27. (1.5 points)

A risk transfer test is being conducted on a quota share reinsurance contract with the following characteristics:

| | |
|---|---|
| Inception Date | January 1, 2014 |
| | |
| Cession | 75.0% |
| Ceding Commission | 10.0% |
| | |
| Profit Commission | |
| Loss Ratio | 65.0% |
| Profit Swing | 5.0% |
| | |
| Reinsurers Expenses as a % of Premium | |
| Brokerage | 1.5% |
| Operating Expenses | 2.0% |
| Fees related to letters of credit | 0.5% |

The Expected Reinsurer Deficit (ERD) risk measuring method is used in determining whether there is risk transfer in a reinsurance contract.

a. (0.5 point)

Describe the two conditions required for a contract to receive reinsurance accounting treatment.

b. (0.5 point)

Describe how the profit commission should be incorporated into the ERD method.

c. (0.25 point)

Briefly describe the impact the reinsurer's expenses will have on the ERD calculation.

d. (0.25 point)

Given an ERD of 2.5%, determine whether the contract is considered to exhibit risk transfer.

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| QUESTION *27* | |
|---|---|
| **TOTAL POINT VALUE: 1.*5*** | **LEARNING OBJECTIVE: C1, knowledge statement c** |

**SAMPLE ANSWERS (BY PART, AS APPLICABLE)**

**Part a: 0.5** point

Risk transfer requires that:

a. The reinsurer assumes significant insurance risk under the reinsured portion of the underlying insurance agreement; and
b. It is reasonably possible that the reinsurer may realize a significant loss from the transaction.

**Part b: 0.5** point

(Full credit is given if the candidate stated that the profit commission should not be included and state a reason)
Profit commissions generally should not be considered in risk transfer analysis
(either one of the following reason will receive the credit)

- The results of the ceding company should not be considered in a risk transfer analysis
- Premium impacted by profit commission since reinsurance contracts are priced while considering any and all expected payments paid and received by the reinsurer. Profit commissions increase the amount of future expected payments by the reinsurer to the ceding company and may result in a higher premium for the contract
- Profit commission would increase the premium

**Part c: 0.25** point

Sample 1:Only cash flows between the ceding company and the reinsurer should be considered in a risk transfer analysis. This means that broker expenses, operating expenses, fees related to letters of credit, and taxes should bear no impact on the analysis

Sample 2: Reinsurer's expenses should have no impact on the ERD calculation.

**Part d:** *0.25* point

Exhibits risk transfer since ERD is greater than 1%.

**EXAMINER'S REPORT (BY PART, AS APPLICABLE)**

**Part a**

- Candidates generally performed well on this part.
- Common errors include:
  - missing key words from the response (e.g., significant insurance risk, reasonably possible).
  - failing to identify it is related to insurance risk.

**Part b**

- Candidates, in general, understood that profit commissions should not be considered in risk transfer analysis, but some candidates failed to describe reasons behind it.

**Part c**

- Most candidates understood that reinsurer's expenses should not be considered in the ERD calculation.

**Part d**

- Candidates performed well on this part.