large and exciting deals. "Our minimum goal was $1 million of pre-tax profits annually for each treaty; the after-tax gains were even higher."

At the same time, term insurance became much more popular, largely due to the tax benefits under Section 818 (c), which allowed companies to have a larger tax deduction for acquisition expenses than were actually incurred, with a resulting significant tax deferral. The effect fueled the "term wars" of the early 1980s. Mr. Tiller recalled, "One small company introduced term rates much lower than the market, supported by some tax enhanced reinsurance. Within a month, many others followed these rates down, with detrimental effects on the life industry. I do not think margins on term insurance have ever really recovered from that downward movement."

These two activities of utilizing Sections 820 and 818(c) eventually led to a very large reduction in federal income taxes collected from life insurers. That, in turn, led Congress and the IRS to modify the taxation of life insurers. The ACLI became a significant debating group for various life insurers to be heard and consensus to be built. Mr. Tiller chaired the Reinsurance Sub-Committee of the ACLI Task Force on Life Taxation. At one point, he made seven trips in eight weeks from L.A. to D.C. for that committee, largely to ensure that all parties were fairly and adequately heard and their views considered. He also met with congressional staff to explain reinsurance on behalf of the industry. The "ultimate" result of the negotiations between the industry, IRS and Congress was a total revision of life insurance taxation, including the elimination of Sections 818 and 820 as well as correcting the inadequacies of the 1959 Act and the creation of Section 845.

Following Transamerica, John joined Tillinghast where he became a principal and unit manager for life insurance consulting in Irvine, Calif. His consulting activities involved a broad range of assignments, many of which were related to accepting or ceding indemnity reinsurance or assumption transactions. "At one point or another in my career, I was a consultant to nearly every life reinsurer in the United States and some outside." During this period, John again benefited from several mentors, epecially Jack Turnquist and Jim Anderson. It was during this period that John and Denise produced the first edition of *Life, Health & Annuity Reinsurance*.

"AT ONE POINT OR ANOTHER IN MY CAREER, I WAS A CONSULTANT TO NEARLY EVERY LIFE REINSURER IN THE UNITED STATES AND SOME OUTSIDE."

In 1991, John became executive vice president and chief actuary for Resource Deployment, Inc., a subsidiary of what is now CitiGroup. In this role, John oversaw the actuarial functions of over 20 insurance companies, including American Health and Life Insurance Company, Transport Life Insurance Company, Voyager Life Insurance and Primerica Life Insurance Company.

In 1993, John became national director of the life insurance actuarial consulting practice of KPMG Peat Marwick LLP. While responsible for a wide range of actuarial and general consulting activities,

continued on page 22

Interview with John E. Tiller, Jr. from page 21

Mr. Tiller maintained a leadership role in reinsurance, frequently asked to review reinsurance activities on behalf of KPMG's clients and others.

LIFE AT A PRIVATE, FAMILY-CONTROLLED COMPANY IS GREAT. NO CORPORATE BUREAUCRACIES. I JUST MEET WITH THE CHAIRMAN AND GET THE RIGHT THINGS DONE.

John joined GE's Employers Reinsurance Company (ERC) in November 1998 as the business development leader for North American Life Reinsurance. In September 1999, he was named to lead the newly formed North American Life and Health Reinsurance Segment, and in January 2001 he became president and chief operating officer for ERC's two North American life reinsurance companies. One year later, he was named president and CEO of GE ERC's Global Life & Health Reinsurance, the first global business unit created within ERC. In this role, he oversaw a truly global and complicated business, with 26 offices around the world doing business in 82 countries and generating over $3 billion of premiums from about 30 different life and health products. He and his team also completed the acquisition of the life reinsurance businesses of Phoenix Home and American United Life.

In late 2003, GE made the decision to exit its insurance businesses and the U.S. life reinsurance business was placed in runoff. At that time, John left for "his next voyage in life." He quickly teamed up with Stonepoint Capital to form Wilton Reinsurance. However, in 2005, John decided that Wilton was not the right place for him at that time. He now serves as president of Unified Life Insurance Company, a privately held life insurer specializing in the acquisition of blocks of life and health insurance and insurers. This winter, Unified has completed the acquisitions of three life and health insurance companies and is close to finalizing a fourth one. "Life at a private, family-controlled company is great. No corporate bureaucracies, I just meet with the chairman and get the right things done. Bill Buchanan, the chairman, asked me how I liked life in a small company. My response is that the work and thought processes are the same, just not necessarily with as many trailing zeros." John also owns a boutique consulting firm, Butterfly Financial Services, where he undertakes selected interesting assignments, often involving some unique application of reinsurance, capital or mortality.

While John has been the more public member of the team, he and his wife, Denise, have worked closely over the years, most significantly in the creation of their book. Denise, also an FSA, was first approached by Dick London of ACTEX Publications regarding the development of a significant book on life reinsurance. Denise began her career with CNA and Maccabees Mutual Life Insurance Company, before joining Transamerica Occidental Life as the Senior Reinsurance Pricing Actuary and then later moving on to Tillinghast until 1987. Since then, she has spent most of her time caring for their five daughters and John, as well as for two new grandsons. However, in her spare time, she decided to write fiction for fun, and had published a mystery novel, *Calculated Risk,* about a young, blonde, single female actuary, set in Southern California. She is currently working on her second mystery novel.

The history of *Life, Health & Annuity Reinsurance* is somewhat illustrative of how difficult it can be to document "what everyone knows." Denise, John and Dick decided that the approach of using several different individuals to write different chapters was not appropriate as it is almost impossible to have a consistent style and not be contradictory. In their first draft, John and Denise produced 12 chapters which were then submitted to about 50 "experts" for comments. There were almost no comments on content or accuracy, but "about five million" comments on style and organization. Jack Turnquist was enlisted as a senior advisor and editor. He spent three days with Denise and John developing the table of contents, now with some 22 chapters. About two years later, the book was finally published. A key aim was to make the information accessible to a wide range of readers, and the authors are most pleased about the number of comments they have received from readers, both actuaries and non-actuaries, about the readability of the book.

John has been an active in many areas other than reinsurance. In addition to being a founding member of the Reinsurance Section, he also served a second term on the Reinsurance Council, on the Futurism Section Council, and on the Nontraditional Marketing Section Council, including terms as vice-chairperson and chairperson, as well as chairperson of both the Program and Continuing Education Committees of the Society. He has also served on numerous Society task forces and committees, including the committees for Services to Members, Research Policy and Professional Development, and the Society's first task force on AIDS, and was a faculty member for the Society's seminars on reinsurance in 1981 and 1988. He chaired the ACLI's special task force on taxation of reinsurance transactions in the early 1980s, and served on an Academy task force on risk classification. He has been a frequent speaker at numerous industry meetings worldwide.

Away from the reinsurance world, John spends his spare time surrounded by his wife and family. When he gets the chance, he might get a free moment to get out on his sailboat. As John looks back over his career in reinsurance, he remembers a lot of wonderful friends and friendly competitors. "I still love this business. The people are fun, and you can know enough to be comfortable, but rarely enough to be bored." ✹

Editor's Note: Special thanks to John and Denise for their help with this article.

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