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# Recurring Issues in Life, Annuity, and Health Reinsurance

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Life, Annuity, and Health reinsurance have distinctive characteristics that lend these classes of business to specialization. The business is a different world from Property and Casualty reinsurance that may be more familiar to many reinsurance practitioners. It follows that the terminology, concepts, disputes, and dynamics of arbitration can differ. This article discusses some critical distinctions that characterize Life, Annuity, and Health reinsurance, the issues that give rise to disputes, and how they may bear on arbitration.

### 1. Important differences between Life and Health reinsurance and Property and Casualty reinsurance

One observable distinction between the Property and Casualty business and Life, Annuity, and Health business has been the greater prominence of actuaries at relatively high executive levels in the company as a whole, or at least within the company's Life and Health reinsurance group. Life and Health reinsurance has been actuarially driven to a greater extent than many Property and Casualty lines.

This is principally explained by deal-driven growth acquisition opportunities in these classes of business where massive blocks of inforce policies are bought and sold. The benefit of these acquisitions often uniquely depends on the astuteness of the pricing actuary. In such transactions, the ability to evaluate actuarial factors such as investment performance, delayed acquisition cost, lapse rate, and mortality (or morbidity) may vault a company from a marginal player to an upper tier insurer or reinsurer. The decision-makers approach such problems from an actuarial perspective—*i.e.*, mathematical and statistical assessment of risk using deterministic and stochastic modelings and they frequently view disputes from that perspective as well. During the last decade, actuarial executives have occupied the highest levels of, for example, American United Life, AXA Equitable Life, Transamerica Re, New York Life, Lincoln Financial Group, and other large life/health companies. When the primary decision-maker is an actuary, rather than an MBA or an attorney, the reinsurance practitioner must be able to speak and understand the operative language and master (at least) a working knowledge of key concepts.

The Life and Health industry employs unique terminology. Policies do not pay indemnity, they pay benefits. (There are rarely "defense costs," as such). A single policy frequently is referred to as a "case," and a single insured as a "life." A group of policies reinsured under a treaty is a "block" of business. Managing agents are "MGUs," or managing general *underwriters*—at least nominally.

Benefit ratios may fluctuate, depending on factors such as persistency, amortization of acquisition costs, and claim continuance, not found in property and casualty business. The "lapse rate" reflects the frequency with which policyholders allow their coverage to terminate, usually because of cessation (voluntary or involuntary) of premium payments. "Persistency" relatedly refers to the rate at which policyholders keep the subject policy in force. "Acquisition costs" consist principally of agency commissions, which may exceed 90% in the first year, and typically are carried as a depreciating asset on the balance sheet. "Claim continuance" describes how long a claimant, for example under a long term care insurance policy, will continue to require benefits. Mortality and longevity, often conflated, are in fact inverse measures of human life expectancy. Mortality is the rate of death under life policies; longevity the measure of life under disability, long term policies and annuities. Each of these factors can make the difference between profit and loss, and thus often figure in disputes, especially disputes over disclosure to the reinsurer at the time of underwriting of the reinsurance.

Treaties reinsuring Life and Health risks contain numerous distinctive provisions. Treaty provisions that are foreign to property and casualty insurance include:

- A multi-life warranty, often found in catastrophe reinsurance, which may cover anywhere from two to twenty (or more) lives, and provides that no liability arises under the treaty until the specified number of lives is involved in the same event.
- A MAOL ("maximum any one life") clause, which sets forth the maximum stated limits, per life, for the policies that will be insured, "or so deemed," in a reinsurance treaty.
- The Recapture clause governs when and how the cedent may be permitted to increase the retention applicable to the reinsurance, whereupon all further premium and claims ceded on the reinsured block within the new retention become the responsibility of the cedent. Some contracts contain recapture clauses that expressly provide the right to recapture after a certain period of time with no increase in retention necessary.
- Reductions and Terminations governs allocation of liability between the parties when the insurance in force with the ceding company, for individual life policies, is terminated or reduced.
- Errors and omissions clauses in life and health reinsurance are typically concerned with the cedent's administration of the reinsurance agreement, rather than its mistakes concerning policyholders.
- Contract duration frequently distinguishes Life and Health treaties from Property and Casualty treaties. Property and Casualty treaties do not customarily have a period exceeding thirty-six months, while Life treaties commonly are indefinite in duration. With no automatic termination provisions, it is not uncommon for such treaties to remain in force for two decades or longer. The treaties often are terminated only when claims on the reinsured business have diminished to the point where the cost of administering the treaty exceeds the value of the reinsurance. At that point, the treaty customarily is terminated by mutual consent.

Because Life and Health reinsurance contracts typically are perpetual, there are a suite of clauses governing how policy changes, continuations, and conversions will affect the reinsurance.

## 2. Recurring Issues in Life and Health Reinsurance

While trigger and allocation issues have been grist for the mill of Property and Casualty reinsurance disputes, a different set of issues has caused Life and Health reinsurers to proceed to arbitration.

**Annuities**. Perhaps the most hotly contested Life and Health reinsurance disputes in recent years have arisen from reinsurance of annuity products and their attendant benefits, including GMIB (guaranteed minimum income benefits) and GMDB (guaranteed minimum death benefits). In the late 1980s and early 1990s, some issuers began adding guaranteed benefits to their annuity contracts in order to make them more attractive to the investing public. These benefits included guaranteed minimum annual returns and guaranteed minimum annuity payments. GMDB contracts were exposed to the equity market's performance, and the guarantees acted as a floor for the purchaser's investment. The issuers reinsured their market exposure on these guaranteed benefits, frequently by 100%. The reinsurance was often written with an expectation of occasional equity market declines in an overall upward trajectory. For GMDB business, underlying insurance consisted mainly of "permanent" life policies and the reinsured guarantee would only pay in the event of the infrequent coincidence of death and market decline.

In 2001-2002 and again in 2008, however, reinsurers of these contracts suffered substantial losses or were forced to increase reserves by hundreds of millions of dollars because of steep market declines. Some disputes that followed these downturns focused on the issuer's ability to change investment options without notice to the reinsurer, the contract holders' ability to lock in the reinsured guarantees while simultaneously withdrawing the bulk of their investment, and wordings in underlying contracts that placed no limitations on the investor's ability to transfer the contract and its benefits.

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The fundamental area of dispute in annuity reinsurance (at least for much written in 1980-2008) was the perception by some of non-alignment of interests between the issuer and the reinsurer: the issuer's concern for profitability and the reinsurer's effort to mitigate loss by the strict application of the terms of the underlying contracts and the reinsurance treaties. A frequent result was double digit percentage rate increases in reinsurance premium and the withdrawal of many reinsurers from the market.

**Non-disclosure/Misrepresentation**. Life and Health disputes, in common with the Property and Casualty world, certainly have seen their share of alleged nondisclosure, concealment, and misrepresentation. Indeed, claims of nondisclosure may be the most common dispute leading to reinsurance arbitrations for Life and Health.

Technical features of the alleged nondisclosure frequently differ from Property and Casualty disputes. Because of the calculated long-tail nature of life, long-term care, and (certain) disability insurance products, reinsurers may need to rely on "early indicators" of performance. Factors such as persistency and continuance may emerge prior to losses, yet signal that a block of business could underperform. Actuaries monitoring such development may be able to observe at an early stage that experience is deviating unfavorably from assumptions, potentially warranting strengthening of reserves in view of the likelihood of adverse loss development. Reinsurers have asserted that the failure to disclose such "early warning signs" represents material nondisclosure, warranting rescission. Other nondisclosure issues have arisen over the scope of benefits provided under the reinsured policies, the use of "aggressive" underwriting practices such as issuance of long-term care policies to nonagenarians residing in Florida, and the use of reciprocal reinsurance as a means of spiraling "working layer" claims to catastrophe excess reinsurance layers.

**Treaty administration** gives rise to frequent disputes, though in the authors' experience only a small fraction cannot be resolved short of an arbitration hearing. Administrative disputes arise because life insurance treaties often reinsure massive blocks of policies that may number in the hundreds of thousands. Accordingly, the reinsured is responsible for accurately ceding large volumes of premiums and thousands of claims, often in accordance with detailed reporting requirements in the treaty. The treaty provisions will define and restrict the policies eligible for cession, according to the amount insured (which may depend on whether the life is insured under more than one policy), and sometimes on the basis of geographical region, age of insured, underwriting guidelines, or other specified criteria.

The volume of business written may overwhelm the cedent's ability to accurately cede the appropriate premium and claims. Volume also may impair the cedent's capacity to avoid ceding claims and premium precluded by the terms of the policy. Overlooked claims may prove more likely to be discovered by the cedent than overlooked premium. Disputes often concern whether the error is "clerical." The result may be that after a decade or more the cedent or reinsurer discovers that millions of dollars in premium, claims, or both, were incorrectly ceded. Concomitantly, it also may be discovered that millions in premium or claims *should have been* ceded, but were not. Errors in the form of "missed premium" or "missed claims" often are not discovered until long after they occurred, and documentation may be incomplete.

The ensuing audit in these circumstances can be grim. The reinsurer may suspect that the cedent has sweated blood to find omitted claims, but has not worked quite as diligently to seek out omitted premium. Cedents not uncommonly seek to excuse compliance with automatic cession rules by reliance on the treaty's "errors and omissions" clause. While incorrect cessions, or "missed cessions," sometimes are forgiven by parties to life reinsurance treaties, if the past mistakes prove to have been deliberate, repeated, or "systematic," or cannot be reconciled, parties have proceeded to arbitrate these disputes.

**Commencement and Termination** disputes provide another source of contention in life reinsurance. Typically, quota share treaties for individual life insurance do not contain an automatic expiration provision, and are theoretically perpetual in duration. Accordingly, if one party wishes to terminate the treaty it must obtain the other's agreement to commute the contract, in the absence of terms permitting unilateral termination. When treaties have not clearly specified whether termination applies to risks previously ceded, disputes have arisen concerning whether termination allows for run-off coverage.

**Right to increase reinsurance premium rates**. Yearly renewable term (YRT) treaties typically provide that reinsurance premium rates are not guaranteed. YRT Treaties so provide, because regulatory requirements have been deemed to mandate setting up of a deficiency reserve by the reinsurer in the absence of language permitting it to raise rates. Yet despite common usage of rate increase provisions, historically it was extremely rare for reinsurers to raise rates even in the event of adverse mortality experience.

More recently, reinsurers have become more inclined to raise rates, though it is by no means common practice. Some cedents have fought back with contentions that rate increases were undertaken in "bad faith," with only certain treaties selected. Cedents have contended that rate increases are contrary to the partnership concept in reinsurance. Some cedents have sought to recapture such treaties rather than pay the increased rates. Cedents also have negotiated the right to contractually limit the right to increase rates, employing a wide variety of wordings, including provisions that permit rate increases only if consistent with specified mortality tables, or only to the extent necessary to eliminate the deficiency reserve.

Unwelcome rate increases have been the cause of ill feeling between a number of cedents and reinsurers, leading to broader disputes that may center on issues such as nondisclosure or termination.

**Recapture**. In excess-of-loss reinsurance, the reinsurer assumes risks above the retention specified in the treaty. The cedent may, however, have the contractual right to "recapture" ceded business, going forward, if it increases its retention. (This has also sometimes arisen with regard to quota share reinsurance.) The cedent frequently is required, in the insurance contract or (it has been asserted) by custom, to increase its retention in the entire class of business, not just on the business ceded under the treaty at issue. Typically, the contract specifies or otherwise contemplates that such a recapture cannot be effected for a specified period of years after policy issuance, to permit the reinsurer to recoup its acquisition costs.

Because cedents have often sought to exercise recapture rights only with regard to profitable business, to their reinsurer's financial disadvantage, disputes (and arbitration) over recapture are not infrequent. Issues have included: (i) whether the treaty permits recapture; (ii) whether the reinsurer gave proper notice of recapture; (iii) whether notice of recapture by the reinsurer is irrevocable; (iv) whether the cedent seeking to recapture actually increased its retention; (v) whether recapture must include all treaties between the parties; and (vi) whether the cedent must apply the recapture to the entire class of business that it insures.

**Facultative Cessions** not uncommonly generate reinsurance disputes. Life treaties typically contain a clause precluding automatic reinsurance for any risk the cedent submitted previously on a facultative basis to the reinsurer, or indeed to any reinsurer. Such cases nevertheless sometimes are ceded automatically, and disputes arise later in the event of a significant claim under such a policy. The parties' course of dealing with respect to acceptance of such cessions has, in the authors' experience, proved weighty if not dispositive. This is also an area in which the panel's grasp of industry custom and practice can be extremely important given the view of certain industry participants that, regardless of treaty provisions, a facultative cession that previously was offered to any reinsurer thereby becomes ineligible for automatic cession.

Sometimes the cedent comes to believe that the reinsurer did facultatively accept a policy. The reinsurer may have had loose processes for recognizing acceptance of facultative cessions. Or the ceding company may deliver a policy, but neglect to advise the facultative reinsurer of the commencement of risk by transmitting a formal cession. Absent clear treaty language specifying how acceptance must be made, disputes will arise if the cedent later claims, for example, that the reinsurer's failure to expressly reject the cession constituted acceptance.[2] Reinsurers have also disputed facultative cessions in which the policy was not underwritten in accordance with the cedent's normal procedures for underwriting and issuance.[3]

## 3. Arbitrating the Life, Annuity, or Health Reinsurance Dispute

Arbitrators within ARIAS who have designated themselves as having some in-house expertise in life reinsurance represent approximately 18% of the total number of arbitrators. Overall, parties seeking expertise among ARIAS-certified arbitrators for a life, annuity, or health reinsurance dispute have relatively fewer choices than with respect to property and casualty disputes.

Historically, some accident and health treaties, and a few life reinsurance treaties, have provided for certain disputes to be decided by "actuarial arbitration." Disputes subject to actuarial arbitration typically are limited to: (i) disputes solely involving mathematical issues, such as reserves or experience refund calculations, and (ii) commutations.

In an actuarial arbitration, a single actuary might be selected, or (more commonly) a panel of three actuaries would decide the issue. Unlike the usual reinsurance arbitration, such panels not infrequently have dismissed the need for a conventional hearing, and instead approached the dispute as if it were a mathematical equation – which frequently it is – so that little, if any, legal argument would be welcome. Attorneys often do not directly participate, but can be instrumental in ensuring that any award is clear, precise, and enforceable.

If the contract contains a standard arbitration clause, the procedures ordinarily will not vary from property and casualty disputes,[4] and the parties will evaluate party-appointed arbitrators

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Rather than hearing an argument focused on the legal definition of "materiality" in a rescission case, the panel likely will be far more interested in hearing how, for example, the projected lapse rate was contrary to the cedent's underwriting experience in an "apples-to-apples" analysis.

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and umpires by the traditional criteria. One important criterion, of course, is hands-on experience, and here there can be some less than obvious distinctions. Many arbitrators can say they understand first-party benefits; fewer, no doubt, have dealt with a wide range of issues at a granular level concerning the precise business at issue. Experience in individual life reinsurance, for example, differs markedly from experience in group life reinsurance. Similarly, experience in disability and long term care reinsurance may be an imperfect background for certain personal accident reinsurance disputes.

Direct actuarial training and knowledge on the arbitrator's part has, in the authors' experience, proved most valuable with regard to reinsurance disputes that center on nondisclosure or similar issues. In such cases, when the central question concerns a subject such as whether the data disclosed accurately reflected the recognized degree or kind of risk, an actuary / arbitrator's superior knowledge can be an indispensable asset in evaluating and explaining during deliberations the relative merits of the parties' positions. In disputes in which contract wording becomes the dominant issue, however, actuary / arbitrators have sometimes been less influential than attorney / arbitrators, even though the attorney / arbitrator's interpretation of a particular clause may vary from the prevailing, practical understanding of the clause in the life, annuity, and health reinsurance business.

Other differences are significant. If the panel is comprised of non-lawyers, such as actuaries, the panel likely will prefer that the arguments emphasize the technical aspects rather than "legalese." Rather than hearing an argument focused on the legal definition of "materiality" in a rescission case, the panel likely will be far more interested in hearing how, for example, the projected lapse rate was contrary to the cedent's underwriting experience in an "apples-to-apples" analysis. Expert witnesses seem to be employed with a slightly higher frequency than in Property and Casualty disputes. This may be so because in general experts are of course more readily received when the umpire does not have superior experience with regard to the subject matter, and this seems more often to be the case in Life, Health, and Annuity reinsurance arbitrations than in Property and Casualty arbitrations.

Counsel's own mastery of Life and Health concepts may be indispensible. Because Life, Annuity, and Health reinsurance disputes frequently turn on concepts that are foreign to many attorneys and arbitrators, the panel cannot help but be inclined to feel greater confidence in positions presented by the side that displays mastery of these concepts. Practitioners who rarely handle Life and Health reinsurance matters should invest in extended hours with the clients' business people to develop optimal knowledge of the reinsurance issues, underwriting terminology, and actuarial concepts.▼

1 The views in this article do not necessarily reflect the views of the authors' clients. The authors thank Denis W. Loring, FSA, Senior Vice President, Global Financial Solutions, RGA Reinsurance Co., for his valuable comments and insight.

2 See Treaty Committee Reinsurance Section Society of Actuaries, Discussion of Reinsurance Provisions in a Life Reinsurance Agreement, p. 10 (On file with author).

3 See id.

4 There may be a somewhat higher inclination for panels to permit enforcement of audit rights during an ongoing arbitration, particularly if new business is being written.

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