COMMONWEALTH OF PUERTO RICO
OFFICE OF THE COMMISSIONER OF INSURANCE

September 14, 2001

CIRCULAR LETTER NUMBER E-06-1611-2001

ALL DOMESTIC INSURERS AUTHORIZED TO TRANSACT PROPERTY INSURANCE BUSINESS

Re: Amendment to Accounting Treatment and Filing of the Annual Report on Catastrophe Reserve Losses

Dear Sirs:

In our Circular Letter Number AC-II-9-1360-94, dated October 14, 1994, we notified domestic insurers of the approval of Public Law No. 73, enacted on August 12, 1994, which added Chapter 25 to the Puerto Rico Insurance Code for the purpose, among other things, of requiring domestic insurers to establish a reserve for payment of catastrophic losses (the "Catastrophe Reserve") and a trust (the "Trust") to deposit the funds to cover the reserve.

Subsequently, in Ruling Letter Number N-E-2-68-95, dated March 10, 1995, domestic insurers were notified regarding the accounting treatment and filing of the Catastrophe Reserve annual report. This ruling letter was promulgated under the authority vested in Section 25.030(6) of the Puerto Rico Insurance Code, which charges the Commissioner of Insurance with the responsibility of determining how the catastrophe reserve will be shown in the insurer's annual statement and ensuring that such determination will not adversely affect the evaluation parameters used by the National Association of Insurance Commissioners (NAIC) or other supervisory organizations.

According to the Ruling Letter, the contributions to the Reserve would not be charged against the operations during the year in which the Catastrophe Reserve was established or for THE transfer of funds to the Trust. The charge to operations will be made for the accounting period in which the catastrophic losses occur.

We have revised the previous guideline to align it with the Codification of Statutory Accounting Principles (the "Codification"), promulgated by the NAIC, which entered into effect on January 1, 2001. 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.

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 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, under the powers vested in this Office by Section 25.030(6) of the Puerto Rico Insurance Code to determine how the Catastrophe Reserve will be shown in the annual report of each insurer, and with a view to avoid that the evaluation parameters employed by the NAIC and other supervisory organizations be adversely affected, we are setting forth below the guidelines to be followed by insurers in the accounting treatment and filing of the Catastrophe Reserve in the record and annual report of the insurer:

> Paragraph 2(b)(ii) of Ruling Letter No. N-E-2-68-95, dated March 10, 1995, is amended to read as follows:
>
> "2. The annual report will be filed as follows:
>
> > (b) "Underwriting and Investment Exhibit - Statement of Income" (Page 4 of the annual report)
> >
> > …

(i) ***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 of page 3 of the annual statement. Refer to paragraph 2(a)(iii) and (iv) above, for the corresponding treatment of the surplus accounts.***

It must be clarified that due to the amendments to the annual report form promulgated by the NAIC, in the 2000 edition, the references to line 22 on page 3 made in Ruling Letter N-E-2-68-95, changed to line 24 and the reference to line 24C changed to line 26C. All of the remaining provisions of the ruling letter remain in full effect.

No provision of this letter shall have the effect of amending the provisions of Chapter 25 of the Insurance Code, and therefore, the Catastrophe Reserve, according to the aforementioned dispositions, will be continued to be considered a liability and will continue to be charged against the assets of the insurer when determining the policyholders surplus that will be used to calculate the premium to surplus ratio established in Section 4.150 of the Puerto Rico Insurance Code, and to calculate the Catastrophe Reserve ratio to policyholders surplus as provided in Rule 72 of the Regulations of the Puerto Rico Insurance Code.

All domestic insurers are required to comply with the guidelines established in this circular letter beginning with the annual report for 2001.

Very truly yours,

SIGNED

Fermín Contreras-Gómez
Commissioner of Insurance