

**Notes to the NAIC Property/Casualty Annual Statement**

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[Note numbers and Annual Statement page references change each year. The footnotes in this reading are for reference only and are not required for the CAS examination.]

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# INTRODUCTION

## ***PURPOSE OF NOTES TO FINANCIAL STATEMENTS***

The National Association of Insurance Commissioners (NAIC) Property/Casualty Annual Statement (“the NAIC Annual Statement” or “the Annual Statement”) provides extensive commentary explaining the accounting entries, including: Notes to Financial Statements (Notes), General Interrogatories, and Management’s Discussion and Analysis. Many topics cannot be fully understood from the numerical exhibits alone, and users of financial statements must refer to the Notes. Structured settlements, intercompany pooling agreements, high deductible policies, asbestos and environmental exposures, and retroactive reinsurance are all described in the Notes, and all affect the reported losses in the NAIC Annual Statement.

The following citation describes in particular the purpose for the Notes: “Notes to the financial statements report the details and additional information that are left out of the main reporting documents, such as the balance sheet and income statement. This is done mainly for the sake of clarity because these notes can be quite long, and if they were included, they would cloud the data reported in the financial statements.” (February 2, 2009, <http://www.investopedia.com/terms/f/footnote.asp>)

Details and additional information from the Notes can be both qualitative and quantitative. An example of a qualitative exposure is the disclosure of the nature of asbestos and environmental exposures (see item I). An example of quantitative information is the disclosure of the amount of asbestos and environmental reserves (see item I).

Notes may also be a major (if not the only) source of publicly disclosed information on off-balance sheet items. Off-balance sheet items are risk exposures to the company that do not show up on the balance sheet. They can be significant sources of solvency risk. One example of off-balance sheet exposure is contingent liability resulting from structured settlements (see item F).

For the NAIC Annual Statement, the instructions require dozens of notes. Some of these notes are permanent and essentially fixed, requiring the same disclosure every year (for example, the required disclosure of significant accounting policies – see item A). Other notes cover more topical items that may have meaning only for a small number of years. In the latter case, these notes are added by the NAIC as a special need arises, and then removed from the instructions as the need goes away. For example, a note was added in 2001 to require disclosure of September 11, 2001, liabilities associated with the World Trade Center terrorist attacks, kept in place for the 2001-2006 statements, and then removed in 2007.

This syllabus reading provides a review of the Notes used by actuaries in valuation or reserving work, such as by actuaries signing a Statement of Actuarial Opinion, with the exception of the Discounting Note, Number 31 for 2009, which is discussed in a separate Study Note.

## **STRUCTURE OF NOTES**

The *NAIC Annual Statement Instructions – Property/Casualty* provide instructions and guidance<sup>1</sup> with regard to the Annual Statement Notes. Each note has an official number, and some have a required disclosure format. Some of these formats allow for electronic data capture, for easier analysis of the results for an individual company and across companies.

The numbers for each disclosure item can change every year, as additional disclosures are added and existing disclosures are discontinued. For example, the disclosure on Asbestos & Environmental Reserves was Note 33 in 2006 but Note 32 in 2007 (after the September 11 disclosure was removed). Therefore, each Note discussed in this study note will be identified by a letter as follows:

- A. Summary of Significant Accounting Policies (Note 1 for 2009)
- B. Subsequent Events (Note 21 for 2009)
- C. Reinsurance (Note 22 for 2009)
- D. Changes in Incurred Losses and Loss Adjustment Expenses (Note 24 for 2009)
- E. Intercompany Pooling Arrangements (Note 25 for 2009)
- F. Structured Settlements (Note 26 for 2009)
- G. Premium Deficiency Reserves (Note 29 for 2009)
- H. High Deductibles (Note 30 for 2009)
- I. Asbestos/Environmental (Note 32 for 2009)

Caution – Students may want to review actual Annual Statements when studying this material. If you do so, please be aware that the Notes to Financial Statements only exist for individual company annual statements, not for annual statements produced on a “combined” basis for a group of companies.

### **Note A. Summary of Significant Accounting Policies**

This is one of many notes to the Financial Statements that are discussed in accounting statements for all firms, including companies that are not insurance companies. This note is not specific to actuarial work but does contain some information that is relevant to actuarial work,

In order to understand and use a financial report, the reader (e.g., the regulator) needs to know what accounting rules were used to produce the financial data that was reported. This note describes

- the principle source of the rules, e.g., the NAIC Accounting Practices & Procedures Manual;
- any exceptions to the use of those rules, e.g., a variation from NAIC rules based on state laws; and

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<sup>1</sup> This guidance includes specific examples and illustrations. “Unless indicated, the format and level of detail in the illustrations are not requirements”. (Preamble to the Notes instructions.)

- options chosen by the insurer where the rules that were followed allow options, e.g., whether or not investment income was considered in calculating premium deficiency reserves.

The NAIC instructions for the 2009 Annual Statement specifically require the insurer to disclose whether the company followed accounting practices that differed from those in the NAIC's *Accounting Practices and Procedures Manual*. These differences can be due to rules "prescribed" by state law, or "permitted" by the regulators, sometimes referred to as "prescribed or permitted practices." For example, several states allowed life insurers to record higher amounts of deferred tax assets at year-end 2008 as a result of the financial crisis at that time. If such practices exist, the insurer is required to describe them and the resulting financial impact, including whether they had any impact on Risk Based Capital (RBC).

## Note B. Subsequent Events

This is one of many notes to the Financial Statements that are discussed in accounting statements for all firms, including companies that are not insurance companies. This note is not specific to actuarial work but does contain some information that is relevant to actuarial work.

This note discloses events that occurred after the report's accounting date, but before the report was filed, where the subsequent event was material to the insurer's financial position. For example, the year-end 2009 statutory annual statement has an accounting date of December 31, 2009, but had to be filed by March 1, 2010, which leaves up to two full months for events to occur between the accounting date and the filing date.

Subsequent events are typically broken up into categories: Type 1 (Recognized Subsequent Events) and Type 2 (Nonrecognized Subsequent Events).

- Type 1 events or transactions are those providing "additional evidence with respect to conditions that existed at the date of the balance sheet." For example, if a lawsuit was tried before a judge or jury in 2009, but the judge or jury's decision came out in February 2010, the court decision would be a Type 1 subsequent event.
- Type 2 events or transactions are those providing "evidence with respect to conditions that did not exist at the date of the balance sheet." For example, if an earthquake occurred in January 2010, it would not and should not be reflected in the loss reserves as of December 31, 2009, even if material to the company's current financial position on the filing date of March 1, 2010.

An insurer is supposed to reflect all Type 1 events in their year-end financial statements. As such, a disclosure in the Notes should not be needed, unless it is "necessary to keep the financial statements from being misleading." Hence, while material Type 1 events may cause last-minute scrambling by management and financial reporting functions, they might not lead to many disclosures. An exception would be where the booked reserve could not be adjusted in time to reflect the Type 1 event, in which case this Note would state the amount by which the booked reserve should be adjusted, so as to reflect the Type 1 event.

Type 2 events "that may have a material effect on the financial condition of the company" need to be disclosed, even if the financial determination is that they weren't material. For example, a company may disclose that a large earthquake took place on January 15, after the balance sheet date, but that the impact on the company is not expected to be material.

The NAIC resolved the question as to whether a change in a reserve estimate due to an updated reserve review should be considered a Type 1 subsequent event. According to the NAIC, changes in reserve

estimates between March 1<sup>st</sup> (due date for filing the statement) and June 1 (due date for filing the audited statement)<sup>2</sup> “resulting from the continuous [reserve] review process” are not Type 1 subsequent events.

## **Note C. Reinsurance**

The existence of reinsurance, both ceded and assumed, can add significant complexities to the evaluation of an insurer’s solvency and financial position. The existence of ceded reinsurance can significantly reduce the net insurance risk faced by an insurer, but also introduce a significant amount of credit risk. The existence of assumed reinsurance can also significantly change the risk profile of an insurer. The purpose of this Note is to concentrate in one place the additional disclosures concerning both assumed and ceded reinsurance, beyond those in the various schedules and exhibits of the annual statement.

Many of the disclosures in this Note relate to information already reported (but in a less usable form) in Schedule F. For example, an analysis of Schedule F – Part 3 would allow the reader to determine whether there are any major concentrations of credit risk exposure to particular reinsurers, but this may require the reader to comb through pages of data to do so. In contrast, Section A of this note does all this work for the reader, as it requires the disclosure of unsecured recoverables from any reinsurer where those recoverables represent over 3% of surplus.

This Note is broken out into the following sections:

1. Unsecured Reinsurance Recoverables (Section A of the Note)
2. Reinsurance Recoverables in Dispute (Section B of the Note)
3. Reinsurance Assumed and Ceded (Section C of the Note)
4. Uncollectible Reinsurance (Section D of the Note)
5. Commutation of Ceded Reinsurance (Section E of the Note)
6. Retroactive Reinsurance (Section F of the Note)
7. Reinsurance Accounted for as a Deposit (Section G of the Note)

### **1. Unsecured Reinsurance Recoverables**

Large recoverables from individual reinsurers pose a potential threat to an insurer’s financial strength if the recoverables are not secured by letters of credit, trust agreements, or funds withheld. The “Unsecured Reinsurance Recoverable,” section of this note asks the insurer to disclose whether or not it has any unsecured recoverables from any reinsurer that exceed three percent (3%) of the insurer’s policyholders’ surplus.

Large concentrations of unsecured ceded balances can result from a number of situations and can occur for both small and large companies. Small companies may rely heavily on reinsurance to enter a market or fund growth, and this can result in high concentrations of credit risk if they rely on a single or a small number of reinsurers. (For example, a startup insurer may decide to cede 50% or more of its volume initially to a single reinsurer, via a quota-share reinsurance agreement.) Medium-to-large companies may rely on reinsurance to address catastrophe risk or to protect themselves from higher severity claims. A large catastrophe event or the accumulation over time of a portfolio of large claims in their claim reserves can result in a concentration of credit risk to a single or a few reinsurers.

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<sup>2</sup> SSAP 55, paragraph 13

The recoverables referenced in this Section include, besides billed but not yet collected amounts, any allocation or assignment of ceded reserves to the reinsurer, including ceded unearned premium reserves.

## **2. Reinsurance Recoverables in Dispute**

Credit risk covers the risk that a counterparty does not pay an amount due. This can occur because the counterparty cannot pay (e.g., due to insolvency) or because the counterparty is unwilling to pay (e.g., due to a dispute as to whether the amounts are really owed). This disclosure covers ceded recoverables (billed plus ceded loss reserves<sup>3</sup>) in the latter category, i.e., amounts in dispute.

Disputed amounts can occur for a number of reasons. They can occur because of aggressive practices of the ceding company, aggressive claim practices of the assuming company, or legitimate disagreements between the two parties on how to interpret an issue not clearly addressed by the contract. Sometimes a dispute is also associated with financial difficulties of one of the parties, although this is by no means always the case. In any case, this section of the Reinsurance Note seeks disclosure of any ceded balances in dispute where the amounts in dispute due from any single reinsurer are over 5% of the ceding company's surplus, or if the total amounts in dispute with all reinsurers is over 10% of the ceding company's surplus.

Ceded balances can only be considered to be in dispute if there is a formal written communication from the reinsurer denying the validity of coverage.<sup>4</sup>

Beyond the credit risk implications, there are at least two reasons why regulators may be concerned with amounts in dispute.

- Insurers in financial difficulty may try to boost their apparent surplus by overstating their reinsurance recoverable amounts. These overstated amounts may result in disputes when they attempt to bill their reinsurers.
- A ceding company can face a reduction in statutory surplus due to Schedule F penalties resulting from slow-paying reinsurers. However, some of these penalties can be avoided if some of the overdue balances are labeled as being in dispute. (See the Schedule F study note for more information on this item.)

*Illustration:* Insurer ABC may be exposed to significant asbestos liabilities, but has recorded ceded amounts equal to 90% of the direct losses. ABC's principal reinsurer has stated that the reinsurance it sold to ABC does not cover asbestos. Without the ceded reinsurance receivable and recoverable on asbestos claims, insurer ABC would have surplus below RBC requirements.

## **3. Reinsurance Assumed and Ceded**

This Section of the Reinsurance Note will not be tested.

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<sup>3</sup> Most amounts in dispute are recoverables on paid losses, but they may include recoverables on unpaid losses. For example, a reinsurer may inform the ceding company that a treaty does not cover non-accidental toxic waste dumping or leakage, but the ceding company may assert that these exposures are covered.

<sup>4</sup> SSAP 62, paragraph 58

## **4. Uncollectible Reinsurance**

This section of the Reinsurance Note requires disclosure of uncollectible reinsurance written off (as uncollectible) during the year. The disclosure includes the name of the reinsurer, losses reserved, LAE incurred, and premiums earned.

This information may be useful for evaluating any reserves or provisions that are set aside for future uncollectible reinsurance amounts.

- Some companies establish Uncollectible Reinsurance Reserves as an offset to their ceded loss reserves. Those companies might be able to utilize the information in or underlying this Note in their determination of an Uncollectible Reinsurance Reserves. (These reserves are sometimes labeled URR.)
- All companies are required to calculate for statutory accounting purposes a “provision for reinsurance” (otherwise known as the Schedule F penalty, and reported as a liability in the statutory balance sheet) to address the potential risk of uncollectible ceded balances. The calculation of this provision is documented in Schedule F – Part 7. (For more information on this calculation, please see the Schedule F study note.) The adequacy of this statutory provision for the risk of ceded balance uncollectibility can be tested by comparing it to the level of write-offs in the recent calendar year (as reported in this Note). If ceded balances take many years to run off, then one would normally expect that a sufficient provision for uncollectible reinsurance would be some multiple of the one-year write-offs disclosed in this Note.

## **5. Commutation of Ceded Reinsurance**

“A commutation of a reinsurance agreement, or any portion thereof, is a transaction which results in the complete and final settlement and discharge of all, or the commuted portion thereof, present and future obligations between the parties arising out of the reinsurance agreement.” (SSAP 62)

Information on commutations can be useful for a number of reasons, including the following:

- They may signal a change in the insurer’s future exposure to insurance risk on a net basis. For example, the insurer may have ceded its long tail Workers Compensation exposures, removing itself from the tail risk on those claims, but it may now be re-exposed to that risk after the commutation of the relevant reinsurance agreement.
- Large commutations can result in significant distortion in income statement and balance sheet values in the year of the commutation. They can generate significant cash inflows and negative paid losses in the year they occur, as well as causing net loss reserves to jump up (as the ceded loss reserves are taken down).
- They may cause a significant change in the future levels of reinsurance collectability risk, either because of a significant reduction in total balances, or the resolution of a long-standing dispute.

Disclosure requirements in this Note relate to the name of the reinsurer, loss and loss adjustment expense, and premium associated with the commutation of ceded reinsurance during the year.

## **6. Retroactive Reinsurance**

Retroactive reinsurance agreements provide coverage for liabilities that occurred prior to the effective date of the agreement. Prior to accounting rule changes in the 1990s, they used to be used by companies to generate surplus relief, as they allowed companies to cede nominal reserves for a present value premium. As a result of abuses, the accounting rules were changed for such contracts.



Retroactive reinsurance contracts now require special accounting (with different rules for statutory and GAAP accounting, discussed in a different study note). The statutory rules still allow a company to benefit from ceding nominal dollars for a reduced (i.e., present valued) premium, but the ceded amounts do not reduce reported loss reserves (instead they are reported in a write-in line), and any surplus gain that results is put in restricted surplus. The surplus restriction is removed as amounts are received in excess of the premium paid.

This Note requires disclosure of all such retroactive reinsurance, including reserves transferred, consideration paid or received, paid losses reimbursed or recovered, and special surplus as well as the names of the reinsurers associated with these transactions.

*Illustration:* Insurer ABC entered into a retroactive reinsurance arrangement with Reinsurer XYZ in year 20X6. The agreement called for a \$25 million payment, with Insurer ABC's initial estimate of the ultimate recoveries being \$30 million. One year later (year 20X7), insurer ABC now estimates ultimate recoveries of \$33 million, with cash recoveries in that year under the contract of \$12 million. The resulting disclosure under this note would look similar to the following:

	<i>Assumed</i>	<i>Ceded</i>
<i>a. Reserves Transferred</i>		
1. Initial Reserves		\$30,000,000
2. Adjustments – Prior Years		
3. Adjustments - Current Year		\$3,000,000
4. Current Total		\$33,000,000
<i>b. Consideration Paid or Received</i>		
1. Initial		\$25,000,000
2. Adjustments – Prior Years		
3. Adjustments - Current Year		
4. Current Total		\$25,000,000
<i>c. Paid Losses Reimbursed or Recovered</i>		
1. Prior Years		
2. Current Year		\$12,000,000
3. Current Total		\$12,000,000
<i>d. Special surplus</i>		
1. Initial Surplus Gain or Loss		\$5,000,000
2. Adjustments - Prior Years		
3. Adjustments - Current Year		\$3,000,000
4. Current Year Restricted Surplus		\$8,000,000
5. Cumulative Total Transferred to Unassigned Surplus		

The restricted surplus of \$8 million (second-to-last row in the above table) represents the difference between the total paid by the ceding company (\$25 million) and the ceded reserves under the contract (\$33 million, recorded as a write-in contra-liability), or \$8 million. This amount will not be reduced (and transferred to “unassigned surplus”) until actual “paid losses recovered” exceed the “consideration paid.”

The above illustration shows the results only for a ceded contract. The company on the assuming end of the contract would also have to disclose the contract in its version of this Note, utilizing the Assumed column of the table. It is possible for an insurer to have both assumed and ceded retroactive reinsurance contracts in effect at the same time, resulting in both columns having non-zero values for a single company.

Note that the table allows for changes over time in all the categories, including changes in the ceded premium (consideration paid). This allows for the potential of contingent commission and other loss sensitive arrangements.

This exhibit shows the total for all retroactive reinsurance contracts still in effect. Once final settlement occurs for a retroactive reinsurance contract, all entries relating to that contract are removed from the table.

The disclosure includes two exhibits showing a breakout of the current balances by individual cedent and reinsurer. The first is just a breakout of the balances in row a.4 above. The second is a breakout of paid Loss/LAE amounts recoverable and amounts more than 90 days overdue, and collateral held as respects amounts recoverable from unauthorized reinsurers. This latter breakout attempts to recreate information obtainable from Schedule F.

## **7. Reinsurance Accounted for as a Deposit**

Reinsurance contracts are reported with reinsurance accounting or deposit accounting, depending on the risk transfer in the contract. See “Reinsurance Accounting: Schedule F” Study Note by S. Feldblum for more information on this issue. All reinsurance contracts that are being accounted for as deposits rather than as reinsurance are required to be disclosed in this Section of the Reinsurance Note.

## **Note D. Changes in Incurred Losses and Loss Adjustment Expenses**

The reported incurred losses and loss adjustment expenses in a financial report include incurred amounts for the current accident year, and ***changes in incurred amounts from prior accident years***. Changes in incurred amounts for prior accident years are common and to be expected, given that the incurred amounts are only estimates and cannot be known with certainty prior to final settlement of all related claims. This Note requires disclosure and discussion of the portion of reported incurred losses and loss adjustment expenses that are the result of changes in estimates for prior accident years (otherwise known as reserve strengthening or weakening).<sup>5</sup>

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<sup>5</sup> Changes in estimates for prior years are included in incurred losses in the period that the estimate is changed. For example, if I originally estimated that incurred losses for AY2010 would be \$100, then changed that to \$105 in the year 2011, the change of \$5 would be included in incurred losses in 2011.

This Note lets the reader (e.g., the state regulator) know the amount, line(s) of business and causes of any prior accident year reserve strengthening or weakening in the current reporting period. It also indicates whether any corresponding additional premiums or return premiums resulted from the change in prior accident year losses (and/or loss expenses). It is similar to a disclosure in many 10K filings for those companies subject to SEC reporting requirements.

This information is important for two reasons. First, it informs the reader as to the quality of current earnings for the company. If the earnings were significantly impacted by changes in prior accident year reserve estimates, then it may imply that the reported earnings are not representative of the insurer's current profitability, and hence may not be indicative of future profitability. Second, it may indicate a problem with the recorded loss reserves or the insurer's overall loss reserving process. This note provides the reader with additional information about the source of these changes in prior accident year reserves, to aid in evaluating whether the reserve strengthening/weakening is likely to be a recurring phenomenon, and in evaluating the ongoing profitability and reserving ability of the company.

At insurance companies, reserving actuaries are typically a primary resource to discuss changes in loss and loss adjustment expense estimates (i.e., Change in Ultimate Losses). For that reason, actuaries should be aware of this Note and understand its content.

This Note would normally be consistent with the similar Note filed in the annual Form 10-K requirement for SEC registrants, for those companies that file 10-Ks. It should also be consistent with the one-year adverse development reported in Schedule P – Part 2, except possibly for adverse development coming from Adjusting & Other Loss Adjustment Expenses (included in this Note but not in the Schedule P – Part 2 numbers).

*Illustration:* Incurred losses and loss adjustment expenses attributable to insured events of prior years were \$25 million, mostly resulting from the Workers Compensation line of business, reflecting increased estimates for lifetime medical claims. The impact was spread over multiple accident years. This was offset by \$2 million of additional accruals of premium under retrospectively rated policies.

## **Note E. Intercompany Pooling Arrangements**

Many property/casualty insurance groups in the U.S. have intercompany pooling arrangements among at least some of their group members. These arrangements typically take the form of a quota-share reinsurance treaty with no expiration date. The participants generally cede 100% of the business to the lead company in the pool, and then assume back a fixed percentage of the pooled results from the lead company.

Where these pools exist, the solvency of one pool member generally cannot be evaluated in isolation of the pool. Therefore, this Note informs the reader (e.g., the state regulator) whether such a pool exists, and enough details about the pool to evaluate its affect on the individual company's solvency.

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The SSAP 3, paragraph 7 wording is "A change in accounting estimate shall be included in the statement of income in the period when the change becomes known". Note that this only relates to changes to due re-estimation. Changes due to errors are treated differently, are disclosed in a separate Note, and can require filing an amended statement that corrects the error. If interested in more information, the reader is directed to SSAP 3.

Required disclosures about the pooling agreement include (among other items):

- The lead company of the pool
- The other pool participants
- Each participants' share of the pool
- The lines of business covered by the agreement

Actuaries must understand the impact of intercompany pooling agreements in the various exhibits and schedules of the statutory annual statement.

Schedule F and other parts of the Annual Statement treat intercompany pooling as reinsurance.

- The cessions to the lead company are ceded reinsurance in Schedule F, Part 3.
- The assumptions of pooled business are assumed business in Schedule F, Part 1.
- The Underwriting & Investment exhibits that show assumed and ceded breakouts will show the cessions to the lead company in the pool and the assumptions back from the lead company. As a result, it is not unusual to see a pool member ceding 100% of its direct business, with the assumed amount from the lead company equaling its net balances.

*Illustration:* No external reinsurance exists. Affiliates X, Y, and Z write substandard (high risk), standard, and preferred (low risk) business with \$10 million, \$20 million, and \$40 million of direct premium, respectively. Insurers X and Y cede all their premium to insurer Z (such that Direct Written Premium for X and Y is the same as Ceded Written Premium). Insurer Z then cedes 10% of its total gross premium (of \$70 million) to X and 20% of its total gross premium to Y.<sup>6</sup>

Underwriting and Investment Exhibit – Part 1B- Premiums Written  
All Business Ceded to Lead Company

	Direct Business	Reinsurance Assumed		Reinsurance Ceded		Net Prem Written
		From affil.	From non-affil.	To affil.	To non-affil.	
Company X	10	7 (b)	0	10	0	7
Company Y	20	14 (c)	0	20	0	14
Company Z	40	30 (a)	0	21	0	49

(a)  $\$30 = \$10 \text{ from X} + \$20 \text{ from Y}$

(b)  $\$7 = 10\% \times \$70$

(c)  $\$14 = 20\% \times \$70$

Schedule P is also impacted by the pooling, but special rules apply. Schedule P requires members of an intercompany pool to ignore the separate cessions to the lead company and assumptions from the lead company. Instead, these pool members are required to first determine the Schedule P for the pool as a whole, and then apply their pool percentage to the pool's Schedule P. They are then required to report this scaled down version of the total Schedule P, instead of reflecting the individual cessions and assumptions between pool members.

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<sup>6</sup> Some of the business that Z is ceding to X and Y was first assumed by Z, and hence, the subsequent cede of that premium is technically a retrocede. For example, of the \$10 million in premium that Z assumed from insurer X, Z will be (retro)ceding a portion back to X and a portion to Y. The Annual Statement schedules and exhibits do not distinguish between cedes of direct business and retrocedes of assumed business.

*Illustration:* Insurers X, Y and Z would report the following in their Schedule P, Part 1. (Assume that the written premium is the same as earned premium in the prior example.)

	Direct & Assumed	Ceded	Net
Pool total	70	0	70
Insurer X	7	0	7
Insurer Y	14	0	14
Insurer Z	49	0	49

Intercompany pooling agreements vary in their treatment of outside reinsurance and the types of business included in the agreement.

- Cessions to (and assumptions from) unaffiliated insurers may occur before or after intercompany pooling.
- Some agreements may exclude certain policies or lines of business from the pool, because they cover business the insurance group wishes to retain in one affiliate.

## Note F. Structured Settlements

Some claim settlements for certain lines, particularly workers compensation and general liability, have historically involved the insurer purchasing an annuity on behalf of the claimant, with the claimant being the beneficiary of the annuity. The amount paid for the annuity is recorded as a paid loss, and the associated claim file is typically treated as “closed.” But sometimes the insurer is contingently liable if the annuity provider ever defaults on the annuity payment. This Note requires disclosure of the remaining amount of the liability on those structured settlements where the insurer is still contingently liable, in the event that the annuity company defaults.

This disclosure can uncover a significant source of off-balance sheet risk for an insurer, whereby a property/casualty insurer has significant credit-risk exposure to a life insurer. (The actual amount of risk exposure, however, would depend on the extent to which the annuity would be covered by guarantee funds and other factors such as the treatment of such contracts by the state regulators supervising the troubled annuity company.)

Besides requiring disclosure of the total amount of these contingent liabilities, the Note also requires a breakout by annuity company wherever the total attributable to a single annuity company exceeds 1% of surplus. This disclosure includes the location of the annuity company, and whether or not it is licensed in the insurer’s domiciliary state. This additional information would presumably aid the domiciliary regulator in any investigation of the credit risk associated with that annuity company.

The instructions require disclosure of that amount that an insurer would set up as a reserve if it had to take over these annuity payments. In practice, insurers obtain this information from the annuity companies themselves. As such, these amounts are probably reported on a discounted basis for most companies. (Note that these annuities would qualify as “tabular” claims if they were reserved directly by the insurer.)

*Illustration:* In settlement of a commercial general liability policy with a \$1 million limit, insurer ABC (domiciled in CA) agrees to buy an annuity from annuity company DEF (domiciled in PA) for \$900,000 that will pay \$5 million to the claimant over the next 40 years. Insurer ABC is contingently liable to the claimant if annuity company DEF ever misses an annuity payment. At the end of the following year,

annuity company DEF reports to insurer ABC that its current reserve for this liability is \$3 million. Insurer ABC has only one other contingent liability (with a different annuity company), totaling \$100,000. Insurer ABC has a total surplus of \$50 million. The Structured Settlement Note for insurer XYZ includes the following:

Loss reserves eliminated by annuities: \$3.1 million

Included in the above are the following annuity company exposures for which the total amount is greater than 1% of surplus

<u>Annuity Company and location</u>	<u>Licensed in CA?</u>	<u>Amount</u>
DEF Annuity Company, Philadelphia, PA	Yes	\$3 million.

## Note G. Premium Deficiency Reserves

This Note requires disclosure as to the amount of such reserves (if any), and whether investment income was considered a factor in the premium deficiency reserve calculation.

The purpose of premium deficiency reserves (PDRs) is to recognize losses in advance (i.e., negative earnings) when the unearned premiums are too low to cover the costs associated with the unexpired portion of premium, rather than waiting for the loss to appear as the premium is earned. The statutory accounting rules require that this calculation be done at a relatively aggregated level, not an individual state/product line basis. The formula also does not include overhead expenses in the runoff calculation. The aggregated level of the calculation, plus the exclusion of overhead costs make the triggering of a PDR relatively rare. Therefore, the existence of a non-zero PDR may be viewed as a significant item by a reviewer of the financial statement.

This instruction requires disclosure of “whether investment income was considered a factor in the [PDR] calculation.” The PDR reserve only is non-zero when a deficiency exists (it cannot be negative), so it operates more as a “pass/fail” test, with a non-zero only during a “failure.” Given this “pass/fail” nature, some calculation methodologies are set up to apply simple calculations first using conservative assumptions (such as not reflecting investment income) to see if a zero PDR can be justified. If the simplified approaches do not produce a zero PDR, more complex assumptions are incorporated until either a zero PDR is proven, or a non-zero PDR amount is calculated. If this approach potentially incorporates investment income under the more complex assumptions, then the insurer would disclose that “investment income was considered a factor,” even if it was not used at that report date to justify a zero PDR.

If a company disclosed that it does not incorporate investment income as a factor, then it cannot start to do so without making a change to its “accounting policy,” which requires separate disclosure and perhaps restatement of prior year’s reports.

## Note H. High Deductibles

The purpose of this note is to report on a source of potential credit risk to the insurer, not otherwise evident in the financial statement.

For certain commercial liability and workers compensation policies, the claims arrangement is such that the insurer pays the full claim and then seeks reimbursement from the insured for the deductible. (These policies are sometimes called “High Deductible” or “Large Deductible” policies. They are also more common for larger commercial insureds than smaller commercial insureds.) This creates a credit-risk exposure for the insurer, as it may end up paying a claim and then not being able to successfully collect the reimbursement from the insured.

This Note requires disclosure of the two categories of this credit risk exposure—those related to outstanding losses that will generate a deductible billing and those related to claims already paid but for which the deductible is not yet collected. This Note requires both those amounts to be reported but does not require disclosing the source (i.e., the counterparties) underlying this exposure.

*Illustration:* Insurer ABC sold a high-deductible workers compensation policy to Corporation DEF, and has done so for five years. At year end 20XX, there were case reserves of \$10 million for this account, with \$7 million of this amount being subject to the deductible. There were also \$500,000 in claim payments made that are under the deductible for which the insurer has not yet collected reimbursement from Corporation DEF. The insurers claim reserves reported in the financial statement would be \$3 million, included in various schedules in the Statement such as Schedule P and the Underwriting & Investment Exhibit. In this Note, the insurer would report \$7 million of reserve credit for outstanding claims due to deductibles, and \$500,000 of recoverable amounts from claims already billed. If Corporation DEF was declared insolvent, the insurer has credit exposure of \$7.5 million on existing claims.

## Note I. Asbestos and Environmental Exposures

Since the 1980s, the US property/casualty insurance industry has seen significant adverse development associated with asbestos claims and claims associated with hazardous waste sites (environmental exposures). This disclosure is intended to identify whether or not these exposures exist for an insurer, as well as providing some initial information regarding the materiality of these exposures to an insurer’s financial position.

This Note requires “full disclosure of the reserving methodology for both case and IBNR” whenever a “company is **potentially** exposed to asbestos and/or environmental claims” [emphasis added]. .

Where such **potential** exposure exists, required qualitative disclosures include:

- lines of business affected,
- nature of the exposures, and
- reserving methodology.

In addition to the more qualitative disclosure of the reserving methodology, the following amounts must be disclosed separately for asbestos and environmental, and separately for direct, assumed, and net of reinsurance.

- Beginning loss & LAE reserves
- Incurred loss & LAE
- Calendar year paid loss & LAE
- Ending loss & LAE reserves

These amounts must also be disclosed for the last five years, not just the most recent year. (For example, the 2009 disclosure would show these amounts for 2005-2009, separately by year, separately for direct, assumed, and net.)

The Note also requires separate disclosure of the Bulk + IBNR and the LAE components for the most recent year-end asbestos and environmental reserves.

This Note should **not** include amounts from policies written specifically to cover asbestos and/or environmental exposures, such as from asbestos abatement policies and Pollution Legal Liability policies. Therefore, the entries on this footnote most often relate to older policy years, before policy exclusions for these items became common, and before specific policy language became the norm for when a policy was designed to explicitly cover these risks.

The term “environmental” is potentially subject to multiple interpretations. For example, some may want to include past pollution claims in the definition (e.g., pollution resulting from amounts spilled from a truck carrying hazardous waste). For this reason, the term “environmental loss” is explicitly defined in this note to mean:

*“Any loss or potential loss (including third-party claims) related directly or indirectly to the remediation of a site arising from past operations or waste disposal.”*

## GENERAL INTERROGATORIES

Besides the Notes, the statutory annual statement also has a section with various questions (“interrogatories”) for which the company has to disclose its answers. There are two parts to these interrogatories. Part 1 is for “Common Interrogatories”, i.e., interrogatories that have to be answered by Life, Health and Property/Casualty insurers. Part 2 is for interrogatories that are specific to a certain class of insurer. Part 2 for Property/Casualty companies is titled “Property and Casualty Interrogatories.”

A major interrogatory of interest to casualty actuaries is Interrogatory #9 (per the 2010 Annual Statement). Interrogatory #9 is designed to track a company’s use of finite risk reinsurance. This disclosure was created in response to various scandals and related regulatory actions regarding finite risk reinsurance in the industry.

Interrogatory #9.1 requires disclosure<sup>7</sup> of ceded reinsurance contracts with a significant impact on surplus and with one or more of the following features:

- Contract term over two years long and noncancellable
- Limitations on cancellation that trigger additional obligations if canceled
- Aggregate stop loss reinsurance
- Unilateral rights on both sides to cancel (except for credit risk reasons)
- Permitted reporting of losses less frequently than quarterly
- Features designed to delay the timing of reimbursement to the ceding company

This list of features was necessary due to the lack of a universally accepted definition of “finite risk.” It attempts to describe the common features of the contracts that gave rise to the finite risk reinsurance concerns.

Interrogatory #9.2 requires disclosure<sup>8</sup> of ceded reinsurance contracts with a significant impact on surplus that do not contain any of the features listed above, but:

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<sup>7</sup> The actual disclosure is outlined in interrogatory #9.3, but it is triggered by a “yes” response to interrogatory #9.1.

<sup>8</sup> The actual disclosure is outlined in interrogatory #9.3, but it is triggered by a “yes” response to



- represent 50% or more of the premium assumed by the reinsurer, or
- have 25% or more of the premium ceded to the reinsurer being retroceded back to the ceding company or an affiliate of the ceding company.