AMERICAN ACADEMY *of* ACTUARIES

May 18, 2004

Mr. Robert Herz, Chairman
Financial Accounting Standards Board
P.O. Box 5116
Norwalk, Connecticut 06856-5116

Re: AICPA Paper entitled "Evaluating Risk Transfer in Reinsurance of Short-Duration Contracts"

Dear Mr. Herz:

The purpose of this letter is for the American Academy of Actuaries[1] Committee on Property and Liability Financial Reporting ("the Committee") to provide comments to the Financial Accounting Standards Board (FASB) on a paper developed by the American Institute of Certified Public Accountants (AICPA) entitled "Evaluating Risk Transfer in Reinsurance of Short-Duration Contracts" (the "AICPA Paper"). We understand that the FASB will soon be issuing a FASB Staff Position on the issues raised in the AIPCA Paper.

In the sections below, we provide both general comments regarding our views of reinsurance accounting and financial reporting and specific comments addressing certain points within the AICPA Paper.

General Comments

Reinsurance is vital to the insurance industry's ability to manage risk, balance business objectives, and promote competition. Nevertheless, we understand that some companies might structure certain contracts with the primary goal of accomplishing a financial reporting objective, while transferring just enough risk to classify -- and therefore account for -- the contracts as reinsurance. We further understand that the diversity in views and practice regarding such contracts ultimately led to the AICPA Paper. In this regard, we would like to provide several points for the FASB to consider:

- We fully appreciate the challenges regarding consistency in the application of FAS 113 that might arise, given the growing complexity of such reinsurance arrangements and the subjectivity of a

[1] The American Academy of Actuaries is the public policy organization for actuaries practicing in all specialties within the United States. A major purpose of the Academy is to act as the public information organization for the profession. The Academy is non-partisan and assists the public policy process through the presentation of clear and objective actuarial analysis. The Academy regularly prepares testimony for Congress, provides information to federal elected officials, comments on proposed federal regulations, and works closely with state officials on issues related to insurance. The Academy also develops and upholds actuarial standards of conduct, qualification and practice, and the Code of Professional Conduct for all actuaries practicing in the United States.

principle-based standard. Despite such challenges, we believe that the accounting and financial reporting for reinsurance should continue to follow its substance, which in our view is accomplished by the appropriate application of FAS 113.

- We do not believe that the principle-based FAS 113 should be replaced with a rules-based approach, which several views in the AICPA appear to advocate. Instead, we believe that better practical guidance in applying FAS 113 could be developed for accountants, actuaries and insurance and reinsurance company executives with regard to the evaluation of risk transfer, the analysis of the substance of reinsurance contracts, and the corresponding financial reporting of such contracts. As it relates to risk transfer, the Casualty Actuarial Society has developed tools to assess and evaluate the transfer of insurance risk, and the Comittee would be happy to work with the FASB and the AICPA to expand and improve these materials.

- FASB might want to consider defining reinsurance arrangements that transfer minimal amounts of insurance risk, and recommending or requiring comprehensive disclosure to the extent such contracts materially impact a company's financial statements. Additional disclosure with respect to such arrangements would provide more transparency in financial reporting.

Specific Comments

Following are specific comments on the three sections of the AICPA Paper:

<u>Section 1: Definition of a contract -- whether a single contract should be bifurcated</u>

Given the amount of information provided in the AICPA Paper, we do not believe that bifurcation is appropriate in the instances cited; this is consistent with the conclusion of View B under each of the four issues. In our view, loss corridors with characteristics such as those described typically limit the amount of risk reinsured by the reinsurance company, and do not necessarily create two contracts. However, we do not believe the examples in Section 1 cover the entire spectrum of issues regarding bifurcation of reinsurance contracts. There might be some situations in which bifurcation is appropriate, but we do not believe such situations are described in the AICPA Paper.

With regard to loss corridors, most points provided in Views A, C and D could also be applicable to other loss-limiting features commonly found in reinsurance contracts, such as aggregate annual deductibles, per occurrence retentions, and loss ratio caps. In evaluating the substance of a reinsurance contract, we believe that loss corridors should be treated consistently with other loss-limiting features and as such we do not believe that the existence of a loss corridor in and of itself should subject a contract to special accounting rules.

The AICPA Paper makes a statement that loss-limiting features such as loss corridors and aggregate caps have the effect of reducing the risk transferred to the reinsurer without a corresponding reduction in ceded premium. This statement presumes that the reinsurer would be willing to write the contract without the loss-limiting features, which is often not true.

Further, we believe that a rule requiring the bifurcation of reinsurance contracts with loss corridors is undesirable, since the judgments necessary to decide how to bifurcate premiums and commissions above and below a loss corridor, and to decide when and when not to bifurcate, may create even more diversity in practice than might currently exist. Following are several points on this matter:

- A requirement to bifurcate such contracts appears to contain an element of circular logic. In order to know whether bifurcation is appropriate, one must evaluate risk transfer for various layers of a contract. Yet, in order to evaluate risk transfer for various layers of a contract, one must be able to bifurcate all of the elements under the contract.

- Requiring bifurcation would presume that there is a point at which risk transfer ends and non-risk transfer begins. While this point might be clear in some contracts, in many others it would likely be a matter of significant judgment and therefore likely result in significant diversity in practice. For example, the reinsurer's estimate of the ultimate loss ratio is typically not the same as the ceding company's estimate, so the two parties most knowledgeable about the contract would be unable to agree on this point.

- Finally, based on our understanding of FAS 113, the presence of both risk and deposit elements in and of itself does not necessitate bifurcation of a reinsurance contract. Even an unrestricted quota-share contract will generally contain both risk and deposit elements, since losses below some point are almost certainly predictable.

Section 2: Determining significant insurance risk

We agree with View A under each of the three issues within this section.

With regard to the first issue, we believe that paragraphs 9 and 10 of FAS 113 give adequate guidance that the proper test of risk transfer measures the variability of cash flows between the ceding company and the reinsurer. Some of the dissenting views in this section would require a further comparison of the ceding company's net cash flows to the reinsurer's net cash flows, and a measurement of whether there is direct variation between the two. Non-proportional loss-limiting features under the reinsurance contract – whether it is a per occurrence limit, a per risk retention, an aggregate deductible, a loss corridor or a loss ratio cap – reduce the correlation between the amount of the reinsurer's payments and the amount of the ceding company's payments. The only type of reinsurance that would meet the direct variation test would be an unlimited quota-share contract.

The second issue provides views that would require an analysis that incorporates other costs related to the reinsured business to compare the financial results between the ceding company and reinsurer. If performed properly, such other costs would need to include the allocation of acquisition costs, overhead expenses, and the use of surplus. Such allocations require significant judgments, and are so complex that many companies do not perform these allocations by line of business, much less for individual reinsurance contracts. The amount of judgment that it would require, coupled with the lack of industry standards for such allocations, leads us to believe that no consistent results could be expected for such an analysis. Further, we believe the arguments provided to support these views are not compelling enough to warrant a change to FAS 113.

We believe that the issue of determining significant insurance risk depends on the practical application of the terms "reasonably possible" and "significant loss" in paragraph 9 of FAS 113. As previously stated, we think that improved practical guidance, jointly developed by accountants and actuaries, might help address this issue.

Section 3: Paragraph 11 exception

We agree with View B under Issue 1, and View C on Issue 2 within this section. We believe that the Paragraph 11 exception is necessary, but fairly limited, and should remain so.

Conclusion

We hope that the comments in this letter are useful to the FASB. We would be pleased to meet with you and discuss this issue in greater depth.

Sincerely,

Andrea M. Sweeny, Chair
Committee on Property and Liability Financial Reporting
American Academy of Actuaries

cc:

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