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Robin Marcotte

- **Senior Manager II – Accounting** Supports
  - Accounting Practices and Procedures (E) Task Force
  - Statutory Accounting Principles (E) Working Group
  - Risk-Limiting Contracts (E) Working Group
- **Provides technical and advisory services in SAP, GAAP and IFRS**
- **Joined the NAIC in August 2000**
  - Prior to joining the NAIC, employed at a Dept. of Insurance
- **CPA, CFE, Associate in Reinsurance, CISA**
- **Member of AICPA, MSCPA and SOFE**

David Shepherd, FCAS, MAAA

- **Started with Merlinos in 1994**
- **Leads Merlinos’ Regulatory practice**
- **Has worked on financial examinations since 1994**
- **Held Executive actuarial and underwriting positions for two reinsurers over 10 years**
- **Continues to work on reinsurance issues with regulatory, insurance/reinsurance company and other clients, including risk transfer and strategic issues**
- **Has provided expert witness services related to reinsurance issues**
Michael Berman, FSA, MAAA

- Merlinos & Associates – 2012 to Present
- Provides health actuarial consulting to insurance companies, regulators, captive insurance companies, and self insured entities.
- Participated in risk focused financial examinations of health insurance companies.
- Served as Appointed Actuary for health insurance company that sold individual and group health insurance.
- Served as expert witness in several insurance related litigation matters.

Learning Objectives

At the end of this presentation, you will be able to:
- Explain general reinsurance risk transfer accounting guidance.
- Identify practical considerations for reviewing life, health and property/casualty (P/C) reinsurance contracts.
- Identify current reinsurance issues that can distort financial statements.
Overview

- Robin: SAP reinsurance overview
- Michael: Health issues
  - Practical considerations
  - Challenges
- David: P&C Issues
  - Practical considerations
  - Challenges

SAP Reinsurance Guidance

**SSAP No. 61R Life & Health**
- Adopts
  - GAAP risk transfer rules
  - Model 785 Credit for Reinsurance (A-785)
  - Model 791 Life Reinsurance (A-791)
    - Significant risks

**SSAP No. 62R P&C**
- Adopts
  - GAAP risk transfer rules
  - Model 785 Credit for Reinsurance (A-785)

Issue: Even though the GAAP risk transfer rules are adopted without modifications, regulators are seeing reinsurance contracts which are deemed to meet risk transfer for SAP and not for GAAP.
SSAP No. 62R and GAAP

- Indemnification of insurance risk in form and fact.
- Insurance risk is fortuitous and includes both:
  - Underwriting risk – uncertainties about the ultimate amount of net cash flows from premiums, commissions, claims and claim settlement expenses
  - Timing risk – the timing of the receipt and payment of those cash flows
- Insurance risk excludes investment returns
- All contractual features are used to evaluate contracts for risk transfer
- No risk transfer = No reinsurance credit

Significant Insurance Risk & Timing

- Assumption of significant insurance risk =
  - Both the amount and timing of the reinsurer's payments depend on and vary directly with the amount and timing of claims settled
  - Must be reasonably possibility of significant reinsurer loss
- There is NOT significant insurance risk transferred =
  - If the probability of significant variation in either the amount or timing of reinsurer’s payments is remote.
- Any provisions delay payment = no timing risk
Risk Transfer Evaluation

- Uses the present value of all cash flows between the ceding and assuming companies under reasonably possible outcomes.
- Use the same interest rate for the PV of all cash flows.
- Reasonably possible if its probability is more than remote.
- NARROW EXCEPTION
  - If, the reinsurer is not exposed to the reasonable possibility of significant loss, the ceding entity is indemnified for insurance risk only if substantially all of the insurance risk have been assumed by the reinsurer.
  - The reinsurer's economic position has to be virtually equivalent to having directly written the insurance contract. So that the reinsurer's exposure to loss is essentially the same as the ceding entity's.

SSAP No. 61 R Risk Transfer

- All – No risk transfer (i.e. limits or diminishes the transfer of risk) = No reinsurance credit a/k/a Deposit Accounting.
- Any feature which delays timely reimbursement = Deposit Accounting.
- Proportional – Transfers significant risk = Reinsurance Accounting.
- Nonproportional – Evaluate all terms for transfer of significant risk.
  - Prepayment schedules and accumulating multi-year retentions can delay timely reimbursement / limit the reinsurer's risks.
  - Transfer significant risk and no provisions that protect the reinsurer from incurring a loss = Reinsurance Accounting.
- Yearly Renewable Term – transfer a proportionate share of mortality or morbidity risk & no conditions in Appendix A-791, paragraph 2 (b, c, d, h, l, j, k) = Reinsurance Accounting.
Overall Concerns

- May not pass risk transfer – Finite Re round 2?
- Risk limiting features raise? - proportional or nonproportional
- Inappropriate reinsurance credit.
- Differences in GAAP and SAP application.
- Some contracts have been described as “RBC Relief” contracts.
- Financially insecure companies may use these to “prop up” the balance sheet and distort the amount of risk ceded.
- SAPWG has directed an agenda item on this topic.
- Merlinos staff to provide practical application issues/ concerns they have encountered.

Contemporary Issues – SSAP No. 61

- Reinsurance companies are marketing quota-share reinsurance policies to health insurers that are designed to meet risk transfer requirements for statutory but NOT meet the requirements for GAAP financial statements.
- Policies designed to nominally be quota share, but they contain “experience refund” provisions that, in effect, transfer significantly less risk than the stated level of quota share. Experience refunds are transferred back to ceding company in most years.
- Accounting analysis based on wording differences between SSAP 61 and 62R.
Contemporary Issues – SSAP No. 61   -
(Continued)

• SSAP 61 lacks the specific wording that states that there must be a “reasonable possibility of a significant insurer loss” that is present in SSAP 62R. Accounting advisors (CPAs) are interpreting this to mean that the NAIC did not intend for reinsurers to have a “reasonable possibility of a significant loss” in order to meet the SSAP 61 risk transfer requirements.
• This was NOT the intention of the NAIC when the accounting guidance was drafted.
• GAAP treatment that is more conservative than statutory is abnormal, as statutory accounting is generally more conservative.
• Financial examiners should be aware of the presence of these policies when conducting risk focused financial exams.

Contemporary Issues – SSAP No. 61   -
(Continued)

• Insurance regulators should understand that the presence of these reinsurance policies, with the current risk transfer interpretations, create a situation where some companies will be significantly more leveraged than their statutory financial statements may indicate.
Risk Transfer Summary

• Philosophy
  – Intent that risk is transferred
  – Don’t distort the financial picture

• Current Situation
  – Binary – “it either is or it isn’t”
  – RBC ignores loss sensitive reinsurance treaty exposure
  – Annual Statement ignore level of risk transfer
    • IRIS Tests: NWP/Surplus, change in NWP

Initial Scenario

• Loss Sensitive Reinsurance Treaty for ABC Insurance Company

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<table>
<thead>
<tr>
<th></th>
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</thead>
<tbody>
<tr>
<td>Gross Premium</td>
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<tr>
<td>Surplus</td>
<td>16,000,000</td>
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<tr>
<td>QS %</td>
<td>60%</td>
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<td>Reinsurer’s Margin</td>
<td>6%</td>
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<tr>
<td>NWP / Surplus</td>
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Commission = 100% - Loss Ratio - 6% Reinsurer’s Margin
=> Subject to a 22% minimum Commission

Gross Expense Ratio 38%
# Economic Benefit QS

- Scenario Testing for ABC Insurance Company

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<thead>
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<table>
<thead>
<tr>
<th>Loss Ratio</th>
<th>Ceding Commission</th>
<th>Gross Underwriting Loss</th>
<th>Net Underwriting Loss</th>
<th>Resulting Surplus</th>
<th>Reinsurer Profit</th>
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<tr>
<td>62%</td>
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<td>(13,600,000)</td>
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<tr>
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<td>22%</td>
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<td>(16,000,000)</td>
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<td>-</td>
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<td>(16,800,000)</td>
<td>(800,000)</td>
<td>(1,200,000)</td>
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**Question #1**

- Is this a Quota Share treaty, or an Aggregate Excess of Loss treaty?

Loss Sensitive Reinsurance Treaty for ABC Insurance Company

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=> Subject to a 22% minimum Commission

Gross Expense Ratio 38%
Form Over Substance

<table>
<thead>
<tr>
<th></th>
<th>Surplus</th>
<th>Premium</th>
<th>LR Att Pt</th>
<th>Commission</th>
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<td>60%</td>
<td>3,600,000</td>
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</table>

<table>
<thead>
<tr>
<th>Direct Loss Ratio</th>
<th>XOL Ceded Losses</th>
<th>AIC Direct Expenses</th>
<th>Net XOL Underwriting Loss</th>
<th>Implied Surplus</th>
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<tr>
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<td>-</td>
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<td>4,400,000</td>
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<tr>
<td>72%</td>
<td>-</td>
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<td>(13,600,000)</td>
<td>2,400,000</td>
</tr>
<tr>
<td>75%</td>
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<td>38,000,000</td>
<td>(14,800,000)</td>
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<td>3,600,000</td>
<td>38,000,000</td>
<td>(16,000,000)</td>
<td>-</td>
</tr>
<tr>
<td>80%</td>
<td>4,800,000</td>
<td>38,000,000</td>
<td>(16,800,000)</td>
<td>(800,000)</td>
</tr>
</tbody>
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Question #2

• Which is the more important ratio?

Quota Share NWP / Surplus Ratio: 2.50

Aggregate XOL NWP / Surplus Ratio: 6.03
Regulatory Challenges

• Treaty provides zero benefit
  – How to handle “life support” treaties that provide no benefit?

• Risk Transfer is not a Binary Issue in reality
  – Annual Statement and RBC treats as such
  – All or nothing

• Risk Transfer is a Spectrum
  – Any treaty where risk is debatable is on the distorting side of the spectrum
  – The SSAP 61 discussion relates to a treaty at the very end of the spectrum
  – Ceding 50% of the premium may only cede 10% of the risk
  – Can you re-format with “as if” contract terms that better reflect the ceded exposure?

Final thoughts

• We need a broader discussion and understanding of reinsurance impact
• This may lead to risk transfer clarifications regarding the appropriate amount of credit
• Possible changes in analysis and or RBC treatment
Questions?

• Robin Marcotte rmarcotte@naic.org
• Michael Berman mberman@merlinosinc.com
• David Shepherd dshepherd@merlinosinc.com

Appendix

Supplemental Information for Reference
Disclosures

• P&C Statutory financial statements include several disclosures to facilitate the identification of specific characteristics in reinsurance contracts that warrant further analysis as to whether risk transfer is sufficient.

• CEO and CFO of the reporting company must specifically attest that reinsurance contracts are accounted for appropriately in the statutory financial statements.

Risk Transfer P&C Disclosures

Interrogatory 7.1 Any Quota Share Agreements with Provisions Limiting Losses Below Stated Quota Share

Interrogatory 7.2 Number of Such Contracts

Interrogatory 7.3 Amount of Credit Taken Reflecting the Quota Share Coverage
Risk Transfer P&C Disclosures

Interrogatory 9.1  Reinsurance Contracts a.) Above 3% Of Defined Surplus; b.) Not Using Deposit Accounting; c.) Contain Various Features

Interrogatory 9.2  Cedes Premium a.) Amounts To More Than 50% Of That Reinsurer’s Gross Premium; b.) Or If 25% Of Ceded Premium Returned

Interrogatory 9.4  Accounting Discrepancy Between GAAP and SAP

Note: If “Yes” to 9.1 or 9.2, must complete Reinsurance Summary Supplemental Filing for General Interrogatory 9.

Risk Transfer P&C Disclosures

• Reinsurance Summary Supplemental Filing for Interrogatory 9
  – Identify the reinsurance contract(s) & summarize the contract terms
  – Discussion of management objectives
  – State financial impact of contract(s)
Risk Transfer Disclosures

• Reinsurance Attestation Supplement
• Signature By CEO & CFO and attest to the fact:
  – No side agreements
  – Complies with SSAP #62
  – Internal controls in place
  – Appropriate documentation for review
  – Disclose & explain exceptions

Statutory Accounting & Reporting

• Deposit Accounting
  – To the extent that a reinsurance agreement does not, despite its form, transfer both components of insurance risk, all or part of the agreement is accounted for and reported as a deposit
  – Applies whether the agreement is prospective or retroactive
  – All cash flows are processed through a deposit account
  – No reduction in reserves or liabilities
  – Any gain from the transaction is not recognized until termination