Risk Transfer Analysis

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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 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.
Key Risk Transfer Documents

- **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
First Type of Contract

- **Exempt – “Substantially All”**

  - Typically Quota Share with no/very limited loss restriction
    - Reasonable ceding commission
    - High loss ratio cap

  - Reinsurance Attestation adds:
    - Contracts with no amounts recoverable,
    - Contracts entered into, renewed or amended before Jan. 1, 1994.
Second Type of Contract

- Reasonably Self-Evident
  - Catastrophe Excess of Loss
  - Casualty Excess of Loss

- Defining characteristics:
  - The potential loss to the reinsurer is much larger than the premium
  - The contractual terms and conditions of coverage are standardized for contract type
  - Contract does not include provisions that enable the reinsurer to recover a significant portion of covered loss
Third Type of Contract

- **Not Reasonably Self-Evident**

  - Defining characteristics:
    - Premium approaches present value of coverage provided
    - Contract is “manuscripted” using contractual terms and conditions of coverage that are not standardized for contract type
    - Contract includes provisions that enable the reinsurer to recover a significant portion of covered loss
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.
    - Paid if and only if the reinsurer is in a profit position.
    - Note: It 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.
  - Carries forward 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 an 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

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