

The Finite Controversy

Reinsurance Accounting & Reporting: Background, Developments, Illustrations

IASA Northeastern Chapter

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Insurance Resolutions, Inc.

Agenda

- Reinsurance Accounting under the spotlight
- Current GAAP and Statutory (SAP) Framework
- NAIC Statutory disclosure enhancements for 2005
- Deposit Accounting Illustrations
- References

Reinsurance Accounting under the Spotlight

- 2001-2003
 - Enron/Worldcom and other Accounting scandals
- 2004
 - Insurance Industry Accounting probes begin
 - Finite transactions receive special attention
- 2005
 - Spitzer/SEC force AIG's Greenberg out
 - States investigate & require additional disclosures
 - FASB initiates project on Risk Transfer
 - SEC investigates alleged abuses
 - NAIC requires additional disclosures
 - CAS proposes alternative Risk Transfer test



Current GAAP and Statutory Framework

Risk Transfer Evaluation

- Evaluate Risk Transfer
 - GAAP: SFAS 113
 - SAP: SSAP 62
 - Guidance for Evaluation is substantially the same
 - Must include both Underwriting and Timing risk
 - Informal “10/10” test has evolved
 - This is the area over which most controversy revolves
- Risk Transfer sufficient: use Reinsurance Accounting
- Risk Transfer insufficient: use Deposit Accounting

Current GAAP and Statutory Framework

Reinsurance Accounting

- Is coverage Prospective, Retroactive, or both?
 - GAAP and SAP use the same distinctions
 - Prospective covers future loss events
 - Retroactive covers loss events that have already occurred
- Prospective Reinsurance Accounting
 - GAAP SFAS 113 – Revenue and Cost recognition are handled as described in SFAS 60 – Balance Sheet is grossed up.
 - SAP – SSAP 62 – Revenue and Cost recognition substantially the same as GAAP. Balance Sheet is netted. Special Provisions apply.
- Retroactive Reinsurance Accounting
 - GAAP SFAS 113 – Gains are deferred and amortized over the settlement period
 - SAP SSAP 62 – Gains are recognized immediately. Special Provisions and Disclosures apply.

Current GAAP and Statutory Framework

Deposit Accounting

- Categorize contract among these types:
 - Transfer of Underwriting Risk only
 - Transfer of Timing Risk only
 - Neither or Indeterminate
- GAAP SOP 98-7
 - Underwriting Risk only:
 - Deposit = Unearned Premium plus PV recoveries
 - Accretion = incurred loss ; Discount rate = US treasury same duration
 - Timing Risk only:
 - Deposit = consideration minus fees
 - Accretion = interest income ; Discount rate = effective yield
 - Neither = same as Timing Risk only
 - Indeterminate = use SOP 92-5
- SAP SSAP 75
 - For all types use Timing Risk only method above



NAIC Statutory Disclosure Changes

- P&C interrogatory changes (9.1 -9.5)
- P&C Reinsurance Supplement
- P&C Reinsurance Attestation requirement
- SSAP 62 requires audit of new interrogatories



NAIC Statutory Disclosure Changes

General Interrogatories 9.1

- Companies respond “Yes” under 9.1 if:
 - company ceded risk under reinsurance contract(s) where :
 - underwriting results or calendar year written premium or year end loss & LAE reserves are impacted by more than 3% of prior year-end surplus (+ or -)
 - **And** the contract(s) are accounted for as reinsurance
 - **And** the contract(s) contain one or more of these types of features:
 - Non-cancelable or contract term longer than 2 years
 - Limited or Conditional cancellation provision
 - Aggregate Stop Loss reinsurance coverage
 - Unconditional or unilateral right to commute
 - Timing of payments/or features delaying reimbursement

NAIC Statutory Disclosure Changes

General Interrogatories 9.2

- Has the reporting entity during the period covered ceded any risk where:
 - The written premium ceded to the reinsurer by the reporting entity or its affiliates represents 50% or more of the entire direct and assumed premium written for the reinsurer
 - 25% or more of the written premium ceded to the reinsurer has been retroceded back to the reporting entity or its affiliates

Excludes approved pooling arrangements and captive insurance companies that are directly or indirectly controlling, controlled by, or under common control with one or more unaffiliated policyholders of the reporting entity or an association of which one or more unaffiliated policyholders of the reporting entity is a member.

NAIC Statutory Disclosure Changes

General Interrogatories 9.3

- Summary Supplemental Filing for “General Interrogatory 9” must be filed if Yes to 9.1 or 9.2:
 - Includes a summary of reinsurance contract terms and indication whether it applies to the contracts meeting the criteria in 9.1 and 9.2
 - A brief discussion of management’s principle objectives in entering into the reinsurance contract including the economic purpose to be achieved
 - The aggregate financial statement impact gross of all such ceded reinsurance contracts on the balance sheet and statement of income



NAIC Statutory Disclosure Changes

General Interrogatories 9.4 & 9.5

- 9.4: Statutory to GAAP differences:
 - Are there any reinsurance contracts that are accounted for as reinsurance for SAP and as Deposits for GAAP?
 - Are there any reinsurance contracts that are accounted for as reinsurance for GAAP and as Deposits for SAP?
- 9.5: If yes to 9.4, in the Reinsurance Supplement explain the different treatment

NAIC Statutory Disclosure Changes

Attestation Requirement (1)

“The CEO and CFO shall attest, under penalties of perjury, with respect to all reinsurance contracts for which the reporting entity is taking credit on its current financial statement, that to the best of their knowledge and belief after diligent inquiry...

Comments:

No materiality threshold. All Companies with or without reinsurance must file

NAIC Statutory Disclosure Changes

Attestation Requirement (2)

“

.....

1. There are no written or oral agreements between the reporting entity and the assuming reinsurer that would reduce, limit, mitigate or affect any actual or potential loss to the parties under the reinsurance contract, other than inuring contracts that are explicitly defined in the reinsurance contract except as disclosed

Comments:

Other agreements (outside the contract(s)) must be reviewed

NAIC Statutory Disclosure Changes

Attestation Requirement (3)

“ . . . :

2. For each such reinsurance contract entered into, renewed, or amended on or after 1/1/94 for which risk transfer is not reasonably considered to be self-evident, documentation concerning the economic intent of the transaction and the risk transfer analysis evidencing the proper accounting treatment is available for review:

Comments:

Economic intent is not defined under SSAP 62.

NAIC Statutory Disclosure Changes

Attestation Requirement (4)

“

3. The reporting entity complies with all the requirement set forth in SSAP 62 – *Property and Casualty Reinsurance*; and

Comments:

Prepare a brief training session for your CEO and CFO and all reinsurance personnel on SSAP 62

4. The reporting entity has appropriate controls in place to monitor the use of reinsurance and adhere to the provisions of SSAP 62 – *Property and Casualty Reinsurance*

Comments:

Incorporate into your SOX controls

Deposit Accounting Example 1 – Timing Risk Only

Premium at Inception	1,000
Coverage Period	1 Year
Total Recoveries	1,250
IRR (calculated)	7.93% Effective Yield
Ultimate Loss Ratio	125.00%

<u>End of Year</u>	<u>Cash Flow</u>	<u>Deposit Balance</u>	<u>Interest</u>	<u>Cash Recoveries</u>
0	(1,000)	1,000		
1	250	829	79	250
2	250	645	66	250
3	250	446	51	250
4	250	232	35	250
5	250	(0)	18	250

Deposit Accounting Example 1 – Timing Risk Only

GAAP Financial Statements

Accounted for as Reinsurance

XYZ Insurance Company GAAP Balance Sheet at End of Year

	<u>Year 1</u>	<u>Year 2</u>	<u>Year 3</u>	<u>Year 4</u>	<u>Year 5</u>
<u>Assets:</u>					
Cash	(750)	(500)	(250)	-	250
Deposit					
<u>Recoverable from Reinsurers</u>	<u>1,000</u>	<u>750</u>	<u>500</u>	<u>250</u>	<u>-</u>
Total Assets	<u>250</u>	<u>250</u>	<u>250</u>	<u>250</u>	<u>250</u>
<u>Liabilities:</u>					
<u>Equity:</u>					
Retained Earnings	250	250	250	250	250
Total Liabilities & Equity	<u>250</u>	<u>250</u>	<u>250</u>	<u>250</u>	<u>250</u>

XYZ Insurance Company GAAP Income Statement For Year Ended

	<u>Year 1</u>	<u>Year 2</u>	<u>Year 3</u>	<u>Year 4</u>	<u>Year 5</u>
<u>Underwriting Income:</u>					
Premiums earned (net)	(1,000)	-	-	-	-
Expenses (net)					
<u>Losses Incurred (net)</u>	<u>(1,250)</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>
Net Underwriting Income	250	-	-	-	-
<u>Investment Income:</u>					
Interest income					
Net Income	<u>250</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>



Deposit Accounting Example 1 – Timing Risk Only

GAAP Financial Statements

Accounted for using Deposit Accounting

XYZ Insurance Company GAAP Balance Sheet at End of Year

	<u>Year 1</u>	<u>Year 2</u>	<u>Year 3</u>	<u>Year 4</u>	<u>Year 5</u>
<u>Assets:</u>					
Cash	(750)	(500)	(250)	-	250
Deposit	829	645	446	232	(0)
Recoverable from Reinsurers	-	-	-	-	-
Total Assets	<u>79</u>	<u>145</u>	<u>196</u>	<u>232</u>	<u>250</u>
<u>Liabilities:</u>					
<u>Equity:</u>					
Retained Earnings	79	145	196	232	250
Total Liabilities & Equity	<u>79</u>	<u>145</u>	<u>196</u>	<u>232</u>	<u>250</u>

XYZ Insurance Company GAAP Income Statement For Year Ended

<u>Underwriting Income:</u>					
Premiums earned (net)					
Expenses (net)					
Losses Incurred (net)	-	-	-	-	-
Net Underwriting Income	-	-	-	-	-
<u>Investment Income:</u>					
Interest Income	79	66	51	35	18
Net Income	<u>79</u>	<u>66</u>	<u>51</u>	<u>35</u>	<u>18</u>



Deposit Accounting Example 2 -Underwriting Risk Only

Premium at Inception	1,000
Coverage Period	1 Year
Recoveries Paid at end	Year 5
Claim #1 - Year 2	2,500
US Gov 3 yr yield	8.00%
Claim #2 - Year 3	2,500
US Gov 2 yr yield	4.00%

<u>End of Year</u>	<u>Cash Flow</u>	<u>Premium Deposit</u>	<u>Claim #1 Deposit</u>	<u>Claim #2 Deposit</u>	<u>Amortization/ (Accretion) to Losses</u>	<u>Cash Recoveries</u>
0	(1,000)	1,000			-	
1	-	-			1,000	-
2	-	0	1,985		(1,985)	-
3	-	0	2,143	2,311	(2,470)	-
4	-	-	2,315	2,404	(264)	-
5	5,000	-	-	-	(281)	5,000

Deposit Accounting Example 2 – Underwriting Risk Only

GAAP Financial Statements

Accounted for as Reinsurance

XYZ Insurance Company GAAP Balance Sheet at End of Year

	<u>Year 1</u>	<u>Year 2</u>	<u>Year 3</u>	<u>Year 4</u>	<u>Year 5</u>
<u>Assets:</u>					
Cash	(1,000)	(1,000)	(1,000)	(1,000)	4,000
Deposit					
<u>Recoverable from Reinsurers</u>	<u>-</u>	<u>2,500</u>	<u>5,000</u>	<u>5,000</u>	<u>-</u>
Total Assets	<u>(1,000)</u>	<u>1,500</u>	<u>4,000</u>	<u>4,000</u>	<u>4,000</u>
 <u>Liabilities:</u>					
 <u>Equity:</u>					
Retained Earnings	(1,000)	1,500	4,000	4,000	4,000
Total Liabilities & Equity	<u>(1,000)</u>	<u>1,500</u>	<u>4,000</u>	<u>4,000</u>	<u>4,000</u>

XYZ Insurance Company GAAP Income Statement For Year Ended

	<u>Year 1</u>	<u>Year 2</u>	<u>Year 3</u>	<u>Year 4</u>	<u>Year 5</u>
<u>Underwriting Income:</u>					
Premiums earned (net)	(1,000)	-	-	-	-
Expenses (net)					
<u>Losses Incurred (net)</u>	<u>-</u>	<u>(2,500)</u>	<u>(2,500)</u>	<u>-</u>	<u>-</u>
Net Underwriting Income	(1,000)	2,500	2,500	-	-
 <u>Investment Income:</u>					
Interest income					
Net Income	<u>(1,000)</u>	<u>2,500</u>	<u>2,500</u>	<u>-</u>	<u>-</u>



Deposit Accounting Example 2 – Underwriting Risk Only

GAAP Financial Statements

Accounted for using Deposit Accounting

XYZ Insurance Company GAAP Balance Sheet at End of Year

	<u>Year 1</u>	<u>Year 2</u>	<u>Year 3</u>	<u>Year 4</u>	<u>Year 5</u>
<u>Assets:</u>					
Cash	(1,000)	(1,000)	(1,000)	(1,000)	4,000
Deposit	-	1,985	4,455	4,719	-
Recoverable from Reinsurers	-	-	-	-	-
Total Assets	<u>(1,000)</u>	<u>985</u>	<u>3,455</u>	<u>3,719</u>	<u>4,000</u>
 <u>Liabilities:</u>					
<u>Equity:</u>					
Retained Earnings	(1,000)	985	3,455	3,719	4,000
Total Liabilities & Equity	<u>(1,000)</u>	<u>985</u>	<u>3,455</u>	<u>3,719</u>	<u>4,000</u>

XYZ Insurance Company GAAP Income Statement For Year Ended

<u>Underwriting Income:</u>					
Premiums earned (net)					
Expenses (net)					
Losses Incurred (net)	<u>1,000</u>	<u>(1,985)</u>	<u>(2,470)</u>	<u>(264)</u>	<u>(281)</u>
Net Underwriting Income	<u>(1,000)</u>	<u>1,985</u>	<u>2,470</u>	<u>264</u>	<u>281</u>
 <u>Investment Income:</u>					
Investment Income	-	-	-	-	-
Net Income	<u>(1,000)</u>	<u>1,985</u>	<u>2,470</u>	<u>264</u>	<u>281</u>

References

- NAIC Accounting Practices & Procedures Manual (SSAP 62, SSAP 75)
- FASB (SFAS 5, SFAS 60, SFAS 113, EITF 93-6, EITF 93-14)
- AICPA (SOP 98-7)
- Casualty Actuarial Society – Report of the Working Party on Risk Transfer Testing

Disclaimer

- The opinions or positions expressed in this presentation do not necessarily reflect the opinions or positions of Insurance Resolutions, Inc. or any of our clients.



Questions

