25. (3.5 points)

a. (1.5 points)

A primary insurer has decided to reinsure policies written for an annual term effective January 1, 2014. For each of the following reinsurance provisions, select a purchase date and effective date of an annual reinsurance contract that satisfies that provision:

- Only prospective reinsurance
- Only retroactive reinsurance
- Both prospective and retroactive reinsurance

Briefly explain the selection.

b. (1 point)

Identify and briefly describe two conditions a reinsurance contract must meet in order to be accounted for as reinsurance.

c. (1 point)

For each of the conditions from part b. above, describe one reinsurance policy provision that would prevent the policy from being accounted for as reinsurance.

END OF EXAMINATION

QUESTION 25	
TOTAL POINT VALUE: 3.5	**LEARNING OBJECTIVE: E**
SAMPLE ANSWERS	

Part a: 1.5 points

Sample 1:

- Purchased 12/1/2013, effective 1/1/2014;
- Purchased 1/1/2015, effective 1/1/2015;
- Purchased 6/1/2014, effective 7/1/2014;
- Prospective Policy is purchased and effective before any of the policy has been incurred. Retro policy is purchased an effective after entire policy has been incurred. Policy with both is purchased and effective during the policy.

Sample 2:

- Prospective – purchase date = 2/1/2015, effective date = 1/1/2015, selected dates because contract needs to be in effect on the day the policies are written and purchase date can be after the effective date as long as close to effective date;
- Retro – purchase date = effective date = 1/1/2020, retro covers liabilities that have already been incurred. Purchase and effective in 2020 ensures ceded losses are in the past;
- Both – purchase = effective = 7/1/2014, this way the liabilities incurred prior to 7/1/2014 will be retro re and the liabilities incurred from 7/1/2014 to 12/31/2014 will be covered by prospective reinsurance.

Sample 3:

- Only Prospective – purchase date and effective date of 1/1/2014. Since it must cover future risks it needs to be effective when reinsured risks are effective, no later;
- Only Retrospective – purchase date of 1/1/2015, effective date of 1/1/2014. This ensures all risks covered are from past occurrence period;
- Both – purchase date of 7/1/2014, effective date of 1/1/2014 so portion of occurrences in the past and portion in a future period; Prospective Policy is purchased and effective before any of the policy has been incurred. Retro policy is purchased and effective after entire policy has been earned.

Part b: 1 point

Sample 1:

- Reinsurer must accept significant underwriting risk, for example > 1% ERD or pass 10 – 10 rule;
- There must be timing risk or the reinsurer is not exposed to as much risk as necessary to qualify for reinsurance accounting.

Sample 2:

- Timing risk, the cash flows between the insurer and reinsurer should not be at predetermined dates;
- Underwriting risk, the reinsurer should not be guaranteed a profit, with exception of substantially all clause.

Sample 3:

- Must be reasonably possible for the reinsurer to realize a loss;
- Timing risk: the timing of the future payments must be unknown.

Sample 4:

- Must transfer significant insurance risk: includes both underwriting risk (in terms of amounts reinsurer must pay) and timing risk (when reinsurer must pay);

- Must be a reasonable chance that the reinsurer will sustain a significant loss from the transaction. Some suggest a 10% or greater chance experience at least a 10% loss.

Part c: 1 point

Sample 1:
- A payment timing clause to prevent immediate availability of funds violates timing risk;
- A loss ratio cap which guarantees profits for the reinsurer would violate the significant loss requirement.

Sample 2:
- A 100% loss ratio cap would mean the reinsurer cannot experience a loss, and therefore they would not pass the ERD test;
- Timing – would prevent reinsurance accounting if contract says reinsurer makes all the payments on 12/31, as there would be no timing risk.

Sample 3:
- All losses will be paid on July 1st, 2016, no timing risk;
- Reinsurer losses will be capped at a LR of 80%, no risk of significant loss.

Sample 4:
- Risk transfer: Premium = $1M, max recoverable = $1.1M;
- Timing risk: all recoverables paid on 1/1/2015.

Sample 5:
- Yearly payment schedule, reinsurer only pays 12/31 for all losses in year, this delays timely reimbursement and this is not enough timing risk;
- Reinsurer has 80-% loss ratio cap, since this limits possibility of significant loss.

EXAMINER'S REPORT

Candidates generally performed well on all parts of this question.

Part a

The most common errors were made on the fully retrospective and both prospective and retrospective treaty dates and explanations. On the retrospective section many candidates provided dates in the middle of the primary policy period. On the both prospective and retrospective section, many candidates that were outside of the primary policy term. In addition, many candidates did not provide a brief explanation.

Part b

Common error: Some candidates stated underwriting and timing risk, but only defined underwriting risk.

Part c

Many candidates listed common reinsurance provisions that did not necessarily result in failing risk transfer, such as contingent ceding commissions or aggregate limits. These items could result in risk transfer depending on the parameters of the provision, but the candidate did not explicitly state a parameter that would result in the policy failing risk transfer.