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

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

Dear Technical Director:

We appreciate the opportunity to review and respond to the Invitation to Comment on Bifurcation of Insurance and Reinsurance Contracts for Financial Reporting. PMA Capital Corporation is a publicly traded insurance holding company, whose operating subsidiaries provide workers' compensation and other commercial property and casualty lines of insurance, primarily in the eastern part of the United States. PMA Capital has been operating as an insurance company since 1915, and has been publicly traded on the NASDAQ market since 1998.

In summary, we do not support the change in accounting that would require the possible bifurcation of insurance and reinsurance contracts. We believe a more detailed study of the contracts that were purportedly accounted for incorrectly (which prompted the Invitation to Comment) is needed. If a reasoned reading of the contracts should have led to a conclusion that deposit accounting was appropriate under the existing accounting framework, or that there were undisclosed ancillary agreements that changed the nature of the contract, then entering into a new round of definitions, further judgments, and increased disclosure would be an over-reaction to these recent events and totally unnecessary.

We believe that the current framework identifies insurance and reinsurance contracts sufficiently and that bifurcation will introduce a significant amount of cost, estimation and complexity into the financial statement preparation process. We also believe the bifurcation process to be somewhat of a misnomer, in that it implies that a contract can be discreetly separated solely into risk and financing components. If the industry could, in

fact, determine risk or lack thereof with the precision contemplated by the Invitation to Comment, then no insurance entity should experience poor operating results.

Our specific comments are as follows. We have utilized the Issues summary provided at the end of the invitation to comment, and for ease of reference, have organized our response to track to the issues:

Issue 1- Does the IFRS definition of insurance contract identify insurance contracts and sufficiently distinguish those contracts from other financial contracts? Does the GAAP definition of insurance risk identify and separate that risk from other risks such as financial risk? Do the descriptions of finite insurance and reinsurance contracts, including the risk-limiting features, identify those contracts? How could the definitions and descriptions be improved?

We believe that the definitions as proposed by IFRS and by current GAAP literature are consistent in their intent, although we agree with the more stringent wording regarding indemnification, as compared to compensation. We believe that by limiting insurance contracts to indemnification, rather than compensation, some of the concerns expressed with regard to derivatives and other financial instrument merging become less likely. While we believe that a triggering event for indemnification may be defined in an insurance contract as something other than a specific loss event, we do believe that the recovery to an insured or to a reinsured should be limited to their actual loss experience.

Similarly, we believe that the current Invitation to Comment suggestion to use the GAAP definition of insurance risk as defined in paragraph 121 of Statement 113 is a reasoned approach.

We believe that "finite" insurance and reinsurance contracts need not be defined in the current accounting literature, as the accounting framework clearly defines elements of risk transfer that are required to permit insurance accounting treatment. Many insurance policies contain loss limiting features, including policy limits, retrospective rating features, policy dividend features, cancellation provisions, etc. For the sake of clarity, we repeat paragraph 121 of Statement 113 below:

"The risk arising from uncertainties about both (a) the ultimate amount of net cash flows from premiums, commission, claims, and claim settlement expenses paid under a contract (often referred to as underwriting risk) and (b) the timing of the receipt and payment of those cash flows (often referred to as timing risk). Actual or imputed investment income returns are not an element of insurance risk.

Insurance risk is fortuitous- the possibility of adverse events occurring is outside the control of the insured. (emphasis added)."

It is critical to note in the definition that insured events are those events that are outside the control of the insured. Even in contracts with an assumed "working layer" of losses, the losses themselves are fortuitous, and outside the control of the insured.

Throughout the current Invitation to Comment are comments that lead one to conclude that a certain number or value of these fortuitous events must or should occur, and that these items should be accounted for differently than the fortuitous events that are outside of the actuarial pricing models. The example used in the Invitation to Comment is employee health care costs.

While we agree that for large employers there is a reasonable range of expected losses that should occur in a given year, there is no certainty as to the type of health care event that will trigger a loss, the timing of when these events will be reported to an employer, the severity of the individual events, or the treatment protocol for an event. It appears to us that because there is no certainty with respect to the occurrence of any individual event within the body of a claim population, irrespective of the size of the claims pool, the occurrences should be treated similarly.

Believing this to be the case, we then defer to paragraph 9 of Statement 113, which requires a greater than remote possibility of a significant variation in either the amount or timing of payments by the reinsurer. This is an area of judgment that we believe practitioners must evaluate, based on all of the facts and circumstances that are involved in the insurance or reinsurance agreement. We believe that most, if not all of the restatements over "abusive" reinsurance agreements have demonstrated the cause of these restatements to be a lack of disclosure of all of the facts and circumstances of an agreement (i.e. side letters) or one of management override of the facts and circumstances of an agreement. It is unclear to us that these isolated items would be clarified by a contentious definition of a subset of reinsurance or insurance transactions, when in fact the agreements in question may not have been reinsurance or insurance agreements under a plain reading of existing accounting literature.

We therefore believe that the existing framework clearly defines reinsurance treaties and we would be comfortable adopting the provisions of paragraphs 9 and 121 of Statement 113 as further clarification for insurance contracts. We further believe that a definition of "finite" reinsurance or insurance is not required and in fact would be misleading under the current accounting framework, as it implies much more of a certainty to the underwriting or actuarial pricing models than exists.

Issue 2- Can the Statement 113 risk transfer guidance for reinsurance contracts be applied by corporate policyholders and insurers for determining whether an insurance contract transfers significant insurance risk? If not, how can the Statement 113 guidance be modified or clarified to apply to insurance contracts?

We believe that the current guidance in Statement 113 is sufficient for defining risk transfer, and can be used by insurers and policyholders if it is determined that insurance policies be evaluated consistently with reinsurance contracts. We believe that the models in Statement 113 are adequate as written.

It is our belief that corporate policyholders and insurers would find the proposed concepts as enumerated in the current Invitation to Comment particularly onerous. This is because

all insurance pricing and underwriting is based upon an expected level of losses (this is the pooling practice to which the FASB currently refers). Even with retrospective rating features, policyholder dividend mechanisms and other loss limiting features in primary insurance policies, there is demonstrable risk in all of these policies, and also no certainty of any particular loss occurring.

These features are generally the result of a pricing negotiation between the insured and their insurer and are the result of uncertainty as to the frequency and severity of future claims under the contract, and the presence or absence of these loss limiting features generally modifies that "standard" or regular premium that an insured pays for their policy. Certain insurance forms do contain loss limiting features that fit into the Invitation to Comment (as an example, deductible programs). This is because there is a contractual assumption of loss assumed by the insured, and the premiums are contractually modified prior to policy issuance. However, to assume that there is an expected level of identifiable fortuitous events that is assignable and allocable at a policy level because of these contractually defined processes is not accurate.

We believe that any insurance underwriter or actuary would agree that there exists an expected level of losses and an expected level of profit for an insurance product. Having made this warranty, however, we know of no underwriter or actuary that would be able to predict with any certainty in advance of policy expiration what events would occur or when they would occur on a policy by policy basis, irrespective of the size of the policy.

It is not surprising to see a large number of issued polices exhibit predictive characteristics, but within these predictive loss ranges, there are a substantive amount of account by account variance. From a practitioner's perspective (and certainly from the perspective of a corporate policyholder) the notion that a contract can be deconstructed into discrete financing components belies the complexity of the contract negotiation process. The further notion that these components could then be valued with any degree of reliability belies the interrelationship of all elements of the insurance contract.

Specifically addressing the items that the FASB notes in paragraph 36, subsection b., we are confused as to how one would value with any degree of precision the value of any of the following:

- (2) Adjustable features that result in profit- and loss-sharing arrangements between the policyholder and the insured;
- (4) Limits on the amount of claims to be paid by the insurer;
- (5) Loss corridors that limit or eliminate the percentage or dollar amount of claims within the range of contract coverage;
- (6) Favorable contract termination provisions, for example, that would result in a loss to the policyholder;

(7) Premiums that are a substantial portion of the maximum coverage provided.

We note that items (1) and (3) have already been defined for reinsurance contracts in FASB Statement 113 and in EITF Issue number 93-6. Statement 113 addresses item 7 as well, through its definition of risk transfer. The framework that currently exists mandates that all of these pricing or contract mechanisms be analyzed currently in the ultimate determination of risk.

Issue 3- Does classifying an entire contract as insurance or bifurcating that contract into insurance and deposit components provide more understandable and decision-useful information? Which qualitative characteristics most influence your decision? Which approach more faithfully represents the economic substance of the contract?

It is our belief that bifurcation will introduce a significant amount of cost, estimation and complexity into the financial statement preparation process, and would require a substantive overhaul of insurance company analysis. This overhaul should not be minimized, as insurance is a heavily regulated industry, and financial strength ratings are a critical competitive element of the insurance sales process. The model as described in this Invitation to Comment would materially modify concepts that independent rating agencies utilize to evaluate insurer financial strength.

More importantly, we find no theoretical justification for the proposed changes. We believe that the current model and level of disclosures provide a reader with detail to understand the effect of underwriting decisions made in an individual underwriting year. The costs to implement the bifurcation processes are substantive, and we believe that bifurcation is not a panacea, in that there are still a number of substantive qualitative decisions that will be required prior to the determination of whether a contract "unequivocally" is insurance.

Practice has shown that these qualitative judgment decisions are not uniformly reached. In fact, bifurcation is somewhat of a misnomer, in that it implies that a contract can be discreetly separated into risk and financing components, when today many large reinsurance and insurance contracts have a substantial number of "moving parts". To assume that these parts can be deconstructed and specifically allocated into an "unequivocal insurance risk" or "deposit accounting" model belies the complexity of the contract negotiation process.

The restatements that have occurred and which this position paper is attempting to manage have largely been attributed to non-contractual problems with the disclosure models (management override or the existence and the non-disclosure of extracontractual obligations). These issues would not be solved by the onerous obligations of this new framework, and it is difficult to believe that this structural accounting change is warranted. Liabilities arising from insurance treaties are not reflective of "economic substance" in that they are largely carried at nominal, rather than economic values. The fact that this remains unchanged in the proposed framework change, indicates to us that

this project is an incomplete attempt to address specific weaknesses in disclosure. This is in stark contrast to the attempt of the FASB to migrate to a principles based model.

Going back to the ratings model issue, it is our belief that a migration of GAAP standards to the bifurcation model without a corresponding change in the statutory financial model would likely lead analysts to rely more on statutory financial information that insurers routinely provide as part of their regulatory framework. This migration would certainly put into question any argument that bifurcation makes the financial model more relevant. As statutory financial solvency testing is predicated on the current accounting model, we do not believe that a similar transition would occur concurrently with the GAAP change.

Issue 4- The flowchart suggests a sequence for analyzing contracts that integrates current insurance accounting guidance with a hypothetical bifurcation analysis. Do you believe that the sequencing and integration are appropriate? What changes would you propose?

We believe that the current framework identifies insurance and reinsurance contracts sufficiently. As a result, we would suggest that the flowchart transfer to the "account for as an insurance contract", immediately after a "no" answer is reached under the "Does the contract contain an embedded derivative element?" If the answer to this question is "yes", we would suggest that the next question be "Does the contract (after bifurcation of the embedded derivative element) meet the Statement 113 risk transfer guidelines?" If yes, it should move to "Account for as insurance contract, if no it should move to "Account for as deposit".

We disagree with the wording of the issue, in that the flowchart introduces the concept of unequivocally transferring significant insurance risk, which we believe is outside of the current framework, and which, for the rationale we previously discussed in responses to issues 1, 2 and 3 is wholly inappropriate to the current accounting framework.

Issue 5- Do you agree with the characteristics identified for contracts that do or do not unequivocally transfer significant insurance risk? If not, why not? Should other characteristics be added? Are the examples in Appendix B representative of the discussions in paragraphs 57-59?

We disagree with the concept of unequivocal testing for the transfer of significant insurance risk. We dismiss the premise of the characteristics discussed, as these characteristics, in our opinion, are much too subjective and create a "bright-line, rules-based" approach to analyzing the results of a contractual analysis of insurance coverage and pricing. Some examples of our concerns are listed below:

Paragraph 58, subsection a. A plain English reading of this would require a detailed bifurcation analysis of a single policy that covers an individual's primary and vacation residence, as there would now be two properties contained in a single policy. We believe as worded, it would also require further analysis for the homeowner's policy that covers an insured for losses other than for the dwelling itself.

Paragraph 58, subsection b. A plain English reading of this would require a detailed bifurcation analysis of a commercial policy that covers a "fleet" of two cars. We believe as worded, it would also require further analysis for a commercial business package that covers two garages, yet would allow a comprehensive business package policy on a high-rise manufacturing facility.

Paragraph 58, subsection c. A plain English reading of this indicates that facultative reinsurance is the only reinsurance that would be excluded from the bifurcation analysis. It should be noted that we believe that facultative reinsurance comprises less than 10% of the world reinsurance market, and there is no logic for treating facultative reinsurance any differently than treaty reinsurance.

Paragraph 58, subsection d. We would be curious as to the definition of a "market-equivalent" level of premium and "standard market" terms.

Paragraph 58, subsection e. We presume that the aforementioned "market terms" deductibles and coverage limits would be excluded as risk-limiting factors.

Paragraph 58, subsection f. We would suggest that this belies the notion of actuarial pricing of even facultative reinsurance, where there is always an expected loss level.

The overarching concern that we have with this test is that there is a presumption that an insurance product does not cover fortuitous events embedded in this testing. Again, we believe that if a policy indemnifies a beneficiary from fortuitous events that are outside the control of the insured, the policy is an insurance policy. By definition, fortuitous events cannot be foreseen at an event level and, therefore, we believe that the notion of codifying a "size-based" screening technique contradicts the definition of insurance.

Issue 6- Do you think the characteristics described in paragraph 58 for unequivocal insurance contracts are an improvement over the exemption from cash flow testing in paragraph 11 of Statement 113 (summarized in paragraph 37(c) of this Invitation to Comment)

As enumerated in our answer to Issue 5, we believe that the concept of unequivocal testing for insurance contracts is incorrect, in that it introduces a "size-based" methodology for inclusion/exclusion, and through this introduction of "size-based" measurements, presumes that fortuitous events can be foreseen and accrued in a larger population. We respectfully disagree with this notion.

Issue 7- Do you prefer Approach A or Approach B for identifying contracts subject to bifurcation? Why? Do you believe that another approach would be superior? If so, how would you describe that approach? Would your preferred approach be operational? Would it make financial statements more decision useful?

We do not believe that the bifurcation screening process is warranted for any of the contracts, and we believe that we have provided the reasons for this belief throughout this comment letter. We will re-emphasize our previous points, namely that it is our belief that the "abuses" that have been cited as rationale for this Invitation to Comment are largely the result of management override; we fail to see how further codification mitigate these risks.

We believe that the approach as suggested in the Invitation to comment will not result in more decision useful financial statements. In fact, we believe that the transition to this model will create a substantive amount of retrofitting of models by investment and by ratings analysts. Ratings analysts model companies and rely heavily on balance sheet and production analysis in determining required capital ratios for financial strength ratings. All of these ratings calibrations would require material revisions under either bifurcation scenario (more so under Scenario B than A).

As an aside, it should be noted that the regulatory accounting model (statutory accounting principles, or SAP) would not be affected by this codification, which will create another level of complexity for practitioners, and further complicate the current financial analysis that is performed on insurance companies.

Issue 8- Should the criteria for bifurcation be different for insurance contracts and reinsurance contracts? Why? If yes, what differences would you suggest?

We believe that no contracts should be bifurcated, as this bifurcation assumes that there is a pure level of losses that can be associated with a large base of assets, lives, etc. As we have stated before, while we believe that a reasonable range of expected results can be predicted, under no circumstances do we believe that an underlying level of unforeseen fortuitous events can be reasonably predicted; therefore, we believe that the concept of bifurcation is flawed. In fact, if the industry could in fact determine risk or lack thereof with the precision contemplated in the exposure draft, then no insurance entity should experience poor operating results.

Further, we believe that the "separate" elements of an insurance or reinsurance contract are clearly linked, and as such, it is not rational to undertake an effort to separate the "significant financing element" from the other elements of the contract. We believe the FASB recognized this in the drafting of Statement 113, where they noted in paragraph 94 that:

94. Contracts that meet the conditions for reinsurance accounting also may include elements of a financing arrangement. Existing accounting pronouncements do not provide guidance that would allow an insurer to identify the separate elements and costs of reinsurance. If a reinsurance contract is prospective, reinsurance activities affect the results of the ceding enterprise while the reinsured contracts are in force (the contract period) and during the subsequent period over which claims are settled. If a reinsurance contract is retroactive, the coverage period is

closed and the reinsurance contract can affect only the remaining settlement period. (emphasis added)

This prohibition is likely grounded in the fact that since reinsurance agreements last for a long period of time, and assets and liabilities are recorded at nominal values (in accordance with the current GAAP accounting model), bifurcation and market valuing specific elements would likely lead to confusion as to intent and design of reinsurance contracts. Additionally, the accounting model in Statement 113 recognizes that it is not possible to separately identify and treat all of the different elements of the amounts paid for reinsurance.

Issue 9- Which of the methods identified in this Invitation to Comment for bifurcating insurance and reinsurance contracts do you believe has the most conceptual merit? Please explain. Please describe any additional bifurcation methods that you believe should be considered. Would corporate policyholders encounter unique implementation problems in applying any of the methods discussed in this Invitation to Comment?

Because all of these methods presume a mathematical certainty of a defined value of foreseen fortuitous events, we do not believe that any of the methods have any conceptual merit.

Issue 10- Would data availability limit the development of any of the bifurcation methods discussed in this Invitation to Comment? To what extent are the models that would form the basis for these methods used to underwrite and price products? Would data availability (or lack thereof) affect only certain insurance forms, products, or lines of business? If so, which ones and why?

In practice, underwriters and actuaries price some insurance based on individual experience as well as by pooled experience. The determinant in these pricing decisions is the "credibility" of the individual data that is being reviewed. In many cases, this credibility is determined based on the size of the insured and the availability of historic loss information. Because this data need is historic as well as size-based, it is a judgment call as to what represents a data size that is credible, or a series of data years that collectively provide credibility to loss data.

In the case of complex or large accounts, this is generally determined on an account by account basis. In reviewing the Appendix B data, we are concerned that these represent a much over-simplified view of insurance transactions. As an example, delineating between a sole practitioner and a large practitioner is ambiguous and may not be reflective of the underwriting of an account. A sole practitioner may be permitted significant rating flexibility based upon his years of being an insured as well as the frequency of his services and the ability to derive credible pricing information based upon these two factors, while a group of start-up enterprises may lack any pricing credibility.

Issue 11- In view of the IASB's project on insurance contracts, should the FASB be considering bifurcation of insurance contracts based on transfer of insurance risk?

If the objective of the FASB is convergence of accounting rules, we would suggest that the current model remain in place until such time as the IASB's deliberations on insurance contracts are completed.

In closing, we ask that the Financial Accounting Standards Board consider these observations as it deliberates on the current invitation to comment. It is our belief that the current accounting literature already provides sufficient guidance to allow both practitioners and auditors to make reasoned judgments on risk transfer and that the current insurance accounting model is not in need of such a material adjustment as contemplated by the current invitation to comment. We appreciate the opportunity to be able to comment on this important issue.

Sincerely,

William Hiselberger, CP

EVP and CFO