



LETTER OF COMMENT NO. 47

August 24, 2006

Technical Director —File Reference No. 1325-100 Financial Accounting Standards Board 401 Merritt 7 PO Box 5116 Norwalk, Connecticut 06856-5116

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

Dear Sir or Madam:

We appreciate the opportunity to comment on the Financial Accounting Standards Board's (FASB) May 26, 2006 Invitation to Comment (ITC) on Bifurcation of Insurance and Reinsurance Contracts for Financial Reporting.

The ACE Group of Companies provide a broad range of insurance and reinsurance products to insureds worldwide through operations in more than 50 countries around the world, and have the authority to conduct business in over 140 countries. ACE Limited, the Bermuda-based holding company of the ACE Group of Companies, is publicly traded on the New York Stock Exchange. Our comment letter has been segregated by general comments on bifurcation approaches specified by the ITC and commentary on the specific issues raised in the paper.

The body of this letter includes our general comments and the Attachment to this letter provides our responses to the specific issues in the ITC.

## **General Comments**

We believe the current accounting model, principally FASB Statement No. 113, Accounting and Reporting of Reinsurance of Short-Duration and Long-Duration Contracts ("FAS 113"), has provided an appropriate basis to evaluate whether an insurance or reinsurance contract should be accounted for as insurance or a financing and overall, the current insurance model has worked well in practice. Nevertheless, it would be helpful to practitioners if the FASB addressed a few critical practice issues that have emerged over the years since FAS 113's issuance. By limiting diversity in practice, consistency in financial reporting would be promoted and the market place would benefit from a level playing field. These practice issues can generally be remedied by

interpreting existing guidance as opposed to developing a new bifurcation model for practitioners.

Specifically, we believe the following critical practice issues should be clarified in the current literature.

- i. Should refundable premiums be bifurcated as deposits? For contracts that pass the risk transfer requirements of FAS 113, premiums that are certain to be returned to the reinsured through claim payments or a return of premium generally have not been bifurcated as deposits in practice. However, some have interpreted bifurcation of this portion of premium as a deposit to be a reasonable approach under GAAP. If there is contractual certainty at inception that a portion of premium would either be used to pay claims or be refunded to the insured regardless of loss experience then should this portion of the contract be accounted as a deposit?
- ii. Should distinct components of loss coverage with separate aggregate policy limits be bifurcated for purposes of assessing risk transfer? We believe practice issues related to the bifurcation of insurance contracts have principally arisen from the lack of specific guidance as to what constitutes a contract for purposes of evaluating risk transfer. The current guidance that is found in EITF D-34: Accounting for Reinsurance: Questions and Answers about FASB Statement No. 113 is very broad and lacks specifics. For purposes of applying this requirement, should the definition of "coverage" include both (1) contracts that provide coverage for two or more types of insurance with separate sub-limits and (2) contracts that provide coverage for one type of insurance where the coverage is not continuous (e.g. the insurance risk includes a primary and excess layer where the layers are not contiguous)? Should companies only be required to separately assess risk transfer for coverages in which all cash flows, including premiums, losses, and other expenses, are separately identifiable or should companies be required to separate premiums and other cash flows to assess risk transfer for each component of loss coverage that maintains a separate aggregate policy limit?
- iii. Clarify practice issues regarding FAS 113 indemnification tests. The FASB should clarify critical practice issues for both insurance and reinsurance contracts.

## 9a Test - Significant Insurance Risk

The insurance risk test requires that the probability of significant variation for the amount and timing of claim payments be more than remote. This suggests there must be some relationship or correlation between the amount and timing of loss payments the (re)insurer makes so they vary with the amount and timing of claims from the underlying (re)insurance contracts. What degree of correlation between insured and insurer results would indicate that the insurer does or does not assume significant

insurance risk under the insured components of coverage and thus the 9a test has failed?

If the 9b test can only be passed at or near contractual limits, does this indicate that the contract lacks sufficient insurance risk to pass the 9a test?

9b Test - Reasonable Possibility of a Significant Loss

Should there be a correlation between probability and significance of loss when assessing risk transfer? For example, if Contract A is susceptible to a higher magnitude of loss relative to Contract B, should Contract A be able to meet risk transfer requirements with a lower probability of loss relative to Contract B?

Can the probability assumption used in the risk transfer assessment supporting the 9b test (supporting the assertion of a reasonable possibility) differ with that used in pricing if supported as reasonable? Or must the probability assumption used in the documented 9b scenario be consistent with that used in pricing?

What is the appropriate interest rate to use in cash flow analyses (e.g., risk-free or asset earnings rate)?

iv. Define contracts for which risk transfer is self-evident. It would be helpful to have guidance to define insurance contracts for which risk transfer is self-evident (and do not require a formal quantitative risk transfer analysis) versus contracts for which risk transfer is not self-evident (and require a formal quantitative risk transfer analysis).

Please see the attachment which provides our responses to the specific issues in the ITC.

We would be pleased to discuss our comments with the Board members or the FASB staff at your convenience.

Sincerely,

Philip V. Bancroft

Chief Financial Officer

## Attachment A

## Views and Comments on Specific Issues identified in Appendix A of the ITC

Our views and comments on the specific issues identified in Appendix A of the ITC are as follows:

Issue 1: Does the IFRS 4 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? (page 10)

In general, the IFRS definition effectively distinguishes insurance from financial contracts through its reference to compensating the policyholder only when a future event adversely affects the policyholder. However, this definition should be clarified whereby compensation cannot exceed the adverse affects experienced by the policyholder. Accordingly, the definition would be improved if it included the concept of indemnification which succinctly clarifies that compensation is intended to indemnify (or "make whole") the policyholder for its losses. Therefore, "compensates" should be revised to "indemnifies". The concept of indemnification has been a guiding difference between insurance, derivatives, and financing. The concept of indemnification has been useful in developing the insurance exceptions from FAS 133 as well as addressing FAS 133 practice issues.

The GAAP definition should clarify when the assumption of credit risk represents insurance risk vs. financial risk. For example, we believe the assumption of credit risk through certain products like financial guaranty and mortgage guaranty insurance should be considered insurance risk whereas the assumption of credit risk through a counterparty's inability to pay amounts owed under a contract would be a financial risk.

A definition of a finite/structured contract should better incorporate some of the concepts identified in the ITC in a succinct manner. For example, we generally consider finite contracts to be reinsurance and insurance contracts that include both significant risk sharing provisions, such as adjustments to premiums or loss coverage based on loss experience, and relatively low policy limits as evidenced by a high proportion of maximum premium assessments to loss limits. Contracts falling within this definition would require judgment to determine whether or not risk transfer requirements are met. Nevertheless, we believe it is unnecessary to define a finite contract for GAAP purposes but would prefer the FASB define contracts for which risk transfer is self-evident (and do not require a formal quantitative risk transfer analysis) versus contracts for which risk transfer is not self-evident (and require a formal quantitative risk transfer analysis). Refer to comments on Issues 4 and 5.

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? (page 11)

We believe the FAS 113 guidance has generally been applied effectively to both groups in practice. In particular, the risk transfer tests of FAS 113 are well understood and have been used in practice for structured (or finite) insurance contracts as well as reinsurance contracts.

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? Why? (page 14)

We do not believe that the bifurcation proposal in the ITC would provide more understandable and decision-useful information. A bifurcation framework based on expected losses would not enhance financial information, not be economically faithful, and would instead introduce subjective accounting judgments reducing the relevance, reliability and comparability of financial statements. However, a bifurcation framework based on segregating contractual components that actually function as a borrowing (e.g., premiums paid to the insurer that must be repaid to the insured pursuant to the terms of the contract) has the potential of being economically faithful and providing useful financial information.

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? (page 17)

No, we believe the first step should be identifying whether more than one contract exists for accounting purposes. Subsequently, one would assess risk transfer for any insurance or reinsurance contract identified. The proposed sequence is unnecessarily complex and should be simplified. We believe the sequence for analyzing contracts should be as follows (italicized commentary specifies where we believe additional GAAP guidance would be helpful):

i. Determine whether there is more than one "substantive" contract for accounting purposes. This would include insurance contracts, financings, or derivatives that could be included in one contract. This analysis is referred to in the Q&A to FAS 113 but requires elaboration. Also, contracts subject to bifurcation into a financing and insurance component should be defined and considered at this point in the accounting assessment.

- ii. For each "substantive" contract identified, assess whether the contract meets the definition of insurance, financing, or a derivative for accounting purposes.

  Current GAAP is sufficient to make this assessment.
- iii. For insurance contracts, determine whether risk transfer is self-evident. This definition requires clarification in GAAP.
- iv. If no, perform a FAS 113 risk transfer analysis to determine whether the contract should be accounted for as insurance or a deposit. Current GAAP is sufficient to make this assessment although practice issues should be addressed.
- v. For "substantive" contracts determined to be insurance, determine whether there are any embedded derivatives that did not constitute a separate contract in Step 1 of the analysis. Current GAAP is sufficient to make this assessment.

Further, we believe a bifurcation model should not be based on expected claims for the following reasons:

- From a theoretical perspective, a financing or deposit represents cash flows paid
  from one party to another that must be repaid pursuant to the terms of the
  contract. Consequently, the only theoretically "sound" bifurcation model is one
  that segregates as a deposit those contractual premiums certain to be returned to
  the insured regardless of loss experience.
- From a practical perspective, the estimate of expected losses for individual risks
  is inherently unreliable and therefore, should not be used as the basis for an
  accounting model. Underwriting or risk assessments are often inaccurate on an
  individual contract basis; however underwriting assessments of estimated losses
  become more reliable when numerous contracts are aggregated.
- The application of deposit accounting for contracts with non-refundable premiums will create complex and unnecessary accounting considerations. For example, if actual losses fall below expectations, impairment issues related to deposit assets will have to be addressed.
- It would create inconsistencies in accounting treatment that are driven by form as opposed to substance. For example, the insurance of 1,000 individual exposures through 1,000 separate contracts is substantively the same as insuring the same 1,000 exposures through one group contract yet the accounting would differ. For individual companies, the assumption of risk through 1,000 individual insurance contracts and reinsurance of those same exposures through one reinsurance treaty would obtain different accounting even though the risk assumed from 1,000 insurance contracts and transferred through one reinsurance treaty are substantively the same.
- Given the considerable judgment involved in bifurcating contracts, there would be inherent inconsistencies in the application of the bifurcation model and therefore, the recognition of premiums would differ from company to company. Since capital models are driven to a great extent by premium volume, the

inconsistent treatment of premium from company to company would result in inconsistent capital requirements among insurers and reinsurers.

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 discussion in paragraphs 57–59? (page 18)

No, we believe the contracts identified as unequivocally transferring risk is too limited and group contracts should not be precluded from this category on the basis of expected losses. Further, we strongly believe criteria should only focus on basic concepts and characteristics and not attempt to identify specific types of insurance contracts. We believe that guidance should be developed to identify features in contracts that would cause a contract to fail risk transfer.

In addressing a new requirement from the National Association of Insurance Commissioners ("NAIC"), US insurers were required to define when risk transfer is selfevident in reinsurance contracts. We found it more effective to identify circumstances when risk transfer is not self-evident. For any contract without any identified criteria, risk transfer was considered to be self-evident. A few criteria identified as indicating risk transfer is not self-evident include the following:

- i. <u>Highly Funded Contracts</u> where contractual premiums, inclusive of installments and adjustable premiums, represent a significant portion of policy limits.
- ii. <u>Multi-Year Contracts</u> where the coverage period is two years or greater and experience from one year could affect other years with respect to the amount of premiums paid (i.e., experience account balances), commissions (i.e., deficit carry forwards), or loss coverage (i.e., available limits).
- iii. <u>Contracts that have Loss Mitigating Features</u> that reduce the (re) insurance entity's net cash outflows when losses emerge under the contract, such as loss corridors, retrospectively rated premiums, etc.
- iv. <u>Multiple Contracts executed simultaneously with the same entity</u> where one contract transfers a risk and another contract transfers all or a portion of that risk back to the client.
- v. <u>Contracts including distinct coverages for two or more lines of business</u> and one coverage may not meet risk transfer criteria if evaluated separately.
- vi. <u>Contracts with Features that Delay Loss Payment</u> -- or schedule claims payment (thereby reducing "timing risk").
- vii. <u>Retroactive Loss Coverages</u> where insured claims are known at the inception of the contract.

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)? (page 18)

No, refer to comments in Issues 4 and 5 above

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? (page 20)

As previously mentioned, we believe the first step in analyzing a contract should be determining whether more than one "substantive" contract exists for accounting purposes. In this process, criteria that would necessitate bifurcation of a contract into a financing vs. insurance should be specified. Second, one should determine whether any "substantive" contract should be accounted for as something other than insurance, such as a financing or a derivative. Third, for each insurance contract, risk transfer should be assessed.

Issue 8: Should the criteria for bifurcation be different for insurance contracts and reinsurance contracts? Why? If yes, what differences would you suggest? (page 20)

No, criteria for bifurcation should be based on basic concepts and characteristics and thus, be the same for insurance and 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? (page 22)

Neither method, refer to comments in Issues 3, 4, and 5 as well as general comments.

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? (page 23)

Yes. For an individual risk, relevant historical data used to assess expected claims may be insufficient to derive reliable results. Also, it is possible that that an insurer's estimate of expected losses could be considerably different from the policyholder's estimate, so the two parties could reach a different conclusion.

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? (page 24)

The proposed bifurcation model contemplated in the ITC would represent too broad of a change to the insurance accounting model and thus, should not be undertaken when the IASB is developing a new insurance model. However guidance and clarification of the questions we outlined above when incorporated into the current insurance accounting model would eliminate many of the practice related issues we face in accounting for insurance/reinsurance contracts.