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Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, Connecticut 06856-5516



LETTER OF COMMENT NO. 2

Re: Accounting for Ceded Reinsurance by Property & Liability Insurance Companies

In light of the highly publicized and continuing controversy regarding finite “reinsurance” and other forms of reinsurance that are designed to smooth earnings, I believe it is time to reconsider the entire accounting model for ceded reinsurance.

Accordingly, I propose the accounting for ceded reinsurance be changed to the following -

(1) Ceded earned premiums would be charged to an expense account (rather than netted against gross earned premiums), and would be accounted for net of ceding commissions. Prepaid ceded premiums, net of ceding commissions, would be accounted for as an asset on the balance sheet.

(2) Reinsurance recoveries would be credited to the reinsurance expense account (uncollected reinsurance recoveries would continue to be accounted for as an asset on the balance sheet). (At this point, the principal changes are only geography on the income statement.)

(3) Reinsurance contracts would be grouped by reinsurer, or if that reinsurer was affiliated with other reinsurers, by affiliated group of reinsurers. If the cumulative results for all reinsurance

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contracts with a particular reinsurer or group of affiliated reinsurers result in a cumulative net debit (net ceded premiums exceed recoveries), no further accounting would be necessary for that group of contracts. However, if there is a cumulative net credit (recoveries exceed net ceded premiums) for all contracts with a particular reinsurer or group of affiliated reinsurers, the cumulative net credit would be charged to reinsurance expense and a liability established (deferred income) as of the balance sheet date.

(4) Any liability established in (3) above would be amortized to reinsurance expense (as a credit) in future years to the extent that the particular contract or group of contracts that gave rise to the liability result in a net debit in a future year. (Any future net credits would also be deferred as of that balance sheet date.)

(5) Any liability established in (3) above and not amortized to income in future years as described in (4) above would be taken into income at the time the ceding company no longer had an obligation (under any circumstances) to pay any future premiums to the particular reinsurer or group of affiliated reinsurers. (This would normally happen when all contracts have expired or been terminated, or are in runoff, and no premiums would be payable in the future under any circumstances.)

Under this proposal, in most years, insurance companies would reflect the net cost of reinsurance as an expense (net ceded premiums would exceed recoveries). However, in some years, insurance companies would reflect a net credit (or negative reinsurance expense) as a result of reinsurance recoveries exceeding net ceded premiums in a particular year. In these years, companies would be recovering prior years' reinsurance expense (net ceded premiums in excess of recoveries). Less frequently, there would be instances when an insurance company would be required to establish a deferred credit (income) in the balance sheet reflecting

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cumulative recoveries in excess of net ceded premiums. It would be understood that this deferred credit would eventually be amortized to income in future years when ceded premiums again exceeded recoveries, or at the time when the company no longer had any ongoing reinsurance agreements with that particular reinsurer or group of affiliated reinsurers.

An additional benefit of this proposal would be that insurance companies would no longer have to determine if sufficient insurance risk had been transferred to the reinsurer in a particular agreement to be accounted for as reinsurance. For example, if a company had only one reinsurance agreement with a group of affiliated reinsurers, and that agreement was a finite agreement, recoveries in excess of net ceded premiums would result in a deferred credit on the balance sheet until that contract was terminated (and no other contracts were entered into with that affiliated group of companies).

The essence of this proposal is the recognition that while reinsurance can legitimately smooth earnings (by reducing the effects of abnormal experience), it is likely that over a period of years the ceding company will ultimately pay more net premiums than it will receive in recoveries (unless at a particular point in time all contracts with that reinsurer or group of affiliated reinsurers are cancelled and no new contracts are entered into). Accordingly, if on a cumulative basis the ceding company has recovered (from a particular reinsurer or group of affiliated reinsurers) more than it has incurred in net ceded premiums, that excess should be deferred and amortized against future net debits (ceded earned premiums in excess of recoveries).

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This proposal would also result in a clearer picture of the ceding company's own operations as earned premiums and incurred claims would principally relate to its own underwriting (plus reinsurance assumed), and the net cost of ceded reinsurance would be identified in a separate expense category. In some respects, the accounting for ceded reinsurance would be similar to the accounting for insurance expense by a non insurance company.

I am a CPA with 40 years of experience in accounting and auditing related to property and liability insurance companies. I am a former partner of a predecessor firm of one of the present Big 4 firms (and was that firm's national insurance industry specialist). I am presently a testifying expert on insurance company accounting and auditing matters.

I would be happy to discuss this proposal with anyone from the FASB at their convenience.

Sincerely,

Loren Kramer