ACTUARIAL STANDARDS BOARD

**Actuarial Standard
of Practice
No. 11**

Financial Statement Treatment of Reinsurance Transactions Involving Life or Health Insurance

Revised Edition

**Developed by the
Task Force to Revise ASOP No. 11 of the
Life Committee of the
Actuarial Standards Board**

**Adopted by the
Actuarial Standards Board
June 2005
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June 2005

TO: Members of the American Academy of Actuaries and Other Persons Interested in the Financial Statement Treatment of Reinsurance Transactions Involving Life or Health Insurance

FROM: Actuarial Standards Board (ASB)

SUBJ: Actuarial Standard of Practice (ASOP) No. 11

This booklet contains the final version of a revision of ASOP No. 11, *Financial Statement Treatment of Reinsurance Transactions Involving Life or Health Insurance*.

<u>Background</u>

The Actuarial Standards Board adopted the original ASOP No. 11, then titled *The Treatment of Reinsurance Transactions in Life and Health Insurance Company Financial Statements*, in 1989. Prior to adoption of the standard, Recommendation No. 4 and Interpretation No. 4-A of the *Financial Reporting Recommendations and Interpretations* of the American Academy of Actuaries covered certain aspects of generally accepted accounting principles (GAAP) financial reporting on reinsurance ceded by life and health insurance companies. The original standard superseded Recommendation No. 4 and Interpretation No. 4-A.

Since the original actuarial standard was issued, reinsurance practice and related accounting guidance have evolved significantly. Such accounting guidance includes, for GAAP financial statements, Statement of Financial Accounting Standard (SFAS) No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts*, issued in 1992; American Institute of Certified Public Accounts (AICPA) Statement of Position (SOP) 98-7, *Deposit Accounting: Accounting for Insurance and Reinsurance Contracts That Do Not Transfer Insurance Risk*; and, for statutory accounting, Statutory Statement of Accounting Principles (SSAP) No. 61 and other statutory guidance, including Appendix A-785 (credit for reinsurance) and Appendix A-791 (risk transfer/in-force accounting) of statutory codification.

The Task Force to Revise ASOP No. 11 included a member of the Casualty Actuarial Society. However, the task force, the Life Committee, and the ASB agreed that the scope of this standard would not be expanded to include reinsurance of purely property/casualty insurance at this time.

In the first exposure draft, the scope was changed to apply to reinsurance transactions involving life (including annuities) and health insurance, rather than to life and health insurance company financial statements. In the second exposure draft, the scope was further clarified to state that this standard will apply when life and health insurance is reinsured by property/casualty companies. Furthermore, should a company enter into a transaction that involves reinsurance of both life/health insurance and property/casualty insurance, it is incumbent on the actuary to determine whether this standard, ASOP No. 36, *Statements of Actuarial Opinion Regarding Property/Casualty Loss and Loss Adjustment Expense Reserves*, or aspects of both are most appropriate to determine the proper treatment of the transaction.

First Exposure Draft

The first exposure draft of this ASOP was issued in June 2003, with a comment deadline of December 15, 2003. Eleven comment letters were received. The Task Force to Revise ASOP No. 11 carefully considered all comments received and made clarifying changes to the language in several sections. The most significant change from the first exposure draft was the revision of section 1.2, Scope, to clarify that the standard will apply to the extent that life/health insurance is reinsured by property/casualty companies. Should a reinsurance transaction involve both life/health and property/casualty insurance, the actuary should use professional judgment to determine whether this standard, ASOP No. 36, or aspects of both are most appropriate to determine the proper treatment of the transaction.

Second Exposure Draft

The second exposure draft of this ASOP was issued in November 2004, with a comment deadline of March 31, 2005. Nine comment letters were received. The Task Force to Revise ASOP No. 11 carefully considered all comments received and made clarifying changes to the language in several sections. For a summary of the substantive issues contained in the second exposure draft comment letters and the task force's responses, please see appendix 2. There were no significant changes from the second exposure draft.

The task force thanks everyone who took the time to contribute comments on the exposure drafts.

The ASB voted in June 2005 to adopt this standard.

ASOP No. 11—June 2005

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ACTUARIAL STANDARD OF PRACTICE NO. 11

FINANCIAL STATEMENT TREATMENT OF REINSURANCE TRANSACTIONS INVOLVING LIFE OR HEALTH INSURANCE

STANDARD OF PRACTICE

Section 1. Purpose, Scope, Cross References, and Effective Date

1.1 Purpose—This actuarial standard of practice (ASOP) provides guidance to actuaries when performing professional services relating to financial statements that contain material reinsurance transactions involving life insurance (including annuities) or health insurance.

1.2 Scope—This standard applies to actuaries when performing professional services in connection with preparing, reviewing, or analyzing financial statement items that reflect reinsurance ceded or reinsurance assumed on life insurance (including annuities) or health insurance.

To the extent that life/health insurance is reinsured by property/casualty companies, this standard will apply. If a reinsurance transaction involves both life/health and property/casualty insurance, the actuary should use professional judgment to determine whether this standard, ASOP No. 36, *Statements of Actuarial Opinion Regarding Property/Casualty Loss and Loss Adjustment Expense Reserves*, or aspects of both are most appropriate to determine the proper treatment of the reinsurance transaction.

If the actuary departs from the guidance set forth in this standard in order to comply with applicable law (statutes, regulations, and other legally binding authority), or for any other reason the actuary deems appropriate, the actuary should refer to section 4.

1.3 Cross References—When this standard refers to the provisions of other documents, the reference includes the referenced documents as they may be amended or restated in the future, and any successor to them, by whatever name called. If any amended or restated document differs materially from the originally referenced document, the actuary should consider the guidance in this standard to the extent it is applicable and appropriate.

1.4 Effective Date—This standard is effective for actuarial services performed in connection with financial statements for periods beginning on or after January 1, 2006.

Section 2. Definitions

The terms below are defined for use in this actuarial standard of practice.

2.1 Health Insurance—Coverage associated with contract provisions for medical, dental, vision care, disability income, accidental death and dismemberment, long-term care, and similar benefits, on either a reimbursement or service-benefit basis, sold by insurance companies, health maintenance organizations, hospital and medical service organizations, and other entities subject to insurance regulatory authorities.

2.2 Net Statement Liabilities—Reserves (net of reinsurance reserve credits), plus any other liabilities (such as amounts due reinsurers), less any other assets arising from reinsurance transactions (such as amounts receivable from reinsurers or deferred acquisition costs), for the reinsured block of business.

2.3 Nonproportional Feature—A feature of a reinsurance agreement that makes the reinsurer's financial experience nonproportional to that of the ceding entity. Examples of such nonproportional features include aggregate claim limits, deductibles, limited coverage periods, experience refunds, profit-sharing provisions, separate but related agreements, i.e., where the results of one agreement affect the operation of the other, and termination provisions.

2.4 Reinsurance Agreement—An agreement whereby one or more elements of risk contained in insurance contracts are transferred from a ceding insurance entity to a reinsuring (or assuming) insurance entity in return for some consideration.

2.5 Reinsurance Assumed—Reinsurance as it affects the entity assuming the risk under a reinsurance agreement.

2.6 Reinsurance Ceded—Reinsurance as it affects the entity ceding the risk under a reinsurance agreement.

2.7 Reinsurance Transaction—A transaction made pursuant to a reinsurance agreement.

Section 3. Analysis of Issues and Recommended Practices

3.1 Financial Features—When preparing, reviewing, or analyzing financial statement items, the actuary should consider the material financial features of relevant reinsurance agreements. In particular, the actuary should appropriately and consistently recognize the risks transferred.

3.2 Cash Flows—When preparing, reviewing, or analyzing financial statement items that reflect reinsurance ceded or reinsurance assumed, the actuary should consider potential cash flows that may, in the actuary's professional judgment, have a material impact under the reinsurance agreement (for example, premiums, allowances, investment income, expenses, modified coinsurance reserve adjustments, benefits, experience refunds, risk fees, and volume or other bonuses, including any contingent payments). The actuary should consider the likely impact of nonproportional features and termination provisions of the reinsurance agreement.

3.3 Treatment of Reinsurance Ceded—The actuary should determine adjustments for reinsurance ceded financial statement items using assumptions that are consistent with those underlying the calculation of the direct items, except as otherwise indicated by the terms and conditions of the reinsurance agreement, even though the values of the direct financial statement items (before reinsurance) and adjustments for reinsurance ceded are generally determined separately.

The actuary should calculate adjustments for reinsurance ceded directly without relying upon the values of financial statement items held by the reinsurer. Because the ceding entity and the assuming entity each establish and test statement liabilities and assets independently, it is possible for the value of the net statement liabilities held by the ceding entity, plus those held by the reinsurer on a reinsured contract, to be more or less than the amount that would have been held if the ceding entity had not reinsured the contract. For example, the two entities may have different investment strategies, resulting in the use of different interest rate assumptions.

3.4 Termination of Reinsurance—When preparing, reviewing, or analyzing financial statement items, the actuary should take into account conditions of the reinsurance agreement whereby the indemnification responsibility of the reinsurer expires prior to the expiration of the benefits underlying the policy. The actuary should consider relevant and material provisions that provide for the termination of the reinsurance at the option of either party.

3.5 Additional Liabilities—For reinsurance ceded, the actuary should consider whether additional liabilities should be established as a result of the reinsurance agreement. The assumptions used in making this consideration should be consistent with the purpose (such as GAAP or statutory accounting). For example, if the reinsurer has the right to raise reinsurance premiums on in-force business without a corresponding right by the ceding entity to raise policyholder premiums or terminate the reinsurance, an additional liability may be indicated.

3.6 Applicable Law—When preparing, reviewing, or analyzing financial statement items that reflect reinsurance ceded or reinsurance assumed, the actuary should consider relevant applicable law, regulation, or other binding authority affecting reserve credit or accounting for reinsurance.

3.7 Accounting Guidance—When preparing, reviewing, or analyzing financial statement items that reflect reinsurance ceded or reinsurance assumed, the actuary should consider the accounting guidance applicable to entries made for material reinsurance transactions. The actuary should consider whether a particular reinsurance agreement qualifies as reinsurance for statutory, GAAP, or other purposes, and how this may affect the accounting treatment.

3.8 Reliance on Data or Other Information Supplied by Others—When relying on data or other information supplied by others, the actuary should refer to ASOP No. 23, *Data Quality*, for guidance.

3.9 Documentation—The actuary should document, as appropriate, the methods, assumptions, procedures, and sources of the data supporting the actuary's work. The documentation should be in a form such that another actuary qualified in the same practice area could assess the reasonableness of the actuary's work.

Section 4. Communications and Disclosures

4.1 Actuarial Communications—When issuing actuarial communications relating to work subject to this standard, the actuary should refer to ASOP No. 23 and ASOP No. 41, *Actuarial Communications*. In addition, such actuarial communications should disclose the following:

a. any unresolved concerns the actuary has about reinsurance information (for example, reinsurance settlement data, in-force information, and legal agreements) that, in the actuary's professional judgment, could have a material effect on the actuarial work product; and

b. the source and extent of reliance on data or other information supplied by others.

4.2 Disclosures—The actuary should include the following, as applicable, in an appropriate actuarial communication:

a. the disclosure in ASOP No. 41, section 4.2, if any material assumption or method was prescribed by applicable law (statutes, regulations, and other legally binding authority);

b. the disclosure in ASOP No. 41, section 4.3, if the actuary states reliance on other sources and thereby disclaims responsibility for any material assumption or method selected by a party other than the actuary; and

c. the disclosure in ASOP No. 41, section 4.4, if, in the actuary's professional judgment, the actuary has otherwise deviated materially from the guidance of this ASOP.

Appendix 1

Background and Current Practices

Note: The following material is provided for informational purposes, but is not part of the standard of practice.

Background

Actuarial practice with respect to reinsurance, as well as the complexity of reinsurance agreements, has evolved significantly since the original standard was issued in 1989. Much of the increased attention to reinsurance has resulted from more recent accounting guidance in both generally accepted accounting principles (GAAP), and statutory financial reporting.

Current Practices

In analyses such as asset adequacy testing or GAAP premium deficiency testing, reinsurance agreements may have a material impact. Under GAAP accounting, reinsurance cash flows may affect the amortization of deferred acquisition costs (DAC) and related financial statement items.

The presentation of the components of the net statement liabilities may vary under different accounting principles. For example, the reserves are shown net of reinsurance ceded in statutory financial statements and generally presented on a gross basis before reinsurance in GAAP financial statements with an offsetting asset.

Statement of Financial Accounting Standard (SFAS) No. 113, issued since the date of the original actuarial standard of practice, provides guidance (with respect to ceded reinsurance) on accounting for reinsurance and requirements for a reinsurance agreement to qualify as reinsurance for purposes of GAAP accounting. SFAS No. 113 defines reinsurance (i.e., a transaction that receives reinsurance accounting) in a restrictive manner. For example, reinsurance of deferred annuities would generally not be considered reinsurance from a GAAP accounting perspective, although it could be reinsurance for statutory accounting.

There are also requirements relating to risk transfer that must be met in order to receive reinsurance accounting treatment under the requirements of Statutory Statement of Accounting Principles (SSAP) No. 61, which incorporates related guidance in Appendices A-785 and A-791 of the NAIC Accounting Practices and Procedures Manual.

Statutory accounting now requires that the after tax initial impact from the reinsurance of an existing block of business be reflected directly through surplus at the inception of the agreement. The resulting increase to surplus is then amortized into income over the life of the reinsured business.

Statutory or other regulatory financial reporting may include "mirror" requirements, that is, a requirement that the ceding entity's reserve credit may not exceed the reserve established by the assuming entity.

The presentation in financial statements differs for assumption reinsurance agreements and indemnity reinsurance agreements. Under indemnity reinsurance agreements, the ceding entity remains legally responsible for all policyholder obligations of the reinsured policies. The assuming entity indemnifies, or protects, the ceding entity against one or more of the risks in the reinsured policies. Under an assumption reinsurance agreement, the ceding entity is relieved of responsibility for the policies reinsured, and the contracts are accounted for by the assuming entity in the same manner as direct business. The reinsurer assumes all of the obligations formerly assumed by the ceding entity. Typically, regulatory and policyholder approval is required. When a company intends to enter into an assumption reinsurance transaction, an indemnity reinsurance agreement may be used for those policies not yet covered by the assumption agreement.

The ceding entity is responsible for assessing the collectibility of reinsurance recoverables, including determining whether the portion that is non-collectable should be written down. Accounting literature and state laws and regulations provide guidance on security for reinsurance. Considerations include financial strength and liquidity of the reinsurer, court or arbitration findings, and other market forces.

Appendix 2

Comments on the Second Exposure Draft and Task Force Responses

The second exposure draft of this actuarial standard of practice (ASOP) was issued in November 2004, with a comment deadline of March 31, 2005. Nine comment letters were received, some of which were submitted on behalf of multiple commentators, such as by firms or committees. For purposes of this appendix, the term "commentator" may refer to more than one person associated with a particular comment letter. The Task Force to Revise ASOP No. 11 carefully considered all comments received. Summarized below are the significant issues and questions contained in the comment letters and the task force's responses. Unless otherwise noted, the section numbers and titles used below refer to those in the second exposure draft.

GENERAL COMMENTS	
In the transmittal memorandum of the second exposure draft, the task force asked readers whether the revised language in section 1.2, Scope, was clear and appropriate in regards to its application to reinsurance assumed by property/casualty insurers, which involves only life/health insurance. There was consensus among commentators that the revised language appropriately clarified the scope of the standard. In addition, the task force asked readers whether revising the scope to clarify that when reinsurance involves both life/health and property/casualty insurance, the actuary should use professional judgment to determine whether this standard, ASOP No. 36, or aspects of both would apply, was clear and appropriate. There was consensus among commentators that this was also the correct approach. The task force implemented editorial changes in addition to those addressed specifically below if they enhanced clarity and did not alter the intent of the section.	
Comment Response	One commentator believed that the language of the standard could be clearer in describing situations in which the actuary needed to use judgment to determine which standard applied, noting that such situations should be limited to those in which life/health and property/casualty insurance are covered under the same reinsurance agreement. The task force agreed and clarified the language in the scope by adding the word "transaction" to section 1.2.
Comment Response	One commentator was concerned that language in paragraph 5.2 of the original standard had been removed. The language stated that net statement liabilities should "make appropriate provision for all of the company's unmatured obligations according to the actuary's best estimate of future experience, considering the reinsurance." The commentator suggested restoring the language in a manner to make clear that the net liability test is an aggregate test covering the entire company. The task force carefully addressed this concern but believed that the original decision to delete this language was the appropriate one. The task force did, however, revise section 2.2, Net Statement Liabilities, to make clear that in the context of this standard, the term refers only to reserves and related items affected by the reinsurance agreement.

Comment	One commentator believed the issues of liquidity and collectibility of reinsurance should be highlighted and specifically mentioned in the standard.
Response	The task force carefully addressed these issues and concluded that they should not be addressed in the body of the standard, recognizing that the actuary may or may not be involved with their assessment. The task force did, however, revise the language in appendix 1 to include reference to liquidity as well as collectibility.
SECTION 2. DEFINITIONS	
Section 2.2, Net Statement Liabilities	
Comment	One commentator believed that the language should be clarified to distinguish more clearly between “reinsurance reserve credits” and “amounts receivable from reinsurers,” so that the relationship is delineated explicitly.
Response	The task force disagreed and made no change because any more specificity could result in unintentionally omitting situations that need to be considered by the actuary.
Section 2.4, Reinsurance Agreement	
Comment	One commentator believed that the word “primary” raised the possibility that the scope does not cover retrocessions of reinsurance and suggested revising the wording to say “ceding” rather than “ primary (or ceding)” insurance entity.
Response	The task force agreed and replaced the phrase “primary (or ceding)” with “ceding” in this section.
Comment	One commentator believed that the definition of “health insurance” in section 2.1, combined with the definition of “reinsurance agreement” in section 2.4, leaves the scope rather unclear for both employer stop-loss programs and the wide variety of managed care arrangements and recommended that this standard be clarified to state that health insurance does not include self-insured benefits or providers who enter into risk-sharing arrangements with HMOs or health insurers.
Response	The task force agrees that, for example, a stop-loss arrangement written by an insurance company on a self-insured health plan, or agreements under Medicare Part D with the federal government as stop-loss and catastrophic claims payor, are outside the scope of this standard. The task force believes that sections 2.4, 2.5, and 2.6 make it clear that, for purposes of this standard, reinsurance requires both a ceding and assuming insurance entity. Therefore, the task force made no change in response to this comment. However, the task force notes that the guidance in this standard may still be useful in situations that are outside the scope of this standard.
SECTION 3. ANALYSIS OF ISSUES AND RECOMMENDED PRACTICES	
Section 3.3, Treatment of Reinsurance Ceded	
Comment	One commentator suggested that the first paragraph be deleted, stating that its language tries to influence the independent judgment approach espoused in the second paragraph.
Response	The task force believes that the commentator has misinterpreted the first paragraph, which is intended to achieve internal consistency of treatment between reinsurance ceded and the direct or assumed business from which it arises, within the scope of a particular company’s financial statements. This paragraph is not intended to refer to consistency between different companies.
Comment	One commentator suggested that the language be revised to clarify that “adjustments for reinsurance ceded” include adjustments to the financial statement items.
Response	The task force agreed, noting that adjustments for reinsurance ceded typically relate to the values of financial statement items. Section 3.3 was revised to clarify this issue.

Comment	One commentator believed that, although section 3.3 states that calculation of the adjustments for reinsurance ceded should be consistent with those underlying the calculation of the direct values, language should be inserted to highlight the impact of the long-term nature of the reinsurance transaction, particularly as it relates to nonproportional features.
Response	The task force disagreed, believing this is already adequately addressed in the standard.
Section 3.8, Reliance on Others (now Reliance on Data or Other Information Supplied by Others)	
Comment	One commentator believed that the language in this section was inconsistent with ASOP No. 23, *Data Quality*, since there is no reference to the actuary's responsibility when reviewing data for reasonableness and consistency. The commentator suggested that such a sentence be added.
Response	The task force agreed with the spirit of the comment and revised the title and language of section 3.8 to make a direct reference to ASOP No. 23.
Section 3.9, Documentation	
Comment	One commentator stated that the first sentence in this section covers documentation for items "used" but should elaborate further to state what the items are used for.
Response	The task force agreed and rewrote the sentence to clarify its meaning.
SECTION 4. COMMUNICATIONS AND DISCLOSURES	
Section 4.1, Communications (now Actuarial Communications)	
Comment	One commentator believed the phrase "unresolved, material concerns" needed further clarification and suggested defining the term "resolved."
Response	The task force disagreed, believing the current language is appropriate. However, the task force did delete the word "material" form the phrase to make the language consistent with other ASOPs.
Comment	One commentator believed that this section should better clarify what "reinsurance information" should include.
Response	The task force agreed and added examples to this section to clarify what items may be included in reinsurance information.