Statutory Issue Paper No. 75

Property and Casualty Reinsurance

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

Type of Issue:
Property and Casualty

SUMMARY OF ISSUE

1. Reinsurance is the assumption by an insurer of all or part of a risk undertaken originally by another insurer. Current statutory guidance on the accounting for property and casualty reinsurance is contained in Chapters 7, 8, and 22 of the Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies (P&C Accounting Practices and Procedures Manual).

2. GAAP guidance on the accounting for property and casualty reinsurance is primarily contained in

be charged through the Statement of Operations by reversing the accounts previously utilized to establish the reinsurance recoverable.

DISCUSSION

8. Statutory accounting for property and casualty reinsurance was recently revised through amendments to Chapter 22. These amendments adopted FAS 113 with modification and EITF 93-6 with modification. This issue paper rejects AICPA Statement of Position No. 92-5, *Accounting for Foreign Property and Liability Reinsurance*. As a result, the statutory accounting principles established by this issue paper are generally consistent with GAAP except for the following significant exceptions:

a. Reinsurance recoverables on unpaid case-basis and incurred but not reported losses and loss adjustment expenses shall be presented as a contra-liability netted against the liability for gross losses and loss adjustment expenses. Under GAAP, these recoverables are reported as assets.

b. Amounts paid for prospective reinsurance that meet the conditions for reinsurance accounting shall be reported as a reduction of unearned premiums whereas under GAAP, the unamortized portion of the amount paid for prospective reinsurance is recorded as a prepaid asset.

c. The gain created by a retroactive reinsurance contract because the amount paid to the reinsurer is less than the gross liabilities for losses and loss adjustment expenses ceded to the reinsurer is reported in the income statement as a write-in gain in "other income" by the ceding entity and a write-in loss by the assuming entity. The gain created by a retroactive reinsurance contract is restricted as a special surplus account until the actual retroactive reinsurance recovered is in excess of the consideration paid. Under GAAP, gains arising from retroactive reinsurance contracts are deferred and recognized over the settlement period.

d. Statutory accounting requires that a liability be established through a provision reducing surplus for unsecured reinsurance recoverables from unauthorized reinsurers and for certain overdue balances due from authorized reinsurers. Under GAAP, no such liability is required. However, both statutory accounting and GAAP require an assessment of the collectibility of recorded reinsurance recoverables.

e. Some reinsurance treaties contain adjustable features that provide for adjustment of commission, premium or amount of coverage, based on loss experience. Chapter 22 and EITF 93-6 require recognition of these adjustable features in the period in which the loss event(s) giving rise to the adjustment occurs. Under EITF 93-6, the asset or liability arising from the adjustable feature may be computed under the assumption that the treaty will be terminated prior to the end of its term if such termination is permitted under the contract and to do so results in a lower asset or liability ("lesser of" provision). Statutory accounting requires that the asset or liability arising from the adjustable feature be

Property and Casualty Reinsurance

insurance risk to which the reinsurer is subject (such as through experience refunds, cancellation provisions, adjustable features, or additions of profitable lines of business to the reinsurance contract) or (b) delay the timely reimbursement of claims by the reinsurer (such as through payment schedules or accumulating retentions from multiple years).

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

1. The reinsurer assumes significant insurance risk under the reinsured portions of the underlying insurance contracts.

2. It is reasonably possible that the reinsurer may realize a significant loss from the transaction.

A reinsurer shall not be considered to have assumed significant insurance risk under the reinsured contracts if the probability of a significant variation in either the amount or timing of payments by the reinsurer is remote. Implicit in this condition is the requirement that both the amount and timing of the reinsurers payments depend on and directly vary with the amount and timing of claims settled by the ceding company. Contractual provisions that delay timely reimbursement to the ceding company would prevent this condition from being met.

The ceding company's evaluation of whether it is reasonably possible for a reinsurer to realize a significant loss from the transaction shall be based on the present value of all cash flows between the ceding and assuming companies under reasonably possible outcomes, without regard to how the individual cash flows are described or characterized. An outcome is reasonably possible if its probability is more than remote. The same interest rate shall be used to compute the present value of cash flows for each reasonably possible outcome tested. A constant interest rate shall be used in determining those present values because the possibility of investment income varying from expectations is not an element of insurance risk. Judgment is required to identify a reasonable and appropriate interest rate.

Significance of loss shall be evaluated by comparing the present value of all cash flows, determined as described in the above paragraph, with the present value of the amounts paid or deemed to have been paid to the reinsurer. If, based on this comparison, the reinsurer is not exposed to the reasonable possibility of significant loss, the ceding company shall be considered indemnified against loss or liability relating to insurance risk only if substantially all of the insurance risk relating to the reinsured portions of the underlying insurance contracts has been assumed by the reinsurer. In this narrow circumstance, the reinsurers economic position is virtually equivalent to having written the insurance contract directly. This condition is met only if insignificant insurance risk is retained by the ceding company on the reinsured portions of the underlying insurance contracts, so that the reinsurers exposure to loss is essentially the same as the insurers.

Payment schedules and accumulating retentions from multiple years are contractual features inherently designed to delay the timing of reimbursement to the ceding company. 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 reinsurers 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. Therefore, any feature that may affect the timing of the reinsurers reimbursement to t

Effective Date: Transition Rule

The revised accounting and reporting practices set forth in this chapter that were adopted on September 18, 1994 shall be effective for all accounting periods beginning on or after January 1, 1995 and shall apply to: (a) reinsurance contracts entered into, renewed, or amended on or after January 1, 1994, (an amendment is any revision or adjustment of contractual terms, but the payment of premiums or reimbursement of losses recoverable under the contract shall not constitute an amendment); and (b) reinsurance contracts in force on January 1, 1995 which cover losses occurring or claims-made on or after that date on policies reinsured under such contracts.

The revised accounting and reporting provisions shall not apply to: (a) reinsurance contracts which cover only losses occurring or claims-made before January 1, 1994 and which were entered into before January 1, 1994, and were not subsequently renewed or amended; and (b) reinsurance contracts that expired before, and were not renewed or amended after, January 1, 1995.

Previously reported amounts relating to contracts to which these revised accounting practices are not applicable shall not be restated. However, for accounting periods commencing on and after January 1, 1995, balances relating to contracts which were entered into, renewed or amended on or after January 1, 1994 and which do not transfer insurance risk shall be reclassified as deposits and shall be accounted for and reported in the manner described under the caption “Reinsurance Contracts Must Include Transfer of Risk”.

Insurers may elect to comply with these revised accounting practices for accounting periods commencing before January 1, 1995.

20. Chapter 22 requires the following accounting for reinsurance contracts that do not qualify for reinsurance accounting (i.e., do not transfer insurance risk):

To the extent that a reinsurance contract does not, despite its form, transfer both components of insurance risk, all or part of the contract shall 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 the cea(To t4tnlect toaed 90004 Tc 0osits icur,)]TJ00Tw (ct thT99((ectices are Tc 0.086emiu
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guidance was adopted by the membership of the NAIC at the March 1996 Plenary Session. Changes adopted have been underlined and struckthrough in this paragraph.

Accounting for Reinsurance

Reinsurance recoverables shall be recognized in a manner consistent with the liabilities (including estimated amounts for claims incurred but not reported) relating to the underlying reinsured contracts. Assumptions used in estimating reinsurance recoverables shall be consistent with those used in estimating the related liabilities. Accounting for members of a reinsurance pool shall follow the accounting for the pool member which wrote the underlying policy.

Accounting for reinsurance depends on whether the contract is considered prospective or retroactive. Prospective reinsurance is reinsurance in which a reinsurer agrees to reimburse a ceding company for losses that may be incurred as a result of future insurable events covered under contracts subject to the reinsurance. Retroactive reinsurance is reinsurance in which a reinsurer agrees to reimburse a ceding company for liabilities incurred as a result of past insurable events covered under contracts subject to the reinsurance. A reinsurance contract may include both prospective and retroactive reinsurance provisions.

The distinction between prospective and retrospective reinsurance contracts is based on whether the contract reinsures future or past insured events covered by the underlying insurance policies. For example, in occurrence-based insurance, the insured event is the occurrence of a loss covered by the insurance contract. In claims-made insurance, the insured event is the reporting to the insurer, within the period specified by the policy, of a claim for a loss covered by the insurance contract. A claims-made reinsurance contract that reinsures claims asserted to the reinsurer in a future period as a result of insured events that occurred prior to entering into the reinsurance contract is a retroactive contract. (However, a reinsurance contract that reinsures claims reported to an insurer that are covered under currently effective claims-made insurance policies is a prospective reinsurance contract.)

It is not uncommon for a reinsurance arrangement to be initiated before the beginning of a policy period but not finalized until after the policy period begins. Whether there was agreement in principle at the beginning of the policy period and, therefore, the contract is substantively prospective must be determined based on the facts and circumstances. However, except as respects business assumed by a U.S. reinsurer from ceding companies domiciled outside the U.S. and not affiliated with such reinsurer, or business assumed by a U.S. reinsurer where either the lead reinsurer or a majority of the capacity on the contract is domiciled outside the U.S. and is not affiliated with such reinsurer, if a contract entered into, renewed or amended on or after January 1, 1994 has not been finalized, reduced to a written form and signed by the parties within nine months after the commencement of the policy period covered by the reinsurance arrangement, the arrangement is presumed to be retroactive -1.15 Tthe lead reinsu(i.e.d by the reinsuse

Accounting for Prospective Reinsurance Contracts

Amounts paid for prospective reinsurance that meets the conditions for reinsurance accounting shall be reported as a reduction of written and earned premiums by the ceding company and shall be earned over the remaining contract period in proportion to the amount of reinsurance protection provided. If the amounts paid are subject to adjustment and can be reasonably estimated, the basis for amortization shall be the estimated ultimate amount to be paid.

Changes in amounts of estimated reinsurance recoverables shall be recognized as a reduction of gross losses and loss expenses incurred in the current periods statement of income. Reinsurance recoverables on paid losses shall be reported as an asset, reinsurance recoverables on loss and loss adjustment expense payments, in the balance sheet. Reinsurance recoverables on unpaid case-basis and incurred but not reported losses and loss adjustment expenses shall be netted against the liability for gross losses and loss adjustment expenses.

Accounting for Retroactive Reinsurance Contracts

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

Effective for accounting periods commencing on or after January 1, 1995, all retroactive reinsurance contracts entered into, renewed or amended on or after January 1, 1994 (including subsequent development of such transactions) must be fully disclosed in the NAIC annual and interim financial statements required to be filed and shall be accounted for and reported in the following manner:

1. The ceding company must record, without recognition of the retroactive reinsurance, its loss and loss expense reserves on a gross basis on its balance sheet and in all schedules and exhibits.

2. The assuming company must exclude the retroactive reinsurance from its loss and loss expense reserves and from its schedules and exhibits.

3. The ceding company and the assuming company must report by write-in item on Page 3, the total amount of all retroactive reinsurance, identified as “retroactive reinsurance reserve ceded or assumed”, recorded as a contra-liability by the ceding company and as a liability by the assuming company.

4. The ceding company must, by write-in item on Page 3, restrict surplus resulting from any retroactive reinsurance as a special surplus fund, designated as “special surplus from retroactive reinsurance account”.

5. The surplus gain from any retroactive reinsurance may not be classified as unassigned funds [considered earned surplus] until such time as the actual retroactive reinsurance recovered is in excess of the consideration paid.

6. The “special surplus from retroactive reinsurance account” for each respective retroactive reinsurance contract shall be reduced at the time the ceding company begins to recover funds from the assuming company in amounts exceeding the consideration paid by the ceding company under such agreement, or adjusted as provided in paragraph 10 below.

7. For each agreement, the reduction in the “special surplus from retroactive reinsurance” account must be limited to the lesser of:

   (a) the actual amount recovered in excess of consideration paid; or

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(b) the initial surplus gain resulting from the respective retroactive

the original reinsurance agreement will not be altered from retroactive to prospective

3. The termination of, or reduction in participation in, reinsurance treaties entered into in the ordinary course of business; or

4. Intercompany reinsurance contracts, 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.

Except for its accounting and reporting provisions, this procedure regarding retroactive reinsurance shall not apply to transactions transferring liabilities in connection with a court-ordered rehabilitation, liquidation or receivership with written approval of the ceding company's domiciliary commissioner.

Retroactive reinsurance contracts resulting in surplus gain to the ceding company (with or without risk transfer) entered into between affiliates or between insurers "under common control" (as those terms are defined in the NAIC Model Insurance Holding Company Regulatory Act) shall be reported in annual and interim statements as follows:

1. The consideration paid by the ceding company shall be recorded as a deposit and reported as a non-admitted asset in Exhibit 1; and

2. No deduction shall be made from loss and loss adjustment expense reserves on the ceding company's balance sheet, schedules and exhibits.

<u>Required Terms for Reinsurance Contracts</u>

In addition to credit for reinsurance requirements applicable to reinsurance transactions generally, no credit or deduction from liabilities shall be allowed for reinsurance recoverable in annual or interim statements required to be filed by the ceding company where the agreement was entered into after the effective date of these requirements unless each of the following conditions is satisfied:

1. The contract must contain an acceptable insolvency clause.

2. Recoveries due the ceding company must be available without delay for payment of losses and claim obligations incurred under the agreement, in a manner consistent with orderly payment of incurred policy obligations by the ceding company.

3. The agreement shall constitutnteredod bes.d policy0.12ik45 TJn2dr

provision may be made for the ceding company's participation in the reinsurer's ultimate profit, if any, under the agreement. A retroactive reinsurance contract may not be canceled or rescinded without the approval of the commissioner of the domiciliary state of the ceding company.

Characteristics of Reinsurance Contracts

Each reinsurance contract may be individually drafted. Commonly included contract provisions that may affect accounting practices include:

1. Reporting responsibility of the ceding insurer. Should be clearly spelled out both as to details required and time schedules.

2. Payment terms. Time schedules, currencies intended and the rights of the parties to withhold funds should be established.

3. Payment of premium taxes. Customarily the responsibility of the ceding company, a recital of nonliability of the reinsurer may be found.

4. Termination. May be on a "cut-off" or "run-off" basis. A "cut-off" provision stipulates that the reinsurer shall not be liable for loss as a result of occurrences taking place after the date of termination. A "run-off" provision stipulates that the reinsurer shall remain liable for loss under reinsured policies in force at the date of termination as a result of occurrences taking place after the date of termination until such time as the term of the policy expires.

5. Insolvency clause. Should provide for the survival of the reinsurer's obligations in the event of insolvency of the ceding company, without diminution because of the insolvency.

Reinsurance contracts shall not permit entry of an order of rehabilitation or liquidation to constitute an anticipatory breach by the insurer nor grounds for retroactive revocation or retroactive cancellation of any contracts of the insurer.

Reinsurance Assumed

The segregation of premiums, losses and expenses arising from reinsurance assumed transactions is required for the Underwriting and Investment Exhibit of the annual statement.

Non-proportional assumed reinsurance transactions should be included in the reinsurance lines of business in the annual statement under four subcategories while all proportional reinsurance (first dollar pro-rata reinsurance) must be allocated to the appropriate lines of business.

Reinsurance premiums receivable at the end of the accounting period are combined with direct business receivables and reported as "Agents' balances or uncollected premiums". Where the ceding insurer withholds premium funds pursuant to the terms of the reinsurance contract, such assets should be shown by the assuming company as "Funds held by or deposited with reinsured companies". Reinsurance premiums more

company. Assuming companies shall estimate such unreported premiums and related costs to the extent necessary to prevent material distortions in the loss development contained in the assuming company's annual statement schedules where calendar year premiums are compared to accident year losses.

Amounts payable by reinsurers on losses are generally classified in the annual statement as unpaid losses. Assumed reinsurance payable on paid losses should be classified as a separate liability item on the balance sheet. IBNR losses on assumed reinsurance business are netted with ceded losses on the balance sheet but are shown separately by annual statement line of business in the Underwriting and Investment Exhibit.

Reinsurance Ceded

The Underwriting and Investment Exhibit of the annual statement presents segregated data on the premiums, losses and expenses from reinsurance ceded transactions in a manner similar to reinsurance assumed.

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

Premiums due reinsurers ("ceded balances payable") are shown as contra assets contained in "Agents' balances or uncollected premiums." Amounts that are withheld by the ceding company from sums that would otherwise be payable under the reinsurance contract are reportable as "Funds held by company under reinsurance treaties."

Adjustable Feature/Retrospective Rating

Reinsurance treaties may provide for adjustment of commission, premium, or amount of coverage, based on loss experience. Examples are:

1. Commission Adjustments:

   Contingent or Straight Profit—The reinsurer returns to the ceding company a stipulated percentage of the profit produced by the business assumed from the ceding insurer. Profit may be calculated for any specified period of time, but the by th-06 Tc rent or StraSliit maSiums0008Atm

This provision is calculated separately for unauthorized and authorized companies in Schedule F. An authorized reinsurer is one that is licensed, accredited or approved by the ceding insurers state of domicile; an unauthorized reinsurer is not so licensed, accredited or approved.

Disputed Items

Occasionally a reinsurer will question whether an individual claim is covered under a reinsurance contract or may even attempt to nullify an entire treaty. A ceding insurer, depending upon the individual facts, may or may not choose to continue to take credit for such disputed balances. The Annual Statement Instructions require notification of a dispute by a formal written communication from the reinsurer denying the validity of coverage. Additionally, the “Notes to Financial Statements” require footnote disclosure of material amounts and the status of disputed items. Furthermore, a ceding insurer may take no credit whatsoever for reinsurance recoverables in dispute with an affiliate.

Commutations

A commutation of a reinsurance contract is a transaction which results in the complete and final

portfolio transfers are to be accounted for as retroactive reinsurance which is discussed earlier in this chapter.

A specific interrogatory requires information on reinsurance of risk accompanied by an agreement to release the reinsurer from liability, in whole or in part, from any loss that may occur on the risk or portion thereof.

A commonly accepted practice among affiliated insurers is the sharing of underwriting results ("pooling") in accordance with predetermined ratios. This is normally accomplished by a procedure whereby all affiliated insurers reinsure their direct business with the major insurers. Business is then retroceded to the affiliates so that each member of the group receives its predetermined share of the gross group business.

Detailed disclosure of certain reinsurance transactions is required in various notes to financial statements. These include retroactive reinsurance, unsecured reinsurance recoverables, reinsurance recoverables in dispute, write off of uncollectible reinsurance, and reinsurance commutations.

23. Chapter 22 provides the following guidance on the National Flood Insurance Program:

<u>National Flood Insurance Program</u>

This program was created by the Federal Emergency Management Agency (FEMA) and is designed to involve private insurers in a "write-your-own" (WYO) flood insurance program financially backed by FEMA at no risk to the insurer. To become a participating WYO company, the insurer signs a document with the Federal Insurance Administration (FIA) of the Federal Emergency Management Agency known as the Financial Assistance/Subsidy Arrangement.

Premium rates are set by FEMA. The WYO participating companies write the flood insurance coverage qualifying for the program on their own policies, perform their own underwriting, premium collections, claim payments, administration, and premium tax payments for policies written under the program.

Monthly accountings are made to FIA and participants are allowed to draw upon FEMA letters of credit for deficiencies of losses, loss expenses and administrative expenses in excess of premiums, subject to certain percentage limitations on expenses.

For purposes of statutory reporting in the WYO participating insurers' annual statements, i Tcency knd insurer5 0 Tds.15 TduidanAICthe Federal

Include: The NAIC group code number, where appropriate, and the Federal Employer Identification Number for each individual company.

12. Reinsurance Recoverable in Dispute

Instruction:

Reinsurance recoverable on paid and unpaid (including IBNR) losses in dispute by reason of notification, arbitration or litigation shall be identified in the schedule if the amounts in dispute from any company (and/or affiliate) exceeds 5% of the ceding

b. Instruction:

Additional or return commission predicated on loss experience or on any other form of profit sharing arrangements in this annual statement as a result of existing contractual arrangements are accrued as follows:

Illustration:

	REINSURANCE			
	(1) DIRECT	(2) Assumed	(3) Ceded	(4) NET
i. Contingent Commission	$ _______	$ _______	$ _______	$ _______
ii. Sliding Scale Adjustments	_______	_______	_______	_______
iii. Other Profit Commission Arrangements	_______	_______	_______	_______
iv. TOTAL	$ _______	$ _______	$ _______	$ _______

c. Instruction:

Disclose all contracts of reinsurance covering losses that have occurred prior to the inception of the contract that have not been accounted for in conformity with the instructions contained in the NAIC *Accounting Practices and Procedures* manual, Chapter 22.

Illustration:

As:	Reported Company (1) Assumed	(2) Ceded
A. Reserves Transferred:		
1. Initial Reserves	$ ________	$ ________
2. Adjustments - Prior Year(s)	________	________
3. Adjustments - Current Year	________	________
4. Total	$ ________	$ ________
B. Consideration Paid or Received		
1. Initial	$ ________	$ ________
2. Adjustments - Prior Year(s)	________	________
3. Adjustments - Current Year	________	________
4. Total	$ ________	$ ________
C. Amounts Recovered/Paid (cumulative)		
1. Prior Year(s)	$ ________	$ ________
2. Current Year	________	________
3. Total	$ ________	$ ________
D. Special Surplus from Retroactive Insurance		
1. Initial	$ ________	$ ________
2. Adjustments - Prior Year(s)	________	________
3. Adjustments - Current Year	________	________
4. Closing Balance	$ ________	$ ________

E. List the other insurers included in the above transactions

Assumed Company	Amount	Ceded Company	Amount
	$ ________		$ ________
	________		________
	________		________
	________		________
Total	$ ________ *	Total	$ ________ *

* Total amounts must agree with totals in A.4.

25. The NAIC Annual Statement Instructions for Property and Casualty Insurance Companies provide the following guidance for line 3 of Schedule F-Part 7, Provision for Overdue Reinsurance:

> Line 3 - Line 1 x Line 2
> If the company's experience indicates that a higher amount should be provided, such higher amount should be entered

Generally Accepted Accounting Principles

26. As noted in paragraph 8, FAS 113 is generally consistent with Chapter 22. The paragraphs that follow are excerpts from FAS 113 which provide guidance on areas that differ from Chapter 22 (see paragraph 8 for a summary of differences).

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27. FAS 113 eliminated the practice of insurance enterprises of reporting assets and liabilities relating to reinsured contracts net of the effects of reinsurance:

> 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 enterprise'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 setoff 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.

28. FAS 113 contains the following guidance on retroactive reinsurance agreements:

> 22. Amounts paid for retroactive reinsurance that meets the conditions for reinsurance accounting shall be reported as reinsurance receivables to the extent those amounts do not exceed the recorded liabilities relating to the underlying reinsured contracts. If the recorded liabilities exceed the amounts paid, reinsurance receivables shall be increased to reflect the difference and the resulting gain deferred. The deferred gain shall be amortized over the estimated remaining settlement period. If the amounts and timing of the reinsurance recoveries can be reasonably estimated, the deferred gain shall be amortized using the effective interest rate inherent in the amount paid to the reinsurer and the estimated timing and amounts of recoveries from the reinsurer (the interest method). Otherwise, the proportion of actual recoveries to total estimated recoveries (the recovery method) shall determine the amount of amortization.
>
> 23. If the amounts paid for retroactive reinsurance exceed the recorded liabilities relating to the underlying reinsured contracts, the ceding enterprise shall increase the related liabilities or reduce the reinsurance receivable or both at the time the reinsurance contract is entered into, so that

29. EITF 93-6 contains the following guidance on multiple-year retrospectively rated reinsurance contracts:

> ISSUE
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> An insurer (ceding enterprise) may enter into a multiple-year retrospectively rated reinsurance contract (RRC) with a reinsurer (assuming enterprise). Examples of these contracts may include transactions referred to as "funded catastrophe covers." These contracts include a "retrospective rating" provision that provides for at least one of the following based on contract experience: (1) changes in the amount or timing of future contractual cash flows, including premium adjustments, settlement adjustments, or refunds to the ceding enterprise, or (2) changes in the contract's future coverage. A critical distinguishing feature of these contracts is that part or all of the retrospective rating provision is obligatory such that the retrospective rating provision creates future rights and obligations as a result of past events. A retrospectively rated contract that could be canceled by either party without further obligation is not covered by this Issue.
>
> The issues are (1) to the extent that the ceding enterprise has an obligation to make payments to the reinsurer that would not have been required absent experience to date under the contract (for example, payments that would not have been required if losses had not been experienced), whether the ceding enterprise should recognize a liability and the assuming enterprise should recognize an asset, (2) to the extent that a ceding enterprise would be entitled to receive a payment from the reinsurer based on experience to date under the contract (for example, the ceding enterprise would receive a payment if no future losses occur), whether the ceding enterprise should recognize an asset and the assuming enterprise should recognize a liability, and (3) how to account for changes in coverage based on past experience under the contract.
>
> EITF DISCUSSION
>
> The Task Force reached a consensus that in order to be accounted for as reinsurance, a contract that reinsures risks arising from short-duration insurance contracts must meet all of the following conditions: (1) the contract must qualify as a short-duration contract under paragraph 7.a. of Statement 60, (2) the contract must not contain features that prevent the risk transfer criteria in paragraphs 8-13 of Statement 113 from being reasonably applied (and those criteria must be met), and (3) the ultimate premium expected to be paid or received under the contract must be reasonably estimable and allocable in proportion to the reinsurance protection provided as required by paragraph 14.a. and 14.b. of Statement 60 and paragraph 21 of Statement 113. If any of these conditions are not met, a deposit method of accounting should be applied by the ceding and assuming enterprises. With respect to condition (2) above, a Task Force member asked whether a contract could be split for purposes of evaluating risk transfer. An FASB staff representative responded that Statement 113 applies to "a contract" and that determining the substance of a contract is a judgmental matter. If an agreement with a reinsurer consists of both risk transfer and nonrisk transfer coverages that have been combined into a single legal document, those coverages must be considered separately for accounting purposes. The FASB staff representative noted that paragraphs 59 and 60 of Statement 113 indicate that the Board did not intend for different kinds of exposures comb

without method, as the difference between the ceding enterprise's total contract costs before and after the experience under the contract as of the reporting date, including costs such as premium adjustments, settlement adjustments, and impairments of coverage. The amount of premium expense related to impairments of coverage should be measured in relation to the original contract terms. Future experience under the contract (that is, future losses and future premiums that would be paid regardless of past experience) should not be considered in measuring the amount to be recognized.

In applying the consensus reached in Issue 1, if the ceding enterprise could terminate the contract prior to the end of its term and if termination would change the amounts paid (for example, if terminating the contract would cost less than continuing the contract in force), the liability resulting from the contract should be measured as follows:

1. If a decision to terminate has been made, the measurement should be based on an assumption of termination and experience to date.

2. Otherwise, the measurement should be based on the lesser of the following:

    a. The total incremental cost that would be paid based on the with-and-without calculation assuming experience to date and assuming termination (that is, excluding the effects of future losses and future premiums that would have been paid regardless of experience to date) or

    b. The total incremental cost that would be paid based on the with-and-without calculation assuming experience to date and assuming no termination (that is, excluding the effects of future losses and future premiums that would have been paid regardless of experience to date).

Issue 2. The ceding enterprise should recognize an asset and the assuming enterprise should recognize a liability to the extent that any cash (or other consideration) would be payable from the assuming enterprise to the ceding enterprise based on experience to date under the contract.

Issue 3. The ceding enterprise and the assuming enterprise 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 ceding enterprise and as a gain by the assuming enterprise 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, the ceding enterprise has no future coverage relating to the deposit with the reinsurer and therefore the deposit is not recoverable).

The provisions of these consensuses are effective as of July 22, 1993 (for example, they are to be initially applied no later than the third quarter of 1993 for calendar-year enterprises) and are to be initially applied 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 Task Force noted that the provisions of Statement 3 apply to all interim periods presented.

2. By restatement of financial statements for all periods presented as long as that restatement is not prohibited by Statement 113.

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The SEC Observer stated that in addition to the disclosures provided under Opinion 20, the SEC staff will require registrants to disclose the nature and the significance of the transactions giving rise to the change. The SEC Observer also noted that registrants would be required to make SAB 74 disclosures for the financial statements filed prior to the period in which this change is adopted.

The Task Force requested that the FASB staff views on Issue 93-6, distributed to the Task Force as Supplement No. 1 (Revised) to the Issue Summary and the FASB Viewpoints article, "Accounting for Reinsurance: Questions and Answers about Statement 113," be included in Appendix D of EITF Abstracts. [Note: See Appendix D, Topics No. 34 and 35.]

STATUS

A related issue was discussed in Issue No. 93-14, "Accounting for Multiple-Year Retrospectively Rated Insurance Contracts by Insurance Enterprises and Other Enterprises." That Issue considers how a multiple-year retrospectively rated contract arising from an insurance transaction that is not a reinsurance contract should be accounted for. The consensuses reached in Issue 93-14 were consistent with those reached in this Issue.

No further EITF discussion is planned.

RELEVANT LITERATURE

Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Issue Paper No. 4—Definition of Assets and Nonadmitted Assets
- Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets
- Issue Paper No. 50—Classifications and Definitions of Insurance or Managed Care Contracts in Force
- Issue Paper No. 55—Unpaid Claims, Losses and Loss Adjustment Expenses
- Issue Paper No. 65—Property and Casualty Contracts
- Issue Paper No. 76—Offsetting and Netting of Assets and Liabilities
- Accounting Practices and Procedures Manual for Property and Casualty Insurance, Chapters 7, 8, and 22 (including Appendix A)
- NAIC Annual Statement Instructions for Property and Casualty Insurance Companies, Notes to Financial Statements and Schedule F
- Minutes of the December 3, 1995, meeting of the Property Casualty Reinsurance Study Group

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
- FASB Emerging Issues Task Force Issue No. 93-6, Accounting for Multiple-Year Retrospectively Rated Contracts by Ceding and Assuming Enterprises-SEC Staff Accounting Bulletin No. 92, Accounting and Disclosures Relating to Loss Contingencies
- AICPA Statement of Position No. 92-5, Accounting for Foreign Property and Liability Reinsurance
- FASB Viewpoints, "Accounting for Reinsurance: Questions and Answers about Statement 113," FASB Status Report, February 26, 1993

State Regulations

- No additional guidance obtained from state statutes or regulations.

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