

Statutory Issue Paper No. 75

Property and Casualty Reinsurance

STATUS

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

Type of Issue:

Property and Casualty

SUMMARY OF ISSUE

1. Reinsurance is the assumption by an insurer of all or part of a risk undertaken originally by another insurer. Current statutory guidance on the accounting for property and casualty reinsurance is contained in Chapters 7, 8, and 22 of the Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies (P&C Accounting Practices and Procedures Manual).
2. GAAP guidance on the accounting for property and casualty reinsurance is primarily contained in FASB Statement No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts* (FAS 113) and Emerging Issues Task Force Issue No. 93-6, *Accounting for Multiple-Year Retrospectively Rated Contracts by Ceding and Assuming Enterprises* (EITF 93-6). In certain instances, FAS 113 differs from the current statutory guidance.
3. The purpose of this issue paper is to establish statutory accounting principles for property and casualty reinsurance 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 property and casualty contracts as defined in *Issue Paper No. 50—Classifications and Definitions of Insurance or Managed Care Contracts In Force*. The provisions of Chapter 8 of the P&C Accounting Practices and Procedures Manual that relate to reinsurance recoverable on paid losses (included in paragraph 16 of this issue paper) and Chapter 22 of the P&C Accounting Practices and Procedures Manual (Chapter 22) are adopted as the statutory accounting principles for property and casualty reinsurance except as modified in paragraph 5 below. In addition, the Annual Statement Instructions that require reinsurance disclosures in notes 11, 12, 13, 15, 16 and 17 to the Annual Statement are also adopted as statutory accounting principles.
5. Ceded reinsurance premiums payable (net of ceding commission) shall be classified as a liability. Consistent with *Issue Paper No. 76—Offsetting and Netting of Assets and Liabilities* (Issue Paper No. 76), ceded reinsurance premiums payable may be deducted from amounts due from the reinsurer, such as amounts due on assumed reinsurance, when a legal right of offset exists.
6. Notwithstanding the fact that reinsurance recoverables on paid losses may meet the criteria for offsetting under the provisions of Issue Paper No. 76, reinsurance recoverables on paid losses are to be reported as an asset without any available offset.
7. The Property and Casualty Annual Statement Instructions to Schedule F provide for a minimum reserve for uncollectible reinsurance with an additional reserve required if a company's experience indicates that a higher amount should be provided. The excess reserve over the minimum amount should

be charged through the Statement of Operations by reversing the accounts previously utilized to establish the reinsurance recoverable.

DISCUSSION

8. Statutory accounting for property and casualty reinsurance was recently revised through amendments to Chapter 22. These amendments adopted FAS 113 with modification and EITF 93-6 with modification. This issue paper rejects AICPA Statement of Position No. 92-5, *Accounting for Foreign Property and Liability Reinsurance*. As a result, the statutory accounting principles established by this issue paper are generally consistent with GAAP except for the following significant exceptions:

- a. Reinsurance recoverables on unpaid case-basis and incurred but not reported losses and loss adjustment expenses shall be presented as a contra-liability netted against the liability for gross losses and loss adjustment expenses. Under GAAP, these recoverables are reported as assets.
- b. Amounts paid for prospective reinsurance that meet the conditions for reinsurance accounting shall be reported as a reduction of unearned premiums whereas under GAAP, the unamortized portion of the amount paid for prospective reinsurance is recorded as a prepaid asset.
- c. The gain created by a retroactive reinsurance contract because the amount paid to the reinsurer is less than the gross liabilities for losses and loss adjustment expenses ceded to the reinsurer is reported in the income statement as a write-in gain in “other income” by the ceding entity and a write-in loss by the assuming entity. The gain created by a retroactive reinsurance contract is restricted as a special surplus account until the actual retroactive reinsurance recovered is in excess of the consideration paid. Under GAAP, gains arising from retroactive reinsurance contracts are deferred and recognized over the settlement period.
- d. Statutory accounting requires that a liability be established through a provision reducing surplus for unsecured reinsurance recoverables from unauthorized reinsurers and for certain overdue balances due from authorized reinsurers. Under GAAP, no such liability is required. However, both statutory accounting and GAAP require an assessment of the collectibility of recorded reinsurance recoverables.
- e. Some reinsurance treaties contain adjustable features that provide for adjustment of commission, premium or amount of coverage, based on loss experience. Chapter 22 and EITF 93-6 require recognition of these adjustable features in the period in which the loss event(s) giving rise to the adjustment occurs. Under EITF 93-6, the asset or liability arising from the adjustable feature may be computed under the assumption that the treaty will be terminated prior to the end of its term if such termination is permitted under the contract and to do so results in a lower asset or liability (“lesser of” provision). Statutory accounting requires that the asset or liability arising from the adjustable feature be computed based on experience to date under the contract, and the impact of early termination may only be considered at the time the contract has actually been terminated.
- f. Structured settlements are addressed in *Issue Paper No. 65—Property and Casualty Contracts* (Issue Paper No. 65). Statutory accounting and FAS 113 are consistent in accounting for structured settlement annuities where the reporting entity is the owner and payee, and where the claimant is the payee and the reporting entity has been released from its obligation. FAS 113 distinguishes structured settlement annuities where the claimant is the payee and a legally enforceable release from the reporting entity’s liability is obtained from those where the claimant is the payee but the reporting entity has not

been released from its obligation. GAAP requires the deferral of any gain resulting from the purchase of a structured settlement annuity where the reporting entity has not been released from its obligation.

9. Reinsurance recoverables on paid losses and loss adjustment expenses are reported as an asset under both statutory accounting and GAAP. Reinsurance recoverables on unpaid losses and loss adjustment expenses also 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 Annual Statement. This “net” presentation is consistent with the reporting of salvage and subrogation established by *Issue Paper No. 55—Unpaid Claims, Losses and Loss Adjustment Expenses*. Statutory requirements for offsetting and netting are addressed in Issue Paper No. 76.

10. The statutory reporting of amounts paid for prospective reinsurance contracts that have not been amortized to income described in subparagraph 8.b. is consistent with the “net” reporting discussed in paragraph 9.

11. The statutory accounting for gains and losses resulting from retroactive reinsurance contracts is consistent with the Statement of Concepts which states:

The cornerstone of solvency measurement is financial reporting. Therefore, the regulator’s ability to effectively determine relative financial condition using financial statements is of paramount importance.

12. The statutory requirement to establish a liability, Provision for Reinsurance, for unsecured reinsurance recoverables from unauthorized reinsurers and overdue balances from authorized reinsurers is contained in the Instructions to the Property and Casualty Annual Statement, Schedule F - Part 7 which are adopted in this issue paper as part of Chapter 22. The Schedule F provision for reinsurance was maintained as part of statutory accounting as an added measure of conservatism consistent with the Statement of Concepts. Maintaining this conservatism was deemed appropriate as there is no other apparent independent measure of the adequacy of the estimates. Maintaining this requirement is in contrast to the elimination of the excess statutory reserve in Issue Paper No. 65. It was determined that sufficient information is available to regulators regarding the adequacy of reserves such that the additional conservatism provided by the excess statutory reserve is no longer justified. Paragraph 7 of this issue paper requires that any portion of reinsurance recoverables deemed to be uncollectible as a result of a reporting entity’s experience being higher than the amounts provided by the minimum Schedule F provision shall be written off through a charge to operations, whereas current statutory accounting would require any additional amount to be added to the Schedule F provision resulting in a direct charge to surplus. This change was made to reflect known losses as charges to operations as opposed to direct charges to surplus.

13. Statutory accounting requires the calculation related to adjustable features to be computed based on experience to date because, from a regulatory standpoint, it is improper to recognize the favorable impact of early termination of the contract until such time as the contract is actually terminated.

14. Ceded reinsurance premiums payable are no longer deducted from agents’ balances and uncollected premiums because this payable meets the definition of a liability as established in *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets* and it does not meet the criteria for offsetting under the provisions of Issue Paper No. 76.

Drafting Notes/Comments

- Reinsurance for life and accident and health contracts is addressed in *Issue Paper No. 74—Life and Accident and Health Reinsurance*.

- Structured settlements for property and casualty insurers are addressed in *Issue Paper No. 65— and Casualty Contracts*.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

15. Chapter 7 of the P&C Accounting Practices and Procedures Manual, Agents' Balance or Uncollected Premiums, provides the following guidance on ceded premiums payable:

Ceded Reinsurance Premiums Payable

Ceded reinsurance premiums payable are those premiums that are due to other insurance companies for coverages purchased to reduce the ceding company's liability. Ceded reinsurance premiums payable are deducted from agents' balances or uncollected premiums in the balance sheet. (See Chapter 22 - Reinsurance.)

16. Chapter 8 of the P&C Accounting Practices and Procedures Manual provides the following guidance on reinsurance recoverable on paid losses:

- (f) Funds held or deposited with reinsured companies, whether they are premiums withheld for unearned premium and outstanding loss reserves or advances for loss payments, are admitted assets provided they do not exceed the liabilities they secure and provided the reinsured is solvent. Those funds which are in excess of the liabilities, and any funds held by insolvent reinsureds, should be nonadmitted.
- (h) Reinsurance recoverable on loss payments is an admitted asset. Unauthorized reinsurance is included in this asset and reflected separately as a liability to the extent required. Penalty for overdue on authorized companies will be reflected as a liability. (See Chapter 22 - Reinsurance.)

17. The guidance for calculating the penalty for unauthorized reinsurance and the penalty for overdue balances from authorized reinsurers is contained in the Annual Statement Instructions.

18. The current statutory accounting for property and casualty reinsurance is contained in the P&C Accounting Practices and Procedures Manual, Chapter 22, Reinsurance. Chapter 22 provides the following guidance with respect to the determination of whether a reinsurance contract qualifies for reinsurance accounting:

Reinsurance Contracts Must Include Transfer of Risk

The essential ingredient of a reinsurance contract is the shifting of risk. The essential element of every true reinsurance contract is the undertaking by the reinsurer to indemnify the ceding insurer (i.e., reinsured company), not only in form but in fact, against loss or liability by reason of the original insurance. Unless the so-called reinsurance contract contains this essential element of risk transfer, no credit whatsoever shall be allowed on account thereof in any accounting or financial statement of the ceding insurer.

Insurance risk involves uncertainties about both (a) the ultimate amount of net cash flows from premiums, commissions, claims and claims settlement expenses (underwriting risk) and (b) the timing of the receipt and payment of those cash flows (timing risk). Actual or imputed investment returns are not an element of insurance risk. Insurance risk is fortuitous - the possibility of adverse events occurring is outside the control of the insured.

Determining whether a contract with a reinsurer provides indemnification against loss or liability (transfer of risk) relating to insurance risk requires a complete understanding of that contract and other contracts or agreements between the ceding company and related reinsurers. A complete understanding includes an evaluation of all contractual features that (a) limit the amount of

insurance risk to which the reinsurer is subject (such as through experience refunds, cancellation provisions, adjustable features, or additions of profitable lines of business to the reinsurance contract) or (b) delay the timely reimbursement of claims by the reinsurer (such as through payment schedules or accumulating retentions from multiple years).

Indemnification of the ceding company against loss or liability relating to insurance risk in reinsurance requires both of the following:

1. The reinsurer assumes significant insurance risk under the reinsured portions of the underlying insurance contracts.
2. It is reasonably possible that the reinsurer may realize a significant loss from the transaction.

A reinsurer shall not be considered to have assumed significant insurance risk under the reinsured contracts if the probability of a significant variation in either the amount or timing of payments by the reinsurer is remote. Implicit in this condition is the requirement that both the amount and timing of the reinsurers payments depend on and directly vary with the amount and timing of claims settled by the ceding company. Contractual provisions that delay timely reimbursement to the ceding company would prevent this condition from being met.

The ceding company's evaluation of whether it is reasonably possible for a reinsurer to realize a significant loss from the transaction shall be based on the present value of all cash flows between the ceding and assuming companies under reasonably possible outcomes, without regard to how the individual cash flows are described or characterized. An outcome is reasonably possible if its probability is more than remote. The same interest rate shall be used to compute the present value of cash flows for each reasonably possible outcome tested. A constant interest rate shall be used in determining those present values because the possibility of investment income varying from expectations is not an element of insurance risk. Judgment is required to identify a reasonable and appropriate interest rate.

Significance of loss shall be evaluated by comparing the present value of all cash flows, determined as described in the above paragraph, with the present value of the amounts paid or deemed to have been paid to the reinsurer. If, based on this comparison, the reinsurer is not exposed to the reasonable possibility of significant loss, the ceding company shall be considered indemnified against loss or liability relating to insurance risk only if substantially all of the insurance risk relating to the reinsured portions of the underlying insurance contracts has been assumed by the reinsurer. In this narrow circumstance, the reinsurers economic position is virtually equivalent to having written the insurance contract directly. This condition is met only if insignificant insurance risk is retained by the ceding company on the reinsured portions of the underlying insurance contracts, so that the reinsurers exposure to loss is essentially the same as the insurers.

Payment schedules and accumulating retentions from multiple years are contractual features inherently designed to delay the timing of reimbursement to the ceding company. 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 reinsurers 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. Therefore, any feature that may affect the timing of the reinsurers reimbursement to the ceding company should be closely scrutinized.

19. The effective date for adopting the accounting and reporting requirements outlined in paragraph 18 are contained in Chapter 22 as follows:

Effective Date: Transition Rule

The revised accounting and reporting practices set forth in this chapter that were adopted on September 18, 1994 shall be effective for all accounting periods beginning on or after January 1, 1995 and shall apply to: (a) reinsurance contracts entered into, renewed, or amended on or after January 1, 1994, (an amendment is any revision or adjustment of contractual terms, but the payment of premiums or reimbursement of losses recoverable under the contract shall not constitute an amendment); and (b) reinsurance contracts in force on January 1, 1995 which cover losses occurring or claims-made on or after that date on policies reinsured under such contracts.

The revised accounting and reporting provisions shall not apply to: (a) reinsurance contracts which cover only losses occurring or claims-made before January 1, 1994 and which were entered into before January 1, 1994, and were not subsequently renewed or amended; and (b) reinsurance contracts that expired before, and were not renewed or amended after, January 1, 1995.

Previously reported amounts relating to contracts to which these revised accounting practices are not applicable shall not be restated. However, for accounting periods commencing on and after January 1, 1995, balances relating to contracts which were entered into, renewed or amended on or after January 1, 1994 and which do not transfer insurance risk shall be reclassified as deposits and shall be accounted for and reported in the manner described under the caption "Reinsurance Contracts Must Include Transfer of Risk".

Insurers may elect to comply with these revised accounting practices for accounting periods commencing before January 1, 1995.

20. Chapter 22 requires the following accounting for reinsurance contracts that do not qualify for reinsurance accounting (i.e., do not transfer insurance risk):

To the extent that a reinsurance contract does not, despite its form, transfer both components of insurance risk, all or part of the contract shall 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 admitted asset in the ceding company's annual statement (as a write-in item for other-than-invested assets) 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. 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 income or loss.
2. No deduction shall be made from the loss and loss adjustment expense reserves on the ceding company's balance sheet, schedules and exhibits.
3. The assuming company shall record net consideration to be returned to the ceding company as liabilities.

21. Chapter 22 requires the following accounting for reinsurance contracts that qualify for reinsurance accounting (i.e., transfer insurance risk). The guidance for retroactive reinsurance contracts was revised by the Property Casualty Reinsurance Study Group at its December 13, 1995 meeting. This

guidance was adopted by the membership of the NAIC at the March 1996 Plenary Session. Changes adopted have been underlined and struckthrough in this paragraph.

Accounting for Reinsurance

Reinsurance recoverables shall be recognized in a manner consistent with the liabilities (including estimated amounts for claims incurred but not reported) relating to the underlying reinsured contracts. Assumptions used in estimating reinsurance recoverables shall be consistent with those used in estimating the related liabilities. Accounting for members of a reinsurance pool shall follow the accounting for the pool member which wrote the underlying policy.

Accounting for reinsurance depends on whether the contract is considered prospective or retroactive. Prospective reinsurance is reinsurance in which a reinsurer agrees to reimburse a ceding company for losses that may be incurred as a result of future insurable events covered under contracts subject to the reinsurance. Retroactive reinsurance is reinsurance in which a reinsurer agrees to reimburse a ceding company for liabilities incurred as a result of past insurable events covered under contracts subject to the reinsurance. A reinsurance contract may include both prospective and retroactive reinsurance provisions.

The distinction between prospective and retrospective reinsurance contracts is based on whether the contract reinsures future or past insured events covered by the underlying insurance policies. For example, in occurrence-based insurance, the insured event is the occurrence of a loss covered by the insurance contract. In claims-made insurance, the insured event is the reporting to the insurer, within the period specified by the policy, of a claim for a loss covered by the insurance contract. A claims-made reinsurance contract that reinsures claims asserted to the reinsurer in a future period as a result of insured events that occurred prior to entering into the reinsurance contract is a retroactive contract. (However, a reinsurance contract that reinsures claims reported to an insurer that are covered under currently effective claims-made insurance policies is a prospective reinsurance contract.)

It is not uncommon for a reinsurance arrangement to be initiated before the beginning of a policy period but not finalized until after the policy period begins. Whether there was agreement in principle at the beginning of the policy period and, therefore, the contract is substantively prospective must be determined based on the facts and circumstances. However, except as respects business assumed by a U.S. reinsurer from ceding companies domiciled outside the U.S. and not affiliated with such reinsurer, or business assumed by a U.S. reinsurer where either the lead reinsurer or a majority of the capacity on the contract is domiciled outside the U.S. and is not affiliated with such reinsurer, if a contract entered into, renewed or amended on or after January 1, 1994 has not been finalized, reduced to a written form and signed by the parties within nine months after the commencement of the policy period covered by the reinsurance arrangement, then the arrangement is presumed to be retroactive and must be accounted for as a retroactive reinsurance contract. This presumption shall not apply to: (a) facultative reinsurance contracts; nor to (b) reinsurance contracts with more than one reinsurer which are signed by the lead reinsurer (i.e. the reinsurer setting the terms of the contract for the reinsurers) within nine months after the commencement of the policy period covered by the reinsurance contract; nor to (c) reinsurance contracts with more than one reinsurer (whether signed by the lead reinsurer or not) which were entered into, renewed or amended on or before December 31, 1996, (and which were not renewed or amended after that date) if reinsurers representing more than 50% of the capacity on the contract have signed cover notes, placement slips or similar documents describing the essential terms of coverage and exclusions within nine months after the commencement of the policy period covered by the reinsurance arrangement.

When practicable, prospective and retroactive provisions included within a single contract shall be accounted for separately. If separate accounting for prospective and retroactive provisions included within a single contract is impracticable, the contract shall be accounted for as a retroactive contract provided the conditions for reinsurance accounting are met.

Accounting for Prospective Reinsurance Contracts

Amounts paid for prospective reinsurance that meets the conditions for reinsurance accounting shall be reported as a reduction of written and earned premiums by the ceding company and shall be earned over the remaining contract period in proportion to the amount of reinsurance protection provided. If the amounts paid are subject to adjustment and can be reasonably estimated, the basis for amortization shall be the estimated ultimate amount to be paid.

Changes in amounts of estimated reinsurance recoverables shall be recognized as a reduction of gross losses and loss expenses incurred in the current periods statement of income. Reinsurance recoverables on paid losses shall be reported as an asset, reinsurance recoverables on loss and loss adjustment expense payments, in the balance sheet. Reinsurance recoverables on unpaid case-basis and incurred but not reported losses and loss adjustment expenses shall be netted against the liability for gross losses and loss adjustment expenses.

Accounting for Retroactive Reinsurance Contracts

Certain reinsurance contracts which transfer both components of insurance risk cover liabilities which occurred prior to the effective date of the contract. Due to potential abuses involving the creation of surplus to policyholders, and the distortion of underwriting results, a special accounting treatment for such agreements is warranted.

Effective for accounting periods commencing on or after January 1, 1995, all retroactive reinsurance contracts entered into, renewed or amended on or after January 1, 1994 (including subsequent development of such transactions) must be fully disclosed in the NAIC annual and interim financial statements required to be filed and shall be accounted for and reported in the following manner:

1. The ceding company must record, without recognition of the retroactive reinsurance, its loss and loss expense reserves on a gross basis on its balance sheet and in all schedules and exhibits.
2. The assuming company must exclude the retroactive reinsurance from its loss and loss expense reserves and from its schedules and exhibits.
3. The ceding company and the assuming company must report by write-in item on Page 3, the total amount of all retroactive reinsurance, identified as "retroactive reinsurance reserve ceded or assumed", recorded as a contra-liability by the ceding company and as a liability by the assuming company.
4. The ceding company must, by write-in item on Page 3, restrict surplus resulting from any retroactive reinsurance as a special surplus fund, designated as "special surplus from retroactive reinsurance account".
5. The surplus gain from any retroactive reinsurance may not be classified as unassigned funds [considered earned surplus] until such time as the actual retroactive reinsurance-recovered is in excess of the consideration paid.
6. The "special surplus from retroactive reinsurance account" for each respective retroactive reinsurance contract shall be reduced at the time the ceding company begins to recover funds from the assuming company in amounts exceeding the consideration paid by the ceding company under such agreement, or adjusted as provided in paragraph 10 below.
7. For each agreement, the reduction in the "special surplus from retroactive reinsurance" account must be limited to the lesser of:
 - (a) the actual amount recovered in excess of consideration paid; or

- (b) the initial surplus gain resulting from the respective retroactive reinsurance contract.

Any remaining balance in the “retroactive reinsurance reserve ceded or assumed”, account derived from any such agreement must be returned to unassigned funds upon elimination of all policy obligations subject to the retroactive reinsurance contract.

8. The ceding company shall report the initial gain arising from a retroactive reinsurance transaction (i.e., the difference between the consideration paid to the reinsurer and the total reserves ceded to the reinsurer) as a write-in item on Page 4, to be identified as “Retroactive Reinsurance Gain” and included under “Other Income” in the Underwriting and Investment Exhibit Statement of Income.
9. The assuming company shall report the initial loss arising from a retroactive reinsurance transaction, as defined in the preceding paragraph 8, as a write-in item on Page 4, to be identified as Retroactive Reinsurance Loss and included under Other Income in the Underwriting and Investment Exhibit Statement of Income.
10. Any subsequent increase or reduction in the total reserves ceded under a retroactive reinsurance agreement shall be reported in the manner described in the preceding paragraphs 8 and 9, in order to recognize the gain or loss arising from such increase or reduction in reserves ceded. The “Special Surplus from Retroactive Reinsurance Account” write-in entry on Page 3 and the pertinent entry in the Notes to the Financial Statement shall be adjusted, upward or downward, to reflect such increase or reduction in reserves ceded. The “Special Surplus from Retroactive Reinsurance Account” write-in entry must be equal to or less than the total ceded reserves under all retroactive reinsurance agreements in-force as of the date of the financial statement. Special surplus arising from a retroactive reinsurance transaction shall be considered to be earned surplus (i.e., transferred to Unassigned Funds) only when cash recoveries from the assuming company exceed the consideration paid by the ceding company as respects such retroactive reinsurance transaction.
11. Each retroactive reinsurance contract shall be included in the Notes to Financial Statements relating to “Ceded or Assumed Unpaid Loss and Loss Adjustment Expenses”.
12. The consideration paid for a retroactive reinsurance contract shall be reported as a decrease in Exhibit 3 ledger assets by the ceding company and as an increase in Exhibit 3 ledger assets by the assuming company (as a write-in item).

(For an illustration of ceding company accounting entries see Question 33 in Appendix A.)

This procedure regarding accounting for retroactive reinsurance contracts shall not apply to the following types of contracts (which shall be accounted for as prospective reinsurance contracts):

1. Structured settlement annuities for individual claims purchased to implement settlements of policy obligations;
2. Novations, i.e. (a) transactions in which the original direct insurer’s obligations are completely extinguished, resulting in no further exposure to loss arising on the business novated or (b) transactions in which the original assuming company’s obligations are completely extinguished, resulting in no further exposure to loss arising on the business novated, provided that (i) the parties to the transaction are not affiliates (or if affiliates, that the transaction has the prior approval of the domiciliary regulators of the parties) and (ii) the accounting for

the original reinsurance agreement will not be altered from retroactive to prospective

3. The termination of, or reduction in participation in, reinsurance treaties entered into in the ordinary course of business; or
4. Intercompany reinsurance contracts, and any amendments thereto, among companies 100% owned by a common parent or ultimate controlling person provided there is no gain in surplus as a result of the transaction.

Except for its accounting and reporting provisions, this procedure regarding retroactive reinsurance shall not apply to transactions transferring liabilities in connection with a court-ordered rehabilitation, liquidation or receivership with written approval of the ceding company's domiciliary commissioner.

Retroactive reinsurance contracts resulting in surplus gain to the ceding company (with or without risk transfer) entered into between affiliates or between insurers "under common control" (as those terms are defined in the NAIC Model Insurance Holding Company Regulatory Act) shall be reported in annual and interim statements as follows:

1. The consideration paid by the ceding company shall be recorded as a deposit and reported as a non-admitted asset in Exhibit 1; and
2. No deduction shall be made from loss and loss adjustment expense reserves on the ceding company's balance sheet, schedules and exhibits.

Required Terms for Reinsurance Contracts

In addition to credit for reinsurance requirements applicable to reinsurance transactions generally, no credit or deduction from liabilities shall be allowed for reinsurance recoverable in annual or interim statements required to be filed by the ceding company where the agreement was entered into after the effective date of these requirements unless each of the following conditions is satisfied:

1. The contract must contain an acceptable insolvency clause.
2. Recoveries due the ceding company must be available without delay for payment of losses and claim obligations incurred under the agreement, in a manner consistent with orderly payment of incurred policy obligations by the ceding company.
3. The agreement shall constitute the entire contract between the parties and must provide no guarantee of profit, directly or indirectly, from the reinsurer to the ceding company or from the ceding company to the reinsurer.
4. The agreement must provide for reports of premiums and losses, and payment of losses, no less frequently than on a quarterly basis. The report of premiums and losses shall set forth the ceding company's total loss and loss expense reserves on the policy obligations subject to the agreement, so that the respective obligations of the ceding company and reinsurer will be recorded and reported on a basis consistent with this manual.
5. With respect to retroactive reinsurance contracts the following additional conditions apply. The consideration to be paid by the ceding company for the retroactive reinsurance must be a sum certain stated in the agreement. Direct or indirect compensation to the ceding company or reinsurer is prohibited. Any provision for subsequent adjustment on the basis of actual experience in regard to policy obligations transferred, or on the basis of any other formula, is prohibited in connection with a retroactive reinsurance transaction, except that

provision may be made for the ceding company's participation in the reinsurer's ultimate profit, if any, under the agreement. A retroactive reinsurance contract may not be canceled or rescinded without the approval of the commissioner of the domiciliary state of the ceding company.

Characteristics of Reinsurance Contracts

Each reinsurance contract may be individually drafted. Commonly included contract provisions that may affect accounting practices include:

1. Reporting responsibility of the ceding insurer. Should be clearly spelled out both as to details required and time schedules.
2. Payment terms. Time schedules, currencies intended and the rights of the parties to withhold funds should be established.
3. Payment of premium taxes. Customarily the responsibility of the ceding company, a recital of nonliability of the reinsurer may be found.
4. Termination. May be on a "cut-off" or "run-off" basis. A "cut-off" provision stipulates that the reinsurer shall not be liable for loss as a result of occurrences taking place after the date of termination. A "run-off" provision stipulates that the reinsurer shall remain liable for loss under reinsured policies in force at the date of termination as a result of occurrences taking place after the date of termination until such time as the term of the policy expires.
5. Insolvency clause. Should provide for the survival of the reinsurer's obligations in the event of insolvency of the ceding company, without diminution because of the insolvency.

Reinsurance contracts shall not permit entry of an order of rehabilitation or liquidation to constitute an anticipatory breach by the insurer nor grounds for retroactive revocation or retroactive cancellation of any contracts of the insurer.

Reinsurance Assumed

The segregation of premiums, losses and expenses arising from reinsurance assumed transactions is required for the Underwriting and Investment Exhibit of the annual statement.

Non-proportional assumed reinsurance transactions should be included in the reinsurance lines of business in the annual statement under four subcategories while all proportional reinsurance (first dollar pro-rata reinsurance) must be allocated to the appropriate lines of business.

Reinsurance premiums receivable at the end of the accounting period are combined with direct business receivables and reported as "Agents' balances or uncollected premiums". Where the ceding insurer withholds premium funds pursuant to the terms of the reinsurance contract, such assets should be shown by the assuming company as "Funds held by or deposited with reinsured companies". Reinsurance premiums more than 90 days overdue should not be included as receivable except (a) to the extent the assuming insurer maintains unearned premium and loss reserves as to the ceding insurer, under normal principles of offset accounting, or (b) where the ceding insurer is licensed and in good standing in assuming insurer's state of domicile. Reinsurance premiums are due pursuant to the original contract terms (as the contract stood on the date of execution); in the absence of a specific contract date, reinsurance premiums will be deemed due thirty (30) days after the date on which (1) notice or demand of premium due is provided to the ceding insurer or (2) the assuming insurer books the premium (See Chapter 9 - Nonadmitted Assets).

A lag will develop between the time of the entry of the underlying policy transaction on the books of the ceding insurer and the transmittal of information and its entry on the books of the assuming

company. Assuming companies shall estimate such unreported premiums and related costs to the extent necessary to prevent material distortions in the loss development contained in the assuming company's annual statement schedules where calendar year premiums are compared to accident year losses.

Amounts payable by reinsurers on losses are generally classified in the annual statement as unpaid losses. Assumed reinsurance payable on paid losses should be classified as a separate liability item on the balance sheet. IBNR losses on assumed reinsurance business are netted with ceded losses on the balance sheet but are shown separately by annual statement line of business in the Underwriting and Investment Exhibit.

Reinsurance Ceded

The Underwriting and Investment Exhibit of the annual statement presents segregated data on the premiums, losses and expenses from reinsurance ceded transactions in a manner similar to reinsurance assumed.

Ceded reinsurance transactions should be included in the annual statement line of business which relates to the direct or assumed transactions creating the cession or retrocession.

Premiums due reinsurers ("ceded balances payable") are shown as contra assets contained in "Agents' balances or uncollected premiums." Amounts that are withheld by the ceding company from sums that would otherwise be payable under the reinsurance contract are reportable as "Funds held by company under reinsurance treaties."

Adjustable Feature/Retropective Rating

Reinsurance treaties may provide for adjustment of commission, premium, or amount of coverage, based on loss experience. Examples are:

1. Commission Adjustments:

Contingent or Straight Profit—The reinsurer returns to the ceding company a stipulated percentage of the profit produced by the business assumed from the ceding insurer. Profit may be calculated for any specified period of time, but the calculation is often based on an average over a period of years.

Sliding Scale—A provisional rate of commission is paid over the course of the treaty, with a final adjustment based on the experience of the business ceded under the treaty.

An accrual shall be maintained for these adjustable features based upon the experience recorded for the period.

2. Premium Adjustments:

The initial provisional or deposit premium is recalculated retrospectively, based on loss experience under the treaty during a specified period of time; the calculation is often based on an average over a period of years.

If the reinsurance treaty incorporates an obligation on the part of the ceding company to pay additional premium to the assuming company based upon loss experience under the treaty, a liability in the amount of such additional premium shall be recognized by the ceding company during the accounting period in which the loss event(s) giving rise to the obligation to pay such additional premium occur(s). The assuming company shall recognize an asset in the same amount.

If the reinsurance treaty incorporates an obligation on the part of the assuming company to refund to the ceding company any portion of the consideration received by the assuming company based upon loss experience under the treaty, an asset in the amount of any such refund shall be recognized by the ceding company during the accounting period in which the loss event(s) giving rise to the obligation to make such refund occur(s). The assuming company shall recognize a liability in the same amount.

3. Adjustments in the Amount of Coverage:

The amount of coverage available for future periods is adjusted, upward or downward, based on loss experience under the treaty during a specified period of time.

If the reinsurance treaty incorporates a provision under which the reinsurance coverage afforded to the ceding company may be increased or reduced based upon loss experience under the treaty, an asset or a liability shall be recognized by the ceding company in an amount equal to that percentage of the consideration received by the assuming company which the increase or reduction in coverage represents of the amount of coverage originally afforded. Such asset or liability shall be recognized during the accounting period in which the loss event(s) (or absence thereof) giving rise to the increase or decrease in reinsurance coverage occur(s), and shall be amortized over all accounting periods for which the increased or reduced coverage is applicable. The term "consideration" shall mean, for this purpose, the annualized deposit premium for the period used as the basis for calculating the adjustment in the amount of coverage to be afforded thereafter under the treaty.

Effective Date

The accounting and reporting provisions set forth in paragraphs 1, 2 and 3 above shall be effective for all accounting periods beginning on or after January 1, 1996, and shall apply to reinsurance contracts entered into, renewed or amended on or after January 1, 1994.

Commissions

Commissions payable on reinsurance assumed business should be included as an offset to "Agents" Balances or Uncollected Premiums. Commissions receivable on reinsurance ceded business should be included as an offset to "Ceded Reinsurance Balances Payable". (See Chapter 18 - Commissions.)

If the ceding commission paid under a non-proportional reinsurance contract exceeds the anticipated acquisition cost of the business ceded, the ceding company shall establish a liability, equal to the difference between the anticipated acquisition cost and the reinsurance commissions received, to be amortized pro rata over the life of the reinsurance contract.

Those reinsurance contracts drafted in form as pro rata but which, in fact, contain per loss deductibles to be retained by the ceding carrier shall be considered non-proportional for the purposes of the paragraph above.

Provision for Reinsurance

The liability "Provision for Reinsurance" is reflected on page three of the Annual Statement, and the change between years is recorded as a gain or loss directly to surplus.

The details of this calculation can be found in Schedule "F-Part 7" of the Annual Statement. The appropriate instructions for calculating this liability can be found in the Instructions to the Annual Statement.

This provision is calculated separately for unauthorized and authorized companies in Schedule F. An authorized reinsurer is one that is licensed, accredited or approved by the ceding insurers state of domicile; an unauthorized reinsurer is not so licensed, accredited or approved.

Disputed Items

Occasionally a reinsurer will question whether an individual claim is covered under a reinsurance contract or may even attempt to nullify an entire treaty. A ceding insurer, depending upon the individual facts, may or may not choose to continue to take credit for such disputed balances. The Annual Statement Instructions require notification of a dispute by a formal written communication from the reinsurer denying the validity of coverage. Additionally, the "Notes to Financial Statements" require footnote disclosure of material amounts and the status of disputed items. Furthermore, a ceding insurer may take no credit whatsoever for reinsurance recoverables in dispute with an affiliate.

Commutations

A commutation of a reinsurance contract 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.

Reasons for commuting reinsurance contracts often include: (1) perceived financial instability of the reinsurer, (2) inefficiencies associated with the runoff of longer tailed liabilities, (3) significantly different evaluation of ultimate loss costs or (4) the reinsurers withdrawal from the reinsurance marketplace.

In commutation agreements, the present value of the reinsurers estimated ultimate losses are paid by the reinsurer to the ceding insurer. The ceding insurer immediately establishes the ultimate loss reserve as its liability and the cash received as a negative paid loss, thus creating a reduction in policyholders surplus equal to the difference between the ultimate and present value of the loss reserve.

The reinsurer, on the other hand, has eliminated a loss reserve carried at ultimate cost for a cash payout calculated at present value. The result is an increase in policyholders surplus equal to the difference between the ultimate and present value of the loss reserves.

Commuted balances must be accounted for by writing them off through the accounts, exhibits and schedules in which they were originally recorded.

Uncollectible Reinsurance

Uncollectible reinsurance balances must be accounted for by writing them off through the accounts, exhibits and schedules in which they were originally recorded.

22. Chapter 22 requires the following disclosures with respect to reinsurance. The guidance for retroactive reinsurance contracts was revised by the Property Casualty Reinsurance Study Group at their December 13, 1995 meeting. This guidance was adopted by the membership of the NAIC at the March 1996 Plenary Session. Changes adopted have been underlined and struckthrough in this paragraph.

Reporting of Reinsurance Transactions

Ceded reinsurance disclosures in the Notes to Financial Statements of the annual statement indicates the impact on the insurers surplus if all its reinsurance were canceled. The effect of return commissions, sliding scale commissions, as well as minimum and maximum commissions, is required to be calculated and then measured as factors reducing surplus.

Portfolio reinsurance is the transfer of the entire liability of an insurer for in force policies or outstanding losses, or both, as respects a described segment of the insurers business. Loss

portfolio transfers are to be accounted for as retroactive reinsurance which is discussed earlier in this chapter.

A specific interrogatory requires information on reinsurance of risk accompanied by an agreement to release the reinsurer from liability, in whole or in part, from any loss that may occur on the risk or portion thereof.

A commonly accepted practice among affiliated insurers is the sharing of underwriting results (“pooling”) in accordance with predetermined ratios. This is normally accomplished by a procedure whereby all affiliated insurers reinsure their direct business with the major insurers. Business is then retroceded to the affiliates so that each member of the group receives its predetermined share of the gross group business.

Detailed disclosure of certain reinsurance transactions is required in various notes to financial statements. These include retroactive reinsurance, unsecured reinsurance recoverables, reinsurance recoverables in dispute, write off of uncollectible reinsurance, and reinsurance commutations.

23. Chapter 22 provides the following guidance on the National Flood Insurance Program:

National Flood Insurance Program

This program was created by the Federal Emergency Management Agency (FEMA) and is designed to involve private insurers in a “write-your-own” (WYO) flood insurance program financially backed by FEMA at no risk to the insurer. To become a participating WYO company, the insurer signs a document with the Federal Insurance Administration (FIA) of the Federal Emergency Management Agency known as the Financial Assistance/Subsidy Arrangement.

Premium rates are set by FEMA. The WYO participating companies write the flood insurance coverage qualifying for the program on their own policies, perform their own underwriting, premium collections, claim payments, administration, and premium tax payments for policies written under the program.

Monthly accountings are made to FIA and participants are allowed to draw upon FEMA letters of credit for deficiencies of losses, loss expenses and administrative expenses in excess of premiums, subject to certain percentage limitations on expenses.

For purposes of statutory reporting in the WYO participating insurers’ annual statements, balances due from or to FEMA should be treated as ceded reinsurance balances receivable or payable in Schedule F, FEMA should be identified as the reinsurer and assigned the NAIC Company Code 46990.

24. The Annual Statement Instructions require the following disclosures related to reinsurance:

11. Unsecured Reinsurance Recoverables

Instruction:

If the company has with any individual reinsurers, authorized or unauthorized, an unsecured aggregated recoverables losses, paid and unpaid including IBNR, loss adjustment expenses, and unearned premium that exceeds 3% of the company’s policyholder surplus, list each individual reinsurer and the unsecured aggregated recoverable pertaining to that reinsurer. If the individual reinsurer is part of a group, list the individual reinsurers, each of its related group members having reinsurance with the reporting company, and the total unsecured aggregate recoverables for the entire group.

Include: The NAIC group code number, where appropriate, and the Federal Employer Identification Number for each individual company.

12. Reinsurance Recoverable in Dispute

Instruction:

Reinsurance recoverable on paid and unpaid (including IBNR) losses in dispute by reason of notification, arbitration or litigation shall be identified in the schedule if the amounts in dispute from any company (and/or affiliate) exceeds 5% of the ceding company's policyholders surplus or if the aggregate of all disputed items exceeds 10% of the ceding company's policyholder surplus. "Notification" means a formal written communication from a reinsurer denying the validity of the coverage.

Illustration:

<u>Name of Reinsurer</u>	<u>Total Amount in Dispute (Including IBNR)</u>	<u>Notification</u>	<u>Arbitration</u>	<u>Litigation</u>
A - Reinsurer	\$10,000			\$10,000
B - Reinsurer	\$20,000		\$10,000	\$10,000
C - Reinsurer	\$30,000	\$30,000		

13. Reinsurance Assumed and Ceded

a. Instruction:

Report the maximum amount of return commission which would have been due reinsurers if they or you had canceled all of your company's reinsurance or if you or a receiver had canceled all of your company's insurance assumed as of the end of the period covered by this annual statement with the return of the unearned premium reserve. Equity amounts should be computed by applying the fixed or provisional commission rate for each contract to the unearned premium reserve. Line (iii) of Column 5 plus Line (iv) must equal Page 3, Column 1, Line 9.

Illustration:

	ASSUMED REINSURANCE		CEDED REINSURANCE		NET	
	(1) Premium Reserve	(2) Commission Equity	(3) Premium Reserve	(4) Commission Equity	(5) Premium Reserve	(6) Commission Equity
i. Affiliates	\$ _____	\$ _____	\$ _____	\$ _____	\$ _____	\$ _____
ii. All Other	_____	_____	_____	_____	_____	_____
iii. TOTAL	\$ _____	\$ _____	\$ _____	\$ _____	\$ _____	\$ _____
iv. Direct Unearned Premium Reserve			\$ _____			

b. Instruction:

Additional or return commission predicated on loss experience or on any other form of profit sharing arrangements in this annual statement as a result of existing contractual arrangements are accrued as follows:

Illustration:

	REINSURANCE			
	(1)	(2)	(3)	(4)
	<u>DIRECT</u>	<u>Assumed</u>	<u>Ceded</u>	<u>NET</u>
i. Contingent Commission	\$ _____	\$ _____	\$ _____	\$ _____
ii. Sliding Scale Adjustments	_____	_____	_____	_____
iii. Other Profit Commission Arrangements	_____	_____	_____	_____
iv. TOTAL	\$ _____	\$ _____	\$ _____	\$ _____

c. Instruction:

Disclose all contracts of reinsurance covering losses that have occurred prior to the inception of the contract that have not been accounted for in conformity with the instructions contained in the NAIC *Accounting Practices and Procedures* manual, Chapter 22.

Illustration:

All contracts of reinsurance covering losses that have occurred prior to the inception of the contract have been accounted for in conformity with the instructions contained in the NAIC *Accounting Policies and Procedures* manual, Chapter 22, except for the following:

15. Uncollectible Reinsurance

Instruction:

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

1. Losses incurred;
2. Loss adjustment expenses incurred;
3. Premiums earned;
4. Other.

Illustration:

Uncollectible Reinsurance Balances Written Off Through Income and Expense

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

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

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

16. Commutation of Ceded Reinsurance

Instruction:

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

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

Illustration:

Commutation of Ceded Reinsurance

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	\$ _____

17. Retroactive Reinsurance

Instruction:

The following shall be completed for all retroactive reinsurance contracts that transfer liabilities for losses that have already occurred and that will generate special surplus transactions. Transactions utilizing "Deposit Accounting" shall not be reported in this note.

The insurer (assuming or ceding) shall assign a unique number to each retroactive reinsurance contract and shall utilize this number for as long as the contract exists. The summary (aggregate of all retroactive reinsurance contracts) is to be reported in the form below. For further guidance, refer to Chapter 22 of the NAIC *Accounting Policies and Procedures* manual. Analysis in a similar format on individual retroactive reinsurance contracts may be necessary upon request.

As:	<u>Reported Company</u>	
	(1)	(2)
	<u>Assumed</u>	<u>Ceded</u>
A. Reserves Transferred:		
1. Initial Reserves	\$ _____	\$ _____
2. Adjustments - Prior Year(s)	_____	_____
3. Adjustments - Current Year	_____	_____
4. Total	\$ _____	\$ _____
B. Consideration Paid or Received		
1. Initial	\$ _____	\$ _____
2. Adjustments - Prior Year(s)	_____	_____
3. Adjustments - Current Year	_____	_____
4. Total	\$ _____	\$ _____
C. Amounts Recovered/Paid (cumulative)		
1. Prior Year(s)	\$ _____	\$ _____
2. Current Year	_____	_____
3. Total	\$ _____	\$ _____
D. Special Surplus from Retroactive Insurance		
1. Initial	\$ _____	\$ _____
2. Adjustments - Prior Year(s)	_____	_____
3. Adjustments - Current Year	_____	_____
4. Closing Balance	\$ _____	\$ _____

E. List the other insurers included in the above transactions

<u>Assumed</u>	<u>Amount</u>	<u>Ceded</u>	<u>Amount</u>
<u>Company</u>		<u>Company</u>	
	\$ _____		\$ _____
	_____		_____
	_____		_____
Total	\$ _____ *	Total	\$ _____ *

* Total amounts must agree with totals in A.4.

25. The NAIC Annual Statement Instructions for Property and Casualty Insurance Companies provide the following guidance for line 3 of Schedule F-Part 7, Provision for Overdue Reinsurance:

Line 3 - Line 1 x Line 2

If the company's experience indicates that a higher amount should be provided, such higher amount should be entered

Generally Accepted Accounting Principles

26. As noted in paragraph 8, FAS 113 is generally consistent with Chapter 22. The paragraphs that follow are excerpts from FAS 113 which provide guidance on areas that differ from Chapter 22 (see paragraph 8 for a summary of differences).

27. FAS 113 eliminated the practice of insurance enterprises of reporting assets and liabilities relating to reinsured contracts net of the effects of reinsurance:

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 enterprise'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 setoff 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.
28. FAS 113 contains the following guidance on retroactive reinsurance agreements:
22. Amounts paid for retroactive reinsurance that meets the conditions for reinsurance accounting shall be reported as reinsurance receivables to the extent those amounts do not exceed the recorded liabilities relating to the underlying reinsured contracts. If the recorded liabilities exceed the amounts paid, reinsurance receivables shall be increased to reflect the difference and the resulting gain deferred. The deferred gain shall be amortized over the estimated remaining settlement period. If the amounts and timing of the reinsurance recoveries can be reasonably estimated, the deferred gain shall be amortized using the effective interest rate inherent in the amount paid to the reinsurer and the estimated timing and amounts of recoveries from the reinsurer (the interest method). Otherwise, the proportion of actual recoveries to total estimated recoveries (the recovery method) shall determine the amount of amortization.
 23. If the amounts paid for retroactive reinsurance exceed the recorded liabilities relating to the underlying reinsured contracts, the ceding enterprise shall increase the related liabilities or reduce the reinsurance receivable or both at the time the reinsurance contract is entered into, so that the excess is charged to earnings.
 24. Changes in the estimated amount of the liabilities relating to the underlying reinsured contracts shall be recognized in earnings in the period of the change. Reinsurance receivables shall reflect the related change in the amount recoverable from the reinsurer, and a gain to be deferred and amortized, as described in paragraph 22, shall be adjusted or established as a result.⁶ When changes in the estimated amount recoverable from the reinsurer or in the timing of receipts related to that amount occur, a cumulative amortization adjustment shall be recognized in earnings in the period of the change so that the deferred gain reflects the balance that would have existed had the revised estimate been available at the inception of the reinsurance transaction.

⁶ Decreases in the estimated amount of the liabilities shall reduce the related amount recoverable from the reinsurer and accordingly reduce previously deferred gains. However, if the revised estimate of the liabilities is less than the amounts paid to the reinsurer, a loss shall not be deferred. The resulting difference shall be recognized in earnings immediately as described in paragraph 23.

29. EITF 93-6 contains the following guidance on multiple-year retrospectively rated reinsurance contracts:

ISSUE

An insurer (ceding enterprise) may enter into a multiple-year retrospectively rated reinsurance contract (RRC) with a reinsurer (assuming enterprise). Examples of these contracts may include transactions referred to as “funded catastrophe covers.” These contracts include a “retrospective rating” provision that provides for at least one of the following based on contract experience: (1) changes in the amount or timing of future contractual cash flows, including premium adjustments, settlement adjustments, or refunds to the ceding enterprise, or (2) changes in the contract’s future coverage. A critical distinguishing feature of these contracts is that part or all of the retrospective rating provision is obligatory such that the retrospective rating provision creates future rights and obligations as a result of past events. A retrospectively rated contract that could be canceled by either party without further obligation is not covered by this Issue.

The issues are (1) to the extent that the ceding enterprise has an obligation to make payments to the reinsurer that would not have been required absent experience to date under the contract (for example, payments that would not have been required if losses had not been experienced), whether the ceding enterprise should recognize a liability and the assuming enterprise should recognize an asset, (2) to the extent that a ceding enterprise would be entitled to receive a payment from the reinsurer based on experience to date under the contract (for example, the ceding enterprise would receive a payment if no future losses occur), whether the ceding enterprise should recognize an asset and the assuming enterprise should recognize a liability, and (3) how to account for changes in coverage based on past experience under the contract.

EITF DISCUSSION

The Task Force reached a consensus that in order to be accounted for as reinsurance, a contract that reinsures risks arising from short-duration insurance contracts must meet all of the following conditions: (1) the contract must qualify as a short-duration contract under paragraph 7.a. of Statement 60, (2) the contract must not contain features that prevent the risk transfer criteria in paragraphs 8-13 of Statement 113 from being reasonably applied (and those criteria must be met), and (3) the ultimate premium expected to be paid or received under the contract must be reasonably estimable and allocable in proportion to the reinsurance protection provided as required by paragraph 14.a. and 14.b. of Statement 60 and paragraph 21 of Statement 113. If any of these conditions are not met, a deposit method of accounting should be applied by the ceding and assuming enterprises. With respect to condition (2) above, a Task Force member asked whether a contract could be split for purposes of evaluating risk transfer. An FASB staff representative responded that Statement 113 applies to “a contract” and that determining the substance of a contract is a judgmental matter. If an agreement with a reinsurer consists of both risk transfer and nonrisk transfer coverages that have been combined into a single legal document, those coverages must be considered separately for accounting purposes. The FASB staff representative noted that paragraphs 59 and 60 of Statement 113 indicate that the Board did not intend for different kinds of exposures combined in a program of reinsurance to be evaluated for risk transfer and accounted for together because that would allow contracts that do not meet the conditions for reinsurance accounting to be accounted for as reinsurance by being designated as part of a program that in total meets the conditions for reinsurance accounting.

For contracts that meet all of the conditions described above, the Task Force reached the following consensus:

Issue 1. The ceding enterprise should recognize a liability and the assuming enterprise should recognize an asset to the extent that the ceding enterprise has an obligation to pay cash (or other consideration) to the reinsurer that would not have been required absent experience under the contract. The amount recognized in the current period should be computed, using a with-and-

without method, as the difference between the ceding enterprise's total contract costs before and after the experience under the contract as of the reporting date, including costs such as premium adjustments, settlement adjustments, and impairments of coverage. The amount of premium expense related to impairments of coverage should be measured in relation to the original contract terms. Future experience under the contract (that is, future losses and future premiums that would be paid regardless of past experience) should not be considered in measuring the amount to be recognized.

In applying the consensus reached in Issue 1, if the ceding enterprise could terminate the contract prior to the end of its term and if termination would change the amounts paid (for example, if terminating the contract would cost less than continuing the contract in force), the liability resulting from the contract should be measured as follows:

1. If a decision to terminate has been made, the measurement should be based on an assumption of termination and experience to date.
2. Otherwise, the measurement should be based on the lesser of the following:
 - a. The total incremental cost that would be paid based on the with-and-without calculation assuming experience to date and assuming termination (that is, excluding the effects of future losses and future premiums that would have been paid regardless of experience to date) or
 - b. The total incremental cost that would be paid based on the with-and-without calculation assuming experience to date and assuming no termination (that is, excluding the effects of future losses and future premiums that would have been paid regardless of experience to date).

Issue 2. The ceding enterprise should recognize an asset and the assuming enterprise should recognize a liability to the extent that any cash (or other consideration) would be payable from the assuming enterprise to the ceding enterprise based on experience to date under the contract.

Issue 3. The ceding enterprise and the assuming enterprise should account for changes in coverage in the same manner as changes in other contract costs. For example, the effects of decreases in coverage without a commensurate reduction in premium should be recognized as a loss by the ceding enterprise and as a gain by the assuming enterprise when the event causing the decrease in coverage takes place.

The Task Force noted that deposit accounting cannot be used to avoid loss recognition that would otherwise be required (for example, the ceding enterprise has no future coverage relating to the deposit with the reinsurer and therefore the deposit is not recoverable).

The provisions of these consensuses are effective as of July 22, 1993 (for example, they are to be initially applied no later than the third quarter of 1993 for calendar-year enterprises) and are to be initially applied in one of two ways:

1. By recognition of the net effect of applying the provisions at the beginning of an enterprise's current fiscal year as a cumulative effect of a change in accounting principle in accordance with paragraph 20 of Opinion 20. Under this approach, the disclosures required by paragraph 21 of Opinion 20 would be required as long as the income statement for the current fiscal year is presented. The Task Force noted that the provisions of Statement 3 apply to all interim periods presented.
2. By restatement of financial statements for all periods presented as long as that restatement is not prohibited by Statement 113.

The SEC Observer stated that in addition to the disclosures provided under Opinion 20, the SEC staff will require registrants to disclose the nature and the significance of the transactions giving rise to the change. The SEC Observer also noted that registrants would be required to make SAB 74 disclosures for the financial statements filed prior to the period in which this change is adopted.

The Task Force requested that the FASB staff views on Issue 93-6, distributed to the Task Force as Supplement No. 1 (Revised) to the Issue Summary and the FASB Viewpoints article, "Accounting for Reinsurance: Questions and Answers about Statement 113," be included in Appendix D of EITF Abstracts. [Note: See Appendix D, Topics No. 34 and 35.]

STATUS

A related issue was discussed in Issue No. 93-14, "Accounting for Multiple-Year Retrospectively Rated Insurance Contracts by Insurance Enterprises and Other Enterprises." That Issue considers how a multiple-year retrospectively rated contract arising from an insurance transaction that is not a reinsurance contract should be accounted for. The consensus reached in Issue 93-14 were consistent with those reached in this Issue.

No further EITF discussion is planned.

RELEVANT LITERATURE

Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets*
- *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets*
- *Issue Paper No. 50—Classifications and Definitions of Insurance or Managed Care Contracts in Force*
- *Issue Paper No. 55—Unpaid Claims, Losses and Loss Adjustment Expenses*
- *Issue Paper No. 65—Property and Casualty Contracts*
- *Issue Paper No. 76—Offsetting and Netting of Assets and Liabilities*
- Accounting Practices and Procedures Manual for Property and Casualty Insurance, Chapters 7, 8, and 22 (including Appendix A)
- NAIC Annual Statement Instructions for Property and Casualty Insurance Companies, Notes to Financial Statements and Schedule F
- Minutes of the December 3, 1995, meeting of the Property Casualty Reinsurance Study Group

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*
- *FASB Emerging Issues Task Force Issue No. 93-6, Accounting for Multiple-Year Retrospectively Rated Contracts by Ceding and Assuming Enterprises-SEC Staff Accounting Bulletin No. 92, Accounting and Disclosures Relating to Loss Contingencies*
- *AICPA Statement of Position No. 92-5, Accounting for Foreign Property and Liability Reinsurance*
- FASB Viewpoints, "Accounting for Reinsurance: Questions and Answers about Statement 113," *FASB Status Report*, February 26, 1993

State Regulations

- No additional guidance obtained from state statutes or regulations.