Casualty Loss Reserve Seminar

Are you properly calculating your ceded reinsurance loss reserves?

by Bruce D. Fell, FCAS, MAAA, CFA

SEPTEMBER 21, 2010
Reinsurance contract types

- Quota share
  - Straight forward percentage
  - Contains caps or corridors
- Per risk/per occurrence excess of loss
  - Plain vanilla coverage
  - Aggregate limits, corridors, annual aggregate deductibles
- Aggregate excess of loss
- Loss portfolio transfer
Approaches used for various reinsurance contract types

- **Quota Share**
  - Straight forward
    - Estimate gross ultimate loss, then apply quota share percentage to estimate ceded ultimate loss
  - Contract contains loss corridors, caps, etc.
    - Estimate ceded losses directly to specifically reflect portions of quota share with reinsurance protection versus portions retained net.
    - Must consider full distribution of gross losses in order to reflect the true ceded losses
Approaches used for various reinsurance contract types

- Excess of Loss (Per Risk/Per Occurrence)
  - Straight forward
    - Estimate gross ultimate loss and net ultimate loss using different loss development factors, then subtract the net ultimate loss from the gross ultimate loss to estimate ceded ultimate loss
    - Estimate ceded losses directly reflecting the attachment point and limits for each year
  - Contract contains deductibles, aggregate limits, etc.
    - Estimate ceded losses directly reflecting the specific contract features.
    - Simulation method or direct consideration of the full distribution of losses in the layer to properly reflect reinsurance terms
Approaches used for various reinsurance contract types

- **Aggregate Excess of Loss/Adverse Development Cover**
  - Estimate ceded ultimate losses directly based on gross ultimate losses reflecting the full distribution of gross losses.
  - Just because gross losses are below the attachment point does not mean that there is not a ceded liability

- **Loss Portfolio Transfer**
  - Estimate ceded ultimate losses directly based on gross ultimate losses reflecting the full distribution of gross losses.
  - Just because gross losses are below the contract limit does not mean that all of the gross liability can be ceded.
  - A net liability can still exist when gross ultimate losses are below the contract limit.
Examples: Basic Assumptions

- Gross unpaid liabilities result from identical accident years
- Premium = $1.5 million/year
- Ultimate losses = $1 million/year
- AY loss distribution = Lognormal (μ = 13.784, σ = 0.25)
- Loss ratio = 66.7%
- Expected direct/gross unpaid liabilities = $2 million
- Reserve distribution = Lognormal (μ = 14.489, σ = 0.20)
- Loss development patterns as follows:

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| Cumulative  | 3.448 | 2.500 | 1.600 | 1.250 | 1.100 | 1.025 | 1.000 |
Gross reported loss triangle

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# Gross estimate of ultimate losses

<table>
<thead>
<tr>
<th>Acc Yr</th>
<th>Paid Losses</th>
<th>Reported Losses</th>
<th>Ultimate Losses</th>
<th>Case Reserves</th>
<th>IBNR</th>
<th>Total Unpaid Liabilities</th>
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<td>7,000,000</td>
<td>1,028,438</td>
<td>971,861</td>
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Gross unpaid loss liabilities distribution
Example #1: Quota share

- Assume 25% quota share of business
- Premium = $375,000/year
- Ultimate losses = $250,000/year
- Loss ratio = 66.7%
- Expected ceded unpaid liabilities = $500,000
- Unpaid liabilities dist. = Lognormal (mu = 13.102, sigma = 0.20)
- Appropriate methods:
  - Apply quota share percentage to gross losses
  - No need to separately use loss development or B-F
  - Easy and straightforward cession
Ceded loss reserve distribution

![Ceded loss reserve distribution graph](image-url)
Example #2: Quota Share with corridor

- Assume 25% quota share of business
- Premium = $375,000/year
- Ultimate losses = $250,000/year
- Loss ratio = 66.7%
- Loss ratio corridor between 70% and 75%
  - Cedant retains liability in this 5% corridor
- Are the expected ceded unpaid liabilities still = $500,000?
Example #2: Quota Share with corridor

- Assume 25% quota share of business
- Premium = $375,000/year
- Ultimate losses = $250,000/year
- Loss ratio = 66.7%
- Loss ratio corridor between 70% and 75%
  - Cedant retains liability in this 5% corridor

- Are the expected ceded unpaid liabilities still = $500,000?

**NO**, The $500,000 represents the cession of the expected gross reserves instead of the expected ceded reserves. How do we handle this in order to get the correct number?
Accident year gross ultimate loss ratio distribution

Expected Loss Ratio = 66.7% @ 55th percentile  
Corridor Attachment = 70.0% @ 63rd percentile  
Corridor Limit = 75% @ 72nd percentile
Accident year gross ultimate loss ratio distribution

Expected Loss Ratio = 66.7% @ 55th percentile
Corridor Attachment = 70.0% @ 63rd percentile
Corridor Limit = 75% @ 72nd percentile

This area is not ceded to the 25% quota share
Accident year gross and ceded losses

- Gross $E(X) = $1,000,000$
- Gross Limited Expected Value @ 70% loss ratio = $921,112$
- Gross Limited Expected Value @ 75% loss ratio = $945,365$

- Quota Share w/o corridor $E(X) = 25% \times 1,000,000 = $250,000$
- Quota Share LEV @70% LR = $230,278$
- Quota Share LEV @75% LR = $236,341$
- $E(X)$ between 70% and 75% = $6,063$
- Quota Share w/corridor $E(X) = $250,000 - $6,063 = $243,937$
Impact on loss reserves

- In order to calculate the correct ceded unpaid liabilities, one must consider the variability of the liabilities for each year to determine the appropriate adjustment.
- As accident years mature there is less variability in the unpaid liabilities and therefore less chance that the corridor will be reached.
Example #3: Adverse development cover

- Assume gross expected unpaid loss liabilities of $2 million
- Adverse development cover is purchased that attaches excess of $2.5 million with a $1 million limit
- How much should the company reflect as a ceded reserve for this contract?

  Zero

Something greater than zero that reflects the expected value of the losses that could potentially reach the reinsurance
Example #3: Adverse development cover

- Assume gross expected unpaid loss liabilities of $2 million
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Example #3: Adverse development cover
Gross unpaid loss liabilities distribution

This portion of the loss reserves is ceded to ADC

Loss Reserves

Thousands

1,000 1,500 2,000 2,500 3,000 3,500 4,000

Gross unpaid loss liabilities distribution
Adverse development cover ceded unpaid liabilities

- Gross $E(X) = $2,000,000$
- Gross Limited Expected Value @ $2.5m = $1,970,352$
- Gross Limited Expected Value @ $3.5m = $1,999,596$

- $\text{ADC } E(X)$ between $2.5m$ and $3.5 m = $29,245$
- Net $E(X) = $1,970,755$
Example #4: Loss Portfolio Transfer

- Assume gross expected loss reserves of $2 million
- Loss portfolio transfer is purchased with a $2.5 million limit
- How much should the company reflect as a ceded reserve for this contract?

  $2 million

  Something less than $2 million that reflects that the company still retains a potential liability
Example #4: Loss Portfolio Transfer

- Assume gross expected loss reserves of $2 million
- Loss portfolio transfer is purchased with a $2.5 million limit
- How much should the company reflect as a ceded reserve for this contract?

$2 million

Something less than $2 million that reflects that the company still retains a potential liability
Example #4: Loss Portfolio Transfer
Gross unpaid loss liabilities distribution

This portion of the loss reserve is ceded to the LPT

This portion of the loss reserve is retained net

Loss Reserves

Thousands

1,000 1,500 2,000 2,500 3,000 3,500 4,000
Loss portfolio transfer cover ceded and net liabilities

- Gross $E(X) = $2,000,000

- Limited Expected Value @ $2.5m = $1,970,352
  - Equivalent to the reserve ceded to the LPT

- Retained net reserves = $29,648
Other Issues

- Data availability
  - Individual claim data availability
  - Appropriate loss triangles and/or loss development factors
- Ceded loss reserves **should not** reflect the cession of the expected value of the gross loss liabilities
- Ceded loss reserves **should** reflect the expected value of the ceded loss liabilities
- Reserve ranges
  - Gross – Ceded ≠ Net
  - Stochastic Modeling
Other Issues

- There is significant debate over the appropriate accounting treatment.
- Some believe the ceded reserves should be “consistent” with the gross liabilities but yet it can overstate or understate the ceded reserves and therefore impact the net reserves.
- Mirroring of assumed and ceded liabilities.
- When you sign a loss reserve opinion, what are you “opining” on?
Potential changes with IASB and FASB accounting requirements for insurance contracts

- IASB Issued exposure draft July 2010 outlining proposed changes to accounting for insurance contracts
  - Comment period ends November 30
  - New standard issued mid-2011
  - Effective date = ??

- FASB and IASB have been holding discussions regarding convergence with goal of one unified global standard

- Major IASB changes relating to property/casualty loss liabilities include:
  - Losses would reflect the time value of money (discounted)
  - A risk margin would be included to reflect uncertainty of liabilities
  - Residual margin to eliminate Day 1 profits (No reflection of Day 1 loss on ceded = same treatment as gross)

- IASB has explicitly stated this approach is not equal to fair value
Discounted Expected Losses

- Expected losses will be based on probability weighting of full range of possible loss outcomes with regard to timing and amount. Individual amounts and the payment timing of those amounts would need to be reflected and discounted.

- A yield curve must be reflected that includes a minimal default risk plus an adjustment for illiquidity

- Future inflation rates must be reflected within cash flow scenarios if cash flows are sensitive to inflation

It will no longer be sufficient to develop a central estimate, apply an expected payment pattern and ignore inflation
Risk Margins

- Three methods have been suggested
  - Confidence level – Margin can be based on specific confidence level. However, only acceptable if distribution is statistically close to normal.
  - Conditional tail expectancy or Tail VaR – Based on probability weighted amounts beyond a certain confidence level.
  - Cost of capital method – Based on cost of additional capital needed such that assets equal liabilities at a certain confidence level.

- Calculations are done on a gross basis, with separate calculations for ceded losses

- How is net handled? Is it just additive?
Potential implications of these changes

- Reserving methodologies may need to change
- Size matters
- Mono-line versus multi-line – in theory risk margins receive diversification benefit.....BUT, IASB has proposed calculation by portfolio without recognition of diversification across portfolios)
  - How will “portfolio” be defined?
- Policy liabilities will no longer be additive (within the portfolio)
- Increased amount of assumptions may result in less consistency, comparability and usefulness of financial statements
- Changes to reinsurance structures
- Mergers & acquisitions