RETAINED RISK FOR NON-INSURERS:

ACCOUNTING TREATMENTS AND PERSPECTIVES

AMERICAN ACADEMY *of* ACTUARIES

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American Academy of Actuaries

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Speakers

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Agenda

- Introduction
- Practice Note Overview
- Practice Note Chapters
- Case Study
- Q & A

Introduction

- Corporate entities typically retain significant amounts of risks that are similar to those commercially insured.
- P&C actuaries are often engaged to value the unpaid claim estimates associated with these exposures.
- The actuarial estimate may be recognized by the management of the entity as a liability for the entity's obligations.

Introduction, continued

- How these liabilities become part of an entity’s financial statements is governed by:
  - the applicable accounting standards for the type of entity
  - the type of exposure to loss
  - the domiciliary jurisdiction of the entity and its parent

Practice Note Overview

- The practice note:
  - Was drafted by a work group of the Committee on Property and Liability Financial Reporting (COPLFR)
  - Is intended to provide information and guidance for P&C actuaries on relevant actuarial and accounting issues where a perceived vacuum in literature exists
  - Was exposed to membership for comment in Winter 2018 and finalized in the Spring of 2018
  - Retained Property Casualty Insurance-Related Risk: Interaction of Actuarial Analysis and Accounting

Practice Note Overview, continued

- Describes:
  - The various ways entities retain exposure to risk
  - The various types of entities and the variation in the retained risk characteristics because the type of entity often determines the particular approach or applicable accounting treatment
  - Common exposures that these various entities may retain

Practice Note Overview, continued

- Includes relevant accounting guidance that will apply to entities and exposures, the interaction of the accounting guidance with the relevant actuarial concepts, and the variation by type of entity
- Discusses the interaction between the actuary, accountants, third party administrators, and risk managers/internal attorneys
- Summarizes the applicable actuarial standards

Chapter 1: Methods of Retaining Risk and Associated Treatments

- Types of Risk Transfer
  - Guaranteed Cost Policies
  - Retrospectively Rated Policies
  - Self-Insurance
  - Claims-Made Coverage
  - Captives
  - Trusts
- Risk Transfer illustrated by bankruptcy

Chapter 2: Types of Entities that Retain Risk

- Characteristics
- Private-sector entities (privately held or publicly traded)
- Group programs
- Governmental entities
- Governmental groups and pools
- Government quasi-insurance programs
- Healthcare providers

Chapter 3: Exposures and Coverages

- First-Party Risks
- Third-Party Risks
- Workers’ Compensation
- Other Property/Casualty Risks

Chapter 4: Relevant Actuarial Concepts and Considerations

- Intended Purpose of the Actuarial Analysis
  - Adequacy of Accruals for Financial Reporting
    - Key issues related to the presentation of indications
    - Key issues related to the comparison with recorded accruals
  - Internal Financial Reporting and Cost Allocation
  - Regulatory Filing for a Qualified Self-Insurance Designation

Concepts and Considerations, continued

- Other Considerations
  - Coverage or Policy Period
  - Key Dates and Interactions
  - Loss Adjustment or Claim Adjustment Expenses

Chapter 5: Applicable Precepts and ASOPs

- Code of Professional Conduct
  - Precepts 3, 4, 8 and 10
- *ASOP No. 7* – Analysis of Life, Health, or Property/Casualty Insurer Cash Flows
- *ASOP No. 13* – Trending Procedures in Property/Casualty Insurance
- *ASOP No. 20* – Discounting of Property/Casualty Unpaid Claim Estimates
- *ASOP No. 21* – Responding to or Assisting Auditors or Examiners in Connection with Financial Audits, Financial Reviews, and Financial Examinations

Chapter 5: Precepts and ASOPs, continued

- *ASOP No. 23* – Data Quality
- *ASOP No. 36* – Statements of Actuarial Opinion Regarding Property/Casualty Loss and Loss Adjustment Expense Reserves
- *ASOP No. 38* – Using Models Outside the Actuary's Area of Expertise
- *ASOP No. 41* – Actuarial Communications
- *ASOP No. 43* – Property/Casualty Unpaid Claim Estimates

Chapter 6: Relevant Accounting Standards

- US Generally Accepted Accounting Principles (GAAP)
- Federal Accounting Standards Board (FASB) Accounting Standards Codification (ASC) 720-20 – Insurance Costs
- Claims Made Contracts
- FASB ASC 954-10-00 – Health Care Entities
- Medical Malpractice Trust Funds

Chapter 6: Accounting Standards, continued

- Environmental Obligations
- Tax Accounting
- Governmental Accounting Standards Board's
  GASB 10 requirements
- International Accounting (IFRS) requirements

Chapter 7: Roles and interactions of Actuary, Accountants and Risk Managers

- Definitions of Roles and Responsibilities
- Actuarial Report and Presentation
- Controls
- Interaction with the Internal Accountants
- Interaction with the External Auditor

Chapter 8: Special Situations and Special Treatments

- Asbestos
- Black Lung
- Environmental
- Group Health
- Other Chemical-related Exposures
- Product Recall
- Silicosis
- Warranty

Case Study

We Love Elderly People and Our Favorite Carrier

Case Study - The Framework

- We Love Elderly People (WLEP) operates several hundred skilled nursing facilities in 20+ states. Some are owned by the parent corporation, others by operating units incorporated in individual states.
- WLEP purchases coverage from Our Favorite Carrier (OFC) for its general and professional liability exposures on a claims made basis. The OFC policy provides for a deductible of $5,000,000 per occurrence plus a pro rata share of ALAE. Policies are annual and effective January 1 of each year, with an extended reporting period of 30 days. WLEP handles its own claims in-house, and OFC is involved only when claims approach the deductible limit.

WLEP Financial Reporting – Question 1

- What does WLEP show on its consolidated balance sheet at December 31, 20XX? At June 30?

WLEP Financial Reporting – Answer #1

Financial Statements December 31, 20XX

Liability: Unpaid cost of occurrences

- All occurrences through 12/31/xx, both reported and unreported
- Unlimited, loss and ALAE
- Claims handling expense (ULAE)

Asset: Expected insurance recoveries

- Losses occurred through 12/31/xx
- reported through 1/30/xx+1 (end of policy + extended reporting)
- Loss in excess of $5,000,000 + pro rata share of ALAE

WLEP Financial Reporting – Answer #1 (cont)

Financial Statements June 30, 20XX+1

Liability: Unpaid cost of occurrences

- All occurrences through 6/30/xx+1, both reported and unreported
- Unlimited, loss and ALAE
- Claims handling expense (ULAE)?

Asset: Expected insurance recoveries

- Losses occurred through 6/30/xx+1
- Reported through 6/30/xx+1 (financial reporting date)
- In excess of $5,000,000 + pro rata share of ALAE

Asset: Prepaid insurance

- If premium paid in advance, the unused portion of the policy (reporting 7/1/xx+1 – 1/30/xx+2) is prepaid premium
- Actuaries not often involved in determining the prepaid asset

WLEP Financial Reporting – Question 2

- WLEP has been in operation for 50 years. In its history, it has had 50 claims in excess of $2,000,000 (15 in the last ten years) and three over $5,000,000 (2 in the last ten years). There are currently no open claims reserved in excess of $1,000,000, nor is WLEP aware of any events that might result in a claim over $2,000,000.
- Does this change the answer to Question #1?

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WLEP Financial Reporting – Answer #2

Items for financial reporting remain the same:

- **Liability for full unpaid cost and Asset of expected recoveries, <u>but</u>**
  - Actuary may calculate an unlimited reserve (include all claims), concluding the probability of any claim reaching the deductible limit is remote
  - Thus the asset of expected recoveries = $0
  - This conclusion is for the current financial reporting date, based on history, current retentions, and current open reported claims

WLEP Financial Reporting – More Questions

- WLEP owns a US-domiciled captive insurance company, OpCap.
- OpCap writes a deductible reimbursement policy covering WLEP and its subsidiaries for the first $1,000,000 per occurrence, including ALAE, on a claims-made basis with no extended reporting period.
- The captive does not purchase reinsurance, nor does it provide claims-handling services to WLEP. Its claims are handled on a bordereau basis.

WLEP Financial Reporting – More Questions

- What does the captive post on its balance sheet?
- How does the captive fit into WLEP's financials?
- What approaches might the actuary take in his/her analysis?
- Does this change the answer to Question # 1?

WLEP Financial Reporting – More Answers

What does the captive post on its balance sheet?

Financial Statements June 30, 20XX+1

Liability: Unpaid cost of insured occurrences

- Reported occurrences through 6/30/xx+1, estimated at ultimate value
- Capped at $1,000,000, loss and ALAE

Liability: Unearned premium reserve

- Generally pro-rata with time; at 12/31 UEP = $0

Asset: The premium collected from the parent, other capital

WLEP Financial Reporting – More Answers

How does the captive fit into WLEP's financials?

On consolidated basis

- Minimal difference
- May affect future tax estimates (OpCap's loss reserves are deductible for the parent; premium paid by other subsidiaries to OpCap may be deductible)

Reporting is more complex

- WLEP still carries full gross liability
- Recoverables need to be estimated by layer
  - OpCap = 1st $1M loss + ALAE
    - shown on OpCap's financial statement, but eliminated upon consolidation
  - OFC = excess of $5M loss + pro rata ALAE, up to OFC's limit

WLEP Financial Reporting – More Answers

What approaches might the actuary take in his/her analysis?

Under any approach all the components must not be contradictory (ASOP 43)

Approach 1: Calculate everything top-down

- Estimate gross unpaid losses on occurrence basis and claims made basis
  - Difference is the true IBNR = "the tail"; is it reasonable?
- Estimate OFC excess claims made; should be consistent with unlimited claims made estimate
- Estimate OpCap claims made up to $1M limit

Approach 2: Build up from the lowest layers

- OpCap = 1st $1M loss + ALAE – claims made basis
- Excess Claims Made above $1M – segregate between retained and OFC's layer (excess of $5M loss + pro rata ALAE up to policy limits)
- Estimate Tail – unreported claims, on unlimited basis
- Sum of the items above should = accident year basis estimates, unlimited

Retained Risk For Non-Insurers

Q&A

Retained Risk For Non-Insurers

For more information, contact

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