

Statutory Issue Paper No. 74

Life, Deposit-Type and Accident and Health Reinsurance

STATUS

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This issue paper may not be directly related to the current authoritative statement.

Type of Issue:

Life Specific

SUMMARY OF ISSUE

1. Reinsurance is an agreement by which a reporting entity transfers all or part of its risk under a contract to another reporting entity. Current statutory guidance on the accounting for life and accident and health reinsurance is contained in Chapters 17, 21 and 24 of the Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies (Life/A&H Accounting Practices and Procedures Manual).
2. GAAP guidance on the accounting for life and accident and health reinsurance is primarily contained in *FASB Statement No. 113, Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts* (FAS 113). In several instances, FAS 113 differs from the current statutory guidance.
3. The purpose of this issue paper is to establish statutory accounting principles for reinsurance of life, deposit-type and accident and health contracts that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

4. This issue paper applies to life and accident and health contracts and deposit-type contracts as defined in *Issue Paper No. 50—Classifications and Definitions of Insurance or Managed Care Contracts In Force* (Issue Paper No. 50). The provisions of Chapter 24 of the Life/A&H Accounting Practices and Procedures Manual (Chapter 24) and the accounting related items in the proposed Actuarial Guideline JJJ - *Guideline Concerning Questions and Answers Related to the Life and Health Reinsurance Agreements Model Regulation* (the proposed Actuarial Guideline JJJ), which provided further clarification of reinsurance accounting as provided in Chapter 24, are adopted as the statutory accounting principles for life and accident and health reinsurance except that all deposit-type contracts reinsured are to be accounted for under the Deposit Accounting section of Chapter 24. Goodwill resulting from the deferral of losses by the assuming entity at the inception of assumption reinsurance agreements shall be included in the total goodwill of a reporting entity when calculating the amount of goodwill that is a nonadmitted asset pursuant to *Issue Paper No. 68—Business Combinations and Goodwill*.
5. With respect to other accounting matters, the provisions of Chapter 17 (included in paragraph 14 of this issue paper) of the Life/A&H Accounting Practices and Procedures Manual that relate to reinsurance in unauthorized companies and funds held under reinsurance treaties with unauthorized reinsurers are adopted as statutory accounting principles. The provisions of Chapter 21 (included in paragraph 15 of this issue paper) of the Life/A&H Accounting Practices and Procedures Manual that relate to commissions and expense allowances on ceded and assumed reinsurance are adopted as statutory accounting principles. In addition, the Annual Statement Instructions require reinsurance disclosures in

notes 10 through 15 to the Annual Statement. These disclosures (included in paragraph 18 of this issue paper) are also adopted as statutory accounting principles.

6. If it is probable that reinsurance recoverables on paid or unpaid claim or benefit payments will be uncollectible, consistent with *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets*, amounts shall be written off through a charge to the Statement of Operations by reversing the accounts previously utilized to establish the reinsurance recoverable.

DISCUSSION

7. The statutory accounting for life and accident and health reinsurance was recently revised through amendments to Chapter 24 and further clarified by the proposed Actuarial Guideline JJJ. The GAAP guidance for life and accident and health reinsurance is contained principally within FAS No. 113 which is adopted with modification for property and casualty reinsurance in *Issue Paper No. 75—Property and Casualty Reinsurance* and by this issue paper for life, deposit-type and accident and health reinsurance. This issue paper applies to all accident and health reinsurance written by life and health and property and casualty insurers. The statutory accounting principles established by this issue paper differ substantially from GAAP, reflecting much more detailed guidance as follows:

- a. Reserve credits taken by ceding entities as a result of reinsurance contracts are netted against the ceding entity's policy and claim reserves and unpaid claims. Under GAAP, reinsurance recoverables are reported as assets.
- b. For statutory reporting, first year and renewal ceding commissions on indemnity reinsurance of new business (ceding commissions on ceded in-force business are included in the calculation of initial gain or loss, see paragraph 7.d.) are recognized as income. Under GAAP, ceding commissions are reported first as a reduction of deferred acquisition costs (DAC) and then if DAC is completely eliminated any excess is established as unearned revenue.
- c. As discussed in Issue Paper No. 50, statutory accounting defines deposit-type contracts as those contracts which do not include any mortality or morbidity risk. GAAP defines investment contracts as those that do not subject the reporting entity to significant policyholder mortality or morbidity risk. (The distinction is any mortality or morbidity risk for statutory purposes vs. significant mortality or morbidity risk for GAAP purposes.) Therefore, a contract may be considered an investment contract for GAAP purposes, and that same contract may be considered other than deposit-type for statutory purposes. A reinsurance treaty covering contracts that have insignificant mortality or morbidity risk (i.e., contracts classified as other than deposit-type contracts for statutory purposes, but investment contracts for GAAP purposes) that does not transfer that mortality or morbidity risk, but does transfer all of the significant risk inherent in the business being reinsured (e.g., lapse, credit quality, reinvestment or disintermediation risk) qualifies for reinsurance accounting for statutory reporting purposes, but would not qualify for reinsurance accounting treatment for GAAP purposes.
- d. For statutory reporting, initial gains or losses on indemnity reinsurance of in-force blocks of business have unique accounting treatment. A portion of the initial gains or losses (equal to the tax effect of the initial gain or loss in surplus) is reported as commissions and expense allowances on reinsurance ceded in the statement of operations. The remainder of the initial gains or losses is reported on a net-of-tax basis as a write-in for gain or loss in surplus in the Capital and Surplus Account. In subsequent years, the ceding entity recognizes income on the reinsurance ceded line for the net-of-tax profits that emerged on the reinsured block of business with a corresponding decrease in the

write-in for gain or loss in surplus. Under GAAP, the cost of reinsurance is amortized to income over the life of the reinsured contracts or the reinsurance contract period, depending on whether the reinsurance contract is long or short-duration. The difference, if any, between amounts paid for a reinsurance contract and the amount of the liabilities for policy benefits relating to the underlying reinsured contracts is part of the estimated cost to be amortized.

- e. Statutory accounting prohibits recognition of a gain or loss in connection with the sale, transfer or reinsurance of an in-force block of business between affiliated entities in a non-economic transaction. Any difference between the assets transferred by the ceding entity and the liabilities, including unamortized IMR, shall be deferred and amortized under the interest method. Under GAAP, such transactions are treated as capital contributions or dividends.
 - f. Statutory accounting requires that a liability be established through a provision reducing surplus for unsecured reinsurance recoverables from unauthorized reinsurers. Under GAAP, no such liability is required. However, both statutory accounting and GAAP require an assessment of the collectibility of recorded reinsurance recoverables.
 - g. Statutory accounting as defined in Chapter 24 prescribes offsetting certain reinsurance premiums. However, FAS 113 states that for GAAP, offsets can occur only when a right of setoff exists.
8. Amounts due from reinsurers on paid claims and benefits are reported as assets under both statutory accounting and GAAP. Reserve credits deducted by ceding entities from their direct and assumed policy and claim reserves and unpaid claims represent amounts that will be recovered from reinsurers. These reinsurance recoverables meet the statutory definition of an asset established in *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets*; however, this asset will continue to be presented as a contra liability in statutory financial statements because a change to “gross” presentation would necessitate extensive changes in and restatement of the reporting of ceded reinsurance in schedules and exhibits of the NAIC Annual Statement.
9. This issue paper maintains current statutory accounting principles that require that losses to the assuming entity at the inception of assumption reinsurance agreements (i.e., liabilities exceed assets) be deferred as goodwill and amortized over the life of the policies, but for a period not to exceed 10 years. This issue paper clarifies that goodwill recorded by an assuming entity related to an assumption reinsurance agreement shall be considered with goodwill of an entity in determining the amount of goodwill to be nonadmitted. If assets exceed liabilities at the inception of the assumption reinsurance agreement, the assuming entity shall record a deferred liability and amortize the amount using the interest method over the expected life of the business, but for a period not to exceed 10 years.
10. *Issue Paper No. 52—Deposit-Type Contracts* (Issue Paper No. 52) establishes statutory accounting principles for income recognition and policy reserves for deposit-type contracts. Under Issue Paper No. 52, reinsurance of deposit-type contracts, which by definition do not have insurance risk, will be accounted for under the provisions of the Deposit Accounting section of Chapter 24. This is consistent with the GAAP treatment of investment contracts under FASB Statement No. 97, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments*, but is inconsistent with reinsurance accounting treatment in Chapter 24 which would allow for reinsurance accounting treatment if the risks other than mortality and morbidity were transferred.
11. The impact of gains or losses from reinsurance of in-force blocks of business can be effectively monitored because such gains and losses are shown as a single line item in the surplus section.

12. The statutory accounting for non-economic assumption reinsurance transactions between affiliated entities is consistent with *Issue Paper No. 25—Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties*.

13. The statutory requirement to establish a liability, Reinsurance in Unauthorized Companies, for unsecured reinsurance recoverables from unauthorized reinsurers is contained in various state statutes, the Life/A&H Accounting Practices and Procedures Manual (Chapter 17) and the Instructions to the Life, Accident and Health Annual Statement, Schedule S - Part 3. This requirement maintains current statutory accounting, and is consistent with the recognition concept and conservatism concept in the Statement of Concepts, which also allows for certain mandated liabilities.

Liabilities require recognition as they are incurred. Certain statutorily mandated liabilities may also be required to arrive at conservative estimates of liabilities and probable loss contingencies (e.g., excess of statutory over statement reserves, interest maintenance reserves, asset valuation reserves, and others).

Financial reporting by insurance enterprises requires the use of substantial judgments and estimates by management. Such estimates may vary from the actual amounts for numerous reasons. To the extent that factors or events result in adverse variation from management's accounting estimates, the ability to meet policyholders obligations may be lessened. In order to provide a margin of protection for policyholders, the concept of conservatism should be followed when developing estimates as well as establishing accounting principles for statutory reporting.

Drafting Notes/Comments

- Deposit accounting for Property and Casualty Companies is currently being considered by the AICPA. Codification may have to be amended to acknowledge an additional SAP/GAAP difference should the AICPA adopt guidance for Life Insurance Companies that differs from Chapter 24.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

14. Chapter 17 of the Life/A&H Accounting Practices and Procedures Manual provides the following guidance on reinsurance in unauthorized companies:

Reinsurance in Unauthorized Companies

This liability is established to offset credit taken in various balance sheet accounts for reinsurance ceded to unauthorized reinsurers. Credit for reinsurance with unauthorized companies also may be permitted if the ceding company holds securities or cash of the assuming company equal to the reserve credit taken. Such deposits are to be held under the control of the ceding company. Additionally, any securities held under such an arrangement must be investments that the ceding company is allowed to make under the provision of the investment sections of the insurance statutes. Other permissible arrangements include irrevocable trusts or "clean" letters of credit. If the assuming company is not licensed or is not an authorized reinsurer in the domiciliary state of the ceding company or if the reinsurance does not meet required standards, the ceding company must set up a net liability equal to the following:

1. Reserve credits taken including any Interest Maintenance Reserve (IMR) liability adjustment, plus
2. Claim liability credits taken on paid and unpaid (in course of settlement) claims recoverable, plus
3. Other asset increases or liability reductions resulting from amounts recoverable from the assuming company including commissions, expense allowances, modified coinsurance

reserve adjustments, experience rating refunds, and estimated incurred but not reported claim liabilities, less

4. Deposits by or funds withheld from the reinsurer, as provided for in the reinsurance treaty, pledged as security for the payment of reinsurance obligations. Such deposits or funds are typically held by the ceding company or are placed in a trust or custodial agreement. Amounts placed in trust or custodial accounts are held subject to withdrawal by, and under the control of, the ceding insurer, less
5. Amounts of reinsurance recoverables covered by a clean, irrevocable letter of credit issued by a qualified banking institution, less
6. Amounts contractually due the assuming company.

The net liability defined above should never be less than zero for any particular reinsurer. Caution should be exercised in taking credit for items in 4, 5, and 6 above since state requirements vary considerably. The change in liability for unauthorized reinsurance is a direct charge or credit to surplus.

Funds Held Under Reinsurance Treaties with Unauthorized Reinsurers

This liability is for funds deposited by or contractually withheld from unauthorized reinsurers. Please note that the withholding of reinsurance premiums represents only one method of securing net reinsurance liabilities. Letters of credit from or funds escrowed in a financial institution represent two other commonly accepted methods.

15. Chapter 21 of the Life/A&H Accounting Practices and Procedures Manual provides the following guidance on expense allowances and reinsurance commissions:

Expense Allowances on Reinsurance

For reinsurance it is common for the assuming insurer to provide an expense allowance to cover expenses of the ceding insurer. The allowance is frequently nonspecific with respect to premium taxes and other general expenses of the ceding insurer and it is usually combined with and accounted for as part of the commissions on reinsurance assumed or ceded.

The portion of reinsurance expense allowances which represents specific reimbursement of premium taxes should be accounted for as premium tax. Any portion specifically reimbursing general expenses should be accounted for as other general expense. Each should be excluded from commissions and expense allowances on reinsurance assumed or ceded.

Reinsurance Commission Accounting Practices

Under current statutory accounting practices and procedures, commissions on direct business, commissions and expense allowances on reinsurance assumed, and commissions and expense allowances on reinsurance ceded are each accounted for separately in the Summary of Operations and on the balance sheet. Accordingly, commissions and expense allowances on reinsurance ceded are reported as income or revenue earned in the Summary of Operations and the balance sheet provision for due and accrued amounts is reported as an asset. This differs from the more customary statutory accounting practice of reporting insurance transactions net of reinsurance in the Summary of Operations and on the balance sheet with reliance upon supporting exhibits for the reinsurance information.

16. Chapter 24 of the Life/A&H Accounting Practices and Procedures Manual provides statutory accounting guidance for life and accident and health reinsurance. A portion of that guidance is excerpted below:

A. Indemnity Reinsurance

Transfer of Risk

Reinsurance agreements must transfer risk from the ceding company to the reinsurer in order to receive the reinsurance accounting treatment discussed in this chapter. If the terms of the agreement violate the risk transfer criteria contained herein, i.e., limits or diminishes the transfer of risk by the ceding company to the reinsurer, the agreement shall be accounted for as discussed in the Deposit Accounting section below. In addition, any contractual feature that delays timely reimbursement, violates the conditions of reinsurance accounting.

This paragraph applies to all life and accident and health reinsurance agreements except for yearly renewable term reinsurance agreements and non-proportional reinsurance agreements such as stop loss and catastrophe reinsurance. All reinsurance agreements covering insurance products or similar products of the type identified in A(6) of Appendix A shall follow the guidance for reinsurance accounting contained in this chapter provided the reinsurance agreement (1) transfers significant insurance risk and (2) does not contain any of the conditions set forth in Appendix A. All products not of the type identified in A(6) of Appendix A or covered in the following two paragraphs, shall follow the guidance for reinsurance accounting contained in this chapter provided that the agreement (1) transfers one or more of the risk categories described in A(6) and (2) does not contain any of the conditions set forth in Appendix A. Contracts that fail to meet the requirements for reinsurance accounting shall follow the guidance contained in the Deposit Accounting section.

Yearly renewable term reinsurance agreements that transfer a proportionate share of mortality or morbidity risk inherent in the business being reinsured and do not contain any of the conditions described in Appendix A(2), (3), (4), (8), (9), (10) or (11), shall follow the guidance for reinsurance accounting. Contracts that fail to meet the requirements for reinsurance accounting shall follow the guidance contained in the Deposit Accounting section.

For non-proportional reinsurance agreements such as stop loss and catastrophe reinsurance agreements, contract terms should be evaluated to assess whether they transfer significant risk to the reinsurer. For example, prepayment schedules and accumulating retentions from multiple years are contractual features inherently designed to delay the timing of reimbursement to the ceding company limits the risk to the reinsurer. Regardless of what a particular feature might be called, any feature that can delay timely reimbursement violates the conditions for reinsurance accounting. Transfer of insurance risk requires that the reinsurer's payment to the ceding company depend on and directly vary with the amount and timing of claims settled under the reinsured contracts. Contractual features that can delay timely reimbursement prevent this condition from being met. Reinsurance accounting shall apply to all non-proportional agreements that transfer significant risk and do not contain any provisions that protect the reinsurer from incurring a loss. Contracts that fail to meet the requirements for reinsurance accounting shall follow the guidance contained in the Deposit Accounting section.

Accounting and Reporting of Reinsurance

The obligation of reporting reinsurance in force and of determining unpaid premiums and incurred claims and other balances is generally on the ceding company because it knows the current status of the policies it has written directly and reinsured. A lag will develop between the time of the entry of the underlying policy transaction on the books of the ceding company and the transmittal of information and its entry on the books of the assuming company. The assuming company shall estimate any material unreported premiums and related costs, since it alone has the responsibility for determining its own financial condition and for preparing accurate financial statements.

The ceding company must report these items in its balance sheet:

1. Credits (deductions) to its policy and claim reserves and unpaid claims;
2. Premiums or other amounts payable on reinsured risks;
3. Amounts recoverable on claims, surrender values, dividends, experience rating refunds, taxes, commissions, and other expenses;
4. Modified coinsurance reserves; and
5. Amounts receivable or payable for funds withheld.

Similarly, in its balance sheet, the assuming company must report:

1. Reserves for reinsurance assumed reduced by any modified coinsurance reserves;
2. Reinsurance premiums receivable or other amounts receivable
3. Amounts payable for claims, surrender values, dividends, experience rating refunds, taxes, commissions, and other expenses; and
4. Amounts receivable or payable for funds withheld by the ceding company.

While the various balances that a company (ceding or assuming) has with its reinsurance partners will result in a net amount, the proper way to report them is in their separate classifications. The balances of one company shall not be netted against those of any other company. Each reinsurance agreement must be accounted for separately.

Reinsurance Premiums

For all reinsurance arrangements, the assuming company must report premiums under the terms of the reinsurance contract as income and establish any asset or liability consistent with the methods and assumptions used to establish its policy reserves and guidance contained in Chapter 18, Premium Income, of this manual. The ceding company shall reduce premium income by the amounts paid or payable to the reinsurers. The ceding company shall reduce its deferred and uncollected premiums reported as an asset and the assuming company shall record an asset for premiums payable to the reinsurer on those insurance policies with premiums collected on a basis more frequent than annual covered by the reinsurance arrangement. On those insurance policies covered by the reinsurance arrangement with premiums collected annually, the ceding company shall establish a liability and the assuming company shall record an asset for premiums payable to the reinsurer.

Reinsurance Benefit Payments

Policy benefit payments paid or payable by the reinsurer shall be reported in the Summary of Operations and reduces the ceding company's reported benefit payments. The reinsurer shall establish a liability for its share of any unpaid claim payments and the ceding company shall reduce any policy and contract claim liability with respect to the reinsured policies or establish a receivable for the amount due from the reinsurer for claims paid.

Expenses

The taxes, commissions, and other expenses that will be paid by the assuming company to the ceding company are agreed upon when the reinsurance agreement is negotiated. These items are calculated in accordance with the reinsurance agreement and usually relate to premiums or claims or both. At the statement date, the amount of unpaid expenses is generally based upon the amount of premiums and claims unpaid at that date.

Some coinsurance contracts provide that the assuming company pay to the ceding company a commission that exceeds the first-year premium. In the absence of any guarantees for payment of future premiums (for example, persistency guarantees), these commissions are accounted for on the cash basis. If, however, the ceding company guarantees that premiums will be paid in the future, which, in essence, returns the excess commission, it must record the excess commission as a liability. This liability is then to be released as future premiums are paid to the assuming

company. The rate of release is determined in accordance with the anticipated experience and reasonable commission rate for first-year and renewal premiums. Excess commissions such as these are nothing more than a means of financing for the ceding company.

If renewal expense allowances in any accounting period are not sufficient to cover anticipated allocable renewal expenses of the ceding insurer on the portion of the business reinsured, a liability is to be established by the ceding company for the present value of the shortfall. In establishing this liability, assumptions are to be used equal to the applicable statutory reserve basis on the business reinsured. Anticipated allocable expenses includes commissions, premium taxes and direct expenses including, but not limited to, billing, valuation, claims and maintenance expected by the company at the time the business is reinsured.

Experience Refunds

Some reinsurance contracts, generally proportional reinsurance, provide that the reinsurer will refund an agreed upon portion of its profit to the ceding company. The reinsurance contract will provide the calculation and the factors to be included.

If the contract provides for experience refunds, the ceding company must record, as an asset, the amount of the refund receivable as of the statement date, but reduced by any amount that is contingent upon future experience. The assuming company is also required to record, as a liability, the amount of the refund calculated at the statement date, but without regard to any effects that future experience might have.

Credits for Ceded Reinsurance

The credit taken by the ceding company under the coinsurance arrangement is calculated using the same methodology and assumptions used in determining its policy and claim reserves. It is, of course, only for the percentage of the risk that was reinsured. Under modified coinsurance, the reserve credit is reduced by the modco deposit retained by the ceding company. If the company reinsures on a yearly renewable term basis, it is itself buying insurance for the portion of the ceded amount at risk. The amount of yearly renewable term reinsurance that is required on a given policy generally decreases each year as the company's reserve increases. The net amount at risk may increase, however, on interest sensitive products such as universal life. The amount at risk on accident and health yearly renewal term reinsurance will remain level and the reinsurance premium increases each year.

The reserve credit taken by the ceding company is reported as a reduction to the reserves and not as an asset of the company. The ceding company's reserve credit and assuming company's reserve for yearly renewable term reinsurance shall be computed as the one year term mean reserve on the amount of insurance ceded. The ceding company must use the same mortality and interest bases which were used for valuing the original policy before reinsurance. The credit may also be computed on a pro rata basis if the result is not materially different from the credit computed on the mean reserve basis. For all types of reinsurance, the ceding company also takes credit for other amounts due from the reinsurer such as unpaid claims and claims incurred but not reported. If contemplated by the reinsurance contract, recognition of related assets and liabilities must occur (policy loans, due and deferred premiums, etc.).

Non-proportional reinsurance is generally purchased in order to safeguard the company's aggregate loss potential. This form of reinsurance is entered into on an annual basis to limit the claims experience of the company and thereby protect its financial integrity. When the period of the arrangement exceeds one year, the contract must be carefully reviewed to determine if the end result more closely follows proportional reinsurance. No reserve credit is taken for non-proportional reinsurance unless the aggregate attachment point has in fact been penetrated. In order for a company to reflect reserve credits on a prospective basis, the company will need to demonstrate that the present value of expected recoveries using realistic assumptions and not statutory assumptions required for the underlying policy reserves, to be realized from the reinsurer is in excess of the present value of the reinsurance premiums guaranteed to be paid by

the ceding insurer under the terms of the contract. Because non-proportional reinsurance aggregates experience, and does not indemnify the ceding insurer for each policy loss, the use of statutory assumptions underlying the insured policies is inappropriate for determining any reserve credit to be taken by the ceding insurer. Historical experience, pricing assumptions and asset shares should be considered in determining if the reinsurer may be reasonably expected to pay any claims. The reserve credit taken may only reflect these reasonable expectations. This treatment of non-proportional reinsurance is similar to the way property and casualty (P&C) reinsurance is considered. This is because these modes of reinsurance more closely follow P&C indemnification principles than life insurance formula basis, and because these coverages are very similar to excess insurance on P&C products. In determining the appropriate reserve credit, the probability of a loss penetrating to the reinsurer's level of coverage (using reasonable assumptions) must be multiplied by the expected amount of recovery. This is the same as reserve credits on coinsurance where the probability of a claim (i.e., mortality) is multiplied by the expected return (i.e., death benefit). In that the coverage is for aggregate experience, the mortality assumptions underlying any one policy risk is inappropriate to analyze the appropriate credits for non-proportional coverage.

Accounting for Interest Maintenance Reserve (IMR)

The interest-related gain or loss (net of taxes) associated with the sale, transfer or reinsurance of a block of liabilities must be credited or charged to the IMR in accordance with the IMR instructions contained in the NAIC Annual Statement Instructions Manual.

Reserves for Reinsurance Assumed

In assuming any insurance risks, the assuming company is required to establish policy reserves that are consistent with its obligations. The reserves it must establish, therefore, are also dependent upon the arrangement of reinsurance that is used. For risks transferred under the reinsurance arrangement, policy and claim reserves must be at least equal to the required reserves calculated using the same methodology and assumptions that would be used if the reinsurer had written the risk directly.

Accounting for Modified Coinsurance Arrangements

When the intent of the parties and the terms of the reinsurance contract are to enter into a modified coinsurance arrangement, the following accounting applies.

Ceding Company

In a modified coinsurance arrangement, the ceding company retains the assets equal to the modified coinsurance reserve. This reserve represents a prepayment of the reinsurer's future obligation. Premiums paid or payable to the reinsurer net of any experience refunds shall result in the reduction of premium income. Policy benefit payments paid by the reinsurer shall reduce the ceding company's reported policy benefits. Expense allowances paid by the reinsurer shall be reported separately in the Summary of Operations as earned. The modified coinsurance reserve is included in the category of policy reserves. The modified coinsurance reserve adjustment from period-to-period shall be reported separately in the Summary of Operations.

Assuming Company (Reinsurer)

Premiums received or receivable by the reinsurer shall increase premium income net of any experience refunds and policy benefit payments paid by the reinsurer shall increase the reported policy benefits. Expense allowances paid by the reinsurer shall be reported separately in the Summary of Operations when payable. The statutory policy reserves excludes the modified coinsurance reserve. The modified coinsurance reserve adjustment from period-to-period shall be reported separately in the Summary of Operations. The reinsurer's accounting of its obligations shall be consistent with the ceding company's accounting for the transfer of the obligations.

Accounting for Coinsurance With Funds Withheld Arrangements

When the intent of the parties and the terms of the reinsurance contract are to enter into a coinsurance arrangement with funds withheld, the following accounting applies.

Ceding Company

Premiums paid or payable to the reinsurer net of any experience refunds shall reduce premium income. Policy benefit payments paid by the reinsurer shall reduce the ceding company's reported policy benefits. Expense allowances paid by the reinsurer shall be reported separately in the Summary of Operations as earned. A net reduction to policy reserves shall be taken for the portion of the obligation assumed by the reinsurer. Any amounts withheld by the ceding company shall be recorded as a separate liability. Any interest due or payable on the amounts withheld shall be recorded as interest on indebtedness.

Assuming Company (Reinsurer)

Premiums received or receivable by the reinsurer net of any experience refunds shall increase premium income and policy benefit payments paid by the reinsurer shall increase the reported policy benefits. Expense allowances paid by the reinsurer shall be reported separately in the Summary of Operations when payable. The reinsurer shall record its share of the statutory policy reserves attributable to the business identified in the contract. Any funds withheld by the ceding company shall be recorded as an accounts receivable. Any interest earned or receivable on the funds withheld shall be recorded as miscellaneous income.

Uncollectible Reinsurance

The ceding and assuming companies must determine if reinsurance receivables are collectible. To the extent that the amounts are determined to be uncollectible, these amounts shall be charged to operations. Companies must write off uncollectible reinsurance receivables through the accounts previously utilized to establish the receivables.

Unauthorized Reinsurance

If the reinsurer is not authorized to do business, or is not otherwise approved, the reinsurance is considered to be unauthorized. The Model Law on Credit for Reinsurance specifying the conditions under which reinsurance credit may be taken, shall be followed. (For further discussion of the liability for unauthorized reinsurance see Chapter 17).

Gains and Losses on Indemnity Reinsurance

Under an indemnity reinsurance arrangement the ceding company continues to be liable to the policyholders and the reinsurer has no obligations to them except in the case of cut-through agreements. Typically the ceding company will continue to perform all functions in connection with claims and other policyholder services. Gains and losses on indemnity reinsurance are defined as the net experience under the reinsurance contract within a calendar year. Net experience (underwriting gains or loss) includes ceded premiums, claims, expense allowances, reserve adjustments, any IMR liability adjustment and experience refunds and dividends.

Losses that occur in any year of an indemnity reinsurance contract are immediately recognized. For reinsurance of in-force blocks of business, gains that occur in the initial calendar year are accounted for in accordance with Section 4, subsection C of Appendix B.

For indemnity reinsurance agreements entered into for other than in-force blocks of business, the gains and losses are immediately recognized by the ceding and assuming company.

Recaptures and Commutations

A recapture or a commutation of a reinsurance agreement is a transaction which results in the complete and final settlement and discharge of all present and future obligations between the parties arising out of the agreement or a portion of the agreement. Reasons for commuting reinsurance agreements often include: perceived financial instability of the reinsurer, inefficiencies associated with the runoff of longer tailed liabilities, or significantly different evaluation of ultimate loss costs. The assumed reserves and reserve credits taken are eliminated by the reinsurer and ceding insurer, respectively. The reinsurer and ceding insurer must also make any required IMR liability adjustment changes. Any net gain or loss is reported in the Summary of Operations.

Deposit Accounting

To the extent that a reinsurance contract does not, despite its form, provide for sufficient transfer of risk, amounts paid are to be accounted for and reported as deposits in the NAIC annual and interim financial statements in the following manner:

1. At the outset of the reinsurance contract the net consideration paid by the ceding company (premiums less commissions or other allowances) shall be recorded as a deposit on the ceding company's books and as a liability on the assuming company's books. The deposit may be reported as an asset in the ceding company's statement if (a) the assuming company is licensed, accredited or otherwise qualified in the ceding company's state of domicile under Section 1 of the NAIC Model Law on Credit for Reinsurance or (b) there are funds held by or on behalf of the ceding company which meet the requirements of Section 2 of that law. Throughout the life of the contract receipts and disbursements shall be recorded through the deposit/liability accounts. Income and losses shall be recognized by a party when, according to the terms of the contract, it has earned the amount and the other party has no recourse to repayment of such amount in future periods. When the contract is completed, or when there is a loss payment in excess of the deposit, any difference between consideration and recoveries shall be recorded as other miscellaneous insurance income or miscellaneous insurance loss.
2. No deduction shall be made from the policy or claim reserves on the ceding company's balance sheet, schedules and exhibits.
3. The assuming company shall record net considerations to be returned to the ceding company as liabilities.

B. Assumption Reinsurance

A company may sell all or part of a block of insurance business through an assumption reinsurance agreement. Typically, under an assumption reinsurance arrangement, the reinsurance contract is intended to effect a novation, thereby to extinguish the ceding company's liability to the policyholder. Assumption reinsurance requires that the reinsurer issue assumption certificates to the existing policyholders and take over responsibility for policyholder services. On occasion, the reinsurer will contract with the original company to continue to provide such services on a fee basis or may contract with a third party. Regulatory approval of assumption reinsurance arrangements is usually required. Approval is also usually required from the policyholders, who have a predetermined time period in which to accept or reject the reinsurance transfer. After the deadline has passed, approval is considered implied for all outstanding responses. For those policyholders that reject the transfer, the reinsurance agreement typically converts to an indemnity arrangement. Under this circumstance, reinsurance accounting, as defined earlier in this chapter, is to be followed.

Accounting for Assumption Reinsurance Transactions

Accounting for assumption reinsurance transactions involves all existing assets and liabilities with respect to the assumed policies. This involves policy reserves, policy loans, net due and deferred premiums, dividend accumulations, dividend liability, policy claims, advance premiums, unearned interest on policy loans, etc. The total effect of all of these assets and liabilities is collectively referred to as net policy liabilities.

Typically, because a block of in-force business has value, the sale transaction will result in a gain to the ceding company. If the policies are somewhat mature and have reasonably large net policy liabilities, the transaction probably will result in a transfer of cash or other assets by the ceding company. In this case, the net policy liabilities released by the ceding company will be greater than the value of the assets transferred. If the policies are young and have very small net policy liabilities, the assuming company may pay some amount in the purchase. The ceding company is to follow accounting for indemnity reinsurance for the policies sold until it has been formally relieved of the legal liability by either consent from the policyholders or when the expiration period for objecting to the transfer has expired. Upon release of the liability or risk, the ceding company shall recognize any gain or loss immediately. The gain or loss shall be the difference between the book value of the assets and liabilities including any unamortized IMR allocated or related to the block of business transferred. Direct and ceded balances are to be eliminated and gains are to be taken into income proportionally as the policyholders approve the transfer or at the end of the response period.

The assuming company is to value the assets acquired at the date of acquisition at their market values, and the reserves are to be established according to statutory requirements based on the benefits in the individual policies reinsured. If the liabilities exceed the assets, the difference represents goodwill that must be amortized using the interest method over the life of the policies, but for a period not to exceed 10 years. If the assets exceed the liabilities, the assuming company shall record a deferred liability and amortize the amount using the interest method over the expected life of the business but not to exceed ten years.

Upon initiation of the assumption reinsurance contract, the ceding and assuming companies are to report all balances reinsured as direct adjustments to the Balance Sheet. Any net gain or loss is reported as miscellaneous income when recognized.

Accounting for Non-economic Assumption Reinsurance Transactions

When the sale, transfer, or reinsurance of an in-force block of business occurs between affiliated companies that is not an economic transaction, the ceding and assuming company shall not recognize any gain or loss. The statutory liabilities and any unamortized IMR shall be transferred from the ceding company to the assuming company without adjustment. The assuming company shall amortize any transferred IMR at the same rate or amount that would have occurred for the ceding company. To the extent that the value of the assets transferred by the ceding company or the net asset value recorded by the assuming company differs from the liabilities including any unamortized IMR, the ceding and assuming company shall defer and amortize their respective differences consistent with the interest method described for non-affiliated transactions.

Effective Date

The revised accounting and reporting practices set forth in this chapter that were adopted on December 4, 1995, shall be effective for all accounting periods beginning on or after January 1, 1996, and shall apply to reinsurance agreements entered into or amended on or after January 1, 1996. The revised accounting and reporting practices shall not apply to reinsurance agreements in force on January 1, 1996.

For accounting periods commencing on or after January 1, 1996, agreements which were: (a) entered into on or after January 1, 1996, and which do not transfer risk shall be accounted for as deposits; (b) amended on or after January 1, 1996, and which do not transfer risk shall be

accounted for prospectively as deposits with the appropriate reclassification of outstanding reinsurance balances as deposits with no surplus impact; or (c) amended on or after January 1, 1996, a change in accounting principle associated with the revised accounting in this chapter shall be applied prospectively with no adjustment to surplus. Notwithstanding the effective dates noted above, any insurer which has previously been subject to compliance with the Life and Health Reinsurance Agreements Model Regulation or substantially similar regulation shall be guided by the effective date of the regulation.

CHAPTER 24 — APPENDIX A

The contents of this appendix is taken from the Life and Health Reinsurance Agreements Model Regulation.

Section 4. Accounting Requirements

- A. No insurer subject to this regulation shall, for reinsurance ceded, reduce liability or establish any asset in any financial statement filed with the Department if, by the terms of the reinsurance agreement, in substance or effect, any of the following conditions exist:
- (1) Renewal expense allowances provided or to be provided to the ceding ins by the reinsurer in any accounting period are not sufficient to cover anticipated allocable renewal expenses of the ceding insurer on the portion of the business reinsured, unless a liability is established for the present value of the shortfall (using assumptions equal to the applicable statutory reserve basis on the business reinsured). Those expenses include commissions, premium taxes and direct expenses including, but not limited to, billing, valuation, claims and maintenance expected by the company at the time the business is reinsured;
 - (2) The ceding insurer can be deprived of surplus or assets at the reinsurer's option or automatically upon the occurrence of some event, such as the insolvency of the ceding insurer, except that termination of the reinsurance agreement by the reinsurer for nonpayment of reinsurance premiums or other amounts due, such as modified coinsurance reserve adjustments, interest and adjustments on funds withheld, and tax reimbursements, shall not be considered to be such a deprivation of surplus or assets;
 - (3) The ceding insurer is required to reimburse the reinsurer for negative experience under the reinsurance agreement, except that neither offsetting experience refunds against current and prior years' losses under the agreement nor payment by the ceding insurer of an amount equal to current and prior years' losses under the agreement upon voluntary termination of in force reinsurance by the ceding insurer shall be considered such a reimbursement to the reinsurer for negative experience. Voluntary termination does not include situations where termination occurs because of unreasonable provisions which allow the reinsurer to reduce its risk under the agreement. An example of such a provision is the right of the reinsurer to increase reinsurance premiums or risk and expense charges to excessive levels forcing the ceding company to prematurely terminate the reinsurance treaty;
 - (4) The ceding insurer must, at specific points in time scheduled in the agreement, terminate or automatically recapture all or part of the reinsurance ceded;

- (5) The reinsurance agreement involves the possible payment by the ceding insurer to the reinsurer of amounts other than from income realized from the reinsured policies. For example, it is improper for a ceding company to pay reinsurance premiums, or other fees or charges to a reinsurer which are greater than the direct premiums collected by the ceding company;
- (6) The treaty does not transfer all of the significant risk inherent in the business being reinsured. The following table identifies for a representative sampling of products or type of business, the risks which are considered to be significant. For products not specifically included, the risks determined to be significant shall be consistent with this table.

Risk categories:

- (a) Morbidity
- (b) Mortality
- (c) Lapse

This is the risk that a policy will voluntarily terminate prior to the recoupment of a statutory surplus strain experienced at issue of the policy.

- (d) Credit Quality (C1)

This is the risk that invested assets supporting the reinsured business will decrease in value. The main hazards are that assets will default or that there will be a decrease in earning power. It excludes market value declines due to changes in interest rate.

- (e) Reinvestment (C3)

This is the risk that interest rates will fall and funds reinvested (coupon payments or monies received upon asset maturity or call) will therefore earn less than expected. If asset durations are less than liability durations, the mismatch will increase.

- (f) Disintermediation (C3)

This is the risk that interest rates rise and policy loans and surrenders increase or maturing contracts do not renew at anticipated rates of renewal. If asset durations are greater than the liability durations, the mismatch will increase. Policyholders will move their funds into new products offering higher rates. The company may have to sell assets at a loss to provide for these withdrawals.

+ – Significant 0 – Insignificant

RISK CATEGORY

	a	b	c	d	e	f
Health Insurance—other than LTC/LTD*	+	0	+	0	0	0
Health Insurance—LTC/LTD*	+	0	+	+	+	0
Immediate Annuities	0	+	0	+	+	0
Single Premium Deferred Annuities	0	0	+	+	+	+
Flexible Premium Deferred Annuities	0	0	+	+	+	+
Guaranteed Interest Contracts	0	0	0	+	+	+
Other Annuity Deposit Business	0	0	+	+	+	+
Single Premium Whole Life	0	+	+	+	+	+
Traditional Non-Par Permanent	0	+	+	+	+	+
Traditional Non-Par Term	0	+	+	0	0	0
Traditional Par Permanent	0	+	+	+	+	+
Traditional Par Term	0	+	+	0	0	0
Adjustable Premium Permanent	0	+	+	+	+	+
Indeterminate Premium Permanent	0	+	+	+	+	+
Universal Life Flexible Premium	0	+	+	+	+	+
Universal Life Fixed Premium	0	+	+	+	+	+
Universal Life Fix Premium dump-in premiums allowed	0	+	+	+	+	+

*LTC = Long Term Care Insurance

LTD = Long Term Disability Insurance

(7) (a) The credit quality, reinvestment, or disintermediation risk is significant for the business reinsured and the ceding company does not (other than for the classes of business excepted in Paragraph (7)(b)) either transfer the underlying assets to the reinsurer or legally segregate such assets in a trust or escrow account or otherwise establish a mechanism satisfactory to the commissioner which legally segregates, by contract or contract provision, the underlying assets.

(b) Notwithstanding the requirements of Paragraph (7)(a), the assets supporting the reserves for the following classes of business and any classes of business which do not have a significant credit quality, reinvestment or disintermediation risk may be held by the ceding company without segregation of such assets:

- Health Insurance—LTC/LTD
- Traditional Non-Par Permanent

- Traditional Par Permanent
- Adjustable Premium Permanent
- Indeterminate Premium Permanent
- Universal Life Fixed Premium
(no dump-in premiums allowed)

The associated formula for determining the reserve interest rate adjustment must use a formula which reflects the ceding company's investment earnings and incorporates all realized and unrealized gains and losses reflected in the statutory statement. The following is an acceptable formula:

$$\text{Rate} = \frac{2(I + CG)}{X + Y - I - CG}$$

Where:

- I is the net investment income (Exhibit 2, Line 16, Column 7)
- CG is capital gains less capital losses (Exhibit 4, Line 10, Column 6)
- X is the current year cash and invested assets (Page 2, Line 10A, Column 1) plus investment income due and accrued (Page 2, Line 16, Column 1) less borrowed money (Page 3, Line 22, Column 1)
- Y is the same as X but for the prior year

Drafting Note: Line references are for the 1992 annual statement. Line references may be deleted or should be updated if regulation is adopted after calendar year 1992. Be aware that annual statement line references may change from year to year.

- (8) Settlements are made less frequently than quarterly or payments due from the reinsurer are not made in cash within ninety (90) days of the settlement date.
- (9) The ceding insurer is required to make representations or warranties not reasonably related to the business being reinsured.
- (10) The ceding insurer is required to make representations or warranties about future performance of the business being reinsured.
- (11) The reinsurance agreement is entered into for the principal purpose of producing significant surplus aid for the ceding insurer, typically on a temporary basis, while not transferring all of the significant risks inherent in the business reinsured and, in substance or effect, the expected potential liability to the ceding insurer remains basically unchanged.

CHAPTER 24 — APPENDIX B

- B. Notwithstanding Subsection A, an insurer subject to this regulation may, with the prior approval of the commissioner, take such reserve credit or establish such asset as the commissioner may deem consistent with the Insurance Law (or Code), Rules or Regulations, including actuarial interpretations or standards adopted by the Department.
- C. (1) Agreements entered into after the effective date of this regulation which involve the reinsurance of business issued prior to the effective date of the agreements, along with any subsequent amendments thereto, shall be filed by the ceding company with the commissioner within thirty (30) days from its date of execution. Each filing shall include data detailing the financial impact of the transaction. The ceding insurer's actuary who signs the financial statement actuarial opinion with respect to valuation of reserves shall consider this regulation and any applicable actuarial standards of practice when determining the proper credit in financial statements filed with this department. The actuary should maintain adequate

documentation and be prepared upon request to describe the actuarial work performed for inclusion in the financial statements and to demonstrate that such work conforms to this regulation.

- (2) Any increase in surplus net of federal income tax resulting from arrangements described in Subsection C(1) shall be identified separately on the insurer's statutory financial statement as a surplus item (aggregate write-ins for gains and losses in surplus in the Capital and Surplus Account, page 4 of the Annual Statement) and recognition of the surplus increase as income shall be reflected on a net of tax basis in the "Reinsurance ceded" line, page 4 of the Annual Statement as earnings emerge from the business reinsured.

{For example, on the last day of calendar year N, company XYZ pays a \$20 million initial commission and expense allowance to company ABC for reinsuring an existing block of business. Assuming a 34% tax rate, the net increase in surplus at inception is \$13.2 million (\$20 million—\$6.8 million) which is reported on the "Aggregate write-ins for gains and losses in surplus" line in the Capital and Surplus account. \$6.8 million (34% of \$20 million) is reported as income on the "Commissions and expense allowances on reinsurance ceded" line of the Summary of Operations.

At the end of year N+1 the business has earned \$4 million. ABC has paid \$.5 million in profit and risk charges in arrears for the year and has received a \$1 million experience refund. Company ABC's annual statement would report \$1.65 million (66% of [\$4 million—\$1 million—\$.5 million] up to a maximum of \$13.2 million) on the "Commissions and expense allowance on reinsurance ceded" line of the Summary of Operations, and—\$1.65 million on the "Aggregate write-ins for gains and losses in surplus" line of the Capital and Surplus account. The experience refund would be reported separately as a miscellaneous income item in the Summary of Operations.}

17. The proposed Actuarial Guideline JJJ, which follows, provided further clarification of reinsurance accounting:

Draft: 11/17/95

Adopted by the Life and Health Actuarial (Technical) Task Force on 12/1/95

ACTUARIAL GUIDELINE JJJ

GUIDELINE CONCERNING QUESTIONS AND ANSWERS RELATED TO THE LIFE AND HEALTH REINSURANCE AGREEMENTS MODEL REGULATION

Background

In September 1992 a revision of the Life and Health Reinsurance Agreements Model Regulation was adopted by the NAIC. Since then a number of questions have arisen by regulators regarding its application and interpretation. In early 1994 the Reinsurance Working Group was formed and charged by the Life and Health Actuarial (Technical) Task Force to provide guidance in interpreting provisions of the model regulation. This charge is being met through the completion of this Guideline in the form of a Q&A document which discusses and adds a degree of insight into certain aspects of the regulation. This document is not intended to expand the content of the model regulation. Each state will retain the authority and ability to independently interpret its own regulation. This document gives some insight into the intent of the original drafters of the model regulation and provides interpretive guidance regarding certain of its provisions.

Text

Section 3

Question: Aside from assumption reinsurance, what other type of reinsurance is exempt from the model regulation?

Answer: The model exempts all yearly renewable term (YRT) and certain nonproportional reinsurance arrangements, such as stop loss and catastrophic reinsurance. The purpose behind the exemption of these types of arrangements was because these did not normally provide significant surplus relief and therefore were not the target of this regulation. Users of the regulation should, however, be cautious of any reinsurance arrangements which could be created to misstate a company's true financial position or attempt to circumvent the regulation by artificially labeling an agreement YRT. If a YRT provides incidental reserve credits for the ceding insurer's net amount at risk for the year with no other "allowance" to enhance surplus, or a catastrophic arrangement which takes a reserve credit for actual losses beyond the attachment point or the unearned premium reserve (UPR) of the current year's premium, there will most likely be no regulatory concern. The NAIC Examiners Handbook (Part 5—Reinsurance section) provides significant insight into all reinsurance agreements, whether covered by this regulation or not. Section II(B)(4) provides discussion on a reinsurance agreement's effect on surplus and provides areas of concern to the regulator in determining a bona fide transfer of risk. Additional pertinent information is contained in the reinsurance chapter of the NAIC Accounting Practices and Procedures Manual which provides accounting guidance.

Section 4A

Question: What is disallowed in the case of non-complying coinsurance with funds withheld treaties? modified coinsurance treaties?

Answer: The underlying intent of the section is to ensure that a company's financial condition is appropriately stated and not distorted by artificially enhancing surplus through "reinsurance" arrangements that do not fully transfer risks to the reinsurer or which otherwise fail to comply with the standards contained in the regulation. Therefore, all reserve credits, liability reductions or assets established by the ceding insurer that are supported by or conditioned on the treaty should be non-admitted to the extent called for in the regulation for any reinsurance agreement that does not comply with Section 4A.

If a reinsurance agreement is such that one or more of its terms violates or fails to comply with the provisions of the model regulation, a company should not include any liability reduction or any asset recognition in any financial statement. A liability reduction or asset may appear in the financial statement in various forms: reserve credits, receivables or transferred funds.

Funds that have been received or credited by the ceding insurer, such as commissions or other front end allowances, regardless of the name given it, shall not be recognized as a surplus enhancement on the annual statement. If so reported, the entire value of such funds currently reported should be non-admitted.

Both forms of coinsurance, funds withheld and modified coinsurance, have an implicit or explicit reserve credit being taken. A modified coinsurance (modco) deposit is also reflected within the same line as an offset to the reserve credit. This ultimately reflects aggregate reserves being reported as if there were no reinsurance. So long as the modco deposit is for the sole purpose of paying FUTURE claims, the modco deposit may be offset against the implicit reserve credit with no additional penalty (other than the nonadmission of any front end allowance as discussed above) being assessed against the ceding insurer.

With regard to coinsurance with funds withheld, the reserve credit taken will be initially nonadmitted. The funds withheld may serve several purposes. It may be funds withheld which the ceding company owes to the reinsurer as a liability payable, such as the last accounting quarter's

premium payable. The funds may also be used, similar to modco, to hold funds to be applied against FUTURE claim payments, with the funds having no other liability. To the extent that funds are available solely for paying future claims, such amount may be used to reduce the otherwise nonadmitted reserve credit. Care must be taken that no reduction in the nonadmitted reserve credit be taken when funds serve another purpose, such as being payable to the reinsurer, in addition to the reinsurer's obligation to pay claims.

An insurer is legally able to enter into contracts with other entities, including other insurers. The provisions of such a contract will be required to be accounted for based on the terms and conditions of the agreement. If the agreement meets the conditions of an acceptable reinsurance arrangement, the ceding insurer is afforded the additional benefit of being able to reduce its otherwise required statutory liabilities by a reserve "credit." If the agreement does not meet the conditions of this regulation, no reserve credit, whether as an asset or as an offset to liability, may be taken. This treatment does not rescind or otherwise eliminate the existence of the contract. Additional pertinent information is contained in the reinsurance chapter of the NAIC Accounting Practices and Procedures Manual which provides accounting guidance for such agreements.

Section 4A(1)

Question: What should be included in the renewal expense allowances with regard to direct expenses? An allocation of salaries? Computer usage? Or just marginal expenses directly related to the business reinsured such as claim payment expenses, postage, etc.? Should the renewal expense allowances cover actual anticipated allocable expenses of a small company in a start-up mode (i.e. high expenses) or should they be based on what expected expenses would be once the company is more mature?

Answer: The primary purpose of the model regulation is to prohibit credit for reinsurance under financial arrangements where the ceding company enters into an agreement for the principal purpose of producing significant surplus aid for the ceding insurer on a temporary basis, while not transferring all of the significant risks inherent in the business being reinsured.

Section 4A(1) implements the purpose of the model by prohibiting credit for reinsurance in certain instances where the ceding insurer is afforded a large ceding commission at the inception of the agreement resulting in a significant increase in surplus only to have the surplus increase be drained away in subsequent periods because renewal expense allowances provided under the agreement are insufficient to cover the direct allocable costs estimated at the time the business is reinsured, which are anticipated to be incurred by the ceding insurer in maintaining the business reinsured.

The model allows an exception to complete disallowance of credit for reinsurance in situations where the ceding insurer reflects a liability for the present value of the shortage between renewal expense allowances provided under the agreement and the direct allocable costs expected in the future by the insurer in maintaining the business reinsured. This liability must be calculated using actuarial assumptions that are consistent with those utilized in the statutory reserve calculation. The expenses to be accounted for in establishing this liability should represent all costs of the ceding insurer in servicing the business that is subject to the agreement.

In determining what the ceding insurer should include in the renewal expenses with regard to direct expenses, there should be an allocation of all renewal expenses anticipated at the time the business is reinsured including salaries, computer usage, postage, etc. This comprehensive calculation should be done regardless of whether a company is in a start-up mode (and experiencing high expenses) or is otherwise more mature but, recognizing that the anticipated expense levels may be estimated, a comparison with pricing assumptions may be considered in determining the reasonableness of such assumptions.

If insurance department staff encounter an agreement that does not comply with Section 4A(1) of the model, this area of non-compliance should be addressed by the posting of a reserve for the present value of the deficiency rather than denial for credit for reinsurance, assuming that no

other area of non-compliance is encountered with the agreement and that the assets received corresponding to the ceding commission are in compliance with other statutes and regulations. For example, the assets received corresponding to the ceding commission must be admissible and not subject to repayment to the reinsurer.

NOTE: Some states have adopted versions of the model regulation that do not allow partial credit when renewal expense allowances are deficient. In those states complete disallowance of reinsurance credit would result for treaties that do not comply with the renewal expense allowance requirement.

Section 4A(2)

Question: With regard to existing business, should the coinsurance reserve percentage or the coinsurance reserve amount not be allowed to increase in a combination coinsurance/modified coinsurance treaty? How would the rule be applicable to the difference between the total reserve and the amount of funds withheld in a coinsurance with funds withheld treaty?

Answer: Section 4A(2) disallows reinsurance credit if the ceding company can be deprived of assets at the reinsurer's option or automatically upon the occurrence of some event. Thus a provision in a coinsurance with funds withheld treaty that allows the reinsurer to convert the treaty to coinsurance at some later date would be in violation of the model regulation. Although the parties could have entered into a coinsurance agreement at its inception, regulators are concerned that the reinsurer would take assets from the ceding company at a time that would be to the detriment of the ceding company's policyholders.

Under a combination coinsurance/modified coinsurance (co/modco) arrangement the ceding company and the reinsurer both establish reserves for future claim payments. When a claim becomes payable, the reserves held by each party must be used proportionally to pay the claim. Treaty provisions that adjust the reserves each party holds in lieu of transferring funds owed to the reinsurer are acceptable. However, adjustment of reserves in lieu of payment when funds are owed to the ceding company is a violation of the model regulation since it is a depletion of the ceding company's assets. This is the case even if the agreement provides for this adjustment at inception and never requires a payment to be owed by the reinsurer. Noncompliance with the model regulation would exist if both the coinsurance amount and the coinsurance percentage (for existing business) were allowed to increase on any settlement date.

Under a coinsurance with funds withheld treaty the reinsurer establishes the entire amount of reserve liability on its share of reinsured policies, but the ceding company withholds assets from the reinsurer, typically in an amount less than the reserves, to offset future obligations. There is no duty on the part of the reinsurer to maintain the book value of the withheld assets at a certain level as there is under co/modco, where the book value of the assets supporting the modco reserves must equal the modco reserves. Provided the withheld assets are not withheld for any purpose other than the payment of future claims, it is not a violation of the model regulation for the reinsurer to require full use of withheld assets for the payment of claims prior to using any other assets owned by the reinsurer.

Section 4A(2) and 4A(5)

Question: Should a reinsurer have a unilateral right to establish underlying cost of insurance rates or credited interest rates for policies that are wholly or partially reinsured?

Answer: No, only the ceding company has the contractual relationship with the insured and the right to set the cost of insurance rates charged policyholders and to set the rates of interest credited to them. However, a representation (but not a warranty) that the ceding company shall vary nonguaranteed elements reinsured in a manner consistent with the ceding company's documented procedures at the time the agreement was entered into does not violate the requirements of the regulation.

Question: May a reinsurance contract allow the reinsurer to increase the cost of insurance that the ceding company must pay under the treaty?

Answer: So long as the aggregate amounts payable by the ceding company in any settlement period do not exceed the income of the reinsured policies during that period, the treaty's structure would not be in violation of Section A(5) of the model regulation. There is not compliance with Section A(5) if any increases could exceed income.

Question: If a reinsured policy allows the ceding company to guarantee rates of interest to be credited to the policyholder that are greater than those guaranteed by the policy, may a reinsurance contract allow the reinsurer to limit its participation in the credited rate as long as it at least provides for the amount based on the rate guaranteed in the contract?

Answer: Again, so long as there is no possibility that the ceding company will have to make payments for which it is not fully reimbursed, no violation exists. Otherwise, the treaty would not be in compliance with Sections 4A(2) and 4A(5).

Section 4A(7)

Question: Is asset segmentation an acceptable mechanism for legal segregation of assets?

Answer: Generally no. Segmentation involves the allocation of a company's general account investment earnings over several lines of business, or various groups of policies within those lines, such that the performance of one corporate bond, for example, may affect the earnings of several segments within a company. The accounting for the segmentation is largely internal, and the detail of the record-keeping varies from company to company.

The fundamental purpose of the requirement for a reinsurance treaty to employ the use of a segregated asset portfolio (SAP) is that all payments (interest, benefits, allowances, etc.) must be made from the SAP, to eliminate any problems that could arise in determining what asset or assets should be sold, and to avoid disputes in the event of insolvency. Any sale of assets that could affect policies not subject to reinsurance, or policies subject to reinsurance with other reinsurers is problematic.

In addition, auditing the performance of a treaty using traditional segmentation methods would be extremely difficult and prone to disagreement, which could provide a reinsurer with broad leverage to contest amounts due that reinsurer, especially in the event of insolvency or rehabilitation of the ceding company.

It is important to determine that the arrangement in place does in fact transfer all of the risks of the underlying assets supporting the reinsured business to the reinsurer.

Question: If some policies out of a group of similar policies are fully or partially reinsured, and the remainder are not, must the assets supporting the reinsured policies be legally segregated from those supporting the business that is not?

Answer: Yes. Assets supporting policies that are not reinsured may not be part of an SAP.

Question: If a percentage of all policies in a block of business is reinsured, must the company segregate that percentage of the assets supporting the business, or can it segregate all the assets?

Answer: The company may segregate only assets supporting the reinsured portion or the segregated asset portfolio may represent the entire block of business if the reinsured portion is the same for all policies. In the later case, the reinsurer would take its proportionate share of the SAP performance.

Question: If the ceding company cedes a portion of each policy in a block of business to one reinsurer and a portion to another, while retaining some itself, does it have to segregate assets

separately for each reinsurer, or is it acceptable to have all the assets segregated together with each reinsurer responsible for its portion of the investment risk?

Answer: The ceding company should not segregate assets separately for each reinsurer if the treaties are virtually identical.

Question: At the time assets are legally segregated under a coinsurance with funds withheld treaty, should they be valued at market value, statutory value or some combination?

Answer: The assets should be valued at their statutory admitted assets value.

Question: When the assets are legally segregated, how are the funds withheld payables and receivables reported?

Answer: The payables and receivables are recorded in the same manner as in a funds withheld treaty where the assets are not legally segregated and will usually mirror the value of the funds withheld account. However, the funds withheld account, which reflects the statutory admitted value of the assets in the SAP, will fluctuate, and thus may differ from the reserves on the reinsured business.

Section 4A(8)

Question: Can a company get around this provision if its treaty states that amounts receivable from the reinsurer are payable (due) at a later date?

Answer: No. All amounts receivable from reinsurers are nonadmitted if not paid within 90 days after the end of the period in which the amounts became receivable. The period may not be longer than one quarter (3 months). These amounts include ceding commissions withheld by reinsurers. A ceding commission is an amount that should be paid "up front" and not over time. Furthermore, arguments that the ceding commission was in fact paid but was then deposited with the reinsurer to create a funds withheld from ceding insurer account are unacceptable. Paid means paid.

Question: Does this section permit modco with funds withheld, since this type of reinsurance involves a receivable from the reinsurer?

Answer: Since the funds withheld would be structured as a receivable, the treaty would be in violation of this section.

Section 4A(9)

Question: Can a treaty impose specific controls on the way the ceding company conducts its business? Examples of such controls include the following:

- a. Limits on the amount of dividends to be paid to stockholders in any year.
- b. Limits on the amount of new business to be issued in any year.
- c. Under certain conditions, the right of the reinsurer to replace the ceding company's investment manager.
- d. Restrictions on the types of investments to be held by the ceding company.
- e. Increased risk charges under certain circumstances, such as risk based capital ratios falling to a specified level.

Answer: Treaty provisions such as those illustrated above appear frequently. They represent an understanding between the ceding company and the reinsurer at inception of the treaty. The impact and intent of the provisions must be analyzed to determine that they do not relate to general business practices of the ceding company, and are reasonably related to the business being reinsured; provisions that only apply to the business reinsured would generally not be in violation of Section 4A(9).

Section 4A(10)

Question: When, if ever, may references to projections be made in a reinsurance treaty?

Answer: Accounting Requirement A-10 prohibits treaty provisions where “the ceding insurer is required to make representations or warranties about the future performance of the business being reinsured.” (It should be noted that “representations or warranties” need not appear in a treaty section entitled “Representations and Warranties” to be considered as such.)

Provisions relating to projections appear in the following forms:

- a. Tables of scheduled amounts, typically showing the amount of outstanding surplus relief expected at different times during the life of the treaty, clearly drawn from projections of future profitability of the block of business being reinsured, but not identified as such. This does not represent violations of either Accounting Requirement A-9 or of Accounting Requirement A-10, because they were agreed to at inception of the treaty, and are reasonably related to the business being reinsured. However, the treaty must clearly disclose that these tables do not constitute a guarantee as to the future profitability of the business reinsured.
- b. Statements acknowledging that, at inception of the treaty, the reinsurer has received and reviewed projections of the future profitability of the business being reinsured. Such statements do not represent a violation of Accounting Requirement A-9 as long as:
 1. there is no language in the treaty implying reliance by the reinsurer on such projections, and
 2. language is included stating, in essence, that the reinsurer acknowledges that the ceding insurer is unable to make any guarantees regarding the future profitability of the business being reinsured.
- c. Statements requiring that, if “projected results are not met,” the reinsurer will take some form of action, such as an increased risk charge. The statements differ from those discussed in Paragraph a. above in that numerical values (drawn from the projections) are not shown in the treaty. Language of this type would be in violation of Accounting Requirement A-10 because it implies a warranty about the future performance of the business being reinsured, on the basis of projections that are not part of the contract.

18. The Annual Statement Instructions require the following disclosures related to reinsurance. Notes 10-12 relate to all reserves including direct, assumed and ceded business. Notes 13-15 relate specifically to reinsurance.

10. Life and Annuities Reserves

Instruction:

- A. Describe reserve practices concerning the following:

Waiver of deduction of deferred fractional premiums upon death of insured;
Return of portion of final premium for periods beyond the date of death; and

Note if any surrender value is promised in excess of the reserve as legally computed.

- B. State methods employed in the valuation of substandard policies.
- C. State the amount of insurance, if any, for which the gross premiums are less than the net premiums according to the standard of valuation required by this state. If not reported in Exhibit 8, Section G, Line 10700001, state the amount of reserves and indicate where reported.

- D. Have the Tabular Interest (Page 7, Part A, Line 4), Tabular Less Actual Reserve Released (Page 7, Part A, Line 5) and Tabular Cost (Page 7, Part A, Line 9) been determined by formula as described for these lines in the instructions for Page 7 or from the basic data for such items?
- E. Describe the method of determination of Tabular Interest on funds not involving life contingencies under Page 7, Part B, Line 3.
- F. Disclose the nature of significant other increases (net) under Page 7, Part B, Line 5.

Illustration:

- A. The Company waives deduction of deferred fractional premiums upon death of insured and returns any portion of the final premium beyond the date of death. Surrender values are not promised in excess of the legally computed reserves.
- B. Extra premiums are charged for substandard lives for policies issued prior to July 1, 19__, plus the gross premium for a rated age.

Mean reserves are determined by computing the regular mean reserve for the plan at the rated age and holding, in addition, one-half (1/2) of the extra premium charge for the year. Policies issued after July 1, 19__, for substandard lives, are charged an extra premium plus the regular premium for the true age. Mean reserves are based on appropriate multiples of standard rates of mortality.

- C. As of December 31, 19__, the Company had \$_____ of insurance in force for which the gross premiums are less than the net premiums according to the standard valuation set by the State of _____. Reserves to cover the above insurance totaled \$_____ at year-end and are reported in Exhibit 8, Sections A and B.
- D. The Tabular Interest (Page 7, Part A, Line 4) has been determined by formula as described in the instructions for Page 7 (or, alternatively, from the basic data for the calculation of policy reserves).

The Tabular Less Actual Reserve Released (Page 7, Part A, Line 5) has been determined by formula as described in the instructions for Page 7 (or, alternatively, from the basic data for the calculation of reserves and the actual reserves released).

The Tabular Cost (Page 7, Part A, Line 9) has been determined by formula as described in the instructions for Page 7 (or, alternatively, from the basic data for the calculation of policy reserves).

- E. For the determination of Tabular Interest on funds not involving life contingencies under Page 7, Part B, Line 3, for each valuation rate of interest, the tabular interest is calculated as one hundredth of the product of such valuation rate of interest times the mean of the amount of funds subject to such valuation rate of interest held at the beginning and end of the year of valuation. The total amount of all such products is entered under Page 7, Part B, Line 3.

F. The details for “Other Increases” (net) under Page 7, Part B, Line 5 are:

ITEM	1 Total	2 Industrial Life	ORDINARY			6 Credit Life Group and Individual	GROUP	
			3 Life Insurance	4 Individual Annuities	5 Supple- mentary Contracts		7 Life Insurance	8 Annuities
5.01								
5.02								
5.03								
5.04								
.								
.								
.								
.								
5.99 Total								

11. Analysis of Annuity Actuarial Reserves and Deposit Liabilities by Withdrawal Characteristics

Instruction:

Disclose the amount of annuity actuarial reserves and deposit liabilities by withdrawal characteristics as follows:

1. Subject to discretionary withdrawal:
 - 1.1 – With market value adjustment.
 - 1.2 – At book value less current surrender charge of 5% or more.
 - 1.3 – At market value.
 - 1.4 – Total with adjustment or at market value.
 - 1.5 – At book value without adjustment (minimal or no charge or adjustment).
2. Not subject to discretionary withdrawal.
3. Total (gross).
4. Reinsurance ceded.
5. Total (net) (3) – (4).

Reconcile the total annuity reserves and deposit fund liabilities amount disclosed in this note to the appropriate sections of Exhibit 8 and Exhibit 10, Line 19, Column 1 of the Life, Accident & Health Annual Statement and the corresponding lines in the Separate Accounts Statement.

A. Withdrawal Characteristic Classification Instructions:

1. Classify annual statement liabilities as “subject to discretionary withdrawal with market value adjustments” (1.1 above) where withdrawal of funds is payable at all times, or prior to specified maturity dates where such dates are more than one year after the statement date and:
 - (a) In a lump sum with adjustments to reflect general changes in interest rates, or asset values since receipt of funds by the insurer. The adjustments either may be based on the insurer’s own investment experience with an assumed duration to the average maturity of the

underlying assets, or related to an index, or related to the maturity date of the liability; or

- (b) In installments over five years or more, with or without a reduction in the interest rate during the installment period.
2. Classify annual statement liabilities as “subject to discretionary withdrawal at book value less surrender charge” (1.2 above) where the withdrawal of funds is payable at all times, or at any time within one year from the statement date in a lump sum subject to a current fixed surrender charge of 5% or more and it does not contain a meaningful bail out rate as provided in (4)(d) below.
3. Classify annual statement liabilities as “subject to discretionary withdrawal at market value” (1.3 above) where the withdrawal of funds is payable at current market value of the assets supporting the liabilities, the assets are stated at current market value, and the liabilities are stated at the current market value or per unit value of the assets supporting the liabilities. These liabilities are for contracts where the customer bears the entire investment risk.
4. Classify all other annual statement liabilities as “subject to discretionary withdrawal at book value (minimal or no charge or adjustments)” (1.5 above) where the withdrawal of funds is either payable at all times, or at any time (including a withdrawal on a scheduled payment date) within one year from the statement date and:
- (a) In a lump sum without adjustment; or
- (b) In installments over less than five years, with or without a reduction in interest rate during the installment period; or
- (c) In a lump sum subject to a fixed surrender charge of less than 5%; or
- (d) In a lump sum subject to a surrender charge, but such charge is waived if the credited rate falls below a specified “bail out” rate and the “bail out” rate is more than the maximum statutory valuation rate for life insurance policies for more than 20 years for new issues; or
- (e) All others.

(The one year period from statement date covers both contracts with specified maturity dates on which withdrawal is permitted in accordance with (a) or (b) and contracts providing for a surrender charge which decreases by duration.)

B. Additional Instructions:

1. The annual statement liabilities to be covered by this note are both those actuarial reserves and deposit fund liabilities reported in the Life, Accident & Health Statement and those reported in the Separate Accounts Statement. Include actuarial reserves for annuities (other than disability annuities) and supplementary contracts with life contingencies reported in Exhibit 8; actuarial reserves for annuities, certain supplementary contracts without life contingencies, and deposit fund liabilities for annuities reported in Exhibit 10. Include all annuity actuarial reserves and deposit liabilities reported in the Separate Accounts Statement in this note.
2. Separate each actuarial reserve or deposit fund liability by its withdrawal characteristics, e.g., subject to discretionary withdrawal – with adjustment, etc. If a product contains more than one type of provision for either the individual policyholder or the participant to withdraw funds from the insurer, e.g., routine

withdrawals are at book value, other withdrawals are at market value, separate the product's reserves into the appropriate categories. Shared employer group or jointly underwritten arrangements are to be reported as direct business.

3. Briefly describe the methods of estimation utilized to complete this disclosure if more precise information was unavailable.

Illustration:

Withdrawal Characteristics of Annuity Actuarial Reserves and Deposit Liabilities

	(1) <u>Amount</u>	(2) <u>% of Total</u>
1. Subject to discretionary withdrawal:		
1.1 – With market value adjustment	\$ _____	_____ %
1.2 – At book value less current surrender charge of 5% of more	_____	_____
1.3 – At market value	_____	_____
1.4 – Total with adjustment or at market value	_____	_____
1.5 – At book value without adjustment (minimal or no charge or adjustment)	_____	_____
2. Not subject to discretionary withdrawal	_____	_____
3. Total (gross)	_____	<u>100</u> %
4. Reinsurance ceded	_____	
5. Total (net)* (3) – (4)	\$ _____	

*Reconciliation of total annuity actuarial reserves and deposit fund liabilities.

Life & Accident & Health Annual Statement:

6. Exhibit 8, Section B, Total (net)	\$ _____	
7. Exhibit 8, Section C, Total (net)	_____	
8. Exhibit 10, Line 19, Column 1	_____	
9. Subtotal	_____	

Separate Accounts Annual Statement:

10. Exhibit 6, Line 0299999, Column 2	_____	
11. Exhibit 6, Line 0399999, Column 2	_____	
12. Page 3, Line 3	_____	
13. Subtotal	_____	
14. Combined Total	\$ _____	

12. Premium and Annuity Considerations Deferred and Uncollected

Instruction:

If the company has reported on Page 2, life insurance premiums and annuity considerations deferred and uncollected on policies in force December 31 of current year, show separately the amounts and the loading excluded for each of the following lines of business: industrial business, ordinary new business, ordinary renewal, credit life, group life, and group annuity.

Illustration:

Deferred and uncollected life insurance premiums and annuity considerations as of December 31, 19XX, were as follows:

<u>Type</u>	(1) <u>Gross</u>	(2) <u>Net of Loading</u>
i. Industrial	\$ _____	\$ _____
ii. Ordinary new business	_____	_____
iii. Ordinary renewal	_____	_____
iv. Credit Life	_____	_____
v. Group Life	_____	_____
vi. Group Annuity	_____	_____
vii. Totals	\$ _____	\$ _____

13. Ceded Reinsurance Report

Section 1 – General Interrogatories

- A. Are any of the reinsurers, listed in Schedule S as non-affiliated, owned in excess of 10% or controlled, either directly or indirectly, by the company or by any representative, officer, trustee, or director of the company? Yes () No () If yes, give full details.
- B. Have any policies issued by the company been reinsured with a company chartered in a country other than the United States (excluding U.S. Branches of such companies) which is owned in excess of 10% or controlled directly or indirectly by an insured, a beneficiary, a creditor or an insured or any other person not primarily engaged in the insurance business? Yes () No () If yes, give full details.

Section 2 – Ceded Reinsurance Report – Part A

- A. Does the company have any reinsurance agreements in effect under which the reinsurer may unilaterally cancel any reinsurance for reasons other than for nonpayment of premium or other similar credits? Yes () No ()
 - i) If yes, what is the estimated amount of the aggregate reduction in surplus of a unilateral cancellation by the reinsurer as of the date of this statement, for those agreements in which cancellation results in a net obligation of the company to the reinsurer, and for which such obligation is not presently accrued? Where necessary, the company may consider the current or anticipated experience of the business reinsured in making this estimate. \$ _____
 - ii) What is the total amount of reinsurance credits taken, whether as an asset or as a reduction of liability, for these agreements in this statement? \$ _____
- B. Does the company have any reinsurance agreements in effect such that the amount of losses paid or accrued through the statement date may result in a payment to the reinsurer of amounts which, in aggregate and allowing for offset of mutual credits from other reinsurance agreements with the same reinsurer, exceed the total direct premium collected under the reinsured policies? Yes () No () If yes, give full details.

Section 3 – Ceded Reinsurance Report – Part B

- A. What is the estimated amount of the aggregate reduction in surplus, (for agreements other than those under which the reinsurer may unilaterally cancel for reasons other than

for nonpayment of premium or other similar credits that are reflected in Section 2 above) of termination of ALL reinsurance agreements, by either party, as of the date of this statement? Where necessary, the company may consider the current or anticipated experience of the business reinsured in making this estimate. \$_____

- B. Have any new agreements been executed or existing agreements amended, since January 1 of the year of this statement, to include policies or contracts which were in force or which had existing reserves established by the company as of the effective date of the agreement? Yes () No ()

If yes, what is the amount of reinsurance credits, whether an asset or a reduction of liability, taken for such new agreements or amendments? \$_____

14. Uncollectible Reinsurance

Instruction:

Describe uncollectible reinsurance written off during the year reported in the following annual statement classifications, including the name or names of the reinsurer(s):

1. Claims incurred;
2. Claim adjustment expenses incurred;
3. Premiums earned;
4. Other.

Illustration:

- i. The Company has written off in the current year reinsurance balances due from the companies listed below, the amount of: \$_____ which is reflected as:

- | | | |
|------|-----------------------------------|----------|
| ii. | Losses incurred | \$ _____ |
| iii. | Loss adjustment expenses incurred | \$ _____ |
| iv. | Premiums earned | \$ _____ |
| v. | Other | \$ _____ |

<u>Company</u>	<u>Amount</u>
XYZ	\$ _____
ZYX	\$ _____

15. Commutation of Ceded Reinsurance

Instruction:

Describe commutation of ceded reinsurance during the year reported in the following annual statement classifications, including the name or names of the reinsurer(s):

1. Claims incurred;
2. Claim adjustment expenses incurred;
3. Premiums earned;
4. Other.

Illustration:

Commutation of Reinsurance Reflected in Income and Expenses.

The company has reported in its operations in the current year as a result of commutation of reinsurance with the companies listed below, amounts which are reflected as:

i.	Losses incurred	\$ _____
ii.	Loss adjustment expenses incurred	\$ _____
iii.	Premiums earned	\$ _____
iv.	Other	\$ _____

<u>Company</u>	<u>Amount</u>
XYZ	\$ _____
ZYX	\$ _____

Generally Accepted Accounting Principles

19. FAS 113 contains the following guidance with respect to reporting assets and liabilities related to reinsurance transactions:

Reporting Assets and Liabilities Related to Reinsurance Transactions

14. Reinsurance contracts that are legal replacements of one insurer by another (often referred to as assumption and novation) extinguish the ceding company's liability to the policyholder and result in removal of related assets and liabilities from the financial statements of the ceding enterprise. Reinsurance contracts in which a ceding enterprise is not relieved of the legal liability to its policyholder do not result in removal of the related assets and liabilities from the ceding enterprise's financial statements. Ceding enterprises shall report estimated reinsurance receivables arising from those contracts separately as assets. Amounts paid to the reinsurer relating to the unexpired portion of reinsured contracts (prepaid reinsurance premiums) also shall be reported separately as assets.
 15. Amounts receivable and payable between the ceding enterprise and an individual reinsurer shall be offset only when a right of offset exists, as defined in Interpretation 39.
 16. The amounts of earned premiums ceded and recoveries recognized under reinsurance contracts either shall be reported in the statement of earnings, as separate line items or parenthetically, or those amounts shall be disclosed in the footnotes to the financial statements.
20. FAS 113 contains the following guidance with respect to reinsurance of long-duration contracts:

Reinsurance of Long-Duration Contracts

12. Indemnification of the ceding enterprise against loss or liability relating to insurance risk in reinsurance of long-duration contracts requires the reasonable possibility that the reinsurer may realize significant loss from assuming insurance risk as that concept is contemplated in Statement 60 and FASB Statement No. 97, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments*. Statement 97 defines long-duration contracts that do not subject the insurer to mortality or morbidity risks as investment contracts. Consistent with that definition, a contract that does not subject the reinsurer to the reasonable possibility of significant loss from the events insured by the underlying insurance contracts does not indemnify the ceding enterprise against insurance risk.
13. The evaluation of mortality or morbidity risk in contracts that reinsure policies subject to Statement 97 shall be consistent with the criteria in paragraphs 7 and 8 of that Statement. Evaluation of the presence of insurance risk in contracts that reinsure other long-duration contracts (such as those that reinsure ordinary life contracts or contracts

that provide benefits related only to illness, physical injury, or disability) also shall be consistent with those criteria.

Recognition of Revenues and Costs for Reinsurance of Long-Duration Contracts

25. Amortization of the estimated cost of reinsurance of long-duration contracts that meets the conditions for reinsurance accounting depends on whether the reinsurance contract is long duration or short duration. The cost shall be amortized over the remaining life of the underlying reinsured contracts if the reinsurance contract is long duration, or over the contract period of the reinsurance if the reinsurance contract is short duration. Determining whether a contract that reinsures a long-duration insurance contract is long duration or short duration in nature is a matter of judgment, considering all of the facts and circumstances. The assumptions used in accounting for reinsurance costs shall be consistent with those used for the reinsured contracts. The difference, if any, between amounts paid for a reinsurance contract and the amount of the liabilities for policy benefits relating to the underlying reinsured contracts is part of the estimated cost to be amortized.

RELEVANT LITERATURE

Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- *Issue Paper No. 4—Definition of Assets and Admitted Assets*
- *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets*
- *Issue Paper No. 25—Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties*
- *Issue Paper No. 50—Classifications and Definitions of Insurance or Managed Care Contracts in Force*
- *Issue Paper No. 51—Life Contracts*
- *Issue Paper No. 52—Deposit-Type Contracts*
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Chapter 17 - Other Liabilities
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Chapter 21 - Commissions
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Chapter 24 - Reinsurance (including appendices A and B)
- NAIC Annual Statement Instructions for Life and Accident and Health Insurance Companies, Notes to Financial Statements and Schedule S

Generally Accepted Accounting Principles

- *FASB Statement No. 113, Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts*
- *FASB Statement No. 5, Accounting for Contingencies*

State Regulations

- No additional guidance obtained from state statutes or regulations.

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