



Life Reinsurance Treaty Recapture Provisions





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REPORT USAGE

This report is intended solely for educational purposes. It is not intended to guide or determine any specific situation. If legal, accounting or actuarial advice or other expert assistance is required, the services of a competent professional should be sought. The authors, the Project Oversight Group, their employers or the Society of Actuaries (SOA) shall not have any responsibility or liability to any person or entity with respect to damages alleged to have been caused directly or indirectly by the content or the use and misuse of this report.

Although the report captures a multitude of perspectives from many individuals, the comments and views expressed may not be representative of the full industry. Also, the observations and comments may not be applicable to certain situations.

Section 1: Executive Summary

This report is a sequel to *Life Reinsurance Treaty Construction* published in 2013. Why a sequel? Why recapture provisions? Why now?

The ability to recapture business ceded under a reinsurance treaty is an important consideration when negotiating treaty terms and can have significant financial implications for the ceding company, the reinsurer and other related parties (e.g., retrocessionaires and third party financiers). A recapture provision defines the obligation or an option of a cedant at a point in time or during a time period. Provisions related to recapture may include changes in retention, insolvency, changes in legal control, changes in rating, changes in financial or capital ratios, and increases in premium rates (we will refer to these collectively as “recapture provisions”). These provisions can give the cedant an option to recapture upon an event or trigger(s) occurring.

More than six years ago, recapture provisions, being several of the dozens of provisions forming a treaty, were discussed without much fanfare. Not that recapture provisions were overlooked; in fact, the 2013 report highlighted contentious provisions and issues including cedants cherry picking recaptures and recaptures as a result of reinsurers raising premium rates. However, they did not receive the heated debate of issues deemed more important and more contentious at that time. Yes, some clauses were not liked by direct companies and some were not liked by reinsurers; as options, parties at times exercised recapture provisions opportunistically and anti-selectively to their advantage; some older treaties had unclear language; and yes, improvements could be made and were being made to newer treaties.

Recapture provisions have more recently been a topic of significant interest resulting from actions by direct-writing companies and reinsurers, including retention increases, rate increases and insolvency:

- a. Unclear language caused some direct companies to attempt recapture when the reinsurer did not see recapture triggers being met.
- b. Direct companies have attempted to recapture after long periods had transpired since the option’s trigger had been triggered.
- c. Direct companies, as a result of their request to reinsurers, have often had the option to recapture in response to reinsurers increasing premium rates on blocks.
- d. In the case that a reinsurance company becomes insolvent, any associated recapture right has largely lost its value.

This sequel specifically looks at industry perspectives regarding recapture provisions and considers whether treaty language can be changed or improved for today’s reinsurance business environment. How and why are recapture provisions being used? How were, are or will recapture provisions be driven by regulation? Both the 2013 report and this sequel explored issues by surveying, interviewing and conducting an in-person roundtable discussion with participants from direct insurers and reinsurers. Since there is only one retro-reinsurer in this group, the retro participant will be referred to as a reinsurer to provide some anonymity.

Participant comments always correspond to bullet points and are either directly quoted or paraphrased as indicated by quotation marks or lack thereof.

Two key themes in this sequel are:

1. Recapture and related provisions are embedded options.
2. Older language did not adequately anticipate or address future business needs and issues.

“I think that is the problem we are facing and why we’re here today, because some of this existing language is inadequate for its purpose.”

Neither of those themes is a startling new insight. Recapture provisions options were called in the 2013 report and their optionality discussed. One could say the themes are common knowledge to those involved in negotiating and administering reinsurance contracts. But common knowledge does not necessarily solve business problems. When treaty language proves inadequate, particularly as a result of broad interpretations, the option seller (typically the reinsurer) may have given away more optionality, more benefits or taken on more risks than was the intention by one party or perhaps even by both parties. The treaty authors’ successors could take advantage of these inadequacies, perhaps even aggressively pushing the meaning of various provisions. What are the issues and challenges today’s successors face? How can today’s authors anticipate tomorrow’s problems?

The past few years have elevated appreciation regarding the parameters and characteristics of these options—and the risk and financial consequences. Options are included to help the counter-parties manage risks (e.g., recapture upon a change in retention is a means to help cedants manage retention). However, whether intended or not, options embedded in a reinsurance treaty can be used as financial options. To some degree, options may be established in treaties with one or both parties expecting they may never be utilized. As a result, some options have been and continue to be undervalued and underpriced. These embedded options are not traded and do not have an observable market. Treaty provisions define the terms of the options. Hence, the two themes are interconnected.

As an embedded option, defining and valuing the option can be a challenge. For example, once a Risk-Based Capital (RBC) ratio threshold or change in retention is triggered, can the option be exercised at any time or only while the trigger is in effect or for some defined period? What are the option’s risks? Can the option be appropriately priced? If so, is the buyer willing to pay that price? Does the seller want to take on the risks? If so, which risks?

Some recapture options are triggered by changes in retention (the most common occurrence), changes in control or adverse changes in a reinsurer’s financial health. Cedants are exercising recapture options if they believe they are in the money. Older language has not always proved to be precise for today’s issues. To the extent that language can be interpreted such that triggers are defined more broadly or that the time to exercise options are extended, options increase in value. If treaty language is unclear or misleading, some direct writers have used this as an

opportunity to recapture a larger portion of the block than intended at the time of writing the treaty. Direct writers understand that aggressively interpreting old language affects their relationship with reinsurers.

In certain cases, contracts have also included a recapture option that is triggered if a reinsurer increases premiums. It cannot be assumed that a reinsurer will not use its option to increase premiums, because more than one reinsurer has increased premiums in recent years. Reinsurers also understand that increasing premiums affect their relationship with the direct writer.

Treaty language has evolved to better define embedded options including recapture provisions. Direct writers and reinsurers are managing risks and option prices by using more precise language or adding restrictions to triggers, time periods or strike prices. Option sellers do not want to underprice or include undesired risks. Option buyers do not want to overpay or pay for risks beyond what is desired.

How options are paid for is also evolving. Option prices can be charged at a treaty's inception, on an ongoing basis, upon exercise of the option, through effectively netting the value of various options within the treaty, or a combination of these. Option prices can be charged with an explicit fee, higher premium rates, lower allowances, options seen as offsetting each other (whether in part or in full), or a combination of these. Treaties may provide an option as recourse upon another option's exercise (e.g., recapture upon exercise of an option to increase premium rates).

1.1 THE BUSINESS OF TREATIES

The consensus view is that the business of reinsurance takes precedence over the relationship. Cedants may change retention with the express intention to recapture profitable blocks (up to the new retention limit). This alters the risk profile of business for reinsurers (i.e., the distribution of profitability around the mean). The number of instances of reinsurers increasing premiums has increased over the six years since the original study. Multiple reinsurers—both writers of new business and those in run off—have used their contractual right to increase premiums in the last several years. This is a reflection of changing business drivers, objectives, relationships and complexity. There was a spectrum of views on the nature and degree of the reasons for changes.

Provisions related to recapture provide an option to recapture if a defined event such as change in retention or change in capital ratios is triggered. This treaty language is viewed as directly related to recapture as one degree removed from recaptures. Some treaty language provisions related to recapture restricts the trigger events attempting to make a trigger itself and hence a resulting recapture less likely. We view this treaty language indirectly related to recapture as two degrees removed from recaptures. We found that generally the more degrees of separation, the greater the opportunity for disagreement to arise regarding the understanding and intent of terms. Here are some participants comments.

1.1.1 First Degree

- Recapture rights on retention increases have historically been vague. Hopefully these are better now, and parties should be encouraged to add detail.
- You have to be careful when writing treaties to distinguish between an individual retention and an expectation that the quota share remains the same.

1.1.2 Second Degree

- “Older treaties did not have recapture rights if a reinsurer raised their rates because they thought the reinsurer would never raise the rates.”

- “The deficiency reserve language is the reason we are doing this [non-guaranteed reinsurance premiums] and we anticipated things to stay the same.”
- “Reinsurer increased rates because treaty language stated that if they increase premiums on one block of business they must do it on all similar blocks.” By increasing all rates, the reinsurer triggered a clause in the contract providing the cedant the option to recapture all affected blocks of business.

1.1.3 Background

Deficiency reserves affect language pertaining to premium guarantees. The presence of a rate guarantee could result in the reinsurer holding deficiency reserves, which would result in higher costs and higher rates for cedants. To lower costs, some or even many cedants accepted nonguaranteed rates (i.e., granted the reinsurer an option to increase rates). Some treaties included granting the cedant the option to recapture upon rate increases to reduce the likelihood that the rate increase option would be exercised and, in some cases, required increases be applied to all “similar blocks.”

1.2 PRINCIPLES AND GUIDELINES VERSUS RULES AND LEGAL DEFINITIONS

Parties should consider the language in their treaties carefully. It is important both to ensure that the language used does not mean different things to various individuals and that the effectiveness of the language in the contract will provide the desired outcome over the next 50 or more years.

- “The more detailed the treaty the better, so it is better to spend a couple of extra weeks to get it right.”
- “Sometimes it is easier to come to an agreement when the treaty is written because both sides think the language satisfies their needs. It is not until years later when a clause comes into play that they find out that one party took the language to mean one thing and another party took it to mean something else.”

When there is disagreement many years later regarding the interpretation of a clause(s), often times both parties reach a satisfactory agreement and amend the contract accordingly. However, there are times when agreement cannot be reached and the dollars involved are large. It is these situations that both sides strive to avoid when writing a treaty. It is also these situations that have a great effect on current issues and changes in treaty language.

Not every issue can be anticipated in advance, even if you take a couple of extra weeks. A participant commented:

- “Even if you anticipate future problems your present day solutions may not work. Ten years ago the increase in premiums was anticipated and the solution at the time was the right to recapture. However, the problem with this turns out to be replacing the recaptured business was more costly and difficult than anticipated.”

Some participants felt that in such a situation, the option to recapture would not be used, and if it were used would be used in a manner different than what some direct companies have done in the past several years. Likewise, some felt the intent of providing an option to the reinsurer to raise premiums was to eliminate deficiency reserves and would never be used, hence the need to consider thoroughly the impact of recapturing in such a situation was undervalued.

1.3 CHANGE IN RETENTION

The recapture option is most often thought to apply to situations when a direct company increases its retention.

- Vague language favors the cedants in that if the treaty were not clear upon what was eligible for recapture, a cedant could recapture profitable business when this was not the intention of the reinsurer at treaty inception.
- With new treaties, we clearly define which retention we were referring to.
- If it was a facultative case because of underwriting concerns, they [direct writer] would not want to recapture the policy.
- If you elect to recapture, you have to recapture the entire block of business.

There were varying interpretations as to applicability and scope arising from change in retention.

1.4 INSOLVENCY

Some insolvency provisions grant the right to recapture in the case of insolvency. Issues pertain to the option's efficacy. Does including recapture rights protect the direct writer? Does such an option increase the chance of the reinsurer's insolvency? If a treaty uses a loose definition of insolvency (i.e., something close to but not yet insolvency), then the presence of recapture rights could result in a run-on-the bank scenario and be the final straw. Whereas in the absence of a recapture provision upon insolvency, a reinsurer may be able to execute the necessary actions to avoid insolvency. With a strict insolvency definition, most participants felt it was too late to recapture.

- Our feeling is that technical insolvency is too late to take action if there are financial problems at the reinsurer.
- Since an insolvent reinsurer is just about useless, it makes sense to offer this recapture option freely.

1.5 CHANGE IN CONTROL

Direct company participants felt that for capacity reasons, recapture with two merging reinsurers makes sense. Reinsurer participants felt a change in control of cedant(s) may mean a change in underwriting practices or claims practice.

- If a reinsurer change in control breaches cedant concentration limit, we can talk. But we will not provide the cedant options to recapture existing business at their discretion, because of vague language in the contract. A cedant is responsible for the consequences of its change in control, and thus termination [of new business] by the reinsurer may be appropriate. Also, "change in control" should be defined in the treaty.

1.6 CHANGE IN RATINGS AND RBC

The reinsurers interviewed expressed a preference to not place recapture options in their contracts that pertain to a change in ratings or RBC.

- Recapture provisions such as RBC and change in ratings may allow direct companies to recapture profitable business and leave reinsurer with poor business
- Recapture on Ratings/RBC—resisted due to snowball effect
- A remedy we have used for this option is a backend recapture fee that allows a reinsurer to obtain to some degree of the profitability they anticipated when they signed the treaty.

1.7 RATE INCREASES

Many older treaties were written without rate guarantees. Anticipating the need for backend protection, the cedants on most treaties requested a recapture option should a reinsurer raise rates. Some cedants also requested that the rates could be increased only if rates were increased on similar or all blocks of business. No provision has consistently worked as anticipated. A problem turned out to be that replacing coverage on recaptured business has been more costly and difficult than anticipated. Some problems include placing facultative cases, recapturing and replacing business in the 90 days typically allowed in the contract, and determining the recapture fee (if any).

- Reinsurers are usually not opposed to allowing recapture if they raise rates, but that's not always feasible, and it's not always easy to find replacement coverage if we do recapture.
- There are costs associated with recapture. It is time consuming. There is a need to find a reinsurer to take the business, and if this doesn't happen, you take on the volatility risk you minimized by entering into this agreement to begin with.

1.8 FUTURE RECAPTURE LANGUAGE

Participants felt recent, current or in-process language addresses most challenges currently faced regarding recapture provisions. Some of these solutions relate to being much more detailed and precise in defining terms related to recaptures—for example, defining the recapture trigger, what is or is not eligible for recapture, what must be recaptured if a recapture is elected, and the period(s) of time a recapture can be exercised. Thus, future recapture language for most provisions is more clear and becoming more standardized. This does not mean language is uniform but that variations are detailed and precise.

Participants have much less clarity regarding future recapture language pertaining to nonguaranteed rates. On the one-on-one calls and at the in-person meeting, participants brainstormed possible concepts related to nonguaranteed rate language. All but one option were summarily rejected. The remaining concept still needs refinement, and details would need to be worked out.

The one remaining concept is banded recapture rules for rate increases:

- If the reinsurer rate increase is between 0% and $X\%$, then no recapture is allowed.
- If the reinsurer rate increase is greater than $X\%$, then recapture is allowed.

This idea was expanded to permit recapture only upon a premium increase based upon mortality experience, after which there was more interest around the table.

Participants generally felt the option held potential to be pursued versus summarily rejected. No attempt was made to consider what the specific details may entail nor reach agreement that this approach was feasible.

1.9 CONCLUSION

A reinsurance treaty's long-term nature challenges both parties during the construction process to negotiate intent and then translate and formulate intent into language that pulls together rules, clarity, guidelines and flexibility to pass the test of time. The business climate and quality of business practices, administration and operations may change favorably or unfavorably over time.

Reinsurance treaties are more complicated today than they were 20 years ago, because language has been modified to address challenges uncovered over time and will continue to evolve as new problems emerge. Twenty years ago, reinsurers did not necessarily anticipate the recapture risk created from business and administrative practices. Recapture options were essentially given away for free. Such risk has manifested itself in reinsurers losing out on future profits. Likewise direct writers have found themselves contemplating recapture or paying much more for reinsurance because their premiums have been increased.

There is no denying that direct companies, reinsurers and retrocessionaires have built strong business relationships, as was evidenced prior to and during the in-person roundtable discussion that supported this project. It is because of the respect and friendships the three sides have for each other that we have no doubt that reinsurance treaties will evolve to the benefit of the life insurance industry.

Section 2: Acknowledgements

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Section 3: Introduction

This report is a sequel to *Life Reinsurance Treaty Construction*, which began in 2012 and was published in 2013. Recapture provisions have been a topic of significant interest resulting from actions by direct-writing companies and reinsurers, including retention increases, rate increases, insolvency and other recapture triggers.

Reinsurance treaty negotiations can be a long process that may lead to lengthy, unwieldy documents and negative experiences for the direct writer or reinsurer. The 2013 report's purpose was to increase awareness of the importance of many reinsurance treaty terms and provisions; identify common treaty structures, practices and solutions in reinsurance treaty construction and negotiation; and illustrate how treaty terms have evolved over time. Lessons can be learned by examining key treaty provisions; by surveying ceding company and reinsurers' viewpoints on business objectives and reasons specific provisions are of particular importance; by identifying how current practice has evolved from the past; and by considering obstacles, compromises, conflicts and solutions during and subsequent to the treaty construction and negotiation process. These purposes also apply to this sequel.

This sequel specifically looks at industry perspectives regarding recapture provisions and considers whether treaty language would benefit from adjustments for today's reinsurance business environment, be it financial stability of companies, new regulations or changes in the relationships between direct writers and their reinsurance partners. How and why are recapture provisions being used? How were, are or will recapture provisions be driven by regulation?

Shared knowledge facilitates the success of future reinsurance treaty negotiations to the mutual benefit of reinsurers and direct companies. Lessons shared potentially will enable both sides to reach better solutions more efficiently. Potential benefits include assisting individuals involved in reinsurance treaty negotiations, utilizing resources in future reinsurance treaty development more effectively, enhancing current processes and treaty language, reducing the length of time needed to complete negotiations, and improving the administration and execution of treaties.

Section 4: Overview

The treaty construction process takes weeks to months and involves negotiation and buy-in from numerous people and departments from both the direct company and reinsurer. While it's easy to foresee that people from different companies will disagree about construction of certain terms, one cannot forget that team members within a company may have disagreements as well, whether due to different perspectives, objectives or concerns. It is well beyond the scope of this report to review negotiation topics. However, we point out that negotiations and the treaty construction process are people-centric. The process is much more than treaty language. Rather than seek or recommend one solution to an issue, we wished to capture and disseminate multiple viewpoints.

We did not seek out best practices but rather a multitude of perspectives and practices regarding the issues, interests, reasons, approaches, and what did or did not work. Difficult issues often arise not from the treaty language but in business practices often related to executing treaty requirements. Again, resolutions cannot be offered or applicable to all situations.

The stages utilized in developing this report entailed:

1. participant selection
2. a questionnaire regarding identification and selection of issues
3. telephone interviews
4. participant research assignments
5. follow-up email correspondence
6. an in-person round-table discussion with 10 participants

Comments provided through the questionnaire and interviews were useful and insightful and allowed participants to see the thought process of other treaty negotiators. However, the rich exploration of issues was only possible through engaging dialogue and debate. A nonpressure, nonnegotiation setting allowed participants to share and listen to other perspectives without the need to compromise, negotiate or persuade.

4.1 PARTICIPANT SELECTION

The Project Oversight Group (POG) solicited reinsurance treaty specialists—actuaries, lawyers or others who had firsthand knowledge or responsibility for drafting or reviewing life reinsurance treaties. The POG then also selected from these the in-person roundtable participants—five representing reinsurers and retrocessionaires and five representing direct writers. In addition, one other reinsurer participated in the questionnaire and telephone interviews.

4.2 QUESTIONNAIRE

We distributed a questionnaire to participants to identify difficult or contentious areas for one or both parties during or after the treaty negotiation and construction process or otherwise resulting in unsatisfactory outcomes. The questionnaire listed six provisions. On a scale of 1–5, where 5 indicated the most dissatisfaction or disagreement, we asked participants to rate each provision or article and exhibit:

- a. From your perspective, rate your degree of satisfaction with the outcome.
- b. From your perception of your reinsurance partner, rate their degree of satisfaction with the outcome.
- c. Rate the degree of disagreement at the onset of and during the process.

For each category that a participant rated 4 or 5, we asked for a brief description or specific examples that formed their opinion.

The following provisions received the most dissatisfied or disagreement ratings (4s and 5s):

1. Change in financial or capital ratios (eight 4s).
2. Recapture, other (three 4s, five 5s).
3. Change in ratings (five 4s, one 5).
4. Change in retention (four 4s).

Change in legal control received one 4 and no 5s. Insolvency did not receive any 4s or 5s.

See [Appendix A](#) for the full questionnaire, average ratings and the number of 4s and 5s each article received.

4.3 TELEPHONE INTERVIEWS, EMAILS AND IN-PERSON ROUNDTABLE DISCUSSION

We conducted one-on-one telephone interviews with each participant covering the provisions they rated 4 or 5 as well as exchanged numerous emails. We discussed the particular recapture provisions; their perspectives on issues, drivers and the evolution of the provisions in treaties; and the nature of negotiations over time. We requested examples of sample language to illustrate the issues and the provision's evolution. In several cases, the provision was absent in older treaties.

We conducted an in-person roundtable discussion in April 2019 with five participants representing reinsurers and retrocessionaires and five participants representing direct writers. Prior to the roundtable, we circulated a summary of the issues and perspectives and sample language for each provision. We developed talking points for each provision to facilitate the in-person roundtable discussion.

Section 5: Participant Perspectives—Treaty Provisions

Participant perspectives are organized by treaty provisions and include two subsections: participant comments and author observations. Comments are a mix from the questionnaire responses, telephone interviews, emails and in-person roundtable discussion. Observations are our aggregation of the multiple perspectives shared through the collective body of comments and discussions that transpired during our research for this report (whether or not explicitly quoted in the report). Each section has a brief introduction to provide background or context.

The roundtable discussions alternated among describing, explaining, debating, clarifying, expounding, disagreeing, defending, supporting, brainstorming and laughing. Some issues provoked strong disagreements on the nature and intent of the provision. Throughout the roundtable, these differences were constructive and met with professional respect. Recurring humor peppered the discussions.

The comment section reflects the back-and-forth dialogue between participants. Our compiled notes encapsulate sometimes concurring, sometimes conflicting, sometimes divergent views on what the issues are; what does and does not work; and different suggestions. We have edited and paraphrased our notes to ease reading. However, in many cases, we felt conciseness would not capture the vibrancy of the issues and opted for a documentary approach. We have attempted as much as possible to be faithful to participants' words and meanings.

5.1 BACKGROUND AND CONTEXT

This report is a sequel to *Life Reinsurance Treaty Construction* that began in 2012 and was published in 2013. More than six years ago, recapture provisions, being several of the dozens of provisions forming a treaty, were discussed without much fanfare. Not that recapture provisions were overlooked; in fact, the 2013 report highlighted contentious provisions and issues including cedants cherry picking recaptures and recaptures as a result of reinsurers raising premium rates. However, they did not receive the heated debate of issues deemed more important and more contentious at that time. Yes, some clauses were not liked by direct companies and some were not liked by reinsurers; as options, parties at times exercised recapture provisions opportunistically and anti-selectively to their advantage; some older treaties had unclear language; and yes, improvements could be made and were being made to newer treaties.

The ability to recapture business ceded under a reinsurance treaty is an important consideration when negotiating treaty terms and can have significant financial implications for the ceding company, the reinsurer and other related parties (e.g., retrocessionaires and third party financiers). A recapture provision defines the obligation or an option of a cedant at a point in time or during a time period, for example:

- a. The cedant shall recapture level term policies at the end of the level term period.
- b. The cedant may recapture policies after 20 years.

In addition, provisions related to recapture may include changes in retention, insolvency, changes in legal control, changes in rating, changes in financial or capital ratios, and increases in premium rates (we will refer to these collectively as "recapture provisions"). These provisions can give the cedant an option to recapture upon an event or trigger(s) occurring. Thus, recapture is an option provided as a response to or recourse from some other event(s) occurring. These events may be under the control of one, both, or neither the cedant and reinsurer.

Recapture provisions have more recently been a topic of significant interest resulting from actions by direct-writing companies and reinsurers, including retention increases, rate increases and insolvency:

- a. Unclear language caused some direct companies to attempt recapture when the reinsurer did not see recapture triggers being met.

- b. Direct companies have attempted to recapture after long periods had transpired since the option's trigger had been triggered.
- c. Direct companies, as a result of their request to reinsurers, have often had the option to recapture in response to reinsurers increasing premium rates on blocks.
- d. In the case that a reinsurance company becomes insolvent, any associated recapture right has largely lost its value.

Two key themes in this sequel are:

- 1. Recapture and related provisions are embedded options.
- 2. Older language did not adequately anticipate or address future business needs and issues.

Neither of those themes is a startling new insight. Recapture provisions options were called in the 2013 report and their optionality discussed. One could say the themes are common knowledge to those involved in negotiating and administering reinsurance contracts. But common knowledge does not necessarily solve business problems. When treaty language proves inadequate, particularly as a result of broad interpretations, the option seller (typically the reinsurer) may have given away more optionality, more benefits or taken on more risks than was the intention by one party or perhaps even by both parties. The treaty authors' successors could take advantage of these inadequacies, perhaps even aggressively pushing the meaning of various provisions. What are the issues and challenges today's successors face? How can today's authors anticipate tomorrow's problems?

The past few years have elevated appreciation regarding the parameters and characteristics of these options—and the risk and financial consequences. To some degree, there was a belief that some options would rarely be exercised due to competitive pressures and ongoing business relationships. To some degree, some options were undervalued and underpriced.

The two themes are interconnected. These embedded options are not traded and do not have an observable market. The treaty provisions define the terms of the options. For example, once an RBC ratio threshold or change in retention is triggered, can the option be exercised at any time or only while the trigger is in effect or for some defined period? What is an option's value? Does value depend on other provisions? Can the option be priced? If so, is the buyer willing to pay that price and should the price change over time? Does the seller want take on the risks? Which risks? While these questions may appear to the reader to lack relevance or clarity, in what follows, participant comments and our observations develop the case for the questions' relevance, import, and implications.

Option prices can be charged at a treaty's inception, on an ongoing basis, upon exercise of the option, through effectively netting the value of various options within the treaty or a combination. Option prices can be charged with an explicit fee, higher premium rates, lower allowance, options seen as offsetting each other (whether in part or in full) or a combination of these. Treaties may provide an option as recourse upon another option's exercise (recapture upon exercise of an option to increase premium rates).

Another important underlying theme is regulations. How do past, current, and future regulations affect reinsurance? Effects on recapture provisions' treaty language tend to be two degrees removed. We single out one regulation. Regulation 830, also known as Triple X, defines the calculation of life statutory reserves and deficiency reserves. Guaranteed reinsurance premium rates result in a higher deficiency reserve than nonguaranteed rates for the reinsurer and hence higher costs passed to the cedant. Regulation 830 further increased the cost and was yet another factor in the common offering of nonguaranteed rates. In addition, coinsurance treaties on level term products became more prevalent. Some treaty language is intended to make rate increases and hence recaptures less likely. A new regulation, the *Valuation Manual*, became effective Jan. 1, 2017, with a three-year transition period to be adopted by insurers and reinsurers. Section 20, or VM-20, defines the modern version of deficiency

reserves. Furthermore, regulators are actively discussing changes to VM-20 regarding nonguaranteed reinsurance premium rates. At the time of this sequel, how VM-20 will impact reinsurance and treaty language in the short or long term is unknown. But known or unknown, both the old and new regulations have and will impact reinsurance and are an issue to be considered. See [Appendix B VM-20: Impact on Reinsurance](#) for a brief summary of VM-20 and its potential impacts on reinsurance.

5.1.1 2013 REPORT THEMES

Some but not all of the themes from the 2013 report are relevant to recapture provisions. We summarize these for the reader's convenience to provide additional context to the discussions and comments contained in this sequel.

The Business of Treaties

Treaties are long term and are bequeathed to their creator's successor's successors. People, relationships, intents, contexts and business environment may not be the same in the future when provision terms are applicable, questioned or enforced as when the treaty was constructed. Forces of change—including unanticipated events, interpretations, actions, regulations, accounting, products, market, competition, capital needs, capacity, administration, technology, disputes, underwriting and risks such as financial, market, legal and operational risks—all provide forward-looking challenges.

The reinsurance business and treaty construction have changed irrevocably. The 2013 consensus view was that the business of reinsurance and treaty construction was different than in the past. An indication is that over the previous 20 years, treaty page count had increased from single digits to as many as 100 pages. Increased page counts are a reflection of changing business drivers, objectives, relationships and complexity. In addition to length, treaty provisions have undergone a significant transformation.

Principles and Guidelines Versus Rules and Legal Definitions

Treaty construction reflects current business objectives as well as the efficacy of previous treaties in meeting past, current and anticipated objectives. Treaty language, original intent, current interpretations and operations including business practices and execution of treaty requirements all influence negotiations and the construction process. Treaties are also constructed with one eye toward the future. Most treaties are entered into with the intent to enter into future treaties, that is, to maintain or even grow the existing business relationship. It is not typically a one-and-done deal. A provision that proves one-sided will be remembered again and again during future negotiations. In *Getting Past No*, William Ury advises, "Next to knowing when to seize an advantage, the next most important thing is knowing when to forgo an advantage," and "to aim for mutual satisfaction, not victory." However, even if your company has good practices, it may be adversely impacted by the practices of other companies.

Treaty construction attempts to anticipate what might happen 10, 20 or 40 years from now. The pendulum swings back and forth between guidelines and rules based on developing experiences. Precise legal language can provide clarity to protect one's interests. Guidelines can provide flexibility when rules do not anticipate or address the instance precisely. Precision can imbue clarity while removing ambiguity when the "letter" of the contract rather than the "intent" is enforced. Not every issue can be anticipated in advance. If the rules approach does not address the instance precisely, then each party decides exactly what it means. These interpretations likely do not coincide. One interviewee said, "You want to be loose and flexible but then it is difficult to figure out how it applies to a specific case or dispute, so you want to tighten that up." We are in a period where the pendulum has swung towards rules and details, perhaps permanently shifting the "center."

Contention can occur during the negotiation process or long after the treaty's consummation. Some provisions are not contentious during the negotiation process; however, they become contentious later. Some provisions are contentious now and later. Some contentious issues have everything to do with treaty language. Treaty language may subsequently permit actions deemed contrary to intent and unfair to one side or the other. Today's interpreters of treaty provisions written years or decades ago cannot necessarily divine intent and understanding

between the treaty's authors. Some contentious issues have everything to do with business operations and practices. Construction of language is inextricably intertwined with business, operational and administrative practices. Regarding treaty evolution, one participant commented, "It's not as if we've been brilliant with foresight in anticipating future issues; we mostly react to bad situations."

If reinsurers are not standardized on an issue, in general, it causes a lengthier negotiation process for the direct companies. New and emerging issues take time to become standardized. Both sides desire consistency across their treaties. Reinsurers enter into thousands of treaties over a short time span. Inconsistent language between cedants, across countries and from year to year creates administrative and operational challenges. Mid-size to large domestic and global direct writers face similar challenges. Evolving and new products, coverages and regulatory and business conditions produce an entropy effect. Language might not be immediately updated, resulting in provisions that do not satisfactorily address new needs or situations. For example, pro rata treaties initially retained excess treaty language regarding recaptures related to retention increases. If language becomes standardized but ends up not working, the construction becomes contentious to address the shortcomings.

A reinsurance treaty's long-term nature challenges both parties during the construction process to negotiate intent and then translate and formulate intent into language that pulls together rules, clarity, guidelines and flexibility to pass the test of time. The business climate and quality of business practices, administration and operations may change favorably or unfavorably.

Reinsurance treaties are more complicated today than they were 20 years ago and will continue to evolve as new problems emerge. In particular, twenty years ago, reinsurers did not necessarily anticipate the operational risk created from business and administrative practices.

5.1.2 2013 REPORT RECAPTURE PROVISION COMMENTS

We provide selected comments and observations from the 2013 report. Recall, that participant comments always correspond to bullet points and either directly quoted or paraphrased as indicated by quote marks or lack thereof.

Participant comments always correspond to bullet points and either directly quoted or paraphrased as indicated by quote marks or lack thereof.

Recapture

One issue is the inclusion of recapture triggers requested by direct writers such as rating downgrades. Another issue arises when a trigger is included on business that the reinsurer has retroceded to another company. The retrocessionaire wants to retain the business it is insuring and if the direct company recaptures policies due to the trigger the retro will want to be compensated for releasing this business.

- "We insist on unilateral recapture rights upon an increase in premium rates."
- "Recapture is tied to material breach of the treaty, change in control, insolvency, ratings agency downgrade, RBC [risk based capital] triggers, failure to pay claims, rate increases—we should discuss terminal accounting and recapture fees."
- "Many treaties require the start of a recapture program within a certain limited period after a retention change. However, I've never seen a reinsurer that would not make an exception and allow recapture to start several years after a retention change. We have a number of old treaties that don't contain any recapture provision, which can lead to problems as business situations change. When we write a treaty where recapture is not anticipated, we always try to include a statement that recapture is only available by mutual agreement."
- "There always seems to be discussion over when recapture is appropriate. I'm not necessarily talking about recapture due to a retention increase but other situations such as ratings downgrades, rate increases, etc. Also, oftentimes there is confusion about how recapture is handled in first dollar quota share arrangements."

- “Companies wish to redeploy capital and hence recapture. Others are grabbing back old business as new business dries up. We need to prevent cherry picking.”
- “Old language lacks clarity as to the extent of a recapture.”
- “Direct companies want control over their own policies. Reinsurers price for a given duration. Several reinsurers have added a recapture fee for ‘early’ recapture. The ‘fixed’ nature of the recapture period should be a point of negotiation. Our thinking revolves around the possibility of having a different set of reinsurance rates/premiums depending on the length of the recapture period. The set of recapture period/reinsurance premiums would be determined before the treaty is finalized.”

Similar to premium accounting, treaty language for the recapture provision is not standard across the industry and many variations exist. This provision is an example of guidelines and flexibility versus rules and precision. Historically, treaty language did not anticipate future conditions and lacked the necessary guidelines or precision, thus leaving gaps allowing broad and divergent interpretations. The recapture provision is also illustrative of the entropy effect where language is reactively rather than proactively responding to changes.

Premium

The option to recapture was also discussed in the 2013 report as it related to being a recourse to reinsurers raising rates. The language between reinsurers is not consistent. Explicit premium guarantees at current rates would likely result in the reinsurer setting up deficiency reserves leading to higher costs for reinsurance. Most of the issues and discussions were indirectly related to recaptures and pertained to making rate increases and hence recaptures less likely.

[The first three comments pertain to language that requires the reinsurer to raise rates on all treaties.]

- “They have to increase rates across a large block of business. How does the direct company know the reinsurer actually raises rates on everyone?” ... “A treaty should be self-contained and the language [referencing business and rates in other treaties] breaks this rule.”
- “One of the keys to this is that if rates were increased and disputed, then the rates of all other treaties would be included in discovery. Reinsurers do not want this at all.”
- “Rate guarantees should have some basis in mortality. A reinsurer tries to recover past losses by raising rates. Regulators look and ask if this is now truly a transfer of risk.”
- “Language is as it is so reinsurer’s do not have to hold deficiency reserves. A hypothetical: If you no longer need to hold deficiency reserves [for example, principle-based reserves], what would happen to this clause?”
- “It would be tied to the recapture rights in the contract.”
- “Recapture is not an answer to raising rates because I need the coverage.”
- “The intent is to not change the rates. No one enters into a deal knowing they underpriced it but intend to jack up prices at a later date.”

5.2 CHANGES IN RETENTION

Treaties often contain a provision permitting the cedant the option to recapture upon a change in retention. Thus, the trigger is a retention change. The word “retention” is not always defined or precise. Ambiguity may exist regarding which retention is more prevalent in first dollar quota share (FDQS) treaties. Issues include which changes, which retention and what business is eligible to be recaptured or required to be recaptured if the option is exercised and the time period in which to exercise the option.

5.2.1 OLDER TREATY LANGUAGE

Older treaties were often vague on recapture terms related to triggers, eligibility and time.

5.2.1.a PARTICIPANT COMMENTS

Recall, participant comments always correspond to bullet points and either directly quoted or paraphrased as indicated by quote marks or lack thereof.

Participant comments always correspond to bullet points and either directly quoted or paraphrased as indicated by quote marks or lack thereof.

- Older treaties are not explicit on reinsurer’s restrictions or requirements for increasing retention.
- Current treaty language is more clear and that cannot necessarily be said about older treaty language.
- Recapture rights on retention increase historically can be vague. Hopefully better now, and parties should be encouraged to add detail.
- We usually have language in our treaties that states a company is not allowed to recapture policies in which the ceding company did not keep their maximum retention at issue.
 - Some reinsurers were trying to apply this (i.e., “at issue”) to mean recapture is not allowed on policies for which a company did not hold its maximum retention at all times since issue.
 - Some of the old treaties might have lacked the words “at issue.”
- It was suggested that since underwriting occurs at issue that this is the time when requirements pertaining to maximum retention should be set.
- The reinsurer should have the same risk as the ceding company, and they only assess that risk at issue.
- You are also depending upon the ceding company to perform administrative functions in accordance to the terms of the treaty and their standards.
- You have to be careful when writing treaties to distinguish between an individual retention and an expectation that the quota share remains the same.
- You cannot just state in a treaty something as vague as “as stated in Exhibit B,” because there may be multiple retentions defined in Exhibit B. Vague language favors the cedant in this situation.
- If a company signs an in-force treaty, the policyholders in this treaty will be under retained. Sometimes a company will mistakenly recapture business issued after the business of the in-force treaty to compensate for the under-retention.
- It was felt by all participants that treaty language is clear in this when pertaining to in-force treaties, and companies who do this (activities described in the previous bullet) are operating outside treaty language.
- How often does anyone recapture, especially under FDQS treaties?
- Recaptures do not happen often because the resource cost is too high or too complicated to recapture.
- When companies first went to FDQS, you ended up with two retentions in the treaty, and when they first started writing FDQS treaties, the language wasn’t clear on which retention they were referencing at which point. What do I have to increase? What was I supposed to retain initially? The treaties are just confusing.
- I think both sides weren’t clear when they entered into the treaty either.
- Someone asked about the intention. I actually think there was no intention.
- In a FDQS, you could say, I was only keeping 20% ... if you think retention is referencing 20%, the reinsurer will say you weren’t going to be able to take everything back, that wasn’t what I meant.
- The direct writer will say I increased my retention so I am going to recapture and I can terminate the FDQS portion of the treaty.
- The lawyers will say you didn’t cap it with any restrictions when you wrote the treaty. That’s why I think some of that vague language may have favored the cedants in terms of recapture rights and whether you could do it.
- The business is already ceded; it’s actually unclear and probably more on the side of the reinsurer. As a direct writer, I am trying to take the business back that I have already ceded, and I don’t have clarity that I’m allowed to do that.
- As it evolves, are you looking at it being both—an individual retention limit as well as the FDQS retention?

- I agree that's exactly what needs to be done. If I increase retention, that means I get to recapture. I appreciate the intentions might not have been so broad, but the only thing you're left with is your language. Maybe you have a more aggressive cedant taking advantage of that.
- Certainly the language that was circulated, I can't say I agree with every bit of it, but it's a lot better. It provides a lot more detail with what's going on and what has to occur than some of the older language I've seen that is four lines long if that.
- Most treaties have a time period where recapture is not permitted (e.g., the first N years). Usually for term, N is the level period, and even for whole life there is some time period.
- Vague language favored the cedants in that if the treaty was not clear upon what was eligible for recapture, a cedant could recapture profitable business when this was not the intention of the reinsurer at treaty inception.
- With new treaties, we clearly define which retention we were referring to.
When old language is found to be vague, do you amend old treaties to better define vague language? No, participants' companies modify new treaty language but are generally not amending old treaties.

["At issue" was revisited, restating earlier comments but then taking a different direction.]

- Also, as account value grows, the net amount at risk decreases, so over time you are retaining less, according to the retention you set at issue.
- To me it's very clear. I don't know why it's not clear.
 - I would agree (by numerous participants).
- What are you keeping? Underwriting and during application—when you issue a policy, those decisions are made.
- If you think my retention is \$10 million, so I hold that at issue, would you as a reinsurer be happy if I gave away \$9 million without telling you?
- If a company holds no retention, would that not alter their motive?
- You can't have a program where you change the underwriting of the block or cede out the retention of the block without the reinsurer receiving notification or giving permission.
- Could you have an in-force treaty ceding out policies that didn't have any reinsurance on those policies?
- But how does that affect retention on reinsured policies? If I have \$10 million retention on excess of retention, when they die, the reinsurer should be able to say to me, show me your \$10 million on the life—when they died, not when it was issued. If you can't, they have a right to have an issue.
- So, if I have a block of policies without reinsurance that doesn't affect reinsured policies, I can cede that out. As a corollary, outside of this box, if I have policies that are affected or have reinsurance, treaty language—one hopes—will prevent me from unilaterally ceding the in force block.
- Yes, this is how it typically does work. If you have Yearly Renewable Term (YRT) on some life business and you want to get financial reinsurance, you usually are required to tell your YRT reinsurers, and language often requires that.
- There could be flexibility if it is to an affiliated party.

5.2.1.b AUTHOR OBSERVATIONS

The issue pertains to older treaties with language that needs to be interpreted and applied today. In regards to new treaties, some have moved to using precise language that requires longer detailed clauses than the brief words or sentences used in the past. Ambiguities generally favor the option's buyer by allowing broader interpretations such as what triggers recapture and when recaptures can be exercised. As a result, recapture options were undervalued in many instances. This favors direct writers who are willing to exercise their recapture option. A counter-point was made that since the business is already ceded, recapture requires clear language permitting recapture and that ambiguity that recapture is not permitted is insufficient.

A possible cause of ambiguous language is that when coinsurance treaties became prevalent due to Triple X's deficiency reserves, in some or even many cases, the treaty construction process started with draft language derived from an existing YRT treaty. Revisions, additions and deletions were then made to provision language, but

treaties sometimes retained language not applicable to a coinsurance context. Although which retention was being referenced in a first dollar quota share (FDQS) treaty change in retention clause may have been clear to all the participants at the time the treaty was signed, that has not prevented some direct writers from trying to interpret retention to their advantage.

Some FDQS treaties had recapture language that matched their excess of retention recapture language and thus opened themselves up to an interpretation that a direct writer could recapture 100% of a policy up to their retention.

Example

Two companies enter into a 90% FDQS treaty. Treaty language states the cedant can recapture up to the new retention when retention changes. The company increases retention from \$1 million to \$2 million. If the block is profitable, they are in some cases changing their retention on a \$2 million policy from \$100,000 (old retention: $10\% \times \$1$ million) to \$2 million (new retention) rather than \$200,000 ($10\% \times \2 million). This may not have been as the reinsurer intended but because the treaty language is sometimes unclear, this recapture has been accepted in certain cases.

Some treaties lacked the timing of the recapture, and many referred individuals to the Appendix of the treaty, which created several recapture options. In general, older treaties were vague and not concise. This worked to the advantage of the direct writer in many instances.

5.2.2 NEW TREATIES

Treaty writers have learned from past experiences and have been or are addressing issues from older treaties as well as attempting to anticipate current and future issues. How language has recently evolved and forward-looking issues were discussed.

5.2.2.a PARTICIPANT COMMENTS

Facultative Recapture

Was the case issued as facultative for capacity or underwriting purposes?

- If it was shopped because of capacity, we would like to recapture to our new retention limit when we increase our retention.
- If it was a facultative case because of underwriting concerns we would not want to recapture the policy.
- My position is, can they do it? Is it permissible? If yes, then we take a look at it.
- When recapture happens we are really only looking at the Automatic side of the house, if there is a facultative case in the treaty—it could be anything—it is almost like a separate contract.
- I haven't seen it in any treaty that specifically differentiated between fac shopped and fac excess.
- If you keep your full retention on a policy and you initiate a recapture program then you need to recapture facultative policies up to your new retention.
- Sometimes the treaty is worded in such a way that recapture on facultative cases is not allowed. In these situations a direct writer can either recapture automatic policies and leave facultative policies unaltered or go to their reinsurance partner and discuss the possibility of recapture.
- The value of underwriting dissipates as the policy ages and facultative mortality converges to automatic mortality—reverse select and ultimate.
- There is a difference between viewing something as facultative from a pricing or legal perspective versus an underwriting perspective.
- As underwriting evolves, a case considered facultative 10 years ago may be automatically issued today because of the evolution of underwriting.

- We (the reinsurer) may want to keep facultative policies and the higher premium that comes with these policies.
- Many treaties state that if you do not hold your full retention on a policy, you can't recapture the policy on a retention increase. In these treaties, policies shopped for underwriting purposes would tend not to be recaptured. Policies issued on a facultative basis because of financial consideration can usually be recaptured up the new retention.
- There a lot of moving parts.
- We would develop the facultative provisions a lot more quickly than others, because that really is a side contract.
- I think there is an ambiguity there.
- You have to look at how the facultative cession creates a contract; in other words, am I bound to everything that is in my automatic treaty, save for the fact that this policy is substandard or whatever? Or do I have my own offer, acceptance and submission that effectively forms a separate contract? If you want to define on each facultative case what your recapture provision is, from an administrative view that is challenging.

No Anti-Selection

- If you elect to recapture, you have to recapture the entire block of business.
- You have to take all of it—whatever is eligible.
- Do they have to apply it to every treaty? Can I pick which treaty?
- I look at it as: What does this particular contract say?
- If you recapture up to your new retention on one treaty, is it anti-selection if you do not recapture up to your retention on all treaties?
 - This was deemed unclear and some of the existing language in treaties is inadequate for this purpose.

Rescission

- You may not rescind an election to recapture.
- The option to recapture is irrevocable. However, a company has asked to rescind a recapture notice in the past, and the reinsurer agreed to the rescission.

Recapture Fees

- A reinsurer stated, "I'm in favor of recapture fees."
- Some or many older contracts don't have recapture fees.
- Reinsurer participant: Our feelings on recapture have evolved. Twenty years ago, recapture was an option we were handing to the cedant. Nobody thought about it, they just gave it away. That is not the current thinking anymore. It's an option, and options have costs. That thinking has evolved at all reinsurers, but it runs into existing market practice and that's where the challenge comes in.
- The old thinking was that if a company wanted to recapture after 15 years, we (the reinsurer) were fine—we'll make our money in 15 years. But now you've got to realize it's an option, because if in the 16th year it's profitable, the odds of it disappearing are much more likely than if it's not profitable. When you're pricing, suppose you think it's a normal curve distributed around the mean. But the reality is that business is no longer distributed around the mean because half your business disappears and half stays. You should, if you are thinking about this economically, have an additional charge built into recapture. That is how the thinking has evolved.
- Does your opinion change if the reason for recapture changes?
- If a reinsurer raises its rates, the reinsurer has exercised its option of its own [to raise premiums]. There are options going both ways, and this becomes a separate category. Because of this, a recapture fee may not be a contractual obligation.

- Direct participant: Regarding your optionality comment: On retention increase, the option is mine to recapture. On a rate increase, the optionality lies with the reinsurer. To throw out a question, it's not my option for you to get into financial difficulty.
- Reinsurer participant: You need to manage counter-party risk, but if they do get into difficulty, their only asset may be your reinsurance. Let me flip it around. We've seen plenty of reinsurers get into financial difficulty, not as bad as the one recently. They had plenty of business. Why did they have plenty of business still? Not because it was super profitable. Even with low ratings that everybody wanted, the direct writers were exercising it as if it were an option, and they are willing to put up with pretty shaking ratings as long as it's in their favor financially.
- Isn't that the same thing that is happening on the direct side, with direct writers saying I never knew the reinsurers had this option because of the way it used to be priced and the understanding that we had before, and now we're feeling that there is an option that we need to contemplate if that option is exercised.
- It's not contractual; therefore, you negotiate.
- Yes, you have the contract, and if you want to do it sooner than that, now we negotiate.

Regulatory Changes

What happens when regulatory change affects the way you operate your business and as a result potentially makes reinsurance less valuable to the cedant?

- For regulatory changes though, you have to bring a reinsurer to the table that allows your cedant to take credit. By definition, you have to have a license to do business. That's pretty standard language. If I can no longer take credit because of who you are or that you lost your license, that's a recapture event unless you are going to set up an letter of credit or trust.
- Perhaps we're talking about something broader than just regulatory change because you lost your license and I can no longer take credit. It could be because the nature of the regulations covering the business changed and the reinsurance is less valuable to me. The impact we're going to see with principle-based reserving (PBR) and your point as to what margin you can put in may or may not allow your reinsurance to be as valuable to you as you thought it was going to be. Is that a regulatory change that should allow recapture, and if so, should there be a fee. I think that is much more subtle.
- I wasn't even going that far. If you have a regulatory change that says you can't have this transaction anymore, what do you do in that situation?
- Since regulatory changes can be retroactive (e.g., changes and amendments to the *Valuation Manual*), a well-written treaty today may not be an effective treaty tomorrow.
- If it is anticipated at the time of contract, it needs to be dealt with and language should be added to the treaty. If it is an unanticipated action, the cedant carries the burden of regulatory change and risk.
- It is not clear how reinsurance credit will be determined or modeled under PBR. Regulators are considering numerous proposals. That means any treaty written today carries additional risk.
- There are issues related to how reinsurance credit is allocated to policies and hence to treaties. Another issue is how quickly can the reserve credit disappear?
- Reinsurance is risk mitigation. Regulators felt that if you group policies that are highly lapse supported with whole life policies, then you can hide the associated risks. VM-20 was amended to categorize by three product groups: Term, Universal Life with Secondary Guarantees (ULSG), and Other. Now cross-hedging risks across product groups no longer are reflected in PBR modeled reserves.
- If because of regulation (PBR) reinsurance became unprofitable, then should a direct writer have the right to recapture?
- The direct writer should be better informed than the reinsurer about their regulatory reserve issues and therefore it is not a reason to recapture.
- It goes back to the point of the risk transfer issue. What is meant by the word "risk" and "risk transfer"? It means the insurance risk is supposed to be passed. If mortality goes up, and I try to write in my coinsurance agreement I'm going to cap it at X% mortality, someone's going to say I can't take credit for this. And that makes sense, mortality risk is one of those insurance risks that need to pass. I don't think regulatory change is.

It's not an element of experience that needs to pass to the reinsurer, so I don't know that we can be guided solely by the risk transfer regulations that regulators might come up with a change in a rule as equivalent as to a change in mortality.

- Recapture is not always a very good option, but maybe that is the solution, and many treaties today contain recapture fees, adding insult to injury [regulatory impact].
- A reinsurer noted that if there were a good reason that recapture was deemed necessary, a reinsurer would consider ignoring the recapture fees as a means to build or maintain the relationship.
- But we have active reinsurers raising rates; I don't buy the whole "relationship" thing is everything. It is business, and it is more a business today than it has ever been.
- If a treaty cannot be maintained because of an illegality (the treaty cannot be performed) then a recapture should occur or possibly an unwinding of the contract.

What if the contract is not illegal but you have just taken a lot of benefit out of the contract?

- You should come back to the table and see if you can come back to the place you intended to be when the contract was written and if the outcome has been skewed to either side.
- If you can't come to an agreement on what to do, then it becomes a little more complicated.
- In most cases, recaptured business is profitable, and the recapture fee is designed to recover the future earnings of this profitable block that is going to be recaptured.
- We (reinsurer) are willing to negotiate and reduce the recapture fee. If the reason for recapture is a rate increase because it is an unprofitable block of business, we have even reduced the recapture fee to zero.

Discussion circled back to a combination of topics in this section.

- The way we handle it, because we don't want to be in a position to tell our clients what to put in their treaties, is say: Here are a set of reasons which are listed for which there is no fee, and for everything else there is a fee.

5.2.2.b AUTHOR OBSERVATIONS

Recapture provisions illustrate issues related to guidelines and flexibility versus rules and precision. Historically, treaty language did not anticipate future conditions and lacked the necessary guidelines or precision, thus leaving gaps allowing broad and divergent interpretations. Broad interpretations favor the option buyer, and option sellers gave away unintended value. Companies and treaty writers have learned from these experiences to be precise regarding the terms of an option.

Reinsurers are pricing recapture options and making sure contracts are specific as to when and how much is eligible for recapture. Reinsurers want to keep their retention on facultative policies because the value of underwriting dissipates as the policy ages and facultative mortality converges to automatic mortality, but the premiums remain higher than in automatic cases. All the participants agreed that anti-selection is not permitted, but it is not clear if that means across one treaty or all treaties.

Recapture is an option, and recapture fees are the means to pay for the option costs, though fees are not always applicable. Aside from fees, the risk of underpricing or overpaying for an option can be managed through more precise language and defining contexts and situations.

5.3 INSOLVENCY

Some insolvency provisions grant a recapture option on the insolvency of the counter-party. Issues pertain to the option's efficacy. Can the solvent counter-party be protected in time?

5.3.1 PARTICIPANT COMMENTS

- Since an insolvent reinsurer is just about useless, it makes sense to offer this recapture option freely.
- Our feeling is that technical insolvency is too late to take action if there are financial problems at the reinsurer. We insist on ratings and financial triggers to give us an earlier out. The main question is whether there should be a recapture fee or not. We have not yet had to test this provision.
- We ignore the insolvency clause. It is too late by then.
- By the time a company becomes insolvent, it is too late to recapture.
- There are situations where a reinsurer is not willing to give this up because it felt it was its obligation to maintain its estate. I don't think that is legally true.
- Direct writers may have different definitions of insolvency. If a direct writer is able to recapture profitable business prior to insolvency, because of the way they define insolvency, this will accelerate the actual timeline to insolvency.

5.3.2 AUTHOR OBSERVATIONS

Some insolvency provisions grant the cedant the right to recapture upon a reinsurer's insolvency. With a strict insolvency definition, all the participants agreed that by the time a company becomes insolvent it is too late. There is one company that as of the time of the in-person meeting was being managed by the regulators, and the regulators were forcing companies to pay premiums but were not reimbursing for death claims nor allowing netting of premiums against due claims. Recapture is no longer an option in this case with these blocks of business, and the insolvency clause was irrelevant to this particular regulator.

5.4 CHANGE IN CONTROL

Issues exist when there is ambiguity on the conditions and rights upon a change in control.

5.4.1 PARTICIPANT COMMENTS

- Change in control is poorly defined in most treaties.
- If a reinsurer change in control breaches a cedant's concentration limit, we can talk at that point. But we do not put it in the contract. A cedant is responsible for the consequences of its change in control, and thus termination may be appropriate. Also, "change in control" should be defined in treaty.
- A party to the agreement needs to be able to negotiate recapture if new company attitude or process is different. New underwriting styles for example are:
 1. Want to terminate new business.
 2. Recapture and allow reinsurer to make their profit on block of business.
- Recapture would be out of line upon a change in control.
- You are ceding to a reinsurer because of its financial strength. Once you have a change in control, are you confident that whoever comes in will provide the same management style, the same attention to detail, etc.? And because of this, a cedant should have the right to at least look at recapture.
- Including this in the treaty creates the effect of a poison put. The contract should follow the reinsurer, and if the reinsurer gets sold, the contract goes with it unless the reinsurer proposes a reason such as a financial condition rating. The change in control is separate and apart from that. For an acquirer, a reinsurer's value reflects its business which this provision would allow to be recaptured.
- If a reinsurer wants to sell off a block of business, that is fair game. It should not make a difference assuming the financial ratings in the contract are not hit as a result of this change in control. A block of business is nothing more than property.
- The merger of two healthy companies has in effect helped you (the cedant), because now you are dealing with a larger and more stable company. You are in a better position because of my merger, and therefore this should not open the door for you to recapture my business.

- What if this is not true? What if this merger weakened your reinsurance partner?
- I should be allowed to force recapture upon a change in control of a cedant. Since this is an act entirely within the control of the ceding company, a ceding company can say if I don't want to recapture this business, I should not sell myself.
- When a participant has talked to regulators about risk transfer provisions, the regulators tell them that if the event is entirely within the ceding company's control, it is acceptable. What they are looking for is the right to protect themselves from losing reinsurance when the event is outside the ceding company's control.
- Why it was OK to provide a poison put in one situation but not another?
 - The response provided the example of different underwriting practices or different claims management.
- Although some have seen change in control to include change in senior management, no one had ever seen language that change in senior management constitutes a change in control on business written in the United States.
- If you have written into the contract defining how that business is written and how claims are managed, then why are you worried. It does not matter who the head of the company is. They have guidelines, and if they divert from their underwriting guidelines, you can terminate the treaty for new business; and if they start mishandling claims, you can go in and audit every claim.
- If we go that way, we are going to want to expand the paragraph that defines ordinary procedures. If that is an issue a reinsurer is concerned about, they are going to want to know a lot more about how you run your business. The language they should include should define how they plan to underwrite and how they will manage claims.
- Most treaties already state what the underwriting guidelines are at the time of pricing, and if they change, you have to have written approval from your reinsurers.
- Reinsurers were comfortable that if change in control resulted in different underwriting standards, they could terminate for new business and avoid business they are not comfortable reinsuring. However, if a change in control means your current business is now in a "bad" claims shop, there is extra unpriced cost in overseeing claims and paying claims that the old claims shop would have avoided.
- One participant was in a situation where it had a change in control and a reinsurer asked it to recapture its business. It was determined that the change in control that occurred at this company was not a change in control as defined in the contract, so there was no recapture. This was an annuity block of business, and the reinsurer wanted to exit this business.
- What are auditors going to say about including language in your contract to allow for a change in control?
- Counter-party exposure is a valid concern for the ceding company, so they should have the right to recapture should two reinsurers with large shares of their business merge. A ceding company needs this right to manage their counter-party risk with a reinsurer after a merger.
- If because of a merger a company is allowed to recapture in force business, the decision to do so will be based upon the financial profitability of the recapture and not counter-party exposure.

Finally, the discussion came back to why it was OK for a reinsurer to be allowed to force recapture upon a change in control and not allow the ceding company to recapture upon change in control of a reinsurer.

- One participant stated that if two reinsurers merge, then a direct writer is still in a good spot. This is not necessarily true if two direct companies merge.

5.4.2 AUTHOR OBSERVATIONS

Past language was either absent or noncomprehensive. New treaties attempt to precisely address the definition of a change in control and whether recapture optionality is allowed under a change in control. If necessary, existing treaties will require negotiation according to current business needs and existing treaty terms. Language has been and continues to evolve. As a two-sided option, the inclusion of a recapture option upon a change in legal control could result in benefitting the reinsurer or the direct company. If the direct company has a change in legal control, the reinsurer is allowed to force a recapture of ceded business. If a block of business proves to be unprofitable, the

reinsurer will exercise this option. Likewise, if the reinsurer has a change in control, the direct company may use its option to recapture profitable business.

The direct companies felt that for capacity reasons, recapture due to two reinsurers merging makes sense. Reinsurers felt a change in control may result in a change in underwriting practices or claims practice. This would mean a profitable business may turn unprofitable. Both sides like an option if it is their option but didn't necessarily want their reinsurance partner to have this option.

5.5 FINANCIAL TRIGGERS

This provision received more discussion and heightened sensitivity for treaties after the 2008 financial crisis, but there is still no standard provision or starting point. As in the 2013 report, study participants from reinsurers expressed their dislike of this provision.

5.5.1 PARTICIPANT COMMENTS

Recall, participant comments always correspond to bullet points and either directly quoted or paraphrased as indicated by quote marks or lack thereof.

Participant comments always correspond to bullet points and either directly quoted or paraphrased as indicated by quote marks or lack thereof.

- One participant noted that there are data points on this in the market. Reinsurers have dipped below A-, and their experience was that most cedants did not recapture business from them, particularly if it was unprofitable to the reinsurer. You can try to argue that whether the treaty was profitable to the reinsurer or not doesn't matter to the direct company, but in those cases, it did. It is an option being given, but it probably shouldn't be given.
- Participants from reinsurers did not like recapture based upon rating changes or RBC, but of the two, they prefer RBC.
- Recapture provisions such as RBC and change in ratings may allow direct companies to recapture profitable business and leave reinsurer with poor business.
- There are data points in the industry where the very profitable blocks were recaptured.
- Ceding company participant: We insist on ratings and financial triggers to give us an earlier out. The main question is whether there should be a recapture fee or not.
- Recapture on ratings and RBC have been resisted due to a snowball effect.
- I have seen options in treaties where dipping below a set point does not trigger the option to recapture. They need to remain below this level for an extended period of time.
- Regulators look at if you have downgrade puts in your contracts. If you have these puts in a large number of your treaties, this could very well have a negative impact on a reinsurer's rating if they are approaching this threshold.
- A remedy for this option is a backend recapture fee that would allow a reinsurer the ability to obtain the profitability they anticipated when they signed the treaty.
- Language exists that says if a reinsurer drops to a specified rating, then a direct company can recapture, but there will be a recapture fee. If the reinsurer drops to a lower rating, the direct company can recapture without a recapture fee. As the ceding companies hit the first trigger, some will recapture, but some will not. This in effect may dilute the cascade effect. But this option also provides the cedants an out prior to insolvency, and recapture at insolvency may not be enforceable.
- There is a reason you have ceded this business to a reinsurer. This is an option you really don't want to exercise, because if you do exercise this option, you have to figure out what you will do with it when you recapture it. That is probably not what you really want.

- I have seen treaties where they have clauses in the treaty that say that if one reinsurer becomes financially impaired they can pull it back and cede the business to a reinsurer already in the pool at the same rates they are receiving in their existing treaty.
- Another issue is the time limits. If a reinsurer hits a rating that allows recapture, is the direct company allowed to wait five years to determine whether recapture is a profitable option? It is important to put a time frame into the treaty. People are starting to see more and more term limits now.
- Include a provision where instead of recapture, additional collateral is required.
- Holding collateral causes a cascade effect too.

5.5.2 AUTHOR OBSERVATIONS

Participants from reinsurers generally did not like placing recapture options in their contract that pertain to a change in ratings or RBC. Of the two, they prefer RBC because they have more control over their RBC. This provision reduces counter-party risk for the cedant but creates additional liquidity risk for the reinsurer. The fear is that when either ratings or RBC trigger is breached, all cedants will analyze their treaties and recapture any treaty in which the block of business is profitable enough to warrant the costs to recapture. This creates a snowball effect and could vastly weaken what is in reality a strong reinsurance company. Regulators and rating agency analysts look for these options in treaties. Participants on both sides expressed concern that the mere presence of this option in too many treaties could lead to a downgrade.

Placing a recapture fee on any recapture would allow the reinsurer to attain the profitability originally anticipated when they signed the treaty. A block's profitability can be better ascertained on the backend than when a treaty was executed. Recapture can still be a profitable decision. However, even if a recapture is in the best interest of the ceding company, that does not mean it is not also in the reinsurer's interest. In exchange for future cash flows, they receive a fee and release the reserves held on this block, freeing up capital to deploy elsewhere. These two positive events may have more value than retaining profitable business for a reinsurer in need of immediate capital for financial position or for opportunities.

A nonstrict definition of insolvency was discussed in tandem with Section 5.5's Financial Triggers. If a treaty uses a loose definition of insolvency (i.e., something close to but not yet insolvency), then the presence of recapture rights can also result in a run-on-the bank scenario and be the final straw. In the absence of a recapture provision upon insolvency, a reinsurer may be able to execute the necessary actions to avoid insolvency. Some participants felt the recapture option for financial triggers or near insolvency was placed into treaties to allow a direct writer to recapture business from a reinsurer having financial difficulty. However, what happened in the recent past was that some direct companies recapture if the block is profitable and keep their business with an unstable company if unprofitable. For the company in receivership at the time of the in-person meeting, a participant commented that many direct writers had ample opportunity to recapture but chose to not recapture.

5.6 RATE INCREASES

As with the 2013 report, most of the issues and discussions were two degrees removed from recaptures, for example, the potential option to recapture following a rate increase. Cedant participants did not construe the lack of rate guarantees as a repricing vehicle. Explicit premium guarantees at current rates would have likely resulted in the reinsurer setting up deficiency reserves due to statutory reserve requirements.

In the past few years, several reinsurance companies have implemented rate increases, in some cases across broad blocks of business. Direct writers felt that in some cases the premium increase was so large or so unwarranted that they were forced to recapture their block of business. Recapture options in light of premium rate increases were perhaps the most contentious issue for this sequel report.

5.6.1 PARTICIPANT COMMENTS

- A reinsurer increased rates because treaty language stated that if it increases premiums on one block of business, it must do it on all similar blocks.
 - Reinsurer offered the option to recapture and then cede back at original rates, but the reinsurer rescinded offer.
 - Refusal made excuse of increasing premiums hollow.
 - The cedant recaptured and ceded to another reinsurer.
 - Facultative cases were problematic.
- Older treaties are not explicit on what to do when a reinsurer increases premiums.
- We include a reinsurance recapture fee (or recapture fee formulas) in negotiations and treaty contracts.
- The reinsurer is usually not opposed to allowing recapture if they raise rates, but that's not always feasible, and it's not always easy to find replacement coverage if we do recapture.
- I do not see a recapture option as a good way to respond to rate increases.
- If someone raises the rates on a profitable block of business, recapturing it should be a positive outcome.
- There are costs associated with recapture. It is time consuming. There becomes the need to find a reinsurer to take the business, and if this doesn't happen, you take on the volatility risk you minimized by entering into this agreement to begin with.

[The next set of comments pertains to rate increases on all similar blocks.]

- The obvious question is: What do similar blocks of business mean?
- The similar blocks clause gives the cedant protection in the fact that they cannot be singled out because a reinsurer has to increase premiums on everybody.
- Does similar mean across cedants or similar business with one specific cedant? Some felt this clause does not mean all cedants and some felt that it did.
- Older treaties may not have had recapture rights if a reinsurer raised its rates because the cedant thought the reinsurer would never raise the rates. Industry customs and practices should be considered when you are analyzing treaty language. If language is incomplete, shouldn't the intent that was intended by those who signed the treaty be considered?
 - Response: Agreement that although an arbitrator may lean on the intent, legally, if the treaty says you can raise premiums, then you can raise premiums regardless of the intent at the time the treaty was written.
- Sometimes it is easier to come to an agreement when the treaty is written because both sides think the language satisfies their needs. It is not until years later when a clause comes into play that they find out that one party took the language to mean one thing and another party took it to mean something else.
- The deficiency reserve language is frequently stated as the reason we are doing this, and we anticipate things to stay the same.
- The more detailed the treaty, the better; so, it is better to spend a couple of extra weeks to get it right.
- One of the challenges, though, is that you can be as detailed as you like, but it is difficult to anticipate problems that will occur once the treaty has been in force for 10–15 years.
- One should take care of what you know now. If a clause needs extra time because of things that have happened in the past, then it is time well spent to be detailed in these areas.
- Amending these treaties would be such a large task that the time involved for this task is just too much. But going forward, time should be taken to create better treaties.
- These contracts are like marriage. In the beginning, everyone is in love and happy. But you need to write the contract for the divorce. So, you need to sit there and think about the remedy if it blows up.

- If there is no rate guarantee, then there is a chance the reinsurer will raise rates, and if you sign a contract that has no rate guarantee, then you can recapture the business, but you have an economic decision. There is a rate increase. What does that cost? If I take it back, who will I give it to, and what rates are they going to give me? I have a lot to consider before I make a decision.
- Reinsurer: What other remedy can there be? If I have the right to raise rates, we will take that as a given, then the ceding company has the right to recapture. What is my middle ground? What is the second remedy I can offer you?
- Consider a provision stating that if another reinsurer in the pool increase rates, the cedant can increase its coverage with you by recapturing and placing it with you at rates determined when the treaty was put in place.
 - I have seen one treaty with language like this in the past, but there is no reinsurer willing to propose anything along these lines today.
 - How does the reinsurer manage retention issues?
 - You have a predetermined price that the reinsurer does not like. You are providing a cedant with an option that will only be used if it is profitable, not due to difficulties to secure replacement coverage.
- We do not include language that says we can only raise rates if we do so on all similar business, because it becomes a nightmare when you do raise rates. If I raise rates in your treaty, I cannot disclose it in an arbitration with another company.
- The reinsurer should have the right to raise rates, but you have to give the ceding company the remedy to recapture.
- You don't understand what the problem will be for 15 years. We should take a little longer to try and figure out those things. And we keep learning, which is why the wording keeps changing.
- There is no going back and correcting all existing treaties. That would be a gargantuan task at best. Going forward there is grounds for improvement.
- You can put as many words in a treaty as you want, but you don't know what you don't know. There are going to be disputes that you cannot anticipate. Take care of what you know.

[In Canada, premium increases and the resulting recapture are a nonissue, because the rates are typically guaranteed.]

- In Canada, the rates are typically guaranteed. In Canada, if the rates are not guaranteed, an assumption would be required for the future expected cost including a margin for adverse deviation. Therefore, rate guarantees are in most contracts. It was stated that “the margins are clearly higher in Canada, so I am not sure the U.S. people would take that trade.” From the rate increase perspective, Canada’s regulations make it easier, but there are other issues that come into play.

5.6.2 AUTHOR OBSERVATIONS

The premium increase provision epitomizes presumed intent versus a legal contract and contractual words. Premium rate increase language in treaty construction remains a source of contention and therefore impacts if and how recapture serves as an adequate option to a potential increase.

Treaties are written without rate guarantees. In newer treaties, cedants have anticipated that they would need protection on the backend, should a reinsurer use its contractual right to increase rates. The recourse or solution on most treaties was a recapture option should a reinsurer raise rates. Another solution was requiring that your rates could be increased only if rates were increased on similar or all blocks of business. In addition, there was a common belief, perhaps misguided, that the likelihood of rate increases were remote due to competitive market pressures and the desire not to harm good will or value of the reinsurer-cedant business relationship.

Even if you anticipate future problems correctly, present-day solutions may not work or you may not anticipate future solutions correctly. In the past, the solution appeared reasonable: Recapture if the reinsurer increases rates. The problem with the recapture option is that recapturing and replacing recaptured business has proven to be more costly and difficult than anticipated. Some problems include placing facultative cases, recapturing and replacing business in the time window (e.g., 90 days, allocated in the contract and determining the recapture fee, if any).

Including a clause requiring rates be increased on all similar business did not work either. “Similar” and “all” did not necessarily precisely define which business was in scope, nor did the clause eliminate the possibility of rates being increased, if that was the objective versus reduce the possibility.

Several reinsurance companies have implemented rate increases, in some cases across broad blocks of business. Direct writers felt that in some cases the premium increase was so large or so unwarranted that they were forced to recapture their block of business. Some companies did not recapture but ceased writing new business with the reinsurer(s) that increased rates.

5.7 FUTURE LANGUAGE

This section discusses premium rate increase provisions and what future provisions and language may be. Future language for other recapture triggers was not discussed, since they are currently seen to be well managed and less contentious.

Participants were solicited for ideas regarding future treaty language or clauses to address recapture issues pertaining to rate increases and subsequent recapture. Several ideas were suggested during the one-on-one discussions. All of these ideas were discussed at the in-person meeting. A few were variations on a similar idea. The first two variations were unanimously rejected by all participants—direct writers and reinsurers alike. The next variation’s proposer deftly introduced and deposed the suggestion by taking credit via a joke that was met with hearty laughter. One idea received some traction.

5.7.1 PARTICIPANT COMMENTS

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Comments included in one-on-one interviews were:

- If a direct company has the need to reinsure a closed block, they would negotiate at that time.
- If a treaty is well written with rate guarantees, you do not need recapture options.
- Reinsurers are not receptive to things that expand a direct company’s recapture rights without a corresponding benefit to the reinsurer.

The following options were provided by meeting participants and discussed in the meeting. Meeting comments follow the option.

1. Option to cede in force business in which a reinsurer already has mortality risk if another reinsurer no longer accepts new business or if another reinsurer raises premiums for any reason.
 - May want to specify premiums in clause. Reinsurer probably wants risk margin for bad blocks of business.

- Treaty rates are as follows: Original treaty rates \times factor \times age of block factor \times current mortality factor \times Maximum (Y, A/E ratio).
- Possibly include a floor or a ceiling.

Comments

- One reinsurer said flat out it would not do this.
- Another agreed that reinsurers would find this option unacceptable.
- You would have to pay the reinsurer more. You are going to a reinsurer and telling it I want to pay money on the basis that I think one of my reinsurers is going to get into financial difficulty. To which it would say, “it should not be in the pool in the first place.”
- The larger direct writers at the meeting said if a reinsurer raised rates on a profitable block of business, they would just take it back. But several of the smaller companies said in the one-on-one that they had this happen to a profitable block of business but could not take it back because they could not replace the coverage nor accept the volatility risk that would come with the recapture.
- There is a clear selection process when a reinsurer raises its rates if it has to raise its rates on all or similar blocks because of treaty clauses. Any ceding company that has profitable business is likely to recapture the business. There will be a little bit around the middle where you try to figure out whether it is good to have or good not to have because, as you were saying, there are costs associated with recapture. So, maybe it is costing me a little bit to reinsure it, but I am going to keep doing it because it is a pain to recapture. The really bad stuff, I am just leaving it with them because it is better than me taking it back.

2. A springing novation option

- Under this option, the ceding company would have to pay the reinsurer more.
- Example: A reinsurer in the pool ceases to write new business, becomes insolvent or raises rates.
- Reinsurance novated to the backup reinsurer, who presumably is in a position to assume the block under the original terms and conditions of the contract.
- There would seem to be treaty drafting challenges to this approach, because the treaty would need to give rights to a third party (the reinsurer who would take the novated business).

Comments

- One participant shared that they had had discussions along these lines. The only time it was discussed, a reinsurer felt it was not going to get the business with the direct writer or the direct writer was going to cancel new business. The idea was that if a specified event occurred, the participant’s company could cut through the other reinsurer and deal with the direct company. The participant’s company would get a piece of the business on day one, and if the event happened, they would get the whole thing. In this particular case, there would be no fee. It was a situation where the reinsurer really felt pressured. The idea and option never came to fruition. First, you have to negotiate with three parties upfront. You have to agree to the economics upfront.
- Direct writer: I don’t want to pay a fee for something I may not need.
- Others commented that they have seen this without a fee, but the one offering the protection is the retro-reinsurer, and in place of a fee, they would get some upfront business.
- A direct writer asked the reinsurers if there could be a recapture trigger should a reinsurer no longer write new business.
 - Reinsurer: I think that would be resisted, for reasons I spoke about earlier with change in control. We want to know what our business is and whether we can move it off and sell it and the buyer will carry that business with it. I think if you say if you stop writing new business we get to recapture or do something else that is adverse, it will be resisted.

3. Reinsurers and cedants find common ground on recapture options as a result of reinsurance rate increases (e.g., banded recapture rules for rate increases).
 - If increase is between 0% and $X\%$, then no recapture is allowed.
 - If increase is greater than $X\%$, then recapture is allowed.

Comments

- Right now, if a reinsurer raises rates the cedants recapture. Maybe this will give the reinsurer incentive to minimize the rate increase.
- With PBR, a company will have to model premium increases. If a treaty has a band, then I should not have to set my assumption higher than this band. At that point, I model the recapture. This would greatly simplify the model and minimize reserves.
- A reinsurer has to include in its model the probability that it will raise rates. Then it also has to model the probability that the counter-party will recapture. If you have the band, then you don't have to model recapture if you don't model raising premiums more than the first band.
- Reinsurer: Assuming in a post-PBR world that not all ceding companies are going to want to go to the level of fully guaranteed rates, what do we need to put in there at a minimum to make the actuary modeling these assumptions comfortable enough that this treaty works? A banded zone is what I thought might work or at least would be a step in the right direction.
- Question: If recaptures in the past have happened, does that play into your analysis?
- Response: Real life is much more complicated, and you try to simplify things in a model. Clock forward 20 years from now and you have hundreds of treaties. Are you going to model each treaty individually for each provision? It could get rather complex. You should model recapture, but at this point, many companies do not model recaptures in their reserve models.
- Participant: The banded recapture feature is eating away at my argument in the future. It is taking a haircut off of what I can make. If I set the band at 10%, then I am saying 10% is reasonable. I am assuming that at some point you are going to raise premiums 10%.
- Question: For PBR, can I bake into the model if 10% is justifiable?
- Response: You still look at experience, you can still say that the actual-to-expected (A/E) ratio over this five-year period in the projection has to exceed the specified threshold on the right to increase. If the A/E ratio as projected in the model exceeds the threshold, the model can assume rates will increase. But if it is less, then contractually the reinsurer cannot increase rates—so the model is justified in reflecting rates are not increased.
- Reinsurer: This is like a banded put which goes hand in hand with the banded right to recapture.
- Expansion of response: Correct. You cannot raise rates until my actual experience is worse than projected experience by $X\%$. Once it exceeds $X\%$, you can increase premiums. By using experience over a time period, there is a built-in time lag to increase rates.
- Reinsurer: And this band for the increase would give the reinsurer incentive to minimize the increase because it does not want the ceding company to recapture.
- Direct writer: People are fine letting the business disappear today, so I don't know if a band eliminates the problem. It may be effective for modeling purposes. But from a practical perspective, how many instances does it take where people push it past that banded amount and then there is a recapture before we determine that it does not mean anything.
- Question: Will it be required to put something in the contract for them to model it?
- Participant: If I can point to a provision that says the right to increase is restricted based upon experience, that is something as an actuary that I can hang my hat on. I have to justify my assumptions and methodology and so forth. If I can point to a provision that states the reinsurer is restricted in their rights to increase, then reflecting the restriction in the model is justifiable.
- Participant: If the contract simply states you can increase rates without restriction, then your model cannot point to anything in the treaty to back an assumption reinsurers wouldn't increase rates when warranted in the model.

- Participant: There is sort of a trade. I give you protection against limited adverse experience and the ability to justify such an assumption in your model and you give me a band where you cannot recapture due to a premium increase.
- Reinsurer: Without this, the deficiency reserve may be thrust upon the cedant.
- Participant: I don't look at it as PBR driving the language. I think economics has and will continue to drive the language. I look at it as the business and economics driving the treaties and the treaty language driving the modeling. When writing the treaties, they are going to look at how their language impacts required reserves.
- Participant: The deficiency reserve [under Triple X] drove the current language. There is wording in treaties because that is where the regulation drives us.

In short, putting a restriction on increases countered with a band received wider support as a provision holding some potential.

4. Introduce language that guarantees the reinsurance premium rates.
 - Reinsurers were fine with this but suggested direct companies should be prepared for higher rates if they insist on this language.
5. Bring back the experience refund.
 - This was immediately and summarily rejected with exclamations of “no” and laughter. Concurring comments from all participants echoed that the administration on this business is costly: It is too time consuming, and from a financial reporting perspective, it is a nightmare.

5.7.2 AUTHOR OBSERVATIONS

The options considered in Section 5.7.1 demonstrate reinsurers and direct writers are willing to entertain new possibilities.

Option 1: No matter how you look at this idea, it is a put and everyone rejected the idea at the meeting. However in the one-on-ones, several people were interested in this idea. The problem would be how to value the put because it would be very complicated. The comments in the one-on-one interviews were that this would be a very complex and expensive option. Therefore, it is difficult to price and cedants are not willing to pay the price if one were determined. Therefore, several reinsurers suggested it is better to look at this at the time the opportunity presents itself, which they are willing to do. These comments were reiterated at the in-person meeting.

Option 2: Even though three companies had discussed this option in a prior treaty, it never came to fruition. The reasons it was crafted were unique. It did not appear there was much interest in this idea.

Option 3: Option 3 gained some traction conceptually with a view that to work, the devil is in the details.

Options 4–5 were all rejected by both reinsurers and direct writers.

Once Option 3 was modified to permit recapture only upon a delayed premium increase based upon mortality experience, the idea received more interest from both sides of the table. This was the one option that was not rejected.

Direct writers expressed more interest. However, most of the ideas expanded the direct writer's optionality and reduced their risks while increasing reinsurers' risks. While the benefits piqued cedants' interest, the missing piece to evaluate an idea's attractiveness was price. How much did the option cost? Reinsurers were more skeptical or realistic. Most of the brainstormed ideas entailed reinsurers taking on complex difficult-to-understand risks and hence difficult to price and prone to mispricing. From a risk management perspective, the risks did not readily fall

within reinsurer's risk appetite or tolerances. And even if the risk hurdles were overcome, direct companies would be unwilling to pay the risk premium. Thus, a lot of work and cost to research, model, and price for offering a provision that would not be purchased (i.e., included in treaties).

Appendix A: Questionnaire and Results

Life Reinsurance Treaty Construction Questionnaire

Do you consider your company a:

- Large company direct writer
- Mid-Size company direct writer
- Small company direct writer
- Reinsurance company

For each part below, please rate each provision or article and exhibit on a scale of 1–5:

Scale 1 = highly satisfied or much agreement

Scale 5 = highly dissatisfied or much disagreement

Column B asks: From your perspective, rate your degree of satisfaction with the outcome.

Column C asks: From your perception of your reinsurance partner, rate their degree of satisfaction with the outcome.

Column D asks: Rate the ease of process at the onset of and during the process.

Column E asks: Rate the ease of process as the treaty matures.

In Column F (Comment section) on items with 4s and 5s: Please provide a brief description of specific examples that formed your opinion.

The participants responses are summarized as follows:

B) Article	Satisfactory Results		Partner's view of Results		Initial Ease in Process		Ease of Process as Treaty Matures	
	Average	# 4/5's	Average	# 4/5's	Average	# 4/5's	Average	# 4/5's
Changes in Retention	2.27	1	2.36	1	2.00	0	2.45	2
Insolvency	1.55	0	1.64	0	1.55	0	1.55	0
Change in Legal Control	1.82	0	1.91	0	1.73	0	2.00	0
Change in Ratings	2.36	2	2.45	1	2.55	3	2.27	2
Change in Financial/ Capital Ratios	2.55	2	2.55	1	2.64	4	2.55	3
Recapture (Other)	2.82	2	2.95	1	2.64	1	3.00	4

Appendix B: VM-20 Impact on Reinsurance

Some old and existing language regarding recapture provisions and premium rate increases are driven by statutory reserve requirements and deficiency reserves. VM-20 specifies new statutory life reserve requirements effective Jan. 1, 2017, with a three-year transition period. VM-20 is not applicable to in-force policies, only policies effective following a company's adoption of VM-20. Most companies have elected to take the full three years and, hence for most companies, it will affect policies issued Jan. 1, 2020, and later. VM-20 is a paradigm shift and alters the landscape regarding deficiency reserves. Some of the participants were actuaries, but many were not. On a few of the phone interviews with actuaries, we had discussions and mini-Q&A exchanges on VM-20 and its potential impact on reinsurance.

Since many of the nonactuarial participants were unfamiliar with VM, we started the in-person meeting with what was intended to be a brief summary of VM-20 requirements. However, one question led to another. VM-20 then resurfaced several times as the day proceeded, especially during the discussion on premium rate guarantees and rate increases. We provide highlights for readers who are not familiar with VM-20. We do not delve into details, so the highlights cannot precisely convey the *Valuation Manual's* hundreds of pages.

Author's Summary

VM-20 is partly based on principles and company experience and partly based on prescribed methods and assumptions. Accordingly, VM-20 reserves are also called principle-based reserves (PBR).

VM-20 requires up to three reserve calculations:

- A seriatim net premium reserve floor (NPR)—think of this as an old style Commissioner's Reserve Valuation Method (CRVM) floor because it is formulaic in nature.
- Two modeled reserves on a group of policies using cash flow models: a deterministic reserve based on one specified interest rate and equity scenario and a stochastic reserve based on many random scenarios.

Depending on a product's risk profile, a company can be excluded from calculating one or both modeled reserves. In general, but not always, ULSG will calculate all three reserves, term will calculate NPR and the deterministic reserve, and whole life will use the traditional CRVM reserve method. The deterministic reserve can be thought of as a modernized version of deficiency reserves. Cash drives the modeled reserves, and lower premiums result in higher modeled reserves. Deficient premiums result in a deterministic reserve higher than NPR, and the excess can be construed as a deficiency reserve. The more gross premiums are deficient, the more modeled premiums will increase over the floor.

Companies satisfying a number of conditions including a premium volume threshold may elect not to adopt VM-20. Small companies that choose the exemption are governed by the old rules, including Triple X and its associated deficiency reserves. Companies that previously found coinsurance to be an attractive solution will likely continue to find coinsurance a viable solution.

The assumptions used in the cash flow models are either:

1. stochastic (e.g., interest rates),
2. prescribed (e.g., default rates), or
3. prudent estimate assumptions (e.g., lapses).

Prescribed and prudent estimate assumptions include explicit or implicit margins. As a general rule, many assumptions are based on company experience, but some assumptions such as mortality prescribe the margin based on company experience credibility (statistical definition of credibility). Regarding nonguaranteed elements

such as Cost of Insurance (COIs), dividend scales or nonguaranteed YRT premiums, the actions of the company or counter-parties (e.g., reinsurers) are modeled. VM is a living document. If regulators decide to change a rule, say in 2025, the new rules do not just apply going forward, the rules apply retroactively to all policies since a company adopted PBR.

Thus, guarantees and treaty language regarding rate increases impact VM-20 reserves. Or because of the impact, VM-20 will have an impact on both guarantees and contract language. Contract language regarding YRT premiums is a factor in the degree to which modeled reserves may or may not exceed the net premium reserve.

In general, the more mortality experience data a company has, the higher its credibility and the smaller its prescribed margin. For example, a small to mid-size company's prescribed margin could be about 12%–15%, whereas a large company's prescribed margin could be 4% or less. This difference in margin may drive the actions of a company regarding treaty provisions. A company with a large margin may be more inclined to request a guarantee on rate increases or put other restrictions on rate increases.

Due to VM-20's prescribed mortality margin, the dynamics of nonguaranteed YRT reinsurance as a cost or source of profit are altered with the cash flow model. That is, a mortality margin increases the YRT claim recoverable to a level that may be considerably higher than the current YRT premiums. VM-20 does not specify how a company should model a reinsurer's actions, and currently, companies are taking a variety of approaches. Over the past year, numerous amendments and proposals to change the rules regarding nonguaranteed YRT premiums have been discussed. It is not clear which new rules will be adopted. Direct companies may be interested in rate guarantees or restrictions on rate increases as they adopt VM-20 or as rules change. However, for similar reasons, reinsurers may be disinclined to provide guarantees due to reserve impacts.

VM-20 applies to direct companies and reinsurers. Reinsurers also calculate a floor and modeled reserve. For YRT reserves, VM-20 was written from the direct company's point of view. The expectation is that VM-20 will be amended for reinsurer YRT reserves. A reinsurer's modeled reserve assumptions do not have to be the same as those of the ceding companies. For example, a reinsurer has its own independent view of mortality and lapses. Thus, VM-20 clearly does not require mirror reserving. Prior to VM-20, a misconception existed that mirror reserving was common or required. It was only required in a few states, such as New York. Since the amount of data (credibility) is a factor in determining the mortality margin, a reinsurer's margin could be smaller than a ceding company.

The impact VM-20 will have remains uncertain. Premium rate increases as reflected in models impact PBR. Reinsurers have indicated that inquiries into rate guarantees have increased in frequency. Guarantees are not free. Reinsurers bear additional risk; but as in the past, reinsurers have stated that direct writers are generally unwilling to pay higher rates for guarantees. Cedants opt for lower rates without guarantees over higher rates with guarantees.

Does PBR provide incentive for direct companies to reinsure term on a YRT basis rather than a coinsurance basis? For term, generally the deterministic reserve is lower than the floor, and VM-20 reserves will be dominated by the NPR floor, at least for many years after VM-20 is effective. Since the VM-20 reserve is the floor, it is likely that direct companies will find YRT to be more financially attractive. As the modeled reserve approaches the floor or is slightly above or below the floor, direct companies can decide how small the gap is, how to manage the gap, and whether to use YRT or coinsurance.

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