Basic Statutory Accounting –P&C & Life

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&
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Grange Insurance
Today’s Agenda

• Economics of Insurance
• Types of Insurance Products
• Statutory Accounting Overview
• Accounting Topics: STAT vs. GAAP
Economics of Insurance
Economics of Insurance

Profit Drivers:

- **Underwriting Gain:**
  - Premium Collected
  - Less: Losses Incurred
  - Less: Operating Expenses

- **Investment Income:**
  - Dividend and Interest Income
  - Less: Investment Expenses
  - +/- Realized Gain (Loss) from sales
  - +/- Unrealized Gain *(Loss) from change in fair value
Economics of Insurance

Risks to Profitability:

- **Underwriting Gain Pressure From:**
  - Weather and Catastrophic Events (highly unpredictable)
  - Large Losses (usually commercial property or liability)
  - Pricing Risk (under price premium given the risk)
  - Inflation Risk (increase in operating expenses)

- **Investment Income Pressure From:**
  - Interest Rate Environment (impact on interest income)
  - Health of Stock Market (exposure of ups/downs of market)
  - Cash Flow from volatile underwriting results (see above)
Economics of Insurance

Pop Quiz:

How often has the P&C Industry made an underwriting profit in the last five years?
Economics of Insurance

Pop Quiz:

**ONCE:** 2013

Severe weather from Catastrophic events drove underwriting losses in the P&C Industry in prior years (Flood, Fire, Hail/Wind, Freezing/Snow, Hurricane)
Economics of Insurance

Balance Sheet:

- Assets dominated by **Invested Assets** (Bonds, Stocks, Cash, etc.) and **Premiums Receivable**.

- Liabilities dominated by **Reserves for Unpaid Losses** and **Unearned Premium**.

- Equity or Surplus, includes gain/loss from operations (underwriting and investments), as well as change in Fair Market Value, change in Deferred Tax Asset, and change in Non-admitted Assets.
Types of Insurance Products
Insurance Products – Property & Casualty

- **Personal Lines**
  - Auto
  - Homeowners
  - Renter’s insurance
  - Umbrella

- **Commercial Lines**
  - Property
  - Liability
  - Auto
  - Umbrella
  - Workers’ compensation
  - Farm
  - Medical malpractice
  - Directors & officers (D&O)
  - Errors & omissions (E&O)
Insurance Products – Life

**Individual Life Insurance (Personal)**
- Traditional (life protection only, no build up of cash value)
  - Term life
- Non-traditional (life protection + investment-type products, accumulates cash value)
  - Whole life
  - Universal life
  - Variable life
  - Deferred annuities (fixed and variable)
  - Immediate annuities

**Group Life Insurance (Business)**
- Term life products covering members of a group (life protection only)
  - Employer provided
  - Affinity groups/associations (like the AICPA)
Statutory Accounting Overview (SAP)
Insurance is regulated on a state-by-state basis in the U.S.

Insurance commissioners are charged with overseeing the financial condition (solvency) of companies in their state.

Oversight is focused on protecting policyholders and claimants of insurance companies – ensuring they receive promised benefits, which may be paid out years (even decades) after a policy term.

Perspective of regulatory oversight is quite often different than other users of company financial statements, such as: management, investors, and lenders (i.e. GAAP basis).
Background on statutory accounting

- Insurance regulators developed statutory accounting requirements that aided in the discharge of their duties – protect policyholders through monitoring of insurer solvency.

- Statutory Accounting Principles (SAP), generally speaking, weren’t designed to relate to the traditional “going concern” concepts that exist under Generally Accepted Accounting Principles (GAAP).

- Under SAP:
  - Emphasis is placed on measuring and evaluating an insurer’s balance sheet (monitor financial condition as of a point in time).
  - The adequacy of statutory surplus is of primary concern, as adequate amounts of surplus = protection for policyholders.

- SAP may be referred to as a “liquidation basis” of accounting, as regulators seek to evaluate the balance sheet to determine if enough funds exist to pay current & future policyholder benefits.
Background on statutory accounting

- The cornerstone of solvency management by regulators financial reporting by insurance companies (using SAP).

- Three key statutory accounting concepts under SAP are:
  - **Conservatism** – financial reporting by insurance companies requires the use of estimates and judgment by management. To maintain a margin of protection for policyholders, conservative valuation procedures should be applied when developing estimates.
  - **Consistency** – accounting rules should be applied consistently over time to provide regulators meaningful, comparable financial information to assess solvency.
  - **Recognition** – proper recording of assets, liabilities, revenues, and expenses are critical to assessing the financial health of insurance companies. Example: assets not available to pay policyholder benefits are excluded from the insurer’s balance sheet (charged off against surplus).
Statutory accounting

- The National Association of Insurance Commissioners (NAIC)
  - Formed by the state commissioners of insurance in order to achieve greater uniformity both in the laws and their administration, and to recommend legislation to state legislatures.
  - States adopted the Manual in whole, or in part*, as an element of prescribed SAP in the states.
  - *If state laws, regulations, and administrative rules differ from the guidance provided in the Manual, they take precedence.*
# Statutory accounting

## NAIC Statutory Hierarchy
- Does not preempt state legislative or regulatory authority

<table>
<thead>
<tr>
<th>Level</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Level 1</td>
<td>The Statements of Statutory Accounting Principles (SSAPs), including GAAP reference material to the extent adopted by the NAIC (i.e. in the “manual”)</td>
</tr>
<tr>
<td>Level 2</td>
<td>Consensus positions of the Emerging Accounting Issues Working Group as adopted by the NAIC</td>
</tr>
<tr>
<td>Level 3</td>
<td>NAIC annual statement instructions and Purposes and Procedures Manual of the NAIC Securities Valuation Office</td>
</tr>
<tr>
<td>Level 4</td>
<td>Statutory Accounting Principles Statement of Concepts</td>
</tr>
<tr>
<td>Level 5</td>
<td>Other sources of nonauthoritative GAAP accounting guidance and literature</td>
</tr>
</tbody>
</table>
Statutory accounting

- Prescribed Statutory Accounting Practices (SAP)
  - Non-standard accounting practices (deviations from SAP) required by state regulators that are incorporated in state laws, regulations, and/or general administrative rules; applicable to all insurance companies domiciled in a particular state.

- Permitted Statutory Accounting Practices
  - Not prescribed, but deviations from SAP that are allowed by the domiciliary state regulator. An insurer may request permission from the regulator to use a specific accounting practice in the preparation of its statutory financial statements if either of the following occur:
    - The entity wishes to depart from SAP.
    - SAP does not address the accounting for the transaction specifically.
  - Accordingly, permitted accounting practices differ from state-to-state, may differ from entity-to-entity within a state.

Note: usage of prescribed/permitted practices is infrequent and requires disclosure.
Statutory accounting

- **Annual Statement**
  - Required by state Insurance Departments
  - Prepared as of December 31 for calendar year-ends
  - Due by March 1 for calendar year-ends (60 days after fiscal year-end)
  - Referred to often by color for insurance industry:
    - Blue book – Life
    - Green book – Separate Accounts
    - Yellow book – P&C
    - Orange book – Health
    - Pink book – Title

- **Audited statutory financial statements and required letters**
  - Issued for insurers who file Annual Statements
  - Due June 1 of following year
  - Model Audit Rule (internal control certification)
## GAAP vs. STAT differences

<table>
<thead>
<tr>
<th></th>
<th>GAAP</th>
<th>STAT</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Emphasis on:</strong></td>
<td>Investors, lenders</td>
<td>Regulators &amp; solvency of insurer (policyholder protection)</td>
</tr>
<tr>
<td><strong>Focus on:</strong></td>
<td>Income Statement and Balance Sheet – Profitability</td>
<td>Balance Sheet &amp; Surplus adequacy – Solvency</td>
</tr>
<tr>
<td><strong>Authoritative Literature:</strong></td>
<td>FASB Accounting Standards</td>
<td>NAIC Accounting Practices and Procedures Manual – Statements of Statutory Accounting Principles (SSAPs)</td>
</tr>
<tr>
<td><strong>Concept:</strong></td>
<td>Matching concept</td>
<td>Conservatism concept</td>
</tr>
<tr>
<td><strong>Output:</strong></td>
<td>GAAP financial statements, 10K &amp; 10Q (for public companies)</td>
<td>Regulatory Filings and Statutory financial statements</td>
</tr>
<tr>
<td>Financial statement account</td>
<td>GAAP treatment</td>
<td>STAT treatment</td>
</tr>
<tr>
<td>-----------------------------------------------------------------</td>
<td>-------------------------------------------------------------------------------</td>
<td>------------------------------------------------------------------------------</td>
</tr>
<tr>
<td>Acquisition costs (principally commissions and brokerage)</td>
<td>Acquisition costs are deferred and amortized over the life of the policy (deferred acquisition costs, or DAC)</td>
<td>Acquisition costs are expensed as incurred</td>
</tr>
<tr>
<td>Premiums receivable (Balances over 90 days past due)</td>
<td>Allowance provision based on judgmental analysis of collectability</td>
<td>Written-off (non-admitted) as a charge to the surplus account based on specific terms (&gt; 90 days past due)</td>
</tr>
<tr>
<td>Uncollateralized receivables from unauthorized reinsurers</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Premium for most non-traditional life products</td>
<td>Not recognized as revenue on I/S</td>
<td>Accounted for as revenue on I/S</td>
</tr>
</tbody>
</table>
### GAAP vs. STAT differences

<table>
<thead>
<tr>
<th>Financial statement account</th>
<th>GAAP treatment</th>
<th>STAT treatment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unpaid losses and LAE (P&amp;C)</td>
<td>Presented gross of reinsurance recoverables</td>
<td>Presented net of reinsurance recoverables</td>
</tr>
<tr>
<td>Life reserves</td>
<td>Typically represents a best estimate of future costs</td>
<td>Formulaic, set by actuarial guidelines established by the Actuarial Standards Board.</td>
</tr>
<tr>
<td>Equity/Policyholder surplus</td>
<td>Assets minus liabilities</td>
<td>Excess of admitted assets minus liabilities, determined in accordance with SAP</td>
</tr>
<tr>
<td>Deferred tax</td>
<td>Reflects temporary differences between carrying value and tax basis</td>
<td>Similar to GAAP, but limitations are imposed on the amount of assets that can be admitted</td>
</tr>
<tr>
<td>Nonadmitted Assets (furniture &amp; equipment, unsecured loans to agents, prepaid expenses)</td>
<td>n/a</td>
<td>Assets that are not liquid or that are unable to be readily converted to cash to pay policyholder benefits are not counted as assets (charged off against surplus)</td>
</tr>
</tbody>
</table>
Accounting Topics
Accounting topics

- Acquisition Costs (DAC)
- Investments
- Loss Reserves
- Reinsurance
- Non-admitted Assets
- Federal Income Tax
Acquisition costs

- Acquisition costs represent the expenses associated with writing new & renewal policies that vary with, and are primarily related to, the production of insurance premiums -- principally commissions, premium taxes and certain underwriting costs (like medical exams, credit reports, etc).

- On a GAAP basis only certain acquisition costs related directly to the successful acquisition of new or renewal insurance contracts are capitalized and deferred and then recognized as expense over time as related premiums are earned (matching principle).

- On a Statutory basis these costs are expensed as incurred and no deferral is allowed.
  - The funds are no longer available to pay future liabilities.
  - This creates a STAT to GAAP difference for the entire amount deferred under GAAP.
Acquisition costs - Commissions

- Recorded as a component of underwriting expenses.
- Commissions are generally incurred when policies are written (or may be incurred as premiums are received):
  - At period end, an accrual is made for incurred commissions that have not been paid to producers.
- For P&C companies, separate presentation occurs for:
  - Basic commissions and contingent commissions (profit sharing),
  - Amounts related to reinsurance ceded/assumed, and
  - Amounts incurred by state & line of business.
- For Life companies, additional presentation is made for first year and renewal business.
**Investment types**

- **Debt securities (SSAP 26)**
  - U.S. Treasury obligations
  - Municipal bonds
  - Corporate bonds
  - Redeemable preferred stock
  - Certain loan-backed or structured securities (SSAP 43R)

- **Equity securities**
  - Unaffiliated common stock & mutual fund shares (SSAP 30)
  - Non-redeemable preferred stock (SSAP 32)

- **Other Investment Types**
  - Mortgage loans (SSAP 37)
  - Real estate (SSAP 40 and 90)
  - Joint ventures and partnerships (SSAP 48, SSAP 97)
  - Subsidiary investments (SSAP 97)
  - Securities lending (SSAP 103)
Debt securities

- Subject to the valuation standards of the NAIC
  - NAIC Securities Valuation Office (SVO)

<table>
<thead>
<tr>
<th>Type of Company</th>
<th>NAIC 1-2</th>
<th>NAIC 3-5</th>
<th>NAIC 6</th>
</tr>
</thead>
<tbody>
<tr>
<td>Life</td>
<td>Amortized Cost</td>
<td>Amortized Cost</td>
<td>Lower of amortized cost or fair value</td>
</tr>
<tr>
<td>P&amp;C</td>
<td>Amortized Cost</td>
<td>Lower of amortized cost or fair value</td>
<td>Lower of amortized cost or fair value</td>
</tr>
</tbody>
</table>

- Interest Income is included in earnings in period earned; includes:
  - Cash received during the period (coupon payments)
  - Change in accrued investment income (receivable for income due)
  - Amortization of premium & discount
Equity securities

- Unaffiliated common stock
  - Reported at fair value as determined by the NAIC’s SVO or other approved sources.
  - Other analytical or pricing mechanisms (e.g., matrix or model pricing).

- Non-redeemable preferred stock

<table>
<thead>
<tr>
<th>Type of company</th>
<th>NAIC P1-P2</th>
<th>NAIC P3-P5</th>
<th>NAIC P6</th>
</tr>
</thead>
<tbody>
<tr>
<td>Life</td>
<td>Book Value (generally cost)</td>
<td>Book Value (generally cost)</td>
<td>Lower of book value or fair value</td>
</tr>
<tr>
<td>P&amp;C</td>
<td>Book Value (generally cost)</td>
<td>Lower of book value or fair value</td>
<td>Lower of book value or fair value</td>
</tr>
</tbody>
</table>
Other investment types

- Real Estate
  - Represents directly-owned real estate in one of three categories:
    - properties occupied by the company (home office real estate),
    - properties held for the production of income, or
    - properties held for sale.
  - Generally reported at cost, net of depreciation. Also always reported net of encumbrances (i.e., mortgage).
  - Parenthetical disclosures for the amount of any related encumbrance and depreciation.
Unrealized and realized gains & losses

- **Unrealized gains and losses**
  - Recorded net of taxes as a credit/charge directly to surplus.

- **Realized gains and losses**
  - Reported net of taxes in the Income Statement.

- **Asset Valuation Reserve (AVR) and Interest Maintenance Reserve (IMR)**
  - Applicable to Life companies only
  - AVR – formula-driven reserve (liability) established to offset potential credit-related investment losses on all invested asset categories.
  - IMR – defers recognition of realized capital gains and losses resulting from changes in the general level of interest rates.
Other Than Temporary Impairment (OTTI)

- All securities should be evaluated each reporting period under SAP.

- Factors to consider:
  - Length of time and extent to which the fair value is less than book value.
  - Credit condition and ratings of the issuer.
  - Financial condition and near term prospect of the issuer.
  - Performance of underlying collateral.
  - Intent and ability to retain the investment until it recovers its value.

- Impairment evaluation by type of security:
  - Bonds (SSAP 26)
    - Focus on the intent and ability to hold the security for a sufficient period to allow for a forecasted recovery in market value (including potentially to maturity).
    - Interest rate related declines – considered other-than-temporary only when the insurer intends to sell the investment before recovering its cost.
    - Credit related declines – main consideration for an other-than-temporary impairment.
  - Equity Securities (SSAP 30)
    - Cannot rely solely on intent and ability to continue holding the security indefinitely.
      - There is no maturity date for these securities.
    - Evaluation is consistent between GAAP and STAT.
P&C loss and LAE reserves

- Relevant literature: SSAP 55
  - Unpaid Losses and Loss Adjustment Expense (LAE) is normally the largest line item within the liability section of the balance sheet.
  - Large degree of management (actuarial) judgment utilized in developing assumptions and factors.
    - Various lines of business require varying degrees of management estimates.
    - Actuarial processes typically contain varying degrees of complexity in developing the estimate for various lines of business.
    - Reported case reserves vs reserves for claims incurred but not reported (IBNR).

- Liability recognized for unpaid claims and unpaid losses (reserves), unpaid LAE (change is a corresponding charge to income).

- Following components are considered in reserves:
  - Reserves for costs to administer/settle out all claims (LAE)
  - Reduction for salvage and subrogation
  - Net of reinsurance recoverables (recoverables on paid losses only)
Reinsurance

- “Insurance for insurance companies”
  - A transaction in which a reinsurer (assuming company), for a premium, assumes all or part of a risk undertaken originally by another insurer (ceding company).
  - The ceding company remains liable to insured and bears risk that the assuming company is unable to pay obligations
- Ceding Company – the direct writing company cedes a portion of the premium associated with a policy, and in return the reinsurer will cover a certain amount of potential losses.
- Assuming Company – the reinsurance company assumes the risk of paying a portion of a potential loss and receives a premium in return.
Types of reinsurance agreements

- **Proportional**
  - Quota share
  - Coinsurance
  - Yearly Renewable Term
  - Modified coinsurance (Mod Co)

- **Non-proportional**
  - Excess of Loss
  - Stop-loss

- **Facultative**
  - Each risk/policy is evaluated and reinsured individually

- **Treaty/Automatic**
  - Agreed upon portion of business/product line
Reinsurance accounting

- Relevant literature:
  - Life: SSAP 61R
  - P&C: SSAP 62R

- Financial Statements are presented net of reinsurance
  - Ceded reserves (P&C) / reserve credits (Life) are recorded as an offset to reserve for losses and LAE / policyholder benefit liabilities.
  - Ceded premium/benefits recorded as offset to premiums/policyholder benefits/incurred losses.

- Reinsurance recoverables
  - Recognized as asset only for ceded paid losses.
  - Written off if the balance is deemed uncollectible, and balances that are past due by 90 days or more are non-admitted.
  - Balances from an unauthorized reinsurer where no collateral was secured may also be non-admitted.
Non-admitted Assets

- Relevant Literature: SSAP 4

- Certain assets that are not liquid or not readily convertible to cash to pay policyholder claims are considered “non-admitted” and are not counted in assets under SAP (liquidation basis accounting) and therefore reduce Surplus.

- Examples: auto fleet, furniture, prepaid expense (includes pension), receivables > 90 days past due, loans, and portions of deferred tax assets and goodwill.

![Balance Sheet (selected lines):](image)

<table>
<thead>
<tr>
<th>Gross Asset</th>
<th>Non-Admit</th>
<th>Net Asset</th>
</tr>
</thead>
<tbody>
<tr>
<td>Premiums Receivable</td>
<td>$165M</td>
<td>$(1M)</td>
</tr>
<tr>
<td>Reinsurance Recoverable</td>
<td>$3M</td>
<td>$(1M)</td>
</tr>
<tr>
<td>Loans to Agents</td>
<td>$10M</td>
<td>$(10M)</td>
</tr>
<tr>
<td>Deferred Tax Asset</td>
<td>$38M</td>
<td>$(13M)</td>
</tr>
<tr>
<td>Furniture, Autos Equipment</td>
<td>$10M</td>
<td>$(10M)</td>
</tr>
<tr>
<td>Prepaid Expenses</td>
<td>$30M</td>
<td>$(30M)</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$256M</strong></td>
<td><strong>$(65M)</strong></td>
</tr>
</tbody>
</table>
Federal Income Tax – Current & Deferred

- Relevant Literature: SSAP 101

- As discussed in Non-admitted Assets section, SAP does not admit a certain portion of deferred tax assets (limited to 15% of surplus and temporary differences that will not reverse within 3 years).

- Presentation: Income statement includes only the current (realized) portion of federal income tax. Changes in DTA is booked directly to surplus.

<table>
<thead>
<tr>
<th>Presentation/Disclosure Example:</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>SAP:</strong></td>
</tr>
<tr>
<td><strong>Balance Sheet:</strong></td>
</tr>
<tr>
<td>Gross DTA</td>
</tr>
<tr>
<td>Non-admitted DTA</td>
</tr>
<tr>
<td>Net DTA</td>
</tr>
<tr>
<td><strong>Income Statement:</strong></td>
</tr>
<tr>
<td>Income Before Tax</td>
</tr>
<tr>
<td>Current FIT</td>
</tr>
<tr>
<td>Net Income</td>
</tr>
<tr>
<td><strong>Statement of Changes in Surplus:</strong></td>
</tr>
<tr>
<td>Beginning Surplus</td>
</tr>
<tr>
<td>Change in DTA</td>
</tr>
<tr>
<td>Ending Surplus</td>
</tr>
</tbody>
</table>

| **GAAP:**                       |
| **Balance Sheet:**              |
| DTA                              | $44M |

| **Income Statement:**           |
| Income Before Tax               | $45M |
| Current FIT                     | (7M) |
| Deferred FIT                    | (6M) |
| Net Income                      | $32M |

| **Statement of Changes in Surplus:** |
| N/A – Deferred tax flows through Income Statement |
Questions?
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