United States Government Accountability Office
Washington, D.C. 20548

February 23, 2006

The Honorable Michael G. Oxley
Chairman
Committee on Financial Services
House of Representatives

Subject: *Definitions of Insurance and Related Information*

Dear Mr. Chairman:

This letter transmits to you our briefing slides concerning a variety of issues related to identifying a universal definition of insurance and the challenges associated with doing so. We briefed your committee staff on the preliminary results of our work on June 24, 2005, and on our final results on November 29, 2005. Specifically, we provided information on (1) the elements that are commonly part of definitions of insurance, (2) a few products not universally defined as insurance or regulated across the states by their insurance departments, (3) possible regulatory implications of developing separate definitions for insurance products covering insurance risks in more than one category, (4) current developments in statutory and financial accounting communities in re-evaluating their guidelines for measuring risk transfer in reinsurance contracts, and (5) certain circumstances when finite risk contracts are used.

We focused on insurance and reinsurance in the private sector and excluded federal insurance programs. We identified elements crucial to defining or developing a definition of insurance, but we did not attempt to compile an exhaustive list of all private sector products that might be considered insurance. We reviewed relevant documents from the National Association of Insurance Commissioners (NAIC), academic sources, accounting boards, insurance companies, professional and industry associations, state insurance regulators, federal securities regulators, court cases, and general media. We also met with knowledgeable staff at NAIC and other professional and industry associations. We conducted our work from December 2004 through December 2005 in accordance with generally accepted government auditing standards.

Definitions of Insurance

We looked at a variety of sources to identify a definition of insurance and found that, while most definitions differed because they were developed for specific purposes or had changed over time, the definitions shared key elements of risk transfer and risk spreading. Definitions of insurance are developed for various purposes such as different fields of study, categories of insurance, and state or federal statutes.[1]

While risk transfer and risk spreading are key elements, these definitions often include other elements, or parameters, commonly found in the definitions. These include

- indemnification, which is the payment for losses actually incurred;
- the ability to make reasonable estimates of future losses;
- the ability to express losses in definite monetary amounts; and
- the possibility of adverse, random events occurring outside the control of the insured.

Further, while products may transfer various types of risks, a product must transfer insurance risk to qualify as an insurance product. Insurance risk is coverage for exposures that have the potential for financial loss. It is defined by NAIC as equivalent to underwriting risk. That is, for property-casualty insurers, it is the risk of mispricing new business or the risk of underestimating needed reserves for business already written. The accounting industry defines insurance risk as those risks related to uncertainties resulting from both the amount and timing of losses paid and other expenses.

Even when some losses lack certain elements of insurance, insurers have sometimes found ways that allow coverage for such losses. For example, nonpecuniary or noneconomic losses (e.g., the loss of well-being or happiness) lack certain elements of insurance—there is no commonly

[1]For example, the Gramm-Leach-Bliley Act, section 302(c) defines insurance by, among other things, making reference to state insurance laws (see slide 8).

accepted method of expressing a definite monetary amount for nonpecuniary losses and no measurable means to indemnify the insured. For example, the loss of happiness upon the death of a loved one would be difficult if not impossible to quantify in monetary terms; instead of attempting to quantify such a loss, life insurers agree to pay a predetermined amount of monetary benefits upon the death of the insured, and they charge a premium based on both the amount of insurance and the expected mortality risk of the insured.

In reviewing the various definitions of insurance, we also found that court interpretations and state regulatory practices change definitions over time. For example, courts have emphasized different elements of an insurance contract such as its principal object and purpose as in *Jordan v. Group Health* or have focused on the legal elements necessary for an enforceable contract as in *Griffin Systems v. Washburn*.[2] (See slides 5-8 and 13-15 for further discussion of various definitions of insurance.)

How States Define and Regulate Insurance

Generally, states define and regulate the same products as insurance. While states rely on a variety of sources to provide a legal and regulatory definition of insurance, these sources sometimes lead to differences in how certain products are categorized—whether as insurance or not. In an effort to reduce confusion, NAIC has attempted to catalog products regulated by each of the state insurance regulators in standardized lists known as Uniform Product Coding Matrices (UPCM)—one for property casualty products and another for life/accident/health products. Insurers are to use the UPCM as a guide for filings of insurance rates and policy forms. Most of the products in the UPCM are recognized and regulated across all states as insurance. However, some differences still exist. For example, prepaid legal service plans are defined and regulated as insurance in Texas but not in South Carolina.

[2]The *Jordan* case focused on insurance contracts that also contained noninsurance features and looked at both the insurance and noninsurance features to determine the "principal object and purpose" of the contract *Jordan v. Group Health Ass'n.*, 107 F.2d 239, 247-48 (D.C. Cir. 1939). The *Griffin* case articulated four elements of an insurance contract: (1) a contract between an insurer and insured that exists for a specific period of time, (2) an insurable interest possessed by the insured, (3) consideration in the form of a premium paid by the insured to the insurer, and (4) the assumption of risk by the insurer who agrees to indemnify the insured for potential loss resulting from specified perils *Griffin Systems v. Washburn*, 505 N.E.2d 1121, 1123-24 (Ill. App. Dist. 1987).

Many states have a statutory definition that is stated generally and may explicitly include and/or exclude specific insurance products.[3] A few states do not have a general definition. For example, Illinois' statute lists classes of products subject to or excluded from regulation. When a product is not listed in the statute, Illinois regulators apply a functional definition consisting of the elements articulated in *Griffin Systems v. Washburn*.

We identified some products either not included in the UPCM or subject to differences in statutory or regulatory approaches among various state insurance regulators. These include

- products created and offered by noninsurers as substitutes for other products underwritten by insurers (e.g., debt cancellation contracts created by lenders as substitutes for credit insurance; see slide 18);

- products that are viewed sometimes as insurance and other times as prepayment or discount payment plans for services (e.g., legal and medical services plans; see slides 21-22);

- various annuity products sold by insurers because whether a particular annuity product is insurance hinged on the level of insurance risk and/or investment risk assumed by the insurer (e.g., variable annuities in which the insurer assumes no investment risk and period certain annuities in which the insurer assumes no mortality risk; see slides 27-28); and

- insurance products regulated by state departments other than state insurance departments because of their historical association with particular industries or economic activities (e.g., title insurance that, according to a state insurance department official, is historically associated with the real estate market; see slide 31).

Products we identified with differences in regulatory approaches among some state insurance regulators are listed and discussed on slides 18-31.

[3]An example of a statutory definition that is stated generally is: "Insurance is a contract whereby one undertakes to indemnify another or pay a specified amount upon determinable contingencies."

Regulation of Products That Cover Insurance Risks in More Than One Category

Products that cover insurance risks in more than one category (life, accident, health, property casualty) could face uncertain regulation if separate insurance definitions were developed and used for each category. Currently, insurance products are classified by regulators as life, accident,[4] health, or property casualty insurance, even though some products cover insurance risks in more than one of these categories.

Based on the product descriptions in NAIC's UPCM, we list and describe eight insurance products we found that cover risks in more than one of the categories (slides 33-34). Our list was not intended to be exhaustive but to illustrate that some products could actually fit in two or more categories even though each product is historically associated with one particular category of insurance. The historical associations have not affected insurance regulation because insurance definitions generally apply across categories. However, if separate statutory definitions of insurance were developed for each category, it is unclear how products characterized by features from multiple categories would be classified for regulatory purposes. As a result, products that cover insurance risks in more than one category might be regulated differently or might be regulated under multiple regimes. For example, it is unclear whether accident insurance that also provides death and health care benefits would be regulated solely as accident insurance or also as both life and health insurance, and whether regulation would differ across the three types of insurance. (See slides 32-34 for additional information on this issue.)

Reinsurance

Reinsurance is insurance for insurers. In contrast to insurance, reinsurance is not sold as a standard product. Each contract is separately negotiated. Two basic types of reinsurance contracts exist—treaty and facultative. The key difference between treaty and facultative reinsurance contracts is how insurers select risks for transfer. In a treaty reinsurance contract, the reinsurer and insurer agree on which select class(es) of underlying policies of the insurer's to underwrite. In a facultative reinsurance contract, the reinsurer and insurer agree on individual underlying policies. In addition to

[4]Accident insurance is a form of health insurance against loss by accidental bodily injury. ("Fundamentals of Risk and Insurance," by Emmett J. Vaughan and Therese Vaughan).

the method of selecting underlying policies, reinsurance contracts usually contain features such as floors and caps that limit the amount of risks underwritten.

The transfer of risk is the key element to defining reinsurance. While reinsurance contracts can also transfer noninsurance risks, it is the transfer of insurance risk that is the focus when evaluating the validity of a reinsurance contract. Further, if sufficient insurance risk is transferred, the entire contract can be defined as reinsurance and qualify for reinsurance accounting—a type of accounting treatment sought when beneficial to the insured's financial statements.[5] Currently, the statutory and financial accounting communities are re-evaluating methods used in determining whether a reinsurer's contract covering property casualty insurance risks actually transfers insurance risk. Both statutory and financial accounting standards establish the necessary conditions of risk transfer for reinsurance contracts including that the reinsurer assume significant insurance risk and face a reasonable possibility of significant loss.[6] Statutory and financial accounting guidelines also clarify that while reinsurance contracts may transfer other types of risks, such as investment risk, only insurance risk is subject to the conditions for determining risk transfer. Also, the guidelines require that determinations of risk transfer should consider all features in a contract such as cancellation provisions or payment schedules that delay the reinsurer's timely reimbursement of claims; features like these may limit the transfer of insurance risk. In addition, financial accounting guidelines explain that determining the extent of risk transferred in one reinsurance contract should be done in the context of all other related contracts or agreements because they may potentially limit the transfer of insurance risk. However, once the determination is made that the contract transfers sufficient insurance risk,

[5]For clarity, contracts that do not transfer sufficient insurance risk can be referred to as "reinsurer's contracts."

[6]The NAIC issues Statements of Statutory Accounting Principles (SSAP) that provide guidance for required filings of insurance company financial statements to state insurance regulators and the NAIC. Another accounting organization, the Financial Accounting Standards Board, also establishes financial accounting and reporting standards—Statement of Financial Accounting Standards—some of which are specifically for insurance and reinsurance companies and transactions. NAIC's Statement of Statutory Accounting Principles No. 62 and FASB's Statement of Financial Accounting Standards No. 113, paragraphs 9a and 9b, establish the necessary conditions of risk transfer for contracts: (1) "reinsurer assumes significant insurance risk under the reinsured portions of the contract" (commonly called the "9a test") and (2) "It is reasonably possible that the reinsurer may realize significant loss" (commonly called the "9b test").

reinsurance accounting can be applied to the entire contract, including any noninsurance risks being transferred. (See slides 35-42 for further information on reinsurance.)

Finite Risk Contracts

No widely accepted definition exists for finite risk contracts. Finite risk contracts can be used by both insurers (finite risk reinsurance) and noninsurers (finite risk insurance). In general, such contracts transfer less insurance risk than traditional reinsurance or insurance. Instead, finite risk contracts tend to emphasize financing and accounting benefits. Specifically, the contracts allow the insured to transfer to a reinsurer or insurer both insurance risk and uncertainties about the timing of certain cash flows and recognition of certain income and expenses. Thus, an insured could use these contracts to both reduce insurance risk and control or smooth the timing of cash flows and the recognition of certain expenses and income. This could favorably affect earnings, capital, and certain ratios that regulators, rating agencies, and investment analysts might use to measure and monitor a company's financial health.

Finite risk contracts must transfer sufficient insurance risk to legitimately qualify for these financing and accounting benefits. Although finite risk contracts can be legitimately structured to meet these requirements, some companies that originally presented their finite risk contracts as transferring sufficient insurance risk, and thus qualifying for the financing and accounting benefits, were discovered to have used mechanisms such as undisclosed side agreements that resulted in little or no insurance risk actually being transferred. Disguising such contracts to look like "real reinsurance" or insurance can mislead regulators, policyholders, and investors about the actual financial condition of the company. (See slides 43-47 for further discussion of finite risk contracts.)

In summary, we found that there is no single, universal definition of insurance. However, we identified certain key elements of risk transfer or risk spreading that were common among the varying definitions. Moreover, while statutory definitions of insurance sometimes differed between states leading to differences in the regulation of certain products, states generally define and regulate the same products as insurance. Insurance products also are categorized by type of insurance risk such as life, accident, health, and property casualty. However, some products, while designated as belonging to one of the major categories, have characteristics that fall into more than one category. Therefore, if separate statutory definitions of

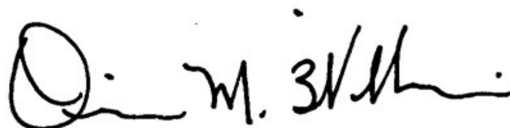
insurance were developed for products in each category of insurance risk, products that transfer insurance risks in more than one category could face uncertain regulation.

Concerning reinsurance and its accounting treatment, the amount of insurance risk actually transferred is important because of the benefits of reinsurance accounting to the ceding company. Specifically, if insurance risk is transferred at sufficient levels, the entire contract would qualify for reinsurance accounting, with resulting positive effects on the ceding company's reserves and surplus. Another type of contract—the finite risk contract—can receive reinsurance accounting or other preferred accounting treatment but transfers less risk at a lower premium than traditional insurance. Recently some companies that had these contracts and used reinsurance accounting treatment were found to have transferred insufficient insurance risk to qualify for such treatment.

As agreed with your office, unless you publicly announce the contents of this report earlier, we plan no further distribution until 30 days from the date of this report. At that time, we will send copies of this report to the Chairman and Ranking Minority Member of the Senate Committee on Banking, Housing, and Urban Affairs and the Ranking Minority Member of the House Committee on Financial Services. We also will make copies available to others upon request. In addition, the report will be available at no charge on GAO's Web site at http://www.gao.gov.

If you or your staff have questions regarding this report, please contact me at (202) 512-5837 or williamso@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. Lawrence D. Cluff, Angela Pun, Mel Thomas, Christine J. Kuduk, Nancy S. Barry, and Tania L. Calhoun made key contributions to this report.

Sincerely yours,



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Enclosure

Definitions of Insurance

Presentation For
Committee on Financial Services
U.S. House of Representatives

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Contents

- Scope and Methodology (slide 3)
- Definitions of Insurance (slides 4-11)
- How States Define and Regulate Insurance (slides 12-31)
- Regulation of Products That Cover Insurance Risks in More Than One Category (slides 32-34)
- Reinsurance (slides 35-42)
- Finite Risk Contracts (slides 43-47)
- Summary (slide 48)

Scope and Methodology

- We focused on products sold by insurers or reinsurers in the private sector and excluded federal insurance programs.
- We did not attempt to compile an exhaustive list of all products in the private sector that might be considered insurance.
- We reviewed academic textbooks and journals; documents from National Association of Insurance Commissioners (NAIC), state insurance regulators, Securities and Exchange Commission, and National Association of Securities Dealers; statutory and financial accounting principles and standards; general media; and court cases.
- We interviewed officials from NAIC, industry associations for life, health, and property casualty insurance, as well as banking and other professional associations. We also interviewed academicians and officials with the Illinois insurance department.

Definitions of Insurance 3

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Definitions of Insurance

In our research, we found that

- There is no universal agreement on a definition of insurance,
- Most definitions have common elements,
- The Gramm-Leach-Bliley Act provides one definition used by the federal government,
- Nonpecuniary losses are usually not covered by insurance, and
- Identity theft insurance pays only for actual expenses incurred by the victim.

Definitions of Insurance 4

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Definitions of Insurance

No Universal Agreement

Insurance industry participants and state regulators develop definitions for different purposes, such as

- Specific subject areas, such as accounting, actuarial science, economics, and finance;
- Specific types of insurance, such as life or property casualty; or
- Statutes and regulations, which can vary across states.

These definitions are dynamic, sometimes caused by

- Evolution of thinking in subject areas;
- Product innovations; and
- Changes in statutes, regulations, and court interpretations.

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Definitions of Insurance

Key Elements

Definitions of insurance have two key elements:

- Risk is transferred.
  - An uncertain, possibly large, loss is transformed into a certain, small cost or premium for the insured; and
  - An insured transfers risk to another entity.

- Risk is spread. That is, an insurer spreads risk over a large enough group for the law of large numbers to predict both total losses and the probability of a single loss with some accuracy.

Definitions of Insurance

Other Elements

Other elements often considered to be conditions necessary for an “insurable” risk are

- Risks that are reasonably homogeneous and independent; and
- Losses that meet certain conditions, including
  - Chance occurrences,
  - Low probability of loss,
  - Occur at a definite time and place, and can be expressed as a definite monetary amount, and
  - Are not catastrophic, i.e., do not affect a large number of insureds at the same time.

Definitions of Insurance

Gramm-Leach-Bliley Definition

Section 302(c) defines insurance as

- Any product regulated as insurance as of Jan. 1, 1999, in accordance with the relevant state insurance law, in the state in which the product is provided; and
- Any product first offered after Jan. 1, 1999, which
  - A state insurance regulator determines shall be regulated as insurance in the state in which the product is provided because the product insures, guarantees, or indemnifies against liability, loss of life, loss of health, or loss through damage to or destruction of property, including, but not limited to, surety bonds, life insurance, health insurance, title insurance, and property and casualty insurance; and
  - Is not a product or service of a bank as described in the section; and
- Any annuity contract, the income on which is subject to tax treatment under section 72 of the Internal Revenue Code.

Definitions of Insurance 8

Description of Nonpecuniary Losses

Pecuniary or economic losses have a market price or can be calculated in monetary terms. Some examples include

- The cost to repair or replace a damaged vehicle, or
- A family's loss of future expected income from the death or disability of an income-earning parent or spouse.

Nonpecuniary or noneconomic losses do not have a market price. These losses are the reduction of insureds' welfare such as their health, well-being, and happiness.

Definitions of Insurance

Nonpecuniary Losses Lack Certain Common Elements, but Some Coverage Provided

Nonpecuniary losses lack certain common insurance elements. For example

- Nonpecuniary losses cannot be calculated as a definite amount;
- The principle of indemnity does not apply; and
- There is no insurable interest for some types of nonpecuniary losses.

Insurers provide coverage for some nonpecuniary losses by paying

- Predetermined monetary amounts, such as life insurance paying the amount chosen by the insured at time of purchase; or
- Amounts calculated in monetary terms under specific circumstances, such as uninsured motorist insurance covering damages for “pain and suffering.”

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Definitions of Insurance

Identity Theft Insurance Covers Pecuniary Expenses

Although the theft of one's identifying information is a nonpecuniary loss, identity theft insurance only pays for associated expenses that have a market price or can be calculated in monetary terms. These include

- Costs of certified mail and long-distance calls;
- Lost wages from time taken off work; and
- Fees, such as attorney and loan application fees.

Definitions of Insurance 11

How States Define and Regulate Insurance

States rely on a variety of sources to help define and regulate insurance. These include

- State statutory definitions,
- Court interpretations,
- Regulatory descriptions of insurance products, and
- Uniform Product Coding Matrices (UPCM) categories of insurance.

However, some products are not universally recognized or regulated as insurance.

Definitions of Insurance 12

How States Define and Regulate Insurance

State Statutory Definitions

- Many states have a statutory definition that is general and inclusive, similar to the following:

  Insurance is a contract whereby one undertakes to indemnify another or pay a specified amount upon determinable contingencies (Kentucky Revised Statutes § 304.1-030)

- Some states have explicit inclusions and/or exclusions. For example, Kentucky's definition includes annuities and sureties, while Wisconsin's excludes continuing care contracts.

- A few states do not have a statutory definition. For example, Illinois' insurance statutes list classes of products subject to or excluded from regulation. When a product is not listed in the statutes, the regulators apply a functional definition consisting of the elements articulated in a court case.

Definitions of Insurance 13

How States Define and Regulate Insurance

Court Interpretations

Two court cases have helped guide states in defining and regulating insurance:

- *Jordan v. Group Health* found that courts may look at the nature of the contractual relationship to determine whether risk transfer or distribution is its "principal object and purpose."
- *Griffin Systems v. Washburn* found that courts may look to see whether a product contains certain elements within a definition of insurance. These elements include
  - A contract between an insurer and insured that exists for a specific period of time,
  - An insurable interest possessed by the insured,
  - Consideration in the form of a premium paid by the insured to the insurer, and
  - The assumption of risk by the insurer who agrees to indemnify the insured for potential loss resulting from specified perils.

How States Define and Regulate Insurance

Regulatory Descriptions of Insurance Products

NAIC worked with insurance departments in 20 to 25 states to develop the UPCM that lists and describes

- Property/Casualty insurance products, and
- Life/Accident/Health insurance products.

NAIC developed the UPCM to

- Identify all products regulated by state departments of insurance,
- Standardize terminology for insurance products across all states, and
- Aid filings of insurance products (rates and policy forms).

Definitions of Insurance 15

UPCM Categories of Insurance

	Category of insurance	Description
Property/Casualty		Coverage against loss or damage to property and liabilities to third parties resulting from such losses or damages or other events
Life, Accident, Health, Annuity, and Credit	Continuing Care Retirement Community (CCRC)	A senior housing arrangement that, in addition to housing, includes some provision for skilled nursing care
	Credit Insurance	Coverage that pays off or takes over scheduled payments on an obligation to a creditor upon occurrence of a specified event such as death, disablement, or unemployment of the insured debtor
	Health Insurance	Coverage that provides benefits for expenses related to and losses resulting from sickness, a medical condition, or an accident
	Health Maintenance Organization (HMO)	A health insurance plan with a range of medical coverages offered on a prepaid and group basis to its enrollees through medical providers under contract
	Life Insurance	Insurance contracts that provide specified benefits amounts to named beneficiaries upon the death of the insured
	Long-Term Care Insurance	Insurance that covers or reimburses for the costs of long-term care, nursing home care, and home care services
	Medicare Supplement	Coverage is known as Medigap insurance because it supplements or fills gaps in coverage of the federal Medicare Program
	Multiline	Insurance not captured elsewhere
	Viatical Settlements	Contract or agreement in which a third party purchases all or a part of a policyholder's life insurance policy

Source: Based on information from NAIC.

How States Define and Regulate Insurance

Products Not Universally Recognized or Regulated as Insurance

Key Issues	Product
Products created by noninsurance entities that substitute for regulated insurance products	Debt cancellation contracts & debt suspension agreements [b] Gap waivers [b] Rental car damage waivers & theft waivers [b]
Products that could be either insurance or payment plans	Legal services plans [b] Medical services plans [b] Extended service contracts [a] Preneed funeral & burial arrangements [a] Continuing care retirement communities [a] Preventive health care coverage [a]
Products underwritten by insurers that contain investment risk	Variable annuities and equity indexed annuities [a] Period certain annuities [b] Viatical settlements & life settlements [a]
Insurance and insurance-like products not always regulated by state departments of insurance	Surety contracts [a] Title insurance [a]

Notes: [a] Located in NAIC's Uniform Product Coding Matrices.
[b] Not located in NAIC's Uniform Product Coding Matrices.

Definitions of Insurance 17

How States Define and Regulate Insurance

Substitutes for Regulated Insurance Products
Debt Cancellation or Suspension Contracts

Description
- Created by lenders as substitutes for credit insurance
- For a fee, lender retains risk in lieu of pursuing collection and potential recovery on loan if borrower defaults
- Lender agrees to cancel or temporarily suspend loan under conditions such as death, disability, or unemployment of borrower
- Unclear whether these are a transfer of insurance risk or forgiveness of financial obligation
- Equivalent to credit insurance from consumer's viewpoint

Information on regulation
- Illinois—does not view as insurance; no indemnity payments from third parties
- Michigan—does not view as insurance but as incidental to loans
- New York—views as insurance but does not regulate when sold by financial institutions

How States Define and Regulate Insurance

Substitutes for Regulated Insurance Products

Gap Waivers

Description

- Created by auto dealers and others as a substitute for gap (originally, guaranteed auto protection) insurance
- For a fee, creditor retains risk by agreeing to waive the excess of the lessee's or debtor's obligation to pay the amount owed on a property over its actual cash value in the event of total loss due to theft or physical damage
- Unclear whether these are a transfer of insurance risk or forgiveness of financial obligation
- Properties include autos, boats, and computers
- Some offer gap waivers as alternative to gap insurance that other entities offer

Information on regulation

- New York—views as insurance under certain conditions; auto dealers or lenders who are not licensed as insurance agents or brokers may offer gap waivers; providers of gap waivers that in turn buy gap insurance from licensed insurers must not charge customers more than they pay
- Mississippi—has not determined whether gap waivers are insurance and does not regulate them

How States Define and Regulate Insurance

Substitutes for Regulated Insurance Products
Rental Car Damage and Theft Waivers

Description
- Created by car rental companies as a substitute for rental insurance
- For a fee, rental company retains risk by agreeing not to hold driver liable in the event of certain damages involving a rental vehicle
- Unclear whether these are a transfer of insurance risk or forgiveness of financial obligation
- Equivalent to rental car insurance from consumer's viewpoint

Information on regulation
- New York—rental company must obtain driver's written consent to buy the waiver before the driver signs the rental agreement
- Texas—does not view as insurance; are waivers of rental company's right to recover on damages to auto

Definitions of Insurance 20

How States Define and Regulate Insurance

Products That Could Be Insurance or Payment Plans
Legal Services Plans

Description

- The term is used to characterize plans that
    - provide legal services
    - pay for the cost of obtaining legal services
    - prepay for future legal services, at discounted prices
    - reimburse for legal services costs
    - prepay for future legal services, if needed
- Unclear whether these are transfers of insurance risk, price discounting plans, prepaid expense plans, or some combination

Information on regulation

- New York—included in the list of authorized insurance is legal services insurance that is defined as providing legal services or reimbursement for the cost of legal services
- South Carolina—prepaid legal service contracts regulated by the state's Department of Consumer Affairs
- Texas—prepaid legal insurance is insurance if one party prepays another for future legal services that may or may not be needed and if the other party assumes the risk that such services may be needed

How States Define and Regulate Insurance

Products That Could Be Insurance or Payment Plans

Medical Services Plans

Description

- Some physicians and medical groups offer prepayment plans to patients
  - to avoid the administrative burden of third-party health insurance
  - that appear to operate as insurer/providers (such as HMOs) on a smaller scale
- Unclear whether these are transfers of insurance risk, price discounting plans, prepaid expense plans, or some combination

Information on regulation

- New York—A plan in which patients prepay for future medical care needs
  - would be insurance and require licensing if the plan provides unlimited services dependent on the happening of a fortuitous event that could cost more than the prepayment
  - would not be insurance and not require licensing if certain services occasioned by the happening of a fortuitous event are offered for an additional fee that covers the cost of the services, although discounted from the usual fee

How States Define and Regulate Insurance

Products That Could Be Insurance or Payment Plans

Extended Service Contracts (ESC)

Description—typically sold for autos, “home” (major home appliances), and consumer products

- Providers assume future costs of repairs or maintenance for a fee
- Not to be confused with written or implied warranties of fitness and merchantability provided by the manufacturer
- Some state courts have determined that ESCs are insurance when the seller of an ESC is not the manufacturer but a repair service provider

Information on regulation—Regulation in some states is based on state court decisions such as those discussed in the *Griffin v. Washburn* case:

- Arizona court—ESC is insurance because third-party insurer sold ESC
- Texas and Virginia courts—ESC is not insurance because merchant of product sold ESC and makes repairs

Definitions of Insurance 23

How States Define and Regulate Insurance

Products That Could Be Insurance or Payment Plans

Preneed Funeral and Burial Arrangements

Description

- Purchase of future funeral services and merchandise at locked in current price
- Can be unfunded or funded in advance of need
- Advance payments are deposited in interest-bearing trust account or used to buy funeral insurance
- Can also be funded with future life insurance or annuity proceeds upon death
- Are typically revocable and movable at any time by consumer and trust account prefunding is returnable
- Unclear whether these are a transfer of insurance risk, price discounting plans, or prepayment of expenses

Information on regulation

- Arkansas—licenses and regulates sales of such services; state finance division examines contracts and bank trust accounts
- California—Department of Consumer Affairs' Cemetery and Funeral Bureau licenses and regulates funeral establishments that sell such services
- Colorado—regulates sellers

How States Define and Regulate Insurance

Products That Could Be Insurance or Payment Plans

Continuing Care Retirement Communities (CCRC)

Description

- Senior housing arrangements that provide for skilled nursing care, if later needed
- Three types of communities
  - Type A—fee is locked in if skilled care is later needed
  - Type B—fee for skilled care is locked in for limited time with later increases that don't reach market rate
  - Type C—access to later skilled care is assured, but at full market rate
- Unclear whether these are transfers of insurance risk, price discounting plans, or prepayments of expenses

Information on regulation

- California—Department of Social Services certifies and regulates CCRCs, but state insurance code regulates uncertified CCRCs
- North Carolina—CCRCs must be licensed by the commissioner of insurance and state insurance code governs their activities
- South Carolina—CCRCs do not include nursing home or residential care facilities licensed by state Department of Health & Environmental Control
- Unclear how many state insurance departments regulate CCRCs

How States Define and Regulate Insurance

Products That Could Be Insurance or Payment Plans

Preventive Health Care Coverage

Description

- Covers health care to keep healthy or to prevent illness
- Health insurance plans appear to typically cover preventive care
- Includes annual physicals, pelvic exams, flu shots, screening mammograms, and dental cleanings
- Many preventive health care activities tend to be recurring and predictable
- Unclear whether these are a transfer of insurance risk, price discounting, or prepayment of expenses

Information on regulation

- Required by some states to be included in health insurance
- Traditionally included in health insurance

Definitions of Insurance 26

How States Define and Regulate Insurance

Products Underwritten by Insurers Containing Investment Risks

Variable Annuities and Equity-Indexed Annuities

Description

- Annuity—a contract that, in return for premium(s) paid, guarantees a series of payments for a specified period or for life.
- Variable annuity—pays a rate of return based on the performance of investments. Interest rate and principal are usually not guaranteed. The customer retains almost all of the investment risks.
- Equity-indexed annuity—pays a minimum rate of return plus an extra rate using a formula based on charges to an equity index such as the S&P 500. The contract usually guarantees a minimum account value. The customer retains some of the investment risk.
- Insurer assumes mortality risks through added features, if offered, such as payments for life and death benefits.

Information on regulation

- Variable annuities
  - Sold by insurance companies, but regulated by SEC
  - In some states, state securities regulators have authority over variable annuities
  - State departments of insurance (DOI) regulate the insurer selling the product
- Equity-indexed annuities are sold by insurance companies and the SEC is evaluating them to determine if they should be regulated as securities

Definitions of Insurance 27

How States Define and Regulate Insurance

Products Underwritten by Insurers Containing Investment Risks

Period Certain Annuities

Description

- Pay a fixed rate of return over a specified term such as 5, 10, 15, or 20 years
- Customer shifts all investment risks to the insurer
- As with any annuity, the insurer could assume mortality risks through added features such as death benefits or retirement benefits, if offered

Information on regulation

- Traditionally regulated by DOI as an insurance product
- Illinois—If an annuity transfers mortality risks to the insurer, it is regulated.

Definitions of Insurance 28

How States Define and Regulate Insurance

Products Underwritten by Insurers Containing Investment Risks

Viatical Settlements and Life Settlements

Description

- Viaticals—policyholders are usually ill with under 2 years of life expectancy
- Life settlements—policyholders are over 65 with normal life expectancy
- Each product may be bundled together and sold to investors
- In both cases
  - Third party pays policyholder cash and becomes a beneficiary of the life insurance death benefit
  - The cash payment is more than the cash surrender value of the policy but less than the expected death benefit
- Unclear whether these products pose insurance risk or investment risk

Information on regulation

- Sometimes regulated by DOI, sometimes by state securities regulator, and sometimes by both
- Some states adopted NAIC's Viatical Settlements Model Act, which requires viatical companies to be licensed by a state DOI
- In California, Connecticut, New York, and Washington, settlement providers are licensed by the DOIs

Definitions of Insurance 29

How States Define and Regulate Insurance

Insurance and Insurance-Like Products That Are Not Always Regulated by State DOIs

Surety Contracts

Description

- A contract where the surety (similar to insurance company) agrees, for a fee, to perform the principal's (similar to the policyholder) obligations to a third party in the event the principal fails to perform
- Surety assumes risk from the third party that the principal will not perform contractual obligations
- Unlike insurer, surety has a right to seek indemnification from the principal after performing contractual obligations

Information on regulation

- New York and Utah—If an issuer sells surety bonds as a vocation, as opposed to incidental to other business activity, then it is subject to insurance regulation
- Kentucky and Delaware—Their statutory definitions explicitly include those who "act as surety"

How States Define and Regulate Insurance

Insurance and Insurance-Like Products That Are Not Always Regulated by State DOIs

Title Insurance

Description

- For a fee, an insurer agrees to indemnify the insured up to a specified amount of loss for defects in the title to real property
- Typically required by mortgage lenders at property settlement

Information on regulation

- Iowa—This is the only state that does not allow the sale of title insurance within its borders; the state's Finance Authority operates a Title Guaranty Program.
- Illinois—Regulated by the Division of Financial Institutions, not the state DOI
- Regulatory treatment does not vary widely among the states

Definitions of Insurance 31

Regulation of Products That Cover Insurance Risks in More Than One Category

Some products, while defined by NAIC as belonging to a particular category of insurance, have characteristics that also fit in other categories.

We have

- Described the products, and
- Identified the categories of risks covered by each product.

Definitions of Insurance 32

Regulation of Products That Cover Insurance Risks in More Than One Category

Product Descriptions

Product	Description
Accident	Coverage for death, dismemberment, disability, or hospital and medical care caused by or necessitated as a result of specified accidents
Credit Disability	Makes monthly loan/credit transaction payments to the creditor upon the disablement of an insured debtor
Credit Life	Coverage sold in connection with loan and credit transactions to provide insurance protection against death
Credit Insurance	Coverage of an obligation to a creditor upon the death or disablement of the insured debtor; includes coverage that protects the value of collateral for a loan
Disability Income	Coverage designed to compensate insured individual for a portion of the income they lose because of a disabling injury or illness
Employee Benefit Liability	Liability protection for employers against employee claims such as for wrongful termination or improper calculation of employee benefits from pension plans, group life, health, or disability income insurance or accidental death and dismemberment insurance
Employers Liability	Coverage for the legal liability of employers arising out of injury to employees
Workers' Compensation	Coverage for an employer's liability for injuries, disability, or death to persons in their employment, without regard to fault, as prescribed by state or federal workers' compensation laws or other statutes

Source: GAO analysis of lines of insurance descriptions.

Definitions of Insurance 33

Regulation of Products That Cover Insurance Risks in More Than One Category

Categories of Risks Covered by One Product

Product	Insurance Category			
	Property/Casualty	L/A/H		
		Life	Accident	Health
Accident		O	P	O
Credit Disability	P		O	O
Credit Life	P	O		
Credit Insurance	P	O	P	
Disability Income	O		P	
Employee Benefit Liability	P	O	O	O
Employers Liability	P		O	
Workers' Compensation	P	O	O	

P = Product's insurance category in NAIC's Uniform Product Coding Matrix.
O = Other categories with products that have similar features.
* Credit insurance is listed under two categories in NAIC's UPCM.

Source: GAO analysis of lines of insurance descriptions.

Definitions of Insurance 34

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Reinsurance

Some of the principal elements of reinsurance and its uses include

- The definition of reinsurance,
- Reinsurance contracts,
- Reinsurance and risk transfer,
- The 9a and 9b "tests" for risk transfer,
- The benefits of statutory reinsurance accounting for insurers, and
- Reinsurance contracts permit the transfer of varying levels of risk.

Definitions of Insurance 35

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Reinsurance

Definition

The Reinsurance Association of America defines reinsurance as

> A transaction whereby the assuming reinsurer, for a payment, agrees to indemnify the ceding insurer against all, or a part, of the loss which the latter may sustain under the policy or policies which it has issued.

Definitions of Insurance 36

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Reinsurance

Reinsurance Contracts

- Reinsurance is not sold as a standardized product. Each contract is separately negotiated.
- Regulators look for risk transfer in each contract to determine if reinsurance has occurred.
- Two basic methods of assuming risks in reinsurers' contracts are
  - Treaty reinsurance, which usually covers a part or a percentage of a book of an insurer's business, for example, all of an insurer's medical malpractice policies with hospitals; and
  - Facultative reinsurance, which covers individual policies, usually of a unique nature, for example, an insurer's medical malpractice policy with the Mayo Clinic.

Definitions of Insurance 37

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Reinsurance

Reinsurance and Risk Transfer

Statement of Statutory Accounting Principles

Reinsurance is the assumption by an insurer of all or part of an insurance risk undertaken originally by another reinsurer.

(Accounting Practices and Procedures Manual, NAIC, underlining added)

Statement of Financial Accounting Standards

Insurance provides indemnification against loss or liability from specified events during a specified period. The insurer (or ceding enterprise) pays (cedes) an amount to the reinsurer, and the reinsurer agrees to reimburse the insurer for a specified portion of claims paid under the reinsured contracts indemnification against loss or liability under a reinsurance contract generally referred to as risk transfer. *(Financial Accounting Standard No. 113, underlining added)*

Definitions of Insurance 38

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Reinsurance

Reinsurance and Risk Transfer

- Risk transfer requires that the reinsurer indemnifies the insurer for unexpected losses.
- Insurance risk does not include investment risk.
- Insurance regulators bear responsibility for determining whether risk transfer has occurred for statutory purposes.
- Risk transfer is determined by applying financial and statutory accounting guidelines:
    - Reinsurer assumes significant insurance risk under the reinsured portions of the contract ("9a test"), and
    - It is reasonably possible that the reinsurer may realize significant loss ("9b test").

Definitions of Insurance 39

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Reinsurance

The 9a and 9b Tests for Risk Transfer

9a test

- The amount and timing of reinsurer's claims settlements should vary directly with the severity and timing of the loss event.
- The extent of risk transfer is determined by examining contract features.

9b test

- The 10/10 rule means the reinsurer has a 10 percent or greater chance of incurring a 10 percent or greater loss of the premium under the contract. While regulators do not universally agree with the "10/10 rule," it is commonly used by industry.
- The extent of risk transfer is determined through risk transfer analysis, but it can yield different results.

If a reinsurer's contract passes the 9a and 9b tests to the regulator's satisfaction, reinsurance accounting can be applied to the entire contract.

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Reinsurance

Benefits of Statutory Reinsurance Accounting for Insurers

Insurers attempt to structure reinsurance contracts to transfer sufficient risk to qualify for reinsurance accounting in order to

- Improve net income on the income statement,
- Improve the surplus on the balance sheet,
- Improve the regulatory ratios used for solvency regulation, and
- Increase the insurers ability to write more policies with existing capital.

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Reinsurance

Reinsurance Contracts Permit the Transfer of Varying Levels of Risk

Simple quota share reinsurance is a basic form of treaty reinsurance contract that fully transfers risk. In this contract, insurer and reinsurer share all business in a fixed proportion. For example, in a 70 percent quota share, 70 percent of premiums, losses, and loss expenses would be ceded to the reinsurer, while 30 percent would be retained by the insurer.

Elements added to a simple contract may limit risk transfer:

- By adding certain types of features into the contract (for example, a sliding scale ceding commission), or
- Through verbal and written side agreements that limit risk transfer.

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Finite Risk Contracts

Finite risk contracts are a mechanism for limiting risk transfer. We discuss

- Their definition,
- Their purposes,
- Current domestic and international scrutiny, and
- Organizations reviewing finite risk issues.

Definitions of Insurance 43

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Finite Risk Contracts

Definition

Finite risk contracts
- Have no global definition;
- Are called by many other names, such as financial reinsurance, financial engineering reinsurance, or structured reinsurance;
- Can take place between a reinsurer and an insurer, or an insurer and a noninsurance entity;
- May transfer to a reinsurer less insurance risk than traditional insurance—or no insurance risk—while emphasizing other features; and
- May cost less than traditional insurance or reinsurance.

Definitions of Insurance 44

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Finite Risk Contracts

Purposes

Insurers may structure finite risk contracts to appear like traditional reinsurance:

- To qualify for preferential accounting and tax treatment while transferring minimal insurance risk;
- To maintain certain financial ratios, such as premiums to surplus, within acceptable or favorable limits for regulators, rating agencies, and investors; or
- For financing purposes, such as spreading multiyear timing risks, that have priority over transferring insurance risk (for example, long-tail risks).

Similarly, noninsurers might use finite risk contracts for smoothing earnings by deferring recognition of losses on major events that might otherwise be fully charged against current earnings, or for evenly spreading cash outflows associated with such events.

Such contracts, if not legitimately structured, may result in misleading financial statements.

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Finite Risk Contracts

Domestic and International Scrutiny

International and U.S. organizations are reviewing issues related to finite risk contracts such as

- Disclosure requirements for finite risk contracts,
- Certification by company officials,
- Different accounting treatments for insurance risks and noninsurance risks when a reinsurance contract contains more than insurance risks ("unbundling"), and
- What constitutes the transfer of insurance risk.

NAIC has approved new requirements for property-casualty insurers that include

- Insurers reporting contract terms and management objectives for certain finite reinsurance contracts, and
- CEO and CFO attesting that no side agreements exist and that risk has transferred.

Definitions of Insurance 46

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Finite Risk Contracts

Organizations Reviewing Finite Risk Issues

U. S. organizations currently reviewing finite risk issues include
- NAIC,
- The American Academy of Actuaries,
- The Casualty Actuarial Society,
- The Financial Accounting Standards Board, and
- The Internal Revenue Service.

International organizations currently reviewing finite risk issues include
- The International Accounting Standards Board, and
- The International Association of Insurance Supervisors.

Definitions of Insurance 47

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Summary

- Insurance has no single, universal definition, but definitions have key elements of risk transfer and risk spreading.
- Although definitions of insurance differ among some states and certain products are not universally recognized and regulated as insurance across all states, states generally define and regulate the same products as insurance.
- Products that cover insurance risks in more than one category (life, accident, health, property-casualty) could face uncertain regulation if separate insurance definitions are developed for each category.
- While reinsurance contracts can transfer various levels of insurance and noninsurance risks, contracts that transfer sufficient insurance risk are defined entirely as reinsurance and qualify for reinsurance accounting.
- Some finite risk contracts that received reinsurance accounting or other preferred accounting treatment were later found to have transferred insufficient insurance risk to qualify for such treatment.

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