Risk Transfer Accounting

Casualty Loss Reserve Seminar

Ernst & Young
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Reinsurance Accounting Guidance

- GAAP – ASC 944-20-15
  - FASB Statement No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts*
  - EITF 93-6, *Accounting for Multi-Year Retrospectively Rated Insurance Contracts by Ceding and Assuming Enterprises*
  - Implementation guidance EITF D-34 and D-35
- Statutory
  - SSAP No. 62R, *Property and Casualty Reinsurance*
    - Risk transfer rules for STAT are same as under GAAP
    - Paragraphs 10-17 of SSAP 62R
    - Implementation Q&A – Questions 6-21
    - Reinsurance agreements with multiple cedents require allocation agreements (paragraph 9)

Short-Duration Risk Transfer – FAS 113

- Risk Transfer Conditions:
  - Paragraph 9a (944-20-15-41) Test:
    - The reinsurer <u>assumes significant ***insurance risk***</u> under the reinsured portions of the underlying insurance policies.
      - Transfer of **insurance risk** requires transferring both:
        - Underwriting risk
        - Timing risk
  - Paragraph 9b (944-20-15-41) Test:
    - It is reasonably possible that the reinsurer <u>may realize a significant loss</u> from the transaction

Short-Duration Risk Transfer – FAS 113

- Definition of Underwriting Risk:
  - Underwriting risk is defined as the uncertainty in the ultimate amount of cash flow from premiums, commissions, claims and claim settlement expenses.
  - The amount of a reinsurer’s payments should depend on and ***directly vary*** with the amount of claims settled under the reinsured contracts (under different scenarios).

Short-Duration Risk Transfer – FAS 113

- Definition of Timing Risk:
  - The timing of the receipt and the payment of cash flows made to the ceding company from the reinsurer must be uncertain at the origination of the contract.
  - FASB 113 requires both significant variation in the timing of claim payments and timely reimbursement
  - A reinsurer's payments should depend on and vary directly with the timing of the claims settled in the underlying insurance policies.

Short-Duration Risk Transfer – FAS 113

- Paragraph 9b test: It is reasonably possible that the reinsurer may realize a significant loss from the transaction.
  - Frequency and severity of losses associated with the reinsurance contract are considered
  - Reasonable Possibility of a Significant Loss:
    - Evaluation of ceding company should be based on the present value of all cash flows between the ceding and assuming enterprises under reasonably possible outcomes.
  - FASB 113 does not provide definitions of “significant” or “reasonably possible” to be used in evaluating the results of the test
  - Requires professional judgment (actuarial modeling often starts with expected losses above 10% to be significant)

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Transfer of Risk Guidelines

Examples of Violations of Transfer of Risk

- Has the reinsurer assumed significant insurance risk?
  - Failed if the probability of significant variation in the amount or timing of payments is remote
  - Failed if the amount and timing of payments is not dependent on and directly varies with the ceding company's settlements
- Is it reasonably possible that the reinsurer may realize a significant loss?
  - Professional judgment is required
  - Failed if the PV of cash outflows (premiums) is greater than the PV of cash inflows (recovered losses)

Short-Duration Risk Transfer – FAS 113

Considerations in the Risk Transfer Analysis:

- Both the 9a and 9b test must be met, therefore failure to transfer insurance risk (9a) is not overcome by the possibility of significant loss to the reinsurer (9b)
- However, if the 9b test is not met, risk transfer is met if substantially all of the insurance risk relating to the business reinsured has been assumed by the reinsurer
- Risk transfer assessment is made at the contract inception based on facts and circumstances known at the time
  - Must be reassessed if there are any subsequent contract amendments

Transfer of Risk Guidelines

Considerations for a Risk Transfer Analysis:

- Companies must have a complete understanding of the contract
  - What terms are “fixed”? What terms are “open”?
- Evaluate all contractual features that:
  - Limit the amount of insurance risk
  - Delay the timely reimbursement of claims by the reinsurer
- Quota share contracts with caps, loss corridors, deductibles, or sliding scale commissions may not pass paragraph 9(a) test

Risk Transfer Red Flags

- Unusually high premium for value of coverage provided (rate online)
- Existence of contingent or sliding scale commission, profit commissions, retrospectively rated premiums
- Accumulating retentions over multiple years
- Experience account/fund balance
- Commutation and termination provisions allowing reinsurer to lock in payment pattern
- Termination provisions limiting ability to cancel
- Related contracts
- Contracts that don't on their face make business sense
- Undefined terms
- Unacceptable insolvency clauses

Statutory Accounting – Risk Transfer

Statutory Accounting is the same as GAAP Accounting

- Paragraphs 10-17 of SSAP 62R, *Property & Casualty Reinsurance*
- Risk transfer requires BOTH:
  - The reinsurer assumes significant insurance risk (paragraph 13a)
  - It is reasonably possible that the reinsurer may realize a significant loss (paragraph 13b)
- Reinsurance agreements with multiple cedents must have allocation agreements that are:
  - In writing (paragraph 9a)
  - Have terms that are fair and equitable (paragraph 9b)

Statutory Accounting – Risk Transfer

Annual Statement Reinsurance Interrogatories

- Reinsurance Interrogatories were required to be included in the P&C Annual Statement beginning in 2006
  - Limited to reinsurance contracts entered into, renewed or amended on or after January 1, 1994
  - For Quota Share Contracts - disclose provisions that would limit the reinsurer's losses below the stated Q/S percentage
  - Disclose information about reinsurance contracts for which
    - The impact to the income statement was > 5% of surplus or loss reserves were > 5% of surplus
    - The contract was accounted for as reinsurance
    - The contract contained certain risk-limiting features