7. If the trigger event takes place before a specified date, the issuer is relieved of some or its entire obligation to repay the securityholders, and the investor incurs a loss of some or all of its investment. The security must be issued with an indemnity trigger.

8. In an insurance-linked security, the insurer that originated the transaction has hedged its portfolio of insurance risks by transferring certain of those risks to the securityholders. Should the triggering event occur, the issuer would incur a loss that would be partly offset by the amount of liability to securityholders from which it is relieved. This issue paper provides statutory accounting guidance solely for indemnity triggered insurance securitization transactions conducted through a protected cell.

**Accounting for Prefunded Insurance-Linked Securities for Business Attributed to the Protected Cell from the General Account**

General Account Reporting

9. Activities such as sales, underwriting and contract administration, premium collection and payment of premium taxes, and claims processing are activities of the insurance company distinct from the protected cell and shall be accounted for as transactions of the general account.

10. Amounts paid to the protected cell for underwriting risks, which ultimately will be securitized by the protected cell, shall be reported separately as a reduction of written and earned premiums in the current period general account's statement of income. This premium is earned by the general account in accordance with *Issue Paper No. 53—Property Casualty Contracts–Premiums*.

11. At the maturity of the protected cell all assets and liabilities of the protected cell are distributed based on the contractual agreement with the securityholders. If after this distribution assets still reside in the protected cell, these assets shall be attributed to the general account and recognized as an adjustment to surplus.

12. Insurance claim liabilities arising from past insurable events attributed to the protected cell account from the general account shall be accounted for as retro-active reinsurance as prescribed in *Issue Paper No. 75—Property and Casualty Reinsurance*.

13. General account recoverables from the protected cell as a result of an indemnity based securitized event, shall be recognized separately as a reduction of gross losses and loss expenses incurred in the current period general account's statement of income. General account recoverables from the protected cell on unpaid reported and incurred but not reported losses and loss adjustment expenses shall be netted against the liability for gross losses and loss adjustment expenses in the general account's balance sheet. Recoverables from the protected cell shall not exceed the assets carried at fair value in the protected cell.

14. The general account shall include an aggregate write-in for the total assets and an aggregate write-in for liabilities of any protected cell which it maintains. Transfers to the general account due or accrued shall be reported on a net basis so that the asset and the liability totals of the general account are not overstated.

Protected Cell Reporting

15. The protected cell annual statement is concerned with the investment activities and obligations relating to insurance-linked securities attributed to that protected cell. As a result, the protected cell statement shall report only the financial activities of the protected cell and shall not include general account expenses related to insurance activities which are recorded for in the general account.

 

16. The protected cell shall record premium income for transactions attributed to it by the general account as income reported in the protected cell's statement of income. This premium attribution is earned by the protected cell in accordance with *Issue Paper No. 53— Property Casualty Contracts–Premiums*.

17. The obligation from the issuance of the insurance-linked security is recorded as Funds Held Under Securitization Agreement, a liability on the protected cell balance sheet which is reported at its contractual value which will be the lower of the scheduled amount to be repaid to investors or the fair value of the investments in the protected cell. All protected cell assets shall be reported at fair value. Interest expenses payable to securityholders associated with the protected cell investment operations shall be deducted in the determination of net operating income of the cell. Net investment income and realized capital gains and losses relating to the investment operations of the protected cell are recorded as net investment income. Payables to the general account shall not exceed the assets carried at fair value in the protected cell.

18. Changes in both (i.) the fair value of the protected cell invested assets and (ii.) the protected cell contractual (or discounted) value of liabilities to investors shall be reported as an unrealized gain/loss in the equity section of the protected cell balance sheet.

19. When the trigger event occurs with respect to the underlying exposures attributed to the protected cell, the protected cell shall record the appropriate incurred losses in its current period statement of income. Correspondingly, the Funds Held Under Securitization Agreement shall be reduced and offset by gross losses incurred in the current period Statement of Income. The applicable funds to cover the subject exposure are then attributed to the general account via a balance sheet account, "Due to/from the General Account."

20. If the trigger event does not take place on or before the contractual maturity date, the protected cell repays the bond principal as prescribed in the debt contract by reducing Funds Held Under Securitization Agreement.

**Disclosures**

General Account

21. Prior to the adoption of formal blanks changes by the NAIC Blanks Task Force, the general account shall reflect all activities with its protected cells as an aggregate write-in in its statutory balance sheet and income statement. The general account shall also disclose in its notes to the financial statements the types and amounts of exposures /risks attributed to each of its protected cells.

Protected Cells

22. Each protected cell of a protected cell company shall prepare and submit to all states where the protected cell company is licensed and the NAIC the following supplemental financial information:

a. Balance Sheet
b. Income Statement
c. Statement of Cash Flows
d. Investment Schedules as typically required for a property/casualty insurer
e. Schedule P

## DISCUSSION

23. This issue paper prescribes the accounting for the issuance of insurance-linked securities issued by a property and casualty insurer through a protected cell. This guidance was adopted by the Insurance Securitization Working Group of the Financial Condition (E) Committee in 1999. The Emerging Accounting Issues Working Group adopted the guidance as "NAIC Preferred Accounting Treatment" in October 1999. This issue is specifically scoped out of FAS 133, and therefore the protected cell concept is unique to statutory accounting.

## RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

### Statutory Accounting

24. In October 1999, the Emerging Accounting Issues Working Group adopted as "NAIC Preferred Accounting Treatment" the issue summary titled *Accounting for the Issuance of Insurance-Linked Securities Issued by a Property and Casualty Insurer through a Protected Cell*. The guidance included in the Summary Conclusion section of this issue paper is consistent with the previously adopted issue summary.

### Generally Accepted Accounting Principles

25. The following language is included in FAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*:

> 192. Example 26: Disaster Bond. A bond that pays a coupon above that of an otherwise comparable traditional bond; however, all or a substantial portion of the principal amount is subject to loss if a specified disaster experience occurs.
>
> Scope Application: A disaster bond can be viewed as a fixed-rate bond combined with a conditional exchange contract (an option). The in

PROTECTED CELL COMPANY MODEL ACT

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E. “Fair value” of an asset (or liability) means the amount at which that asset (or liability) could be bought (or incurred) or sold (or settled) in a current transaction between willing parties, that is, other than in a forced or liquidation sale. Quoted market prices in active markets are the best evidence of fair value and shall be used as the basis for the measurement, if available. If a quoted market price is available, the fair value is the product of the number of trading units times market price. If quoted market prices are not available, the estimate of fair value shall be based on the best information available. The estimate of fair value shall consider prices for similar assets and liabilities and the results of valuation techniques to the extent available in the circumstances. Examples of valuation techniques include the present value of estimated expected future cash flows using a discount rate commensurate with the risks involved, option-pricing models, matrix pricing, option-adjusted spread models, and fundamental analysis. Valuation techniques for measuring financial assets and liabilities and servicing assets and liabilities shall be consistent with the objective of measuring fair value. Those techniques shall incorporate assumptions that market participants would use in their estimates of values, future revenues, and future expenses, including assumptions about interest rates, default, prepayment, and volatility. In measuring financial liabilities and servicing liabilities at fair value by discounting estimated future cash flows, an objective is to use discount rates at which those liabilities could be settled in an arm’s-l

to protected cell assets or a protected cell account when in favor of a creditor of the protected cell and otherwise allowed under applicable law.

D. This Act shall not be construed to prohibit the protected cell company from contracting with or arranging for an investment advisor, commodity trading advisor, or other third party to manage the protected cell assets of a protected cell, provided that all remuneration, expenses and other compensation of the third party advisor or manager are payable from the protected cell assets of that protected cell and not from the protected cell assets of other protected cells or the assets of the protected cell company's general account.

E. (1) A protected cell company shall establish administrative and accounting procedures necessary to properly identify the one or more protected cells of the protected cell company and the protected cell assets and protected cell liabilities attributable to the protected cells. It shall be the duty of the directors of a protected cell company to:

(a) Keep protected cell assets and protected cell liabilities separate and separately identifiable from the assets and liabilities of the protected cell company's general account and;

(b) Keep protected cell assets and protected cell liabilities attributable to one protected cell separate and separately identifiable from protected cell assets and protected cell liabilities attributable to other protected cells.

(2) Notwithstanding the foregoing, if this section is violated, the remedy of tracing shall be applicable to protected cell assets when commingled with protected cell assets of other protected cells or the assets of the protected cell company's general account. The remedy of tracing shall not be construed as an exclusive remedy.

F. The protected cell company shall, when establishing a protected cell, attribute to the protected cell assets with a value at least equal to the reserves and other insurance liabilities attributed to that protected cell.

Section 5. Use and Operation of Protected Cells

A. The protected cell assets of a protected cell may not be charged with liabilities arising out of any other business the protected cell company may conduct. All contracts or other documentation reflecting protected cell liabilities shall clearly indicate that only the protected cell assets are available for the satisfaction of those protected cell liabilities.

B. The income, gains and losses, realized or unrealized, from protected cell assets and protected cell liabilities shall be credited to or charged against the protected cell without regard to other income, gains or losses of the protected cell company, including income, gains or losses of other protected cells. Amounts attributed to any protected cell and accumulations on the attributed amounts may be invested and reinvested without regard to any requirements or limitations of Section [insert reference applicable sections of the insurance code imposing limitations on insurance company investments] and the investments in a protected cell or cells shall not be taken into account in applying the investment limitations otherwise applicable to the investments of the protected cell company.

C. Assets attributed to a protected cell shall be valued at their fair value on the date of valuation.

 

**Accounting for the Issuance of Insurance-Linked Securities Issued by a Property and**

Section 8. No Transaction of an Insurance Business

A protected cell company insurance securitization shall not be deemed to be an insurance or reinsurance contract. An investor in a protected cell company insurance securitization shall not,

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