12. (2 points)

An insurance company has entered into a retroactive reinsurance agreement.

a. (1 point)

Assuming the agreement meets risk transfer requirements, briefly describe the retroactive reinsurance agreement's effect on the insurance company for each of the following under SAP:

i. Loss Reserves

ii. Total Liabilities

iii. Net Income

iv. Policyholders' Surplus

b. (1 point)

Assuming the agreement meets risk transfer requirements, briefly describe the retroactive reinsurance agreement's effect on the insurance company for each of the following under U.S. GAAP:

i. Loss Reserves

ii. Total Liabilities

iii. Net Income

iv. Policyholders' Surplus

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Many candidates struggled to interpret what was meant by case incurred loss in part a. Also, some candidates struggled to connect the data given to potential regulatory concerns, either pointing out a trend in the data without the potential issue or providing the issue without a direct correlation to the data.
Part a
Candidates were expected to calculate the 2016 CY case incurred using the data given. Common errors included: • Calculating incurred – paid – IBNR (2-3-4) instead of just incurred – IBNR (2-4) • Calculating just CY incurred (just 2) • Calculating incurred + IBNR (2+4) • Calculating incurred – paid (2-3) • Calculating paid + IBNR (3+4) • Calculating paid + 2016 case instead of paid + change in case • Only using 2016 column and not subtracting 2015
Part b
Candidates were expected to calculate the 2016 CY paid using the data given. Common errors included: • Only using 2016 column and not subtracting 2015
Part c
Candidates were expected to connect trends in the data given to potential regulatory concerns Common errors included: • Recognizing the IBNR was decreasing over time but with no connection to a long-tailed line or comparing that trend across AYs • Recognizing the reserves were potentially overstated b/c of the downward trend in incurreds but not tying to a regulatory concern • Recognizing other trends in the data but not providing a potential concern • Only providing a concern without tying it to the data given

QUESTION 12	
TOTAL POINT VALUE: 2	**LEARNING OBJECTIVE: C1**
SAMPLE ANSWERS	
Part a: 1 point	

Sample 1 i) No impact ii) Decrease – due to a write-in contra liability equal to the amount transferred iii) Increase (because Other Income increases) iv) The overall surplus increases, but it is assigned to special surplus rather than unassigned Sample 2 i) Unaffected ii) Decrease by the write-in contra liability amount iii) It will change by the difference of consideration paid and paid loss recovered iv) PHS will change by the difference of consideration paid and contra-liability Sample 3 iv) impact equal to impact on net income Sample 4 iii) increase, any gain -> “other income” -> “retro gain”
Part b: 1 point
Sample 1 i) No effect on loss reserves ii) Increase in total liabilities. iii) No increase (or decrease) at least initially, gain amortized over time. iv) Whether gain or loss initially will be no change in PHS. Gain is amortized over time. Sample 2 i) Loss Rsvs – no effect – GAAP reserves are gross ii) Total Liab – a retro reins liab is created iii) No impact iv) Defers recognition of surplus/amortizes -> increase Sample 3 i) Not reduced, asset established for Reinsurance recoverables ii) iii) Any income/loss is listed under other income, gain deferred over contract iv) Surplus gain deferred over life of contract Sample 4 iii) no gain/loss is recognized immediately – rather expected gain loss is amortized over 10 years iv) no effect on PHS

EXAMINER'S REPORT
Candidates were expected to understand the accounting treatment of retroactive reinsurance contracts from the cedant's perspective under both SAP and GAAP accounting standards.
Part a
Under SAP: i) Candidates were expected to know that loss reserves continue to be reported gross of the retro reinsurance recoverable ii) Candidates were expected to know that total liabilities are reduced by the amount of retro reinsurance recoverable (due to a reported contra-liability) iii) Candidates were expected to know that net income is increased or decreased by the amount of any gain or loss on a retro reinsurance contract, and/or that typically a retro reinsurance contract is a gain to the cedant causing an equal increase in net income (reported as "other income") iv) Candidates were expected to know that any gain or loss on the contract causes an equal gain or loss to policyholder surplus (even though this surplus is designated as "special surplus") Common mistakes included: • Stating that loss reserves are held net of reinsurance • Stating the liabilities are unchanged or decreased • Stating that income would increase by the amount of the liability ceded without accounting for the premium paid for retro reinsurance. • Stating that income would be reduced by the amount of premium paid • Stating that income would decrease or be unchanged without explanation • Stating that policyholder surplus is unaffected because it is "special surplus" • Stating that the amount of net income and surplus change is the "ceding commission"
Part b
Under GAAP i) Candidates were expected to know that loss reserves continue to be reported gross of the retro reinsurance recoverable ii) Candidates were expected to know that total liabilities are increased due to establishment of a liability for deferred retro reinsurance gain

iii) Candidates were expected to know that net income is not immediately increased or decreased in the event of a gain or loss on a retro reinsurance contract, but that the gain/loss is deferred and amortized into income over the period of payments

iv) Candidates were expected to know that any gain or loss is deferred and/or gives no immediate surplus change

Common mistakes included:

- Stating that reserves are stated net of retroactive reinsurance
- Stating that total liabilities would be unchanged because a reinsurance asset would be established
- Stating that income would increase by the gain in the contract, but not mentioning that the gain is amortized over the payment period of the contract, and thus income is not immediate
- Stating that surplus would increase due to a gain, without mentioning that such an increase would not be immediate.

QUESTION 13	
TOTAL POINT VALUE: 2.25	**LEARNING OBJECTIVE: C1**
SAMPLE ANSWERS	
Part a: 0.75 point	

Sample Answer:

Bond 1 = Amortized Cost = 21,000

Bond 3 = minimum (Fair Value, Amortized Cost) = 75,000

Bond 6 = minimum (Fair Value, Amortized Cost) = 8,000

Total Carrying value = 21,000 + 75,000 + 8,000 = 104,000

Part b: 1.5 points

Sample answers:

- Cash is only 1.6% of admitted assets so a regulator would be concerned about liquidity, the insurer's ability to quickly pay out claims.
- 42.9% of the uncollected premiums is not admitted and is too high, suggesting that much of this is due to the balance being overdue by over 90 days. The regulator would be concerned about credit risk, the insurer's ability to collect premium balances.
- The company has a high portion of stocks relative to bonds. Stocks can result in more volatile earnings. Most insurers' holdings are made up predominantly of bonds.
- Too large of a portion of bond investments are in low grade bonds (greater than class 2) which exposes the insurer to credit risk.
- The proportion of uncollected premiums and agents balances and deferred premiums and agents balances are high. They are not as liquid as other assets.