Statement of Statutory Accounting Principles No. 75

Reinsurance Deposit Accounting—An Amendment to SSAP No. 62R—Property and Casualty Reinsurance

STATUS

Type of Issue: Property and Casualty

Issued: Finalized December 4, 2000

Effective Date: January 1, 2001

Affects: Supersedes paragraph 35 of SSAP No. 62R

Affected by: Superseded with guidance included in SSAP No. 62R

Interpreted by: No other pronouncements
This page intentionally left blank
Reinsurance Deposit Accounting—An Amendment to SSAP No. 62R, Property and Casualty Reinsurance

SCOPE OF STATEMENT

1. This statement provides statutory accounting principles for reinsurance contracts that do not transfer both components of insurance risk (underwriting risk and timing risk).

SUMMARY CONCLUSION

2. This statement supersedes paragraph 35 of SSAP No. 62R—Property and Casualty Reinsurance (SSAP No. 62R). The following guidance shall be followed when reinsurance contracts do not transfer both components of insurance risk.

3. To the extent that a reinsurance agreement does not, despite its form, transfer both components of insurance risk, all or part of the agreement shall be accounted for and reported as deposits in the following manner:

   a. At the outset of the reinsurance agreement, the net consideration paid by the ceding entity (premiums less commissions or other allowances) shall be recorded as a deposit by the ceding company and as a liability by the assuming entity. The deposit shall be reported as an admitted asset by the ceding company if (i) the assuming company is licensed, accredited or otherwise qualified in the ceding company’s state of domicile as described in Appendix A-785 or (ii) there are funds held by or on behalf of the ceding company which meet the requirements of paragraph 16 of Appendix A-785;

   b. At subsequent reporting dates, the amount of the deposit/liability shall be adjusted by calculating the effective yield on the deposit agreement to reflect actual payments to date (receipts and disbursements shall be recorded through the deposit/liability accounts) and expected future payments (as discussed below), with a corresponding credit or charge to interest income or interest expense;

   c. The calculation of the effective yield shall use the estimated amount and timing of cash flows. If a change in the actual or estimated timing or amount of cash flows occurs, the effective yield shall be recalculated to reflect the revised actual or estimated cash flows. The deposit shall be adjusted to the amount that would have existed at the reporting date had the new effective yield been applied since the inception of the reinsurance agreement. Changes in the carrying amount of the deposit asset/liability resulting from changes in the effective yield shall be recorded as interest income or interest expense;

   d. It shall be assumed that any cash transactions for the settlement of losses will reduce the asset/liability accounts by the amount of the cash transferred. When the remaining losses are revalued upward, an increase in the deposit liability shall be recorded as interest expense – by the assuming company. Conversely, the ceding company shall increase its deposit (asset) with an offsetting credit to interest income; and increase its outstanding loss liability with an offsetting charge to incurred losses;

   e. No deduction shall be made from the loss and loss adjustment expense reserves on the ceding company’s Statement of Financial Position, schedules, and exhibits;

   f. The assuming company shall record net consideration to be returned to the ceding company as a liability.
Disclosures

4. The financial statements shall disclose the following with respect to reinsurance agreements that have been accounted for as deposits:

   a. A description of the reinsurance agreements.

   b. Any adjustment of the amounts initially recognized for expected recoveries. The individual components of the adjustment (e.g., interest accrual, change due to a change in estimated or actual cash flow) shall be disclosed separately.

5. Refer to the preamble for further discussion regarding disclosure requirements.

Relevant Literature

6. This statement adopts American Institute of Certified Public Accountants (AICPA) Statement of Position 98-7, Deposit Accounting: Accounting for Insurance and Reinsurance Contracts That Do Not Transfer Insurance Risk (SOP 98-7) paragraphs 10-12 and 19 (subsection b. only). This statement rejects AICPA SOP 98-7 paragraphs 13-17 and 19 (subsections a. and c.).

Effective Date and Transition

7. This statement is effective for years beginning January 1, 2001. Changes 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

Generally Accepted Accounting Principles

- AICPA Statement of Position 98-7, Deposit Accounting: Accounting for Insurance and Reinsurance Contracts That Do Not Transfer Insurance Risk

RELEVANT ISSUE PAPER

- Issue Paper No. 104—Reinsurance Deposit Accounting – An Amendment to SSAP No. 62—Property and Casualty Reinsurance
SSAP NO. 75 – EXHIBIT A

Illustration of a Reinsurance Contract That Is Accounted for as a Deposit using the Interest Method

Assumptions:

- **Premium = $1,000** (assumes no commissions or allowances)
- **Coverage Period = 1 year**
- **Initial expected recoveries = $225 per year (at end of year) for five years**
- **Initial Implicit rate = 4 percent**

*present value of $225 per year for five years at 4 percent = $1,000

At the end of Year 2, the timing of anticipated recoveries under the reinsurance contract changes. A reevaluation of the implicit interest rate produces a rate of 3.63 percent and an asset of $640 at the end of the year.

<table>
<thead>
<tr>
<th>Description</th>
<th>Interest Income</th>
<th>Cash Recoveries</th>
<th>Deposit Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Initial payment</td>
<td></td>
<td></td>
<td>$1,000</td>
</tr>
<tr>
<td>Year 1 (4%)</td>
<td>$ 40</td>
<td>$ (225)</td>
<td>$1,040</td>
</tr>
<tr>
<td>End of Year 1</td>
<td></td>
<td></td>
<td>$ 815</td>
</tr>
<tr>
<td>Year 2 (4 %)</td>
<td>$ 33</td>
<td>$ (200)</td>
<td>$ 848</td>
</tr>
<tr>
<td>End of Year 2</td>
<td></td>
<td></td>
<td>$ 648</td>
</tr>
<tr>
<td>Yield adjustment</td>
<td>$ (8)</td>
<td></td>
<td>$ 640</td>
</tr>
<tr>
<td>Year 3 (3.63 %)</td>
<td>$ 23</td>
<td>$ (175)</td>
<td>$ 663</td>
</tr>
<tr>
<td>End of Year 3</td>
<td></td>
<td></td>
<td>$ 488</td>
</tr>
<tr>
<td>Year 4 (3.63 %)</td>
<td>$ 18</td>
<td></td>
<td>$ 506</td>
</tr>
<tr>
<td>End of Year 4</td>
<td></td>
<td>$ (175)</td>
<td>$ 331</td>
</tr>
<tr>
<td>Year 5 (3.63 %)</td>
<td>$ 12</td>
<td>$ (175)</td>
<td>$ 343</td>
</tr>
<tr>
<td>End of Year 5</td>
<td></td>
<td></td>
<td>$ 168</td>
</tr>
<tr>
<td>Year 6 (3.63 %)</td>
<td>$ 7</td>
<td></td>
<td>$ 175</td>
</tr>
<tr>
<td>End of Year 6</td>
<td></td>
<td>$ (175)</td>
<td>$ 0</td>
</tr>
</tbody>
</table>

At the inception of the contract, the ceding insurer records a deposit asset of $ 1,000 and the assuming company, a $1,000 deposit liability. The asset is admitted providing the conditions for credit for reinsurance are met.

At subsequent reporting dates, the deposit asset is adjusted by calculating the effective yield on the reinsurance agreement to reflect actual payments to date and expected future payments with a corresponding credit to interest income by the ceding company and interest expense by the assuming company.

At the end of year two, it is determined that the expected cash flows will differ from previous estimates, resulting in a lower effective yield on the deposit asset. The deposit asset is adjusted to the amount that would have existed at the reporting date had the new effective yield been applied from the inception of the reinsurance agreement. The adjustment is charged to interest income, i.e., as a reduction of interest income. Interest income during the remaining term of the agreement is reduced accordingly (i.e., the yield is reduced from 4.0% to 3.63%).
This page intentionally left blank.