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ON ASOP NO. 11

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In June 2003, the Actuarial Standards Board released an exposure draft to revise ASOP No. 11, The *Treatment of Reinsurance Transactions Reflecting Life or Health Insurance Risks in Financial Statements.* Section 3.5, *Additional Liabilities*, states, in part, "...if the reinsurer has the right to raise reinsurance premiums on in-force business without a corresponding right by the ceding entity to raise policyholder premiums or terminate the reinsurance, an additional current liability may be indicated." The same language appeared in the original ASOP of July 1989. Unfortunately, the ASOP provides no further guidance on when an additional current liability is indicated. Furthermore, the linking of (a) the possible need for an additional current liability to (b) the right of the insurer to raise premiums or terminate the reinsurance, may be inappropriate.

In considering if and when an additional ceding company current liability is indicated, the actuary may find it useful to analyze the rate guarantee language (if any) in the reinsurance agreement. Generally, the rate guarantee language will fall into one of the following three categories:

1. Rates are guaranteed by the reinsurer.
2. Rates can be raised by the reinsurer at its discretion, perhaps up to a limit.
3. Rates can be raised by the reinsurer if certain conditions exist or are met.

If reinsurance rates are guaranteed by the reinsurer, then an additional ceding company current liability is not indicated. Presumably, the current (guaranteed) rates have been used by the ceding company's actuary in computing net reserves, deferred acquisition cost assets and other balance sheet items.

If reinsurance rates can be raised by the reinsurer at its discretion, then an additional ceding company current liability may be needed. For example, a yearly renewable term reinsurance agreement may contain a schedule of current rates and a schedule of guaranteed maximum rates. (In many cases, the guaranteed maximum rates are based on the valuation mortality table.) In determining whether an additional current liability is indicated, the ceding company's actuary may wish to assess both the intention of the reinsurer to raise rates as well as the intention of the ceding company to pass any such rate increase along to its policyholders by modifying non-guaranteed policy elements. In assessing the intentions of the reinsurer, the ceding company's actuary will likely take into account the reinsurer's earnings from the block of business reinsured. This can be coupled with the actuary's understanding of the reinsurer's position regarding rate increases. For example, if a block of business has been profitable for the reinsurer, the actuary may determine that rates are highly unlikely to be raised, and so no additional current liability will be established for the ceding company. Conversely, if a block of business has not been profitable for the reinsurer, the actuary will need to assess the likelihood of a rate increase and the amount of such an increase. If the ceding company has the right, *but not the intention*, to pass rate increases along to the policyholders by modifying non-guaranteed policy elements, an additional liability may be indicated. Reliance on the right to change non-guaranteed policy elements in response to an increase in reinsurance rates may not justify the failure to establish an additional liability if the ceding company has no intention of passing along such increases to its customers.

If reinsurance rates can be raised provided certain conditions exist, and if such conditions currently exist, then the ceding company's actuary may wish to assess the likelihood of the rates being increased. If reinsurance rates can be increased only if certain conditions are met, the actuary may wish to assess the likelihood of such conditions occurring, and to assess the likelihood of rates being raised in response to such conditions being met. Again, an additional liability may be necessary, even if the ceding company has the right to change non-guaranteed policy elements, because the ceding company may not have the intention of changing the policy elements.

In implementing ASOP No. 11, then, the ceding company's actuary must first determine if the right to raise reinsurance rates exists. This is accomplished by careful reading of the reinsurance agreement. If the right exists, the likelihood of a rate increase should be considered, taking into account the particular facts and circumstances. Finally, the actuary should also take into account the ceding company's *intention* to pass rate increases along to its policyholders, not just its right to do so. ✺

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