Client Alert

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UPDATE: Caveat Emptor-Caveat Seller – Current Developments Concerning Finite Insurance/Reinsurance

Contributing Authors

Norris W.. Clark
nclark@lordbissell.com
213.687.6771

Timothy S. Farber
tfarber@lordbissell.com
312.443.0532

John C. Gurley
jgurley@lordbissell.com
312.443.0318

William J. Kelty
wkelty@lordbissell.com
312.443.0464

In our Client Alert issued in November 2004 entitled *Caveat Emptor-Caveat Seller* (available at http://www.lordbissell.com) we discussed the renewed scrutiny of financial or finite arrangements (referred to as "non-traditional" insurance or reinsurance agreements) resulting from the investigation launched by New York Attorney General Elliott Spitzer and related probes by the Securities and Exchange Commission ("SEC") and Department of Justice ("DOJ").

We predicted that scrutiny by regulators, investors and other vested constituencies of non-traditional reinsurance and insurance arrangements would intensify in the coming months. This proved to be an accurate assessment, as additional investigations have been launched and numerous interested parties are currently focusing on the topic in an attempt to bring clarity to the subject and develop new or additional guidelines as to what qualifies as adequate risk transfer in order to qualify for insurance/reinsurance accounting treatment. We highlight below the flurry of activity.

> "...{FASB} Board indicated it would explore rules for bifurcating contracts into their insurance and financing counterparts for accounting purposes.

National Association of Insurance Commissioners ("NAIC")

The NAIC Property and Casualty Reinsurance Study Group ("Reinsurance Study Group") is currently in the process of proposing changes to clarify the boundary between insurance and deposit or financing transactions. The initiatives being considered include: (i) additional disclosure obligations, (ii) sworn certifications from senior corporate officers affirming no side agreements accompany the transactions, (iii) bifurcating the transactions into their reinsurance and financing components, (iv) new risk transfer thresholds in the statutory accounting guidance, and (v) making underwriting files available at all times.

The discussion concerning the threshold used to determine if an agreement meets the requirements for reinsurance accounting focuses on Statutory Accounting Principle No. 62 ("SSAP 62"). SSAP 62 is the statutory counterpart to the Financial Accounting Standard Board's ("FASB") Statement of Financial Accounting Standard No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts*. SSAP 62 provides guidance for accounting and reporting for reinsurance by cedants and reinsurers and establishes conditions for determining whether significant risk is transferred by an insurer to a reinsurer in a reinsurance contract. SSAP 62 requires: (i) the reinsurer to assume significant insurance risk under the reinsured portions of the underlying insurance contracts, and (ii) there be a reasonable possibility that the reinsurer may realize significant loss from the transaction. Uncertainty arose under SSAP 62 as to exactly how much risk must be transferred to qualify as significant insurance risk and what constitutes a reasonable possibility of a significant loss. In the absence of a clear definition, it became accepted by many auditors and others in the industry to use a seemingly bright line 10/10 rule. This informal rule of thumb requires a 10 percent probability of a 10 percent loss of premium by the reinsurer on a reinsurance contract in order for a contract to satisfy the SSAP 62 risk transfer test.

The Reinsurance Study Group has asked for assistance from the NAIC Casualty and Actuarial Task Force which has turned to the American Academy of Actuaries for assistance. The American Academy of Actuaries Property and Liability Financial Reporting Risk Transfer subgroup has taken up the risk transfer project and is prepared to provide independent, objective ideas and information. The risk transfer subgroup will examine four areas of current accounting practice and ultimately assess the viability of alternative

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approaches. The focus will be primarily on the threshold being used to determine whether or not an agreement meets the requirements for reinsurance accounting.

Fast Track to Implementation: Heightened Disclosure The Reinsurance Study Group discussed at its May 10, 2005 meeting changes to the disclosure required by the interrogatories included in property and casualty companies' annual statements. Two of the more significant suggested changes to the interrogatories are as follows:

> Has the reporting entity ceded any risk under any reinsurance contract (or under multiple contracts with the same reinsurer or its affiliates) for which it recorded a positive or negative underwriting result greater than 3 percent of surplus as regards policyholders, or for which the premium or losses are greater than 3 percent of surplus as regards policyholders, and accounted for that contract as reinsurance and not as a deposit on either the Statutory or GAAP financial statements, that contain one or more specified features?

> Has the reporting entity ceded any risk under any reinsurance contract where:
>
> - The business or risk originated by the reporting entity or its affiliates represents greater than 50 percent of the entire amount of business underwritten by the assuming reinsurer; or
> - 25 percent or more of the risks ceded in the contract have been retroceded back to the ceding reporting entity or its affiliates. This provision excludes approved pooling arrangements.
> - Contracts are accounted for differently between generally accepted accounting principles (GAAP) and statutory accounting principles (SAP)?

"(NAIC Industry Interested Parties) believe...the threshold requirement that an insurer report any agreement that has the effect of altering policyholders' surplus by more than 3 percent...is too low and should be raised.

If the reporting entity answers either of these interrogatories in the affirmative, detailed supplemental information regarding the transaction would have to be disclosed, including: (i) a brief discussion of management's principal objectives in entering into the reinsurance contract, including the economic purpose to be achieved, and (ii) the impact on the balance sheet and income statement gross of all such reinsurance contracts in the aggregate.

The proposals are currently being exposed for a 30-day comment period. The Reinsurance Study Group hopes to expeditiously move the proposals forward with a goal of adopting the changes during the Boston meeting on June 11-14. This would mean the proposals will be effective for the 2005 annual statements that would be filed on or before March 1, 2006.

Fast Track to Implementation: Addition of Annual Statement Instruction Requiring Attestation by CEO and CFO regarding Reinsurance Agreements The Reinsurance Study Group discussed at its May 10 meeting annual statement attestation requirements that would require the Chief Executive Officer and Chief Financial Officer to attest, under penalty of perjury, that:

- there are no separate agreements between the insurer and the reinsurer that could serve to modify the actual or potential losses under the contract,
- the reporting entity has an underwriting file documenting the economic intent of the transaction and the risk transfer analysis evidencing the proper accounting treatment,
- the insurer complies with all requirements of SSAP 62, and
- the entity has proper controls in place to monitor such compliance.

The attestation proposals are subject to a 30-day comment period, with a goal of being adopted at the Boston meeting on June 11 to 14. As noted below, several states are considering or have already adopted attestation requirements, and the NAIC proposal may be seen as a way to bring uniformity in the area of CEO and CFO attestation regarding finite insurance transactions.

Bifurcation Proposal On May 5, 2005, the NY Insurance Department proposed significant revisions to SSAP 62, which include a new Bifurcation of Reinsurance Agreements section. The SSAP 62 revisions were formally presented and further explained at the May 10 meeting. The amendments would require bifurcating certain agreements into their insurance and financing counterparts for accounting purposes. The amendments include guidance on how to account for bifurcation of reinsurance agreements in that "Losses incurred and any accompanying entries shall be reported under deposit accounting guidance until the estimated layer of coverage for which there is a greater than ninety percent (>90 percent) probability that the ceding insurer will be indemnified for those losses under the reinsurance agreement has been exhausted." The amendments also make changes to eliminate current treatment for retroactive agreements, requiring all retroactive insurance agreements to be bifurcated. The portion that transfers insurance risk would be reported under reinsurance guidance, while the portion that finances losses would be reported under deposit accounting guidance.

The Reinsurance Study Group exposed the proposal for a 45-day comment period beginning on May 10, 2005 and will continue its consideration of the proposal over the summer. A report by the NAIC Casualty and Actuarial Task Force is expected in

August regarding standards of risk transfer. After this report is received and evaluated, a final accounting proposal should be placed on the Reinsurance Study Group's agenda in the Fall. Thereafter, the proposal would move to the Statutory Accounting Principles Working Group where it would be considered under the Working Group's procedures for approximately six to nine months.

Interested Party Response-Reinsurance Association of America ("RAA") A group of interested parties in the insurance industry, led by the RAA, developed a rough draft response being considered by the Reinsurance Study Group. The rough draft focuses on additional disclosures but does not recommend changes to SSAP 62. The proposals were presented to the Reinsurance Study Group during its March 2005 meeting. The rough draft contained suggested changes to the property and casualty interrogatories. The interested parties said that the recommended interrogatories are intended to improve the transparency of reinsurance contracts that may warrant closer review and to provide information regarding the principal objectives of reinsurance contracts containing certain kinds of provisions.

Many of the interrogatories suggested by the interested parties were the bases for the interrogatories proposed by the Reinsurance Study Group at its May 10 meeting. The interested parties are expected to provide comments to the NAIC's proposed interrogatories during the 30-day comment period. But they indicated at the May 10 meeting that they believe the threshold requirement that an insurer report any agreement that has the effect of altering policyholders' surplus by more than 3 percent, or representing more than 3 percent of premium or losses is too low and should to be raised.

The interested parties are also expected to issue comments regarding the CEO/CFO attestations, although at the May 10 meeting they seemed open to some attestation requirement by the NAIC that could better bring uniformity rather than attestation requirements that differed state to state. The industry interested parties remain firm that current accounting guidance is adequate when followed and that the regulatory response at this time should be limited to increased disclosure, not amendments to the accounting guidance, which may ultimately be out of sync with FASB guidance.

FASB

On April 6, 2005, the FASB voted unanimously to pursue an insurance and reinsurance risk transfer project designed to clarify when contracts structured as insurance and reinsurance contracts qualify for insurance or reinsurance accounting. The Board concluded the project should initially focus on existing guidance from various U.S. GAAP sources.

Existing GAAP guidance is found in several sources, most notably in FAS Nos. 5, 60 & 113. FAS No. 5-*Accounting for Contingencies*-defines certain specified criteria for accruing loss contingencies and sets forth thresholds for loss estimation as either probable, reasonably possible or remote. This statement also addresses conditions upon which a (re)insurance company should accrue losses on assumed (re)insurance. FAS No. 60-*Accounting and Reporting by Insurance Enterprises*-requires, among other items, insurance contracts to be classified as either short-duration or long-duration contracts, with different accounting rules provided for each. FAS No.113-*Accounting and Reporting for Reinsurance of Short-Duration and Long Duration Contracts*-provides detailed guidance for accounting and reporting for reinsurance by cedants and reinsurers and establishes conditions for determining whether significant risk is transferred by an insurer to a reinsurer in a reinsurance contract. Generally, the indemnification of the ceding enterprise against loss or liability relating to insurance risk in reinsurance of short-duration contracts requires: (i) the reinsurer to assume significant insurance risk under the reinsured portions of the underlying insurance contracts, and (ii) a reasonable possibility that the reinsurer may realize significant loss from the transaction.

The current accounting guidance, however, includes no definition of the terms insurance contract or insurance risk. Instead, the accounting standards rely solely on illustrative language. The Board indicated, however, that it does not intend to establish bright line rules for the level of required risk transfer, such as the 10/10 rule of thumb (10 percent probability of a 10 percent loss by the reinsurer on a reinsurance contract).

After developing a definition of insurance contract and insurance risk, and possibly amending current FASB rules if needed, the Board indicated it would explore rules for bifurcating contracts into their insurance and financing counterparts for accounting purposes. The Board also noted that disclosure in this area was clearly inadequate but was uncertain as to whether it should get involved in establishing disclosure requirements or whether it should leave this to some other authority, such as the SEC.

> **"(FASB)….indicated…that it does not intend to establish bright line rules for the level of required risk transfer.**

NY Insurance Department

Concern over the improper use of finite reinsurance to manipulate reporting results has led the New York State Insurance Superintendent to issue a circular letter that requires CEOs to attest to the complete nature of each insurance contract. The circular letter mandates that chief executive officers attest under oath with respect to cessions under any reinsurance contract that:

- There are no separate written or oral agreements that would under any circumstances reduce, limit, mitigate or otherwise affect any actual or potential loss to the parties under the reinsurance contract; and
- The reporting entity has available for

inspection an underwriting file that documents the economic intent of the transaction and the risk transfer analysis evidencing the proper accounting treatment.

In addition to the attestation described above, the Department is also requiring increased disclosure of finite risk transactions in the companies' annual statements.

Florida, Massachusetts Delaware, Georgia & Rhode Island

In **Florida**, a proposed rule by the Florida Office of Insurance Regulations would require CEOs to certify there are no side agreements and that there is an underwriting file with an appropriate summary of the contract terms, objectives and risk transfer analysis. In addition, companies would have to identify certain specified contracts within the last twelve months that meet certain red flags for finite insurance. For each contract identified, a file must contain certain required financial information. If the ceding company fails to comply, the ceding company would lose credit for reinsurance. In addition, Florida House Bill 591 has been proposed that would make it an unfair trade practice to represent that "a contract is an insurance or reinsurance contract and transfers risk when the primary purpose and effect of the contract is other than the transfer of risk."

In **Massachusetts**, the Massachusetts Insurance Commissioner has stated that Massachusetts will require the chair of an insurer's audit committee to sign off on any finite reinsurance contracts, including certifying that there are no informal side agreements that might affect such reinsurance.

In **Delaware**, we understand a draft regulation by the Delaware Insurance Department regarding finite reinsurance has been distributed to interested parties.

In **Georgia**, the Georgia Insurance Department has issued orders to preserve documents and has issued subpoenas to a number of insurance companies asking for information on transactions of a finite nature. If an insurer does not cooperate with the investigation or is found to be participating in wrongful conduct, the insurer would not be allowed to take credit for any of its reinsurance business in Georgia. The Georgia Insurance Department is setting up a command post for staff members who have been assigned to the finite insurance investigations and is also considering implementing such items as chief executive officer attestations certifying to the nature of finite insurance arrangements.

In **Rhode Island**, the Rhode Island Insurance Department has sent out inquiries to insurers regarding contracts of a finite nature. The Rhode Island Insurance Department is asking for summaries of such contracts, management's objectives, whether there are any side agreements and the contents of any underwriting files regarding the finite transactions.

Standard & Poor's ("S&P")

Ratings agencies, such as Standard & Poor's ("S&P"), have developed criteria to detect finite reinsurance in financial statements of insurance companies and, if necessary, make appropriate adjustments to insurance company earnings. A report entitled "Property and Casualty Insurance Criteria: Adjusting For Finite Reinsurance," explains a two-step process whereby S&P requests certain reinsurance contracts and related documents from interactively rated insurance and reinsurance companies and compares the economic impact of each contract with the reported accounting treatment. If the economic impact of the contract differs with the accounting treatment, earnings may be adjusted to reflect the economic reality of the transaction. S&P will also require enhanced disclosure of certain reinsurance contracts that contain attributes that are commonly viewed as problematic, such as side agreements that alter the risk and loss to the parties.

International Accounting Standards Board ("IASB")

The IASB is currently undertaking a comprehensive insurance contracts project. Phase I of the Project went into effect January 1, 2005 and may focus greater scrutiny on finite insurance and reinsurance arrangements. The new rules are known as International Financial Reporting Standards 4 ("IFRS 4") and define an insurance contract as a "contract under which one party accepts *significant insurance risk* from another party…" Contracts that do not transfer significant insurance risk, including certain financial or finite arrangements will generally be classified as financial instruments and be accounted for as such under International Accounting Standard ("IAS") 39-Financial Instruments: Recognition and Measurement. However, the lack of clear guidelines as to what exactly qualifies as significant insurance risk presents similar types of problems and confusion that United States regulatory authorities are dealing with today.

The IASB continues to debate the scope and content of Phase II of its insurance contracts project and is taking a fresh look at financial reporting by insurers. While the scope and content of the project is still being defined, the IASB is analyzing fair value accounting concepts and whether these are suitable for the industry. No implementation date for any new standards has been set, but the IASB has indicated that a discussion paper cannot be expected before the end of 2005, and quite possibly later. An exposure draft would follow at least 18 months after the IASB publishes the discussion paper and any final standards would take at least another 12 months.

Financial Services Authority ("FSA")

In March of 2005 the FSA sent letters to UK insurance senior executives asking them to provide details on their use of finite

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risk contracts. The FSA intends to take action in cases where there is no actual risk transfer involved. The letters ask the executives to: (i) provide information regarding the extent to which their company engages in transactions where the economic value of the transaction "differs materially from the value placed on the transaction," (ii) state what systems and controls are in place to subject such transactions to adequate scrutiny, (iii) confirm that the company does not engage in financial engineering transactions or side agreements that might obscure the firm's financial position, and (iv) confirm that the company's individual capital assessment explains the extent to which financial engineering has been used, for what purposes and the impact on assets and liabilities.

The FSA stated in April 2005 that it is currently in the process of determining the extent to which insurers engage in financial engineering through the use of finite insurance and is also considering enhanced disclosure requirements. It is likely that the FSA will continue to review finite (re)insurance arrangements and focus not only on risk transfer and disclosure issues, but also on the systems for monitoring, managing and controlling these types of risks.

Federal U.S. Agencies: Federal Bureau of Investigations ("FBI"), Securities and Exchange Commission ("SEC") & Department of Justice ("DOJ")

The SEC and DOJ have instituted investigations, filed complaints and reached settlements with a number of companies related to finite insurance arrangements. Recently, the FBI has launched a probe into accounting transactions related to finite insurance arrangements as well as other areas of the insurance industry.

Conclusion

Lord, Bissell & Brook LLP will continue to closely follow and track all developments in this fast moving area.

ABOUT THE AUTHORS

Non-attorney financial and regulatory specialist Norris Clark, Partners John Gurley and Bill Kelty and Associate Tim Farber are experienced in a wide range of insurance regulatory and transactional issues.

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