Property and Casualty Reinsurance Accounting Guidance:
A Historical Perspective

By

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Introduction

The recent accounting scandals involving Enron and WorldCom, among others, have heightened public awareness of financial reporting abuses that seem to have flourished during the late 1990s bull market. In the insurance industry, the capability of reinsurance transactions to influence the financial statements of insurance enterprises has always led to significant interest among the accounting profession and the regulatory community based on the potential for such abuse. Accordingly, an expanding body of accounting guidance related to reinsurance has evolved to address this risk. In light of recent events, controversy concerning the application of accounting guidance for determining whether or not reinsurance agreements contain "risk transfer" has increased, since alternative accounting treatments that result from this analysis can significantly affect the financial statements of both parties to a reinsurance transaction.

The objective of this article is to provide an understandable overview of the development of the current property and casualty reinsurance accounting guidance using a historical perspective, including a discussion of its more controversial elements.

Who makes these rules?

The individual States, not the federal government, have regulated the business of insurance in the United States since the mid 1800s. This allocation of governmental power was essentially ratified by Congress with the passage of the McCarran-Ferguson Act in 1945 in response to a Supreme Court decision (US vs. South-Eastern Underwriters

Association) which called into question the state role[1]. One aspect of this regulatory responsibility has been the authority to prescribe accounting rules governing the financial statements, exhibits, and schedules which are required to be submitted to the state regulatory officials. Over the years, a body of accounting practices known as statutory accounting practices (SAP) has evolved from the coordinated activities of the state regulators and their nationwide association, the National Association of Insurance Commissioners (NAIC). In 2001, following a period of growing concern over the uniformity and completeness of the previously existing insurance regulatory accounting guidance, the regulatory community implemented a codification of statutory accounting principles. Although each state may prescribe its own accounting rules (which may be unique), the influence of the NAIC in producing model legislative bills means that the NAIC, more than any other single party, has been responsible for the development of SAP[2]. Owing to the overriding regulatory interest in the solvency of insurers, SAP tends to be highly conservative in nature and is focused on the balance sheet.

For insurance enterprises that are required to (or choose to) prepare financial statements on a generally accepted accounting principles (GAAP) basis, there are additional rule making bodies that are relevant to their financial statements. The need to prepare GAAP basis financial statements generally arises as a result of the differing information needs of investors and creditors which are not satisfied by SAP basis financial reports. For example, publicly held entities must submit GAAP financial statements to the Securities and Exchange Commission (SEC). Since 1973, the chief rule making body for GAAP has been the Financial Accounting Standards Board (FASB). As a result of its focus on providing information for investor and creditor decision making, GAAP tends to be less conservative in nature than SAP, and is focused on the measurement of earnings.

Over the years, the statutory guidance for reinsurance accounting has been amended to more closely align with the GAAP guidance. Accordingly, an overview of the evolution of the key elements of the GAAP guidance is presented below, followed by a discussion of the current SAP guidance and the major differences from GAAP guidance which currently exist.

Origins of GAAP rules for reinsurance accounting

In 1982, the FASB issued Statement of Financial Accounting Standards No. 60 (SFAS 60) entitled "*Accounting and Reporting by Insurance Enterprises*". This was the result of an initiative undertaken by the FASB to extract specialized accounting and reporting principles from previously published guidance issued by the American Institute of Certified Public Accountants (AICPA), and issue them as Statements of Financial Accounting Standards. SFAS 60 essentially adopted without change the principles previously laid out in AICPA publications. An explanation of the major provisions of SFAS 60 follows.

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[1] A federal oversight role continues to exist, primarily with respect to Anti-trust issues.

[2] For example, the NAIC initially developed the Model Act which was later passed by Congress as the McCarran-Ferguson Act.

SFAS 60: What are "short duration" and "long duration" insurance contracts?

SFAS 60 makes a distinction between short duration and long duration insurance contracts in presenting its guidance. This distinction does not exist outside of the accounting literature, but provides a versatile way in which to classify those insurance contracts (potentially not yet devised) to which particular aspects of the accounting guidance apply. As the name implies, long duration contracts are defined as those in which benefits and services are provided over an extended period. In addition, long duration contracts are generally characterized by a prohibition on unilateral changes to the contract terms. As such, a perfect example would be a whole life insurance policy which may be kept in force for the insureds' lifetime with the payment of one or more premiums and which will pay a benefit upon the death of the insured.

Conversely, short duration contracts are defined as those in which benefits and services are provided for a fixed period of short duration. In addition, short duration contracts are generally characterized by the ability of the insurer to cancel or revise the premium at the beginning of each contract period. Accordingly, an ideal example would be a personal automobile policy that is typically in force for a year at most, and allows the insurer the opportunity to reprice the policy premium at each policy anniversary.

Although not explicitly defined this way in the guidance, almost all property and casualty insurance contracts qualify as short duration contracts. However, not all short duration contracts are property and casualty insurance contracts. For instance, a yearly renewable term life insurance policy, which may provide a death benefit in the event of the insured's death during the one-year policy period, would be considered a short duration insurance contract. Although a short duration insurance contract may have a one-year policy period, for casualty lines the period over which settlements are made related to insured events which occur during the policy period may be considerably longer – up to 20 years and beyond in some cases.

SFAS 60: What rules apply to "short duration" contracts?

SFAS 60 provides the following four basic rules which apply to the measurement of revenues and costs for short duration insurance contracts:

1. Premium revenue (premiums earned) ordinarily must be recognized over the period of the contract in proportion to the amount of insurance protection provided[3]. The period of the contract is the period from the policy effective date to the policy expiration date. This is typically achieved through the calculation of the amount of the deferred premium revenue (the unearned premium) that is associated with the amount of insurance coverage that has not yet been provided as of the financial statement date[4]. However, in some cases the insurance protection may be exhausted prior to the expiration date of the policy. In this case, it is therefore appropriate to

[3] If premiums are adjustable (through retrospective rating, etc.) and the ultimate premiums are reasonably estimable, then ultimate premiums must be used as the basis of this premium revenue recognition. If premiums are adjustable and the ultimate premiums are not reasonably estimable, an alternate amortization method (cost recovery method/deposit method) which postpones income recognition must be utilized.

[4] This generally assumes that the insurance protection is provided evenly over the period of the contract.

fully recognize the premium revenue when the insurance protection has been fully used up.

2. Claims costs (including claim adjustment costs) must be recognized when the insured events occur and must include an estimate for claims which have occurred but which have not been reported to the insurer (IBNR). Changes in estimates are recognized in the future period in which the estimate is changed. This significantly affects the nature of insurance enterprises financial statements, since current period earnings can be materially affected (either positively or negatively) by changes in estimated claims costs from prior periods.

3. Acquisition costs which vary with, and are primarily related to the acquisition of new and renewal insurance contracts (commissions, brokerage, etc) are capitalized and charged to expense in proportion to the amount of associated premium revenue recognized. When reinsurance ceded agreements provide for recovery of acquisition costs from the reinsurer (through a ceding commission for instance) then <u>net</u> acquisition costs are to be capitalized and charged to expense in proportion to <u>net</u> premium revenue recognized.

4. Costs other than claims costs that do not vary with and primarily relate to the acquisition of new and renewal insurance contracts are expensed as incurred.

Special rules for revenue and cost recognition apply if a “premium deficiency” exists. This occurs when future expected claims and other costs (including unamortized acquisition costs) exceed the related unearned premium (the future revenue to be recognized)[5]. In such a case, following the rules for revenue and cost recognition laid out above would result in the postponement of the recognition of a loss. If such a deficiency exists, the amount of the probable loss must be recognized by first charging unamortized acquisition cost to expense, and then by establishing a liability for the remaining excess, if any. This is necessary because it is a general principle of accounting that if a loss is probable and the amount is reasonably estimable, then it should be accrued for by means of a charge against income[6].

SFAS 60 also provides for a special rule to apply whenever an insurance contract does not provide “indemnification of the ceding enterprise by the reinsurer against loss or liability” (i.e. risk transfer). In these situations, SFAS 60 requires that “the premium paid less the premium to be retained shall be accounted for as a deposit” by the ceding enterprise. However, no further explanation of the conditions necessary for neither risk transfer nor deposit accounting is provided in SFAS 60.

The final major provision of SFAS 60 is the so-called “net” accounting provision. “Net” accounting entails that only reinsurance ceded balances that relate to <u>paid</u> claim and claim adjustment expenses be classified explicitly as assets (with an allowance for

[5]Anticipated investment income may be considered in determining whether a premium deficiency exists but must be disclosed if it is considered

[6] SFAS 5

estimated uncollectable amounts). The typically more significant reinsurance ceded balances that relate to liabilities for unpaid claims and claim adjustment expenses are deducted directly from these liabilities. Likewise, reinsurance ceded unearned premiums are also deducted directly from the related unearned premium liability, and receivables and payables from the same reinsurer are also netted. Reinsurance ceded premiums and recoveries on claims may be netted to the related premiums and claims items, and need not appear on the face of the statement of earnings.

When SFAS 60 was released, the FASB noted that it did not address certain issues currently being studied by the insurance industry and the accounting and actuarial professions. Among other things, this included the question of what would constitute "risk transfer" under a reinsurance contract.

SFAS 113: FASB issues a statement exclusively addressing reinsurance

More than 10 years passed before, in 1992, the FASB issued SFAS 113 entitled "*Accounting and reporting for reinsurance of short-duration and long-duration contracts*" which provided some guidance on the "risk transfer" question. High interest rates in the 1980s increased the gap between the economic and book value of property and casualty insurer's liabilities particularly in the casualty lines of business[7]. The temptation (among both buyers and sellers) to unlock this difference through the use of innovative reinsurance products was great. Buyers were interested in the financial statement engineering possibilities which were available, and sellers liked the opportunity to earn virtually "risk free" profits following a minimal investment in creative expertise.

Thus, the "risk transfer" question took on increasing importance. For its part, SFAS 60 only inadequately addressed this issue[8]. Although it required deposit accounting for reinsurance contracts which did not transfer risk, it failed to provide any guidance on how this transfer of risk should be assessed[9]. SFAS 113 also responded to other significant concerns about reinsurance accounting which existed. Chief among these other concerns were issues such as "net" accounting for reinsurance, the overall adequacy of reinsurance disclosures, and the limited guidance regarding reinsurance accounting contained in SFAS 60.

SFAS 113: "Net" accounting is abolished

Well publicized insurance company failures in the late 1980s, involving particularly heavy use of reinsurance, gave critics of the "net" accounting provisions of SFAS 60 excellent justification for their concerns[10]. In addition, the accounting profession had long wrestled with the apparent inconsistency between the "net" accounting allowed by SFAS

[7] Between 1980 and 1985 interest rates reached unusually high levels. For instance, rates on 5 year treasury securities ranged from 10% to 15%. These levels have not returned since then.

[8] Some regulatory officials (New York – Regulation 108) responded to the emerging market for loss portfolio transfer reinsurance in 1984 by requiring specialized SAP accounting and disclosure for such transactions.

[9] Effectively removing the financial reporting benefits of such contracts

[10] The failures of Mission, Transit, and Integrity were chronicled in the 1990 Congressional Report on Insurance company insolvencies "*Failed Promises*". Reinsurance was identified as the number 2 cause of the insolvencies.

60 and the established criteria for offsetting[11]. As a result, SFAS 113 abolished the practice of "net" accounting for reinsurance by requiring that assets be established for "reinsurance receivables" including paid and unpaid claims, claims settlement expenses, and estimates for unsettled claims and IBNR (except where a complete extinguishment of the cedants liability to the policyholder was effected – such as in novations and assumptions - in which case the related assets and liabilities can be removed from the financial statements) and that offsetting only be utilized where a right of setoff exists[12]. A separate asset for prepaid reinsurance premiums (premiums paid to the reinsurer related to the unexpired portion of the reinsured contracts, also known as ceded unearned premiums) is also required.

SFAS 113: What constitutes "risk transfer"?

SFAS 113 expands upon SFAS 60 by providing two conditions that both must be met in order to determine if a reinsurance contract provides "indemnification against loss or liability" relating to insurance risk[13]. Insurance risk incorporates underwriting risk and timing risk. Underwriting risk refers to uncertainty concerning the ultimate amount of premium and claims cash flows under the contract. Timing risk refers to uncertainty concerning the timing of these cash flows. These two conditions are listed below:

1. The reinsurer must assume "significant" insurance risk under the reinsured portions of the underlying insurance contracts.

2. It must be "reasonably possible" that the reinsurer may realize a "significant" loss from the transaction[14].

With respect to the first condition, in circumstances where the likelihood of "significant" variation in either the amount or the timing of the reinsurers' payments is "remote" the condition is not considered to be met[15]. Reinsurance contracts may contain terms that may prevent this condition from being met. Any term, or combination of terms, that has the effect of reducing the reinsurers' risk to this level will prevent this condition from being met. For instance (although unrealistic), a quota share reinsurance contract may provide a fixed percentage ceding commission as well as a fixed percentage loss ratio cap (above which the reinsurer will not share in any underlying losses). If the sum of these percentages (representing the maximum pay back to the reinsured) were less than 100%, clearly the reinsurer could not have assumed significant insurance risk.

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[11] APB 10 issued in 1966 provided that "It is a general principle of accounting that the offsetting of assets and liabilities in the balance sheet is improper except where a right of setoff exists". FASB Interpretation 39 issued in 1992 (just prior to the issuance of SFAS 113) established 4 conditions that are required to be met in order for a "right of setoff" to exist.
[12] As defined in FASB Interpretation 39
[13] An exception exists for reinsurance contracts that transfer substantially all insurance risk related to the underlying insurance contracts to the reinsurer. It is necessary that the cedant retain "insignificant" insurance risk in this regard
[14] (SFAS 5, paragraph 3) The chance of the future event or events occurring is more than remote but less than likely.
[15] (SFAS 5, paragraph 3) The chance of the future event or events occurring is slight.

Analysis of the second condition requires that all cash flows between the cedant and the reinsurer be discounted to present value under reasonably possible outcomes[16]. The resulting present value gain or loss is compared to the present value of amounts paid or deemed to have been paid to the reinsurer. If it can be demonstrated that the reinsurer is exposed to a "significant" loss under a "reasonably possible" scenario, then this condition is considered to be met. Below is a sample illustration of the type of calculations required to perform this evaluation.

Sample calculations - Reasonable possibility of a significant loss

Assumptions:

1. Ceding Commission percentage: 30% of gross ceded premiums
2. Loss (inc Loss and LAE) ratio cap: 80% of gross ceded premiums
3. Reasonably possible underlying loss ratio range: from 60% to 90%
4. Loss Payment pattern: Year 1:50%, Year 2:20%, Year 3:15%, Year 4:15%
5. Appropriate discount rate: 7%

		High Loss Ratio Scenario				
Assumptions:						
Underlying Loss ratio:	90.0%					
Loss ratio cap:	80%					
Limited Loss Recovery:	80,000					
% Loss paid in year:		50%	20%	15%	15%	100%
		Year 1	Year 2	Year 3	Year 4	
Reinsurance Premium:		100,000	-			100,000
Ceding Commission:		30,000	-			30,000
Reinsurance Loss Recoveries:		45,000	18,000	13,500	3,500	80,000
Reinsurers Cash Flow		25,000	(18,000)	(13,500)	(3,500)	(10,000)
PV factor (7%, midyear)		0.9667	0.9035	0.8444	0.7891	
Reinsurers PV Cash Flow		24,168	(16,263)	(11,399)	(2,762)	(6,256)

Based on this sample illustration, under the worst reasonably possible scenario (the high loss ratio scenario), the reinsurer is exposed to a present value loss of $6,256. Although the FASB was asked to provide additional guidance concerning the meaning of the term "significant" in this context, its response was limited to clarifying that the significance of the loss must be evaluated in relation to the present value of the amounts paid to the reinsurer. Accordingly, the question to be asked becomes "is the reinsurer's $6,256 loss significant in relation to the reinsurer's $96,670 ($100,000 times .9667) premium payment?" The lack of any further guidance on this issue must be taken as an indication that judgment be applied in the analysis. Some have suggested using as a benchmark that

[16] SFAS 113 requires a consistent rate (selected using judgment) be used for all scenarios since interest rate risk is not a component of insurance risk

anything less than a 10% loss cannot be considered significant. In that case, the example cannot be considered to satisfy the second required condition for risk transfer.

If either one of the two conditions is not met, the reinsurance contract must be accounted for as a deposit as required under SFAS 60.

SFAS 113: What are "prospective" and "retroactive" reinsurance contracts?

For reinsurance contracts which qualify for reinsurance accounting treatment (that is, they pass the "risk transfer" test), SFAS 113 draws a distinction between "prospective" and "retroactive" reinsurance contracts. This classification is necessary in order to apply the rules regarding the recognition of revenues and costs. Prospective reinsurance contracts provide coverage for future insured events that may occur under the contracts subject to the reinsurance. A typical property catastrophe excess reinsurance contract illustrates this classification. Retroactive reinsurance contracts provide coverage for past insured events that have occurred under the contracts subject to the reinsurance. A loss portfolio transfer reinsurance contract (where all the underlying contracts subject to the reinsurance have expired) illustrates this classification.

The determination of whether a reinsurance contract is prospective or retroactive depends solely on whether the underlying insured events have already occurred. In this regard, the insured event for an occurrence policy is the occurrence of a loss, but the insured event for a claims-made policy is the reporting to the insurer of a loss. Accordingly, a claims-made reinsurance contract may be either prospective, retroactive, or both depending the nature of the underlying insured events[17]. Unfortunately, many reinsurance contracts provide coverage that effectively combines both classifications. For instance, a company wishing to exit a line of business will require a reinsurance agreement that provides both classifications of coverage. In this case, SFAS 113 requires the prospective and the retroactive elements be accounted for separately. If this is not possible, SFAS 113 requires the entire contract to be accounted for as a retroactive reinsurance contract.

SFAS 113: What rules apply to revenue and cost recognition?

For prospective reinsurance, there is no change to the rules contained in SFAS 60. For retroactive reinsurance, the accounting revolves around the relationship between the amount paid to the reinsurer and the recorded amount (book value) of the liabilities reinsured. If the liabilities exceed the amount paid, the amount of the difference must be recorded as a deferred gain and amortized over the remaining settlement period[18]. If the amount paid exceeds the liabilities, the amount of the difference must be charged to earnings. Since the amount of this difference is subject to reevaluation over the entire settlement period as claims are paid and new estimates of the amounts unpaid are prepared, SFAS 113 requires that changes in the estimated liabilities relating to the

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[17] If the underlying insurance contracts are occurrence policies and the reinsurance provides coverage for claims which occurred prior to the effective date of the reinsurance contract but which are reported to the reinsurer during the reinsurance contract term – the reinsurance is at least partly retroactive. If the underlying insurance contracts are claims made policies the reinsurance may be prospective.

[18] Defined in SFAS 113 as "The estimated period over which a ceding enterprise expects to recover substantially all amounts due from the reinsurer under the terms of the reinsurance contract". The gain may be amortized using either an interest method or the recovery method.

underlying reinsured contracts be recognized in earnings in the period of the change, and that reinsurance receivables and the deferred gain be adjusted or established as a result.

To illustrate the effect of these requirements, assume a retroactive reinsurance agreement is entered into whereby the ceding company pays $100 of premium for $150 million of coverage for liabilities with a recorded value of $110. Further assume that the expected settlement period will be 5 years[19]. At inception, the transaction will result in a reinsurance recoverable of $110 and a deferred gain of $10. If adverse development of $30 occurred in year 1 (meaning that the ceding company has incurred losses of $30 in year 1 as a result of the change in estimate of the losses on the underlying policies) the reinsurance recoverable would be adjusted to $140, and the deferred gain would be adjusted to $40 prior to any year 1 settlements or amortization. At the end of year 1, the ceding company will record $8 in earnings related to the amortization of the deferred gain but will record a charge of $30 for the adverse development on the underlying policies reinsured. Alternately, if favorable development of $15 occurred in year 1 the reinsurance recoverable would be adjusted to $95, the deferred gain would be eliminated, and a $5 charge to earnings would result prior to any year 1 settlements or amortization[20]. Overall therefore, two significant impacts of the retroactive rules are 1) to prevent cedants from recording any immediate gains from retroactive reinsurance transactions, and 2) to prevent cedants from avoiding income statement impacts as a result of prior year adverse loss development on policies subject to retroactive reinsurance coverage.

<u>EITF 93-6: "Funded Cat" covers receive some special attention</u>

In July 1993, the FASB's Emerging Issues Task Force (EITF) issued EITF 93-6 entitled "*Accounting for Multiple-year Retrospectively Rated Contracts by Ceding and Assuming Companies*" [21]. EITF 93-6 applies to multiple year reinsurance contracts having obligatory terms which can result in changes to the contracts future coverage and/or the amount and timing of future cash flows depending on the experience of the contract, and which cannot be avoided through cancellation[22].

One such type of agreement was commonly known as a "funded cat" cover. Through coverage and premium adjustment mechanisms, these agreements provided for some "pay back" of losses recovered under the agreement through future increases in premium payments or decreases in coverage amounts. The effect was to spread catastrophe shock losses over multiple years. FASB and SEC interest in these types of contracts increased following the unusually heavy catastrophic losses which occurred in 1992. EITF 93-6 essentially requires that changes to future coverage and/or cash flows under the reinsurance agreement, which result from the experience to date, be recognized in the earnings of both the ceding and the assuming companies in the same period as the experience arises.

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[19] Assume amortization will be straight line

[20] These examples appeared in *FASBViewpoints*, Question no 34.

[21] The EITF was formed in order to assist the FASB by identifying emerging issues that require its attention. The EITF considers more narrowly focused issues as well as issues that require immediate attention.

[22]Insurance contracts were later addressed in EITF 93-14 with the result that similar provisions apply

SOP 98-7: Deposit Accounting: Accounting for agreements that do not transfer risk

As described above, GAAP requires deposit accounting in situations where insurance or reinsurance contracts do not contain risk transfer. However, until the release of the AICPA's Accounting Standards Executive Committee Statement of Position no. 98–7 (SOP 98-7), *Deposit Accounting: Accounting for insurance and reinsurance contracts that do not transfer insurance risk* in 1998, the precise nature of "deposit accounting" was not defined. Although SOP's do not rise to the authoritative level of a SFAS, they nonetheless are considered to be a component of GAAP and are approved by the FASB. SOP 98-7 classified insurance and reinsurance contracts which do not transfer insurance risk into 4 categories:

1. Contracts which transfer only significant timing risk
2. Contracts which transfer neither significant timing nor underwriting risk
3. Contracts which transfer only significant underwriting risk
4. Contracts which transfer indeterminate risk

At the inception of the contract, a deposit asset (or liability) is established based on the amount of consideration received or paid less any explicitly identified premium or fees to be retained independent of the results of the contract. Over the settlement period of the contract, the accounting required depends on the category into which it falls. For contracts falling into categories 1 & 2, the interest method is required. As changes in the estimates of the amount and timing of recoveries occur, the effective yield should be recalculated and applied to the future amortization. Revenues and expenses should be included in interest income or expense. For contracts in category 3, the deposit amount should be set at the proportion of unexpired coverage until losses are incurred that will be reimbursed. At that point, the deposit should be set at the proportion of unexpired coverage plus the present value of expected future cash flows. As the deposit amount is changed due to the passage of time and changes in the estimates of the amount and timing of recoveries, revenues and expenses should be included as incurred loss[23]. For contracts in category 4, guidance is provided in SOP 92-5 *Accounting for foreign property and liability insurance contracts* using the open year method[24].

This completes the discussion of the major elements of the GAAP guidance for reinsurance accounting. The concluding section describes the current SAP guidance and its relationship to the GAAP guidance described above.

SAP Guidance

One of the main factors leading to the formation of the NAIC in the late 1800s was the need for uniform financial reporting by insurers to state regulatory officials. In response, the NAIC produced the first version of what is the current NAIC annual statement reporting form. Over the years the NAIC has extensively revised and expanded the annual statement and has supplemented this with other accounting reference materials. Federal interest in insurance regulation peaked in the late 1980s and early 1990s

[23] Or expense if the entity is not an insurance enterprise
[24] SSAP 62 rejects this guidance

following a number of prominent insurer insolvencies[25]. At the time, no comprehensive guide to SAP was available and there was no systematic foundation to the accounting practices prescribed or permitted by the various states. Partially in response to this challenge, the NAIC committed itself to establishing a codification of SAP. This project was completed in 2000 and codification was implemented with 2001 financial statements. As reflected in the revised *NAIC Accounting Practices and Procedures Manual*, the codification project has resulted in the preparation of the *Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy* and the current 84 individual *Statements of Statutory Accounting Principles* (SSAP's) dealing with different SAP accounting issues. SSAP No. 62 *Property and Casualty Reinsurance* (SSAP 62), establishes SAP guidance for this category of transactions. Prior to codification, the main source of SAP guidance for reinsurance accounting was Chapter 22 of the *NAIC Accounting Practices and Procedures Manual for Property and Casualty Insurance* (Chapter 22) as revised. SSAP 62 is essentially consistent with the previous guidance reflected in Chapter 22.

SAP Guidance: Comparison to GAAP

Subsequent to the issuance of SFAS 113 by the FASB in 1992, in October 1994 the NAIC revised its guidance on reinsurance accounting, to adopt the provisions of SFAS 113 and EITF 93-6 with modification. SSAP 62 also contains a number of special provisions that are not contained in the GAAP guidance. These include a provision that for reinsurance contracts which are not "reduced to written form and signed by the parties within nine months" of their effective date, there is a presumption that the contract is retroactive and must be accounted for as a retroactive reinsurance agreement[26]. In addition, certain agreements are specifically required to be accounted for as prospective reinsurance. These include: structured settlements, novations, termination and changes in participations in reinsurance agreements, and intercompany reinsurance agreements[27].

SSAP 62 also stipulates certain specific conditions that reinsurance agreements must meet before the ceding company may take credit for the reinsurance in its SAP financial statements. These include that the agreement must contain an acceptable insolvency clause, that recoveries must be payable without delay, that no guarantees of profit between the ceding company and the reinsurer may exist, and that the agreement contain an acceptable reports and remittances clause. Retroactive reinsurance agreements are subject to additional conditions that the consideration paid be fixed, that subsequent adjustments depending on actual experience may only be payable to the ceding company and that the agreement may not be canceled or rescinded without the approval of the commissioner of the domiciliary state.

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[25] "Failed Promises" (1990) & "Wishful Thinking" (1994) – Congressional reports on the investigation of insurance company insolvencies called the existing state system of regulation into question and proposed a federal role.

[26] There are a number of exceptions to this rule. They include: facultative contracts, contracts where the "lead reinsurer" has signed within 9 months, contracts entered into prior to 12/31/96 where more than 50% of the capacity had signed within 9 months, and agreements where one party is in conservation, rehabilitation, receivership, or liquidation. In addition, an interpretation of SSAP 62 (INT 01-33) created a special exception to this rule for enterprises affected by the September 11th tragedy.

[27] Where the companies are 100% owned by a common parent or ultimate controlling person and no surplus gain results.

Within Issue Paper No. 75, which forms the basis of SSAP 62, the NAIC has identified the following 6 "significant" current exceptions between GAAP described above and SAP guidance:

1. SAP continues to allow "netting" for unpaid case basis and IBNR loss and LAE reinsurance recoverable against the corresponding gross liabilities. GAAP requires that these balances be included in the reinsurance receivable asset.

2. SAP also allows "netting" of ceded unearned premiums against the corresponding gross liability. GAAP requires this to be recorded as a prepaid asset.

3. SAP requires a gain on retroactive reinsurance to be recorded as a write-in gain in "other income" and the amount to be restricted as a special surplus account until the actual recoveries exceed the amount paid. GAAP requires the gain to be deferred and amortized over the settlement period.

4. Through Schedule F, SAP requires that a minimum liability be mechanically established (the "provision for reinsurance") for certain unsecured and/or overdue reinsurance recoverables. GAAP only requires that an appropriate allowance be established.

5. Both SAP and GAAP require that for reinsurance contracts that contain adjustable features, the effect of the adjustable terms be reflected in the period in which the underlying loss event(s) giving rise to the adjustment occur. However, GAAP allows that this calculation may be computed based on the assumption that the reinsurance contract may be terminated early. SAP does not allow this assumption to be used.

6. For structured settlements where the insurer has not been released from its obligation, GAAP requires the deferral of any gain. SAP does not require such a deferral.

Subsequent to the NAIC's identification of these 6 differences, as previously mentioned, the AICPA adopted SOP 98-7 in 1998 to address GAAP guidance for insurance or reinsurance contracts that do not transfer insurance risk. The deposit accounting outlined in SOP 98-7 differs from the SAP deposit accounting. GAAP requires that revenues and expenses be recorded over the settlement period in order to amortize the difference between the initial deposit and the expected recoveries. SAP guidance in SSAP 62 initially rejected the guidance of SOP 98-7 and required that gains and losses only be recorded at the end of the settlement period or when recoveries exceeded the amount of the initial deposit through Other Income. SSAP No. 75 (SSAP 75), *Reinsurance Deposit Accounting – An Amendment to SSAP No. 62, Property and Casualty Reinsurance*, partially adopts the guidance of SOP 98-7. SSAP 75 requires deposit accounting and the interest method (through interest income or interest expense) to be applied for all contracts that do not transfer insurance risk. Unlike SOP 98-7, SSAP 75 does not allow contracts which transfer only significant underwriting risk to be accounted for through the underwriting section (incurred losses) of the financial statements.

Summary

With only a few exceptions, current SAP accounting guidance for property and casualty reinsurance accounting corresponds with the applicable current GAAP guidance. Moreover, the codified SAP reflected in SSAP 62 and SSAP 75 is essentially unchanged from the previous SAP guidance contained in Chapter 22 of the *NAIC Accounting Practices and Procedures Manual for Property and Casualty Insurance*. Nonetheless, the reinsurance market has repeatedly demonstrated that it can rapidly respond to industry-wide and individual company pressures with innovative products. As such, application of the current guidance will continue to be difficult in some areas such as the evaluation of risk transfer, and additional guidance may become necessary.

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