Reinsurance – Risk Transfer Update

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Discussion Topics

- Recap of Developments
  - NAIC: Changes to reporting (effective year-end 2005)
    - Additional disclosures on ceded reinsurance
    - CEO, CFO Attestation
    - Introduction of "Reasonably Self-Evident" Concept
  - FASB: Invitation to Comment on Bifurcation (2006)
- Academy's Role on Risk Transfer
  - 2005 – Report, survey for NAIC on Risk Transfer
  - 2005 – Practice Note to actuaries on Risk Transfer
  - 2006 – Response to FASB on Bifurcation ITC
  - 2007 – Update to Practice Note on Risk Transfer
    - More Guidance on Reasonably Self-Evident
    - Sample "Checklists"
- COPLFR's Next Projects
- Current Trends in Industry Practice

Recap of Developments

- 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

- 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
- 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 FASB

- FASB's Invitation to Comment on Bifurcation
  - Released May 24, 2006
- Key Content:
  - Proposed Clarification as to what Constitutes Transfer of Significant Insurance Risk in Insurance and Reinsurance Contracts.
  - Suggested Various Alternatives as to how Bifurcation of Insurance Contracts that include both Insurance and Financing Elements would be Implemented;
    - Narrowed to Finite Products, or
    - Implemented to Nearly all Insurance Products other than "Single Risk" Policies

Activity at the FASB

- FASB's Invitation to Comment on Bifurcation
  - Released May 24, 2006
- Common Themes to the Responses:
  - Scope of Bifurcation Project should be Limited to Certain Finite Arrangements – i.e., the Industry Opposed a Comprehensive Restructuring of the Insurance Accounting Model
  - Corporate Policyholders would be at an Information and Expertise Disadvantage
  - The Cost Substantially Outweighs the Benefit, in Particular for Corporate Policyholders
  - Many Practice Issues could be Addressed with Clarification of Existing Guidance in US GAAP

Activity at the FASB

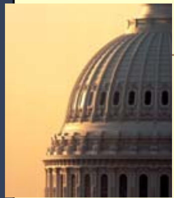
- FASB’s Next Steps
  - Last updated July 12, 2007 at FASB website
  - There could be some changes to FAS 113
    - Drafting editorial changes to clarify the level of insurance risk transfer required for a contract to be accounted for as reinsurance. Current language could lead to “10/10 rule”, which is inconsistent with a principles-based standard
  - More guidance for direct insurance
    - Drafting changes to clarify that noninsurance company policyholders must evaluate whether contracts they hold transfer significant insurance risk.
  - Considering new disclosures
    - Considering those used by NAIC

Academy Involvement in Risk Transfer

- Committee on Property Liability Financial Reporting (COPLFR) formed a Risk Transfer Work Group (RTWG)
  - Led by Nancy Watkins
  - Represented by insurance and reinsurance company actuaries, regulatory actuaries, and auditing/consulting actuaries
- COPLFR and the RTWG
  - 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)
  - Response Letter to FASB on ITC (August 2006)
  - Updated Practice Note on Risk Transfer (January 2007)

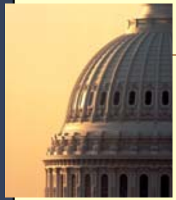
Academy's 2005 Risk Transfer Report

- COPLFR and the RTWG issued a report on Risk Transfer in August 2005
  - Found at www.actuary.org/pdf/casualty/risk_transfer.pdf
  - Includes results from NAIC's survey of companies; survey was developed by the RTWG
  - 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



Academy's 2005 Risk Transfer Report

- 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?

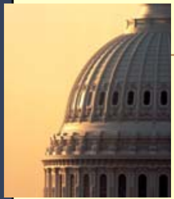


Academy’s Practice Note on Risk Transfer

- Guidance to actuaries, written by actuaries, when evaluating Risk Transfer in Property and Casualty reinsurance contracts
- Updated in 2007, and found at Academy website
  - http://www.actuary.org/pdf/practnotes/pc_risk07.pdf
- Includes Sections:
  - Background and Purpose
  - Selected Accounting Principles
  - <u>UPDATED – Evaluating When Risk Transfer is Reasonably Self-Evident</u>
  - Considerations When Evaluating the Cash Flow Economics Under a Reinsurance Contract
  - Answers to Frequently Asked Questions
  - <u>NEW – Sample Checklists</u>

Academy's Practice Note on Risk Transfer

- Originally issued November 2005
- Well received by insurance Industry
  - Demonstrated leadership by the Academy to the insurance industry on this complex topic
  - Provided much needed guidance to industry as companies complied with the Attestation Requirement
- Requests for additional guidance, clarification
  - Reasonably Self-Evident (RSE)
  - Documentation – what information could be retained?



Academy’s Practice Note on Risk Transfer

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
  - The Reinsurance Attestation Supplement places requirements on the company’s CEO and CFO and not on the Appointed Actuary. However, the CEO or CFO may seek actuarial support related to the risk transfer analysis

Academy's Practice Note on Risk Transfer

CEO, CFO Attestation

- <u>Attestation Requirement</u>: The CEO and CFO attestation with respect to active ceded reinsurance contracts should state the following:

:

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, <u>for which risk transfer is not reasonably considered to be self-evident</u>, <u>documentation concerning the economic intent of the transaction and the risk transfer analysis evidencing the proper accounting treatment</u> is available for review;

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.

Academy's Practice Note on Risk Transfer

Typical actuarial involvement in CEO, CFO attestation

- Includes participation in:
  - Selection – the identification of which contracts are not RSE and therefore require a cash flow analysis to determine 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 by the company on each reinsurance contract that would permit an outside observer to follow the process used by the company to assess the proper reinsurance accounting treatment

Academy's Practice Note on Risk Transfer

Documentation

- What might be included in a documentation file for ceded reinsurance?
  - Relevant correspondence and related agreements
  - Memorandum supporting business purpose of transaction
  - Risk Transfer support
    - <u>Either a statement that Risk Transfer is considered to be RSE, or an analysis that displays the possible outcomes, Their likelihood, and economic Impact</u>
    - Signoff from management that Risk Transfer has been demonstrated or is believed to be RSE
  - Other relevant information
- Actuaries might be asked to provide the underlined (above)
  - Actuaries may wish to refer to ASOP #9 for guidance in preparing documentation

Academy's Practice Note on Risk Transfer

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
- "Paragraph 11 Contracts"
  - "Substantially all of the insurance risk relating to the reinsured portions of the underlying insurance contracts has been assumed by the reinsurer," "retained risk is insignificant"
  - The only exception identified in 113 is referred to as a "very limited circumstance" (Par 67)

Academy’s Practice Note on Risk Transfer

Where testing is not required for CEO, CFO Attestation

- Cash Flow Testing also exempted where Risk Transfer is RSE
  - Purpose is to eliminate / avoid time and expense associated with unnecessary analyses
  - New term, but consistent with industry practice
    - Cash Flow Testing Rarely Applied to standard “traditional” contracts
    - Likely basis for “catastrophe exception”
  - Detailed Cash Flow Testing not needed, but some documentation supporting Risk Transfer being RSE would be expected

Academy's Practice Note on Risk Transfer

RSE - Updated Guidance

- RSE is consistent with the guidance that already exists in SSAP 62.
- Page 12 of the Risk Transfer Practice Note.:
  - "The concept of "reasonably self-evident" does not imply that risk transfer analysis is not required. Rather, it means that in situations where the fundamental structure and substance of the contract would obviously result in compliance with the criteria defined in paragraphs 12a and 12b of SSAP 62, substantive contract-specific calculations are not necessary. Rather, in these instances a company may reach its conclusions about a contract by evaluating its adherence to risk transfer characteristics and/or the cash flow characteristics of the class of contracts to which it belongs."

Academy's Practice Note on Risk Transfer

RSE - Updated Guidance

- There are several defining characteristics of those contracts for which Risk Transfer is considered to be RSE:
  - The potential loss to the reinsurer is much larger than the premium for the coverage provided;
  - The contractual terms and conditions of coverage are standardized for the classification or type of contract; and
  - The contract does not include provisions that enable the reinsurer to recover all or a significant portion of the covered losses.
- <u>Important Point</u> – A company might want to identify an entire class of contracts as having Self-evident Risk Transfer because each contract within the class has each of the characteristics defined above.

Academy’s Practice Note on Risk Transfer

RSE - Updated Guidance

- Similarly, if a contract has any of the following features, it would be unlikely that Risk Transfer would be RSE:
  - The premium approaches the present value of the coverage provided;
  - The contract is “manuscripted” using terms of coverage that are not standard for contracts within the classification or type of contract; or
  - The contract includes provisions that enable the reinsurer to recover all or a significant portion of the covered losses.
- When Risk Transfer is not RSE, the next step is Cash Flow Testing

Academy's Practice Note on Risk Transfer

RSE - Updated Guidance

- Contracts in which 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

- Key points to consider
  - 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.

Academy's Practice Note on Risk Transfer

RSE - Updated Guidance

- Contracts in 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
- 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

Academy's Practice Note on Risk Transfer

Cash Flow Testing

- Guidance provided on the key steps of Cash Flow Testing
  - Understanding the substance of arrangement
    - Obtain an understanding of the business purpose and intended substance of the transaction.
  - Preparing calculations of Cash Flows/Scenario Testing – subject losses
    - Loss and payout pattern scenarios
  - Overlaying the contractual terms
    - Consider all provisions in contract
    - When in doubt (complex terms), seek advice
  - Determining the present value

Academy's Practice Note on Risk Transfer

- 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 Loss	NPV Ultimate Ceded Loss	NPV Reinsurer's Profit / (Loss)	NPV Profit/(Loss) to NPV Premium
5.0%	44,586	46,718	43,386	41,718	5,000	10.7%
10.0%	50,062	51,983	48,862	46,983	5,000	9.6%
15.0%	54,305	56,062	53,105	51,062	5,000	8.9%
20.0%	57,960	59,577	56,760	54,577	5,000	8.4%
25.0%	61,179	62,672	59,979	57,672	5,000	8.0%
30.0%	64,027	65,411	62,827	60,411	5,000	7.6%
35.0%	67,224	68,485	66,024	63,485	5,000	7.3%
40.0%	70,223	71,368	69,023	66,368	5,000	7.0%
45.0%	73,392	74,415	72,192	69,415	5,000	6.7%
50.0%	76,845	77,735	75,645	72,735	5,000	6.4%
55.0%	79,781	80,559	78,581	75,559	5,000	6.2%
60.0%	83,308	83,950	82,108	78,950	5,000	6.0%
65.0%	86,874	87,379	85,674	82,379	5,000	5.7%
70.0%	90,774	91,100	89,544	86,100	5,000	5.5%
75.0%	95,970	96,125	94,770	91,125	5,000	5.2%
80.0%	100,000	100,000	99,613	95,781	4,219	4.2%
85.0%	100,000	100,000	106,301	102,213	(2,213)	-2.2%
87.5%	100,000	100,000	112,109	107,797	(7,797)	-7.8%
90.0%	100,000	100,000	117,391	112,876	(12,876)	-12.9%
92.5%	100,000	100,000	120,000	115,385	(15,385)	-15.4%
95.0%	100,000	100,000	120,000	115,385	(15,385)	-15.4%
97.5%	100,000	100,000	120,000	115,385	(15,385)	-15.4%
Mean	76,180	77,096	77,939	74,941	2,155	2.8%

Academy's Practice Note on Risk Transfer

Evaluating Risk Transfer

- <u>Quantification of Cash Flows</u>
  - 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

  - <u>Several Key Points</u>
    - 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
    - <u>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.</u>

Academy's Practice Note on Risk Transfer

Updated Guidance - Checklists

- Sample company checklists provided in the 2007 Update
- Purpose
  - To provide examples of how certain companies address their Internal compliance monitoring with respect to the evaluation and documentation of Risk Transfer in reinsurance agreements
- Important Comments/Limitations:
  - These sample checklists were not developed or substantively modified by COPLFR. These are <u>examples only</u>, not guidance.
  - The Academy does not endorse any particular approach or make any representation that the checklists assure adherence to Risk Transfer principles or are sufficient to meet the requirements of the reinsurance attestation supplement.
  - Management must consider the specifics of its own business and reinsurance program in order to develop an appropriate categorization and documentation procedure.

COPLFR – 2007 and Beyond

- COPLFR and RTWG – Project List for 2007/2008
  - Education Session for Regulators
  - Consideration of an ASOP for Risk Transfer
  - Update the Questionnaire Issued in 2005
    - Expectation that the industry has improved
    - Better participation by larger insurers
  - Response to FASB on changes to FAS 113 et al

Current Trends in Industry Practice

- <u>From my perspective as an audit firm actuary</u>:
  - 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 TVaR
    - These alternatives are generally not used as bright line measures but as additional data points
  - 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/Side Car structures
    - Supplements existing CAT reinsurance program
  - Trend away from highly structured arrangements, such as those involving experience accounts

- Q&A