

# **RECORD, Volume 22, No. 3\***

---

Orlando Annual Meeting  
October 27-30, 1996

## **Session 122TS**

### **Accounting for Reinsurance Agreements**

**Track:** Reinsurance  
**Key words:** Reinsurance, Financial Reporting Statutory Accounting

**Instructors:** ALAN E. CLOSE†  
WILLIAM M. FRASIER‡

**Recorder:** WILLIAM M. FRASIER

*Summary: The National Association of Insurance Commissioners (NAIC) has rewritten Chapter 24 of its Accounting Practices and Procedures Manual (Accounting for Life and Accident and Health Reinsurance). This session describes the various types of reinsurance agreements, the requirements for each type of agreement received, reinsurance accounting treatment, current accounting treatment for various types of reinsurance agreements, and potential impacts for ceding companies and reinsurers.*

**Mr. Alan E. Close:** Bill Frasier will join me as the other speaker. Some of you may come from the property and casualty side and there is separate guidance dealing with property and casualty reinsurance agreements. We're primarily focusing on life and accident and health (A&H) business. I will begin with a brief overview of the current guidance that exists from a statutory perspective. Bill will spend some time talking about the various types of reinsurance, as well as some of the requirements for reinsurance accounting. I will spend some time on financial reporting.

So what is the authoritative guidance for statutory accounting? We often talk about Chapter 24. Chapter 24 is part of the NAIC Accounting Practices and Procedures Manual. There are separate manuals for the life side and for the property and casualty side. So Chapter 24 is the place where people find out what the

---

\*Copyright © 1997, Society of Actuaries

†Mr. Close, not a member of the sponsoring organizations, is Associate Controller at Northwestern Mutual Life Insurance in Milwaukee, WI.

‡Mr. Frasier, not a member of the sponsoring organizations, is International/Financial Reinsurance Services Director, Security Life Reinsurance in Denver, CO.

accounting requirements are for reinsurance contracts. In 1995, there was a major revision to this chapter. I was fortunate to be a part of that process. I worked with the regulators to make the changes that we'll spend some time discussing. It was significantly expanded. The prior guidance, for the most part, focused on what I call indemnity reinsurance. There's very little in the chapter on assumption reinsurance, so one of the major changes was that it was expanded to include guidance with respect to assumption reinsurance treaties. Probably the most important change that now resides in Chapter 24 is the risk transfer rules.

I just want to call your attention quickly to the pages that deal with the transfer rules, just to give you some feel for what is in this Chapter. We'll be referencing it from time to time. Page 24-11 is titled Chapter 24, Appendix A. This appendix, as well as Appendix B, was added to the Chapter in 1995, and it is extracted from the model regulation on life and health reinsurance agreements. That model contained all of the requirements for risk transfer rules. The first item under Risk Categories is Health Insurance Other than Long-Term Care and Long-Term Disability. Letters appear across the top: *A, B, C, D, E* and *F*. Those letters refer to various types of risks. Under category *A* is a plus sign which means that for health insurance, *A* refers to the morbidity risk; that is a risk that needs to be transferred in order for a contract to qualify for reinsurance. We'll spend more time on this as we go through it, but I just wanted you to be aware it exists in the chapter. This is extracted from the model regulation and, in effect, brings a model into the accounting, regardless of what the state rules are. It says that these are the risk characteristics that must exist for the various contracts in order for them to qualify for reinsurance accounting. There is a grandfathering provision in this chapter because of the significant changes that were made, and many companies might have treaties dating back for some time, and the rules may now be different. The grandfathering provision says that contracts in existence prior to January 2, 1996 will be allowed to use whatever accounting guidance they were using. However, if there is any change whatsoever, even if you change one line in the agreement, it causes that entire agreement to now be subject to the current rule. As long as the agreement stays intact, and is dated prior to 1996, whatever accounting guidance you were following is appropriate.

Subsequent transactions and subsequent reinsurance agreements will now be subject to the current rules. The guidance also included considerable accounting with respect to both modified coinsurance (modco) and coinsurance with funds withheld. There was considerable discussion with the regulators over the past few years about these two types of reinsurance agreements. At one point, the regulators believed that they were essentially the same and ought to be accorded the same accounting treatment. With industry's help and education we pointed out that there are significant differences in the way these contracts are drafted; therefore, the

accounting should be different. The key difference is this. It's not as obvious in a going concern, where both the ceding company and the assuming company are going through performing as expected under the terms of the agreement. The difference is probably most notable in the event of an insolvency of the ceding company.

Under a coinsurance with funds withheld type of an arrangement, there is a risk that the assuming company will pay twice. As the claims become due, it may be required to pay again, even though the ceding company has these funds on hand and will then need to stand in line to try to collect the amounts withheld. That's a different position than what exists under modco where there is a presumption that the reinsurer has prepaid their claim and will not be required to pay a second time. As long as the arrangement is performing as expected, there's no difference, other than the geography in the financial statement. It's only in the event of insolvency that these two contracts have notable differences.

The guidance in Chapter 24 was also expanded to look at both sides of the process. By that I mean, it looks at the ceding company as well as the assuming company. Historically, the guidance tended to focus on what the ceding company would do.

There was also new guidance developed regarding deposit accounting and I'll spend more time on this subject later. I think we'll find that this will be more important as we go through the next few years because of some pending changes in the codification project.

Let me back up for just a moment and give you some history on how we arrived at this point and why some of these changes occurred. Those that have been involved in the industry for some time, and are close to the financial reporting side are probably well aware that the accounting rules historically tended to be very general. About four or five years ago, it offered many alternatives. Accounting for pensions is a good one. There may have been four or five different methodologies companies could use to account for their pension plans. The guidance allowed that to occur. While many states used the NAIC *Accounting Practices and Procedures Manual* as their reference, they often developed their own guidance or changed what was in the manual. Another example would be accounting for furniture and equipment as an admitted asset. Some states allow that as an admitted asset, even though typical accounting considers it a nonadmitted item.

Finally, we reached a point where, because of these variances and these differences, we needed to step back and look at the entire accounting. The codification project evolved for a number of reasons. As many of you are well aware, in the late 1980s and early 1990s, there was an increase in insolvencies, Executive Life being one of

the more notable ones. When that occurred, Congress became very concerned about the insurance industry and put some pressure on the states. The accounting profession was also feeling the heat because when the insurer went insolvent, the accountants found themselves on the short end of many lawsuits. They found themselves in need of more definitive accounting guidance to render an opinion.

So with Congress on one end and the accountants on the other end talking to the state regulators, the codification project was born. One of the factors that was taken into account was the fact that there is a need to have audited financial statements. Since the accountants are the ones who provide that service, they needed some basis on which to provide their opinion. Because there was this lack of consistency, lack of uniformity, and the manual was incomplete, we needed to develop some fundamental accounting basis that could be relied on. As a result, the NAIC project became very active in 1994. The NAIC also hired a consultant to work with them, and we have been in that process up to this point. Chapter 24 evolved out of this discussion and is really what I would call the first step of codification in that it provides very complete authoritative guidance with respect to accounting for reinsurance. It's expected that as this project continues and is finalized, that much of what you see before you in Chapter 24 will be retained.

When I return, I will point out there may be one or two minor differences that may result that you may want to be aware of. With that as an introduction, I'll turn it over to Bill who will spend some time talking about the types of reinsurance and risk transfer.

**Mr. William M. Frasier:** I don't know how many of you know it, but Alan spends a tremendous amount of his time working on behalf of the life insurance industry with the NAIC helping support the industry position on many issues. We owe him a great deal of credit for the fine work he's doing with the insurance commissioner groups and the success he's had in getting favorable results on some very difficult issues.

Chapter 24, in addition to defining all of these accounting principles, is also designed to provide some training to the people that work for the state insurance offices. It starts out by describing the basic items of reinsurance to give the employees in the departments some knowledge of what they're working with before it gets into the more detailed accounting items. I'd like to start with some of those items. Some of you are well aware of them. This will give you some idea of what the employees in the insurance departments that you have to work with will see and will be learning.

Reinsurance is the transfer of risk from one insurance company to another. Reinsurance is purchased by companies primarily to transfer this risk. Most of the reinsurance that's purchased is bought to protect companies from paying claims that are larger than they can afford, either on an income basis or a surplus basis. Each life insurance company will establish a retention, which is the maximum amount of risk that they are willing to accept on any one life. There is no magic formula for calculating the retention, but it's the amount that the insurance companies think is a safe amount for them to retain. If they have a number of deaths on large policies, they will still continue to be a viable company. Again, most reinsurance is purchased to limit the amount of risk retained by a life insurance company.

Reinsurance may also be purchased to minimize the risk when a company enters into a new line of business. If a life insurance company wants to enter into the disability income business, that company will purchase reinsurance on a large percentage of that business until they become more familiar with it and become more comfortable with the risk involved. I think we're seeing this type of a reinsurance purchase by a number of the mutual companies who are now seriously entering into the term insurance market. Many of these companies are ceding 70%, 80%, or 90% of the risk on the term insurance products they sell. I think this is partly due to their newness in the term insurance market.

Reinsurance can also be purchased to help manage the finances of a company. If a company is having much larger sales than it anticipated, this will increase the strain on its books. If the company cannot afford this, it can reinsure a portion of the business. That will allow them to keep their sales momentum going.

Reinsurance also can be used to minimize the impact of poor experience on earnings, dividend scales, and surplus. Again, I think the mutual companies reinsuring a large portion of their term business is a good example of this. Their primary business is selling permanent participating policies. By reinsuring a large portion of their term business, they'll protect their dividend scales on their permanent products.

Business can be ceded to the reinsurer either on an automatic or a facultative basis. For automatic reinsurance, all of the underwriting is done by the ceding company. There is a reinsurance treaty that defines the parameters of automatic reinsurance. The parameters for example are: What products can be reinsured under an agreement? What is the maximum amount that the reinsurer will accept? What ages and table ratings are acceptable for this automatic reinsurance? There are a number of other automatic parameters, but I think these are the key ones. Under automatic reinsurance, the reinsurer must accept all risks that fall within the parameters of the

automatic treaty, so the reinsurer has no choice about the risk on an individual policy basis.

Under facultative reinsurance, both the reinsurer and the ceding company will underwrite a policy. When the ceding company gets an application, the first thing it does is check to see if that application is within their retention. If it is, they'll go ahead and start the underwriting process. If it's larger than their retention, they'll check to see if it's within the parameters of an automatic reinsurance treaty. If that is the case, they can go ahead and start the underwriting process. But if the policy for some reason doesn't fit within the automatic reinsurance parameters, then they'll immediately send the case to a reinsurer to see if they can get a facultative offer. During the underwriting process, the ceding company underwriter might determine that, for some reason, he or she is uncomfortable with the risk; maybe there's a medical condition that he or she is not certain about how to underwrite or maybe there's a question about whether the insured may qualify for the amount of reinsurance that's applied for. In such cases, the underwriter may send the case to a reinsurer for a facultative offer, even if it is within their retention or the automatic binding limits.

The reinsurer then has the option of either making an offer on the case or not making an offer. If the reinsurer makes an offer, it will state the maximum amount it will accept and what table rating it will offer on that life. There will be no reinsurance in force until the ceding company has accepted the reinsurer's offer. The ceding company hopefully will get offers back from many reinsurers for more capacity than they need on the policy, so the ceding company must decide which reinsurer's offer to accept.

There's basically no limit on the types of cases that a ceding company can send to a reinsurer on a facultative basis. In an automatic treaty, we have very well-defined limits, but anything is fair game on a facultative basis. I think the ceding company underwriters learn very quickly which cases their reinsurer will be likely to make offers on and it saves both companies a lot of money if the ceding company doesn't send many of cases to the reinsurer that it knows will not be accepted.

There are three basic types of indemnity reinsurance contracts used to cede these individual policy risks. The first of these is coinsurance. Under our coinsurance agreement, all of the risks in the original policy are ceded to the reinsurer. At the end of the coinsurance agreement, the reinsurer is in the position it would have been in had it written the portion of the policy reinsured on a direct basis. A ceding company will pay reinsurance premiums to the reinsurer. These premiums will be the gross premiums that the ceding company receives under the policy. The reinsurer will pay allowances to the ceding company. These allowances are

designed to cover the expenses of the ceding company in writing the policy. We will talk about that a little more later. As I indicated earlier, all of the risks in the original policy are ceded, so the reinsurer will reimburse the ceding company for all of the policy benefits. The reinsurer will hold the reserve on the policy and the ceding company may take a reserve credit for the reserve ceded to the reinsurer. If the reinsurer is not licensed or not an authorized reinsurer in the state of domicile of the ceding company, this reserve credit will need to be supported by a trust account or a letter of credit or some other form of security.

The next type of reinsurance agreement is modified coinsurance. Modified coinsurance is just a version of coinsurance where the modification is that the ceding company holds the reserve on the policies that are ceded. In order to accomplish this, there are some provisions that need to be in a modified coinsurance agreement that are not in a coinsurance agreement. On the effective date of the reinsurance agreement, the ceding company must pay to the reinsurer the initial reserve. This will be the in-force reserve on the policies reinsured on the effective date. Of course, if the business covers new issues, this reserve will be zero, but if their reinsurance covers an in-force block, this reserve will be greater than zero. At the time the ceding company pays the initial reserve to the reinsurer, the reinsurer will pay the ceding company what's called a modco deposit. This deposit is typically greater than or equal to the initial reserve. It would be greater than the initial reserve if the reinsurer is willing to give upfront some of the profits on the business to the ceding company.

As I mentioned earlier, the ceding company holds the reserve on its statement. We need two other provisions in the modified coinsurance agreement to get the accounting to come out right. The ceding company has the increase in the reserve on their books, but the reinsurer has received the premium on the policies, so the reinsurer must pay to the ceding company the increase in the reserve that the ceding company is holding. But the premium is not the only component of the increase in reserve; there is also the interest that the ceding company has earned on the reserve. This amount needs to be paid by the ceding company to the reinsurer. The economic result of a modified coinsurance treaty should end up to be the same as a coinsurance treaty with the only difference being that the ceding company holds the reserve under a modified coinsurance treaty, and there are the adjustments to the reinsurance treaty that make this happen.

The third type of indemnity reinsurance is yearly renewable term (YRT). This type of an agreement normally only transfers a single risk. This is usually the mortality risk. The premiums under a yearly renewable term agreement are unique to the risk being reinsured. Under coinsurance and modified coinsurance, the premium paid was the gross premium on the policy. Under a yearly renewable term agreement,

the premium is a premium for the risk transferred. This could be a schedule of premiums that the reinsurer develops or often the yearly renewable term premiums are a percentage of the mortality charges contained in a product. If the latter is the case, this makes the reinsurance cost for the ceding company coincide with their income to pay those costs. Under a yearly renewable term agreement, the reserve credit is limited to a one-year term reserve for the risk transferred.

There's another type of indemnity reinsurance that does not cede risk on an individual policy basis, but cedes the risk on a group of policies. These are called nonproportional reinsurance agreements. There are many types of nonproportional reinsurance agreements, but three common types are stop-loss, spread-loss and catastrophe reinsurance.

Stop-loss agreements are agreements where the reinsurer reimburses the ceding company if the total claims on a block of business exceed the maximum that's stated in the agreement. This may be a percentage of expected mortality, such as 120% of expected mortality. Or it can be stated as an amount per million in force or stated in other ways. The claims are only payable by the reinsurer if the total experience on a block of business exceeds some predefined amount.

A spread-loss agreement is an agreement where for some reason, the ceding company thinks that its claims will be erratic and they will tend not to be level and the ceding company would like to levelize the effect of this product on its income and surplus. Under this type of an agreement, the ceding company will pay a relatively level premium, and the reinsurer will pick up the fluctuations in the claim experience.

A third type of nonproportional agreement is catastrophe reinsurance. This type of reinsurance will pay only if multiple lives are killed in a single event, like a plane crash, an earthquake, or a tornado. Nonproportional agreements are typically one-year agreements. A spread-loss agreement may run for more than one year and often does, but it runs for a fixed period of time. At the end of that period of time, the ceding company must sit down with the reinsurer and renegotiate the agreement; otherwise the agreement will end.

Under the proportional reinsurance agreements, coinsurance, modco and YRT—the reinsurer must maintain the risk on that policy for as long as the policy is in force, unless it's recaptured by the ceding company. Proportional reinsurance agreements are long-term agreements; there's no option for the reinsurer to get out of the agreement. Nonproportional agreements are designed to be short-term agreements that end in a relatively short period of time. Typically, the ceding company will take no reserve credit for a nonproportional reinsurance agreement.



As Alan mentioned, Chapter 24 includes the required provisions for a reinsurance agreement to receive reinsurance accounting treatment. This was originally defined in the model reinsurance regulation, which I believe was enacted by the NAIC in 1992. The reinsurance model regulation is an important regulation to the insurance commissioners and has become one of the requirements for a state to become accredited.

The first provision is that the renewal allowance must cover the ceding company's actual expenses. These expenses certainly include commissions, the underwriting costs, the premium taxes, and the cost of administering the business. For some of the expenses it's not quite as clear whether they have to be covered, including general overhead-type expenses and some expenses that the company has for developing an agency system or entering a new marketing adventure. It is very clear that nearly all expenses of the ceding company relating to the business ceded need to be reimbursed by the reinsurer, but there is some margin for discussion about exactly what those expenses are. Generally we have found that if all of the expenses the ceding company used in pricing the product are included in the reinsurance agreement, this will be acceptable to the state insurance departments.

The next provision is that the ceding company cannot be deprived of surplus or assets at the reinsurer's option upon the occurrence of some event. The event that was normally anticipated when this was included in the regulation is the insolvency of the ceding company. One cannot put a provision in the reinsurance agreement that says, this agreement will end if the ceding company becomes insolvent. I think the reinsurers have gotten a little more clever than that. In the recent past they've learned that once the ceding company is insolvent, it doesn't really matter what's in the agreement. They would like to put in a provision that says the agreement will end when the risk-based capital falls below a certain level, but that's also prohibited by the model regulation. So the agreement must continue and you cannot put any language in the agreement that says if some event occurs, the reinsurance will automatically terminate.

The next provision is that the ceding company cannot be required to reimburse the reinsurer for negative experience. If you remember our coinsurance example, the ceding company pays the premium to the reinsurer, and the reinsurer pays the allowances and the benefits to the ceding company. You cannot add another provision in the agreement that says that if this result ends up to be a settlement to the ceding company, the ceding company will pay that amount to the reinsurer; that is prohibited.

The next provision is that the ceding company cannot be forced to recapture all or a portion of the business at specific points in time. We talked a little bit about this

earlier. Under coinsurance, modco and YRT agreements, the reinsurer must be on the risk for the life of the policies, unless the ceding company voluntarily recaptures. This prohibits one from making an indemnity reinsurance agreement that runs for ten years. It also prohibits one from putting a schedule in the reinsurance agreement that says, in the first year, 50% of the risk will be ceded, the next year 45%, etc. Having a decreasing percentage of insurance ceded is prohibited.

The ceding company cannot be required to pay amounts other than those received from the business reinsured. I think there are two ways that this could happen. The first way is you could define the premiums in the reinsurance agreement to be 110% of the gross premiums that the ceding company collects. This would be prohibited. Another way that this could happen is if you have a modified coinsurance agreement where the ceding company is holding the reserve; one cannot put a statement in the reinsurance agreement that forces the ceding company to pay a larger interest rate to the reinsurer than the ceding company actually earns on those assets. A little later on we'll see how this is accomplished in the regulation. The ceding company must transfer the assets to the reinsurer or legally segregate the assets in a trust or escrow account. This would apply to modified coinsurance agreements. Under a coinsurance agreement the assets would transfer, unless it's a funds-withheld agreement, in which case the ceding company retains the assets. In modco and coinsurance funds-withheld agreements, when the ceding company retains the assets, the assets must be legally segregated in a trust or escrow account.

Settlements in the reinsurance agreement must be made at least quarterly. This provision is in the model regulation to prevent the ceding company from having to absorb the short-term fluctuations in the reinsurance experience.

The ceding company cannot be required to make representations or warranties not reasonably related to the business reinsured. This is an interesting provision, and I think it has a valid purpose. The reason it is in the model regulation is to prevent the ceding company from pledging some profits on another block of business to the reinsurer, if the business ceded under an agreement becomes unprofitable. For that purpose, it's helpful and it's a good provision to prevent the ceding company from paying more for the reinsurance than it should. This provision, however, may prevent some companies from being able to purchase reinsurance. A provision like the ceding company notifying the reinsurer if its risk-based capital falls below a certain level would be prohibited. If a ceding company is not as strong as it would like to be, and it is trying to entice a reinsurer to help it out until it gets back on its feet, the reinsurer might be more comfortable if it could put a provision in the agreement that would require the ceding company to inform the reinsurer if there is an additional problem with the company.

I think another example is if a company has had problems with its real estate portfolio. It wants to reinsure a block of business to help boost income and surplus. The reinsurer would be much more comfortable if it could put a provision in the agreement that says the ceding company will somehow manage the real estate business in a more reasonable manner. Those kinds of provisions would help the reinsurer be more comfortable with the business and possibly provide reinsurance to a company that is having some problems. Those provisions are prohibited.

A key part of the regulation, as Alan mentioned, is that it defines what risks need to be transferred for various products. Six risks are defined as potentially significant risks in agreements. One is morbidity. Two is mortality. The third is the lapse risk, which is defined as the risk that the policy will lapse before the acquisition costs are recovered. The credit quality risk, the fourth risk, is the risk an asset supporting the reserves under the agreement will default; the reinvestment risk is the fifth and is the risk that interest rates fall after the effective date of the agreement and when an asset matures, that asset must be reinvested at a lower rate of interest. Finally, there's the disintermediation risk, which is the risk that interest rates will rise and the policyholders will want to surrender the policies and move their funds to some other place and the ceding company will have to sell assets at below their par value in order to pay these surrender costs. Alan pointed out the table in Chapter 24, which is also in the model regulation. It defines the different types of products and which risks in those products are significant risks and must be transferred under the reinsurance agreements.

When a permanent life insurance product is reinsured, the last five risks must be transferred. If the product has flexible premiums, in order to satisfy the requirement of transferring the investment risks, the assets must be placed in a trust or an escrow account or transferred to the reinsurer. There's no other choices for the assets for flexible-premium, permanent products. There is some break if you have a fixed-premium, permanent life insurance product. The regulation says that the investment risk is still a significant risk, but the investment risk transfer requirement may be satisfied by using the portfolio rate including capital gains of the ceding company. There's a formula in Chapter 24 that defines how this portfolio rate is calculated. The requirements for fixed-premium products are much less severe than for flexible-premium-type products.

The final provision is that the ceding company cannot be required to make representations about the future of the business being reinsured. This does not imply that the ceding company cannot share with the reinsurer all of its pricing assumptions and information about the marketing. This does not limit the sharing of information between the reinsurer and the ceding company. All of that is still fine. What this provision prevents is the ceding company guaranteeing the experience on the block

of business. For example, the reinsurance agreement cannot contain a provision that says, "If, after ten years, the annual lapse experience on the block of business is worse than 10% per year, then the ceding company will somehow reimburse the reinsurer for that poor experience." Again this doesn't prohibit any types of disclosure or sharing of information, but it does prevent the ceding company from guaranteeing any of the experience on the block of business.

**Mr. Close:** I have an easy question for this group. How many seconds are there in a year? This should be easy, actuaries should know this. Did you say 31 million?

**From the Floor:** Twelve.

**Mr. Close:** Why do you say 12?

**From the Floor:** January second, February second.

**Mr. Close:** They're both right, 31.5 million is the actual number of seconds in a year or 12 is correct too. I use that example to illustrate that often there is a fundamental difference between the way an actuary will look at something and the way an accountant will look at something. That's especially important when we look at financial reporting, whether it be on a statutory basis or a generally accepted accounting principles (GAAP) basis. Sometimes we question why numbers appear the way they do. It doesn't make any sense. I'm not here to make some sense out of it for you, but to simply point out that sometimes we need to step back and try to look at it from the other person's point of view. It may help us to understand why things are the way they are.

Much of what we've talked about to this point pertains to the requirements necessary for a contract to qualify for reinsurance, and that's a presumption that I will use in talking about the presentation in the financial statement. We will assume that the contracts qualify for reinsurance. They will meet all the risk transfer rules and all the other requirements.

One of the things that I think is safe to say, from a statutory perspective, is that, at least from my point of view, it does tend to report the results more from an actuarial perspective; that is, it looks at what's the net risk to the company, whether it be the ceding company or the assuming company. While this isn't a GAAP discussion, a GAAP presentation shows more of an accountant's view and it tends to gross up everything. So the two statements put side by side, even though the numbers are often the same, may give a significantly different point of view. From a statutory perspective, much of what we see on the balance sheet is what I would call a net approach. There is no longer mirror imaging. Some of the earlier accounting rules

that were drafted basically said that the assuming company had to use the money in just the opposite way the ceding company did. But when we rewrote Chapter 24 a year ago, we were able to point out to the regulators that mirror imaging, just from a practical point of view, is very difficult to administer, so we no longer have that requirement.

But I think it is appropriate to say that what happens for the ceding company has to happen in a similar way for the assuming company. Take the example of going to the bank and taking out a loan. If I go to the bank and they give me \$1,000 as a loan, they expect to receive repayment. They will set up a receivable account, and I'm expected to pay it. Therefore, I will set up a payable account. Looking at reinsurance from that perspective, and applying that rule to the ceding company and assuming company, this should be fairly straightforward as we go through the balance sheet. What happens to the ceding company needs to happen in some way for the assuming company. So regarding the balance sheet, most amounts are reported net. Some of the examples are deferred and uncollected premiums.

On the ceding company's books, they will typically show an asset, especially if they're using a mean reserve calculation, for deferred and uncollected premiums. They will have an asset for some amount. If the business has been ceded, they will report the amount of the deferred and uncollected on a net basis. In other words, that portion of the deferred and uncollected premiums attributable to the reinsurance agreement reduces the amount and therefore is reported on a net basis. Likewise, policy reserves, to the extent that the ceding company is entitled to take a reserve credit, will be reported on a net basis. So the process is to calculate your policy reserves on whatever methodology applies to that series of policies; calculate the reserve credit, based upon the terms of the reinsurance agreement and report the net amount as a liability.

On the flip side, the assuming company would do the reverse with both a deferred and uncollected premium, assuming this is a coinsurance type of arrangement, and will set up the appropriate reserves.

Unpaid claims is another example where amounts will be reported net for the ceding company and the amounts paid by the assuming company were reported as claim payments. Reinsurance receivables, however, are reported differently. They're taken from the reinsurance agreement as the amounts that will be exchanged between the ceding company and the assuming company. Accountants always need to have debits and credits that are equal and so if one creates a debit, for example, for unpaid claims and they haven't paid it, they need to set up a liability. So in the case of a ceding company, when they pay a claim to the beneficiary, they will have a claim expense; they will also have an amount due from the

reinsurer. They will set up a receivable as a separate component of the balance sheet. The amount will not be netted against any other transactions or against any other company's receivables or payables. So receivables are reported separately as an asset on the books of the ceding company and as a liability for the assuming company.

Examples of other amounts that will appear on the balance sheet are amounts payable on business assumed. Again, this is the flip side of the receivable that the ceding company would typically record. The assuming company needs to make a payment to the extent that they have an obligation to the ceding company. They will establish the appropriate liability, and you will see that amount separately on the statutory statement. An unusual item—unusual in accounting terms—is the reinsurance in unauthorized companies. As Bill mentioned earlier, if the ceding company has a contract with an assuming company that is not authorized to do business in the state, and if the ceding company has not gone through the process of either putting the amount in escrow or taken other appropriate action, the result is the contract will be with an unauthorized reinsurer. The ceding company will still take the reserve credit, the same way that it would if this was a qualifying contract, but will then turn around and set up a liability for the same amount separately on the financial statement. It does complicate the balance sheet somewhat, especially for the ceding company on the liability side because we have the reserve being reported on a net basis and then we're reporting the reserve credit taken in an item called reinsurance in unauthorized companies, further down the statement. This is just the way that the regulators felt they would like to see this information so that they can isolate transactions with the unauthorized reinsurer.

Coinsurance with funds withheld also appears separately. As I mentioned earlier, when a company has a modco transaction, the reserves, from a ceding company's perspective, appear as if nothing happened or nothing was transferred. The amount that's being retained from the reinsurer is included in the reserve calculation and reported as a policy reserve. If the contract, however, is classified as coinsurance with funds withheld, the amounts withheld are reported as a separate line item on the liability side, below policy reserves.

The point here is that it does not have the same characteristics and the same status as a policy reserve claim. This reinforces the point I made earlier about there being a risk of double payment in a coinsurance with funds-withheld transaction, because if there is an insolvency, the assuming company may find itself paying twice for the same claim.

I want to talk about deposit accounting, what it means, and the significance of it going forward. If a contract between the ceding company and the assuming

company fails the risk transfer rules, or for whatever reason, fails to qualify as a reinsurance contract, the guidance contained in Chapter 24 says that one then needs to account for it as a deposit transaction.

The best way to describe this is to think about this as a bank account. When you go to the bank and make a deposit to your savings account or checking account, you simply make an entry in your checkbook to show that deposit of \$1,000, and the bank does likewise. Those are what I would call balance sheet transactions. They are just receivables and payables between the two parties. To the extent that the bank will pay you interest on the account, the bank will charge that as an expense and you will bring that in as income. In that transaction all that one would see on the operating statement are the effects of interest. We don't have this premiums/benefits reporting when we deal with deposit-type transactions or a banking account transaction. That's the way one needs to look at deposit accounting on a statutory basis. The effects of the transaction then are primarily on the balance sheet. The funds that are being exchanged between the ceding company and the assuming company is a transfer of funds and the companies will create an asset or a liability.

For example, let's assume that the ceding company enters into a contract that doesn't qualify as insurance and gives the assuming company \$1,000; rather than reporting this as an adjustment to premium the assuming company establishes a liability. The ceding company will create an asset receivable from the reinsurer. The reinsurer will create a payable and nothing will happen to that sum of money until, either by contract or by termination of the contract, the result of that transaction is determined. So if we assume that this is a two-year deal, and there is an exposure period of two years and it isn't clear until the end of that term to what extent the ceding company will owe or the assuming company will receive a sum of money, the amount reported on the financial statement as an asset or liability will continue until the end of that two years.

Let's assume that at the end of the two years, the assuming company gets to keep the \$1,000 and the ceding company is off the risk. That was the deal, and everyone is happy with that result. At that time the ceding company would charge its operating statement \$1,000 as an expense, and the assuming company would record a revenue item for the \$1,000. If there are points during the contract, let's say at one-year intervals where it is clear that there is no recourse to some portion of this \$1,000, both parties would recognize their proportionate share as they move through the term of the contract. So if \$500 was earned at the end of one year, each party would recognize \$500 of revenue or expense, and would do the same at the end of the second year.

This type of accounting will become more useful or more usable as we move forward because one of the changes that appears to be coming down the road in statutory accounting is a change in what items will be recognized as insurance contracts and what will be considered as deposit-type contracts. Statutory accounting will be introducing, for the first time, the concept of deposits, which is similar to what I would call a GAAP-type approach. The more obvious transaction that will fall into this category will be guaranteed investment contract (GICs), where there is no mortality, morbidity or any risk, other than maybe the interest risk. So even though the contract may qualify under the terms of the risk transfer rule, it will not necessarily mean that it will be accounted for in the way that we've historically understood reinsurance accounting.

Examples of contracts classified as a deposit-type contract are GICs, supplementary contract without life contingencies, and dividend accumulations. If there is a reinsurance arrangement covering any of those types of contracts, they will be accounted for as deposit-type contracts. So this will be a significant change, but we may still have a few years before it is implemented. Nevertheless, you ought to be aware that deposit-type accounting may be something that we'll see a lot more of in the future.

Let's turn for a moment to the summary of operations, again from a statutory perspective. Much of what we do is on a net basis. The ceding company will report premiums, net of any reinsurance ceded, but will include all amounts from contracts where they are the assuming company. One item that is often overlooked in the area of premiums is experience rating refunds. If there is a provision in the contract that calls for an experience refund, and it's called an experience rating refund, a very common term, sometimes people don't know where this goes in the financial statement. From an accounting perspective, experience rating refunds are seen as a return of the premium, and therefore should be taken as an adjustment to the premium account, not buried somewhere else in the financial statement. Benefits, likewise, are reported on a net basis. It should reflect the net amount that the ceding company is obligated to pay or has paid. Likewise, the assuming company will report what its portion of the risk is for that period. Reserves and dividends are also reported on a net basis. However, commissions and allowances receivable are isolated and reported in the income section, to the extent that the ceding company receives allowances, and the assuming company will report it separately as an expense. That is one type of transaction that is isolated and reported separately, and is not netted against other items.

I won't spend a lot of time on notes to the financial statements, other than to simply point out that statutory, like GAAP, requires certain disclosures about reinsurance contracts. The regulators like to know everything they can about what companies



are doing. So there are a series of notes that companies must complete as part of the filing requirement. With respect to the ceding reinsurer, they tend to be in the form of interrogatory, yes/no-type questions. The uncollectible reinsurance and commutation activity is more of a description. If a company has a situation that results in being unable to collect some of the amounts from a reinsurer, these amounts need to be disclosed. Any reinsurance transaction that was commuted during the year needs to be identified with the appropriate amounts disclosed in the financial statement. I would expect most actuaries are familiar with Schedule S as an additional reporting requirement. This schedule went through significant change. The first year that we saw four new columns appear in the schedule was 1995. The reporting may not be very clear, but I want you to just simply focus on the new columns that appear in Schedule S, two of which are the outstanding surplus relief.

There was considerable confusion about what regulators were trying to find out about transactions when they added these two columns. The confusion is about whether this applied to all types of reinsurance, because, as Bill pointed out, most reinsurance is entered into because of its surplus relief characteristics and whether this schedule is an attempt to identify all surplus increases or changes that resulted from all reinsurance. I think the answer is no, that is not the intent and in fact there is a blanks change that will appear next year, that clarifies this point. The intent of these two columns is to identify those contracts that are described in Chapter 24, Appendix B, where there is reinsurance of an existing block of business, where the ceding company is not allowed to take into income, the entire financial impact of that transaction, but needs to segregate part of the surplus and amortize it over a period of time. It's consistent with the accounting guide that's in Appendix B. It's with respect to those treaties that these two columns were added. They capture information on a per-contract basis. So if there is any confusion in that area, hopefully this will help clarify it.

The last two columns, modified coinsurance reserve and funds withheld under coinsurance, were added to capture, by contract, the amount that the ceding company and the assuming companies are reporting in their financial statement, with respect to those types of agreements. This is simply a contract-by-contract detail. They were first in the 1995 blank and will no doubt continue to expand the reporting that we all know and love.

Now let me discuss cessions of in-force blocks of business. There are really two types of transactions that I think are important here. The first one is assumption reinsurance, which is probably the more typical arrangement for an in-force block. Company A wants to get out of a certain line of business and will find a carrier that

is willing to take it, and will negotiate an agreement that effectively transfers 100% of the business to them in the form of an assumption.

There is a model regulation on assumption reinsurance that many states have adopted that spells out the requirements necessary for assumption reinsurance to be effective. One of the requirements that makes it complicated from an accounting perspective is that there is a time period that exists before the assumption can be complete. It requires the insurer to send notice to all of the insureds asking for their approval. Do they want to be party to this assumption transaction? Do they want the new company to assume this block of business and do they want their policy then to be subject to these new rules? There is a window of 25 months in which the insured can respond. The problem is, what does one do during this 25-month period? The answer is to treat those items as indemnity reinsurance until notification is received. If the insured sends back the notice immediately and accepts the arrangement, to the extent that those amounts are determinable, one can proportionately take the reserves, the assets and liabilities and accord the assumption reinsurance accounting to those items. As long as they are outstanding, that portion will need to be accounted for as indemnity reinsurance. Any gains and losses will be recognized by the ceding company immediately with respect to the items that qualify as completed assumption reinsurance items. The assuming company, however, will defer any gains or losses over the life of the business or over ten years, whichever is shorter.

This was a portion of the accounting chapter that was added, that helped the assuming companies better understand what their accounting requirements were with respect to these contracts. I think the best way for the assuming company to look at it is that on assumption reinsurance, the assuming company should not be in a position to have any gains or losses. It's as if one is writing this for the first time. That's the way the accounting was drafted and why the provision states that one takes the assets, marks them to market, and establishes its liabilities as if the business was written directly. Generally the amounts won't equal. Since debits and credits must equal, we have to make them equal. The difference will either be an asset, which we call goodwill, or it will be called a deferred liability. The assuming company will establish either goodwill or a deferred revenue item on the balance sheet, and then spread it according to the terms, either over the life of the business or over ten years. There obviously is an issue if one has a goodwill asset because many states do not allow goodwill as an admitted asset. The assuming company, I expect, will tend to keep that number to a minimum if it's in that situation.

I was in Kansas City at a codification meeting where we talked about the accounting for reinsurance and revisited much of Chapter 24. I'm happy to report that they've left everything intact. In fact, they were making a change to the section on

assumption reinsurance. Because of their concern about goodwill being a nonadmitted asset, they were proposing to change the accounting so that gains and losses for the assuming company would be recognized immediately as well. We pointed out that this didn't seem to make sense, both from an accounting and a logical perspective. They changed their minds and have returned to the guidance as it exists in Chapter 24. So it appears that what you see in the guidance will continue to exist. One of the possible accounting changes is that more goodwill may be recognized as an admitted asset going forward. We'll know more about that within a year when codification is finished. But whether they're admitted or nonadmitted, goodwill might be an issue. The liability will be recorded as a deferred revenue item and amortized.

A somewhat different arrangement exists with an assumption transaction accounted for as indemnity reinsurance. It's different to the extent that there are funds being transferred between the ceding and the assuming company; one would account for them in the same way as coinsurance. There are adjustments to premiums, benefits, and commissions. During this period, especially when we have this 25-month window, the accounting is done as if this was an indemnity reinsurance contract. Then, on the 25th month, we will finalize it. From that point forward, we apply assumption reinsurance accounting. There has been some discussion that the assuming company ought to account for the transaction as assumption reinsurance immediately. That's still up in the air, but for now, one simply needs to remember that indemnity reinsurance accounting is applied with adjustments to premiums and benefits. Then, prospectively, you apply assumption reinsurance accounting and defer any gains or losses.

There is a situation that does occur from time to time between parents and affiliates where the ceding company and assuming company will have an agreement that, from a regulator's perspective, will be classified as noneconomic. It was not an arm's-length transaction. Unfortunately one may not know it until after one has completed the transaction and the regulators review the contract. If it is determined to be noneconomic, then what happens is that any funds that are transferred and any reserves that were transferred would be treated as if the assuming company were in the shoes of the ceding company. The assuming company would pick up, dollar-for-dollar, the amounts and report them in the same way that the ceding company had reported them on its books, including using the interest maintenance reserve (IMR). Often the IMR is overlooked, except when the company is trying to release it and enhance their surplus.

Let me give you a brief example. If the ceding company entered into an arrangement with a subsidiary, and it had on its books a series of bonds that were valued at \$1 million and had reserves at \$1 million, but also had IMR of \$1,000 and entered

into a transaction with the assuming company, the assuming company would gross up the assets because the bonds would generally have a market value that's different than the carrying value. All of that would need to be unwound on the assuming company's books. They would go back and look at what the ceding company had at the moment it transferred the assets and liabilities and the assuming company would need to re-establish all of the assets and liabilities, dollar for dollar, in the same way that they appeared on the ceding company's books. In effect, it negates the whole transaction and puts the new company in the same position they would be in if they were the original carrier. That concludes our formal portion of our presentation.

**Ms. Diane Wallace:** Alan, I just wanted to make a comment. You have mentioned a couple of times in your presentation a distinction you are making on the set-off rights of a reinsurer with respect to modco reserves and funds-withheld liabilities. I'd just like to say that in my experience, most people who have studied the laws on this subject conclude that there is no distinction on the set-off rights of the reinsurer between a modco reserve and a funds-withheld liability. Both the written laws and the common law on this subject are quite clear that the reinsurer does have the right of set-off in both instances. There are no court cases, to my knowledge, that change that precedent in any way, with the exception of very specific and unique Oklahoma law that allows the reinsurer set-off, or that analyze the set-off by looking at the risk transfer in the reinsurance agreement. I think that it's dangerous for us to suggest that there might be any question about the right of set-off in either of those instances, because that would have a great impact on the reinsurance market and affect both ceding companies and reinsurers alike.

**Mr. Close:** Diane worked with us on much of the development of this chapter. I think it demonstrates the industry's position and the regulator's position. While industry, for the most part, has been able to support, in a court of law, the right of offset, there is still a potential timing risk that the regulators, because they don't necessarily hold that view, will do what they can to get as much money from the assuming company as possible. With respect to coinsurance with funds withheld, they will often take the position that they will go after the assuming company for additional funds, and it will be up to the assuming company to take this through due process. In many cases, which I think is unfortunate, regulators don't always hold the same position as we do in the industry.

**Ms. Wallace:** I don't know of any instance where that has occurred. I don't believe it has.

**Mr. Close:** What about the Colorado case which was an example where at least the contract was subject to some legal action. I think there was at least a period of time

before the parties were able to receive the appropriate amounts due and the assuming company was not at risk.

**Ms. Wallace:** I don't believe that had to do with the distinction between modco and funds withheld, however.

**Mr. James W. Dallas:** Alan, you mentioned there's a move to make contracts, such as GICs, deposit accounting versus premium for offsetting the liability. Would the premium or the payment from the policyholder to the writing company be accounted for as premium or more as deposit accounting?

**Mr. Close:** Deposit accounting. If deposit accounting goes through, with respect to the insured making its payment to the insurer, that deposit will be simply a balance sheet entry. It will not be reported as premiums, and the benefit payment will not be reported as benefits. All that one will see in the operating statement will be the interest that the insurer pays with respect to those contracts. So that will change the reporting as well.

**From the Floor:** It's a little bit complicated, so I'll pose it as a multiple choice question. You have a ceding company with a portfolio of policies that it wishes to reinsure a quota share of less than 100%. They agree to set up a trust or segregate assets in an amount equal to the reserves on the entire underlying block of business. Would this practice be (a) required, (b) permitted, or (c) prohibited?

**Mr. Frasier:** I think certainly it would be permitted. I would expect that if you would draft separate agreements for different types of products, say term products versus permanent products, you could not establish a trust account for the whole reserve. Certainly that would be permitted. One thing I didn't make completely clear is that when regulators require you to set up a trust or escrow account to support a modified coinsurance agreement, for example, they are not requiring it for security reasons; they're requiring it so they can look at the trust or escrow account to see what the actual investment earnings were on that account. That would be the amount of the investment earnings that are transferred to the reinsurer. The purpose is not security. I think it would certainly be permitted, but I think you could, if you didn't want to put all of the assets in the account, write separate agreements for different types of products.

**From the Floor:** As an assuming reinsurer we have about a three- to six-month reporting lag between when premiums are earned and when our ceding companies actually report them and pay them to us. How do we account for that in our income statement and in our reserves?

**Mr. Close:** A change from the mirror-imaging concept was made because of this problem. There always seems to be a lag in communicating the amounts, and so the assuming company needs to make its best estimate. To the extent that you had some history and are able to project with some degree of certainty with respect to premiums and accrued benefit payments that will need to be made, use your best estimate. When you know the exact amount, you make the adjustment in the period in which you know it. That's really what the guidance now calls for.