

CAMAR – 2008

Update from COPLFR

- Reinsurance - Risk Transfer
- Reserve Variability

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Section one



Reinsurance – Risk Transfer

Reinsurance Accounting History

- 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.”

- FAS 113 Required Transfer of Insurance Risk
- NAIC Adopted Similar Guidance Soon After

Reinsurance Accounting History

- Over the Next 10 years . . .
 - Use of “finite reinsurance” grew
 - As defined by the AICPA, “Finite reinsurance contracts are contracts that transfer a clearly defined and restricted amount of insurance risk from the cedant to the reinsurance company, and the cedant retains a substantial portion of the related risks under most scenarios. Nevertheless, under certain finite contracts there may be a reasonable possibility that the reinsurance company will incur a loss on the contract.”

Reinsurance Accounting History

- Beginning in fall of 2004 . . .
 - Certain rating agencies went public with criticisms of some companies that were allegedly using finite reinsurance
 - Multiple investigations initiated, restatements attributed to reinsurance accounting
 - Heightened Focus of Regulators on Reinsurance Accounting (e.g., SEC, US DOJ)

Reinsurance Accounting History

- Events in 2005 - NAIC
 - US Statutory accounting adopts changes:
 - Increased disclosure for certain reinsurance contracts
 - Aggregate stop loss
 - Quota share with risk limiting features
 - Many others with certain terms/conditions
 - Supplement 20-1 Reinsurance Attestation Supplement, required annually from CEO and CFO
 - No side deals
 - Documentation exists supporting risk transfer and the economic intent of certain reinsurance contracts
 - NAIC considered, then deferred, a bifurcation proposal

Reinsurance Accounting History

- From 2006 through today
 - Companies have completed attestations and disclosures
 - Use of finite reinsurance has declined among larger companies
 - The FASB considered various changes to US GAAP accounting
 - Bifurcation (2006)
 - Rewriting of the criteria that would determine if there is a reasonable possibility of a significant loss (2007-2008)
 - In the end, the FASB has withdrawn each of these proposals without making changes

Academy Involvement – 2005 - 2006

- Report on Risk Transfer
 - Survey of insurance companies (2005)
 - Report on views of actuaries on what tests might be useful to measure risk transfer (2005)
- Practice Note on Risk Transfer
 - Issued in 2005, re-issued with additional guidance on reasonably self-evident in 2007
- Response letters to NAIC and FASB on various matters surrounding risk transfer

Survey from 2005

- Risk Transfer Survey in 2005
 - Designed for statutory regulators to understand:
 - The extent of the use of finite reinsurance
 - The degree in which controls exist surrounding the evaluation of risk transfer
 - The extent actuaries are used in such evaluations
 - The response rate was about 25% of 1600 companies or groups

Survey from 2005

■ Key Findings:

- Approximately 1 in 4 Companies Entered into a Ceded Finite Agreement in the Past Four Years
 - Similar proportion for small, mid-sized and large companies
- It is Uncommon for Companies to have Written Policies Regarding Reinsurance Accounting and Risk Transfer
 - Close to half of larger companies had such policies; much less for smaller companies
- Evaluation and Quantification of Insurance Risk is Largely an Accounting Function, Not Actuarial
 - Larger companies were more likely to have actuarial involvement
- 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

Survey update in 2008

- Reasons for Update:
 - Passage of time renders the 2005 survey less applicable
 - A way to measure progress
 - A view shared by some regulators and industry participants that companies enhanced their control environments surrounding risk transfer assessments
 - To determine if approaches used to quantify risk transfer have changed or evolved

Survey update in 2008

- Key Finding #1 – Use of Finite Declined (but not evenly)
 - The percentage of respondents that have recently entered into a finite contract, either assumed or ceded, has declined 30% to 40%
 - Larger companies showed a substantial decline in the usage of finite ceded reinsurance - from 29% to 5%
 - Smaller companies showed only a slight decline, from 21% to 19%

Survey update in 2008

- Key Finding #2 – Modest Improvement in Corporate Governance over Risk Transfer
 - While the percentage of companies that have a formal written policy regarding the evaluation of reinsurance accounting for both ceded and assumed contracts has increased, as of 2008, fewer than half have such policies
 - Smaller companies continue to be much less likely than larger companies to have such policies

Survey update in 2008

- Key Finding #3 – While 10/10 is still commonly used as a threshold for risk transfer, Expected Reinsurer's Deficit (ERD) has emerged as a complementary tool
 - X% probability of a Y% loss
 - Remains the most common benchmark for cash flow testing
 - Almost all of those using such a benchmark continue to use a 10% chance of a 10% loss
 - Where actuaries lead the analysis, ERD has emerged as a relatively common measure (ERD was not explicitly addressed in the 2005 survey)

Survey update in 2008

■ Others Findings

- Large companies usually have stronger controls
 - More likely than small companies to document, cash flow test, and explicitly consider various types of risk
- Most companies do not perform cash flow testing on each and every contract
 - Most companies have classes of contracts for which they consider risk transfer to be reasonably self-evident without having to perform cash flow testing
- Risk transfer remains largely an accounting responsibility

Speakers' perspectives on changes from 2005 - 2008

- Less finite; also, trend away from highly structured arrangements, such as those involving experience accounts
- Trend away from bright-line measures, and to a greater use of multiple statistics, thresholds and judgment
- Trend to a greater use of quantitative measures that are alternatives to 10/10, such as ERD and Tail Value at Risk (TVaR)
 - Usually used complementary to 10/10, not in lieu of
- More discussion/consideration of the Paragraph 11 exception
 - How does a loss ratio cap impact the exception?
 - How about a profit commission?
- Greater use of CAT Bond structures

2009 and subsequent

- Actuarial Standards Board is considering an ASOP on Risk Transfer with Reinsurance Contracts
- All quiet at the NAIC, FASB
- International Accounting Standards
 - Convergence with the FASB
 - Readdressing key issues
 - What constitutes risk transfer
 - Is there bifurcation
 - Will be addressed over the next few years

Discussion

Section two



Issue Brief on Reserve Variability

A Summary of the COPLFR Issue Brief

- Issue Brief is found at Academy website:
 - http://www.actuary.org/pdf/casualty/range_sept08.pdf
 - Issued September 2008
- History Behind the Issue Brief
 - 2006 CLRS Blanchard presentation (SRO)
 - SEC and disclosures
 - Comment letters asking for ranges and other measures of variability
 - Companies providing ranges in 10Ks
 - COPLFR view that “ranges” and “reserve ranges” can have multiple meanings but are rarely communicated effectively

Introduction

- Issue Brief Available at Academy Website
- Focus is on Effective Communication
 - Ranges and Distributions add great value in communicating variability
 - Understand how the intended and unintended users will perceive the amounts
 - Be aware of the types of ranges used

Purpose & Use of Reserve Ranges

- Ranges are used to communicate uncertainty in many settings:
 - Internal communications
 - Enterprise Risk Management
 - SEC filings
 - Pre-acquisition evaluations
 - Supporting financial statement audits
 - Rendering Statements of Actuarial Opinion

Common Types of Reserve Ranges

- Two common types:
 - Range of Reasonable Estimates
 - AND
 - Range of Possible Outcomes
- Sometimes both are referred to in a generic way as a “reserve range,” but these have very different meanings
- Range of Possible Outcomes
 - Breadth of possible results of the claims process
 - Used to evaluate surplus needs and in ERM, among other purposes
 - Statistics and simulations are commonly used to generate estimates of a range or distribution of possible outcomes

Common Types of Reserve Ranges

- Common Challenges with Statistical Ranges
 - Dealing with and communicating uncertainties with parameter and model risk
- Other approaches to determine possible outcomes
 - Scenario testing
 - Historical observation
- Range of Reasonable Estimates
 - Produced by appropriate actuarial methods or alternative sets of assumptions that the actuary judges to be reasonable
 - Used for SAO preparation
 - Typically narrower than a range of possible outcomes

Issues in Communicating Ranges

- Measurement Objectives
 - What is the metric the actuary is intending to measure?
 - Mean, median, mode?
 - Fair value?
 - Actuarial central estimate?
 - Set percentile?

 - ASOP 43 now guides the actuary to state the measurement objective

Issues in Communicating Ranges

- Other Key Issues
 - Reasonable range endpoints
 - No objective boundary exists
 - May be clearer to discuss “a” range of reasonable estimates, since it may be impossible to state “the” range of reasonable estimates
 - Aggregating reasonable ranges from individual line ranges
 - Matter of covariance

Issues in Communicating Ranges

■ Other Key Issues

- Speculative Outcomes / Reliability

- Example *

$$N = R^* \times f_p \times n_c \times f_l \times f_i \times f_c \times L$$

- This equation produces an answer as to how many advanced civilizations there are in our galaxy
- However, the parameters cannot be verified
- Hence, the ability to produce an outcome does not mean that the estimate is reliable

* The Drake Equation (Sagan, Carl, Cosmos, Random House, New York, 1980, pp 298-302)

Transparent Disclosure

- Understanding / Perspective of User(s)
 - Tailor the communication to the audience
 - Address the necessary points by making sure the following questions are answered:
 - Who are the intended users of the information?
 - What experience do the intended users have?
 - Are there likely to be additional unintended users?

Transparent Disclosure

- Clarity as to Type of Range
 - Address key questions in the communication:
 - Is it a range of reasonable estimates?
 - Is it a range of possible outcomes?
 - How was the range calculated?
 - If it is a range of reasonable estimates, what is the measurement objective of the estimates?

Transparent Disclosure

- Reliability of the Range
 - Address key questions in the communication:
 - How comfortable is the actuary with the reliability of the estimates that define the range or the models and/or model parameters that estimate the distribution?
 - What is the likelihood of outcomes outside the disclosed range?
 - Does the width of the range appropriately reflect the breadth of uncertainty, given the measurement objective?

Selecting a Single Point Within the Range

- Interaction of Uncertainty, Conservatism, and Bias
 - Complicated by accounting frameworks
 - US GAAP
 - IFRS
 - US statutory

- The possibility of differing guidance between U.S. GAAP, U.S. statutory accounting, and other accounting bases may create confusion and conflict, increasing the need for effective transparency in communication of ranges

Discussion

Speaker Details



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