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Technical Director
Financial Accounting Standards Board
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LETTER OF COMMENT NO. 46

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

Liberty Mutual Group (LMG) is a diversified global insurer and the sixth largest property and casualty insurer in the U.S. As of June 2006, LMG had approximately \$82B in consolidated assets and \$73B in consolidated liabilities. Our consolidated revenues were approximately \$21B and \$12B for the year ended December 31, 2005 and the six months ended June 30, 2006, respectively.

We take this opportunity to respond to the FASB's Invitation to Comment (ITC) on Bifurcation of Insurance and Reinsurance Contracts for Financial Reporting. Understanding that events of recent years have caused concern about "non-traditional products," we understand the FASB's review of its guidance to ensure it remains appropriate and clear and that it best serves the users of financial statements.

While certain types of non-traditional contracts may merit additional disclosure in the interests of users of financial statements, these types of products represent only a small fraction of all contracts in the industry. The ITC as written would change the accounting for most insurance products, while still not specifically calling attention to non-traditional products; thus, the ITC will not achieve the FASB's desired result of improved understandability and decision usefulness of financial statements. To achieve these characteristics, we advocate focusing financial statement users' attention to certain non-traditional contracts through additional disclosures, similar to how the NAIC enhanced reinsurance disclosures in their 2005 statutory statements.

Our response to the ITC will include an assessment of issues in the ITC as drafted and a proposal of an alternative approach. It is our desire in this response to help the FASB identify issues with the ITC and identify opportunities to assure transparency in financial statements.

Assessment of Issues

A. Rules-based Approach

It is commonly agreed that substance takes priority over form when determining appropriate accounting treatment. Establishing principles upon which professionals can apply their good judgment allows companies to make solid business decisions and determine the appropriate accounting for the resulting transactions. The ITC approach moves further from substance and more toward a specific rules-based approach.

Applying a rules-based approach can lead to problems in application of the FASB guidance. Specifically, it can lead to inconsistencies in reporting both within a company and among

companies related to the same transaction. Secondly, it may incite companies to manipulate insurance arrangements to effect the desired accounting treatment.

1. Rules-based approach is likely to result in inconsistent reporting.

For example, a company may need reinsurance coverage for a homeowners' book with exposures in a coastal area prone to hurricane damage. The company may obtain a quota share contract that spreads its risk to a reinsurer on a pro rata basis. Under the ITC, the insurer will account for the direct homeowners' policies as insurance, but the quota share contract will be bifurcated. The reinsurer will also be required to bifurcate its pro rata share of the homeowners' book, even though the reinsurer stands in the same position as the insurer relative to the risks covered.

The result is the insurer has inconsistencies within its financial statements. Premium and losses are booked accordingly in the income statement for the direct book, while at least a portion of the ceded risks are captured on the balance sheet. Inconsistencies are created across the industry by requiring the reinsurer to bifurcate its share of the risks. Financial statement users will have to contend with more complexities to decipher such statements. Direct and ceded risks will be mismatched on the income statement making it harder for users to understand the risks retained by the insurer. Similarly, it will be difficult for users to ascertain the risks assumed by the reinsurer.

To treat part of this quota share as deposit accounting implies that there is a portion of the contract that is fixed with respect to known losses. In fact, in a straight quota share, particularly in this example of hurricane exposed risks, there is great volatility in expected losses. As the direct exposures have inherent volatility, so too do the ceded and assumed shares.

2. Rules-based approach may result in manipulation of insurance arrangements.

Another issue with rules-based guidance is the greater opportunity to manipulate transactions to achieve the desired financial statement impact. According to the ITC, only single-risk policies can unequivocally transfer significant insurance risk because these are the only ones in which no known losses are expected. One can then infer that once single-risk policies are aggregated, the ITC would require bifurcation. The insurer, in this example, might then change the accounting and resulting financial statement impact by changing the structure of its reinsurance arrangement. Rather than buying one quota share, which would require some deposit accounting and some insurance accounting, the insurer could purchase individual facultative contracts for each homeowner's policy. The insurer could account for the cessions as reinsurance according to the ITC rules-based approach. In this case, one streamlined quota share can be segmented into many individual contracts to achieve the desired accounting.

B. Technical Challenges

Several technical challenges are presented by the ITC.

1. Bifurcation of related risks

At its heart, bifurcation involves breaking the risk associated with an insurance contract into pieces and accounting for those pieces in different ways.

If risks that do not naturally belong together have been combined into a single contract for the sole purpose of obtaining different accounting treatment, then there is a reasonable argument for insisting that the risks be treated separately despite the fact that they were combined into a single

contract. For these types of contracts, separation can be accomplished by reversing the process that was used to effect the combination.

Bifurcation does not make sense, however, for risks that naturally belong together. For example, when a fleet owner with 200 vehicles buys a Commercial Auto policy; the policy combines coverage for all 200 vehicles in a single policy, and typically combines Liability and Physical Damage coverage in a single policy. In this case, the combination of 200 vehicles under a single policy is done for practical reasons.

The fleet owner is thinking about the management of a fleet, not of 200 separate vehicles. The expense associated with purchasing 200 separate policies would be substantially greater than the expense associated with a single policy. If required to bifurcate such a policy, there would be a number of potential approaches, none of which is intuitively the right one:

- Divide the exposure into 200 pieces, one for each vehicle; in this case all of the pieces would be treated as insurance;
- Divide the Liability from the Physical Damage (the Physical Damage, being more predictable, might be viewed as having a non-insurance component);
- Separate out the first few hundred dollars of loss on each vehicle as consideration for non-insurance treatment; or
- Select an aggregate dollar amount reflecting the probability that there is a 1%, or 0.1% or 0.01% chance that total losses for the policy will be less than such aggregate dollar amount, and treat the losses up to such aggregate amount with non-insurance accounting.

As illustrated by this example, bifurcation would not be reliable, because different firms would likely make different choices about how to separate the exposures. The end result would be that firms with similar exposures that pay similar amounts of insurance premium would produce financial statements that are substantially different.

2. Determination of expected losses

The ITC asserts that in all cases where more than one risk is involved, one can expect losses. In these cases, it will require companies to apply judgment in each situation to determine the expected losses.

Using the Commercial Auto policy example above, there could be significant differences in the amount of expected loss depending on how the company assesses the policy. Based on the law of large numbers, each auto added to the fleet increases the chance of a loss, but the company will have to decide the threshold to use. As significant judgment is required, different companies will arrive at different answers. This particular technical challenge will lead to further inconsistencies in accounting among companies.

3. Sum of the parts may not equal the whole

The ITC introduces the phenomenon that the sum of the parts may not equal the whole. The law of large numbers in insurance dictates that as exposures are aggregated, the certainty of a loss increases, as does the percentage of the certain loss to the total exposures.

One example of this is the involuntary insurance market. Servicing carrier companies cede 100% of this business to the involuntary pool, which in turn cedes the business back to pool members. Because each servicing carrier handles only a portion of the business, the transactions ceded by the servicing carriers will include a larger percentage of insurance treatment than the transactions assumed by the pool members. In this case, the assumptions in total will not agree to the cessions in total.

C. Defining Insurance vs. Financing

The ITC defines a narrow view of true insurance products. It assumes that most commercial insurance products and reinsurance contracts are not true insurance but rather are part insurance and part financing. While some insurance products may contain financing components, in most cases this type of financing is quite different from traditional financing or banking arrangements.

For example, in a loan given by a bank to a customer, the loan is for a defined amount and typically has a defined payback schedule with a defined interest rate. There is little risk to the bank's financial statement other than the inherent credit risk in the loan.

An insurance product is different in two ways. First, the insurance contract must have an underlying component of underwriting risk, meaning that while some losses may be expected, neither the insurer nor the customer knows the amount of such losses. Secondly, insurance contracts must also contain timing risk. In this regard, not only does the insurer not know the amount of such losses, but it also does not know when the losses will be paid. Considering the long-tailed nature of some commercial business, timing considerations add significant risk to the contract. In short, the insurer's financial statement contains potential volatility in amount and timing as to losses.

To further understand the difference in insurance and financing products, consider a typical case in which a commercial insurance customer buys a policy because of an exposure to loss arising from its operations. The customer has potential exposure to costs:

- Of work-related injuries to its employees under state Workers' Compensation (WC) laws;
- Of vehicular accidents because it operates a fleet of vehicles; and
- Resulting from fires, windstorms or other perils that damage property it owns or occupies and/or replacing the contents of those properties.

Although the customer could in certain circumstances retain the risk and self-administer the claims, in most cases it is simpler to purchase an insurance policy, transferring the potential exposure to the insurer. Risk transfer is only one reason to buy a policy; often an equally important reason is that the insurer will take on many of the administrative tasks associated with handling the risk. For example, only for the largest customers is it economically feasible to maintain an in-house capability to carry out all the tasks that are needed to handle WC claims. Most customers purchase a WC policy that provides both risk transfer and service, and consider that the amount of the WC policy premium represents the cost to operations arising from this exposure.

Under today's accounting, the customer records an expense for the amount of the premium, and users of financial statements can interpret this cost as one of the costs of doing business. This is understandable, relevant and reliable. Notwithstanding deductibles or similar characteristics, the amount of the insurance premium is the only payment the customer will have to make for WC losses.

For medium or large-sized customers, it is likely that there is some minimum level of WC losses that is almost certain to be incurred. Under the concepts presented in the FASB ITC, it appears that the WC policy will be bifurcated with a complex series of transactions that will stretch over a number of years. This accounting will make financial statements less understandable by hiding the fact that the only cash flow associated with WC losses is a premium payment, and less relevant by introducing transactions that do not reflect actual costs.

Alternative Approach

A. Current Guidance

Current FASB guidance clearly establishes the requirement for risk transfer to obtain insurance accounting, and such requirements are applicable to both insurance and reinsurance products. Such guidance is appropriately principles-based. When professionals apply the guidance appropriately and in an ethical manner, the accounting will correctly reflect the substance of the transactions on the financials. We therefore believe current guidance is appropriate.

B. Additional disclosures required

The review of insurance accounting was triggered by specific, widely publicized instances of accounting treatment abuse involving non-traditional contracts. We understand the FASB's goal is to provide users of financial statements understandable, relevant and reliable information. As written, however, the ITC will result in the following: a majority of commercial and reinsurance products being bifurcated, reduced financial statement transparency, and financial reporting inconsistencies among companies. The sheer volume of bifurcated contracts, along with the judgments applied by each company in applying bifurcation, and the inconsistent methods of financial reporting will unfortunately mask any underlying contracts that may merit closer review.

We thus advocate as an alternative to bifurcation that the FASB require additional disclosures to highlight certain non-traditional contracts, similar to how the NAIC enhanced reinsurance disclosures in their 2005 statutory statements.

We would be pleased to discuss any questions or comments you might have regarding this submission.

Sincerely,



John D. Doyle
Vice President and Comptroller
Liberty Mutual Insurance Company