Risk Transfer and Attestation

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Table of Contents

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Overview of New NAIC Reinsurance Requirements

- General Interrogatories 7.1 and 7.2 remain in place (QS contracts with loss limitations).
- Six new General Interrogatories (7.3; 9.1 – 9.5)
- New CEO/CFO attestation

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Overview
Scope of Requirements

- Contracts for which the reporting entity is taking financial statement credit
- Entered into, renewed, or amended on or after January 1, 1994

Overview
Types of Contracts Subject to New Rules

- Treaties
- Facultative
- Captives
- Pools

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General Interrogatories – 7.1 to 7.3

7.1 Are there ceded quota share contracts with deductibles, loss corridors, loss ratio caps, aggregate limits, or any similar provisions?

7.2 If yes, how many contracts?

7.3 If yes, is the reduction in coverage reflected?

General Interrogatories – 9.1

Requires reporting of contracts based on three triggers:

1. +/- underwriting result or ceded premium or ceded reserves greater than 3% of prior year-end surplus

   and

2. Accounted for as reinsurance

   and

3. Contains one or more of six designated features, or features that would produce similar results (term > 2 years, aggregate stop loss, etc.)

General Interrogatories – 9.2

Requires reporting of contracts based on two questions:

1. Written premium ceded to any reinsurer represents 50% or more of the entire direct and assumed premium written by that reinsurer (except captives and approved pools)

   or

2. 25% of the written premium ceded has been retroceded back to the reporting entity or its affiliate.

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General Interrogatories – 9.3

Requires a supplemental filing for affirmative responses to 9.1 and 9.2, including:

1. The aggregate financial statement impact on the balance sheet and income statement.

   and

2. Summary of reinsurance contract terms.

   and

3. Brief summary of management’s principal objectives including the economic purpose.

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General Interrogatories – 9.4 & 9.5

9.4 Review whether there are any contracts:

1. Accounted for as reinsurance under SAP and as a deposit under GAAP

   or

2. Accounted for as a deposit under SAP and as reinsurance under GAAP

9.5 Explain why.

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General Interrogatories – How an Actuary Can Help

7.1 to 7.3	Assist in identifying agreements; making sure corridors, aggregate limits are correctly reflected
9.1	Assist in identifying agreements with one of the 6 risk mitigating features
9.3	Assist in preparing summaries of contract terms and economic intent
9.5	Assist in explaining why there is different accounting used for agreements identified in 9.4

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CEO/CFO Attestation

The CEO and CFO shall attest that to the best of their knowledge and belief after diligent inquiry:

1. There are **no separate written or oral agreements** between the reporting entity and the assuming reinsurer that would affect any actual or potential loss to the parties under the reinsurance contract
2. For each reinsurance contract 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;
3. The reporting entity **complies with all the requirements set forth in *SSAP No. 62*** *—Property and Casualty Reinsurance; and*
4. 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.

CEO/CFO Attestation Compliance (No. 1)

No. 1: There are no separate written or oral agreements

- Review complete contract files
- Review accounting data for unusual results
- Look for possible “linked” agreements
- Survey underwriters
- DOCUMENT FINDINGS!

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CEO/CFO Attestation Compliance (No. 2)

No. 2: Documentation concerning the economic intent of the transaction and the risk transfer analysis.

- General framework for reviewing contracts
  - Determining when risk transfer is reasonably self-evident; or
  - Determining if significant insurance risk is transferred (i.e. paragraph 12.a); and
  - Determining when cash flow testing is needed to determine risk transfer (i.e. paragraph 12.b)
- Cash Flow Testing
  - Approach
  - Measures of risk transfer

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General Framework for Reviewing Contracts Determining if Risk Transfer is Self-Evident

- Develop a Risk Transfer Criteria Checklist - a list of 15 to 20 features (in the form of questions) that can mitigate risk, such as
  - Aggregate excess/stop loss structures
  - Quota Shares with corridors or caps
  - High rates-on-line
  - Others
- Use 6 features contained in General Interrogatories 9.1 as a starting point

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General Framework for Reviewing Contracts Determining if Risk Transfer is Self-Evident

- Level 1 – if you can answer “No” to all questions, conclude that risk transfer is self-evident
- Level 2 – if there is at least one “Yes”, but you can conclude that risk transfer is self-evident after further review without further analysis/cash flow testing
- Level 3 – if there is at least one “Yes”, but you have to do further analysis to determine if there is significant insurance risk (12.a) and reasonable possibility of significant loss (12.b)
- Consider Paragraph 15 exception (Paragraph 11 in FAS 113)

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General Framework for Reviewing Contracts Determining if Significant Insurance Risk is Transferred

Don't forget about the 12.a test (9.a in FASB 113)!

- The reinsurer must assume significant insurance risk (both underwriting and timing risks)
- A qualitative test; determined after reviewing all terms contained in the agreement
- A contract can fail 12.a and thus not have sufficient risk transfer – irrespective of any cash flow testing
- Need to pass both 12.a and 12.b for risk transfer

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General Framework for Reviewing Contracts Determining when Cash Flow Testing is Needed

- Answered “Yes” to one or more Risk Transfer Criteria questions
- Sufficient insurance risk transferred (i.e. pass 12.a)
- Thereafter, professional judgment is needed
- Suggestion: If in doubt or a gray area, it is “safer” to perform the cash flow testing

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Cash Flow Testing Approach

- Build cash flow model reflecting economic terms and conditions of contract (premium, limits, ceding commissions, etc.)

- Need assumptions regarding three key variables
  - Ultimate Losses (and variability)
  - Loss Payment patterns (and variability)
  - Interest/Discount Rates

- Run assumptions through model using:
  - Historical Results
  - Loss Scenarios
  - Simulation

Cash Flow Testing
Measures of Risk Transfer

- At least one reasonably possible scenario
- "10/10" benchmark (or some variation)
- Expected Reinsurer Deficit (ERD)
- Others suggested

CEO/CFO Attestation Compliance (No. 2) – Final Word

DOCUMENTATION!!!!!

- Document economic intent of contract
- Document risk transfer and cash flow testing – both narrative and exhibits
- Document those agreements where risk transfer is self evident

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CEO/CFO Attestation Compliance (No. 3)

No. 3: The reporting entity **complies with all the requirements set forth in *SSAP No. 62*** —*Property and Casualty Reinsurance*

- Required Terms for Reinsurance Agreements (Paragraph #8)
- "Nine Month Rule" (Paragraph #23)
  - Statutory guidance to ascertain that a reinsurance agreement was in place at the beginning of a policy period and is therefore *prospective*
  - Applies to all agreements entered into, renewed or amended after January 1, 1994
  - Rule requires than an agreement be, "…finalized, reduced to written form and signed by the parties within nine months after the commencement of the policy period."
  - A number of exceptions (i.e. facultative, syndicated placements, pre-12/31/1996, others)

CEO/CFO Attestation Compliance (No. 34 (con't)

- Retroactive Reinsurance Agreements (Paragraphs #27-#33)
  - Understand/be able to explain the difference from GAAP retroactive reinsurance accounting
  - Special rules for intercompany retroactive reinsurance
  - Understand novations

- Deposit Accounting (SSAP No. 75 – superseded Paragraph #34)
  - Understand the difference between retroactive and deposit accounting
  - Actuaries can/should assist in the deposit calculations (i.e. effective yield method)

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CEO/CFO Attestation Compliance (No. 4)

No. 4: Requires that "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."

- Limited formal guidance as to this evaluation
- Reference to the Financial Condition Examiners Handbook
  - Part 3 – Control Testing
  - Part 4 – Reinsurance, Section VII – Review of Reinsurers & Evaluation of Risk Transfer
- Existence of accounting processes and policies

CEO/CFO Attestation Compliance (No. 4) (con’t)

Actuaries should be part of the on-going control process

- Perform risk transfer analysis for new or renewing agreements incepting in current and future years
- Keep abreast of current risk transfer guidance, accounting guidance (i.e. AAA Risk Transfer Testing Practice Note, FAS Invitation to Comment on Bifurcation, etc.)