FINITE REINSURANCE ISSUES CASUALTY ACTUARIAL SOCIETY

SEMINAR ON RATEMAKING

March 10, 2005

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Financial Reinsurance

- Predecessor to Finite Covers
- Early 1980s – Developed to provide for reserve discounting or acceleration of income
- Contracts were rather crude “time and distance” or “loss portfolio”
- Insurance risk was not transferred

Example of Early Transaction

Cession of $100,000 of Losses/Assuming 5% Investment Income				
Losses Ceded	100,000			
Premiums or Assets Transferred	87,000			
Earnings on Transfer	13,000			
Reinsurer Cash Flows	Premium	Invest. Income	Payments to Cedent	Balance
Year 1	87,000	4,250	20,000	71,250
Year 2		3,563	20,000	54,813
Year 3		2,741	20,000	37,553
Year 4		1,878	20,000	19,431
Year 5		972	20,000	402

Finite Reinsurance Today

- Evolutionary process by designers of treaties over the years, e.g.:
  - Loss Portfolio Transfers
  - Aggregate Excess Treaties
  - Hybrid Retroactive/Prospective
  - Non-proportional Proportional or Q/S
- Transfer just enough risk to get credit for reinsurance

Finite Reinsurance Today

- Financial Accounting Standards Board (FASB) Financial Accounting Standard (FAS) No. 113
- NAIC Accounting Practices and Procedures Manual Chapter 22
- Statement of Statutory Accounting Principles (SSAP) No. 62
  SSAP No. 61 for Life

Transfer of Risk

- Requires:
  - That reinsurer assumes significant insurance risk under reinsured portions of underlying insurance agreements, and
  - That it is “reasonably possible” that the reinsurer may realize a significant loss from the transaction- SSAP No. 62, paragraph 12

Transfer of Risk

- Significant insurance risk transfer not met if probability of significant variation in amount or timing of payments is remote
- Significance of loss shall be evaluated by comparing present value of all cash flows

Transfer of Risk

- Who does the evaluation?
- What is considered?
- When is it done?
- Are there safe harbors or rules of thumb?
  - 10%/10%
  - Actuarial or Auditor Certification?

Who Does the Evaluation?

- Parties to reinsurance agreement
- Intermediaries
- Auditors
- Insurance Regulators
- And maybe now, Non-Insurance Regulators

What is Considered?

- Evaluation is not limited to four corners of a contract
- Contract is not defined - Focus is on substance, not form
- Evaluation is done in the aggregate if:
  - Multiple contracts
  - Multiple parties

What is Considered?

- Cash Flow Analysis
- Assumptions are key component
- Assessment of probabilities, while seemingly empirical rely upon professional judgment
  - Surprise! Judgments differ
  - Final decision may be regulators

When is Evaluation Done?

- Before transaction is entered into?
  - And when agreement is amended
- Annually?
- When trouble or litigation arises?
- Timing of evaluations does seem to be changing

Safe Harbors/Rules of Thumb

- Safe harbors no longer seem to exist
- Auditor and Actuarial approvals more difficult to obtain
- Principles based Accounting Standards placed significant and expensive burdens on practitioners

Current Accounting Environment

- AICPA White Paper - Evaluating Risk Transfer in Reinsurance of Short-Duration Contracts
- Seems to advocate rules as opposed to principles
- Not popular with the Insurers or Reinsurers

Possible Accounting/Disclosure Alternatives

- NAIC is considering additional disclosures
- A life reinsurance alternative??
  - Guidance in NAIC SSAP No. 61
  - Bright-line tests

Conclusion

- Finite reinsurance is in the spotlight
- Political/Public pressure for tougher standards
- Insurance Regulators are being put in defensive position
- It is difficult to predict a probable outcome, but change seems inevitable