Reinsurance Matters

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Presented by:

Insurance Resolutions, Inc.

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Today's Topics

- Part I: Risk Transfer Case Study
- Part II: State of the Market

Part I
Risk Transfer
Case Study
Short-Duration
Contracts

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A Challenging Area

- Implementation of the applicable guidance continues to be a confusing and difficult process to many practitioners
- Recent focus on this area by AICPA committee
- We think a Case Study can be a valuable tool to assist practitioners in becoming familiar with the practical aspects of the applicable guidance

Why the issue?

- Insurers were creating short-term surplus and earnings impacts for reinsurance contracts that were nothing more than financing or debt transactions.
- IRS – Internal Revenue Service caught wind of this when insurers were recording tax deductions for mere financing transactions.
- Regulators and rating agencies didn't like the earnings games.

How was this happening?

- 1980’s there was a change in the business environment with exceptionally high interest rates. (5 year treasury 15% return)
- For Property and Casualty Insurance Companies, high interest rates causes larger and larger differences between market value (discounted) and book value (nominal) of their liabilities.

Opportunities Created

- Property and Casualty Companies may enter into reinsurance transactions to cede liabilities on their balance sheet (loss portfolio transfers) substantially at market value
- Effects to cedant included:
  - Current earnings and surplus increase
  - Future earnings will be depressed by loss of invested assets or by reinsurers claim on them
  - May be in exactly the same (or slightly worse) economic position
  - May be analogous to selling a bond without the “Realized Gain” treatment

Original Guidance was mild

- Both FASB Statement No. 5 “Accounting for Contingencies” (1975) and FASB Statement No. 60 “Accounting and Reporting by Insurance Enterprises” (1982) provide that whenever an insurance or reinsurance contract does not provide “indemnification of the insured or reinsured against loss or liability” the premium paid less the premium retained shall be accounted for as a deposit.
- Explanation of how “indemnification ... against loss or liability” or “Risk Transfer” can be determined was not provided in either SFAS 5 or SFAS 60

Reactions of Regulators and the Accounting Profession

- In 1984, the New York Division of Insurance issues Regulation No. 108 which requires specialized SAP accounting and disclosure for loss portfolio transfers
- In 1992, FASB Statement No. 113 “Accounting and Reporting for Reinsurance of Short–Duration and Long-Duration Contracts” was issued
  - Among other things, guidance on the subject of “Risk Transfer” was provided

Fast Forward to Today

- Current Guidance is embodied by:
  - SAP – SSAP No. 62 “Property and Casualty Reinsurance”
  - GAAP – FASB Statement No. 113 “Accounting and Reporting for Reinsurance of Short – Duration and Long Duration Contracts” and EITF 93-6
- Both SAP and GAAP Assessment of “Risk Transfer” is substantially as defined in SFAS No. 113

Risk Transfer Conditions

- Reinsurer must assume “significant” insurance risk under the reinsured portions of the underlying insurance contracts [so called “9a” test]
  - Insurance Risk is composed of BOTH
    - Underwriting Risk (amount of ultimate net cash flows)
    - Timing Risk (the timing of these cash flows)
- It must be “reasonably possible” that the Reinsurer may realize a “significant” loss from the transaction [so called “9b” test]
  - “significance” to be based on discounted cash flows
  - “significant” not defined

Seaport Indemnity Case

- Refer to Summary of Key terms and conditions (the "Slip" or "Covernote") for contract to be analyzed included in your booklet
- Review key terms and conditions
- Assume no other reinsurance agreements exist between Seaport Indemnity and Alaska Re

Analysis of 9a Condition

- We need some more information:
  - Estimates of ultimate loss ratios for personal automobile business written by Seaport
    - Range of estimates with “Select” and “Hi” and “Lo”
  - Refer to Exhibit I included in your booklet
  - Estimates of payout patterns for personal automobile business written by Seaport
    - Range of estimates with “Select” and “Fast” and “Slow”
  - Scenarios must be more than “remotely” possible
    - Many practitioners have defined “remote” as less than a 10% chance
  - Refer to Exhibit II in your booklet

Analysis of 9a Condition – (Con't)

- With Exhibit I and II for the underlying business construct a model of the reinsurers experience based on the parameters of the reinsurance contract
- Refer to Exhibit III in your booklet

Analysis of 9a Condition – (Con't)

- Based on Exhibit III:
  - Is the probability of a significant variation in the amount of the reinsurers payments more than "Remote"?
  - Is the probability of a significant variation in the timing of the reinsurers payments more than "Remote" ?
- If "yes" to both; the 9a condition is met
- Otherwise; it is not met and reinsurance accounting is not allowed

Analysis of 9b Condition

- Using Exhibit III as a starting point:
  - Select an interest rate using judgment
  - Apply it to all scenarios
  - Prepare discounted cash flow analyses
- Refer to Exhibit IV in your booklet

Analysis of 9b Condition (Con't)

- Based on Exhibit IV:
  - Is there a scenario resulting in a significant loss to the Reinsurer?
  - In this context, many practitioners have defined "significant" as more than 10% of the reinsurers [gross] revenues from the transaction
- If "yes" and the 9a test was also passed "risk transfer" has been established and the contract will qualify for reinsurance accounting treatment
- Otherwise; reinsurance accounting is not allowed

Parting Thoughts

- Exceptions
- Use of checklists
- Documentation of “risk transfer” assessment

Part II
The Reinsurance Marketplace

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Remarks & Observations

- Market Overview
- Recent History
- Buyers Perspective

Looking Back

- September 11, 2001
- Fifteen Years of Competition
- Capacity Lost and Gained
- Fewer Underwriters, Fewer Choices

Capacity, Terms & Trends: Renewals 2002 and 2003

- Primary Insurance and Reinsurance Rate Increases
- Profitable Results for Some Underwriters
- Lack Luster Support for Casualty Lines
- Increased Use of Modeling

The Property Reinsurance Market

- Reinsurers' Preferences
- Catastrophe & Per Risk Covers
- Pro Rata (Proportional) Treaties
- Regional & National Company Programs
- Good IT

Property Catastrophe Outlook

- Distractions After 9/11
- Terrorism Exclusions
- Terrorism Risk Insurance Act of 2002
- Market Security
- Significant 2002 Rate Increases
- Favorable experience 2002
- New Capacity for 2003 renewals
- Weakening Worldwide Cat Rates 2003 Renewals
- Better Terms for 2004

Property Per Risk Outlook

- Terms and Conditions
- Renewals 2003
- Capacity and Competition
- Rate Relief 2004
- Benefits of Good Data

Property Pro Rata Outlook

- Property Pro Rata Outlook
- Original Rates
- Catastrophe Concentrations
- Follow the Fortunes
- Capacity and Returns
- Continue as Expiring 2004

Casualty Market Outlook

- Support Problematic in 2003
- Reinsurers Ceased Writing
- Little or no New Capacity
- Prior Years Loss Reserves
- Market Security
- Small “Global” Market
- A “Tighter” 2004

Something Old, Something New...

- The Credit Risk
- Reinsurers Exiting
- Securitization

Questions ?

Thank You

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