and amounts due to insureds under retrospectively rated contracts are admitted assets to the extent they conform to the requirements of this issue paper.

6. Initial premiums shall be recognized in accordance with *Issue Paper No. 51—Life Contracts*, *Issue Paper No. 53—Property Casualty Contracts - Premiums* (Issue Paper No. 53) and *Issue Paper No. 54—Individual and Group Accident and Health Contracts*.

7. Because policy periods do not always correspond to reporting periods and because an insureds loss experience may not be known with certainty until some time after the policy period expires, retrospective premium adjustments shall be estimated based on the experience to date using one of the following methods:

a. Property and Casualty Contracts

i. Use of actuarially accepted methods in accordance with filed and approved retrospective rating plans. This includes but is not limited to the application of historical ratios of retrospective rated developments to earned standard premium to develop a ratio which is then applied to those policies for which no retrospective calculation has been recorded or for which no modification to the recorded calculation is needed. This method results in the calculation of one amount which is either a net asset or a net liability;

ii. Reviewing each individual retrospectively rated risk, comparing known loss development (including IBNR) with that anticipated in the policy contract to arrive at the best estimate of return or additional premium earned at that point in time. This method results in the calculation of an asset or a liability for each risk. The total of all receivables shall be recorded as an asset and the total of all return premiums shall be recorded as a liability.

b. Life and Accident & Health Contracts: Reporting entities offering group coverage have extensive underwriting procedures and complex individually negotiated benefits and contracts. Due to cost and reporting deadlines, these factors make it difficult to establish an exact valuation of retrospective premium. The method used to estimate the liability shall be reasonable based on the reporting entity’s procedures, and consistent among reporting periods. Common methods include a mathematical approach using a complex algorithm of the reporting entity’s underwriting rules and experience rating practices, and an aggregate or group approach.

8. Assumptions used in estimating retrospective premium adjustments shall be consistent with the assumptions made in recording other assets and liabilities necessary to reflect the underwriting results of the reporting entity such as claim and loss reserves (including IBNR) and contingent commissions. Contingent commissions and other related expenses shall be adjusted in the same period the additional or return retrospective premiums are recorded.

9. Retrospective premium adjustments are estimated for the portion of the policy period that has expired and shall be considered an immediate adjustment to premium. Additional retrospective premiums and return retrospective premiums shall be recorded as follows:

a. Property And Casualty Insurers:

i. Accrued additional retrospective premiums shall be recorded as a receivable with a corresponding entry made either to written premiums or as an adjustment to earned premiums. Premiums not recorded through written premium when accrued shall be recorded through written premium when billed;

financial guaranty coverage must allow the insured under the financial guaranty policy the same degree of access to payments under that policy as a beneficiary has under a qualified letter of credit.

Accrued retrospectively rated premiums relating to bulk IBNR must be allocated to individual policyholder accounts prior to categorizing by Quality Rating.

Insured's Current Quality Rating*****	Insured's Corporate Debit Equivalent to (S&P/Moody's)******	Percentage of Rat pto (S&P/M03rl6to

Disclosure

13. The financial statements shall disclose the method used by the reporting entity to estimate retrospective and other premium adjustments. The amount of net premiums written that are subject to retrospective rating features and other adjustments, as well as the corresponding percentage to total net premiums written, shall be disclosed.

14. The financial statements shall disclose the calculation of nonadmitted retrospective premium. If a reporting entity chooses treatment described in paragraph 10.c. or 10.d., the appropriate exhibit must be included in the notes to financial statements in the Annual Statement. Once a reporting entity has elected either 10.c. or 10.d., a change from one to the other requires approval from the reporting entity's domiciliary state and such change must be disclosed in the financial statements.

DISCUSSION

15. This issue paper addresses premium adjustments for retrospectively rated contracts. Premium adjustments that have been billed are also addressed in Issue Paper No. 6 and Issue Paper No. 10. The statutory principles outlined in the conclusion above are consistent with the current statutory guidance for accounting for retrospectively rated contracts except as follows:

a. Paragraph 10 requires property and casualty entities to record accrued retrospective premium credits as an aggregate write in for other liabilities whereas current statutory provides for retrospective premium credits to be recorded with unearned premiums.

b. Paragraph 12 requires that any impairment of recorded additional retrospective premiums be charged against operations in the period in which the impairment is determined.

c. Paragraph 14 expands the disclosure requirements that are currently in place for property and casualty insurers to life and accident & health entities.

d. Paragraph 11 expands the requirement for accident and health entities to nonadmit any retrospective premium balances that are more than 90 days past due to life insurers.

These changes were made to be consistent with the approach reflected for earned but unbilled premiums (EBUB) in Issue Paper No. 53 and with the approach reflected in Issue Paper No. 5 which requires the recognition of a loss when an asset has been impaired.

16. The statutory principles outlined in the conclusion above are consistent with the guidance provided for accounting for retrospectively rated insurance contracts in FAS 60 and EITF 93-14 with the exception of the requirement to record certain amounts as nonadmitted. Although FAS 60 is rejected in *Issue Paper No. 50—Classifications and Definition of Insurance or Managed Care Contracts In Force* and EITF 93-14 is rejected in this issue paper since it applies only to multiple-year retrospectively rated contracts, it is considered appropriate that the accounting for retrospectively rated contracts be consistent with those provisions of both FAS 60 and EITF 93-14 as they are consistent with the Statement of Concepts.

17. The statutory accounting principles outlined in the conclusion above are consistent with the recognition concept in the Statement of Concepts of which a pertinent excerpt follows:

> Recognition
>
> The ability to meet policyholder obligations is predicated on the existence of readily marketable assets available when both current and future obligations are due. Assets having economic value other than those which can be used to fulfill policyholder obligations, or those assets which may be unavailable due to encumbrances or other third party interests should not be recognized on

experience, but not to exceed the limitations, if any, contained in such policies or reinsurance agreements. Net of reinsurance; plus reinsurance assumed fund balance minus reinsurance ceded balance

Exclude: Agents' balances or uncollected premium items (Line 9.1 and Line 9.2) and accrued rate credits

The amount reported in Column I must be zero and the amount reported in Column 2 must agree with the amount reported on Page 8, Part 2A, Line 33.

Include as non-admitted in Column 3, amounts for accrued retrospective premiums which represent:

a. 100% of the amount recoverable from any person for whom any agents' balances or uncollected premiums (Lines 9.1 or 9.2)

Insured's Current Quality Rating*	Insured's Corporate Debt Equivalent to (S&P/Moody's)**	Percentage of Retro Premium to be Nonadmitted***
1	AAA, AA, A/Aaa, Aa, A	1%
2	BBB/Baa	2%
3	BB/Ba	5%
4	B/B	10%
5	CCC, CC, C/Caa, Ca	20%
6	CI, D/C, or insured in default on debt service payments, or insured's debt service payments are jeopardized upon filing of a bankruptcy petition.	100%

* The Percentage of Retro Premium to be Nonadmitted is based upon the Current Quality Rating (i.e., if an insured's quality rating drops, the percentage relating to the lower quality rating is used in calculating the amount to be nonadmitted and vice versa).

** Insureds that do not have a debt rating i

The maximum possible payment by the insured should also be at least 15% (7.5% for reinsurance contracts) above what the insured would pay based on expected loss experience. In other words, the maximum charge should not approximate the expected charge.

The additional payment shall be in the form of additional premiums or additional commissions.

The additional losses and corresponding payments must flow through the income and balance sheets and cannot be "off-balance sheet." For example, a deductible feature does not make a contract "loss sensitive" under this definition, as neither the losses under the deductible nor the reimbursements for these losses flow through the income statement.

2. In all development exhibits, only reported data as of year end 1993 and subsequent is required. Data for prior year ends is encouraged, but not required. For each year end, data for all issue years is required.

3. Schedule P, Part 7 is only required of insurers who claim a reduction in their Risk-Based Capital for Loss Sensitive Contracts. Such insurers must complete the entire schedule in each year that they claim such credit.

4. Schedule P, Part 7A provides experience on primary contracts. Schedule P, Part 7B provides experience on reinsurance contracts. The segregation should be consistent with the Risk-Based Capital formula.

<u>Current Year Loss and LAE Reserves and Net Written Premium</u>

5. Column (2) ir 80.964 (hsegregation should6by2 reidn should bPart 7 is only r262 0 0 103ers whort ation s.000

algorithm of the company's underwriting rules and experience rating practices. Other companies use aggregate or grouping approaches. Regardless of the approach used, the liability must stand the test of reasonableness and consistency. No company should pay experience refunds unless its contracts provide for such payment.

The experience rating refund may be reported as a separate liability item or may be included as an active life reserve.

28. The Life/A&H Accounting Practices and Procedures Manual, Chapter 15, Liabilities Related to Policyholder Dividends, provides the following guidance with respect to experience rated contracts:

<u>Experience Rating Refunds (Retrospective Rate Credits)</u>

Nonparticipating group insurance and pension contracts may be subject to experience rating. Experience credits for a given group are usually developed by determining the excess, if any, of the premium and investment income earned with respect to the group over the corresponding benefits and expenses incurred with respect to the group and applying an appropriate credibility adjustment to that excess.

At specified dates, such as the contract anniversary or the end of the calendar year, the experience of the contract is calculated and the refund, if any, is paid. If the balance sheet date falls between the dates on which the refund is paid, the experience up to the balance sheet date is calculated and the appropriate liability is established.

Generally Accepted Accounting Principles

29. FAS 60, paragraph 14, states the following:

If premiums are subject to adjustment (for example, retrospectively rated or other experience rated insurance contracts for which the premium is determined after the period of the contract based on claim experience or reporting-form contracts for which the premium is adjusted after the period of the contract based on the value of insured property), premium revenue shall be recognized as follows:

a. If, as is usually the case, the ultimate premium is reasonably estimable, the estimated ultimate premium shall be recognized as revenue over the period of the contract. The estimated ultimate premium shall be revised to reflect current experience.

b. If the ultimate premium cannot be reasonably estimated, the cost of recovery method or the deposit method may be used until the ultimate premium becomes reasonably estimable.

30. FAS 60, paragraph 44, states the following:

Retrospective and Contingent Commission Arrangements

If retrospective commission or experience refund arrangements exist under experience-rated insurance contracts, a separate liability shall be accrued for those amounts, based on experience and the provisions of the contract. Income in any period shall not include any amounts that are expected to be paid to agents or others in the form of experience refunds or additional commissions. Contingent commissions receivable or payable shall be accrued over the period in which related income is recognized.

31. EITF 93-14, includes the following:

ISSUE

An enterprise (for example, a manufacturing concern, a retailer, a service entity, or a financial institution) enters into a multiple-year retrospectively rated contract with an insurance company.

The insured should recognize an asset and the insurer should recognize a liability to the extent that any cash (or other consideration) would be payable by the insurer to the insured based on experience to date under the contract.

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

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

The provisions of this consensus are effective as of November 18, 1993 and should be initially applied no later than the fourth quarter of 1993 for calendar-year enterprises in one of two ways:

1. By recognition of the net effect of applying the provisions at the beginning of an enterprise's current fiscal year as a cumulative effect of a change in accounting principle in accordance with paragraph 20 of Opinion 20. Under this approach, the disclosures required by paragraph 21 of Opinion 20 would be required as long as the income statement for the current fiscal year is presented. The provisions of Statement 3 apply to all interim periods presented.

2. By restatement of financial statements for all periods presented. The Task Force noted that the FASB Staff Views on Issue 93-6 that appear as Topic No. D-35 in Appendix D are useful guidance for applying this consensus.

STATUS

No further EITF discussion is planned.

RELEVANT LITERATURE

Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, Chapters 7, 9 and 12
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies - Chapters 13 and 15
- NAIC Annual Statement Instructions
- *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets* and[(Com)8(p)-2

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