Don't 'bifurcate' — co-operate

It's not often that changes in accounting have the potential to change the (re)insurance industry fundamentally, but a current proposal by the US Financial Accounting Standards Board (FASB) does. **David Spiller** of Guy Carpenter spells it out

David Spiller is president and chief executive of Guy Carpenter

'Bifurcation' refers to the concept of splitting an insurance or reinsurance contract into two parts: an insurance component and a financial component. The insurance component would then be accounted for under insurance accounting rules, and the financing component would be accounted for as financing, with the premium viewed as a deposit.

On 26 May 2006, the FASB issued an invitation to comment (ITC) on a proposed system of bifurcation. It received 62 responses, indicative of the wide interest in this issue. Guy Carpenter responded with a fairly detailed critique of the bifurcation proposal.

Over the years, a general consensus has been reached that (re)insurance policies may include elements that limit risk transfer. Given that consensus, US accounting authorities developed the following basic principles regarding how such (re)insurance should be accounted.

Here's how it works:

1) If a contract transfers significant insurance risk, then it is accounted for entirely as a (re)insurance contract. The policyholder expenses the premium, and claim recoveries are treated as income to the policyholder.

2) If a contract is determined not to transfer significant insurance risk, the entire contract is accounted for as a deposit. The premium is viewed as a loan. Hence, it is recorded as an asset by the policyholder. Claim recoveries are treated as a reduction of the asset by the policyholder.

3) The ITC suggests that, rather than stay with this 'either/or' test for a whole contract, many contracts should be separated (or 'bifurcated') into insurance and deposit components, with each component using its respective accounting treatment.

Our concerns about this proposal are twofold: poor timing and lack of consistency.

Too soon? Too inconsistent?

International standards for accounting for insurance contracts are currently being developed by the International Accounting Standards Board (IASB). It seems premature for one accounting authority to change its insurance accounting model radically now, especially when it has a stated goal of international convergence of accounting principles. In its response to the ITC, the Association of British Insurers (ABI) concurs: "...it would be better for the FASB to work with the IASB, rather than seeking to bring forward its own proposal before the IASB work is complete."

Accounting authorities, including the FASB, regard consistency as one of the fundamental characteristics of a sound accounting system. Unfortunately, the ITC proposal would lead to inconsistent accounting for entities with the same risk profile. The following are some illustrative examples.

Group vs individual: For an insurer that insures 100 people individually, compared to an insurer that insures these same individuals as a group, the ITC proposal would lead to different accounting treatment for items such as premiums and losses.

Personal vs commercial lines

An insurer that insures 100 individual cars would show different accounting results compared to an insurer that covers a fleet of 100 autos. Not only would there be inconsistencies across entities but, if one insurer writes both these hypothetical individual auto policies and the fleet policy, it would have different accounting in its own financial statements for the same risk exposure.

Such a company will need to use completely different financial measures to evaluate similar businesses, which will certainly make the insurer's consolidated results more difficult to explain and understand.

Insurance vs reinsurance

A personal-lines insurer that insures numerous individual homeowners' policies would record different results compared to a reinsurer that reinsures that book of business on an unlimited quota-share basis. Not only would the insurer's and reinsurer's treatment of the same risk be handled differently, so would the insurer's direct and ceded business.

In preparing our response to the ITC, our own actuaries developed some detail for this last example. They assumed a straightforward quota-share contract with an unlimited, 100% transfer of $100 000 in premium. Under current insurance accounting, the net premium recorded by the cedent would be zero, as all the risk and premium are transferred to the reinsurer.

Using our interpretation of the proposed ITC's bifurcation methodologies, the cedent could report as much as $88 000 in retained premium without the associated retained risk. We would argue that an accounting change that can lead to such startling changes in reported results needs further study.

In conclusion, we believe all those involved would benefit if the FASB joined with the IASB to come to a joint proposal for any changes in this difficult area. If the FASB decides to proceed with a bifurcation proposal independent of the IASB, it should strive to develop a system that emphasises clarity, consistency and comparability for equivalent risks. re

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