Small Talk

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Reinsurance Under PBR: An Update on the Treatment of Risk Transfer

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The current draft of VM-20 reflects the recommendation from the American Academy of Actuaries (the Academy) that current rules regarding risk transfer not be applied under a principle-based system of calculating reserves. The rationale is that the reserves will incorporate the cash flows expected between the reinsurance parties. Reinsurance agreements that transfer little risk will generally result in small changes to the reserves, while reinsurance agreements that transfer substantial risk will generally result in greater changes to the reserves. Furthermore, prescribed assumptions would be used for reinsurance provisions that present public policy concerns.

The National Association of Insurance Commissioners' (NAIC) Life and Health Actuarial Task Force (LHATF) PBR Reinsurance Subgroup did not agree with the elimination of the risk transfer rules and submitted a proposal to LHATF to amend VM-20 to only recognize reinsurance agreements in the principle-based reserves if they (1) comply with the existing risk transfer rules, or (2) if including them would result in a decrease in company reported surplus. Thus, in the case of a non-compliant reinsurance agreement, one of the reinsurance parties may be subject to deposit accounting and not be able to reflect the agreement in its reserve calculation, while the other reinsurance party may have to reflect the agreement in its reserves.

LHATF is also considering an amendment proposal submitted by the California Department of Insurance. This proposal attempts to find a middle ground by limiting, rather than disallowing, the reserve impact of reinsurance agreements that do not comply with current risk transfer rules.

The California Proposal

This proposed amendment was introduced to encourage more discussion of ways to reflect the following views:

- A reinsurance agreement that is not in compliance with current risk transfer rules should be recognized under a principle-based reserving system if it has a valid business purpose and its provisions are reflected in the reserves.
- A reinsurance agreement with the purpose of reducing reserves without a comparable transfer of risk should be discouraged in most cases through the limitation of reinsurance credit.*

If a reinsurance agreement does not comply with existing risk transfer requirements, the company may only reduce reserves by the lesser of the proportional reduction in the stochastic and deterministic reserves. In the second sample treaty described below, the stochastic reserve would be minimally impacted and therefore the impact on the minimum reserve would also be minimal. The commissioner may further reduce the reduction; this is primarily to be able to deal with reinsurance agreement provisions separately. Otherwise, a treaty could contain one provision aimed at reducing the stochastic reserve and another aimed at reducing the deterministic reserve. In such a case, each of these should be dealt with separately.

The commissioner may also limit the recognition of any related assets. In the first example below, the commissioner would want to take account of the $10 million cash together with the impact on reserves in limiting the recognition of the financial impact of the reinsurance.

* Examples of reinsurance agreements that reduce reserves without a comparable reduction in risk transfer:

- Company A receives $10 million from Company B in exchange for guaranteed annual repayments of $1.05

Continued on **page 14**

million per year for 10 years. Excluding recognition of the agreement, Company A's projected cash flows in one of the tail scenarios is negative $2 million in each of the first five years followed by positive cash flows of $2 million every year thereafter. The stochastic scenario reserve would recognize the negative cash flows in the first five years but not the positive cash flows afterwards. Including recognition of the transaction, the scenario reserve would increase by the present value of the additional $1.05 negative cash flow in the first five years, but would not be impacted by the final five years of payments since these would just change the magnitude of the positive cash flows in years six through 10.

- Company A reinsures the cash value benefit of its life insurance policies on December 31 for only one day. Company A's deterministic reserve as of December 31 would therefore not include the actual cash value floor.

Conclusion

The challenge in opening the door to more types of reinsurance agreements is to not open the door so far as to allow agreements whose main purpose is to reduce reserves without a comparable reduction in risk. We welcome new ideas on how to meet this challenge.

Stay tuned. ●

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