25. (1.5 points)

An insurance company is considering the following three reinsurance contracts:

i. The reinsurer covers 50% of all losses. The reinsurer will pay all covered losses five years after the reinsurance contract inception date.

ii. The reinsurer covers losses excess of $500,000, with a profit commission of 5%. The expected reinsurance deficit (ERD) is 0.9% for the contract.

iii. The reinsurer covers aggregate losses up to $5 million. The ceding company is certain to incur at least $10 million in losses. The reinsurer holds highly volatile investments that may result in returns between -30% to 120%.

Briefly explain whether each reinsurance contract qualifies for reinsurance accounting treatment under GAAP. For any contracts that do not qualify, propose a modification so that it will.

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SAMPLE ANSWERS AND EXAMINER'S REPORT

<table>
<tr><td colspan="2">QUESTION 25</td></tr>
<tr><td>TOTAL POINT VALUE: 1.5</td><td>LEARNING OBJECTIVE: E1</td></tr>
<tr><td colspan="2">SAMPLE ANSWERS</td></tr>
<tr><td colspan="2">Contract i:
Contract doesn't qualify because no timing risk
Any one of the following modifications:
• Change contract such that reinsured losses are reimbursed as they occur
• Change contract such that reinsured losses are reimbursed in a timely manner, or within set time period (i.e. 30 days / 60 days / 90 days after the reinsured paid the loss)
• Removing the fixed timing clause

Contract ii:
ERD threshold = 1%, should not be treated as reinsurance.
Any one of the following modifications:
• Reduce premium to increase ERD above the chosen threshold
• Increase ceded losses (lower attachment point, higher reinsured limit) to increase ERD above the chosen threshold
• Reduce profit commission such that reinsurance premium can be reduced and ERD is increased above chosen threshold
Contract ii alternate:
Assume ERD threshold = 0.7%, contract qualifies for reinsurance accounting

Contract iii:
Contract doesn't qualify due to lack of underwriting risk.
Any one of the following:
• Change contract to cover losses in excess of a higher limit (i.e. $9M or higher) where losses are uncertain
• Change contract to a quota share to reinsure substantially all risk</td></tr>
<tr><td colspan="2">EXAMINER'S REPORT</td></tr>
<tr><td colspan="2">The candidates were expected to be able to determine what contractual features would qualify, or could preclude, a contract from qualifying for reinsurance accounting (i.e. passes risk transfer)

For contract i, candidates typically identified the lack of timing risk due to the contractually determined payment date.

A common mistake was providing a modification that did not provide for timely reimbursement (i.e. 5 years after reinsured makes payment).

For contract ii, candidates typically selected a 1% ERD and then used this threshold correctly to</td></tr>
</table>

state that the contract would not qualify for reinsurance accounting under such a threshold. Under this approach, candidates often proposed modification that recognized that either less premium or more ceded loss would impact the ERD calculation such that reinsurance accounting could be achieved. A common approach was to state a lower attachment point, or state that the attachment point should be lowered until the ERD achieves the selected value.

A less common approach was to select an ERD threshold less than 0.9% and conclude that reinsurance accounting was appropriate.

Common mistakes included:

- Focusing on the profit commission without connecting this to the reinsurance premium and thus the ERD
- Suggesting modifications without direction or without clear connection to their impact on the ERD calculation.

For contract iii, candidates generally were able to identify that the contract did not qualify for reinsurance accounting due to the lack of underwriting risk. Acceptable responses focused on introducing uncertainty in the ceded losses or modifying the contract such that substantially all of the risk was transferred.

A common mistake was a response that focused on the reinsurer's investment returns.

For all contracts, a common mistake included stating a conclusion without providing any reasoning and failure to include modifications.