



GOVERNMENT OF PUERTO RICO  
Office of the Commissioner of Insurance

April 6, 2018

**RULING LETTER NUMBER: CN-2018-240-D**

**TO ALL DOMESTIC INSURERS AUTHORIZED TO TRANSACT PROPERTY INSURANCE BUSINESS**

**ACCOUNTING TREATMENT, FILING OF ANNUAL REPORT, AND RELEASE OF THE CATASTROPHE LOSS INSURANCE RESERVE**

Dear Sirs and Madams:

This Ruling Letter addresses concerns and questions regarding the accounting treatment of the catastrophe reserve after the passage of hurricanes Irma and María in Puerto Rico and the release of catastrophe reserve funds, while providing clarification and guidelines for accounting treatment, filing of the annual report, and the release of the catastrophe loss insurance reserve.

**Accounting Treatment**

Circular Letter Number E-06-1611-2001, dated September 14, 2001, pursuant to the authority vested in this Office in Section 25.030(6) of the Insurance Code, provides that the accounting treatment of the catastrophe reserve that should be followed by domestic insurers in the annual statement filing is as follows:

“Paragraph 2(b)(ii) of Ruling Letter Number N-E-68-95, dated March 10, 1995, is amended to read as follows:

2. The annual report will be filed as follows:

(a)...

(b) Underwriting and Investment Exhibit-Statement of Income...

(i)...

(ii) No charge shall be made against operations for the accounting period in which the catastrophic losses occur for the portion of the reserve that was consumed. The portion of the reserve that is consumed shall be



charged directly to the items shown on line 24<sup>1</sup> on page 3 of the annual statement. Refer to paragraph 2(a)(iii) and (iv) above, for the corresponding treatment of the surplus accounts.”

Furthermore, Circular Letter E-06-1611-2001 refers to subparagraph 2(a)(iv) of Ruling Letter N-E-2-68-95, which establishes the following:

(iv) In the accounting period in which the catastrophic losses provided for in Chapter 25 of the Puerto Rico Insurance Code occur, the respective amount will be transferred from line 22, "Aggregate write-ins for special surplus funds," page 3 of the annual statement, to line 24C, "Unassigned funds (surplus)", and the amount will be deducted from line 2201, on the same page. The amount to be transferred will be determined according to the provisions of Chapter 25 and the deed of trust executed by the insurer.”

Our Office will maintain the accounting provisions of Ruling Letter Number N-E-68-95 and Circular Letter E-06-1611-2001, to recognize that catastrophic losses will be charged against the insurer’s surplus. The accounting treatment for the catastrophe reserve used for catastrophe losses will be charged against the insurer’s surplus in the “Aggregate Write-ins for Special surplus funds” item. At no time will they be charged against the insurer’s operations. If there are catastrophe losses, the corresponding amount will be transferred to the “Aggregate write-ins for special surplus funds” to the “Unassigned Funds Surplus” item.

### **Deferred tax liability**

Circular Letter E-06-1611-2001 established the following:

“...The Codification adopts accounting rules that are similar to GAAP with regard to the accounting treatment of tax expenses of insurers. Under these accounting principles, each insurer must register in advance the possible tax effect of certain items whose accounting and tax treatment is not uniform. To that end, the Codification requires that on certain occasions a deferred tax liability may be entered when the insurer deducts in one year an expense that will be charged against operations in a future year.

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<sup>1</sup> The item on line 24 of the annual report is “Aggregate write-ins for special surplus funds”

This is the case of the Catastrophe Reserve, for which the Puerto Rico Internal Revenue Code of 1994, as amended, and Section 25.030, recognize that contributions to the reserve are deductible in the year in which the contribution is made. Therefore, under the Codification, the insurer should recognize a deferred tax liability with regard to the amount contributed to the Catastrophe Reserve

It is our opinion that in a year in which a catastrophe occurs it is quite possible that insurers may show losses on their income tax returns due to the losses incurred in a catastrophic event. Therefore, it is highly unlikely that the insurer will have to pay income tax as required by the Codification due to the Catastrophe Reserve.

Furthermore, to enter a deferred tax liability under these circumstances would adversely affect the evaluation parameters used by the NAIC and other supervisory organizations, if domestic insurers are to be compared with insurers located outside of Puerto Rico that are not subject to the requirements of Chapter 25 of the Puerto Rico Insurance Code.”

Therefore, the accounting treatment in which the deferred tax will not be entered as a liability with regard to the amount contributed to the catastrophe reserve is maintained.

### **Amendment to Rule 72 of the Regulations**<sup>2</sup>

The most recent amendment of Rule 72 of the Insurance Code establishes that beginning with the annual statement for 2017, domestic insurers will show the catastrophe loss reserve as a liability in an amount that is equivalent to two percent (2%) of their catastrophe exposure for hurricanes. It was further provided that the reclassification of the liability will be in the surplus “aggregate write-ins liabilities” item, for the total amount of the minimum retention. If the insurer has not accumulated a sufficient amount to reach the minimum retention, the total amount of the “Aggregate write-ins for liabilities” should be reclassified, and the insurer will continue adding to this until the liability reaches the minimum retention. This Office hereby has determined to postpone the reclassification of liabilities required under Rule 72, as amended, and begin with the annual report for 2018, and subsequent years, instead of the report for 2017.

### **Procedure for Withdrawing Funds of the Catastrophe Reserve Trust**

Prior approval should be obtained from this Office for the release of assets of the Catastrophe Reserve Trust for the payment of catastrophe insurance losses and for adjustment costs that are inherent to such losses, and for the release of surplus funds in the catastrophe reserve. Therefore, insurers should formally request the release of the amount of the catastrophe reserve. All requests to withdraw funds made by the insurer to this Office should include the following information:

#### **I. For Payment of Losses and Adjustment Expenses**

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<sup>2</sup>The most recent amendment to Rule 72 of the Regulations of the Insurance Code was approved by the Department of the Treasury on October 25, 2016.

1. Evidence that the catastrophe losses exceeded 5% of the net direct premium written by the insurer during the calendar year prior to the year in which such losses occur
2. Identify the exact amount they intend to release.
3. A detailed report of the claims and adjustment expenses that have been paid as a result of the catastrophic event, and exclusively for risks located in Puerto Rico. The report should be submitted in Excel format and should include at least the following information:
  - ✓ Claim number
  - ✓ Disbursement type (Loss or Adjustment expense)
  - ✓ Date of Loss (m-d-y)
  - ✓ Policy Number
  - ✓ Name of the insured, claimant, attorney, adjuster, and others. To whom the check was issued.
  - ✓ Amount Paid
  - ✓ Date of Payment (m-d-y)
  - ✓ Number of Check
  - ✓ Date of Check (m-d-y)
  - ✓ Portion, if any, of reinsurance to be recovered
  - ✓ Any information that may be deemed necessary
4. As provided in Section 25.060(1) of the Insurance Code, the amount shall not exceed the amount retained by the insurer according to its reinsurance treaties. Therefore, and as provided in said Section of the law, the insurer shall provide the following evidence
  - ✓ Recovery from reinsurance, if any.
  - ✓ Summary of the insurer's reinsurance program that covers all of its catastrophe exposure.
  - ✓ Identify the amount retained by the Insurer under treaties that cover the insurer's catastrophe exposure. The insurer shall also indicate if part of the retention is in turn reinsured, in which case the insurer should indicate under which reinsurance contract it is reinsured.
  - ✓ Copy of two (2) probable maximum loss (PML) studies. A complete study by two (2) entities with which the risk was simulated should be submitted.

## **II. For Withdrawing Surplus**

In the case of a release of surplus funds of the Catastrophe Reserve Trust, Ruling Letter 2007-80-EX, dated March 9, 2007, established a procedure for requesting authorization

to withdraw funds that exceed the maximum required by law. The following was established in said Ruling Letter 2007-80-EX:

- ✓ The request shall be signed the President of the insurer, or in lieu of the President, by the Comptroller of the entity.
- ✓ The request shall include a detailed calculation of the PML, accompanied by a certification by the President of the insurer, sworn before a notary public [attorney], describing the risk-simulation model used to calculate the PML, and, if applicable, the version used. Alternatively, the insurer may submit calculations prepared and signed by the entity that developed the model.
- ✓ The request shall be accompanied with a check made out to the Secretary of the Treasury for payment of taxes to fifteen percent (15%) of the amount the insurer is proposing to withdraw.
- ✓ In cases in which the insurer claims not to have had a taxable revenue, and therefore does not have an obligation to pay the fifteen percent (15%) tax, the insurer shall submit along with the request for the withdrawal a certification by the Department of the Treasury<sup>3</sup> that such determination has been made.
- ✓ The 60-day term provided in Section 5 of Act No. 227 will begin to run once the insurer has submitted to the Office of the Commissioner of Insurance a request to withdraw the funds that fully complies with the provisions of this Ruling Letter.

We remind you that the Catastrophe Reserve Trust funds will only be used for payment of catastrophic losses and the expenses that are inherent to such. Furthermore, this Office has the ministerial duty to ensure the appropriate use of the reserve trust funds.

In both cases of releasing funds of the catastrophe reserve, the accounting transaction shall be shown on the financial statement for the year for which the release of the funds was authorized.

### **Additional Contributions**

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<sup>3</sup> In Internal Revenue Circular Letter Number 10-05, dated March 8, 2010, the Department of State set forth the methodology for determining the tax liability on a withdrawal of the surplus in the catastrophic insurance loss reserve.

Every year this Office issues a Ruling Letter establishing that the annual contribution and the deposit of reserve funds will be a percentage each year that takes into consideration the proportion of the net direct premium for catastrophe risk. If due to payment for losses the catastrophe reserve is reduced, domestic insurers will continue to contribute to the catastrophe reserve funds until reaching at least 8% of their catastrophe exposure for hurricanes.

The provisions of this Circular Letter do not amend the provisions of Ruling Letter Number N-E-2-68-95, dated March 10, 1995, Circular Letter Number E-06-1611-2001, dated September 14, 2001, and Ruling Letter 2007-80-EX, dated March 9, 2007, or the provisions of Rule 72 and Chapter 25 of the Insurance Code.

Strict compliance with the guidelines set forth in this circular letter is hereby required.

Very truly yours,

**Javier Rivera-Ríos, LUTCF**  
Commissioner of Insurance