Note: This version of ASOP No. 11 is no longer in effect.
It was superseded on January 1, 2006 by ASOP No. 11, Doc. No. 098.

ACTUARIAL STANDARDS BOARD

Actuarial Standard
of Practice
No. 11

The Treatment of Reinsurance Transactions in Life and Health Insurance Company Financial Statements

Developed by the
Committee on Life Insurance Financial Reporting
for the Life Committee of the
Actuarial Standards Board

Adopted by the
Actuarial Standards Board
July 1989

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July 1989

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

FROM: Actuarial Standards Board (ASB)

SUBJ: Actuarial Standard of Practice No. 11

This booklet contains the final version of Actuarial Standard of Practice (ASOP) No. 11, *The Treatment of Reinsurance Transactions in Life and Health Insurance Company Financial Statements.* This standard is intended to cover the work of ceding company and assuming company actuaries in preparing statutory, GAAP, or other financial statements containing material reinsurance transactions.

Background

The Committee on Life Insurance Financial Reporting (COLIFR) of the American Academy of Actuaries (AAA) undertook the drafting of this standard at the request of the Life Committee of the ASB. The COLIFR's charge was to avoid detailed "how to" instructions, and to encompass the effect on the entire financial statement of material reinsurance agreements and transactions.

Recommendation 4, and Interpretation 4-A, of the existing *Financial Reporting Recommendations and Interpretations* of the AAA cover certain aspects of GAAP financial reporting on reinsurance ceded by life and health insurance companies. The present standard is more comprehensive and up-to-date, and therefore supersedes Recommendation 4 and Interpretation 4-A.

The committee made use of and borrowed language from three existing documents:

1. *The Valuation of Reinsurance Policies*, Canadian Institute of Actuaries, October 1987.

2. Proposed Actuarial Guideline on Reinsurance, National Association of Insurance Commissioners (NAIC), August 1986.

3. Report of the NAIC Reinsurance Advisory Committee (Zeilman Committee), December 1985.An exposure draft of this standard was approved for exposure by the ASB in January 1989. The deadline for comments was May 1, 1989.

Sixteen responses to the exposure draft were received. The letters were most welcome, and the document was revised to reflect many of the comments.

Responses to Comments on Exposure Draft

At the suggestion of several responders, the Purpose, Scope, and Effective Date sections were expanded for clarity.

Although two responders thought that mirror reserving should be required, the drafting committee felt that the standard as currently written better reflects current opinion. The committee did, however, agree with a responder who suggested showing an example where mirror reserving would be inappropriate.

Section 5.5 was amended to remove the statement that the actuary may rely on others to consider the likelihood of collection. Several responders felt that the reliance sentence did not give adequate guidance. It was the intention of the standard drafters to allow the actuary to rely on others in the performance of duties discussed throughout the document. Since Interpretative Opinion 3(a)(4) of the AAA better describes the circumstances and requirements for reliance, it was decided to make no reference to reliance within this standard. This should also satisfy responders who felt it was too difficult for actuaries to comply with section 5.6, which requires familiarity with regulatory requirements. Appropriate reliance on others is permitted.

Finally, section 5.7 was amended to delete a specific reference requiring cash flow testing when there is concern about particular assumptions. Responders felt this statement was not definitive. A separate standard of practice concerning when to do cash flow testing is currently under development. That document should provide the assistance needed to carry out section 5.7 of the Reinsurance Standard.

Section 5.2 of the final standard requires reported net statement liabilities to meet all applicable legal, accounting, and valuation requirements and to make appropriate provision for the company's obligations according to the actuary's best estimate of future experience. Three responders felt that the best-estimate requirement was not conservative enough, and that the best estimate should contain margins for adverse deviation. Since the standard requires reserves to be at least equal to those required by law on statutory statements, and by other standards on GAAP statements, the ASB felt that further conservatism was unnecessary in the second test.

One responder asked to expand the standard to cover such aspects as treaty design and arbitration activities. The ASB decided that these activities were beyond the scope of a standard on financial reporting.

The ASB wishes to thank all who contributed comments on the exposure draft.

The standard was adopted by the ASB on July 14, 1989.

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ACTUARIAL STANDARD OF PRACTICE NO. 11

THE TREATMENT OF REINSURANCE TRANSACTIONS IN LIFE AND HEALTH INSURANCE COMPANY FINANCIAL STATEMENTS

PREAMBLE

Section 1. Purpose, Scope, and Effective Date

1.1 Purpose—This standard of practice sets out the considerations that bear on the actuary's professional work in preparing life and health insurance company statutory, GAAP, or other financial statements containing material reinsurance transactions. It is intended to describe a minimum level and quality of actuarial attention necessary to properly reflect reinsurance agreements in the financial statement.

1.2 Scope—This standard applies to both ceding company and assuming company actuaries who are operating subject to this standard.

1.3 Effective Date—This standard is effective for all financial statements prepared for fiscal periods beginning after December 15, 1989.

Section 2. Definitions

2.1 Net Statement Liabilities—Net statement liabilities are 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, in GAAP financial statements, the deferred acquisition costs).

2.2 Reinsurance Agreement—A reinsurance agreement is any contractual arrangement whereby some element of risk contained in insurance contracts is transferred from a primary (or ceding) insurance company to a reinsuring (or assuming) insurance company in return for some consideration.

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

Section 3. Background and Historical Issues

Since very little guidance is currently available to actuaries in accounting for reinsurance, it was widely believed that a standard of practice on this subject was necessary. In addition, the National Association of Insurance Commissioners in 1987 asked the Interim Actuarial Standards Board (IASB) to consider the issues involved in life and health insurance company reserve valuation when material reinsurance transactions were present. Therefore, the IASB initiated action toward the adoption of this standard.

Section 4. Current Practices

Practices have varied. The level of attention given to reinsurance transactions has ranged from perfunctory to detailed cash flow analysis. Some actuaries have considered only actuarial liabilities, and others have considered all statement assets and liabilities associated with the transactions.

STANDARD OF PRACTICE

Section 5. Analysis of Issues and Recommended Practices

5.1 Gross Direct Liabilities and Adjustments—A company is liable to its policyholders and to companies which cede reinsurance to it for all benefits guaranteed in its contracts, regardless of subsequent reinsurance. The reinsurance transaction is a separate indemnity agreement providing for reimbursement of some of the company's obligations.

5.2 Net Statement Liabilities—Even though the gross direct liabilities and the adjustments for reinsurance are generally determined separately, the principal responsibility of the ceding company and the assuming company is to establish net statement liabilities for their respective obligations. The reported amounts of net statement liabilities must both:

a. satisfy all applicable legal, accounting, and valuation requirements; and

b. make appropriate provision for all of the company's unmatured obligations according to the actuary's best estimate of future experience, considering reinsurance.

Since the ceding company and the assuming company each establish and test net statement liabilities independently, it is possible for the net statement liabilities held by the ceding company, 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 company had not reinsured the contract. For example, the two companies may have different investment strategies, resulting in the need to use different interest assumptions.

5.3 Review of All Material Reinsurance Agreements—To determine the sufficiency of net statement liabilities, the actuary must undertake review of all material reinsurance agreements.

5.3.1 Review of Financial Features—The actuary should be familiar with all financial features of material reinsurance agreements. In particular, the actuary must ensure that all risks transferred, and only the risks transferred, are recognized in determining the reinsurance credits and the sufficiency of net statement liabilities.

5.3.2 Review of Cash Flows—The actuary should review all material potential cash flows under the agreement, including premiums, allowances, investment income, expenses, modified coinsurance reserve adjustments, benefits, experience refunds, risk fees, and volume or other bonuses. Contingent payments should be understood and considered. The actuary should take care in understanding agreements when the conditions of reinsurance do not parallel those of the original insurance.

5.3.3 Review of Accounting Treatment—The actuary should review the accounting treatment given to all material reinsurance transactions throughout the financial statement. If assets or liabilities such as receivables or payables beyond reserves and other actuarial items arise as a result of the reinsurance agreements, the actuary should consider such assets or liabilities in arriving at conclusions about the sufficiency of net statement liabilities.

5.3.4 Termination of Reinsurance—Determination of net statement liabilities should take into account any conditions of the reinsurance agreement whereby the indemnification responsibility of the reinsurer expires prior to the expiration of the benefits underlying the policy. Particular attention should be paid to provisions that provide for the termination of the reinsurance at the option of either party.

5.4 Additional Liabilities—In some cases, an agreement may specify future obligations of the ceding company to the reinsurer that are in excess of the ceding company's expected revenues under the reinsured plans. For example, if the reinsurer has the right to raise reinsurance premiums on in-force business without a corresponding right by the ceding company to raise policyholder premiums or terminate the reinsurance, an additional current liability may be indicated.

The ceding company actuary should consider whether additional liabilities should be established solely as a result of the reinsurance agreement.

5.5 Likelihood of Collection—Before adjusting liabilities or assets on account of reinsurance, the actuary should consider the likelihood of collection. In this regard, the actuary may want to review appropriate accounting literature and state laws and regulations on security for reinsurance.

5.6 Regulatory Requirements—The actuary should be familiar with state laws and regulations concerning reserve credit, such as (but not limited to) required insolvency agreement provisions, risk transfer requirements, and in some cases, agreement filing or pre-approval requirements.

5.7 Net Statement Liabilities and Cash Flow Testing—Under certain circumstances, the actuary may undertake to confirm sufficiency of net statement liabilities through the use of cash flow testing. Such circumstances might include material reinsurance transactions with partial or nonproportional benefit reimbursements or with treaty structures which do not parallel the original insurance.

When an actuary finds it necessary to perform cash flow testing to confirm sufficiency of net statement liabilities, the actuary should take into account all aspects of the underlying policy and reinsurance cash flows including a scenario reflecting the actuary's best estimate of future experience. The actuary should refer to Actuarial Standard of Practice No. 14, *When to Do Cash Flow Testing for Life and Health Insurance Companies*, for guidance.

Section 6. Communications and Disclosures

6.1 Conformity with Standard—The actuary should be prepared to describe the actuarial work performed for inclusion in the financial statement, and to demonstrate that such work conforms to this standard of practice.

6.2 Documentation—The actuary should maintain adequate documentation in support of the conclusion that reinsurance was properly recognized in the valuation of reserves and other actuarial items.

6.3 Deviation from Standard—An actuary who uses a procedure which differs from this standard should include, in the actuarial communication disclosing the result of the procedure, an appropriate and explicit statement with respect to the nature, rationale, and effect of such use.