Information, technical reserves and accounting principles in assumed reinsurance

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«A general solution, which may seem a little unorthodox but which is very practical, and complies with the accounting principles of accrual, prudence and correlation of income and expenditure, is to constitute a type of reserve for liabilities in order to replace the conventional reserves for unearned premiums and outstanding claims.»

BACKGROUND TO THE PROBLEM

Assumed reinsurance presents a number of particular characteristics affecting its accounting treatment. One of the main sources of problems concerns the time differences between the carrying out of reinsurance transactions and their notification to the reinsurance company, in general through the accounts which are sent by the cedant. In this sense the dates and time periods used have a fundamental influence on economic results, as they influence the size of the technical reserves which are affected by the concept of periodicity. The most important dates and/or time periods are the following:

- Effective terms of the contracts: 1 year with certain exceptions.
- Account issuing frequency of the cedants: irregular, generally quarterly or half yearly.
- Account closure period of the cedants for the reinsurance company: also irregular, there may be a wide time difference.
- Account receiving period: from 15 to 30 days after the issuing date.

In proportional contracts, the reinsurance company only finds out about transactions after a period of time when it receives the account. With the exception of very large losses this tends to be many months after the cedant records the last economic transaction. All of this leads to the fact that the reinsurer can only record its transactions as it receives the accounts which include them, this is indeed logical as this is when it finds out about them.

With regard to the problems which have been noted, it may be commented that the accepting entities must confront a number of difficulties in order to apply the following accounting principles:

- The accrual principle as a consequence of the lack of information, this may make it necessary to estimate unknown transactions.
- The difficulty in applying the accounting principle of correlation of income and expenditure.
- The recording principle, due to lack of information as to any rights and liabilities which have been assumed until the accounts are received.
- The application of the principle of due prudence, within this environment of a lack of information and many estimates.

Amongst the problems which were given at the beginning it is necessary to consider the following aspects when attempting to formulate suitable solutions:

- That priority should be given to accounting principles, bearing in mind that the principle of due prudence stands above all others in situations where there is a lack of information.
- The problems which may arise from any possible estimates of magnitudes, above all in qualitative terms, in accordance with the available information and an analysis of the accounting principles.
- The strict correlation of income and expenditure, related to the principle of due prudence.

IMPACT ON THE TECHNICAL RESERVES

The technical reserves which are affected by this problem are the following:

a) The unearned premiums reserve.

b) The claims reserve.

The calculation of the unearned premiums reserve within the context of assumed reinsurance presents the following problems:

1. The choice between a global or a policy by policy criterion.

2. The problems which arise after choosing the calculation basis of the reserve, when there are two time differences when accounts are received — this is a common situation.

3. Technical difficulties when automating the process.

Although article 29.2 of the Ordening and Supervision of Private Insurance Regulation (ROSP) specifies that it is compulsory to calculate this reserve for assumed reinsurance, article 30, which is further to the aforementioned article, only refers to problems connected with direct insurance, specifying that it is compulsory to calculate it on a policy by policy basis, with recording periods depending on loss experience, or if this is assumed to be uniform, on a pro rata basis. It is difficult for the reinsurer to comply with these conditions for the following reasons:

• Proportional contracts are "blind", and lack information on the policies.

• Non-proportional contracts affect a whole portfolio or line of business, and not individual policies.

The alternatives to the aforementioned conditions could be:

• To use the contract as the operative unit, instead of the policy.

• To use global time criteria, such as twenty-fourths.

These alternatives, although they do not comply with article 30 of the ROSP, are practicable and viable.

With respect to the time differences, there are various alternatives when it comes to choosing the premium or time factor which will be used to calculate the reserve. This choice will affect the criteria on which the claims reserve is based, or vice versa, so as to comply with the principle of income and expenditure correlation:

a) Use the premiums received up to date as the calculation basis, and the date to which the account refers as the starting date for the computation.

This criterion presents an important advantage which may facilitate the reconciliation of income and expenditure if they use the same time period — the reference date of the account — avoiding the problem of non-correlation. The main disadvantage is the lack of homogeneity of this information with the rest of the balance sheet as it does not refer to the closing date, but instead to the date of the account. Therefore neither are the premiums those corresponding to the year in question, nor does the reserve correspond to the closing date.

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b) To make an estimate of unknown premiums from the date of reference of the account up until the close of the fiscal year, and calculate the reserve using this information.

Using this criterion, the information which is presented will be more in accordance with the reality for the accounting periods. In addition to practical difficulties, this criterion also requires estimates to be made — with the consequent error margin — although this is partially compensated for by the corrective effect of the reserve.

The following points should be considered when choosing one of the aforementioned criteria:

• The time frame coherence which should exist between the unearned premiums reserve and the claims reserve.

• Criterion b) would be more technically correct, but it has the previously mentioned limitations.

• Solution a), although less technically correct as it is transfers the result of one or various quarters to the following year, is much more easily put into practice.

The following problems are noted with respect to the outstanding claims reserve:

• Reliability with respect to the setting of the reserve for losses incurred and reported to the company.

• Assessment of incurred but not reported losses, irrespective of the cedant's knowledge of them (IBNR).

PROPOSED ALTERNATIVE

A general solution, which may seem a little unorthodox but which is very practical, and complies with the accounting principles of accrual, prudence and correlation of income and expenditure, is to constitute a type of reserve for liabilities in order to replace the conventional reserves for unearned premiums and outstanding claims.

This new reserve, which, although it would be considered a technical reserve and would be recorded in the accounts as a reserve for claims, aims to cover liabilities which have been acquired by the company which, in line with the technical reserves, would be:

• Incurred but not reported losses.

• Losses which may occur until the end of the cover provided by the premium.

This method is put into practice by, at the time the premiums are recorded by the cedant, the constitution of a reserve for unknown claims which would be equivalent to a percentage of the difference between premiums paid and commissions charged. It is advisable for this percentage to be 100% in order not to reflect any profit before the contract is cancelled.

This reserve would be reduced as claims are received and it would be increased due to the inflow of premiums for the contract. After all claims related to these premiums have been received the amount of this reserve will be the result of the assumed reinsurance, this may now be recorded through the cancellation of this, now unnecessary, reserve.

The aim of this procedure is to defer the results of the covers of one year to a time when the company is able to determine the results itself, and at that time to record its results, thus avoiding the recording of profits before they have been confirmed. If the reserve were insufficient, and the company estimates that it will receive claims for the cover it has given for a higher amount, then it should make a transfer to the reserve for unknown claims at that time.

In any case, this method requires that the situation regarding its contracts is closely monitored in order to adjust the reserve to the real situation affecting the contract using up-to-date information.

The use of this method is very advantageous in situations where there is a lack of information or when the information is received at a very late stage. It has the following advantages:

- It is very easy to apply in practice.
- Additional information is not required, only basic information (premiums, losses and commissions) and the working period is not important. As is logical, if a claims reserve exists then this should also be considered in order to improve its calculation.
- It complies with the accounting principles: accrual, correlation between income and expenditure, etc.
- Due to its flexibility and practicality it is excellent for reflecting provisional results in the intermediary accounting stages, even though accounting norms are not strictly complied with.
- It is also very useful in XL transactions for collection of specialpremiums: half yearly or quarterly.

The following disadvantages may be given:

- Information regarding the performance of the unearned premiums reserve and the claims reserve is not available, with the consequent loss of quality of information.
- If the contracts are not individually checked with a certain frequency then it is possible that there may be latent results, either positive or negative.

In any case, compliance with the principle of due prudence means that the reinsurer should not recognise profits until the contract comes to an end, or in the case of long tail losses profits should be recorded in the accounts over a period of time.

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