

Reinsurance and Risk Transfer Recent Developments

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Discussion Topics

- Current Era of Reinsurance Accounting
- 2005 Activity at the NAIC – Statutory Accounting
- American Academy of Actuaries' Involvement with Risk Transfer
- AAA's Practice Note on Risk Transfer
- 2006 And Beyond

Current Era of Reinsurance Accounting

- Why the Accounting Rules Matter
- Current Era of Reinsurance Accounting began when FASB adopted Statement 113 Effective for Year-end 1993
 - *“The Board concluded that it was necessary to consider the lack of guidance in Statement 60 on recognition issues relating to reinsurance because of the increasing diversity and complexity of reinsurance arrangements and the proliferation of nontraditional reinsurance contracts.”*

Current Era of Reinsurance Accounting

- FAS 113 Required Transfer of Insurance Risk
 - NAIC Adopted Similar Guidance Soon After
- Rapid Developments in 2004/2005
 - Multiple Investigations Initiated, Restatements Attributed to Reinsurance Accounting
 - Heightened Focus of Regulators on Reinsurance Accounting

Activity at the NAIC in 2005

- NAIC - Changes to SSAP 62 for Year-end 2005:
 - Increased Disclosure for certain reinsurance contracts
 - Aggregate Stop Loss
 - Quota Share with Limiting Features
 - Many others with Certain Terms/Conditions
 - Attestation from CEO and CFO
 - No Side deals
 - Documentation exists Supporting Risk Transfer and the Economic Intent of Certain Reinsurance contracts

Numerous Restatements

- To date, restatements relate to intent not to transfer risk
- To date, no restatements when:
 - contemporaneous documentation
 - appropriately modeled for all facts in the agreements (oral or written)
 - and judgment made and documented that risk transfer was met
- i.e., SEC has not challenged appropriately documented risk transfer analysis

Activity at the NAIC in 2005

- NAIC Considered a Proposal that Would have Required Bifurcation of Certain Contracts
 - Portions of Certain Contracts where there is more than a 90% Probability that Premiums would be Recovered would be Accounted for as a Deposit
 - Not Adopted in 2005

Activity at the NAIC in 2005

- NAIC's Expectation of Documentation
 - Expectation by Regulators that Documentation Exists Supporting Risk Transfer and the Economic Intent of All Reinsurance Contracts
 - One Regulator has Suggested that a Lack of Such Documentation might be a Lack of Compliance with SSAP 62 and the corporate recordkeeping requirements of Foreign Corrupt Practices Act of 1977 (as Amended).
 - Compliance Would Effectively Require Documentation Contemporaneous with Entering into Transactions

AAA Involvement in Risk Transfer in 2005

- Committee on Property Liability Financial Reporting (COPLFR) Formed a Risk Transfer Subgroup
 - Co-Chairs Nancy Watkins-Milliman and Marc Oberholtzer-PwC
 - Representation by Actuaries at Insurance Companies, Reinsurance Companies and Consulting Firms

AAA Involvement in Risk Transfer in 2005

➤ COPLFR and the RTS

- Provided Response Letters to the NAIC Regarding its Various Proposals (May, June 2005)
- At the NAIC's Request, COPLFR Provided a Report to the NAIC on Risk Transfer (August 2005)
- Issued a Practice Note to Actuaries on the Topic of Evaluating Risk Transfer (November 2005)

AAA Risk Transfer Report - Highlights

- COPLFR and the RTS issued a Report on Risk Transfer in August 2005
 - Found at www.actuary.org/pdf/casualty/risk_transfer.pdf
 - Includes Results from Survey of Companies

AAA Risk Transfer Report - Highlights

➤ Several Highlights from Survey:

- 25% Response Rate from 1,600 Companies
- Approximately 1 in 4 Companies Entered into a Ceded Finite Agreement in the Past Four Years
- It is Uncommon for Companies to have Written Policies Regarding Reinsurance Accounting and Risk Transfer
- Evaluation and Quantification of Insurance Risk is Largely an Accounting Function, Not Actuarial
- It is Uncommon to Rely Exclusively on a Numeric Test to Evaluate whether there is Sufficient Risk Transfer. Where Applicable, the 10/10 Approach (i.e., 10% chance of a 10% loss) was the most common numerical threshold used by Respondents.

AAA Risk Transfer Report - Highlights

- AAA Risk Transfer Report Also Includes Research Ideas and Discussion Thereof on Risk Transfer Provided by CAS Members. Ideas Provided in Response to Four Questions:
 - 1) What is an effective test for risk transfer?
 - 2) What criteria should be used to determine whether a reinsurance contract transfers significant risk to the reinsurer?
 - 3) What safe harbors, if any, should be established so that a full risk transfer analysis does not have to be completed for each and every reinsurance contract?
 - 4) What are the advantages and disadvantages of the suggested approach versus other approaches commonly used?

AAA Practice Note on Risk Transfer

- Guidance to Actuaries, Written by Actuaries, When Evaluating Risk Transfer in Property and Casualty Reinsurance Contracts
- Includes Sections:
 - Background and Purpose
 - Selected Accounting Principles
 - Evaluating When Risk Transfer is Reasonably Self-Evident
 - Considerations When Evaluating the Cash Flow Economics Under a Reinsurance Contract
 - Answers to Frequently Asked Questions

AAA Practice Note – Purpose

- **New CEO, CFO Attestation Requirement**
 - Anticipated that Actuaries will have Increased Role in Evaluating Ceded Reinsurance from this New Requirement
- **Purpose of Practice Note**
 - To Provide Advisory, Non-binding Guidance to Property/Casualty Actuaries Regarding Testing for Risk Transfer.
 - Provided Now in the Context that it is Likely that CEOs, CFOs will Seek Assistance from Actuaries when Evaluating Risk Transfer for Purposes of the Attestation

AAA Practice Note – CEO, CFO Attestation

- New Attestation Requirement: For the CEO and CFO to Attest, with Respect to Active Ceded Reinsurance Contracts (these are not direct quotes):
 - a. There are no separate written or oral agreements between the reporting entity . . .;
 - b. For each such reinsurance contract entered into, renewed, or amended on or after January 1, 1994, for which risk transfer is not reasonably considered to be self-evident, documentation concerning the economic intent of the transaction and the risk transfer analysis evidencing the proper accounting treatment is available for review;

AAA Practice Note – CEO, CFO Attestation

- New Attestation Requirement: For the CEO and CFO to Attest, with Respect to Active Ceded Reinsurance Contracts (these are not direct quotes):
 - c. and d. The reporting entity complies with the requirements set forth in SSAP 62, and has appropriate controls in place to adhere to the provisions of SSAP 62.

AAA Practice Note – Potential Actuarial Involvement in CEO, CFO Attestation

- Possible Actuarial Involvement Includes Participation in:
 - Selection
 - Quantification
 - Documentation

AAA Practice Note – Potential Actuarial Involvement in CEO, CFO Attestation

- Selection – the determination of which contracts are not reasonably self-evident and therefore require a cash flow analysis to evaluate risk transfer
- Quantification – the development of a cash flow analysis to measure the economic losses transferred from the ceding company to the reinsurer under the agreement
- Documentation - the file maintained on each reinsurance contract whereby an outside observer may follow the process used by the company to assess the proper reinsurance accounting treatment.

AAA Practice Note – Excerpts from Reinsurance Accounting Standards

➤ SSAP 62 (FAS 113 Contains Similar Language)

- Para 9 – “The essential ingredient of a reinsurance contract is the transfer of risk.... Unless the agreement contains this essential element of risk transfer, no credit shall be recorded.”
- Para 12a – Transfer of Significant Insurance Risk
- Para 12b – Reasonable Possibility of Significant Loss
- Para 14 – Cash Flow Testing of Reasonably Possible Outcomes

AAA Practice Note – Excerpts from Reinsurance Accounting Standards

- Key Point: It is typically NOT the responsibility of the actuary to decide whether the risk transfer so measured is sufficient to meet the standards of SSAP 62; for many companies this decision is made by accounting professionals after considering actuarial input.

AAA Practice Note – Documentation Files

- What Might be Included in a Documentation File for Ceded Reinsurance?
 - Relevant Correspondence including Previous Drafts of Agreement; Includes Related Agreements
 - Memorandum Supporting Business Purpose of Transaction
 - Risk Transfer Support
 - Other Relevant Information

AAA Practice Note – Documentation Files

➤ Risk Transfer Support

- Either a Statement that Risk Transfer is Considered to be Reasonably Self-evident, or an Analysis that Displays the Possible Outcomes, Their Likelihood and Economic Impact
- Signoff from Management that Risk Transfer has been Demonstrated or is Believed to be Reasonably Self-evident.

➤ Actuaries Might be Asked to Provide the Underlined Above

- Actuaries May Wish to Refer to ASOP #9 for Guidance in Preparing Documentation

AAA Practice Note – Contracts Where Testing is Not Required for CEO, CFO Attestation

- **Contracts with No Amounts Recoverable**
 - Attestation is for Active Contracts Only
 - Contracts that No Longer have Amounts Recoverable are Excluded from Scope
- **Certain Older Contracts**
 - Contracts Entered into, Renewed or Last Amended Prior to 1994
- **Contracts Where Risk Transfer is Reasonably Self-Evident**
 - Purpose is to Eliminate / Avoid Time and Expense Associated with Unnecessary Analyses

AAA Practice Note – Reasonably Self-Evident

- Contracts Where Risk Transfer is “*Reasonably Considered to be Self-Evident*” Typically Includes:
 - Most Traditional Excess of Loss Arrangements
 - Quota Share without Risk Limiting Features
 - Most Single Year Catastrophe Covers

AAA Practice Note – Reasonably Self-Evident

Key Points to Consider Where Risk Transfer is *“Reasonably Considered to be Self-Evident”*

- Existence and Significance of Risk Limiting Features, such as Experience Accounts, Profit Commissions, etc.
- The More Risk Retained by the Ceding Company through these Features, the Less Likely Risk Transfer is Reasonably Self Evident.
- As the Rate on Line Approaches the Present Value of the Aggregate Limit, the Less Likely Risk Transfer is Reasonably Self Evident.

AAA Practice Note – *Not* Reasonably Self-Evident

- Contracts for which Risk Transfer is ***not*** “*Reasonably Considered to be Self-Evident*”

Typically Includes:

- Aggregate Excess of Loss Arrangements
- Contracts with Experience Accounts
- Many Multiple Year Contracts
- Quota Share with Risk Limiting Features

AAA Practice Note – *Not* Reasonably Self-Evident

- Next Steps When Risk Transfer is Not Reasonably Self-Evident
 - Management will need to Evaluate Risk Transfer
 - Management will need to Document the Business Rationale for the Transaction

AAA Practice Note – Cash Flow Testing

- Understand The Substance of Arrangement
 - Obtain and Read Entire Contract and Related Contracts, if any
 - Obtain from Management an Understanding of the Business Purpose and Intended Substance of the Transaction.
 - Obtain and Review as much Background Information to the Transaction as Possible
 - Obtain and Review Underwriting Memo, Accounting Memo or Deal Summary as Applicable

AAA Practice Note – Cash Flow Testing

- Prepare Calculations of Cash Flows/Scenario Testing – Subject Losses
 - Develop Reasonably Possible Scenarios of Estimates of Ultimate Losses for the Business Reinsured
 - Selected Loss Scenarios or Stochastic Simulation
 - Stochastic Simulation includes Selection of Mean, CV and Distribution of Subject Losses
 - Incorporation of Parameter Risk
 - Payout Patterns
 - Selection of Mean Pattern
 - When Varying Payout Patterns among Scenarios, Use Care that the Resultant Patterns are Reasonable

AAA Practice Note – Cash Flow Testing

➤ Overlay the Contractual Terms

- Amount and Timing of Additional Premiums, Commissions, or Related Payments
 - Take Care to Consider All Relevant Contractual Terms in the Evaluation of Cash Flows
- Interaction of Loss Payments with Experience Accounts and/or Funds Held Accounts, including Interest Credits and Charges adds Complexity
- Consider Impact of Commutation Clauses or Related Terms
 - Understand the Intention regarding Such Clauses

AAA Practice Note – Cash Flow Testing

➤ Complex Terms – Seeking Advice

- Some Terms, Conditions or Circumstances that Actuary May Wish to Seek Advice from Accountants, Legal Professionals. Possible Examples:
 - Multi-Year Arrangements - Does Loss Experience under the Contract create Rights for the Assuming Company
 - Different Interest Rates; For example, Interest Credit on Funds Held Accounts exceeding the Rate used to Present Value Cash Flows
 - Treatment of Ceding Commissions Paid in the Future, Maintenance Fees, Commutation Accounts and Funds Held Agreements

AAA Practice Note – Cash Flow Testing

- Interest Rate used to Calculate Present Value of Various Scenarios
 - Use a Reasonable Interest Rate to Present Value Cash Flows
 - No Requirement to Use Risk Free Rate, Although Risk-Free Rates at Expected Duration of Cash Flows is Commonly Used
 - Determine the Expected Timing and Duration of Payments based on Cash Flow Analysis
 - Present Value All Cash Flows at the Same Single Interest Rate
 - Actuary May Want to Consider the Implied Interest Rate from Using a Yield-Curve at a Selected Scenario

AAA Practice Note – Cash Flow Testing

➤ Presentation of Results – Example from Practice Note

➤ NPV P/(L) to NPV Premium

➤ NPV P/(L) is Net Cash Flow Between Parties

➤ NPV Premium is NPV of Premium to Assuming Entity

Percentile or Scenario	Nominal Total Ceded Premium	NPV Total Ceded Premium	Nominal Ultimate Ceded Losses	NPV Ultimate Ceded Loss	NPV Reinsurer's Profit / (Loss)	NPV Profit/(Loss) to NPV Premium
20.0%	58	60	57	55	5	8%
40.0%	70	71	69	66	5	7%
60.0%	83	84	82	79	5	6%
80.0%	100	100	100	96	4	4%
85.0%	100	100	106	102	(2)	-2%
87.5%	100	100	112	108	(8)	-8%
90.0%	100	100	117	113	(13)	-13%
92.5%	100	100	120	115	(15)	-15%
95.0%	100	100	120	115	(15)	-15%
Mean	76	77	78	75	2	3%

AAA Practice Note – Evaluating Risk Transfer

➤ Quantification of Cash Flows

- Information in Previous Table Could be Used as Input to a Method or Methods used to Quantify the Economics under an Agreement.
- Results of Application of Such Methods Provides Meaningful Input to the Decision Maker
- Several Key Points
 - For many Companies the Accounting Decision is Made by Accounting Professionals after Considering Actuarial Input
 - Though Methods Such as “10/10 Rule of Thumb” Commonly Used, Other Methods are Possible
 - The Decision-maker may want to Consult with Accounting and Actuarial Professionals when Considering which Method or Methods are Suitable for Evaluating Risk Transfer under a Specific Agreement.

2006 and Beyond

- NAIC to Continue to Consider Changes to SSAP 62
- Activity at the FASB – Insurance-Risk Transfer Project

2006 and Beyond

FASB – Insurance-Risk Transfer Project

➤ See: www.fasb.org/project/insurance_risk_transfer.shtm

➤ Objectives

- To clarify what constitutes transfer of significant insurance risk in insurance and reinsurance contracts first by defining insurance contracts and related terms.
- Simple approaches to bifurcation of insurance contracts that include both insurance and financing elements also will be explored.
- Scope has been Narrowed to Finite Insurance and Reinsurance Products

➤ Timing

- Current Phase is Focusing on Bifurcation of Finite Products
- Exposure Draft in First Quarter of 2006
- Final Document in Third Quarter of 2006

QUESTIONS