

Statutory Issue Paper No. 153

Counterparty Reporting Exception for Asbestos and Pollution Contracts

STATUS

Finalized February 22, 2016

Original SSAP and Current Authoritative Guidance: SSAP No. 62R

Type of Issue:

Common Area

5. On August 24, 2013, the Statutory Accounting Principles (E) Working Group adopted nonsubstantive revisions to SSAP No. 62R in agenda item 2011-45: Impact of Additional Reinsurance on Provision for Reinsurance as reflected in Appendix A. The adopted revisions provided a reporting exception for paid losses under retroactive reinsurance contracts on asbestos and pollution risks that received department of insurance approval and met certain criteria. This exception resulted in a reduction of the provision for reinsurance liability for overdue payments related to losses which had been paid by the retroactive counterparty, but were pending recovery from the “original” reinsurers.

6. As the adopted guidance was limited to a reduction of the liability for overdue paid losses and loss adjusting expenses, the two industry advocates for the original agenda item repeated their requests for a broader reduction in the provision for reinsurance liability. In addition, some Working Group members subsequently indicated their willingness to consider a broader reduction in the provision for reinsurance liability. As a result, NAIC staff was directed to provide additional recommendations to the Working Group regarding possible reductions to the provision for reinsurance liability for unpaid losses. This direction resulted in agenda item 2014-28: Asbestos and Pollution Reinsurance Reporting Exception. The agenda item was adopted on September 24, 2015 and is reflected in Appendix B. Although these items were both adopted as nonsubstantive changes, the cumulative impact of the two separate changes was closer to the definition of substantive change, and this issue paper was directed to be drafted to provide historical documentation and context for these complex and unusual transactions.

7. As a result of both agenda items, the following revisions were made to SSAP No. 62R: 2014-

67. With the approval of the reporting entity's domestic state commissioner pursuant to the applicable state credit for reinsurance law regarding the use of other forms of collateral acceptable to the commissioner, the reporting entity shall present the amount of other approved security related to the retroactive reinsurance agreement as an "Other Allowed Offset Item" with respect to the uncollateralized amounts recoverable from unauthorized reinsurers for paid and unpaid losses and loss adjustment expenses under the original reinsurance contracts. Amounts approved as "Other Allowed Offset Items"

DISCUSSION

Provision for Reinsurance

10. The statutory accounting liability known as the provision for reinsurance is calculated on ceded reinsurance in the property and casualty annual statement Schedule F on reinsurance. The provision for reinsurance contains multiple calculations to determine the liability reported in total on the liabilities, surplus and other funds part of the balance sheet. As an overview, the provision is calculated using the following sections of Schedule F:

- a. Part 3 reflects ceded reinsurance;
- b. Part 4 reflects aging of ceded reinsurance. Part 4 calculates information based on aging of paid losses and paid loss adjusting expenses which are recoverable from reinsurers which were reflected on Schedule F part 3. It calculates an overdue total and a percentage of overdue and the percentage of losses which is more than 120 days overdue. The provision for overdue liability that results from this information is a statutory accounting convention that is similar to a valuation allowance.
- c. Part 5 reflects the provision for unauthorized reinsurance. This is the method used to reflect the unauthorized reinsurer requirements of the Credit for Reinsurance Law. The Credit for Reinsurance Law does not permit reinsurance reserve reduction for the amounts ceded to unauthorized reinsurers unless adequate collateral is provided.
- d. Parts 7 and 8 use amounts determined in parts 2, 4, and 5 to calculate a total provision for reinsurance. This includes liabilities for overdue amounts, for authorized reinsurers, for unauthorized for amounts in dispute. Collateral including other available offsets are reflected as reductions to the liability however these amounts do not reduce the provisions for overdue amounts.

Initial Agenda Item Resulting in a Reduction of the Provision for Overdue

11. Agenda item 2011-45: Impact of Additional Reinsurance on Provision for Reinsurance was first discussed in November 2011. The industry sponsor advocated for changes to the provision for reinsurance liability for a special type of retroactive reinsurance which the industry advocated transfers both the liability to the inuring third party reinsurance and the related collection risk. In the circumstance under discussion, the retrocessionaire assumes responsibility to collect inuring third party reinsurance on behalf of the cedent. Any amounts not collected are covered under the available limit of the retroactive agreement. The retrocessionaire reimburses the cedent for gross losses paid regardless of whether the inuring reinsurance has been collected from the third party. The sponsor noted that in such instances, the reporting entity has limited its net exposure from the initial third party reinsurer; however, it was still forced to record a balance due on its Schedule F and compute a provision for reinsurance for paid amounts it has already received.

12. The sponsor recommended that the reporting entity be allowed to reflect in its property and casualty annual statement Schedule F the balances receivable from/payable to the retrocessionaire, including amounts related to the inuring reinsurance, in lieu of separately reporting the underlying third party reinsurers. In addition, the industry sponsor advocated calculating the provision for reinsurance based on the retrocessionaire's authorization status and payment history. The exception was proposed for contracts which met the following conditions:

- a. The reinsurance agreement must clearly indicate the retrocessionaire has assumed the credit risk associated with the collection of the inuring reinsurance recoverables;
- b. The reinsurance agreement must transfer significant risk of loss to the retrocessionaire;

- c. The retrocessionaire must have a financial strength rating from at least two nationally recognized statistical rating organizations (NRSRO), the lowest of which is higher than or equal to the

IP 153-6 19. balances related to the original reinsurers. It was noted novated and there was not a legal assignment of the risks. Because of this

Example of the Use of Commissioner Discretion

38. The draft language exposed in Summer 2014 included an example of the use of commissioner discretion to approve other acceptable security. The language included was:

An example of the use of such discretion would be to approve the funds held in trust related to the retroactive reinsurance contract as other security acceptable to the commissioner related to the asbestos and environmental obligations of the original insurers.

The Working Group agreed to remove the example in the authoritative text, at the request of the industry sponsors because they noted it implied a limitation on the commissioner discretion to approve other security that was not in the Credit for Reinsurance Law. However, because the Working Group agreed the example would likely be the most common use of the discretion, the Working Group directed staff to document this as a valid, potential example in this issue paper.

Timeline of Working Group Actions-2014-28

39. In response to the Summer 2014 National Meeting exposure of both reporting methods, the industry advocates jointly provided two comment letters which were discussed at the Fall 2014 National Meeting. The first comment letter advocated for reporting option two and provided wording suggestions to SSAP No. 62R. The second comment letter affirmed that consistent with the prior discussions, the sponsors agreed that the proposed reporting supplement would be public. The industry advocates also continued disagreement with the requirement to disclose the use of the commissioner's discretion under the Credit for Reinsurance Law of the use of other security as a prescribed or permitted practice. The industry sponsors acknowledged that option two is a departure from the normal preparation of reinsurance on Schedule F; however, advocated it is more reflective of the economics of the transaction.

40. At the Fall 2014 National Meeting the Working Group voted to proceed with option one and directed NAIC staff to submit the annual statement blanks proposal to the Blanks (E) Working Group. As part of this

the substitution of the retroactive counterparty in place of the original reinsurers when determining timeliness for amounts recoverable as reimbursement from the original reinsurers for claims that have been paid by the retroactive counterparty, was adopted in 2013. The element still under discussion was focused on decreasing the provision for reinsurance related to unpaid losses, which is required by the Credit for Reinsurance Law for unauthorized reinsurers that are uncollateralized. This results in an increased reserve credit for unpaid losses for unauthorized and uncollateralized original reinsurers if other acceptable security is approved by the use of commissioner's discretion under the Credit for Reinsurance Law in the laws adopted by the state of domicile of the ceding entity.

44. During the June 1, 2015 conference call, the Working Group considered the staff recommendation to adopt the exposed reporting option one language with minor edits to: 1) revise the heading to remove "paid amounts"; 2) delete the reference to paragraph 67 in the first sentence of paragraph 68, as aggregate reporting is only allowed under paragraph 66; 3) add "amount of other approved security related to" in paragraph 67 to be consistent with prior Working Group discussions not

50.

- d. The ceding entity shall, by write-in item on the balance sheet, restrict surplus resulting from any retroactive reinsurance as a special surplus fund, designated as special surplus from retroactive reinsurance account;
- e. The surplus gain from any retroactive reinsurance shall not be classified as unassigned funds (surplus) until the actual retroactive reinsurance recovered exceeds the consideration paid;
- f. The special surplus from retroactive reinsurance account for each respective retroactive reinsurance agreement shall be reduced at the time the ceding entity begins to recover funds from the assuming entity in amounts exceeding the consideration paid by the ceding entity under such agreement, or adjusted as provided in subparagraph 29.j.;
- g. For each agreement, the reduction in the special surplus from retroactive reinsurance account shall be limited to the lesser of (i) the actual amount recovered in excess of consideration paid or (ii) the initial surplus gain resulting from the respective retroactive reinsurance agreement. Any remaining balance in the special surplus from retroactive reinsurance account derived from any such agreement shall be returned to unassigned funds (surplus) upon elimination of all policy obligations subject to the retroactive reinsurance agreement;
- h. The ceding entity shall report the initial gain arising from a retroactive reinsurance transaction (i.e., the difference between the consideration paid to the reinsurer and the total reserves ceded to the reinsurer) as a write-in item on the statement of income, to be identified as Retroactive Reinsurance Gain and included under Other Income;
- i. The assuming entity shall report the initial loss arising from a retroactive reinsurance transaction, as defined in the preceding subparagraph 29.g., as a write-in item on the statement of income, to be identified as Retroactive Reinsurance Loss and included under Other Income;
- j. Any subsequent increase or reduction in the total reserves ceded under a retroactive reinsurance agreement shall be reported in the manner described in the preceding subparagraphs 29 h. and 29 i., in order to recognize the gain or loss arising from such increase or reduction in reserves ceded. The Special Surplus from Retroactive Reinsurance Account write-in entry on the balance sheet shall be adjusted, upward or downward, to reflect such increase or reduction in reserves ceded. The Special Surplus from Retroactive Reinsurance Account write-in entry shall be equal to or less than the total ceded reserves under all retroactive reinsurance agreements in-force as of the date of the financial statement. Special surplus arising from a retroactive reinsurance transaction shall be considered to be earned surplus (i.e., transferred to unassigned funds (surplus)) only when cash recoveries from the assuming entity exceed the consideration paid by the ceding entity as respects such retroactive reinsurance transaction; and
- k. The consideration paid for a retroactive reinsurance agreement shall be reported as a decrease in ledger assets by the ceding entity and as an increase in ledger assets by the assuming entity.

Provision for Reinsurance

55. The NAIC Annual Statement Instructions for Property and Casualty Companies for Schedule F—Provision for Overdue Reinsurance, provide for a minimum reserve for uncollectible reinsurance with an additional reserve required if an entity's experience indicates that a higher amount should be provided. The minimum reserve Provision for Reinsurance is recorded as a liability and the change between years is recorded as a gain or loss directly to unassigned funds (surplus). Any reserve over the minimum amount shall be recorded on the statement of income by reversing the accounts previously utilized to establish the reinsurance recoverable.

56. The provision for reinsurance is calculated separately for unauthorized and authorized companies. An authorized reinsurer is licensed, accredited or approved by the ceding entity's state of domicile; an unauthorized reinsurer is not so licensed, accredited or approved.

55. *SSAP No. 64—Offsetting and Netting of Assets and Liabilities* has the following existing guidance on right of offset:

SUMMARY CONCLUSION

2. Assets and liabilities shall be offset and reported net only when a valid right of setoff exists except as provided for in paragraphs 3 and 4. A right of setoff is a reporting entity's legal right, by contract or otherwise, to discharge all or a portion of the debt owed to another party by applying an amount that the other party owes to the reporting entity against the debt. A valid right of setoff exists only when all the following conditions are met:

- a. Each of the two parties owes the other determinable amounts. An amount shall be considered determinable for purposes of this provision when it is reliably estimable by both parties to the agreement;
- b. The reporting party has the right to setoff the amount owed with the amount owed by the other party;
- c. The reporting party intends to setoff; and
- d. The right of setoff is enforceable at law.

3. Assets and liabilities that meet the criteria for offset shall not be netted when prohibited by specific statements of statutory accounting principles. An example of such is in the case of reinsurance recoverables on paid losses and ceded premiums payable as provided for in *SSAP No. 62R—Property and Casualty Reinsurance*.

4. Netting of assets and liabilities for reporting purposes when no valid right of setoff exists shall be allowed only when provided for by specific statements of statutory accounting principles. An example of such is in the case of real estate investments required to be shown net of encumbrances as provided for in *SSAP No. 40—Real Estate Investments*.

5. Amounts due to or from affiliates shall be offset and reported net only when the provisions of paragraph 2 above are met.

retroactive reinsurance counterparty, and additionally to reinsurance recoverable on unpaid losses if the domestic state commissioner has approved amounts related to the retroactive reinsurance contract as any other form of security acceptable under the applicable provisions of

APPENDIX C- ILLUSTRATION ADOPTED ON SEPTEMBER 24, 2015

SCHEDULE F – PART 3
Ceded Reinsurance as of December 31, Current Year
(000 Omitted)

<u>1</u> ID Number	<u>2</u> NAIC Company Code	<u>3</u> Name of Reinsurer	<u>4</u> Domiciliary Jurisdiction	<u>5</u>
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SCHEDULE F – PART 4
Aging of Ceded Reinsurance as of December 31, Current Year
(000 Omitted)

1 ID Number	2 NAIC Company Code	3 Name of Reinsurer	4 Domiciliary Jurisdiction	Reinsurance Recoverable on Paid Losses and Paid Loss Adjustment Expenses						11 Total Due Cols. 5 + 10	12 Percentage Overdue Col. 10/Col. 11	13 Percentage More Than 120 Days Overdue Col. 9/Col.11
				5 Current	Overdue				10 Total Overdue Cols. 6 + 7 + 8 + 9			
					6 1 to 29 Days	7 30 - 90 Days	8 91 - 120 Days	9 Over 120 Days				
FEIN	#####	Retroactive Reinsurer X	NE	6,000						6,000	=	=

SCHEDULE F – PART 5
Provision for Unauthorized Reinsurance as of December 31, Current Year
(000 Omitted)

<u>1</u> ID Number	<u>2</u> NAIC Company Code	<u>3</u> Name of Reinsurer	<u>4</u> Domiciliary Jurisdiction	<u>5</u> Reinsurance Recoverable All Items Schedule F Part 3 Col. 15	<u>6</u> Funds Held by Company Under Reinsurance Treaties	<u>7</u> Letters of Credit	<u>8</u> Issuing or Confirming Bank Number	<u>9</u> Ceded Balances Payable	<u>10</u> Miscellan- eous Balances Payable	<u>11</u> Trust Funds and Other Allowed Offset Items	<u>12</u> Total Collateral and Offsets Allowed (Cols. 6+7+9+10+ 11 but not in excess of Col. 5)	<u>13</u> Provision for Unauthorized Reinsurance (Col. 5 minus Col. 12)	<u>14</u> Recoverable Paid Losses & LAE Over 90 Days Past Due not in Dispute	<u>15</u> 20% of Amount in Col. 14	<u>16</u> 20% of Amount in Dispute Included in Col. 5	<u>17</u> Provision for Overdue Reinsur- ance (Col. 15 plus Col. 16)	<u>18</u> Total Provision for Reinsurance Ceded to Unauthorized Reinsurers (Col. 13 plus Col. 17 but not in Excess of Col. 5)
		Original Company B	UK	48,500	-	-		-			48,500						
		Original Company C	UK	41,500							41,500						

