Setting the Uncollectible Reinsurance Reserve (URR) under the new FASB requirements

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Outline – Setting the URR

- Why is this an issue?
- Current Practice.
- What's changing?
- What causes uncollectibility risk?
- Where has dispute risk been an issue?
- Estimation methods
- Data Issues/cautions
- Questions.

Why is setting the URR an issue

- New reasons
  - New FASB rules for 2020/2021 *(ASU 2016-13)*
  - “Market consistent” valuations – Solv. II, Bermuda
- Old reasons
  - Actuarial opinion instructions
  - Part of net reserves
- Note: uncollectibility includes both:
  - Inability to pay (credit)
  - Willingness to pay (dispute)

Current practice for the URR

Two approaches in use today

- "Incurred Loss" model
  - Only reserve for known impairments
- "Expected Loss" model
  - Reserve for ultimate amount uncollectible.

Basis for the current approaches – part 1

- FAS 5 – recognize a loss if probable, then measure it using your best estimate
- But using what unit of account?
- Not probable on an individual reinsurer basis (?), but some loss may be probable for the total
  - Aggregate unit of account ⇨ expected loss model
  - Individual unit of account ⇨ incurred loss model

Basis for the current approaches – part 2

- SSAP 62R, paragraph 71

  "Uncollectible reinsurance balances shall be written off through the accounts, exhibits, and schedules in which they were originally recorded"

- If billed amount was originally recorded as a negative paid loss, reverse the paid loss

- Hence uncollectible amounts impact the net loss reserve (typically a "central estimate")

Basis for the current approaches – part 3

- Applying an "expected loss model" when only a few reinsurers may seem inappropriate – high likelihood of zero uncollectible ➡ incurred loss model may seem more reasonable in that situation.

- Bottom line – current practice varies.

What's changing?

- New FASB standard –

  Accounting for Financial Instruments – Credit Losses (ASU 2016-13 issued 06/16/2016)

- Main focus was bonds at amortized cost, but **scope includes credit portion of URR**
- Requires expected loss model for URR (credit)
- Not applicable to URR (dispute)
- Effective 2020 for SEC filers, 2021 for others
- Includes new disclosures (e.g., URR roll-forward)

What causes uncollectibility?

Obvious causes

- Inability to pay (credit risk)
- Willingness to pay (dispute risk)

What causes uncollectibility?

Less obvious causes

- Aggressiveness (or caution) in ceding claims
- Experience in processing ceded claims
  - *Quality of ceded presentation*
  - *Knowing what to expect (on both sides)*
- Business relationship (ongoing vs. runoff)
- Timeliness of billing
- Commutations

Where have disputes been an issue?

Latent liabilities have been a major source of some past disputes

- Long time since policies originally issued
- Allocation uncertainty (across yrs, coverages, layers – with rules varying by state)
- Occurrence definition (for retentions, limits)
- Inexperience of those for whom reinsurance was a “minor line”

Where have disputes been an issue?

Examples of dispute issues

- Was the loss covered (extra-contractual payment?)
- Was the excess policy really triggered
- Occurrence definition
- Missing policies/contracts
- Missing endorsements
- Late notice

URR Estimation Methods

Two main types

- Experience-based methods
  - *Credit default and dispute write-offs comingled in the data/method*
- Rating-based methods
  - *Ratings generally reflect credit risk only*
  - *Requires separate dispute risk component*

Experience-based method

(Overly) Simplistic example

Recent experience		
Billed cessions	**200**	
Write-offs	**3**	
%	**1.5%**	
URR reserve setting		
Ceded balances*	**80**	
URR %	**1.5%**	
URR	**1.2**	
**includes both ceded o/s and recoverable*		

Experience-based methods – issues 1

- Write-off rates can
  - *Change over time*
  - *Vary by line*
  - *Vary for runoff vs. ongoing business*
  - *Vary based on AY age/maturity*
- Co-mingles credit and dispute risk
  - *Not an issue if expected loss model for both*
  - *Otherwise, hard to isolate the two in data*

Experience-based methods – issues 2

- Collection efforts can drag on for years
  - *Extreme example – 2002 billing still in litigation (2016)*
  - *Tie write-offs to billing year? Write-off development triangles?*

- Commutations
  - *How do they affect your data? Included in collections or not? Shown separately? Shown consistently over time?*
  - *Impact on ceded balances? (Reduce ceded outstanding at time of commutation, or time of billing?)*

Experience-based methods – issues 3

- Impact of insolvencies
  - *Reduce ceded outstanding at time of insolvency, or time of billing?*
  - *Recovery of previous write-offs? (Possible recoveries on dispute write-offs?)*
- Billing lags
  - *Can't always assume the billing is timely.*
  - *Delayed billing can affect collection rates AND direct/cede relationship*

Experience-based methods Data collection

If you want to use experience-based methods starting in 2020 or 2021

DATA COLLECTION SHOULD HAVE ALREADY STARTED!

Rating-based methods

Underlying Concept – collectability risk is measured by a credit (or financial strength) rating

Reminder – rating is only for credit risk,

not dispute risk.

Rating-based methods

Credit risk is a function of

- Current rating
- Time until the amount is due
  - *Insurer rated Best A/A- today unlikely to default tomorrow*
  - *But over 5% may be impaired 10 years from now**

* *Best's Special Report, "Best's Impairment Rate and Rating Transition Study – 1977 to 2014", August 21, 2015*

Rating-based methods Requirements

- Schedule of future ceded billings by:
  - *Reinsurer rating*
  - *Billing (lag) year*
- Schedule of default rates by rating by lag year
  - *Either historical table, or*
  - *Build from a transition matrix*
- Assumption regarding recovery rate given default

Rating-based methods
Schedule of default rates – lag yr

Illustrative example:

Cumulative default rates by rating/lag year					
Rating	1	2	3	4	5
a	0.1%	0.2%	0.3%	0.5%	0.6%
b	0.2%	0.5%	0.9%	1.4%	2.0%
c	0.7%	1.8%	2.9%	4.3%	5.9%
d	2.2%	4.8%	7.2%	9.5%	12.0%

Rating-based methods
Transition matrix

Illustrative example:

Rating transition matrix - 1 yr period					
	End				
Begin	a	b	c	d	default
a	93%	6%	1%	0%	0%
b	3%	93%	3%	1%	0%
c	1%	10%	82%	5%	2%
d	0%	7%	14%	75%	4%

Rating-based methods

Illustrative example, using billings by rating/yr and defaults by rating/yr

	Rating	1	2	3	4	5	Ttl
Billings							
	a	20	15	10	5	5	55
	c	10	5	5	5		25
Cumulative Default Rates							
	a	0.1%	0.2%	0.3%	0.5%	0.6%	
	c	0.7%	1.8%	2.9%	4.3%	5.9%	
Projected write-offs							
		0.09	0.12	0.18	0.24	0	0.7

Assumes no recovery given default

Rating-based methods

Sources of default rates by rating

- Rating agencies (for bond defaults)
  - *Google "bond default rates by credit rating"?*
- AMBest (for insurer impairment rates by fin'l strength rating)

Don't forget

- Recovery rates given default
- Impairment not quite the same as default

Rating-based methods Dispute risk

Find out what causes disputes in your book

- Break out cedes on that basis
- If no history on dispute write-offs, then judgment
  - *Watch for conservatism/optimism*
  - *Knowledge of "trees vs. the forest"*

Watch out for double-counting the risks

- Apply one first, then apply the second
- *E.g., $100 cede, less $2 URR-dispute, leaves $98 exposed to credit risk*

Data Issues, Cautions "100% cede data"

- Ceded contracts may have multiple participants
  - *Some may become commuted or insolvent*
- Some ceded contracts may apply only to the net after other contracts
  - *Some of those may become commuted or insolvent*
- As a result, reinsurance system may track cessions as if never commuted/insolvent ("100% ceded basis)

Data Issues, Cautions "100% cede data" (cont.)

- If system is on 100% cede basis, then adjustments for commutations/insolvents may be added outside the data base you are using.
- Need to know how this issue is handled in your data
  - *May be handled differently by different systems.*
  - *May vary by legacy system.*

Data Issues, Cautions
Cedes by reinsurer

Source of ceded balances by reinsurer (Sch. F)?

- Ceded paid (but uncollected) – <u>actual bills</u>
- Ceded case – <u>may be known, may be allocation</u>
- Ceded IBNR – <u>higher likelihood of an allocation</u>
  - *May be a rough allocation.*
- Getting a good line split by reinsurer credit rating may be difficult
  - *No line splits in Schedule F.*

<u>Hence amount/timing of cede by reinsurer may be rough estimate</u>

Data Issues, Cautions
Billing lags

- Billing lags can be substantial
- Can have ceded outstanding ("o/s") even after all gross liabilities are gone
- If not purely mechanical, even simplest billings will have some lag
- Hence ratios of ceded o/s or ceded billed to direct o/s or direct paid may not be "apples to apples"

Data Issues, Cautions Consistency

- Be Consistent
- URR should be consistent with Cede, Cede should be consistent with Gross.
- Consistency with indicated Cede/Gross may not result in consistency with held Cede/Gross.
- Held URR should be consistent with held Cede, which should be consistent with held Gross.

Other – method choice

- IRS has argued that reasonableness of URR can be reviewed separately from reasonableness of aggregate net loss reserve.

Other - Remote risk of uncollectibility

Do I need to bother if uncollectibility risk is remote?

"326-20-30-10 An entity's estimate of expected credit losses shall include a measure of the expected risk of credit loss even if that risk is remote, regardless of the method applied to estimate credit losses. However, an entity is not required to measure expected credit losses on a financial asset (or group of financial assets) in which historical credit loss information adjusted for current conditions and reasonable and supportable forecasts results in an expectation that nonpayment of the amortized cost basis is zero. …" (from the new FASB standard on credit impairments)

Answer – Maybe. Ask your accountants.

Questions

?

Appendix – new GAAP disclosures

- Reins. receivables by rating
- Source of rating, and when updated
- URR methodology
- Discussion of reins. receivables risk characteristics
- Roll-forward of URR, including incurred amount in the period (no breakout of current vs. prior AYs), write-offs and recoveries of previous write-offs.
- Aging analysis of past-due amounts.