Accounting Issues: Evaluating Risk Transfer in Reinsurance of Short Duration Contracts

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The Industry

- Payback provisions
- Time and Distance
- Finite
- Reinsurance=Capital
- FAS 113
- Downgrades
- Failures
- Independent/HIH
- Disclosure
- Market Cycle

Recent Insurance Environment

- Direct writers:
  - High premium rate environment
  - Insurers desire to increase volume
  - Premium capacity constraints:
    - Premiums/surplus ratio
    - RBC impact
- Reinsurers:
  - Requiring primary companies to retain more risk
  - Seeking to replenish capital and rebuild financial strength
  - Assuming top layers of risk where losses are less frequent
  - Upper limits to reduce risk
  - Different perspectives on loss ratio estimates

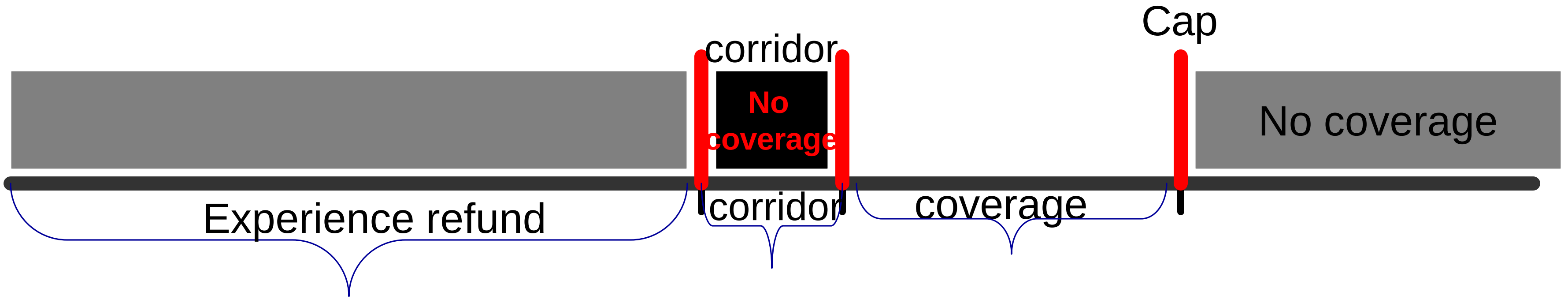
What's New in Reinsurance Accounting?

- FASB considering interpretation of FAS 113 risk transfer criteria
- Requested by AICPA AcSEC and Insurance Expert Panel
- Main issues include:
  - Evaluation of "insurance risk" under Par. 9a of FAS 113
    - **<u>NOT</u>** par. 9b "reasonable possibility of significant loss test"
  - What constitutes a single contract vs. more than one
  - Par. 11 exception where reinsurer is "stepping into the shoes" of ceding company

Why An Issue Now?

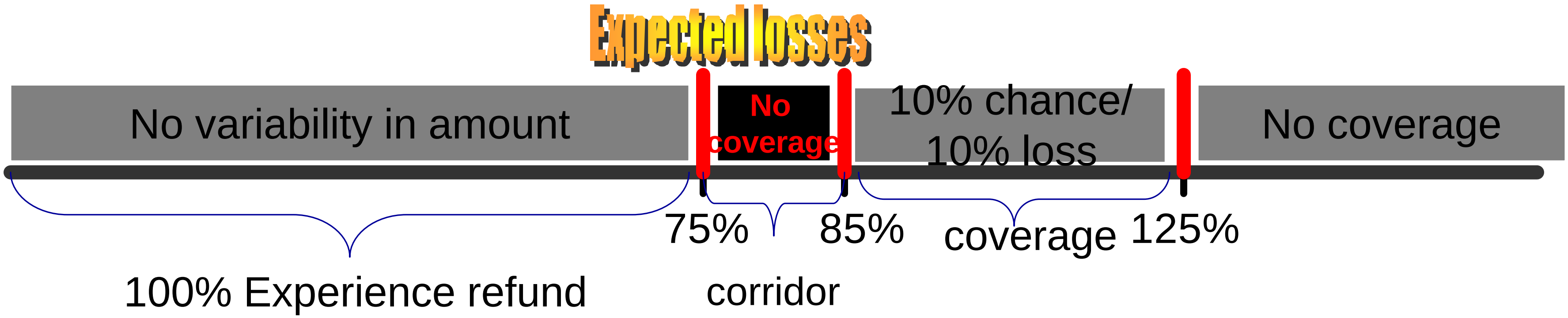
Contracts resulting from this environment:

- Structured as quota share
  – Net premiums/surplus improved
- But include combination of risk limiting features:
  – Experience refunds
  – Loss corridors
  – Aggregate limits or caps

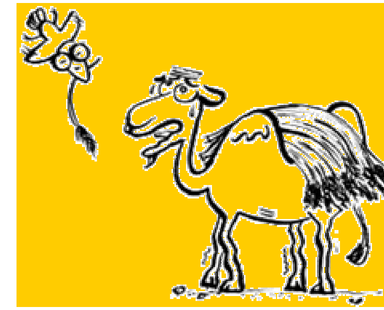


Example “Loss Corridor” Contract

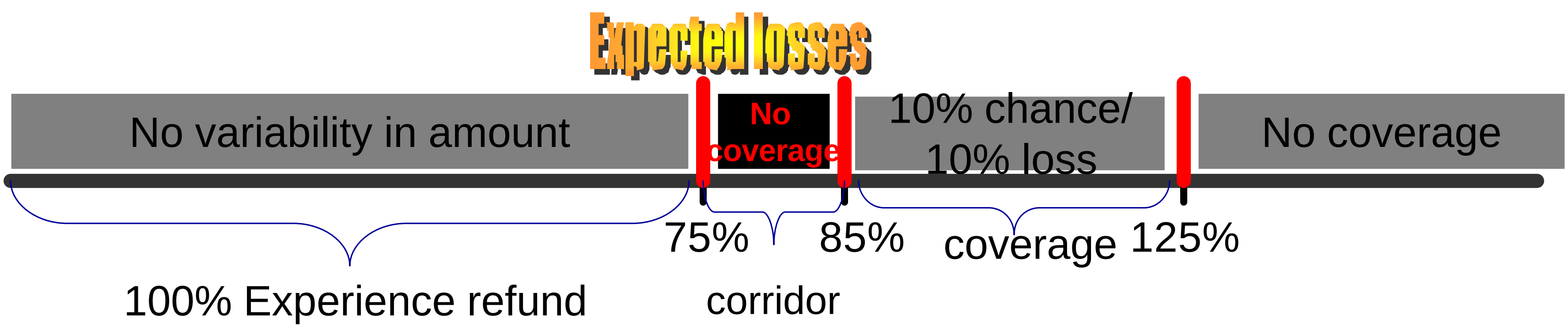
- $100 million premium ceded; $22 million ceding commission
- 100% experience refund provision calculated as premiums, less ceding commission, less paid losses, less risk margin (3% of ceded premium), plus interest
- Contract is funds withheld, with losses paid first from funds withheld account



Issues

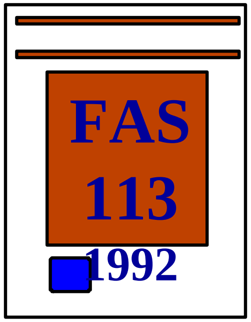


- Form vs. substance
  - Quota share in form
  - Similar to capped excess of loss contract in substance
- Ceded premium credit as if quota share
- Reduces premiums/surplus even though minimal risk transferred
  - Statutory: RBC and IRIS ratios impacted
  - GAAP: relationship of premium/gross margin distorted



AICPA Insurance Expert Panel

- Started with “loss corridor” contract example
- How to analyze such contracts under FAS 113 risk transfer provisions?

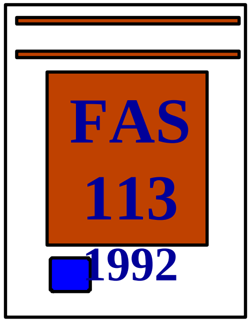


- Any interpretive guidance should be:
  - Based on FAS 113 existing principles
  - Not limited to specific examples or contract types
  - Conceptual/broad, so as to apply to:
    - Any reinsurance contract, no matter what it is called (e.g., quota share, excess of loss)
    - New contract designs with similar substance
    - Existing contract designs with similar substance

Summary of AICPA Paper Presented to FASB

3 Main FAS 113 Issues

- Interpretation of par. 9(a) significant insurance risk
- What constitutes a contract?
- Par. 11 “stepping into the shoes” of ceding company exception



FAS 113 Risk Transfer Test

- FAS 113 requires both of the following:

9(a) Insurance risk

"The reinsurer assumes significant insurance risk under the reinsured portions of the underlying contracts"

9(b) Reasonable possibility of a significant loss

$$\frac{\text{PV of all cash flows under reasonably possible outcomes}}{\text{PV amounts paid or deemed to be paid to reinsurer}}$$

Interpretation of Par. 9(a) Test

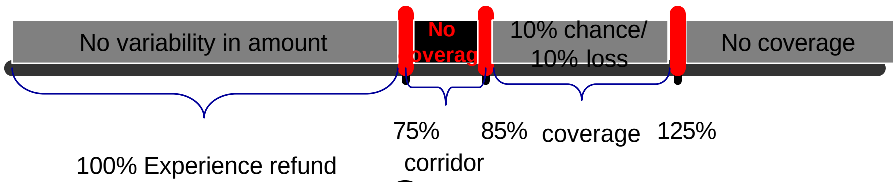
- Current issue focuses on interpretation of par. 9a only:

  "The reinsurer assumes significant insurance risk under the reinsured portions of the underlying contracts"

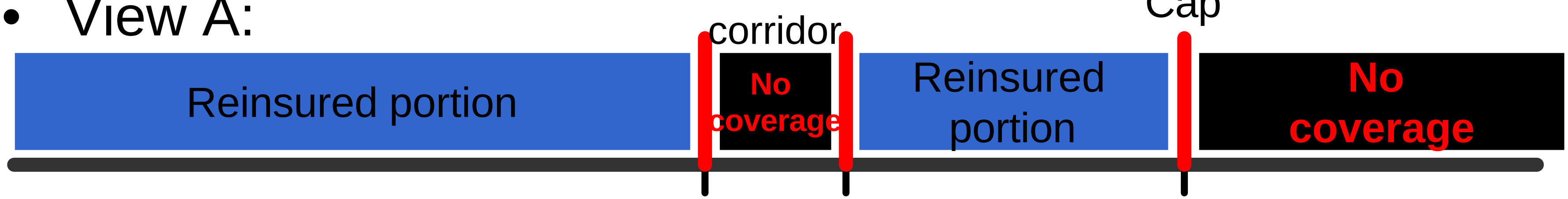
  – Underwriting risk: uncertainty about ultimate amount of net cash flows from premiums, commissions, claims, and claims settlement expenses under a contract
  – Timing risk: uncertainty about timing of receipt and payment of those cash flows

Interpretation of Par. 9(a) Test

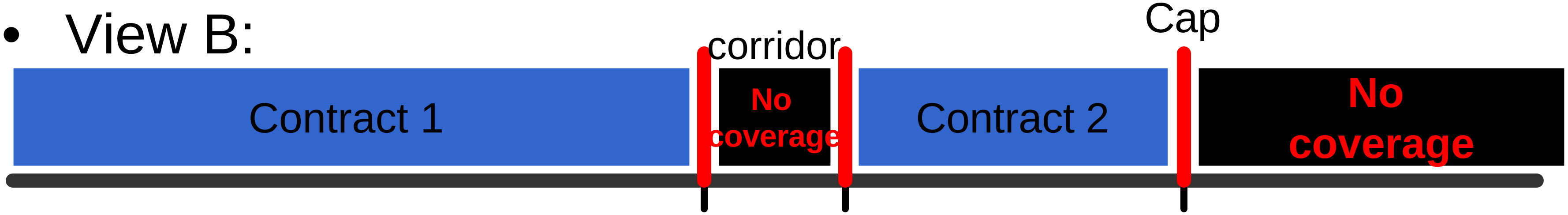
- Par. 9(a) Issue 1: What are "the reinsured portions" of the underlying contracts?



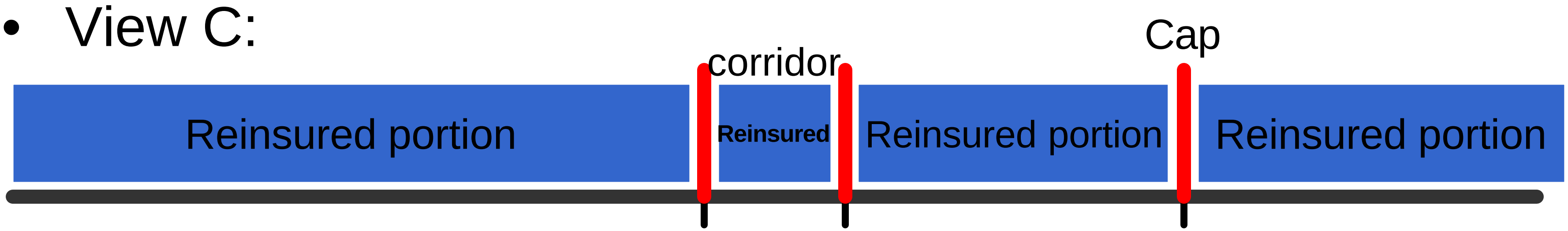
- View A:



- View B:



- View C:



Interpretation of Par. 9(a) Test

- Par. 9(a) Issue 2: What analysis required to prove "significant insurance risk?"
  - Reinsurer has not assumed significant insurance risk if probability of a significant variation in either amount or timing of payments by reinsurer is remote
    - Contractual provisions that delay timely reimbursement prevent this condition from being met
  - Par. 62 notes that:

" implicit in [par. 9a] is requirement that both amount and timing of the reinsurer's payments depend on and directly vary with the amount and timing of claims settled under the reinsured contracts.

Interpretation of Par. 9(a) Test

- Par. 9(a) Issue 2: What analysis required to prove "significant insurance risk/significant variation in amount and timing of payments?"

- View A: Compare cash flows (1) of reinsurer under various loss scenarios; no timing delays
  - Probability of a significant variation in either amount or timing of payments by reinsurer must be more than remote

  (1) Cash flows include claims and claim settlement expenses and adjustable features based on loss experience (e.g., adj. premiums and commissions)

- View B: Compare amount and timing of net cash flows (2) of reinsurer with ceding company
  - Par. 62 requires that both amount and timing of reinsurer's payments depend on and directly vary with the amount and timing of claims settled under the reinsured contracts

  (2) Net cash flows include premiums, commissions, claims and claims settlement expenses, however characterized

Interpretation of Par. 9(a) Test

- Par. 9(a) Issue 2: What analysis required to prove “significant insurance risk/significant variation in amount and timing of payments?” (cont.)

- View C: If 9b passed, and if no timing delays, 9a passed

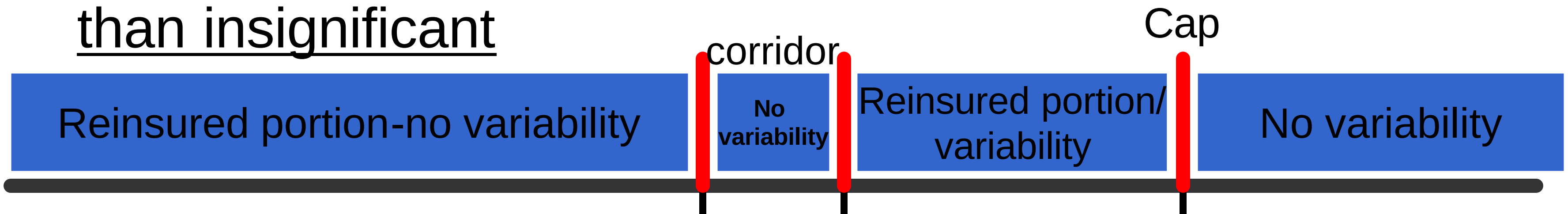
- View D: Compare amount and timing of cash flows (3) of reinsurer with ceding company

(3) Cash flows include claims and claim settlement expenses and adjustable features based on loss experience (e.g., adj. premiums and commissions)

Interpretation of Par. 9(a) Test

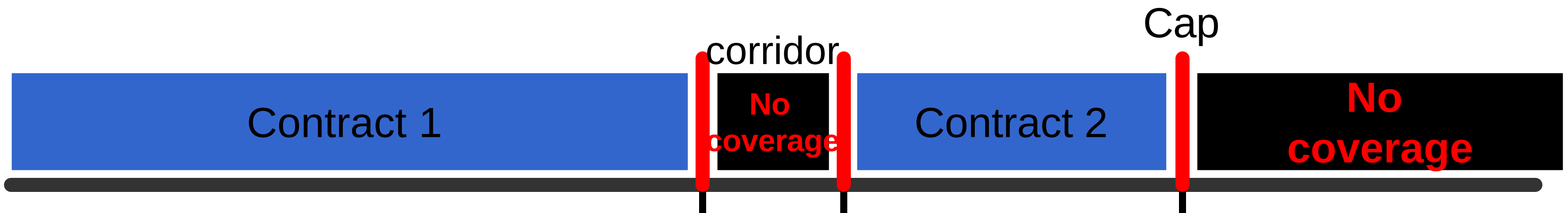
- Par. 9(a) Issue 3: Meaning of "directly vary"
  - Reinsurer's payments must "directly vary" with amount and timing of ceding company cash flows under reinsured portions of contract

- View A: N/A (consistent with View A of Issue 2)
- View B: <u>High</u> correlation in amount and timing for a <u>substantial</u> portion of expected reinsured cash flows
- View C: Movement in <u>same direction</u>, but not directly proportional for some portion of cash flows that are <u>more than insignificant</u>



What Constitutes a Contract?

- Risk transfer test and FAS 113 accounting
- Is contract with 100% loss corridor in substance 2 contracts?
  - View A: Yes, two different layers of protection, with no coverage in middle layer
  - View B: No, FASB Q and A only referred to splitting contracts with two different types of coverage/exposure
- Other issues:
  - What if corridor caused by other reinsurance in middle layer?
  - What if in form of one for one sliding scale commission instead of corridor?
  - What if corridor is not 100% elimination of coverage, just reduced percentage (e.g., 40% quota share, reinsurer assumes 5% losses in 75-85% corridor?



Par. 11 “Stepping into the Shoes” Exception

If 9 (b) reasonable possibility of significant loss test not met, limited exception exists under par. 11:

- if substantially all insurance risk relating to reinsured portions of underlying insurance contracts has been assumed by reinsurer
- Only if insignificant risk retained (insignificant = trivial)
- Very limited circumstances, where “reinsurer economic position is virtually equivalent to having written the insurance contract directly”

Par. 11 “Stepping into the Shoes” Exception

- Issues under par. 11:
- Contract ineligible for par. 11 exception if experience refund provision or similar adjustable feature that returns more than insignificant favorable experience to cedent?
- View A: No. Par. 11 requires that substantially all losses be assumed, but not all gains
- View B: Yes. “Economic position virtually equivalent” refers to both gains and losses

Par. 11 “Stepping into the Shoes” Exception

- Contract ineligible for par. 11 exception if it has an aggregate limit (cap)?
- View A: No
  - If considered remote that cap would be reached, would still qualify
  - even if more than insignificant risk retained by ceding co. in remote scenario
- View B: No
  - Par. 11 only requires transfer of substantially all risks *for reinsured portion*; cap is not part of reinsured portion
- View C: Yes
  - Unless only trivial amount of risk retained as a result of cap under any scenario, no matter how remote
- View D: Possibly
  - Probability weighted analysis of likelihood and severity to determine if risk retained trivial
  - Would pricing change by more than trivial amount in response to a further increase in the cap? If so, cap not trivial.

Status of Project

- AICPA letter and white paper to FASB November 2003
- January 14, 2004 FASB Board meeting
  - Compelling need for guidance, with strong views held on both sides of issue
  - FASB Board agreed to add this project to its agenda; likely guidance as a FASB Staff Position (FSP)
  - FSPs have public comment period (30 days)
- Several comment letters received by FASB already
  - March 5 letter from trades: RAA, PCI, NAMIC, ACLI
  - May 18 letter from American Academy of Actuaries
- FASB staff may have draft FSP some time after June

Industry Responses to AICPA Paper

- Joint trade associations – representing majority of life and health and property and casualty insurance and reinsurance premiums written in the US
  - American Council of Life Insurers (ACLI)
  - Property Casualty Insurers Association of America (PCI)
  - National Association of Mutual Insurance Companies (NAMIC)
  - Reinsurance Association of America (RAA)
- American Academy of Actuaries (AAA)
- Other interested parties

Industry Responses to AICPA Paper

Shared Comments

- Objection based on the perception that the paper advocates moving away from the FAS 113 principle-based approach to a more rules-based approach
- While recognizing that application is divergent in practice, view that FAS 113 is comprehensive and adequate
- Some views, if adopted, would move US GAAP away from the direction of current international accounting efforts and hinder global convergence

Industry Responses to AICPA Paper

Shared Comments (Continued)

- Numerous points/objections raised regarding bifurcation
  - All quota share contracts could be subject to bifurcation
  - The existence of corridors provides an arbitrary cut-off point for bifurcation
  - Allocation of premiums and commissions would result in additional complexity and variations in practice
- Significant insurance risk interpretation
  - What is/is not meant by the 9a and the “depend on and directly vary with” wording in paragraph 62
  - Only unlimited quota-share treaties would qualify under certain interpretation
  - Responses blend the concepts of 9a and 9b

Industry Responses to AICPA Paper

RAA specific comments

- Objection to AICPA closed-door process resulting in a narrow view of the issues it addresses
- Some views presented in the paper would result in significant negative effect on insurance and reinsurance markets

AAA specific comments

- Suggest better practical guidance in applying FAS 113 be developed
- Suggest considering additional disclosures regarding the financial impact of reinsurances which transfer minimal insurance risk

Examples

Paragraph 9a Test

9a test considers probability of outcomes and impact of loss sensitive features

Example Contract

-Quota share treaty

-25% ceding commission

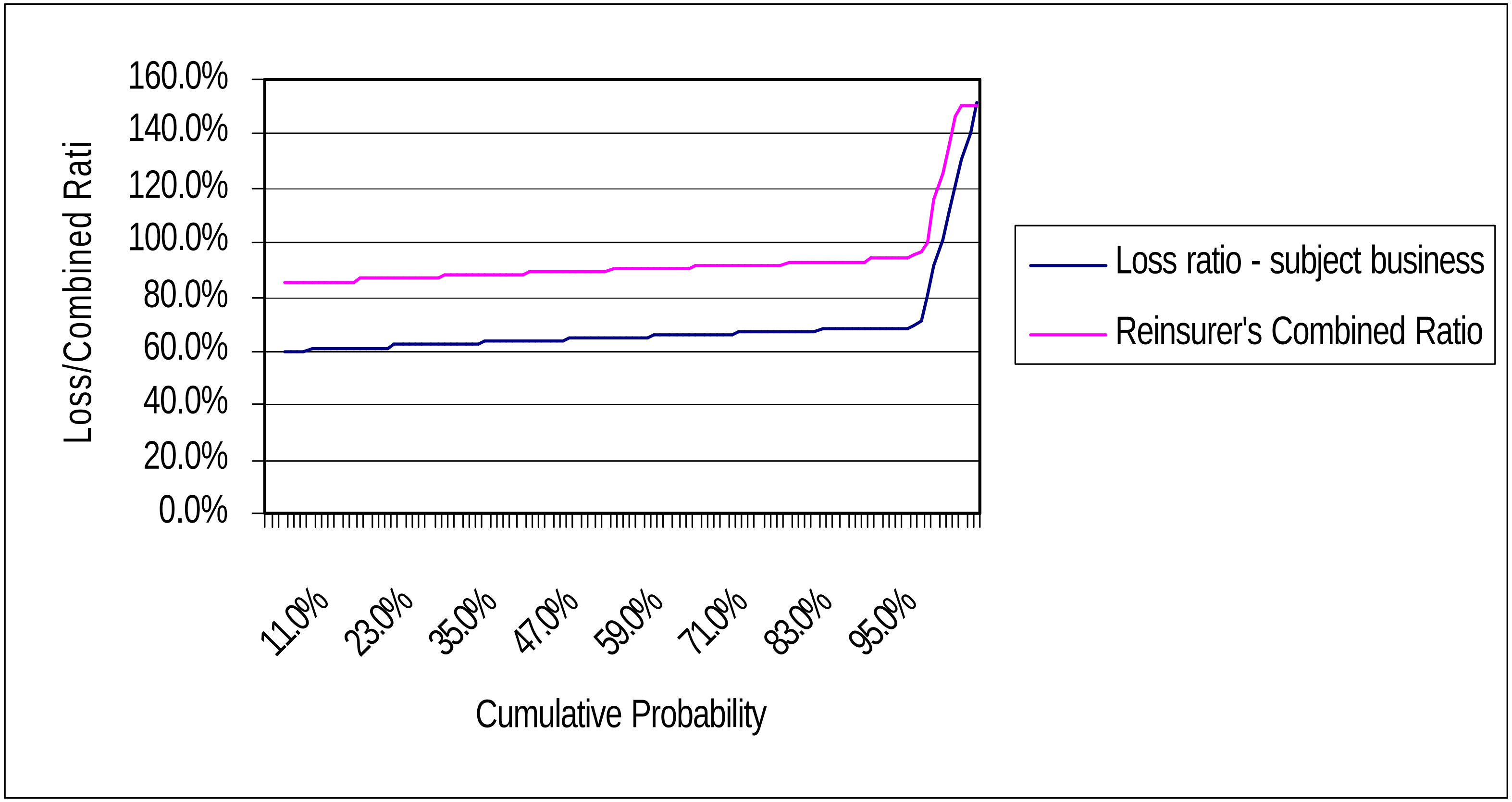
-Loss corridor from 75 – 85 loss ratio

-Loss ratio cap – 125%

Paragraph 9a (continued)

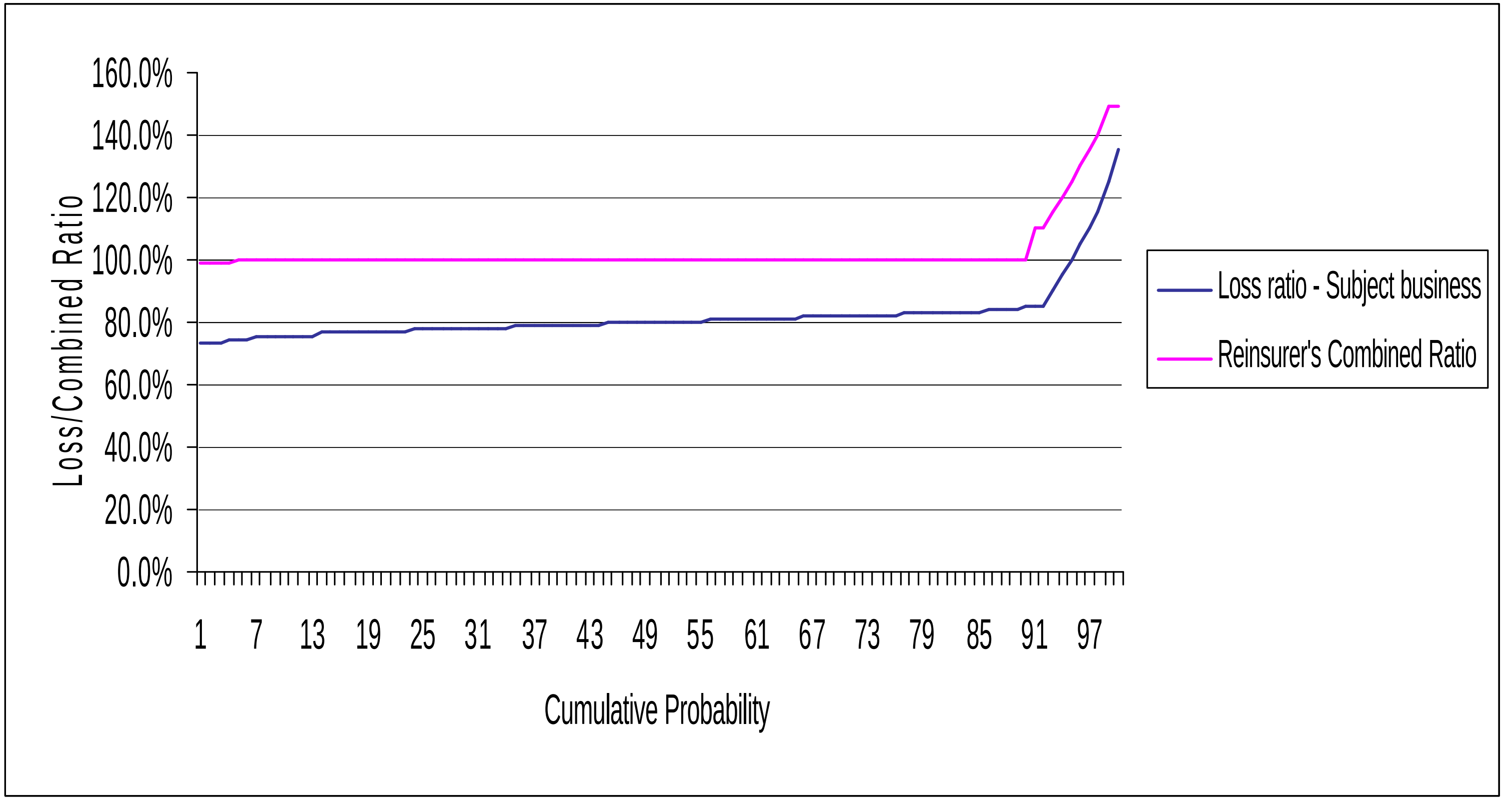
Scenario 1: Depends on and varies with impacted minimally by loss corridor

Distribution around expected loss of 65%



Paragraph 9a (continued)

Scenario 2: Depends on and varies with impacted by loss corridor
Distribution around expected loss of 80%



Simple Example - 50% QS

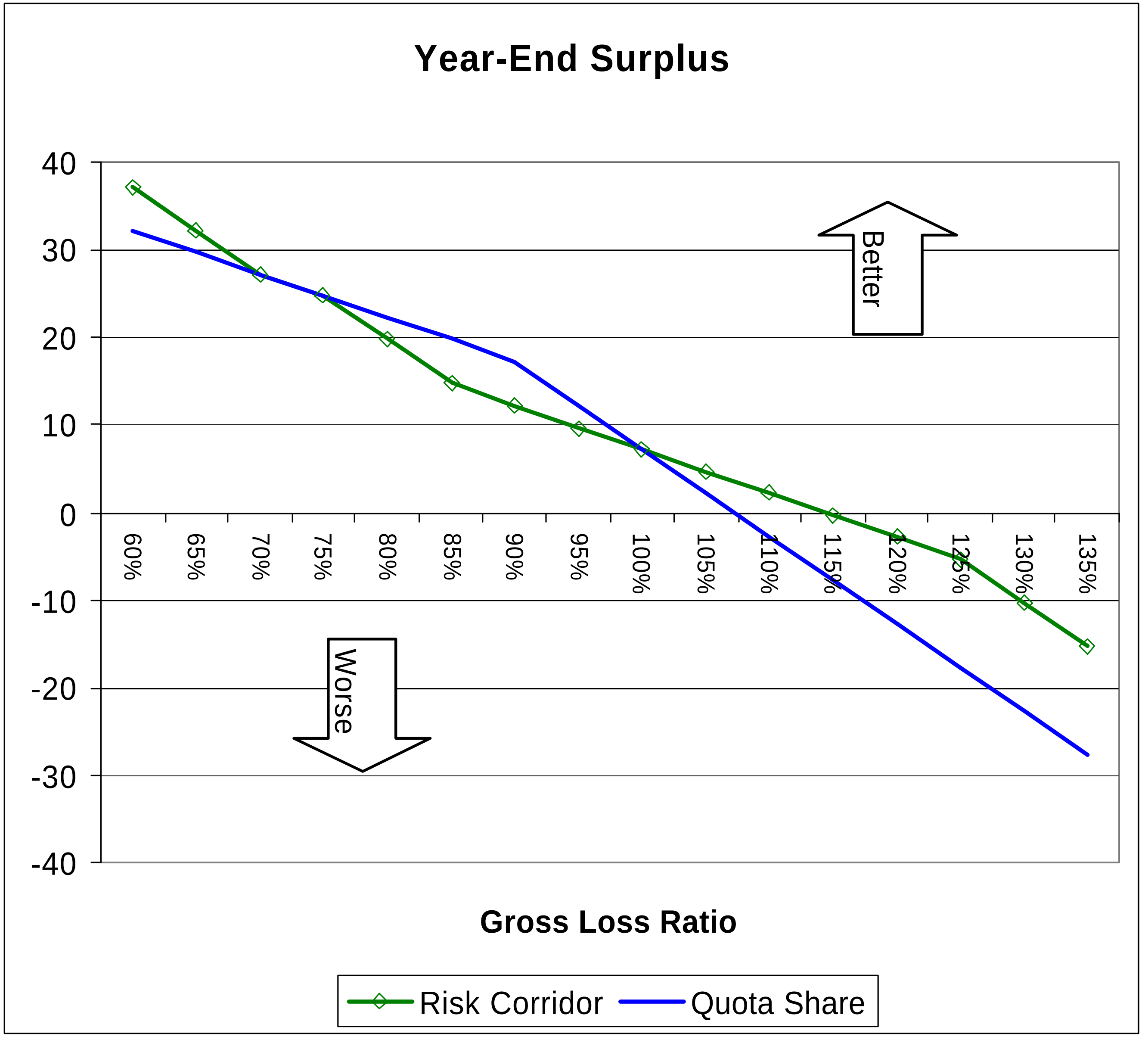
- $75m Assets
- $50m Reserves
- $25m Surplus
- $100m GWP
- $30m Expenses
- E[LR] = 60%
- Loss pd at 24 months

Risk Corridor

- Cede 30%-45%
- 1:1 Slide
- Cede + Loss = 100%
- 75-85% Corridor
- LR Cap at 125%

Quota Share

- Fixed 30% Cede
- LR Cap at 95%



Year-End Surplus
40
30
20
10
0
-10
-20
-30
-40
60%
65%
70%
75%
80%
85%
90%
95%
100%
105%
110%
115%
120%
125%
130%
135%
Better
Worse
Gross Loss Ratio
Risk Corridor
Quota Share

Applying Credibility to Assumptions

There are 2 reasonably possible mean loss ratios for a book of business (40% and 60%). Under the 60% assumption Ceding Co. determines the reinsurance passes 113. They book the 40% loss ratio under the other mean loss ratio scenario.

Could a ceding company use different reasonably possible loss scenarios for booking and calculating risk transfer?

IFRS 4 Insurance Contract

Glossary definition

Insurance Contract: A contract under which one party (the **insurer**) accepts significant **insurance risk** from another party (the **policyholder**) by agreeing to compensate the policyholder if a specified uncertain future event (the **insured event**) adversely affects the policyholder.

IFRS 4 - Significant Insurance Risk

Appendix B22 - B23

If and only if an insured event could cause an insurer to pay significant additional benefits in any scenario

If significant additional benefits payable, condition met even if:

• insured event is extremely unlikely or

•expected (i.e., probability weighted) present value of contingent cash flows is small proportion of expected present value of all remaining contractual cash flows

  – E.g., even life insurance contract has death benefit and cash surrender value

IFRS 4 - Uncertain Future Event

- B2
- One of following needs to be uncertain
  - When it will occur
  - Cost if it occurs
  - Whether it will occur

- ADC covered by cost uncertainty