

# HARBOR POINT LIMITED



August 23, 2006

LETTER OF COMMENT NO. 17

Technical Director – File Reference No. 1325-100  
Financial Accounting Standards Board  
401 Merritt 7  
P. O. Box 5116  
Norwalk, CT 06856-5116

RE: File Reference No. 1325-100  
Invitation to Comment on Bifurcation of Insurance and Reinsurance contract for  
Financial Reporting

Dear Sir or Madam:

We appreciate the opportunity to comment on the Board's Invitation to Comment ("ITC") entitled *Bifurcation of Insurance and Reinsurance Contracts* dated May 26, 2006.

Harbor Point Limited ("Harbor Point") is a Bermuda domiciled holding company engaged, through its Bermuda and U.S. based subsidiaries, in the business of providing a broad range of reinsurance products on a worldwide basis. Harbor Point's management team, along with its underwriting, actuarial and finance staff has extensive experience in the insurance and reinsurance business.

The ITC addresses a wide range of complicated issues and time does not permit us to provide an issue by issue response. However, we will comment on the several aspects of the ITC that concern us most.

1. Our initial reaction is that the proposals in the ITC attempt to "fix something that is not broken". We believe that Statement of Financial Accounting Standard No. 113 *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts* ("SFAS 113") is an appropriate principles-based standard that financial statement preparers have been applying in a reasonably consistent manner since it was issued in 1992. Further, users of insurance and reinsurance company financial statements have come to understand SFAS 113. As highlighted recently in the media, some preparers have applied SFAS 113 in an aggressive and possibly inappropriate manner. However, we do not believe that this is a problem with the standard itself. Also, the recent regulatory scrutiny of so-called "finite" reinsurance contracts has effectively put financial statement

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preparers and their auditors on notice that aggressive interpretations of SFAS 113 are not acceptable to the constituent users of insurance and reinsurance company financial statements. Accordingly, we do not believe that a wholesale change in the way insurance and reinsurance contracts are accounted for, as advocated in the ITC, is warranted.

We acknowledge, however, that disclosures concerning reinsurance purchases and risk management could be enhanced. Introductory comments in the ITC and public comments by FASB staff members have included concerns about the “all or nothing” aspect to SFAS 113; that is a reinsurance contract that just barely satisfies the risk transfer criteria of SFAS 113 is accounted for in its entirety as reinsurance. It strikes us that a better approach to dealing with this issue would be more informative disclosure about the extent of risk being transferred and significant risk-limiting features in reinsurance contracts purchased. The extent to which regulators and financial statement users will begin to make demands on financial statement preparers in this regard is yet to be seen. However, if the FASB were to consider expanding disclosure requirements, the extensive disclosure enhancements already put in place by the National Association of Insurance Commissioners (“NAIC”) may be a good starting point. We would not advocate including anything as extensive as the NAIC requires in GAAP-basis financial statements, however the Board could select what it views as the most relevant items from the NAIC requirements in formulating new disclosure standards.

2. We do not believe that the proposals in the ITC will achieve the stated objective of enhancing the comparability and decision usefulness of financial statements of insurers and reinsurers. SFAS 113 requires that reinsurance contracts that satisfy various risk transfer criteria are accounted for in their entirety as reinsurance – that is premiums are recorded as revenues by the assuming company and a reduction of revenues by the ceding company. Losses and other underwriting expenses are recorded as expenses in the income statement by the reinsurer and a reduction of expenses by the ceding company. While the counterparties to a given reinsurance contract (including the ceding company and perhaps multiple participating reinsurers) may come to different judgments about the extent of risk transfer in a contract, as long as they all conclude that the risk transfer criteria of SFAS 113 have been met, they account for the transaction in a consistent manner. The ITC proposal to bifurcate that contract introduces the notion that those differing judgments about the extent of risk transfer would result in differing determinations of the “risk” premium and the likelihood that each counterparty would account for a single contract differently. One contract in isolation is not significant, but the potential impact of differing judgments about the extent of risk transferred across the whole of the reinsurance marketplace would be. We do not believe that this will improve comparability of financial statements among companies. In fact, we believe that this approach diminishes comparability among companies.

Furthermore, company management teams as well as regulators, rating agencies and other users of insurance company financial statements rely to a large extent on a well-developed array of ratios and other predictable quantitative relationships that allow for effective company to company comparisons as well as current and prior period comparisons for a single company. Altering the make-up of premiums and underwriting costs through a bifurcation model will, at best, require a significant re-thinking on the part of managements and financial statement users about how to best to make those comparisons. At worst, management and users will be required to develop entirely new paradigms for assessing important company characteristics such as solvency and capital adequacy.

3. We are concerned about the possibility that the mere inclusion in a contract of one or more of the features listed in paragraph 36 of the ITC would trigger different accounting treatment from that used for a contract that did not have one of these features. Some of these features are present in many contracts to one degree or another. Reinsurers find some of these features useful and necessary to align the interests of the reinsurer and cedant and to avoid “betting the company” on a single contract.

SFAS 113 requires preparers to include all of the features of a contract in their evaluation of whether the SFAS 113 risk transfer criteria are met. If one of these features, in the professional judgment of the preparer, alters the economics of the contract to such a degree that the preparer concludes that those risk transfer criteria are not met, then the deposit accounting model should be followed. We much prefer an approach that requires professional judgment to a bright line approach that does not take into account the degree to which one of these features actually impacts the economics of the contract.

A list of features such as that in paragraph 36 could be useful in the development of enhanced disclosure guidance as mentioned previously. However, similar to our comment above, we would not advocate disclosure guidance where the mere existence of the feature triggered a disclosure.

As to specific items in the list in paragraph 36:

- 36b(1) – we would hope that this condition exists in every contract we write. In fact, we would expect that premium plus investment income would exceed the loss and other costs by at least cost of the risk we have assumed. We do not agree that this is a valid “finite” contract identifier.
- 36b(2) and (5) – loss corridors and other adjustable features are useful in aligning our interests with those of our cedants and avoiding moral hazard. As noted above, the degree to which such contract terms alter the economics of the contract is what would be important in determining accounting and/or disclosure requirements.

- 36b(4) – almost all contracts place limits on the amount of claims that an insurer or reinsurer will pay.
4. There is a fundamental inconsistency in the discussion of contracts that “unequivocally transfer insurance risk.” Appendix B to the ITC includes a number of examples of contracts that are so deemed. These follow the guidelines in paragraph 58 and B2 that suggest that single contracts that insure a single risk are deemed to unequivocally transfer insurance risk and can be accounted for as insurance without further evaluation. So for example, an insurance company that writes a portfolio of individual personal auto policies can account for each of the contracts in that portfolio as insurance. However, if that company purchases quota-share reinsurance protection for that portfolio, both the insurance company and its reinsurer must evaluate that reinsurance contract to determine how much risk premium is included in the reinsurance premium. The likely result would be bifurcation of the reinsurance contract because, on a portfolio basis, there likely would be some level of expected loss. The accounting by the insurance company for the policies written and the reinsurance purchased will not match even though the total risk present in the portfolio of policies written and the reinsurance purchased is exactly the same.

The flaw seems to lie in the statement in paragraph 58f and B2 that exempt contracts (i.e., those that unequivocally transfer insurance risk) are “not likely to incur a loss”. While this may be an accurate statement for an individual policy, each policy does in fact have a risk of loss associated with it and the price the policy owner pays for that coverage includes a charge for overall losses that the policies in the portfolio of similar policies will incur. To answer Issue 6 of the ITC, the suggested characteristics of contracts that unequivocally transfer insurance risk do not seem to be completely grounded in theory and thus appear somewhat arbitrary. Difficult as it is to apply in some cases, we prefer the principles-based approach of paragraph 11 of SFAS 113 where professional judgment is required.

We appreciate this opportunity to share our views on this ITC and I would be pleased to discuss these points further should you have questions or comments.

Sincerely,



Jeffrey L. Webb  
Chief Financial Officer