

FIT Briefing

An Update from the Financial Integration Team

March 30, 2006

United States Accounting and Regulatory Update

The purpose of this briefing, which was prepared by the Financial Integration Team and the Financial Services Group, is to report on regulatory activities and rule-making efforts since our last briefing dated August 2005.

Reinsurance and Risk Transfer: The Discussion Continues...

With the filing of their 2005 Annual Statements, companies had to submit the expanded reinsurance disclosures and CEO/CFO reinsurance attestations. The disclosures were developed to increase regulators' awareness of those types of contracts with features that they have found problematic in the past. One element of the attestation is intended to ensure the existence of file documentation regarding economic intent and risk transfer for all contracts where risk transfer is not reasonably self-evident. The National Association of Insurance Commissioners (NAIC) did not define reasonably self-evident, and it was up to company management to make the determination. However, late last year the American Academy of Actuaries (AAA) issued a Practice Note (described below) with advisory, nonbinding guidance for actuaries. Meanwhile, both the NAIC and the U.S. Financial Accounting Standards Board (FASB) continue to discuss reinsurance issues.

Definition of Reasonably Self-Evident

As a result of the new disclosures and attestations, the American Academy of Actuaries prepared a Risk Transfer Testing Practice Note in November 2005 to provide advisory, nonbinding guidance to actuaries regarding testing for risk transfer. The Practice Note also included guidance on the phrase "Reasonably Self-Evident" and common safe harbors. In particular, the Practice Note states the following with respect to reasonably self-evident risk transfer:

"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 reasonable 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% 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.”

The AAA practice note provides some examples of contracts that are safe harbors. They are:

- *“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.”*

FASB – Risk Transfer and Bifurcation

In December 2005, the FASB met to clarify and strengthen existing risk transfer guidance. Since several board members believe that current accounting guidance results in accounting that does not reflect the economic substance of certain insurance and reinsurance contracts, the FASB staff was directed to develop approaches to bifurcating **both** insurance and reinsurance contracts into financing and insurance components. A formal Invitation to Comment (ITC) document (a neutral staff discussion document) soliciting feedback on bifurcation approaches and related implementation issues is expected to be issued during the second quarter.

NAIC – Risk Transfer

Now that the 2005 yellow books have been filed, the NAIC Property and Casualty Reinsurance Study Group will be seeking and reviewing industry and regulatory comments and questions regarding the disclosures and attestation. They will report on whether the instructions and information received at the June NAIC meeting were clear and useful.

At the March NAIC meeting, the Property and Casualty Reinsurance Study Group discussed the next steps in the review and development of risk transfer guidance, including:

- Definition of reasonably self-evident and safe harbors
- Specific guidance on risk transfer testing considerations
- Proposals for alternative methods of evaluating risk transfer

A new AAA Risk Transfer Subgroup is planning to complete a White Paper for submission to the Property and Casualty Reinsurance Study Group in August 2006. This White Paper will address technical issues in risk transfer testing for property and casualty reinsurance. The Property and Casualty Reinsurance Study Group will consider this paper in establishing guidance to enhance recognition and measurement of insurance risk transfer.

The Risk Transfer Subgroup will also monitor the bifurcation proposals at the FASB and the status of fair value accounting proposals at the International Standards Board (IASB).

U.S. and International Convergence

Several emerging issues, described below, demonstrate the increasing focus by U.S. regulators and accountants on the convergence of U.S. insurance regulation and accounting with international insurance regulation and accounting.

Reinsurance Collateral

Currently, foreign reinsurers are required to post collateral to secure reinsurance balances. The NAIC's Reinsurance Task Force has been asked to develop alternatives to the current reinsurance regulatory framework, including the use of collateral within the United States and abroad. It was instructed to consider approaches that address a reinsurer's financial strength regardless of domicile and was told to consult with international regulators in addition to all other interested parties. The proposal is to be presented at the 2006 Winter NAIC meeting in December.

Risk Based Capital

The NAIC is beginning a project to study the incorporation of modeled catastrophe exposure within the risk based capital (RBC) formula. Regulators are considering a small company exclusion in this proposal. The NAIC has also established a new working group to review the European Solvency II framework to determine how RBC could be improved and modernized. For more information about Solvency II, see the article titled "From Anticipation to Action" (Chapter 8) included in the October 2005 report: "*The Review Cedant's Guide to Renewals 2005*," available on Guy Carpenter's website (www.guycarp.com) in the "Our Insights" section.

Common Accounting Standards

In February, the FASB and the International Accounting Standards Board (IASB) reaffirmed their shared objective of developing common accounting standards. The FASB also issued an exposure draft in January entitled "Fair Value Option for Financial Assets and Liabilities." The proposal will allow companies the option to account for each specific reinsurance or insurance contract at fair value. One of the key objectives of the proposed accounting is convergence with International Accounting Standards. For an insurance or reinsurance contract, the primary change introduced by fair value accounting is discounting of loss reserves and the addition of a margin for risk and uncertainty. For a discussion regarding the IASB's initial views on market value accounting for assets and liabilities arising from insurance contracts, see the August 2004 report: "Convergence in Capital Adequacy Measures and Financial Reporting Rules," available on Guy Carpenter's website (www.guycarp.com) in the "Our Insights" section.

Sarbanes-Oxley

After years of discussion, the NAIC proposed potential adoption of parts of Sarbanes-Oxley requirements at its spring meeting. This proposal would primarily impact mutual companies that meet certain size criteria, since these requirements are already in place for public companies. The proposed requirements include:

1. A management report of internal control over financial reporting
2. Independent audit committee members, who are also members of the board of directors, would be required.
3. Auditor rotation and independence requirements would be more closely aligned with the Sarbanes-Oxley requirements.

Conclusion

2006 will be another year of discussion and review on the topics of risk transfer, bifurcation, collateralization, capital models and fair value accounting. Each of these topics has the potential to have a major impact on the insurance industry. Guy Carpenter's Financial Services Group and Financial Integration Team are both available to keep you apprised of the developments relating to the issues discussed in this briefing. If you have any questions or require additional information, please contact one of the Guy Carpenter specialists listed below.

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