

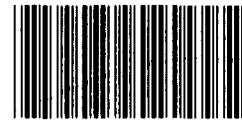
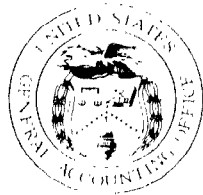
**GAO**

Report to the Chairman, Subcommittee  
on Oversight and Investigations,  
Committee on Energy and Commerce,  
House of Representatives

May 1990

# INSURANCE REGULATION

## State Reinsurance Oversight Increased, but Problems Remain



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United States  
General Accounting Office  
Washington, D.C. 20548

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**General Government Division**

B-233704

May 4, 1990

The Honorable John D. Dingell  
Chairman, Subcommittee on Oversight  
and Investigations  
Committee on Energy and Commerce  
House of Representatives

Dear Mr. Chairman:

In response to your request, this report provides information on the practice and regulation of property/casualty reinsurance. Specifically, the report discusses the types and limitations of data available to regulators in assessing reinsurance activity. The report also discusses the extent of state reinsurance regulation and recent regulatory improvements.

We are sending copies of this report to other appropriate congressional committees and the President, National Association of Insurance Commissioners. Copies will also be made available to other interested parties upon request.

Major contributors to this report are listed in appendix V. Please contact me on 275-8678 if you or your staff have any questions concerning this report.

Sincerely yours,

A handwritten signature in black ink, appearing to read 'Craig A. Simmons'.

Craig A. Simmons  
Director, Financial Institutions  
and Markets Issues

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# Executive Summary

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## Purpose

Transit Casualty Company and Mission Insurance Company, the two largest insurance insolvencies in U.S. insurance history, failed partly due to uncollectible reinsurance from their reinsurers. In addition, Mission's inability to meet its obligations as a reinsurer was a contributing factor in the insolvency of Integrity Insurance Company, the third largest insolvency. Many in the property/casualty industry agree that uncollectible reinsurance may be a significant problem.

Congress has been concerned about the public effect of insurer insolvencies and the ability of the state regulatory system to prevent future failures. The Chairman of the Subcommittee on Oversight and Investigations of the House Committee on Energy and Commerce requested that GAO review the types and limitations of data available to state regulators in assessing reinsurance activity and potential problems. The Chairman also requested that GAO report on the extent of state reinsurance regulation and recent regulatory improvements.

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## Background

Like other businesses, property/casualty insurance companies purchase insurance, for among other reasons, to spread their risks and limit their exposure to large or catastrophic losses. Reinsurance is a form of insurance for an insurance company. Under a reinsurance contract, the primary insurer transfers or "cedes" to another insurer (the "reinsurer") all or part of the financial risk of loss accepted in issuing insurance policies to the public. The reinsurer, for a premium, agrees to indemnify or reimburse the ceding company for all or part of the losses the latter may sustain from claims it receives.

Reinsurance may be obtained from professional reinsurers (insurers that specialize in assuming reinsurance), reinsurance departments of primary companies, reinsurance pools, and foreign reinsurers. Reinsurance represents about 10 percent of the total premiums written by the property/casualty industry. In 1988, domestic reinsurers accounted for over 61 percent of reinsurance written, and foreign reinsurers accounted for nearly 39 percent.

The regulation of reinsurance, like primary insurance regulation, is done entirely by the states. The National Association of Insurance Commissioners, an organization composed of the heads of the insurance departments of the 50 states, the District of Columbia, and four U.S. territories, encourages uniformity and cooperation among the various states and territories as they individually regulate the property/casualty industry.

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## Results in Brief

Reinsurance can have a substantial effect on the financial condition of an insurance company. However, annual financial data reported by property/casualty insurers may have limited the ability of state regulators to assess the effect of reinsurance on the financial condition of reinsurance participants.

An individual state has no direct authority to regulate reinsurers in other states or countries who are not licensed in that state. Instead, each state emphasizes regulation of ceding insurers and reinsurers within its jurisdiction. In 1984, the Association developed a model law with minimum standards to encourage uniform reinsurance regulation. The model law was amended in 1989 to increase the standards. Although some states have adopted the model law, others have not followed the Association's guidance.

The Association also has increased reinsurance reporting requirements for the annual financial statement that insurers file with state regulators. Once they are fully implemented, these requirements will allow state regulators to better assess the impact of reinsurance on the financial condition of property/casualty insurers. In particular, new reporting requirements will quantify overdue reinsurance and should enable regulators to better detect potential problems with uncollectible reinsurance.

However, since the states have not yet adopted the amended model law and the financial reporting requirements, while applicable to all states, have not been fully implemented, GAO could not determine whether the regulatory changes will prove effective, how consistently they will be implemented across the states, and whether additional regulatory initiatives will be necessary. Thus, continued congressional oversight of this situation is appropriate.

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## GAO's Analysis

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### Reinsurance Data Limitations Affect Regulatory Review

The annual financial statement, filed in accordance with statutory accounting principles, is the primary financial report used by state insurance regulators to evaluate the financial condition of property/casualty insurers and reinsurers.

Availability of reinsurance financial data reported to regulators varies by the type of reinsurer. Professional reinsurers file the same financial

statements with the Association and state regulators as do other insurers. However, primary insurers assuming reinsurance combine primary insurance and reinsurance financial data in their annual statements. These aggregate data have not been detailed enough to reflect reinsurance activity and its impact on an insurer's financial condition. Unlicensed foreign reinsurers do not file comparable financial statements with state regulators. (See pp. 4 to 5.)

Certain reinsurance arrangements that are legitimate practices within the industry may be subject to conflicts of interest and potential abuse. For example, intermediaries receive commissions for arranging reinsurance between ceding companies and reinsurers. To generate more commissions, an intermediary may place business with reinsurers of questionable financial condition. Other practices, such as reinsurance transactions between affiliates, may obscure an insurer's financial condition. However, reinsurance practices cannot be determined readily, if at all, from annual financial data. (See pp. 15 to 21.)

Inadequate internal controls may impair the accuracy and reliability of the financial data reported to regulators. For example, due to inadequate recordkeeping, Transit Casualty Company's 1983 annual statement listed 450 reinsurers, but the receiver for the insurer identified business with 1,700 reinsurers. Annual financial statements provided by insurance companies are used by most states without verification. (See pp. 22 to 23.)

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## Reinsurance Regulation and Improvements

The primary goal of reinsurance regulation is to ensure that reinsurers are able to meet their obligations for losses paid by ceding companies. Like a primary insurer, a reinsurer licensed in a state is subject to that state's solvency requirements. These requirements (e.g., minimum capital levels) vary among the states. However, unlike a primary insurer, a reinsurer does not have to be licensed in each state in which it operates. An individual state is unable to directly impose its solvency standards on reinsurers in other states or countries.

Instead, each state may have statutory or regulatory requirements that limit licensed insurers from taking financial credit for reinsurance transactions with reinsurers not licensed in that state. To encourage uniformity in state regulation, the Association promulgated a model law with minimum standards for granting credit for reinsurance. For example, the model law, as amended in 1989, does not allow credit for amounts ceded to a reinsurer not licensed in a state and with less than \$20 million

in surplus. However, as of 1989, 40 states had not adopted the Association's guidance. (See pp. 24 to 29.)

In part due to several reinsurance-related insolvencies, the Association also has increased disclosure and reporting requirements for reinsurance activity. Since every state has adopted the Association's annual financial statement, reporting changes apply to all states. Improved financial data will enable state regulators to better assess reinsurance activity and its impact on an insurer's financial condition. For example, effective in 1990 for the 1989 reporting year, ceding companies now must disclose overdue amounts recoverable from reinsurers. This new reporting requirement will enable regulators to quantify the extent of overdue reinsurance and identify slow-paying reinsurers. Also, a new measure requires ceding companies to write off 20 percent of amounts overdue more than 90 days. (See pp. 29 to 33.)

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### Matters for Congressional Consideration

While regulatory controls over reinsurance have increased, some controls have not yet been fully implemented by the Association and the states, and many states have not yet adopted other controls. Thus, Congress should continue its oversight of state efforts. Congress could do so by focusing on the effectiveness of recent reforms and the extent to which changes are implemented across the states.

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### Regulator and Industry Comments

GAO provided copies of a draft of this report to the National Association of Insurance Commissioners for formal review and comment. In general, the Association noted that the report was well balanced, but the Association also provided comments designed to correct and clarify certain statements. (The Association's comments and GAO's responses are contained in app. IV.) GAO provided a copy of the report to the Reinsurance Association of America for informal comment. The Reinsurance Association commented that the report was thorough, and it provided technical corrections to the report that were incorporated where appropriate.

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**Abbreviations**

AICPA	American Institute for Certified Public Accountants
NAIC	National Association of Insurance Commissioners
RAA	Reinsurance Association of America



# Introduction

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In the two largest insolvencies in U.S. insurance history, Mission Insurance Company and Transit Casualty Company failed, partly due to their inability to collect significant amounts of reinsurance from their reinsurers. Many of their reinsurers alleged fraud and misrepresentation on the part of the ceding insurers as legal justification for not paying. In addition, Mission's failure to pay its obligations on reinsurance assumed from ceding companies, in turn, was a contributing factor in the insolvency of Integrity Insurance Company, the third largest insolvency. While the total amount of uncollectible reinsurance is not known, many in the industry and their regulators agree that the problem is significant. At least one industry analyst estimated that \$10 to \$20 billion, or 8 to 17 percent of the net worth of the property/casualty industry in 1988, may ultimately be uncollectible.

In the fall of 1988 and the spring of 1989, the Subcommittee on Oversight and Investigations of the House Committee on Energy and Commerce held a series of investigative hearings into the causes of the insolvencies of Mission Insurance Company, Integrity Insurance Company, Transit Casualty Company, and Anglo-American Insurance Company. According to the companies' liquidators, the total losses associated with these insolvencies are estimated to be nearly \$4 billion. In April 1989, we testified about the similarities between those insolvencies and the savings and loan association failures.<sup>1</sup> In its report based on the hearings, the Subcommittee found that reinsurance abuse was a key factor in every insolvency it studied.<sup>2</sup>

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## Reinsurance Basics

Insurance companies, as do other businesses, purchase insurance to spread their risks and limit liabilities from large or catastrophic losses. Reinsurance is a form of insurance for an insurance company. Under a reinsurance contract, the primary insurer transfers or "cedes" to another insurer (the "reinsurer") all or part of the financial risk of loss for claims incurred under insurance policies sold to the public. The reinsurer, for a premium, agrees to indemnify or reimburse the ceding company for all or part of the loss that the latter may sustain from claims.

Reinsurers may, in turn, transfer or "retrocede" some of the risk they assume under reinsurance contracts. This form of reinsurance is known

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<sup>1</sup>Property and Casualty Insurance: Thrift Failures Provide Valuable Lessons (GAO/T-AFMD-89-7, Apr. 19, 1989).

<sup>2</sup>Failed Promises: Insurance Company Insolvencies. Subcommittee on Oversight and Investigations of the Committee on Energy and Commerce, U.S. House of Representatives (Feb. 1990).

as "retrocession," and the reinsurer of reinsurance is known as the "retrocessionaire." Since retrocessions are simply reinsurance for reinsurers, they will not be discussed separately.

One of the basic functions of reinsurance is to spread the risk of losses throughout the property/casualty industry and increase the amount of coverage insurers can provide. Through reinsurance an insurer can share its risk with another insurer or insurers and limit its losses on claims sustained under policies issued. An insurance company generally limits the amount of insurance coverage it is willing to underwrite relative to its policyholders' surplus. Policyholders' surplus, the difference between an insurer's assets and liabilities, is an insurance accounting term equivalent to owners' or stockholders' equity. The surplus represents a safety cushion for policyholders in the event an insurer suffers adverse results. Through reinsurance, an insurer can reduce its loss reserves by the amount transferred to the reinsurer and, as a result, increase its capacity to write more business. A more extensive discussion of the uses and types of reinsurance is presented in appendix I.

Reinsurance does not change the nature of an insured risk, nor does it diminish the obligation of the primary insurer to pay policyholder claims. Only after loss claims have been paid may the primary company seek reimbursement from a reinsurer for its share of paid losses. With limited exceptions, a reinsurer has no direct relationship or responsibility to policyholders.

Property/casualty insurers operating in the United States may obtain reinsurance from insurance companies that specialize in assuming reinsurance, referred to as professional reinsurers; reinsurance departments of primary insurers; and foreign reinsurers.<sup>3</sup> Generally, any primary insurer may assume reinsurance for those lines of business in which it is licensed. Reinsurance is also available from pools, which are groups of insurers organized to jointly underwrite reinsurance.

The exact number of reinsurers is indeterminable. According to industry experts, participation in the U.S. reinsurance market fluctuates as companies enter and leave the business. The Reinsurance Association of America estimates that reinsurance premiums average about 10 percent

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<sup>3</sup>Throughout the report, the term "foreign" reinsurer is used to refer to a reinsurer incorporated under the laws of a foreign country. In the industry, a reinsurer domiciled in another country is technically known as an "alien" reinsurer. A U.S. insurer or reinsurer is considered a foreign reinsurer in every state except its state of domicile.

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of total U.S. property/casualty premium volume. In 1988, the reinsurance market was estimated at \$21.8 billion.<sup>4</sup> Professional reinsurers accounted for \$11.1 billion, or nearly 51 percent of those premiums, and reinsurance departments of primary insurers assumed \$2.3 billion, or 10.4 percent. Preliminary data indicated that \$8.4 billion, or 38.6 percent, was ceded to foreign reinsurers. Appendix II presents other data on the U.S. reinsurance market, including statistics on the underwriting experience of reinsurers as obtained from publicly available data compilations.

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## Reinsurance Regulation

The regulation of reinsurance, as with primary insurance, is the responsibility of the individual states. State insurance regulators have established a central structure, the National Association of Insurance Commissioners (NAIC), to coordinate their activities. NAIC consists of the heads of the insurance departments of the 50 states, the District of Columbia, and 4 U.S. territories. NAIC's basic purpose is to encourage uniformity and cooperation among the states and territories as they individually regulate the insurance industry.

Through its committees and a central staff, NAIC serves as a clearinghouse for legal and regulatory information, provides information on and financial analyses of insurance companies, and coordinates multistate financial examinations of insurance companies. NAIC promulgates model insurance laws and regulations for state consideration. NAIC also determines the format for the annual financial statement that insurers and reinsurers are required to file with state insurance departments. Each state has adopted the NAIC annual statement as the official report, and revisions to NAIC data reporting requirements apply to all states. According to NAIC, state variations from the NAIC annual statement itself are rare, though additional data or supplementary reporting may be required to meet each state's statutory requirements.

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## Objectives, Scope, and Methodology

Congressional interest in reinsurance has focused on the role of reinsurance in the solvency problems of the property/casualty insurance industry. As a result, the Chairman of the Subcommittee on Oversight and Investigations of the House Committee on Energy and Commerce requested that we (1) review the data available to regulators to use in assessing reinsurance activity, including the determination of an

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<sup>4</sup>National Underwriter, Property/casualty edition, June 19, 1989. Data on foreign reinsurers were based on information provided by the Bureau of Economic Analysis of the Department of Commerce.

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insurer's financial health, and potential problems; and (2) report on the extent to which reinsurance is regulated, including a discussion of state efforts to improve reinsurance regulation.

The objectives of our review of reinsurance practices and regulations were to (1) provide basic information on the function and uses of reinsurance; (2) identify data on reinsurance activity, including the types and limitations of information reported to regulators; (3) determine how the states regulate reinsurance; and (4) provide insight into current issues in reinsurance regulation and the status of regulatory improvements.

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## Reinsurance Practices and Regulation

We obtained basic information about reinsurance practices and regulation from published material and through interviews. We reviewed relevant articles in industry trade journals and periodicals, the proceedings of congressional hearings, and other reports and reinsurance literature. We interviewed officials of NAIC, state insurance departments, reinsurance companies, the Reinsurance Association of America (RAA) trade association, and others knowledgeable about the reinsurance business. We also attended industry and regulatory conferences.

We reviewed the NAIC model legislation and laws of some states relating to reinsurance regulation. We did not evaluate the NAIC model laws to determine their appropriateness or completeness. We also did not assess the extent that reinsurance laws in each state conform with the NAIC models.

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## Reinsurance Data

We obtained data on reinsurers and reinsurance activity in the United States from the following sources:

- Best's Aggregates and Averages, published by A.M. Best Company, a statistical and publishing organization, reports financial statistics and premium and loss data for approximately 130 reinsurers. Industry aggregates are tabulated from the A.M. Best database of annual financial statements filed with NAIC and state regulators.
- Reinsurance Underwriting Review, published by RAA, reports annual premium and loss data for domestic reinsurers and reinsurance departments of primary insurers. RAA collects information through a voluntary survey of major reinsurers licensed in the United States. According to RAA, its survey represents approximately 90 percent of the premiums written by professional reinsurers.

- National Underwriter, a national publication on property/casualty insurance and risks and benefits management, publishes an annual analysis of the United States reinsurance market. Based on a survey by the Standard and Poor's Insurance Rating Services, this compilation includes underwriting and loss data for domestic reinsurers and reinsurance departments of primary insurers.
- Annual Survey of Reinsurance and Other Insurance Transactions by U.S. Insurance Companies With Foreign Persons is compiled by the Bureau of Economic Analysis of the Department of Commerce. In 1987 and 1988, Commerce surveyed about 1,600 U.S. insurers and reinsurers to collect premium and loss data for reinsurance ceded to and assumed from other countries. Commerce received responses from approximately 350 insurers and reinsurers that met its \$1 million reporting threshold.

We also obtained estimates of current and forecasted reinsurance recoverable, or the funds due to ceding companies from reinsurers. Estimates were compiled by the A.M. Best Company, Standard and Poor's Insurance Rating Services, and the Insurance Services Office, a nonprofit statistical organization that provides rating, actuarial, and policy services for property/casualty insurance companies. We did not test the adequacy or accuracy of the data obtained from these sources.

In an effort to develop independent estimates of the number of reinsurers, the volume of reinsurance transactions in the United States, and the amounts recoverable from reinsurers, we analyzed computerized data from NAIC for the years from 1984 to 1987. The tapes included financial data for all U.S.-domiciled property/casualty insurance companies and foreign insurers licensed in the United States that filed annual financial statements with state insurance regulators and NAIC. Annual statements are the official financial statements of property/casualty insurance companies for regulatory purposes. However, as of 1989, 35 states did not require independent verification by a certified public accountant of annual financial statements for insurance companies. We did not audit the annual financial statements filed by property/casualty insurers or assess the overall reliability of NAIC's computer-generated information.

We provided copies of a draft of this report to NAIC for formal review and comment. In its comments, NAIC noted that the report was well balanced. Nevertheless, NAIC provided a number of comments designed to correct or clarify statements in the draft report. NAIC's comments and our responses are presented in appendix IV. We also obtained informal comments from RAA. While commenting that the report was thorough,

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RAA provided technical corrections to the report, which we incorporated where appropriate.

We did our work from May 1988 to January 1990 in accordance with generally accepted government auditing standards.

# Problems in Assessing Reinsurance

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In the past, reinsurance problems may have been difficult to anticipate due to limited data available to assess the effect of reinsurance on a company's financial condition and to identify potential problems. As discussed in chapter 1, reinsurance serves a variety of legitimate business purposes. However, misuse of the reinsurance mechanism also may obscure an insurer's true financial condition or be used to avoid licensing requirements and regulatory oversight. Certain reinsurance practices may be susceptible to conflicts of interest and possible abuse. Reinsurance transactions have been cited as contributing to several recent insolvencies.

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## Reinsurance Data Limitations

Property/casualty insurance companies are required to file annual financial statements prepared in accordance with statutory accounting principles with state regulators. The format of the annual statement and the rules to be followed in preparing it are prescribed by NAIC. While NAIC has codified statutory accounting principles, any state can adopt or permit accounting practices that differ from those prescribed by NAIC. The annual financial statement provides information about a company's assets and liabilities as well as data on premiums, losses, expenses, and disclosure of reinsurance arrangements. The annual statement is the primary financial report used by state insurance regulators to evaluate the financial condition of property/casualty insurers and reinsurers. Key financial data from the annual statements are included in NAIC's computerized database. NAIC and state regulators use the database primarily to analyze the financial condition of insurance companies.

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## No Data Available for Some Reinsurers

Availability of financial data on reinsurance reported to regulators varies by the type of reinsurer. Like primary insurers, professional reinsurers file annual financial statements with regulators in the states where they are licensed. According to an NAIC study of financial data, the reinsurance activity of primary insurers operating reinsurance departments and reinsurance pools cannot be separately determined by reviewing aggregate data reported in annual financial statements. Further, unlicensed foreign reinsurers do not file comparable annual financial statements with state regulators, since they are not subject to U.S. regulatory jurisdiction and filing requirements.

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## Reinsurance Activity Not Discernible From Aggregate Financial Data

Aggregate data reported by property/casualty insurers have not always included information necessary for regulators to assess reinsurance activity or its impact on an insurer's financial condition. According to the Chief of the Financial Analysis Division of the California Insurance Department, aggregate data reported by Mission Insurance Company may have masked its true financial condition. Reinsurance transactions could either mask or distort an insurer's loss experience because loss data have been reported net of reinsurance ceded to other insurers. Also, before the 1989 annual statement, premium and loss data for reinsurance assumed were combined with primary insurance data.

Aggregate data reported before 1988 also may not have indicated what type of business a reinsurer assumed. Premium and loss data are supposed to be reported by line of business, such as auto liability, homeowner's insurance, and workers' compensation. Such information is necessary for regulators to assess the adequacy of loss reserves for paying policyholder claims. However, a line-by-line breakdown of premiums and losses has not always been available for reinsurance activity, since reinsurance agreements generally cover multiple lines. While some reinsurers attempt to estimate premium and loss amounts by line, others combined all amounts assumed into a catchall reinsurance line.

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## Reinsurance Practices May Be Subject to Abuse but Are Not Discernible From Financial Data

Certain reinsurance arrangements are common practices in the property/casualty industry and not necessarily detrimental per se, but they may be subject to conflicts of interest and potential abuse.<sup>1</sup> For example, a reinsurance intermediary, in an effort to generate commissions, may place business with reinsurers of questionable financial condition, contrary to the interest of the ceding company. Other practices, such as reinsurance transactions between affiliated companies, can obscure an insurer's financial condition. Also, a reinsurer may use a licensed insurer as a "front" to avoid regulatory oversight. On the basis of its investigation into the causes of the Mission, Integrity, Transit, and Anglo-American insolvencies, the Subcommittee on Oversight and Investigations of the House Committee on Energy and Commerce found that abuse of reinsurance arrangements contributed to those failures.

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<sup>1</sup> A conflict of interest is a situation in which a person or business serving more than one interest can benefit by favoring one interest at the expense of another. Potential conflicts exist during the normal course of many business operations, including insurance and reinsurance. An abuse of a conflict situation occurs when an insurance company or its representative takes an action favoring one interest at the expense of another in violation of customary industry practices, fiduciary responsibilities, or insurance laws and regulations.



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In September 1989, we reported that insurance regulators rely primarily on annual financial statements to detect insurer solvency problems.<sup>2</sup> However, reinsurance practices, such as the use of reinsurance intermediaries, cannot be determined readily, if at all, from the annual financial statement. Since reinsurance can have a significant effect on insurer solvency, NAIC and the states target reinsurance for special attention during field examinations. On-site examination procedures have been developed to review reinsurance practices and attempt to detect abuses. However, as we reported in September 1989, most states require field examinations only once every 3 to 5 years. Some states may examine companies on a priority basis, and a domiciliary state must respond when one of its insurance companies is targeted for regulatory attention under NAIC's Insurance Regulatory Information System. While a state may examine troubled insurers more frequently, this requirement does not help in initial problem detection. Given the lengthy intervals between most examinations, regulators face a time lag in detecting questionable transactions and potential problems.

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## Reinsurance Between Affiliated Companies

A group of affiliated insurance companies may use reinsurance as a mechanism to diversify the portfolios of individual companies and to allocate premiums, assets, liabilities, and surplus among affiliates. Intercompany pooling, where each company reinsures a fixed proportion of all business written by pool members, is a standard practice among companies under common management. From an economic standpoint, reinsurance transactions between affiliated insurance companies do not reduce risk for the group but instead shift risk among affiliates.

Each individual insurance company must satisfy state solvency requirements regardless of the consolidated performance of the group. Reinsurance ceded to affiliates may significantly affect the financial condition of an individual insurer. A.M. Best estimated that interaffiliate reinsurance, including intercompany pooling, accounted for 75 percent of total reinsurance premiums in 1988. Before 1988, individual insurers were not required to report reinsurance premiums ceded to or assumed from affiliates separately from other premium data. Insurers have reported amounts recoverable on reinsurance ceded to each affiliate with an aggregate of amounts recoverable from all affiliates. Similarly, insurers also list reinsurance assumed from each affiliate with an aggregate of amounts payable to all affiliates.

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<sup>2</sup>Insurance Regulation: Problems in the State Monitoring of Property/Casualty Insurer Solvency (GAO/GGD-89-129, Sept. 1989).

For the group as a whole, reinsurance transactions between affiliates cancel out and are eliminated when reported on a consolidated basis. Although consolidated statements are useful in evaluating the overall financial condition of a group, not every state requires groups of affiliated companies to file such statements, and some states do not require consolidated statements to be filed with NAIC. We found that out of over 400 insurance groups with property/casualty insurance units, 211 filed consolidated annual financial statements with NAIC in 1987.

Reinsurance between affiliated companies presents opportunities for manipulation and potential abuse. In a group of affiliated insurers, intercompany reinsurance may serve to obscure one insurer's financial condition by shifting loss reserves from one affiliate to another. Improper support or subsidy of one affiliate at the expense of another may adversely affect the financial condition of one or more companies within the group. In hearings before the Subcommittee on Oversight and Investigations of the House Committee on Energy and Commerce, the Special Deputy Insurance Commissioner of the Louisiana Insurance Department testified that reinsurance transactions with foreign affiliates caused the insolvency of Anglo-American Insurance Company.

Because of the close relationship that may exist among affiliates or insurers under common control, most states have statutory guidelines for transactions among affiliated companies. Holding company provisions usually require annual registration of each company's organization and disclosure to regulators of material transactions between affiliates and an insurer at the time the transactions occur. The statutes also establish standards of fairness and reasonableness that interaffiliate transactions must meet. Some states require 30 days' notification for material reinsurance transactions between affiliates to enable regulators to evaluate the effect of a transaction before it occurs.

Additionally, insurance regulators target interaffiliate reinsurance transactions for special audit attention. According to NAIC's Financial Condition Examiners Handbook, examiners are supposed to check reinsurance transactions between affiliates for evidence of improper support or subsidy favoring one affiliate at the expense of another. For example, an affiliate reinsurer may receive exorbitant premiums, or an affiliated ceding company may receive excessive commissions. In the case of Anglo-American, insurance examiners detected that premiums were received by an affiliate although Anglo-American had no reinsurance agreement with that affiliate. Where interaffiliate reinsurance

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transactions are substantial relative to policyholders' surplus, regulators may examine affiliated insurers simultaneously.

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## Fronting Arrangements

Fronting is the practice in which an insurer issues policies with an agreement in hand to cede all or most of the risk to a reinsurer in exchange for a fee. For example, some reinsurers assume 100 percent of particular insurance risks, such as contact lenses or rental equipment. A ceding company may front its entire book of business or may front only certain insurance lines or particular risks. Financial statement data may not indicate the extent to which reinsurance is used for fronting purposes.

Like any ceding company, the front company remains liable for paying any claims before seeking reimbursement from the reinsurer. The original insurer faces large potential losses in the event that its reinsurer refutes coverage or fails to pay. The fronting company may be unable to pay policyholder claims and, therefore, face insolvency. According to the liquidators for Integrity Insurance Company and Transit Casualty Company, fronting arrangements contributed to those insolvencies. Both companies acted as fronts with the impression that they faced little or no risk of loss on reinsured business. However, when their reinsurers refused to pay losses, these companies remained liable for all losses on the reinsured business.

Fronting also can be subject to potential abuse by either the ceding company or the reinsurer. For example, where fronting commissions received by the ceding company from the reinsurer exceed the ceding company's costs of selling policies to the public, the insurer has incentive to write additional business to generate commissions and profits. An insurer may underwrite poor risks at underpriced rates because it believes it will not have to pay all the resulting losses. In fact, the ceding company may not have adequate details about the business being written by its representatives to assess its potential losses.

While few states expressly prohibit fronting, this practice may be used to circumvent state licensing requirements and thus avoid regulatory oversight. Although an insurance company must first be licensed in a state to sell insurance directly to the public, a reinsurer may assume

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reinsurance without a license in that state.<sup>3</sup> Through a fronting arrangement, a company not licensed in a state may reinsure all or nearly all of the liabilities for policies that it cannot directly write.

Some states require prior approval before an insurer reinsures all or substantially all of its business. A handful of states prohibit an insurer from acting as a front for an insurer or reinsurer not licensed in their states. Under Florida law, fronting occurs if an insurer transfers too much risk of loss to an insurer not licensed in the state nor approved as a reinsurer.<sup>4</sup> The law prohibits an insurer from transferring 50 percent or more of risk to one unauthorized company or 75 percent or more to two or more unauthorized companies without prior approval of the Florida Insurance Department.

NAIC has identified fronting as a factor in some financially troubled insurance companies. According to NAIC's Financial Condition Examiners Handbook, examiners are supposed to review the legality of fronting arrangements and determine whether regulatory approval is necessary. Where an insurer is fronting, examiners are supposed to investigate the ceding company's internal control system to determine whether the insurer has information available to assess its potential losses. According to Transit's liquidator, the insurer did not know the number of policies that had been written or the amount of premium income that had been written, paid, or collected on business fronted to reinsurers.

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## Reinsurance Intermediaries

While some major professional reinsurers are direct marketers, intermediaries (brokers, managers, or managing general agents) may arrange reinsurance agreements between a ceding company and a reinsurer in exchange for commissions and fees. A reinsurance broker negotiates agreements for a ceding company but does not have the authority to bind the insurer to a reinsurance agreement. On the other hand, a reinsurance manager acts as the agent for a reinsurer and has the authority to bind a reinsurer to an agreement. Finally, a managing general agent may have authority both to underwrite primary insurance and to bind reinsurance agreements on that business for the ceding company.

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<sup>3</sup>A reinsurer domiciled in the United States would be licensed in at least the state of domicile.

<sup>4</sup>The limit on risk transfer applies on all insurance written in the state, on any lines of insurance, on insurance written by any particular agent, or on insurance from a particular geographical area.

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An intermediary, either a broker, manager, or managing general agent, has an incentive to place reinsurance with sound reinsurers when its commission is tied to the success of the business being reinsured. However, when commissions are based on volume of business, reinsurance placed through an intermediary may be subject to conflicts of interest and potential abuse. To generate more income, a managing general agent may cede business to reinsurers who later are unable or unwilling to pay losses, or a reinsurance manager may assume poor, underpriced risks. On the basis of its hearings, the Subcommittee found that conflicts of interest were an inherent problem with managing general agents. The intermediary bears no financial risk in the event of underpriced or poor underwriting or placement with a troubled reinsurer. But poor performance by an intermediary can affect both ceding companies and reinsurers.

Reinsurance transactions arranged by intermediaries affiliated with either the ceding company or the reinsurer are particularly susceptible to conflicts of interest and potential abuse. For example, a managing general agent for Transit Casualty Company ceded reinsurance to foreign reinsurers allegedly affiliated with the agent. To generate more commission, the managing general agent had Transit, acting as a retrocessionaire, reinsure its own direct business.

Even in the case of managing general agents who have authority to enter binding agreements on behalf of insurance companies, intermediaries generally are not licensed and not subject to state insurance department supervision. However, NAIC has identified the use of intermediaries as a potential factor in financially troubled companies. The use of reinsurance intermediaries is not disclosed in an insurer's financial statement. When transactions through intermediaries are substantial or an intermediary has underwriting authority, examiners are supposed to investigate the insurer's internal controls over the reporting and accounts of the intermediary. Also, examiners are supposed to determine whether the intermediary or its directors, officers, or managers have any conflicts of interest that could affect the financial condition of the ceding company.

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## Retrocession Chain

The chain of reinsurance does not end once a primary insurer cedes business to a reinsurer. Since a reinsurer purchases reinsurance for the same reasons as a primary insurer, the reinsurer may, in turn, retrocede a portion of its business to another reinsurer and so on. Moreover, an

insurer may reinsure business written by its reinsurers. Since each ceding company may rely on many reinsurance agreements with multiple reinsurers participating in each agreement, retrocessions further complicate assessing how reinsurance affects an insurer's financial condition.

Retrocessions serve to spread the risk of loss throughout the U.S. property/casualty industry and worldwide. While shifting the loss exposure among individual insurers, reinsurance does not reduce the overall liability for policies sold to the public. However, according to NAIC, as each party deducts its commissions and fees from the premiums, the costs of extra layers of retrocessions and intermediaries can reduce funds available to the ultimate assuming company to cover losses.

According to NAIC's Troubled Insurance Company Handbook, retrocessions by the apparent reinsurer may transfer risk to parties unknown to the original ceding company. However, financial data cannot be used to track the retrocession chain from the original ceding company to the ultimate reinsurers. The annual financial statement for an insurer identifies its reinsurers and the amounts recoverable on reinsurance. Similarly, reinsurers list their retrocessionaires on annual financial statements. Reinsurers and retrocessionaires also disclose their ceding companies and the amounts payable on reinsurance. Despite these disclosures in the annual statement, a ceding company cannot readily assess the identity or financial condition of each retrocessionaire from its reinsurers' financial statements.

While a ceding company remains liable for all claims filed by its policyholders before seeking reimbursement from its reinsurers, an insurer's continued solvency may be impaired if the reinsurance chain fails. In the Mission, Transit, and Integrity insolvencies, their reinsurers were unable to pay or refused to pay on the basis of allegations of fraud and misrepresentation on the part of the ceding insurers. Moreover, the insolvency of retrocessionaires can ripple through the reinsurance chain to affect the original ceding companies. For example, Mission's inability to collect from its retrocessionaires resulted in its failure to pay on reinsurance assumed from Integrity. Integrity, in turn, became insolvent and is unable to pay its reinsurance commitments to its ceding companies, including Mission.

## The Importance of Adequate Internal Controls Over Reinsurance

Given the complexity of reinsurance arrangements, any insurer either ceding or assuming reinsurance needs adequate internal controls to document and monitor its reinsurance activity. The American Institute of Certified Public Accountants (AICPA) emphasized the need for adequate internal controls over reinsurance transactions in a statement of position on the auditing of property and liability reinsurance.<sup>5</sup> According to AICPA, the internal control system for a ceding company should provide accurate and reliable information for reporting premium and loss data to reinsurers and for monitoring and following up on amounts recoverable. Also, a ceding company should have adequate procedures to assess the financial condition and stability of its reinsurers and their retrocessionaires. A reinsurer should have an adequate internal control system to assess the reliability and accuracy of information reported by ceding companies.

Such controls are particularly important for any insurer using a reinsurance intermediary or managing general agent. Both the reinsurer and the ceding company need adequate control systems to assess the reporting and accounts of their intermediary. According to AICPA, an insurance company should audit its intermediaries' internal control systems for reporting accurate, reliable data and safeguarding funds, such as premiums, commissions, or loss payments, held on behalf of the insurer.

Inadequate controls over reinsurance may impair the accuracy and reliability of financial data reported to regulators. According to the receiver for Transit Casualty Company, records were so inadequate that the extent of the company's reinsurance activities was not known. In 1983, Transit's annual financial statement listed 450 reinsurers, but the receiver has identified business placed with about 1,700 reinsurers. According to AICPA, an independent audit of an insurance company should include an assessment of internal controls over reinsurance. However, as we reported in September 1989, 35 states did not require independent verification by a certified public accountant of annual financial statements submitted to state insurance regulators.

Although the AICPA position statement has been incorporated into NAIC's Financial Condition Examiners Handbook, lengthy intervals between examinations and starting and completing examinations may delay detection of internal control deficiencies. For example, an examination report for the 3 years ending in 1981 disclosed minor concerns about Mission, but an examination in 1985 identified that Mission lost control

<sup>5</sup>AICPA Statement of Position "Auditing Property and Liability Reinsurance," Oct. 1982.

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of its reinsurance accounting function and recorded questionable transactions obscuring its financial condition. In another example, Transit's examination report for the 3 years ending in 1980 noted no serious problems, but an examination report for the 3 years ending in 1983, which was not issued until April 1985, revealed deficiencies in accounting and poor internal controls.

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## Conclusions

The format of reinsurance data reported in annual financial statements limited the ability of regulators to assess the financial condition of insurance companies. Certain reinsurance practices cannot be discerned readily, if at all, from aggregate data available to assess reinsurance activity. Moreover, some arrangements, while common practices within the industry, may be subject to conflicts of interest and potential abuse.

Any insurer participating in reinsurance needs adequate controls to manage its reinsurance arrangements. Inadequate management controls and abuse of reinsurance practices contributed to several recent insolvencies. To oversee reinsurance and detect potential problems, insurance regulators have targeted certain reinsurance practices for special examination attention. However, most states require examinations only once every 3 to 5 years. Improvements in reinsurance regulation and data reporting are discussed in chapter 3.



# States' Response to Reinsurance Problems

Because of several reinsurance-related insolvencies, insurance regulators have taken a number of steps to increase reporting and oversight of reinsurance arrangements. These regulatory reforms will allow regulators to better assess reinsurance activity and its impact on an insurer's financial condition. Also, in 1989, NAIC adopted financial standards designed to strengthen and provide consistency in the regulation of insurance and reinsurance. Unless each state adopts reforms and meets the new standards, the effectiveness of state-by-state regulation and solvency monitoring may be impeded.

One concern of state regulators has been that some insurers might not be as financially sound as their annual statements indicate. Before reforms, a company's financial condition could be masked by reinsurance that would never be collected. According to A.M. Best, reinsurance due, currently or in the future, on losses ceded to nonaffiliated reinsurers amounted to 54 percent of the property/casualty industry's surplus in 1988. However, one industry analyst estimated that as much as \$20 billion, or nearly 17 percent of the industry's surplus, may be uncollectible. To address this issue, regulators have changed the way insurers account for and report amounts recoverable on reinsurance and have developed techniques to identify companies with potential reinsurance collection problems.

## Overview of State Regulation

The financial solvency of an insurance company, that is, its ability to meet policyholder obligations, is a basic concern of state regulation of the insurance industry. Similarly, the regulation of reinsurance transactions centers on ensuring that reinsurers pay their obligations for reinsured business, thus protecting the solvency of the primary insurer. While regulatory approaches vary, state insurance departments use similar methods to assess the financial strength of the insurance and reinsurance companies under their jurisdiction. These include the following:

- Set minimum financial requirements, such as capital and surplus levels and investment restrictions. A company must meet these requirements to obtain a license and continue as a licensed insurer or reinsurer. These requirements vary among the states.
- Review annual financial statements that a company must submit to the insurance departments of those states in which it is licensed.
- Examine an insurer's financial condition periodically. State laws usually require an examination at least once every 3 to 5 years. NAIC coordinates multistate examinations for any company with a large volume of business in many states.

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## Credit for Reinsurance

A reinsurer licensed in a state is subject to the same regulatory oversight as a primary insurer. However, a reinsurer does not have to be licensed in every state in which it operates. As a result, regulators in an individual state cannot assess the financial condition of unlicensed foreign reinsurers<sup>1</sup> and, to some extent, reinsurers licensed in other states. Instead, regulators have focused on reinsurance transactions of ceding companies within a state's jurisdiction.

Most states have laws or regulations that restrict their ceding companies from taking financial statement credit for the amount of reinsurance ceded unless certain conditions are met. The credit for reinsurance is given to recognize that some portion of an insurer's losses are to be reimbursed by its reinsurers. When taking financial credit, a ceding insurer reports amounts currently recoverable from reinsurers on paid losses as an asset in its financial statement, and liabilities are reduced by the amount of unearned premiums and estimated future losses ceded to reinsurers.

Laws and regulations on granting reinsurance credit vary by state. The following is a brief discussion of the approach that has been recommended by NAIC. Under the NAIC model law on credit for reinsurance, an insurer may take full credit for reinsurance with an authorized reinsurer—a reinsurer licensed in the same state as the primary company or domiciled and licensed in another state having comparable or higher regulatory requirements. Credit may be allowed for reinsurance ceded to an unauthorized reinsurer—a reinsurer not licensed in any state or licensed in a state with lesser regulatory requirements. For the ceding company to qualify for credit, an unauthorized reinsurer must either (1) maintain in the United States a regulated trust fund of usually not less than \$20 million in excess of all U.S. liabilities or (2) post another acceptable form of security adequate to cover amounts payable to the ceding company.

Letters of credit have been the most common means of security used in the reinsurance market. As defined in the NAIC model law, a letter of credit must be (1) "clean," or unconditional; (2) "irrevocable," or such that it cannot be modified or revoked without the consent of the ceding company; (3) "evergreen," or automatically renewable each year unless the reinsurer provides 30-day notice of nonrenewal; and (4) issued by a qualified U.S. financial institution. Other acceptable forms of security

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<sup>1</sup>Some foreign insurers are licensed in the United States through U.S. branches. These companies are subject to state insurance regulation just the same as any domestic insurance company. However, a foreign insurer does not have to obtain a license and be subject to regulation in the United States to do business with domestic insurers and reinsurers.

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may include cash, securities approved by NAIC, or another type of security acceptable to the state insurance commissioner. Authorized reinsurers are not required to post security since they are subject to state solvency regulation.

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## Contract and Rate Regulation

Unlike primary insurance policies, reinsurance contracts and rates are to a large extent not directly regulated. Although reinsurance agreements are not standardized, regulators usually require certain clauses for a reinsurance arrangement to qualify for financial credit. The three standard clauses are (1) an insolvency clause, (2) a service of process clause, and (3) an intermediary clause.

An insolvency clause provides that in the event a ceding company becomes insolvent and is unable to pay its losses, the reinsurer is not relieved from its obligation for losses covered by the reinsurance agreement. Without the clause, reinsurers generally are obligated to indemnify, or reimburse, primary companies only for losses actually paid. The clause also provides that reinsurance amounts recoverable are payable to the insolvent insurer's successor, usually the state insurance commissioner.

A service of process clause requires an unauthorized reinsurer to (1) accept the jurisdiction of federal and state courts in the United States and (2) appoint an agent (the insurance commissioner or a law firm) as its attorney for the purpose of receiving service of process. This clause allows a ceding company to file suit in U.S. courts under U.S. laws rather than file suit in the reinsurer's country of domicile.

An intermediary clause is required when reinsurance is placed through intermediaries, including brokers, managers, and managing general agents. The intermediary is usually responsible for the flow of funds, including premium and loss payments, between the ceding company and the reinsurer. The clause provides that, for the transfer of funds, the intermediary is the agent of the reinsurer and, as such, the reinsurer must assume all risk on payments to the intermediary. Stated simply, any payments made by a ceding company to an intermediary are considered to have been made to the reinsurer. Conversely, a reinsurer's payments to an intermediary are not considered to have been made to the ceding company until the funds are transmitted to the ceding company by the intermediary.

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## Increased Regulatory Controls Over Reinsurance

Since 1984, the states, working through NAIC, have proposed model legislation to improve uniformity in reinsurance regulation and have required an increasing amount of information about reinsurance arrangements from both primary insurers and reinsurers. The primary emphasis of these efforts has been to improve the states' ability to assess the quality or collectibility of ceded reinsurance and its impact on an insurer's financial condition. Individual states also have taken or are considering taking actions to improve regulation of reinsurance.

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## Emphasis on Uniform Reinsurance Regulation

Because of varying state approaches to reinsurance regulation, NAIC adopted a model law on credit for reinsurance in 1984 to emphasize the need for regulating reinsurance transactions and to encourage uniformity. An NAIC advisory committee found that the existing practices of the states were inconsistent: some states had varying laws or regulations on reinsurance, and other states simply were not monitoring or regulating reinsurance transactions at all.

The original model law on credit for reinsurance established minimum criteria for allowing a ceding company to take financial statement credit for reinsurance ceded. These conditions were discussed in the previous section on reinsurance regulation. According to NAIC, as of 1989, only 10 states had adopted the model law on credit for reinsurance or substantially similar legislation, and the laws and regulations of 35 other states varied from NAIC's minimum criteria. According to NAIC, five states have no reinsurance credit laws. While many states grant credit for a reinsurer licensed in another state with "substantially similar" regulation, one regulator said differing laws and regulations complicated regulators' efforts to assess whether other states have substantially similar requirements.

In 1989, NAIC amended the model law to increase the standards that reinsurers must satisfy for a ceding company to receive reinsurance credit. For example, to qualify for accreditation, a reinsurer not licensed in a state must submit to the state's jurisdiction and authority to examine its books and records, file an annual statement in a form substantially similar to NAIC's annual financial statement, and maintain a policyholders' surplus of at least \$20 million. NAIC considered the higher surplus requirement necessary due to the increased uncertainty and risk associated with reinsurance assumptions compared to primary insurance business.

NAIC has also promulgated other model legislation to promote consistent and effective regulation. Given the potential for abuse among affiliates, the NAIC model insurance holding company law requires 30 days' notification for material transactions, including reinsurance, among an insurer and affiliates.<sup>2</sup> According to NAIC, the model law would allow regulators to assess the effect of interaffiliate transactions on the financial condition of an insurer and its affiliates before they occur. Regulators could disapprove arrangements that are not fair and reasonable to protect an insurer's surplus from being drained by intercompany transactions. In 1988, NAIC adopted a model law that restricts an agent from placing business with an the insurer or reinsurer that the agent controls either through ownership or management contract.

In 1989, NAIC also adopted model laws for licensing reinsurance intermediaries and managing general agents. Most states have not regulated these intermediaries. The NAIC reinsurance intermediary model law requires reinsurance brokers and managers to be licensed as insurance agents subject to recordkeeping and reporting requirements as well as regulatory examination. The new model law generally prohibits a reinsurance manager from binding a reinsurer to reinsurance agreements. Under the model law, a reinsurer must obtain independent annual financial statements on the financial condition of the manager and actuarial certification of loss reserves on business produced by the manager. The model law also provides that an intermediary may be subject to penalties or be ordered to make restitution for net losses due to violations. The NAIC managing general agents model law requires all managing general agents to be licensed and imposes many requirements and restrictions on both the agent and the insurer. The model law generally prohibits a managing general agent from binding reinsurance agreements.

While a model act represents a consensus among state regulators on the minimum standards for regulation, NAIC has no statutory or regulatory authority, and its model laws and regulations are not always adopted by every state. While NAIC adopted the original model law on credit for reinsurance in 1984, in the 5 years since then, 40 states have not acted to adopt the model law or similar legislation. Because the credit for reinsurance model law was substantially amended in September 1989, the

<sup>2</sup>The NAIC definition of a material transaction includes (1) any interaffiliate transaction, exceeding 3 percent of the insurer's assets or 25 percent of surplus; and (2) all reinsurance agreements in which the premium or change in the insurer's liabilities is 5 percent or more of the insurer's surplus.

states have not yet amended their statutes to include the new provisions. NAIC anticipates that most states will adopt the 1989 amendments, since states must adopt the model law to meet NAIC's new standards for state solvency regulation.

To address problems that may be caused by varying state approaches to solvency regulation, NAIC adopted comprehensive standards for financial regulation of insurance including reinsurance in 1989. The overall objective of the standards is to assist state regulators in developing and maintaining the resources and procedures necessary for effective solvency surveillance. Among other provisions, the standards identify the NAIC model laws and regulations, such as the model laws on credit for reinsurance and insurance holding companies, that are necessary, at a minimum, for effective solvency surveillance. To implement the standards, NAIC adopted a program under which all state insurance departments must evaluate themselves on their compliance with the standards and, by mid-1990, must report to NAIC on their compliance. It is not clear, at this time, what sanction, if any, NAIC would impose on insurance departments that do not comply with the standards.

In addition to the uniform solvency standards and state self-evaluation program adopted in 1989, NAIC also approved a solvency policing agenda for 1990. A major objective in the agenda is to improve uniformity in the monitoring and regulation of reinsurance. NAIC plans to assess the states' efforts to evaluate the solvency of foreign reinsurers and examine ways NAIC can assist in evaluating reinsurance.

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### **Increased Disclosure and Data Reporting**

To improve the data available to assess reinsurance and its impact on an insurer's financial condition, NAIC has required increased disclosure of reinsurance activity. New data requirements for reinsurance transactions have been incorporated into the annual financial statement that property/casualty insurers and reinsurers file with state regulators and NAIC. Since every state has adopted the NAIC annual financial statement as the official financial report, revisions to NAIC data reporting requirements apply to all states.

One change, effective since 1984, provided regulators with data to assess an insurer's dependence on unauthorized reinsurers for future losses. Previously, insurers reported an aggregate estimate of incurred

but not reported losses net of amounts ceded to reinsurers.<sup>3</sup> A ceding company also must now disclose the estimate of incurred but not reported losses ceded to each unauthorized reinsurer, so regulators can assess the adequacy of posted security. Since 1985, an insurer also must report separately the aggregate amounts of incurred but not reported losses for direct insurance, reinsurance assumed, and reinsurance ceded.

As of 1988, NAIC required insurance companies to separate their reporting of premium and loss data on nonproportional reinsurance from that on their other business. In some reinsurance arrangements the ceding company pays all losses up to a certain amount; this limit is referred to as its retention. The reinsurer then reimburses the ceding company for losses exceeding the retention rather than sharing in losses on a proportional basis. Such nonproportional arrangements have a less predictable loss pattern than other business and cannot be adequately assessed when reported on a combined basis. Nonproportional reinsurance now must be categorized as property coverage, liability coverage, or fidelity, surety, and guaranty coverage. Separate reporting of nonproportional reinsurance will provide regulators with more data to assess a reinsurer's loss reserves to pay ceding companies.

Also, as of 1988 an insurer had to disclose in its annual statement aggregate premiums paid for reinsurance ceded to and assumed from its affiliates. This information will be useful in assessing interaffiliate reinsurance and an insurer's dependence upon the financial condition of its affiliates. As discussed in chapter 2, reinsurance transactions between affiliates may be subject to abuse.

As of 1989, all insurers must separately report premium and loss data for direct and assumed business and for business ceded to reinsurers. As previously reported, premium and loss data combined direct business and reinsurance assumed and were presented net of reinsurance ceded. As a result of past aggregate presentation, reinsurance transactions could have masked or distorted loss experience and thus an insurer's financial condition. Also beginning in 1989, the annual statement will require 10-year loss data for reinsurance not reported by appropriate line of business; previously, only 2 to 3 years were disclosed. These increased reporting requirements will provide regulators with detailed data necessary to assess an insurer's loss reserves and the impact of reinsurance activity.

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<sup>3</sup>Incurred but not reported losses are estimates of the funds needed to pay claims on losses that have occurred but have not yet been reported to the insurer.

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Effective as of the 1989 annual financial statement, in addition to reporting aggregate data on reinsurance premiums, insurers will have to disclose reinsurance premiums ceded to each reinsurer, including affiliates, nonaffiliated domestic companies, and unlicensed foreign reinsurers. In 1990, reinsurers similarly will have to report premiums assumed from each ceding company. NAIC is developing an Alien Reporting Information System to determine how much business U.S. insurers are ceding to specific foreign reinsurers. NAIC has assigned identification numbers to unlicensed foreign companies that do not file financial statements with NAIC but who reinsure U.S. companies. Further, NAIC will be able to do industrywide analyses of reinsurance, including calculating the amount of reinsurance ceded by country and projecting the impact of a reinsurer's insolvency.

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### Uncollectible Reinsurance Prompts Special Changes

To address growing concerns about uncollectible reinsurance, NAIC has changed the way ceding companies must disclose and account for amounts recoverable from reinsurers. Previously, no data were readily available to assess how much reinsurance ultimately may be uncollectible. Appendix III discusses data on and estimates of reinsurance recoverable. Effective for the 1989 annual statement, new disclosure requirements will quantify the amount of overdue reinsurance and serve to identify licensed and authorized reinsurers who are slow payers. Also, in 1989 a new statutory accounting rule limits a ceding insurer's ability to recognize certain overdue recoverables as an asset on its financial statement.

Since 1987, a ceding company has been required to disclose in its annual statement situations that might affect its ability to collect from a reinsurer. An insurer must footnote whether any recoverables were due from (1) an insolvent reinsurer, (2) a reinsurer with which the ceding company is involved in arbitration or legal actions concerning any disputed amount of recoverable claimed, (3) a reinsurer whose recoverable payments remain unpaid 90 days after the payment is due under the terms and conditions of the reinsurance contract. An insurer must also disclose the specific amounts in dispute from any company if the amount exceeds 5 percent of the ceding company's surplus or if the aggregate of all disputed amounts exceeds 10 percent of the ceding company's surplus. An insurer cannot take credit for reinsurance recoverables in dispute with any affiliate.

As of 1989, ceding insurers must disclose the age of amounts recoverable from reinsurers on losses paid by the ceding company. These data



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will allow regulators to quantify the amount of overdue reinsurance and will provide additional insight on potential problems in collectibility. In addition to the total amounts recoverable on paid losses, a ceding company must report amounts that are overdue less than 30 days, those overdue between 30 and 90 days, those overdue between 91 and 180 days, and those over 180 days past due.

Effective at year-end 1989, ceding companies cannot claim full credit for overdue amounts recoverable from authorized reinsurers. While not a law or regulation, this change in the annual statement reporting, in effect, penalizes a ceding company for overdue reinsurance from each reinsurer. The "90-day rule" requires a ceding company to (1) reduce its surplus by an amount equal to 20 percent of undisputed amounts recoverable on paid losses more than 90 days overdue; or (2) reduce its surplus by an amount equal to 20 percent of all amounts, including disputed amounts and loss adjustment expenses, recoverable from a slow-paying reinsurer. A reinsurer will be considered a slow payer if overdue amounts comprise more than 20 percent of all amounts due on paid losses plus the amount of recoverables paid to the ceding company in the last quarter of the reporting year.

A penalty for overdue reinsurance is an important step towards assuring that the annual financial statement accurately reflects the financial condition of a ceding company and, according to NAIC, reducing reinsurance-related insolvencies. NAIC plans to assess whether an increasing penalty percentage should apply in future years. During the drafting of the 90-day rule, some state regulators advocated a 100-percent penalty for overdue reinsurance. In perspective, amounts due on paid losses represent only 5 percent of all losses ceded to reinsurers.

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## Continuing Reinsurance Issues

Despite the regulatory improvements by NAIC and the individual states, some regulators and others knowledgeable about reinsurance continue to question the adequacy of the present system of regulation. In investigative hearings held in 1987, the California Insurance Department found that the state's existing laws were inadequate to reasonably regulate reinsurance; reinsurance intermediaries should be licensed and regulated; and the Department did not have an adequate, experienced staff needed to more closely regulate and examine reinsurance relationships.

Some insurance regulators and others knowledgeable about the industry have suggested that alternatives to state-by-state regulation of reinsurance may be necessary. In 1987 hearings about insurance availability

and affordability before the Subcommittee on Commerce, Consumer Protection, and Competitiveness of the House Committee on Energy and Commerce, the New Jersey Insurance Department Commissioner recommended that Congress should study the need to establish national standards for the transaction of reinsurance and implement a federal system for licensing and monitoring foreign insurers.

In an April 1989 hearing before the Subcommittee on Oversight and Investigations of the House Committee on Energy and Commerce, the receiver for Transit Casualty Company testified about difficulties in collecting from foreign reinsurers who were poorly capitalized and unlicensed in the United States. Similar problems with foreign reinsurers also played a role in the insolvencies of the Mission, Integrity, and Anglo-American insurance companies. The Transit receiver recommended a federal accreditation program for foreign reinsurers, including requirements for minimum capital levels, annual statement reporting, and periodic on-site examinations.

Accounting professionals and insurance regulators are concerned that reinsurance credit is taken for some agreements that are merely financing arrangements. Reinsurance, by definition, must transfer risk of insurance loss from the ceding company to the reinsurer. Reinsurance contracts are often complex, so it may be difficult to evaluate whether a contract constitutes reinsurance. A reinsurance contract could be interpreted differently by various state regulators. For example, Missouri regulators were unclear as to whether one of Transit's reinsurance contracts actually transferred risk of loss. However, several other states did not accept the Transit arrangement as reinsurance and disallowed reinsurance credit in the annual financial statement. AICPA is currently drafting a new statement of position on "Accounting for Property and Liability Reinsurance Contracts." This statement will identify factors that indicate whether a reinsurance contract is a financing arrangement.

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## Conclusions

NAIC and the states have instituted reforms to improve and strengthen reinsurance regulation, including efforts towards more consistent regulation and increased disclosure of reinsurance data. The role of reinsurance transactions in recent failures of large insurance companies underscores the importance of NAIC and state actions to strengthen regulation and monitoring of reinsurance activity. Since the extent of uncollectible reinsurance is still unknown, serious financial problems may exist in the property/casualty industry. If state-by-state regulation does not provide adequate regulatory control and oversight to this important

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segment of the insurance industry, then other regulatory approaches may warrant consideration. However, alternative approaches may not be appropriate until recent reforms are fully implemented and can be evaluated.

Since the states have not yet adopted the amended model law and the financial reporting requirements, while applicable to all states, have not been fully implemented, we could not determine whether the regulatory changes will prove effective, how consistently they will be implemented across the states, and whether additional regulatory initiatives will be necessary.

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## Matters for Congressional Consideration

While regulatory controls over reinsurance have increased, some controls have not yet been fully implemented by the states and NAIC, and many states have not yet adopted other controls. Thus, Congress should continue its oversight of state efforts. Congress could do so by focusing on the effectiveness of recent reforms and the extent to which changes are implemented across the states.



# The Uses and Types of Reinsurance

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The basic function of reinsurance is to spread the risk of loss. Through reinsurance, an insurer can limit its losses under policies issued, as the reinsurer assumes the obligation to indemnify the insurer. However, reinsurance does not change the nature of a risk reinsured or reduce the overall losses to be paid. According to industry literature, insurers use reinsurance to (1) increase underwriting capacity, (2) stabilize underwriting results, (3) protect against catastrophic losses, and (4) increase financial strength.

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## Increase Underwriting Capacity

Reinsurance increases an insurer's capacity to write greater amounts of policy coverage than it could cover on its own. Some risks (e.g., commercial risks) would be too large for any company to insure alone. According to RAA, prudent management and certain insurance regulations demand limits on any one potential loss proportionate to the size of the insurer's surplus. By transferring risks in excess of this prudent "retention," an insurer can write policies with greater amounts of coverage without having to bear the full impact of potential losses under such policies. This function is crucial for small and medium size insurers to compete with larger insurers in meeting policyholders' coverage needs.

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## Stabilize Underwriting Results

Reinsurance can serve to stabilize an insurer's overall underwriting results by allowing an insurer to pass along losses to reinsurers in bad years in exchange for sharing profits in good years. Like other businesses, an insurance company tries to avoid wide fluctuations in profits and losses from year to year. As discussed above, an insurer limits exposure to an individual risk by retaining a portion of the original risk and reinsuring the balance. To some extent, an insurer may also limit aggregate losses sustained over a specific period, such as a year, by reinsuring losses in excess of a predetermined cap.

Reinsurance also stabilizes underwriting results by reducing the possible impact of any one line of business or geographic area on overall results. To adjust its mix of business or geographic spread of risk, an insurer may reinsure certain (e.g., more hazardous or unprofitable) lines of business or policies concentrated in a particular geographic region. Also, insurers may rely on reinsurers for underwriting assistance when entering new lines of business.

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## Protect Against Catastrophic Losses

Reinsurance protects insurers against large aggregate losses due to natural or man-made catastrophes, such as hurricanes or riots. While individual losses may be small, an insurer may not be able to absorb the accumulation of multiple losses due to a single event or occurrence. Protecting against catastrophic losses is related to stabilizing underwriting results, since catastrophes are major causes of loss instability.

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## Increase Financial Strength

Reinsurance provides a form of financing for insurance companies. Generally, an insurance company limits the amount of insurance it is willing to underwrite relative to its policyholders' surplus.<sup>1</sup> Upon issuing a policy, an insurer must recognize the unearned portion of premiums as a liability. However, the insurer also must pay its expenses at the beginning of the policy. Since premium income is deferred over the policy period and expenses are charged off immediately, an insurer's surplus shrinks. Thus, its capital base to finance new growth is reduced.

Reinsurance can relieve the impact of this accounting allocation. When reinsuring its policies, an insurer transfers a portion of its unearned premiums to the reinsurer and receives a ceding commission from the reinsurer. As a result, the ceding company's surplus rises by an amount equal to the ceding commission. This function of reinsurance is referred to as "surplus relief."

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## Types of Reinsurance

Since reinsurance needs vary from company to company, as well as within a company over time, there is no standard reinsurance contract. According to industry literature, there are two basic types of reinsurance agreements—treaty and facultative. A reinsurance treaty is a standing agreement between a ceding insurer and its reinsurer that covers broad classes of business, such as workers' compensation or homeowners' insurance. In contrast, a facultative reinsurance agreement is negotiated between a ceding insurer and the reinsurer to cover an individual policy risk.

Both treaty and facultative reinsurance agreements may be on a proportional basis where the ceding insurer and its reinsurer divide premiums and losses in agreed-upon proportions. Reinsurance agreements may also be on a nonproportional basis, where the ceding company pays

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<sup>1</sup>NAIC uses the ratio of premiums to policyholders' surplus as one preliminary test of an insurer's financial strength. A ratio greater than three to one is considered unusual and may prompt regulatory scrutiny.

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losses up to a predetermined amount, or its retention. The reinsurer then reimburses losses in excess of the ceding company's retention. Under a nonproportional agreement, the ceding company's retention may be stated per risk, per occurrence or catastrophe, or as an aggregate of losses in a time period. As a general industry practice, commissions are paid to the ceding company under a proportional agreement but not under a nonproportional agreement.

No single type of reinsurance can be described as best, since individual insurance companies have different needs. As characterized in industry literature, proportional agreements provide greater financing and capacity. However, nonproportional forms of reinsurance provide greater coverage limits, catastrophe protection, and stabilization. Generally, facultative agreements are used for unique risks involving high-value property or special hazards, which may be excluded under a treaty covering more routine risks. An insurance company may enter into multiple reinsurance agreements with several reinsurers participating in each agreement.

# The Reinsurance Market in the United States

As discussed in chapters 1 and 2, property/casualty reinsurance is available from professional reinsurers, reinsurance departments of primary insurers, and foreign reinsurers. This appendix presents characteristics of the U.S. reinsurance market, including estimates of the amounts paid to reinsurers in the form of premiums and the underwriting results of major reinsurers. These characteristics and estimates were reported in publicly available data compilations.

## Estimates of Market Size Vary

Several organizations, including the A.M. Best Company, RAA, and National Underwriter, compile financial information and statistics about major participants in the U.S. reinsurance market. Although their estimates vary due to different data collection methods, each organization believes its information is representative of the U.S. reinsurance market. Table II.1 shows these organizations' estimates of net premiums written in 1987, the most recent year for which we have a complete set of data, and the number of domestic reinsurance organizations included in each compilation.<sup>1</sup>

**Table II.1: 1987 Net Premiums Written and Number of U.S. Reinsurers by Source**

Dollars in billions

Source	Net premiums written	Number of reinsurers
A.M. Best	\$13.9	139
RAA	13.6	96
National Underwriter	15.2	170

The reinsurers included in the various compilations vary from year to year, as companies enter and leave the market. Also, a company may be dropped from data compilations due to declining reinsurance volume or failure to respond to a survey, even though the company may still participate in reinsurance. Similarly, companies added to data compilations as a result of increasing reinsurance volume or a new survey response may not be new entrants to the market. Such changes in the numbers or characteristics of the companies reporting make year-to-year comparisons difficult.

<sup>1</sup>Net premiums written represent the sum of premiums from selling insurance to the public and premiums for reinsurance assumed from other insurers less the amount of premiums paid for reinsurance ceded to other reinsurers.



Using NAIC's database of annual statements for the years 1984 to 1987, we found that about 60 percent of domestic property/casualty companies assumed some amount of reinsurance, including intercompany pooling. We attempted to identify the number of property/casualty insurers whose principal business is reinsurance. We defined a reinsurance-predominant company as an insurer with gross reinsurance assumptions greater than or equal to its direct business. However, some insurers operating reinsurance departments, which may not meet this criterion, probably rank among the largest reinsurers.

Using the NAIC database, we found that more than 20 percent of property/casualty insurance companies were reinsurance-predominant. Of the 1,428 companies that assumed some reinsurance in 1987, 524 companies, or 22 percent of all property/casualty insurers in 1987, assumed more reinsurance than they wrote in direct business. Only 193 companies, or 8 percent of all companies reporting in 1987, assumed only reinsurance and wrote no direct business.

Not every company that we classified as reinsurance-predominant may be recognized by the insurance industry as a major player in the reinsurance market. For example, of the 524 reinsurance-predominant insurers in 1987, 151 were small reinsurers with less than \$3 million in net premiums written, which might not be included in industry compilations of major reinsurers. Also, annual statements did not include data to identify the number of companies that wrote principally reinsurance but reinsured only affiliated companies.

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## Reinsurance Premium Volume

Table II.2 shows the amount of net premiums written by each type of reinsurer from 1978 to 1988. Domestic reinsurers, including U.S.-domiciled insurance companies and U.S. branches of foreign insurers, provide most of the reinsurance capacity for U.S. property/casualty insurers. From 1978 to 1988 an average of about 30 percent was assumed by foreign reinsurers domiciled in other countries. In 1988, net premiums of almost \$22 billion written by reinsurers represented about 11 percent of the \$202 billion in net premiums written by the property/casualty industry.

**Table II.2: Net Premiums Written in the U.S. Property/Casualty Reinsurance Market 1978-1988**

Dollars in millions

Year	Professional reinsurers	Reinsurance departments	Foreign reinsurers	Total U.S. market <sup>a</sup>
1978	\$4,332	\$1,955	\$2,248	\$8,535
1979	4,608	1,725	2,356	8,689
1980	4,841	1,803	2,961	9,605
1981	5,269	1,720	3,227	10,216
1982	5,703	1,766	3,018	10,487
1983	6,286	1,412	3,194	10,892
1984	7,286	1,351	3,305	11,942
1985	9,454	1,801	4,625	15,879
1986	12,580	2,522	5,333	20,435
1987	12,222	2,928	7,335	22,486
1988	11,085	2,269	8,400 <sup>b</sup>	21,755

<sup>a</sup>Premium amounts may not add to the total for the U.S. market due to rounding differences.

<sup>b</sup>Net premiums paid to foreign reinsurers for 1988 were estimated by Standard and Poor's Insurance Rating Services for National Underwriter. The estimate is based on preliminary data collected by the Department of Commerce.

Source: The National Underwriter, Property/casualty edition, June 19, 1989.

## Underwriting Experience of Reinsurers

One measure of underwriting experience in the property/casualty industry is the "combined ratio"—the ratio of claims, underwriting expenses, and dividends to premium income. The combined ratio measures the amount paid per dollar of premium to cover losses and expenses. A ratio below 100 represents an underwriting gain, and a ratio above 100 represents an underwriting loss. Table II.3 lists the combined ratios for professional reinsurers and the property/casualty industry from 1981 to 1988. Professional reinsurers generally followed the same underwriting cycle as other property/casualty insurers, but reinsurance underwriting ratios were considerably worse than the property/casualty industry in 1984 and 1985. The combined ratios reported in National Underwriter indicated that in 1984 reinsurers paid an average of \$1.31 in losses for every premium dollar.

**Table II.3: Combined Ratios for Professional Reinsurers and the Property/Casualty Industry 1981-1988**

Year	Professional reinsurers	Property/casualty industry
1981	105.6%	106.0%
1982	109.5	109.8
1983	116.3	111.8
1984	130.9	117.5
1985	124.1	116.1
1986	109.3	107.9
1987	105.9	104.6
1988	104.2	105.4

Source: Reinsurance ratios were reported in National Underwriter. Property/casualty industry ratios were reported in Best's Aggregates and Averages.

While the combined ratios indicated that professional reinsurers and insurers paid more in losses than they received in premiums during the 1980s, these ratios do not take into account the effect of investment income. An operating ratio—the combined ratio less the ratio of investment income to premium income excluding realized capital gains—is another measure of insurer profitability. A ratio below 100 represents an underwriting and investment gain, and a ratio above 100 represents an underwriting and investment loss. Table II.4 lists the operating ratios for professional reinsurers and the property/casualty industry from 1981 to 1988.

**Table II.4: Operating Ratios for Professional Reinsurers and the Property/Casualty Industry 1981-1988**

Year	Professional reinsurers	Property/casualty industry
1981	85.8%	93.0%
1982	88.0	95.0
1983	95.6	96.9
1984	110.5	102.2
1985	105.4	101.4
1986	93.3	94.8
1987	87.5	91.9
1988	82.2	91.6

Source: Reinsurance ratios were derived from National Underwriter. Property/casualty industry ratios were reported in Best's Aggregates and Averages.

With the exceptions of 1984 and 1985, operating ratios indicated professional reinsurers and the property/casualty industry were profitable overall. Also, the operating ratios for professional reinsurers were lower than industrywide ratios, even though reinsurers experienced worse

underwriting results during the 1980s than the property/casualty industry. Professional reinsurers could experience greater underwriting losses in a year and still have been profitable in overall operations as long as investment income was sufficient to subsidize poor underwriting results.

## Development of Reinsurance Losses

According to RAA, reinsurance losses are slower to develop than primary insurance losses because there is a “longer tail”— the time lag between the loss occurrence, the claim report, and the settlement. First, reinsurance is used more in hazardous, volatile lines of business, including medical malpractice and general commercial liability. These lines of business include latent risks where policyholder claims may not be filed for years after the policy is sold. In addition, a primary insurer may not report losses to reinsurers until the claim exceeds its retention.

Table II.5 illustrates the difference between reinsurers and primary insurers in loss development; that is, the difference between losses initially reported and amounts paid in final settlement. For example, at the end of the first year, a primary insurer knows of 50 percent of its medical malpractice losses. However, the reinsurer is aware of only 1 percent of losses ultimately to be incurred. After the fourth year, the primary insurer knows of 85 percent of the ultimate losses it will incur, but the reinsurer is only aware of 20 percent of its total losses.

**Table II.5: Comparison of Loss Development Patterns of Reinsurers and Primary Insurers**

Line of business	Percentage of final loss			
	First year		Fourth year	
	Reinsurer	Insurer	Reinsurer	Insurer
Automobile Liability	25	80	75	100
General Liability (including asbestos)	3	35	25	90
Medical Malpractice	1	50	20	85
Workers' Compensation	15	75	40	95

Source: Reinsurance Association of America, Loss Development Study 1987 edition. Data for primary companies were derived from 1986 Best's Casualty Loss Reserve Development.

# Reinsurance Recoverable

As reinsurance recoverable increases relative to policyholders' surplus, the financial health of ceding insurers becomes increasingly dependent on the collectibility of amounts recoverable from reinsurers. Reinsurance recoverables are funds due from reinsurers, both currently and in the future, for losses incurred on business written by the ceding company. The total amount recoverable consists of the following four elements:

- those amounts currently due for claims and related expenses paid by the ceding company;
- an estimate of amounts recoverable on losses that have occurred and been reported, but have not yet been paid by the ceding company and related expenses;
- an estimate of amounts recoverable on incurred but not reported losses; and
- an amount equal to the portion of unearned reinsurance premiums paid to the reinsurer.

In the balance sheet of the annual financial statement, amounts currently recoverable on paid losses are classified as an asset, and all other amounts are offset against the related liabilities. The annual financial statement for an individual insurer also lists all its reinsurers classified by affiliated companies, U.S. companies, reinsurance pools, and "all other" (e.g., foreign) reinsurers. For each reinsurer, the amounts of paid losses, unpaid losses, and unearned premiums are disclosed. Finally, insurers also report an aggregate estimate of incurred but not reported losses ceded to reinsurers.

Using the NAIC database, we attempted to provide a perspective on the size and composition of amounts recoverable on reinsurance. From 1987 data for 2,482 property/casualty insurance companies, we found that these insurers reported \$216.9 billion in total reinsurance recoverable. In 1987, paid losses represented 4 percent of the total recoverable; unpaid losses were 50 percent; incurred but not reported losses were 25 percent; and unearned premiums were 21 percent. Of \$161.8 billion in paid losses, unpaid losses, and unearned premiums ceded to reinsurers, 64 percent was due from affiliates; and 36 percent was due from nonaffiliated companies, including 18 percent from U.S. insurers, 9 percent from pools, and 9 percent from foreign reinsurers.

## Varying Statistics Reported on the Extent of Recoverables

While several organizations compile statistics about reinsurance recoverable, each organization defines reinsurance recoverable differently. The estimates generally represent only amounts recoverable from nonaffiliated companies. Further, estimates may not include all amounts recoverable from nonaffiliated companies.

A.M. Best calculates the ratio of unpaid losses, unearned premiums, and an estimate of incurred but not reported losses recoverable from nonaffiliated companies to the consolidated surplus for the property/casualty industry. The estimate of incurred but not reported losses recoverable from nonaffiliated companies is based on the nonaffiliated share of unearned premiums. A.M. Best does not include the amount of paid losses due from reinsurers, and total amounts recoverable are offset by reinsurers' funds held by ceding companies.

The Insurance Services Office, a statistical and actuarial organization, calculates the ratio of paid losses, unpaid losses, unearned premiums, and an estimate of incurred but not reported losses recoverable from nonaffiliated companies to the consolidated surplus for the industry. The estimate of incurred but not reported losses recoverable from nonaffiliated companies is based on the nonaffiliated share of unpaid losses.

The Standard and Poor's Insurance Rating Services uses three sets of ratios to assess the extent of reinsurance recoverable relative to the consolidated surplus for the industry. The first ratio is paid and unpaid losses recoverable from all reinsurers, including affiliates, U.S. insurers, pools, and foreign reinsurers to surplus. The second ratio is percentage of paid and unpaid losses recoverable from only nonaffiliated companies to surplus. The third ratio is paid and unpaid losses recoverable from only foreign reinsurers to surplus. Each ratio is calculated both with and without unearned premiums. Standard and Poor's does not include incurred but not reported losses ceded to reinsurers in its calculations.

Table III.1 compares the ratios reported of reinsurance recoverable to consolidated surplus for the property/casualty industry for 1986, the most recent year for which we obtained complete statistics. The ratios reflect different measures of reinsurance recoverable from nonaffiliated companies as a percentage of policyholders' surplus. The ratios ranged from 41 percent to 67 percent.

**Table III.1: Comparison of Ratios of Reinsurance Recoverable as a Percent of 1986 Surplus by Source**

Data source	Recoverables	1986 estimate
A.M. Best	unpaid losses, unearned premiums, and incurred but not reported losses recoverable from nonaffiliated companies, offset by funds withheld from reinsurers	55.7%
Insurance Services Office	paid losses, unpaid losses, unearned premiums, and incurred but not reported losses recoverable from nonaffiliated companies	67.0
Standard and Poor's	paid losses and unpaid losses recoverable from nonaffiliated companies	41.2
	paid losses, unpaid losses, and unearned premiums recoverable from nonaffiliated companies	52.1

According to A.M. Best, the ratio of reinsurance recoverable relative to policyholders' surplus increased during the 1980s. In 1981, reinsurance recoverable from nonaffiliated companies amounted to 35 percent of policyholders' surplus. However, by 1988 reinsurance recoverable from nonaffiliated insurers had increased to 54 percent of surplus. Reinsurance recoverable from nonaffiliated reinsurers peaked at 56 percent of surplus in 1985.

Including amounts recoverable from both affiliated and nonaffiliated reinsurers, recoverables have exceeded the consolidated surplus of the property/casualty industry in recent years. Standard and Poor's estimated that amounts recoverable from all reinsurers on paid losses, unpaid losses, and unearned premiums represented 152 percent of policyholders' surplus in 1986; recoverables on paid and unpaid losses alone amounted to 105 percent of the industry's consolidated surplus in 1986.

## GAO Estimates

Using the NAIC database, we attempted to assess the extent of reinsurance recoverables relative to policyholders' surplus. Since the NAIC database did not contain consolidated data adjusted for intercompany ownership and transactions for all groups of affiliated insurers, our figures overstate policyholders' surplus on an industrywide basis. For 2,482 companies included in the NAIC 1987 database, the aggregate of policyholders' surplus reported by individual insurers amounted to \$132.4 billion. According to A.M. Best, the consolidated surplus for the property/casualty industry was \$105 billion in 1987. Estimates of the extent of reinsurance recoverable would represent a greater proportion of policyholders' surplus on a consolidated basis.

Using the NAIC database, we found that reinsurance recoverable from all reinsurers, including affiliated and nonaffiliated companies, represented a significant share of policyholders' surplus.<sup>1</sup> In 1987, reinsurance recoverable on paid and unpaid losses amounted to nearly 88 percent of the unconsolidated surplus reported by property/casualty insurers. Including unearned premiums ceded to reinsurers, recoverables increased to 122 percent of surplus. Total amounts recoverable, including incurred but not reported losses ceded to reinsurers, represented 164 percent of surplus. In other words, total amounts recoverable from reinsurers were more than one and a half times the size of surplus.

While total reinsurance recoverable exceeds policyholders' surplus on an industrywide basis, the extent of recoverables varied from company to company. Out of 2,450 property/casualty insurers, we found that 901 companies, or nearly 37 percent, reported total reinsurance recoverable greater than their policyholders' surplus.<sup>2</sup> Reinsurance recoverable on paid and unpaid losses alone exceeded surplus for 564 insurers, or 23 percent. Moreover, nearly 6 percent of all insurers reported that recoverables on paid and unpaid losses were 5 times greater than policyholders' surplus, and over 2 percent reported recoverables 10 times greater than surplus.

## Potential Impact of Uncollectible Reinsurance

Given the extent of reinsurance recoverables relative to surplus, uncollectible reinsurance may have detrimental effects on the solvency of some insurers. Many in the industry and regulators agree that uncollectible reinsurance is a significant problem. However, no data were previously available to accurately assess the extent of uncollectible reinsurance. At least one industry analyst estimated that \$10 to \$20 billion may be uncollectible. Since writing off uncollectible reinsurance would reduce surplus, insurers may have claimed credit for reinsurance that is overdue and uncollectible.

While uncollectible reinsurance may not threaten the solvency of the industry as a whole, individual companies may be vulnerable to large losses on reinsurance. If an insurer has reinsurance recoverables equal to its surplus, failure to collect 10 percent of the recoverables would

<sup>1</sup>As discussed in chapter 2, 75 percent of all reinsurance is transacted between affiliates.

<sup>2</sup>The NAIC database for 1987 included 2,482 insurers. Thirty-two companies reported no policyholders' surplus. These companies included insolvent insurers and state-operated auto insurance pools. We did not include these companies in our analysis of individual insurers, since a positive amount of surplus was necessary to calculate the recoverable-to-surplus ratio.



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translate into a 10-percent reduction in its surplus. The reduction in surplus due to uncollectible reinsurance becomes progressively larger as the ratio of recoverables to surplus increases. For example, if an insurer has recoverables 10 times greater than surplus, failure to collect 10 percent of the recoverables would eliminate policyholders' surplus. If 20 percent of its reinsurance is uncollectible, an insurer with recoverables 5 times greater than surplus could face insolvency.

# Comments From the National Association of Insurance Commissioners

Note: GAO comments supplementing those in the report text appear at the end of this appendix.



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National  
Association  
of Insurance  
Commissioners

March 29, 1990

Mr. Richard L. Fogel  
Assistant Comptroller General  
U.S. General Accounting Office  
Washington, D.C. 20548

Dear Mr. Fogel:

Thank you for allowing us to comment on your draft report Property/Casualty Insurance: Reinsurance Problems Create Need For Increased State Regulatory Oversight. On the whole, the report is well written and balanced in its perspective. It raises a number of important issues which are being addressed by state insurance regulators, as the report points out. At the same time, the report contains some statements which should be corrected or clarified. Our specific comments follow:

1. Page 4: The report states that an individual state has no direct authority to regulate reinsurers in other states or countries. However, it should be pointed out that states do regulate reinsurers if they are licensed. Other states than the domiciliary state may take action against a licensed reinsurer and the NAIC can instigate and coordinate such actions if the domiciliary state fails to take action.
2. Page 16: The report states that, although each state has adopted the NAIC Annual Statement Blank, variations are required to meet each state's statutory requirements. It should be noted that state variations to the NAIC Blank itself are rare. When variations do occur, they are typically additional or supplementary reporting requirements.
3. Page 21: The report states that any state can adopt or permit accounting practices which differ from those prescribed by the NAIC. However, it should be pointed out that other states in which an insurer is licensed may challenge accounting practices permitted by the state of domicile if they appear to be hazardous to the insurer and may not permit the practice to be used in preparing the statement filed in their jurisdictions.
4. Page 22: The report states that reinsurance activity of primary insurers operating reinsurance departments and reinsurance pools cannot be separately identified from aggregate data reported in the Annual Statement. The report also states that no data are readily available for unlicensed foreign reinsurers. Schedule F-Part 1A, Section 2 (assumed reinsurance) of the Annual

Now on p. 3.  
See comment 1.

Now on p. 10.  
See comment 2.

Now on p. 14  
See comment 3.

Now on p. 14.

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See comment 4.

Statement identifies, by ceding company, the reinsurance payables on paid losses and unpaid losses and unearned premiums which are included in the gross (direct plus assumed) business of a primary insurer assuming reinsurance.

See comment 5.

Also, some financial information on foreign reinsurers is available through A.M. Best and Insurance Solvency International as well as the NAIC's Non-Admitted Insurers Information Office (NAIIO). In addition, the NAIC is developing an Alien Reporting Information System (ARIS) which can be used to determine how much business U.S. insurers are ceding to specific alien insurers.

Now on p. 15.

See comment 6.

5. Page 23: The report states that some reinsurers may combine all amounts assumed into a catchall reinsurance line. However, the catchall reinsurance line no longer exists except for operations prior to 1988. Nonproportional reinsurance is now required to be broken down into three basic groups: property coverages; liability coverages; and fidelity, surety and guaranty coverages. Run off is continuing for reinsurance reported on the catchall reinsurance line prior to 1988. All proportional reinsurance, i.e. first dollar pro rata reinsurance, must be allocated to the appropriate line of business.

Now on p. 16.

See comment 7.

6. Page 25: The report comments that most states require field examinations only once every 3 to 5 years, causing a time lag in detecting questionable transactions and potential problems. The report should point out that some states examine companies on a priority basis and may send examiners into a company every year or even more often to look at problem areas. The NAIC Insurance Regulatory Information System (IRIS) system requires affirmative action on the part of a domiciliary regulator where a company has been determined to be a "first priority" company.

See comment 8.

The report states that reinsurance practices, such as the use of reinsurance intermediaries, cannot be determined readily, if at all, from the Annual Statement. It is not clear that reporting on the use of intermediaries would be relevant or appropriate for the Annual Statement because the focus should be on the reinsurer.

Now on p. 16.

See comment 9.

7. Page 26: The report states that, before 1988, individual insurers were not required to report reinsurance ceded to or assumed from affiliates separately from reinsurance with other reinsurers. This is incorrect -- reinsurance with affiliates has been reported separately for a number of years.

Now on p. 18.

See comment 10.

8. Page 28: The report states that financial statement data do not indicate the extent to which reinsurance is used for fronting purposes. This statement should be modified to say that annual statement data may not indicate the extent of reinsurance for fronting purposes.

Now on pp. 18-19.

9. Page 30: The report states that a reinsurer may assume reinsurance without a state license. It should be clarified that a reinsurer domiciled in the U.S.

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would have to be licensed at least in the state of domicile. Also, while laws in some states may not expressly prohibit fronting, prior approval requirements for substantial transfer of business may have the same effect in those states.

10. Page 34: The report states that financial data cannot be used to track the retrocession chain from the original ceding company to the ultimate reinsurers. However, the report fails to indicate what could be gained from such information. The NAIC ARIS system may provide some assistance in this area by showing the potential impact of a particular insurer's failure.

11. Page 36: The report states that 35 states do not have CPA audit requirements. However, most of those states that have such a requirement require both domestic and foreign insurers to file CPA audited statements. Consequently, most insurers of significant size are subject to a CPA audit requirement by virtue of being licensed in one of those states even if its domiciliary state does not have such a requirement.

12. Page 45: The report notes that the NAIC has recently adopted a model act which addresses reinsurance intermediaries. The objectives and provisions of this act might also be noted. The NAIC Reinsurance Intermediary Model Act (adopted December 1989) requires reinsurance brokers and managers to be licensed as insurance producers (agents). The Act imposes rigid record keeping and reporting requirements. It prohibits the reinsurance manager from binding retrocessions in most instances as well as committing the reinsurer to participate in reinsurance syndicates. The reinsurer is required to obtain annual, independently prepared, financial statements from its reinsurance manager and a certification of loss reserves on business produced by the manager. The Act authorizes the Commissioner to examine the books and records of the reinsurance intermediary and provides that the acts of the reinsurance manager are deemed to be the acts of the company on whose behalf it is acting. The Act further authorizes the Commissioner to order the reinsurance intermediary to make restitution for net losses incurred attributable to violations of the Act.

Two other recently enacted NAIC model acts address reinsurance and agents and brokers. The Business Transacted with Producer Controlled Property/Casualty Insurer Model Act (adopted September 1988) applies to situations in which the producer (agent) for a company controls the insurer or the assumptive reinsurer of the insurer, either through ownership or management contract. The Managing General Agents Act (adopted September 1989) requires all managing general agents (MGAs) to be licensed and imposes many requirements and restrictions on both the MGA and the company for which it is acting. In most instances, the Act prohibits MGAs from binding reinsurance.

Implementation of these acts by the states should cause insurers to significantly tighten their systems of internal control over reinsurance transactions.

See comment 11.

See comment 12.

Now on p. 21.

See comment 13.

Now on p. 22.

See comment 14.

Now on p. 28.

See comment 15.

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Now on pp. 27, 28 and 29.  
See comment 16.

Now on p. 31.  
See comment 17.

Now on p. 32.  
See comment 18.

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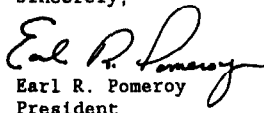
The report also states that, as of 1989, only 10 states had adopted the NAIC's Model Law on Credit for Reinsurance (or substantially similar legislation) which contains a provision that does not allow credit for amounts ceded to a reinsurer not licensed in a state and with less than 20 million in surplus. However, it should be pointed out that this provision was only adopted in September 1989 and it is anticipated that most states will amend their statutes accordingly.

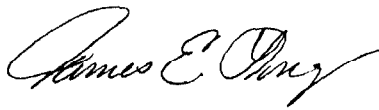
13. Page 51: The report states that an insurer must disclose specific amounts in dispute from any company or affiliate if the amount exceeds certain thresholds. It also should be noted that an insurer is disallowed any credit for reinsurance recoverables in dispute with any affiliate.

14. Page 52: The report states that the "90-day rule" requires a ceding company to reduce its surplus by an amount equal to 20 percent of all amounts recoverable from a slow paying reinsurer. This should be modified to read "...amounts, including disputed amounts and loss adjustment expenses, recoverable..."

We hope that these comments are helpful to you in finalizing your report. Please let us know if we can be of any further assistance to you.

Sincerely,

  
Earl R. Pomeroy  
President

  
James E. Long  
Vice President

The following are GAO's comments on the National Association of Insurance Commissioners' letter dated March 29, 1990.

## GAO Comments

1. We changed the text to clarify that an individual state regulates licensed reinsurers but has no direct authority over reinsurers in other states and countries who are not licensed in that state. (See p. 3.)
2. We changed the report to reflect that, according to NAIC, state variations from the NAIC annual statement itself are rare, though some states may require additional or supplemental data reporting. (See p. 10.)
3. We recognize that other states may challenge an insurer on accounting practices permitted by the state of domicile. Our report cites an example where several states disallowed reinsurance credit in the annual financial statement for Transit Casualty Company, although the state of domicile accepted the reinsurance arrangement. (See p. 33.)
4. NAIC is correct that Schedule F of the annual statement lists amounts payable on reinsurance assumed by a primary insurer operating a reinsurance department. As our report says, every reinsurer is to list its ceding companies and amounts payable on reinsurance assumed. (See p. 21.) However, in a 1986 report, the NAIC Statistical Information Advisory Committee found that the underwriting experience of a reinsurance department cannot be separately determined by reviewing the primary company's annual financial statement.
5. We changed the text to reflect that unlicensed foreign reinsurers are not required to report financial data to state regulators. (See p. 14.) We acknowledge that some financial information on foreign reinsurers is available through rating services and NAIC's Non-Admitted Insurers Information Office. We expanded the discussion of NAIC's planned Alien Reporting Information System. (See p. 31.)
6. We changed the report to clarify that the catchall reinsurance line was used before 1988. (See p. 15.) We discuss the 1988 changes on page 30.
7. We changed the report to reflect that problem insurers may be examined more frequently. Some states may examine companies on a priority basis. Likewise, a domiciliary state must respond when one of its insurance companies is targeted for regulatory attention under NAIC's Insurance Regulatory Information System. While a state may examine

troubled insurers on a more frequent and regular basis, this requirement, however, does not help in initial problem detection. Since on-site examination procedures are the only means to detect abuses of certain reinsurance practices, we believe a 3- to 5-year interval between examinations may delay detecting questionable transactions that could lead to serious problems. (See p. 16.)

8. We believe reporting on the use of intermediaries would provide useful information for the annual financial statement. Under the new model laws for both reinsurance intermediaries and managing general agents, insurers and reinsurers are required to use licensed intermediaries and agents. Disclosure of intermediaries and managing general agents would provide state regulators with information necessary to enforce these requirements.

9. NAIC is correct that insurers have separately reported some information about reinsurance with affiliates. As our report says, every ceding company is to list its reinsurers, and every reinsurer is to list its ceding companies. (See p. 21.) We have added that insurers were required to report both losses recoverable on reinsurance ceded to affiliates and losses payable on reinsurance assumed from affiliates. (See p. 16.) However, before 1988, insurers were not required to separately report premiums ceded to and assumed from affiliates.

10. We made the suggested change. (See p. 18.)

11. We changed the text to clarify that a reinsurer may assume reinsurance without a license in the state where it assumed the business. To accommodate NAIC's concern, we added a footnote stating that a reinsurer domiciled in the United States would be licensed in at least the state of domicile. (See pp. 18 and 19.)

12. We added the suggested language that some states require prior approval before an insurer reinsures all or substantially all of its business. (See p. 19.)

13. We expanded the discussion to reflect that a ceding company cannot readily assess the identity or financial condition of each retrocessionaire from its reinsurers' annual financial statements. Retrocessions by an apparent reinsurer may transfer risk to parties unknown to the original ceding company, although an insurer's continued solvency may be impaired if the reinsurance chain fails. (See p. 21.) As our report says,

the AICPA Statement of Position "Auditing Property and Liability Reinsurance," which has been incorporated into NAIC's Financial Condition Examiners Handbook, requires that a ceding company evaluate the financial condition of its reinsurers and their retrocessionaires. (See p. 22.) We believe that a ceding company could use more information about the retrocession chain to satisfy the AICPA requirement and protect its solvency interest.

14. As NAIC indicated, any company licensed in a state that requires audited statements would submit audited statements to all states in which it is licensed. As a result, although 35 states do not require an audit by a certified public accountant, these states may receive audited annual financial statements from some insurers. However, an insurer licensed in only those 35 states would not be required to present audited annual financial statements. We are encouraged that NAIC's new financial standards prescribe that every state require annual audits of insurers domiciled within its jurisdiction.

15. We expanded the discussion of all new model laws addressing reinsurance intermediaries and managing general agents. (See p. 28.)

16. Because the NAIC model law on credit for reinsurance was adopted in September 1989, we recognize the states have not yet acted to adopt the new provisions. We changed the text to clarify that 40 states still have not adopted the original model law. We also added that NAIC anticipates that more states will adopt the 1989 amendments since the model law on reinsurance credit is required to meet NAIC's new regulatory standards. (See pp. 27, 28 and 29.)

17. We changed the text to reflect that an insurer cannot take credit for reinsurance recoverables in dispute with any affiliate. (See p. 31.)

18. We made the suggested change. (See p. 32.)



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# Glossary

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<b>Annual Statement</b>	A summary of an insurance company's (or reinsurer's) financial operations for a calendar year, including a balance sheet supported by detailed exhibits and schedules, filed with the state insurance department of each jurisdiction in which the company is licensed to do business.
<b>Authorized Company</b>	An insurer licensed by a state insurance department to write certain types of insurance in that state.
<b>Authorized Reinsurance</b>	Reinsurance placed with a reinsurer that is licensed or otherwise recognized by a particular state insurance department.
<b>Balance Sheet</b>	A statement of the assets, liabilities, and owners' equity (surplus) of an enterprise. (Assets minus liabilities equals owners' equity.)
<b>Capacity</b>	The amount of insurance (measured either by face value of policies or by premium) that an insurer is able or willing to issue as a maximum. Capacity may be subject to legal restrictions.
<b>Casualty Insurance</b>	Insurance concerned primarily with the insured's legal liability for injuries to others or for damage to other peoples' property. Casualty insurance also encompasses such forms of insurance as plate glass, burglary, robbery, and workers' compensation.
<b>Cede</b>	To pass on to another insurer (the reinsurer) all or part of the insurance written by an insurer (the ceding insurer) with the object of reducing the ultimate losses of the ceding company.
<b>Direct Premiums Written</b>	The premiums from selling insurance policies to the public.
<b>Domestic Reinsurer</b>	A reinsurer domiciled in the United States. A domestic reinsurer is licensed in at least its state of domicile. Within the industry, a U.S.-domiciled reinsurer operating in a state other than its domiciliary state is also referred to as a foreign reinsurer.

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Facultative Reinsurance	The reinsurance of part or all of an individual policy risk.
Foreign Reinsurer	A reinsurer domiciled outside the United States that does business within the United States. Within the industry, also referred to as an alien reinsurer.
Insolvency	A state of financial condition in which an insurance company is unable to pay claims as they fall due in the usual course of business.
Insurance	A system under which individuals, businesses, and other organizations or entities, in exchange for payment of a sum of money (a premium), are guaranteed compensation by an insurance company for losses from certain perils under specified conditions.
Insurance Company	An organization chartered to operate as an insurer.
Insured	A person or an organization covered by an insurance policy, including the "named insured" and any other parties for whom protection is provided under the policy terms.
Managing General Agent	An insurance producer or agent who manages all or part of the insurance business for an insurer, underwrites gross direct premiums equal to or more than 5 percent of policyholders' surplus, and adjusts or pays claims. A managing general agent may also negotiate and bind ceding reinsurance contracts on behalf of the insurer.
Net Premiums Written	The balance of direct premiums written plus and assumed reinsurance premiums minus reinsurance premiums ceded to other insurers. An insurer's net premiums constitute a measure of its business volume.
Policy	A contract of insurance.

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Policyholder	The party in whose name an insurance policy is issued.
Policyholder Surplus	The amount by which the assets of an insurer exceed its liabilities.
Premium	The amount of money an insurer charges to provide coverage.
Professional Reinsurer	An organization whose business is mainly reinsurance and related services, as contrasted with other insurance organizations, which may operate reinsurance departments in addition to their basic primary insurance business.
Reinsurance	Assumption by one insurance company of all or part of a risk undertaken by another insurance company.
Reinsurance Assumed	That portion of risk the reinsurer accepts from the original insurer or ceding company.
Reinsurance Broker	A reinsurance intermediary who solicits, negotiates, or places reinsurance cessions or retrocessions on behalf of a ceding insurer without the authority or power to bind reinsurance on behalf of the insurer.
Reinsurance Ceded	That portion of the risk that the ceding company transfers to the reinsurer.
Reinsurance Manager	A reinsurance intermediary who has the authority to bind or who manages all or part of the assumed reinsurance business and acts as an agent for the reinsurer.
Reinsurance Pool	A joint underwriting operation of reinsurance in which pool members assume a predetermined and fixed interest in all business assumed by the pool.

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Retention	The amount that an insurer retains for its own account.
Retrocession	The transaction whereby a reinsurer cedes to another reinsurer all or part of the reinsurance it has assumed.
Retrocessionnaire	The assuming reinsurer in a retrocession. The ceding reinsurer is known as the retrocedent.
Risk	The chance of loss. Also used to refer to the insured or to property covered by a policy.
Treaty Reinsurance	A general reinsurance agreement between the ceding company and the reinsurer covering a class or classes of business, in contrast to a facultative agreement covering an individual policy risk.
Unauthorized Reinsurer	A reinsurer that is not licensed, approved or otherwise does not have authorized status in the jurisdiction in question.
Underwriting	The process of selecting risks for insurance and determining in what amounts and on what terms the insurance company will accept the risks.

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# Related GAO Products

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Insurance Regulation: Problems in the State Monitoring of Property/Casualty Insurer Solvency (GAO/GGD-89-129, Sept. 29, 1989).

Tax Policy: The Insurance Excise Tax and the Competition for U.S. Reinsurance Premiums (GAO/GGD-89-115BR, Sept. 25, 1989).

Property and Casualty Insurance: Thrift Failures Provide Valuable Lessons (GAO/T-AFMD-89-7, Apr. 19, 1989).

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