



Update from AAA's Risk Transfer Subgroup

Marc Oberholtzer, FCAS, MAAA - PwC
Vice Chair, AAA's COPLFR
Co-Chair, AAA's RTS

2005 MAF Fall Meeting
September 22, 2005
Bloomington, IL



Update from AAA's Risk Transfer Subgroup

Topics of Discussion

- *Background*
- *Activity at the NAIC*
- *Activity at the AAA*
- *Activity from Other Industry Groups*
 - *CAS*
 - *FASB*
 - *IRS*
- *Looking Ahead*



Background

What are the perceived problems?

- *Heavy press exposure of finite in 2004 and early 2005; rating agency articles, etc.*
- *Statutory and GAAP accounting guidelines are principle-based; as a result, there have been varying industry practices in establishing whether reinsurance transfers significant risk and there is a reasonable possibility of significant loss to the reinsurer*
- *Binary industry interpretation of Statutory and GAAP accounting guidelines allows for reinsurance accounting to be used for entire transactions, even though a portion might essentially be financing*
- *Perceived result is that accounting for some contracts differs from the economic substance*



Activity at the NAIC

What is the NAIC doing?

- *P&C Reinsurance Study Group asked CATF to identify what risk transfer tests are being used in the industry today and provide guidance on what the minimum transfer of risk standard should be*
- *CATF is working on a formal response*
- *Study Group proposed additional disclosures and CEO/CFO attestation (see Attachment A)*
- *Study Group proposed changes to SSAP 62 requiring bifurcation of all treaties that include certain contract features (see Attachment B)*
- *Clarification of regulatory expectations for appointed actuaries for year-end 2005 (see Attachment C)*



Activity at the AAA

What is the AAA doing?

- *Formed Risk Transfer Subgroup as part of COPLFR*
- *Responded to NAIC on disclosures (on AAA website)*
- *Responded to NAIC on bifurcation (on AAA website)*
- *Assisted CATF in surveying P/C companies regarding their current risk transfer practices (on AAA website; see Attachment D)*
- *Developed a summary of alternative approaches for the NAIC's consideration with respect to a standard on risk transfer (on AAA website; see Attachment E) P&C Reinsurance Study Group asked CATF to identify what risk transfer tests are being used in the industry today and provide guidance on what the minimum transfer of risk standard should be*



Other Industry Groups

What is the CAS doing?

- *Existing 2002 paper from VFIC on risk transfer testing*
- *Formed Research Working Party on Risk Transfer Testing to respond to AAA call for alternative approaches (on CAS website)*

What is the FASB doing?

- *Engaged in a project to clarify what constitutes transfer of significant insurance risk in insurance and reinsurance contracts, and to improve accounting by more clearly defining which contracts/portions should be accounted for as insurance vs. deposits.*
- *First step is to define insurance contracts and related terms – starting point is IFRS 4, Insurance Contracts*
- *FASB will also explore simple approaches to bifurcation of insurance contracts that include both insurance and financing elements*

What is the IRS doing?

- *IRS plans to issue new guidance with respect to the tax treatment of finite reinsurance contracts*
- *Comments are requested by October 3*



Looking Ahead

What still needs to be done?

- *The establishment of a definition of a “safe harbor” and/or practical guidance on “reasonably self-evident” for year-end 2005*
- *Development an actuarial practice note and eventually a standard of practice*
- *Understand the new statutory accounting guidelines if NAIC makes changes*
- *Monitoring and responding to FASB, IASB and SEC actions on risk transfer and reinsurance accounting*

Attachment A – Excerpted Additional Disclosures and CEO/CFO Attestation

[For complete text, see <http://www.naic.org/documents/2005-40BWG.doc>]

GENERAL INTERROGATORIES

PART 2 – PROPERTY & CASUALTY INTERROGATORIES

- 7.1 Has the reporting entity reinsured any risk with any other entity under a quota share reinsurance contract that includes a provision that would limit the reinsurer's losses below the stated quota share percentage (e.g., a deductible, a loss ratio corridor, a loss cap, an aggregate limit or any similar provisions)?
- 7.2 If yes, indicate the number of reinsurance contracts containing such provisions.
- 7.3 If yes, does the amount of reinsurance credit taken reflect the reduction in quota share coverage caused by any applicable limiting provision(s)?
- 9.1 Has the reporting entity ceded any risk under any reinsurance contract (or under multiple contracts with the same reinsurer or its affiliates) for which during the period covered by the statement: (i) it recorded a positive or negative underwriting result greater than 3% of current year-end surplus as regards policyholders or it reported calendar year written premium ceded or year-end loss and loss expense reserves ceded greater than 3% of current year-end surplus as regards policyholders; (ii) it accounted for that contract as reinsurance and not as a deposit; and (iii) the contract(s) contain one or more of the following features or other features that would have similar results:
- (a) A contract term longer than two years when the contract is noncancellable by the reporting entity during the contract term;
 - (b) A limited or conditional cancellation provision under which cancellation triggers an obligation by the reporting entity, or an affiliate of the reporting entity, to enter into a new reinsurance contract with the reinsurer, or an affiliate of the reinsurer;
 - (c) Aggregate stop loss reinsurance coverage;
 - (d) An unconditional or unilateral right by either party to commute the reinsurance contract;
 - (e) A provision permitting reporting of losses, or payment of losses, less frequently than on a quarterly basis (unless there is no activity during the period); or
 - (f) Payment schedule, accumulating retentions from multiple years or any features inherently designed to delay timing of the reimbursement to the ceding entity.
- 9.2 Has the reporting entity during the period covered by the statement ceded any risk under any reinsurance contract (or under multiple contracts with the same reinsurer or its affiliates), excluding cessions under approved pooling agreements or to captive insurance companies owned directly or indirectly by the policyholders of the reporting entity that are unaffiliated with, and/or not controlled by the reporting entity, where:
- (a) The written premium ceded to the reinsurer by the reporting entity or its affiliates represents fifty percent (50%) or more of the entire direct and assumed premium written by the reinsurer based on its most recently available financial statement; or

(b) Twenty–five percent (25%) or more of the written premium ceded to the reinsurer has been retroceded back to the reporting entity or its affiliates.

- 9.3 If yes to 9.1 or 9.2, please provide the following information in a supplemental filing:
- (a) A summary of the reinsurance contract terms and indicate whether it applies to the contracts meeting the criteria in 9.1 or 9.2;
 - (b) A brief discussion of management's principal objectives in entering into the reinsurance contract including the economic purpose to be achieved; and
 - (c) The aggregate financial statement impact gross of all such ceded reinsurance contracts on the balance sheet and statement of income.

9.4 Has the reporting entity ceded any risk under any reinsurance contract (or multiple contracts with the same reinsurer or its affiliates) during the period covered by the financial statement, and either:

- (a) accounted for that contract as reinsurance (either prospective or retroactive) under statutory accounting principles (“SAP”) and as a deposit under generally accepted accounting principles (“GAAP”); or
- (b) accounted for that contract as reinsurance under GAAP as a deposit under SAP?

9.5 If yes to 9.4, explain in a supplemental filing why the contract(s) is treated differently for GAAP and SAP.

REINSURANCE SUMMARY TO GENERAL INTERROGATORY 9 (Part 2 P&C)

SUMMARY OF REINSURANCE CONTRACT TERMS	MANAGEMENT’S OBJECTIVES

FINANCIAL IMPACT			
	As Reported	Restated Adjustments	Restated
Assets			
Liabilities			
Surplus as Regards to Policyholders			
Net Income			

If the response to General Interrogatory 9.4 (Part 2 Property & Casualty Interrogatories) is yes, explain below why the contract is treated differently for GAAP and SAP.

Supp 19-1

REINSURANCE SUMMARY TO GENERAL INTERROGATORY 9 (Part 2 P&C) SUPPLEMENT

Insurers may be required to file a supplement to the annual statement titled "Reinsurance Summary to General Interrogatory 9" by March 1 each year. The following provides a list of what is required within this filing.

9.3 If yes to 9.1 or 9.2, please provide the following information:

- (a) A summary of the reinsurance contract terms;
- (b) A brief discussion of management's principal objectives in entering into the reinsurance contract including the economic purpose to be achieved; and
- (c) The aggregate financial statement impact gross of all such ceded reinsurance contracts on the balance sheet and statement of income.

If the response to General Interrogatory 9.4 (Part 2 Property & Casualty Interrogatories) is yes, explain below why the contract is treated differently for GAAP and SAP.

Supp 20-1

REINSURANCE ATTESTATION SUPPLEMENT

ATTESTATION OF CHIEF EXECUTIVE OFFICER AND CHIEF FINANCIAL OFFICER REGARDING REINSURANCE AGREEMENTS SUPPLEMENT

Insurers are required to file a supplement to the annual statement titled "Reinsurance Attestation Supplement" by March 1 each year. The following provides a list of what is required within this filing.

The Chief Executive Officer and Chief Financial Officer shall attest, under penalties of perjury, with respect to all reinsurance contracts which the reporting entity is taking credit on its financial statement, that to the best of their knowledge and belief after diligent inquiry:

- (I) Consistent with *SSAP No. 62—Property and Casualty Reinsurance*, there are no separate written or oral agreements between the reporting entity (or its affiliates or companies it controls) and the assuming reinsurer that would under any circumstances, reduce, limit, mitigate or otherwise affect any actual or potential loss to the parties under the reinsurance contract, other than inuring contracts that are explicitly defined in the reinsurance contract except as disclosed herein;
- (II) 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, as required by *SSAP No. 62—Property and Casualty Reinsurance*, is available for review;

(III) The reporting entity complies with all the requirements set forth in *SSAP No. 62—Property and Casualty Reinsurance*; and

(IV) The reporting entity has appropriate controls in place to monitor the use of reinsurance and adhere to the provisions of *SSAP No. 62—Property and Casualty Reinsurance*.

Any exceptions to the aforementioned shall be disclosed in the attestation and an explanation of the exceptions shall be attached to the attestation.

Exceptions:

Attachment B –Excerpts from Proposed Revisions to SSAP 62

[Source: SSAP No 62 - Proposed Revisions.doc]

Bifurcation of Reinsurance Agreements

N1. Reinsurance agreements can provide for varying degrees of transfer of insurance risk. In certain circumstances, as addressed in paragraphs N2, N3, and N4, a reinsurance agreement should be bifurcated for accounting purposes in order more accurately reflect the economic substance of the agreement.

N2. Reinsurance agreements provide for a range of transfer of insurance risk. In most instances reinsurance agreements have elements of both insurance risk transfer and pure financing of losses (i.e. no transfer of insurance risk). Ideally, these transactions should be bifurcated. The part of the transaction transferring insurance risk, as determined under the guidance in paragraphs 9 through 16, should be reported in accordance with reinsurance accounting and the part of the transaction financing losses (and not transferring insurance risk) should be reported in accordance with deposit accounting. Such a treatment would better match the economic substance of the transaction with the financial reporting. However, the complexity, feasibility and cost of a broad application of bifurcation of reinsurance transactions may exceed the benefit of increased accuracy in financial statement reporting. Accordingly, only transactions that exhibit common characteristics of financing need to be bifurcated for accounting purposes.

N3. The following types of reinsurance agreements need not be considered for bifurcation:

- a. excess per risk treaties;
- b. excess per occurrence treaties (property catastrophe);
- c. fronting arrangements wherein 100% of the premiums on the direct policies written by the ceding insurer, less a fronting fee, and 100% of the losses incurred on those policies, is ceded to the reinsurer;
- d. facultative contracts (pro rata or excess of loss);
- e. agreements where the annual premium is less than XX% of the maximum payable loss under the terms of the reinsurance agreement; and
- f. any other agreements, including quota share reinsurance treaties and surplus reinsurance treaties, that do not meet any of the conditions set forth in paragraph N4.

N4. If any of the following conditions are present in a reinsurance agreement not exempted in paragraph N3 above, the agreement should be bifurcated:

- a. the reinsurance agreement contains any of the following provisions:

- i. contractual limitations on the assuming reinsurer's loss exposure for agreements where the annual premium is greater than XX% of the maximum payable loss under the terms of the reinsurance agreement;
 - ii. aggregate loss ratio limits;
 - iii. loss corridors reducing the reinsurer's risk exposure for a range of losses within a layer of the covered losses, including the existence of deductibles;
 - iv. retrospective premium adjustments;
 - v. sliding scale or other adjustable commissions that are dependent on the level of the ceding insurer's losses;
 - vi. profit sharing formulas, including adjustable commissions that are contingent upon the level of losses ceded under the reinsurance agreement;
 - vii. mandatory reinstatement premiums;
 - viii. a commutation clause allowing ceding company refunds of premiums based upon experience to date;
 - ix. a limited or conditional cancellation provision under which cancellation triggers an obligation, direct or indirect, by the parties to the agreement to enter into a new reinsurance contract;
 - x. reporting of experience under the agreement less frequently than on a quarterly basis;
 - xi. funds are held by the ceding company for payments of losses; or
- b. the reinsurance agreement, or any part thereof, is retroactive; or
 - c. coverage period under the reinsurance agreement exceeds one year.

N5. Accounting for Bifurcation of Reinsurance Agreements

- a. In reporting the bifurcation of a reinsurance agreement, the reporting insurer shall estimate the portion of the layer of coverage provided for in the agreement for which there is a greater than ninety percent (>90%) probability that the ceding insurer will be indemnified for the losses in that layer. Upon inception, the portion of the premium that supports that layer of coverage shall be reported pursuant to the deposit accounting guidance in SSAP No. 75. The remainder of the premium shall be reported pursuant to the reinsurance accounting guidance contained herein. Commissions and expenses should be pro-rated according to the percentage of premium allocated to insurance accounting and deposit accounting, respectively.
- b. Losses incurred and any accompanying entries shall be reported under deposit accounting guidance until the estimated layer of coverage for which there is a greater than ninety percent (>90%) probability that the ceding insurer will be indemnified for those losses under the reinsurance agreement has been exhausted. Subsequent losses

incurred and accompanying entries shall be reported under reinsurance accounting guidance.

B. SSAP 62 Text Changes to Eliminate Treatment for Retroactive Agreements

Accounting for Retroactive Reinsurance Agreements

27. Certain reinsurance agreements which transfer both components of insurance risk cover liabilities which occurred prior to the effective date of the agreement. These transactions are required to be bifurcated and accounted for pursuant to paragraphs N2 – N5. Reinsurance agreements which do not transfer insurance risk should be accounted for pursuant to the deposit accounting provisions in SSAP No. 75. Due to potential abuses involving the creation of surplus to policyholders and the distortion of underwriting results, special accounting treatment for these agreements is warranted.

29. Portfolio reinsurance is the transfer of an insurer's entire liability for in force policies or outstanding losses, or both, of a segment of the insurer's business. Loss portfolio transactions are to be accounted for as retroactive reinsurance. If loss portfolio transfers provide for a transfer of insurance risk, they should be bifurcated and accounted for pursuant to paragraphs N2 – N5. Loss portfolio transfers which do not transfer insurance risk should be accounted for pursuant to the deposit accounting provisions in SSAP No. 75.

Attachment C – Excerpt on Reinsurance from Regulatory Guidance Document

[Source: REGULATORY GUIDANCE On Property and Casualty Statutory Statements of Actuarial Opinion For the Year 2005 Prepared by the NAIC's Casualty Actuarial Task Force, draft dated August 23, 2005.]

Reinsurance

Recent industry developments regarding the appropriate treatment of reinsurance have elevated the attention given to this disclosure. The Scope of the statutory Opinion does not include an evaluation of risk transfer nor an assessment of the appropriateness of the accounting treatment on the reinsurance contracts of a company. However, opining on the carried Net Reserves calls for knowledge of the ceded program and what agreements are accounted for as reinsurance. The Instructions advise the actuary on a number of actions in gathering background information. For year-end 2005 Appointed Actuaries should expect that the NAIC will require additional disclosures from the company in the Annual Statement Interrogatories regarding reinsurance and risk transfer. The CATF expects that an Appointed Actuary has sufficient awareness of the background information and disclosures in order to provide an informed opinion. This background information will not reveal every possible question regarding reinsurance. It does have the potential to identify inconsistencies that deserve clarity prior to reaching a conclusion. The Relevant Comments on reinsurance should reflect the actuary's approach. Further detail and documentation should be included in the Actuarial Report.

Attachment D – Summary of Observations from NAIC Risk Transfer Survey

[Source: RISK TRANSFER IN P&C REINSURANCE: REPORT TO THE CASUALTY ACTUARIAL TASK FORCE OF THE NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS, American Academy of Actuaries Committee on Property and Liability Financial Reporting August 2005.

For complete text, see http://www.actuary.org/pdf/casualty/risk_transfer.pdf

Summary of Observations

There were 390 survey responses provided to the RTS by the CATF; our observations as they relate to those responses are provided in detail below. Following are a few of our more significant conclusions:

- Approximately 25% of those receiving the survey provided responses – however, we believe it is possible that larger companies were underrepresented relative to small and mid-sized companies. Interestingly, where observed, and where we considered it to be statistically significant, the size of the company did not appear to have a significant bearing on most responses.
- Based on responses to question #3, for the majority of respondents, there are no individual terms, conditions or other characteristics that define a contract as “finite.” This might suggest that the respondents generally believe such a definition is a matter of substance rather than form, and might arise from a combination of certain conditions.
- Approximately 23% of respondents have entered into at least one ceded finite contract in the past four years – large insurers were slightly more likely, at 29%.
- It is uncommon for a company to have a formal written policy regarding the evaluation of reinsurance accounting and risk transfer; this is even the case for those that have entered into finite ceded contracts in the past four years.
- As evidenced by the responses to question #16 and #17, the evaluation and quantification of insurance risk appears to be largely an accounting function. It is rare that actuaries actually lead the evaluation of ceding and assuming company risk transfer evaluations. It is also uncommon that the respondents have a requirement that risk transfer analyses require internal actuarial approval.
- Similarly, a minority of respondents (31%) employ statistical / modeling approaches to evaluate risk. This percentage is much higher (70%) when actuaries lead the risk analysis. Further, most companies report that they do not explicitly consider process, parameter, or acceleration risk. This suggests that companies may either be performing an incomplete evaluation of risk, or that their approaches do not allow them to explicitly identify the types of risks being evaluated.

Although the need for risk-transfer testing arises from the application of accounting rules, we believe that it would be beneficial for actuaries, who have significant

expertise in evaluation and quantification of insurance risk, to take a larger role in this process.

- Relatively few respondents rely exclusively on a numeric test to evaluate whether there is sufficient risk transfer. Most use calculations as a starting point, supplemented by other considerations and judgment. Where applicable, the 10/10 rule (i.e., 10% chance of a 10% loss) was the most common numerical threshold used by respondents in determining risk transfer. However, many respondents elected not to respond to this question.

Attachment E – Summary of Findings from Alternatives Project

[Source: RISK TRANSFER IN P&C REINSURANCE: REPORT TO THE CASUALTY ACTUARIAL TASK FORCE OF THE NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS, American Academy of Actuaries Committee on Property and Liability Financial Reporting August 2005.

For complete text, see http://www.actuary.org/pdf/casualty/risk_transfer.pdf

Summary of Findings

While the responses were very diverse, thoughtful and generally well designed, there were several commonly recurring themes. Following is a listing of several of the more common and more highly emphasized themes (*in this section, RTS comments are presented in italics*):

- Many respondents stated that the “10/10 rule,” defined as a 10% chance of a 10% loss, was inadequate for purposes of testing across the spectrum of reinsurance agreements, and noted that frequency and severity of loss should be combined into one test statistic. This was particularly emphasized for agreements that reinsured low frequency/high severity risks. *The RTS concurs with this view. Further, we do not believe a bright-line approach, without allowance for judgment, is an optimal approach.*
- Several respondents believed that a risk transfer analysis must not only consider the variability of the reinsurer’s results but also the variability of the underlying business. *The RTS concurs with this view.*
- Many respondents emphasized the need to consider parameter uncertainty, and the mismatch in information between the ceding company and reinsurer, in assessing risk. *The RTS concurs with this view and would add that we believe parameter uncertainty is an important, and often misunderstood, element of risk transfer.*
- Several respondents provided alternatives to the 10/10 rule for the evaluation of risk transfer. *The RTS suggests that the NAIC may wish to consider these alternative methods, and evaluate these alternative methods among a variety of “real world” reinsurance agreements to assess their feasibility and effectiveness.*

Several of the new risk transfer analysis methods suggested are worth serious consideration. The ones we consider most promising, in breaking new ground while attempting to strike a balance between theoretical soundness and practicality, are contained in the papers from the CAS Working Party, Gluck, Wenitsky and Belfatti. Furthermore, many of the ideas offered could be altered, or used in combination with each other; there is no one correct version of how to approach the subject of risk transfer.

- Several respondents believe that the binary, “either-or” nature of accounting (i.e., contracts are either 100% reinsurance or 100% deposits) was inadequate to encompass contracts that contain both risk and financing elements, and suggested approaches to bifurcate contracts so that these elements could be accounted for

separately. *The RTS was not asked to evaluate, and has not evaluated, the feasibility of bifurcation as an accounting concept. Absent such an evaluation, RTS members have various opinions as to whether bifurcation is feasible as an accounting practice. If the NAIC wishes to consider these or other methods for the purpose of bifurcation, we recommend further analysis on real-life contracts to determine what types of situations are appropriate for bifurcation, how the accounting would be done, how complicated and useful the bifurcation process would be, and whether the results would improve the matching of accounting versus economics for the sample contracts.*

- Several respondents introduced new ideas, often related to the Paragraph 11 Exception, to identify and potentially expand the types of contracts for which risk transfer is reasonably self-evident.

Although some of the ideas regarding safe harbors may be controversial, we believe that many of them have well-founded justifications and should be considered. We do not believe it is necessary to expand the Paragraph 11 Exception in order to justify safe harbors that exempt certain types of contracts from cashflow testing.