

A PUBLIC POLICY PRACTICE NOTE

Risk Transfer Practice Note

November 2022

Developed by the
Committee on Property and Liability Financial Reporting
of the American Academy of Actuaries



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(2022)

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1. Introduction

This practice note is not a promulgation of the Actuarial Standards Board (ASB), is not an actuarial standard of practice (ASOP), is not binding upon any actuary, and is not a definitive statement as to what constitutes generally accepted practice in the area under discussion. Events occurring subsequent to the publication of this practice note may make the practices described in this practice note irrelevant or obsolete.

This practice note was prepared by the Committee on Property and Liability Financial Reporting (COPLFR) of the Casualty Practice Council of the American Academy of Actuaries (Academy). COPLFR is a committee comprised of actuaries from various roles in the property and casualty (P&C) industry that monitors and advises on activities as respects financial reporting related to P&C risks. COPLFR periodically updates and publishes this practice note as required.

COPLFR also authors other publications that may be useful for practicing actuaries and provides comment from an independent actuarial viewpoint on financial reporting issues and proposed reporting changes as they develop that may impact the work of practicing actuaries.

1.1 What are practice notes?

The Academy's Guidelines for Developing Practice Notes¹ states:

"The purpose of practice notes is to provide information to actuaries on current or emerging practices in which their peers are engaged. They are intended to supplement the available actuarial literature, especially where the practices addressed are subject to evolving technology, recently adopted external requirements, or advances in actuarial science and other applicable disciplines.

...

Practice notes are not interpretations of actuarial standards of practice nor are they meant to be a codification of generally accepted actuarial practice. Actuaries are not bound in any way to comply with practice notes or to conform their work to the practices described in practice notes."²

1.1.1 Discussion

Practice notes provide discussion and illustration on areas of common practice among actuaries. Each practice note focuses on a specific topic or application of practice.

As noted in the Academy's guidelines, practice notes are not intended to be an interpretation of the actuarial standards of practice, nor are practice notes meant to be a codification of generally accepted or appropriate actuarial practice. Actuaries are not in any way bound to comply with practice notes or to conform their work to the practices they describe.

1.2 Purpose of this practice note

The purpose of this practice note is to provide information to actuaries on current practices in which their peers are engaged related to the determination of the existence of risk transfer within insurance and reinsurance contracts.

1.2.1 Discussion

¹ Adopted by the Academy's Board of Directors in September 2006.

² Id. See <http://www.actuary.org/content/guidelines-developing-practice-notes>.

Each year COPLFR reviews and updates the practice note for Statement of Actuarial Opinion (SAOs) on P&C loss reserves. The updates typically include discussion around changes in the National Association of Insurance Commissioners (NAIC) Annual Statement Instructions—Property/Casualty, Actuarial Opinion (NAIC SAO Instructions). Changes to this year’s practice note that are due to any new 2021 requirements from the ASB or NAIC (i.e., new or revised ASOP, NAIC Annual Statement Instructions, or Statement of Statutory Accounting Principles [SSAP]s) are highlighted in yellow, while additional discussion or clarifying edits are highlighted in gray. Minor edits such as year changes, moving text, correcting typos, and areas with deleted text may not be highlighted.

1.2.2 Terms of construction

As with the ASOPs promulgated by the ASB, there are certain terms used throughout this practice note that are integral to an informed reading. These include “must,” “should,” and “may”. Rather than paraphrase these definitions, we will quote the definitions as provided in ASOP No. 1, *Introductory Standard of Practice*, section 2.1; these definitions are equally applicable to this practice note where it relates to actuarial

Must/Should — The words “must” and “should” are used to provide guidance in the ASOPs. “Must” as used in the ASOPs means that the ASB does not anticipate that the actuary will have any reasonable alternative but to follow a particular course of action. In contrast, the word “should” indicates what is normally the appropriate practice for an actuary to follow when rendering actuarial services. Situations may arise where the actuary applies professional judgment and concludes that complying with this practice would be inappropriate, given the nature and purpose of the assignment and the principal’s needs, or that under the circumstances it would not be reasonable or practical to follow the practice.

Failure to follow a course of action denoted by either the term “must” or “should” constitutes a deviation from the guidance of the ASOP. In either event, the actuary is directed to ASOP No. 41, *Actuarial Communications*.

The terms “must” and “should” are generally followed by a verb or phrase denoting action(s), such as “disclose,” “document,” “consider,” or “take into account.” For example, the phrase “should consider” is often used to suggest potential courses of action. If, after consideration, in the actuary’s professional judgment an action is not appropriate, the action is not required and failure to take this action is not a deviation from the guidance in the standard.

May—“May” as used in the ASOPs means that the course of action described is one that would be considered reasonable and appropriate in many circumstances. “May” in ASOPs is often used when providing examples (for example, factors the actuary may consider; methods that may be appropriate). It is not intended to indicate that a course of action is reasonable and appropriate in all circumstances, nor to imply that alternative courses of action are impermissible.

Additionally, this practice note uses the term “required” when the course of action is required by a particular body (e.g., the NAIC’s SSAP 62R or the Financial Accounting Standards Board’s [FASB] Accounting Standards Codification [ASC] Topic 944), as specified.

2. Executive Summary

The first major regulatory recommendation for the treatment of risk transfer in property and casualty insurance was issued at the end of 1992 with the publication by the Financial

Accounting Standards Board (FASB) of Statement of Financial Accounting Standards (FAS) No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts*. Shortly thereafter, the NAIC revised statutory accounting for property and casualty reinsurance with amendments to Chapter 22 of its *Accounting Practices & Procedures Manual for Property and Casualty Companies*, which adopted FAS 113 and Emerging Issues Task Force (EITF) 93-6 *Accounting for Multiple-Year Retrospectively Rated Contracts by Ceding and Assuming Enterprises*, with modification.^{3,4} This amendment was incorporated into Statement of Statutory Accounting Principle (SSAP) No. 62—*Property and Casualty Reinsurance* in early 2000 effective from January 1, 2001.⁵ Finally, in 2017, the International Accounting Standards Board (IASB) released International Financial Reporting Standard (IFRS) 17, *Insurance Contracts*, which is expected to become effective on January 1, 2023, for most jurisdictions outside of the U.S. We will compare how each of these pronouncements treat risk in (re)insurance contracts, pointing out similarities and differences. We will also touch on the insurance solvency regime put in place by the European Insurance and Occupational Pensions Authority (EIOPA), Solvency II, which is included as insurance regulatory oversight in many countries where IFRS 17 will be applied.

This practice note updates the *Risk Transfer Testing Practice Note* released in January 2007 by COPLFR. That report followed COPLFR's *Risk Transfer Testing Practice Note: Report to the Casualty Actuarial Task Force of the National Association of Insurance Commissioners*, released in August 2005 in anticipation of the requirement to include a Reinsurance Attestation Supplement within the Annual Statement.

The excerpts describing risk transfer in the sections below are not intended to be an all-encompassing treatment of risk transfer as discussed in the U.S. Statutory, U.S. GAAP and IASB insurance standards for property and casualty (non-life) insurance and reinsurance. In evaluating risk transfer, the decisionmaker needs to consider the definitions of “significant,” “reasonably possible,” and “remote” from the perspective of the entity. This involves the interpretation of accounting guidance, which are outside of the scope of this practice note. The actuary may wish to read the remaining portions of SSAP 62R, FASB ASC Topic 944, and IFRS 17, including the questions and answers to these statements. The actuary might also consider consulting with accounting and/or legal professionals as he or she deems appropriate to assist in understanding the issue of risk transfer in reinsurance contracts.

3. Introduction—Background and Purpose

a. Background

For statutory accounting, beginning with the 2005 Annual Statement, U.S. domiciled insurance company executives (CEO and CFO) were required to provide a Reinsurance Attestation Supplement, corroborating that they maintain risk transfer analysis documentation, as applicable. This requirement applies to all ceded reinsurance contracts that satisfy the following criteria:

- The contract is effective or amended after January 1, 1994;
- The ceding company is “taking credit for” the contract in its current financial statement (i.e. has either established an asset or reduced a liability); and
- Risk transfer is not “reasonably self-evident.”

³ Statutory Issue Paper No. 75, *Property and Casualty Reinsurance*, National Association of Insurance Commissioners.

⁴ FAS 113 is and EITF 93-6 are superseded. Guidance from FAS 113 and EITF 93-6 currently resides in FASB Accounting Standard Codification (ASC) Topic 944, *Financial Services—Insurance*.

⁵ SSAP No. 62 was substantively revised primarily to incorporate guidance originally from EITF 93-6 and EITF Topic D-35, *FASB Staff Views on Issue No. 93-6, Accounting for Multiple-Year Retrospectively Rated Contracts by Ceding and Assuming Enterprises*, effective January 1, 2019. SSAP No. 62R refers to the revised statement.

The insurance industry had recently undergone a significant oversight review by regulators related to the proper recognition of reinsurance contracts regarding risk transfer with the NAIC providing a list of attestations to be addressed. These NAIC attestations require that the CEO and CFO of U.S. regulated non-life insurance companies attest that their company:

- Had no separate written or oral agreements that limited recoveries under a ceded reinsurance contract, other than inuring contracts explicitly defined in the reinsurance contract;
- Could provide documentation for all cessions incepting, renewed or amended after December 31, 1993, regarding the economic intent of the ceded reinsurance transaction, including risk transfer analysis to provide support for the proper accounting treatment where risk transfer is not self-evident;
- Complied with the requirements set forth in SSAP 62R; and
- Had appropriate controls in place to monitor the use of reinsurance and adhered to the provisions of SSAP 62R.

The Academy reissues practice notes periodically as practice evolves and as more guidance on certain elements of a process is needed. Changes in both the prior existing sources as well as a new standard regarding risk transfer have occurred since the publication of the 2007 risk transfer testing practice note, so an update was deemed beneficial.

b. Purpose

This practice note intends to be a more universal document on risk transfer for property and casualty insurance, touching upon:

- Definitions and relationships between regulatory treatments of risk transfer, including, US Statutory, U.S. generally accepted accounting principles (GAAP), International Financial Reporting Standards (IFRS) 17, and Solvency II;
- Determination of risk transfer;
- Identification of current techniques used in practice for determining risk transfer; and
- Recommended documentation from the perspective of both the company and the actuary.

4. Definitions of Risk Transfer Within Accounting Standards and Statements and Their Implications

a. Accounting Standards and Statements

The insurance industry has adapted to the significant increase in regulatory oversight relating to reinsurance contracts from the time that FAS 113 was adopted at the end of 1992, effective for fiscal years commencing after December 15, 1992. The FASB clarified the accounting treatment of multiple year retrospectively rated reinsurance contracts under the US GAAP Standard with the publication of EITF 93-6 and extended the impact to include a limited number of multiple-year retrospectively rated insurance contracts under EITF 93-14. The NAIC adopted FAS 113 and EITF 93-6 with modification through an amendment to Chapter 22 of the P&C Accounting Practices and Procedures Manual and ultimately issued SSAP 62 in early 2000, becoming effective at January 1, 2001 (there have been a number of revisions)⁶. Finally, in 2017, the IASB released IFRS 17,

⁶ EITF 93-6 was explicitly incorporated into SSAP 62R when the latter was revised in 2018, effective January 1, 2019

which is to become effective on January 1, 2023, for most jurisdictions outside of the U.S., including U.S. subsidiaries of foreign-owned corporations. We also will discuss the insurance solvency regime put in place by the EIOPA, Solvency II. Solvency II is included as it provides insurance regulatory oversight in many countries where IFRS 17 will provide the accounting standards. Thus, the relationship between Solvency II and IFRS17 is akin to the relationship between the U.S. Statutory regime and U.S. GAAP.

This practice note will discuss risk transfer as defined by these various accounting and regulatory standards and will highlight the differences.

i) U.S. Statutory

SSAP 62R

The NAIC issues the U.S. Statutory accounting guidance underlying the completion of an insurer's Annual Statement and audited financial statements; it is provided in the SSAPs, which are published in the NAIC's *Accounting Practices and Procedures Manual*. Guidance regarding the recording of reinsurance transactions, including the definition of risk transfer, is provided in *SSAP 62R: Property and Casualty Reinsurance*. The statement's scope "establishes statutory accounting principles for property and casualty reinsurance,"⁷ but it also declares, "Many short-duration insurance and reinsurance contracts have retrospective rating provisions."⁸ SSAP 62R ultimately adopts portions of the Association of International Certified Professional Accountants' (AICPA's) Statement of Position 98-7, *Deposit Accounting: Accounting for Insurance and Reinsurance Contracts That Do Not Transfer Insurance Risk*,⁹ but treatment for insurance contracts is outside the scope of SSAP 62R.

Risk Transfer Defined

Paragraphs 10 through 21 of SSAP 62R are subtitled "Reinsurance Contracts Must Include Transfer of Risk."

SSAP 62R notes:

"Indemnification of the ceding entity against loss or liability relating to insurance risk in reinsurance requires both of the following:

- The reinsurer assumes significant insurance risk under the reinsured portions of the underlying insurance agreements; and
- It is reasonably possible that the reinsurer may realize a significant loss from the transaction."¹⁰

This paragraph goes on to say, "The conditions are independent and the ability to meet one does not mean that the other has been met. A substantive demonstration that both conditions have been met is required to transfer risk."¹¹

This statement elaborates, "Whether underwriting risk has transferred to the reinsurer depends on how much uncertainty about the ultimate amount of net cash flows from premiums,

⁷ SSAP 62R §1.

⁸ SSAP 62R §61.

⁹ SSAP 62R §127.

¹⁰ SSAP 62R §13.

¹¹ Ibid.

commissions, claims, and claim settlement expenses paid under a contract has been transferred to the reinsurer.”¹²

SSAP 62R states, “Insurance risk involves uncertainties about both (a) the ultimate amount of net cash flows from premiums, commissions, claims, and claims settlement expenses (underwriting risk) **and** (b) the timing of the receipt and payment of those cash flows (timing risk). Actual or imputed investment returns are not an element of insurance risk. Insurance risk is fortuitous—the possibility of adverse events occurring is outside the control of the insured.”¹³ (emphasis added)

“A reinsurer shall not have assumed significant insurance risk under the reinsured contracts if the probability of a significant variation in either the amount **or** timing of payments by the reinsurer is remote.”¹⁴ (emphasis added)

Finally, “the ceding entity’s evaluation of whether it is reasonably possible for a reinsurer to realize a significant loss from the transaction shall be based on the present value of all cash flows between the ceding and assuming companies under reasonably possible outcomes, without regard to how the individual cash flows are described or characterized. An outcome is reasonably possible if its probability is more than remote.”¹⁵

Interest Rate Guidance

“The same interest rate shall be used to compute the present value of cash flows for each reasonably possible outcome tested. A constant interest rate shall be used in determining those present values because the possibility of investment income varying from expectations is not an element of insurance risk. Judgment is required to identify a reasonable and appropriate interest rate. To be reasonable and appropriate, that interest rate shall reflect both of the following:

- The expected timing of payments to the reinsurer; and
- The duration over which those cash flows are expected to be invested by the reinsurer.”¹⁶

According to the standard, “a complete understanding includes an evaluation of all contractual features that (a) limit the amount of insurance risk to which the reinsurer is subject (e.g., experience refunds, cancellation provisions, adjustable features, or additions of profitable lines of business to the reinsurance contract) or (b) delay the timely reimbursement of claims by the reinsurer (e.g., payment schedules or accumulation retentions from multiple years).”¹⁷ In determining reasonably possible outcomes, in addition to contractual features of a financial nature, the ceding entity might consider those situations where it may not be in a position to recover under the agreement; for example, insolvency.

SSAP 62R contains a description of one instance where cash flow testing is not required to demonstrate risk transfer. “If, based on this comparison, the reinsurer is not exposed to the reasonable possibility of significant loss, the ceding entity shall be considered indemnified against loss or liability relating to insurance risk only if substantially all of the insurance risk relating to the reinsured portions of the underlying insurance agreements has been assumed by the reinsurer. In this narrow circumstance, the reinsurer’s economic position is virtually

¹² SSAP 62R §16.

¹³ SSAP 62R §11.

¹⁴ SSAP 62R §16.

¹⁵ SSAP 62R §17.

¹⁶ SSAP 62R §17.

¹⁷ SSAP 62R §12.

equivalent to having written the insurance contract directly. The assessment of that condition shall be made by comparing both of the following: (a) The net cash flows of the reinsurer under the reinsurance contract; and (b) The net cash flows of the ceding entity on the reinsured portions of the underlying insurance contracts.”¹⁸ That is, “when substantially all of the insurance risk relating to the reinsured portions of the underlying insurance contracts has been assumed by the reinsurer, the contract meets the conditions for reinsurance accounting.”¹⁹ But, “If the economic position of the reinsurer relative to the insurer cannot be determined, the contract shall not qualify under the exception” in §18.

In conclusion, “the essential ingredient of a reinsurance contract is the transfer of risk..., [u]nless the agreement contains this essential element of risk transfer, no credit shall be recorded.”²⁰

ii) Financial Accounting Standards Board

FASB ASC 944

FASB ASC 944, *Financial Services–Insurance*, codifies much of the guidance from superseded FAS No. 113. The actuary will likely also find this document helpful when considering the issue of risk transfer.

Risk Transfer Defined

There are parallels between SSAP 62R and FASB ASC 944. Of particular interest are FASB ASC and SSAP 62R regarding the definition of insurance risk: “[t]he risk arising from uncertainties about both underwriting risk and timing risk. Actual or imputed investment returns are not an element of insurance risk. Insurance risk is fortuitous; the possibility of adverse events occurring is outside the control of the insured.”²¹ Additionally, “The guidance in the Reinsurance Subsections of this Subtopic applies to the following instruments:

- (a) Any Transaction, regardless of its form, whose individual terms indemnify an insurer against loss or liability relating to insurance risk. That is, all contracts, including contracts that may not be structured or described as reinsurance, shall be accounted for as reinsurance if those conditions are met, including reinsurance contracts used to, in effect, sell a line of business by coinsuring all or substantially all of the risks related to the line.
- (b) All contract amendments.²²

Similar to paragraph 13 of SSAP 62R, FASB ASC 944 reads as follows:

“Unless the condition in paragraph 944-20-15-53 is met, indemnification of the ceding entity against loss or liability relating to insurance risk in reinsurance of short-duration contracts exists under paragraph 944-20-15-37(a) only if both of the following conditions are met:

- (a) Significant insurance risk. The reinsurer assumes significant insurance risk under the

¹⁸ SSAP 62R §18.

¹⁹ SSAP 62R §19.

²⁰ SSAP 62R §10.

²¹ FASB ASC 944-20-20.

²² FASB ASC 944-20-15-37.

reinsured portions of the underlying insurance contracts. Implicit in this condition is the requirement that both the amount and timing of the reinsurer's payments depend on and directly vary with the amount and timing of claims settled under the reinsured contracts.

- (b) Significant loss. It is reasonably possible that the reinsurer may realize a significant loss from the transaction.

The conditions are independent and the ability to meet one does not mean that the other has been met. A substantive demonstration that both conditions have been met is required for a short-duration contract to transfer risk.”²³

Further, FASB ASC 944 elaborates: “A reinsurer shall not be considered under paragraphs 944-20-15-37(a) to have assumed significant insurance risk under reinsured short duration contracts if the probability of a significant variation in either the amount or timing of payments by the reinsurer is remote. Contractual provisions that delay timely reimbursement to the ceding enterprise would prevent this condition from being met because they prevent the reinsurer’s payments from directly varying with the claims settled under the reinsured contract.”²⁴

Similar to SSAP 62R, FASB ASC 944 requires that:

“Significance of loss shall be evaluated by comparing the following:

- (a) The present value of all cash flows (determined as described in paragraph 944-20-15-49)
- (b) The present value of the amounts paid or deemed to have been paid to the reinsurer.

Determining (for purposes [b]) the amounts paid or deemed to have been paid for reinsurance requires an understanding of all contract provisions. For example, payments and receipts under a reinsurance contract may be settled net. The ceding entity may withhold funds as collateral or may be entitled to compensation other than recovery of claims. Gross premiums shall be used – expenses shall not be deducted from premiums in evaluating the significance of a reasonably possible loss.”²⁵

Interest Rate Guidance

FASB ASC 944 requires the cedent to use a single interest rate for all reasonable outcomes to be tested:

“The ceding entity’s evaluation of whether it is reasonably possible for a reinsurer to realize a significant loss from the transactions shall be based on the present value of all cash flows between the ceding and assuming entities under reasonably possible outcomes, without regard to how the individual cash flows are characterized. The same interest rate shall be used to compute the present value of cash flows for each reasonable possible outcome tested. To be reasonable and appropriate. That rate shall reflect both of the following:

- (a) The expected timing of payments to the reinsurer
- (b) The duration over which those cash flows are expected to be invested by the reinsurer.”²⁶

Later, the FASB ASC 944 elaborates:

²³ FASB ASC 944-20-15-41.

²⁴ FASB ASC 944-20-15-46.

²⁵ FASB ASC 944-20-15-51.

²⁶ FASB ASC 944-20-15-49.

“All cash flows are included in the calculation in the preceding (FASB ASC 944-20-15-49) paragraph because payments that effectively represent premiums or refunds of premiums may be described in various ways under the terms of a reinsurance contracts. The way a cash flows is characterized does not affect whether it should be included in determining the reinsurer’s exposure to loss. Only cash flows between the ceding and assuming entities are considered, therefore precluding consideration of other expenses of the reinsurer (such as taxes and operating expenses) in the calculation.”²⁷

“Because the present value of cash flows shall be determined over the period in which cash flows are reasonably expected to occur, unless commutation (termination) is expected in the scenario being evaluated, commutation shall not be assumed in the calculation. Further, the assumptions used in a scenario shall be internally consistent and economically rational for that scenario’s outcome to be considered reasonably possible.”²⁸

For testing required to demonstrate significance of loss, both SSAP 62R and FASB ASC 944 have described a case wherein such testing is not required. When discussing this situation, this practice note uses the term “**substantially all**”.²⁹

FASB ASC 944 states:

“If, based on the comparison in paragraph 944-20-15-51, the reinsurer is not exposed to the reasonable possibility of significant loss, the ceding entity shall be considered indemnified against loss or liability relating to insurance risk only if substantially all of the insurance risk relating to the reinsured portions of the underlying insurance contracts has been assumed by the reinsurer. That condition is met only if insignificant insurance risk is retained by the ceding entity on the reinsured portions of the underlying insurance contracts. The assessment of that condition shall be made by comparing both of the following:

- (a) The net cash flows of the reinsurer under the reinsurance contract
- (b) The net cash flows of the ceding entity on the reinsured portions of the underlying insurance contracts.

If the economic position of the reinsurer relative to the insurer cannot be determined, the contract shall not qualify under the exception in this paragraph.”³⁰

“The extremely narrow and limited exemption in the preceding paragraph [FASB ASC 944-20-15-53] is for contracts that reinsure either an individual risk or an underlying book of business that is inherently profitable. To qualify under that exception, no more than trivial insurance risk on the reinsured portions of the underlying insurance contracts may be retained by the ceding entity. The reinsurer’s economic position shall be virtually equivalent to having written the relevant portions of the reinsured contracts directly.”³¹

FASB extended the impact of FAS 113 (as well as the clarifying document, EITF 93-6) to include a limited number of insurance contracts under EITF 93-14, i.e., certain multiple-year retrospectively rated insurance contracts. Under FASB ASC 944:

²⁷ FASB ASC 944-20-15-50.

²⁸ FASB ASC 944-20-15-52.

²⁹ FASB ASC 944-20-15-53, and FASB ASC 944-20-15-54, and SSAP 62R §18.

³⁰ FASB ASC 944-20-15-53.

³¹ FASB ASC 944-20-15-54.

"Paragraph 720-20-25-1 states that, to the extent than an insurance contract or reinsurance contract does not, despite its form, provide for indemnification of the insured or the ceding entity by the issuer or reinsurer against loss or liability, the premium paid less the amount of the premium to be retained by the insurer or reinsurer shall be accounted for as a deposit by the insured or the ceding entity."³²

FASB ASC 720 clarifies this in saying:

"Those contracts may be structured in various ways, but if, regardless of form, their substance is that all or part of the premium paid by the insured or the ceding entity is a deposit, it shall be accounted for as such."³³

iii) International Accounting Standards Board (IASB)

IFRS 17

Risk Transfer Defined

IFRS 17—Insurance Contracts states that:

One of "[t]he key principles in IFRS 17 [is] that an entity identifies as insurance contracts as those contracts under which the entity accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder."³⁴ IFRS 17 defines an insurance contract as "[a] contract under which one party (the issuer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder."³⁵

IFRS 17 does not distinguish between an insurance contract and a reinsurance assumed contract, The standard states: "An entity shall apply IFRS 17 to:

- (a) insurance contracts, including reinsurance contracts, it issues;
- (b) reinsurance contracts it holds; and
- (c) investment contracts with discretionary participation features it issues, provided the entity also issues insurance contracts."³⁶

Further, a reinsurance contract is defined as: An insurance contract issued by one entity (the reinsurer) to compensate another entity for claims arising from one or more insurance contracts issued by that other entity (underlying contracts).³⁷ From the perspective of the standard, an entity is expected to treat the insurance risks that it writes similarly to the reinsurance contracts that it issues. The purchase of reinsurance, i.e., reinsurance held (or ceded reinsurance) is handled separately with significant discussion in §§60-70 of the standard.

³² FASB ASC 944-20-15-1B.

³³ FASB ASC 720-20-25-1.

³⁴ IFRS 17 §IN6.

³⁵ IFRS 17 Appendix A.

³⁶ IFRS 17 §3.

³⁷ IFRS 17 Appendix A.

Insurance risk is defined as,

“Risk, other than financial risk, transferred from the holder of a contract to the issuer,”³⁸

while the definition of financial risk is,

“The risk of a possible future change in one or more of a specified interest rate, financial instrument price, commodity price, currency exchange rate, index of prices or rates, credit rating or credit index or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract.”³⁹

To further clarify, IFRS 17 states that “a contract that exposes the issuer to financial risk without significant insurance risk is not an insurance contract.”⁴⁰

Elaborating on what constitutes insurance risk, IFRS 17 states:

“Insurance risk is significant if, and only if, an insured event could cause the issuer to pay additional amounts that are significant in any single scenario, excluding scenarios that have no commercial substance (i.e., no discernible effect on the economics of the transaction). If an insured event could mean significant additional amounts would be payable in any scenario that has commercial substance, the condition in the previous sentence can be met even if the insured event is extremely unlikely, or even if the expected (i.e., probability-weighted) present value of the contingent cash flows is a small proportion of the expected present value of the remaining cash flows from the insurance contract.”⁴¹

The IASB provides commonality to SSAP 62R and FASB ASC 944 regarding insurance structures that do not expose the assuming carrier with significant loss as IFRS 17 states:

“In addition, a contract transfers significant insurance risk only if there is a scenario that has commercial substance in which the issuer has a possibility of a loss on a present value basis. However, even if a reinsurance contract does not expose the issuer to the possibility of a significant loss, that contract is deemed to transfer significant insurance risk if it transfers to the reinsurer substantially all the insurance risk relating to the reinsured portions of the underlying insurance contracts.”⁴²

Note that the IASB, in addition to the FASB and the NAIC, states that risk is transferred if substantially all of the risk is transferred from the policyholder to the insurer and no analytical analyses are required in this situation.⁴³ Note also that both the FASB and the NAIC have included commentary that “the reinsurer’s economic position is virtually equivalent to having written the insurance contract directly” whereas the IASB does not discuss this equivalence.

Risk is determined at the contract level:

³⁸ IFRS 17 Appendix A.

³⁹ Ibid.

⁴⁰ IFRS 17 §B7.

⁴¹ IFRS 17 §B18.

⁴² IFRS 17 §B19.

⁴³ FAS 113 §67, SSAP 62R §18, and FASB ASC 944-20-15-1B.

“An entity shall assess the significance of insurance risk contract by contract. Consequently, the insurance risk can be significant even if there is minimal probability of significant losses for a portfolio or group of contracts.”⁴⁴

Further,

“A contract that meets the definition of an insurance contract remains an insurance contract until all rights and obligations are extinguished (i.e., discharged, cancelled or expired), unless the contract is derecognized applying paragraphs 74–77, because of a contract modification.”⁴⁵

The ability to modify a non-life contract is severely limited within the standard.

Interest Rate Guidance

The IASB goes further than SSAP 62R or FASB ASC 944 regarding the interest rate to use in determining the present value. While there is extensive discussion about the consideration of the interest rate to be employed, the following provides several considerations for use on non-life insurance contracts:

“For cash flows of insurance contracts that do not vary based on the returns on underlying items, the discount rate reflects the yield curve in the appropriate currency for instruments that expose the holder to no or negligible credit risk, adjusted to reflect the liquidity characteristics of the group of insurance contracts. That adjustment shall reflect the difference between the liquidity characteristics of the group of insurance contracts and the liquidity characteristics of the assets used to determine the yield curve. Yield curves reflect assets traded in active markets that the holder can typically sell readily at any time without incurring significant costs. In contrast, under some insurance contracts the entity cannot be forced to make payments earlier than the occurrence of insured events, or dates specified in the contracts.”⁴⁶

IFRS 17 goes on to provide additional direction:

“For cash flows of insurance contracts that do not vary based on the returns on underlying items, an entity may determine discount rates by adjusting a liquid risk-free yield curve to reflect the differences between the liquidity characteristics of the financial instruments that underlie the rates observed in the market and the liquidity characteristics of the insurance contracts (a bottom-up approach).”⁴⁷

IFRS 17 states that “An entity shall use the discount rates required in paragraph 36 to determine the present value of the additional amounts”⁴⁸ required for confirming risk transfer. These rates align with those employed when posting financial results under IFRS 17 where this standard states in paragraph 36:

⁴⁴ IFRS 17 §B22.

⁴⁵ IFRS 17 §B25.

⁴⁶ IFRS 17 §B79.

⁴⁷ IFRS 17 §B80.

⁴⁸ IFRS 17 §B20.

“An entity shall adjust the estimates of future cash flows to reflect the time value of money and the financial risks related to those cash flows, to the extent that the financial risks are not included in the estimates of cash flows. The discount rates applied to the estimates of the future cash flows described in paragraph 33 shall:

- reflect the time value of money, the characteristics of the cash flows and the liquidity characteristics of the insurance contracts;
- be consistent with observable current market prices (if any) for financial instruments with cash flows whose characteristics are consistent with those of the insurance contracts, in terms of, for example, timing, currency and liquidity; and
- exclude the effect of factors that influence such observable market prices but do not affect the future cash flows of the insurance contracts.”⁴⁹

Later, IFRS 17 clarifies the discount rate as “the yield curve (or range of yield curves) used to discount cash flows that do not vary based on the returns on underlying items, applying paragraph 36.”⁵⁰ In this case, one assumes that the cash flows are the expected nominal amount. IFRS 17 also requires the reporting entity to provide disclosures of the yield curves employed.⁵¹

iv) European Insurance and Occupational Pensions Authority (EIOPA)

Solvency II

Solvency II sets out principles for the valuations of the reinsurance that need to be applied to submissions to insurance regulators under EIOPA and these provide information related to an entity’s solvency. Similar to IFRS 17, Solvency II Article 77 (2) states that the Best Estimate Liability “shall correspond to the probability-weighted average of future cash-flows, taking into account the time value of money (expected present value of future cash-flows), using the relevant risk-free interest rate term structure.” These rates are dictated by EIOPA for the various underlying currencies. However, Solvency II does not test for specific risk transfer in determination of those liabilities that fall within the statutory balance sheet, so no further discussion is presented in the remainder of this practice note.

b. Compare and Contrast

FASB ASC 944 vs SSAP 62R

Risk transfer was introduced by the FASB for fiscal years beginning after December 15, 1992. SSAP 62R covers reinsurance agreements effected, renewed or amended after December 31, 1993, as well as all reinsurance agreements in force after December 31, 1994.⁵² SSAP 62R and FASB ASC 944 have nearly identical definitions of insurance risk, what is required of indemnification, and the determination of the present value of the cash flows used to determine whether the risk has actually been transferred. Additionally, the verbiage in each of these two standards is nearly identical. As such, this practice note highlights the main components of the

⁴⁹ IFRS 17 §36.

⁵⁰ IFRS 17 §120.

⁵¹ Ibid. In addition, IFRS 17 §117 states that: “[a]n entity shall disclose the significant judgements and changes in judgements made in applying IFRS 17.”

⁵² SSAP 62R §129.

process of determining risk transfer for these on a combined basis below, exposing the one area where they differ. These two standards relate to an entity reviewing its reinsurance contracts, with FASB including consideration of certain multiple-year retrospectively rated insurance contracts.⁵³

Recall—insurance risk arises from underwriting risk (the ultimate amount of net cash flows from premiums, commissions, claims, and claims settlement expenses paid under a contract) and timing risk (i.e., timing of the receipt and payments related to the net cash flows from premiums, commissions, claims, and claim settlements expenses paid under the contract). Actual or imputed investment returns are not an element of insurance risk. Insurance risk is fortuitous: The possibility of adverse events occurring is outside the control of the insured.⁵⁴ The indemnification of the cedent requires both that the reinsurer assumes significant insurance risk from the portions of the underlying agreements that are reinsured and that the reinsurer is exposed to the reasonable possibility of a significant loss from the transaction.⁵⁵ FASB ACS 944 describes the process of “assessing indemnification” as follows:

Determining under paragraph 944-20-15-37(a) whether a contract with a reinsurer provides indemnification against loss or liability relating to insurance risk requires a complete understanding of that contract and other contracts or agreements between the ceding entity and related reinsurers. A complete understanding includes an evaluation of all contractual features that do either of the following:

- (a) Limit the amount of insurance risk to which the reinsurer is subject (such as through experience refunds, cancellation provisions, adjustable features, or additions of profitable lines of business to the reinsurance (contract))
- (b) Delay the timely reimbursement of claims by the reinsurer (such as through payment schedules or accumulating retentions from multiple years).

This risk transfer assessment shall be made at contract inception, based on facts and circumstances known at that time.⁵⁶

Then, when the cedent determines the significance of the loss, it is to be determined by considering the present value of all cash flows between the cedent and the reinsurer regardless of how those cash flows are characterized. The same (or constant) interest rate will be used to determine the present value of each reasonably possible outcome. The single rate is selected because investment income differing from expectations is not a component of insurance risk.⁵⁷ Each standard uses identical language to discuss the process to determine “reasonable possibility of significant loss,” which is accomplished by comparing the present value of all cash flows between the cedent and the reinsurer with the present value of the cash flows paid (or deemed to have been paid) to the reinsurers. Further, the implication is that if there is a “reasonable possibility of significant loss,” then the cedent will be considered indemnified by the reinsurance contract. Even if there is not a “reasonable possibility of significant loss,” the cedent is considered indemnified if the cedent has ceded “substantially all of the insurance risk relating to the reinsured portions of the underlying insurance agreements has been assumed by the reinsurer. In this

⁵³ Initially under EITF 93-14.

⁵⁴ SSAP 62R §11 and the definition of insurance risk located, including underwriting and timing risk, in FASB ASC 944-20-20.

⁵⁵ SSAP 62R §13 and FASB ASC 944-20-15-41

⁵⁶ FASB ASC 944-20-15-40

⁵⁷ SSAP 62R §17 and FASB ASC 944-20-15-49

narrow circumstance, the reinsurer's economic position is virtually equivalent to having written the insurance contract directly."⁵⁸ However, "[i]f the economic position of the reinsurer relative to the insurer cannot be determined, the contract shall not qualify under the exception in this paragraph."⁵⁹ SSAP 62R expands on this aspect by discussing that cessions transferring "inherently profitable" business to a reinsurer qualify for the "substantially all" exception when only insignificant portions of the reinsured exposures may be retained by the cedent.⁶⁰ Note that FASB ACS 944 states that substantially all of the insurance risk related to reinsured portions of the underlying insurance contracts are to be assessed "comparing both of the following: (a) the net cash flows of the reinsurer under the reinsurance contract; (b) the net cash flows of the ceding entity on the reinsured portions of the underlying insurance contracts."⁶¹

The sole wording difference in determining risk transfer between FAS 113 and SSAP 62R lies in the selection of the constant interest rate to be employed. The FASB does not require the reporting entity to "specify in detail the interest rate used in the calculation" as judgment will be applied when selecting a reasonable and appropriate interest rate.⁶² SSAP 62R takes the above directive from FAS 113, but adds the clarification that a "reasonable and appropriate interest rate" will consider both the expected timing of the payments to the reinsurer and the duration where those cash flows may be invested by the reinsurer.⁶³ FASB ASC 944 clarifies that the rate should be "reasonable and appropriate" and needs to reflect the timing of the payments to the reinsurer and the duration over which the reinsurer will be expected to invest those funds based upon the cash flows.⁶⁴

IFRS 17 vs. FASB ASC 944 and SSAP 62R

Scope

IFRS 17's scope differs from each of FASB ASC 944 and SSAP 62R in that the IASB standard governs any covered insuring entity for the "insurance" contracts it issues or may acquire from another insuring entity, whether it is an insurance company or a reinsurance company. While FASB ASC 944 provides guidance to a specific set of insurance contracts that an insurance company might issue, its main purpose remains the treatment of reinsurance contracts. For SSAP 62R, discussion is limited to reinsurance contracts.

IFRS 17's perspective on risk also differs. For each of FASB ASC 944 and SSAP 62R, insurance risk requires both underwriting risk and timing risk. IFRS 17 defines insurance risk as all risks assumed from the policyholder other than financial risks.⁶⁵ Note that IFRS 17 does not require both underwriting risk and timing risk to be present for a contract to be considered to transfer insurance risk.

Threshold for Risk Transfer

⁵⁸ SSAP 62R §18, FAS 113 §11, and FASB ASC 944-20-15-53.

⁵⁹ Ibid.

⁶⁰ SSAP 62R §19.

⁶¹ FASB ASC 944-20-15-53.

⁶² FAS 113 §66.

⁶³ SSAP 62R §17.

⁶⁴ FASB ASC 944-20-15-49.

⁶⁵ IFRS 17 Appendix A.

According to the IASB, a contract transfers risk when “there is a scenario that has commercial substance in which the issuer has a possibility of a loss on a present value basis.”⁶⁶ This indicates that if the cedent finds a single situation that has commercial substance where a reinsurance contract possibly transfers a loss to the reinsurer, then that entity can consider the contract as having passed risk transfer. This IFRS 17 requirement is less stringent than those required under FASB ASC 944 and SSAP 62R, where the company is required to demonstrate that the reinsurer has a reasonable possibility of a significant loss.⁶⁷

Similarly to FASB ASC 944 and SSAP 62R, IFRS 17 states that “even if a reinsurance contract does not expose the issuer to the possibility of a significant loss, that contract is deemed to transfer significant insurance risk if it transfers to the reinsurer substantially all the insurance risk relating to the reinsured portions of the underlying insurance contracts.”⁶⁸ However, IFRS 17 does not include the requirement of economic equivalence regarding reinsurance present in FASB ASC 944 and SSAP 62R.

Present Value

In all instances, risk transfer considers the present value of the cash flows between the parties to the contracts to be analyzed in the determination. FASB ASC 944 and SSAP 62R reflect a single rate to be applied in all scenarios, whereas IFRS 17 directs the user to employ a market discount rate curve in the derivation, which will be disclosed by the entity in its financial statements.⁶⁹

Applicability

Each of FASB ASC 944 and SSAP 62R discuss the significance of loss required to be transferred in order for a cedent to recognize the transfer under a reinsurance contract. For IFRS 17, there is no differentiation between those contracts written as direct insurance and those contracts assuming reinsurance from a third party. Treatment of risk transfer is handled by both parties in a reinsurance arrangement, while only the insurer will determine risk transfer on its direct insurance products.

⁶⁶ IFRS 17 §B19.

⁶⁷ SSAP 62R §13 and FASB ASC 944-20-15-41.

⁶⁸ IFRS 17 §B19.

⁶⁹ IFRS 17 §120.

c. Summary Table

The table below consolidates the discussion above comparing the requirements from the various standards (principles) for easier review.

Item	Standard		
	FASB ASC 944	SSAP 62R	IASB IFRS 17
Definition of insurance risk	The risk arising from uncertainties about both underwriting risk and timing risk. Actual or imputed investment returns are not an element of insurance risk. Insurance risk is fortuitous; the possibility of adverse events occurring is outside the control of the insured. ⁷⁰	Insurance risk involves uncertainties about both the ultimate amount of net cash flows (... of an insurance contract) and the timing of the receipt and payment of those cash flows (i.e., underwriting risk and timing risk). Actual or imputed investment returns are not an element of insurance risk. ⁷¹	Risk, other than financial risk, transferred from the holder of a contract to the issuer. ⁷²
Cash flows to be utilized for determining risk transfer	The ceding entity's evaluation of whether it is reasonably possible for a reinsurer to realize a significant loss from the transaction shall be based on the present value of all cash flows between the ceding and assuming entities under reasonably possible outcomes, without regard to how the individual cash flows are characterized. ⁷³ Only cash flows between the ceding and assuming entities are considered, therefore precluding consideration of other expenses of the reinsurer (such as taxes and operating expenses) in the calculation. ⁷⁴	The present value of all cash flows between the ceding and assuming companies under reasonably possible outcomes, without regard to how the individual cash flows are described or characterized. ⁷⁵	The expected value (i.e., the probability-weighted mean) of the full range of possible future cash flows (of all cash flows between the policyholder and the insurance entity) ⁷⁶
Interest/discount rate to be used	"The same interest rate shall be used to compute the present value of cash flows for each reasonably possible outcome tested. To be reasonable and appropriate, that rate shall reflect both of the following: (c) The expected timing of payments to the reinsurer (d) The duration over which those cash flows are expected to be invested by the reinsurer" ⁷⁷	The same interest rate shall be used to compute the present value of cash flows for each reasonably possible outcome tested. That interest rate shall reflect both the expected timing of payments to the reinsurer and the duration over which those cash flows are expected to be invested by the reinsurer. ⁷⁸	For cash flows of insurance contracts that do not vary based on the returns on underlying items, the discount rate reflects the yield curve in the appropriate currency for instruments that expose the holder to no or negligible credit risk, adjusted to reflect the liquidity characteristics of the group of insurance contracts. ⁷⁹
Threshold for risk transfer	Unless the condition in paragraph 944-20-15-53 is met, indemnification of the ceding entity against loss or liability relating to insurance risk in reinsurance of short-duration contracts exists under paragraph 944-20-15-37(a) only if both of the following conditions are met: (a) Significant insurance risk...	Indemnification requires that the reinsurer assumes significant insurance risk under the reinsured portions of the underlying insurance agreements; and that it is reasonably possible that the reinsurer may realize a significant loss from the transaction. ⁸¹	A contract transfers significant insurance risk only if there is a scenario that has commercial substance in which the issuer has a possibility of a loss on a present value basis. ⁸²

⁷⁰ FASB ASC 944-20-20. In the same section, timing risk is defined as "[t]he risk arising from uncertainties about the timing of the receipt and payments of the net cash flows from premiums, commissions, claims, and claim settlement expenses paid under a contract," while underwriting risk is "[t]he risk arising from uncertainties about the ultimate amount of net cash flows from premiums, commissions, claims, and claim settlement expenses paid under a contract."

⁷¹ SSAP 62R §11.

⁷² IFRS 17, Appendix A—Defined Terms.

⁷³ FASB ASC 944-20-15-49.

⁷⁴ FASB ASC 944-20-15-50.

⁷⁵ SSAP 62R §17.

⁷⁶ IFRS 17 §33.

⁷⁷ FASB ASC 944-20-15-49.

⁷⁸ SSAP 62R §17.

⁷⁹ IFRS 17 §B79.

⁸¹ SSAP 62R §13.

⁸² IFRS 17 §B19.

	(b) Significant loss... The conditions are independent and the ability to meet one does not mean that the other has been met. A substantive demonstration that both conditions have been met is required for a short-duration contract to transfer risk. ⁸⁰		
Exceptions to determination	If, based on the comparison in paragraph 944-20-15-51, the reinsurer is not exposed to the reasonable possibility of significant loss, the ceding entity shall be considered indemnified against loss or liability relating to insurance risk only if substantially all of the insurance risk relating to the reinsured portion of the underlying insurance contracts has been assumed by the reinsurer. That condition is met only if insignificant insurance risk is retained by the ceding entity on the reinsured portions of the underlying insurance contracts. ⁸³	The cedent shall be considered indemnified against loss or liability relating to insurance risk only if substantially all of the insurance risk relating to the reinsured portions of the underlying insurance agreements has been assumed by the reinsurer. ⁸⁴	A contract is deemed to transfer significant insurance risk if it transfers to the reinsurer substantially all the insurance risk relating to the reinsured portions of the underlying insurance contracts. ⁸⁵
Applicability	Per § 720-20-25-1, "to the extent than an insurance contract or reinsurance contract does not, despite its form, provide for indemnification of the insured or the ceding entity by the issuer or reinsurer against loss or liability, the premium paid less the amount of the premium to be retained by the insurer or reinsurer shall be accounted for as a deposit by the insured or the ceding entity." ⁸⁶	The contracts considered are those between an insurance entity and its reinsurer. ⁸⁷	This standard is applicable to all insurance contracts, "including reinsurance contracts" issued. ⁸⁸

5. Determination of Risk Transfer

a. Process flow

FAS 113 and SSAP 62 were introduced in 1992 and 2000 (although the NAIC had earlier adopted most of FAS 113 with amendments to Chapter 22), respectively. The FASB has updated FAS 113 through codification now located in FASB ASC 944. As already highlighted, these documents have nearly identical definitions and expectations regarding risk transfer within a non-life insurance entity.

These standards were challenged in the early years of the 21st century resulting in increased responsibilities for insurers' managements in the form of increased control activities. There were several high-profile events that occurred in the early years of the 21st century that resulted in regulators increasing their oversight and strengthening regulations. These events included filing improper financial statements by Enron and WorldCom that became public in 2001 and 2002, respectively. As a result, the U.S. implemented the Sarbanes-Oxley Act in 2002.

In 2005, several attorneys general for various states joined by the Securities and Exchange Commission began reviewing various accounting activities within the insurance industry related

⁸⁰ FASB ASC 944-20-15-41.

⁸³ FASB ASC 944-20-15-53. Note: Further elaboration is provided in the paragraph as to what constitutes risk transfer in this case.

⁸⁴ SSAP 62R §18.

⁸⁵ IFRS 17 §B19.

⁸⁶ FASB ASC 944-20-15-1B.

⁸⁷ SSAP 62R §1.

⁸⁸ IFRS 17 §3.

to finite risk reinsurance. Also, in 2005, the NAIC began requiring the Reinsurance Attestation Supplement be included with the filed annual statements. The first attestations were submitted in early 2006 with the Statutory annual statement. Sarbanes-Oxley requires the CEO and CFO that the overall control activity related to the financial statements have met, while the Reinsurance Attestation Supplement requires the CEO and the CFO of the regulated non-life insurance entity to:

- attest to the accuracy of the financial documents;
- affirm that there are adequate controls in place; and
- ensure proper treatment of the accounting entries.

Also in 2006, the FASB released an invitation to comment on the accounting for reinsurance. This project was ultimately folded into the broader project for accounting changes for insurance contracts.

Thus, the determination of risk transfer has become a critical aspect of the filing of the U.S. Property and Casualty Annual Statement with the inclusion of the Reinsurance Attestation Supplement as well as the U.S. GAAP financial statements published by the various insurance entities.

As a result of the Sarbanes-Oxley Act and the NAIC's inclusion of the Reinsurance Attestation Supplement in the Annual Statement, companies implemented explicit oversight of internal controls in the attempt to ensure that underlying compliance tasks take place to meet the obligations of one or both of these requirements. In most companies, a robust compliance function is in place to provide support in the determination of the presence of risk transfer in (re)insurance contracts among various other activities regarding the balance sheet.

i. Does Risk Transfer Exist?

To determine the proper accounting treatment of a (re)insurance contract, the reporting entity must first determine whether the issuer of the contract has taken on sufficient risk from the contract it has issued. For an insurance entity, the process to formally determine and document risk transfer typically involves accounting, actuarial, and management personnel. Many insurance companies have ceded reinsurance departments charged with overseeing the risk transfer determination process, its documentation, and controls. There also are annual reinsurance interrogatories and other disclosures required to be provided within the various reporting regimes.

The process starts with a proposed contract. A complete understanding of the contract is necessary by those involved. The contract is assessed, the risk transfer analysis is completed and reviewed, and conclusions are documented. If a contract does not transfer "substantially all"⁸⁹ of the risk or the risk transfer is not reasonably self-evident, testing is required to determine

⁸⁹ FASB ASC 944-20-15-53 states "[t]hat condition is met only if insignificant insurance risk is retained by the ceding entity on the reinsured portions of the underlying contract. The assessment of that condition shall be made by comparing both of the following:

- (a) The net cash flows of the reinsurer under the reinsurance contract;
- (b) The net cash flows of the ceding entity on the reinsured portions of the underlying insurance contracts."

If the economic position of the reinsurer relative to the insurer cannot be determined, the contract shall not qualify under the exception in this paragraph.

whether “significant” risk transfer exists. This analysis likely involves actuarial expertise and methodology. Applicable methodologies are discussed later in the practice note.

ii. Controls

Once a contract is determined to have risk transfer, application of the required controls ensure that the Reinsurance Attestation Supplement⁹⁰ may be appropriately supported. In the Reinsurance Attestation Supplement, the entity’s CEO and CFO attest that:

- there are no separate written or oral agreements between the entity, including affiliates or other entities that it controls and the assuming reinsurer, that would “reduce, limit, mitigate or otherwise affect any actual or potential loss to the parties under the reinsurance contract” under any circumstances excepting inuring contracts explicitly provided within the contract as per SSAP 62R⁹¹;
- documentation is available for review of any new, renewed, or amended contract entered into after December 31, 1993, for which risk transfer cannot be considered self-evident;
- the entity complies with all requirements of SSAP 62R; and
- the entity has appropriate controls in place to monitor the use of reinsurance and adhere to the provision of SSAP 62R.

According to a survey of insurers,⁹² the following items were considered of value to include in the reinsurance contract file of the ceding entity:

- relevant correspondence between the ceding and assuming entities, which might include any related agreements, including but not limited to interlinked reinsurance contracts or trust agreements;
- a memorandum or other appropriate documentation from management describing the business purpose and the economic intent for the reinsurance cession;
- a statement regarding risk transfer, either that the risk transfer is considered to be reasonably self-evident or a copy of an analysis that displays the possible outcomes, their likelihood, and their economic impact;
- signoff from management that risk transfer has been demonstrated or is believed to be reasonably self-evident; and
- copy of signoff from an external auditor or other party as to risk transfer, if available.

⁹⁰ A description of the terms used and the requirements for the Reinsurance Attestation Supplement are included in the COPLFR’s *Reinsurance Attestation Supplement 20-1: Risk Transfer Testing Practice Note* 2007 paper, pp. 58-60.

⁹¹ Note: This language follows from SSAP 62R §12 (similar language is located in FAS 113 §8, and FASB ASC 944-20-15-40), where it states, “Determining whether a contract with a reinsurer provides indemnification against loss or liability relating to insurance risk requires a complete understanding of that contract and other contracts or agreements between the ceding enterprise and related reinsurers. A complete understanding includes an evaluation of all contractual features that (a) limit the amount of insurance risk to which the reinsurer is subject (such as through experience refunds, cancellation provisions, adjustable features, or additions of profitable lines of business to the reinsurance contract) or (b) delay the timely reimbursement of claims by the reinsurer (such as through payment schedules or accumulating retentions from multiple years).” IFRS 17 §9 defines a combination of insurance contracts as a set or series of insurance contracts with the same or a related counterparty may achieve, or be designed to achieve, an overall commercial effect. In order to report the substance of such contracts, it may be necessary to treat the set or series of contracts as a whole.

⁹² From COPLFR’s *Reinsurance Attestation Supplement 20-1: Risk Transfer Testing Practice Note* (2007).

b. Responsibilities for Determination

The insurer's accounting function is typically responsible for coordination of the risk transfer assessment process, including involving the actuary when needed. Actuaries possess the technical ability to evaluate and quantify the variability component of risk transfer. It is the responsibility of accounting to determine whether a reinsurance contract meets the standards required of SSAP 62R, FASB ASC 944, or IFRS 17 to pass risk transfer. This decision is made by the accounting function based, in part, on an actuarial evaluation of the economics of the transaction.

To the extent an actuary is asked to quantify the risk transfer, the actuary "should state the actuarial findings, and identify the methods, procedures, assumptions, and data used by the actuary with sufficient clarity that another actuary qualified in the same practice area could make an objective appraisal of the reasonableness of the actuary's work as presented" in that communication.⁹³

i. Determination

The Reinsurance Attestation Supplement identifies circumstances where contracts are excluded from all or a portion of the scope of the attestation. These exclusions are:

- Contracts with no amounts recoverable: The attestation statement identifies its scope as "all reinsurance contracts for which the reporting entity is taking credit on its current financial statement." Contracts that are not active,⁹⁴ or where there are no unearned premiums, losses, or other amounts recognized as recoverable as of the Annual Statement date are excluded from the scope of the attestation.
- Certain older contracts: Regarding maintaining documentation evidencing risk transfer, the attestation statement requires that management only consider "each such reinsurance contract entered into, renewed, or amended on or after January 1, 1994," since this is the date when the current statutory accounting rules surrounding risk transfer in reinsurance contracts became effective. Prior to that date, no risk transfer analysis was required under statutory accounting rules. The Spitzer review of insurance risk transfer in the middle years of the first decade of this century required documentation from certain (re)insurers to demonstrate that adequate risk was present in contracts that the companies deemed to provide risk transfer, thus validating applicability for all pertinent active contracts that became effective on or after January 1, 1994, with FAS 113.
- Risk transfer is reasonably self-evident: Regarding evidencing risk transfer, the attestation requires that management maintain documentation with respect to contracts "for which risk transfer is not reasonably considered to be self-evident." The purpose of this clarification is to eliminate and/or avoid the time and expense associated with unnecessary analyses but it may be appropriate to provide documentation to the file explaining why risk transfer is reasonably self-evident.

⁹³ ASOP No. 41, *Actuarial Communications*.

⁹⁴ IFRS 17 considers these contracts to be derecognized.

While the first two exclusions above provide specific, well-defined situations where testing for risk transfer is not required, the last does not. Accordingly, the discussion below provides guidance to actuaries as they assist management in determining whether risk transfer is reasonably self-evident.

The following section summarizes approaches, observed in general practice for determining whether risk transfer is reasonably self-evident. There may be contracts or classes of contracts in addition to those identified in this section for which it can be deemed that risk transfer is reasonably self-evident. In making this determination, important considerations include an evaluation of the substance of the arrangement, the existence, impact, and role of risk-limiting features, and the use of professional judgment.

The evaluation of reinsurance contracts as to whether risk transfer is reasonably self-evident is principles-based, and therefore lacks a bright line that can be used for its application. As a matter of practice, it might be more conservative to evaluate contracts for risk transfer where there is any doubt as to whether risk transfer is reasonably self-evident.

ii. Categorization of Contracts

With respect to the level of risk transfer testing required, this practice note groups contracts into three categories:

- Exempt: contracts exempt from risk transfer testing standards;
- Reasonably Self-Evident: contracts for which risk transfer is considered to be reasonably self-evident by virtue of the class and/or the individual characteristics of the contract; and,
- Not Reasonably Self-Evident: contracts for which risk transfer is not reasonably self-evident, so that some type of quantitative cash flow analysis must be performed in order to assess risk transfer.

There may be other ways to categorize and describe contracts.

(a) Exempt Contracts

FASB ASC 944, SSAP 62R, and IFRS 17 explicitly exempt from the risk transfer testing requirement any contracts where “substantially all of the insurance risk relating to the reinsured portions of the underlying contracts has been assumed by the reinsurer.” As discussed previously, certain old contracts and contracts with no amounts recoverable are excluded from the Reinsurance Attestation Supplement.

The “substantially all” exception is further clarified in FASB ASC 944:

If, based on the comparison in paragraph 944-20-15-51, the reinsurer is not exposed to the reasonable possibility of significant loss, the ceding entity shall be considered indemnified against loss or liability relating to insurance risk only if substantially all of the insurance risk relating to the reinsured portions of the underlying insurance contracts has been assumed by the reinsurer. That condition is met only if insignificant insurance risk is retained by the ceding entity

on the reinsured portions of the underlying insurance contracts. The assessment of that condition shall be made by comparing both of the following:

- (a) The net cash flows of the reinsurer under the reinsurance contract
- (b) The net cash flows of the ceding entity on the reinsured portions of the underlying insurance contracts.

If the economic position of the reinsurer relative to the insurer cannot be determined, the contract shall not qualify under the exception in this paragraph.⁹⁵

SSAP 62R and IFRS 17 contain similar language. In such instances, the reinsurer acts as if it stands in the shoes of the original insurer. While it remains a matter of informed professional judgment as to what is insignificant, FASB Statement No. 97 defines insignificant to mean “having little or no importance; trivial.” There may be some diversity in practice in the application of the “substantially all” exception and in determining when the criteria are met. Under the most restrictive considerations, the only type of contract for which the exception applies is a straight quota share, with all fixed terms and no risk-limiting features or variable terms,⁹⁶ and with a fixed ceding commission that adequately compensates the ceding company for all acquisition costs. A less restrictive but generally accepted set of criteria for the “substantially all” exception would be the case of a straight quota share reinsurance contract with no risk-limiting features, other than a very high loss ratio cap that has negligible effect on the economics of the transaction.

In summary, straight quota-share contracts are exempt from risk transfer requirements under the “substantially all” exception. However, the introduction of risk-limiting features to a quota-share contract, such as a loss ratio cap,⁹⁷ a loss retention corridor, or a sliding scale commission, usually prevents the contract from qualifying under the exception.

(b) Reasonably Self-Evident

There are several characteristics of those contracts for which risk transfer is generally considered to be reasonably self-evident:

- The potential loss to the reinsurer is much larger than the premium for the coverage provided (the contract has low rate on line⁹⁸);
- The contractual terms and conditions of coverage are standardized for the classification or type of contract; and
- The contract does not include provisions that enable the reinsurer to recover all or a significant portion of the covered losses.

⁹⁵ ASC 944-20-15-53.

⁹⁶ Including no sharing of positive experience.

⁹⁷ Other than one that is so high its effect on the economics of the contract is *de minimis*.

⁹⁸ “Rate on line” is defined by dividing the premium paid to reinsure 100% of a reinsurance contract by the aggregate limits of the reinsurance contract.

In most instances, if a contract satisfies all three of these characteristics, the contract is generally considered to transfer risk. For contracts with material risk-limiting features, generally risk transfer is not reasonably self-evident.

Based on the risk transfer characteristics, contracts in the following classes are typically presumed to have met the risk transfer standards without individual quantitative analysis, because risk transfer is reasonably self-evident:

- Single-year property catastrophe and casualty clash contracts with little or no risk-limiting features (e.g. sub-limits, exclusions, etc.) apart from reinstatement premium common to these types of contracts;
- Most facultative and treaty per risk excess of loss arrangements with premium well below the present value of the aggregate limit of coverage, and without unusual provisions such as sub-limits, experience accounts, or other risk-limiting contingent features; and
- Most catastrophic worker's compensation covers.

This list is not intended to be an exhaustive list. A company may have contracts for which risk transfer is determined to be reasonably self-evident even though they do not fall into a particular class. In these instances, the company may support its risk transfer decisions by showing how classes of contracts adhere to the risk transfer characteristics.

Risk transfer is reasonably self-evident in most traditional per-risk or per-occurrence excess of loss reinsurance contracts. For these contracts, a predetermined amount of premium is paid and the reinsurer assumes a significant portion of the potential variability in the underlying losses. It is typically evident from reading the basic terms of these contracts that the reinsurer may incur a significant loss. The existence of experience-based contract terms, such as experience accounts, contingent commissions, and additional premiums, may reduce the amount of risk transfer or make it less likely that risk transfer is reasonably self-evident. Typically, the more risk that a ceding company retains through these risk-limiting terms, the less likely that risk transfer is reasonably self-evident. The rate on line is an important consideration with excess of loss reinsurance contracts having aggregate limits. In excess of loss contracts with no or minimal risk-limiting features having relatively low rates on line, the presence of risk transfer is typically found to be reasonably self-evident. However, even if a contract has no risk-limiting features, as the premium approaches the present value of the limit of the coverage provided, risk transfer is no longer reasonably self-evident. An argument exists that best practice requires at least a basic explanation regarding risk transfer for those contracts that have risk transfer that have been determined to be "reasonably self-evident."

(c) Not Reasonably Self-Evident

If a contract has any of the following features, it is unlikely that risk transfer is reasonably self-evident:

- The present value of the premium may approach the present value of the coverage provided;

- The contract is “manuscripted” using terms of coverage that are non-standard for contracts within the risk classification; or
- The contract includes provisions that enable the reinsurer to recover a significant portion of the covered losses from the cedent.

While there are often exceptions, examples of contracts that do not typically qualify for risk transfer being reasonably self-evident include:

- Contracts with loss sensitive or risk-limiting features such as, but not limited to:
 - present value of the premium approaching the present value of the coverage provided,
 - swing rated premium or fee adjustments,
 - sliding scale commissions,
 - loss corridors,
 - deductibles,
 - profit commissions,
 - profit-sharing mechanisms,
 - occurrence caps,
 - aggregate caps,
 - experience accounts,
 - experience rating refunds
 - loss payment schedules,
 - accumulations of variable retentions,
 - any feature whose intent is to postpone timely reimbursement, and
 - fixed ceding commission below the ceding company’s acquisition costs;
- Aggregate excess of loss contracts except where the ceding entity is a non-insurance company or does not file an NAIC Statutory or U.S. GAAP financial statement;
- Multiple-year contracts—these frequently have provisions that protect the reinsurer from changes in exposure over the contract period, or have features that adjust the terms of subsequent years of the contract, explicitly or implicitly, based on results of the earlier years;
- Contracts with terms longer than a year;
- Contracts permitting reporting or payments less frequently than quarterly;
- Retroactive contracts, including, but not limited to:
 - adverse development covers, and
 - loss portfolio transfers;
- Contracts providing the unilateral right to commutation to either party, other than those related to contractual conditions outside the control of the exercising party, e.g., downgrades or reduction of surplus; and
- Contracts where cancellation, termination, or commutation requires the reporting entity or affiliates to enter into another reinsurance arrangement.

For a given reinsurance contract, once the determination is made that risk transfer is not reasonably self-evident, management must evaluate the amount of risk transferred and prepare documentation supporting the business rationale for entering into the contract. In most cases, it might be expected that the rigor of the analysis and documentation may increase as the contract contains more restrictive risk limiting provisions.

A final observation is that failure to satisfy the “reasonably self-evident” standard does not mean that a contract lacks sufficient risk transfer. Rather, it simply requires additional analysis in order to determine the presence of risk transfer. In the context of the attestation by the CEO and CFO, there is a requirement that management maintain documentation of that analysis and to ensure proper governance that the activities

required through the compliance function to determine the presence of risk transfer within the respective contracts has been performed.

c. Actuarial Support for Determination of Risk Transfer

This section provides information for actuaries to consider when performing cash flow testing for reinsurance contracts.

i. **Common Techniques and Methodologies for Testing Risk Transfer**

There are a number of methods by which the underwriter or actuary might determine the presence of risk transfer in the subject contract. When reflecting on each of these methods, it is necessary to consider the viability of the entities where risk transfer resides.

(a) Method 1—“10-10 Rule”

The “10-10” rule emerged in the years subsequent to the implementation of FAS 113 as a common benchmark for resolving whether a reinsurance contract satisfies the requirement of a “reasonable” chance of “significant” loss to the reinsurer. The test defines that adequate insurance risk is present if there is “at least a 10% chance of a 10% loss.” A “10% chance of a 10% loss” is usually interpreted to mean that the underwriting loss at the 90th percentile (of the probability distribution of underwriting results) must be at least 10% of the ceded reinsurance premiums, where both underwriting loss and premiums are understood to be present values.

There are at least two major shortcomings of the “10-10” test. First, the focus on the present value loss only at the 90th percentile ignores the information in the remainder of the tail represented by the percentiles beyond the 90th. A better test might take account of the loss potential in the right tail of the distribution, which sometimes can be extreme (as in the case of catastrophe reinsurance). Second, both the 10% probability and 10% loss thresholds are arbitrary. The risk transfer test might be generalized to allow for both low frequency-high severity and high frequency-low severity combinations.

(b) Method 2—Expected Reinsurer Deficit (ERD) Method

The Expected Reinsurer Deficit (ERD) equals the product of; 1) the probability that the reinsurer experiences a net loss on a present value basis; and 2) the expected present value loss that the reinsurer will experience in the event that there is a loss. A treaty is typically considered to exhibit risk transfer if ERD is greater than 1%, which is consistent with the “10-10” rule (10% loss multiplied by 10% chance is a 1% ERD). The ERD test is more robust than the 10-10 Rule and produces reasonable results when applied to a variety of reinsurance structures covering insurance portfolios having a wide range of risk characteristics.

This method has a couple of drawbacks. This test provides just a single statistic in a two-prong test requirement under FAS 113 and SSAP 62R of a “reasonable” chance of “significant” loss to the reinsurer. Additionally, as with any method, thresholds are arbitrary.

The CAS Research Working Party on Risk Transfer Testing’s paper⁹⁹ concluded that:

- The ERD methodology, with a 1% threshold for significant risk transfer, is numerically comparable to the “10-10” benchmark; and
- The ERD methodology is qualitatively superior to that benchmark.
- **Other considerations**

These two methods focus on the reasonable possibility of a significant loss. They are frequently considered together in order to obtain a prudent judgment of the contract, in addition to the actuary or underwriting determining an expectation of the distribution of ultimate results. Please note that there is no bright-line threshold where decisions are typically made.

ii. Process for Applying these Methods

(a) Understand the Substance of the Agreement

In order to understand the substance of the reinsurance agreement before evaluating and quantifying the amount of the economic losses being transferred, the actuary may wish to do the following:

- Obtain and review the background to the transaction, including the business purpose and the substance of the transaction. In this regard, the actuary may wish to have discussions with management or other key personnel as appropriate.
- Obtain and review internal accounting memoranda or other relevant internal documentation regarding the transaction.
- Obtain and read the entire agreement, as well as all related agreements¹⁰⁰ including, but not limited to, interlinked reinsurance contracts or trust agreements. If it is not clear how certain contractual terms operate, the actuary might choose to seek assistance from accounting and legal professionals, as applicable.

In reviewing the contract, the actuary may encounter contract provisions that create contingent rights or obligations that appear to reduce risk if applied. These include special termination clauses, warranties, and adjustable limits or deductibles. The actuary may consider the potential impact of insolvency or insurance department supervision on the contract. In some cases, reinsurance contract provisions are worded in indefinite or ambiguous ways that make modeling difficult—perhaps impossible unless one were to

⁹⁹ *Risk Transfer Testing of Reinsurance Contracts: Analysis and Recommendations*, included in the Academy’s 2005 Risk Transfer in P&C Reinsurance: Report to the Casualty Actuarial Task Force of the National Association of Insurance Commissioners.

¹⁰⁰ IFRS 17 §9 correspondingly calls this a “Combination of insurance contracts” and defines it as a set or series of insurance contracts with the same or a related counterparty may achieve, or be designed to achieve, an overall commercial effect. In order to report the substance of such contracts, it may be necessary to treat the set or series of contracts as a whole.

make assumptions about the behavior of one or both parties to the contract. In those cases, if it is not possible to clarify the intent of the parties, the actuary might be unable to complete a quantification of the economic losses to be transferred under the agreement. If the actuary does make assumptions regarding the behavior of parties to the contract, it is appropriate to incorporate documentation of these assumptions in the documentation. To the extent that the actuary relies on the interpretation of contractual language from another person or party, the actuary would typically disclose such reliance in their documentation.

(b) Risk Transfer Cash Flow Testing

For contracts where risk transfer is not deemed to be reasonably self-evident, management will need documentation supporting risk transfer available for regulatory review. This section will focus on the cash flow testing as part of the risk transfer analysis and the issues to consider, industry practice as it relates to incorporating parameter risk and handling various exposures, and the value of judgment to the process. Note that the risk transfer measurement process is intended to be a prospective analysis, to be completed when entering into the reinsurance contract. Once determined for a contract, the determination for that contract will not change unless the contract is amended, or regulators require a change to the accounting treatment of the contract.

When documenting risk transfer, there will likely be instances where company management looks to its internal or external actuaries for assistance regarding the measurement of risk. While SSAP 62R, FASB ASC 944, and IFRS 17 are accounting statements, and thus the need for risk transfer cash flow testing arises from the application of accounting rules, actuaries may provide significant input in, or even take the lead in the understanding, evaluation, and quantification of the insurance risk being transferred under the contract. Nevertheless, despite the actuary's role in quantifying the risk within a contract, the final determination of whether that risk transfer is sufficient is typically a decision of an accounting function.

Risk transfer analyses may range from very simple premium to loss limit approaches for certain contracts to highly sophisticated stochastic models with multiple inputs and variables. Typically, the required rigor of such analyses increases as the contractual terms become more complex, or as risk transfer becomes more limited through risk-limiting contract features. In cases where the actuary is asked to perform cash flow tests as part of the risk transfer analysis, the actuary may wish to review the steps outlined in the remainder of this document before undertaking such an evaluation.

In reading this section, it is important to note that there are currently no actuarial standards of practice on risk transfer analyses. Though the goal of evaluating risk transfer differs to some extent from the goals in pricing (re)insurance contracts or setting loss reserves, parts of the approach and development of estimates require similar considerations that are outlined in existing standards of practice regarding property/casualty ratemaking and loss reserving. Though not directly applicable, these statements may be a useful resource for actuaries when they are performing cash flow testing for risk transfer.

(c) Overlay the Contractual Terms

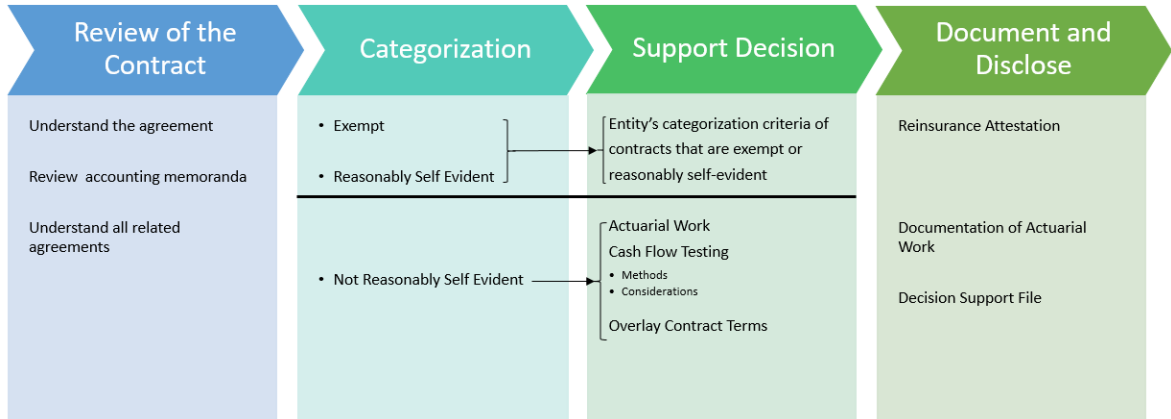
Whether determined through the selection of a single scenario or through thousands of iterations via stochastic simulation, the actuary normally considers the amount and timing of cash flows that would be ceded under the contract for each loss scenario that is being modeled. Cash flow items may include loss payments, loss adjustment expense payments, initial premiums, additional premium payments, payments of profit or experience-based commissions, and other related cash flows as described above for contracts where risk transfer is not reasonably self-evident. An appropriate quantification of the economics under an agreement includes contractual terms to the extent that they impact cash flows between the ceding company and the reinsurer.

(d) Process Flow

The flowchart depicted as Illustration 1 provides the considerations and actions that are necessary as risk transfer is ascertained:

Illustration 1:

Risk Transfer Determination - Process Flow



iii. Tools Available for the Methods

(a) Modeling Considerations

In order to employ the above-mentioned methods, actuaries often require a cash flow analysis. These analyses may be based on stochastic models that project estimates of subject losses using thousands of iterations. There are several key assumptions normally selected, such as:

- A mean and coefficient of variation of losses;
- An assumed distribution of such losses;
- Selected payout patterns, as well as variation of these patterns; and
- Considerations for parameter risk.

The modeled distributions may be based on aggregate losses, individual frequency and severity distributions, or some combination thereof. In many cases, the mean is selected by reviewing available historical data, supplemented by industry or peer group data where appropriate. Usually, there is less data available to estimate the coefficient of variation of losses. While historical data is often used as a starting point, in many cases it is appropriate to supplement such data with other information and judgment.

Similar to an insurance pricing exercise, it may be appropriate to adjust historical data to provide an unbiased estimator of results for the prospective analysis period. Possible adjustments include trending losses, on-leveling premiums, adjusting for changes in exposure, and consideration for the presence or absence of large losses or catastrophic events. As the standards require comparing the expected cash outflows (for losses) with the expected cash inflows (premiums and experience adjustments) on a present value basis, one should employ a discount rate considered appropriate.

When determining a loss distribution, a positively skewed distribution such as the lognormal distribution is often used. Again, this is largely a matter of judgment and experience, and will depend on the individual situation.

Payout patterns are usually determined from historical paid loss development patterns, if available, or from industry patterns. While variation in such patterns is a feature that is modeled by actuaries, there is little practical guidance on how to vary a payout pattern, or how much variation could be reasonably expected. It is normally a matter of actuarial judgment to determine whether the resultant approach and amount of variation in the payout pattern is reasonable.

Finally, the inclusion of parameter risk is usually an important element to cash flow testing. Parameter risk in this context refers to the potential inaccuracy in the form and parameters of the loss distribution. The sources of parameter risk are typically numerous in a reinsurance risk transfer analysis. A very good discussion of parameter risk may be found in the Casualty Actuarial Society's Research Working Party on Risk Transfer Testing white paper, *Risk Transfer Testing of Reinsurance Contracts: Analysis and Recommendations*,¹⁰¹ also contained in a draft version in Appendix 2 of the Academy's 2005 Risk Transfer Report.¹⁰²

By definition, parameter risk is very difficult to model and measure. In many cases, the actuary will account for parameter risk by increasing the coefficient of variation (CV) in the modeled analysis. In other instances, the actuary might adjust the mean or weigh together multiple models, each having its own mean and CV, to encompass parameter risk. More elaborately, parameter risk can be incorporated by explicitly treating the parameters of the loss distribution as stochastic variables themselves. In any case, the selection and application of parameter risk is complex and usually involves the significant application of professional judgment on the part of the actuary.

(b) Interest Rate Used to Present-Value Cash Flows

FASB ASC 944 and SSAP 62R do not specify a method for choosing the interest rate to be used for discounting; it specifically refers that this as an area to which judgment should be applied. These standards, however, require that "[t]he same interest rate shall be used to compute the present value of cash flows for each reasonably possible outcome tested. ... Judgment is required to identify a reasonable and appropriate interest rate. To be reasonable and appropriate, that interest rate shall reflect both of the following:

- a. The expected timing of payments to the reinsurer; and
- b. b. The duration over which those cash flows are expected to be invested by the reinsurer."¹⁰³

¹⁰¹ *Casualty Actuarial Society Forum*, Winter 2006, p. 277.

¹⁰² *Risk Transfer in P&C Reinsurance Report to the Casualty Actuarial Task Force of the National Association of Insurance Commissioners*. American Academy of Actuaries, Committee on Property and Liability Financial Reporting, August 2005.

¹⁰³ SSAP 62R §17.

While not specified in the standards, a commonly used approach is to employ a risk-free interest rate, with duration approximately equal to that of the net cash flows. Based on current industry practice in the U.S., an interest rate is often selected based on U.S. Treasury securities with similar durations. Typically, this is either performed based on a weighted average of the cash flows with U.S. Treasury yield curve analysis using zero-coupon securities, or through the selection of a single rate based on a simple review of U.S. Treasury rates and judgment.

IFRS 17 provides more explicit recommendations to determine an appropriate discount rate for various exercises. It should reflect the time value of money, characteristics of the cash flows, and the liquidity characteristics of the contract. Further, the rate should be consistent with observable current market prices for financial instruments whose characteristics are similar to the contract in question as it relates to currency, timing of payments, and liquidity. And it must exclude the effect of factors that may change the financial instrument's market price but does not impact the future cash flows of the insurance contract.¹⁰⁴

6. Required Documentation and Disclosures

a. U.S. Statutory

The Reinsurance Attestation Supplement forms part of the Annual Statement for property/casualty insurance companies and is public information. This supplement is required to be filed by March 1 each year. The requirements of the Reinsurance Attestation Supplement apply to a company's ceded reinsurance program, and not to any assumed reinsurance.

The supplement requires the CEO and CFO of the company to attest, with respect to active ceded reinsurance contracts, to the four items listed in the Controls section.

The CEO and CFO are required to attest that a process is in place to fulfill the company's obligations under SSAP 62R and that the appropriate responsible parties have met their obligations regarding the accounting for reinsurance. Areas of actuarial involvement in support of the Reinsurance Attestation Supplement could include the selection, quantification, and documentation of ceded reinsurance contracts.

Essential items to be considered by the decision-maker in deciding whether a reinsurance agreement meets the risk transfer requirements of SSAP 62R include:

- the "reasonable possibility of," where the estimate measures the likelihood or probability of a given loss amount;
- "a significant loss," where the estimate measures the potential magnitude of an economic loss to the reinsurer, for example using different scenarios or a model; and,
- the timing of the receipt and payment of the underlying cash flows.

For a given reinsurance contract, once the determination is made that risk transfer is not reasonably self-evident, management needs to evaluate the amount of risk transferred and prepare documentation supporting the business rationale for entering into the contract.

¹⁰⁴ IFRS 17 §36.

Management will need to have documentation supporting risk transfer available for regulatory review and audit. Failure to satisfy the “reasonably self-evident” standard does not mean that a contract has insufficient risk to qualify as reinsurance. It simply may require more analysis in order to determine whether risk transfer exists. In the context of the attestation by the CEO and CFO, it also means that there is a requirement for management to maintain documentation of that analysis.

“Documentation” refers to written and electronic materials, including risk transfer analyses, which are maintained on each reinsurance contract in which risk transfer is not considered to be reasonably self-evident, such that an auditor or regulatory examiner may follow the process used by the company to assess the proper reinsurance accounting treatment as required by SSAP 62R.

For all reinsurance contracts, where risk transfer is not self-evident, or where there is question as to whether it is reasonably possible that the reinsurer may realize a significant loss, financial modeling may be a tool in order to assess risk transfer.

b. Ceding Company

Regarding evidencing risk transfer, the Reinsurance Attestation Supplement requires that management maintain documentation with respect to contracts “for which risk transfer is not reasonably considered to be self-evident.”

The purpose of this clarification is to eliminate or avoid the time and expense associated with unnecessary analyses, but it may still be appropriate to provide documentation to the file explaining why risk transfer is reasonably self-evident.

c. Actuary

When documenting risk transfer, there will likely be instances in which management looks to its internal or external actuaries for assistance as regards the measurement of risk.

To the extent the actuary is asked to quantify the risk transfer, the retention of supporting documentation of the analysis and calculations would be governed by the ASOPs, as with any other actuarial communication. Documentation should be sufficient for another actuary practicing in the same area to follow and determine reasonability.

The risk transfer documentation may be required to be made available to state regulators and auditors.

In developing actuarial documentation, the actuary should refer to Actuarial Standard of Practice No. 41, *Actuarial Communications*.

Further, if the actuary does make assumptions about the behavior of parties to the contract, it may be appropriate to incorporate documentation of these assumptions into the analysis documentation.

d. Risk Transfer Documentation

“Documentation” refers to written materials, including risk transfer analyses, which are maintained on each reinsurance contract in which risk transfer is not considered to be reasonably self-evident, such that an auditor or regulatory examiner may follow the process used by the company to assess the proper reinsurance accounting treatment as required by SSAP 62R, FASB ASC 944 or IFRS 17. The process could define what the company treats as “reasonably self-evident,” which may include a check list of features that might create a presumption that risk is not self-evident, and could establish the normal thresholds for determination for sufficient risk. A formal policy could then be used as default documentation to add to the cash flow statistics rather than requiring full risk transfer documentation with each contract.

Among the items to be considered in completing the documentation are:

- Treaty year experience exhibits with losses
- Historic large loss exhibits that shows excess losses have occurred
- Policy profiles that show any number of risks exposed in the treaty, including policy limits and attachment points
- Historic loss trends, premium on-level factors and exposure changes
- Loss Triangles
- Market quotes based upon rate-on-line (ROL)
- Aggregate summaries showing exposed limits
- All available cash flows
- Rating model output with estimates of 1 in 100- or 250-year events
- Industry experience for similar type insurance products

Documentation may be completed to outline the evaluation of the reinsurance contract. It may include relevant items noted in the reinsurance contract terms and conditions to demonstrate and explain the review, including commutation features, interest rate features, etc.

For all reinsurance contracts, where risk transfer is not self-evident, or there is a question as to whether it is reasonably possible that the reinsurer may realize a significant loss, the actuary may be requested to perform financial modeling in order to assess risk transfer. The actuarial analysis should be documented according to ASOP No. 41, *Actuarial Communications*. All analyses, assumptions, related documentation, conclusions, approvals, and reliances should be documented.

7. Conclusion

This practice note provides an overview of the various accounting standards and their requirements on the treatment of risk transfer along with a comparison of the standards. It also includes a high-level summary of the process steps in analyzing risk transfer and the categorization of contracts. In addition to the process described, actuaries should continue to rely on professional ASOPs in their communication and documentation. Actuaries are well suited to provide support and analysis of risk transfer for any (re)insurance contract regardless of the accounting standard being applied.

8. Appendices (Links)

a) **Statement of Statutory Accounting Principles No. 62R—Revised Property and Casualty Reinsurance**

- i) Included in: *Statements of Actuarial Opinion on Property and Casualty Loss Reserves—* December 2021

(https://www.actuary.org/sites/default/files/2021-12/PC_Practice_Note_2021_.pdf)

- ii) **Reinsurance Attestation Supplement 20-1: Risk Transfer Testing Practice Note (2007)**

https://www.actuary.org/sites/default/files/files/publications/pc_risk_jan2007.pdf

- iii) **Risk Transfer in P&C Reinsurance: Report to the Casualty Actuarial Task Force of the National Association of Insurance Commissioners (2005)**

https://www.actuary.org/sites/default/files/pdf/casualty/risk_transfer.pdf

- iv) **Reinsurance Attestation Supplement**

- b) Located in the final two pages of the Reinsurance Attestation Supplement 20-1: Risk Transfer Testing Practice Note (2007) **FASB Accounting Standard Codification (ASC) Topic 944, Financial Services—Insurance**

<https://asc.fasb.org/home>

c) **Statement of Financial Accounting Standards No. 113 (As Amended)**

- i) **Accounting for Multiple-Year Retrospectively Rated Contracts by Ceding and Assuming Enterprises (EITF 93-6)**

https://www.fasb.org/pdf/aop_FAS113.pdf

<https://www.fasb.org/pdf/abs93-6.pdf>

- ii) **Accounting for Multiple-Year Retrospectively Rated Insurance Contracts by Insurance Enterprises and Other Enterprises (EITF 93-14)**

<https://www.fasb.org/pdf/abs93-14.pdf>

d) **International Accounting Standards Board**

- i) **IFRS 17 Insurance Contracts**

Available at: www.ifrs.org/issued-standards/list-of-standards/ifrs-17-insurance-contracts/

- ii) **Basis for Conclusions on IFRS 17 Insurance Contracts**

Available at: www.ifrs.org/issued-standards/list-of-standards/ifrs-17-insurance-contracts/

e) **Actuarial Standards Board—Applicable ASOPs**

- 41 **Actuarial Communications**

<http://www.actuarialstandardsboard.org/asops/actuarial-communications/>

- 53 **Estimating Future Costs for Prospective Property/Casualty Risk Transfer and Risk Retention**

<http://www.actuarialstandardsboard.org/asops/estimating-future-costs-prospective-property-casualty-risk-transfer-risk-retention/>

- 56 **Modeling**

<http://www.actuarialstandardsboard.org/asops/modeling-3/>

- 39 **Treatment of Catastrophe Losses in Property/Casualty Insurance Ratemaking**

<http://www.actuarialstandardsboard.org/asops/treatment-catastrophe-losses-propertycasualty-insurance-ratemaking/>

7 Analysis of Life, Health, or Property/Casualty Insurer Cash Flows

<http://www.actuarialstandardsboard.org/asops/analysis-life-health-propertycasualty-insurer-cash-flows/>

13 Trending Procedures in Property/Casualty Insurance

<http://www.actuarialstandardsboard.org/asops/trending-procedures-propertycasualty-insurance/>

20 Discounting of Property/Casualty Unpaid Claim Estimates

<http://www.actuarialstandardsboard.org/asops/discounting-propertycasualty-unpaid-claim-estimates/>

29 Expense Provisions in Property/Casualty Insurance Ratemaking

<http://www.actuarialstandardsboard.org/asops/expense-provisions-propertycasualty-insurance-ratemaking/>

30 Treatment of Profit and Contingency Provisions and the Cost of Capital in Property/Casualty

<http://www.actuarialstandardsboard.org/asops/treatment-profit-contingency-provisions-cost-capital-propertycasualty-insurance-ratemaking/>