

# **Mastering Life Reinsurance: A Guide For The Property/Casualty Industry Professional**

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## **Body**

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By **Susan E. Mack**

### I. Introduction

Originally a property/casualty reinsurance lawyer, I first obtained a senior corporate counsel position in the life reinsurance industry in 1998. Excited about the new opportunity, I spoke to friends about the pending transition. One such colleague expressed dismay at my future path. "I can't believe you'll no longer be in insurance," he said. Once I arrived at the new job, I touched base with other lawyers who serviced that portion of our company providing life and annuity products to consumers. My first contact shared his impression; "I'm so glad you're practicing in insurance now, instead of that property/casualty stuff you used to do."

From this anecdote, it's clear that our past experiences and biases shape how we view the disciplines to which we are unaccustomed.

The purpose of this article is to therefore acclimate property/casualty reinsurance professionals to life reinsurance, assuming they have only limited exposure to the life insurance and reinsurance businesses. Throughout this article, parallels will be drawn to property/casualty concepts familiar to most reinsurance professionals in that industry sector.

In illustrating the characteristics of life reinsurance, this article will confine its focus to indemnity reinsurance rather than assumption reinsurance.<sup>1</sup>

### II. Life Reinsurance's Importance To The Life Insurance Industry

Based on 2013 statistics provided by the American Council of Life Insurers, it is clear that the cession of risk to reinsurers is integral to the risk transfer and management functions of both the property/casualty and life sectors.

Of combined property/casualty and life premiums generated in 2013, \$491 billion was assumed by reinsurers.<sup>2</sup> Life reinsurance was 21 percent of that total.

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Within the life industry itself, ceded reinsurance premiums attributable to life insurance, health insurance and annuities in 2013 totaled \$189.1 billion. Significantly, this amount constitutes 27.9 percent of total direct life lines premium of \$677.66 billion.

Based on 2013 assumed premiums,<sup>3</sup> the top life, health and annuity reinsurers, including both intra-company and inter-company transfers, are:

Prudential Financial

Global Atlantic Financial

RGA Group

Great West

United Healthcare Group

Swiss Re America

Berkshire Hathaway

SCOR Group

Hannover Group

and Munich American Holding.

### III. Hallmarks Of Life Reinsurance

To truly understand life reinsurance's scope one must understand that it encompasses reinsurance not only of underlying life insurance policies or products, but also annuities and accident and health insurance. Many life reinsurance businessmen and businesswomen will refer to life and annuity reinsurance as "baseline business", since accident and health reinsurance has many attributes not typical of the other lines. Divided into medical business (including but not limited to disability reinsurance and medical stop loss reinsurance) and special risk business (including but not limited to workers' compensation or aviation "carve-out" business, that is, the health and disability exposures of what originated as a casualty product), accident and health reinsurance can be categorized (in such instances as the "carve-out" lines) as reinsurance of third party coverages<sup>4</sup>. Life and annuity reinsurance typically pertains to insurance of individual lives or length of lives, and is therefore reinsurance for first party coverage.

Relating to entirely different underlying policies or products, "base-line" life indemnity reinsurance can be seen as the inverse of property/casualty indemnity reinsurance. Property/casualty reinsurance coverage often deals in reinsuring underlying policies of short-term coverage duration associated with a long claims tail. An example is reinsurance coverage of a one year casualty excess policy, to which asbestos or environmental exposures may attach. Reinsurance of life policies involves lengthy periods of coverage and hence long-term accounting<sup>5</sup> associated with a short claims tail. An example in reinsurance of a whole life policy (designed for the remainder of the individual's life), where the individual's death will be quickly known, reported and benefits will be paid relating thereto.

Because of the lengthy underlying policy durations, reinsurance remains in effect for long periods for "in force" annuities and life insurance policies. By contrast, property/casualty reinsurance (and often accident and health reinsurance) is renewed year-to-year. Accordingly, termination rights as to life reinsurance contracts are much more limited than in property/casualty reinsurance.

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The typical life reinsurance treaty termination provision allows for termination on new lives only.<sup>6</sup> As to in force policies, the cedent continues to pay premium on those lives and the reinsurer has the related responsibility to pay death benefits with respect to those policies.

Akin to termination is recapture. A bargained-for right in a life reinsurance treaty, recapture means that only the cedent can take back from the reinsurer all like risks covered by the reinsured contract after a specified length of time has elapsed.<sup>7</sup> Also, in the author's experience, the cedent typically exercises recapture rights to either (a) take back business which has proved to be more profitable than original expectations or (b) keep pace with the fact that the cedent has increased its retention. Recapture must be voluntary on the part of the cedent. Otherwise, reinsurance treatment-rather than deposit accounting-will not be allowed as to the cedent's financial statements. Forced or mandatory recapture is prohibited by the terms of the NAIC Model Life and Health Reinsurance Agreements Regulation, unique to the life reinsurance industry and adopted in 48 states.<sup>8</sup>

In so providing, it is apparent that the regulatory purpose of NAIC Life and Health Reinsurance Agreements Model Regulation is to assure actual risk transfer in proportional forms of life reinsurance. All significant risks "inherent in the business" must be transferred by means of reinsurance, pursuant to the express terms of the regulation. Those risks are, of course, distinctly different from those in the property/casualty context. They are:

Mortality (death);

Morbidity (illness);

Lapse (risk that the policyholder may relinquish underlying policy)

Credit quality (risk that assets supporting the reinsured business will lose value)

Reinvestment (risk that, with declining interest rates, funds reinvested will earn less than expected)

Disintermediation (risk that, with rising interest rates, policy loans and lapses/surrenders increase or that maturing contracts do not renew at anticipated rates of renewal)

#### IV. For Both Property/Casualty and Life Reinsurance, Treaty Terminology And Basic Concepts Are Parallel

The Treaty Concept. Common to both property/casualty and life reinsurance is the treaty concept. The contract between cedent and reinsurer or "treaty" is typified by the practice of reinsuring a "book of business". In property/casualty, a treaty could cover all casualty umbrella policies. In life, a treaty could cover all universal life products with specified features.

Reinsurance Mechanisms. As in property/casualty reinsurance, life reinsurance can be affected by both non-proportional and proportional mechanisms.

A frequently employed non-proportional life reinsurance coverage is Yearly Renewable Term (YRT). Under Yearly Renewable Term reinsurance, the risk mentioned in the NAIC Life and Health Reinsurance Agreements Model Regulation as "mortality" is that which is transferred to the reinsurer.<sup>9</sup> As is appropriate to a non-proportional form of reinsurance, the reinsurance rates are not directly related to the premium rates for the reinsured insurance policies. The cedent maintains the responsibility for establishing policy reserves.

Two well-known forms of proportional life reinsurance are coinsurance and modified coinsurance (known as modco). As typified by proportional reinsurance, the reinsurer receives its proportionate share of gross premium from the cedent.<sup>10</sup> The reinsurer bears its proportionate share of the policy reserves and, accordingly, shares proportionately in all the risks of loss attributable to the reinsured business. Modco resembles coinsurance. In modco, however, while the premium is transferred on a proportionate basis to the reinsurer, the reserves are actually retained by the ceding company. The modco reserve adjustment is used to account for interest, as well as the difference between the ending policy reserves and the beginning policy reserves.

Baseline Concepts. Other concepts common to both the life and property/casualty reinsurance sectors are:

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Accepted Business and Retrocession Business. In both property/casualty and life reinsurance, cedents and reinsurers alike can manage risk. Accepted reinsurance involves risk transfer directly from a cedent to a reinsurer. To limit its retention of risk, the reinsurer in turn can transfer risk to its retrocessionaires.

No Privity Between the Reinsurer and the Cedent's Policyholder. In both property/casualty and life reinsurance, the duties owed by a reinsurer are owed exclusively to its contracting party, the cedent.<sup>11</sup> Only the cedent is in privity of contract with the reinsurer. Absent unusual, very specific contractual provisions known as cut-throughs, no obligation is owed from the reinsurer to the cedent's policyholder.

Indemnity Concept or "Pay as Paid". Just as the reinsurer is paid premium, it has a claims-paying obligation in life reinsurance as well as property-casualty reinsurance. In both sectors, the reinsurer's obligation to pay does not arise until payment by the cedent to its policyholder. The reinsurance contract is a contract of indemnity only.

Doctrine of "Follow the Fortunes". Not every property/casualty or life reinsurance contract contains express terms mandating that the reinsurer follow the fortunes of the cedent. However, as to both types of reinsurance coverage, as long as the cedent acts in accord with the terms and limits of its policies provided to the insureds, then the reinsurer should pay without second-guessing or re-examining the original claim.<sup>12</sup>

Uberrimae Fide or "Utmost good faith". In both property/casualty and life reinsurance, the duty owed between the cedent and the reinsurer is that of "utmost good faith" (in Latin, Uberrimae Fide). Neither as casual a relationship as the arms-length relationship present in most other commercial contracts nor as protective as the fiduciary duty owed by a trustee to a trust, the duty of "utmost good faith" falls somewhere between the two. At a minimum, this duty means that full and fair disclosure of all relevant facts must be made and that neither party should look exclusively to its own interests.<sup>13</sup>

### V. Unique Facets Of The Life Reinsurance Treaty

"Facultative" vs. "Automatic". The stand-alone property/casualty facultative certificate reinsuring a given policy or risk does not exist in life reinsurance. A life reinsurance treaty can be automatic or facultative or both.

An "automatic" treaty allows cession of the risk occurs without specific selection, within certain classifications. The "automatic" treaty will not automatically allow the acceptance of certain risk parameters.

Risk underwriting in life reinsurance or insurance is merely a matter of determining the ratable medical conditions of lives to be covered. A risk may not be automatically accepted: (1) where company risk parameters would not allow automatic risk selection at rated prices; or (2) where a reinsured life has exceeded its "jumbo limit." See the definition of "jumbo limit" under Treaty Clauses with a Difference, *infra*. In such instances, the reinsurer may make an offer which must when be accepted by cedent for coverage to become effective. Facultative coverage means simply that the reinsurer may or may not choose to accept cession of a risk from such cedent.

Facultative reinsurance in the context of life reinsurance may take the form of a stand-alone treaty. It may also be incorporated into a treaty otherwise automatic in form.

Limits: Besides the distinction of having "facultative treaties", limitation of coverage concepts in life reinsurance are quite different from property/casualty reinsurance. The two primary concepts are the definitions of:

#### Automatic Binding Limit

The amount of risk over the cedent's retention which may be automatically ceded if all other conditions are met.

#### Jumbo Limit

The limit applicable to amounts of coverage that may be in force or applied for on an individual life.

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Treaty Clauses with a Difference. Certain treaty clauses are unique to life reinsurance. As described above, provisions define the automatic binding limits and jumbo limits concepts specific to life reinsurance. The Parties to the Agreement clause and Entire Agreement clause are also clauses seen only in life reinsurance.

The Parties to the Agreement clause underscores that only the cedent and reinsurer are in privity of contract. Usually found at a treaty's beginning, the clause specifies that there are no third party beneficiaries to the reinsurance relationship. Curiously, while this same concept underlies property/casualty reinsurance, those treaties do not commonly include this clause.

The Entire Agreement clause provides that the parties' understandings are contained in their entirety within the four corners of the written and executed reinsurance treaty. This clause provides that the treaty is the final integrated contract, which cannot be varied by parol evidence. Mandated as to proportional reinsurance by the NAIC Life and Health Reinsurance Agreements Model Regulation, the clause is commonly found in both proportional and non-proportional covers.

Several clauses exist in both property/casualty and life reinsurance treaties, yet are given a unique twist in the life reinsurance sector. Prime among these are the Errors and Omissions Clause, the Extra-Contractual Obligations clause, the Insolvency clause, offset provisions and the Arbitration clause.

The Errors and Omissions clause in life reinsurance is designed to rectify errors of administration. The clause is designed to restore both parties to their bargained-for positions, as if the errors had not occurred. From the reinsurer's perspective, such a correction could be made if, under an automatic treaty, a policy cession covered by the terms of the treaty has not been notified or implemented.

In property/casualty reinsurance, a variety of Extra-Contractual Obligations may be encompassed within the scope of the ECO clause. First, Extra-Contractual Obligations can consist of reinsurance coverage for the contract-based obligations of an insurer in the event it is liable to an insured defendant for a plaintiff's jury verdict exceeding policy limits. Second, Extra-Contractual Obligations can consist of reinsurer's coverage for the tort-based liability of an insurer for its independent bad acts or bad faith towards an insured. Since "baseline" life reinsurance coverage is first party in nature, only the second form of Extra-Contractual Obligations coverage is found in life reinsurance treaties. As of this writing, life reinsurance treaties omit Extra-Contractual Obligations Clauses more frequently than do property/casualty treaties.

Mandated by state statute or regulation in many states (see e.g. New York Insurance Code Section 1308), the Insolvency clause obligates the reinsurer to pay the cedent's receiver or other legal representative directly and "without diminution" in the event of the cedent's insolvency. This clause is an exception to the rule that the cedent must first pay its policyholders, before only the cedent itself is paid by the reinsurer. While applicable alike to property/casualty reinsurance and life reinsurance, the life version may contain additional non-state-mandated provisions pertaining to the reinsurer's insolvency. So far untested by the courts, it appears that this additional reinsurer-specific language does not vitiate the effectiveness of the remainder of the clause.

Offset provisions in both property/casualty and life reinsurance contracts allow for remitting a net total of premiums and claims owed on one or several treaties in effect between the parties. Although similar in concept in each reinsurance sector, life-specific laws have been implemented in certain states to limit offset in insolvency situations if the relevant treaty does not meet acceptable risk transfer parameters.<sup>14</sup>

Finally, the Arbitration clause is found in both property/casualty and life reinsurance treaties, since mandatory binding arbitration to resolve disputes is largely the norm. Since the Arbitration clause is omitted from some property/casualty facultative certificates but is invariably present in the treaty-only discipline of life reinsurance, agreed-to arbitration is even more universally employed in life reinsurance than property/casualty. The better form of the life arbitration clause restricts arbitrator selection to executives from life insurance or reinsurance entities, since many life reinsurance practices and the underlying risks differ greatly from those in the property/casualty industry.

## VI. Applicability Of Regulation

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Much reinsurance regulation applies to both the property/casualty and life reinsurance sectors. Revised as of 2011 and, again in 2012, in order to conform to the federal statute entitled the Nonadmitted and Reinsurance Reform Act (effective July 21, 2011), the NAIC Credit for Reinsurance Model Law speaks to those instances in which credit for reinsurance should be allowed by a state to a domestic cedent in the form of an asset or reduction from liability on its financial statements in both life/health and property/casualty transactions. Formerly protective of domestic reinsurers in that alien or "unauthorized" reinsurers were forced to entirely collateralize their obligations, the new version of this Model Law recognizes the reality that many alien reinsurers are well capitalized. The revised Model Law now provides for certification of alien reinsurers and for the issuance of a rating to each certified reinsurer by the specific state insurance commissioner according to applicable regulation. The extent to which the certified alien reinsurer's obligations are secured depends on the individual rating. To obtain certification and hence a rating, the alien reinsurer must (a) be domiciled in a "qualified" jurisdiction as determined by the NAIC Committee process, (b) submit to the jurisdiction of that state; (c) maintain minimum capital and surplus and (d) maintain financial ratings with at least two rating agencies.<sup>15</sup>

Also applicable to both sectors are the NAIC Protected Cell Model Act and the NAIC Model Intermediary Act<sup>16</sup> (although "baseline" life reinsurance is originated more often by the reinsurer's own sales employees, rather than by brokers).

Previously acknowledged as the template unique to the life reinsurance industry, the NAIC Life and Health Reinsurance Agreements Model Regulation is applicable only to proportional forms of reinsurance (not Yearly Renewable Term). Besides precluding credit for reinsurance treatment upon mandatory recapture or insufficient risk transfer, credit for reinsurance is also denied: (a) where renewal expenses are insufficient to cover the business reinsured; (b) where the cedent can be deprived of assets or surplus at the reinsurer's option; (c) where the cedent is obliged to reimburse the reinsurer for negative experience or (d) where there is payment by the cedent of amounts other than income realized by the reinsured policies. Treaty regulation occurs in (1) the mandate of the Entire Agreement clause; (2) in an additional clause that all amendments must be in writing and duly executed by both parties and (3) that reinsurance agreements or preliminary letters of intent must be duly executed by the effective date of the cedent's financial statement. If only a preliminary letter of intent is signed, it must be formalized by a full and definitive reinsurance treaty within 90 more days.

## VII. Conclusion

Even to the industry professional accustomed to property/casualty reinsurance sector, it is worthwhile to learn the many nuances of similarities and differences inherent in life reinsurance. For all industry professionals, exposure to this reinsurance sector broadens career expertise and career options. For those industry professionals who are also lawyers, additional opportunities for service abound. Over time, as deal flow complexity accelerates, regulatory and contract wording issues become more important. Although disputes have been more characteristic of the property/casualty arena than the life arena until recently, life side disputes and arbitrations are starting to proliferate. Industry lawyers can be of increasing service to this sector, where industry trends dictate increasing lawyer involvement.

## Endnotes

1. Assumption reinsurance constitutes a novation of a single or, more commonly, several reinsurance or insurance contracts. Referenced in property/casualty reinsurance as portfolio transfer, this means that Reinsurer 2 takes the place of Reinsurer 1 with respect to the entirety of the specified reinsurance contract. See, e.g. Reinsurance Contract Wording at p. 772 (Robert Strain, ed. 1998). It can also mean that Insurer 2 takes the place of Insurer 1 with respect to obligations owed insureds. The NAIC Assumption Reinsurance Model Act explicitly applies only to the situation where the risks of insurance contracts with consumers are transferred from one insurer to another. See NAIC Model Laws, Regulations and Guidelines (Vol. V, current as of 2013) at p. 803-1.

2. American Council of Life Insurers 2013 Statistics. The author expresses her sincere appreciation to the ACLI's Carolyn Cobb and Jiangmei Wang who graciously provided this information.

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3. Top life reinsurers were identified by the ACLI based on 2013 assumed reinsurance premium volume. Notable are the facts that, from 2011 to 2013, Prudential went from second on the list to first, Swiss Re America escalated from eighth to sixth and Berkshire Hathaway ascended from ninth to seventh. AEGON USA, which had been ranked at tenth, merged with SCOR and together the companies became the eighth largest life reinsurer.
4. Carve-out business litigation has plagued the life reinsurance industry since the late 1990s, so it is this author's view that this mechanism is used much less frequently than in past years.
5. See Federal Accounting Standard 60-Accounting for (Tradition Business in) Stock Companies and Federal Accounting Standard 97- Accounting for Limited Payment, Universal Life- Type and Investment Contracts.
6. Thomas G. Kabele, "Life Reinsurance" in Reinsurance, p. 717 (R. W. Strain, ed. 1997).
7. John E. Tiller, Jr. and Denise Fagerberg Tiller, Life, Health & Annuity Reinsurance at pp. 204-05 (3d ed. 2005).
8. NAIC Model Laws, Regulations and Guidelines, (Volume 5, 2004; current as of 2013) at pp. 791-1; 791-12. Certain reinsurance agreements such as yearly renewable term, catastrophe and stop loss are exempt from the ambit of the regulation.
9. John E. Tiller, Jr. & Denise Fagerberg Tiller, Life, Health & Annuity Reinsurance at p. 72 (3d ed. 2005). In health YRT treaties, morbidity risk is passed.
10. Tiller at 90.
11. Jack R. Scott, "Life Reinsurance" in Reinsurance Contract Wording at p. 573 (R.W. Strain ed., 1998).
12. [\*Christiana General Ins. Co. vs. Great American Ins. Co.\* 979 F.2d 268, 280 \(2nd Cir. 1992\)](#); [\*Aetna Cas. And Sur. Co. v. Home Ins. Co.\*, 882 F. Supp. 1328, 1350 \(S.D.N.Y., 1995\)](#); but cf. [\*Michigan Millers Mutual Ins. Co. v. North American Reinsurance Corp.\* 182 Mich. App. 410, 418, 452 N.W. 2d 841 \(1990\)](#).
13. See [\*United States v. Brennan\* 183 F.3rd 139 \(2nd Cir., 1999\)](#); [\*Unigard Security Ins. Co. v. North River Ins. Co.\*, 4 F.3rd 1049, 1066 \(2nd Cir. 1993\)](#).
14. See *Oklahoma ex. rel. Crawford v. Guardian Life Ins. Co. of America*. 1997 Ok 10, 954 P.2d 1235 (1998)
15. NAIC Model Laws, Regulations and Guidelines (Vol. V, as amended effective 2013) at p. 785-1 - 785-8.
16. Id. at 790-1 and Vol. II at 290-1.

[Editor's Note: **Susan E. Mack**, an attorney, enjoys the distinction of having served as a senior executive and general counsel for both property/casualty and life/health insurers and reinsurers. One of the founding directors of the ARIAS-US organization, she is certified by that organization as an umpire and arbitrator. A frequent speaker at insurance-related seminars hosted by the American Bar Association and insurance trade associations, she also acts as an insurance/reinsurance expert witness and consultant. The views expressed in this article are the views of the author and not the views of any of her clients. Copyright (C) 2015 by **Susan E. Mack**. Responses are welcome.]

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