Statutory Issue Paper No. 66

Accounting for Retrospectively Rated Contracts

STATUS
Finalized June 23, 1998

Original SSAP and Current Authoritative Guidance: SSAP No. 66

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. A retrospectively rated contract is one which has final policy premium calculated based on the loss experience of the insured or subscriber during the term of the policy (including developments after the term of the policy) and the stipulated formula set forth in the policy. The periodic adjustment involves either the payment of return premium to the insured or subscriber or payment of an additional premium by the insured or subscriber, or both, depending on experience. Retrospective rating features are common in certain property and casualty contracts, group life, and group accident and health contracts. Contracts with retrospective rating features are referred to as loss sensitive contracts.

2. Current statutory guidance for accounting for retrospectively rated contracts is contained in Chapter 12, Unearned Premiums, of the Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies (P & C Accounting Practices and Procedures Manual) and Chapter 13, Aggregate Reserves for Accident and Health Policies, and Chapter 15, Liabilities Related to Policyholder Dividends, of the Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies (Life/A&H Accounting Practices and Procedures Manual) and the NAIC Annual Statement Instructions (Annual Statement Instructions). This guidance requires the recognition of a liability for return premium due to an insured or subscriber and an asset for additional premium due from an insured or subscriber under a retrospectively rated contract. Retrospective premiums reported as assets are subject to various requirements for asset admissibility.

3. GAAP guidance for accounting for retrospectively rated contracts is contained in FASB Statement No. 60, Accounting and Reporting by Insurance Enterprises (FAS 60), and FASB Emerging Issues Task Force Issue No. 93-14, Accounting for Multiple-Year Retrospectively Rated Insurance Contracts by Insurance Enterprises and Other Enterprises (EITF 93-14). This guidance also requires the recognition of a liability for return premium due to an insured and an asset for additional premium due from an insured under a retrospectively rated insurance contract.

4. The purpose of this issue paper is to establish statutory accounting principles for retrospectively rated contracts that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts). This issue paper applies to property and casualty contracts, life insurance contracts and accident and health contracts. Retrospective reinsurance contracts are not within the scope of this issue paper, they are addressed in Issue Paper No. 75—Property and Casualty Reinsurance.

SUMMARY CONCLUSION

5. Amounts due from insureds and amounts due to insureds under retrospectively rated contracts meet the definition of assets and liabilities as set forth in Issue Paper No. 4—Definition of Assets and Nonadmitted Assets (Issue Paper No. 4) and Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets (Issue Paper No. 5), respectively. Amounts due from insureds
and amounts due to insureds under retrospectively rated contracts are admitted assets to the extent they conform to the requirements of this issue paper.


7. Because policy periods do not always correspond to reporting periods and because an insured’s loss experience may not be known with certainty until some time after the policy period expires, retrospective premium adjustments shall be estimated based on the experience to date using one of the following methods:

   a. Property and Casualty Contracts
      
      i. Use of actuarially accepted methods in accordance with filed and approved retrospective rating plans. This includes but is not limited to the application of historical ratios of retrospective rated developments to earned standard premium to develop a ratio which is then applied to those policies for which no retrospective calculation has been recorded or for which no modification to the recorded calculation is needed. This method results in the calculation of one amount which is either a net asset or a net liability;

      ii. Reviewing each individual retrospectively rated risk, comparing known loss development (including IBNR) with that anticipated in the policy contract to arrive at the best estimate of return or additional premium earned at that point in time. This method results in the calculation of an asset or a liability for each risk. The total of all receivables shall be recorded as an asset and the total of all return premiums shall be recorded as a liability.

   b. Life and Accident & Health Contracts: Reporting entities offering group coverage may have extensive underwriting procedures and complex individually negotiated benefits and contracts. Due to cost and reporting deadlines, these factors make it difficult to establish an exact valuation of retrospective premium. The method used to estimate the liability shall be reasonable based on the reporting entity’s procedures, and consistent among reporting periods. Common methods include a mathematical approach using a complex algorithm of the reporting entity’s underwriting rules and experience rating practices, and an aggregate or group approach.

8. Assumptions used in estimating retrospective premium adjustments shall be consistent with the assumptions made in recording other assets and liabilities necessary to reflect the underwriting results of the reporting entity such as claim and loss reserves (including IBNR) and contingent commissions. Contingent commissions and other related expenses shall be adjusted in the same period the additional or return retrospective premiums are recorded.

9. Retrospective premium adjustments are estimated for the portion of the policy period that has expired and shall be considered an immediate adjustment to premium. Additional retrospective premiums and return retrospective premiums shall be recorded as follows:

   a. Property And Casualty Insurers:
      
      i. Accrued additional retrospective premiums shall be recorded as a receivable with a corresponding entry made either to written premiums or as an adjustment to earned premiums. Premiums not recorded through written premium when accrued shall be recorded through written premium when billed;
ii. Accrued return retrospective premiums shall be recorded as a write-in liability with a corresponding entry made either to written premiums or as an adjustment to earned premiums. Premiums not recorded through written premium when accrued shall be recorded through written premium when billed.

iii. Ceded retrospective premium balances payable shall be recorded as liabilities, consistent with Issue Paper No. 75—Property and Casualty Reinsurance. Ceded retrospective premiums recoverable shall be recorded as an asset. Consistent with Issue Paper No. 76—Offsetting and Netting of Assets and Liabilities (Issue Paper No. 76), ceded retrospective premium balances payable may be deducted from ceded retrospective premiums recoverable when a legal right of setoff exists.

b. Life and Accident & Health Insurers:

i. Accrued additional retrospective and other premiums shall be recorded as a write-in for other-than-invested assets, with a corresponding entry made to premiums;

ii. Accrued return retrospective and other premiums shall be recorded as a liability, Provision for experience rating refunds, with a corresponding entry to premiums.

10. The amount of accrued estimated retrospective premiums to be recorded as a nonadmitted asset for property and casualty insurers shall be determined as follows:

a. 100% of the amount recoverable from any person for whom any agents’ balances or uncollected premiums are classified as nonadmitted, and item (b), plus item (c) or (d) below. Once an insurer has elected either (c) or (d) below, a change from one to the other requires approval from the insurer’s domiciliary state and such change must be disclosed in the financial statements.

b. Retrospective premium adjustments shall be determined and billed or refunded in accordance with the policy provisions or contract provisions. If accrued additional retrospective premiums are not billed in accordance with the policy provisions or contract provisions, the accrual shall be nonadmitted.

c. 10% of any accrued retrospective premiums not offset by retrospective return premiums, other liabilities to the same party (other than loss and loss adjustment expense reserves), or collateral, not otherwise used. Collateral shall be of the same types and quality permitted for use in connection with reinsurance (types of acceptable collateral vary from state to state) or by financial guaranty coverage issued by an insurer having an “A” or better rating from a nationally recognized rating agency. The financial guaranty coverage must allow the insured under the financial guaranty policy the same degree of access to payments under that policy as a beneficiary has under a qualified letter of credit as described in Appendix A-785. Accrued retrospectively rated premiums relating to bulk IBNR must be allocated to individual policyholder accounts prior to applying collateral by account. If the insurer is unable to allocate amounts by account, no credit may be taken for collateral.

d. An amount calculated using the factors below for accrued retrospective premiums not offset by retrospective return premiums, other liabilities to the same party (other than loss and loss expense reserves), or collateral, not otherwise used. Collateral shall be of the same types and quality permitted for use in connection with reinsurance (types of acceptable collateral vary from state to state) or by financial guaranty coverage issued by an insurer having an “A” or better rating from a nationally recognized rating agency. The
financial guaranty coverage must allow the insured under the financial guaranty policy the same degree of access to payments under that policy as a beneficiary has under a qualified letter of credit.

Accrued retrospectively rated premiums relating to bulk IBNR must be allocated to individual policyholder accounts prior to categorizing by Quality Rating.

<table>
<thead>
<tr>
<th>Insured’s Current Quality Rating*</th>
<th>Insured’s Corporate Debit Equivalent to (S&amp;P/Moody’s)**</th>
<th>Percentage of Retro Premium to be Nonadmitted***</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 AAA, AA, A/Aaa, Aa, A</td>
<td>1%</td>
<td></td>
</tr>
<tr>
<td>2 BBB/Baa</td>
<td>2%</td>
<td></td>
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<tr>
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<td>5%</td>
<td></td>
</tr>
<tr>
<td>4 B/B</td>
<td>10%</td>
<td></td>
</tr>
<tr>
<td>5 CCC, CC, C/Caa, Ca</td>
<td>20%</td>
<td></td>
</tr>
<tr>
<td>6 CI, D/C, or insured in default on debt service payments, or insured’s debt service payments are jeopardized upon filing of a bankruptcy petition</td>
<td>100%</td>
<td></td>
</tr>
</tbody>
</table>

* The Percentage of Retro Premium to be Nonadmitted is based upon the Insured’s Current Quality Rating (i.e., if an insured’s quality rating drops, the percentage relating to the lower quality rating is used in calculating the amount to be nonadmitted and vice versa).

** Insureds that do not have a debt rating issued by a publicly recognized rating agency are required to be rated by the NAIC’s Securities Valuation Office (SVO).

*** In the event the insured has no debt rating (either from a publicly recognized rating agency or from the SVO) the insured’s quality rating will be considered category 5 for purposes of this calculation (i.e., a factor of 20% shall be applied), unless the insurer is aware of conditions of the insured that would warrant a category 6 classification (i.e., a factor of 100%).

11. Once accrued retro premiums are billed, the due date is governed by Issue Paper No. 6—Amounts Due From Agents and Brokers (Issue Paper No. 6) (if premium is agency billed), or Issue Paper No. 10—Uncollected Premium Balances (Issue Paper No. 10) (if premium is direct billed). Life and accident & health insurers shall nonadmit any accrued retrospective premium that is more than 90 days due. If a reporting entity has more than one policy with the same insured, retrospective balances shall be netted in accordance with Issue Paper No. 76.

12. If, in accordance with Issue Paper No. 5, it is probable that the additional retrospective and other premium is uncollectible, any uncollectible additional retrospective and other premium shall be written off against operations in the period the determination is made. If it is reasonably possible a portion of the balance in excess of the nonadmitted portion determined in accordance with paragraph 11 of this issue paper is not anticipated to be collected, the disclosure requirements outlined in Issue Paper No. 5 shall be made.
Disclosure

13. The financial statements shall disclose the method used by the reporting entity to estimate retrospective and other premium adjustments. The amount of net premiums written that are subject to retrospective rating features and other adjustments, as well as the corresponding percentage to total net premiums written, shall be disclosed.

14. The financial statements shall disclose the calculation of nonadmitted retrospective premium. If a reporting entity chooses treatment described in paragraph 10.c. or 10.d., the appropriate exhibit must be included in the notes to financial statements in the Annual Statement. Once a reporting entity has elected either 10.c. or 10.d., a change from one to the other requires approval from the reporting entity’s domiciliary state and such change must be disclosed in the financial statements.

DISCUSSION

15. This issue paper addresses premium adjustments for retrospectively rated contracts. Premium adjustments that have been billed are also addressed in Issue Paper No. 6 and Issue Paper No. 10. The statutory principles outlined in the conclusion above are consistent with the current statutory guidance for accounting for retrospectively rated contracts except as follows:

   a. Paragraph 10 requires property and casualty entities to record accrued retrospective premium credits as an aggregate write in for other liabilities whereas current statutory provides for retrospective premium credits to be recorded with unearned premiums.

   b. Paragraph 12 requires that any impairment of recorded additional retrospective premiums be charged against operations in the period in which the impairment is determined.

   c. Paragraph 14 expands the disclosure requirements that are currently in place for property and casualty insurers to life and accident & health entities.

   d. Paragraph 11 expands the requirement for accident and health entities to nonadmit any retrospective premium balances that are more than 90 days past due to life insurers.

These changes were made to be consistent with the approach reflected for earned but unbilled premiums (EBUB) in Issue Paper No. 53 and with the approach reflected in Issue Paper No. 5 which requires the recognition of a loss when an asset has been impaired.

16. The statutory principles outlined in the conclusion above are consistent with the guidance provided for accounting for retrospectively rated insurance contracts in FAS 60 and EITF 93-14 with the exception of the requirement to record certain amounts as nonadmitted. Although FAS 60 is rejected in Issue Paper No. 50—Classifications and Definition of Insurance or Managed Care Contracts In Force and EITF 93-14 is rejected in this issue paper since it applies only to multiple-year retrospectively rated contracts, it is considered appropriate that the accounting for retrospectively rated contracts be consistent with those provisions of both FAS 60 and EITF 93-14 as they are consistent with the Statement of Concepts.

17. The statutory accounting principles outlined in the conclusion above are consistent with the recognition concept in the Statement of Concepts of which a pertinent excerpt follows:

   Recognition

   The ability to meet policyholder obligations is predicated on the existence of readily marketable assets available when both current and future obligations are due. Assets having economic value other than those which can be used to fulfill policyholder obligations, or those assets which may be unavailable due to encumbrances or other third party interests should not be recognized on
the balance sheet but rather should be charged against surplus when acquired or when availability otherwise becomes questionable.

18. Based on the above concept, accrued retrospective premium balances should reflect only amounts that are available to meet both current and future policyholder obligations. Therefore, amounts determined to be impaired should be charged to income in the period such determination is made. In addition, premium taxes and commissions relating to the accrued retrospective premium should be recorded. The adoption of this methodology will more appropriately provide the statutory financial statement reader with an indication of those assets available to meet policyholder obligations.

19. The statutory accounting principles outlined in the conclusion above are consistent with the conservatism concept in the Statement of Concepts of which a pertinent excerpt follows:

**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.

**Drafting Notes/Comments**
- Earned but unbilled premiums are addressed in Issue Paper No. 53—Property Casualty Contracts Premiums.
- Retrospectively rated reinsurance contracts are addressed in Issue Paper No. 75—Property and Casualty Reinsurance.
- The definition of loss sensitive contracts included herein includes all contracts with retrospective rating features. The instructions to Schedule P - Part 7 require reporting for loss sensitive contracts subject to very specific percentage changes in premiums based on loss experience.
- Premium adjustments that have been billed are further discussed in Issue Paper No. 6—Amounts Due from Agents and Brokers and Issue Paper No. 10—Uncollected Premium Balances.

**RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE**

**Statutory Accounting**

20. The P & C Accounting Practices and Procedures Manual, Chapter 7, Agents’ Balances or Uncollected Premiums, provides the following guidance regarding recording accrued retrospective premiums net of ceded reinsurance:

The annual statement blank requires the following separation: (1) premiums and agents' balances in course of collection (i.e., premiums both booked and billed), less ceded reinsurance balances payable; (2) premium, agents' balances and installments booked but deferred and not yet due (e.g., premiums which have been booked but are not yet billed), less ceded reinsurance balances payable; (3) accrued retrospective premiums (i.e., accrued retrospective premiums which have not been booked or billed), less ceded retrospective rated balances payable.

21. The P & C Accounting Practices and Procedures Manual, Chapter 9, Nonadmitted Assets, point 5, lists examples of nonadmitted assets:

Accrued retrospective premiums from whom any agents' balances or uncollected premiums are classified as nonadmitted.

22. The NAIC Annual Statement Instructions for Property and Casualty Insurance Companies, Notes and Miscellaneous, Instructions and Illustrations of How to Report Information in the Notes to Financial Statements, page 101, provide the following instructions:
Instruction:

Describe the basis used to determine the amount of accrued retrospective premiums reported as admitted assets in Line 9.3.

23. The P & C Accounting Practices and Procedures Manual, Chapter 12, Unearned Premiums, states the methodology that shall be used in determining the unearned premium reserve adjustment relating to accrued retrospective contracts following:

Retrospective Rated Policies

Retrospectively rated policies have a final premium calculated on the experience of the insured during the term of the policy (including developments after the term of the policy) and the stipulated formula set forth in the policy. The adjustment involves either the payment of a return premium to the insured or the payment of an additional premium by the insured.

Recognizing the need for reserve provisions to account for these potential additional or return premiums, provision has been made in the Underwriting and Investment Exhibit of the annual statement for the recording of a special unearned premium reserve fund by line of business called "Reserve for Rate Credits and Retrospective Adjustments Based on Experience." Such amounts should be calculated using actuarially acceptable methods in accordance with filed and approved retrospective rating plans. Accrued net additional retrospective premiums are reported as assets and subject to collateralization requirements for asset admissibility.

Two methods are commonly employed by insurance companies in computing this unearned premium reserve. The first method is to build up for each line by policy year, a historical record of the ratio of retrospective rated developments to earned standard premium. The ratio is applied to the earned standard premium of those policies for which no retrospective calculation has yet been recorded, producing the indicated unearned premium. A second method is to review each individual retrospectively-rated risk, comparing known loss developments with those anticipated in the policy contract to arrive at the best estimate of return or additional premium due at that point in time.

24. The NAIC Annual Statement Instructions for Property and Casualty Insurance Companies, Underwriting and Investment Exhibit, Part 2A, Recapitulation of All Premiums, page 59, also sets forth the methodology for calculating and reporting for the reserve for accrued credits and retrospective premium:

The reserve for accrued credits and retrospective return premium adjustments based upon experience, Column 4, may be computed under one of two methods. The first method is to build up for each line by policy year, a historical record of the ratio of retrospective rated developments to earned standard premium. The ratio is then applied to the earned standard premium of those policies for which no retrospective calculation has yet been recorded, producing the indicated unearned premium. The second method is to review each individual retrospectively-rated risk, comparing known loss developments with those anticipated in the policy contract to arrive at the best estimate of return or additional premium due at that point in time. Include, as a negative amount in Column 4, the amount of net accrued retrospective debit adjustments only to the extent they are for incurred (paid and/or unpaid) losses, loss adjustment expenses and, if any, other underwriting expenses also included in the financial statement of the company.

25. The Annual Statement Instructions for Property and Casualty Insurance Companies, Exhibit 1, Analysis of Assets, provides additional guidance regarding admissibility:

Line 9.3 - Accrued Retrospective Premiums on Insurance Contracts

Include: Estimated additional direct premiums and assumed premiums accrued that will become due under prescribed terms from insureds or reinsureds under policies or reinsurance agreements containing retrospective rating formulas based on current or expired policies’
experience, but not to exceed the limitations, if any, contained in such policies or reinsurance agreements. Net of reinsurance; plus reinsurance assumed fund balance minus reinsurance ceded balance

Exclude: Agents' balances or uncollected premium items (Line 9.1 and Line 9.2) and accrued rate credits

The amount reported in Column 1 must be zero and the amount reported in Column 2 must agree with the amount reported on Page 8, Part 2A, Line 33.

Include as non-admitted in Column 3, amounts for accrued retrospective premiums which represent:

a. 100% of the amount recoverable from any person for whom any agents' balances or uncollected premiums (Lines 9.1 or 9.2) are classified as non-admitted (Column 3), and item (b) or (c) below. Once an insurer has elected either (b) or (c) below, a change from one to the other requires approval from the insurer's domiciliary state and such change must be disclosed in Note #1 of Notes to Financial Statements.

b. 10% of any accrued retrospective premiums not offset by retrospective return premiums, other liabilities to the same party (other than loss and loss adjustment expense reserves), or collateral, not otherwise used. Collateral shall be of the same types and quality permitted for use in connection with reinsurance (see notes to Schedule F) or by financial guaranty coverage issued by an insurer having an "A" or better rating from a nationally recognized rating agency. The financial guaranty coverage must allow the insured under the financial guaranty policy the same degree of access to payments under that policy as a beneficiary has under a qualified letter of credit as per Section 11 of the NAIC Credit for Reinsurance Model Regulation. Accrued retrospectively rated premiums relating to bulk IBNR must be allocated to individual policyholder accounts prior to applying collateral by account. If the insurer is unable to allocate amounts by account, no credit may be taken for collateral.

c. An amount calculated using the factors below for accrued retrospective premiums not offset by retrospective return premiums, other liabilities to the same party (other than loss and loss expense reserves), or collateral, not otherwise used. Collateral shall be of the same types and quality permitted for use in connection with reinsurance (see notes to Schedule F) or by financial guaranty coverage issued by an insurer having an "A" or better rating from a nationally recognized rating agency. The financial guaranty coverage must allow the insured under the financial guaranty policy the same degree of access to payments under that policy as a beneficiary has under a qualified letter of credit as per Section 11 of the NAIC Credit for Reinsurance Model Regulation. Accrued retrospectively rated premiums relating to bulk IBNR must be allocated to individual policyholder accounts prior to categorizing by Quality Rating.
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** Insureds that do not have a debt rating issued by a publicly recognized rating agency are required to be rated by the NAIC's Securities Valuation Office SVO.

*** In the event the insured has no debt rating (either from a publicly recognized rating agency or from the SVO), the insured's quality rating will be considered category 5 for purposes of this calculation (i.e., a factor of 20% shall be applied), unless the insurer is aware of conditions of the insured that would warrant a category 6 classification (i.e., a factor of 100%).

If an insurer chooses item (b) or (c) above, the appropriate exhibit must be included in Note #18 of the Notes to Financial Statements of the annual statement to summarize the calculation of nonadmitted retrospective premium (see instructions to Notes to Financial Statements).

Include as nonadmitted in Column 3, amounts for accrued retrospective premiums on assumed business which represents 100% of the amount accrued (gross of ceded reinsurance) for any reinsured for which any agents' balances or uncollected premiums (Lines 9.1 or 9.2) are classified as nonadmitted (Column 3).

26. The NAIC Annual Statement Instructions for Property and Casualty Insurance Companies, Schedule P Part 7, Supplement for Loss Sensitive Contracts, page 221 requires the following disclosure:

**General**

1. Only the experience on contracts that meet the following definition should be included in Schedule P, Part 7. The experience on all other contracts should not be included.

   Loss sensitive contracts shall meet the following criteria:

   Contracts where an increase in losses on a policy can cause an increase in net payment (by the insured) for that policy.

   The amount of additional payment (by the insured) must be at least 75% (50% for reinsurance contracts) of the additional losses, before application of aggregate and per accident/claimant limits or caps.

   The net amount paid (by the insured) must also be able to differ by at least 20% (10% for reinsurance contracts), from highest to lowest possible charge in reaction to the loss experience.
The maximum possible payment by the insured should also be at least 15% (7.5% for reinsurance contracts) above what the insured would pay based on expected loss experience. In other words, the maximum charge should not approximate the expected charge.

The additional payment shall be in the form of additional premiums or additional commissions.

The additional losses and corresponding payments must flow through the income and balance sheets and cannot be "off-balance sheet." For example, a deductible feature does not make a contract "loss sensitive" under this definition, as neither the losses under the deductible nor the reimbursements for these losses flow through the income statement.

2. In all development exhibits, only reported data as of year end 1993 and subsequent is required. Data for prior year ends is encouraged, but not required. For each year end, data for all issue years is required.

3. Schedule P, Part 7 is only required of insurers who claim a reduction in their Risk-Based Capital for Loss Sensitive Contracts. Such insurers must complete the entire schedule in each year that they claim such credit.

4. Schedule P, Part 7A provides experience on primary contracts. Schedule P, Part 7B provides experience on reinsurance contracts. The segregation should be consistent with the Risk-Based Capital formula.

Current Year Loss and LAE Reserves and Net Written Premium

5. Column (2) of Parts 7A and 7B of Schedule P, when combined, should agree with the net loss and loss expense reserves (undiscounted) reported in the corresponding Part I of Schedule P. Column (3) should reflect the reserve for Loss Sensitive Contracts only.

6. Column (5) of Parts 7A and 7B of Schedule P, when combined, should agree with the net written premiums reported in the Underwriting and Investment Exhibit. Column (6) should reflect the corresponding premium for Loss Sensitive Contracts only.

7. Columns (4) and (7) are ratios of (3) to (2) and (6) to (5), respectively. Express as percentages showing one decimal place (e.g., 24.2%).

27. Chapter 13, Aggregate Reserves For Accident And Health Policies, of the Life/A&H Accounting Practices and Procedures Manual provides the following guidance on individual and group accident and health reserves:

Reserve For Experience-Rating Refunds Or The Dividend Liability In Group Insurance Policies

Some group insurance policyholders may receive partial or full retrospective premium credit for their policy-year experience. On the statutory financial statement date, a provision for the experience rated refund is established based on the experience of the policy year up to the statement date. This liability may include certain funds contributed by the policyholder as a premium stabilization fund. Since many policy years do not end at the statutory financial statement date, subsequent experience may cause the rate credit actually to be greater or less than the liability established on the statement date. For this reason, the rate credit liability becomes a very difficult liability to establish and an equally difficult liability to reconcile. Only for the very smallest of group insurance carriers is it possible to do an exact valuation of this liability based on the company underwriting rules and practices. Larger group insurers have massive texts of underwriting procedures, along with complex individually negotiated benefits and contracts. For reasons of economy and reporting deadlines, few companies can establish an “exact” valuation of this liability. Some companies use a certain approach, using a complex
algorithm of the company’s underwriting rules and experience rating practices. Other companies use aggregate or grouping approaches. Regardless of the approach used, the liability must stand the test of reasonableness and consistency. No company should pay experience refunds unless its contracts provide for such payment.

The experience rating refund may be reported as a separate liability item or may be included as an active life reserve.

28. The Life/A&H Accounting Practices and Procedures Manual, Chapter 15, Liabilities Related to Policyholder Dividends, provides the following guidance with respect to experience rated contracts:

**Experience Rating Refunds (Retrospective Rate Credits)**

Nonparticipating group insurance and pension contracts may be subject to experience rating. Experience credits for a given group are usually developed by determining the excess, if any, of the premium and investment income earned with respect to the group over the corresponding benefits and expenses incurred with respect to the group and applying an appropriate credibility adjustment to that excess.

At specified dates, such as the contract anniversary or the end of the calendar year, the experience of the contract is calculated and the refund, if any, is paid. If the balance sheet date falls between the dates on which the refund is paid, the experience up to the balance sheet date is calculated and the appropriate liability is established.

**Generally Accepted Accounting Principles**

29. FAS 60, paragraph 14, states the following:

If premiums are subject to adjustment (for example, retrospectively rated or other experience rated insurance contracts for which the premium is determined after the period of the contract based on claim experience or reporting-form contracts for which the premium is adjusted after the period of the contract based on the value of insured property), premium revenue shall be recognized as follows:

a. If, as is usually the case, the ultimate premium is reasonably estimable, the estimated ultimate premium shall be recognized as revenue over the period of the contract. The estimated ultimate premium shall be revised to reflect current experience.

b. If the ultimate premium cannot be reasonably estimated, the cost of recovery method or the deposit method may be used until the ultimate premium becomes reasonably estimable.

30. FAS 60, paragraph 44, states the following:

**Retrospective and Contingent Commission Arrangements**

If retrospective commission or experience refund arrangements exist under experience-rated insurance contracts, a separate liability shall be accrued for those amounts, based on experience and the provisions of the contract. Income in any period shall not include any amounts that are expected to be paid to agents or others in the form of experience refunds or additional commissions. Contingent commissions receivable or payable shall be accrued over the period in which related income is recognized.

31. EITF 93-14, includes the following:

**ISSUE**

An enterprise (for example, a manufacturing concern, a retailer, a service entity, or a financial institution) enters into a multiple-year retrospectively rated contract with an insurance company.
That contract is similar to the type of contract discussed in Issue No. 93-6, "Accounting for Multiple-Year Retrospectively Rated Contracts by Ceding and Assuming Enterprises," and may cover various types of exposures such as product and environmental liability risks.

Those contracts include a "retrospective rating" provision that provides for at least one of the following based on contract experience: (1) changes in the amount or timing of future contractual cash flows, including premium adjustments, settlement adjustments, or refunds to the noninsurance enterprise, or (2) changes in the contract's future coverage. A critical feature of those contracts is that part or all of the retrospective rating provision is obligatory such that the retrospective rating provision creates for each party to the contract future rights and obligations as a result of past events. A retrospectively rated insurance contract that is not a multiple-year contract or that could be canceled by either party without further obligation is not covered by this Issue. Contracts used by enterprises in certain industries where risks are "pooled," like those discussed in paragraph 45 of Statement 5 and a reinsurance contract entered into by a captive insurer, are addressed by this Issue.

The issue is how a multiple-year retrospectively rated contract arising from an insurance transaction that is not a reinsurance contract should be accounted for.

EITF DISCUSSION

The Task Force reached a consensus that in order to be accounted for as insurance, an insurance contract must indemnify the insured as required by paragraph 44 of Statement 5. For those contracts that do not provide indemnification, the premium paid, less the amount of the premium to be retained by the insurer, should be accounted for as a deposit by the insured.

For a multiple-year retrospectively rated insurance contract accounted for as insurance, the Task Force reached a consensus that the insured should recognize a liability and the insurer should recognize an asset to the extent that the insured has an obligation to pay cash (or other consideration) to the insurer that would not have been required absent experience under the contract. The amount recognized in the current period should be computed, using a with-and-without method, as the difference between the insured's total contract costs before and after the experience under the contract as of the reporting date, including costs such as premium adjustments, settlement adjustments, and impairments of coverage. The amount of premium expense related to impairments of coverage should be measured in relation to the original contract terms. Future experience under the contract (that is, future losses and future premiums that would be paid regardless of past experience) should not be considered in measuring the amount to be recognized.

If the insured could terminate the contract prior to the end of its term and if termination would change the amounts paid (for example, if terminating the contract would cost less than continuing the contract in force), the liability resulting from the contract should be measured as follows:

1. If a decision to terminate has been made, the measurement should be based on an assumption of termination and on experience to date.
   
2. Otherwise, the measurement should be based on the lesser of the following:
   a. The total incremental amount that would be paid based on the with-and-without calculation assuming experience to date and assuming termination (that is, excluding the effects of future losses and future premiums that would have been paid regardless of experience to date).
   b. The total incremental amount that would be paid based on the with-and-without calculation assuming experience to date and assuming no termination (that is, excluding the effects of future losses and future premiums that would have been paid regardless of experience to date).
The insured should recognize an asset and the insurer should recognize a liability to the extent that any cash (or other consideration) would be payable by the insurer to the insured based on experience to date under the contract.

The insured and the insurer should account for changes in coverage in the same manner as changes in other contract costs. For example, the effects of decreases in coverage without a commensurate reduction in premium should be recognized as a loss by the insured and as a gain by the insurer when the event causing the decrease in coverage takes place.

The Task Force noted that deposit accounting cannot be used to avoid loss recognition that would otherwise be required (for example, if the insured has no future coverage relating to the deposit with the insurer and, therefore, the deposit is not recoverable).

The provisions of this consensus are effective as of November 18, 1993 and should be initially applied no later than the fourth quarter of 1993 for calendar-year enterprises in one of two ways:

1. By recognition of the net effect of applying the provisions at the beginning of an enterprise’s current fiscal year as a cumulative effect of a change in accounting principle in accordance with paragraph 20 of Opinion 20. Under this approach, the disclosures required by paragraph 21 of Opinion 20 would be required as long as the income statement for the current fiscal year is presented. The provisions of Statement 3 apply to all interim periods presented.

2. By restatement of financial statements for all periods presented. The Task Force noted that the FASB Staff Views on Issue 93-6 that appear as Topic No. D-35 in Appendix D are useful guidance for applying this consensus.

STATUS

No further EITF discussion is planned.

RELEVANT LITERATURE

Statutory Accounting
- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, Chapters 7, 9 and 12
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies - Chapters 13 and 15
- NAIC Annual Statement Instructions
- Issue Paper No. 4—Definition of Assets and Nonadmitted Assets
- Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets
- Issue Paper No. 6—Amounts Due From Agents and Brokers
- Issue Paper No. 10—Uncollected Premium Balances
- Issue Paper No. 53—Property Casualty Contracts - Premiums
- Issue Paper No. 75—Property and Casualty Reinsurance
- Issue Paper No. 76—Offsetting and Netting of Assets and Liabilities

Generally Accepted Accounting Principles
- FASB Statement 60, Accounting and Reporting by Insurance Companies
- FASB Emerging Issues Task Force No. 93-14, Accounting for Multiple-Year Retrospectively Rated Insurance Contracts

State Regulations
- No additional guidance from state statutes or regulations.
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