

# Statutory Issue Paper No. 162

## Property and Casualty Reinsurance Credit

### STATUS

Finalized August 3, 2019

Original SSAP: 62R; Current Authoritative Guidance: SSAP No. 62R

### Type of Issue:

Common Area

### SUMMARY OF ISSUE

1. This issue paper documents substantive revisions to *SSAP No. 62R—Property and Casualty Reinsurance* which were drafted to clarify the application of existing concepts in SSAP No. 62R.
2. The substantive revisions to SSAP No. 62R (illustrated in Exhibit A), are intended to clarify reinsurance risk-transfer requirements and that reinsurance accounting credit for contracts that pass risk transfer is only for the amount of risk ceded. The clarifications were primarily accomplished by incorporating U.S. generally accepted accounting principles (GAAP) guidance which was previously adopted by reference. The revisions included the following key elements:
  - a. Explicitly incorporate guidance from Financial Accounting Standards Board (FASB) *Emerging Issues Task Force No. 93-6, Accounting for Multi-Year Retrospectively Rated Contracts by Ceding and Assuming Enterprises* (EITF 93-6), which was adopted previously by reference.
  - b. Explicitly incorporate guidance from the EITF 93-6 related implementation guidance in *EITF Topic D-35, FASB Staff Views on Issue No. 93-6, Accounting for Multiple-Year Retrospectively Rated Contracts by Ceding and Assuming Enterprises*.
  - c. The revisions also moved some existing implementation guidance in SSAP No. 62R Exhibit A to be closer to the related topic. In some cases, the incorporated or moved guidance was also revised to better match the current U.S. GAAP presentation of guidance in accounting standards codification (ASC) topic 944-20.

### DISCUSSION

3. This issue paper intends to provide historical information on the consideration of the revisions to SSAP No. 62R regarding reinsurance credit and more explicitly incorporating U.S. GAAP guidance.

#### Reasons for the Development of Revisions

4. The Financial Condition (E) Committee previously had a Risk-Limiting Contracts (E) Working Group which was charged with reviewing risk transfer guidance for property and casualty reinsurance. The Risk-Limiting Contracts (E) Working Group stopped work in 2016, because it was determined that needed accounting clarifications should be addressed by the Statutory Accounting Principles (E) Working Group.
5. At the 2016 Fall National Meeting, the chair of the Statutory Accounting Principles (E) Working Group, directed NAIC staff to research the application of reinsurance credit under *SSAP No. 61R—Life, Deposit-Type, and Accident and Health Reinsurance* and *SSAP No. 62R—Property and Casualty Reinsurance* and develop materials for future discussion.

6. In April 2017, the Financial Analysis (E) Working Group (FAWG) provided a referral to the Statutory Accounting Principles (E) Working Group which noted concerns regarding risk-limiting features and the resulting application of reinsurance credit for property and casualty entities and for health contracts. In addition, the referral also requested that the Statutory Accounting Principles (E) Working Group develop life and health disclosures for inclusion in SSAP No. 61R.

7. The FAWG noted it had recently discussed a number of troubled and potentially troubled insurers that have participated in quota share/proportional reinsurance contracts with significant risk-limiting features. In many of these situations, the motivation for the contracts appeared to be surplus relief without a significant amount of insurance risk being transferred to the reinsurer. The contracts often utilize loss corridors, sliding scale commissions, or other risk-limiting features to significantly limit the risk transferred to the reinsurer. The FAWG noted that often these limitations result in a quota share reinsurance agreement operating more like an excess of loss reinsurance agreement, but the ceding insurer is accounting for the contract as if full, proportional reinsurance were in place. In certain cases, the ceding insurers have lost millions of dollars on certain blocks of business and even reached insolvency, while the reinsurers have continued to recognize profits on the contracts.

8. The FAWG referral further noted that while property and casualty insurers are required to disclose some of these features in the interrogatories, health insurers are not. The referral noted that the FAWG was surprised by the fact that U.S. GAAP seems to prevent some of these contracts from being recorded as meeting risk transfer requirements while statutory accounting principles may not. Although the number of property and casualty companies reporting these contracts differently between U.S. GAAP and statutory accounting principles reporting may be limited, the referral noted that they appear to be more prevalent in troubled company situations and are being offered by otherwise well-regarded reinsurers. Therefore, the FAWG referral suggested further changes to statutory accounting principles to prevent these situations.

#### **Existing Statutory Accounting Guidance:**

9. Existing statutory accounting guidance for property and casualty reinsurance is in SSAP No. 62R. The primary U.S. GAAP guidance which is adopted by reference is listed in paragraph 105 as follows:

105. This statement adopts with modification FASB Statement No. 113, Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts (FAS 113) and FASB Emerging Issues Task Force No. 93-6, Accounting for Multiple-Year Retrospectively Rated Contracts by Ceding and Assuming Enterprises for the following:

- a. Reinsurance recoverables on unpaid case-basis and incurred but not reported losses and loss adjustment expenses shall be reported as a contra-liability netted against the liability for gross losses and loss adjustment expenses;
- b. Amounts paid for prospective reinsurance that meet the conditions for reinsurance accounting shall be reported as a reduction of unearned premiums;
- c. The gain created by a retroactive reinsurance agreement 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 statement of income 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 agreement is restricted as a special surplus account until the actual retroactive reinsurance recovered is in excess of the consideration paid;
- d. This statement requires that a liability (provision for reinsurance) be established through a provision reducing unassigned funds (surplus) for unsecured reinsurance recoverables from unauthorized or certified reinsurers and for certain overdue balances due from authorized reinsurers;

- e. Some reinsurance agreements contain adjustable features that provide for adjustment of commission, premium or amount of coverage, based on loss experience. This statement requires that the asset or liability arising from the adjustable feature be computed based on experience to date under the agreement, and the impact of early termination may only be considered at the time the agreement has actually been terminated;
- f. Structured settlements are addressed in SSAP No. 65—Property and Casualty Contracts. 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; and
- g. This statement requires that reinsurance recoverables on unpaid losses and loss adjustment expenses be presented as a contra-liability. Requirements for offsetting and netting are addressed in SSAP No. 64.

10. From its original effective date, SSAP No. 62R has adopted with modification FAS 113. In reviewing the cross-reference of FAS 113 to current ASC topic 944-20, almost all of FAS 113 survives intact in the current ASC.

11. From its original effective date, SSAP No. 62R has also adopted with modification FASB *Emerging Issues Task Force No. 93-6, Accounting for Multiple-Year Retrospectively Rated Contracts by Ceding and Assuming Enterprises* (EITF 93-6). The primary statutory modification to EITF 93-6 relates to early termination considerations as SSAP No. 62R is consistent with EITF 93-6 regarding recognition of retrospective features based on experience to date.

12. The ASC topic 944-20 cross-reference to sources indicates it includes codified guidance from other standards than FAS 113 and EITF 93-6. Two of these other standards include FASB staff directed *EITF Topic D-34 Accounting for Reinsurance: Questions and Answers about FASB Statement No. 113* (EITF D-34) and *EITF Topic D-35, FASB Staff Views on Issue No. 93-6, Accounting for Multiple-Year Retrospectively Rated Contracts by Ceding and Assuming Enterprises* (EITF D-35). EITF D-34 is implementation guidance on FAS 113 and EITF D-35 is implementation guidance for EITF 93-6.

13. Prior to FASB Codification, FASB staff EITFs were lower in the GAAP hierarchy and were not automatically reviewed as part of the statutory accounting maintenance process. However, after incorporation within the FASB codification, all guidance carries the same authority.

14. SSAP No. 62R Exhibit A Implementation Questions and Answers was based on a *EITF Topic D-34 Accounting for Reinsurance: Questions and Answers about FASB Statement No. 113*, even though it is not named in the relevant literature of SSAP No. 62R.

15. SSAP No. 62R did not previously adopt *EITF Topic D-35, FASB Staff Views on Issue No. 93-6, Accounting for Multiple-Year Retrospectively Rated Contracts by Ceding and Assuming Enterprises*, however, it simply provides additional implementation guidance on EITF 93-6 guidance, which was adopted. As a FASB Staff EITF, it would not necessarily have been automatically reviewed for statutory accounting when the statutory accounting codification project was completed.

**Development of Statutory Accounting Guidance:**

16. On August 6, 2017, the Statutory Accounting Principles (E) Working Group exposed nonsubstantive revisions prepared by NAIC staff to *SSAP No. 62R—Property and Casualty Reinsurance*. The revisions were to clarify reinsurance risk transfer requirements and that reinsurance accounting credit for contracts that pass risk transfer is only for the amount of risk ceded. In addition, the Working Group also exposed updates to terminology and incorporated revisions and disclosures in *SSAP No. 61R—Life and Health Reinsurance* to assist in reviewing contracts, similar to existing disclosures in SSAP No. 62R. The exposure also included revisions to the QA guidance in Appendix A-791, Life and Health Reinsurance. Although agenda item 2017-28: Reinsurance Credit included revisions to SSAP No. 61R, A-791, and SSAP No. 62R, this issue paper was prepared to document the revisions adopted to SSAP No. 62R.

17. On November 6, 2017, the Statutory Accounting Principles (E) Working Group discussed comments from the interested parties and the ACLI (American Council of Life Insurers). The commenters expressed concerns that some of the revisions were substantive in nature and overly broad. The interested parties provided specific recommendations for the exposed SSAP No. 62R revisions. Both the interested parties and the ACLI indicated willingness to lend expertise to continue to assist the Working Group on this technical project. The Working Group provided the following directions for the next phase of project work:

- a. NAIC staff were directed to work with Working Group and industry representatives to hold drafting calls to refine the exposure drafts for future Working Group consideration. The Working Group directed the formation of two drafting groups as follows 1) the informal property and casualty reinsurance drafting group; and 2) the informal life and health reinsurance drafting group.
- b. The August 2017 exposed revisions to add the U.S. GAAP definitions of short-duration and long-duration contracts to the master glossary were directed to be removed, as the comments from the interested parties and the ACLI responded that the proposed additional definitions were not helpful.
- c. NAIC staff was directed to use language proposed by interested parties for a replacement of the SSAP No. 62R, paragraph 29, exposure on nonproportional reinsurance credit as a starting point for the informal property and casualty reinsurance drafting group's future discussions. The proposed starting point language for SSAP No. 62R, paragraph 29, is as follows:

29. Reporting entities shall not record reinsurance credit for non-proportional reinsurance until such time as losses have been incurred on the underlying business, which exceed the attachment point of the applicable reinsurance contract(s).

18. The revisions to SSAP No. 62R were developed in consultation with the informal property and casualty reinsurance drafting group (informal drafting group). Members of the drafting group included regulators, members of industry, representatives of the NAIC/ American Institute Certified Public Accountants (AICPA) (E) Working Group from the major CPA firms and industry trade representatives. The informal drafting group held approximately eight calls.

19. The informal drafting group discussions identified that the SSAP No. 62R guidance prior to the November 2018 updates was fairly consistent with the presentation of guidance in FAS 113. In researching this topic, it was identified that SSAP No. 62R was not consistent with how ASC topic 944-20 was arranged after FASB codification in 2009. This difference can confuse a casual reader, and the informal drafting group discussions identified that more explicitly incorporating guidance from EITF 93-6 and its related implementation guidance in EITF D-35, would be beneficial. Discussions from the informal drafting group members agreed that the intended application of SSAP No. 62R was intended to have very few differences

from U.S. GAAP as reflected in originally in FAS 113 and EITF 93-6 and from the current text of ASC 944-20.

20. During the 2018 Summer National Meeting, the Statutory Accounting Principles (E) Working Group exposed proposed revisions to SSAP No. 62R which were recommended by the informal property and casualty reinsurance drafting group. The revisions to SSAP No. 62R were to clarify reinsurance risk transfer requirements and to provide clarifications that reinsurance accounting credit for contracts that pass risk transfer is only for the amount of risk ceded. These revisions were consistent with the informal drafting group consensus that SSAP No. 62R intends to match U.S. GAAP to the extent feasible. The clarifications were primarily accomplished by incorporating U.S. GAAP guidance which was previously adopted by reference. The revisions in the exposure included the following key elements:

- a. Explicitly incorporate guidance from FASB *Emerging Issues Task Force No. 93-6, Accounting for Multi-Year Retrospectively Rated Contracts by Ceding and Assuming Enterprises* (EITF 93-6) which was adopted previously by reference.
- b. Explicitly incorporate guidance from the EITF 93-6 related implementation guidance in *EITF Topic D-35, FASB Staff Views on Issue No. 93-6, Accounting for Multiple-Year Retrospectively Rated Contracts by Ceding and Assuming Enterprises*.
- c. The revisions also rearranged existing implementation guidance in SSAP No. 62R Exhibit A to be closer to the related topic.
- d. Incorporated other revisions to be more consistent with ASC topic 994-20 format.

21. The 2018 Summer National Meeting exposure noted that although the informal property and casualty reinsurance drafting group views the revisions as consistency updates, due to the extent of revisions, NAIC staff recommended categorizing the revisions as substantive and exposing the revisions to SSAP No. 62R. With the exposure, the Working Group also requested input on the effective date.

22. In response to the exposure, comments from interested parties noted that interested parties had no comments.

23. During the 2018 Fall National Meeting, after considering the interested parties' comments the Working Group adopted the exposed revisions to SSAP No. 62R. As part of the adoption action, the Working Group identified the revisions as a substantive change, and designated a January 1, 2019 effective date for the revisions.

24. The January 1, 2019 effective date was supported by informal drafting group members because the revisions were viewed as not representing changes for the average user, but more of consistency updates and clarifications. It was believed that the change in accounting revisions will not prompt many entities to revise their evaluation of risk transfer for reinsurance contracts in effect as of January 1, 2019. However, if a reporting entity, after reading the incorporated guidance, now has a better understanding that they were applying existing guidance incorrectly, they do have a duty to update their risk transfer assessments for all contracts that were in effect as of January 1, 2019. With the substantive classification, the Working Group directed NAIC staff to prepare an issue paper for historical documentation. With the effective date in the SSAP, the substantive revisions will be effective prior to the availability of this issue paper.

25. As issue papers are not represented in the Statutory Hierarchy (see Section IV of the Preamble), the subsequent consideration and adoption of this issue paper will not have any impact of the effective date of the substantive revisions adopted to SSAP No. 62R during the 2018 Fall National Meeting.

**EXHIBIT A – Substantive Revisions to SSAP No. 62R—Property and Casualty Reinsurance:**

Note: These substantive revisions to SSAP No. 62R were adopted during the November 15, 2018 Fall National Meeting with an effective date of January 1, 2019. This issue paper was directed for historical documentation.

**Property and Casualty Reinsurance****SCOPE OF STATEMENT**

1. This statement establishes statutory accounting principles for property and casualty reinsurance. A wide range of methods for structuring reinsurance arrangements can be employed depending on the requirements of individual companies. This statement deals with the more commonly employed methods.

**SUMMARY CONCLUSION****General**

2. Reinsurance is the assumption by an insurer of all or part of a risk undertaken originally by another insurer. The transaction whereby a reinsurer cedes all or part of the reinsurance it has assumed to another reinsurer is known as a retrocession.

3. Reinsurance has many beneficial purposes. Among them are that it enables an insurance entity to (a) expand its capacity, (b) share large risks with other insurers, (c) spread the risk of potential catastrophes and stabilize its underwriting results, (d) finance expanding volume by sharing the financial burden of reserves, (e) withdraw from a line or class of business, and (f) reduce its net liability to amounts appropriate to its financial resources.

4. Reinsurance agreements are generally classified as treaty or facultative. Treaty reinsurance refers to an arrangement involving a class or type of business written, while facultative reinsurance involves individual risks offered and accepted.

5. Reinsurance coverage can be pro rata (i.e., proportional reinsurance) where the reinsurer shares a pro rata portion of the losses and in the same proportion as it shares premium of the ceding entity or excess of loss (i.e., non-proportional) where the reinsurer, subject to a specified limit, indemnifies the ceding entity against the amount of loss in excess of a specified retention. Most reinsurance agreements fall into one of the following categories:

a. Treaty Reinsurance Contracts—Pro Rata:

- i. Quota Share Reinsurance—The ceding entity is indemnified against a fixed percentage of loss on each risk covered in the agreement;
- ii. Surplus Share Reinsurance—The ceding entity establishes a retention or “line” on the risks to be covered and cedes a fraction or a multiple of that line on each policy subject to a specified maximum cession;

b. Treaty Reinsurance Contracts—Excess of Loss:

- i. Excess Per Risk Reinsurance—The ceding entity is indemnified, subject to a specified limit, against the amount of loss in excess of a specified retention with respect to each risk covered by a treaty;
- ii. Aggregate Excess of Loss Reinsurance—The ceding entity is indemnified against the amount by which the ceding entity’s net retained losses incurred during a

specific period exceed either a predetermined dollar amount or a percentage of the entity's subject premiums for the specific period subject to a specified limit;

- c. Treaty Reinsurance Contracts—Catastrophe: The ceding entity is indemnified, subject to a specified limit, against the amount of loss in excess of a specified retention with respect to an accumulation of losses resulting from a catastrophic event or series of events;
- d. Facultative Reinsurance Contracts—Pro Rata: The ceding entity is indemnified for a specified percentage of losses and loss expenses arising under a specific insurance policy in exchange for that percentage of the policy's premium;
- e. Facultative Reinsurance Contracts—Excess of Loss: The ceding entity is indemnified, subject to a specified limit, for losses in excess of its retention with respect to a particular risk.

### Characteristics of Reinsurance Agreements

6. Common contract provisions that may affect accounting practices include:
  - a. Reporting responsibility of the ceding entity—Details required and time schedules shall be established;
  - b. Payment terms—Time schedules, currencies intended, and the rights of the parties to withhold funds shall be established;
  - c. Payment of premium taxes—Customarily the responsibility of the ceding entity, a recital of nonliability of the reinsurer may be found;
  - d. 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 policies expire or are canceled; and
  - e. Insolvency clause—Provides for the survival of the reinsurer's obligations in the event of insolvency of the ceding entity, without diminution because of the insolvency.
7. Reinsurance contracts shall not permit entry of an order of rehabilitation or liquidation to constitute an anticipatory breach by the reporting entity, nor grounds for retroactive revocation or retroactive cancellation of any contracts of the reporting entity.

### Required Terms for Reinsurance Agreements

8. In addition to credit for reinsurance requirements applicable to reinsurance transactions generally, no credit or deduction from liabilities shall be allowed by the ceding entity for reinsurance recoverable where the agreement was entered into after the effective date of these requirements (see paragraphs ~~108~~129 and ~~109~~130) unless each of the following conditions is satisfied:
  - a. The agreement must contain an acceptable insolvency clause;
  - b. Recoveries due the ceding entity 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 entity;

- c. 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 entity or from the ceding entity to the reinsurer;
- d. The agreement must provide for reports of premiums and losses, and payment of losses, no less frequently than on a quarterly basis, unless there is no activity during the period. The report of premiums and losses shall set forth the ceding entity's total loss and loss expense reserves on the policy obligations subject to the agreement, so that the respective obligations of the ceding entity and reinsurer will be recorded and reported on a basis consistent with this statement;
- e. The agreement must include a proper reinsurance intermediary clause, if applicable, which stipulates that the credit risk for the intermediary is carried by the assuming insurance entity;
- f. With respect to reinsurance contracts involving a certified reinsurer, the agreement must include a proper funding clause, which requires the certified reinsurer to provide and maintain security in an amount sufficient to avoid the imposition of any financial statement penalty on the ceding insurance entity for reinsurance ceded to the certified reinsurer. However, this does not preclude negotiation for higher contractual collateral amounts; and
- g. With respect to retroactive reinsurance agreements, the following additional conditions apply:
  - i. The consideration to be paid by the ceding entity for the retroactive reinsurance must be a sum certain stated in the agreement;
  - ii. Direct or indirect compensation to the ceding entity or reinsurer is prohibited;
  - iii. 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 entity's participation in the reinsurer's ultimate profit, if any, under the agreement;
  - iv. A retroactive reinsurance agreement shall not be canceled or rescinded without the approval of the commissioner of the domiciliary state of the ceding entity.

### **Reinsurance Agreements with Multiple Cedents**

9. Reinsurance agreements with multiple cedents require allocation agreements. The allocation agreement can be part of the reinsurance agreement or a separate agreement. If the agreement has multiple cedents:
- a. The allocation must be in writing and
  - b. The terms of the allocation agreement must be fair and equitable.

### **Reinsurance Contracts Must Include Transfer of Risk**

10. The essential ingredient of a reinsurance contract is the transfer of risk<sup>1</sup>. The essential element of every true reinsurance agreement is the undertaking by the reinsurer to indemnify the ceding entity, i.e.,

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<sup>1</sup> Exhibit A Questions and Answers, questions 6-19 provide additional risk-transfer implementation guidance.

reinsured entity, not only in form but in fact, against loss or liability by reason of the original insurance. Unless the agreement contains this essential element of risk-transfer, no credit shall be recorded.<sup>(INT 02-22)</sup>

11. 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.

12. Determining whether an agreement 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 entity 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 (e.g., 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 (e.g., payment schedules or accumulating retentions from multiple years).

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

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

The conditions are independent and the ability to meet one does not mean that the other has been met. A substantive demonstration that both conditions have been met is required to transfer risk.

14. The reference in paragraph 13.a. acknowledges that a ceding entity may reinsure only part of the risks associated with the underlying contracts. For example, a proportionate share of all risks or only specified risks may be reinsured. The conditions for reinsurance accounting are evaluated in relation to the reinsured portions of the underlying insurance contracts, rather than all aspects of those contracts.

15. The word “timely” is used in paragraph 12 in the ordinary temporal sense to refer to the length of time between payment of the underlying reinsured claims and reimbursement by the reinsurer. While the test for reasonable possibility of significant loss to the reinsurer provides for a present-value-based assessment of the economic characteristics of the reinsurance contract, the concept of timely reimbursement relates to the transfer of insurance risk (the condition in paragraph 13.a.), not the reasonable possibility of significant loss (the condition in paragraph 13.b.). Accordingly, timely reimbursement shall be evaluated based solely on the length of time between payment of the underlying reinsured claims and reimbursement by the reinsurer.

14.16. Whether underwriting risk has transferred to the reinsurer depends on how much uncertainty about the ultimate amount of net cash flows from premiums, commissions, claims, and claim settlement expenses paid under a contract has been transferred to the reinsurer. A reinsurer shall not 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 reinsurer’s payments depend on and directly vary with the amount and timing of claims settled by the ceding entity. Accordingly, the significance of the amount of underwriting risk transferred shall be evaluated in relation to the ceding entity’s claims payments. Contractual provisions that delay timely reimbursement to the ceding entity prevent this condition from being met.

15.17. The ceding entity’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. To be reasonable and appropriate, that interest rate shall reflect both of the following:

- a. The expected timing of payments to the reinsurer; and
- b. The duration over which those cash flows are expected to be invested by the reinsurer.

~~16.18.~~ Significance of loss shall be evaluated by comparing the present value of all cash flows, determined as described in paragraph ~~15~~17, 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 entity 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 agreements has been assumed by the reinsurer. In this narrow circumstance, the reinsurer's 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 entity on the retained portions of the underlying insurance contracts, so that the reinsurer's exposure to loss is essentially the same as that of the reporting entity. The assessment of that condition shall be made by comparing both of the following:

- a. The net cash flows of the reinsurer under the reinsurance contract; and
- b. The net cash flows of the ceding entity on the reinsured portions of the underlying insurance contracts.

If the economic position of the reinsurer relative to the insurer cannot be determined, the contract shall not qualify under the exception in this paragraph<sup>2</sup>.

19. An extremely narrow and limited exemption is provided for contracts that reinsure either an individual risk or an underlying book of business that is inherently profitable. When substantially all of the insurance risk relating to the reinsured portions of the underlying insurance contracts has been assumed by the reinsurer, the contract meets the conditions for reinsurance accounting. To qualify under this exception, no more than insignificant insurance risk on the reinsured portions of the underlying insurance contracts may be retained by the ceding entity.

~~17.20.~~ Payment schedules and accumulating retentions from multiple years are contractual features inherently designed to delay the timing of reimbursement to the ceding entity. Regardless of what a particular feature might be called, any feature that can delay timely reimbursement violates the conditions for reinsurance accounting. Transfer of insurance risk requires that the reinsurer's payment to the ceding entity 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 reinsurer's reimbursement to the ceding entity shall be closely scrutinized.

21. Contracts that reinsure insurance risks over a significantly longer period than the underlying insurance contract are, in substance, financing transactions, if any of the following conditions exist:

- a. Premiums are deferred over a period beyond the term of the underlying insurance contracts;

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<sup>2</sup> See additional detail on this topic in Exhibit A, question 19.

- b. Losses are recognized in a different period than the period in which the event causing the loss takes place; or
- c. Both events, 21.a. and 21.b., occur at different points in time.

Contracts that are in substance financing receive deposit accounting treatment.

### Accounting for Reinsurance

~~18~~22. 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. Certain assets and liabilities are created by entities when they engage in reinsurance contracts. Reinsurance assets meet the definition of assets as defined by *SSAP No. 4—Assets and Nonadmitted Assets* and are admitted to the extent they conform to the requirements of this statement.

~~19~~23. Accounting for members of a reinsurance pool shall follow the accounting for the pool member which issued the underlying policy.<sup>(INT 03-02)</sup> Specific accounting rules for underwriting pools and associations are addressed in *SSAP No. 63—Underwriting Pools* (SSAP No. 63).

~~20~~24. Reinsurance recoverable on loss payments is an admitted asset. Notwithstanding the fact that reinsurance recoverables on paid losses may meet the criteria for offsetting under the provisions of *SSAP No. 64—Offsetting and Netting of Assets and Liabilities* (SSAP No. 64), reinsurance recoverables on paid losses shall be reported as an asset without any available offset. Unauthorized reinsurance and reinsurance ceded to certified reinsurers is included in this asset and reflected separately as a liability to the extent required. Penalty for overdue authorized reinsurance shall be reflected as a liability.

~~21~~25. Funds held or deposited with reinsured companies, whether premiums withheld as security 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 an insolvent reinsured shall be nonadmitted.

~~22~~26. Prospective reinsurance is defined as reinsurance in which a reinsurer agrees to reimburse a ceding entity for losses that may be incurred as a result of future insurable events covered under contracts subject to the reinsurance. Retroactive reinsurance is defined as reinsurance in which a reinsurer agrees to reimburse a ceding entity for liabilities incurred as a result of past insurable events covered under contracts subject to the reinsurance. A reinsurance agreement may include both prospective and retroactive reinsurance provisions.

~~23~~27. The distinction between prospective and retroactive reinsurance agreements is based on whether the agreement 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 agreement. 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 agreement is a retroactive agreement. (However, a reinsurance agreement that reinsures claims reported to an insurer that are covered under currently effective claims-made insurance policies is a prospective reinsurance agreement.)

~~24~~28. 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 agreement is substantively prospective shall 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

agreement is domiciled outside the U.S. and is not affiliated with such reinsurer, if an agreement 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 shall be accounted for as a retroactive reinsurance agreement. This presumption shall not apply to: (a) facultative reinsurance contracts, nor to (b) reinsurance agreements with more than one reinsurer which are signed by the lead reinsurer (i.e., the reinsurer setting the terms of the agreement for the reinsurers) within nine months after the commencement of the policy period covered by the reinsurance agreement, nor to (c) reinsurance agreements 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 agreement 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. Also exempt from this presumption are reinsurance agreements where one of the parties is in conservation, rehabilitation, receivership or liquidation proceedings.

25-29. Prospective and retroactive provisions included within a single agreement shall be accounted for separately. If separate accounting for prospective and retroactive provisions included within a single agreement is impracticable, the agreement shall be accounted for as a retroactive agreement provided the conditions for reinsurance accounting are met.

### **Accounting for Prospective Reinsurance Agreements**

26-30. Amounts paid for prospective reinsurance that meet the conditions for reinsurance accounting shall be reported as a reduction of written and earned premiums by the ceding entity and shall be earned over the remaining contract period in proportion to the amount of reinsurance protection provided or, if applicable, until the reinsurer's maximum liability under the agreement has been exhausted. 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. Reinstatement premium, if any, shall be earned over the period from the reinstatement of the limit to the expiration of the agreement.

27-31. Changes in amounts of estimated reinsurance recoverables shall be recognized as a reduction of gross losses and loss expenses incurred in the current period 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.

32. Prospective reinsurance agreements that meet the conditions for reinsurance accounting shall only reflect reinsurance credit for the portion of risk which is ceded. Provisions that would limit the reinsurer's losses (e.g., a deductible, a loss ratio corridor, a loss cap, an aggregate limit or any similar provisions) caused by any applicable risk-limiting provision(s) shall be reflected adjustments to ceded premiums, commissions or losses. Reporting entities shall only take credit for reinsurance, i.e., record a reinsurance recoverable, for non-proportional reinsurance when and to the extent that incurred losses on the underlying subject business exceed the attachment point of the applicable reinsurance contract(s).

### **Accounting for Retroactive Reinsurance Agreements**

28-33. Certain reinsurance agreements which transfer both components of insurance risk cover liabilities which occurred prior to the effective date of the agreement. Due to potential abuses involving the creation of surplus to policyholders and the distortion of underwriting results, special accounting treatment for these agreements is warranted.

29.34. All retroactive reinsurance agreements entered into, renewed or amended on or after January 1, 1994 (including subsequent development of such transactions) shall be accounted for and reported in the following manner:

- a. The ceding entity shall record, without recognition of the retroactive reinsurance, loss and loss expense reserves on a gross basis on the balance sheet and in all schedules and exhibits;
- b. The assuming entity shall exclude the retroactive reinsurance from loss and loss expense reserves and from all schedules and exhibits;
- c. The ceding entity and the assuming entity shall report by write-in item on the balance sheet, the total amount of all retroactive reinsurance, identified as retroactive reinsurance reserve ceded or assumed, recorded as a contra-liability by the ceding entity and as a liability by the assuming entity;
- d. The ceding entity shall, by write-in item on the balance sheet, restrict surplus resulting from any retroactive reinsurance as a special surplus fund, designated as special surplus from retroactive reinsurance account;
- e. The surplus gain from any retroactive reinsurance shall not be classified as unassigned funds (surplus) until the actual retroactive reinsurance recovered exceeds the consideration paid;
- f. The special surplus from retroactive reinsurance account for each respective retroactive reinsurance agreement shall be reduced at the time the ceding entity begins to recover funds from the assuming entity in amounts exceeding the consideration paid by the ceding entity under such agreement, or adjusted as provided in paragraph 2934.j.;
- g. For each agreement, the reduction in the special surplus from retroactive reinsurance account shall be limited to the lesser of (i) the actual amount recovered in excess of consideration paid or (ii) the initial surplus gain resulting from the respective retroactive reinsurance agreement. Any remaining balance in the special surplus from retroactive reinsurance account derived from any such agreement shall be returned to unassigned funds (surplus) upon elimination of all policy obligations subject to the retroactive reinsurance agreement;
- h. The ceding entity 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 the statement of income, to be identified as Retroactive Reinsurance Gain and included under Other Income;
- i. The assuming entity shall report the initial loss arising from a retroactive reinsurance transaction, as defined in the preceding paragraph 2934.g., as a write-in item on the statement of income, to be identified as Retroactive Reinsurance Loss and included under Other Income;
- j. 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 2934.h. and 2934.i., 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 the balance sheet 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 shall 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 (surplus)) only when cash recoveries from the assuming entity exceed the consideration paid by the ceding entity as respects such retroactive reinsurance transaction; and

- k. The consideration paid for a retroactive reinsurance agreement shall be reported as a decrease in ledger assets by the ceding entity and as an increase in ledger assets by the assuming entity.

(For an illustration of ceding entity accounting entries see question ~~31~~33 in Exhibit A.)

~~30~~35. Portfolio reinsurance is the transfer of an insurer's entire liability for in force policies or outstanding losses, or both, of a segment of the insurer's business. Loss portfolio transactions are to be accounted for as retroactive reinsurance.

~~31~~36. The accounting principles for retroactive reinsurance agreements in paragraph ~~29~~34 shall not apply to the following types of agreements (which shall be accounted for as prospective reinsurance agreements unless otherwise provided in this statement):

- a. Structured settlement annuities for individual claims purchased to implement settlements of policy obligations;
- b. Novations, (i.e., (i) 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 (ii) transactions in which the original assuming entity's obligations are completely extinguished) resulting in no further exposure to loss arising on the business novated, provided that (1) 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 (2) the accounting for the original reinsurance agreement will not be altered from retroactive to prospective;
- c. The termination of, or reduction in participation in, reinsurance treaties entered into in the ordinary course of business;
- d. Intercompany reinsurance agreements, 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; or
- e. Reinsurance/retrocession agreements that meet the criteria of property/casualty run-off agreements described in paragraphs ~~81-84~~102-105.

~~32~~37. Retroactive reinsurance agreements resulting in surplus gain to the ceding entity (with or without risk-transfer) entered into between affiliates or between insurers under common control (as those terms are defined in Appendix A-440) shall be reported as follows:

- a. The consideration paid by the ceding entity shall be recorded as a deposit and reported as a nonadmitted asset; and
- b. No deduction shall be made from loss and loss adjustment expense reserves on the ceding entity's balance sheet, schedules, and exhibits.

~~33~~38. The accounting and reporting provisions applicable to retroactive reinsurance apply to all transactions transferring liabilities in connection with a court-ordered rehabilitation, liquidation, or receivership. The requirement to include stipulated contract provisions in the reinsurance agreements shall not apply to these transactions, with written approval of the ceding entity's domiciliary commissioner.

34.39. Novations meeting the requirements of paragraph ~~34.36~~36.b. shall be accounted for as prospective reinsurance agreements. The original direct insurer, or the original assuming insurer, shall report amounts paid as a reduction of written and earned premiums, and unearned premiums to the extent that premiums have not been earned. Novated balances (e.g., loss and loss adjustment expense reserves) shall be written off through the accounts, exhibits, and schedules in which they were originally recorded. The assuming insurer shall report amounts received as written and earned premiums, and obligations assumed as incurred losses in the statement of income.

### Deposit Accounting

35.40. 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 18 of Appendix A-785;
- b. At subsequent reporting dates, the amount of the deposit/liability shall be adjusted by calculating the effective yield on the deposit agreement to reflect actual payments to date (receipts and disbursements shall 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 shall 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 shall be recalculated to reflect the revised actual or estimated cash flows. The deposit shall 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 company. Conversely, the ceding company 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 35.40, see Exhibit C)

41. Deposit accounting shall not be used to avoid loss recognition that would otherwise be required. For example, if the ceding entity has no future coverage relating to the deposit with the reinsurer, the deposit is not recoverable.

### Assumed Reinsurance

36.42. 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 entity withholds premium funds pursuant to the terms of the reinsurance agreement, such assets shall be shown by the assuming entity as funds held by or deposited with reinsured companies. Reporting entities shall record any interest earned or receivable on the funds withheld as a component of aggregate write-ins for miscellaneous income.

37.43. If the assuming entity receives reinsurance premium prior to the effective date of the reinsurance contract, consistent with *SSAP No. 53—Property Casualty Contracts-Premiums*, paragraph 15, advance premiums shall be reported as a liability in the statutory financial statement and not considered income until the effective date of the coverage. Such amounts are not included in written premium or the unearned premium reserve. If the assuming entity receives reinsurance premium after the effective date of the reinsurance contract but prior to the due date, the amount received shall be reported as a reduction of the asset for deferred but not yet due (earned but unbilled premiums).

38.44. Reinsurance premiums more than 90 days overdue shall be nonadmitted except (a) to the extent the assuming entity maintains unearned premium and loss reserves as to the ceding entity, under principles of offset accounting as discussed in *SSAP No. 64*, or (b) where the ceding entity is licensed and in good standing in assuming entity's state of domicile. Reinsurance premiums are due pursuant to the original contract terms (as the agreement 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 (i) notice or demand of premium due is provided to the ceding entity or (ii) the assuming entity books the premium (see *SSAP No. 6—Uncollected Premium Balances, Bills Receivable for Premiums, and Amounts Due From Agents and Brokers*).

39.45. A lag will develop between the time of the entry of the underlying policy transaction on the books of the ceding entity and the transmittal of information and entry on the books of the assuming entity. Assuming companies shall estimate unreported premiums and related costs to the extent necessary to prevent material distortions in the loss development contained in the assuming entity's annual statement schedules where calendar year premiums are compared to accident year losses.

40.46. Proportional reinsurance (i.e., first dollar pro rata reinsurance) premiums shall be allocated to the appropriate annual statement lines of business in the Underwriting and Investment exhibits. Non-proportional assumed reinsurance premiums shall be classified as reinsurance under the appropriate subcategories.

41.47. Assumed retroactive reinsurance premiums shall be excluded from all schedules and exhibits as addressed in paragraph 2934.

42.48. Amounts payable by reinsurers on losses shall be classified as unpaid losses. Assumed reinsurance payable on paid losses shall be classified as a separate liability item on the balance sheet. IBNR losses on assumed reinsurance business shall be netted with ceded losses on the balance sheet and listed separately by annual statement line of business in the Underwriting and Investment exhibits.

### Ceded Reinsurance

43.49. Ceded reinsurance premiums payable (net of ceding commission) shall be classified as a liability. Consistent with *SSAP No. 64*, 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.

44.50. With regard to reinsurance premium paid prior to the effective date of the contract, the ceding entity shall reflect the prepaid item as a write-in admitted asset and it should not be recognized in the income statement until the effective date of the coverage. Such amounts are not included in ceded written premiums

or ceded unearned premium but should be subject to impairment analysis. With regard to reinsurance premium paid by ceding entity after the reinsurance contract is in effect but prior to the due date, the ceding entity shall treat this item as a reduction to the liability for ceded reinsurance premiums payable. That liability reflects not only premiums unpaid but also amounts booked but deferred and not yet due.

45.51. Amounts withheld by the ceding entity that would otherwise be payable under the reinsurance agreement shall be reported as funds held by entity under reinsurance treaties. Reporting entities shall record any interest due or payable on the amounts withheld as a component of aggregate write-ins for miscellaneous income.

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

47.53. Ceded retroactive reinsurance premiums shall be excluded from all schedules and exhibits as addressed in paragraph ~~29~~34.

48.54. Reinsurance accounting shall not be allowed for modeled trigger securitizations. Modeled trigger securitization transactions do not result in the kind of indemnification (in form and in fact) required by this SSAP, and are therefore not eligible for reinsurance accounting. Modeled trigger transactions should be evaluated as securitization transactions rather than as reinsurance transactions and should receive the accounting treatment recommended for securitization transactions.

### **Adjustable Features/Retropective Rating**

49.55. Reinsurance treaties may provide for adjustment of commission, premium, or amount of coverage, based on loss experience. The accounting for common examples is outlined in the following paragraphs:

#### Commission Adjustments

50.56. An accrual shall be maintained for the following adjustable features based upon the experience recorded for the accounting period:

- a. Contingent or Straight Profit—The reinsurer returns to the ceding entity a stipulated percentage of the profit produced by the business assumed from the ceding entity. Profit may be calculated for any specified period of time, but the calculation is often based on an average over a period of years; and
- b. Sliding Scale—A provisional rate of commission is paid over the course of the agreement, with a final adjustment based on the experience of the business ceded under the agreement.

#### Premium Adjustments

51.57. If the reinsurance agreement incorporates an obligation on the part of the ceding entity to pay additional premium to the assuming entity based upon loss experience under the agreement, a liability in the amount of such additional premium shall be recognized by the ceding entity during the accounting period in which the loss event(s) giving rise to the obligation to pay such additional premium occur(s). The assuming entity shall recognize an asset in a consistent manner. If the reinsurance agreement incorporates an obligation on the part of the assuming entity to refund to the ceding entity any portion of the consideration received by the assuming entity based upon loss experience under the agreement, an asset in the amount of any such refund shall be recognized by the ceding entity during the accounting period in which the loss event(s) giving rise to the obligation to make such refund occur(s). The initial provisional or deposit premium is recalculated retrospectively, based on loss experience under the agreement during a specified period of time; the calculation is often based on an average over a period of years. The assuming entity shall recognize a liability in a consistent manner.

## Adjustments in the Amount of Coverage

52-58. The amount of coverage available for future periods is adjusted, upward or downward, based on loss experience under the agreement during a specified period of time. If the reinsurance agreement incorporates a provision under which the reinsurance coverage afforded to the ceding entity may be increased or reduced based upon loss experience under the agreement, an asset or a liability shall be recognized by the ceding entity in an amount equal to that percentage of the consideration received by the assuming entity which the increase or reduction in coverage represents of the amount of coverage originally afforded. The 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 agreement.

59. The ceding entity and the assuming entity shall 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 shall be recognized as a loss by the ceding entity and as a gain by the assuming entity when the event causing the decrease in coverage takes place.

60. Changes in either the probability or amount of potential future recoveries are considered a change in coverage. For example, if the contract limit stayed the same but the ceding entity could not receive any recoveries unless losses for the industry as a whole reached a certain level, coverage has been reduced. What matters is not the specific contract provisions regarding coverage, but whether the probability or amount of potential future recoveries has increased or decreased as a result of those provisions.

**Multiple-Year Retrospectively-Rated Contracts**

61. Many short-duration insurance and reinsurance contracts have retrospective rating provisions. A retrospectively-rated contract is a multiple-year contract in which events in one period of the contract create rights and obligations in another. For example, if losses above a certain level occur in one contract year, premiums increase in future years unless the ceding entity compensates the reinsurer through a settlement adjustment. The ceding entity has an obligation because it must pay either the settlement adjustment or the higher future premiums.

62. An insurer (ceding entity) may enter into a multiple-year retrospectively-rated reinsurance contract with a reinsurer (assuming entity). 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:

- a. Changes in the amount or timing of future contractual cash flows, including premium adjustments, settlement adjustments, or refunds to the ceding entity; or
- b. Changes in the contract’s future coverage.

63. 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. Therefore, a retrospectively-rated contract that could be cancelled without further obligation (because it does not create rights and obligations that will be realized in a future period) is excluded.

64. The principal issues in accounting for a multiple-year retrospectively-rated contract involve how to recognize and measure assets and liabilities resulting from the obligatory retrospective rating provisions. While it may be difficult for some types of multiple-year retrospectively-rated contracts to pass the risk-transfer test, the recognition and measurement questions are present regardless of whether the contract

transfers risk. In fact, the questions become clearly evident with contracts that meet the risk-transfer test and are accounted for as reinsurance.

### **Multiple-Year Retrospectively-Rated Contracts by Ceding and Assuming Entities**

65. To be accounted for as reinsurance, a reinsurance contract must meet all of the following conditions:

- a. The contract shall not contain features that prevent the risk-transfer criteria from being reasonably applied and the risk-transfer criteria shall be met.
- b. The ultimate premium expected to be paid or received under the contract shall be reasonably estimable and allocable in proportion to the reinsurance protection provided.

If any of these conditions are not met, a deposit method of accounting shall be applied by the ceding and assuming entities.

66. The condition in paragraph 65.a. applies to a contract and determining the substance of a contract is a judgmental matter. If an agreement with a reinsurer consists of both risk-transfer and non-risk-transfer coverages that have been combined into a single legal document, those coverages must be considered separately for accounting purposes. This statement does 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.

67. Recognizing a smaller asset based on potential unfavorable loss development implies that claim liabilities are understated at the financial reporting date. Accordingly, changes in estimates of claim liabilities shall not be recognized in measuring the related asset until the change in estimate takes place.

### **Obligatory Retrospective Rating Provisions**

68. This guidance discusses how the guidance on multiple-year retrospectively-rated contracts is based on the concept that there is a substantive difference between a contract that contains an obligatory retrospective rating provision and one that does not. This distinction is derived from SSAP No. 5R—*Liabilities, Contingencies and Impairments of Assets* (SSAP No. 5R), which requires recognition of liabilities (which are defined as present obligations) as of a financial reporting date but prohibits recognition of losses and expenses that will result from future events. For example, it may be a virtual certainty that an entity will pay employee salaries next year. But because there is no present obligation to pay those salaries, they are not recognized today.

69. Similarly, under SSAP No. 5R even if there is a high probability that an asset will be impaired in the future or a liability incurred in the future, the conditions for accrual have not been met because there is no present impairment or obligation to be recognized. Consistent with this principle, the guidance on multiple-year retrospectively-rated contracts does not permit recognition of the effects of retrospective rating provisions unless those provisions are obligatory.

### **Allocation of Certain Payments Between Coverage and Past Losses**

70. This guidance addresses a circumstance in which, under a multiple-year retrospectively-rated reinsurance contract, the ceding entity has to make additional payments to the reinsurer, but the ceding entity also receives expanded coverage. The single payment is allocated to the two separate transactions. In one transaction, the ceding entity has acquired an asset by making a payment to the reinsurer in exchange for expanded coverage. In the other, the ceding entity has incurred a loss or liability to the extent that it is reimbursing the reinsurer for past losses. Because a variety of factors may affect the value of reinsurance

coverage at any point in time, the most appropriate measure of the value of additional coverage generally is the price of the initial coverage. For example, if coverage of \$6.00 was acquired for a \$1.00 premium, and the ceding entity would pay \$4.00 more for another \$6.00 of coverage if a loss occurs, the most relevant measure of the amount of premium that relates to the new coverage would be \$1.00. The other \$3.00 presumably is a reimbursement for the loss that has been incurred.

### **Contractual Termination Features**

71. In some circumstances, the ceding entity will be relieved of its obligation if the reinsurer cancels the contract and only has to pay additional amounts if either:

- a. The contract remains in force; or
- b. The ceding entity cancels before the end of the contract term.

Unless the reinsurer has terminated the contract, the ceding entity has an obligation for the additional amounts and must recognize the related liability. The effect of termination, which is to relieve the ceding entity of its liability, shall not be recognized until termination takes place.

72. If either party entering into a new contract in consideration for canceling a retrospectively-rated contract would not have agreed to cancel the existing retrospectively-rated contract unless a new contract were entered into, the two contracts are, in effect, the same contract for purposes of measuring assets and liabilities and shall be accounted for in that way.

### **Impairment**

53-73. Include as a nonadmitted asset, amounts accrued for premium adjustments on retrospectively rated reinsurance agreements with respect to which all uncollected balances due from the ceding company have been classified as nonadmitted.

74. The amount of the asset to be recognized may be affected by credit risk, and appropriate impairment shall be recognized for any amounts deemed uncollectible. The relevant recorded claim liability at that date represents the ceding entity's best estimate of the expected ultimate claim liability and is the liability that must be used in measuring the refundable amount based on contract experience to date.

### **Commissions**

54-75. Commissions payable on reinsurance assumed business shall be included as an offset to Agents' Balances or Uncollected Premiums. Commissions receivable on reinsurance ceded business shall be included as an offset to Ceded Reinsurance Balances Payable.

55-76. If the ceding commission paid under a reinsurance agreement exceeds the anticipated acquisition cost of the business ceded, the ceding entity 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 effective period of the reinsurance agreement in proportion to the amount of coverage provided under the reinsurance contract.

### **Unauthorized Reinsurance**

56-77. If the assuming reinsurer is not authorized, otherwise approved or certified to do business in the ceding entity's domiciliary state, the assumed reinsurance is considered to be unauthorized. A provision is established to offset credit taken in various balance sheet accounts for reinsurance ceded to unauthorized reinsurers. Credit for reinsurance with unauthorized reinsurers shall be permitted to the extent the ceding entity holds collateral in accordance with Appendix A-785. If the assuming reinsurer is not licensed or is not an authorized reinsurer in the domiciliary state of the ceding entity or if the reinsurance does not meet

required standards, the ceding entity must set up a provision for reinsurance liability in accordance with the NAIC Annual Statement Instructions for Property and Casualty Insurance Companies Schedule F.

~~57.78.~~ The provision defined in paragraph ~~5677~~ shall never be less than zero for any particular reinsurer. The change in liability for unauthorized reinsurance is a direct charge or credit to surplus.

### **Reinsurance Ceded to a Certified Reinsurer**

~~58.79.~~ The term certified reinsurer shall have the same meaning as set forth in the Appendix A-785.

~~59.80.~~ Credit for reinsurance ceded to a certified reinsurer is permitted if security is held by or on behalf of the ceding entity in accordance with the certified reinsurer's rating assigned by the domestic state of the ceding insurance entity, and in accordance with Appendix A-785 of this manual. However, nothing in this guidance would prohibit the parties to a reinsurance agreement from agreeing to provisions establishing security requirements that exceed the minimum security requirements established for certified reinsurers.

~~60.81.~~ An upgrade in a certified reinsurer's assigned rating applies on a prospective basis, i.e., the revised collateral requirement applies only to contracts entered into or renewed on or after the effective date of the new rating (see A-785). A downgrade in a certified reinsurer's rating applies on a retroactive basis, i.e., the revised collateral requirement applies to all reinsurance obligations incurred by the assuming insurer under its certified reinsurer status. Notwithstanding a change in a certified reinsurer's rating or revocation of its certification, a reporting entity that has ceded reinsurance to such certified reinsurer is allowed a three (3)-month grace period before recording a provision for reinsurance due to collateral deficiency associated with such rating downgrade and increased collateral requirement for all reinsurance ceded to such assuming insurer under its certified reinsurer status, unless the reinsurance is found by the commissioner of the reporting entity's domestic state to be at high risk of uncollectibility.

~~61.82.~~ A provision is established by the ceding entity to offset credit taken in various balance sheet accounts for reinsurance ceded to a certified reinsurer in an amount proportionate to any deficiency in the amount of acceptable security that is provided by the certified reinsurer as compared to the amount of security that is required to be provided in accordance with the certified reinsurer's rating. The calculation of the provision for a collateral shortfall is separate from the calculation of the provision for overdue reinsurance ceded to certified reinsurers and shall be calculated in accordance with the NAIC Annual Statement Instructions for Property and Casualty Insurance Companies.

~~62.83.~~ The provision defined in paragraph ~~6182~~ shall never be less than zero for any particular certified reinsurer. The change in liability for reinsurance with certified reinsurers is a direct charge or credit to surplus.

### **Funds Held Under Reinsurance Treaties**

~~63.84.~~ This liability is established for funds deposited by or contractually withheld from reinsurers or reinsurers.

### **Provision for Reinsurance**

~~64.85.~~ The NAIC Annual Statement Instructions for Property and Casualty Companies for Schedule F—Provision for Overdue Reinsurance, provide for a minimum reserve for uncollectible reinsurance with an additional reserve required if an entity's experience indicates that a higher amount should be provided. The minimum reserve Provision for Reinsurance is recorded as a liability and the change between years is recorded as a gain or loss directly to unassigned funds (surplus). Any reserve over the minimum amount shall be recorded on the statement of income by reversing the accounts previously utilized to establish the reinsurance recoverable.

65-86. The provision for reinsurance is calculated separately for unauthorized, authorized and certified reinsurers. An authorized reinsurer is licensed, accredited or approved by the ceding entity's state of domicile; a certified reinsurer is certified by the ceding entity's state of domicile; an unauthorized reinsurer is not so licensed, accredited, approved or certified.

### **Asbestos and Pollution Contracts – Counterparty Reporting Exception**

66-87. Upon approval by the domiciliary regulator(s) of the ceding entity (either the original direct insurer in the case of a reinsurance agreement or the original assuming reinsurer in the case of a retrocession agreement), an exception may be allowed with respect to a retroactive reinsurance agreement providing substantially duplicate coverage as prior reinsurance agreements on asbestos and/or pollution exposures, including reinsurance provided through an affiliated reinsurer that retrocedes to the retroactive reinsurance counterparty. Under this exception, a reporting entity may aggregate reinsurers into one line item in Schedule F reflecting the counterparty under the retroactive agreement for the purposes of determining the Provision for Reinsurance regarding overdue amounts paid by the retroactive counterparty (both authorized and unauthorized). This exception would allow the Provision for Reinsurance to be reduced by reflecting that amounts have been recovered by the reporting entity under the duplicate coverage provided by the retroactive contract, and that inuring balances from the original contract(s) are payable to the retroactive counterparty. In addition, such approval would also permit the substitution of the retroactive counterparty for authorized original reinsurers without overdue balances for purposes of reporting on the primary section of the annual statement Schedule F. An agreement must meet all of the requirements in paragraphs ~~66~~87.a. through ~~66~~87.e. in order to be considered for this exception.

- a. The underlying agreement clearly indicates the credit risk associated with the collection of the reporting entity's inuring reinsurance recoverables and losses related to the credit risk will be covered by the retroactive reinsurance counterparty.
- b. The retroactive reinsurance agreement must transfer significant risk of loss.
- c. The assuming retroactive reinsurance counterparty must have a financial strength rating from at least two nationally recognized statistical rating organizations (NRSRO), the lowest of which is higher than or equal to the NRSRO ratings of the underlying third-party reinsurers.
- d. The transaction is limited to reinsurance recoverables attributable to asbestos, and/or pollution.
- e. The recoverables from the inuring reinsurers remain subject to credit analysis and contingent liability analysis.

67-88. With the approval of the reporting entity's domestic state commissioner pursuant to the applicable state credit for reinsurance law regarding the use of other forms of collateral acceptable to the commissioner, the reporting entity shall present the amount of other approved security related to the retroactive reinsurance agreement as an "Other Allowed Offset Item" with respect to the uncollateralized amounts recoverable from unauthorized reinsurers for paid and unpaid losses and loss adjustment expenses under the original reinsurance contracts. Amounts approved as "Other Allowed Offset Items" shall be reflected as amounts recoverable from the retroactive counterparty and aggregated reporting described in paragraph ~~66~~87 shall also be applied for unpaid losses and loss adjustment expenses under the original reinsurance contracts. The security applied as an "Other Allowed Offset Item" shall also be reflected in the designated sub-schedule and disclosed as a prescribed or permitted practice. (See Exhibit D of this statement.)

68-89. The reporting entity will continue to detail the reporting of original reinsurers that were aggregated for one line reporting per paragraph ~~66~~87 as provided in the annual statement instructions. The aggregation reporting in schedule F applies only to the extent that inuring balances currently receivable under original

reinsurance contracts are also payable to the retroactive reinsurance counterparty, and additionally to reinsurance recoverable on unpaid losses if the domestic state commissioner has approved amounts related to the retroactive reinsurance contract as any other form of security acceptable under the applicable provisions of the state's credit for reinsurance law. This guidance is not intended to otherwise change the application of retroactive accounting guidance for the retroactive portions of the contract that are not duplicative of the original reinsurance. Other than measurement of the provision for reinsurance and presentation in Schedule F, the retroactive contracts should continue to follow guidance applicable to retroactive accounting and reporting.

### **Syndicated Letters of Credit**

~~69~~90. With a Syndicated Letter of Credit (Syndicated LC), the reinsurer enters into an agreement with a group of banks (the "Issuing Banks") and an agent bank (the "Agent"). Each Issuing Bank and the Agent is an NAIC-approved bank and a "qualified bank." This agreement requires the Agent to issue, on behalf of each of the Issuing Banks, letters of credit in favor of the ceding insurer. The credit is issued (as an administrative matter) only through the Agent's letter of credit department. Each issuing bank signs the Syndicated LC through the Agent, as its attorney-in-fact. Syndicated LCs are consistent with A-785, in that the Syndicated LC is the legal equivalent of multiple letters of credit separately issued by each of the issuing banks. Reporting entities shall take a reduction in the liability on account of reinsurance recoverables secured by the Syndicated LC if all of the following conditions are met:

- a. All listed banks on the letter of credit are qualified and meet the criteria of the NAIC SVO approved bank listing;
- b. Banks are severally and not jointly liable; and
- c. Specific percentages for each assuming bank are listed in the letter of credit.

### **Disputed Items**

~~70~~91. Occasionally a reinsurer will question whether an individual claim is covered under a reinsurance agreement or may even attempt to nullify an entire agreement. A ceding entity, depending upon the individual facts, may or may not choose to continue to take credit for such disputed balances. A ceding entity shall take no credit whatsoever for reinsurance recoverables in dispute with an affiliate.

~~71~~92. Items in dispute are those claims with respect to which the ceding entity has received formal written communication from the reinsurer denying the validity of coverage.

### **Uncollectible Reinsurance**

~~72~~93. Uncollectible reinsurance balances shall be written off through the accounts, exhibits, and schedules in which they were originally recorded.

### **Commutations**

~~73~~94. A commutation of a reinsurance agreement, or any portion thereof, is a transaction which results in the complete and final settlement and discharge of all, or the commuted portion thereof, present and future obligations between the parties arising out of the reinsurance agreement.

~~74~~95. In commutation agreements, an agreed upon amount determined by the parties is paid by the reinsurer to the ceding entity. The ceding entity immediately eliminates the reinsurance recoverable recorded against the ultimate loss reserve and records the cash received as a negative paid loss. Any net gain or loss shall be reported in underwriting income in the statement of income.

75.96. The reinsurer eliminates a loss reserve carried at ultimate cost for a cash payout calculated at present value. Any net gain or loss shall be reported in underwriting income in the statement of income.

76.97. Commuted balances shall be written off through the accounts, exhibits, and schedules in which they were originally recorded.

### **National Flood Insurance Program**

77.98. The National Flood Insurance 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 entity, the entity signs a document with the Federal Insurance Administration (FIA) of the Federal Emergency Management Agency known as the Financial Assistance/Subsidy Arrangement.

78.99. 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.

79.100. Monthly accountings are made to FIA and participants 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.

80.101. Policies written by the reporting entity under the National Flood Insurance Program are considered insurance policies issued by the reporting entity, with reinsurance ceded to FEMA. (Such policies are not considered uninsured plans under *SSAP No. 47—Uninsured Plans* (SSAP No. 47.) Balances due from or to FEMA shall be reported as ceded reinsurance balances receivable or payable. The commission and fee allowances received from FEMA shall be reported consistent with reinsurance ceding commission.

### **Accounting for the Transfer of Property and Casualty Run-Off Agreements**

81.102. Property and casualty run-off agreements are reinsurance or retrocession agreements that are intended to transfer essentially all of the risks and benefits of a specific line of business or market segment that is no longer actively marketed by the transferring insurer or reinsurer. A property and casualty run-off agreement is not a novation as the transferring insurer or reinsurer remains primarily liable to the policyholder or ceding entity under the original contracts of insurance or reinsurance. Reinsurance agreements between affiliates or between insurers under common control (as those terms are defined in Appendix A-440) are not eligible for the exception for property and casualty run-off agreements in paragraph 3136.e.

#### **Criteria**

82.103. The accounting treatment for property and casualty run-off agreements must be approved by the domiciliary regulators of the transferring entity (either the original direct insurer in the case of a reinsurance agreement or the original assuming reinsurer in the case of a retrocession agreement) and the assuming entity. If the transferring entity and assuming entity are domiciled in the same state, then the regulator of the state where the majority of the transferred liabilities is located shall be asked to approve the accounting treatment. In determining whether to approve an agreement for this accounting treatment, the regulators shall require the following:

- a. Assuming Entity Properly Licensed – The entity assuming the run-off agreement must have the appropriate authority or license to write the business being assumed.
- b. Limits and Coverages – The reinsurance or retrocession agreement shall provide the same limits and coverages that were afforded in the original insurance or reinsurance agreement.

- c. Non-recourse – The reinsurance or retrocession agreement shall not contain any adjustable features or profit share or retrospective rating, and there shall be no recourse (other than normal representations and warranties that would be associated with a purchase and sale agreement) directly or indirectly against the transferring entity.
- d. Risk-Transfer – The reinsurance or retrocession agreement must meet the requirements of risk-transfer as described in this statement.
- e. Financial Strength of Reinsurer – The assuming reinsurer shall have a financial strength rating from at least two independent rating agencies (from NAIC credit rating providers (CRP)) which is equal to or greater than the current ratings of the transferring entity. The lowest financial strength rating received from an NAIC acceptable rating organization rating agency will be used to compare the financial strength ratings of the transferring and assuming entities.
- f. Assessments – The assuming reinsurer or retrocessionaire (if required in the original reinsurance contract) shall be financially responsible for any and all assessments, including guaranty fund assessments, that are assessed against the transferring entity related to the insurance business being assumed.
- g. Applicable Only to “Run-off” Business – The reinsurance or retrocession agreement shall only cover liabilities relating to a line(s) of business or specific market segments no longer actively marketed by the transferring entity.
- h. Non-cancelable Reinsurance – The reinsurance or retrocession agreement shall provide that the reinsurance or retrocessional coverage provided by the proposed agreement cannot be cancelable by either party for any reason. (However, this provision will not override standard contracts law and principles and will not prevent any remedies, including rescission or termination that might be available for breach, misrepresentation, etc.)

#### Statutory Schedules and Exhibits

83-104. At the inception of the transaction, the transferring entity shall record the consideration paid to the assuming entity as a paid loss. If the consideration paid by the transferring entity is less than the loss reserves transferred, the difference shall be recorded by the ceding entity as a decrease in losses incurred. The assuming entity shall record the consideration received as a negative paid loss. In addition, the transferring entity shall record an increase to ceded reinsurance recoverable for the amount of the transferred reserve. Journal entries illustrating these transactions, including situations in which the transaction includes an unearned premium reserve, are included in Exhibit B of this statement.

84-105. The assuming entity will report the business in the same line of business as reported by the original insurer or reinsurer. The assuming entity will report the business at the same level of detail using the appropriate statutory schedules and exhibits.

#### Disclosures

85-106. Unsecured Reinsurance Recoverables:

- a. If the entity has with any individual reinsurers, authorized, unauthorized, or certified an unsecured aggregate recoverable for losses, paid and unpaid including IBNR, loss adjustment expenses, and unearned premium, that exceeds 3% of the entity’s policyholder surplus, list each individual reinsurer and the unsecured aggregate recoverable pertaining to that reinsurer; and

- b. If the individual reinsurer is part of a group, list the individual reinsurers, each of its related group members having reinsurance with the reporting entity, and the total unsecured aggregate recoverables for the entire group.

86-107. Reinsurance Recoverables in Dispute—Reinsurance recoverable on paid and unpaid (including IBNR) losses in dispute by reason of notification, arbitration or litigation shall be identified if the amounts in dispute from any entity (and/or affiliate) exceed 5% of the ceding entity's policyholders surplus or if the aggregate of all disputed items exceeds 10% of the ceding entity's policyholders surplus. Notification means a formal written communication from a reinsurer denying the validity of coverage.

87-108. Uncollectible Reinsurance—Describe uncollectible reinsurance written off during the year reported in the following annual statement classifications, including the name(s) of the reinsurer(s):

- a. Losses incurred;
- b. Loss adjustment expenses incurred;
- c. Premiums earned; and
- d. Other.

88-109. Commutation of Ceded Reinsurance—Describe commutation of ceded reinsurance during the year reported in the following annual statement classifications, including the name(s) of the reinsurer(s):

- a. Losses incurred;
- b. Loss adjustment expenses incurred;
- c. Premiums earned; and
- d. Other.

89-110. Retroactive Reinsurance—The table illustrated in the NAIC Annual Statement Instructions for Property and Casualty Companies under Retroactive Reinsurance in the Notes to Financial Statements section shall be completed for all retroactive reinsurance agreements that transfer liabilities for losses that have already occurred and that will generate special surplus transactions. The insurer (assuming or ceding) shall assign a unique number to each retroactive reinsurance agreement and shall utilize this number for as long as the agreement exists. Transactions utilizing deposit accounting shall not be reported in this note.

90-111. Reinsurance Assumed and Ceded—The tables illustrated in the NAIC Annual Statement Instructions for Property and Casualty Companies under "Reinsurance Assumed and Ceded in the Notes to Financial Statements" section shall be completed as follows:

- a. The financial statements shall disclose the maximum amount of return commission which would have been due reinsurers if all reinsurance were canceled with the return of the unearned premium reserve; and
- b. The financial statements shall disclose the accrual of additional or return commission, predicated on loss experience or on any other form of profit sharing arrangements as a result of existing contractual arrangements.

91-112. 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.

~~92,113.~~ Disclosures for paragraphs ~~93-98~~114-119 represent annual statement interrogatories, which are required to be included with the annual audit report beginning with audit reports on financial statements as of and for the period ended December 31, 2006. The disclosures required within paragraphs ~~93-98~~114-119 shall be included in accompanying supplemental schedules of the annual audit report beginning in year-end 2006. These disclosures shall be limited to reinsurance contracts entered into, renewed or amended on or after January 1, 1994. This limitation applies to the annual audit report only and does not apply to the statutory annual statement interrogatories and the reinsurance summary supplemental filing.

~~93,114.~~ Disclose if any risks are reinsured under a quota share reinsurance contract with any other entity that includes a provision that would limit the reinsurer's losses below the stated quota share percentage (e.g. a deductible, a loss ratio corridor, a loss cap, an aggregate limit or any similar provisions)? If yes, indicate the number of reinsurance contracts containing such provisions and if the amount of reinsurance credit taken reflects the reduction in quota share coverage caused by any applicable limiting provision(s).

~~94,115.~~ Disclose if the reporting entity ceded any risk under any reinsurance contract (or under multiple contracts with the same reinsurer or its affiliates) for which during the period covered by the statement: (i) it recorded a positive or negative underwriting result greater than 5% of prior year-end surplus as regards policyholders or it reported calendar year written premium ceded or year-end loss and loss expense reserves ceded greater than 5% of prior year-end surplus as regards policyholders; (ii) it accounted for that contract as reinsurance and not as a deposit; and (iii) the contract(s) contain one or more of the following features or other features that would have similar results:

- a. A contract term longer than two years and the contract is noncancellable by the reporting entity during the contract term;
- b. A limited or conditional cancellation provision under which cancellation triggers an obligation by the reporting entity, or an affiliate of the reporting entity, to enter into a new reinsurance contract with the reinsurer, or an affiliate of the reinsurer;
- c. Aggregate stop loss reinsurance coverage;
- d. A unilateral right by either party (or both parties) to commute the reinsurance contract, whether conditional or not, except for such provisions which are only triggered by a decline in the credit status of the other party;
- e. A provision permitting reporting of losses, or payment of losses, less frequently than on a quarterly basis (unless there is no activity during the period); or
- f. Payment schedule, accumulating retentions from multiple years or any features inherently designed to delay timing of the reimbursement to the ceding entity.

~~95,116.~~ Disclose if the reporting entity during the period covered by the statement ceded any risk under any reinsurance contract (or under multiple contracts with the same reinsurer or its affiliates) for which during the period covered by the statement it recorded a positive or negative underwriting result greater than 5% of prior year-end surplus as regards policyholders or it reported calendar year written premium ceded or year-end loss and loss expense reserves ceded greater than 5% of prior year-end surplus as regards policyholders; excluding cessions to approved pooling arrangements or to captive insurance companies that are directly or indirectly controlling, controlled by, or under common control with (i) one or more unaffiliated policyholders of the reporting entity, or (ii) an association of which one or more unaffiliated policyholders of the reporting entity is a member, where:

- a. The written premium ceded to the reinsurer by the reporting entity or its affiliates represents fifty percent (50%) or more of the entire direct and assumed premium written by the reinsurer based on its most recently available financial statement; or

- b. Twenty-five percent (25%) or more of the written premium ceded to the reinsurer has been retroceded back to the reporting entity or its affiliates in separate reinsurance contract.

~~96~~117. If affirmative disclosure is required for paragraph ~~94~~115 or ~~95~~116, provide the following information:

- a. A summary of the reinsurance contract terms and indicate whether it applies to the contracts meeting paragraph ~~94~~115 or ~~95~~116;
- b. A brief discussion of management's principal objectives in entering into the reinsurance contract including the economic purpose to be achieved; and
- c. The aggregate financial statement impact gross of all such ceded reinsurance contracts on the balance sheet and statement of income.

~~97~~118. Except for transactions meeting the requirements of paragraph ~~34~~36, disclose if the reporting entity ceded any risk under any reinsurance contract (or multiple contracts with the same reinsurer or its affiliates) during the period covered by the financial statement, and either:

- a. Accounted for that contract as reinsurance (either prospective or retroactive) under statutory accounting principles (SAP) and as a deposit under generally accepted accounting principles (GAAP); or
- b. Accounted for that contract as reinsurance under GAAP and as a deposit under SAP.

~~98~~119. If affirmative disclosure is required for paragraph ~~97~~118, explain in a supplemental filing why the contract(s) is treated differently for GAAP and SAP.

~~99~~120. Disclosures for the Transfer of Property and Casualty Run-off Agreements

- a. Disclose if the reporting entity has entered into any agreements which have been approved by their domiciliary regulator and have qualified pursuant to paragraph ~~34~~36.e. (also see paragraphs ~~81~~84~~102-105~~).
- b. If affirmative, provide a description of the agreement and the amount of consideration paid and liabilities transferred.

~~100~~121. The financial statements shall disclose the following with respect to reinsurance agreements which qualify for reinsurer aggregation in accordance with paragraphs ~~66~~68~~87-89~~:

- a. A description of the significant terms of the reinsurance agreement, including established limits and collateral, and
- b. The amount of unexhausted limit as of the reporting date.
- c. To the extent that the domestic state insurance department approves the use of the retroactive contract as an acceptable form of security related to the original reinsurers under the applicable provisions of the state's credit for reinsurance law, the use of such discretion shall be disclosed in the annual statement Note 1 as a prescribed or permitted practice. In addition, Note 1 shall disclose as part of the total impact on the provision for reinsurance the impact on the overdue aspects of the calculation if the reporting entity also receives commissioner approval pursuant to paragraph ~~66~~68~~7~~ related to overdue paid amounts (both authorized and unauthorized).

~~101.122.~~ 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.

~~102.123.~~ The financial statements shall disclose the impact on any reporting period in which a certified reinsurer's rating has been downgraded or its certified reinsurer status is subject to revocation and additional collateral has not been received as of the filing date. The disclosure should include the following:

- a. Name of certified reinsurer downgraded or subject to revocation of certified reinsurer status and relationship to the reporting entity;
- b. Date of downgrade or revocation and jurisdiction of action;
- c. Collateral percentage requirements pre and post downgrade or revocation;
- d. Net ceded recoverable subject to collateral;
- e. As of the end of the current quarter, the estimated impact of the collateral deficiency to the reporting entity as a result of the assuming entity's downgrade or revocation of certified reinsurer status. (At year-end the actual impact of the collateral deficiency on the provision for reinsurance shall be disclosed.)

~~103.124.~~ U.S. domiciled reinsurers are eligible for certified reinsurer status. If the reporting entity is a certified reinsurer, the financial statements shall disclose the impact on any reporting period in which its certified reinsurer rating is downgraded or status as a certified reinsurer is subject to revocation. Such disclosure shall include information similar to paragraphs ~~102.123.b.~~, ~~102.123.c.~~ and ~~102.123.d.~~ and the expectation of its certified reinsurer's ability to meet the increased requirements.

~~104.125.~~ Refer to the Preamble for further discussion regarding disclosure requirements.

### Relevant Literature

~~105.126.~~ This statement adopts with modification *FASB Statement No. 113, Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts* (FAS 113) and *FASB Emerging Issues Task Force No. 93-6, Accounting for Multiple-Year Retrospectively Rated Contracts by Ceding and Assuming Enterprises* for the following:

- a. Reinsurance recoverables on unpaid case-basis and incurred but not reported losses and loss adjustment expenses shall be reported as a contra-liability netted against the liability for gross losses and loss adjustment expenses;
- b. Amounts paid for prospective reinsurance that meet the conditions for reinsurance accounting shall be reported as a reduction of unearned premiums;
- c. The gain created by a retroactive reinsurance agreement 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 statement of income 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 agreement is restricted as a special surplus account until the actual retroactive reinsurance recovered is in excess of the consideration paid;

- d. This statement requires that a liability (provision for reinsurance) be established through a provision reducing unassigned funds (surplus) for unsecured reinsurance recoverables from unauthorized or certified reinsurers and for certain overdue balances due from authorized reinsurers;
- e. Some reinsurance agreements contain adjustable features that provide for adjustment of commission, premium or amount of coverage, based on loss experience. This statement requires that the asset or liability arising from the adjustable feature be computed based on experience to date under the agreement, and the impact of early termination may only be considered at the time the agreement has actually been terminated;
- f. Structured settlements are addressed in *SSAP No. 65—Property and Casualty Contracts*. 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; and
- g. This statement requires that reinsurance recoverables on unpaid losses and loss adjustment expenses be presented as a contra-liability. Requirements for offsetting and netting are addressed in SSAP No. 64.

~~106.127.~~ This statement adopts American Institute of Certified Public Accountants (AICPA) *Statement of Position 98-7, Deposit Accounting: Accounting for Insurance and Reinsurance Contracts That Do Not Transfer Insurance Risk* (SOP 98-7) paragraphs 10-12 and 19 (subsection b only). This statement rejects AICPA SOP 98-7 paragraphs 13-17 and 19 (subsections a and c).

~~107.128.~~ This statement rejects AICPA *Statement of Position No. 92-5, Accounting for Foreign Property and Liability Reinsurance*. This statement incorporates Appendix A-785 as applicable.

### Effective Date and Transition

~~108.129.~~ This statement shall apply to:

- a. Reinsurance agreements entered into, renewed, or amended on or after January 1, 1994. An amendment is any revision or adjustment of contractual terms. The payment of premiums or reimbursement of losses recoverable under the agreement shall not constitute an amendment; and
- b. Reinsurance agreements in force on January 1, 1995, which cover losses occurring or claims made on or after that date on policies reinsured under such agreements.

~~109.130.~~ The guidance shall not apply to:

- a. Reinsurance agreements 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 agreements that expired before and were not renewed or amended after January 1, 1995.

~~110.131.~~ The guidance in paragraphs ~~49-53~~~~55-74~~ shall be effective for all accounting periods beginning on or after January 1, 1996, and shall apply to reinsurance agreements entered into, renewed or amended on or after January 1, 1994.

~~111.132.~~ This statement, including the guidance in paragraph ~~3540~~ incorporated from SSAP No. 75, is effective for years beginning January 1, 2001. Changes resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with *SSAP No. 3—Accounting Changes and Corrections of Errors*.

- a. Revisions to paragraph ~~3436.e.~~, related to paragraphs ~~81-84~~~~102-105~~, and disclosures in paragraph ~~99120~~ documented in *Issue Paper No. 137—Transfer of Property and Casualty Reinsurance Run-off Agreements* are effective for contracts entered on or after January 1, 2010.
- b. The guidance in paragraphs ~~3540~~, ~~401122~~ and ~~406127~~ was previously included within *SSAP No. 75—Reinsurance Deposit Accounting—An Amendment to SSAP No. 62R, Property and Casualty Reinsurance* (SSAP No. 75) and was also effective for years beginning January 1, 2001. In 2011, the guidance from SSAP No. 75 was incorporated within this statement, with SSAP No. 75 nullified. The original guidance included in this statement for deposit accounting, as well as the original guidance adopted in SSAP No. 75, are retained for historical purposes in Issue Paper No. 104. The guidance in paragraph ~~4854~~ was originally contained within *INT 02-06: Indemnification in Modeled Trigger Transactions* and was effective June 9, 2002. The guidance in paragraph ~~6990~~ was originally contained within *INT 02-09: A-785 and Syndicated Letters of Credit* and was effective September 12, 2004.
- c. The guidance related to certified reinsurers is applicable only to cedents domiciled in states that have enacted/promulgated the new collateral framework and only for their cessions to reinsurers certified under that domestic law/rule. The requirements applicable to contracts with certified reinsurers shall be effective for all reporting periods beginning on or after December 31, 2012.

~~133.~~ The guidance in paragraphs ~~66-68~~~~87-89~~ and ~~400121~~ which allowed retroactive reinsurance exceptions for asbestos and pollution contracts was effective for all accounting periods beginning on or after January 1, 2014, for paid losses. This guidance was revised to also allow for unpaid losses effective for reporting periods ending on and after December 31, 2015.

134. The substantive revisions adopted November 15, 2018, which primarily incorporated guidance originally from *EITF 93-6, Accounting for Multiple-Year Retrospectively-Rated Contracts by Ceding and Assuming Enterprises*, and from *EITF Topic D-35, FASB Staff Views on Issue No. 93-6, Accounting for Multiple-Year Retrospectively Rated Contracts by Ceding and Assuming Enterprises* are effective January 1, 2019. These revisions are documented in *Issue Paper No. 162—Property and Casualty Reinsurance Credit*.

## REFERENCES

### Relevant Issue Papers

*Issue Paper No. 75—Property and Casualty Reinsurance*

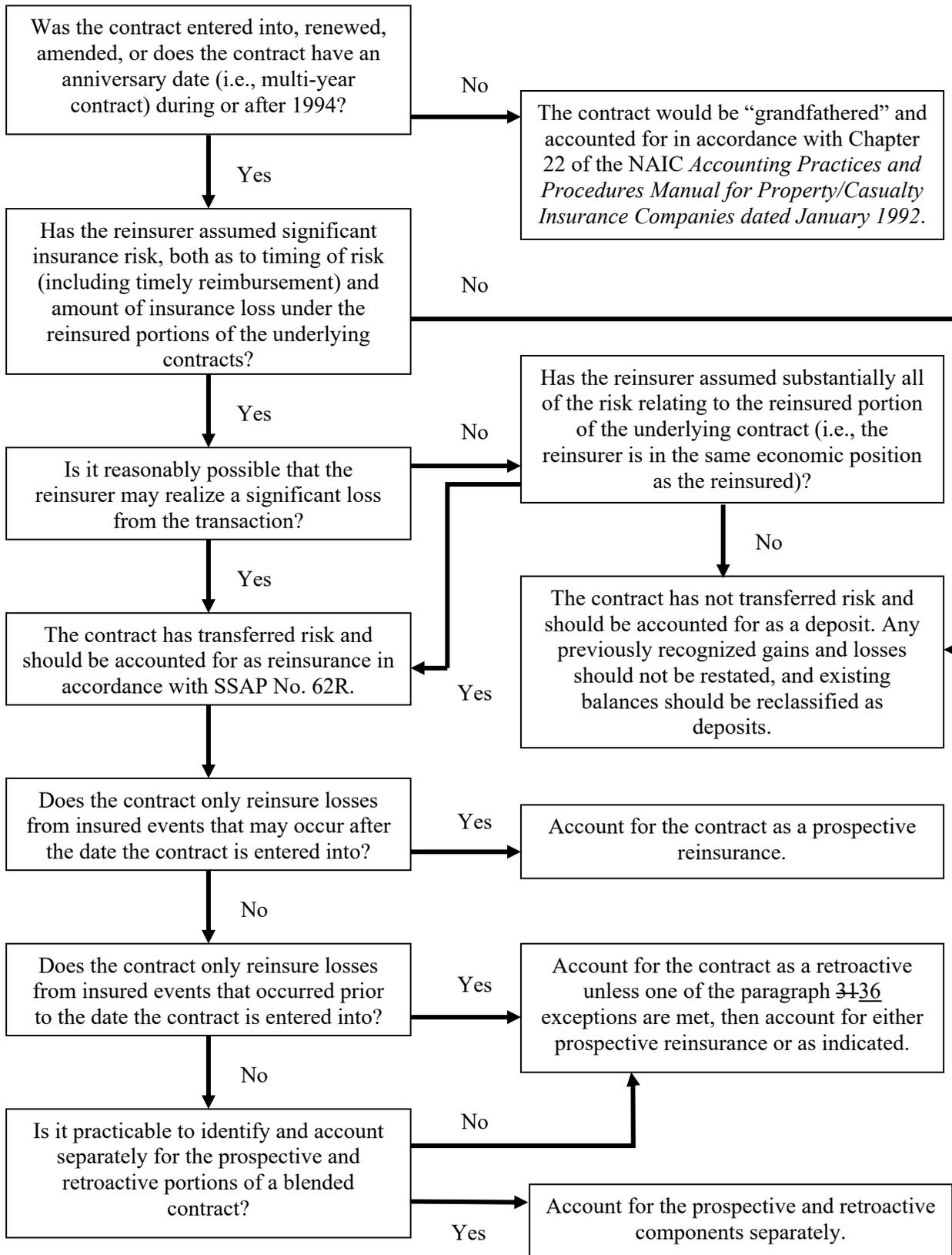
*Issue Paper No. 104—Reinsurance Deposit Accounting – An Amendment to SSAP No. 62R—Property and Casualty Reinsurance*

*Issue Paper No. 137—Transfer of Property and Casualty Reinsurance Run-off Agreements*

*Issue Paper No. 153—Counterparty Reporting Exception for Asbestos and Pollution Contracts*

*Issue Paper No. 162—Property and Casualty Reinsurance Credit*

**CLASSIFYING REINSURANCE CONTRACTS**



**EXHIBIT A – IMPLEMENTATION QUESTIONS AND ANSWERS**

## Applicability

1. Q: The accounting practices in SSAP No. 62R specify the accounting and reporting for reinsurance contracts. What contracts are considered reinsurance contracts for purposes of applying these accounting practices?

A: Any transaction that indemnifies an insurer against loss or liability relating to insurance risk shall be accounted for in accordance with the accounting practices included in SSAP No. 62R. Therefore, all contracts, including contracts that may not be structured or described as reinsurance, shall be accounted for as reinsurance when those conditions are met.

2. Q: The provisions of this statement will apply to (a) reinsurance contracts entered into, renewed or amended on or after January 1, 1994, and (b) any other reinsurance contracts that are in force on January 1, 1995 and cover insurable events on the underlying insurance policies that occur on or after that date. What contracts would be exempt from the ~~new~~-accounting rules included in SSAP No. 62R?

A: The only exempt contracts are:

- 1) Purely retroactive reinsurance contracts that cover only insured events occurring before January 1, 1994, provided those contracts were entered into before that date and are not subsequently amended and
- 2) Contracts that expired before January 1, 1995 and are not amended after that date.

3. Q: This statement is to be applied to contracts which are amended on or after January 1, 1994. What if the change in terms is not significant, or the terms changed have no financial effect on the contract?

A: In general, the term amendment should be viewed broadly to include all but the most trivial changes. Examples of amendments include, but are not limited to, replacing one assuming entity with another (including an affiliated entity), or modifying the contract's limit, coverage, premiums, commissions, or experience-related adjustable features. No distinction is made between financial and non-financial terms.

4. Q: Must the accounting provisions of SSAP No. 62R be applied to an *otherwise exempt* contract if the ceding entity pays additional premiums under the contract on or after January 1, 1994?

A: The answer depends on why the additional premiums are paid. If the additional premiums are the result of a renegotiation, adjustment, or extension of terms, the contract is subject to the accounting provisions of SSAP No. 62R. However, additional premiums paid without renegotiation, adjustment, or extension of terms would not make an otherwise exempt contract subject to those provisions.

5. Q: Prospective and retroactive portions of a reinsurance contract are allowed to be accounted for separately, if practicable. Can the retroactive portion of an existing contract be segregated and, therefore, exempted with other retroactive contracts covering insured events occurring prior to January 1, 1994?

A: No. The transition provisions apply to an entire contract, which is either subject to or exempt from the ~~revised~~-provisions of SSAP No. 62R. A ceding entity may bifurcate a contract already subject to the ~~new~~-accounting rules in SSAP No. 62R and then account for both the prospective and retroactive portions in accordance with the ~~new~~-accounting standard.

## Risk-Transfer

6. Q: Do the ~~new~~-risk-transfer provisions apply to existing contracts?

A: Yes, the ~~new~~-risk-transfer provisions apply to some existing contracts. SSAP No. 62R applies in its entirety only to existing contracts which were renewed or amended on or after January 1, 1994, or which cover losses occurring or claims made after that date. Therefore, those contracts must be evaluated to determine whether they transfer risk and qualify for reinsurance accounting. For accounting periods commencing on or after January 1, 1995, balances relating to such contracts 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.

SSAP No. 62R does not apply to existing contracts which were entered into before, and were not renewed or amended on or after, January 1, 1994, and which cover only losses occurring or claims made before that date, nor to contracts which expired before, and were not renewed or amended on or after, January 1, 1995. Those contracts will continue to be accounted for in the manner provided by SSAP No. 62R before these revisions.

7. Q: How does the effective date affect the assessment of whether a significant loss to the reinsurer was reasonably possible?

A: The risk-transfer assessment is made at contract inception, based on facts and circumstances known at the time. Because that point in time has passed for existing contracts, some have suggested that the risk-transfer provisions be applied as of the effective date. However, that approach to the risk-transfer assessment would violate the requirement to consider all cash flows from the contract. Therefore, the test must be applied from contract inception, considering the effect of any subsequent contract amendments. Careful evaluation and considered judgment will be required to determine whether a significant loss to the reinsurer was reasonably possible at inception.

8. Q: Should risk-transfer be reassessed if contractual terms are subsequently amended?

A: Yes. When contractual terms are amended, risk-transfer should be reassessed. For example, a contract that upon inception met the conditions for reinsurance accounting could later be amended so that it no longer meets those conditions. The contract should then be reclassified and accounted for as a deposit.

9. Q: How should the risk-transfer assessment be made when a contract has been amended?

A: No particular method is prescribed for assessing risk-transfer in light of a contract amendment. Whether an amended contract in substance transfers risk must be determined considering all of the facts and circumstances in light of the risk-transfer requirements. Judgment also will be required to determine whether an amendment in effect creates a new contract.

10. Q: For purposes of evaluating whether a contract with a reinsurer transfers risk, what constitutes a contract?

A: A contract is not defined, but is essentially a question of substance. It may be difficult in some circumstances to determine the boundaries of a contract. For example, the profit-sharing provisions of one contract may refer to experience on other contracts and, therefore, raise the question of whether, in substance, one contract rather than several contracts exist.

The inconsistency that could result from varying interpretations of the term *contract* is limited by requiring that features of the contract or other contracts or agreements that directly or indirectly compensate the reinsurer or related reinsurers for losses be considered in evaluating whether a particular contract transfers risk. Therefore, if agreements with the reinsurer or related reinsurers,

in the aggregate, do not transfer risk, the individual contracts that make up those agreements also would not be considered to transfer risk, regardless of how they are structured.

11. Q: If the assessment of risk—transfer changes after the initial assessment at contract inception, how should the ceding entity account for the change?

A: The status of a contract should be determinable at inception and, absent amendment, subsequent changes should be very rare. If the risk of significant loss was not deemed reasonably possible at inception, and a significant loss subsequently occurred, the initial assessment was not necessarily wrong, because remote events do occur. Likewise, once a reasonable possibility of significant loss has been established, such loss need not occur in order to maintain the contract's status as reinsurance.

12. Q: SSAP No. 62R requires that reasonably possible outcomes be evaluated to determine the reinsurer's exposure to significant loss. What factors should be considered in determining whether a scenario being evaluated is reasonably possible?

A: The term *reasonably possible* means that the probability is more than remote. The test is applied to a particular scenario, not to the individual assumptions used in the scenario. Therefore, a scenario is not reasonably possible unless the likelihood of the entire set of assumptions used in the scenario occurring together is reasonably possible.

13. Q: In determining the amount of the reinsurer's loss under reasonably possible outcomes, may cash flows directly related to the contract other than those between the ceding and assuming companies, such as taxes and operating expenses of the reinsurer, be considered in the calculation?

A: No. The evaluation is based on the present value of all cash flows *between the ceding and assuming enterprises* under reasonably possible outcomes and, therefore, precludes considering other expenses of the reinsurer in the calculation.

14. Q: In evaluating the significance of a reasonably possible loss, should the reasonably possible loss be compared to gross or net premiums?

A: Gross premiums should be used.

15. Q: How does a commutation clause affect the period of time over which cash flows are evaluated for reasonable possibility of significant loss to the reinsurer?

A: All cash flows are to be assessed under reasonably possible outcomes. Therefore, unless commutation is expected in the scenario being evaluated, it should not be assumed in the calculation. Further, the assumptions used in a scenario must be internally consistent and economically rational in order for that scenario's outcome to be considered reasonably possible.

~~16. Q: What interest rate should be used in each evaluated scenario to make the present value calculation?~~

~~A: A reasonable and appropriate rate is required, which generally would reflect the expected timing of payments to the reinsurer and the duration over which those cash flows are expected to be invested by the reinsurer.~~

~~17~~16. Q: SSAP No. 62R refers to payment schedules and accumulating retentions from multiple years as features that delay timely reimbursement of claims. Does the presence of those features generally prevent a contract from meeting the conditions for reinsurance accounting?

A: Yes. Payment schedules and accumulating retentions from multiple years are contractual features inherently designed to delay the timing of reimbursement to the ceding entity. Regardless of what

a particular feature might be called, any feature that can delay timely reimbursement violates the conditions for reinsurance accounting. Transfer of insurance risk requires that the reinsurer's payments to the ceding entity 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 reinsurer's reimbursement to the ceding entity should be closely scrutinized.

~~17.~~ Q: What if a contract contains a feature such as a payment schedule or accumulating retention but could still result in the reasonable possibility of significant loss to the reinsurer?

A: Both of the following conditions are required for reinsurance accounting:

- a. Transfer of significant risk arising from uncertainties about both (i) the ultimate amount of net cash flows from premiums, commission, claims, and claim settlement expenses paid under a contract (underwriting risk) and (ii) the timing of the receipt and payment of those cash flows (timing risk); and
- b. Reasonable possibility of significant loss to the reinsurer.

Because both condition (a) and condition (b) must be met, failure to transfer significant timing and underwriting risk is not overcome by the possibility of significant loss to the reinsurer.

18. Q: Can a reinsurance agreement compensate a reinsurer for losses?

A: A contract does not meet the conditions for reinsurance accounting if features of the reinsurance contract or other contracts or agreements directly or indirectly compensate the reinsurer or related reinsurers for losses to an extent that risk-transfer criteria is violated. That compensation may take many forms, and an understanding of the substance of the contracts or agreements is required to determine whether the ceding entity has been indemnified against loss or liability relating to insurance risk. For example, contractual features may limit the reinsurer's exposure to insurance risk or delay the reimbursement of claims so that investment income mitigates exposure to insurance risk. Examples of those contractual features noted in paragraph 12 are not all-inclusive.

~~19. Q: Is it permissible to evaluate timely reimbursement on a present value basis?~~

~~A: No. The word timely is used in the ordinary temporal sense to refer to the length of time between payment of the underlying reinsured claims and reimbursement by the reinsurer.~~

~~While the test for reasonable possibility of significant loss to the reinsurer provides for a present value based assessment of the economic characteristics of the reinsurance contract, the concept of timely reimbursement relates to the transfer of insurance risk (condition a. above), not the reasonable possibility of significant loss (condition b. above). Accordingly, timely reimbursement should be evaluated based solely on the length of time between payment of the underlying reinsured losses and reimbursement by the reinsurer.~~

~~20. Q: Are there any circumstances under which the conditions for risk transfer need not be met?~~

~~A: Yes. An extremely narrow and limited exemption is provided for contracts that reinsure either an individual risk or an underlying book of business that is inherently profitable. When substantially all of the insurance risk relating to the reinsured portions of the underlying insurance contracts has been assumed by the reinsurer, the contract meets the conditions for reinsurance accounting. To qualify under this exception, no more than trivial insurance risk on the reinsured portions of the underlying insurance contracts may be retained by the ceding entity. The reinsurer's economic position must be virtually equivalent to having written the relevant portions of the reinsured contracts directly.~~

~~2119~~. Q: In determining whether a reinsurance contract qualifies under the exception referred to in ~~the preceding question~~ paragraph 18, how should the economic position of the reinsurer be assessed in relation to that of the ceding entity?

A: The assessment should be made by comparing the net cash flows of the reinsurer under the reinsurance contract with the net cash flows of ceding entity on the reinsured portions of the underlying insurance contracts. This may be relatively easy for reinsurance of individual risks or for unlimited-risk quota-share reinsurance, because the premiums and losses on these types of reinsurance generally are the same as the premiums and losses on the reinsured portions of the underlying insurance policies.

In other types of reinsurance, determining the reinsurer's net cash flows relative to the insurer is likely to be substantially more difficult. For example, it generally would be difficult to demonstrate that the ceding entity's premiums and losses for a particular layer of insurance are the same as the reinsurer's premiums and losses related to that layer. If the economic position of the reinsurer relative to the insurer cannot be determined, the contract would not qualify under the exception.

#### Accounting Provisions

~~2220~~. Q: An existing contract that was accounted for as reinsurance no longer qualifies for reinsurance accounting under the ~~new~~ accounting rules included in SSAP No. 62R. How should the ceding and assuming companies account for the contract in future periods?

A: Because the statement of income cannot be restated, previously recognized gains and losses are not revised. If the contract was entered into before, and not renewed or amended on or after, January 1, 1994 and covers only losses occurring or claims made before that date, or the contract expired before January 1, 1995 and was not renewed or amended on or after that date, it would continue to be accounted for in the manner provided before these revisions.

For accounting periods commencing on or after January 1, 1995, existing balances relating to contracts which do not transfer insurance risk and which were entered into on or after January 1, 1994 (covering losses occurring or claims made after that date) would be reclassified as deposits.

Premium payments to a reinsurer would be recorded as deposits. Likewise, losses recoverable from a reinsurer would not be recognized as receivables. Rather, any reimbursement for losses would be accounted for upon receipt as a refund of a deposit.

~~2321~~. Q: What is the definition of past insurable events that governs whether reinsurance coverage is prospective or retroactive? For example, could a reinsurance contract that covers losses from asbestos and pollution claims on occurrence-based insurance policies effective during previous periods be considered prospective if the reinsurance coverage is triggered by a court interpretation that a loss is covered within the terms of the underlying insurance policies?

A: The distinction between prospective and retroactive reinsurance is based on whether a contract reinsures future or past insured events covered by the underlying reinsurance contracts. In the example above, the insured event is the occurrence of loss within the coverage of the underlying insurance contracts, not the finding of a court. Therefore, the fact that the asbestos exposure or pollution is covered under insurance policies effective during prior periods makes the reinsurance coverage in this example retroactive.

~~2422~~. Q: Would the answer to the above question change if the reinsurance were written on a claims-made basis?

A: No. The form of the reinsurance—whether claims-made or occurrence-based—does not determine whether the reinsurance is prospective or retroactive. 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.

2523. Q: What is the effect of adjustments to future premiums or coverage in determining whether reinsurance is prospective or retroactive?

A: Adjustments to future premiums or coverage may affect the accounting for a reinsurance contract. Whenever an adjustment results in a reinsurer providing new or additional coverage for past insurable events, that coverage is retroactive. For example, if subsequent years' premiums under a multiple accident year contract create additional coverage for previous accident years, the additional coverage is retroactive, even if the original coverage provided in the contract for those accident years was prospective. Likewise, if current losses under a multiple-year contract eliminate coverage in future periods, some or all of the premiums to be paid in those future periods should be charged to the current period.

2624. Q: A reinsurance contract is entered into after the contract's effective date. Is the coverage between the contract's effective date and the date the contract was entered into prospective or retroactive?

A: The portion of the contract related to the period of time between the effective date of the contract and the date the contract was entered into is retroactive because it covers insured events that occurred prior to entering into the reinsurance contract.

2725. Q: How is the date the reinsurance contract was entered into determined?

A: 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. For example, a contract may be considered to have been substantively entered into even though regulatory approval of that contract has not taken place.

The absence of agreement on significant terms, or the intention to establish or amend those terms at a later date based on experience or other factors, generally indicates that the parties to the contract have not entered into a reinsurance contract, but rather have agreed to enter into a reinsurance contract at a future date. If contractual provisions under a contract substantively entered into at a future date covered insurable events prior to that date, that coverage is retroactive.

In any event, SSAP No. 62R provides that if a contract (except facultative contracts and contracts signed by the lead reinsurer and certain cover notes or similar documents signed by reinsurers representing more than 50% of the capacity on the contract) has not been finalized, reduced to written form and signed by the parties within 9 months after its effective date, it is presumed to be retroactive.

2826. Q: Are contracts to reinsure calendar-year incurred losses considered blended contracts that have both prospective and retroactive elements?

A: Yes. Most reinsurance contracts covering calendar-year incurred losses combine coverage for insured events that occurred prior to entering into the reinsurance contract with coverage for future insured events and, therefore, include both prospective and retroactive elements.

In any event, SSAP No. 62R provides that if a contract (except facultative contracts, contracts signed by the lead reinsurer and certain cover notes or similar documents signed by reinsurers

representing more than 50% of the capacity on the contract) has not been finalized, reduced to written form and signed by the parties within 9 months after its effective date it is presumed retroactive.

2927. Q: When the prospective and retroactive portions of a contract are being accounted for separately, how should premiums be allocated to each portion of the contract?

A: No specific method for allocating the reinsurance premiums to the risks covered by the prospective and retroactive portions of a contract is required. However, separate accounting for the prospective and retroactive portions of a contract may take place only when an allocation is practicable.

Practicability requires a reasonable basis for allocating the reinsurance premiums to the risks covered by the prospective and retroactive portions of the contract, considering all amounts paid or deemed to have been paid regardless of the timing of payment. If a reasonable basis for allocating the premiums between the prospective and retroactive coverage does not exist, the entire contract must be accounted for as a retroactive contract.

3028. Q: A retroactive reinsurance contract contains a cut-through provision that provides the ceding entity's policyholders and claimants with the right to recover their claims directly from the reinsurer. May the ceding entity immediately recognize earned surplus associated with this type of contract?

A: No. SSAP No. 62R states that earned surplus may not be recognized "until the actual retroactive reinsurance recovered exceeds the consideration paid."

3429. Q: A ceding entity enters into a retroactive reinsurance agreement that gives rise to segregated surplus. If the reinsurer prepays its obligation under the contract, may the ceding entity recognize earned surplus at the time the prepayment is received?

A: Segregated surplus arising from retroactive reinsurance transactions is earned as actual liabilities that have been transferred are recovered or terminated. Therefore, earned surplus is based on when the reinsurer settles its obligations to the ceding entity, and it may be appropriate to recognize earned surplus at the time the prepayment is received.

However, all of the facts and circumstances must be considered to determine whether the ceding entity has substantively recovered the liabilities transferred to the reinsurer. For example, if the ceding entity agrees to compensate the reinsurer for the prepayment, such as by crediting the reinsurer with investment income on prepaid amounts or balances held, the ceding entity has not, in substance, recovered its transferred liabilities but rather has received a deposit from the reinsurer that should be accounted for accordingly.

3230. Q: If the ceding entity does not expect to receive any recoveries because the reinsurer has agreed to reimburse claimants under the reinsured contracts directly, would the ceding entity be considered to have recovered or terminated its transferred liabilities?

A: No. In the example given, the reinsurer is substantively acting as disbursing agent for the ceding entity. Therefore, the ceding entity cannot be said to have recovered amounts due from the reinsurer before payment is made to the claimant.

3331. Q: What accounting entries would a ceding entity make to report a retroactive reinsurance contract?

A: Accounting Entries for a Ceding Entity to Report a Retroactive Reinsurance Contract:

Entry 1

Retroactive Reinsurance Reserves

Ceded or Assumed (B/S)	10,000	
Retroactive Reinsurance Gain (I/S)		2,000
Cash		8,000

To record initial portfolio transfer, see items #3 and #8. The ceding entity must establish the segregated surplus per item #4.

Entry 1A

Retro. Reins. Gain	2,000	
Profit/Loss Account		2,000

To close gain from retroactive transaction.

Entry 1B

Profit/Loss Account	2,000	
Special Surplus from Retro. Reins.		2,000

To close profit from retroactive reinsurance to special surplus.

Entry 2

Cash	2,000	
Retroactive Reinsurance Reserves		2,000
Ceded or Assumed (B/S)		

To record recovery of paid losses from the reinsurer. Outstanding ceded reserves after this recovery equals \$8,000, and special surplus from retroactive reinsurance account equals \$2,000; therefore, segregated surplus account is not changed per item #10.

Entry 3

Retroactive Reinsurance Reserves		
Ceded or Assumed (B/S)	3,000	
Retroactive Reinsurance Gain (I/S)		3,000

To record subsequent revision of the initial reserves ceded per item #10. The segregated surplus account is increased to \$5,000 as a result of this upward development.

Entry 3A

Retro. Reinsurance Gain	3,000	
Profit/Loss Account		3,000

To close profit from retroactive reinsurance.

Entry 3B

Profit/Loss (I/S)	3,000	
Special Surplus from Retro. Reins.		3,000

To close profit and loss account to special surplus. (Retroactive reinsurance reserves ceded or assumed account balance equals \$11,000. Special Surplus from retroactive reinsurance balance equals \$5,000.)

Entry 4

Cash	4,000	
Retroactive Reinsurance Reserves		
Ceded or Assumed (B/S)		4,000

To record recovery of paid losses from the reinsurer. Outstanding ceded reserves after this recovery equals \$7,000, therefore segregated surplus account is not changed per item #10.

Entry 5

Cash	3,000	
Retroactive Reinsurance Reserves		
Ceded or Assumed (B/S)		3,000

To record recovery of paid losses from reinsurer. Outstanding ceded reserves after recovery equals \$4,000, therefore the following entry is needed per items #6 and #10.

Entry 5A

Special Surplus—Retro. Reins.	1,000	
Unassigned Funds		1,000

Retroactive Reinsurance reserves ceded or assumed after this entry equals \$4,000.

Entry 6

Retroactive Reinsurance Loss (I/S)	1,000	
Retroactive Reinsurance Reserves		
Ceded or Assumed (B/S)		1,000

To record subsequent revision of the initial reserves ceded per item #10. The segregated surplus account is decreased as a result of this downward development to \$3,000. The following entry is needed per items #6 and #10.

Entry 6A

Profit/Loss Account	1,000	
Retro. Reins. Loss		1,000

To close loss to profit and loss account.

Entry 6B

Special Surplus from Retro. Reins.	1,000	
Profit/Loss Account		1,000

To close profit and loss account to special surplus. (Remaining balance of retroactive reinsurance reserve ceded or assumed account equals \$3,000.) (Special surplus from retro. reins. account balance equals \$3,000.)

Entry 7

Cash	2,500	
Retroactive Reinsurance Gain (I/S)	500	
Retroactive Reinsurance Reserves		
Ceded or Assumed (B/S)		3,000

Entry 7A

Profit and Loss Account	500	
Retro. Reins. Gain		500

To close other income to profit and loss account.

Entry 7B

Special Surplus from Retro. Reins.	500	
Profit/Loss Account		500

To close profit and loss account to special surplus. (Remaining balance of special surplus from retro. reins. account equals \$2,500.) (Remaining balance of retroactive reinsurance reserve ceded or assumed account -0-.)

Entry 7C

Special Surplus from Retro. Reins.	2,500	
Unassigned Funds		2,500

To close remaining special surplus account to unassigned surplus.

3432. Q: How should the parties account for an adverse loss development reinsurance contract where, as of the statement date, the attachment level of the contract exceeds the ceding company's current case and IBNR reserves for the covered accident years (i.e. no surplus gain and no reinsurance recoverable as of the statement date), and the ceding company transferred cash to the reinsurer at the inception of the contract?

A: An adverse loss development reinsurance contract covering prior accident years meets the definition of "retroactive reinsurance" set forth in paragraph 2226 of SSAP No. 62R:

....reinsurance in which a reinsurer agrees to reimburse a ceding entity for liabilities incurred as a result of past insurable events covered under contracts subject to the reinsurance....

Paragraph 2934.k. of SSAP No. 62R specifically provides that the consideration paid for a retroactive reinsurance contract is to be recorded as a decrease in ledger assets by the ceding entity and an increase in ledger assets by the assuming entity.

Question 3133 illustrates the accounting entries for retroactive reinsurance contracts.

If the retroactive reinsurance contract transfers both components of insurance risk then, pursuant to paragraph 2934 of SSAP No. 62R, the ceding company would record the consideration paid as a decrease in ledger assets, recognize an expense for the reinsurance ceded through Other Income or Loss accounts as a write-in item identified as "Retroactive Reinsurance Ceded", and record the recoverable from the reinsurer as a contra liability.

No contra liability is established until and unless (and then only to the extent that) the ceding company establishes reserves which exceed the attachment point.

For the contract described, at inception no contra liability is recorded to offset current liability for the business ceded, since the ceded retroactive reinsurance premium relates to coverage in excess of the current liabilities recorded by the ceding company.

Once the ceding company's recorded liabilities exceed the attachment point of the adverse loss development reinsurance contract and triggers reinsurance recoverable from the reinsurer, a contra liability is established by the ceding company for the amount of the reinsurance recoverable. Any surplus resulting from the retroactive reinsurance is carried as a write-in item on the balance sheet designated as "Special Surplus from Retroactive Reinsurance Account." The surplus gain may not be classified as unassigned funds (surplus) until the actual retroactive reinsurance recovered exceeds the consideration paid.

If any portion of a retroactive reinsurance contract does not transfer insurance risk, then the portion which does not transfer risk is accounted for as a deposit pursuant to paragraph 3540. The deposit is reported as an admitted asset of the ceding company if the reinsurer is licensed, accredited, certified or otherwise qualified in the ceding company's state of domicile as described in Appendix A-785, or if there are funds held by or on behalf of the ceding company as described in that appendix. Receipts and disbursements under the contract are recorded through the deposit/liability accounts. Amounts received in excess of the deposit made are recognized as a gain in the Other Income or Loss account.

Accounting entries for a ceding entity to report a retroactive reinsurance contract at the inception of which the cedent's reserves are lower than the attachment point of the reinsurance coverage:

Assume the company pays \$16m to purchase adverse development coverage of \$50m, above an attachment point.

Entry 1: Payment of Retrospective Reinsurance Premium

Retrospective Reinsurance Expense*	\$16m	
Cash		\$16m

The company pays \$16m premium for the retrospective reinsurance contract.  
\*This is an Other Expense item, it does not flow through Schedule F or Schedule P.

Entry 2: Adverse Development Reaches the Attachment Point

Losses Incurred	\$25m	
Gross Loss Reserve		\$25m
Recoverable on Retro Reinsurance Contract**	\$25m	
Other Income*		\$9m
Contra – Retro Reinsurance Expense*		\$16m
Surplus***	\$9m	
Segregated Surplus***		\$9m

The company incurs \$25m development on reserves related to the contract.  
\*These are Other Income/Expense items do not flow through Schedule F or Schedule P.  
\*\*A contra-liability write-in item; not netted against loss reserves.  
\*\*\*Surplus is segregated in the amount of [ $\$25m - \$16m = \$9m$ ] recoverables less consideration paid.

Entry 3: Cash is Recovered on Paid Losses

Cash	\$20m	
Recoverable on Retrospective Reinsurance Contract		\$20m
Segregated Surplus	\$4m	
Surplus		\$4m

The company recovers \$20m cash from reinsurer on this retro contract. Segregated Surplus decreases in the amount of [ $\$20m - \$16m = \$4m$ ] (decreases for amount recovered in excess of consideration paid).

3533. Q: How should a ceding company account for payment of the premium for a retroactive reinsurance contract by the ceding company's parent company or some other person not a party to the reinsurance contract (for example, adverse loss development reinsurance contracts purchased by the parent company in the context of the purchase or sale of the ceding company)?

- A: If the reinsurance premium is not paid directly by the ceding company but is instead paid on behalf of the ceding company by the ceding company's parent company or some other entity not a party to the reinsurance contract, then the ceding company should (1) record an increase in gross paid in and contributed surplus in the amount of the reinsurance premium to reflect the contribution to surplus by the parent or third party payor, and (2) record an expense in the amount of the reinsurance premium and account for the contract as provided in questions 3331 and 3432.

#### **EXHIBIT B – P&C RUNOFF REINSURANCE TRANSACTIONS**

*Exhibit is unchanged- Omitted to save space.*

#### **EXHIBIT C – ILLUSTRATION OF A REINSURANCE CONTRACT THAT IS ACCOUNTED FOR AS A DEPOSIT USING THE INTEREST METHOD**

*Exhibit is unchanged- Omitted to save space.*

#### **EXHIBIT D – ILLUSTRATION OF ASBESTOS AND POLLUTION COUNTERPARTY REPORTING EXCEPTION**

*Exhibit is unchanged- Omitted to save space*