c. For monthly premium plans, revenues are earned either in the month received or the month due.

7. Losses and loss adjustment expenses are generally recognized on the default date regardless of when claims are reported to the insurer.

8. The purpose of this issue paper is to establish statutory accounting principles for recording premium revenue and the liability for unpaid losses and loss adjustment expenses that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

9. Written premium shall be recorded in accordance with *Issue Paper No. 53—Property and Casualty Contracts - Premiums* (Issue Paper No. 53). Premium revenue shall be earned as follows:

a. For single premium plans, revenues shall be earned over the policy life in relation to the expiration of risk;

b. For annual premium plans, revenues shall be earned on a pro rata basis over the applicable year;

c. Additional first year premiums on nonlevel policies shall be deferred and amortized to income over the anticipated premium paying period of the policy in relation to the expiration of risk;

d. Initial renewal premiums that are higher than subsequent renewals shall be deferred and amortized over the remaining anticipated premium paying period in a manner consistent with additional first year premiums (i.e., in relation to the expiration of risk);

e. For monthly premium plans, revenues shall be earned in the month to which they relate.

10. When the anticipated losses, loss adjustment expenses, commissions and other acquisition costs, and maintenance costs exceed the recorded unearned premium reserve, contingency reserve, and the estimated future renewal premium on existing policies, a premium deficiency reserve shall be recognized by recording an additional liability for the excess deficiency with a corresponding charge to operations. Commission and other acquisition costs need not be considered in the premium deficiency analysis since they have previously been expensed. If an insurer utilizes anticipated investment income as a factor in the premium deficiency calculation, disclosure of such shall be made in the financial statements.

11. Unpaid losses and loss adjustment expenses shall be recognized in accordance with *Issue Paper No. 55—Unpaid Claims, Losses and Loss Adjustment Expenses* (Issue Paper No. 55). For mortgage guaranty insurance contracts, the date of default shall be considered the incident that gives rise to a claim as discussed in Issue Paper No. 55. If a claim is ultimately presented, the date of default shall be considered the loss incurred date.

12. The process for estimating the liability shall include projections for losses that have been reported as well as those that have been incurred but not reported. The estimates shall be made based on historical data, trends, economic factors, and other statistical information including paid claims, reported losses,

13. Real estate and mortgages are acquired by mortgage guaranty insurers to mitigate losses. These assets shall be shown on the balance sheet at the lower of cost or net realizable value, net of encumbrances. Any gains or losses from the holding or disposition of these assets shall be recorded as a component of losses incurred. Any rental income or holding expenses shall be included in loss adjustment expenses.

14. In addition to the unearned premium reserve, mortgage guaranty insurers shall maintain a liability referred to as a statutory contingency reserve. The purpose of this reserve is to protect policyholders against loss during periods of extreme economic contraction. The annual addition to the liability shall equal 50% of the earned premium from mortgage guaranty insurance contracts and shall be maintained for ten years regardless of the coverage period for which premiums were paid. With commissioner approval, when required by statute, the contingency reserve may be released in any year in which actual incurred losses exceed 35% of the corresponding earned premiums. Any such reductions shall be made on a first-in first-out basis. Changes in the reserve shall be recorded directly to surplus.

15. Mortgage guaranty insurers shall make all disclosures required by other issue papers within the codification, including but not limited to the requirements of Issue Paper No. 55, and *Issue Paper No. 77—Disclosures of Accounting Policies, Risks & Uncertainties, and Other Disclosures.*

16. This issue paper is not consistent with current statutory guidance as follows:

a. Premium Recognition

i. The P & C Accounting Practices and Procedures Manual distinguishes premiums for high risk policies from other policies. The conclusions reached in this issue paper make no such distinction because the concept is implicit in the requirement to earn revenues in relation to the expiration of risk.

ii. Certain states dictate by statute that a specific formula, table, or earnings curve be utilized to determine earned premiums. To the extent that the requirements are based on the exposure period and the relative risk during that period, they are consistent with the concepts set forth in this issue paper.

iii. The Mortgage Guaranty Insurance Model Act provides no specific guidance on premium revenue recognition other than the requirement to establish an unearned premium reserve. The method of establishing such reserve is based on regulation of the state of domicile.

iv. Current statutory guidance has no requirement to establish a premium deficiency reserve.

b. Contingency Reserve

The contingency reserve may be recorded through income or directly to surplus. This issue paper requires changes in the reserve to be recorded through surplus.

i. The Model Act requires that the contingency reserve shall be computed as an amount equal to 50% of the unearned premium after the establishment of the

the inconsistency with all property casualty insurers will not hinder evaluation of the mortgage guaranty insurers results.

22. The contingency reserve does not meet the definition of a liability which is set forth in *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets*. However, it is consistent with the "*ultimate objective of solvency regulations*" as stated in the Statement of Concepts. This states:

> the ultimate objective of solvency regulation is to ensure that policyholder, contract holder and other legal obligations are met when they come due and that companies maintain capital and surplus at all times and in such forms as required by statute to provide an adequate margin of safety.

Additionally, recording the contingency reserve as a liability is consistent with the Statement of Concepts which states:

> 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 reserves over statement reserves, interest maintenance reserves, asset valuation reserves, and others).

23. This issue paper is inconsistent with the guidance set forth in the AICPA exposure draft for mortgage guaranty insurance for the following reasons:

a. This issue paper requires that acquisition costs shall be accounted for in accordance with *Issue Paper No. 71—Policy Acquisition Costs and Commissions* rather than deferred as indicated in the exposure draft.

b. Paragraph 14 of this issue paper requires insurers to establish a contingency reserve. The AICPA exposure draft has no such requirement.

24. This issue paper is consistent with Issue Paper No. 55 which requires the ultimate cost of all known and unknown claims as well as related settling costs to

The period of exposure for a particular risk is significantly longer for mortgage insurance than for other property/liability insurance products. The exposure period for mortgage insurance can run for the term of the mortgage; however, the average policy life is seven years. The policy is terminated when the mortgage obligation is satisfied or the lender elects to cancel or not renew the policy.

Mortgage insurance is renewable at the option of the insured and at the renewal rate quoted when the policy commitment was issued. Disability income and certain life and health insurance products are other policies written with similar terms regarding renewal rate and cancellation.

In contrast to mortgage insurance, most property/liability products need not be renewed by the insurer at the expiration of the policy. The fact that mortgage insurance is guaranteed renewable at a definite rate is one of the factors necessitating the establishment of a contingency reserve. In effect, this reserve protects not only against catastrophic economic events, but also against a decrease in the quality of the insurance portfolio because of adverse selection at each renewal period.

2. Losses

The insured peril—the default of a borrower—arises from the credit risk associated with mortgage loans. The frequency of loss is strongly influenced by economic conditions. The likelihood of individual default is further increased if the property has deteriorated since a borrower in financial difficulty will be less able to sell the property at a price sufficient to discharge the mortgage.

Mortgage insurance losses can be divided into three categories:

(a) Normal losses associated with regular business cycles, interruptions in the borrower's earning power and random errors made in evaluating the insured's willingness or ability to meet mortgage obligations.

(b) Defaults caused by adverse local economic conditions.

(c) Widespread defaults caused by a severe depression in the U.S. economy.

The possible magnitude of loss contemplated in the last category has no analogy in any other private property/liability line of insurance.

3. Loss Incidence

Losses are incurred over an exposure period which can, as previously discussed, run for the term of the mortgage. The pattern of normal loss incidence is not uniform over the exposure period. The loss incidence peaks in the earlier years.

When a loan has been delinquent two or four months, the mortgage insurance policy requires the lender to notify the insurer. Further, the lender agrees to institute foreclosure proceedings six to nine months from the date of delinquency. Foreclosure can require an additional 18 months which could mean a considerable delay between the delinquency and the date of the claim. Without adverse economic conditions, most delinquencies do not result in a claim. Once a claim is presented, payment normally is made within one or two months and ultimate loss costs can be known relatively quick. An exception is the case where an insurer chooses to take the title to the property and sell it. Thus, reporting of losses and loss payments occur within the period that title is held by the insurer.

Pool Insurance

In addition to insuring mortgage loans on an individual basis (primary insurance), mortgage guaranty insurance is provided on pools of mortgage loans. Typically, such insurance supports mortgage-backed securities or group sales. Unlike other pool or group products, each loan is individually underwritten.

Pool insurance may be provided on loans that are already insured by primary insurance, in which case the pool insurance provides an additional level of coverage, or it may be provided on loans without primary insurance (usually loans with loan-to-value ratios below 80%). Generally, pool insurance provides 100% coverage and includes a stop-loss limit of liability which may range from 5% to 20% of the initial aggregate principal balance. Because of regulatory requirements in some states, pool insurance usually uses participating reinsurance arrangements to limit the exposure of any one mortgage insurer of a pool of loans to 25% of each mortgage insured.

Pool insurance policies are not cancelable by the insurer except for nonpayment of premium. These policies are generally written on mortgage pools having terms of up to 30 years. However, for all practical purposes, it is expected that the life of each pool will be considerably shorter than 30 years and will result in average policy life of 8 to 12 years. This compares to an individual policy which has an average term of 7 years.

In the case of default, the insurer has the same options as with individual insured mortgage loans. However, pool insurance loss payments are reduced by any settlements under primary insurance and subject to the stop-loss limit.

Three kinds of mortgage-backed securities which use pool insurance are described as follows:

1. Mortgage-Backed Bonds

   Issued by banks, savings and loan associations and other mortgage lenders as a general obligation of the issuing institution. These bonds are collateralized by a pool or mortgages and have a stated rate of return and maturity date.

2. Mortgage Revenue Bonds

   Issued by state and local housing authorities to support housing affordability for targeted income groups.

3. Mortgage Pass-Through Certificates

   Issued by banks, savings and loan associations, mortgage bankers and others providing an undivided interest in a pool of mortgages with principal and interest payment passed to the certificate holder as received.

Special Regulatory Requirements for Mortgage Insurers

1. Risk Ratio

   Since the inception of the private mortgage insurance industry in 1957, private mortgage insurers have been required to operate within a 25-to-1 ratio of risk to surplus, a ratio which many state insurance commissioners have determined to be prudent for the protection of lenders. For the purposes of arriving at this risk ratio, the regulatory authorities have defined “risk” as the total amount of exposure (percentage coverage) relating to the insurance in force, and “surplus” as policyholders’ surplus (capital, paid-in surplus, and unassigned surplus) plus the contingency reserve.

Valuation

1. Estimation of Reported Losses Unpaid

   Unpaid losses are estimated based on predictions of loss frequency and loss severity. These estimates are based on historic data, trends, economic information, and other

A mortgage guaranty insurance company shall compute and maintain an unearned premium reserve as set forth by regulation adopted by the commissioner of insurance.

B. Loss Reserve

A mortgage guaranty insurance company shall compute and maintain adequate case basis and other loss reserves which accurately reflect loss frequency and loss severity and shall include components for claims reported and for claims incurred but not reported, including estimated losses on:

(1) Insured loans which have resulted in the conveyance of property which remains unsold;

(2) Insured loans in the process of foreclosure;

(3) Insured loans in default for four (4) months or for any lesser period which is defined as default for such purposes in the policy provisions; and

(4) Insured leases in default for four (4) months or for any lesser period which is defined as default for such purposes in policy provisions.

(2) Unearned premium reserves and contingency reserves shall be computed and maintained on risks insured after the effective date of this chapter as required by Sections 16A and 16C. Unearned premium reserves and contingency reserves on risks insured before the effective date of this chapter may be computed and maintained as required previously.

Section 17. Regulations

The commissioner shall have the authority to promulgate rules and regulations deemed necessary to effectively implement the requirements of this chapter.

- No specific GAAP guidance obtained.

27. The AICPA Exposure Draft on mortgage guaranty insurance provides the following guidance.

Conclusions with respect to earning premium

19. Single premiums should be earned on a pro rata basis throughout the policy term, or on a declining basis if the amount of coverage significantly declines during the policy term. Annual premiums should be earned on the same basis. Level annual premiums should be earned on a pro rata basis over the policy term (usually one year). Additional first-year premiums on nonlevel policies, that is, the difference between first-year and level renewal premiums, should be deferred and amortized to income over the anticipated premium-paying period of the policies in relation to total anticipated premium receipts excluding the additional first-year premiums. If the dollar amount of coverage significantly declines during the anticipated premium-paying period, the additional first-year premium should be amortized to income in relation to anticipated coverage. If the initial renewal premium rate is higher than subsequent renewal premium rates, the excess premiums should be deferred and amortized to income over the remaining anticipated premium paying period of the policies in the same manner as the additional first-year premiums (this does not apply to policies with reduced premiums in later years, such as the tenth year or later). Level renewal premiums and the portion of the first-year premium equal to the level renewal premium should be earned on a pro rata basis over the policy term (generally one year). When significant differences between anticipated and actual renewal premiums occur, the predetermined amortization of additional first-year premiums should be adjusted to reflect actual experience.

Conclusions with respect to premium deficiencies

36. When anticipated losses and loss adjustment expenses, maintenance expenses and unamortized deferred acquisition costs exceed unearned premiums and estimated renewal premiums on existing policies, a provision for the anticipated premium deficiency should be provided. Premium deficiencies should be determined by reasonable groupings of business based on line of business or geographical area. (Premium deficiencies should be recognized by writing off any unamortized deferred acquisition costs to the extent required. If the deficiencies are more than the unamortized deferred acquisition costs, a separate liability should be provided for the excess deficiency).

37. In addition, companies that consider anticipated investment income in computing premium deficiencies should disclose the fact in their financial statements, together with the effects on the financial statements.

Conclusions with respect to recording claims

49. Losses should be accrued as of the initial default date, however, if a company can demonstrate that another date is more appropriate, such as 60 or 90 days after the initial default losses may be accrued as of that date.

50. In addition, companies that discount loss or loss adjustment expense reserves (see paragraphs 56 through 59) should disclose that fact in their financial statements, together with the effects on the financial statements.

51. No conclusion has been reached regarding whether loss reserves should be discounted; that is, whether the time value of money should be considered in determining loss reserves. This issue, as it applies to all insurance companies, is being considered separately by the AICPA Insurance Companies Committee.

- Accounting Practices and Procedures Manual for Property and Casualty Insurers, Appendix A
- The Mortgage Guaranty Insurance Model Act
- *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets*
- *Issue Paper No. 22—Leases*
- *Issue Paper No. 53—Property Casualty Contracts - Premiums*
  Issue Paper No. 55—Unpaid Claims, Losses and Loss Adjustment Expenses
- *Issue Paper No. 65—Property and Casualty Contracts*
- *Issue Paper No. 71—Policy Acquisition Costs and Commissions*
- *Issue Paper No. 77—Disclosure of Accounting Policies, Risks & Uncertainties, and Other Disclosures*

- *FASB Statement No. 60, Accounting and Reporting by Insurance Enterprises*

- No additional guidance obtained from state regulations or laws.

- AICPA Exposure Draft on Mortgage Guaranty Insurance
- California Insurance Code §§ 12640.01 to 12640.18 (1961/1993)
- Illinois Administration Regulation, TITLE 50 §§ 202.10 to 202.60 (1982/1986)
- New York Insurance Law §§ 6501 to 6507 (1984/1994)
- Wisconsin Administrative Code §§ 3.09 (1992)