Reinsurance risk transfer and accounting key topics

Casualty Actuarial Society

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Agenda

1. What is reinsurance?
2. Why is reinsurance important?
3. Prospective or retroactive?
4. Deposit accounting
5. Multiyear retrospectively rated
6. Risk transfer – the test
7. Risk transfer – requiring further consideration

What is reinsurance?

- **Excerpt from Accounting Standards Codification (ASC) 944-20-20**
- A transaction in which a reinsurer (assuming entity), for a consideration (premium), assumes all or part of a risk undertaken originally by another insurer (ceding entity). For indemnity reinsurance, the legal rights of the insured are not affected by the reinsurance transaction and the insurance entity issuing the insurance contract remains liable to the insured for payment of policy benefits. Assumption or novation reinsurance contracts that are legal replacements of one insurer by another extinguish the ceding entity's liability to the policyholder.

Why is reinsurance important?

- For the ceding company
  - Protect the capital of ceding company
  - Protect against catastrophic losses
    - Particularly if concentrated in a geographic area
  - Ability to exit a line of business
  - Increase volume of writings without increasing capital
    - Companies need to meet certain solvency requirements

- For the reinsurer
  - Access to new markets
  - Ability to diversify

- These are significant because risk transfer depends on the business purpose of the transaction in many cases.

How are short durations contracts accounted for? The basics

- Does it pass risk transfer?
  - If no, subject to deposit accounting or “offset accounting”
- Is it prospective (losses that will occur) or retroactive (losses that have occurred)?
  - If retroactive, subject to retroactive accounting
- Is it a multiyear retrospectively rated contract?
  - If this is true and premiums can be estimated, subject to multiyear retrospectively rated accounting
  - If premiums can not be estimated, accounted for as deposit accounting
- If not retroactive or multiyear retrospectively rated, qualifies for prospective reinsurance accounting
  - Note that this is the preferred accounting, because it allows a company to basically offset its incurred costs with recoveries under the reinsurance, whereas the retroactive reinsurance model does not.

Prospective or retroactive?

- Prospective = covers future events
- Retroactive = covers past events
- The significant terms and conditions need to be agreed upon at the inception of the contract period for contract to be prospective.
  - If not, the contract would be bifurcated into prospective and retroactive or would cause the entire contract to be retroactive.
- Contract might not be fully finalized until the insured period begins, but the key terms and conditions must be agreed to at inception of coverage period.
- Statutory allows for a nine-month rule, but GAAP is more restrictive.
- Examples of purely retroactive contracts would be adverse development covers, or loss portfolio transfers.

Prospective or retroactive?

- Prospective
  - Covers future events
  - Impacts premiums/surplus ratio (or leverage ratio)
  - Ceded premiums recognized as contra-premium over risk period
  - Ceded losses recognized as contra losses as incurred
  - Ceding commission received by ceding company reduces deferred acquisition costs to the extent it represents recovery of acquisition costs
- Retroactive
  - Covers past events
  - Premiums paid to the reinsurer reported in balance sheet only as reinsurance receivable
  - Gains (premium paid < recorded liabilities) deferred over settlement period
  - Losses (premium paid > recorded liabilities) recognized immediately

Deposit accounting

- Deposit
  - Accounting model differs based on the following:
    - Whether neither timing and underwriting risk exist
    - Whether there is only significant underwriting risk
    - Whether the risk is indeterminate
  - Premiums paid to reinsurer that are non-refundable are recognized by cedant as an expense over time.
  - All other amounts paid (initial and any subsequent) are recorded as a deposit asset by cedant.
  - It is recorded as financing with no impact on premiums, losses incurred or related insurance ratios.
  - The ceding company accretes interest income based on expected cash flows.

Multiyear retrospectively rated accounting

- Multiyear retrospectively rated
  - Multiple year contracts that meet risk transfer criteria
  - Contains obligatory retrospective rating provisions
  - Ultimate premium expected to be paid or received must be reasonably estimable in order to allocate premium in proportion to the reinsurance protection provided
  - Balance sheet and income statement presentation similar to prospective, except the ceding company should record a liability to the extent that it has an obligation to pay cash, or other consideration, to the reinsurer that would not have been required absent contract experience
    - Important to note that estimation of additional premium or consideration and estimation of losses should be consistent

Risk transfer

- To meet the requirements of risk transfer, the contract should pass both of the following tests (ASC 944-20-15-41):
  - Reinsurer assumes **significant insurance risk**
  - Reinsurer has the **reasonable possibility of a significant loss**
    - This risk transfer assessment shall be made at contract inception, based on facts and circumstances known at the time.
    - Reassessment of risk transfer is required in the event of a contract amendment.

Risk transfer

- 41(a) test – **significant insurance risk requires both:**
  - Significant underwriting risk
    - Risk arising from uncertainties about the ultimate amount of net cash flows from premiums, commissions, claims, and claim settlement expenses paid under a contract
  - Significant timing risk
    - Risk arising from uncertainties about the timing of the receipt and payments of the net cash flows from premiums, commissions, claims, and claim settlement expenses paid under a contract
    - Timely reimbursement criteria

Risk transfer test

- 41(b) test – **reasonable possibility of a significant loss**
  - Present value of net cash flows for premiums, losses and commissions, divided by the present value of the amounts paid or deemed to be paid to the reinsurer (e.g., gross premiums):

$$= \frac{\textbf{Premiums, losses, commissions}}{\textbf{Present value of amounts paid to reinsurer}}$$

- Commonly interpreted minimum threshold by industry to be an X% chance of a Y% loss; however, use of a bright-line test without consideration of qualitative factors is not in accordance with the standard
  - Industry has used 10/10 guideline and expected reinsurer deficit – but be careful

Risk transfer test

- Other qualitative considerations:
  - Understand the **business purpose** of the contract
  - What is the maximum loss under the contract to the assuming company?
  - Are the assumptions in the cash flow model reasonable and consistent?
  - Any off market terms (e.g., interest on funds withheld)?

Risk transfer test

- Paragraph 53-54 “stepping into the shoes” exception
- Extremely narrow and limited exemption for contracts that reinsure either an individual risk or an underlying book of business that is inherently profitable.
- Exception applies if contract fails reasonable possibility of significant loss and …
  - Substantially all of the insurance risk relating to the reinsured portions of the underlying insurance contracts has been assumed by the reinsurer
  - Condition is met only if insignificant insurance risk is retained by the ceding entity on the reinsured portions of the underlying insurance contracts
- No more than trivial insurance risk on the reinsured portions of the underlying insurance contracts may be retained by the ceding entity.
- Reinsurer’s economic position shall be virtually equivalent to having written the relevant portions of the reinsured contracts directly.
- In practice, this is used more than it should be as it was originally meant only for fronting arrangements, and it should only be applied to a strict quota share with no “bells and whistles.”

Risk transfer – requiring further consideration

- Contracts that don't make business sense
- Risk limiting features (e.g., contingent and sliding scale commission, profit commissions, unusually high commission rate, retrospectively rated premiums, reinstatement premium, experience accounts)
- Caps and loss corridors
- Multiyear retrospectively rated contracts
- Delayed timing/payment schedules (always look for this clause)
- Accumulating retentions over multiple years
- Significant coverage changes in a multiyear contract
- Side agreements
- Related-party contracts
- Nonstandard commutation/termination provisions that allow reinsurer to limit risk (e.g., material change in conditions clauses)
- Termination provisions limiting ability of cedant to cancel, in combination with other potential risk limiting features
- Retroactive reinsurance contracts
- Contract contains an interest rate feature where the interest rate differs from the prevailing market rate
- Unusually high premium for value of coverage obtained

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