

VOLUNTARY TAX-DEFERRED PRE-EVENT CATASTROPHE RESERVE PROPOSAL

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Tax-Deferred, Pre-Event Catastrophe Reserves

PROBLEM STATEMENT

NAIC TAX-DEFERRED PRE-EVENT CATASTROPHE RESERVE

(Original Adopted July 28, 1997 – Amended 2001 – Additional Changes proposed below)

Catastrophes present a significant challenge to the U.S. economy and to the U.S. property-casualty insurance industry, posing financial solvency, capital accumulation and insurance availability issues.

Insurers should be encouraged to engage in prudent risk management behavior. Existing methods to manage insurer risk include loss mitigation, geographic spreading of risk, reinsurance, capital market instruments, derivatives products and short and long-term pre and post-event financing. One additional method proposed to encourage prudent risk behavior—which should augment, not supplant those existing risk management methods—is to permit insurers to establish tax-deferred reserves for future catastrophes.

Current tax laws and accounting principles discourage U.S. property and casualty insurers from accumulating assets specifically to pay for future catastrophe losses. Instead, payments for catastrophe losses are made from unrestricted policyholder surplus after the losses are incurred.

Current U.S. tax law does not permit deduction of reserves for future catastrophe losses.

Current U.S. accounting principles (both Generally Accepted Accounting Principles and Statutory Accounting Principles) applicable to property and casualty insurers: 1) limit the recording of loss reserves to losses which have already occurred, and 2) require the recognition of catastrophe premiums in periods prior to the periods in which catastrophe losses are incurred.

Some non-U.S. insurers, because of their domestic tax laws and accounting principles, are able to deduct reserves for future catastrophe losses free of tax. That ability gives those non-U.S. insurers a competitive advantage over U.S. insurers enabling them to attract insurance and reinsurance business, which would otherwise be written, by U.S. insurers.

U.S. State insurance regulators believe that existing tax treatment of catastrophe risk fails to maximize the ability of insurers to appropriately respond to catastrophe coverage related solvency and availability issues. State insurance regulators recognize that the portion of approved rates earmarked for catastrophes is intended to finance catastrophe losses that are not expected to occur on an annual basis. If these funds are not set aside in a dedicated reserve for these losses, funds may not be available to meet policyholder obligations. Accordingly, regulators may be more inclined to approve catastrophe-related rates if they were assured that the resultant premiums would be set aside for their intended purpose until the indicated catastrophe exposure has had adequate opportunity to materialize.

Some state insurance regulators recognize that U.S. property and casualty insurers, in the absence of assurance that approved catastrophe insurance rates will reflect past experience and projected exposures, are reluctant to maintain or expand their catastrophe insurance writings in regions with significant historical or projected catastrophe exposures.

In the absence of tax deductibility and in consideration of domestic accounting principles, a required or permitted catastrophe reserve would provide no additional assets to finance insured catastrophe claims. Requiring or permitting such a reserve without tax deductibility would diminish insurer's capital and would likely restrict availability of insurance coverages to consumers.

It is in the public interest to consider whether current U.S. accounting principles and tax law should be revised to permit tax-deferred reserves for future catastrophe losses.

While considering those steps, it is in the public interest to determine whether a tax-deferred reserve for future catastrophes can be structured in such a way as to provide incentives for:

- Property and casualty insurers to appropriately manage their catastrophic loss exposures by making specific provision for future catastrophe losses while continuing to provide and expand catastrophe insurance coverage in regions with significant catastrophe exposure; and
- State insurance regulators to approve catastrophe insurance rates which, among other appropriate factors, reflect past experience and projected exposures,

so that the U.S. federal government and taxpayers benefit, in the form of possible reduced demand for catastrophe relief, as a result of these changes in the insurance regulatory and tax systems.

PROPOSAL - SUMMARY AND DEFINITIONS

NAIC VOLUNTARY TAX-DEFERRED PRE-EVENT CATASTROPHE RESERVES

For regulatory purposes, certain insurers that write qualifying property lines of business will be allowed to establish voluntary tax-deferred pre-event catastrophe reserves within the parameters set forth in the definitions and related materials set forth below. These parameters contemplate that such voluntary reserves will be accorded tax-deferred status under federal tax law and that implementation of such reserves will not be effected until and unless such tax deferral is granted. Within this voluntary program, insurers may, but shall not be required to, establish and maintain a pre-event catastrophe reserve in excess of amounts that could be accorded tax deferred status under federal tax law subject to the limits set forth below. However, those insurers that choose to establish a tax-deferred disaster fund under federal tax law must establish and maintain a pre-event catastrophe reserve for statutory reporting purposes at a level not less than the outstanding balance of such fund. The following definitions assume that a tax-deferred, pre-event catastrophe reserve has been elected.

This voluntary program is based on the regulatory approach that insurers will be allowed to use voluntary tax-deferred pre-event catastrophe reserves as one available tool among many to be financially ready to effectively deal with their catastrophe exposures.

1. **Subject Entities**—Insurers shall be allowed to establish a statutory Catastrophe Reserve if they: (1) write property/casualty contracts for the Qualifying Lines of Business; (2) file an NAIC annual statement for property casualty companies and (3) are subject to federal tax on net income.
2. **Catastrophe Reserve**—A voluntary pre-event provision for future Qualifying Losses within specified Thresholds attributable to Qualifying Catastrophe Events that are insured under Qualifying Lines of Business. An aggregate reserve for all Qualifying Lines of Business shall be established.
3. **Statutory Reporting**—A Catastrophe Reserve shall be reported in statutory financial statements as a separate liability; distinct from loss, loss adjustment expense and unearned premium liabilities. Additions to, and reductions from, the Catastrophe Reserve shall be reported through a Change in Catastrophe Reserve in the Underwriting Income section of the Statutory Statement of Income. The Catastrophe Reserve shall be included in the scope of the statutory financial statement audit performed by a certified public accountant.
4. **Geographic Scope**—A Catastrophe Reserve shall be established for Qualifying Losses for Qualifying Catastrophes to which the United States, its territories and possessions are exposed in the Qualifying Lines of Business. Insurers domiciled in Puerto Rico shall not establish a Catastrophe Reserve for catastrophes to which Puerto Rico is exposed as a catastrophe reserve is already included in the Puerto Rican insurance code.
5. **Qualifying Lines of Business**—Fire, allied lines, farm-owners multiple-peril, homeowners multiple-peril, commercial multiple-peril (non-liability portion), earthquake, private passenger auto physical damage, commercial auto physical damage, inland marine, workers' compensation and non-proportional reinsurance for the qualified lines of business.

6. **Qualifying Catastrophe Events**—Wind; hail; earthquake and fire following; winter catastrophes such as snow, ice, freezing; fire; tsunami; flood; acts of terrorism and volcanic eruption (including lahar). These events shall be 1) designated a catastrophe by Property Claims Service or any successor organization or 2) declared an emergency or disaster by the President of the United States pursuant to the Stafford Act or 3) declared an emergency or disaster in a similar declaration by the chief executive official of a State, territory or possession of the United States or the District of Columbia.

“Act of Terrorism” is defined as an act of violence or force or an act dangerous to human life, health, tangible or intangible property or infrastructure, carried out by a person or group that is not a sovereign state, directed towards overthrowing or influencing the government of a sovereign state. If federal legislation is enacted and, under that legislation, a federal official declares an act to be an “act of terrorism,” then it is considered to be an act of terrorism for purposes of determining if it is a qualifying catastrophe event.

Generally war is not considered to be a qualifying catastrophe event, however, if an insurer is required by state law to pay workers’ compensation benefits that are attributable to war, that event is considered to be a qualifying catastrophe event.

7. **Qualifying Losses**—Direct and assumed losses and loss adjustment expenses incurred and any non-recoverable assessments, surcharges or other liabilities attributable to Qualifying Catastrophe Events borne by such insurer in the qualifying lines of business as reported in such insurer’s annual statement that are attributable to one or more qualifying events, plus the amounts by which such losses and loss adjustment expenses have been reduced for contractual payments from catastrophe management resources and for salvage and subrogation. Recoveries from any federal program related to acts of terrorism, or war in the case of workers’ compensation must be taken into account. Qualifying Losses shall be determined and maintained by Catastrophe Year for purposes of determining how they apply to the Catastrophe Reserve drawdown criteria.

Note: Catastrophe management resources may include reinsurance that meets the risk transfer definition contained in Statement of Statutory Accounting Principle No. 62, Property and Casualty Reinsurance, of the *NAIC Accounting Practices and Procedures Manual* and qualifies for credit for reinsurance per the domiciliary state’s credit for reinsurance law; insurance risk securitizations that constitute risk transfer or reinsurance per the NAIC or domiciliary state rules; unrestricted surplus, capital notes and surplus notes to the extent that, in combination, they exceed the insurer’s Company Action Level Risk-Based Capital of the NAIC Risk-Based Capital Model Act; commissioner-approved support agreements from parent or affiliated entities such as intragroup reinsurance, stop loss, guarantees, net worth maintenance or other similar arrangements; voluntary tax-deferred pre-event catastrophe reserves as defined herein; and other risk transfer arrangements (including contingent equity or contingent surplus notes or contingent capital notes that, when issued, would meet risk-based capital credit, surplus enhancement, credit for reinsurance, or risk transfer requirements) as permitted by state law or regulation or approved by the Commissioner of the state of domicile. Catastrophe management resources are subject to regulatory review.

8. **Catastrophe Year**—Catastrophe Year in concept and application is similar to the insurance accounting concept of accident year since it represents the identification and

development of losses occurring within a particular calendar year. Catastrophe Year is somewhat different from accident year, however, since individual Qualifying Losses, which are attributable to a Qualifying Catastrophe Event, are included in the year in which the Qualifying Catastrophe Event started, disregarding the possibility that the Qualifying Catastrophe Event spans more than one calendar year. For purposes of determining Qualifying Losses, Catastrophe Year shall be determined from the time that a Qualifying Catastrophe Event first occurs and shall include all Qualifying Losses attributable to that Qualifying Catastrophe Event regardless of the year incurred.

9. **Reserve Cap**—The Reserve Cap establishes a maximum limit for the insurer’s Voluntary Tax-deferred Pre-event Catastrophe Reserve. The Reserve Cap is calculated using a formula that multiplies Catastrophe Reserve Cap Factors by an insurer’s net written premiums (including net written premiums under intercompany pooling arrangements) for each corresponding Qualifying Line of Business. The resulting amounts are added together to obtain a single aggregate Catastrophe Reserve Cap for the insurer. The Catastrophe Reserve shall be established and maintained at a level not to exceed the Reserve Cap. Additions to the Catastrophe Reserve shall be limited to an amount equal to the difference between the Reserve Cap and the reserve balance at the time of the addition.
10. **Catastrophe Reserve Cap Factors**—The following Catastrophe Reserve Cap Factors are to be used to calculate the insurer’s Reserve Cap.

Fire	0.25
Allied Lines	0.85
Farmowners Multi-Peril	0.10
Homeowners Multi-Peril	0.60
Commercial Multi-Peril	0.30
Earthquake	16.30
Private Passenger Auto Physical Damage	0.01
Commercial Auto Physical Damage	0.01
Inland Marine	0.20
Workers’ Compensation	0.10
Non-proportional Reinsurance for Other Qualifying Lines	0.45

The Catastrophe Reserve Cap Factors will be the same as the factors promulgated under federal tax law to allow tax deferral of such reserves. Given the unique prerogative of the U.S. Congress over the determination of the basis for taxation, these factors may be updated periodically by federal law with advice and counsel from other parties, to include the NAIC. Any changes to such factors for use in the federal tax law shall also be made to the Catastrophe Reserve Cap Factors, herein. The methodology used to determine these factors is included for reference at page 7.

11. **Reserve Drawdown/Thresholds**—Drawdowns from the Catastrophe Reserve shall be made in accordance with the following criteria:
 - a. **Drawdown for Qualifying Losses in Excess of Threshold**—The Catastrophe Reserve shall be drawn down in an amount not to exceed the lesser of the amount determined under subparagraph (1) or (2):

- 1) Qualifying Losses for the Catastrophe Year net of contractual payments from catastrophe management resources, net of salvage and subrogation, net of any recoveries from federal government programs for terrorism, and net of any federal program recoveries for war in the case of workers' compensation
- 2) Qualifying Losses for the Catastrophe Year to the extent that such Qualifying Losses exceed the lesser of:
 - i. 100% of the insurer's prior year Reserve Cap, or
 - ii. 30% of the insurer's surplus at December 31 of the prior year.

Note: Federal enabling tax legislation includes a second event trigger that is not included here subject to further discussion.

- b. **Drawdown for Amounts in Excess of Cap**—The catastrophe reserve balance shall be drawn down to the extent it exceeds the Reserve Cap.
 - c. **Drawdown for Insolvency**—The domiciliary Commissioner may cause an insurer to release the Catastrophe Reserve as a rehabilitation, conservation or liquidation measure or to forestall insolvency of the insurer.
12. **Adjustment for Affiliate Risk Sharing Arrangements**—Many insurers share risk among affiliates through excess of loss or stop loss reinsurance agreements. For such insurers, the reserve cap shall be computed on a consolidated basis for the participating affiliates and then allocated to each participating affiliate on a basis that reasonably reflects the relative retained exposure of each entity to Qualifying Losses.
 13. **Effective Date and Transition**—No reporting or calculation of a catastrophe reserve shall be required until enabling federal tax legislation is in effect.

Appendix

Derivation of Line of Business Catastrophe Reserve Cap Factors

For Voluntary Tax-Deferred Pre-Event Catastrophe Reserves

Objective—Reserve cap factors by line of business were derived to produce a maximum insurance industry reserve of \$40 billion when applied to 1999 net written premiums. The reserve cap factors are designed to reflect the historic variability in industry loss ratios for the relevant lines of business, as well as the expected catastrophe losses implied by a catastrophe model.

Reserve Calculation Methodology

The proposed reserve cap factors are based on the following methodology:

1. Adjust the reinsurance A and B premiums and losses to account for the portion attributable to the qualified lines only (qualified lines in reinsurance A are fire, allied, inland marine, earthquake, private passenger auto physical damage, and commercial auto physical damage; qualified lines in reinsurance B are farmowners, homeowners, and CMP non-liability) by multiplying the reinsurance A and B premiums and losses by the following ratio: (reinsurance X qualified lines premiums ceded to non-affiliates)/(total reinsurance X premiums ceded to non-affiliates), where X = A or B.
2. Combine the reinsurance A and B lines into one reinsurance line by summing the respective reinsurance A and B premiums and losses.
3. Calculate industry direct incurred loss ratios (direct incurred losses and loss adjustment expenses divided by direct earned premiums) from 1967 through 1999 for each of the subject lines of business based on data published by A.M. Best. (Farmowners data was only available starting in 1973; commercial multiple peril data was only available in total from 1967 through 1991 [the non-liability portion of CMP was available starting in 1992]; earthquake data was not available in 1971 and 1972; reinsurance A and B data was only available starting in 1976 [only total reinsurance data was available from 1976-1987; beginning in 1988, the data was split into the separate reinsurance lines].)
4. Calculate the mean and standard deviation of the annual direct incurred loss ratios for each line.
5. Adjust the loss ratios from step 3 such that there is no loss ratio greater than the mean plus one standard deviation as calculated in step 4. In other words, if an annual loss ratio is greater than the mean plus one standard deviation, set the loss ratio equal to the mean plus one standard deviation. If an annual loss ratio is less than the mean plus one standard deviation, do not adjust it.
6. Calculate the adjusted mean and standard deviation of the direct incurred loss ratios from step 5 for each line.
7. Calculate a threshold loss ratio for each line, equal to the adjusted mean loss ratio plus two

adjusted standard deviations from step 6.

8. Calculate the excess loss ratio for each line and year equal to the excess of the actual loss ratio over the threshold loss ratio. (It was assumed that non-liability represented 50% of CMP premiums and losses during the period 1967-1991. To reflect this assumption, any excess loss ratios during this period were doubled. In addition, CMP excess loss ratios for 1983-1985 were set to zero because the large loss ratios in those years were primarily due to inadequate casualty pricing rather than property catastrophes. For farmowners, the excess loss ratios for 1967-1972 are the homeowners excess loss ratios. For earthquake, the excess loss ratios for 1971 and 1972 are allied lines excess loss ratios.)
9. Calculate losses in excess of the threshold loss ratio for each line by applying the all years sum of the excess loss ratios for each line to the 1999 direct written premium.
10. Prorate the excess losses from step 9 to a total of two thirds of the projected cap (two-thirds of \$40 billion based on 1999 premiums).
11. Estimate expected catastrophe losses by line of business, based on an analysis of data published by a prominent catastrophe modeling firm.
12. Prorate the expected catastrophe losses from step 11 to a total of one-third of the projected cap (one-third of \$40 billion based on 1999 premiums).
13. Add the amounts from steps 10 and 12 to produce an initial reserve cap by line of business.
14. Calculate an initial reserve cap factor by dividing the reserve caps for each line (from step 13) by 1999 net written premium by line.
15. Cap the factor in step 14 for the private passenger auto physical damage line of business equal to 0.01
16. Cap the factor in step 14 for the commercial auto physical damage line of business equal to 0.01.
17. Using the capped factors in steps 15 and 16, calculate the reserve caps for private passenger auto physical damage and commercial auto physical damage.
18. Prorate the difference between the original private passenger auto physical damage and the commercial auto physical damage reserve caps from step 13 and the reserve caps from step 17 back to the other lines and recalculate the reserve cap factors.
19. Select a reserve cap factor for each line by rounding the ratios calculated in step 18 to the nearest 0.05, with a minimum factor of 0.05 (except the auto physical damage lines).

Statutory Issue Paper No. ____

Title:

CATASTROPHE RESERVES

Status:

Revised Draft of the Catastrophe Insurance Working Group February 2001

Type of Issue:

Property-Casualty

SUMMARY OF ISSUE:

1. Catastrophes present a significant challenge to the U.S. economy and to the U.S. property-casualty insurance industry, posing financial solvency, capital accumulation and insurance availability issues. Insurers should be encouraged to engage in prudent risk management behavior. Existing methods to manage insurer risk include loss mitigation, geographic spreading of risk, reinsurance, capital market instruments, derivatives products and short and long-term pre and post-event financing. One additional method proposed to encourage prudent risk behavior—which should augment, not supplant those existing risk management methods—is to permit insurers to establish a reserve for future catastrophes.
2. Current statutory and GAAP accounting limits the recognition of loss reserves to losses that have been incurred. A reserve for future catastrophes is intended to enhance property and casualty insurers' capability to manage their catastrophic loss exposures by allowing specific provision for future catastrophe losses. Existing statutory accounting and tax treatment of catastrophe exposure fails to maximize the ability of insurers to appropriately respond to catastrophe related and availability issues. With respect to solvency issues, the current statutory accounting and tax treatment does not encourage the prudent accumulation of capital to absorb catastrophe losses.
3. It is in the public interest to determine whether a reserve for future catastrophes can be structured in such a way so as to provide incentives for:
 - Property and casualty insurers to appropriately manage their catastrophic loss exposures by making specific provision for future catastrophe losses while continuing to provide and expand catastrophe insurance coverage in regions with significant catastrophe exposure, and
 - State insurance regulators to approve catastrophe insurance rates which, among other appropriate factors, reflect past experience and projected exposures,

so that the U.S. federal government and taxpayers benefit, in the form of possible reduced demand for catastrophe relief, as a result of these changes in the insurance regulatory and tax systems.

4. This paper establishes statutory accounting criteria for recording a pre-event catastrophe reserve.

SUMMARY CONCLUSION:

5. Insurers writing property and casualty contracts as defined in SSAP 50—Classifications and Definitions of Insurance or Managed Care Contracts In Force, writing the lines of business described in paragraph 7 below and required under state law to file a NAIC annual statement shall establish a catastrophe reserve for the purpose of paying for future catastrophe losses occurring in the United States and its territories and possessions. Insurers domiciled in Puerto Rico shall not establish the reserve for Puerto Rico risks as a catastrophe reserve is already included in the Puerto Rico insurance code.
6. The catastrophe reserve shall be a separate liability on the balance sheet distinct from loss and loss adjustment expense reserves and unearned premium reserves. Additions to, and deductions from, the catastrophe reserve shall be reported through a change in catastrophe reserve in the underwriting income section of the statutory statement of income.
7. The catastrophe reserve shall be established in the aggregate for the following lines: fire, allied lines, farm-owners multiple-peril, homeowners multiple-peril, commercial multiple-peril (non-liability portion), earthquake, private passenger auto physical damage commercial auto physical damage, inland marine, workers' compensation and non-proportional reinsurance for the Qualifying Lines of Business.
8. The types of events that must occur for an insurer to be allowed to deduct Qualifying Losses (as defined in paragraph 9 below) from the catastrophe reserve are as follows:
 - a. Wind
 - b. Hail
 - c. Earthquake/fire following
 - d. Winter catastrophes (snow, ice, freezing)
 - e. Fire
 - f. Tsunami
 - g. Flood
 - h. Acts of terrorism; and
 - i. Volcanic eruption (including lahar)

These events shall be 1) designated a catastrophe by Property Claims Service or any successor organization, 2) declared an emergency or disaster by the President of the United States pursuant to the Stafford Act, or 3) declared to be an emergency or disaster in a similar declaration by the chief executive official of a State, possession, or territory of the United States, or the District of Columbia.

“Act of Terrorism” is defined as an act of violence or force or an act dangerous to human life, health, tangible or intangible property or infrastructure, carried out by a person or group that is not a sovereign state, directed towards overthrowing or influencing the government of a sovereign state. If federal legislation is enacted and, under that legislation, a federal official declares an act to be an “act of terrorism,” then it is considered to be an act of terrorism for purposes of determining if it is a qualifying catastrophe event.

Generally war is not considered to be a qualifying catastrophe event, however, if an insurer is required by state law to pay workers’ compensation benefits that are attributable to war, that event is considered to be a qualifying catastrophe event.

9. Qualifying Losses are: direct and assumed losses and loss adjustment expenses incurred and any non-recoverable assessments, surcharges or other liabilities attributable to Qualifying Catastrophe Events borne by such insurer in the qualifying lines of business as reported in such insurer’s annual statement that are attributable to one or more qualifying events, plus the amounts by which such losses and loss adjustment expenses have been reduced for contractual payments from catastrophe management resources and for salvage and subrogation. Recoveries from any federal program related to acts of terrorism, or war in the case of workers’ compensation must be taken into account.

Calculation and Basis for Reserve Additions

10. Permissible annual reserve additions to the catastrophe reserve will be determined by applying catastrophe reserve cap factors to the insurer’s net premiums written. Although the maximum permissible reserve is to be derived from premiums multiplied by an exposure factor, the design of the reserve is not intended to affect rates. Additions to the Catastrophe Reserve shall be limited to an amount equal to the difference between the Reserve Cap and the reserve balance at the time of the addition.
11. Catastrophe reserve cap factors, promulgated under federal law and developed and updated periodically with input from the NAIC, will be established for each line of business written (as specified in paragraph 7). These catastrophe reserve cap factors shall be applied to net written premiums (including net written premium under inter-company pooling arrangements) by qualifying line of business in order to determine the maximum permissible amount of the catastrophe reserve (or “catastrophe reserve cap”). The catastrophe reserve cap factors are included in federal legislation and may be revised periodically. They will be maintained as updated for any subsequent changes, in the *NAIC Annual Statement Instructions – Property & Casualty*.

Criteria for Catastrophe Reserve Drawdowns

12. The following criteria shall be followed for the drawdown of the reserve.
 - a. For purposes of the catastrophe reserve drawdown criteria, catastrophe year shall be determined from the time that a qualifying event’s first loss occurs and shall include all qualifying losses (as defined in paragraph 9) related to that qualifying event regardless of the year incurred. Catastrophe year in concept and application is similar to the insurance accounting concept of accident year since it represents the identification and development of losses occurring within a particular calendar year. Catastrophe year is somewhat different from accident year, however, since

individual losses, which are part of a catastrophic event, are included in the year in which the catastrophic event started, disregarding the possibility that the event spans more than one calendar year. Qualifying losses shall be maintained by catastrophe year.

13. **Reserve Drawdown/Thresholds**—Drawdowns from the Catastrophe Reserve shall be made in accordance with the following criteria:

a. **Drawdown for Qualifying Losses in Excess of Threshold** – The Catastrophe Reserve shall be drawn down in an amount not to exceed the lesser of the amount determined under subparagraph 1) or 2):

1) Qualifying Losses for the Catastrophe Year net of contractual payments from catastrophe management resources, net of related subrogation and salvage, net of any recoveries from federal government programs for terrorism, and net of any federal program recoveries for war in the case of workers' compensation, or

2) Qualifying Losses for the Catastrophe Year to the extent that such Qualifying Losses exceed the lesser of:

i. 100% of the insurer's prior year Reserve Cap, or

ii. 30% of the insurer's surplus at December 31 of the prior year.

Note: Federal enabling tax legislation includes a second event trigger that is not included here subject to further discussion.

b. **Drawdown for Amounts in Excess of Reserve Cap**—The catastrophe reserve balance shall not exceed the reserve cap (the sum of the amounts obtained by multiplying each line of business reserve cap factor by its corresponding net written premium for the insurer). The reserve shall be drawn down to the extent the balance of the reserve exceeds the reserve cap.

c. **Drawdown for Insolvency**—The insurer's domiciliary Commissioner may cause an insurer to release the reserve as a rehabilitation, conservation or liquidation measure or to forestall insolvency.

14. Many insurers share risk among affiliates through excess of loss or stop loss reinsurance agreements. For such insurers, the reserve cap should be computed on a consolidated basis for the participating affiliates and then allocated to each participating affiliate on a basis that reasonably reflects the relative retained exposure of each entity to Qualifying Losses.

Disclosures

15. The annual financial statements shall disclose a reconciliation of the catastrophe reserve between years, including:

a. The balance of the catastrophe reserve at the beginning of the year;

- b. The annual reserve addition;
- c. Drawdowns of the reserve, including the nature of the drawdown; (i.e. qualifying losses, amounts in excess of the reserve cap, etc.)
- d. The balance of the catastrophe reserve at the end of the year.

Effective Date and Transition

- 16. No reporting or calculation of a catastrophe reserve shall be required until enabling federal tax legislation is in effect.

DISCUSSION:

17. Under the preamble to the NAIC Accounting Practices and Procedures Manual effective January 1, 2001, it is contemplated that special reserves may be established for regulatory solvency. That provision of the preamble provides the basis for the establishment of this reserve.
18. Consistent with the solvency and conservatism concepts in the Statutory Accounting Principles Statements of Concepts and Statutory Hierarchy, the statutory accounting model uses numerous accounting methods to accomplish the objective of reporting a company's statutory financial position to demonstrate solvency. Notwithstanding the accounting guidance in SSAP 5 and SSAP 55 recording of a catastrophe reserve is consistent with the solvency and conservatism concepts.
19. The catastrophe reserve does not meet the definition of a liability, which is set forth in SSAP 5—Liabilities, Contingencies and Impairments of Assets. Nor does the catastrophe reserve meet the definition and characteristics of a liability as defined in FASB Statement of Concepts No. 6—Elements of Financial Statements. However, it is consistent with the “*ultimate objective of solvency regulation*” as stated in the Statement of Concepts. This states:

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

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

Liabilities require recognition as they are incurred. Certain statutorily mandated liabilities may also be required to arrive at conservative estimates of liabilities and probable loss contingencies.

20. This issue paper is consistent with certain principles discussed in SSAP 60—Financial Guaranty Insurance regarding a contingency reserve. Similarities can be drawn between the calculation of the contingency reserve as specified in SSAP 60 and the calculation of the catastrophe reserve as specified in this issue paper. Both reserves are on a pre-event basis and reference premiums written. The purpose of both is to protect policyholders.
21. The statutory accounting principles outlined in the conclusion above are consistent with the conservatism and recognition concepts in the Statement of Concepts. Pertinent excerpts follow:

Conservatism

Financial reporting by insurance enterprises requires the use of substantial judgments and estimates by management. Such estimates may vary from the actual amounts for numerous reasons. To the extent that factors or events result in adverse variation from management's accounting estimates, the ability to meet policyholder obligations may be lessened. In order

to provide a margin of protection for policyholders, the concept of conservatism should be followed when developing estimates as well as establishing accounting principles for statutory reporting.

22. A catastrophe reserve without tax-deductibility would diminish an insurer's capital and would likely have the effect of restricting availability of insurance coverage to consumers in catastrophe prone areas. It is anticipated that tax-deductibility of the catastrophe reserve will provide incentive for insurers to write in catastrophe prone areas and should result in greater availability of insurance and increase risk-bearing capacity to cover catastrophic exposure.
23. The specified treatment of the annual reserve additions and qualifying losses do not meet the defined recording and treatment of claims, losses, loss/claim adjustment expense, unpaid claims, unpaid losses and unpaid loss/claim adjustment expenses as defined in SSAP 55—Unpaid Claims, Losses, and Loss Adjustment Expenses or FASB Statement No. 60, Accounting and Reporting by Insurance Enterprises (FAS 60). These pronouncements specify that the event must have occurred for a liability to be recorded and an estimate of the ultimate cost must be determined. However the treatment is consistent with the "*ultimate objective of solvency regulations*" as stated in the Statement of Concepts, please refer to paragraph 18 above.

RELEVANT LITERATURE:

Statutory Accounting Practices and Procedures

- Preamble to the NAIC Accounting Practices and Procedures Manual
- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- SSAP 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets
- SSAP 55—Unpaid Claims, Losses, and Loss Adjustment Expenses
- SSAP 60—Financial Guaranty Insurance

Generally Accepted Accounting Principles

- FASB Statement of Concepts No. 6—Elements of Financial Statements
- FASB Statement No. 60—Accounting and Reporting by Insurance Enterprises

State Regulations

- Puerto Rico Statutes, Title 26, Ins. Code §25.010, Reserve for Catastrophic Insurance Losses
- Florida Statutes, Title XXXVII, Chapter 627, Insurance Rates and Contracts §067.062

Statement of Statutory Accounting Principles No. __

Catastrophe Reserves

Scope of Statement

1. This statement establishes statutory accounting principles for a pre-event catastrophe reserve for property and casualty companies.

Summary Conclusion

2. Insurers writing property and casualty contracts as defined in SSAP 50—Classifications and Definitions of Insurance or Managed Care Contracts In Force, writing the lines of business described in paragraph 4 below and required under state law to file a NAIC annual statement shall establish a catastrophe reserve for the purpose of paying for future qualifying catastrophe losses occurring in the United States and its territories and possessions. Insurers domiciled in Puerto Rico shall not establish the reserve for Puerto Rico risks as a catastrophe reserve is already included in the Puerto Rico insurance code.
3. The catastrophe reserve shall be a separate statutory liability on the balance sheet distinct from loss and loss adjustment expense reserves and unearned premium reserves. Additions to, and deductions from, the catastrophe reserve shall be reported through a change in catastrophe reserve in the underwriting income section of the statutory statement of income.
4. The catastrophe reserve shall be established in the aggregate for the following lines: fire, allied lines, farm-owners multiple-peril, homeowners multiple peril, commercial multiple-peril (non-liability portion), earthquake, private passenger auto physical damage, commercial auto physical damage, inland marine, workers' compensation and non-proportional reinsurance for Qualifying Lines of Business.
5. The types of events that must occur for an insurer to be allowed to deduct qualifying losses (defined in paragraph 6) from the catastrophe reserve are as follows:
 - a) Wind;
 - b) Hail;
 - c) Earthquake/fire following;
 - d) Winter catastrophe (snow, ice, freezing);
 - e) Fire;
 - f) Tsunami;
 - g) Flood;
 - h) Acts of terrorism; and
 - i) Volcanic eruption (including lahar)

These events shall be 1) designated a catastrophe by Property Claims Service or any successor organization, 2) declared an emergency or disaster by the President of the United States pursuant to the Stafford Act, or 3) declared to be an emergency or disaster in a similar declaration by the chief executive official of a State, possession, or territory of the United States, or the District of Columbia.

“Act of Terrorism” is defined as an act of violence or force or an act dangerous to human life, health, tangible or intangible property or infrastructure, carried out by a person or group that is not a sovereign state, directed towards overthrowing or influencing the government of a sovereign state. If federal legislation is enacted and, under that legislation, a federal official declares an act to be an “act of terrorism,” then it is considered to be an act of terrorism for purposes of determining if it is a qualifying catastrophe event.

Generally war is not considered to be a qualifying catastrophe event, however, if an insurer is required by state law to pay workers’ compensation benefits that are attributable to war, that event is considered to be a qualifying catastrophe event.

6. Qualifying losses are: Direct and assumed losses and loss adjustment expenses incurred and any non-recoverable assessments, surcharges or other liabilities attributable to Qualifying Catastrophe Events borne by such insurer in the qualifying lines of business as reported in such insurer’s annual statement that are attributable to one or more qualifying events, plus the amounts by which such losses and loss adjustment expenses have been reduced for contractual payments from catastrophe management resources and for salvage and subrogation.

7. Calculation and Basis for Reserve Additions

- a) Annual reserve additions for each insurer shall not exceed the catastrophe reserve cap. The catastrophe reserve cap is the sum of the amounts determined by multiplying the catastrophe reserve cap factor for each qualifying line of business by the insurer’s net written premium for the corresponding qualifying line of business. Additions to the Catastrophe Reserve shall be limited to an amount equal to the difference between the Reserve Cap and the reserve balance at the time of the addition.
- b) Catastrophe reserve cap factors, promulgated under federal law and developed and updated periodically with input from the NAIC will be established for each line of business written (as specified in paragraph 4). These catastrophe reserve cap factors shall be applied to net written premiums (including net written premiums under inter-company pooling arrangements) by qualifying line of business in order to determine the maximum permissible amount (or “reserve cap”) of the catastrophe reserve. The catastrophe reserve cap factors are included in federal tax legislation and may be revised periodically and will be maintained in *the NAIC Annual Statement Instructions – Property & Casualty*.

8. Criteria for Drawdown of the Catastrophe Reserve

The following criteria shall be followed for the drawdown of the reserve:

- a. For purposes of the catastrophe reserve drawdown criteria, catastrophe year shall be determined from the time that a qualifying event’s first loss occurs and shall include all qualifying losses (as defined in paragraph 6) related to that qualifying event regardless of the year incurred. Catastrophe year in concept and application is similar to the insurance accounting concept of accident year since it represents the identification and development of losses occurring within a particular calendar year. Catastrophe year is somewhat different from accident year, however, since individual

losses, which are part of a catastrophic event, are included in the year in which the catastrophic event started, disregarding the possibility that the event spans more than one calendar year. Qualifying losses shall be maintained by catastrophe year.

- b. The Catastrophe Reserve shall be drawn down in an amount not to exceed the lesser of the amount determined under subparagraph 1) or 2):
 - 1) Qualifying Losses for the Catastrophe Year net of contractual payments from catastrophe management resources, a net of subrogation and salvage, net of any recoveries from federal government programs for terrorism, and net of any federal program recoveries for war in the case of workers' compensation, or
 - 2) Qualifying Losses for the Catastrophe Year to the extent that such Qualifying Losses exceed the lesser of:
 - i. 100% of the insurer's prior year initial reserve cap, or
 - ii. 30% of the insurer's surplus at December 31 of the prior year

Note: Federal enabling tax legislation includes a second event trigger that is not included here subject to further discussion.

- c. The catastrophe reserve shall be drawn down to the extent it exceeds the reserve cap.
 - d. The insurer's domiciliary commissioner may cause an insurer to release the reserve as a rehabilitation, conservation or liquidation measure or to forestall insolvency.
9. Many insurers share risk among affiliates through excess of loss or stop loss reinsurance agreements. For such insurers, the reserve cap should be computed on a consolidated basis for the participating affiliates and then allocated to each participating affiliate on a basis that reasonably reflects the relative retained exposure of each entity to Qualifying Losses.

Disclosures

10. The annual financial statements shall disclose a reconciliation of the catastrophe reserve between years, including:
- a) The balance of the catastrophe reserve at the beginning of the year;
 - b) The annual reserve addition;
 - c) Drawdowns of the reserve, including the nature of the drawdown (i.e. qualifying losses, amounts in excess of the reserve cap, etc.); and
 - d) The balance of the catastrophe reserve at the end of the year.

Effective Date

11. No reporting or calculation of a catastrophe reserve shall be required until enabling federal tax legislation is in effect. A change resulting from the adoption of this statement shall be

accounted for as a change in accounting principle in accordance with *SSAP No. 3—Accounting Changes and Corrections of Errors*.

Authoritative Literature

Statutory Accounting

- Preamble to the NAIC Accounting Practices and Procedures Manual
- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- SSAP 5—Definition of Liabilities, Contingencies, and Impairments of Assets
- SSAP 55—Unpaid Claims, Losses and Loss Adjustment Expenses
- SSAP 60—Financial Guaranty Insurance

Relevant Issues Papers

- Issue Paper No. ____, Catastrophe Reserves
- Issue Paper No. 5—Liabilities, Contingencies, and Impairments of Assets
- Issue Paper No. 55—Unpaid Claims, Losses and Loss Adjustment Expenses
- Issue Paper No. 69—Financial Guaranty Insurance

SSAP No. __ - Exhibit A Implementation Guidance

Voluntary tax-deferred pre-event catastrophe reserve calculation rules

For insurer's that choose to use the reserve, the reserve balance calculation should be completed on an **annual basis** in the order as listed below.

1. Calculate the annual reserve cap and thresholds.
2. Determine the allowable drawdown for qualifying losses.
3. Reduce the reserve balance for the amount of qualifying losses to be drawn down from the reserve subject to the limit in 2 above.
4. Determine the maximum amount of the annual reserve addition allowed by subtracting the remaining reserve balance from the reserve cap.
5. Add the desired reserve addition to the remaining balance of the reserve subject to the limitation in 4 above
6. Determine if the resulting balance exceeds the reserve cap, if so, reduce the reserve for any balance in excess of the reserve cap.

The determination of qualifying losses is a complicated procedure since all losses shall be maintained by catastrophe year. Catastrophe year in concept and application is similar to the commonly understood insurance accounting concept of accident year since it represents the identification and development of losses occurring within a particular calendar year. Catastrophe year is somewhat different from accident year, however, since individual losses that are part of a catastrophic event are included in the year in which the catastrophic event started, disregarding the possibility that the event spans more than one calendar year.

The development of losses from a qualifying event shall be continuously maintained. Losses from a qualifying event might not reach the qualifying loss threshold for several years after the year of occurrence. Accordingly, each company shall maintain losses by catastrophe year and, their qualifying loss limitation thresholds for each year as a permanent benchmark. Once the annual determination of qualifying losses is completed for the current year the qualifying losses are deducted from the reserve. Favorable loss development should not be used to re-establish reserves previously drawdown.

The reserve cap is the sum of the amounts determined by multiplying the catastrophe reserve cap factor for each qualifying line of business by the insurer's net written premium for the corresponding qualifying line of business.

**Proposed NAIC Annual Statement Instructions for
Property and Casualty Insurance Companies**

LIABILITIES, SURPLUS AND OTHER FUNDS

Line 18 - Catastrophe Reserve

Include: Amounts for catastrophe reserves. Refer to SSAP #__, Voluntary Tax-deferred Pre-event Catastrophe Reserves for guidance regarding these amounts.

The following represents the catastrophe reserve cap factors as specified in SSAP #__, paragraph 7. These factors are used in the calculation of catastrophe reserve cap, which limits annual reserve additions.

Fire	0.25
Allied lines	0.85
Farmowners Multi-peril	0.10
Homeowners Multi-peril	0.60
Commercial Multi-peril	0.30
Earthquake	16.30
Private Passenger Auto Physical Damage	0.01
Commercial Auto Physical Damage	0.01
Inland Marine	0.20
Workers' Compensation	0.10
Non-proportional Reinsurance for Qualifying Lines	0.45

LIABILITIES, SURPLUS AND OTHER FUNDS	1 Current Year	2 Prior Year
1. Losses (Part 2A, Line 34, Column 8).....		
2. Reinsurance payable on paid loss and loss adjustment expenses (Schedule F, Part 1, Column 6).....		
3. Loss adjustment expenses (Part 2A, Line 34, Column 9).....		
4. Commissions payable, contingent commissions and other similar charges		
5. Other expenses (excluding taxes, licenses and fees).....		
6. Taxes, licenses and fees (excluding federal and foreign income taxes).....		
7. Federal and foreign income taxes (including \$..... on realized capital gains (losses)) (including \$..... net deferred tax liability)		
8. Borrowed money \$..... and interest thereon \$.....		
9. Unearned premiums (Part 1A, Line 37, Column 5) (after deducting unearned premiums for ceded reinsurance of \$..... and including warranty reserves of \$.....)		
10. Advance premium.....		
11. Dividends declared and unpaid:		
11.1 Stockholders.....		
11.2 Policyholders.....		
12. Ceded reinsurance premiums payable (net of ceding commissions)		
13. Funds held by company under reinsurance treaties (Schedule F, Part 3, Column 19).....		
14. Amounts withheld or retained by company for account of others.....		
15. Remittances and items not allocated.....		
16. Provision for reinsurance (Schedule F, Part 7).....		
17. Net adjustments in assets and liabilities due to foreign exchange rates.....		
18. Catastrophe Reserve.....		
19. Drafts outstanding.....		
20. Payable to parent, subsidiaries and affiliates.....		
21. Payable for securities.....		
22. Liability for amounts held under uninsured accident and health plans.....		
23. Capital notes \$..... and interest thereon \$.....		
24. Aggregate write-ins for liabilities.....		
25. Total liabilities excluding protected cell liabilities (Lines 1 through 24).....		
26. Protected cell liabilities.....		
27. Total liabilities (Lines 25 and 26).....		
28. Aggregate write-ins for special surplus funds.....		
29. Common capital stock.....		
30. Preferred capital stock.....		
31. Aggregate write-ins for other than special surplus funds.....		
32. Surplus notes.....		
33. Gross paid in and contributed surplus.....		
34. Unassigned funds (surplus).....		
35. Less treasury stock, at cost:		
35.1 shares common (value included in Line 29 \$.....)		
35.2 shares preferred (value included in Line 30 \$.....)		
36. Surplus as regards policyholders (Lines 28 to 34, less 35) (Page 4, Line 39).....		
37. TOTALS (Page 2, Line 28, Col. 3)		
DETAILS OF WRITE-INS		
2401.		
2402.		
2403.		
2498. Summary of remaining write-ins for Line 24 from overflow page.....		
2499. Totals (Lines 2401 through 2403 plus 2498) (Line 24 above)		
2801.		
2802.		
2803.		
2898. Summary of remaining write-ins for Line 28 from overflow page.....		
2899. Totals (Lines 2801 through 2803 plus 2898) (Line 28 above)		
3101.		
3102.		
3103.		
3198. Summary of remaining write-ins for Line 31 from overflow page.....		
3199. Totals (Lines 3101 through 3103 plus 3198) (Line 31 above)		

UNDERWRITING AND INVESTMENT EXHIBIT
STATEMENT OF INCOME

Line 4 - Change in Catastrophe Reserve

Include: Additions to and drawdowns from the catastrophe reserve. Refer to SSAP #__,
Voluntary Tax-deferred Pre-event Catastrophe Reserves for guidance regarding these amounts.

UNDERWRITING AND INVESTMENT EXHIBIT STATEMENT OF INCOME		1 Current Year	2 Prior Year
UNDERWRITING INCOME			
1.	Premiums earned (Part 1, Line 34, Column 4)		
DEDUCTIONS			
2.	Losses incurred (Part 2, Line 34, Column 7)		
3.	Loss expenses incurred (Part 3, Line 25, Column 1)		
4.	Change in Catastrophe Reserve (Page 3, Line 18, Column 1 minus Column 2)		
5.	Other underwriting expenses incurred (Part 3, Line 25, Column 2)		
6.	Aggregate write-ins for underwriting deductions		
7.	Total underwriting deductions (Lines 2 through 6)		
8.	Net income of protected cells		
9.	Net underwriting gain (loss) (Line 1 minus Line 7 plus Line 8)		
INVESTMENT INCOME			
10.	Net investment income earned (Exhibit of Net Investment Income, Line 17)		
11.	Net realized capital gains (losses) (Exhibit of Capital Gains (Losses))		
12.	Net investment gain (loss) (Lines 10 + 11)		
OTHER INCOME			
13.	Net gain (loss) from agents' or premium balances charged off (amount recovered \$..... amount charged off \$.....)		
14.	Finance and service charges not included in premiums		
15.	Aggregate write-ins for miscellaneous income		
16.	Total other income (Lines 13 through 15)		
17.	Net income before dividends to policyholders and before federal and foreign income taxes (Lines 9+12+16)		
18.	Dividends to policyholders		
19.	Net income, after dividends to policyholders but before federal and foreign income taxes (Line 17 minus Line 18)		
20.	Federal and foreign income taxes incurred		
21.	Net income (Line 19 minus Line 20) (to Line 21)		
CAPITAL AND SURPLUS ACCOUNT			
22.	Surplus as regards policyholders, December 31 prior year (Page 4, Line 39, Column 2)		
GAINS AND (LOSSES) IN SURPLUS			
23.	Net income (from Line 210)		
24.	Net unrealized capital gains or (losses)		
25.	Change in net unrealized foreign exchange capital gain (loss)		
26.	Change in net deferred income tax		
27.	Change in nonadmitted assets (Exhibit 1, Line 5, Col. 3)		
28.	Change in provision for reinsurance (Page 3, Line 16, Column 2 minus Column 1)		
29.	Change in surplus notes		
30.	Surplus (contributed to) withdrawn from protected cells		
31.	Cumulative effect of changes in accounting principles		
32.	Capital changes:		
32.1	Paid in		
32.2	Transferred from surplus (Stock Dividend)		
32.3	Transferred to surplus		
33.	Surplus adjustments:		
33.1	Paid in		
33.2	Transferred to capital (Stock Dividend)		
33.3	Transferred from capital		
34.	Net remittances from or (to) Home Office		
35.	Dividends to stockholders		
36.	Change in treasury stock (Page 3, Lines 35.1 and 35.2, Column 2 minus Column 1)		
37.	Aggregate write-ins for gains and losses in surplus		
38.	Change in surplus as regards policyholders for the year (Lines 23 through 37)		
39.	Surplus as regards policyholders, December 31 current year (Line 22 plus Line 38) (Page 3, Line 36)		
DETAILS OF WRITE-INS			
0601.		
0602.		
0603.		
0698.	Summary of remaining write-ins for Line 6 from overflow page		
0699.	Totals (Lines 0601 through 0603 plus 0698) (Line 6 above)		
1501.		
1502.		
1503.		
1598.	Summary of remaining write-ins for Line 15 from overflow page		
1599.	Totals (Lines 1501 through 1503 plus 1598) (Line 15 above)		
3701.		
3702.		
3703.		
3798.	Summary of remaining write-ins for Line 37 from overflow page		
3799.	Totals (Lines 3701 through 3703 plus 3798) (Line 37 above)		

NOTES TO FINANCIAL STATEMENTS

The financial statements shall disclose the following:

- a. The balance of the catastrophe reserve at the beginning of the year;
- b. The annual reserve addition;
- c. Drawdowns of the reserve, including the nature of the drawdown (i.e. qualifying losses, amounts in excess of the reserve cap, etc.); and
- d. The balance of the catastrophe reserve at the end of the year.

Note: Refer to SSAP #__, Voluntary Tax-deferred Pre-event Catastrophe Reserves for the guidance on calculating and maintaining catastrophe reserves.

Illustration:

i.	Catastrophe Reserve Balance at the Beginning of Year	\$ _____
ii.	Current Annual Reserve Addition to the Catastrophe Reserve	\$ _____
iii.	Current Drawdowns from Qualifying Losses	\$ _____
iv.	Current Drawdowns for Amounts in Excess of the Reserve Cap	\$ _____
v.	Catastrophe Reserve Balance at the End of the Year	\$ _____

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