



LETTER OF COMMENT NO. 58

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Submitted by e-mail to: director@fasb.org

**RE: File Reference No. 1325-100
Bifurcation of Insurance and Reinsurance Contracts for Financial Reporting**

The following provides my comments in response to the Financial Accounting Standards Board Invitation to Comment on Bifurcation of Insurance and Reinsurance Contracts for Financial Reporting. My comments are focused on the captive insurance industry and on corporate accounting and risk management, as much of my consulting experience is with captive insurance companies. The views expressed herein are solely my own, and may not reflect the views of my employer.

The goal of the captive insurance industry is the efficient management of risk. Bifurcation of insurance and reinsurance contracts would

- Increase the cost of operating a captive insurance company
- Make it more difficult to negotiate satisfactory contract terms with the reinsurance market
- Result in inconsistent accounting treatment of the same insurance policies
- Make corporate and captive financial statements more difficult to understand
- Decrease the secondary tax benefit of owning a captive insurance company

Each of these outcomes, as discussed in more detail below, would result in less efficient management of risk.

Increase in the Cost of Operating a Captive Insurance Company

The Invitation to Comment presents an unequivocal test for insurance and reinsurance accounting. Under the unequivocal test, insurance contracts that insure single risks and have

market-based premiums would qualify as insurance contracts that unequivocally transfer significant insurance risk. Most captive insurance policies (whether written directly by the captive, assumed from a fronting carrier, or ceded to a reinsurer) would not meet the unequivocal test for insurance accounting.

- Captive insurance companies most often provide insurance to groups of risks. The exceptions would be professional liability insurance policies provided to single practitioners or professionals. Even in this circumstance, any ceded reinsurance purchased by the captive insurance company would cover multiple risks and would not meet the unequivocal test for insurance accounting.
- The captive insurance market is often used in situations where coverage is unavailable in the commercial insurance market. Thus an insurance policy issued by a captive insurance company may, by definition, not use standard market terms or be based on market premiums.

Thus most captive insurance policies (whether written directly by the captive, assumed from a fronting carrier, or ceded to a reinsurer) would be subject to bifurcation analysis. This would involve additional time and effort on the part of accountants, actuaries, and auditors.

The initial bifurcation analysis for each of the policies written, ceded, or assumed by a captive insurance company (upon inception) and the on-going accounting and actuarial analyses for existing policies would easily add \$50,000 to \$100,000 to the annual cost of operating a captive insurance company. This additional cost would be significant relative to the current average annual operating costs of \$75,000 to \$100,000. Bifurcation would also add to the annual operating cost of the parent company or captive owner. The actual increase in cost would depend on the extent and nature of the contracts determined to be exempt from bifurcation as well as the specific bifurcation methodology employed.

Negotiation of Contract Terms

Contract terms such as profit-sharing agreements are often used as a negotiating tool between captive insurance companies and the reinsurance market. Suppose, for example, that a captive insurance company wants to purchase an excess-of-loss reinsurance contract and the ultimate losses estimated by the captive insurance company and the reinsurance market differ.

	Captive	Reinsurer
Expected Losses	1,000	1,500
Premium	1,500	1,500
Profit Sharing Provision	50%	50%

The captive insurance company may be unwilling to pay the proposed reinsurance premium of \$1,500 because it believes the ultimate losses estimated by the reinsurer to be overstated. The

reinsurer may be unwilling to write the reinsurance policy at a premium lower than its estimated ultimate loss amount. The use of a profit sharing provision allows both parties to reach satisfactory contract terms. If the actual ultimate losses turn out to be the \$1,000 estimated by the captive insurance company, the final reinsurance premium for the policy will be \$1,250 (\$1,500 less a profit-sharing commission of \$250). If the actual ultimate losses turn out to be the \$1,500 estimated by the reinsurer (or higher), then the reinsurer will have a lower underwriting loss than if it had lowered the initial premium.

This is, of course, a simplified example that does not consider the expenses of the reinsurer or the time value of money. We simply wanted to demonstrate that contract terms such as profit-sharing provisions are often used as a business negotiation tool when the parties to an insurance contract disagree as to the cost of the claims being insured. Bifurcation of insurance and reinsurance contracts would make such terms less desirable because a) a contract with such terms may be more likely to require bifurcation and b) such terms may complicate the bifurcation analysis, adding more cost to the operation of the captive insurance company.

Inconsistent Accounting

Bifurcation of insurance and reinsurance contracts would result in inconsistent accounting depending on how contracts are written and amalgamated. Suppose, for example, that a captive insurance company issues 100 professional liability policies to individual medical practitioners. Each of these 100 policies would meet the test for an unequivocal insurance contract and would not be subject to bifurcation analysis. If the captive insurance company then purchases a reinsurance contract to cover the same losses covered under the original 100 policies, for the same total premium, the reinsurance contract would not meet the test for an unequivocal insurance contract and would be subject to bifurcation analysis (and potentially subject to bifurcation).

In other words, the criteria for an unequivocal insurance contract result in an illogical inconsistency. The root of the problem lies in the following assumptions:

- i. an insurance policy where the premium provides compensation to the insurer for payment of expected claims would require risk transfer testing and a bifurcation analysis; and
- ii. insurance policies covering “single risks” are assumed not to have expected losses and therefore not require risk transfer testing or bifurcation analysis.

It is not true that there are no expected losses on a single risk insurance contract. The premium for every insurance contract is based on the expected losses (adjusted for expenses, investment income, risk margin, etc.). The most likely outcome for a single risk insurance contract (such as a homeowners insurance contract) may be losses of \$0. But the expected losses for the contract are greater than \$0 and would be based on the historical loss experience for a group of similar risks.

It is also not true that an insurance policy for which the premium is equal to the expected cost of claims, even if the expected cost of claims can be estimated with some certainty, does not transfer insurance risk. An insurance contract that covers a “working layer” of claims still indemnifies the policyholder in exchange for an insurance premium, and transfers risk to the insurer. The premium may be based on the expected claim costs, but the indemnification of the policyholder provides protection to the policyholder from potential variability in claim costs.

Bifurcation of insurance and reinsurance contracts would also result in inconsistent accounting depending on the opinion of the parties performing the bifurcation analysis. Each party to an insurance contract (e.g. the captive owner and the captive insurance company; or the captive insurance company and the reinsurer) would perform its own bifurcation analysis. Each bifurcation analysis would involve the use of actuarial judgment and expertise. The parties may *differ not only on their estimates of the expected losses under the contract, but also on their estimates as to the variability of the expected losses under the contract*. Thus the parties may reach different conclusions as to whether a contract should be bifurcated and how and where a contract should be divided into its insurance and deposit components. This would result in different accounting treatment for the same insurance contract.

More Complicated Financial Statements

An insurance contract provides indemnification to a policyholder in exchange for the payment of a premium. Policyholders purchase insurance contracts to stabilize their cost of risk and to protect themselves against losses they would be unable to sustain themselves. The basic concept of insurance (the payment of a premium in exchange for indemnification of risk) is relatively *easy to understand*. *Accounting for insurance contracts is more difficult as it requires the estimation of certain values such as loss and loss adjustment expense reserves, retrospective premiums payable, and extended reporting reserves*. Bifurcating insurance and reinsurance contracts into insurance and deposit components would complicate insurance accounting even further and make it more difficult to a) estimate the values to related to an insurance contract and b) understand the insurance-related entries on financial statements.

Decrease in Secondary Tax Benefit of Owning a Captive Insurance Company

For some captive insurance company owners, a secondary benefit of captive insurance is that it allows for the deduction of the cost of retained risks when premiums are paid, rather than as losses are paid. This more closely matches income to expenses, since the cost of claims are *deducted when they are incurred, rather than as the associated losses are paid out over time*. The benefit exists because tax accounting for corporations differs from tax accounting for insurance companies. An insurance company may deduct incurred losses (paid losses plus changes in reserves) from taxable income whereas a corporation can only deduct loss payments from taxable income.

Were captive insurance company owners required to bifurcate their captive insurance contracts into insurance and deposit components, less of the insurance premium paid to the captive

insurance company would qualify for this tax deduction, and the company's taxable income would increase.

While the acceleration of tax deductions is not the primary driver of the captive insurance industry, it does represent a potential intrinsic economic benefit that would be reduced by the bifurcation of insurance contracts.

I respectfully submit these comments for your consideration.

Best regards,

A handwritten signature in black ink, appearing to read 'Amy P. Angell', with a stylized, cursive script.

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