19. (3.25 points)

The following information is available for an insurance company (all figures are in millions of dollars):

	As of December 31, 2013
Statutory policyholders' surplus	122
Statutory gross loss and LAE reserves	46
Statutory ceded loss and LAE reserves	22
Statutory gross unearned premium reserve	57
Statutory ceded unearned premium reserve	30
Provision for reinsurance	1.3
Deferred acquisition cost asset	18

a. (1.25 points)

Calculate the company's 2013 surplus on a GAAP basis.

b. (2 points)

Briefly describe how each of the following items differs in its treatment under GAAP and SAP.

- Structured settlements
- Discounting of loss reserves
- Retroactive reinsurance
- Deferred tax assets

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QUESTION 19	
TOTAL POINT VALUE: 3.25	**LEARNING OBJECTIVE: C3**
SAMPLE ANSWERS	

Part a: 1.25 points

Sample 1:

Statutory Surplus + Provision for Reinsurance + DAC Asset = GAAP-Adjusted Surplus
122,000,000 + 1,300,000 + 18,000,000 = 141,300,000

Sample 2:

Assuming management's best estimate of uncollectible reinsurance is equal to the provision for reinsurance, Statutory Surplus + DAC Asset = GAAP-Adjusted Surplus
122,000,000 + 18,000,000 = 140,000,000

Part b: 2 points

Structured Settlements:

SAP:

- When a full release is signed by the claimant upon agreement to settle for the future annuity payments, the purchase price of the annuity is recorded as a paid loss and the claim is closed.
- When a full release is not provided to the insurance company by the claimant, accounting under SAP is the same as when a full release is obtained, but requires that the insurance company disclose the amount of these contingent liabilities in the Notes to Financial Statements
- When the reporting entity is the owner and payee, no reduction shall be made to loss reserves. The annuity shall be recorded at its present value and reported as an other than invested asset.
- When the claimant is the payee, loss reserves shall be reduced to the extent that the annuity provides for funding of future payments. The cost of the annuities shall be recorded as paid losses.

GAAP:

- When a full release is signed by the claimant upon agreement to settle for the future annuity payments, the purchase price of the annuity is recorded as a paid loss and the claim is closed.
- When a full release is not provided to the insurance company by the claimant, GAAP treats the structured settlement like a reinsurance contract, thus retaining the loss reserve and establishing an equivalent reinsurance recoverable.

Discounting of Loss Reserves:

SAP:

- With the exception of fixed and reasonably determinable payments such as those emanating from workers' compensation tabular indemnity reserves and long-term disability claims, property and casualty loss reserves shall not be discounted.
- Non-tabular discounting is less common than tabular discounting and is typically only done in specific cases where a company has been permitted by its state regulator.
- For those reserves that are tabular based, most state regulations are silent on the permitted discount rate, but typically 3.5% per annum is used. For non-tabular reserves the discount rate should be determined in accordance with Actuarial Standards of Practice

20, but capped at the lesser of: 1) the company's net rate of return on statutory invested assets minus 1.5%, 2) the current yield to maturity on a US Treasury debt instrument with a duration that is consistent to the payment of the claims.

GAAP:

- With the exception of fixed and reasonably determinable payments such as those emanating from workers' compensation tabular indemnity reserves and long-term disability claims, property and casualty loss reserves shall not be discounted.
- GAAP indicated that it is permissible to apply the same discount calculated under SAP for US GAAP purposes. It also indicates that an alternate discount rate could be used, as long as the alternative rate "is reasonable on the facts and circumstances applicable to the registrant at the times the claims are settled."

<u>Retroactive Reinsurance</u>

SAP:

- SAP requires that undiscounted ceded reserves be recorded as a negative write-in liability.
- Any gain to the ceding company (excess of the negative write-in liability over the consideration paid for the reinsurance) is treated as a write-in gain in other income and restricted as special surplus until the actual paid reinsurance recovery is in excess of the consideration paid.

GAAP:

- GAAP requires ceded reserves to be recorded as a reinsurance asset.
- Any gain is deferred, thereby resulting in no immediate income or surplus benefit.

<u>Deferred Tax Assets</u>

SAP:

- Under SAP there is a strict admissibility test for all DTAs.
- Only a portion of the SAP DTA is admitted, and calculated as the amount of DTA expected to reverse in the forthcoming year, plus the amount of DTA expected to reverse during a forthcoming period (beyond the initial year) limited to a percentage of surplus, plus the amount of DTA that can be offset against existing DTLs.

GAAP:

- Under GAAP DTAs are fully recognized.
- A valuation allowance is established if, based on the weight of evidence, it is more likely than not that the DTAs will not be realized.
- GAAP established a hierarchy of evidence to be considered when evaluating DTAs; this is a subjective determination requiring management to use significant judgment.

EXAMINER'S REPORT

Part a

Candidates generally performed well on this calculation. Common errors included:

- Adjusting for reserves to some degree (loss and unearned premium reserves (both ceded and gross) should not be included in the calculation because the differing accounting treatments have no net balance sheet impact)
- Not adding the deferred acquisition cost asset to the SAP policyholder surplus
- Adjusting the DAC asset for a premium deficiency reserve; however, a premium deficiency reserve could not be calculated from the data provided

• Subtracting the provision for reinsurance (this is a SAP liability, and should be added back to arrive at GAAP-adjusted surplus)
Part b
Many candidates were able to demonstrate their knowledge of the differing accounting treatments of the four items listed, particularly from a SAP perspective. Common errors included: • Structured settlements: failing to note that the signing of a release impacts the accounting treatment under GAAP and SAP • Loss reserve discounting: stating that GAAP simply allows discounting with no limitations • Deferred tax assets: confusing the DAC asset with DTAs, and assuming that under SAP DTAs are admitted for only the amount expected to reverse in the next year, when in fact the evaluation period can go beyond one year