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Accounting for loss portfolio transfers that are financing arrangements

American Institute of Certified Public Accountants. Task Force on Reinsurance Auditing and Accounting

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January 16, 1985

J.T. Ball, CPA
Financial Accounting
Standards Board
High Ridge Park
P. O. Box 3821
Stamford, CT 06905-0821

Dear J.T.:

Attached is proposed guidance on accounting for loss portfolio transfers that are financing arrangements. The guidance was prepared by the Reinsurance Auditing and Accounting Task Force of the AICPA Insurance Companies Committee, and it has been approved by the Accounting Standards Executive Committee for submission to the FASB for its consideration.

The proposed guidance describes loss portfolio transfers, provides certain conditions which, if not met, should cause the transaction to be considered a financing arrangement, and describes the accounting by ceding and assuming companies for financing arrangements.

The proposed guidance was developed as part of a broader project to consider accounting and reporting issues for reinsurance transactions. Those issues include, among others, the transfer of risk and gain and loss recognition under reinsurance transactions. Because loss portfolio transfers have recently become more common, and because concern has been expressed about current accounting practices for loss portfolio transfers that, in substance, are financing arrangements, we believe that guidance on this particular issue is needed at this time. The guidance addresses only accounting for financing arrangements. The task force and the Insurance Companies Committee will continue their project to develop guidance on accounting for reinsurance.

The proposed guidance is based on paragraph 40 of FASB Statement No. 60, "Accounting and Reporting by Insurance Enterprises." However, because the proposed guidance is more specific than the existing standard, AcSEC recommends that guidance on this issue by the FASB be effective for transactions entered after December 31, 1984.

Representatives of the Accounting Standards Division or of the Insurance Companies Committee will be happy to assist the Board or its staff with this matter at your convenience.

Sincerely,

Roger mej

Roger Cason, CPA
Chairman
Accounting Standards
Executive Committee

RC:rj
Attachment

cc: Accounting Standards Executive Committee
Task Force on Reinsurance Auditing and
Accounting (3164)

ACCOUNTING FOR LOSS PORTFOLIO TRANSFERS THAT ARE FINANCING ARRANGEMENTS

Concern has been expressed relating to certain loss portfolio transfer agreements being entered into by some insurers. These are agreements whereby, under their present accounting practices, insurers (ceding companies) have recognized current gains as the result of payment to other insurers (assuming companies) for undertaking loss obligations already incurred in excess of the consideration paid. The characteristics of many of these agreements are such that, in substance, they are not reinsurance, but rather are financing arrangements (for example, the arrangements are such that the present value of the consideration paid by the ceding company and the present value of the scheduled reimbursement under the agreement, at current interest rates, are substantially equivalent). Such agreements should be considered financing arrangements unless they meet <u>all</u> of the following conditions:

a. The agreement should provide for the assuming company to reimburse the ceding company currently on payment of covered losses by the ceding company; such reimbursement should be made at least annually. The agreement should not include provisions that specify the amounts to be reimbursed at fixed or determinable future dates, nor should it include predetermined payment schedules, delayed payment clauses, or formulas that, in substance, delay reimbursements to the ceding company.

b. The consideration to be paid by the ceding company (net of commissions, if any) should be a fixed amount specified in the agreement. The agreement should not include provisions that require or permit the payment, directly or indirectly, of additional consideration by the ceding company to the assuming company. The agreement may include provisions that permit the ceding company to participate in the ultimate profit, if any, of the assuming company.

c. The agreement should constitute the entire understanding between the parties and should not provide financial guarantees to the assuming company either directly, indirectly, or by side agreement.

d. The agreement should not include cancellation provisions that would result in a loss to the ceding company on cancellation.

e. The agreement should provide for the indemnification of the ceding company by the assuming company against loss or liability (see FASB Statement No. 60, paragraph 40).

Under generally accepted accounting principles, the ceding company should account for financing arrangements as follows:

- The consideration paid by the ceding company should be recorded as a deposit, and

- The difference between the consideration paid by the ceding company and the estimated amounts to be returned under the agreement should be recognized in investment income over the period specified in the agreement (or, if no period is specified, over the expected repayment period) using the interest method (see APB Opinion No. 21, paragraph 15).

If the agreement provides for the ceding company to participate in the ultimate profit, if any, of the assuming company, the ceding company should not recognize such amounts in income until they are realized.

Under generally accepted accounting principles, the assuming company should account for financing arrangements as follows:

- The consideration received by the assuming company should be recorded as a liability, and

- The difference between the consideration received and the estimated amount to be paid by the assuming company under the agreement should be recognized as investment expense over the period specified in the agreement (or, if no period is specified, over the expected payment period) using the interest method (see APB Opinion No. 21, paragraph 15).