Statutory Issue Paper No. 103

Accounting for the Issuance of Insurance-Linked Securities Issued by a Property and Casualty Insurer Through a Protected Cell

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Property and Casualty

SUMMARY OF ISSUE

1. Insurance–linked securities are fully funded corporate securities with special language that requires the securityholder to forgive or defer some or all payments of interest or principal if actual insurance losses surpass a specified amount, or trigger event. Should a triggering event occur, an insurer or reinsurer that issued insurance-linked securities can pay claims with all or a portion of the securityholder proceeds. To the extent that securityholders proceeds are at risk of loss, the insurer or reinsurer can write down its liability for the securities, and recognize a surplus benefit in an equal amount.

2. Chapter 1 of the Accounting Practices and Procedures Manual for Property/Casualty Insurance Companies does not specifically address accounting for the issuers of insurance-linked securities issued through a protected cell. Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 133 - Accounting for Derivative Instruments and Hedging Activities (FAS 133) dictates that these types of contracts would be accounted for as reinsurance.

3. The purpose of this issue paper is to provide guidance for protected cells that is consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

Definitions
4. The Protected Cell Model Act (included in its entirety in the Relevant Statutory Accounting and GAAP Guidance section) includes a complete listing of definitions used in this issue paper.

General
5. An insurance-linked security can be issued by the insurer through a protected cell for purchase by investors. A protected cell is retained within the insurance or reinsurance company and is used to insulate the proceeds of the securities offering from the general business risks of the insurer, granting an additional comfort level for investors of the securitized instrument. The insurance exposures that have been securitized by the insurance-linked security are attributed to the protected cell.

6. Under the terms of the security, the principal may be paid to the investor on a specified maturity date, with interest, unless a trigger event occurs. The proceeds of the security offering will collateralize (i) the issuer's obligation under an insurance or reinsurance agreement if a trigger event occurs and (ii) the issuer's obligation to repay the security if a trigger event does not occur.
7. If the trigger event takes place before a specified date, the issuer is relieved of some or its entire obligation to repay the securityholders, and the investor incurs a loss of some or all of its investment. The security must be issued with an indemnity trigger.

8. In an insurance-linked security, the insurer that originated the transaction has hedged its portfolio of insurance risks by transferring certain of those risks to the securityholders. Should the triggering event occur, the issuer would incur a loss that would be partly offset by the amount of liability to securityholders from which it is relieved. This issue paper provides statutory accounting guidance solely for indemnity triggered insurance securitization transactions conducted through a protected cell.

Accounting for Prefunded Insurance-Linked Securities for Business Attributed to the Protected Cell from the General Account

General Account Reporting

9. Activities such as sales, underwriting and contract administration, premium collection and payment of premium taxes, and claims processing are activities of the insurance company distinct from the protected cell and shall be accounted for as transactions of the general account.

10. Amounts paid to the protected cell for underwriting risks, which ultimately will be securitized by the protected cell, shall be reported separately as a reduction of written and earned premiums in the current period general account’s statement of income. This premium is earned by the general account in accordance with Issue Paper No. 53—Property Casualty Contracts—Premiums.

11. At the maturity of the protected cell all assets and liabilities of the protected cell are distributed based on the contractual agreement with the securityholders. If after this distribution assets still reside in the protected cell, these assets shall be attributed to the general account and recognized as an adjustment to surplus.

12. Insurance claim liabilities arising from past insurable events attributed to the protected cell account from the general account shall be accounted for as retro-active reinsurance as prescribed in Issue Paper No. 75—Property and Casualty Reinsurance.

13. General account recoverables from the protected cell as a result of an indemnity based securitized event, shall be recognized separately as a reduction of gross losses and loss expenses incurred in the current period general account’s statement of income. General account recoverables from the protected cell on unpaid reported and incurred but not reported losses and loss adjustment expenses shall be netted against the liability for gross losses and loss adjustment expenses in the general account’s balance sheet. Recoverables from the protected cell shall not exceed the assets carried at fair value in the protected cell.

14. The general account shall include an aggregate write-in for the total assets and an aggregate write-in for liabilities of any protected cell which it maintains. Transfers to the general account due or accrued shall be reported on a net basis so that the asset and the liability totals of the general account are not overstated.

Protected Cell Reporting

15. The protected cell annual statement is concerned with the investment activities and obligations relating to insurance-linked securities attributed to that protected cell. As a result, the protected cell statement shall report only the financial activities of the protected cell and shall not include general account expenses related to insurance activities which are recorded for in the general account.
16. The protected cell shall record premium income for transactions attributed to it by the general account as income reported in the protected cell’s statement of income. This premium attribution is earned by the protected cell in accordance with Issue Paper No. 53—Property Casualty Contracts—Premiums.

17. The obligation from the issuance of the insurance-linked security is recorded as Funds Held Under Securitization Agreement, a liability on the protected cell balance sheet which is reported at its contractual value which will be the lower of the scheduled amount to be repaid to investors or the fair value of the investments in the protected cell. All protected cell assets shall be reported at fair value. Interest expenses payable to securityholders associated with the protected cell investment operations shall be deducted in the determination of net operating income of the cell. Net investment income and realized capital gains and losses relating to the investment operations of the protected cell are recorded as net investment income. Payables to the general account shall not exceed the assets carried at fair value in the protected cell.

18. Changes in both (i.) the fair value of the protected cell invested assets and (ii.) the protected cell contractual (or discounted) value of liabilities to investors shall be reported as an unrealized gain/loss in the equity section of the protected cell balance sheet.

19. When the trigger event occurs with respect to the underlying exposures attributed to the protected cell, the protected cell shall record the appropriate incurred losses in its current period statement of income. Correspondingly, the Funds Held Under Securitization Agreement shall be reduced and offset by gross losses incurred in the current period Statement of Income. The applicable funds to cover the subject exposure are then attributed to the general account via a balance sheet account, “Due to/from the General Account.”

20. If the trigger event does not take place on or before the contractual maturity date, the protected cell repays the bond principal as prescribed in the debt contract by reducing Funds Held Under Securitization Agreement.

Disclosures

General Account

21. Prior to the adoption of formal blanks changes by the NAIC Blanks Task Force, the general account shall reflect all activities with its protected cells as an aggregate write-in in its statutory balance sheet and income statement. The general account shall also disclose in its notes to the financial statements the types and amounts of exposures /risks attributed to each of its protected cells.

Protected Cells

22. Each protected cell of a protected cell company shall prepare and submit to all states where the protected cell company is licensed and the NAIC the following supplemental financial information:

   a. Balance Sheet
   b. Income Statement
   c. Statement of Cash Flows
   d. Investment Schedules as typically required for a property/casualty insurer
   e. Schedule P
DISCUSSION

23. This issue paper prescribes the accounting for the issuance of insurance-linked securities issued by a property and casualty insurer through a protected cell. This guidance was adopted by the Insurance Securitization Working Group of the Financial Condition (E) Committee in 1999. The Emerging Accounting Issues Working Group adopted the guidance as “NAIC Preferred Accounting Treatment” in October 1999. This issue is specifically scoped out of FAS 133, and therefore the protected cell concept is unique to statutory accounting.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

24. In October 1999, the Emerging Accounting Issues Working Group adopted as “NAIC Preferred Accounting Treatment” the issue summary titled Accounting for the Issuance of Insurance-Linked Securities Issued by a Property and Casualty Insurer through a Protected Cell. The guidance included in the Summary Conclusion section of this issue paper is consistent with the previously adopted issue summary.

Generally Accepted Accounting Principles

25. The following language is included in FAS No. 133, Accounting for Derivative Instruments and Hedging Activities:

192. Example 26: Disaster Bond. A bond that pays a coupon above that of an otherwise comparable traditional bond; however, all or a substantial portion of the principal amount is subject to loss if a specified disaster experience occurs.

Scope Application: A disaster bond can be viewed as a fixed-rate bond combined with a conditional exchange contract (an option). The investor receives an additional coupon interest payment in return for giving the issuer an option indexed to industry loss experience on a specified disaster. Because the option contract is indexed to the specified disaster experience, it cannot be viewed as being clearly and closely related to an investment in a fixed-rate bond. Therefore, the embedded derivative should be separated from the host contract and accounted for by both parties pursuant to the provisions of this Statement.

However, if the “embedded derivative” entitles the holder of the option (that is, the issuer of the disaster bond) to be compensated only for changes in the value of specified assets or liabilities for which the holder is at risk (including the liability for insurance claims payable due to the specified disaster) as a result of an identified insurable event (refer to paragraph 10.c.(2)), a separate instrument with the same terms as the “embedded derivative” would not meet the Statement's definition of a derivative in paragraphs 6–11. In that circumstance, because the criterion in paragraph 12.c. would not be met, there is no embedded derivative to be separated from the host contract, and the disaster bond would not be subject to the requirements of this Statement. The investor is essentially providing a form of insurance or reinsurance coverage to the issuer.

26. This issue paper only contemplates transactions with an indemnity-based trigger, as such they would be excluded from FAS 133 and accounting for as reinsurance under FAS 113, Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts.

Other Sources

27. The Insurance Securitization Working Group developed the following Protected Cell Model Act. Details of considerations made in drafting this model act can be found in the minutes of the working group.
PROTECTED CELL COMPANY MODEL ACT

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Section 1. Short Title
This Act may be cited as the “Protected Cell Company Act.”

Section 2. Purpose
This Act is adopted to provide a basis for the creation of protected cells by a domestic insurer as one means of accessing alternative sources of capital and achieving the benefits of insurance securitization. Investors in fully funded insurance securitization transactions provide funds that are available to pay the insurer’s insurance obligations or to repay the investors or both. The creation of protected cells is intended to be a means to achieve more efficiencies in conducting insurance securitizations.

Drafting Note: Under the terms of the typical debt instrument underlying an insurance securitization transaction, prepaid principal is repaid to the investor on a specified maturity date with interest, unless a trigger event occurs. The insurance securitization proceeds secure both the protected cell company’s insurance obligations if a trigger event occurs, as well as the protected cell company’s obligation to repay the insurance securitization investors if a trigger event does not occur. Insurance securitization transactions have been performed through alien companies in order to utilize efficiencies available to alien companies that are not currently available to domestic companies. This Act is adopted in order to create more efficiency in conducting insurance securitization, to allow domestic protected cell companies easier access to alternative sources of capital, and to promote the benefits of insurance securitization generally.

Section 3. Definitions
For the purposes of this Act, the following terms shall have the following meanings:

A. “Domestic insurer” means an insurer domiciled in the State of [insert state].
B. “Fully funded” means that, with respect to any exposure attributed to a protected cell, the fair value of the protected cell assets, on the date on which the insurance securitization is effected, equals or exceeds the maximum possible exposure attributable to the protected cell with respect to such exposures.
C. “General account” means the assets and liabilities of a protected cell company other than protected cell assets and protected cell liabilities.
D. “Indemnity trigger” means a transaction term by which relief of the issuer’s obligation to repay investors is triggered by its incurring a specified level of losses under its insurance or reinsurance contracts.
E. “Fair value” of an asset (or liability) means the amount at which that asset (or liability) could be bought (or incurred) or sold (or settled) in a current transaction between willing parties, that is, other than in a forced or liquidation sale. Quoted market prices in active markets are the best evidence of fair value and shall be used as the basis for the measurement, if available. If a quoted market price is available, the fair value is the product of the number of trading units times market price. If quoted market prices are not available, the estimate of fair value shall be based on the best information available. The estimate of fair value shall consider prices for similar assets and liabilities and the results of valuation techniques to the extent available in the circumstances. Examples of valuation techniques include the present value of estimated expected future cash flows using a discount rate commensurate with the risks involved, option-pricing models, matrix pricing, option-adjusted spread models, and fundamental analysis. Valuation techniques for measuring financial assets and liabilities and servicing assets and liabilities shall be consistent with the objective of measuring fair value. Those techniques shall incorporate assumptions that market participants would use in their estimates of values, future revenues, and future expenses, including assumptions about interest rates, default, prepayment, and volatility. In measuring financial liabilities and servicing liabilities at fair value by discounting estimated future cash flows, an objective is to use discount rates at which those liabilities could be settled in an arm’s-length transaction. Estimates of expected future cash flows, if used to estimate fair value, shall be the best estimate based on reasonable and supportable assumptions and projections. All available evidence shall be considered in developing estimates of expected future cash flows. The weight given to the evidence shall be commensurate with the extent to which the evidence can be verified objectively. If a range is estimated for either the amount or timing of possible cash flows, the likelihood of possible outcomes shall be considered in determining the best estimate of future cash flows.

F. “Non-indemnity trigger” means a transaction term by which relief of the issuer’s obligation to repay investors is triggered solely by some event or condition other than the individual protected cell company incurring a specified level of losses under its insurance or reinsurance contracts.

G. “Protected cell” means an identified pool of assets and liabilities of a protected cell company segregated and insulated by means of this Act from the remainder of the protected cell company’s assets and liabilities.

Drafting Note: This term is meant to reference identification of statutorily segregated assets and liabilities through the accounting function. By attributing certain assets and liabilities to a protected cell on the protected cell company’s books and records, and otherwise complying with the provisions of this Act, the protected cell company will receive statutory insulation of those assets and liabilities from the protected cell company’s other assets and liabilities not identified in the accounting records as attributable to the protected cell.

H. “Protected cell account” means a specifically identified bank or custodial account established by a protected cell company for the purpose of segregating the protected cell assets of one protected cell from the protected cell assets of other protected cells and from the assets of the protected cell company’s general account.

Drafting Note: This term is meant to reference a custodial account established to hold and invest protected cell assets, such that protected cell assets are also distinct and identifiable from the assets of the general account.
I. “Protected cell assets” means all assets, contract rights and general intangibles, identified with and attributable to a specific protected cell of a protected cell company.

J. “Protected cell company” means a domestic insurer that has one or more protected cells.

K. “Protected cell company insurance securitization” means the issuance of debt instruments, the proceeds from which support the exposures attributed to the protected cell, by a protected cell company where repayment of principal or interest, or both, to investors pursuant to the transaction terms is contingent upon the occurrence or nonoccurrence of an event with respect to which the protected cell company is exposed to loss under insurance or reinsurance contracts it has issued.

L. “Protected cell liabilities” means all liabilities and other obligations identified with and attributable to a specific protected cell of a protected cell company.

Section 4. Establishment of Protected Cells

A. A protected cell company may establish one or more protected cells with the prior written approval of the commissioner of a plan of operation or amendments thereto submitted by the protected cell company with respect to each protected cell in connection with an insurance securitization. Upon the written approval of the commissioner of the plan of operation, which shall include, but not be limited to, the specific business objectives and investment guidelines of the protected cell, the protected cell company may, in accordance with the approved plan of operation, attribute to the protected cell insurance obligations with respect to its insurance business and obligations relating to the insurance securitization and assets to fund the obligations. A protected cell shall have its own distinct name or designation, which shall include the words “protected cell.” The protected cell company shall transfer all assets attributable to a protected cell to one or more separately established and identified protected cell accounts bearing the name or designation of that protected cell. Protected cell assets shall be held in the protected cell accounts for the purpose of satisfying the obligations of that protected cell.

Drafting Note: Insert the title of the chief insurance regulatory official wherever the term “commissioner” appears.

B. All attributions of assets and liabilities between a protected cell and the general account shall be in accordance with the plan of operation approved by the commissioner. No other attribution of assets or liabilities may be made by a protected cell company between the protected cell company’s general account and its protected cells. Any attribution of assets and liabilities between the general account and a protected cell, or from investors in the form of principal on a debt instrument issued by a protected cell company in connection with a protected cell company securitization shall be in cash or in readily marketable securities with established market values.

C. The creation of a protected cell does not create, in respect of that protected cell, a legal person separate from the protected cell company. Amounts attributed to a protected cell under this Act, including assets transferred to a protected cell account, are owned by the protected cell company and the protected cell company may not be, nor hold itself out to be, a trustee with respect to those protected cell assets of that protected cell account. Notwithstanding the foregoing, the protected cell company may allow for a security interest to attach
to protected cell assets or a protected cell account when in favor of a creditor of the protected cell and otherwise allowed under applicable law.

D. This Act shall not be construed to prohibit the protected cell company from contracting with or arranging for an investment advisor, commodity trading advisor, or other third party to manage the protected cell assets of a protected cell, provided that all remuneration, expenses and other compensation of the third party advisor or manager are payable from the protected cell assets of that protected cell and not from the protected cell assets of other protected cells or the assets of the protected cell company’s general account.

E. (1) A protected cell company shall establish administrative and accounting procedures necessary to properly identify the one or more protected cells of the protected cell company and the protected cell assets and protected cell liabilities attributable to the protected cells. It shall be the duty of the directors of a protected cell company to:

(a) Keep protected cell assets and protected cell liabilities separate and separately identifiable from the assets and liabilities of the protected cell company’s general account and;

(b) Keep protected cell assets and protected cell liabilities attributable to one protected cell separate and separately identifiable from protected cell assets and protected cell liabilities attributable to other protected cells.

(2) Notwithstanding the foregoing, if this section is violated, the remedy of tracing shall be applicable to protected cell assets when commingled with protected cell assets of other protected cells or the assets of the protected cell company’s general account. The remedy of tracing shall not be construed as an exclusive remedy.

F. The protected cell company shall, when establishing a protected cell, attribute to the protected cell assets with a value at least equal to the reserves and other insurance liabilities attributed to that protected cell.

Section 5. Use and Operation of Protected Cells

A. The protected cell assets of a protected cell may not be charged with liabilities arising out of any other business the protected cell company may conduct. All contracts or other documentation reflecting protected cell liabilities shall clearly indicate that only the protected cell assets are available for the satisfaction of those protected cell liabilities.

B. The income, gains and losses, realized or unrealized, from protected cell assets and protected cell liabilities shall be credited to or charged against the protected cell without regard to other income, gains or losses of the protected cell company, including income, gains or losses of other protected cells. Amounts attributed to any protected cell and accumulations on the attributed amounts may be invested and reinvested without regard to any requirements or limitations of Section [insert reference applicable sections of the insurance code imposing limitations on insurance company investments] and the investments in a protected cell or cells shall not be taken into account in applying the investment limitations otherwise applicable to the investments of the protected cell company.

C. Assets attributed to a protected cell shall be valued at their fair value on the date of valuation.
D. A protected cell company shall, in respect of any of its protected cells, engage in fully funded indemnity triggered insurance securitization to support in full the protected cell exposures attributable to that protected cell. A protected cell company insurance securitization that is non-indemnity triggered shall qualify as an insurance securitization under the terms of this Act only after the commissioner, in accordance with the authority granted under Section 9 of this Act, adopts regulations addressing the methods of funding of the portion of the risk that is not indemnity based, accounting, disclosure, risk based capital treatment, and assessing risks associated with such securitizations. A protected cell company insurance securitization that is not fully funded, whether indemnity triggered or non-indemnity triggered, is prohibited. Protected cell assets may be used to pay interest or other consideration on any outstanding debt or other obligation attributable to that protected cell, and nothing in this subsection shall be construed or interpreted to prevent a protected cell company from entering into a swap agreement or other transaction for the account of the protected cell that has the effect of guaranteeing interest or other consideration.

E. In all protected cell company insurance securitizations, the contracts or other documentation effecting the transaction shall contain provisions identifying the protected cell to which the transaction will be attributed. In addition, the contracts or other documentation shall clearly disclose that the assets of that protected cell, and only those assets, are available to pay the obligations of that protected cell. Notwithstanding the foregoing, and subject to the provisions of this Act and any other applicable law or regulation, the failure to include such language in the contracts or other documentation shall not be used as the sole basis by creditors, reinsurers or other claimants to circumvent the provisions of this Act.

F. A protected cell company shall only be authorized to attribute to a protected cell account the insurance obligations relating to the protected cell company’s general account. Under no circumstances shall a protected cell be authorized to issue insurance or reinsurance contracts directly to policyholders or reinsureds or have any obligation to the policyholders or reinsureds of the protected cell company’s general account.

G. At the cessation of business of a protected cell in accordance with the plan approved by the commissioner, the protected cell company shall voluntarily close out the protected cell account.

Section 6. Reach of Creditors and Other Claimants

A. (1) Protected cell assets shall only be available to the creditors of the protected cell company that are creditors in respect to that protected cell and shall thereby be entitled, in conformity with the provisions of this Act, to have recourse to the protected cell assets attributable to that protected cell, and shall be absolutely protected from the creditors of the protected cell company that are not creditors in respect of that protected cell and who, accordingly, shall not be entitled to have recourse to the protected cell assets attributable to that protected cell. Creditors with respect to a protected cell shall not be entitled to have recourse against the protected cell assets of other protected cells or the assets of the protected cell company’s general account.

(2) Protected cell assets shall only be available to creditors of a protected cell company after all protected cell liabilities have been extinguished or otherwise provided for in accordance with the plan of operation relating to that protected cell.
B. When an obligation of a protected cell company to a person arises from a transaction, or is otherwise imposed, in respect of a protected cell:

(1) That obligation of the protected cell company shall extend only to the protected cell assets attributable to that protected cell, and the person shall, with respect to that obligation, be entitled to have recourse only to the protected cell assets attributable to that protected cell; and

(2) That obligation of the protected cell company shall not extend to the protected cell assets of any other protected cell or the assets of the protected cell company’s general account, and that person shall not, with respect to that obligation, be entitled to have recourse to the protected cell assets of any other protected cell or the assets of the protected cell company’s general account.

C. When an obligation of a protected cell company relates solely to the general account, the obligation of the protected cell company shall extend only to, and that creditor shall, with respect to that obligation, be entitled to have recourse only to, the assets of the protected cell company’s general account.

D. The activities, assets, and obligations relating to a protected cell are not subject to the provisions of Section [insert applicable sections of the insurance code addressing life and health and property and casualty guaranty or insolvency funds], and neither a protected cell nor a protected cell company shall be assessed by or otherwise be required to contribute to any guaranty fund or guaranty association in this state with respect to the activities, assets, or obligations of a protected cell. Nothing in this subsection shall affect the activities or obligations of an insurer’s general account.

E. In no event shall the establishment of one or more protected cells alone constitute or be deemed to be a fraudulent conveyance, an intent by the protected cell company to defraud creditors, or the carrying out of business by the protected cell company for any other fraudulent purpose.

Section 7. Conservation, Rehabilitation or Liquidation of Protected Cell Companies

A. Notwithstanding any contrary provision in the insurance code of this state, the regulations promulgated under the insurance code of this state, or any other applicable law or regulation, upon any order of conservation, rehabilitation or liquidation of a protected cell company, the receiver shall be bound to deal with the protected cell company’s assets and liabilities, including protected cell assets and protected cell liabilities, in accordance with the requirements set forth in this Act.

B. With respect to amounts recoverable under a protected cell company insurance securitization, the amount recoverable by the receiver shall not be reduced or diminished as a result of the entry of an order of conservation, rehabilitation or liquidation with respect to the protected cell company notwithstanding any provisions to the contrary in the contracts or other documentation governing the protected cell company insurance securitization.

Drafting note: A number of states require a liquidator to cancel policies within a pre-specified time period in the event of a liquidation. While reviewing the Plan of Operation, commissioners should consider the termination provisions, if any, of the securitization instruments in the event of the cancellation of all of the insurance policies underlying the securitization in order to assess whether any portion of the risk premium relating to those underlying policies should equitably be returned to the estate of the general account.
Section 8. No Transaction of an Insurance Business

A protected cell company insurance securitization shall not be deemed to be an insurance or reinsurance contract. An investor in a protected cell company insurance securitization shall not, by sole means of this investment, be deemed to be transacting an insurance business in this state. The underwriters or selling agents (and their partners, directors, officers, members, managers, employees, agents, representatives and advisors) involved in a protected cell company insurance securitization shall not be deemed to be conducting an insurance or reinsurance agency, brokerage, intermediary, advisory or consulting business by virtue of their activities in connection therewith.

Section 9. Authority to Adopt Regulations

The commissioner may promulgate regulations necessary to effectuate the purposes of this Act.

Section 10. Effective Date

This Act shall become effective on [insert date].

RELEVANT LITERATURE

Statutory Accounting
- Emerging Accounting Issues Working Group Minutes 99-3

Generally Accepted Accounting Principles
- FAS 113, Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts
- FAS 133, Accounting for Derivative Instruments and Hedging Activities

State Regulations
- No additional guidance obtained from state statutes or regulations.

Other Sources
- Protected Cell Model Act
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