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 supports the development and enforcement of actuarial standards of conduct, qualification and practice, and the Code of Professional Conduct for all actuaries practicing in the United States.
Reinsurance Attestation Supplement 20-1: 
Risk Transfer Testing 
Practice Note

Background and Purpose of Document

The Property and Casualty Annual Statement Instructions for 2005 issued by the National Association of Insurance Commissioners (NAIC) contain a new supplement, Supplement 20-1, titled the “Reinsurance Attestation Supplement: Attestation of Chief Executive Officer and Chief Financial Officer Regarding Reinsurance Agreements” (Reinsurance Attestation Supplement). The 2005 Annual Statement Instructions do not change the scope of the Statement of Actuarial Opinion to include an evaluation of risk transfer. Further, the Reinsurance Attestation Supplement places requirements on the company’s chief executive officer (CEO) and chief financial officer (CFO) and not on the Appointed Actuary. However, it is very possible that the CEO or CFO will seek actuarial support related to the risk transfer analysis and documentation requirements outlined in the Reinsurance Attestation Supplement.

This communication by the American Academy of Actuaries Committee on Property and Liability Financial Reporting (COPLFR) is intended to provide advisory, non-binding guidance to property/casualty actuaries regarding testing for risk transfer. It has been written by actuaries, for actuaries, and is not intended to be professional accounting guidance. Further, the guidance is not intended for use in life and health insurance.

This communication is not an Actuarial Standard of Practice. It has not been adopted by the Actuarial Standards Board (ASB) and is not binding on any actuary. It should not be deemed to describe or codify generally accepted actuarial practice. From the perspective of the actuarial profession, meeting the requirements of the Reinsurance Attestation Supplement is an evolving area and a generally accepted practice which may apply does not yet exist.

Reinsurance Attestation Supplement

The Reinsurance Attestation Supplement will be part of the Annual Statement for property/casualty insurance companies and will be public information. This new supplement is required to be filed by March 1 each year. The requirements of the Reinsurance Attestation Supplement apply to a company’s ceded reinsurance program, and not to any assumed reinsurance.

A complete copy of the Reinsurance Attestation Supplement is included as an attachment to this document. In summary, the supplement requires the CEO and CFO of the company to attest, with respect to active ceded reinsurance contracts, to the following four items:
• There are no separate written or oral agreements between the reporting entity and the assuming reinsurer that would reduce, limit, mitigate, or otherwise affect any actual or potential loss to the parties under the reinsurance contract;

• For each such reinsurance 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 is available for review;

• The reporting entity complies with the requirements set forth in SSAP 62; and

• The reporting entity has appropriate controls in place to monitor the use of reinsurance and adhere to the provisions of SSAP 62.

**Actuarial Involvement in Reinsurance Attestation Supplement**

The CEO and CFO are required to attest that a process is in place to fulfill the company’s obligations under SSAP 62 and that the appropriate responsible parties have met their obligations regarding the accounting for reinsurance. We anticipate that the most likely areas of actuarial involvement in support of the Reinsurance Attestation Supplement will be in the selection, quantification, and documentation of ceded reinsurance contracts.

The wording of the Reinsurance Attestation Supplement provides for a “safe harbor” such that cash flow testing is unnecessary for contracts where risk transfer is considered to be reasonably self-evident. However, it does not define or describe the contracts or situations that might qualify for this safe harbor. “Selection” refers to the evaluation of ceded reinsurance contracts to determine those where risk transfer is not reasonably self-evident, so that such contracts will require a cash flow analysis to evaluate risk transfer.

“Quantification” refers to the development of a cash flow analysis to evaluate the economics of the transaction, including the premiums, losses and other cash flows between the ceding company and the reinsurer under the reinsurance agreement. Two essential items considered by the decision-maker in deciding whether a reinsurance agreement meets the risk transfer requirements of SSAP 62 are as follows:

• the “reasonable possibility of”, where the estimate measures the likelihood or probability of a given loss amount.

• “a significant loss”, where the estimate measures the potential magnitude of an economic loss to the reinsurer, for example using different scenarios or a model.

In this document, we may refer to the quantification of economic losses as “cash flow testing” or “measuring risk transfer.” However, it is typically not the responsibility of the actuary to decide whether a reinsurance contract meets the standards of SSAP 62; for many companies this decision is made by accounting professionals after considering the actuarial evaluation of the economics of the transaction.
“Documentation” refers to written materials, including risk transfer analyses, which are maintained on each reinsurance contract where risk transfer is not considered to be reasonably self-evident, such that an auditor or regulatory examiner may follow the process used by the company to assess the proper reinsurance accounting treatment as required by SSAP 62.

Contents of Practice Note

The remainder of this document contains the following sections:

- Key excerpts from statutory and GAAP reinsurance accounting standards;
- Documentation files for ceded reinsurance transactions;
- Safe harbors for which risk transfer may be self-evident without the requirement of cash flow testing;
- A summary of issues to be considered when performing cash flow testing;
- Frequently asked questions and answers that may be helpful to the practicing actuary; and
- A copy of the Reinsurance Attestation Supplement (see attachment).

In several places within the Practice Note, we refer to a report issued by the American Academy of Actuaries (Academy) in August 2005 titled “Risk Transfer in P&C Reinsurance: Report to the Casualty Actuarial Task Force of the National Association of Insurance Commissioners” (the Academy risk transfer report).

The report can be downloaded from the Academy website at the following addresses:

Committee on Property and Liability Financial Reporting (COPLFR) 2004-05

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COPLFR prepared this Practice Note with a great deal of assistance from Sheldon Rosenberg and Marvin Pestcoe.
Excerpts from Reinsurance Accounting Standards

SSAP 62

Guidance for the accounting underlying the completion of an insurer Annual Statement is provided in the Statement of Statutory Accounting Principles (SSAPs) issued by the NAIC and published in the NAIC’s Accounting Practices and Procedures Manual. Guidance regarding the recording of reinsurance transactions is provided in SSAP 62: Property and Casualty Reinsurance. The actuary may find the following excerpts from SSAP 62 helpful when considering the issue of risk transfer.

Paragraphs 9 through 16 of SSAP 62 are subtitled “Reinsurance Contracts Must Include Transfer of Risk.”

In paragraph 9 of SSAP 62 it is stated that “The essential ingredient of a reinsurance contract is the transfer of risk….Unless the agreement contains this essential element of risk transfer, no credit shall be recorded.”

Paragraph 10 of SSAP 62 includes the statement that “Actual or imputed investment returns are not an element of insurance risk.”

Paragraph 12 of SSAP 62 reads as follows:
“12. Indemnification of the ceding entity against loss or liability relating to insurance risk in reinsurance requires both of the following:

a. The reinsurer assumes significant insurance risk under the reinsured portions of the underlying insurance agreements; and

b. It is reasonably possible that the reinsurer may realize a significant loss from the transaction.”

In paragraph 13 of SSAP 62 it is stated that “A reinsurer shall not have assumed significant insurance risk under the reinsured contracts if the probability of a significant variation in either the amount or timing of payments by the reinsurer is remote.”

Paragraph 14 of SSAP 62 states that “The ceding entity’s evaluation of whether it is reasonably possible for a reinsurer to realize a significant loss from the transaction shall be based on the present value of all cash flows between the ceding and assuming companies under reasonably possible outcomes, without regard to how the individual cash flows are described or characterized. An outcome is reasonably possible if its probability is more than remote. The same interest rate shall be used to compute the present value of cash flows for each reasonably possible outcome tested. A constant interest rate shall be used in determining those present values because the possibility of investment income varying from expectations is not an element of insurance risk. Judgment is required to identify a reasonable and appropriate interest rate.”
Paragraph 15 of SSAP 62 contains a description of one instance where cash flow testing is not required to demonstrate risk transfer, previously referred to as a “safe harbor.” Paragraph 15 contains the comment that “In this narrow circumstance, the reinsurer’s economic position is virtually equivalent to having written the insurance contract directly.”

**FAS 113**

*Statement of Financial Accounting Standards, No. 113: Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts...* (FAS 113) was published in December 1992 and provides guidance regarding the accounting and reporting for reinsurance contracts under U.S. Generally Accepted Accounting Principles (GAAP). The actuary will likely also find this document helpful when considering the issue of risk transfer. There are many parallels between SSAP 62 and FAS 113. Of particular interest are paragraphs 9 and 11. Paragraph 9, similar to paragraph 12 of SSAP 62, reads as follows:

“9. Indemnification of the ceding enterprise against loss or liability relating to insurance risk in reinsurance of short-duration contracts requires both of the following, unless the condition in paragraph 11 is met:

a. The reinsurer assumes significant insurance risk under the reinsured portions of the underlying insurance contracts.

b. It is reasonably possible that the reinsurer may realize a significant loss from the transaction.”

Paragraph 11 of FAS 113, similar to paragraph 15 of SSAP 62, reads as follows:

“11. Significance of loss shall be evaluated by comparing the present value of all cash flows, determined as described in paragraph 10, with the present value of the amounts paid or deemed to have been paid to the reinsurer. If, based on this comparison, the reinsurer is not exposed to the reasonable possibility of significant loss, the ceding enterprise shall be considered indemnified against loss or liability relating to insurance risk only if substantially all of the insurance risk relating to the reinsured portions of the underlying insurance contracts has been assumed by the reinsurer.”

In describing the type of testing required to demonstrate significance of loss, paragraph 11 also describes a case where such testing is not required. When discussing this type of safe harbor, we will use the term “paragraph 11 exception,” which is a commonly used term that refers back to FAS 113.

The above excerpts from FAS 113 and SSAP 62 are not intended to be a complete treatment of risk transfer as discussed in these documents. For example, in evaluating risk transfer the decision-maker normally considers such issues as the definitions of “significant,” “reasonably possible” and “remote.” Such issues involve interpretation of accounting guidance and are outside the scope of this Practice Note. The actuary may
wish to read the remaining portions of SSAP 62 and FAS 113, including the questions and answers to these statements. The actuary should also consider consulting with accounting and/or legal professionals as he or she deems appropriate to assist in understanding the issue of risk transfer in reinsurance contracts.
Documentation Files for Ceded Reinsurance Transactions

Among other requirements, the Reinsurance Attestation Supplement contains the attestation that there is documentation concerning the economic intent of the transaction and the risk transfer analysis for certain contracts. According to a recent survey of insurers described in the Academy’s risk transfer report, the following items were considered to be of value for the contract file of the ceding entity:

a. Relevant correspondence between the ceding and assuming entities. This usually includes any related agreements, including but not limited to interlinked reinsurance contracts or trust agreements.

b. A copy of each draft of the reinsurance slip and contract.

c. A memorandum from management describing the business purpose and the economic intent for the reinsurance cession.

d. A statement regarding risk transfer, either that the risk transfer is considered to be reasonably self-evident or a copy of the analysis that displays the possible outcomes, their likelihood, and their economic impact.

e. Signoff from management that risk transfer has been demonstrated or is believed to be reasonably self-evident.

f. Copy of signoff from an external auditor or other party as to risk transfer, if available.

To the extent the actuary is asked to quantify the risk transfer described in d. above, it might be helpful to have available documentation supporting the analysis and calculations sufficient for another actuary practicing in the area to follow. The risk transfer documentation will be available to state regulators and auditors. In developing such documentation, the actuary might wish to refer to Actuarial Standard of Practice (ASOP) 9, *Documentation and Disclosure in Property and Casualty Insurance Ratemaking, Loss Reserving and Valuations.*
Safe Harbors – Where Risk Transfer Is Reasonably Self-Evident

The Reinsurance Attestation Supplement, and in particular its second paragraph, identifies several circumstances whereby contracts are excluded from all or a portion of the scope of the attestation:

- **Contracts with No Amounts Recoverable:** The introduction statement to the attestation statement identifies its scope as “all reinsurance contracts for which the reporting entity is taking credit on its current financial statement”. As such, contracts that are not active, or where there are no unearned premiums, losses or other amounts recognized as recoverable as of the Annual Statement date, are excluded from the scope of the attestation.

- **Certain Older Contracts:** With regard to maintaining documentation evidencing risk transfer, the attestation statement requires that management only consider “each such reinsurance contract entered into, renewed, or amended on or after January 1, 1994,” since this is the date when the current accounting rules surrounding risk transfer in reinsurance contracts were adopted by the NAIC. Prior to that date, no risk transfer analysis was required under statutory accounting rules. Note that this exception only relates to the second paragraph of the attestation statement.

- **Risk Transfer Is Reasonably Self-Evident:** Also with regard to evidencing risk transfer under the second paragraph, the attestation statement requires that management maintain documentation with respect to contracts “for which risk transfer is not reasonably considered to be self-evident.” It is our understanding that the purpose of this clarification is to eliminate and/or avoid the time and expense associated with unnecessary analyses.

While the first two bullet-point exclusions are self-explanatory, the last bullet point concerning possible safe harbors is not. Accordingly, the discussion below provides guidance to actuaries when assisting management in making the determination as to whether or not risk transfer is reasonably self-evident.

**Risk Transfer Reasonably Self-Evident**

Since the adoption of the current accounting rules surrounding risk transfer, it has been common practice that risk transfer analyses and related documentation be completed only for contracts considered to be “finite” or “structured,” as opposed to “traditional.” In most cases, these analyses and documentation have not been completed for many traditional reinsurance contracts presumably because risk transfer was deemed to be self-evident. Furthermore, risk transfer cash flow tests generally have not been required for traditional contracts by auditors or financial examiners performing regulatory functions. However, since there are no universally accepted definitions of the terms “finite” and
“traditional,” and the same contract features and/or structures may be present in either finite or traditional contracts, there is no simple way to divide the two groups.

With regard to the attestation statement, company management may consider this matter anew and may review all of its ceded reinsurance contracts that are still active. For those contracts that are not exempted by the first two exclusions above, management would need to decide if risk transfer is self-evident and might look to its internal or consulting actuaries for assistance in making this determination.

When evaluating reinsurance contracts as to whether risk transfer is reasonably self-evident, it should be understood that this is a principles-based standard. Therefore, there is no bright line that can be used for its application. As a matter of practice, it would be more conservative to evaluate contracts for risk transfer when there is any doubt as to whether or not risk transfer is reasonably self-evident.

**Common Safe Harbors**

This section of the Practice Note summarizes common safe harbors observed by practitioners, but these ideas are not intended to be exhaustive, nor are they exclusive. In practice, there will be contracts in addition to those identified in this section where it can be deemed that risk transfer is reasonably self-evident. In making this determination, important considerations include an evaluation of the substance of the arrangement, the existence, impact, and role of risk-limiting features, and the use of professional judgment.

Also, as described in the Academy’s risk transfer report, the Academy asked casualty actuaries to contribute ideas with respect to appropriate safe harbors for risk transfer cash flow testing. A wide variety of answers were received. Many of these ideas fall in the category of research ideas as yet untested in the marketplace, and include suggestions intended for future consideration. These ideas are contained in their entirety in the Academy risk transfer report. We believe that the regulators of individual states may have their own ideas regarding safe harbors. Actuaries may find it beneficial to discuss this issue with their domiciliary regulators as questions arise.

Risk transfer is reasonably self-evident in most traditional per-risk or per-occurrence excess of loss reinsurance contracts. For these contracts, a predetermined amount of premium is paid and the reinsurer assumes nearly all or all of the potential variability in the underlying losses, and it is evident from reading the basic terms of the contract that the reinsurer can incur a significant loss. In many cases, there is no aggregate limit on the reinsurer’s loss. The existence of certain experience-based contract terms, such as experience accounts, profit commissions, and additional premiums, generally reduce the amount of risk transfer and make it less likely that risk transfer is reasonably self-evident. Typically, the more risk retained by the ceding company through these terms, the less likely that risk transfer is self-evident.

Also, the “rate on line” is an important consideration with excess of loss reinsurance contracts. (Rate on line is defined here as the premium paid to reinsure 100 percent of a layer divided by the size of the layer.) Excess of loss contracts with no or minimal risk-
limiting features and with relatively low rates on line are typically deemed to transfer risk. However, even if a contract has no risk-limiting features, as the rate on line approaches the present value of the limit of coverage, risk transfer is usually no longer deemed to be reasonably self-evident.

Straight quota-share contracts are typically exempted from risk transfer requirements under the paragraph 11 exception of FAS 113. However, the introduction of risk limiting features to a quota share contract, such as a loss ratio cap (other than one that is so high its effect is de minimus), a loss retention corridor, or a sliding scale commission, often prevents the contract from qualifying for the exception.

In summary, the following contracts would typically be considered safe harbors, either through the paragraph 11 exception or because risk transfer is reasonably self-evident:

- A straight quota share with no risk-limiting features other than a loss ratio cap with negligible effect on the economics of the transaction;
- Single year property catastrophe and casualty clash contracts with little or no risk limiting features apart from a reinstatement premium common to these types of contracts;
- Most facultative and treaty per risk excess of loss arrangements with rates on line well below the present value of the limit of coverage, or without aggregate limits, sub-limits, or contingent features.

Of course, as noted above, this list is not intended to be an exclusive or exhaustive list.

While there are always exceptions, contracts that would not typically qualify for risk transfer being reasonably self-evident include:

- Aggregate excess of loss contracts--most of these contracts either contain significant risk-limiting features, and/or attach in an expected layer of loss so that the premium approaches the present value of the coverage provided;
- Contracts with experience accounts, experience rating refunds, or similar provisions, if such provisions have a significant impact on the contract’s economics;
- Multiple year contracts--many of these have provisions that protect the reinsurer from changes in exposure over the contract period and make the analysis complicated, and/or have features that adjust the terms of later years explicitly or implicitly based on results in earlier years;
- Quota share contracts with risk limiting features such as loss retention corridors, sliding scale commissions, loss ratio caps and/or sub-limits that significantly impact the amount of risk being transferred.
For a given reinsurance contract, once the determination is made that risk transfer is not reasonably self-evident, management will need to evaluate the amount of risk transferred and prepare documentation supporting the business rationale for the contract. In most cases, it would be expected that the rigor of the analysis and documentation would increase to the extent that the contract transfers less risk. The following section provides guidance for actuaries to consider when performing cash flow testing for reinsurance contracts.

A final observation is that failure to satisfy the “reasonably self-evident” standard does not necessarily mean that a contract has insufficient risk to qualify as reinsurance, nor that it is a finite risk contract. It simply means that more analysis is required in order to make a determination of risk transfer. In the context of the attestation by the CEO and CFO, it also means that there is a requirement for management to maintain documentation of that analysis, as described in the next section.
Risk Transfer Cash Flow Testing

For contracts where risk transfer is not deemed to be reasonably self-evident, management will need to have documentation supporting risk transfer available for regulatory review. This section will focus on the cash flow testing as part of the risk transfer analysis and the issues to consider, current industry practice as it relates to incorporating parameter risk and handling various exposures, and the value of judgment to the process. It should be noted that the risk transfer measurement process is intended to be a prospective analysis, to be completed at the time of entering the reinsurance contract.

When documenting risk transfer, there will likely be many instances in which management looks to its internal or external actuaries for assistance as regards the measurement of risk. While SSAP 62 is an accounting statement, and thus the need for risk transfer cash flow testing arises from the application of accounting rules, actuaries may provide significant input in, or even take the lead in, the evaluation and quantification of insurance risk. Nevertheless, despite the actuaries’ role in quantifying a contract’s risk, the final determination of whether that risk is sufficient is typically an accounting decision.

Risk transfer analyses may range from very simple premium to loss limit approaches for certain contracts, to highly sophisticated stochastic models with many inputs and variables for other contracts. Typically, the required rigor of such analyses increases as the contractual terms become more complex, and/or to the extent that risk transfer becomes more limited through risk-limiting contract features. In cases where the actuary is asked to perform cash flow tests as part of the risk transfer analysis, the actuary may wish to review the steps outlined in the remainder of this document before undertaking such an evaluation.

In reading this section, it is important to note that there are currently no actuarial standards of practice on risk transfer analysis, and practice is evolving rapidly. Though the goal of evaluation of risk transfer differs to some extent from the goals in pricing reinsurance contracts or setting loss reserves, parts of the approach and development of estimates require some of the same considerations that are outlined in existing statements of principles and standards of practice regarding property/casualty ratemaking and loss reserving. Though not directly applicable, these statements might be used as a resource by actuaries when performing cash flow tests for risk transfer.

Understand the Substance of the Agreement

In order to understand the substance of the agreement before evaluating and quantifying the amount of the economic losses being transferred, the actuary may wish to do the following:
• Obtain and review as much background to the transaction as practicable, including the business purpose and the substance of the transaction. In this regard, the actuary may wish to have discussions with management or other key personnel as applicable. Furthermore, the actuary may wish to obtain and review internal accounting memoranda or other relevant internal documentation.

• Obtain and read the entire agreement, as well as any related agreements, including but not limited to interlinked reinsurance contracts or trust agreements.

If it is not clear how certain contractual terms operate, the actuary might choose to seek assistance from accounting and legal professionals, as applicable. Should the actuary rely on the interpretation of contractual language from another person or party, the actuary usually discloses such reliance in his/her documentation.

In reviewing the contract, the actuary may encounter contract provisions which may create contingent rights or obligations that appear to reduce risk if applied. These include special termination clauses, warranties, and adjustable limits or deductibles. In some cases, these provisions are worded in indefinite or ambiguous ways that make modeling difficult and, perhaps, impossible unless one were to make assumptions about the behavior of one or both parties to the contract. In those cases, if it is not possible to clarify the intent of the parties, the actuary might not be able to complete a quantification of the economic losses transferred under the agreement. Further, if the actuary does make assumptions about the behavior of parties to the contract, it may be appropriate to incorporate documentation of these assumptions in the analysis documentation.

**Develop Cash Flow/Scenario Testing of Subject Losses**

Once the actuary understands the substance of the contract, the next step is usually to determine what losses or loss events subject to the contract are reasonably possible. As with any actuarial analysis, the use of informed judgment is critical when developing cash flow analyses under reinsurance agreements.

In some cases, in particular for those contracts in which a single event, such as a large catastrophe, is required to produce a significant loss to the reinsurer, an analysis of what is reasonably possible is sometimes limited to the identification of one scenario or several alternative scenarios, and discussion as to whether or not those are reasonably possible.

In other cases, the actuary may develop a stochastic model that projects estimates of subject losses using thousands of scenarios. In these models, there are several key assumptions that the actuary normally selects, such as:

• A mean and coefficient of variation of losses;
• An assumed distribution of such losses;
• Selected payout patterns, as well as variation in such patterns;
• Adjustments for parameter risk.
The modeled distributions may be based on aggregate losses, individual frequency and severity distributions, or some combination of these.

In many cases, the mean is selected by reviewing historical data where available, supplemented by industry or competitor company data when appropriate. There is often less data available to estimate the coefficient of variation of losses; while historical data is often used as a starting point, in many cases it is appropriate to supplement such data with other information and judgment.

Similar to a pricing application, it might be appropriate to adjust historical data to make it an unbiased estimator of results for the prospective analysis period. Possible adjustments might include: trending losses, on-leveling premiums, adjusting for changes in exposure, and adjusting for the presence or absence of large losses or catastrophic events.

When determining a loss distribution, a positively skewed distribution such as the lognormal distribution is often used. Again, this is largely a matter of judgment and will depend on the individual situation.

Payout patterns are usually determined from historical payout patterns, if available, or from industry patterns. While variation in such patterns is a feature that is modeled by actuaries, there is little, if any, practical guidance on how to vary a payout pattern, or how much variation could be reasonably expected. It is normally a matter of actuarial judgment to determine whether the resultant approach and amount of variation in the payout pattern is reasonable.

Finally, the inclusion of parameter risk is usually an important element to cash flow testing. Parameter risk in this context refers to the potential inaccuracy in the form and parameters of the loss distribution. The sources of parameter risk are typically numerous in a reinsurance risk transfer analysis; there is a very good discussion of this in the Casualty Actuarial Society (CAS) white paper contained in Appendix 2 of the Academy’s risk transfer report.

By definition, parameter risk is very difficult to model and measure. In many cases, the actuary will account for parameter risk by increasing the coefficient of variation (CV) in the modeled analysis. In other cases, the actuary might adjust the mean or weigh together multiple models, each having its own mean and CV, to encompass parameter risk. More elaborately, parameter risk can be incorporated by explicitly treating the parameters of the loss distribution as stochastic variables themselves. In any case, the selection and application of parameter risk is complex and usually involves the significant application of professional judgment on the part of the actuary.¹

¹ A possible resource for understanding and modeling parameter uncertainty is Parameter Uncertainty in (Log) Normal Distributions, by Rodney E. Kreps.
Overlay the Contractual Terms

Whether determined through the selection of a single scenario or through thousands of scenarios via stochastic simulation, the actuary normally considers the amount and timing of cash flows that would be ceded under the contract for each loss scenario that is being modeled. Cash flow items may include loss payments, loss adjustment expense payments, initial premiums, additional premium payments, payment of profit or experience-based commissions, and other related cash flows. An appropriate quantification of the economics under an agreement includes contractual terms to the extent they affect cash flows between ceding company and reinsurer.

For certain contracts, modeling of contractual terms can become very difficult. This is often the case when there are notional experience accounts, funds-held accounts, and other accounts where there are interest credits and charges. Further, the impact of commutation, cancellation, or similar clauses may also significantly complicate the analysis.

For some contracts, there might be more than one applicable term for a given scenario. For example, the reinsurance company might have the option to cancel a contract, or not cancel and receive more premium. Usually, for purposes of evaluating risk transfer, it is appropriate to presume that the company with the option (in this case the reinsurer) will act in its financial best interest. Often the reinsurer will be required by the contract to exercise its option before it is clear how losses will ultimately develop. In those cases it is common practice to attribute “perfect knowledge” to the reinsurer. While computationally easier, this assumption might inappropriately underestimate the reinsurer’s risk. If it is not clear how such contractual terms interact with each other, the actuary may find it prudent to seek clarification or other assistance from accounting and legal professionals.

There are other circumstances in which the actuary may choose to seek assistance from accounting and legal professionals. These include contracts with the following provisions:

- Multiple year arrangements--some multiple year contracts, particularly those covering more than two years, contain contractual features that reduce the risk to the reinsurer through clauses that are very difficult to reflect when modeling the contractual cash flows.

- For crediting funds-held and/or experience accounts, interest rates that are significantly below or above risk-free rates, and/or different from the rate that is used to present value the cash flows.

- Ceding commissions paid in the future or at the expiration of the contract.

- Consideration of maintenance fees--while such fees are usually considered to be additional consideration to the reinsurer in an evaluation of risk transfer, it might depend on the contract language.
• Existence of commutation clauses, cancellation rights, or similar clauses—the existence of such clauses in some contracts provides either or both parties with rights that might appropriately be considered in the quantification of the economics under an agreement.

Sometimes, the existence of the above features can significantly complicate the actuary’s ability to appropriately quantify cash flows.

Once the loss scenarios are determined and the contractual terms are applied, the actuary may present-value the cash flows and quantify the economics of the reinsurance agreement under various scenarios.

**Interest Rate Used to Present-Value Cash Flows**

SSAP 62 does not specify a method for choosing the interest rate to be used for discounting; it specifically refers to this as an area to which judgment should be applied. SSAP 62 does, however, require that a single interest rate be used to present value the cash flows, and that the interest rate reflect the time value of money.

While not specified in the regulations, a commonly used approach is to use a risk-free interest rate, with duration approximately equal to that of the net cash flows. Based on current industry practice, an interest rate is often selected based on U.S. Treasury securities with similar durations. Typically, this is either performed based on a weighted average of the cash flows with U.S. Treasury yield curve analysis using zero-coupon securities, or through the selection of a single rate based on a simple review of U.S. Treasury rates and judgment.

**Summary of Ceded Cash Flows**

According to SSAP 62, significance of loss shall be evaluated by comparing the present value of all cash flows with the present value of the amounts paid or deemed to have been paid to the reinsurer. This comparison is frequently developed through a ratio comparison whose numerator and denominator are developed as follows:

• The numerator reflects the present value of the cash flows between the parties. This would include premiums less losses, ceding commissions if applicable, and other contractually determined cash flows, if any.

• The denominator reflects the present value of the total consideration to the reinsurer regardless of how it is characterized. This may include the initial premium, plus additional premiums, reinstatement premiums, maintenance fees, etc., less experience-based profit commissions or similar cash flows. Such premiums are typically not reduced for ceding commissions, brokerage payments, or other fees.
There are several items that are specifically not considered—brokerage paid to an intermediary, investment risk, and general and other expenses of the reinsurance company that are not cash flows between the parties.

Where the actuary performed stochastic testing, estimated cash flow would typically be presented by percentile in a manner similar to the following:

<table>
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<th>Percentile or Scenario</th>
<th>Nominal Total Ceded Premium</th>
<th>NPV Total Ceded Premium</th>
<th>Nominal Ultimate Ceded Loss</th>
<th>NPV Ultimate Ceded Loss</th>
<th>NPV Reinsurer’s Profit/(Loss) to NPV Premium</th>
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<tr>
<td>25.0%</td>
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<td>59,979</td>
<td>57,672</td>
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<td>30.0%</td>
<td>64,027</td>
<td>65,411</td>
<td>62,827</td>
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<td>35.0%</td>
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<td>69,023</td>
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<td>50.0%</td>
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<td>77,735</td>
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<td>55.0%</td>
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<td>80,559</td>
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<td>75,559</td>
<td>5,000</td>
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<td>60.0%</td>
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<td>83,950</td>
<td>82,108</td>
<td>78,950</td>
<td>5,000</td>
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</tr>
<tr>
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<td>86,100</td>
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<tr>
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<td>91,125</td>
<td>5,000</td>
</tr>
<tr>
<td>80.0%</td>
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<td>99,613</td>
<td>95,781</td>
<td>4,219</td>
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<tr>
<td>85.0%</td>
<td>100,000</td>
<td>100,000</td>
<td>106,301</td>
<td>102,213</td>
<td>(2,213)</td>
</tr>
<tr>
<td>87.5%</td>
<td>100,000</td>
<td>100,000</td>
<td>112,109</td>
<td>107,797</td>
<td>(7,797)</td>
</tr>
<tr>
<td>90.0%</td>
<td>100,000</td>
<td>100,000</td>
<td>117,391</td>
<td>112,876</td>
<td>(12,876)</td>
</tr>
<tr>
<td>92.5%</td>
<td>100,000</td>
<td>100,000</td>
<td>120,000</td>
<td>115,385</td>
<td>(15,385)</td>
</tr>
<tr>
<td>95.0%</td>
<td>100,000</td>
<td>100,000</td>
<td>120,000</td>
<td>115,385</td>
<td>(15,385)</td>
</tr>
<tr>
<td>97.5%</td>
<td>100,000</td>
<td>100,000</td>
<td>120,000</td>
<td>115,385</td>
<td>(15,385)</td>
</tr>
<tr>
<td>Mean</td>
<td>76,180</td>
<td>77,096</td>
<td>77,939</td>
<td>74,941</td>
<td>2,155</td>
</tr>
</tbody>
</table>

Following is a brief summary of the columns in the table:

- “Percentile or Scenario” represents a common way to present results of stochastic simulation. For this particular table, outcomes from stochastic simulation are ordered in terms of losses ceded to the reinsurer.
- “Nominal Total Ceded Premium” reflects the total premium under the contract. These amounts are stated gross of ceding commissions, and are increased for additional premiums and reduced for experience-based profit commissions, as applicable, for each of the respective scenarios presented in the table. “NPV Total
Ceded Premium” reflects these amounts discounted to present value. The fact that the NPV Total Ceded Premium is sometimes greater than the Nominal Total Ceded Premium, while unexpected, is a function of the particular terms of the contract represented by this table.

- “Nominal Ultimate Ceded Loss” reflects the total losses and expenses, as applicable, for which the reinsurer would be obligated to pay under the contract. “NPV Ultimate Ceded Loss” reflects these amounts discounted to present value.

- The “NPV Reinsurer’s Profit or Loss” column is the difference between the NPV Total Ceded Premium and the NPV Ultimate Ceded Loss columns. This amount is then divided by the “NPV Total Ceded Premium” column to generate the percentages in the final column.

**Quantification of Cash Flows**

The information in the above table could be used as input to the method used to quantify the economics under an agreement, the results of which could provide meaningful input to decision-makers when deciding whether the reinsurance agreement meets the risk transfer requirements of SSAP 62. No one method for evaluating risk transfer may be appropriate for use in all cases. Company management must decide which method or methods on which to rely, and in this decision they may be aided by the advice of an actuary. It is typically not the responsibility of the actuary to decide whether the risk transfer so measured is sufficient to meet the standards of SSAP 62; for many companies this decision is made by accounting professionals after considering the actuarial input.

Methods that have been proposed or used by actuarial practitioners include relative risk approaches, Value at Risk (VaR) methods, and Tail Value at Risk (TVaR) methods, including an Expected Reinsurer Deficit method. For a description and discussion of various methods, please see the Academy’s risk transfer report, in particular Appendix 2. It is important to note that such proposed or used methods may or may not be suitable for evaluating risk transfer under any given agreement. Therefore, the decision-maker may want to consult with actuaries and accounting professionals when considering which method or methods are suitable for evaluating risk transfer under a specific agreement.
Questions and Answers on Risk Transfer

Question 1: Which contracts should be subject to a risk transfer cash flow analysis?

Answer: Beginning with the 2005 Annual Statement, insurance companies are required to attest that they maintain risk transfer analysis documentation. This requirement applies to all ceded reinsurance contracts which satisfy the following criteria:

1. The contract is effective or amended after Jan. 1, 1994;
2. The ceding company is “taking credit for” the contract in its current financial statement (i.e. has either established an asset or reduced a liability);
3. Risk transfer is not “reasonably self-evident.”

Question 2: What is the “reasonably self-evident” standard and how is it applied?

Answer: The CEO and CFO of the ceding company are required to attest that they maintain documentation of the risk transfer analysis for certain contracts. Contracts for which risk transfer is “reasonably self-evident” are exempt from this requirement. This exemption reduces the burden of requiring risk transfer analysis for all contracts.

“Reasonably self-evident” is a principles-based standard. Thus, judgment needs to be applied. In addition, this particular standard has not been tested. The safe harbor section of this Practice Note contains more ideas with respect to this area. In the event of uncertainty, it may be wise to err on the side of performing a risk transfer analysis. Nevertheless, it is possible to make a number of observations about the application of the standard.

The first observation is that risk transfer would normally be reasonably self-evident for most traditional reinsurance contracts which are written using standard contract features and for which the motivation was simple risk transfer. For these contracts, it may be easy to conclude that it is reasonably possible (i.e. more than remote) that the reinsurer can incur a significant loss.

A second observation is that even for traditional reinsurance contracts, it is normally prudent to pay particular attention to contracts with aggregate limits that cap the reinsurer’s total loss. For these contracts it is often useful to compare the reinsurer’s premium to the present value of its aggregate limit.

A final observation is that failure to satisfy the “reasonably self-evident” standard does not necessarily mean that a contract has insufficient risk to meet the requirements of SSAP 62, nor that it is a finite risk contract. It simply means that a risk transfer analysis is required in order to evaluate whether the reinsurance agreement meets those
accounting requirements. In the context of the attestation by the CEO and CFO, it also means that there is a requirement to maintain documentation of that analysis.

**Question 3:** Who determines the meaning of “reasonably self-evident”?

**Answer:** The “reasonably self-evident” standard is a principles-based standard, and as such, judgment is required in its application. As with any statutory rule, company management is responsible for making this judgment, although the judgment may be made after consultation with internal and/or external advisors.

**Question 4:** What is the actuary’s responsibility in the risk transfer analysis process?

**Answer:** Actuaries can be expected to play several roles, depending on the circumstances.

In-house actuaries are likely to be asked to help company management develop guidelines for the risk transfer analysis process, including operational procedures for determining which contracts are reviewed, the methods used for the analysis, and the format of the documentation. It is also likely that actuaries will provide significant input in, or even take the lead in, the evaluation and quantification of insurance risk.

Actuaries will also likely be involved in supporting the review work performed by external auditors and regulators.

Nevertheless, while actuaries may take the lead role in quantifying a contract’s risk, it is important to remember that the determination of whether that risk is sufficient for a given accounting treatment is typically an accounting rather than an actuarial decision.

**Question 5:** Will the Appointed Actuary need to certify certain elements of risk transfer?

**Answer:** No, this is not a responsibility of the Appointed Actuary. The guidance on the Statement of Actuarial Opinion Instructions from the NAIC Casualty Actuarial Task Force (CATF) specifically notes that the scope of the opinion does not include an evaluation of risk transfer.

The selection of the individual who is to perform the risk transfer analysis is the responsibility of management. It need not be the Appointed Actuary, nor need it be an actuary at all. Although an actuary may be asked to play a role in cash flow testing for risk transfer, there is no requirement to this effect.

**Question 6:** What is the 10/10 rule and how does it relate to the quantification of sufficient risk transfer in a reinsurance contract?
Answer: SSAP 62 includes a risk transfer standard that states that a contract has sufficient risk for reinsurance accounting treatment if the reinsurer has a “reasonable probability” of a “significant loss.” SSAP 62 goes on to define reasonably probable as “not remote.” No further guidance is provided and the SSAP 62 risk transfer test remains a principles-based rather than a bright-line test.

The 10/10 rule is a frequently cited test for determining if there is enough risk in a contract to satisfy the risk transfer standard laid out in SSAP 62. Specifically, the 10/10 rule equates “reasonable possibility” with “at least a 10 percent chance” and “significant loss” with “a net present value loss at least equal to 10 percent of the reinsurer’s net present value premium.” The 10/10 rule may be thought of as a specific case of a more general Value at Risk method for measuring economic losses under a reinsurance agreement.

The Academy’s risk transfer report notes that many actuaries believe the 10/10 rule is inadequate for purposes of testing across the spectrum of all reinsurance agreements, particularly for agreements that reinsure low frequency/high severity risks. Further, COPLFR does not believe a bright-line approach, without allowance for judgment, is an optimal approach. These conclusions were supported by the NAIC’s CATF in its comment letter on the Academy’s risk transfer report.

Question 7: What interest rate should be used in each evaluated scenario to make the present value calculation?

Answer: Paragraph 14 of SSAP 62 states that “The same interest rate shall be used to compute the present value of cash flows for each reasonably possible outcome tested. … Judgment is required to identify a reasonable and appropriate interest rate.” Similarly, paragraph 66 of FAS 113 states that “A constant interest rate is used in determining these present values because the possibility of investment income varying from expectations is not an element of insurance risk. The Board concluded that it was not necessary to specify in detail the interest rate used in the calculation; judgment is required to identify a reasonable and appropriate rate.”

While not specified in the regulations, a common approach is to use a risk-free interest rate, with duration approximately equal to that of the net cash flows. Based on current industry practice, an interest rate is selected based on U.S. Treasury securities with similar durations. Typically, this is either performed based on a weighted average of the cash flows with U.S. Treasury yield curve analysis using zero-coupon securities, or through the selection of a single rate based on a simple review of U.S. Treasury rates and judgment.

Some contracts may specify interest rates for crediting funds-held and/or experience accounts that are significantly below or above risk-free rates, and/or different from the rate that is used to present value the cash flows. In these situations, the actuary may choose to seek assistance from accounting and legal professionals in determining how to model the contract terms.
**Question 8:** Let us assume our company plans to improve the content and documentation in the underwriting file prospectively, and we discover that some currently in-force contracts meet the risk transfer standard but are not sufficiently documented in the file. What could we do?

**Answer:** According to regulators who drafted the Reinsurance Attestation Supplement, it is permissible to add explanatory memoranda to the underwriting file as long as it is clear that this material is dated after entering into the contract and is being provided for ease of explanation purposes.

**Question 9:** If a company did not complete a risk transfer analysis at the time the reinsurance contract was written and then retrospectively constructs a risk transfer analysis for inclusion in the documentation file, would it base the analysis on the most current information and loss experience?

**Answer:** No. The analysis would be completed as though it were prospective, using the information available to the company at the time at which it entered into the contract. As noted in the answer to Question 8, the analysis would be dated when completed, noting that it has been added to the documentation file for ease of explanation purposes.

As a separate matter, such retrospective analyses should only be completed when necessary. It is the view of regulators that compliance with SSAP 62 requires that documentation supporting risk transfer be prepared at the time the contract is agreed upon between the parties.

**Question 10:** May a ceding company use a risk transfer analysis performed by a third party, such as a reinsurance intermediary, as support in satisfying the requirements of the Reinsurance Attestation Supplement?

**Answer:** Yes. Management may obtain expert advice from third parties. However, company management must select the appropriate parties to advise them, must take ownership of the results of the analysis, and must be responsible for maintaining the documentation. These responsibilities cannot be delegated to an outside entity.

**Question 11:** May a ceding company and a reinsurer reach different conclusions regarding risk transfer on a reinsurance contract?

**Answer:** Yes, it is possible that this may happen. A reinsurer and a ceding company may reach agreement on the terms of a reinsurance contract without agreement upon the expected loss ratio or the potential distribution of results on the subject business. Each company is responsible for its own assessment of risk transfer. Typically, the ceding company and the reinsurer do not share their analyses of risk transfer. Given the potential for a difference in knowledge of the subject business and in factors that may affect ceded experience between the ceding company and the reinsurer, and given the
amount of subjective judgment that may be involved in the analysis, there is a reasonable possibility that two entities might reach different conclusions regarding risk transfer on the same reinsurance contract.

**Question 12:** Does a risk transfer analysis always need to include probability distributions of cash flow estimates?

**Answer:** No. Sometimes it may be sufficient to generate one or several scenarios to support the risk transfer analysis. The amount of work that is appropriate is a matter of judgment. It typically depends on factors such as the level of complexity of the reinsurance contract, the materiality of the contract, and the nature of any risk-limiting features.

**Question 13:** If a prospective risk transfer analysis indicates that there is significant risk under a treaty, but subsequent loss experience is different than estimated, does that mean the risk transfer analysis is faulty and that the company may need to revise its accounting treatment?

**Answer:** No. The fact that loss experience is different than originally estimated, even if no losses are sustained under the contract, does not imply that there was not risk transfer at inception.

**Question 14:** Where may I find additional information from the CAS or Academy regarding risk transfer standards and testing?

**Answer:** In August 2005, the Academy issued its risk transfer report. The report contains the results of a survey on current industry practices in the evaluation of risk transfer. It includes a variety of alternatives to evaluating risk transfer suggested by actuarial professionals practicing in the area as well as the thoughts of professionals on the subject of which types of contracts should qualify for a “safe harbor” from a risk transfer cash flow analysis. It also includes thoughts on how risk transfer could be measured. Among the attachments to the report is a paper produced by a Research Working Party on Risk Transfer formed by the CAS, as well as insights from 18 individuals who responded to a June 2005 letter asking respondents to address the following four questions: What is an effective test for risk transfer? What criteria should be used to determine whether a reinsurance contract transfers significant risk to the reinsurer? What safe harbors, if any, should be established so that a full risk transfer analysis does not have to be completed for each and every reinsurance contract? What are the advantages and disadvantages of the suggested approach versus other approaches commonly used?

The actuary may also find it helpful to review a paper produced by the CAS Valuation, Finance and Investments Committee (VFIC), “Accounting Rule Guidance Statement of Financial Accounting Standards No. 113 – Considerations in Risk Transfer Testing”. The paper may be found in the 2002 fall edition of the CAS Forum. The paper was written to provide some considerations to CAS members on risk transfer testing.
As the questions of risk transfer and reasonable self-evidence are principles-based conclusions, the actuary may find this material useful when measuring risk and giving advice on issues surrounding the Reinsurance Attestation Supplement. However, it is important to note that the material in these publications falls in the category of research ideas and does not constitute official guidance.

**Question 15:** I understand that the NAIC is exploring possible changes to statutory accounting for ceded reinsurance. What changes have been made for 2005, and what is the NAIC considering for 2006 and beyond? Is the FASB considering similar changes for US GAAP accounting?

**Answer:** During 2005, the NAIC adopted certain changes to SSAP 62 effective beginning with the 2005 Annual Statement. In addition to the Reinsurance Attestation Supplement described herein, the NAIC also increased disclosure requirements for property/casualty insurance companies. Companies will be required to report the contract terms and management objectives of reinsurance agreements with certain features that have the effect of altering policyholders' surplus by more than 3 percent. The Reinsurance Attestation Supplement and the new disclosures will be part of the Annual Statement for property/casualty insurance companies and will be public information. These changes can be found at the NAIC's website, www.naic.org.

In addition, during 2005 the NAIC's Property and Casualty Reinsurance Study Group considered a proposal to change SSAP 62 to require bifurcation of reinsurance agreements that meet certain criteria. As described in the proposal, bifurcation of a reinsurance agreement entails accounting for a reinsurance transaction in two parts, such that the part of the transaction transferring insurance risk is accounted for as reinsurance and the part of the transaction financing losses and not transferring insurance risk is accounted for as a deposit. While this change was not adopted for 2005, the NAIC is expected to continue evaluating the requirements in SSAP 62 in 2006.

During 2005, the FASB also engaged in a project to clarify what constitutes transfer of significant insurance risk in insurance and reinsurance contracts, and to improve accounting by more clearly defining which contracts, or portions thereof, should be accounted for as insurance versus deposits. FASB is also exploring simple approaches to bifurcation of insurance contracts that include both insurance and financing elements. The FASB expects to have a draft issued during the first quarter of 2006, with a final document issued during the third quarter of 2006.
REINSURANCE ATTESTATION SUPPLEMENT

ATTESTATION OF CHIEF EXECUTIVE OFFICER AND CHIEF FINANCIAL OFFICER REGARDING REINSURANCE AGREEMENTS

Insurers are required to file a supplement to the annual statement titled “Reinsurance Attestation Supplement” by March 1 each year. The following provides a list of what is required within this filing.

The Chief Executive Officer and Chief Financial Officer shall attest, under penalties of perjury, with respect to all reinsurance contracts for which the reporting entity is taking credit on its current financial statement, that to the best of their knowledge and belief after diligent inquiry:

(I) Consistent with SSAP No. 62—Property and Casualty Reinsurance, 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 insuring contracts that are explicitly defined in the reinsurance contract except as disclosed herein;

(II) For each such reinsurance 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, as required by SSAP No. 62—Property and Casualty Reinsurance, is available for review;

(III) The reporting entity complies with all the requirements set forth in SSAP No. 62—Property and Casualty Reinsurance; and

(IV) The reporting 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 in the attestation and an explanation of the exceptions shall be attached to the attestation.

Exceptions:

Signed:

___________________________ _______________________
Chief Executive Officer Chief Financial Officer