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NAIC Nine-Month Contract Signing Provisions
“If it’s not signed, it’s not Reinsurance!”

Background

Effective January 1, 1994, the National Association of Insurance Commissioners (“NAIC”) amended Chapter 22 of the Accounting Practices and Procedures Manual for property/casualty insurance companies to require that prospective reinsurance contracts must be finalized, reduced to written form and signed by both parties (cedent and reinsurer) within nine months of the effective date; otherwise, retroactive accounting treatment will be required.

The principal reason for this requirement, known as the “nine-month rule”, may have evolved from concerns raised by state examiners and liquidators who found little documentation for some multi-million dollar agreements. Signed slips were found to lack substance and details in the settlement of any claims or other contractual issues.

The regulators have been unwavering in their position and are expected to follow the rule to its strictest form, with no maneuverability. Accordingly, compliance with this provision is a regulatory issue....and an administrative undertaking.

What will be the impact of non-compliance?

Retroactive accounting treatment impacts both the ceding company and the assuming company. The underwriting results and operating ratios, are more adversely impacted on the ceding company since the consequence of non-compliance is to reverse the benefit of reinsurance.

Retroactive accounting treatment for non-compliance of the nine-month rule may have an adverse impact to the following:

- Underwriting results, both underwriting income and operating ratios. Results can be affected on an even greater basis, if long-term casualty business is written.
- Loss reserves are increased for ceding companies.
- Reduced availability of unassigned surplus for dividends of ceding companies.
- Effect on risk-based capital with potential exposure to rating agency issues.
- Potential tax-ramifications from increase or decrease in reserves for statutory purposes.
- On one and two year statutory reserve development and other IRIS ratios.
- Assuming company’s marketing position can be greatly hindered by lack of compliance.
- As respects a ceding company with a small capital base, where reinsurance is a major part of its funding, could diminish its business opportunities.

- Additional administrative workload for both ceding and assuming companies, such as GAAP (Generally Accepted Accounting Principles) vs. STAT (Statutory Accounting Principles) reconciliations, keeping duplicate worksheets for GAAP and STAT, for regulatory purposes, and the preparation of the ten-year reserve development triangle for gross and ceded reserves.

How is BRMA addressing the Nine-Month Rule?

A joint sub-committee at BRMA, comprised of members from the Accounting and Contract Wording Committees, was formed to examine the Nine-Month Rule and to communicate information regarding the provisions, the impact these provisions will have on the ceding companies, assuming companies and intermediaries, and to offer suggestions on how BRMA members can work to ensure compliance with these provisions. The topics discussed in this paper include:

- The contracts impacted by these provisions.
- Exemptions from these provisions.
- Determining the date the contract was entered into.
- The financial statement impact of non-compliance from both the ceding company and assuming company perspective.
- Issues in interpreting and applying these provisions.
- Suggestions on how BRMA members can help ensure compliance with these provisions.

What contracts are impacted by the Nine-Month Rule?

- The NAIC Nine-Month Rule applies to contracts entered into, renewed or amended on or after January 1, 1994. This means that new/renewal reinsurance contracts written on and after that date, as well as endorsements to contracts that inception prior to that date, will be subject to these provisions.

What are the exemptions to the Nine-Month Rule?

- Facultative reinsurance contracts.
- Contracts with more than one reinsurer where the lead has signed the contract within nine months after the commencement of the reinsurance contract.
- Contracts with more than one reinsurer where more than 50% of the capacity on the contract have signed, within nine months after the commencement of the reinsurance contract, placement slips, cover notes or other similar documents describing the essential terms of the exclusion. **This exemption does not apply to contracts entered into, renewed or amended January 1, 1997 and subsequent.**

- Business assumed by a U.S. reinsurer where either the lead reinsurer or majority of the capacity is domiciled outside the U.S. and is not affiliated with the U.S. reinsurer. **Note that this exemption is worded to apply specifically to the U.S. reinsurer - this exemption does not apply to the ceding company.**
- All of the ceding insurers are domiciled outside of the U.S. and are not affiliated with the reinsurer.
- Unsigned contracts where one of the parties is in conservation, rehabilitation, receivership or liquidation proceedings.

How is the date the reinsurance contract was entered into determined?

- It is not uncommon for the reinsurance arrangement to be initiated before the beginning of a policy period but not finalized until after the policy period begins. Whether there was agreement in principle at the beginning of the policy period and, therefore, the contract is substantively prospective must be determined based on the facts and circumstances. For example, a contract may be considered to have been substantively entered into even though regulatory approval of that contract has not taken place.

The absence of agreement on significant terms, or the intention to establish or amend those terms at a later date based on experience or other factors, generally indicates that the parties to the contract have not entered into a reinsurance contract, but rather have agreed to enter into a reinsurance contract at a future date. If contractual provisions under a contract substantively entered into at a future date covered insurable events prior to that date, that coverage is retroactive.

In any event, Chapter 22 provides that if a contract (with the exceptions noted above) has not been finalized, reduced to written form and signed by the parties within nine months after its effective date it is presumed to be retroactive.

What is the impact of non-compliance for both a ceding company and an assuming company?

- Neither company will be allowed to treat the contract as PROSPECTIVE REINSURANCE. Therefore, the underwriting results of both the ceding and assuming companies will not reflect the effects of the transaction. The regulators will instead nullify the coverage period underlying the contract and will treat the entire contract as retroactive.

The statutory accounting and reporting effects of non-compliance are highlighted as follows:

- The ceding company must record, without recognition of the retroactive reinsurance, its loss and loss expense reserves on a gross basis on its balance sheet and in all respective statutory filings.
- The assuming company must exclude the retroactive reinsurance from its loss and loss expense reserves and from its schedules and exhibits.

- The ceding company and the assuming company must report by write-in item on Page 3 of the Annual Statement, the total amount of all retroactive reinsurance, identified as “retroactive reinsurance reserved ceded or assumed.” recorded as a contra-liability by the ceding company and as a liability by the assuming company.
- The ceding company must, by write-in item on Page 3, restrict surplus resulting from any retroactive reinsurance as a special surplus fund, designated as “special surplus from retroactive reinsurance account.”
- The surplus gain from any retroactive reinsurance may not be classified as unassigned funds [considered earned surplus] until such time as the actual retroactive reinsurance recovered is in excess of the consideration paid.
- The special surplus from retroactive reinsurance, account for each respective retroactive reinsurance contract shall be reduced at the time the ceding company begins to recover funds from the assuming company in accounts exceeding the consideration paid by the ceding company under such agreement, or the account is adjusted as provided in paragraph below.
- For each agreement, the reduction in the “special surplus from retroactive reinsurance.” account must be limited to the lesser of (a) the actual amount recovered in excess of consideration paid or (b) the initial surplus gain resulting from the respective retroactive reinsurance contract. Any remaining balance in the “special surplus from retroactive reinsurance,” account derived from any such agreement must be returned to unassigned funds upon elimination of all policy obligations subject to retroactive reinsurance contract.
- The ceding company shall report the initial gain arising from a retroactive reinsurance transaction (i.e., the difference between the consideration paid to the reinsurer and the total reserves ceded to the reinsurer) as a write-in item on Page 4 of the Annual Statement, to be identified as “Retroactive Reinsurance Gain” and included under “Other Income” in the Underwriting and Investment Exhibit Statement of Income.
- The assuming company shall report the initial loss arising from a retroactive reinsurance transaction, as defined in the preceding bullet point, as a write-in item on Page 4, to be identified as “Retroactive Reinsurance Loss” and included under “Other Income” in the Underwriting and Investment Exhibit Statement of Income.
- Any subsequent increase or reduction in the total reserves ceded under a retroactive reinsurance agreement shall be reported in the manner described in the preceding paragraphs, in order to recognize the gain or loss arising from such increase or reduction in reserves ceded. The “Special Surplus from Retroactive Reinsurance Account” write-in entry on Page 3 and the pertinent entry in the Notes to Financial Statement shall be adjusted, upward or downward, to reflect such increase or reduction in reserves ceded. The “Special Surplus from Retroactive Reinsurance Account” write-in entry must be equal to or less than the total ceded reserves under all retroactive reinsurance agreements in-force as of the date of the financial statement. Special surplus arising from a retroactive reinsurance transaction shall be considered to be earned surplus (i.e., transferred to Unassigned Funds) only when cash recoveries from the assuming company exceed the consideration paid by the ceding company as respects such retroactive reinsurance transaction.
- Each retroactive reinsurance contract shall be included in the Notes to Financial

Statements relating to “Retroactive Reinsurance.”

- The consideration paid for a retroactive contract shall be reported as a decrease in ledger assets by the ceding company and as an increase in ledger assets by the assuming company as a write-in item.

Appendix A and B of this paper illustrate the statutory financial statement impact of non-compliance.

What are some issues in interpreting and applying the Nine-Month Rule?

The following issues are not addressed in the Nine-Month Rule, but it is anticipated that considerable discussion may ensue as these provisions are applied to specific contracts.

- **Endorsements**

An issue that arises when applying the provisions to contract endorsements is whether examiners will make a distinction between endorsements that alter the terms and conditions of the contract versus those that do not. For example, will an endorsement simply reflecting a change in intermediary receive the same treatment as an endorsement which changes the limit and retention of the contract? The provisions do not define what types of endorsements will be subject to review; it is suggested that a conservative approach be applied, i.e., all endorsements should be considered as being subject to these provisions.

The provisions will also impact the practice of backdated endorsements. In the past, if a revision to the contract effective from inception was determined to be required, say ten months into the contract period, the parties simply endorsed the contract. The Nine-Month Rule will impact such backdated endorsements, in that any endorsement issued more than nine months after the effective date of the amendment will automatically be considered a “retroactive” endorsement.

- **The “Lead” Reinsurer**

As discussed above, should the lead reinsurer sign its documentation within nine months of the effective date of the contract, the contract will be deemed to comply with the Nine-Month Rule. A critical issue then concerns the definition of the “lead”, since it is anticipated that considerable interest will be placed by intermediaries on ensuring that the lead executes the document within the nine-month time frame.

Within the provisions the lead reinsurer is defined as “the reinsurer setting the terms of the contract for the reinsurers.” In that several reinsurers may have had a role in setting the terms of the contract, which of these reinsurers constitutes the “lead”, or are all such reinsurers the “lead”? In such instances would the reinsurer with the largest percentage participation be deemed the “lead”? Another related scenario is a contract placed with both a London and Domestic market lead. Again, will both “leads” need to sign the document within nine months, or is the execution by only one “lead” sufficient for the provisions?

What are some suggestions for Ensuring Compliance with the Nine-Month Rule?

A significant challenge for the broker channel is to ensure there is compliance with the Nine-Month Rule. Some of the issues/suggestions involved in ensuring compliance are:

Reporting

Due to the possibility of multiple reinsurers on a contract, reporting the status of compliance will be of interest to all reinsurers on the contract, each reinsurer (unless they are the lead reinsurer) will not know whether the other reinsurers have executed the contract, and therefore whether the contract has complied with the provisions. As intermediary is in the position of knowing the signing status of the ceding company and all assuming companies, it is reasonable to expect that the intermediary will play a major role in communicating when/if a particular contract has met compliance with the Nine-Month Rule. It is strongly suggested that intermediaries develop procedures and reporting systems to track the documentation signing process and to report to assuming companies those contracts that have not complied.

Accelerating the Document Process

Accelerating the process of drafting, reviewing and executing documentation can help ensure compliance with the Nine-Month Rule:

- Submitting draft documentation early in the placement process. By submitting documentation early in the process, the parties have the opportunity to review the document and resolve any issues during the placement when the terms and conditions are fresh in everyone's minds. This will result in a faster turnaround of executed documentation.
- Using BRMA clauses and/or intermediary specific clauses on placement slips and draft wording to accelerate the documentation process by enabling the parties to "pre-approve" clauses.
- Submitting intermediary specific clauses that are substantively different from existing BRMA clauses and in common use to the BRMA Contract Wording Contract Committee for inclusion in the BRMA Contract Wording Reference Book.
- Submitting contract documentation to all parties at once, rather than the customary process of sending documentation to the ceding company first, then to assuming companies once the ceding company has signed the document, will reduce the lag time in getting documentation to the reinsurers and improve overall turnaround time.
- Moving toward electronic submission, exchange and signing of contract documentation.

APPENDIX A

Example of Impact of Non-Compliance on a Ceding Company's Statutory Financial Statements

ABC Company (ceding company) enters into a reinsurance agreement with XYZ Company (assuming company) effective January 1, 19x1. ABC Company determined that the contract meets the risk transfer provisions of Chapter 22 and qualifies for treatment as reinsurance (prospective) accounting as of January 1, 19x1. In this example, ABC Ceding Company made premium payments to XYZ Assuming Company for \$400. ABC Company reported gross reserves of \$2,600 and ceded loss reserves of \$500, related to this contract.

Column A illustrates the accounting for the transaction of reinsurance; thereby benefiting the underwriting results. The presumption at the beginning of the year is that all significant provisions of the agreement are in place and there is a reasonable basis for accruing amounts in the financial statements. Column B illustrates the adjustment, which would occur to the extent the agreement, was not signed/finalized within the prescribed nine-month period. As the example illustrates the benefit from the reinsurance is reversed from underwriting and recorded "below the underwriting line" as other income. Column C illustrates the treatment of the transaction or "retroactive" reinsurance, after considering the adjustments recorded in Column B. To the extent that the nine-month period overlaps two calendar years (i.e., a contract incepting April 1 or later) the adjustment will be recorded in a different year.

APPENDIX A

**ABC Ceding Company
INCOME STATEMENT
(In thousands)**

	(A) Nine-Months Ending 9/30/19x1	(B) Impact of 9-Month Rule (10/1/19x1)	(C) Adjusted Nine-Month Ending 9/30/19x1
<u>Premiums</u>			
Gross premiums written	\$4,000	-	\$4,000
Ceded premiums written	(400)	\$400	-
Net premiums written	3,600	400	4,000
Gross premiums earned	4,000	-	4,000
Ceded premiums earned	(400)	400	-
Net premiums earned	3,600	400	4,000
<u>Expenses</u>			
Gross claims and claims expense	2,600	-	2,600
Ceded claims and claims expense	(500)	500	-
Net claims and claims expenses	2,100	500	2,600
Commissions expenses	600	-	600
Operating expenses	500	-	500
Total underwriting expenses	3,200	500	3,700
Net U/W Gain(Loss)	400	(100)	300
Investment income	250	-	250
Other income (retroactive reinsurance gain [1])	-	100	100
Pretax Net Income [2]	\$650	\$0	\$650
<u>Composite Ratio</u>			
Losses	58.3%	6.7%	65.0%
Expenses	30.6	(3.1)	27.5
Total	88.9%	3.6%	92.5%

NOTE

(1) The gain arising from the retroactive reinsurance transaction is the difference between the ceded premiums paid and the total ceded reserves recorded in the books. Any subsequent increase or decrease in the ceded reserves will be reported in the same manner. In accordance with Chapter 22, the gain is reported in "other income" with the offset in special surplus fund. The special surplus fund is reduced and is credited to unassigned at the time the ceding company begins to recover funds from the assuming company in amounts exceeding the consideration paid by the ceding company.

(2) We have excluded commission and income taxes for simplicity.

APPENDIX A

**ABC Ceding Company
BALANCE SHEET
(In thousands)**

	September 30, 19x1 Prospective	Adjustments	Adjusted September 30, 19x1
<u>Assets</u>			
Cash	\$5,700	-	\$5,700
Agent balances	2,000	-	2,000
Other	150	-	150
Total Assets	7,850	-	7,850
 <u>Liabilities</u>			
Loss Reserves:			
Gross	2,600	-	2,600
Ceded	(500)	\$500	-
Net	2,100	500	2,600
Unearned premium reserve	4,000	-	4,000
Aggregate write-in for liabilities (1)	-	(500)	(500)
Total liabilities	6,100	-	6,100
 <u>Surplus</u>			
Aggregate write-in for special surplus funds (2)	-	100	100
Capital stock	1,500	-	1,500
Unassigned funds	650	(100)	550
Total Surplus	\$2,150	\$0	\$2,150
Total Liabilities and Surplus	\$7,850	\$0	\$7,850

(1) Details of Aggregate write-ins.

Retroactive Reinsurance reserve Ceded: \$500

(2) See note (1) on Income Statement illustration for ABC Ceding Company.

NOTE: The reserves are not earned until actual liabilities are terminated or recovered.

**Example of Impact of Non-Compliance
on an Assuming Company's Statutory Financial Statements**

This illustration identifies the accounting treatment for the reinsurer, given the facts identified in Appendix A. Essentially, the accounting treatment mirrors the treatment of the ceding company to maintain accounting symmetry.

Column A illustrates the accounting for the transaction of reinsurance; thereby benefiting the underwriting results. The presumption at the beginning of the year is that all significant provisions of the agreement are in place and there is a reasonable basis for accruing amounts in the financial statements. Column B illustrates the adjustment, which would occur to the extent the agreement, was not signed/finalized within the prescribed nine-month period. As the example illustrates the benefit from the reinsurance is reversed from underwriting and recorded "below the underwriting line" as other income. Column C illustrates the treatment of the transaction or "retroactive" reinsurance, after considering the adjustments recorded in Column B.

APPENDIX B

**XYZ Assuming Company
INCOME STATEMENT
(In thousands)**

	(A) Nine-Months Ending 9/30/19x1	(B) Impact of 9-Month Rule (10/1/19x1)	(C) Adjusted Nine-Month Ending 9/30/19x1
<u>Premiums</u>			
Gross premiums written	\$5,400	(\$400)	\$5,000
Ceded premiums written	(500)	-	(500)
Net premiums written	4,900	(400)	4,500
Gross premiums earned	5,400	(400)	5,000
Ceded premiums earned	(500)	-	(500)
Net premiums earned	4,900	(400)	4,500
<u>Expenses</u>			
Gross claims and claims expense	3,500	(500)	3,000
Ceded claims and claims expense	(650)	-	(650)
Net claims and claims expenses	2,850	(500)	2,350
Commissions expenses	800	-	800
Operating expenses	650	-	650
Total underwriting expenses	4,300	-	3,800
Net U/W Gain(Loss)	600	100	700
Investment income	350	-	350
Other income (retroactive reinsurance gain)	-	(100)	(100)
Pretax Net Income [1]	\$950	\$0	\$950
<u>Composite Ratio</u>			
Losses	58.2%	(6.0)%	52.2%
Expenses	29.6	2.6	32.2
Total	87.8%	(3.4)%	84.4%

NOTE

(1) We have excluded commission and income taxes for simplicity.

APPENDIX B

**XYZ Assuming Company
BALANCE SHEET
(In thousands)**

	September 30, 19x1 Prospective	Adjustments	Adjusted September 30, 19x1
<u>Assets</u>			
Cash	\$7,000	-	\$7,000
Agent balances	3,000	-	3,000
Other	500	-	500
Total Assets	10,500	-	10,500
<u>Liabilities</u>			
Loss Reserves:			
Gross	5,500	(500)	5,000
Ceded	(1,000)	-	(1,000)
Net	4,500	(500)	4,000
Unearned premium reserve	4,900	-	4,900
Aggregate write-in for liabilities	-	500	500
Total liabilities	9,400	-	9,400
<u>Surplus</u>			
Capital stock	150	-	150
Unassigned funds	950	-	950
Total Surplus	\$1,100	\$0	\$1,100
Total Liabilities and Surplus	\$10,500	\$0	\$10,500