# Statutory Issue Paper No. 104

# Reinsurance Deposit Accounting - An Amendment to SSAP No. 62—Property and Casualty Reinsurance

**STATUS**
**Finalized September 12, 2000**

**Original SSAP and Current Authoritative Guidance: SSAP No. 62R**

**Type of Issue:**
**Property and Casualty**

## SUMMARY OF ISSUE

1. *SSAP No. 62—Property and Casualty Reinsurance* (SSAP No. 62) prescribes the accounting treatment for reinsurance contracts that do not transfer both components of insurance risk (underwriting risk and timing risk). The requirements for Generally Accepted Accounting Principles (GAAP) are contained within American Institute of Certified Public Accountants (AICPA) *Statement of Position No. 98-7, Deposit Accounting: Accounting for Insurance and Reinsurance Contracts That do not Transfer Insurance Risk* (SOP No. 98-7).

2. The purpose of this issue paper is to address the requirements of SOP 98-7 and amend the deposit accounting provisions of SSAP No. 62. In considering GAAP guidance as reflected in SOP 98-7, the purpose of this issue paper is to amend the deposit accounting provisions of SSAP No. 62 and remain consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

## SUMMARY CONCLUSION

**Deposit Accounting**

3. This issue paper supersedes paragraph 34 of SSAP No. 62. The following guidance shall be followed when reinsurance contracts do not transfer both components of insurance risk.

4. To the extent that a reinsurance agreement does not, despite its form, transfer both components of insurance risk, all or part of the agreement shall be accounted for and reported as deposits in the following manner:

a. At the outset of the reinsurance agreement, the net consideration paid by the ceding entity (premiums less commissions or other allowances) shall be recorded as a deposit by the ceding company and as a liability by the assuming entity. The deposit shall be reported as an admitted asset by the ceding company if (i) the assuming company is licensed, accredited or otherwise qualified in the ceding company's state of domicile as described in Appendix A-785 or (ii) there are funds held by or on behalf of the ceding company which meet the requirements of paragraph 16 of Appendix A-785;

b. At subsequent reporting dates, the amount of the deposit/liability should be adjusted by calculating the effective yield on the deposit agreement to reflect actual payments to date (receipts and disbursements should be recorded through the deposit/liability accounts) and expected future payments (as discussed below), with a corresponding credit or charge to interest income or interest expense;

 

c. The calculation of the effective yield should use the estimated amount and timing of cash flows. If a change in the actual or estimated timing or amount of cash flows occurs, the effective yield should be recalculated to reflect the revised actual or estimated cash flows. The deposit should be adjusted to the amount that would have existed at the reporting date had the new effective yield been applied since the inception of the reinsurance agreement. Changes in the carrying amount of the deposit asset/liability resulting from changes in the effective yield shall be recorded as interest income or interest expense.

d. It shall be assumed that any cash transactions for the settlement of losses will reduce the asset/liability accounts by the amount of the cash transferred. When the remaining losses are revalued upward, an increase in the deposit liability shall be recorded as interest expense – by the assuming insurer. Conversely, the ceding insurer shall increase its deposit (asset) with an offsetting credit to interest income; and increase its outstanding loss liability with an offsetting charge to incurred losses;

e. No deduction shall be made from the loss and loss adjustment expense reserves on the ceding company's Statement of Financial Position, schedules, and exhibits;

f. The assuming company shall record net consideration to be returned to the ceding company as a liability.

(For an illustration of the provisions of paragraph 4 see Exhibit A)

**Disclosures**

5. The financial statements shall disclose the following with respect to reinsurance agreements that have been accounted for as deposits:

a. A description of the reinsurance agreements.
b. Any adjustment of the amounts initially recognized for expected recoveries. The individual components of the adjustment (e.g., interest accrual, change due to a change in estimated or actual cash flow) shall be disclosed separately.

## DISCUSSION

6. Subsequent to the adoption of SSAP No. 62, the AICPA issued SOP 98-7. This SOP provides guidance on how to account for insurance and reinsurance contracts that do no transfer insurance risk. It applies to all entities and all insurance and reinsurance contracts that do not transfer insurance risk, except for long-term life and health insurance contracts. The method used to account for insurance and reinsurance contracts that do not transfer insurance risk is referred to in this SOP as deposit accounting. The SOP does not address when deposit accounting should be applied.

7. This issue paper adopts, with modification, AICPA SOP 98-7 paragraphs 10 to 12 and 19 (subsection b only). The fundamental concepts of SSAP No. 62 are based upon the fact that unless a reinsurance contract contains a transfer of insurance risk, no underwriting credit shall be granted. The critical ingredient of a reinsurance contract is the transfer of risk. The essential element of every true reinsurance agreement is the undertaking by the reinsurer to indemnify the ceding entity, i.e., reinsured entity, not only in form but in fact, against loss or liability by reason of the original insurance. 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). SOP 98-7 paragraphs 10 to 12 requires the use of the interest method for contracts that transfer neither timing nor underwriting risk and contracts that only transfer timing risk. This issue paper adopts the interest method contained with those paragraphs, but modifies the SOP to require the interest method when the contract does not transfer one or both components of insurance risk.

 

8. The issue paper rejects AICPA SOP 98-7 paragraphs 13 to 17 and 19 (subsections a and c). This is due to the fact that the SOP allows entities to take underwriting credit for contracts that only transfer significant underwriting risk. This is in direct conflict with the fundamental concept that reinsurance contracts must transfer insurance risk (both underwriting and timing risks).

## RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

### Statutory Accounting

9. SSAP No. 62 paragraph 34:

**Deposit Accounting**

34. To the extent that a reinsurance agreement does not, despite its form, transfer both components of insurance risk, all or part of the agreement shall be accounted for and reported as deposits in the following manner:

a. At the outset of the reinsurance agreement the net consideration paid by the ceding entity (premiums less commissions or other allowances) shall be recorded as a deposit by the ceding entity and as a liability by the assuming entity. The deposit shall be reported as an admitted asset by the ceding entity if (i) the assuming entity is licensed, accredited or otherwise qualified in the ceding entity's state of domicile as described in Appendix A-785 or (ii) there are funds held by or on behalf of the ceding entity as described in Appendix A-785;

b. Throughout the life of the agreement, receipts and disbursements shall be recorded through the deposit/liability accounts;

c. When individual case reserves are the basis for the deposit and the assuming entity pays in excess of the amount transferred by the ceding entity, the amount paid in excess of the deposit received shall be recognized as a loss by the assuming entity and as a gain by the ceding entity as Other Income in the statement of income;

d. When the agreement is completed, or when there is a loss payment in excess of the deposit, any difference between consideration and recoveries shall be recorded in the Other Income or Loss account as a loss to the reinsurer and as a gain in the Other Income or Loss account by the reinsured;

e. With regard to bulk reserves,(i.e., IBNR) it shall be assumed that any cash transactions for the settlement of losses will reduce the asset/liability accounts by the amount of the cash transferred. When the remaining losses are revalued upward, an increase in the liability shall be recorded as a loss recognized by the assuming entity. Conversely, the ceding entity shall increase its deposit (asset) and outstanding loss liability;

f. No deduction shall be made from the loss and loss adjustment expense reserves on the ceding entity's balance sheet, schedules, and exhibits; and

g. The assuming entity shall record net consideration to be returned to the ceding entity as liabilities.

10. The Property Casualty Reinsurance Study Group of the Accounting Practices and Procedures (E) Task Force reviewed SOP 98-7 in detail. The Study Group adopted its position at its March 7, 1999 meeting. The conclusion of this issue paper is consistent with the Study Group's recommendation. The applicable section of the minutes is included herein:

Michael Moriarty (N.Y.) opened the meeting by inviting Keith Bell (Travelers) to comment on his previously submitted proposal to revise statutory accounting guidance to permit accrual of interest income or expense related to funds held on deposit type transactions. Mr. Bell stated that the intent of the proposed revision was to make the statutory rules more consistent with Generally Accepted Accounting Procedures (GAAP) treatment, by using the interest method to reflect the actual cash flows and to periodically adjust the implicit rate of interest.

Peter Medley (Wis.) raised a question regarding the interest rate to be used for this purpose. Frank Maffa (American Reinsurance Company) explained that reinsurance agreements which did not satisfy risk transfer requirements had to be accounted for as deposit-transactions, and suggested that it would be appropriate to recognize the interest income or expense associated with the funds on deposit in a timely manner over the life of the transaction. Mr. Moriarty commented that he saw no reason not to permit accrual of such amounts and asked Norris Clark (Calif.) to explain how the proposed revision would be implemented. Mr. Clark said that the proposal would go from the study group to the Accounting Practices and Procedures Task Force, which would presumably consider the proposal to be a codification maintenance item which need not be referred to the Emerging Accounting Issues Task Force before the proposal could be implemented as a revision to the pertinent language in SSAP No. 62 and the corresponding section of the Accounting Practices and Procedures Manual for Property and Casualty Companies.

Thomas Burke (N.H.) moved to adopt the proposal and Mr. Clark seconded the motion which passed on a 4 to 1 vote of the study group members.

## Generally Accepted Accounting Principles

11. AICPA SOP 98-7 paragraphs 9 to 20:

<u>Initial Measurement</u>

9. At inception, a deposit asset or liability should be recognized for insurance and reinsurance contracts accounted for under deposit accounting and should be measured based on the consideration paid or received, less any explicitly identified premiums or fees to be retained by the insurer or reinsurer, irrespective of the experience of the contract. Accounting for such fees should be based on the terms of the contract. Deposit assets and liabilities should be reported on a gross basis, unless the right of offset exists as defined in *FASB Interpretation No. 39, Offsetting of Amounts Related to Certain Contracts.* The accounting by the insured and insurer are symmetrical, except as noted in paragraph 15 of this SOP.

<u>Subsequent Measurement</u>

Insurance and Reinsurance Contracts That Transfer Only Significant Timing Risk and Insurance and Reinsurance Contracts That Transfer Neither Significant Timing Nor Underwriting Risk

10. For insurance and reinsurance contracts that transfer only significant timing risk or that transfer neither significant timing nor significant underwriting risk, the amount of the deposit asset or liability should be adjusted at subsequent reporting dates by calculating the effective yield on the deposit to reflect actual payments to date and expected future payments (as discussed in paragraph 11 below), with a corresponding credit or charge to interest income or expense. This approach is consistent with the interest method described in *Accounting Principles Board (APB) Opinion No. 21, Interest on Receivables and Payables,* and *FASB Statement No. 91, Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases.*

11. The calculation of the effective yield should use the estimated amount and timing of cash flows. Consistent with paragraph 19 of FASB Statement No. 91, if a change in the actual or estimated timing or amount of cash flows occurs, the effective yield should be recalculated to reflect the revised actual or estimated cash flows. The deposit should be adjusted to the amount that would have existed at the balance-sheet date had the new effective yield been applied since

 

the inception of the insurance or reinsurance contract. Changes in the carrying amount of the deposit should be reported as interest income or interest expense.

12. Significant changes in the expected amounts of aggregate cash flows are expected to occur infrequently because of the nature of these kinds of contracts. Should a significant change occur in the total amount of actual or estimated cash flows, the enterprise should determine whether the change indicates that the contract does include significant underwriting risk and therefore should be converted to the accounting for contracts that transfer only significant underwriting risk. (See paragraphs 13 through 15 for the accounting guidance for insurance and reinsurance contracts that transfer only significant underwriting risk.) In addition, a contract that transfers only significant timing risk, which subsequently is determined also to transfer significant underwriting risk, cannot be accounted for under insurance or reinsurance accounting when the revised determination is made.

<u>Insurance and Reinsurance Contracts That Transfer Only Significant Underwriting Risk</u>

13. Until such time as a loss is incurred that will be reimbursed under an insurance or reinsurance contract that transfers only significant underwriting risk, the deposit should be measured based on the unexpired portion of the coverage provided. Once a loss is incurred that will be reimbursed under such a contract, then the deposit should be measured by the present value of the expected future cash flows arising from the contract plus the remaining unexpired portion of the coverage provided.

14. Changes in the recorded amount of the deposit, other than the unexpired portion of the coverage provided, arising from an insurance or reinsurance contract that transfers only significant underwriting risk should be recorded in an insured's income statement as an offset against the loss recorded by the insured that will be reimbursed under the insurance or reinsurance contract and in an insurer's income statement as an incurred loss. Insurance enterprises should record the reduction in the deposit related to the unexpired portion of the coverage provided as an adjustment to incurred losses. Insurance enterprises should disclose the amounts related to those deposit contracts that are reported in incurred losses in their statement of earnings. (See paragraph 19.) If the insured is an enterprise other than an insurance enterprise, the reduction in the deposit related to the unexpired portion of the coverage provided should be recorded as an expense.

15. For the insured or ceding enterprise, the discount rate used to determine the deposit asset should be the current rate on United States government obligations with similar cash-flow characteristics, adjusted for default risk. Consideration of the default risk, if any, should be based on the assessment of the creditworthiness of the insurer. For the insurer or assuming enterprise, the discount rate used to determine the deposit liability should be the current rate on United States government obligations with similar cash-flow characteristics. These rates should be established at the date of each loss incurred and used for the remaining life of the contract and should not be changed. If numerous losses occur, the use of average rates is permitted because establishing individual rates might require detailed recordkeeping and computations that could be burdensome and unnecessary to produce reasonable approximations of the results.

<u>Insurance and Reinsurance Contracts With Indeterminate Risk</u>

16. Uncertainties surrounding insurance and reinsurance contracts with indeterminate risk are analogous to those often associated with foreign property and liability reinsurance as addressed in *SOP 92-5*, *Accounting for Foreign Property and Liability Reinsurance.* As a result, the guidance in SOP 92-5, regarding the open-year method, should be followed. The open-year method should not, however, be used to defer losses that otherwise would be recognized pursuant to FASB Statement No. 5.

17. Under the open-year method, the effects of the contracts are not included in the determination of net income until sufficient information becomes available to reasonably estimate

and allocate premiums. The open-year method requires that these effects be aggregated in the balance sheet. If sufficient information becomes available to reasonably estimate and allocate premiums, the insurance or reinsurance contract with indeterminate risk should be reclassified into one of the three categories as an insurance or reinsurance contract that transfers neither significant timing nor significant underwriting risk, transfers only significant timing risk, or transfers only significant underwriting risk, as appropriate, and accounted for accordingly. The change in deposit assets or liabilities that result if sufficient information becomes available is treated as a change in accounting estimate in accordance with *APB Opinion 20, Accounting Changes.*

<u>Disclosures</u>

18. Entities should disclose a description of the contracts accounted for as deposits and the separate amounts of total deposit assets and total deposit liabilities reported in the statement of financial position.

19. Insurance enterprises should disclose the following information regarding the changes in the recorded amount of the deposit arising from an insurance or reinsurance contract that transfers only significant underwriting risk:

a. The present values of initial expected recoveries that will be reimbursed under the insurance or reinsurance contracts that have been recorded as an adjustment to incurred loses

b. Any adjustment of amounts initially recognized for expected recoveries (The individual components of the adjustment (meaning, interest accrual, the present value of additional expected recoveries, and the present value of reductions in expected recoveries) should be disclosed separately.)

c. The amortization expense attributable to the expiration of coverage provided under the contract

20. This SOP is effective for financial statements for fiscal years beginning after June 15, 1999, with earlier adoption encouraged. Previously issued annual financial statements should not be restated. The initial application of this SOP should be as of the beginning of an entity's fiscal year (that is, if the SOP is adopted prior to the effective date and during an interim period, all prior interim periods should be restated). The effect of initially adopting this SOP should be reported as a cumulative effect of a change in accounting principle (in accordance with the provisions of APB Opinion 20).

## RELEVANT LITERATURE

### Statutory Accounting

- *SSAP No. 62—Property and Casualty Reinsurance*
- March 7, 1999 minutes of the P/C Reinsurance Study Group

### Generally Accepted Accounting Principles

- *American Institute of Certified Public Accountants (AICPA) Statement of Position No. 98-7, Deposit Accounting: Accounting for Insurance and Reinsurance Contracts That do not Transfer Insurance Risk*

### State Regulations

- No additional guidance obtained from state statutes or regulations.

 

**Exhibit A**
**Illustration of a Reinsurance Contract That Is Accounted for as a Deposit using the Interest Method**

Assumptions:

Premium = $1,000 (assumes no commissions or allowances)
Coverage Period = 1 year
Initial expected recoveries = $225 per year (at end of year) for five years
Initial Implicit rate = 4 percent*

*present value of $225 per year for five years at 4 percent = $1,000

At the end of Year 2, the timing of anticipated recoveries under the reinsurance contract changes. A reevaluation of the implicit interest rate produces a rate of 3.63 percent and an asset of $640 at the end of the year.

| Description | Interest Income | Cash Recoveries | Deposit Balance |
|---|---|---|---|
| Initial payment | | | $1,000 |
| Year 1 (4% ) | $ 40 | | $1,040 |
| End of Year 1 | | $ (225) | $ 815 |
| Year 2 (4 %) | $ 33 | | $ 848 |
| End of Year 2 | | $ (200) | $ 648 |
| Yield adjustment | $ (8) | | $ 640 |
| Year 3 (3.63 %) | $ 23 | | $ 663 |
| End of Year 3 | | $ (175) | $ 488 |
| Year 4 (3.63 %) | $ 18 | | $ 506 |
| End of Year 4 | | $ (175) | $ 331 |
| Year 5 (3.63 %) | $ 12 | | $ 343 |
| End of Year 5 | | $ (175) | $ 168 |
| Year 6 (3.63 %) | $ 7 | | $ 175 |
| End of Year 6 | | $ (175) | $ 0 |

At the inception of the contract, the ceding insurer records a deposit asset of $1,000 and the assuming company, a $1,000 deposit liability. The asset is admitted providing the conditions for credit for reinsurance are met.

At subsequent reporting dates, the deposit asset is adjusted by calculating the effective yield on the reinsurance agreement to reflect actual payments to date and expected future payments with a corresponding credit to interest income by the ceding company and interest expense by the assuming company.

At the end of year two, it is determined that the expected cash flows will differ from previous estimates, resulting in a lower effective yield on the deposit asset. The deposit asset is adjusted to the amount that would have existed at the reporting date had the new effective yield been applied from the inception of the reinsurance agreement. The adjustment is charged to interest income, i.e., as a reduction of interest income. Interest income during the remaining term of the agreement is reduced accordingly (i.e., the yield is reduced from 4.0% to 3.63%).

 

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