



Endurance



LETTER OF COMMENT NO. 44

August 24, 2006

Technical Director  
Financial Accounting Standards Board  
401 Merritt 7  
PO Box 5116  
Norwalk, Connecticut 06856-5116

Re: Bifurcation of Insurance and Reinsurance Contracts for Financial Reporting  
(File No. 1325-100)

Dear Director:

Endurance Specialty Holdings Ltd. ("Endurance") appreciates the opportunity to comment on the Financial Accounting Standards Board's ("FASB") Invitation to Comment ("ITC"), *Bifurcation of Insurance and Reinsurance Contracts for Financial Reporting*, dated May 26, 2006. We note that the ITC covers numerous topics and questions, and we will limit our observations to those we believe are most significant and relevant to our operations.

#### Endurance Background Information

Headquartered in Bermuda, Endurance, through its operating subsidiaries, is a global provider of property and casualty insurance and reinsurance. Endurance conducts its business through its operating subsidiaries located in Bermuda, the United States and the United Kingdom. Endurance, which commenced operations in late 2001, reported approximately \$1.7 billion in written premiums in 2005 and its ordinary shares are traded on the New York Stock Exchange.

#### Executive Summary

We applaud the FASB's efforts to address issues of current concern in insurance and reinsurance accounting and reporting. However, we do not support the concept of bifurcation as contemplated in the ITC. We believe bifurcation will result in significant accounting and reporting inconsistencies and will detract from, rather than enhance, the comparability, transparency and usefulness of insurance and reinsurance company financial statements while greatly increasing their complexity. When appropriately interpreted and applied, we believe the existing accounting guidance governing insurance

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and reinsurance accounting provides an adequate framework, although we suggest that additional interpretive guidance from the FASB would substantially enhance and help formalize certain accounting practices and interpretations which have evolved during the period since the initial guidance was issued. We also believe the existing literature could be modified to more clearly define its applicability to both insurance and reinsurance.

We have organized our response by addressing the aspects we believe are most problematic in the ITC. We then identify certain areas in existing, generally accepted accounting principles (“GAAP”) literature which we believe would greatly benefit from additional formal guidance and interpretation by the FASB.

#### Problematic Aspects of the ITC

The concept embodied in the ITC we find most problematic relates to the accounting treatment for individual risk insurance contracts. The assumption made in the ITC is that no single individual risk insurance contract contains an expected loss component. While we disagree with this assumption on several bases, our more important concern is that aggregating and reinsuring such individual risks would require different accounting treatments under the ITC, even if substantially all risk was transferred. We believe such a result creates significant and meaningful accounting inconsistencies and results in confusing and potentially misleading financial information. We consider this a basic and critical flaw in the accounting theory underlying the ITC proposal.

We also believe that the ITC’s rules-based approach to identifying contracts exempt from and those requiring bifurcation is impractical and inconsistent with the spirit and direction of GAAP. Such an approach would prove cumbersome and likely prone to error and/or abuse. Risk transfer in the insurance and reinsurance market is accomplished via a broad range of products and structures, many of which have evolved over extended periods to serve particular markets. Insurance risk is a continuum, and markets have evolved to serve and specialize in accepting certain portions of such risk. Prescribed accounting treatment resulting from a rules-based approach could lead to unintended market consequences which could inhibit the effective spreading of risk through the risk bearing markets.

Additionally, it is likely that new products and structures would come into existence designed specifically to circumvent such rules. For instance, if a quota share reinsurance agreement would require bifurcation, such a contract could be structured as individual risk facultative reinsurance and potentially avoid the consequences of bifurcation. This would clearly not be within the spirit of the ITC, however, it could be the result of such a rules-based approach.



We also observe that if bifurcation, as contemplated in the ITC, was adopted, the financial position of insurers relying heavily on reinsurance as a source of capital could be severely adversely impacted. As previously noted, this would likely be the case even if substantially all insurance risk was transferred. Conversely, the financial position of reinsurers accepting such risk could be significantly improved. Such a situation would prove very confusing, disruptive and potentially misleading to financial statement users, including those who use financial statements to assess and monitor financial strength and solvency.

In addition to our view that bifurcation would significantly detract from the transparency, comparability and usefulness of financial statements, the practical implications of employing bifurcation, both in the assessment process and the process of implementing a bifurcation accounting model, would be considerable. Given that the current ITC would subject nearly all reinsurance treaties to bifurcation and Endurance writes in excess of one thousand treaties per year, the human resource burden would be substantial, as it would for virtually all reinsurers. In addition, significant and costly changes would be required to numerous systems, including underwriting, accounting and actuarial reserving systems. Incurring such costs and introducing the complexity associated with implementing a bifurcation accounting model is not justified given that it will detract from the usefulness of financial statements to users of such statements.

We have chosen not to comment on the specific bifurcation alternatives included in the ITC because we do not support bifurcation, as contemplated in the ITC, as a preferable alternative to the existing insurance and reinsurance accounting model. We also believe that implementing such a bifurcation accounting model will lead to significant inconsistencies between companies as a result of differing application and assumptions from company to company, and believe such differences could be material, confusing and potentially misleading.

Additionally, it would appear that any of the bifurcation methods listed would be reliant upon some concept of an expected loss, whether such amount is directly estimated or is the bi-product of a selected rate. Such measures either include significant assumptions which may materially differ between companies, impairing comparability, or, in the case of a rate-based method, have the potential to erroneously ascribe market changes, such as those resulting from rate and capacity changes. Additionally, such methods fail to adequately recognize the inherent variability in cash flow which exists within the “expected loss”.

Finally, the complexity associated with any bifurcation approach, along with the inevitable lack of financial transparency which would result from such a method, appear



wholly counter to the FASB's stated objectives. For example, on December 6, 2005, the Chairman of the FASB, Mr. Robert Herz highlighted these objectives, stating:

“In our view, despite the improvements in financial reporting resulting from Sarbanes-Oxley and related actions, our reporting system faces a number of important and difficult challenges. Perhaps most significant and pressing of these is the need to reduce complexity and improve the transparency and overall usefulness of reported financial information to investors and capital markets. I think this is an issue of both national and international importance.”

We believe bifurcation would move accounting and reporting farther from these stated objectives.

We understand that the International Accounting Standards Board (“IASB”) is currently considering a “current value” approach to valuing insurance and reinsurance portfolios. While we do not believe a substantial change to the existing US GAAP accounting framework governing insurance and reinsurance is appropriate at this time, we believe the “current value” approach under consideration has more conceptual merit in comparison with the bifurcation approach discussed in the ITC. We would suggest that the FASB either delay adopting any significant changes to existing GAAP, such as those contemplated in the ITC, until the IASB has completed its work or consider a principles-based approach similar to that being currently contemplated by the IASB. Near term implementation of the concepts presented in the ITC would significantly detract from and run counter to the convergence efforts of both the FASB and IASB.

#### Commentary on Statement of Financial Accounting Standards No. 113

While not specifically requested in the ITC, we would like to take this opportunity to suggest certain areas where we believe additional authoritative guidance and interpretation would prove most beneficial. Specifically, we believe that Paragraphs 9 and 11 of Statement of Financial Accounting Standards No. 113, Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts (“FAS 113”) are the main sources of interpretive diversity in addressing risk transfer and additional guidance would help to standardize the analysis and conclusions of risk transfer. We also believe that minimizing interpretive diversity of risk transfer assessment, and in the case of insurance, applicability, is critical in addressing the broader FASB goal of improving the usefulness and comparability of financial reporting of insurance and reinsurance contracts.



For simplicity, we have listed our comments numerically and, where appropriate, we have restated the relevant sections of FAS 113:

**1. Paragraph 9.a. of FAS 113:**

*9. Indemnification of the ceding enterprise against loss or liability relating to insurance risk in reinsurance of short-duration contracts requires both of the following, unless the condition in paragraph 11 is met:*

*a. The reinsurer assumes significant insurance risk under the reinsured portions of the underlying insurance contracts.*

*Appendix A – Basis for Conclusions*

*62. The Board concluded that two conditions must be met for reinsurance of a short duration contract to indemnify the ceding enterprise against loss or liability relating to insurance risk. First, the reinsurer must assume significant insurance risk under the reinsured portions of the underlying contracts. Implicit in this condition is the requirement that both the amount and timing of the reinsurer's payments depend on and directly vary with the amount and timing of claims settled under the reinsured contracts. Contractual features that delay timely reimbursement to the ceding enterprise prevent the reinsurer's payments from directly varying with the claims settled under the reinsured contracts. (emphasis added)*

We believe that provisions which delay the timely reimbursement of losses, such as payment schedules and certain aggregating retention clauses, result in the failure to transfer appropriate timing risk. We consider the timely reimbursement of claim payments a basic requirement to the definition of insurance. Loss sensitive features such as loss corridors, sliding scale commissions and profit commissions all impact the estimated amount and timing of cash flow payments where the underwriting results of the insurer and reinsurer are not always directly aligned. Such loss sensitive features are common in reinsurance contracts and we believe that their inclusion does not necessarily preclude risk transfer accounting. We believe that the current principles-based guidance is appropriate but that additional clarification would be useful in ensuring that interpretations are consistent. We are aware of diversity in practice whereby some constituents have determined that unless the results of the insurer and reinsurer are very directly aligned, the reinsurance contracts do not meet the 9.a. requirement. We also believe that a significant amount of risk transfer analysis assumes that the 9.a. test is satisfied as long as there are no claim payment schedules or contract features which directly impact the timely reimbursement of claim payments. The preceding sentence uses the term “claim payments” in the context of only claims reimbursable under the



contract and would exclude consideration of loss corridors, loss occurrence limits, commission adjustments, etc.

We believe that the current wording of FAS 113 is resulting in differing interpretations of “directly varying” causing diversity in applying the 9.a. test. We are aware that there is a range regarding the appropriate level variability of underwriting results between the insurer and reinsurer which can exist under risk transfer accounting, and, accordingly, we believe additional clarification would be useful in applying the 9.a. test consistently across the industry.

**2. Paragraph 9.b. of FAS 113 (“9.b.”):**

*b. It is reasonably possible that the reinsurer may realize a significant loss from the transaction.*

We believe that in order to assess the reasonable possibility of a significant loss to the reinsurer, all cash flows between the ceding and assuming companies under reasonably possible outcomes need to be considered. Largely due to a lack of authoritative guidance regarding 9.b. requirements, the 10/10 rule has developed in practice as a rule of thumb in assessing risk transfer. The 10/10 rule is generally intended to represent that a contract should have at least a 10% chance of resulting in at least a 10% loss. We are aware of different interpretations of this rule of thumb resulting in different pass-fail risk transfer conclusions for contracts with identical risk assessments.

We believe that there are many valid methods of assessing risk transfer in addition to the 10/10 rule of thumb. Different types of contracts and underlying exposures each lend themselves to differing analytical methods. The Casualty Actuarial Society (“CAS”) prepared a white paper titled *Risk Transfer Testing of Reinsurance Contracts: Analysis and Recommendations* which provides many meaningful comments, analysis and suggestions which, we believe, would result in improved quantitative analysis in assessing risk transfer for reinsurance contracts.

We suggest that any additional guidance promulgated regarding the assessment of risk transfer under 9.b. be equally applicable in assessing risk transfer for contracts with low probability and high severity loss potential as for contracts with high probability and lower severity loss potential. A risk transfer assessment should provide for and respond to the interdependent nature of these two variables, probability and severity, rather than concluding based on any single point or points along the probability/severity continuum over which risk transfer takes place in the markets.



### **3. Paragraph 11 of FAS 113:**

*11. Significance of loss shall be evaluated by comparing the present value of all cash flows, determined as described in paragraph 10, with the present value of the amounts paid or deemed to have been paid to the reinsurer. If, based on this comparison, the reinsurer is not exposed to the reasonable possibility of significant loss, the ceding enterprise shall be considered indemnified against loss or liability relating to insurance risk only if substantially all of the insurance risk relating to the reinsured portions of the underlying insurance contracts has been assumed by the reinsurer.*

We believe there are different interpretations of the paragraph 11 exception. The CAS risk transfer paper assumed that profit sharing does not preclude the paragraph 11 exclusion. We are also aware that others believe the existence of any loss sensitive feature would prohibit the paragraph 11 exception. Loss sensitive features are common in quota share contracts and are generally reflective of negotiations in the pricing of the contract and not necessarily in place to preclude the transfer of risk.

Due to the diversity in practice, we believe that additional guidance regarding how contracts with loss sensitive features would meet the risk transfer exception in paragraph 11 would be useful in ensuring consistent interpretations.

### **4. FAS 113 and its application to Insurance Contracts**

We believe that FAS 113 is often referred to, through analogy, to address risk transfer considerations for complex and nontraditional insurance contracts. While we believe that this analogy is an appropriate process to properly assess risk transfer for these contracts, we think the inclusion of insurance contracts within the scope of FAS 113 or other published guidance on risk-transfer is appropriate. While we believe such inclusion is appropriate, we also believe that most insurance contracts would not require extensive risk transfer analysis.

### **Conclusion**

Endurance believes that the existing accounting guidance governing insurance and reinsurance provides an adequate framework and that clarifying guidance from the FASB would result in an improved and more effective model. We believe that the adoption of a bifurcation accounting model for insurance and reinsurance contracts would significantly detract from the comparability, transparency and usefulness of financial statements and add substantial complexity to the current accounting model. We also believe that the bifurcation approach outlined in the ITC contains a critical and important flaw in accounting theory which undermines the conceptual validity of the approach.



We appreciate the opportunity to provide our comments and our views relating to this ITC.

Sincerely,

Michael Moore  
Chief Accounting Officer  
Endurance Specialty Holdings Ltd.

William Babcock  
Chief Financial Officer  
Endurance Reinsurance Corporation of America