Common Pitfalls and Practical Considerations in Risk Transfer Analysis

Call paper by
Derek Freihaut, FCAS, MAAA
Paul Vendetti, FCAS, MAAA

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Paul A. Vendetti, FCAS, MAAA

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Risk Transfer

- Principle based
- No bright-line indicator
  - 10/10 Rule
  - ERD at 1.0%
- It is an accounting decision
  - CEO and CFO attest to the risk transfer in contracts

Key Risk Transfer Documents

- **FASB 113/SSAP 62**
  - Define risk transfer:
    - Reinsurer assumes significant ***insurance*** risk.
    - ***Reasonably possible*** that the reinsurer may realize a ***significant*** loss.
  - Exempt for FASB 113 and SSAP 62 are treaties that assume ***substantially all*** of the insurance risk related to the underlying insurance contracts.

- **Reinsurance Attestation** (Statutory Requirement)
  - CEO and CFO attestation that reinsurance treaties have been accounted for corrected,
    - No separate written or oral side agreements,
    - Documentation for every contract exists for which risk transfer is not ***reasonably self-evident*** that details the economic intent and that documentation evidencing risk transfer is available for review.
    - Reporting entity complies with SSAP 62
    - Appropriate controls are in place to monitor the use of reinsurance.

Risk Transfer – Common Pitfalls

- Profit Commissions
- Reinsurers Expense
- Interest Rates and Discount Factors
- Premiums
- Evaluation Date
- Commutations and Timing Payments

Risk Transfer – Common Pitfalls

- Profit Commissions
  - True profit commission does not affect risk transfer.
    - Profit commission is paid if and only if the reinsurer is in a profit position.
    - Note: profit commission impacts potential profitability of the contract but not risk transfer.
    - This is not a swing rate.
  - Important to understand how experience based cash flows are triggered and when they are due.
    - Carryforwards on multi-year contracts.

Risk Transfer – Common Pitfalls

- Reinsurer Expenses
  - SSAP 62 states:
    - "The evaluation is based on the present value of all cash flows between the ceding and assuming enterprises under reasonably possible outcomes."
  - Reinsurer expense are not considered.
    - Only cash flows between ceding and assuming enterprises are considered.
    - All cash flows between ceding and assuming enterprises are considered.

Risk Transfer – Common Pitfalls

- Interest Rates and Discount Factors

  - SSAP 62 states:
    - "Generally reflect the expected timing of payments to the reinsurer and the duration over which those cash flows are expected to be invested by the reinsurer."

  - Risk free rate – generally the lower the rate used the easier it is to demonstrate risk transfer
  - Must be constant
  - Needs to be "reasonable and appropriate" this means the rate can be selected

Risk Transfer – Common Pitfalls

- Premium
  - SSAP 62 states:
    - Q: "…should the reasonably possible loss be compared to gross or net premiums?"

      A: "Gross Premium should be used."
  - What does this mean in practice?
    - Deposit premium
    - Expected premium
    - Actual premiums developed from each scenario (should be used)
  - Remember to include all cash flows no matter what they are called.

Risk Transfer – Common Pitfalls

- Evaluation Date
  - SSAP 62 states:
    - Risk Transfer assessments are made “at the inception date based on facts and circumstances known at the time.”
      - Interest rates
      - Loss development patterns
      - Other factors
  - It is not necessary to retest the contract at renewal unless there are significant amendments to the contract.

Risk Transfer – Common Pitfalls

- Commutations and Timing of Payments
  - Timing risk is important aspect of risk transfer
    - No fixed loss payment schedule
    - “Timely reimbursement payments”
    - Any commutation fees need to be incorporated in the analysis (similar to a premium)
- Incorporate commutation clause using economically rational decision-making

Risk Transfer – Practical Considerations

- Parameter Selection
- Interest Rate
- Payment Pattern
- Loss Distribution
- Parameter Risk
- Use of Pricing Assumptions
- Commutation Clauses

Risk Transfer – Practical Considerations

- Parameter Selection
  - Interest rate
  - Payment pattern
  - Loss distribution
    - Frequency/Severity – typically for excess of loss
    - Loss Ratio – typically for quota share
  - Company specific vs. industry data

Risk Transfer – Practical Considerations

- Interest Rate
  - Interest rate risk is not considered in risk transfer analysis
  - Alternative rates
    - Reinsurer's return on invested assets
      - Different reinsurers have different return
    - Yield curve
      - Not a constant rate as required by SSAP and FASB
    - Risk free rate or some approximation
      - Most reasonable

Risk Transfer – Practical Considerations

- Loss Distribution
  - Tail of the loss distribution is most important
    - Variance
  - This is difficult to quantify based upon company data especially for
    - Quota share contracts
    - High layer excess of loss contracts
  - Pricing assumptions (more on this later)

Risk Transfer – Practical Considerations

- Parameter Risk
  - Loss distribution
  - Payment patterns
  - Size of the company (including captive insurers)
  - Type of company (Start-up vs. established)
  - Industry benchmark vs. individual company

Risk Transfer – Practical Considerations

- Pricing Assumptions
  - Need expected loss and variance
  - Premiums charged can be helpful but you need to be cautious since:
    - Premium can be market driven
    - May include risk loads, expenses or other variables not easily recognized.
  - Pricing vs. Risk Transfer
    - Pricing is more concerned with the expected loss
    - Risk transfer is concerned with the right tail of the distribution.

Risk Transfer – Practical Considerations

- Commutation Clauses
  - There is a need to understand the commutation clauses in any contract.
  - Commutation clause may reduce the risk being transferred, especially if commutation dates and terms are predefined.

Questions

Paul Vendetti

Consulting Actuary

Pinnacle Actuarial Resources, Inc

(309) 807-2312

pvendetti@pinnacleactuaries.com