Statutory Issue Paper No. 74

Life, Deposit-Type and Accident and Health Reinsurance

STATUS
Finalized March 16, 1998

Original SSAP: SSAP No. 61; Current Authoritative Guidance: SSAP No. 61R

This issue paper may not be directly related to the current authoritative statement.

Type of Issue:
Life Specific

SUMMARY OF ISSUE

1. Reinsurance is an agreement by which a reporting entity transfers all or part of its risk under a contract to another reporting entity. Current statutory guidance on the accounting for life and accident and health reinsurance is contained in Chapters 17, 21 and 24 of the Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies (Life/A&H Accounting Practices and Procedures Manual).

2. GAAP guidance on the accounting for life and accident and health reinsurance is primarily contained in *FASB Statement No. 113*, *Accounting and Reporting for Reinsurance of Short-Duration and*

notes 10 through 15 to the Annual Statement. These disclosures (included in paragraph 18 of this issue paper) are also adopted as statutory accounting principles.

6. If it is probable that reinsurance recoverables on paid or unpaid claim or benefit payments will be uncollectible, consistent with *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets,* amounts shall be written off through a charge to the Statement of Operations by reversing the accounts previously utilized to establish the reinsurance recoverable.

DISCUSSION

7. The statutory accounting for life and accident and health reinsurance was recently revised through amendments to Chapter 24 and further clarified by the proposed Actuarial Guideline JJJ. The GAAP guidance for life and accident and health reinsurance is contained principally within FAS No. 113 which is adopted with modification for property and casualty reinsurance in *Issue Paper No. 75—Property and Casualty Reinsurance* and by this issue paper for life, deposit-type and accident and health reinsurance. This issue paper applies to all accident and health reinsurance written by life and health and property and casualty insurers. The statutory accounting principles established by this issue paper differ substantially from GAAP, reflecting much more detailed guidance as follows:

a. Reserve credits taken by ceding entities as a result of reinsurance contracts are netted against the ceding entity's policy and claim reserves and unpaid claims. Under GAAP, reinsurance recoverables are reported as assets.

b. For statutory reporting, first year and renewal ceding commissions on indemnity reinsurance of new business (ceding commissions on ceded in-force business are included in the calculation of initial gain or ,n thd0.0008 Tc 5.1103 T319 [illegible]

12. The statutory accounting for non-economic assumption reinsurance transactions between affiliated entities is consistent with *Issue Paper No. 25—Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties*.

13. The statutory requirement to establish a liability, Reinsurance in Unauthorized Companies, for unsecured reinsurance recoverables from unauthorized reinsurers is contained in various state statutes, the Life/A&H Accounting Practices and Procedures Manual (Chapter 17) and the Instructions to the Life, Accident and Health Annual Statement, Schedule S - Part 3. This requirement maintains current statutory accounting, and is consistent with the recognition concept and conservatism concept in the Statement of Concepts, which also allows for certain mandated liabilities.

> Liabilities require recognition as they are incurred. Certain statutorily mandated liabilities may also be required to arrive at conservative estimates of liabilities and probable loss contingencies (e.g., excess of statutory over statement reserves, interest maintenance reserves, asset valuation reserves, and others).
>
> Financial reporting by insurance enterprises requires the use of substantial judgments and estimates by management. Such estimates may vary from the actual amounts for numerous reasons. To the extent that factors or events result in adverse variation from management's accounting estimates, the ability to meet policyholders obligations may be lessened. In order to provide a margin of protection for policyholders, the concept of conservatism should be followed when developing estimates as well as establishing accounting principles for statutory reporting.

Drafting Notes/Comments

reserve adjustments, experience rating refunds, and estimated incurred but not reported claim liabilities, less

4. Deposits by or funds withheld from the reinsurer, as provided for in the reinsurance treaty, pledged as security for the payment of reinsurance obligations. Such deposits or funds are typically held by the ceding company or are placed in a trust or custodial agreement. Amounts placed in trust or custodial accounts are held subject to withdrawal by, and under the control of, the ceding insurer, less

5. Amounts of reinsurance recoverables covered by a clean, irrevocable letter of credit issued by a qualified banking institution, less

6. Amounts contractually due the assuming company.

The net liability defined above should never be less than zero for any particular reinsurer. Caution should be exercised in taking credit for items in 4, 5, and 6 above since state requirements vary considerably. The change in liability for unauthorized reinsurance is a direct charge or credit to surplus.

Funds Held Under Reinsurance Treaties with Unauthorized Reinsurers

This liability is for funds deposited by or contractually withheld from unauthorized reinsurers. Please note that the withholding of reinsurance premiums represents only one method of securing net reinsurance liabilities. Letters of credit from or funds escrowed in a financial institution represent two other commonly accepted methods.

15. Chapter 21 of the Life/A&H Accounting Practices and Procedures Manual provides the following guidance on expense allowances and reinsurance commissions:

Expense Allowances on Reinsurance

For reinsurance it is common for the assuming insurer to provide an expense allowance to cover expenses of the ceding insurer. The allowance is frequently nonspecific with respect to premium taxes and other general expenses of the ceding insurer and it is usually combined with and accounted for as part of the commissions on reinsurance assumed or ceded.

The portion of reinsurance expense allowances which represents specific reimbursement of premium taxes should be accounted for as premium tax. Any portion specifically reimbursing general expenses should be accounted for as other general expense. Each should be excluded from commissions and expense allowances on reinsurance assumed or ceded.

Reinsurance Commission Accounting Practices

Under current statutory accounting practices and procedures, commissions on direct business, commissions and expense allowances on reinsurance assumed, and commissions and expense allowances on reinsurance ceded are each accounted for separately in the Summary of Operations and on the balance sheet. Accordingly, commissions and expense allowances on reinsurance ceded are reported as income or revenue earned in the Summary of Operations and the balance sheet provision for due and accrued amounts is reported as an asset. This differs from the more customary statutory accounting practice of reporting insurance transactions net of reinsurance in the Summary of Operations and on the balance sheet with reliance upon supporting exhibits for the reinsurance information.

16. Chapter 24 of the Life/A&H Accounting Practices and Procedures Manual provides statutory accounting guidance for life and accident and health reinsurance. A portion of that guidance is excerpted below:

© 1999-2015 National Association of Insurance Commissioners

A. Indemnity Reinsurance

Transfer of Risk

Reinsurance agreements must transfer risk from the ceding company to the reinsurer in order to receive the reinsurance accounting treatment discussed in this chapter. If the terms of the agreement violate the risk transfer criteria contained herein, i.e., limits or diminishes the transfer of risk by the ceding company to the reinsurer, the agreement shall be accounted for as discussed in the Deposit Accounting section below. In addition, any contractual feature that delays timely reimbursement, violates the conditions of reinsurance accounting.

This paragraph applies to all life and accident and health reinsurance agreements except for yearly renewable term reinsurance agreements and non-proportional reinsurance agreements such as stop loss and catastrophe reinsurance. All reinsurance agreements covering insurance products or similar products of the type identified in A(6) of Appendix A shall follow the guidance for reinsurance accounting contained in this chapter provided the reinsurance agreement (1) transfers significant insurance risk and (2) does not contain any of the conditions set forth in Appendix A. All products not of the type identified in A(6) of Appendix A or covered in the following two paragraphs, shall follow the guidance for reinsurance accounting contained in this chapter provided that the agreement (1) transfers one or more of the risk categories described in A(6) and (2) does not contain any of the conditions set forth in Appendix A. Contracts that fail to meet the requirements for reinsurance accounting shall follow the guidance contained in the Deposit Accounting section.

Yearly renewable term reinsurance agreements that transfer a proportionate share of mortality or morbidity risk inherent in the business being reinsured and do not contain any of the conditions described in Appendix A(2), (3), (4), (8), (9), (10) or (11), shall follow the guidance for reinsurance accounting. Contracts that fail to meet the requirements for reinsurance accounting shall follow the guidance contained in the Deposit Accounting section.

For non-proportional reinsurance agreements such as stop loss and catastrophe reinsurance agreements, contract terms should be evaluated to assess whether they transfer significant risk to the reinsurer. For example, prepayment schedules and accumulating retentions from multiple years are contractual features inherently designed to delay the timing of reimbursement to the ceding company limits the risk to the reinsurer. 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 company 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. Reinsurance accounting shall apply to all non-proportional agreements that transfer significant risk and do not contain any provisions that protect the reinsurer from incurring a loss. Contracts that fail to meet the requirements for reinsurance accounting shall follow the guidance contained in the Deposit Accounting section.

Accounting and Reporting of Reinsurance

The obligation of reporting reinsurance in force and of determining unpaid premiums and incurred claims and other balances is generally on the ceding company because it knows the current status of the policies it has written directly and reinsured. A lag will develop between the time of the entry of the underlying policy transaction on the books of the ceding company and the transmittal of information and its entry on the books of the assuming company. The assuming company shall estimate any material unreported premiums and related costs, since it alone has the responsibility for determining its own financial condition and for preparing accurate financial statements.

© 1999-2015 National Association of Insurance Commissioners

The ceding company must report these items in its balance sheet:

1. Credits (deductions) to its policy and claim reserves and unpaid claims;
2. Premiums or other amounts payable on reinsured risks;
3. Amounts recoverable on claims, surrender values, dividends, experience rating refunds, taxes, commissions, and other expenses;
4. Modified coinsurance reserves; and
5. Amounts receivable or payable for funds withheld.

Similarly, in its balance sheet, the assuming company must report:

1. Reserves for reinsurance assumed reduced by any modified coinsurance reserves;
2. Reinsurance premiums receivable or other amounts receivable
3. Amounts payable for claims, surrender values, dividends, experience rating refunds, taxes, commissions, and other expenses; and
4. Amounts receivable or payable for funds withheld by the ceding company.

While the various balances that a company (ceding or assuming) has with its reinsurance partners will result in a net amount, the proper way to report them is in their separate classifications. The balances of one company shall not be netted against those of any other company. Each reinsurance agreement must be accounted for separately.

Reinsurance Premiums

For all reinsurance arrangements, the assuming company must report premiums under the terms of the reinsurance contract as income and establish any asset or liability consistent with the methods and assumptions used to establish its policy reserves and guidance contained in Chapter 18, Premium Income, of this manual. The ceding company shall reduce premium income by the amounts paid or payable to the reinsurers. The ceding company shall reduce its deferred and uncollected premiums reported as an asset and the assuming company shall record an asset for premiums payable to the reinsurer on those insurance policies with premiums collected on a basis more frequent than annual covered by the reinsurance arrangement. On those insurance policies covered by the reinsurance arrangement with premiums collected annually, the ceding company shall establish a liability and the assuming company shall record an asset for premiums payable to the reinsurer.

Reinsurance Benefit Payments

Policy benefit payments paid or payable by the reinsurer shall be reported in the Summary of Operations and reduces the ceding company's reported benefit payments. The reinsurer shall establish a liability for its share of any unpaid claim payments and the ceding company shall reduce any policy and contract claim liability with respect to the reinsured policies or establish a receivable for the amount due from the reinsurer for claims paid.

Expenses

The taxes, commissions, and other expenses that will be paid by the assuming company to the ceding company are agreed upon when the reinsurance agreement is negotiated. These items are calculated in accordance with the reinsurance agreement and usually relate to premiums or claims or both. At the statement date, the amount of unpaid expenses is generally based upon the amount of premiums and claims unpaid at that date.

Some coinsurance contracts provide that the assuming company pay to the ceding company a commission that exceeds the first-year premium. In the absence of any guarantees for payment of future premiums (for example, persistency guarantees), these commissions are accounted for on the cash basis. If, however, the ceding company guarantees that premiums will be paid in the future, which, in essence, returns the excess commission, it must record the excess commission as a liability. This liability is then to be released as future premiums are paid to the assuming

© 1999-2015 National Association of Insurance Commissioners

company. The rate of release is determined in accordance with the anticipated experience and reasonable commission rate for first-year and renewal premiums. Excess commissions such as these are nothing more than a means of financing for the ceding company.

If renewal expense allowances in any accounting period are not sufficient to cover anticipated allocable renewal expenses of the ceding insurer on the portion of the business reinsured, a liability is to be established by the ceding company

Recaptures and Commutations

A recapture or a commutation of a reinsurance agreement is a transaction which results in the complete and final settlement and discharge of all present and future obligations between the parties arising out of the agreement or a portion of the agreement. Reasons for commuting reinsurance agreements often include: perceived financial instability of the reinsurer, inefficiencies associated with the runoff of longer tailed liabilities, or significantly different evaluation of ultimate loss costs. The assumed reserves and reserve credits taken are eliminated by the reinsurer and ceding insurer, respectively. The reinsurer and ceding insurer must also make any required IMR liability adjustment changes. Any net gain or loss is reported in the Summary of Operations.

Deposit Accounting

To the extent that a reinsurance contract does not, despite its form, provide for sufficient transfer of risk, amounts paid are to be accounted for and reported as deposits in the NAIC annual and interim financial statements in the following manner:

1. At the outset of the reinsurance contract the net consideration paid by the ceding company (premiums less commissions or other allowances) shall be recorded as a deposit on the ceding company's books and as a liability on the assuming company's books. The deposit may be reported as an asset in the ceding company's statement if (a) the assuming company is licensed, accredited or otherwise qualified in the ceding company's state of domicile under Section 1 of the NAIC Model Law on Credit for Reinsurance or (b) there are funds held by or on behalf of the ceding company which meet the requirements of Section 2 of that law. Throughout the life of the contract receipts and disbursements shall be recorded through the deposit/liability accounts. Income and losses shall be recognized by a party when, according to the terms of the contract, it has earned the amount and the other party has no recourse to repayment of such amount in future periods. When the contract is completed, or when there is a loss payment in excess of the deposit, any difference between consideration and recoveries shall be recorded as other miscellaneous insurance income or miscellaneous insurance loss.

2. No deduction shall be made from the policy or claim reserves on the ceding company's balance sheet, schedules and exhibits.

3. The assuming company shall record net considerations to be returned to the ceding company as liabilities.

B. Assumption Reinsurance

A company may sell all or part of a block of insurance business through an assumption reinsurance agreement. Typically, under an assumption reinsurance arrangement, the reinsurance contract is intended to effect a novation, thereby to extinguish the ceding company's liability to the policyholder. Assumption reinsurance requires that the reinsurer issue assumption certificates to the existing policyholders and take over responsibility for policyholder services. On occasion, the reinsurer will contract with the original company to continue to provide such services on a fee basis or may contract with a third party. Regulatory approval of assumption reinsurance arrangements is usually required. Approval is also usually required from the policyholders, who have a predetermined time period in which to accept or reject the reinsurance transfer. After the deadline has passed, approval is considered implied for all outstanding responses. For those policyholders that reject the transfer, the reinsurance agreement typically converts to a indemnity arrangement. Under this circumstance, reinsurance accounting, as defined earlier in this chapter, is to be followed.

© 1999-2015 National Association of Insurance Commissioners

accounted for prospectively as deposits with the appropriate reclassification of outstanding reinsurance balances as deposits with no surplus impact; or (c) amended on or after January 1, 1996, a change in accounting principle associated with the revised accounting in this chapter shall be applied prospectively with no adjustment to surplus. Not withstanding the effective dates noted above, any insurer which has previously been subject to compliance with the Life and Health Reinsurance Agreements Model Regulation or substantially similar regulation shall be guided by the effective date of the regulation.

CHAPTER 24 — APPENDIX A

The contents of this appendix is taken from the Life and Health Reinsurance Agreements Model Regulation.

Section 4. Accounting Requirements

A. No insurer subject to this regulation shall, for reinsurance ceded, reduce liability or establish any asset in any financial statement filed with the Department if, by the terms of the reinsurance agreement, in substance or effect, any of the following conditions exist:

(1) Renewal expense allowances provided or to be provided to the ceding ins by the reinsurer in any accounting period are not sufficient to cover anticipated allocable renewal expenses of the ceding insurer on the portion of the business reinsured, unless a liability is established for the present value of the shortfall (using assumptions equal to the applicable statutory reserve basis on the business reinsured). Those expenses include commissions, premium taxes and direct expenses including, but not limited to, billing, valuation, claims and maintenance expected by the company at the time the business is reinsured;

(2) The ceding insurer can be deprived of surplus or assets at the reinsurer’s option or automatically upon the occurrence of some event, such as the insolvency of the ceding insurer, except that termination of the reinsurance agreement by the reinsurer for nonpayment of reinsurance premiums or other amounts due, such as modified coinsurance reserve adjustments, interest and adjustments on funds withheld, and tax reimbursements, shall not be considered to be such a deprivation of surplus or assets;

(3) The ceding insurer is required to reimburse the reinsurer for negative experience under the reinsurance agreement, except that neither offsetting experience refunds against current and prior years’ losses under the agreement nor payment by the ceding insurer of an amount equal to current and prior years’ losses under the agreement upon voluntary termination of in force reinsurance by the ceding insurer shall be considered such a reimbursement to the reinsurer for negative experience. Voluntary termination does not include situations where termination occurs because of unreasonable provisions which allow the reinsurer to reduce its risk under the agreement. An example of such a provision is the right of the reinsurer to increase reinsurance premiums or risk and expense charges to excessive levels forcing the ceding company to prematurely terminate the reinsurance treaty;

(4) The ceding insurer must, at specific points in time scheduled in the agreement, terminate or automatically recapture all or part of the reinsurance ceded;

© 1999-2015 National Association of Insurance Commissioners

(5) The reinsurance agreement involves the possible payment by the ceding insurer to the reinsurer of amounts other than from income realized from the reinsured policies. For example, it is improper for a ceding company to pay reinsurance premiums, or other fees or charges to a reinsurer which are greater than the direct premiums collected by the ceding company;

(6) The treaty does not transfer all of the significant risk inherent in the business being reinsured. The following table identifies for a representative sampling of products or type of business, the risks which are considered to be significant. For products not specifically included, the risks determined to be significant shall be consistent with this table.

Risk categories:

(a) Morbidity

(b) Mortality

(c) Lapse

This is the risk that a policy will voluntarily terminate prior to the recoupment of a statutory surplus strain experienced at issue of the policy.

(d) Credit Quality (Cl)

This is the risk that invested assets supporting the reinsured business will decrease in value. The main hazards are that assets will default or that there will be a decrease in earning power. It excludes market value declines due to changes in interest rate.

(e) Reinvestment (C3)

This is the risk that interest rates will fall and funds reinvested (coupon payments or monies received upon asset maturity or call) will therefore earn less than expected. If asset durations are less than liability durations, the mismatch will increase.

(f) Disintermediation (C3)

This is the risk that interest rates rise and policy loans and surrenders increase or maturing contracts do not renew at anticipated rates of renewal. If asset durations are greater than the liability durations, the mismatch will increase. Policyholders will move their funds into new products offering higher rates. The company may have to sell assets at a loss to provide for these withdrawals.

+ – Significant 0 – Insignificant

© 1999-2015 National Association of Insurance Commissioners

RISK CATEGORY

	a	b	c	d	e	f
Health Insurance—other than LTC/LTD*	+	0	+	0	0	0
Health Insurance—LTC/LTD*	+	0	+	+	+	0
Immediate Annuities	0	+	0	+	+	0
Single Premium Deferred Annuities	0	0	+	+	+	+
Flexible Premium Deferred Annuities	0	0	+	+	+	+
Guaranteed Interest Contracts	0	0	0	+	+	+
Other Annuity Deposit Business	0	0	+	+	+	+
Single Premium Whole Life	0	+	+	+	+	+
Traditional Non-Par Permanent	0	+	+	+	+	+
Traditional Non-Par Term	0	+	+	0	0	0
Traditional Par Permanent	0	+	+	+	+	+
Traditional Par Term	0	+	+	0	0	0
Adjustable Premium Permanent	0	+	+	+	+	+
Indeterminate Premium Permanent	0	+	+	+	+	+
Universal Life Flexible Premium	0	+	+	+	+	+
Universal Life Fixed Premium	0	+	+	+	+	+
Universal Life Fix Premium dump-in premiums allowed	0	+	+	+	+	+

*LTC = Long Term Care Insurance

LTD = Long Term Disability Insurance

(7) (a) The credit quality, reinvestment, or disintermediation risk is significant for the business reinsured and the ceding company does not (other than for the classes of business excepted in Paragraph (7)(b)) either transfer the underlying assets to the reinsurer or legally segregate such assets in a trust or escrow account or otherwise establish a mechanism satisfactory to the commissioner which legally segregates, by contract or contract provision, the underlying assets.

(b) Notwithstanding the requirements of Paragraph (7)(a), the assets supporting the reserves for the following classes of business and any classes of business which do not have a significant credit quality, reinvestment or disintermediation risk may be held by the ceding company without segregation of such assets:

- Health Insurance—LTC/LTD
- Traditional Non-Par Permanent

© 1999-2015 National Association of Insurance Commissioners

- Traditional Par Permanent
- Adjustable Premium Permanent
- Indeterminate Premium Permanent
- Universal Life Fixed Premium
  (no dump-in premiums allowed)

The associated formula for determining the reserve interest rate adjustment must use a formula which reflects the ceding company's investment earnings and incorporates all realized and unrealized gains and losses reflected in the statutory statement. The following is an acceptable formula:

$$\text{Rate} = \frac{2(I + CG)}{X + Y - I - CG}$$

Where:

I is the net investment income (Exhibit 2, Line 16, Column 7)

CG is capital gains less capital losses (Exhibit 4, Line 10, Column 6)

X is the current year cash and invested assets (Page 2, Line 10A, Column 1) plus investment income due and accrued (Page 2, Line 16, Column 1) less borrowed money (Page 3, Line 22, Column 1)

Y is the same as X but for the prior year

Drafting Note: Line references are for the 1992 annual statement. Line references may be deleted or should be updated if regulation is adopted after calendar year 1992. Be aware that annual statement line references may change from year to year.

(8) Settlements are made less frequently than quarterly or payments due from the

documentation and be prepared upon request to describe the actuarial work performed for inclusion in the financial statements and to demonstrate that such work conforms to this regulation.

(2) Any increase in surplus net of federal income tax resulting from arrangements described in Subsection C(1) shall be identified separately on the insurer's statutory financial statement as a surplus item (aggregate write-ins for gains and losses in surplus in the Capital and Surplus Account, page 4 of the Annual Statement) and recognition of the surplus increase as income shall be reflected on a net of tax basis in the "Reinsurance ceded" line, page 4 of the Annual Statement as earnings emerge from the business reinsured.

{For example, on the last day of calendar year N, company XYZ pays a $20 million initial commission and expense allowance to company ABC for reinsuring an existing block of business. Assuming a 34% tax rate, the net increase in surplus at inception is $13.2 million ($20 million—$6.8 million) which is reported on the "Aggregate write-ins for gains and losses in surplus" line in the Capital and Surplus account. $6.8 million (34% of $20 million) is reported as income on the "Commissions and expense allowances on reinsurance ceded" line of the Summary of Operations.

At the end of year N+1 the business has earned $4 million. ABC has paid $.5 million in profit and risk charges in arrears for the year and has received a $1 million experience refund. Company ABC's annual statement would report $1.65 million (66% of [$4 million—$1 million—$.5 million] up to a maximum of $13.2 million) on the "Commissions and expense allowance on reinsurance ceded" line of the Summary of Operations, and—$1.65 million on the "Aggregate write-ins for gains and losses in surplus" line of the Capital and Surplus account. The experience refund would be reported separately as a miscellaneous income item in the Summary of Operations.}

17. The proposed Actuarial Guideline JJJ, which follows, provided further clarification of reinsurance accounting:

Draft: 11/17/95

Adopted by the Life and Health Actuarial (Technical) Task Force on 12/1/95

ACTUARIAL GUIDELINE JJJ

GUIDELINE CONCERNING QUESTIONS AND ANSWERS RELATED

<u>Text</u>

Section 3

Question: Aside from assumption reinsurance, what other type of reinsurance is exempt from the model regulation?

Answer: The model exempts all yearly renewable term (YRT) and certain nonproportional reinsurance arrangements, such as stop loss and catastrophic reinsurance. The purpose behind the exemption of these types of arrangements was because these did not normally provide significant surplus relief and therefore were not the target of this regulation. Users of the regulation should, however, be cautious of any reinsurance arrangements which could be created to misstate a company's true financial position or attempt to circumvent the regulation by artificially labeling an agreement YRT. If a YRT provides incidental reserve credits for the ceding

premium payable. The funds may also be used, similar to modco, to hold funds to be applied against FUTURE claim payments, with the funds having no other liability. To the extent that funds are available solely for paying future claims, such amount may be used to reduce the otherwise nonadmitted reserve credit. Care must be taken that no reduction in the nonadmitted reserve credit be taken when funds serve another purpose, such as being payable to the reinsurer, in addition to the reinsurer's obligation to pay claims.

An insurer is legally able to enter into contracts with other entities, including other insurers. The provisions of such a contract will be required to be accounted for based on the terms and conditions of the agreement. If the agreement meets the conditions of an acceptable reinsurance arrangement, the ceding insurer is afforded the additional benefit of being able to reduce its otherwise required statutory liabilities by a reserve "credit." If the agreement does not meet the conditions of this regulation, no reserve credit, whether as an asset or as an offset to liability, may be taken. This treatment does not rescind or otherwise eliminate the existence of the contract. Additional pertinent information is contained in the reinsurance chapter of the NAIC Accounting Practices and Procedures Manual which provides accounting guidance for such agreements.

Section 4A(1)

Question: What should be included in the renewal expense allowances with regard to direct expenses? An allocation of salaries? Computer usage? Or just marginal expenses directly related to the business reinsured such as claim payment expenses, postage, etc.? Should the renewal expense allowances cover actual anticipated allocable expenses of a small company in a start-up mode (i.e. high expenses) or should they be based on what expected expenses would be once the company is more mature?

Answer: The primary purpose of the model regulation is to prohibit credit for reinsurance under financial arrangements where the ceding company enters into an agreement for the principal purpose of producing significant surplus aid for the ceding insurer on a temporary basis, while not transferring all of the significant risks inherent in the business being reinsured.

Section 4A(1) implements the purpose of the model by prohibiting credit for reinsurance in certain instances where the ceding insurer is afforded a large ceding commission at the inception of the agreement resulting in a significant increase in surplus only to have the surplus increase be drained away in subsequent periods because renewal expense allowances provided under the agreement are insufficient to cover the direct allocable costs estimated at the time the business is reinsured, which are anticipated to be incurred by the ceding insurer in maintaining the business reinsured.

The model allows an exception to complete disallowance of credit for reinsurance in situations where the ceding insurer reflects a liability for the present value of the shortage between renewal expense allowances provided under the agreement and the direct allocable costs expected in the future by the insurer in maintaining the business reinsured. This liability must be calculated using actuarial assumptions that are consistent with those utilized in the statutory reserve calculation. The expenses to be accounted for in establishing this liability should represent all costs of the ceding insurer in servicing the business that is subject to the agreement.

In determining what the ceding insurer should include in the renewal expenses with regard to direct expenses, there should be an allocation of all renewal expenses anticipated at the time the business is reinsured including salaries, computer usage, postage, etc. This comprehensive calculation should be done regardless of whether a company is in a start-up mode (and experiencing high expenses) or is otherwise more mature but, recognizing that the anticipated expense levels may be estimated, a comparison with pricing assumptions may be considered in determining the reasonableness of such assumptions.

If insurance department staff encounter an agreement that does not comply with Section 4A(1) of the model, this area of non-compliance should be addressed by the posting of a reserve for the present value of the deficiency rather than denial for credit for reinsurance, assuming that no

© 1999-2015 National Association of Insurance Commissioners

other area of non-compliance is encountered with the agreement and that the assets received corresponding to the ceding commission are in compliance with other statutes and regulations. For example, the assets received corresponding to the ceding commission must be admissible and not subject to repayment to the reinsurer.

NOTE: Some states have adopted versions of the model regulation that do not allow partial credit when renewal expense allowances are deficient. In those states complete disallowance of reinsurance credit would result for treaties that do not comply with the renewal expense allowance requirement.

Section 4A(2)

Question: With regard to existing business, s

Question: May a reinsurance contract allow the reinsurer to increase the cost of insurance that the ceding company must pay under the treaty?

Answer: So long as the aggregate amounts payable by the ceding company in any settlement period do not exceed the income of the reinsured policies during that period, the treaty's structure would not be in violation of Section A(5) of the model regulation. There is not compliance with Section A(5) if any increases could exceed income.

Question: If a reinsured policy allows the ceding company to guarantee rates of interest to be credited to the policyholder that are greater than those guaranteed by the policy, may a reinsurance contract allow the reinsurer to limit its participation in the credited rate as long as it at least provides for the amount based on the rate guaranteed in the contract?

Answer: Again, so long as there is no possibility that the ceding company will have to make payments for which it is not fully reimbursed, no violation exists. Otherwise, the treaty would not be in compliance with Sections 4A(2) and 4A(5).

Section 4A(7)

Question: Is asset segmentation an acceptable mechanism for legal segregation of assets?

Answer: Generally no. Segmentation involves the allocation of a company's general account investment earnings over several lines of business, or various groups of policies within those lines, such that the performance of one corporate bond, for example, may affect the earnings of several segments within a company. The accounting for the segmentation is largely internal, and the detail of the record-keeping varies from company to company.

The fundamental purpose of the requirement for a reinsurance treaty to employ the use of a segregated asset portfolio (SAP) is that all payments (interest, benefits, allowances, etc.) must be made from the SAP, to eliminate any problems that could arise in determining what asset or assets should be sold, and to avoid disputes in the event of insolvency. Any sale of assets that could affect policies not subject to reinsurance, or policies subject to reinsurance with other reinsurers is problematic.

In addition, auditing the performance of a treaty using traditional segmentation methods would be extremely difficult and prone to disagreement, which could provide a reinsurer with broad leverage to contest amounts due that reinsurer, especially in the event of insolvency or rehabilitation of the ceding company.

It is important to determine that the arrangement in place does in fact transfer all of the risks of the underlying assets supporting the reinsured business to the reinsurer.

Question: If some policies out of a group of similar policies are fully or partially reinsured, and the remainder are not, must the assets supporting tao fully insuree policied br legall(segregate6(from)]TJ0.0004

QuestionI

separately for each reinsurer, or is it acceptable to have all the assets segregated together with each reinsurer responsible for its portion of the investment risk?

Answer: The ceding company should not segregate assets separately for each reinsurer if the treaties are virtually identical.

Question: At the time assets are legally segregated under a coinsurance with funds withheld treaty, should they be valued at market value, statutory value or some combination?

Answer: The assets should be valued at their statutory admitted assets value.

Question: When the assets are legally segregated, how are the funds withheld payables and receivables reported?

Answer: The payables and receivables are recorded

D. Have the Tabular Interest (Page 7, Part A, Line 4), Tabular Less Actual Reserve Released (Page 7, Part A, Line 5) and Tabular Cost (Page 7, Part A, Line 9) been determined by formula as described for these lines in the instructions for Page 7 or from the basic data for such items?

E. Describe the method of determination of Tabular Interest on funds not involving life contingencies under Page 7, Part B, Line 3.

F. Disclose the nature of significant other increases (net) under Page 7, Part B, Line 5.

Illustration:

A. The Company waives deduction of deferred fractional premiums upon death of insured and returns any portion of the final premium beyond the date of death. Surrender values are not promised in excess of the legally computed reserves.

B. Extra premiums are charged for substandard lives for policies issued prior to July 1, 19__, plus the gross premium for a rated age.

Mean reserves are determined by computing the regular mean reserve for the plan at the rated age and holding, in addition, one-half (1/2) of the extra premium charge for the year. Policies issued after July 1, 19__, for substandard lives, are charged an extra premium plus the regular premium for the true age. Mean reserves are based on appropriate multiples of standard rates of mortality.

C. As of December 31, 19__, the Company had $__________ of insurance in force for which the gross premiums are less than the net premiums according to the standard valuation set by the State of ________________. Reserves to cover the above insurance totaled $__________ at year-end and are reported in Exhibit 8, Sections A and B.

D. The Tabular Interest (Page 7, Part A, Line 4) has been determined by formula as described in the instructions for Page 7 (or, alternatively, from the basic date for the calculation of policy reserves).

The Tabular Less Actual Reserve Released (Page 7, Part A, Line 5) has been determined by formula as described in the instructions for Page 7 (or, alternatively, from the basic data for the calculation of reserves and the actual reserves released).

The Tabular Cost (Page 7, Part A, Line 9) has been determined by formula as described in the instructions for Page 7 (or, alternatively, from the basic data for the calculation of policy reserves).

E. For the determination of Tabular Interest on funds not involving life contingencies under Page 7, Part B, Line 3, for each valuation rate of interest, the tabular interest is calculated as one hundredth of the product of such valuation rate of interest times the mean of the amount of funds subject to such valuation rate of interest held at the beginning and end of the year of valuation. The total amount of all such products is entered under Page 7, Part B, Line 3.

© 1999-2015 National Association of Insurance Commissioners

F. The details for "Other Increases" (net) under Page 7, Part B, Line 5 are:

	1	2	ORDINARY			6	GROUP	
			3	4	5		7	8
ITEM	Total	Industrial Life	Life Insurance	Individual Annuities	Supple-mentary Contracts	Credit Life Group and Indivi dual	Life Insurance	Annuities
5.01								

underlying assets, or related to an index, or related to the maturity date of the liability; or

(b) In installments over five years or more, with or without a reduction in the interest rate during the installment period.

2. Classify annual statement liabilities as “subject to discretionary withdrawal at book value less surrender charge” (1.2 above) where the withdrawal of funds is payable at all times, or at any time within one year from the statement date in a lump sum subject to a current fixed surrender charge of 5% or more and it does not contain a meaningful bail out rate as provided in (4)(d) below.

3. Classify annual statement liabilities as “subject to discretionary withdrawal at

withdrawals are at book value, other withdrawals are at market value, separate the product's reserves into the appropriate categories. Shared employer group or jointly underwritten arrangements are to be reported as direct business.

3. Briefly describe the methods of estimation utilized to complete this disclosure if more precise information was unavailable.

Illustration:

Withdrawal Characteristics of Annuity Actuarial Reserves and Deposit Liabilities

		(1) Amount	(2) % of Total
1.	Subject to discretionary withdrawal:		
	1.1 – With market value adjustment	$________	________%
	1.2 – At book value less current surrender charge of 5% of more	________	________
	1.3 – At market value	________	________
	1.4– Total with adjustment or at market value	________	________
	1.5 – At book value without adjustment (minimal or no charge or adjustment)	________	________
2.	Not subject to discretionary withdrawal	________	________
3.	Total (gross)	________	100 %
4.	Reinsurance ceded	________	
5.	Total (net)* (3) – (4)	$________	

*Reconciliation of total annuity actuarial reserves and deposit fund liabilities.

Life & Accident & Health Annual Statement:

6.	Exhibit 8, Section B, Total (net)	$ ________
7.	Exhibit 8, Section C, Total (net)	________
8.	Exhibit 10, Line 19, Column 1	________
9.	Subtotal	________

Separate Accounts Annual Statement:

10.	Exhibit 6, Line 0299999, Column 2	________
11.	Exhibit 6, Line 0399999, Column 2	________
12.	Page 3, Line 3	________
13.	Subtotal	________
14.	Combined Total	$________

12. Premium and Annuity Considerations Deferred and Uncollected

Instruction:

If the company has reported on Page 2, life insurance premiums and annuity considerations deferred and uncollected on policies in force December 31 of current year, show separately the amounts and the loading excluded for each of the following lines of business: industrial business, ordinary new business, ordinary renewal, credit life, group life, and group annuity.

© 1999-2015 National Association of Insurance Commissioners

Illustration:

Deferred and uncollected life insurance premiums and annuity considerations as of December 31, 19XX, were as follows:

	Type	(1) Gross	(2) Net of Loading
i.	Industrial	$___________	$___________
ii.	Ordinary new business	___________	___________
iii.	Ordinary renewal	___________	___________
iv.	Credit Life	___________	___________
v.	Group Life	___________	___________
vi.	Group Annuity	___________	___________
vii.	Totals	$___________	$___________

13. Ceded Reinsurance Report

Section 1 – General Interrogatories

A. Are any of the reinsurers, listed in Schedule S as non-affiliated, owned in excess of 10% or controlled, either directly or indirectly, by the company or by any representative, officer, trustee, or director of the company? Yes (   ) No (   ) If yes, give full details.

B. Have any policies issued by the company been reinsured with a company chartered in a country other than the United States (excluding U.S. Branches of such companies) which is owned in excess of 10% or controlled directly or indirectly by an insured, a beneficiary, a creditor or an insured or any other person not primarily engaged in the insurance business? Yes () No (   ) If yes, give full details.

Section 2 – Ceded Reinsurance Report – Part A

A. Does the company have any reinsurance agreements in effect under which the reinsurer may unilaterally cancel any reinsurance for reasons other than for nonpayment of premium or other similar credits? Yes (   ) No (   )

i) If yes, what is the estimated amount of the aggregate reduction in surplus of a unilateral cancellation by the reinsurer as of the date of this statement, for those agreements in which cancellation results in a net obligation of the company to the reinsurer, and for which such obligation is not presently accrued? Where necessary, the company may consider t eements ie of thi9ed, own10%1 for thoeinsurer

for nonpayment of premium or other similar credits that are reflected in Section 2 above) of termination of ALL reinsurance agreements, by either party, as of the date of this

The company has reported in its operations in the current year as a result of commutation of reinsurance with the companies listed below, amounts which are reflected as:

i.	Losses incurred	$_____
ii.	Loss adjustment expenses incurred	$_____
iii.	Premiums earned	$_____
iv.	Other	$_____

Company	Amount
XYZ	$_____
ZYX	$_____

Generally Accepted Accounting Principles

19. FAS 113 contains the following guidance with respect to reporting assets and liabilities related to reinsurance transactions:

Reporting Assets and Liabilities Related to Reinsurance Transactions

14. Reinsurance contracts that are legal replacements of one insurer by another (often referred to as assumption and novation) extinguish the ceding company's liability to the policyholder and result in removal of related assets and liabilities from the financial statements of the ceding enterprise. Reinsurance contracts in which a ceding enterprise is not relieved of the legal liability to its policyholder do not result in removal of the related assets and liabilities from the ceding enterprise's financial statements. Ceding enterprises shall report estimated reinsurance receivables arising from those contracts separately as assets. Amounts paid to the reinsurer relating to the unexpired portion of reinsured contracts (prepaid reinsurance premiums) also shall be reported separately as assets.

15. Amounts receivable and payable between the ceding enterprise and an individual reinsurer shall be offset only when a right of offset exists, as defined in Interpretation 39.

16. The amounts of earned premiums ceded and recoveries recognized under reinsurance contracts either shall be reported in the statement of earnings, as separate line items or parenthetically, or those amounts shall be disclosed in the footnotes to the financial statements.

20. FAS 113 contains the following guidance with respect to reinsurance of long-duration contracts:

Reinsurance of Long-Duration Contracts

12. Indemnification of the ceding enterprise against loss or liability relating to insurance risk in reinsurance of long-duration contracts requires the reasonable possibility that the reinsurer may realize significant loss from assuming insurance risk as that concept is contemplated in Statement 60 and FASB Statement No. 97, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments*. Statement 97 defines long-duration contracts that do not subject the insurer to mortality or morbidity risks as investment contracts. Consistent with that definition, a contract that does not subject the reinsurer to the reasonable possibility of significant loss from the events insured by the underlying insurance contracts does not indemnify the ceding enterprise against insurance risk.

13. The evaluation of mortality or morbidity risk in contracts that reinsure policies subject to Statement 97 shall be consistent with the criteria in paragraphs 7 and 8 of that Statement. Evaluation of the presence of insurance risk in contracts that reinsure other long-duration contracts (such as those that reinsure ordinary life contracts or contracts

© 1999-2015 National Association of Insurance Commissioners

that provide benefits related only to illness, physical injury, or disability) also shall be consistent with those criteria.

<u>Recognition of Revenues and Costs for Reinsurance of Long-Duration Contracts</u>

25. Amortization of the estimated cost of reinsurance of long-duration contracts that meets the conditions for reinsurance accounting depends on whether the reinsurance contract is long duration or short duration. The cost shall be amortized over the remaining life of the underlying reinsured contracts if the reinsurance contract is long duration, or over the contract period of the reinsurance if the reinsurance contract is short duration. Determining whether a contract that reinsures a long-duration insurance contract is long duration or short duration in nature is a matter of judgment, considering all of the facts and circumstances. The assumptions used in accounting for reinsurance costs shall be consistent with those used for the reinsured contracts. The difference, if any, between amounts paid for a reinsurance contract and the amount of the liabilities for policy benefits relating to the underlying reinsured contracts is part of the estimated cost to be amortized.

RELEVANT LITERATURE

Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- *Issue Paper No. 4—Definition of Assets and Admitted Assets*
- *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets*
- *Issue Paper No. 25—Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties*
- *Issue Paper No. 50—Classifications and Definitions of Insurance or Managed Care Contracts in Force*
- *Issue Paper No. 51—Life Contracts*
- *Issue Paper No. 52—Deposit-Type Contracts*
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Chapter 17 - Other Liabilities
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Chapter 21 - Commissions
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Chapter 24 - Reinsurance (including appendices A and B)
- NAIC Annual Statement Instructions for Life and Accident and Health Insurance Companies, Notes to Financial Statements and Schedule S

Generally Accepted Accounting Principles

- *FASB Statement No. 113*, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts*
- *FASB Statement No. 5*, *Accounting for Contingencies*

State Regulations

- No additional guidance obtained from state statutes or regulations.

© 1999-2015 National Association of Insurance Commissioners

This page intentionally left blank.