Accounting Principles (E) Working Group

**Maintenance Agenda Submission Form**

**Form A**

## **Issue:** **Retroactive Reinsurance Exception**

**Check (applicable entity):**

 P/C Life Health

Modification of Existing SSAP [x]  [x]  [x]

New Issue or SSAP [ ]  [ ]  [ ]

Interpretation [ ]  [ ]  [ ]

Description of Issue:

At the 2019 Summer National Meeting, the Statutory Accounting Principles (E) Working Group, the Casualty Actuarial and Statistical (C) Task Force and the Surplus Lines (C) Task Force received a request from the Committee on Property and Liability Financial Reporting (COPLFR) of the American Academy of Actuaries Working Group. The request was to clarify the accounting and reporting for retroactive reinsurance which meets the *SSAP No. 62R—Property and Casualty Reinsurance* exceptions to be accounted for as prospective reinsurance. The request specifically asked for the NAIC groups to:

* Provide consistent guidance on the reporting treatment to both the ceding entity and assuming entity, where both are members of the same group and are consolidated in the same Combined Annual Statement.
* Clarify the reporting method to be used if the ceding entity and assuming entity are not in the same group.

This agenda item is to address the inconsistencies in application of the reinsurance accounting and reporting guidance, particularly the impact on Schedule P – Analysis of Losses and Loss Expenses (Schedule P) that were highlighted in the request.

The request indicated that COPLFR has noted that the guidance for portfolio retroactive reinsurance that meets the exceptions to be accounted for as prospective reinsurance (SSAP 62R, paragraph 36) but that does not meet the definition of Run-Off Agreements (SSAP 62R, paragraphs 102-105) is ambiguous regarding reporting requirements, and specifically the reporting in the NAIC Statutory Annual Statement’s Schedule P. The ambiguity has led to materially different presentations in Schedule P. The letter requested that this ambiguity in Schedule P presentation should be addressed, given that industry Schedule P is utilized for risk-based capital (RBC) purposes as well as other purposes, and given the increased propensity for companies to entertain partial loss portfolio transfers that do not fully meet the requirements of “Run-Off Agreements.”[[1]](#footnote-1)

Attached to the letter were two insurance company examples of publicly filed Schedule P’s illustrating this ambiguity. This resulted in different reporting in Schedule P of intercompany retroactive reinsurance agreements that met the intercompany exception for prospective accounting. Note that COPLFR did not state a preference for the approach and the impact on annual statement Schedule P.

* + Entity A in the retroactive cession (accounted for prospectively) initially reported the reinsurance premium paid as current calendar year ceded earned premium. Initially, entity A included all of the ceded losses in accident year 2015. However, for the following year, entity A recorded the ceded losses across the subject accident years and prior. This approach distorted the initial calendar year and accident year loss ratios and the loss development patterns for accident years 2015 and 2012 and prior years.
	+ Entity G in the year of the retroactive cession (accounted for prospectively) to a parent reported the reinsurance premium paid as ceded earned premium spread to prior calendar years (based on the allocation of loss reserves by accident year as of January 1, 2014), with the ceded losses also spread across prior accident years. This avoided distorting the calendar year / accident year loss ratios but distorted the loss development patterns.

 COPLFR noted that:

Attached to this letter are two insurance company examples of filed Schedule P’s illustrating this ambiguity. We note that the Schedule P information is publicly available data.

In 2015 Allianz Global Risks US Insurance Company (“Allianz”) ceded much of its 2012 & prior Workers Compensation (“WC”) business to a U.S. affiliate, San Francisco Reinsurance (“San Francisco Re”). San Francisco Re is now named Allianz Reinsurance of America, Inc. (“Allianz Re”). In doing so it treated all the consideration paid as calendar year (“CY”) 2015 ceded earned premium. Initially, as of December 31, 2015, Allianz included all of the ceded losses in accident year (“AY”) 2015. However, for the following year (as of December 31, 2016), Allianz recorded the ceded losses across the subject AYs 2012 and prior. This approach distorted the 2015 CY and AY loss ratios and the loss development patterns for AYs 2015 and 2012 and prior. We have attached the relevant Schedule P excerpts from Allianz’s 2015 and 2016 Annual Statements as Attachment A. Descriptions of the transaction are described in the Allianz Re Statement of Actuarial Opinion as of December 31, 2018, also a public document, in Attachment A1SAO. The Management Discussion and Analysis for Allianz Re as of December 31, 2018, is attached as Attachment A2MDA.

In 2014, Government Employees Insurance Company (“GEICO”) ceded half of its loss and Loss Adjustment Expense (hereinafter collectively referred to as “loss”) reserves as of January 1, 2014, to its indirect parent, National Indemnity Company (“NICO”). In doing so it treated the consideration paid as ceded earned premium spread to prior CYs (based on the allocation of loss reserves by AY as of January 1, 2014), with the ceded losses also spread across prior AYs. This avoided distorting the CY/AY loss ratios but did distort the loss development patterns. We have attached the Schedule P and Note 21 excerpts from the 2014 GEICO Annual Statement as Attachment B.

Both transactions had the potential to materially distort industry totals with regard to loss development. They also most likely did distort data used in the RBC calculations for those companies. We note that it is unclear from either SSAP 62R or Schedule P instructions whether either should have done anything different. Whether to record ceded earned premium all to one CY, or to all the CYs with impacted AYs, appears to be up to the individual company’s option. We also note that these transactions can distort other schedules on the Annual Statement such as Page 3, the Underwriting and Investment Exhibits, and Schedule F.

For those agreements meeting the definition of “Run-Off Agreements” in SSAP 62R (paragraph 81), the required accounting is clear. The ceded earned premium from such agreements is to be recorded as a negative paid loss, so as not to distort the incurred development data by AY. But neither the GEICO nor the Allianz agreements were “run-off” agreements as they transferred only a portion of the prior book (and the ceding companies were still writing new business for that line/market).

We suggest that the NAIC expand the Annual Statement Instructions, and recommend SSAP 62R be clarified, as follows:

* Provide consistent guidance on the reporting treatment in these situations to both the ceding entity and assuming entity, where both are members of the same group and are consolidated in the same Combined Annual Statement.
* Clarify the reporting method to be used if the ceding entity and assuming entity are not in the same group.

We note that the treatment of these transactions impacts the industry RBC calculation. If both sides handle the transaction the same way and both are U.S. reporting entities, the industry RBC calculation might not be impacted. However, the industry RBC calculation would be impacted if the two sides handle the transaction differently, or if one side was a U.S. company and the other side was a non-U.S. company. Therefore, we recommend clarification to the Annual Statement Instructions and SSAP 62R.

Existing Authoritative Literature:

SSAP No. 62R

**Accounting for Retroactive Reinsurance Agreements**

1. 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.
2. 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:
3. 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;
4. The assuming entity shall exclude the retroactive reinsurance from loss and loss expense reserves and from all schedules and exhibits;
5. 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;
6. 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;
7. 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;
8. 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 34.j.;
9. 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;
10. 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;
11. The assuming entity shall report the initial loss arising from a retroactive reinsurance transaction, as defined in the preceding paragraph 34.g., as a write-in item on the statement of income, to be identified as Retroactive Reinsurance Loss and included under Other Income;
12. 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 34.h. and 34.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
13. 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 in Exhibit A.)

1. 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.
2. The accounting principles for retroactive reinsurance agreements in paragraph 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):
3. Structured settlement annuities for individual claims purchased to implement settlements of policy obligations;
4. 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;
5. The termination of, or reduction in participation in, reinsurance treaties entered into in the ordinary course of business;
6. 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
7. Reinsurance/retrocession agreements that meet the criteria of property/casualty run-off agreements described in paragraphs 102-105.
8. 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:
9. The consideration paid by the ceding entity shall be recorded as a deposit and reported as a nonadmitted asset; and
10. No deduction shall be made from loss and loss adjustment expense reserves on the ceding entity’s balance sheet, schedules, and exhibits.
11. 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.
12. Novations meeting the requirements of paragraph 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.

Activity to Date (issues previously addressed by the Working Group, Emerging Accounting Issues (E) Working Group, SEC, FASB, other State Departments of Insurance or other NAIC groups): This request was received at the 2019 Summer National Meeting by the Statutory Accounting Principles (E) Working Group, the Casualty Actuarial and Statistical (C) Task Force and the Surplus Lines Task Force.

**Information or issues (included in *Description of Issue*) not previously contemplated by the Working Group:**

None

**Convergence with International Financial Reporting Standards (IFRS): not applicable**

Staff Recommendation:

NAIC staff agrees that there is diversity in practice and improved accounting and reporting guidance, with examples, would be beneficial. NAIC **staff recommends that the Working Group move this item to the active listing, categorized as nonsubstantive and expose a request for comments and for industry and regulator volunteers to assist with developing guidance.** The goal is to clarify both the accounting and reporting for retroactive contracts which are accounted for prospectively, including:

* Both the ceding entity and assuming entity, where both are members of the same group and are consolidated in the same Combined Annual Statement.
* The reporting method to be used if the ceding entity and assuming entity are not in the same group.

Comments are specially requested regarding the preferred approaches to reporting and the advantages and disadvantages to each approach being used, including both the Schedule P (and related loss analysis) and risk-based capital impacts.

NAIC staff also recommends that the Working Group direct a referral to notify the Casualty Actuarial (C) Task Force of the request for comments and the need for coordination.

Staff Review Completed by:

**Robin Marcotte** **- NAIC Staff**

**Status:**

On December 7, 2019, the Statutory Accounting Principles (E) Working Group moved this agenda item to the active listing, categorized as nonsubstantive, with a request for comments on the preferred approaches to reporting and the advantages and disadvantages to each approach being used, including impacts on the Schedule P (and related loss analysis) and risk-based capital. Industry and state insurance regulator volunteers are requested to assist with developing guidance to clarify both the accounting and reporting for retroactive contracts which are accounted for prospectively. The Working Group directed NAIC staff to notify the Casualty Actuarial and Statistical (C) Task Force of the request for comments.

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1. SSAP 62R gives guidance on the accounting treatment of “Run-Off Agreements,” but that definition only applies to situations where an insurer exits “essentially all the risks ... of a specific line” and no longer writes business in that line. That guidance does not address the increasingly common situation where an insurer cedes reserves from all or a portion of prior writings for a line but continues to write new/renewal business for that line, i.e., partial portfolio transfers. [↑](#footnote-ref-1)