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Technical Director  
Financial Accounting Standards Board  
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By E-Mail



LETTER OF COMMENT NO. 45

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

Dear FASB Technical Director:

The National Association of Mutual Insurance Companies (NAMIC) comprises approximately 1,400 insurers in the United States and Canada, and these companies make very extensive use of reinsurance in conduct of their property-casualty businesses. Most of those members do not use GAAP and report solely on the basis of statutory accounting prescribed by the states from the National Association of Insurance Commissioners' (NAIC) *Accounting Practices And Procedures Manual*. We believe, however, that the Board is aware that its pronouncements, as they are issued, are compared with the fabric of statutory accounting by the NAIC for possible inclusion in some form in that *Manual*. Indeed, FASB pronouncements are part of the statutory accounting hierarchy of authority as specified in that *Manual* prescribed by the states for insurers' jurisdictional regulatory reporting. Because of that relationship between GAAP and statutory accounting, and in anticipation that content related to the Invitation to Comment will be considered for, or might enter, statutory accounting, we comment here on this subject matter.

**Introduction:**

Given the nature of NAMIC's membership, our comments center on insurance and reinsurance reporting performed by property-casualty insurers and do not take a pan-industry approach. With regret, we abstract from content of the Invitation to Comment (ITC) a presumption that bifurcation, when certain elements are present in an agreement, is appropriate for insurers and reinsurers. It is worth stating, even for this ITC, that such presumption should be tested and vetted with the most deliberate care and with acknowledgement of the burdens that would accompany imposition of bifurcation. We will not be alone in remarking to the Board that of bifurcation, as is generally described in the ITC, leads inexorably to guidance is necessarily rules-based with respect to

screening contracts in or out of bifurcation and with the procedures, algorithms, and decision nodes for bifurcation itself.

There is a general taxonomy of reinsurance agreements between property-casualty insurers and reinsurers; within and across classes in that taxonomy, agreements in current use have great variation in individual provisions in recognition of the respective characteristics of the cedent, including combinations and permutations of features identified as “finite.” We suggest as strongly as possible that *every* yes/no decision made in the flow chart—“Risk Transfer and Bifurcation Testing—demands formulation of not just a few rules. This inevitable proliferation of rules will be accompanied by an unavoidable increment of expense and time generated by the labors of accountants, auditors and actuaries. Absent in the ITC is an examination of what are alleged or what are proven to be the failures in reporting that clearly are not resolved or somehow stand outside the scope of SFAS 113 or do not contradict SFAS 113. In other words, is the Board content already that responsible use of SFAS 113 was made in the instance of what are accepted or suggested to be misstatement in preparation of financial statements?

We believe the now informal guidance allowing a reinsurance agreement to be regarded as such and to receive full credit if it embodies a 10 percent chance of a 10 percent loss, continues to be an anchor guideline of great utility. We do not necessarily suggest its codification into formal guidance, but this rule, if parsed carefully and observed faithfully, allows a reasonable distinction between contracts that are, and are not, reinsurance in sufficient degree. Surely, 10 percent probability lies in the realm of “reasonable probability” and surely a 10 percent loss is material in the scope of any contract. These minima, whether or not codified, are a sufficiently high bar, if honestly applied.

**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)*

IFRS 4 provides no sharper resolution with respect to defining insurance and distinguishing underwriting risk from financing. In relation to that analysis explained in SFAS 113, the definition in IFRS 4 adds no distinguishing power or criteria that are not present in SFAS 113.

**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 question the need for such application of any new guidance to the situation of corporate policyholders, especially with respect to what might be added to content and value of financial statements. Such application clearly engenders problems of comparability, soluble only, we suggest, through very broad and deep sets of rules.

**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)

This is the central question involved in this inquiry and is posed, especially in the last sentence, in such a way that may tilt answers toward bifurcation—without acknowledgement of the burdens entailed. Rather than asking, “Which approach more faithfully represents the economic substance . . . ?” one might better pose the following question: Using great numbers of rules and decisions, can probabilistic elements of a reinsurance agreement be teased from the greater context of the agreement, analyzed, and reassembled for the purpose of splitting the contract between income statement and balance sheet? Any honest respondent to either form of the question would begin by examining the predictability of the cash flows, particularly those underlain by losses and loss-adjustment expenses. What, for example, is the shape of the distribution of the aggregate cash flows. How is that shape expected to change over time and with different assumptions? Moreover, that respondent would ask if, in such a risk-based business, those cash flows were of a quality to be inserted in the balance sheet. We suggest this is not the case and that this fact of bifurcation is liable to do disservice to reinsurance accounting.

Particularly disconcerting from the flow chart and from paragraphs 57-59 is the requirement that, basically, only a single contract could be regarded as unequivocally transferring risk, if suitably drafted, and that aggregations of contracts would otherwise be subject to bifurcation, given the probabilistic element introduced by that aggregation. We can not say, indeed we disagree with the proposition, that that faithful representation is enhanced or users of financial statements are served by prima facie classification of aggregations as subject to bifurcation. The insurance business is simply more volatile than is framed by the issue here. By reason of the tort system and changing Congressional priorities, we could not more strongly disagree that users of financial statements are better served with respect to relevance, understandability, or comparability should such comprehensive bifurcation be imposed.

In summary for this issue, the marketplace for reinsurance for property-casualty insurers brings together buyers and sellers whose risk transactions may meld financing and underwriting elements in such a way that they are not usefully to be disengaged for financial statements, assuming passage of the reasonably simple “10/10” test now informally used to qualify whole contracts. Departure from this status brings a brave and undesirable new world of myriad rules.

**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)*

The SFAS risk-transfer tests are largely subordinated to rules not yet created. SFAS 113 requires a principles-based judgment and should be the basis for classifying reinsurance contracts for property-casualty companies.

**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)*

As have other commenters, we observe that only single-risk contracts would meet the test for unequivocal risk. This is, finally, irrationally constraining for the creation of insurance and reinsurance contracts and statistically short-sighted.

**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)*

As suggested above, we find that the essential requirement that only a single-risk contract qualifies is contrary to reasonable use of expected loss concepts and unacceptable as the sole criterion for unequivocal transfer of risk.

**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)*

No comment.

**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 comment.

**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)*

No comment.

**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)*

It would indeed. In the absence of data, indeed in some situations when data is available, the judgments of the parties to the contract are to be respected.

**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)*

We have stated our reservations with bifurcation and believe that decisions on material in this ITC should be subordinate to the larger issues contemplated in the IASB's Phase II project and therefore postponed for reason that they may not be relevant in any joint or similar FASB-IASB approach.

Very truly yours,

/s/ William D. Boyd

Financial Regulation Manager