



AMERICAN ACADEMY *of* ACTUARIES

June 7, 2005

Mr. Joseph Fritsch, Chairman
Property and Casualty Reinsurance Study Group
National Association of Insurance Commissioners
2301 McGee Street, Suite 800
Kansas City, MO 64108-2604

Re: NAIC Property and Casualty Reinsurance Study Group's Proposed Changes to Reinsurance Interrogatories

Dear Mr. Fritsch:

The NAIC's Property and Casualty Reinsurance Study Group ("the Study Group") has exposed changes with respect to Annual Statement General Interrogatories, Part 2 – Property & Casualty Interrogatories ("Interrogatories") 7.3, 9.1, 9.2 and 9.3, as well as the addition of a Chief Executive Officer ("CEO") attestation and a Chief Financial Officer ("CFO") attestation. The purpose of this letter is for the Committee on Property and Liability Financial Reporting ("COPLFR") of the American Academy of Actuaries¹ to provide comments to the National Association of Insurance Commissioners ("NAIC") on these proposed changes.

Background

The Study Group is recommending changes to the Interrogatories in the Annual Statement Blank that are designed to provide regulators with additional information relating to companies' use of ceded reinsurance. The proposed changes are as follows:

- *Additional Disclosure.* The additional disclosure will provide more information on reinsurance contracts that may be deemed "finite."
- *Attestations.* The proposed attestations require both the CEO and CFO to take specific ownership for ensuring that there are no side agreements that are not properly accounted for, that ceding companies have documentation of active ceded reinsurance contracts with respect to risk transfer and economic substance, and that their reinsurance accounting complies with SSAP 62.

It is our understanding that the proposed changes are being suggested by the Study Group to improve the ability of regulators to perform solvency regulation by:

¹ The American Academy of Actuaries is the public policy organization for actuaries practicing in all specialties within the United States. A major purpose of the Academy is to act as the public information organization for the profession. The Academy is non-partisan and assists the public policy process through the presentation of clear and objective actuarial analysis. The Academy regularly prepares testimony for Congress, provides information to federal elected officials, comments on proposed federal regulations, and works closely with state officials on issues related to insurance. The Academy also develops and upholds actuarial standards of conduct, qualification and practice, and the Code of Professional Conduct for all actuaries practicing in the United States.

- Providing additional information regarding companies' accounting practice with respect to ceded reinsurance;
- Reducing or eliminating the incidence of side agreements that are not properly accounted for; and
- Requiring that companies maintain documentation supporting their analysis of the risk transfer and economic substance of their ceded reinsurance contracts.

Purpose of Letter

In addressing the proposed changes, the Academy has taken the desired outcomes outlined above as a given. The purpose of this letter is to provide input on the proposed changes as to whether they are feasible, and whether we believe they are likely to achieve the desired outcomes. We have commented in certain instances where we do not believe the proposed changes are feasible. Further, we have recommended several revisions to enhance the effectiveness of the proposed changes.

Conclusions and Recommendations

We believe the proposed additional disclosure requirements, as written, will likely provide additional meaningful information for the user of the financial statements and improve their transparency. However, we recommend clarifying certain portions of the suggested changes to the Interrogatories, to make the information obtained more meaningful. These recommendations are described in the following section.

In addition, we believe that the proposed attestations could result in the CEO and CFO taking more ownership of certain specific aspects of the company's reinsurance accounting, possibly reduce the risk of unaccounted for side agreements and potentially result in improved internal controls and documentation. However, we believe that this would be best handled by expanding the Interrogatories, which are attested to via the signatures on the Jurat page, rather than requiring company officers to sign a separate attestation. Further, the proposed CEO and CFO attestations provision, as written, has practical issues that would likely result in most company CEOs and CFOs being unable to sign their respective attestations, whether their company was involved in finite reinsurance contracts or not.

The remainder of this letter contains expanded comments on our conclusions and recommended changes to address these points and make the attestation both meaningful and practical.

Discussion

Following are specific comments on the recommended disclosures and the CEO and the CFO attestations.

Disclosures (Sections 7.3, 9.1 through 9.3)

For Interrogatory 7.3, it is common for quota share reinsurance that covers property risks to have catastrophe limits. Such catastrophe limits would trigger a "yes" for question 7.1, but a "no" for question 7.3. For clarification, we suggest adding a follow-up interrogatory, such as "If the answer to question 7.3 is 'no,' please explain."

For Section 9.1, we agree that the additional disclosures generally would provide regulators with more meaningful information. However, we believe there are several points that should be clarified or otherwise adjusted for the information received to be meaningful, and so that unintended consequences, such as the receipt of substantial information for contracts that are essentially traditional contracts, be reduced. Following is a discussion of these points:

- The wording in the first paragraph of Section 9.1 is unclear since premiums and losses are not defined, and it is not clear whether or not the request relates to current-year financial statements only. Therefore, we suggest the following language:

“Has the reporting entity ceded any risk under any reinsurance contract (or under multiple contracts with the same reinsurer or its affiliates) for which it recorded a positive or negative underwriting result for the current calendar year greater than 3% of current year-end surplus as regards policyholders, or for which the calendar year written premium or year-end loss and loss expense reserves are greater than 3% of current year-end surplus as regards policyholders, and accounted for that contract as reinsurance and not as a deposit on either the Statutory or GAAP financial statements, that contain one or more of the following features or other features that would have similar results:”

- We recommend eliminating the request for retroactive reinsurance, since there is already extensive disclosure for retroactive reinsurance. Blending this disclosure with that for prospective finite contracts might create less transparency.
- The request for additional disclosure for contracts that have a greater than 50% chance of commuting would trigger those contracts containing automatic commutations or sunset provisions after a certain number of years. Such clauses are common for workers’ compensation excess of loss contracts after six or seven years. We suggest that this be modified as follows:

“The management of the reporting entity believes that there is greater than a fifty percent (> 50%) probability the reporting entity will commute the treaty before material amounts of paid losses are ceded under the contract.”

For Section 9.2, question (a) would likely result in most of the disclosed information being captive insurance companies. We understand that information on captive insurance companies could be relevant to the regulator; however, in this circumstance we believe such information might not be what is intended by the disclosure. Therefore, we recommend that this disclosure be adjusted as follows:

“Has the reporting entity ceded any risk under any reinsurance contract (or multiple contracts with the same reinsurer or its affiliates) during the calendar year (via a ceded premium or ceded loss and loss expense reserve), excluding captive insurance companies that are unaffiliated with, and/or not controlled by, the reporting entity.”

If the regulators wish to have more information disclosed for captive insurance arrangements, we suggest that this be accomplished in a separate interrogatory.

The suggested changes for Section 9.2 (b) include the request for information on contracts where 25% or more of the risks ceded in the contract have been retroceded back to the ceding reporting entity or its affiliates. We believe these instances would be relatively unusual, and therefore we would recommend a lower percentage, such as 10%.

For Section 9.2 (c), we suggest clarifying the language to exclude retroactive reinsurance, as the accounting for retroactive reinsurance already differs between GAAP and SAP. This language would

need to be revisited in the future if the accounting treatment for retroactive contracts changes under either GAAP or SAP.

For Section 9.3 (c), we suggest clarifying the language to either exclude retroactive reinsurance, or show the aggregate financial statement impact of retroactive contracts separately from the aggregate financial statement impact of prospective contracts.

CEO, CFO Attestations

As discussed above, we agree with the concept that senior management making specific statements regarding their reinsurance accounting could reduce the risk of side agreements that are not appropriately accounted for, and would likely improve internal controls. However, we believe that this would be best handled by expanding the Interrogatories, which are attested to via the signatures on the Jurat page, rather than requiring company officers to sign a separate attestation. Ceded reinsurance is only one of many items for which proper accounting is important. It is not clear that developing separate attestations for specific items in the financial statements is the best course of action.

If an attestation is desired, we suggest that it be limited to reinsurance contracts that have a material effect on the financial statements; this would be consistent with the approach taken under Sarbanes-Oxley to differentiate among levels of control activity which may or may not require disclosure.

Most significantly, we believe that the proposed attestation, as written, has practical issues that would likely result in most company CEOs and CFOs being unable to sign the attestation:

- The CEO and the CFO cannot state with certainty that they are aware of all reinsurance contracts, side agreements and endorsements. However, they can attest that reasonable and due diligence has been performed to identify and appropriately account for such contracts and agreements.
- The attestation makes no exception for reinsurance contracts incepting prior to the implementation of SSAP 62, which affects reinsurance contracts entered into, renewed or amended on or after January 1, 1994. Prior to that no risk transfer analysis was required under statutory accounting rules.
- It has been common practice that risk transfer analysis and related economic purpose memos be completed only for finite contracts. Such analyses have not been completed for traditional reinsurance contracts, for which risk transfer is deemed to be self-evident, nor have they been required by auditors or financial examiners to do so.

For example, the NAIC Financial Examiners' Handbook guidance on the Ceded Reinsurance Contract Review does not require examiners to check for documentation of risk transfer analysis on all contracts; the closest mention of risk transfer documentation in that section says, "Is there a significant transfer of risk (underwriting and timing)? If no, has the deposit method of accounting been properly followed? (Refer to Section VI of this document.) Does a cash flow analysis need to be performed?"

- A risk transfer analysis would typically include estimation of the present value of all cash flows under the contract, and often would include extensive scenario testing as well. In our opinion, requiring this type of analysis and documentation for contracts other than finite reinsurance would be

costly, time-consuming and unnecessary. Nevertheless, if the NAIC wishes to obtain risk transfer analyses on traditional contracts, we believe such requirement should only be for those contracts incepting after the effective date of the suggested changes to the Interrogatories.

Following is a rewriting of this attestation with our recommended changes, as shown below in redlined text:

“The Chief Executive Officer and Chief Financial Officer attest, under penalty of perjury, that with respect to ~~all~~ reinsurance contracts that have a material effect on the financial statements, for which the reporting entity is taking credit on its financial statement, that to the best of their knowledge and belief and after reasonable due diligence:

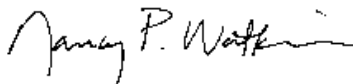
- (I) Consistent with *SSAP No. 62—Property and Casualty Reinsurance*, paragraph 8c there are no separate written or oral agreements between the reporting entity (or its affiliates or companies it controls) and the assuming reinsurer that would under any circumstances, reduce, limit, mitigate or otherwise affect any actual or potential loss to the parties under the reinsurance contract other than inuring contracts that are explicitly defined in the reinsurance contract except as disclosed herein;
- (II) For each such reinsurance ~~contract, the reporting entity has an underwriting file documenting~~ contract entered into, renewed, or amended on or after January 1, 1994, for which risk transfer is not reasonably considered to be self-evident, documentation concerning the economic intent of the transaction and the risk transfer analysis evidencing the proper accounting treatment, ~~which~~ is available for review; and
- (III) The reporting entity complies with all the requirements set forth in *Statement of Statutory Accounting Principle No. 62—Property and Casualty Reinsurance*; and
- (IV) The entity has appropriate controls in place to monitor the use of reinsurance and adhere to the provisions of *SSAP No. 62—Property and Casualty Reinsurance*.

Any exceptions to the aforementioned shall be disclosed on the attestation. In addition an explanation of the exceptions shall be attached to the attestation. (Note that agreements that settle disputes on ceded losses or provide clarification as to how future losses are to be ceded are considered part of the original contract and not separate agreements, provided that they are sufficiently documented and considered in the attestation above.)”

We also note that we have changed “underwriting file” to “documentation,” as we do not believe such documentation supporting reinsurance is commonly referred to as underwriting files.

We hope that the comments in this letter are useful to the NAIC. We would be pleased to meet with you and discuss this issue in greater depth.

Sincerely,



Nancy Watkins, Chair
Committee on Property and Liability Financial Reporting
American Academy of Actuaries

cc: John Purple, Chair, Casualty Actuarial Task Force