



June 12, 2023

CC:PA:LPD:PR (REG– 109309-22)
Room 5203, Internal Revenue Service
P.O. Box 7604
Ben Franklin Station
Washington, DC 20044

Re: Proposed Rule: Micro-Captive Listed Transactions and Micro-Captive Transactions of Interest

To Whom it May Concern:

On behalf of the Committee on Property and Liability Financial Reporting (COPLFR) of the American Academy of Actuaries,¹ I appreciate the opportunity to provide comments on the [proposed rules](#) related to guidelines for identification of microcaptive insurance companies as listed transactions and transactions of interest proposed by the U.S. Department of Treasury, Internal Revenue Service (IRS).

COPLFR appreciates your consideration of the following comments:

1) From an actuarial perspective, variability in loss ratios is an essential aspect of property-casualty insurance.

Risk transfer, and therefore variability in loss and loss adjustment expense (LAE) ratios to premium,² is an essential element of insurance. Several of the actuarial standards of practice (ASOPs), which are promulgated by the Actuarial Standards Board, address the uncertainty inherent in loss experience associated with providing property-casualty insurance. These including ASOP No. 53, *Estimating Future Costs for Prospective Property/Casualty Risk Transfer and Risk Retention* (which deals with prospective premium determination) and ASOP No. 43, *Property/Casualty Unpaid Claim Estimates* (which deals with estimating the value of claims that have occurred, but are not yet paid).

This is particularly true when insuring coverages exhibiting low claim frequency and high claim severity and also new, innovative or emerging coverages. See further sections 3.10 and 3.13 of ASOP No. 53 that specifically address these issues.

¹ The American Academy of Actuaries is a 19,500-member professional association whose mission is to serve the public and the U.S. actuarial profession. For more than 50 years, the Academy has assisted public policymakers on all levels by providing leadership, objective expertise, and actuarial advice on risk and financial security issues. The Academy also sets qualification, practice, and professionalism standards for actuaries in the United States.

² This letter adopts the same “loss ratio” terminology as used by the IRS to describe the ratio of loss and loss adjustment expenses to earned premiums.

The 2022 [*Risk Transfer Practice Note*](#), developed by the COPLFR, provides key insights into the nature of risk transfer from both an actuarial and accounting perspective. A great deal of the guidance in the practice note addresses actuarial aspects of accounting standards including Financial Accounting Standards (FAS) No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts* (FAS 113), Statement of Statutory Accounting Principle (SSAP) No. 62—*Property and Casualty Reinsurance* (SSAP 62R), and International Accounting Standards Board (IASB) International Financial Reporting Standard (IFRS) 17, *Insurance Contracts* (IFRS 17).

This statement from SSAP62R is illustrative of much of the accounting guidance in these standards:

“Whether underwriting risk has transferred to the reinsurer depends on how much uncertainty about the ultimate amount of net cash flows from premiums, commissions, claims, and claim settlement expenses paid under a contract has been transferred to the reinsurer.”

Essentially, loss uncertainty, which can be measured via loss ratios among other metrics, is fundamental to risk transfer. Insurance industry data shows for lines of business exhibiting significant loss uncertainty (low claim frequency and high claim severity), nine-year average loss ratios under 65% are common. Due to the prospective nature of ratemaking, premiums must contemplate the probability of a high severity loss event in the upcoming policy period.

2) The use of countrywide loss ratio data for all insurance companies and insurance coverages combined to establish a benchmark loss ratio for microcaptive insurance companies would be inappropriate for several reasons.

The IRS’ stated basis for the nine-year average loss ratio of 65% for microcaptive insurance companies is based on a review of “data from the National Association of Insurance Commissioners (NAIC) ... 2021 Annual Property & Casualty and Title Insurance Industries Report (2021 NAIC P&C Report).” Also known as the NAIC Profitability by Line and State, this resource is a generally accepted resource in the property-casualty insurance industry for aggregated industry statistics. The 72.5% loss ratio stated by the IRS includes all property-casualty insurance companies in the U.S. that file an NAIC financial statement, across all lines of property-casualty insurance companies, and across all U.S. insurance domiciles.

Using this nine-year loss ratio as the basis for a loss ratio threshold for microcaptive insurance companies would be inappropriate for several reasons:

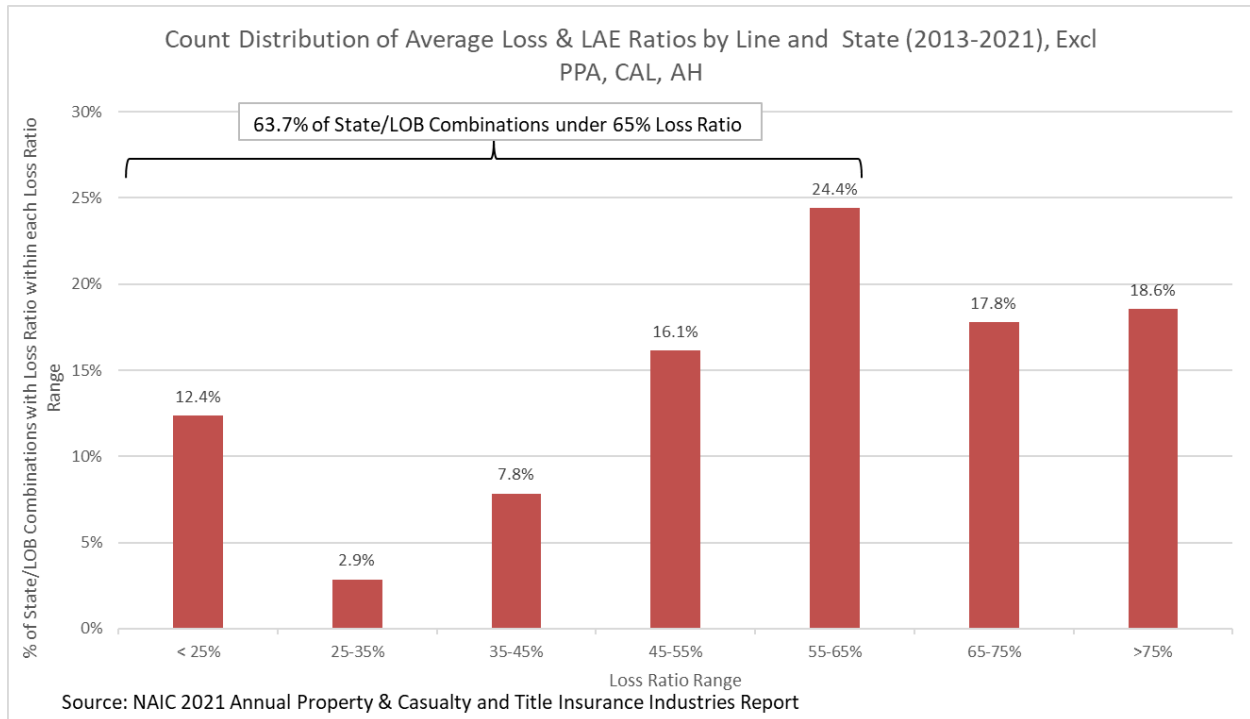
- The loss ratio reflects the combined experience of the entire U.S. property-casualty insurance industry, which is capable of far more risk diversification or risk distribution than any single small insurer meeting the 831(b) election premium threshold. For example, in 2021 alone, the U.S. property-casualty insurance had direct earned premiums of over \$758 billion, compared to the current 831(b) premium threshold of \$2.65 million.

- The loss ratio reflects experience in multiple states, whereas microcaptive insurance companies commonly issue policies to only a single business, which would lack the geographic distribution present in the aggregated data of the U.S. property-casualty insurance industry.
- The loss ratio relied upon by the IRS includes coverages that are commonly prohibited from captive insurance companies, such as private passenger auto insurance and homeowners insurance (i.e., personal lines). In fact, these personal lines of coverage represent more than \$350 billion of earned premium in 2021, or almost half of the total industry premium. Personal lines also commonly have some of the higher industry loss ratios due to the competitive dynamics of these markets. See Appendix 1 for support.
- The NAIC profitability study specifically does not include experience for the vast majority of captive insurance companies, including microcaptive insurance companies, which are generally not required to file an NAIC annual financial statement. As a general rule, the only type of captive insurance company that files an NAIC annual statement are risk retention groups (a federally regulated form of captive insurance that rarely qualifies as a microcaptive insurance company).

3) Detailed examination of U.S. property-casualty insurance loss ratios for industry segments more closely aligned with microcaptive insurance companies suggests that a 65% loss and loss adjustment expense ratio for microcaptive insurance companies would be inappropriate for several reasons.

For example, if there is an examination of the same NAIC 2021 Profitability Study by State and Line data source that the IRS utilized and the nine-year average loss ratios by state alone, one would find that 12 states have a nine-year average loss ratio of below 65% for all coverages combined. In other words, the aggregate property-casualty insurance market in 12 states would fail the IRS test in their entirety.

Similarly, if there was an examination of the same data on a by line of business (LOB) and state basis and exclusion of private passenger auto, homeowners, and commercial auto liability, one would find that 63.7% (422 of 663) of line-state combinations exhibit a nine-year average loss ratio of below 65%. This information is summarized in the following graph. See Appendix 2 for support.



We suggest that the IRS engage with appropriate stakeholders and insurance regulators to further study potential specific and objective metrics, factors, and standards that would allow better identification of potentially abusive microcaptive insurance transactions. In order to empower the IRS to be effective in distinguishing abusive microcaptive insurance transactions from other microcaptive insurance transactions, the selected measure would need to be the product of a robust framework—not unlike the quantitative measures the NAIC has designed over time to measure risk in insurance companies. Using a metric that may be overly simplified, such as a nine-year average loss ratio of 65%, would cast too wide of a net and risk producing more problems than solutions for the mission of accurately distinguishing abusive microcaptive insurance transactions from others.

COPLFR appreciates this opportunity to provide comments on the proposed rule. We hope these observations are helpful, and we welcome further discussion. If you have any questions about our comments, please contact Rob Fischer, the Academy’s casualty policy analyst, at fischer@actuary.org.

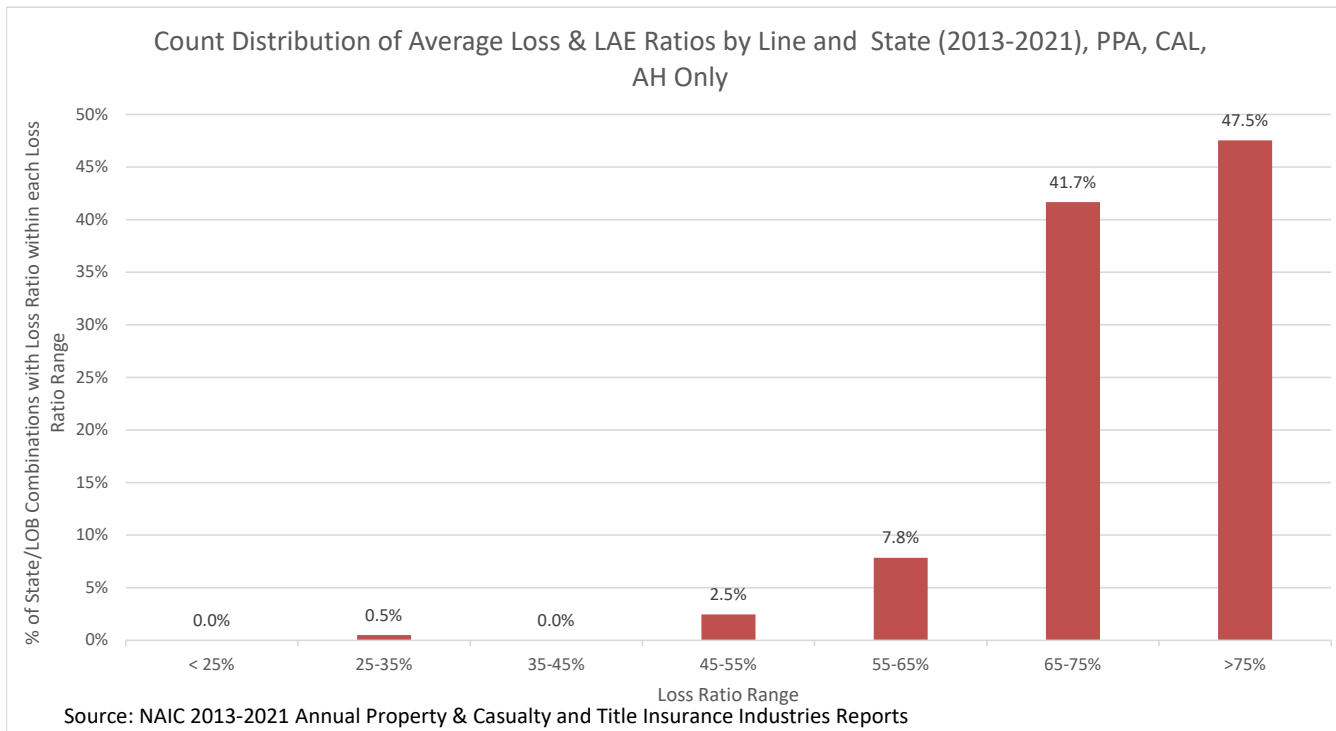
Sincerely,

Stephen Koca, MAAA, FCAS

Chairperson
Committee on Property and Liability
Financial Reporting
American Academy of Actuaries

NAIC Profitability Study
 Loss and LAE Ratios by State and Coverage
 9 Year Average (2013-2021)
 Distribution of Loss and LAE Ratios by State and Coverage (PPA, CAL & AH Only)

Loss & LAE Ratio	Count	Distribution
≤ 25%	-	0.0%
25-35%	1	0.5%
35-45%	-	0.0%
45-55%	5	2.5%
55-65%	16	7.8%
65-75%	85	41.7%
>75%	97	47.5%
Total	204	100.0%



Note: Calculations based on Appendix 3

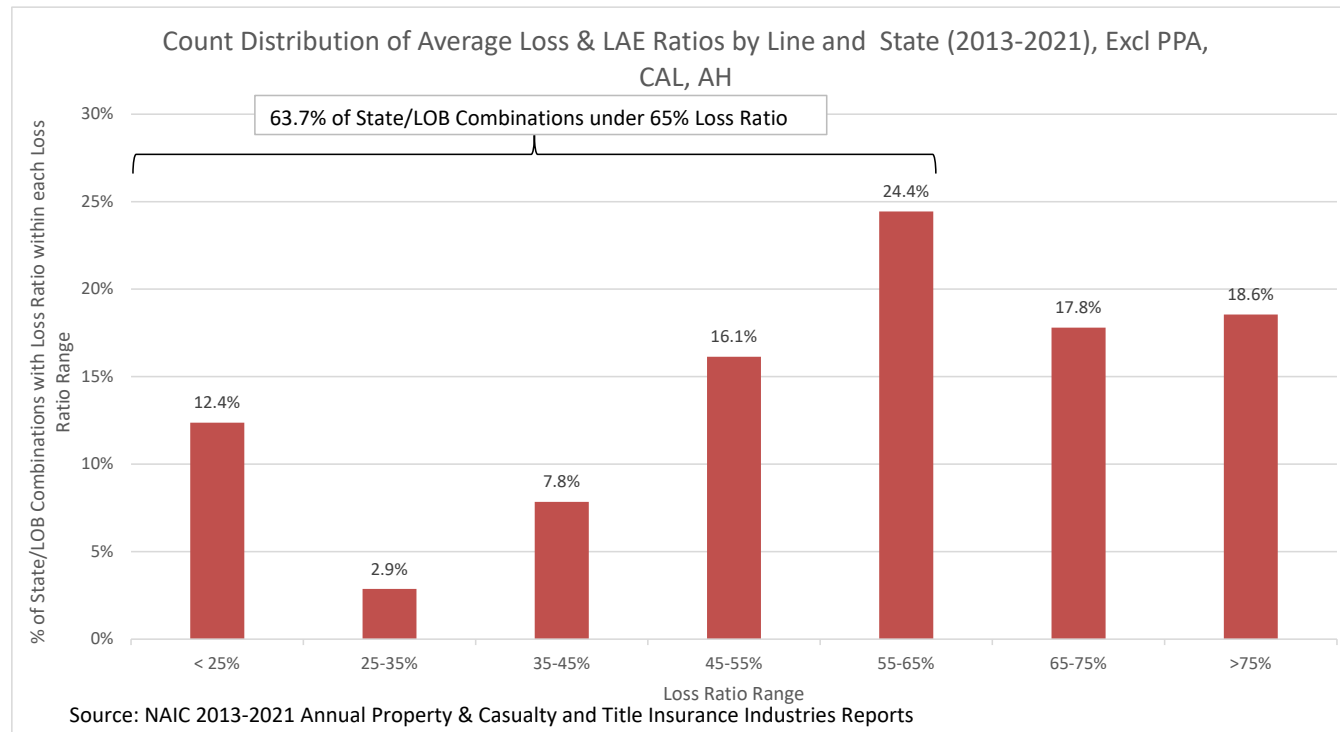
NAIC Profitability Study

Loss and LAE Ratios by State and Coverage

9 Year Average (2013-2021)

Distribution of Loss and LAE Ratios by State and Coverage (Excl. PPA, CAL & AH)

Loss & LAE Ratio	Count	Distribution
≤ 25%	82	12.4%
25-35%	19	2.9%
35-45%	52	7.8%
45-55%	107	16.1%
55-65%	162	24.4%
65-75%	118	17.8%
>75%	123	18.6%
Total	663	100.0%



Note: Calculations based on Appendix 3

