



AMERICAN ACADEMY *of* ACTUARIES

June 19, 2003

Ms. Anne Kelly, FCAS, MAAA
NAIC Property & Casualty Risk-Based Capital Working Group
National Association of Insurance Commissioners (NAIC)
Chief Casualty Actuary
New York State Insurance Department
25 Beaver Street
New York, NY 10004

Re: Retroactive Reinsurance Treatment in the Risk-Based Capital Formula

Dear Ms. Kelly:

The NAIC has requested that the AAA P&C RBC Committee review the manner in which retroactive reinsurance is considered in the RBC calculation. This letter illustrates the findings of our Committee.

Background

Currently, retroactive reinsurance is not reflected in Schedule P, i.e., there is no reduction in loss reserves for the ceding carrier and no addition to loss reserves for the assuming reinsurer. Since the RBC formula uses Schedule P reserves and makes no specific adjustments for retroactive reinsurance, there is no reduction in the RBC charge on loss reserves for the ceding carrier and no addition to the RBC charge on loss reserves for the assuming carrier. However, the net effect of the ceded premium and ceded losses are added or subtracted to the policyholder surpluses of the ceding and assuming carriers.

In summary, the AAA P&C RBC Committee recommendation is that no action be taken at this time. This recommendation is consistent with our previous review, which was conducted four years ago at the NAIC's request, and is made for the reasons discussed below.

Results of Prior Review

In March 1999, the AAA P&C RBC Committee finished its review of this issue and recommended that no action be taken at that time. This recommendation was based on 1) insufficient data available in the Annual Statement, 2) an apparent lack of materiality, and 3) conflicting conceptual views.

Regarding item (1), the 1998 Annual Statement reporting requirements for retroactive reinsurance were limited to completing a Note to the Financial Statements that required disclosure of the aggregate retroactive reinsurance premium and loss amounts. There was no separation of this data by Schedule P line of business, or even by property versus casualty. In addition, there was no accident year information or division of data by type of contract (e.g. quota share, specific excess, aggregate excess, etc.). Even if appropriate, it was not possible to develop a set of reasonable RBC charges without more information being available.

Regarding item (2), at 12/31/1997 retroactive reinsurance was \$2.1 billion or 0.6% of the total insurance industry loss and loss adjustment expense (LAE) reserves. There was some concern about data quality and that the actual amount of retroactive reinsurance might have been somewhat greater than 0.6%.

Regarding item (3), the AAA P&C RBC Committee developed a contrarian view to that which apparently underlies the NAIC request. The NAIC request seems to assume that the ceding insurer is being penalized because it has RBC charges on loss reserves that have been reinsured. The contrarian view counters that assumption by pointing out two significant reasons for not considering the ceding carrier to be penalized. First, retroactive reinsurance transactions are often, if not primarily, written with the ceded premium being less than the ceded losses. This "discounting" provision benefits the ceding insurer through an increase to policyholder surplus that would not be available absent the reinsurance transaction. Second, retroactive reinsurance contracts are often, if not primarily, written on an aggregate excess basis with total and annual loss limits that significantly limit the amount of risk transferred to the reinsurer. The amount of ceded losses significantly overstates the amount of risk reduction to the ceding insurer.

Current Review

In response to the NAIC request, the prior conclusions of the P&C RBC Committee were reviewed to determine if they were still applicable based on the data available at the time of our analysis.

Regarding item (1) underlying the prior recommendation, nothing has changed since the prior review. The current reporting requirements are identical to those in place for the 1998 Annual Statement. Aggregate assumed and ceded amounts are reported without any detail regarding line of business, accident year, or type of reinsurance coverage.

Regarding item (2), the amount of retroactive reinsurance is up since 12/31/1997. The attached exhibit shows the companies reporting assumed or ceded retroactive reinsurance and compares those amounts to carried loss and LAE reserves and reported surplus. The amounts are totaled and compared to total industry reported amounts, and are discussed below.

First note that there is some concern about accuracy of data being reported. The total assumed does not equal the total ceded. Although there may be some discrepancy between the assumed and ceded amounts due to transactions with non-U.S. companies, there still is concern that some of the difference is due to missing data or incorrect data. There are many instances of negative amounts being reported. There are also many instances where the ceded retroactive reserves are greater than the carried reserves even though there should be no reduction in the carried reserves for retroactive reinsurance.

The aggregate ceded retroactive reinsurance at 12/31/2001 is about \$14.3 billion, or about 3.8% of the total industry loss and LAE reserves. At 12/31/1997, retroactive reinsurance was \$2.1 billion, or 0.6% of the total industry loss and LAE reserves. The growth may not be as great as indicated because there was speculation in the prior review that the data base did not include all companies with ceded retroactive reinsurance. Also, from a usage standpoint, the long-tail nature of the payouts would generate reserve growth even if the annual usage was stable or declining. It would be necessary to obtain data from each year of Annual Statements in order to track annual usage.

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Also note the concentration of usage. There are only four companies that have \$1 billion or more in ceded retroactive reinsurance. These four companies total \$6.9 billion, or 48% of all ceded retroactive reinsurance. On the assumed side, only one company assumes \$1 billion or more of retroactive reinsurance. That company assumes \$10.3 billion, or 70% of the aggregate assumed retroactive reinsurance.

Regarding item (3), the contrarian view is equally applicable at this time. Although based on an unscientific sampling, it appears that most retroactive reinsurance contracts are of an aggregate excess type with total and annual loss limits that significantly reduce the amount of true risk transfer and have a premium charge that is less than the amount of ceded losses. The "discounting" benefit to the ceding insurer offsets, or possibly exceeds, any penalty the ceding insurer incurs by not having its loss reserves reduced for ceded retroactive reinsurance. Additionally, the ceding insurer does not incur any RBC credit risk charge on reinsurance recoverables from retroactive reinsurance further offsetting any penalty resulting from the RBC formula approach.

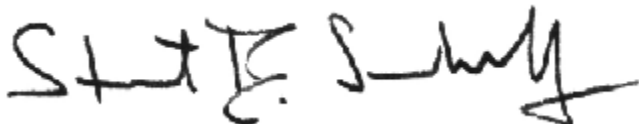
P&C RBC Committee Recommendation

The P&C RBC Committee recommendation is that no action be taken at this time. This recommendation is based on the following:

1. There is not adequate retroactive reinsurance information in the Annual Statement to make any reasonable adjustment to the RBC formula.
2. Although the amount of retroactive reinsurance reserves has grown, it is still minor and concentrated in a few companies. For those few companies, as well as companies with smaller dollar amounts of ceded or assumed retroactive reinsurance that are a significant portion of surplus, it would be better handle supervision through the examination process not the RBC formula.
3. The contrarian view presented in the prior review is a strong argument against the position that the ceding insurer is being penalized by the current RBC calculation. The NAIC has not presented any response to this contrarian view.

We would be happy to assist and are available to discuss this matter with you. Please contact me or Greg Vass, the Academy's senior casualty policy analyst (vass@actuary.org; 202-785-7865), if you have any questions.

Sincerely,



Stuart B. Suchoff, MAAA, FCAS, FCA, Chairperson
Property/Casualty Risk-Based Capital Committee