26. (2.5 points)

A primary insurance company is considering the following reinsurance contracts.

Contract #1
Summary of Reinsurance Terms

Date Incepted	July 1, 2013
Reinsurance Term	12 months
Cession	80% Quota Share
Reinsurance Premium	$10.4 million
Maintenance Fee	$100,000
Provisional Ceding Commission	22% provisional commission. Adjusts according to following schedule: 19%, if Loss Ratio (LR) = 71%; 28%, if LR $\leq$ 62%; 90% - LR, if 62% < LR < 71%
Profit Commission	None
Loss Ratio Cap	315%
Brokerage	5%
Underwriting Expenses	2%

Contract #2
Summary of Reinsurance Terms

Date Incepted	July 1, 2013
Reinsurance Term	12 months
Reinsurance Layers	Layer 1 - 75% of $1 million excess of $3 million Layer 2 - 56% of $5 million excess of $5 million
Maintenance Fee	$70,000
Reinsurance Premium	$2.4 million for Layers 1 & 2
Ceding Commission	15%
Profit Commission	5% Profit Commission after a reinsurer's margin of 12.5%
Brokerage	8%
Underwriting Expenses	4%

- The contracts have commutation clauses which state that they be will be commuted after seven years unless the cedent pays maintenance fees.

<<QUESTION 26 CONTINUED ON NEXT PAGE>>

26. (continued)

a. (1.5 points)

Assess whether each contract meets the "reasonably self-evident" criteria for reinsurance risk transfer.

b. (0.5 point)

Briefly describe the requirements for a contract to qualify for reinsurance accounting treatment under GAAP.

c. (0.5 point)

Briefly explain the rationale for whether each of the following should be included in risk transfer analysis:

- Maintenance fee
- Profit commission

END OF EXAMINATION

QUESTION 26	
TOTAL POINT VALUE: 2.5	**LEARNING OBJECTIVE: E1**
SAMPLE ANSWERS	

Part a: 1.5 points

- Contract #1:
  - Yes, contract #1 meets the criteria. It's a QS agreement that transfers a large portion of insurer's risk (80%), the provisional commission looks reasonable. Although there is a loss ratio cap, the cap is very high, so it should be able to transfer a large amount of insurance risk.
  - Contract 1 meets the criteria for reinsurance risk transfer. It is reasonably possible for the reinsurer to realize a significant loss, when loss ratio exceeds 200%. Quota share treaty ensures that the reinsurer assumes both underwriting and timing risks.
  - #1: reasonably self-evident due to high loss ratio cap, and high amount of % ceded in quota share
  - Contract #1 qualifies because It has no significant limiting features because it is a quota share contract with a high loss ratio cap
  - Meets because reinsurer assumes substantially all of the underlying risk due to being quota share with high loss ratio cap
- Contract #2:
  - No, the premium paid is relatively high compared to the loss transferred. Need further analysis to investigate whether it's possible to realize a significant loss.
  - Exposed to limit of 0.75 x 1 + 0.56 x 5 = 3.55M:
    Given the premium of 2.4M (or 2.47 incl. maintenance fee to avoid commutation), this is high relative to the limit. Moreover, losses in the high excess layers might be much less likely. It is therefore not reasonably self-evident that the contract transfers significant insurance loss.
  - Not reasonably self-evident because partial participation in high excess layers are significant limiting features.

Part b: 0.5 point

- Transfers both underwriting and timing risk; It's reasonably possible for reinsurer to realize a significant loss (exception in cases where substantially all of the risk is transferred)
- Timing risk; Underwriting risk; Reasonable possibility of significant loss
- Contract must transfer both u/w (uncertainty of amount) and timing (uncertainty of payment) risks; Assuming entity must be reasonable possible to realize significant loss
- Significant insurance risk; Reasonably possible that reinsurer may realize significant loss
- Requirements for GAAP/SAP: if SAP recognizes then GAAP will too. No strict rules but industry standard is ERD>1% or 10-10 Rule, which says risk transfer exists if >10% chance that reinsurer incurs >10% loss.
- To qualify for reinsurance accounting under GAAP the following criteria must be met: reasonable chance that the reinsurer will incur a significant loss and there is uncertainty in the timing and payments.

Part c: 0.5 point

- Maintenance Fee

o Yes, it's a cash flow between insurer and reinsurer o Yes, cedent must pay this to reinsurer to prevent commutation o Yes should be included because it is a payment between insurer and reinsurer and could eliminate coverage if not paid o Yes, it would change the reinsurer's calculated profit or loss • Profit Commission o No, risk transfer analysis focuses on loss scenario, which will have no profit commission o No, profit commission impacts cedent's results which should not be considered in risk transfer analysis o No, any indirect economic impact is already accounted for in premium o No, including would have potential for manipulation
EXAMINER'S REPORT
Candidates were expected to have a good grasp of the fundamentals of risk transfer and be able to use a basic understanding of the material and apply it to specific examples.
Part a
Candidates were expected to be able to evaluate the "reasonably self-evident" criteria for reinsurance contracts. Common errors included: not providing enough information, assuming that any loss ratio cap meant no chance of significant loss even if cap is high, and misunderstanding commutation clauses, reinsurer's margin and profit commission. Some candidates seem to have been thrown off by the sliding scale commission stated in the question for Contract #1 as "90% - LR, if 62% < LR < 71%" and misinterpreted that as the commission is 90% when the LR is between 62% and 71%.
Part b
Common errors included providing an incomplete answer, such as referencing the 10-10 or 1% ERD rule without discussing how it relates to the GAAP requirements. Many candidates confused the idea of underwriting risk with a chance of significant loss.
Part c
This question required a deeper understanding of risk transfer than part b. Common errors included assuming that a maintenance fee is not a cash flow between insurer and reinsurer, and that not including profit commission would lead to manipulation.