

Reinsurance news

Issue 78 | MARCH 2014

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Non-Traditional Product Options For Reinsurance Protection

By Mark Troutman

If conventional reinsurance is viewed as a “vanilla” product offering, what other flavors are available? The following article describes several product permutations offered to reinsurance reinsureds interested in restructuring the risk/reward trade-off of conventional reinsurance coverage. No one product is superior to the others. Each has its advantages and disadvantages. Once a coverage is chosen, the actual claims experience will determine the proportion of losses shared by the reinsured and reinsurer.

Experience refund – this is the most common (and simplest) approach for sharing profits between the reinsurer and the reinsured health plan. If the claim experience is favorable, the reinsured shares in a portion of the favorable experience through a partial refund of premium.

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Council of the Society of Actuaries

This newsletter is free to section members.
Current issues are available on the SOA website (www.soa.org).

To join the section, SOA members and non-members can locate a membership form on the Reinsurance Section Web page at <http://www.soa.org/reinsurance>.

Reinsurance news

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Call for Articles for next issue of Reinsurance News.

While all articles are welcome, we would especially like to receive articles on topics that would be of particular interest to Reinsurance Section members.

Please e-mail your articles to Richard Jennings (richard.jennings@sunlife.com) or David Xia (dxia@mit.edu).

Some articles may be edited or reduced in length for publication purposes.

Issue 78 | March 2014



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Sam Phillips, Staff Newsletter Editor
e: sphillips@soa.org

Ronora Stryker, Staff Research Actuary
e: rstryker@soa.org

Chairperson's Corner

By Audrey Chervansky

Thanks to all of you who completed the survey that we sent to all members last May. In the survey, each respondent was asked to choose up to five activities that they wanted the Section to support. Based on the results shown below, the consensus seems to be that educational opportunities are the top priority for our members. Of course, this is based on only 190 responses (out of 2,091 members)—so perhaps those of you with more altruistic tendencies were too busy helping others to respond!



Audrey Chervansky is vice president and marketing actuary with Swiss Re in Armonk, NY. Audrey can be contacted at audrey_chervansky@swissre.com.

Answer	Response	%
Sponsor general seminars on various topics of interest to our membership (i.e., legislative updates, risk transfer, capital solutions).	134	71%
Advanced Reinsurance Topics seminar (similar to boot camp format).	123	65%
Sponsor reinsurance forums for various functions (i.e., administration, valuation, contracts) to share best practices/ideas/concerns.	113	59%
Consolidated listing of reinsurance resources (i.e., literature request) for use by members and non-members.	93	49%
More/major research.	77	41%
Sponsor quality outside speakers at industry conferences.	74	39%
More promotion of LEARN (Life Insurance Education and Reinsurance Navigation)—make available as podcast, online course.	63	33%
Sponsor social/networking events at industry conferences.	38	20%
Sponsor meeting attendance (i.e., ReFocus, ARC, AHOU) both to provide educational support and sharing within the section.	30	16%
Academic scholarships.	9	5%
Matching Actuarial Foundation/Actuarial Foundation of Canada donations from section members.	2	1%
Charitable contributions.	2	1%

Our plan is now to take this information and formulate our short- and long-term plans. On January 29th, the Section Council met face-to-face for an

CONTINUED ON **PAGE 4**

intensive planning session. Although we do meet monthly, we find that there is never enough time during our regular phone calls to think long term.

Some of the questions that we addressed are:

- How should we coordinate our activities with those of both the SOA and the American Academy of Actuaries' Reinsurance Section?
- How do we want to "brand" our Section? What are our goals and how do we want to achieve them?
- When should we offer the seminars and boot camps? Is it necessary to tack on to an SOA meeting or would we be able to draw enough attendees as a stand-alone event?
- How can we make the most of our networking events? Are they even needed? For the last few years, we have been promoting an event at both the L&A Symposium and the Annual Meeting.
- What is the best way to get more members involved?
- Why isn't research a higher priority for our membership? Is our budget too low to support truly important studies?
- There seems to be a good amount of interest in holding forums supporting the non-actuarial reinsurance functions as well. Have we been overlooking this segment of our membership/potential members?

Unfortunately, we will have to share the results of our planning session in the next newsletter—given the publishing deadlines. However, please feel free to share your own ideas with me or any of the council members at any time. We are always interested in your input! ■

Experience refunds are offered to reinsureds for competitive reasons and for increased retention (often, reinsureds do not receive the experience refund unless they renew their reinsurance treaty). Key components of a refund formula are the expenses deducted and the trigger when profit sharing begins, minimum premium requirements (small accounts don't usually receive refunds), the percent refund shared and whether or not a deficit from a prior period is being carried forward. The cost of refunds was calculated at 4 percent over the Summit Re portfolio. The benefits may include a higher renewal rate (i.e., more reinsureds retained rather than terminated).

An experience refund has the advantage of the reinsured sharing the favorable experience, but not assuming additional risk for unfavorable experience. That is why the reinsurer imposes a minimum loss ratio requirement before sharing profits and only pays back a portion of the profits. If the reinsurer returned all profits, yet absorbed all losses, it would be a losing proposition or it must add a much higher risk and profit charge. If the experience is unfavorable, the reinsurer is still at risk for all claims above the target premium rate, unlike in several of the following product features.

Aggregating excess – this is also known as an aggregating specific deductible, or ASD. The reinsured assumes a given aggregate dollar amount for all individual claims before reinsurance covers subsequent individual claims.

For example, if the health plan has a \$400,000 specific stop loss deductible, an additional aggregating excess corridor of \$1 million may be imposed. This \$1 million threshold must be exceeded for any or all individual claims in excess of the \$400,000 specific deductible before any individual specific claim has coverage reimbursed by reinsurance.

It has the advantage of lowering the reinsured's premium given the additional liability the reinsured assumes and, in addition, the premium is reduced for the expected claims because the reinsurer charges less risk and profit margin for this portion of the program



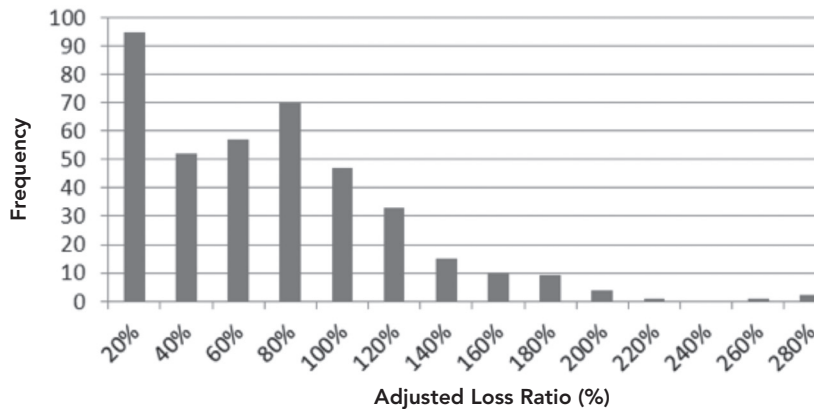
given that the reinsured assumes this risk. The aggregating excess corridor is negotiated between the reinsured and the reinsurer. The higher the corridor, the larger the premium reduction. If only a modest corridor is imposed, total reinsurer risk and profit charges would not be materially affected since it would be highly likely that the aggregate claim corridor would be exceeded. Although 50 percent and 75 percent ASD are more common, a 100 percent ASD option is possible but would command a higher risk premium by the reinsurer given that it still absorbs all losses, but returns all gains to the reinsured.

The aggregating specific deductible concept where a reinsured still has protection for losses above 100 percent of expected claims but receives a refund for claims under 100 percent of expected was modeled. To balance this out, the reinsurer charges a premium to all groups. In this historical pricing analysis, it was 19 percent of premium. Stated another way, the reinsurer would have to raise fixed costs 19 percent to compensate for the fact that it would be giving away favorable experience and still be liable to cover all unfavorable experience.

Enclosed is a summarized distribution of historical loss ratios (claims/premium) for 10 years of Summit Re experience (See chart on page 6). It allows one to see the relative range of experience results over a large portfolio.

CONTINUED ON **PAGE 6**

P & L 1999-2011



Using the historical data, a distribution of losses was created from the entire portfolio over 10 years of experience. If business is underpriced, there is an obvious skew to the right. If profitable, the distribution is skewed to the left. The cases with gains must make up for the cases with losses. There is a fair distribution of profits and losses depicted in this historical distribution. This distribution was used to model each product permutation.

Layered aggregating specific – this is a more complicated permutation of the previous concept wherein any given claim may have portions applied to both the aggregating specific dollar corridor as well as paid in excess of the individual specific deductible. This has the advantage of having a reinsured potentially receive partial reimbursement for a large claim even before the aggregate dollar corridor is exceeded. A very large claim would have portions reimbursed immediately regardless of whether there were amounts remaining in the aggregating specific claim fund.

Aggregating specific approaches are common in situations where the reinsured is interested in assuming more risk, but prefers a lower specific deductible. The logical alternative would otherwise be to simply increase the specific individual deductible.

Swing rate – this product feature offers the reinsured a target premium rate which can then be adjusted up or down (typically ± 25 percent) depending upon the actual claim experience for the health plan for the given year. For example, if experience is good, the final rate is adjusted downward 25 percent. If claim experience is poor, the health plan assumes up to an additional 25 percent increase in premium. A plan typically pays a provisional (interim) amount equal to 90 percent of the traditional premium rate.

A swing rate is used where the reinsured’s perception of new or emerging catastrophic claim experience is significantly below the reinsurer’s evaluation of the experience. In essence, they are willing to bet on favorable experience.

A swing rate would also be used on newer blocks of business with little experience, which would also imply smaller size. In this instance, one sets the swing rate to give the plan the opportunity for an “experience refund” in exchange for upside protection to the reinsurer.

The swing rate will retrospectively range between the minimum and maximum rates as calculated by actual paid claims divided by the target loss ratio. The time-frame for the calculation would be as if an experience refund calculation were taking place.

It is an arrangement that allows the two parties to modify the conventional risk arrangement so that the plan still has coverage in excess of a certain additional premium corridor as well as for very favorable experience. However, these adjustments are done retrospectively, so it’s difficult to see where one stands at any point.

The loss distribution data was used to model what the gains and losses would be if the entire portfolio was based on swing rates. The minimum corridor was 75 percent of the expected claims and the maximum corridor was 125 percent of the expected claims. In swing rate coverage, the reinsured takes the risk or gets the reward for the middle 50 percent of claims. The reinsurer wins when the actual claims are below 75 percent

of the expected claims and losses when the actual claims are more than 125 percent above the expected claims.

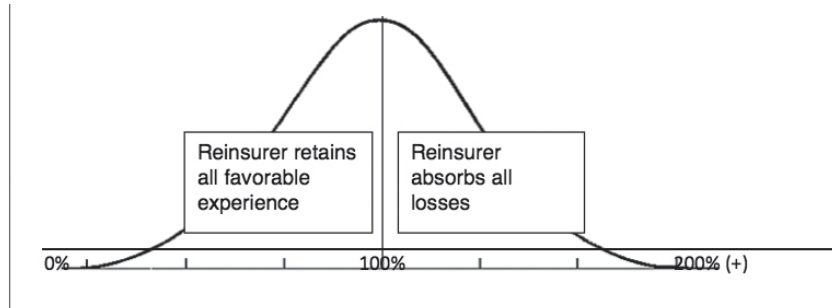
If the entire loss distribution portfolio was based on swing rates, losses and gains would be cut in half. The total profitability of the reinsurer was reduced slightly in this case. This product reduces profits when loss ratios are good, but protects the reinsurer when loss ratios are bad.

Split funding – this is essentially a premium financing option whereby the reinsured only pays a small portion of the premium initially to cover expenses and then pays additional amounts as claims are paid. Given the short-tail nature of the medical business and low current interest rate levels, this arrangement doesn't produce any material impact on the reinsured. It also does not affect the risk versus reward profile between the parties with respect to the claim liabilities assumed.

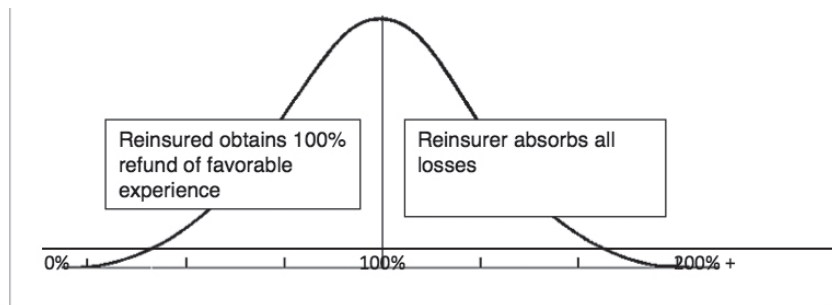
Lasers – lasers are a premium reduction option in that they exclude from reinsurance coverage a given individual (a known claimant) or imposes a higher deductible on the individual with potential chronic large claims. The advantage to the reinsured is that the reinsurer doesn't have to add expense and profit margin on a known claim. The disadvantage is that the reinsured self-insures an additional liability for a known claimant.

The charts to the right describe which entity, reinsurer or reinsured, is responsible for the gains or losses in three main product options (conventional, 100 percent ASD, swing rate).

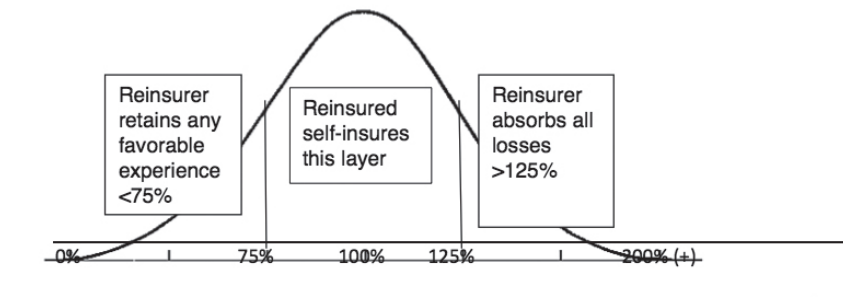
A. Conventional (no experience refund)



B. 100% ASD



C. Swing Rate



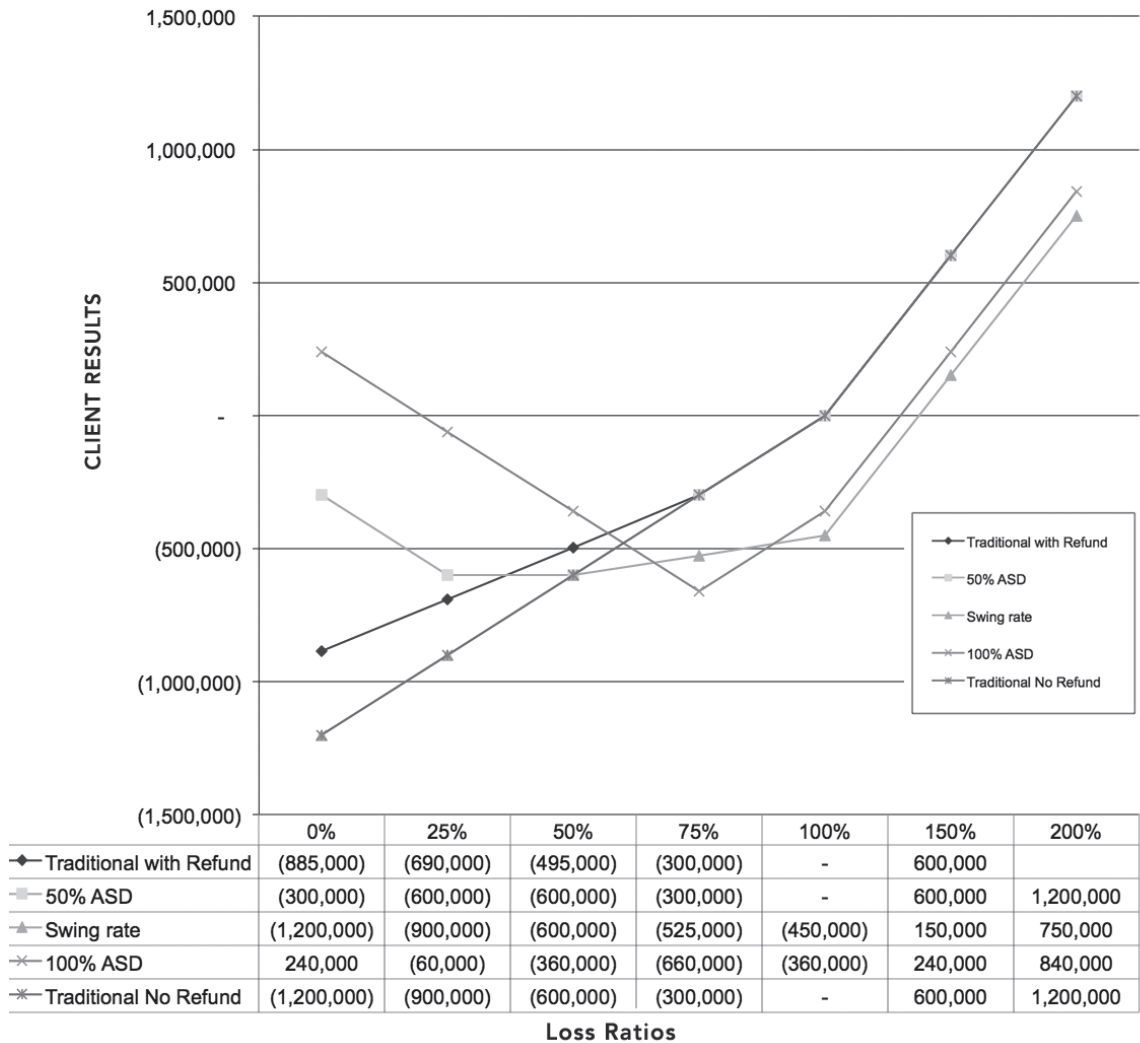
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The following describes the net financial results to the reinsured under a variety of loss ratio scenarios for a variety of products discussed in this article. It demonstrates that no one product is superior to the others given a variety of potential claim outcomes.

A negative number indicates the reinsured has paid more in premium and retained more in claims than it has received in claim reimbursements from the reinsurer.

A positive number indicates the reinsured has received more in claims from the reinsurer than it has paid through premiums and been liable for claims it has retained.

Although taking risk is always a gamble, it is a safer bet that one of these options will meet the risk tolerance profile of both the reinsurer and reinsured. ■



Non-Traditional Product Summary

Coverage feature	Description	Advantage	Disadvantage	Comments
Experience refund.	Reinsurer refunds some premium for favorable loss ratio results.	Reinsured receives partial premium refund for favorable experience.	Reinsured may have to renew treaty to receive refund. Reinsured may need to meet a minimum premium threshold (e.g., \$1 million)	Various target loss ratios and refund percent are offered based on size and risk profile.
Traditional aggregating excess/aggregating specific deductible.	Reinsured assumes an aggregate risk amount for all specific claims eligible for reinsurance.	Reduced premium.	Increased risk corridor in working layer, and potential gap in coverage early in the year.	This is a complex product with volatile results. The fixed cost is higher due to the risks.
Layered aggregating specific deductible.	Reinsured assumes an additional aggregate risk amount for all or a portion of certain specific claims eligible for reinsurance.	Reduced premium and some specific claims can be reimbursed even before the aggregating specific total is met.	Increased risk corridor in working layer.	This is a slightly more complicated version of traditional aggregating specific coverage.
Swing rate premium.	Reinsured and reinsurer agree to a target rate plus a corridor (e.g., ± 25 percent swing corridor).	Potential for reduced retrospective premium rate for favorable experience.	Potential for increased retrospective premium rate for unfavorable experience.	You don't always know where you stand at any point in time.
Split funding premium.	Premium financing mechanism. Pay expenses up front and claims costs as they come in, up to some limit.	Small increase in cash flow.	None.	There is no real change in reinsurance liabilities.
Laser claimant(s).	Reinsurer imposes a higher deductible or excludes from coverage certain known chronic claimants.	Reduced reinsurer expense and profit margins.	Reinsured self-funds lasered risk.	The alternative is higher premium.



Mark Troutman, FSA, MAAA, is president of Summit Reinsurance Services, Inc. He can be contacted at mtroutman@summit-re.com.

Interview with Michael DeKoning, CEO of Munich American Reassurance Company

By Reinsurance News



Michael DeKoning, FSA, MAAA, FCIA, is president and CEO of Munich American Reinsurance Company in Atlanta, Georgia. Michael can be reached at mdekoning@munichre.com.

Mr. DeKoning, thank you for taking time to speak with us. Could you begin by telling us some of your personal history and about your role at Munich American Reassurance Company (“Munich Re”)?

I joined Munich Re in 2008, after 20 years at a large international Insurance Company based in their head office in Canada. I was born and raised in Toronto of immigrant parents in a middle-class neighborhood in North Toronto. My father was in the insurance business for most of his career in sales and sales management so when I was thinking about what to study in University, he suggested Actuarial Science. Like most people, I didn’t know what it was, but being good at math, the more I looked into it, the more interested I became. For most of my career, I have been interested in running a business and using my technical and risk management skills to grow a business. I was given this opportunity, in increasingly larger businesses, prior to joining Munich Re, but these were always as part of divisions within a head office environment. The real opportunity to run a business came when I joined Munich Re as the president & CEO of its Life Reinsurance business in the United States. Our company has a very broad and diverse market position, with leading positions in Individual Life and Individual Disability as well as the Group business (both Life and LTD). I am thoroughly enjoying the opportunity to lead a great group of people from various backgrounds (actuarial, underwriting, claims, IT, operations, etc.) in growing our business. As the CEO of a subsidiary with a parent company based somewhere else, I also have learned a very different perspective and appreciation of the “home office” versus “foreign office” dynamic that I had during the first 20 years of my career.

What led you to the reinsurance industry and to your current position at Munich Re?

As an actuarial student, I had the opportunity to rotate through various pricing, valuation and reporting roles in various businesses, from a direct marketing insurance business, to an Individual Life business, a Group Annuity business as well as a retrocession business. In the latter business, what I really liked was that it was

a B-to-B business, with a lot of client interaction who were all insurance company professionals. I also got to see how all of the aspects of the business interact with each other (underwriting, pricing, admin, claims, financial reporting)—this was much harder to see in bigger, more segmented businesses. I also loved the challenge and reward of getting to understand the challenges faced by clients and working with them and for them to develop solutions to those problems, while bringing in business (and income) to your company. Having spent most of the last 20 years in various aspects of the Reinsurance market, needless to say, I am hooked!

Were there any special mentors in your past who played an important role in your career growth?

It is very hard to single out one or two. I have always tried to learn from people I admire and emulate the traits that I thought fit well with what I wanted to do, in the way that I wanted to do it. One of the people I really respected relatively early in my career had a very healthy work/family balance. It’s not that he didn’t work long hours, it’s just that he made sure he was home at a reasonable time to have dinner with his family, participate in his kids’ activities, etc. This was something that I admired, and tried to incorporate into my life (it has become harder and harder as my jobs have changed!). I have also worked for a couple of people who had great people leadership skills, engendering loyalty and high performance because people wanted to “walk through fire” for them because their people respected them so much both as a person and a leader. I have also learned a lot from a few people on how to craft messages and communicate effectively to various audiences (from staff, to executive management, board members, clients, etc). So my style has been to try to find a specific skill or trait that I admire in a person, and try to incorporate that as opposed to having one or two specific people who acted as mentors.

In recent years, there has been several notable mergers and acquisitions within the U.S. life reinsurance industry. What impact do these consolidations have for your company?

There has certainly been a contraction in the life reinsurance market with the spate of mergers and acquisitions over the past five years, which has changed the landscape of the life reinsurance market in the United States. For Munich Re, our focus remains on building and maintaining relationships with our client companies in the individual and group life and disability markets. Yet, with a more concentrated competitive market, we have to ensure that we are offering the products and services to our clients that will help them grow and develop. We treat our relationships as partnerships and take a vested interest in their success. With less choice, it's even more important to be in tune with our customers to make sure they are getting what they need from us.

Munich Re has predominantly grown organically. How does M&A fit in your corporate strategy? Do you foresee your company participating in future acquisitions?

We have always kept an open mind on potential mergers or acquisitions, but not at the cost of our operating model or client companies and it has to be at the right price. We also believe that any acquisition needs to be done for the right reason. We believe access to markets you don't have access to, access to specific skills or tools that you do not have or scale are the main reasons why we would undertake an acquisition—but it always must be attractive from an economic point of view. Finally, any merger or acquisition would need to allow us to manage our business and client relationships in the same fashion that has made us successful. Our corporate strategy continues to focus on growing our existing base of clients through a strengthened partnership and developing customized solutions to meet their needs.

Despite a shrinking U.S. life reinsurance market, Munich Re has experienced positive growth in market share. What strategic choices have you made to produce and sustain these results?

Market share growth has not been our focus, our focus

has been on individual client relationships and writing profitable business. We have been increasingly successful over the last few years by listening to what our clients want and need out of their reinsurer relationship, developing products and services that meets those needs, and then delivering. All of this has to be done in a manner that is beneficial for both parties and preserves our overall financial strength—a good reinsurer partner must be there for the long haul.

Can you foresee when the U.S. life reinsurance market will begin to grow again? What can the industry do to reverse the decade-long decline?

This is a difficult challenge for the entire market. Historically, growth has occurred when the market delivers products and services that the direct market cannot or chooses not to deliver. If the industry is going to reverse the trend of market decline, we must provide products and services that can deliver growth to our clients, or create value through enhanced capital management. One area that we believe reinsurers can help direct writers grow their business is in the middle market. With reinsurer support, direct writers may be able to grow their business in this market, and, in turn, this will result in growth in the reinsurance market.

Munich Re is known for being a leader in individual disability income reinsurance. Could you explain how this product line works? How important is this product line in your overall growth strategy?

Disability income insurance is meant to provide income protection for an individual in the event that an accident or injury causes them to be unable to earn an income. Many individuals who have this coverage get it through group coverage with their employer. However, Individual Disability Income (IDI) is offered to individuals who cannot meet their income replacement needs through employer-provided group coverage or are self employed or small businesses.

While our disability business is not our largest line of business, the market potential and business perfor-

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““WHILE OUR DISABILITY BUSINESS IS NOT OUR LARGEST LINE OF BUSINESS, THE MARKET POTENTIAL AND BUSINESS PERFORMANCE MAKE IT AN INTEGRAL PART OF OUR OVERALL STRATEGY.””

mance make it an integral part of our overall strategy. However, a more important part of the strategy is making sure that we have the proper controls in place to manage the risks associated with this business to avoid the same issues that caused significant losses in the IDI market 20 years ago. Here, we work with our clients to ensure underwriting, pricing and claims discipline to ensure that business continues to perform well.

What is Munich Re’s view on financial solutions or “Fin Re”?

For Munich Re, Fin Re must satisfy two key objectives. First, any Fin Re product that we offer must deliver value creation to our clients. This can be through enhanced capital management or reduced risk. Second, it must meet our own internal view of a risk and reward trade-off. When we find opportunities that meet these two objectives, we are very supportive of Fin Re. Munich Re has a very successful track record globally in what is called “financially motivated” reinsurance. This takes many shapes and forms, but all of them have a strong client capital management motivation behind them.

Munich Re is experiencing success with its partnership with the Allfinanz automated underwriting system developed by Munich Re Automation Solutions. How would you differentiate the Allfinanz solution from similar systems offered by your competitors?

We believe our business model is unique in that Munich Re Automation Solutions, while owned by Munich Re, continues to be run as a standalone IT company. This allows us to bring the best of both worlds to our clients. We not only offer top-notch technology through the Allfinanz suite of products, but MARC also applies intimate reinsurance expertise in order to support our clients from both a process and a risk management perspective. Having a software company and a reinsurance company under the strength of the Munich Re umbrella brings a total solution to our clients. ■



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SOCIETY OF ACTUARIES

Determining “Premiums Paid” For Purposes Of Applying The Premium Excise Tax To Funds Withheld Reinsurance

Brion D. Graber This article first appeared in the February 2013 issue of *Taxing Times*. It is reprinted with permission.



Brion D. Graber is a partner with the Washington, D.C. law firm of Scribner, Hall & Thompson, LLP and may be reached at bgrab@scribnerhall.com.

Since 1917, the federal tax law has included an insurance excise tax.¹ Over the last century, various modifications and refinements have occurred, but the excise tax remains. In its current form, I.R.C. § 4371 imposes an excise tax on policies issued by foreign insurers or reinsurers covering U.S. risks.² The rate of tax is 4 percent of each dollar of premium paid for property and casualty insurance and 1 percent of each dollar of premium paid for life, sickness, or accident insurance or for reinsurance. The beneficiary of the policy and any person who issues or sells the policy are jointly and severally liable for the tax, although the Internal Revenue Service (IRS) generally looks to the person making the premium payments for the tax. Certain U.S. income tax treaties waive the excise tax if conditions specified in the treaty are satisfied.

The basic structure of the premium excise tax is simple, but its application to actual transactions can raise difficult questions. One particular area that raises issues is funds withheld reinsurance, a type of indemnity reinsurance. In a funds withheld reinsurance arrangement, the ceding company typically retains the initial premium due the reinsurer, usually in an amount equal to the statutory reserves attributable to the business identified in the reinsurance agreement. The ceding company withholds the funds to permit statutory reserve credit for non-admitted reinsurance, to reduce the ceding company's potential credit risk, or to retain control over investments. The ceding company and reinsurer establish accounting records that allow the parties to track increases and decreases in the net balance of the funds withheld. The ceding company uses the funds withheld to satisfy obligations of the reinsurer, such as expense reimbursement and the payment of claims. The net balance of the funds withheld increases or decreases over time as the reserves increase or decrease, surplus is repaid, and profit emerges. An investment adjustment is made each period to reflect the fact that the ceding company is holding the reinsurer's assets.

Except for the reinsurer's risk charge (the portion of the reinsurance premium that the reinsurer retains for pro-

viding the reinsurance), cash is not typically transferred between the ceding company and the reinsurer until the net balance of the funds withheld equals zero. The reinsurance is typically terminated once the net balance reaches zero because there is little need for continuing reinsurance coverage. If termination occurs prior to that time, the assets held by the ceding company on behalf of the reinsurer are “returned” to the ceding company.

In an audit technique guide released on the IRS website in October 2008, the IRS expressed its view on the application of the premium excise tax to funds withheld reinsurance. The IRS asserted that:

In determining when premiums are paid, and thus subject to the tax, the accrual method of accounting, not the cash-basis method of accounting applies. Revenue Ruling 77-453, 1977-2 C.B. 237, and G.C.M. 37,201 (July 26, 1977) support an interpretation of the term “amounts paid for reinsurance” under IRC § 832(b)(4) as including amounts accrued as well as amounts actually paid. Ceded premiums are considered paid to the reinsurer when all events have occurred that fix the reinsurer's right to the premiums and the amount of such premiums is reasonably ascertainable.³

The IRS did not provide a further explanation of this position. It did state that some taxpayers have taken the position that the premium excise tax applies only to actual transfers made by the ceding company to the reinsurer, which it called “an incorrect position.”⁴ It also stated that some taxpayers have taken the position that the excise tax applies only to the net amount of the ceded premiums.

No authority directly addresses this question, so taxpayers and the IRS are left with the plain language of the statute and Treasury regulations, as well as authorities addressing other tax provisions they believe provide relevant analogies, to determine the proper application of the premium excise tax to funds withheld reinsurance. Several of these authorities are discussed below, including those briefly mentioned in the audit technique guide.



As that discussion demonstrates, the IRS position expressed in the audit technique guide is questionable. The underlying flaw in the IRS position is that it seeks to apply an income tax accounting concept (the accrual method of accounting) to an excise tax.⁵ Excise taxes are generally imposed on a transaction, which contemplates a specific event. The issue with the premium excise tax, therefore, is identifying when the tax attaches and measuring the tax at that time. In contrast, an income tax is concerned with determining a net taxable amount that takes into account many events occurring during a taxable year. While the accrual method of accounting has great relevance in that context, it has little utility in the excise tax context.

THE TAXPAYER POSITION

In examining this question, one begins with the statute and the relevant Treasury regulations. I.R.C. § 4371(3) states that a 1 percent excise tax is imposed “on each dollar, or fractional part thereof, of the premium paid on the policy of reinsurance.” Treas. Reg. § 46.4371-3(b) provides that “the term ‘premium payment’ means the consideration paid for assuming and carrying the risk or obligation, and includes any additional assessment or charge paid under the contract, whether payable in one sum or installments.” Consistently, Treas. Reg. § 46.4374-1(b) provides that liability for the tax “shall attach at the time the premium payment is transferred to the foreign insurer or reinsurer (including transfers to any bank, trust fund, or similar recipient, designated by the foreign insurer or reinsurer), or to any nonresident agent, solicitor, or broker.” Recognizing the nature of an excise tax, each of these provisions requires that an actual premium payment occur before the excise tax may apply, and then it applies only to that specific payment.

LEGISLATIVE HISTORY

Prior to 1965, I.R.C. § 4371 measured the excise tax according to the “premium charged” and I.R.C. § 4374 required that the tax be paid by stamp. In the Excise Tax Reduction Act of 1965 (the “1965 Act”), Congress amended those provisions to permit the payment of the excise tax by return.⁶ In addition, the 1965 Act required the tax to be based on the “premium paid” rather than the “premium charged” if the tax was paid by return. In the Tax Reform Act of 1969 (the “1969 Act”), Congress again amended I.R.C. § 4371 to reflect the implementation of a return system. The 1969 Act required the tax to be measured by the “premium paid” in lieu of the “premium charged” in all cases.⁷ These changes reflect a congressional intent to measure the premium by the actual payment rather than the gross premium “charged.”

OTHER PROVISIONS WHERE PAYMENT MEANS ACTUAL PAYMENT

The rule that “when a statute says paid it means actual payment,” is found in numerous instances throughout the Code in addition to the regulations under the premium excise tax. Examples exist under the income tax provisions, the withholding tax provisions, the information return provisions, and even the other excise tax provisions.

For example, I.R.C. § 461(h)(2)(C) of the income tax provisions provides that in certain circumstances economic performance does not occur until “a payment to another person.” Treas. Reg. § 1.461-4(g)(1)(ii)(A) defines payment as having “the same meaning as is used when determining whether a taxpayer using the cash receipts and disbursements method of accounting has made a payment.” It gives as examples of a payment the furnishing

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“A TRANSFER OF CASH FROM A CEDING COMPANY TO A REINSURER IS PERHAPS THE MOST OBVIOUS EXAMPLE OF A PAYMENT.”

of cash or cash equivalents and the netting of offsetting accounts. It also states that payment does not include the furnishing of a note, a promise to provide services or property in the future (whether or not evidenced by a contract or other written agreement), or an amount transferred as a loan, refundable deposit, or contingent payment. Other income tax provisions provide similar examples.⁸

The withholding tax provisions also make clear that payment as used in the Code does not contemplate an accrual concept. For example, I.R.C. § 3406(a) imposes backup withholding on certain reportable “payments.” Treas. Reg. § 31.3406(a)-4(a)(1) provides that if backup withholding is required:

The payor must withhold at the time it makes the payment to the payee or to the payee’s account that is subject to withholding. Amounts are considered paid when they are credited to the account of, or made available to, the payee. Amounts are not considered paid solely because they are posted (e.g., an informational notation on the payee’s passbook) if they are not actually credited to the payee’s account or made available to the payee.

Similarly, I.R.C. § 3402 imposes income tax withholding on employers making “payment” of wages.⁹

I.R.C. § 6041(a), an information return provision, requires reporting on a “payment” made of certain income items. For this purpose:

an amount is deemed to have been paid when it is credited or set apart to a person without any substantial limitation or restriction as to the time or manner of payment or condition upon which payment is to be made, and is made available to him so that it may be drawn at any time, and its receipt brought within his own control and disposition.¹⁰

Treas. Regs. §§ 1.6049-1(b) and 1.6044-2(c) contain substantially similar language with respect to interest and dividends, respectfully.

Notwithstanding the structure and language of I.R.C. § 4371, other types of excise taxes are not generally imposed on “payments” or amounts “paid.” Nevertheless, there are exceptions. I.R.C. §§ 4261 and 4271 impose excise taxes on certain amounts “paid” for air transportation. These taxes accrue at the time of actual payment, irrespective of when the transportation is provided.¹¹

THE SUPREME COURT

Consistent with the interpretations of payment or paid in each of the above examples is the holding of the Supreme Court in *Don E. Williams Co. v. Commissioner*.¹² In that case, the court rejected the argument that when the code requires an amount to be “paid,” it incorporates the taxpayer’s method of accounting. The court explained that when Congress intends to adopt an accrual standard it uses the phrase “paid or accrued” or “paid or incurred.” In contrast, when Congress merely uses the term “paid,” it intends a cash basis standard, regardless of the taxpayer’s general accounting method. The court’s view is long-standing,¹³ and has repeatedly been relied on by the courts and the IRS.¹⁴ Nevertheless, the audit technique guide makes precisely the same argument rejected by the court—namely, that the term “paid” in I.R.C. § 4371 incorporates the taxpayer’s accrual method of accounting.

I.R.C. § 848 REGULATIONS

While the regulations under I.R.C. § 4371 do not specifically address funds withheld reinsurance, the I.R.C. § 848 regulations provide some guidance. I.R.C. § 848 requires insurance companies to capitalize and amortize specified policy acquisition expenses. The amount of such expenses is determined by application of a percentage to the excess of (1) the gross amount of premiums and other consideration over (2) return premiums and premiums and other consideration incurred for reinsurance. The regulations make plain that, in the case of funds withheld reinsurance, the premiums subject to I.R.C. § 848 are considered to be the *net* amount transferred to the reinsurer.¹⁵ This net amount is not grossed up for expenses that are netted against the amounts due the reinsurer.

WHAT CONSTITUTES A PAYMENT?

The above authorities consistently show that the premium excise tax applies only to “payments,” thus requiring

an understanding of what is a payment. A transfer of cash from a ceding company to a reinsurer is perhaps the most obvious example of a payment. The delivery of a check similarly constitutes a payment, assuming it is honored in due course.¹⁶ A distinction is made, however, between a check and a note, even when the note may be a cash equivalent. “[A] promissory note, even when payable on demand and fully secured, is still, as its name implies, only a promise to pay, and does not represent the paying out or reduction of assets.”¹⁷ Thus, in *Don E. Williams*, the court rejected the argument that the taxpayer’s issuance and delivery of an interest-bearing promissory note that was secured by collateral and guaranteed by persons with substantial net worth constituted a payment. Even under these circumstances, the note was merely a promise to pay, which might never be fulfilled.

In the case of funds withheld reinsurance, it is apparent that the ceding company makes a payment to the reinsurer to the extent that it transfers cash (or a check) to the reinsurer. It is equally apparent that the fact that the ceding company has promised under the reinsurance agreement to pay the reinsurer for assuming certain risks does not constitute a payment. Cash and checks, however, are not the only means of making a payment.

A payment may also occur by offset against a debt owed¹⁸ or when a creditor applies property in its possession against a debtor’s liability.¹⁹ In *Jergens v. Commissioner*, for example, the taxpayer was determined to have made interest payments when his employer paid interest the taxpayer owed to third parties and offset those amounts against the compensation the employer owed to him. The Tax Court rejected the IRS’s argument that the taxpayer had not made a payment because he had not suffered a cash detriment. To the contrary, “[i]n each of the taxable years [taxpayer’s] personal account attained a credit balance after the debits were made and he suffered a cash detriment to the extent of the charges made to his account. On the facts, we cannot hold that the requisites for cash basis payments were not met.”²⁰

Authorities, such as *Jergens*, that state a payment occurs when there is an offset are quite instructive in the context

of funds withheld reinsurance. Offsets regularly occur with funds withheld reinsurance. Whenever the ceding company pays an amount that the reinsurer has agreed to reimburse (such as a claim on the portion of a policy that the reinsurer has assumed), the result is a reduction in the amount that the ceding company owes to the reinsurer. Thus, even though no cash is directly transferred from the ceding company to the reinsurer, these authorities support a conclusion that there has been a payment.

THE IRS POSITION

As previously stated, the 2008 audit technique guide reaches a different conclusion from the taxpayer position discussed above, stating that an accrual concept is used to determine the premium payments to which the premium excise tax applies. The audit technique guide does not discuss any of the above authorities, all of which are contrary to its position. Rather, it briefly refers to Rev. Rul. 77-453²¹ and G.C.M. 37,201.²² Separately, it includes a citation to Rev. Rul. 79-138.²³ These authorities are discussed below.

REV. RUL. 77-453

In Rev. Rul. 77-453, the IRS considered when, for purposes of I.R.C. § 832(b)(4), it is appropriate for a ceding company to reduce gross premiums by the amount of reinsurance premiums and, similarly, when a reinsurer should include those same premiums in its gross premiums. The IRS states that for this purpose reinsurance premiums reduce gross premiums written as opposed to being a deductible expense. Once the risks related to the reinsured policies have been shifted to the reinsurer, the ceding company is merely an agent with respect to those risks, and thus cannot earn premiums with respect to them.²⁴ Accordingly, the ceding company should reduce its gross premiums “when the risks under the reinsured contracts have shifted . . . and the amount of the reinsurance premium is reasonably ascertainable.” As for the reinsurer, it should include in gross premiums “the amount of the reinsurance premium that it has a fixed right to receive under the reinsurance treaty when the amount is reasonably ascertainable.”

Rev. Rul. 77-453 does not provide much explanation of its conclusion, but a more robust discussion is found

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in G.C.M. 37,201, which was prepared in connection with the ruling. In particular, the G.C.M. considers the argument that when I.R.C. § 832(b)(4)(A) allows a deduction for "premiums paid for reinsurance" in calculating premiums earned, it means that a ceding company cannot reduce its gross premiums written until there has been an actual payment of reinsurance premiums. The G.C.M. rejects that argument, concluding that gross premiums should be reduced when the risks on the reinsured policies are transferred to the reinsurer, "which is when all events have occurred to fix the obligation, and the amount of the premiums can be determined with reasonable accuracy." Critically, the G.C.M. states that this conclusion prevents the "absurd and inequitable" result in which both the ceding company and the reinsurer are taxed on the same premium income in the same taxable year as might happen if I.R.C. § 832(b)(4)(A) was interpreted to require an actual payment before the ceding company could reduce its gross premiums written.

Significantly, the possibility of double taxation, which Rev. Rul. 77-453 seeks to avoid, is not present in a situation in which one is trying to determine the proper treatment of funds withheld reinsurance for purposes of the premium excise tax. The only issue in such a case is the amount of the premiums to which the premium excise tax will apply; there is no possibility that the tax will be collected more than once on those same premiums. Moreover, the audit technique guide does not explain why this revenue ruling, which addresses issues under I.R.C. § 832, is of greater relevance in determining the application of the I.R.C. § 4371 excise tax than the numerous other code provisions (some of which are discussed above) that make plain payment require an actual payment.

REV. RUL. 79-138

The audit technique guide states that the amount of premiums paid, and thus subject to the excise tax, should not be reduced by any allowance due the ceding company from the reinsurer. Rev. Rul. 79-138 is cited as support for this statement, though it is unclear how, if at all, the audit technique guide believes it should apply to funds withheld reinsurance.

In Rev. Rul. 79-138, the IRS considered how the premium excise tax should apply to two situations involving

coinsurance. In the first, the ceding company agreed to pay the reinsurer its proportionate share of the premiums received on the policies covered by the reinsurance agreement, and the reinsurer agreed to bear its proportionate share of all losses and loss adjustment expenses. The reinsurer also agreed to pay the ceding company a ceding commission equal to 42 percent of the net premiums received. For convenience, it was agreed the ceding company would remit to the reinsurer only the net amount of the gross premiums less the ceding commission and the reinsurer's share of any losses and loss adjustment expenses. The second situation was similar to the first, except the agreement merely called for the ceding company to pay the reinsurer an amount equal to 58 percent of the net premiums attributable to the reinsurer's share of the risk.

The IRS concluded that in "determining the amount of a premium paid ... the law does not provide for reduction of the gross premium paid for expenses incurred in connection with underwriting the taxable insurance contract." Thus, the premium excise tax applied to the proportionate share of the premiums received by the ceding company that were attributable to the foreign reinsurer not reduced by any ceding commission, losses, or loss adjustment expenses. In the second situation, the premium excise tax still applied to the proportionate share of the gross premiums received by the ceding company, even though the reinsurance agreement required payment of only a net amount. The IRS stated the same conclusions would apply to modified coinsurance.

By its terms, Rev. Rul. 79-138 applies to coinsurance and modified coinsurance, but not to funds withheld reinsurance. The issue with funds withheld reinsurance is determining when there is a payment to which the premium excise tax applies. The revenue ruling concludes that when there is an actual payment and expense items that are obligations of the reinsurer (such as losses and loss adjustment expenses) are netted against premiums otherwise due the reinsurer, the premium excise tax applies to the gross amount of the payment made by the ceding company. To the extent this holding states that a cash basis taxpayer will be considered to have paid an amount in circumstances in which there are concurrent debits and credits to a cash basis taxpayer's account, it

merely restates the well-established proposition discussed above.²⁵ To the extent it holds that the premiums paid by the ceding company should be determined without reduction for the ceding commissions due from the reinsurer, it is asserting a position contrary to *National Capital Insurance Co.*, which held that premiums paid to a reinsurer should be computed net of ceding commissions.²⁶ In such a case there is no actual payment. In any event, in the case of funds withheld reinsurance, the types of offset contemplated by the revenue ruling do not normally occur immediately upon entry into a reinsurance agreement, which is why Rev. Rul. 79-138 addresses only coinsurance and modified coinsurance.

TERMINATION

The audit technique guide states that when there is a cancellation of a policy, amounts that are refunded or credited are return premiums that result in a reduction in the premium subject to the premium excise tax.²⁷ Under the IRS position, the ceding company will have paid the premium excise tax on the entire initial premium. However, when the reinsurance agreement is terminated, as is likely to happen, a portion of the funds withheld may be “returned” to the ceding company. If the IRS position is followed and the premium excise tax is imposed on an accrual basis, then the excise tax is negated to the extent it is later determined the funds withheld are returned. That is, the IRS position inappropriately requires that the premium excise tax be paid on too large an amount in the first instance, only to have a portion of that premium excise tax credited or refunded when the reinsurance agreement is subsequently terminated.²⁸ The taxpayer position discussed above avoids this issue by having the ceding company pay the premium excise tax only on actual payments.

CONCLUSION

The IRS’s position on the application of the premium excise tax to funds withheld reinsurance is clearly expressed in the 2008 audit technique guide—an accrual concept applies. The soundness of that position is less clear. Taxpayers that determine the excise tax by looking only to actual payments made by the ceding company to the reinsurer or to the net amount of the ceded premiums after adjusting for the allowance paid by the reinsurer have a variety of arguments to support their position.

The language of the premium excise tax, the regulations thereunder, the legislative history of the provision, and the very nature of an excise tax all support the position that the tax applies only when there is an actual payment. Other code provisions that use similar language as well as the Supreme Court also support this view.

Nevertheless, taxpayers that take a position that the excise tax applies to something less than all amounts due to the reinsurer for which all events have occurred that fix the reinsurer’s right to the premiums and the amount of which is reasonably ascertainable should expect the IRS to challenge that treatment. The discussion of this issue in the audit technique guide suggests the IRS is prepared to raise this issue on audit. In time, increased attention may result in greater clarity, but for now it remains an area of potential dispute. ■

END NOTES

- ¹ War Revenue Act of 1917, Pub. L. No. 65-50, § 504, 40 Stat. 300, 315 (1919).
- ² Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986, as amended (the “Code”).
- ³ Internal Revenue Service, *Foreign Insurance Excise Tax—Audit Technique Guide* (2008).
- ⁴ *Id.*
- ⁵ The IRS similarly seems to fail to appreciate the differences between income taxes and excise taxes in its position on the cascading premium excise tax as expressed in Rev. Rul. 2008-15, 2008-12 I.R.B. 633, and the audit technique guide. See Peter H. Winslow & Biruta S. Kelly, *IRS Foreign Insurance Excise Tax—Audit Technique Guide Presents Questionable Positions*, *TAXING TIMES*, May 2009, at 48.
- ⁶ Pub. L. No. 89-44.
- ⁷ Pub. L. No. 91-172.
- ⁸ I.R.C. § 404(a) provides for a limitation on the deduction for contributions “paid” by an employer under a pension, annuity, stock bonus, or profit-

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END NOTES CONT.

sharing plan. The regulations provide that deductions under this section are "generally allowable only for the year in which the contribution or compensation is paid, regardless of the fact that the taxpayer may make his returns on the accrual method of accounting." Treas. Reg. § 1.404(a)-1(c).

I.R.C. § 561(a) provides a deduction for certain taxpayers for dividends "paid" in the taxable year. A dividend is considered paid "when it is received by the shareholder." Treas. Reg. § 1.561-2(a)(1). This determination is in no way dependent on the corporation's method of accounting for keeping its books or determining its taxable income. Treas. Reg. § 1.561-2(b).

⁹ "The employer is required to collect the tax by deducting and withholding the amount thereof from the employee's wages as and when paid, either actually or constructively. Wages are constructively paid when they are credited to the account of or set apart for an employee so that they may be drawn upon by him at any time although not then actually reduced to possession. To constitute payment in such a case, the wages must be credited to or set apart for the employee without any substantial limitation or restriction as to the time or manner of payment or condition upon which payment is to be made, and must be made available to him so that they may be drawn upon at any time, and their payment brought within his own control and disposition." Treas. Reg. § 31.3402(a)-1(b).

¹⁰ Treas. Reg. § 1.6041-1(h).

¹¹ Treas. Reg. § 49.4261-1(b).

¹² 429 U.S. 569 (1977).

¹³ See *Eckert v. Burnet*, 283 U.S. 140, 141 (1931).

¹⁴ See, e.g., *Black Gold Energy Corp. v. Commissioner*, 33 F.3d 62 (10th Cir. 1994); *Vander Moere v. Commissioner*, T.C. Memo 1978-430; Rev. Rul. 81-262, 1981-2 C.B. 164; Rev. Rul. 80-140, 1980-1 C.B. 90.

¹⁵ Treas. Reg. § 1.848-2(f)(5). This treatment is illustrated in Treas. Reg. § 1.848-2(f)(9), Example 5, which involves a funds withheld reinsurance agreement in which the reinsurer is credited with an initial premium equal to the ceding company's reserves on the reinsured contracts. The reinsurer makes a loan to the ceding company in the same amount and is issued a note by the ceding company. The loan is netted against the reinsurance premium for I.R.C. § 848 purposes. Consequently, immediately after the agreement is entered into, no net consideration has been provided. As discussed in more detail in the next section of this article, the ceding company's issuance of the note does not constitute a payment for tax purposes.

¹⁶ *Belcher Est. v. Commissioner*, 83 T.C. 227 (1984); *Spiegel Est. v. Commissioner*, 12 T.C. 524 (1949), *acq.*, 1949-2 C.B. 3.

¹⁷ *Don E. Williams*, 429 U.S. 569 (1977); see also *Helvering v. Price*, 309 U.S. 409 (1940); *Eckert v. Burnett*, 283 U.S. 140 (1931); *Foley v. Commissioner*, T.C. Memo 1976-60; Rev. Rul. 76-135, 1976-1 C.B. 114.

¹⁸ E.g., *Carroll v. Commissioner*, 30 T.C.M. 249, 254-55 (1971); *Jergens v. Commissioner*, 17 T.C. 806, 808-09 (1951), *acq.*, 1952-1 C.B. 2.; *Rosenblatt v. Commissioner*, 16 T.C. 100, 104-05 (1951); *Reynolds v. Commissioner*, 44 B.T.A. 342, 355-56 (1941), *acq.*, 1941-2 C.B. 11.

¹⁹ See *Sherman v. Commissioner*, 18 T.C. 746 (1952) (holding that a taxpayer was entitled to an interest deduction when a creditor foreclosed on collateral securing the loan on which the taxpayer owed the interest and applied the proceeds against the interest owed), *acq.*, 1952-2 C.B. 3, *acq. withdrawn on other issue and nonacq. substituted*, 1964-2 C.B. 9.

²⁰ *Jergens*, 17 T.C. at 809.

²¹ 1977-2 C.B. 236.

²² G.C.M. 37,201 (July 26, 1977).

²³ 1979-1 C.B. 359.

²⁴ See *Colonial Surety Co. v. United States*, 178 F. Supp. 600, 602 (Ct. Cl. 1959).

²⁵ See, e.g., *Jergens*, 17 T.C. at 808-09; *Rosenblatt v. Commissioner*, 16 T.C. 100, 104-05 (1951).

²⁶ 28 B.T.A. 1079 (1933). G.C.M. 37,201 (July 29, 1977), which was prepared in connection with Rev. Rul. 79-138, contends that the case does not control because of a subsequent change in the predecessor to I.R.C. § 832 that it argues would have resulted in a different outcome.

²⁷ See also Rev. Rul. 66-197, 1966-2 C.B. 478 (stating that the taxpayer may either claim a credit for the resulting excise tax overpayment on his next quarterly excise tax return or file a claim for refund).

²⁸ In addition, the IRS position may create a statute of limitations issue if the ceding company seeks a refund of the "excess"



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The Health Care Journey Continues

By Michael L. Frank

This article first appeared in the November 2013 issue of Actuary of the Future. It is reprinted with permission.



Michael L. Frank, ASA, FCA, MAAA, CHE, is the president and actuary of Aquarius Capital. He can be reached at Michael.Frank@AquariusCapital.com.

This is a follow up to an article “A Global Perspective of the Health Insurance Market” written in 2012. After completing our second year as Professors at Columbia University in the Masters in Actuarial Science program (the course was taught by principals at Aquarius Capital, Michael Frank and Don Rusconi), we continued the journey from the first year’s class. The course provided an overview of the health care insurance industry, including products, delivery systems, health care reform, reinsurance and capital markets with focus in the U.S. and international markets.

As part of the course, students were given traditional actuarial projects in pricing, reserving and underwriting, as well as other projects and coursework to understand sales, provider contracting, disease management/wellness programs, claims management and finance. The course was an intensive program on the health insurance industry with the objective of providing detailed training as a health actuary while increasing the students’ chances of reaching C-Suite roles (e.g., CEO, CFO, COO).

Rather than using a textbook to teach the course, the class material was on PowerPoint (more than 1,000 slides) and more than 200 recent health industry articles. The objective was to help students hit the ground running on their first job. Students also benefited by expanding their resume through research and experience, which is critical in a difficult job market.

Students worked independently, as well as in teams, and made presentations that often took them out of their comfort zones, exposing them to public speaking, project management, networking, and team building. Students were given homework assignments and readings to critique as part of their regular class work. We wanted to make sure that the course also covered a professionalism component, so material included the review of actuarial standards of practice, traditional health actuarial projects, and other professionalism issues.

The 2013 course was similar to the one in 2012, except for the expansion of four key areas, which are as follows:

- Study of international health care systems (ten new countries);
- Impact of health care reform, known as the Patient Protection and Affordable Care Act (PPACA);
- Retiree health systems in the U.S., including research in retiree health valuations (e.g., GASB45);
- Reinsurance.

STUDY OF INTERNATIONAL HEALTH CARE SYSTEMS (TEN NEW COUNTRIES)

Columbia University’s actuarial program has students from a variety of countries. Thirty seven of the 40 students in the 2013 class were international students. As a result, the course was designed to study international health care systems, in addition to the U.S. health care system. In the 2012 course, 11 countries were selected by students—Australia, Brazil, Canada, France, Germany, India, Japan, Singapore, South Korea, Sweden, and U.K. This year’s course incorporated ten new countries including Austria, Bermuda, Mexico, Netherlands, New Zealand, South Africa, Spain, Switzerland, Turkey, and United Arab Emirates. Students were divided into teams of three or four, and were instructed to research their selected countries’ health care system. As part of the course, each team provided both research papers and PowerPoint presentations.

As part of the course, students teach a class for approximately 30 minutes on their specific country’s insurance system, reinsurance, regulations, health care reform, market penetration, and roles of actuaries in those countries. Students also networked—with assistance from the professors in the course—with actuaries and insurance professionals in other countries to expand their research. One beneficial result of the class is that some students were able to obtain internships and employment post-graduation of the class through the contacts developed as part of their international project work.

IMPACT OF HEALTH CARE REFORM (PPACA)

With health care reform becoming a day-to-day issue for health actuaries, as well as many individuals and corporations within and outside of the insurance industry, it was important for the course to address



health care reform and its impact in the market (e.g., insurance companies, health care providers, corporations, municipalities). Students were assigned research projects around health care reform, and the results of this research were incorporated into the class. The 2012 course reflected the use of poll surveys to gauge the influence of health care reform on the consumer.

In 2013 course, additional time was devoted to the implementation and timeline on PPACA. Some of the areas studied in detail included:

- Impact on commercial (fully insured vs. self-funded) and government programs (e.g., Medicare, Medicaid, etc.);
- Strategies pursued by insurance companies and HMOs, including marketing, pricing strategy and operations;
- Impact of accountable care organizations (ACOs), as a result of health care reform;
- Impact of health care reform on other organizations serving the insurance industry including insurance brokers, third-party administrators, preferred provider organizations, disease management/wellness companies, technology companies, reinsurers, and private equity;
- Strategies around “pay or play” for corporations, as well as exploring implementation of health insurance exchanges by insurance regulators and health plans;
- Other areas including claims audits, provider billing and wellness initiatives.

RETIREE HEALTH SYSTEMS AND GASB45

Significant class time was spent understanding the Medicare system and health insurance programs avail-

able to retirees. Students were exposed to all types of Medicare plans, including Medicare Advantage and Medicare Supplement arrangements. The course was expanded to health students to help them learn about retiree health valuation methods for other post-employment benefits (OPEB), including FAS106 (single employers), SOP92-6 (multiemployer), and GASB45 (municipalities).

In addition to learning about traditional actuarial formulas around retiree health valuations, students were involved in research projects to understand methods used in the market, and summarize results to ascertain trends and benchmarks (averages). We wanted students to get a sense of the output results from a valuation program, since many actuarial firms are utilizing this software, which may be a “black box” to many students and practicing actuaries.

The research involved students gathering valuation reports, which reflected reports prepared by 35 different actuarial firms, reflecting municipalities in 40 states. In aggregate, results were compiled for 114 municipalities with results compiled so that students were able to learn the following:

- Types of retiree benefits offered by municipalities nationwide;
- Types of assumptions and methodologies used by outside actuarial firms (e.g., 35 different organizations);
- Patterns of results so students can obtain insights on what they should expect in results (e.g., benchmarks, ratios, etc.);
- Most common report elements provided by practicing actuaries.

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“THE OVERALL GOAL FOR THE RESEARCH WAS TO HELP STUDENTS BE MORE CONSULTATIVE WITH THE RESULTS ...”

Some highlights identified as a result of students’ research are as follows:

- **Actuarial Cost Methods:** 69.3 percent of all valuations reviewed reflected a selected actuarial cost method of projected unit credit, which is the most common valuation method used for GASB45. The second most common method was Entry Age Normal, which was used 24.6 percent of the time.
- **Discount Rates:** Discount rates varied widely, with rates as low as 3 percent and as high as 8.5 percent. Students were able to see a high range of discount rates used by actuaries, as well as assumptions made for funded and unfunded retiree benefits programs. 28.1 percent of all municipalities evaluated had funded some portion of its retiree health benefits.
- **Health care Inflation (Trend) Rates:** Similar to discount rates, students were able to see a wide range of health care inflation rates used with the average first year discount rate being 8.5 percent and the ultimate trend rate assumption averaging approximately 5 percent (average was 4.92 percent).
- **Mortality Tables:** 69 percent of all valuations reviewed were based on the RP-2000 mortality table, while 71.9 percent of all valuations reviewed reflected some component of mortality improvement.
- **Fifty-one percent of the reports had splits for actives vs. retirees for both employee counts and unfunded accrued liability.** For those reports splitting actives vs. retirees, active lives reflected 72.6 percent of the total employee count and 58.1 percent of the unfunded accrued liability.

Other trends were also identified by students and reviewed in the course. Results were also illustrated for the class in aggregate, so that students can see trends and relationships between unfunded accrued liability, annual required contribution (ARC), pay-as-you-go amounts, and net OPEB obligations. Students were also able to see different formatting of reports and how results were presented to the end user. The overall goal for the research was to help students be more

consultative with results and be able to audit output for reasonableness when calculations are generated out of the actuarial “black box” (valuation program).

REINSURANCE

For the second straight year, the course also included reinsurance. With an ever-changing reinsurance market, we wanted to provide insight to actuaries on health reinsurance, as well as reinsurance for other product lines (e.g., life insurance, annuities, accident products, catastrophic coverages, property casualty products). The course includes an overview of the history of reinsurance, along with providing an overview of the market (e.g., study of various countries, top reinsurers by line of business).

Topics included actuarial, underwriting, claims, auditing, treaties, retrocession, captives, and financial reporting as part of the course. Back in the fall of 2012, we had developed a three-day reinsurance course held in the Dominican Republic, and we incorporated material from that course into the Columbia University program.

FALL 2013

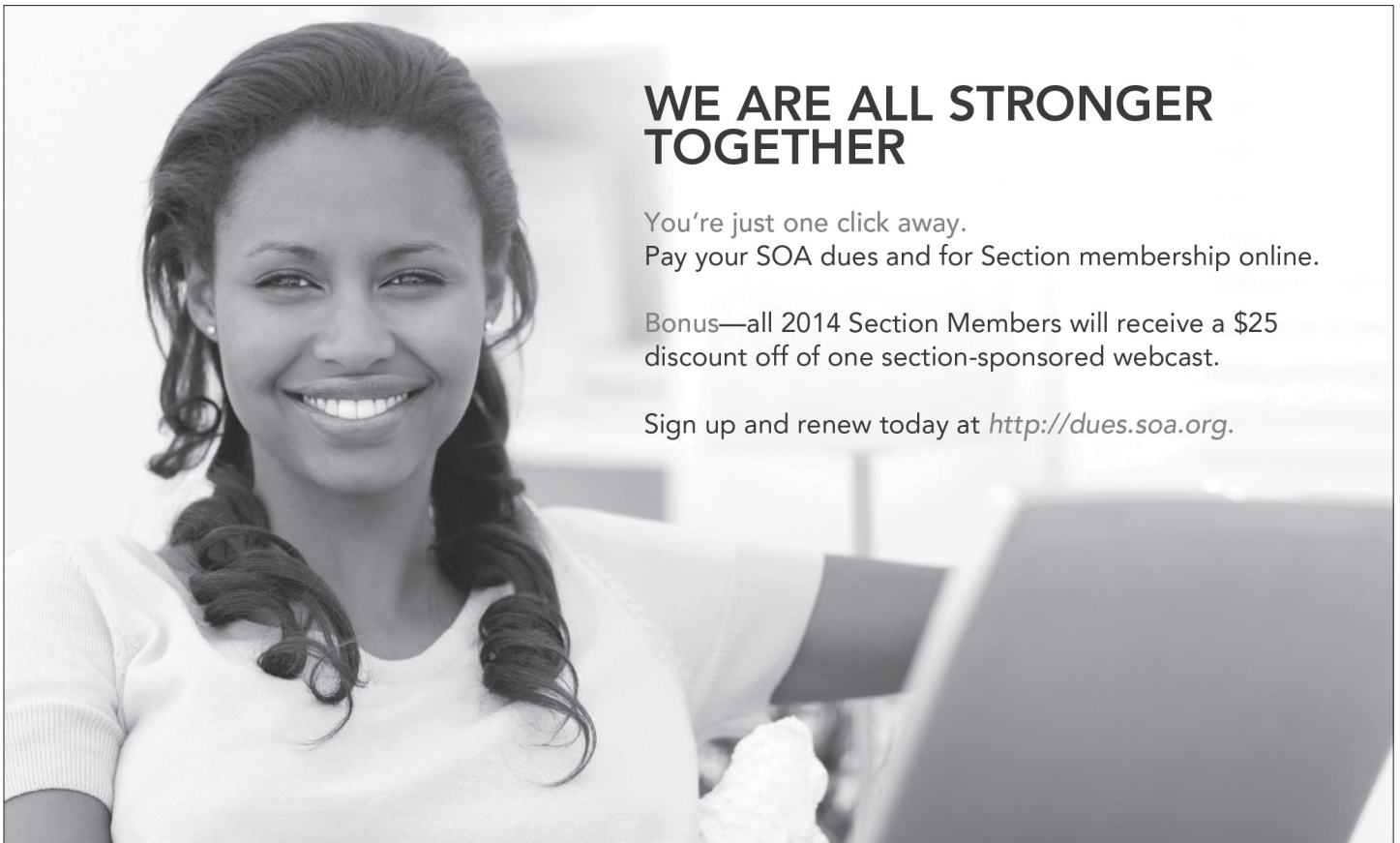
In September 2013, the third class commenced with a total of 55 new students. As part of the class, research projects were expanded from the prior classes and include the following: (1) research on health insurance exchanges in nine states reflecting a combination of state and federally run exchanges; (2) study and evaluation of six publicly traded HMOs; (3) evaluation of four additional healthcare systems—Italy, Israel, Greece and Thailand. We have also incorporated discussions on medical tourism and advancements in healthcare technology.

ACKNOWLEDGEMENTS

Thanks to Donald Rusconi, vice president and chief financial officer at Aquarius Capital, for his work in this joint effort, and to Noor Rajah, program director and actuary at Columbia University, for his assistance in getting this course off the ground and for trusting us to create a unique program for Columbia’s graduate students.

We also want to thank the various actuaries and insurance professionals that assisted the students in research. Their participation was very valuable for the course and we hope other actuaries will participate in the future.

Most importantly, a special thanks to the Columbia University graduate students that ventured on this unchartered course called, "A Global Perspective of the Health Insurance Market." Many of those students have gone on to graduate the program and have provided positive feedback on how the course helped them transition seamlessly into their new position. To learn more about the program, visit <http://ce.columbia.edu/Actuarial-Science>. ■



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Leadership Interview Series: James Glickman

By Sophia Dao

This article first appeared in the November 2013 issue of *Stepping Stone*. It is reprinted with permission.



Sophia Dao, FSA, MAAA, is a director and actuary in the Financial Management Group of MetLife. She can be reached at sophia.dao@alico.com.



James M. Glickman, FSA, CLU, FLMI is president and CEO of LifeCare Assurance Company. He can be reached at Jim.Glickman@LifeCareAssurance.com.

Interviewer's notes: This article features Jim Glickman, who has one of the most impressive résumés I have ever seen! He has a long list of accomplishments, and below are just some of the highlights:

- *Founded LifeCare, a market-leading reinsurer and administrator of long-term care insurance (LTCI) products in 1988. Jim is the creative force behind LifeCare's innovative approach to LTCI product design.*
- *Led the effort to form the Society of Actuaries' Long Term Care Insurance (LTCI) Section and was its chairperson for its inaugural year in 2000, as well as his final year on the council in 2004.*
- *Led the effort to develop the annual Intercompany Long-Term Care Insurance (ILTCI) Conference, serving as chairperson for the first four conferences, and as president/board member for the non-profit association that runs the conference. He was presented with a "Lifetime Achievement Award" at the Fifth Annual ILTCI Conference.*
- *Member of the Society of Actuaries' board of directors from 2005 to 2010 (serving as vice president of the board from 2008 to 2010).*

I am honored to interview Jim, who, despite his busy schedule, has been very generous with his time. I hope you enjoy this interview as much as I did.

What is your greatest accomplishment?

Guiding LifeCare Assurance Company from a startup with \$3 million of borrowed funds into a company with over 200 dedicated employees, nearly \$2 billion in assets and \$375 million of annual revenue. LifeCare has been profitable for 20 consecutive years, operating exclusively in the LTCI industry, an industry that has faced many challenges over the years, including carriers exiting the business.

What is the most difficult thing that you have had to deal with in your career? What have you learned from that experience?

Building a company from scratch, no matter how strong a business plan, is a series of ups and downs that need to be navigated. In 1991, about three years after the company started, we had burned through \$2 million of the original \$3 million of capital. After three years of losses, it was necessary to change our fee structure with one of our partner companies. We discussed what minimum amount of business they needed to produce, and by having them guarantee that production, we made their program more successful for both sides.

The basic lesson from this experience, one that is often repeated in all aspects of life, is that working (or negotiating) with others is not a zero-sum game. It is a mutual evaluation of what each party needs and values, in order to maximize both sides' positions.

How has your volunteer experience helped you develop as a leader?

In 1998, I attended the SOA annual meeting in NYC, and, much to my disappointment, there were no educational sessions regarding LTCI. It was at this point that I realized there was a need for an SOA long-term care (LTC) section, and set about recruiting other LTC actuaries to assist in forming it and getting the SOA board's approval.

Once formed, the LTCI Section set about developing a national conference that would provide networking and education for the LTCI industry. The LTCI Section became the first section to promote widespread non-actuarial participation, and then successfully convinced the SOA board to empower those non-actuarial participants by allowing non-actuarial council members. Both the LTCI Section activities and the LTCI annual conferences were accomplished with volunteers dedicated to making the LTCI Section and the LTCI industry better every year.

I found that to get and keep volunteers engaged, you need to organize activity around the strengths and the interests of those volunteers, and perhaps most importantly, lead by example, as well as continually strive to develop the next generation of volunteer leaders. I am convinced that in private business, these

same leadership qualities are just as important. A leader must provide the vision and find the best people to execute that vision, keeping employees engaged and developing the next generation of leaders.

What advice do you wish someone had given you early in your career?

In stressful situations, it is extremely important to remain calm and controlled, gather all of the available information, and reason out the best solution. Inevitably, an emotional response will not succeed.

Do you have any tips that you would like to share on how to control your emotions in stressful situations?

When you sense yourself getting angry or annoyed, develop a habit of detaching yourself from the situation. When successful, which is not always the case, this gives you the time to calmly consider the situation, gather more information, and then respond in a logical manner.

What are some of the things you have low tolerance for in your organization?

I have a very low tolerance for wasteful spending, especially under the guise of it won't matter much, or it is not worth the effort. Throughout our organization and starting at the top, everyone embraces and is rewarded for maximizing value and minimizing cost. When we first started our company, this approach was a necessity, but now it is just part of the company culture. Surprisingly, it takes only a small amount of effort from each person, in each situation, to have saved millions of dollars over the years.

What qualities do you think a successful leader should have?

- a. A leader needs to have a vision of where the organization is headed and successfully communicate that vision throughout the organization.
- b. A leader needs to empower those in the organization to succeed in executing that vision.
- c. A leader needs to provide those within the organization the opportunity to shine and advance.

What is one mistake that you witness leaders making more frequently than others?

The mistake I see most often in leaders is living by a different standard than they espouse for the rest of the organization. This breeds contempt, and encourages others to carve out their own silos with special rules that only apply to them.

Can you expand on the above?

To me this represents the concept of leading by example, and not having different sets of rules for the leaders, versus the rest of the organization. Often, an objective analysis can readily reveal when a leader operates under a different set of rules than the rest of the organization. Yet, this will only work if the leader wants to be objective. It is far too easy for leaders to rationalize that the different rules are worth the "extra cost" since the leader's "time" is so much more valuable.

What are a few resources you would recommend to someone looking to become a good leader?

Perhaps the most important resource is to develop a mentor relationship with a leader you currently know. This type of relationship is often as satisfying for the mentor as the mentee. It only takes the effort, willingness and bravery to make that contact.

What particular challenges, from your perspective, do actuaries usually face as they try to be seen as leaders?

As technical specialists, often with skills that those in other parts of the organization do not possess, actuaries can become boxed into their specialty, since they are not necessarily required to network or to communicate with non-actuaries. Because of this reality, actuaries must make an effort to seek out these opportunities for interaction and communication, both to broaden their perspectives and to become visible as leaders outside of their technical actuarial roles.

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"PERHAPS ONE OF THE BIGGEST INDUSTRY OPPORTUNITIES EXISTS IN THOSE PRODUCT LINES WHERE THE INTEREST RATE ENVIRONMENT NOW MAKES THEM SEEM THE MOST PRECARIOUS."

In your opinion, what are the biggest opportunities and the biggest risks in our industry?

The insurance and pension industries are exposed to risks that were never envisioned prior to the financial crisis, mostly due to the low interest rate environment, and its indefinite continuation by the government.

Perhaps one of the biggest industry opportunities exists in those product lines where the interest rate environment now makes them seem the most precarious. Currently, LTCI has just gone through that type of perfect storm, where originally unanticipated low lapse rates together with low interest rates have created what in property and casualty (P&C) terms is called a "hard market." This phenomenon, which occurs regularly in the P&C industry after its catastrophic events, causes new business premiums to skyrocket as companies seek to replenish their surplus, while other carriers just choose to exit.

For the LTCI industry, this same phenomenon has occurred recently, with LTCI new business pricing now being about double what prices were in the late

1990s, for products with the same benefits. When new carriers choose to go against this tide of negative sentiment and enter during a "hard market," they often find themselves making outsized profits. In particular, for carriers who lack any legacy issues associated with having previously been in the LTCI market, the opportunity to achieve both better-than-expected profits together with substantial growth makes this one of the biggest opportunities in the insurance industry today.

What should actuaries do to stay competitive and relevant?

I believe that actuaries need to make a concerted effort to reach out to non-actuarial constituencies in their area of practice, both to learn from them, as well as using their actuarial expertise to become an unbiased teacher. This is especially important in situations where political motives may encourage the non-actuaries to believe what they want to be true, rather than looking for the objective solutions.

If you would like to recommend someone to be interviewed for this series, please contact Sophia Dao at sophia.dao@alico.com. ■

SOA AND LIMRA RELEASE NEW STUDY ON VARIABLE ANNUITIES!

The SOA and LIMRA are proud to release a brand new study of variable annuity guaranteed benefit options. Researchers examined more than 3.4 million contracts with a guaranteed lifetime withdrawal benefit, guaranteed minimum withdrawal benefit, guaranteed minimum accumulation benefit or guaranteed minimum income benefit option. The analysis is based on 2011 experience and looks at how policyholders use these guaranteed options and exhibit other behaviors involving step-ups, cash flow and persistency. See the report for the findings in this important new study.

2013 Reinsurance Research Review

By Ronora Stryker and Scott Campbell

One of the major initiatives of the Reinsurance Section Council is to initiate and produce quality research that benefits Reinsurance Section members. A dedicated group of volunteers have been assembled to oversee this process. This research team was very active in 2013 and this article will summarize some of the highlights from last year.

One such project completed in 2013 is on life reinsurance treaty construction and has been featured in a past issue of the newsletter. Reinsurance treaty negotiations can be a long complicated process that may lead to lengthy unwieldy documents and negative experiences for the direct writer and/or reinsurer. While the ACLI Life Treaty Sourcebook provides sample treaty language and the 2007 updates to the 1994 Guidance and Commentary on Life Reinsurance Treaties provides insight on the purposes of most reinsurance treaty clauses, it is difficult to find information on historical construction of treaties including the current prevalence of treaty terms and the impact on the reinsurance transaction, ceding company, and reinsurer. The Section initiated this project to increase awareness of the importance of many reinsurance treaty terms/provisions, identify common treaty structures, practices, and/or solutions in reinsurance treaty construction and negotiation and illustrate how treaty terms have evolved over time. The knowledge from this research should assist individuals involved in reinsurance treaty negotiations to optimize resources and success in future reinsurance treaty development. The report authored by Steve Stockman and Tim Cardinal of Actuarial Compass is available on the SOA website under Completed Research Projects – Life Insurance.

The research team met throughout the year and deliberated on many ideas before selecting two projects to move forward, living benefit riders and conversion mortality experience. Project teams were assembled to further develop the scope and prepare solicitation materials to hire researchers to perform the studies.

The living benefit riders project group recognized that many life insurance and annuity companies offer living benefit riders—riders that provide for the payment of

all or a portion of the death benefit or account value upon the occurrence of a covered event prior to death. The market is beginning to demand these riders be attached to more policies. Direct writing companies of these riders may desire that reinsurance on the base policies extend to these riders as well. Yet reinsurers and direct writing companies may not fully appreciate the complexities associated with issuing, administering and reinsuring these riders. Therefore, the project group defined a study to identify and describe the various living benefit riders available in the life insurance and annuity marketplaces and discuss the implications of these benefits from both a direct writer and reinsurer perspective. The outcome of the study could help companies enhance current practices around these benefits.

This project group has selected a researcher to catalog a listing of common living benefit riders and features, highlighting the impact of each feature on policy pricing (e.g., increased policyholder optionality/antiselection; impact on mortality, policy persistency, and premium persistency), legal/compliance requirements, and the impact of each feature on reinsurance pricing and administration (inforce policy administration, claims administration, etc.). Some of the items to be addressed in the study include:

Identification and definition of the types of living benefit riders available in the life insurance and annuity marketplaces:

- Company policy language and variations;
- Sales by type of benefit/rider;
- Underwriting for these riders;
- Cost of the benefit;
- Overall level of claims activity associated with these riders;
- Administrative handling (including outsourcing);
- Filing requirements; and
- State variations.

The conversion mortality experience project team has also been busy investigating the need and likelihood of available data for a study. It is common that term life policyholders can convert their insurance to permanent



Ronora Stryker, ASA, MAAA, is research actuary with the Society of Actuaries in Schaumburg, Ill. Ronora can be contacted at rstryker@soa.org.



Scott Campbell, FSA, MAAA, is director and actuary with Prudential Financial in Newark, N.J. Scott can be contacted at scott2.campbell@prudential.com.

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life insurance without new evidence of insurability. For example, if a 20-year term policy has a 10-year conversion clause, it is possible that the policyholder could develop health problems within the 10-year conversion period and convert the term policy to a permanent policy without a physical exam and other underwriting. The policyholder could end up having permanent coverage at a much lower annual premium than if he would have gone through the underwriting process for a new permanent policy. Therefore, the mortality experience on conversion policies could be higher than expected on similar permanent policies due to the anti-selection.

To help with the planning for a study, the group conducted a short survey of insurers to gain a better understanding of the type of data available and interest in participating in the experience study. Responses

were encouraging leading the project group to prepare a Request For Proposals to find a researcher to develop the request for data, perform the necessary aggregation and analysis, and summarize the research findings in a report.

As these two projects are in very early stages, no definitive completion date has been determined. Look for more information about the studies in the second half of 2014.

The Reinsurance Section's research team has already begun establishing a 2014 research agenda. If you have an idea for a research project that would help Reinsurance Section members or would like to help with Section research efforts, please contact Scott Campbell at scott2.campbell@prudential.com. ■

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Summaries Of Two Reinsurance Section Annual Meeting Sessions

By Paul Myers

The SOA Annual Meeting in San Diego was a huge success—the second most highly attended Annual Meeting ever! For those of us that were there, San Diego proved to be a wonderful place to find great weather, great networking, and some great educational sessions. The Reinsurance Section sponsored several sessions at the conference. In case you missed it, following are brief summaries of a couple of the highest rated sessions that we sponsored.

SESSION 140 – The Business of Fraud (Reinsurance Section and Product Development Section Joint Hot Breakfast)

- **Moderator:** Paul Myers (Munich Re; Reinsurance Section), Paula Hodges (Ameritas; Product Development Section)
- **Presenter:** Daniel Marsano (Prudential)

Insurance fraud costs consumers and insurers \$80 billion each year. The states in our country spend \$0.1 billion each year to fight it. It is estimated that insurance fraud costs each U.S. household \$1000 each and every year. These numbers are staggering. Clearly, insurance fraud has an impact on the products we develop and reinsure.

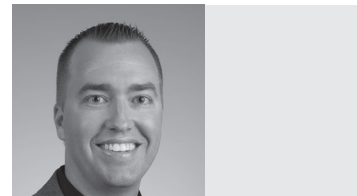
As a former police officer and detective from the Detroit area and author of the book “In Search of the Truth ... An Analytical Approach to the Interview Process,” Daniel Marsano is recognized as an international expert in his field. As vice president of Prudential’s Special Investigation Unit, Marsano has led a team that has aggressively confronted insurance fraud to keep the fraudulent business off of Prudential’s books and keep the bad guys out of our business!

In this session, Marsano dug into this issue and showed the importance of detecting fraud early, and then demonstrated how the Data Verification Reports (DVR) completed by the Special Investigation Unit personnel at his company have been more effective at protecting the company than conventional inspection reports. The DVR’s are completed in 3.5 days versus 14 days for the conventional reports, they are technology based and transparent to the customer, and since they are completed and analyzed by SIU personnel instead of an



outside vendor, motives are well aligned and protective value has been demonstrated.

Daniel then went on to tell a number of informative and entertaining stories that illustrated real life examples of how our industry has been attacked in the past. He explained some of the techniques used by his team to investigate and resolve issues. His examples demonstrated the value of the DVR, showing how the report raised red flags which led to successful investigations. The examples showed the creativity displayed by the perpetrators, and why we as an industry need to be aware and agile to adjust to the developing environment. Finally, he highlighted the keys to successfully combating fraud—based on a strong investigation unit that engages in the underwriting process and prosecutes fraud aggressively.



Paul Myers, FSA, MAAA, is vice president, IL marketing with Munich Re in Atlanta, Ga. Paul can be contacted at pmyers@munichre.com.

SESSION 153 – Reinsurance Treaty Construction and Terms

- **Moderator:** Steve Stockman (Actuarial Compass)
- **Panel:** Bob Diefenbacher (Pacific Life Re), Tom Spurling (Lincoln Financial), Melinda Webb (Munich Re), Brett Wiggins (MetLife)

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In this highly interactive (and many times amusing) session, the panel of industry experts debated several important reinsurance treaty topics, approaching each from a unique perspective. Steve Stockman set the stage by asking the panellists to address each topic from the unique perspective of their particular segment of the market (from the perspective of a direct writer, a reinsurer, or a retrocessionaire). Steve made it very clear that the panellists were not representing the view of their respective companies, but rather trying to lay out the ideal approach given the segment of the market represented by each.

The topics discussed were the Letter of Intent (LOI), Underwriting, the Jumbo Limit, Late Reporting, Errors and Omissions (E&O), Facultative Claims, and Automatic Claims.

For each topic, the panel reviewed basic principles of agreement, and then debated areas of contention. For example, they agreed on the purpose of the LOI, the fact that its execution may be necessary for a cedent to take reserve credit, and that the LOI is replaced by the subsequent execution of a treaty. Alternatively, they debated whether an LOI was necessary in all circumstances, whether it could be backdated, if it was fair for a party to sign the LOI and then later try to renegotiate terms covered by it, and whether business should be ceded to (and/or accepted by) a reinsurer when there is no signed LOI or treaty.

The experts on the panel did a really good job engaging each other in the debate and painting a picture that clearly made sense from their unique perspective and why. They discussed real world, factual scenarios such as if a facultative policy was underwritten and an offer was made by a reinsurer, but the reinsurer never received written acceptance of that offer within the timeframe laid out in the treaty, is that policy, and any claim on the policy, reinsured under the treaty? Is it covered by E&O? Where do you then draw the line on the acceptable timeframe? What if the reinsurer or retro no longer had available capacity? Does payment (and acceptance) of premium by the cedent to the rein-

surer constitute “notice”? If that is the case, then why does the treaty ask for a specific notice? Why can’t the cedent just pay premiums on the fac offers that they want to accept? In other words, if payment of premium was an acceptable form of notice, then why would the treaty even ask for a different form of notice given every accepted policy would pay premiums? Since it does ask for a different form of notification, does this imply that payment of premium is not an acceptable notice?

In the end, the audience gained a much greater feel and appreciation of the importance of a treaty negotiation. Some issues are more important for Company A than Company B, so it is very important to invest the time into those discussions so both sides can clearly communicate which issues are important to them and why. As the panel discussed, all sides clearly agreed that these types of discussions are much more productive and ideal *before* a claim is on the table. The debate format of this panel discussion was effective and appreciated. As one member of the audience reported: “The best session I’ve attended in 20+ years. Well organized, penetrating insights, multiple points of view persuasively presented. They agreed to disagree.” ■



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