



October 13, 2006

LETTER OF COMMENT NO. 63

Mr. Lawrence Smith
Director – TA&I
Financial Accounting Standards Board
401 Merritt 7
Norwalk, CT 06856

Re: File Reference No. 1325100, Invitation to Comment, *Bifurcation of Insurance and Reinsurance Contracts for Financial Reporting*

Dear Mr. Smith:

We are pleased to comment on the Financial Accounting Standards Board's (FASB or the Board) Invitation to Comment, *Bifurcation of Insurance and Reinsurance Contracts for Financial Reporting* (ITC). Ernst & Young acknowledges that due to differing views as to the application of the risk transfer guidance included in FASB Statement No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-duration Contracts* (Statement 113), diversity in practice exists with regard to the manner in which companies account for insurance and reinsurance contracts. Accordingly, Ernst & Young supports the FASB's undertaking of a project to clarify existing guidance and reduce that diversity.

We are intrigued with the conceptual theory behind the Board's bifurcation theory, but we are concerned that the breadth of such a project will mean that it may take several years to arrive at an accounting model that embraces the ideas in the Board's conceptual model. We believe the issues that have caused the most recent accounting and current diversity in practice with regard to assessing risk transfer require immediate attention. Because of the length of time that it will take to develop an accounting standard based on concepts in the ITC, we believe that the Board could follow a simpler and more direct approach to address the differing interpretations of risk transfer for those contracts that barely meet the elusive "just enough" risk transfer criteria. Our simpler and more direct approach would have a bifurcation concept and would require the SOP 98-7 deposit method to be applied to contracts under which the insured is guaranteed to have a significant portion of its insurance premiums returned back to them in a profit sharing mechanism or via losses settled under the contract. As such, the guaranteed portion of the premium would be the deposit component and the remainder of the premium, the insurance component, would be accounted for under the existing insurance accounting guidance. We also believe that providing clarifying guidance on the risk transfer requirements of Statement 113 will reduce the current diversity in practice. And, we believe the Board should explore whether some level of the bifurcation model could be incorporated into Phase II of the IASB's Insurance Project.

As noted, we do believe that there are certain insurance and reinsurance contracts where the bifurcation of the contracts would provide improved financial reporting and the Board should make appropriate changes to require such bifurcation. However, we believe that the Board's criteria to identify finite risk contracts included in the ITC are too broad to reduce the number of contracts that would require bifurcation to an appropriate number in the first phase. Furthermore, under Approach A, companies will need to consider the various filters to ultimately determine if a contract should be bifurcated. We do not believe that guidance that adds subjective analysis beyond the already subjective assessment required by FASB 113 is the right direction to address the issues raised in the ITC. We believe that the Board should instead consider a more simple approach that identifies those contracts that should be bifurcated and those that should continue to use the existing traditional insurance accounting guidance. We propose the following set of criteria to identify the contracts that should be bifurcated and the deposit component accounted for under the guidance in SOP 98-7, while the insurance component would be accounted for under the existing insurance accounting guidance.

- Features that guarantee a value to the policyholder. That is, contracts that have profit sharing arrangements where the policyholder is guaranteed to receive its premium (or a significant portion of the premium), less claims and any fee.
- Features intended to alter items covered under the reinsured contracts to limit or reduce the overall exposure of the reinsurer based on overall aggregate results. Examples include, but are not limited to, quota-share reinsurance contracts with loss corridors, loss caps (except for caps that are set at levels that are expected to be remote of occurring), or deductibles that do not correspond to the deductibles in underlying reinsured contracts.
- Features that impact the cashflows between the policyholder and insurer that could adjust the initial premium or initial retention of claims/losses by an amount greater than 10% of the initial or provisional premium. An example would be a retrospectively rated policy or reinsurance contract, including multiple year contracts.

While the FASB's project, *Insurance – Risk Transfer*, may have been added to the Board's agenda to respond to the recent risk transfer reporting issues that are outlined in the ITC, there are several issues relating to the assessment of risk transfer that were included in the AICPA's White Paper, *Evaluating Risk Transfer in Reinsurance of Short-Duration Contracts* (the "AICPA White Paper") that have not been addressed in the ITC. Those issues include, among others, the following:

- What constitutes the reinsured portions?
- What type of qualitative or quantitative analyses are required to demonstrate assumption of significant insurance risk?
- What amount of correlation is needed between the ceding company and reinsurer?

Because the Board's Approaches A and B maintain the FASB 113 risk transfer assessment as part of the evaluation to determine if a contract should be bifurcated

these issues raised by the AICPA would need to be addressed if the Board does not proceed with our proposed simpler approach.

Further as FASB Statement No. 97, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments* already requires bifurcation of long-duration contracts similar to those short-duration contracts that we have identified for bifurcation, our approach would eliminate the need to further develop a bifurcation model for long-duration contracts.

* * * * *

If the Board decides to undertake a path other than simpler and more direct alternative that we have proposed we have attached to this letter specific responses to Board's various questions in the ITC. We hope that our ideas and comments provide useful insight to the Board as you evaluate the best approach to address the practice issues identified in the ITC. We would be pleased to discuss our comments with the Board members or the FASB Staff at your convenience.

Very truly yours,

Ernst + Young LLP

Attachment A --

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?

The ITC implies that a lack of a definition of an insurance contract under U.S. GAAP may have contributed to the recent misclassification of certain financing contracts as (re)insurance. We do not believe the lack of a U.S. GAAP definition for an insurance contract was a significant factor in the recent misclassification issues. But, we agree that U.S. GAAP would be improved if the Board developed a definition for what constitutes an insurance contract.

The IFRS 4 definition of an insurance contract, along with the application guidance in Appendix B, *Definition of an Insurance Contract*, (Appendix B) of IFRS 4, provides reasonable guidance to distinguish most insurance contracts from other financial contracts. We believe that the IFRS 4 guidance in Appendix B, and the definition of insurance risk in U.S. GAAP are effectively equivalent to distinguish those contracts that should be accounted for as insurance. We do note that there are a few differences between the two definitions that may result in some contracts being treated as an insurance contract under IFRS that may not be treated as insurance under U.S. GAAP. For example, when assessing if significant insurance risk is present, IFRS 4, paragraph B23 permits companies to consider insured events that have an extremely unlikely occurrence. Under Statement 113, the risk transfer guidance only permits companies to consider reasonably possible scenarios. Accordingly, under IFRS 4, a contract could be deemed to transfer significant insurance risk, while that same contract may not transfer significant insurance risk under Statement 113.

The IFRS definition of an insurance contract does not have a sub category for retroactive insurance. Under U.S. GAAP, insurance contracts have to be classified as either a prospective or retroactive contract. The retroactive accounting model under U.S. GAAP is more aligned with the deposit model than the insurance model, therefore, even though a retroactive contract may transfer significant risk, the resulting accounting is consistent with financing. If the Board decides to develop an insurance contract definition it should distinguish prospective contracts from retroactive contracts.

As previously noted, we do not believe the recent U.S. GAAP financial reporting issues related to (re)insurance contracts resulted entirely from a lack of a definition of what constitutes an insurance contract. We believe companies have been able to identify those contracts that are clearly financing or insurance. The accounting confusion that exists is because companies have not been able to easily determine if those agreements deemed to be insurance contracts transfer enough risk to permit the entire contract to be accounted for as (re)insurance. While a specific definition for an

insurance contract would be an improvement to U.S. GAAP, we believe the risk transfer issue is a broader issue that requires guidance beyond just an insurance contract definition. The AICPA White Paper highlighted the areas where diversity in practice exists in assessing risk transfer. We believe that the Board should equally focus its attention on the identified risk transfer issues and the insurance contract definition.

We agree that there is no common definition of finite risk insurance. We do not understand why there is a need to develop a finite risk definition or descriptions to address the risk transfer accounting issues outlined in the Board's project summary for *Insurance – Risk Transfer*. We believe the Board should not label a contract as finite or non-finite, but instead should decide what characteristics in a contract cause that contract to have a certain type of a financing component that requires bifurcation.

Even though we do not believe that descriptions or a definition of finite insurance is needed, we believe the features that are identified in the ITC are too broad. For example, item (4) indicates limits on the amount of claims, but most, if not all, insurance contracts will contain some type of limit.

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 risk transfer guidance, modified to improve the guidance relating to what constitutes the reinsured portions that is included in Statement 113, could be applied to corporate policyholder and insurers. We also think that the application of paragraph 11 of Statement 113 would need to be clarified to describe how that guidance would be applied to a single insurance contract as that guidance currently is written to apply to reinsurance arrangements.

We believe that the cost of applying this guidance to certain types of insurance coverage purchased by corporate policyholders may significantly exceed any reporting benefit in the corporate policyholder's financial statements.

We agree with the Board's view noted in the ITC that the current all or nothing insurance accounting model provides companies with an incentive to achieve insurance accounting. And, we believe that there are some corporate insurance policies that should be bifurcated to restrict the all or nothing model to those *arrangements where substantially all the risk is transferred to the insurance company*. However, in the ITC, the Board's illustration that highlights the deficiencies in the current accounting model is confusing. Specifically, the illustration notes that the premium paid by a corporate policyholder is often immaterial to the corporate policyholder's financial statement. Then the illustration points out that a recovery under an insurance policy could provide a significant benefit in the year of the loss because the insurance model permits the insurance recovery to be recorded at an undiscounted amount. The illustration appears to be questioning if the insurance recovery should be discounted and not if the insurance premium should be bifurcated. We do not believe, based on other observations in the ITC, that the illustration used in

the ITC fully articulates the Board's bifurcation concerns. We do not think the Board intends to require corporate policyholders to expend a significant amount of resources to separate an immaterial insurance premium into a risk and financing component. However, this conclusion could be reached based on the illustration in the ITC.

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?

Bifurcating a contract into its insurance and deposit components would provide more understandable and decision useful information for some contracts and not for others. For example, for those contracts where a significant portion of the policyholder's premium is guaranteed to be returned through either insurance claims or profit sharing arrangements, we believe financial reporting would be improved if the contract were bifurcated.

With regard to which approach more faithfully represents the economic substance, we cannot make a generic statement that one approach is superior to the other. As we have noted previously, we believe the bifurcation model would be preferable for certain contracts, while there will be other contracts where recognizing the entire contract as insurance is preferable. As an example of the latter, a non-refundable fixed premium catastrophe contract with a reinstatement premium should be accounted for in its entirety as insurance and not bifurcated.

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?

As noted in our cover letter, we do not believe that it is necessary at this time to include life insurance contracts in the scope of this project. However, if the Board decides to move forward with this project, as described in the ITC, we note that the flowchart appears to provide a decision tree that is more applicable to the thought process for assessing a property/casualty contract. This is evident by the flowchart not providing any guidance on how to handle a life insurance contract. If the Board intends to apply the concepts in the ITC equally to long and short duration contracts, the flowchart should be equally understood by all parties that will be required to use it or separate flowcharts should be developed for long and short duration contracts.

We also note that the flowchart does not contain any filter for the additional assessment criteria required by EITF 93-6, *Accounting for Multiple-Year Retrospectively Rated Contracts by Ceding and Assuming Companies*. If the Board assumed that the filter to meet the risk transfer criteria of Statement 113 incorporates the EITF 93-6 criteria, it is not clear from the flowchart that the EITF 93-6 criteria are also included. If the Board keeps the Statement 113 assessment in the flowchart, we suggest that an additional decision box be added to include EITF 93-6 criteria number

3 (i.e., that the ultimate premium expected to be paid or received under the contract must be reasonably estimable and allocable in proportion to the reinsurance protection provided).

The filter to identify which contracts should be considered for bifurcation appears to be out of sequence. We believe a review for those characteristics that will identify contracts to be considered for bifurcation should be performed before the risk transfer test.

The sequencing of the filters also raises a theoretical question about Approach B. We have noted in this letter that we do not support Approach B, but if the Board moves forward with Approach B, we do not understand what value the assessment of whether the contract meets the Statement 113 risk transfer criteria provides if it occurs after the assessment that the contract unequivocally transfers risk. Under the proposed sequencing the Board will continue to require insurance contracts, other than those that unequivocally transfer risk, to be accounted for either under a bifurcated or deposit model. We believe the use of the two accounting models (e.g., bifurcation and deposit) if the concept of unequivocal is utilized is not required. Continuing to apply the risk transfer guidance of Statement 113 means that a contract that is just below the risk transfer threshold will be accounted for as a deposit and another contract that is just above the risk transfer threshold will be bifurcated.

If the intention of the risk transfer filter is to identify those contracts with unacceptable loss limiting terms (e.g., delay of the timely reimbursement) and, therefore, prevents any qualification for insurance accounting treatment, the risk transfer filter could be replaced with a filter to look for such unacceptable terms.

Finally, the flowchart does not address those situations where a company has to bifurcate a contract, but for some reason is unable to bifurcate the contract. We believe, another box should be added to the flowchart that indicates if contract that is required to be bifurcated cannot be bifurcated; the entire contract should be accounted for as a deposit contract.

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?

The characteristics outlined in items d. through f. of paragraph 58, in most cases, would be appropriate for the unequivocal evaluation for the limited scope of contracts (e.g., types a., b., and c.) to which those characteristics are intended to apply. The contract types listed in a. to c. of paragraph 58 are contracts that normally would be expected to transfer significant risk between the parties. For example, for most personal lines contracts the coverage is based on standard filed rates and forms, coverage is fixed, market terms are used, and, at inception, it is reasonable to assume that it is not likely to result in a claim under the contract. Therefore, we are not sure that specific guidance is necessary to determine whether the types of contracts in paragraph 58 do or do not pass the unequivocal test for insurance accounting.

With respect to the characteristics in d.-f. of paragraph 58, we have the following observations. For certain insurance contracts (i.e., excess of loss) there may not be any economic difference between a contract that includes an aggregate deductible and another contract that has an additional premium provision based on losses. Specifically, the insured's additional economic cost (e.g., the additional premium or the payment of a portion of the loss via the deductible) could be structured to be *exactly the same amount when losses under the contract occur*. We do not believe that the Board intended a contract with a deductible to meet the unequivocal test when the deductible feature effectively was a mechanism to adjust the premium. The intent of the reference to a deductible in paragraph 58, based on the views expressed in the ITC, was to capture a deductible on a specific event where the policyholder and insurer are sharing the loss. *Therefore, we suggest that the Board clarify when a deductible would not present a problem in passing the unequivocal test and those situations when a deductible would cause it to fail.*

The ITC implies that a standard insurance contract, such as a traditional personal lines policy, generally will meet the *unequivocal test*. However, we note that often contracts have minor features or terms that may cause what might appear to be a traditional policy to actually be nontraditional. For example, some contracts may have a feature under which the policyholder is provided a bonus (i.e., a return of a portion of their original premium) if there are no claims made against the contract. Our understanding of the criteria that must be met for a contract to meet the *unequivocal test* would mean that contracts with no claims bonuses appropriately would fail the *unequivocal test*. We believe that Appendix B should be expanded to illustrate that a contract with a no claims bonus would be prohibited from meeting the *unequivocal test*.

Using phrases such as “market-equivalent” and “standard market terms” will result in diversity in practice. Market terms and practices can differ significantly by region and by country. We believe that the guidance should result in companies accounting for contracts that have similar features on a consistent basis even though those features may not be at standard market terms in each of the jurisdictions (countries) that a company operates within. Also, an individual's definition of these phrases could be quite different and this could result in inconsistencies in reporting of similar contracts. If the Board decides to use these phrases, additional interpretative guidance is needed as to what these phrases mean for purposes of applying them to this test.

Lastly, we do not understand why the Board implied that a life insurance contract that has only timing risk may still transfer significant insurance risk. Statement 113 is clear that a contract that only has timing risk will fail risk transfer; however, the ITC indicates in item f. of paragraph 58 that for life contracts, the timing of death is all that is needed to satisfy the required characteristic, and, therefore, could transfer significant risk if the other characteristics are met. We believe that item f. is more applicable to catastrophe and certain excess of loss contracts as the event giving rise to a loss under these contracts is remote. Therefore, we believe the reference to life insurance contracts for this item will cause confusion and specific reference to the *aforementioned contracts* would be more appropriate. An additional characteristic specific to life insurance risks also would improve the guidance.

We believe the examples and the conclusions included in Appendix B fairly represent the guidance included in paragraphs 57 – 59. However, the examples only address

situations that either clearly meet or do not meet the characteristics. More complex examples would be necessary if the Board decided to proceed with the bifurcation approach outlined in Approach B of the ITC.

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)?

We believe the objective of the paragraph 11 exemption from cash flow testing differs from the objective of the filter for determining whether an insurance contract unequivocally transfers significant insurance risk. The objective of paragraph 11 is to identify those situations where the reinsurer, as a result of the reinsurance agreement, has an economic position that is virtually equivalent to having written the business directly. As noted in Statement 113, the paragraph 11 exemption is intended to only apply in very limited circumstances. The Board's characteristic for unequivocal insurance contracts focuses on whether the purchaser of insurance is buying coverage at market rates with standard policy terms. Charging a cedent a reinsurance market rate premium to accept a risk may not be identical to being in the same economic position as the cedent. Accordingly, we do not believe it is appropriate to compare the two concepts.

We would like to highlight that a strict reading of the unequivocal test could result in the failure of certain insurance contracts that truly transfer risk between two parties. A contract that has a fixed premium to transfer an uncertain future amount is the basic definition of insurance. However, the unequivocal test will cause certain contracts that transfer a significant amount of risk to fail that test due to either a mandatory reinstatement feature (i.e., loss sharing feature) or specific entity underwriting that causes the premium to deviate from the market equivalent premium. Most excess of loss contracts for unique risks, contracts with very high attachment points, or catastrophe covers would appear to fail the unequivocal test. We do not believe the Board intended for all of these types of contracts to be bifurcated if the premium paid was fixed (including any fixed reinstatement premiums), and non-refundable. We believe that when the adjustable features effectively places a significant portion of the cost of the loss event on the policyholder and not on the insurer then the unequivocal test is not met.

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 believe that both Approach A and Approach B are inappropriate options to identify those contracts that should be considered for bifurcation. With regard to Approach A, we do not agree with the Board's definition of finite contracts as noted in our response to Issue 1. For Approach B, we believe that requiring all remaining contracts to be bifurcated represents a wholesale change to the (re)insurance

accounting model that is not warranted at this time. We also believe that the cost to apply a bifurcation model to those contracts covered under Approach B would exceed any reporting benefit.

We do not agree with either Approach A or B because they will take a significant amount of time to develop and will, like the current risk transfer guidance, require a significant amount of judgment. However, we do agree with the Board that certain contracts should be bifurcated. Therefore, we suggest simpler and more direct criteria that could be implemented quickly and would not include the level of judgment in the Board's approaches. We propose the following set of criteria to identify the contracts that should be bifurcated and the deposit component accounted for under the guidance in SOP 98-7, while the insurance component would be accounted for under the existing insurance accounting guidance.

- *Features that guarantee a value to the policyholder. That is, contracts that have profit sharing arrangements where the policyholder is guaranteed to receive its premium (or a significant portion of the premium), less claims and any fee.*
- *Features intended to alter items covered under the reinsured contracts to limit or reduce the overall exposure of the reinsurer based on overall aggregate results. Examples include, but are not limited to, quota-share reinsurance contracts with loss corridors, loss caps (except for caps that are set at levels that are expected to be remote of occurring), or deductibles that do not correspond to the deductibles in underlying reinsured contracts, including multiple year contracts.*
- *Features that impact the cashflows between the policyholder and insurer that could adjust the initial premium or initial retention of claims/losses by an amount greater than 10% of the initial or provisional premium. An example would be a retrospectively rated policy or reinsurance contract.*

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

See response to Issue 7.

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?

We are unable to conclude on which bifurcation method has the most conceptual merit as the ITC does not provide sufficient information about each of the methods to allow us to perform a proper evaluation of each method. Illustrative examples of how

each method would be applied to a standard fact pattern are necessary to provide a basis to assess which method has the most conceptual merit.

Even though we were unable to conclude as to which model is best, we do not believe that the Board should select one method over another method. If the Board were to continue down this path, we believe the Board should establish a set of objectives that the models should achieve and allow practitioners to select a method that meets those objectives. For example, the Board specifically did not require one method for valuing stock options in FASB Statement No. 123(R), *Share Based Payment*; instead, the Board provided objectives that the model used by a company had to meet. We believe the Board should not require the same method for bifurcation of all contracts.

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?

For many corporate policyholders, availability of relevant data most likely would limit a company from applying the bifurcation models discussed in the ITC. Companies could get generic industry data for most, if not all, insurance risks covered by their insurance policies. However, for certain of the insured risks, a particular company's own historical loss data may be the best source of data to use in the bifurcation model because the company's risks may not be consistent with overall industry data.

We understand some companies may have access to all of their own claim data, but many others may not. For those companies without access, we understand that their insurance carrier would not have to provide it to the companies and, in fact, in most cases would not provide it. Without detailed information regarding claims incurred and paid, the corporate policyholders would be unable to make timely adjustments to the deposit component of the bifurcated premium.

We do not believe that lack of available data can be attributable to specific insurance forms or products. We think that the lack of data in many cases will occur because of either the size of the entity or the cost of insurance. We, therefore, we do not believe that available data or lack thereof should be attributable to certain insurance forms or products.

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?

We believe that the FASB should address the current diversity in the application of risk transfer regardless of the IASB's Phase II project. Bifurcation of certain

contracts may capture a large portion of the issues relating to the transfer of insurance risk, but clarification of the existing risk transfer guidance in Statement 113 also will be required to eliminate the diversity that currently exists in financial reporting under U.S. GAAP.