

AMERICAN ACADEMY of ACTUARIES

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

LETTER OF COMMENT NO. 49 A

Via email to: director@fasb.org, File Reference No. 1325-100

Re: Invitation to Comment, "Bifurcation of Insurance and Reinsurance Contracts for Financial Reporting"

Dear Sir or Madame:

The Financial Accounting Standards Board (FASB) published an Invitation to Comment on the Bifurcation of Insurance and Reinsurance Contracts for Financial Reporting (ITC), dated May 26, 2006. The purpose of this letter is for the Committee on Property and Liability Financial Reporting (COPLFR) of the American Academy of Actuaries¹ (Academy) to provide comments to the FASB on the ITC as it relates to property/casualty (P&C) insurance and reinsurance.

Background

As stated in the "Conceptual Framework" section of the ITC, the principal issue in the ITC is whether bifurcation of insurance and/or reinsurance contracts would improve the understandability and decision usefulness of financial statement information. As stated in the ITC, bifurcation would divide some or all of these contracts into the following components for financial reporting purposes:

- a. Components that transfer significant insurance risk and are accounted for as insurance
- b. Financing components that are accounted for as deposits.

The Conceptual Framework Section of the ITC lists the following criteria the FASB would consider in deciding whether bifurcation would improve the decision usefulness of financial statements:

• Understandability – enabling users to perceive the significance of information in financial statements

The American Academy of Actuaries is a national organization formed in 1965 to bring together, in a single entity, actuaries of all specializations within the United States. A major purpose of the Academy is to act as a public information organization for the profession. Academy committees, task forces and work groups regularly prepare testimony and provide information to Congress and senior federal policy-makers, comment on proposed federal and state regulations, and work closely with the National Association of Insurance Commissioners and state officials on issues related to insurance, pensions and other forms of risk financing. The Academy establishes qualification standards for the actuarial profession in the United States and supports two independent boards. The Actuarial Standards Board promulgates standards of practice for the profession, and the Actuarial Board for Counseling and Discipline helps to ensure high standards of professional conduct are met. The Academy also supports the Joint Committee for the Code of Professional Conduct, which develops standards of conduct for the U.S. actuarial profession.

- Relevance helping users to form predictions about the outcomes of past, present, and future events or to confirm or correct prior expectations
- Reliability verifiability and representational faithfulness
- Constraints balancing costs versus benefits

In addressing the concepts in the ITC, COPLFR has accepted the criteria outlined above as guidelines by which to evaluate the proposal. Our letter is focused primarily on the actuarial and market aspects of the proposals in the ITC, rather than the accounting, tax, or regulatory aspects. As such, our comments address some, but not all, of the specific questions posed throughout the ITC. We also have separated our comments for insurance contracts versus reinsurance contracts, because we believe that, for the most part, the substance of the arrangements between policyholders and insurance companies differs significantly from arrangements between insurance and reinsurance entities. Finally, this letter addresses only P&C insurance and reinsurance arrangements; other Academy letters have been provided to address this topic from the life and healthcare perspectives.

Throughout this letter, we refer to "problematic" insurance and reinsurance contracts, which we define as contracts that have each of the following characteristics:

- The primary intent and/or motivation of the purchasing or ceding entity is to obtain a financial reporting result, as opposed to the primary motivation of purchasing a traditional contract, which would be to obtain a risk transfer and/or servicing benefit;
- The form of the contract is a nontraditional or manuscript form, in which most of the individual contract terms are not generally available to a market, but rather are negotiated on a case-by-case basis;
- The contract is "finite," meaning that the contract contains an element of risk transfer, but the purchasing or ceding entity retains more of the risk in the insured or reinsured layer than would typically be the case under traditional contracts; and
- The financial reporting result over most or all scenarios is significantly disproportionate to the economics and amount of risk actually transferred.

Conclusions and Recommendations

We understand and strongly support the FASB's desire to address problematic contracts, and as such we believe that the FASB should limit its focus in this assignment to such contracts instead of considering a much broader focus that results in a comprehensive restructuring of the fundamental insurance accounting model. We believe that such restructuring could have considerable unintended consequences, and we recommend that the FASB consider the potential impact of the unintended consequences before deciding whether to implement such extensive changes.

We believe there are other important considerations that impact the FASB's decision, as follows:

Many of the problems that have been encountered result from the undisclosed effects of finite
reinsurance agreements on ceding companies' financial statements. The National Association of
Insurance Commissioners (NAIC) has just approved extensive new reinsurance disclosure
requirements that took effect at year-end 2005. Further, the NAIC has implemented a CEO and CFO
attestation requirement regarding the documentation of risk transfer and economic purpose for

reinsurance contracts in which risk transfer is not reasonably self-evident. We believe that these new disclosures and documentation requirements will have a major impact on the existence of problematic reinsurance contracts.

- COPLFR is currently engaged in a project to assist the NAIC's P&C Reinsurance Study Group by
 addressing technical questions regarding risk transfer analysis and screening. The results of the
 project will be available in the fall of 2006. We believe the results of this project could be useful to
 the FASB in evaluating what changes, if any, should be made to address risk transfer issues.
 COPLFR is available to assist the FASB in evaluating proposals and testing alternative approaches
 on real-life reinsurance contracts.
- The International Accounting Standards Board (IASB) is addressing the entire insurance accounting model and, as we understand it, the FASB intends to work with the IASB towards a single, optimal accounting system for insurance and reinsurance products. In order to avoid potentially significant divergence between international accounting and Generally Accepted Accounting Principles (GAAP) accounting for reinsurance contracts, which would likely create substantial inefficiency and confusion, we recommend that the FASB evaluate the insurance accounting model concurrently with the IASB.
- On a similar note, the current insurance accounting guidance under U.S. Statutory Accounting
 Practices (SAP) is very similar to U.S. GAAP. Significant changes to the U.S. GAAP accounting
 model would result in substantial divergence between U.S. SAP and U.S. GAAP, which we believe
 would create inefficiencies and confusion and therefore should be avoided.

Summary of Comments

Our overall comments regarding the ITC are as follows:

- The ITC expanded the FASB's scope from an initial focus on addressing the financial reporting
 for finite insurance and reinsurance contracts to a comprehensive evaluation of the accounting
 model for traditional insurance and reinsurance arrangements, which includes potentially
 bifurcating traditional insurance and reinsurance arrangements.
 - We strongly disagree with this expansion of scope because we believe that bifurcation of corporate insurance contracts, as well as non-problematic reinsurance contracts, would result in less useful information for the user of the financial statements of insurance companies and policyholders. We believe that bifurcation would also result in less comparability of financial statements among insurance companies and significant market disruption and cost to both policyholders and insurance companies, with little or no apparent benefit.
- With the possible exception of a narrow category of contracts that clearly bundle an insurance
 arrangement with a deposit arrangement, bifurcation of problematic contracts may not result in
 more decision-useful information. To deal with problematic contracts, we suggest requiring
 deposit accounting in its entirety, more comprehensive disclosure, and/or other approaches. The
 NAIC recently expanded its disclosure requirements for certain reinsurance contracts, and we
 suggest that the FASB consider some type of similar requirements.
- We strongly believe that the FASB should separate insurance from reinsurance when considering risk transfer and bifurcation, in large part because insurance agreements often contain a

significant servicing component in addition to risk transfer.

We believe that bifurcation should not be considered for primary insurance because of the significant servicing element generally inherent in such contracts; the severe limitations regarding data, expertise, and the resulting cost to the policyholder; and the minimal, if any, identifiable financial reporting benefit.

These particular limitations are less prevalent with reinsurance, because there is generally a smaller servicing component, and the buyer and seller of a reinsurance contract are presumed to have some of the requisite expertise to comprehend the risks inherent in the transaction.

 If Statement of Financial Accounting Standards, No. 113: Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts (FAS 113) and/or related guidance were modified so as not to require cashflow testing for contracts in which risk transfer and/or insurance servicing is/are deemed to be reasonably self-evident, we believe FAS 113 could be applied to primary insurance.

If the FASB intends to continue pursuing bifurcation despite the theoretical and pragmatic issues we have summarized above (and describe in greater detail in the following sections), we then offer the following comments on the flowchart and methods in the ITC:

- With regard to the flowchart and Approaches A and B, as defined in paragraphs 61 through 69, we believe that bifurcation should be considered only for problematic reinsurance contracts. Therefore, we do not believe Approach B should be adopted. Furthermore, we believe that the description in Approach A would require significant refining to be specific enough to achieve consistency among practitioners in the identification of problematic contracts. A possible improvement to this description would be to limit it to those contracts that are bundled, i.e., where the financing and insurance elements are clear and unambiguous.
- With regard to the methodology, we believe the most appropriate way to bifurcate a contract is to disassemble it in the manner in which it was originally assembled. There is no single bifurcation method that we know of that can separate the deposit and risk transfer components of a given contract such that the accounting and the economics would be aligned. Because no one method would work better than another for every contract structure, the accuracy of a bifurcation method would depend on how well the method and assumptions used to bifurcate the contract relate to the actual pricing and structuring of the transaction.

Therefore, we do not endorse any particular method or approach in all circumstances. We suggest that the efficacy of any method for a given purpose only be assessed after testing it on a wide variety of real-world insurance and reinsurance contracts.

The remainder of this letter provides more in-depth discussion of the points we have summarized in this section.

Expansion of Scope

The history of this bifurcation project is summarized in the notes published on the FASB website from an April 6, 2005 FASB meeting, as follows:

"Recently, a number of issues have arisen concerning the determination of whether an insurance or reinsurance contract transfers significant insurance (reinsurance) risk. The determination of significant risk transfer is necessary to determine whether the contract is accounted for as an insurance or reinsurance arrangement or whether it is accounted for as a financing arrangement (similar to a loan)... This project's objective is to define an insurance contract and provide further assistance in identifying those contracts that transfer significant insurance risk. In addition, the project will explore the notion of bifurcation of insurance contracts into risk transfer and financing segments for purposes of establishing the appropriate accounting for those contract segments."

It is our understanding that the original issue being addressed was the occurrence of problematic contracts in which there may be sufficient risk transfer to meet the requirements for insurance or reinsurance accounting, but the economic substance of the transaction does not appear to match the accounting. The "Recent Reporting Issues" section of the ITC refers to press reports of alleged abuses of accounting for certain insurance and reinsurance contracts, specifically finite risk insurance and reinsurance. However, the ITC also extends well beyond problematic contracts and asks whether financial statements would be improved if many or most insurance and reinsurance contracts were bifurcated.

It appears that the original focus of the Risk Transfer Project was to address abusive contracts, i.e., to fix something that was perceived to be broken. However, the current scope of the ITC is a comprehensive revisiting of the insurance accounting model, such that fixing the broken element is now a small byproduct of a much larger concept.

We disagree with the expansion of the original scope of the FASB's Risk Transfer Project to include bifurcation of traditional insurance and reinsurance contracts because we believe that:

- The current insurance accounting model is not so flawed that it needs a comprehensive change of this nature and magnitude.
- Bifurcation of most insurance and reinsurance contracts is likely to result in less, rather than more, decision-useful information regarding traditional contracts.
- A comprehensive change in the current U.S. GAAP model for insurance to one that differs dramatically from statutory accounting in the United States is likely to cause significant market cost, confusion, and dislocation, in return for little or no apparent benefit.
- The focus of the Risk Transfer Project should remain on the identification and financial reporting of problematic or abusive contracts.

Decision Usefulness of Bifurcation

Problematic Contracts. There are limited instances in which a problematic insurance or reinsurance contract essentially consists of two or more bundled coverages or layers, at least one of which transfers significant risk and at least one of which does not. By "bundled," we mean that the contract explicitly provides separate cash flows, such as individual premium and loss calculations, for the two coverages or layers. In these instances, the contracts have essentially been structured in a bifurcated fashion, so that the cash flows for each component are explicit in the contract. The decision criteria regarding verifiability, representational faithfulness, and relevance of bifurcated accounting may typically be

satisfied in these instances. The benefit in these circumstances may justify the cost, which is likely to be fairly low, since little analysis is likely to be needed.

However, for other problematic contracts, we believe that bifurcation would not be the preferred approach and should be considered only as a last resort. Our reasoning, summarized using the decision criteria outlined in the ITC, is as follows:

- <u>Verifiability</u> For many of these contracts, estimating the component parts of financing and risk transfer for bifurcation purposes would typically require significant judgment regarding both the method to be used and the underlying assumptions, and therefore it is likely that there would not be a high degree of consensus among independent measurers as to the outcome.
- Representational faithfulness Unless the contract were bifurcated using the same assumptions and methods as those employed in the pricing and structuring of the original contract, a bifurcated contract would typically not represent the economics of the transaction.
- <u>Understandability</u> If the bifurcated contract does not represent the economics of a transaction, the resulting accounting would not enable users to accurately perceive its significance.
- Relevance Given the issues regarding verifiability and representational faithfulness, we do not believe that bifurcation is likely to help users of financial statements to form better predictions or to confirm or correct prior expectations.
- Costs versus benefits The amount of additional work required to bifurcate problematic
 contracts is unlikely to yield a commensurate benefit with respect to better financial statements.
 We expect that one significant benefit of bifurcation would be to reduce the incidence of
 problematic contracts, but this result could be achieved in a more direct and cost-effective
 fashion.

As an alternative to bifurcating a problematic insurance or reinsurance contract, we suggest (a) requiring the ceding or purchasing company either to deposit account the contract in its entirety, or (b) requiring disclosure of the financial reporting effects so that they are not hidden in the financial statements. If the reporting entity does not wish to accept either of these alternatives, its option would be to restructure the contract to increase the risk transfer component and/or reduce the financing element so the resulting risk transfer and financial reporting are better aligned.

We believe that this approach to addressing problematic contracts will preserve the representational faithfulness of financial statements and result in more relevant information, while removing the concern of verifiability as described above.

Further, we believe that identifying problematic contracts will require better guidance on screening and analysis of risk transfer than has previously been available. By screening, we mean that cashflow analysis to assess risk transfer would not be required for groups of contracts that meet certain characteristics. COPLFR has been working with the NAIC on these issues, including guidance on situations in which risk transfer for P&C reinsurance is "reasonably considered to be self-evident," and the FASB may wish to consider the materials developed as a result of these efforts in developing future guidance.

Non-Problematic Contracts. We believe that for the vast majority of insurance and reinsurance contracts, which are traditional contracts entered into primarily for risk transfer and/or servicing purposes, bifurcation is not desirable. Moreover, for finite contracts that are not determined to be abusive or problematic, we do not believe bifurcation is desirable.

Our opinion is based on the following:

Representational faithfulness – The concept underlying bifurcation implies that risk transfer and
financing are the only two items to consider in dividing up the premium paid for an insurance or
reinsurance contract. However, particularly for insurance contracts, there are other important
considerations that impact premiums, such as the claims handling, loss prevention and other
services provided by the insuring entity, the market availability for the product, and the relative
risk appetites of the buyer and seller.

In particular for insurance arrangements, we believe that bifurcating contracts without considering the servicing element oversimplifies the market dynamics, such that the resulting accounting elements would not accurately correspond to the economic elements they purport to represent.

- Verifiability In most cases, the various considerations that impact the premium paid for an
 insurance or reinsurance contract are not reasonably separable between risk transfer, servicing,
 financing and other elements. The amount of subjective judgment needed and the inherent data
 constraints, especially with respect to primary insurance, will lead to a significant variety of
 estimates among reporting entities.
- <u>Relevance</u> Given our comments regarding representational faithfulness and verifiability, we believe that bifurcation would generally result in confusing and non-standardized information in financial statements.

For example, if the bifurcation method is focused on "dollar trading," an insurance company writing a large number of very small contracts might not bifurcate any of its contracts, if the probability of one or more claims is low for any given contract. However, another company, writing the same group of risks via a small number of large contracts, might bifurcate each of the contracts, because for any one contract the probability of one or more claims is higher. Thus, two entities having the same economics would report different premiums, unpaid losses and loss expenses, and amounts recoverable from reinsurance.

Therefore we believe that the relevance of this information to users is likely to be significantly reduced from the information available under current accounting practices.

<u>Cost/Benefit Constraints</u> – We believe that the cost of implementing a bifurcation proposal that
encompasses traditional insurance and reinsurance contracts is likely to significantly outweigh
the benefits, if any, and could be particularly onerous to midsize and small insurance companies
and policyholders.

Furthermore, in the vast majority of cases, we do not believe that policyholders' financial statements would be impacted in a material manner by bifurcation. For such companies, insurance expense is typically a relatively minor component of total expenses, and in most cases the financial reporting of insurance premiums and self-insured insurance would be very similar.

Therefore, given that we believe the resulting information is likely to reduce the relevance of financial statements, we do not believe the cost justifies any expected benefit.

These issues are discussed further in this comment letter in the sections on "Implementation Issues" and "Bifurcation Methods."

Stock analysts, regulators, rating agencies, and many other financial statement users generally have a strong understanding of the current GAAP accounting model for traditional insurance and reinsurance. The current model for such contracts results in reasonably comparable financial statements among companies. The introduction of bifurcation of such contracts to financial reporting would introduce a very significant cost, i.e., the expense incurred to develop and maintain the estimates and the risk of market and financial reporting disruption. Therefore, we believe there should be a very high threshold—a clearly and widely accepted understanding—that bifurcation of traditional contracts would significantly improve the decision-usefulness of financial statements to justify the cost. Given our concerns that bifurcation would actually decrease decision-usefulness, we do not believe that such a threshold has been met.

Implementation Issues for Primary Insurance vs. Reinsurance

Bifurcating Primary Insurance Contracts. Based on our collective experiences in the P&C insurance market, we believe that nearly all primary insurance contracts are purchased for the purpose of risk transfer and the associated services provided by the insurer – most notably insurance expertise, claims handling, and the satisfaction of regulatory requirements. This statement is generally true even though there are many insurance contracts with elements of financing, "dollar trading" or experience rating. It is our experience that the circumstances under which an insurance contract is purchased primarily to achieve a financial reporting result are very rare.

The process suggested in the ITC of evaluating primary insurance contracts for risk transfer and bifurcation would require insurance buyers to obtain actuarial expertise, either by developing it internally or by engaging consultants. The following discussion is intended to provide a simplified explanation of the steps that would be required for a policyholder to implement bifurcation of an insurance contract.

To estimate expected losses for the policy period, which is generally the first step for risk transfer cashflow tests and the bifurcation methods suggested in the ITC, a buyer of insurance would typically need to go through the following process:

- Capture historical loss and loss adjustment expense data with, at a minimum, the following information line of business, accident date, report date, payments, outstanding losses, all stated net and gross of deductible/retention.
- Reconcile the loss data to be sure it is materially accurate.
- Develop the historical losses to ultimate, using loss development factors that reflect the claims settlement patterns for the historical periods.

- Adjust the historical losses for changes in insurance limits and deductibles, irregular policy
 periods, exposures (new divisions, new types of hazards, etc.), and trends (wages, benefit levels,
 inflation, etc.).
- Project the historical losses to the upcoming policy period, considering future changes in trends, exposures, policy limits, and deductibles.

This will need to be repeated for each separate line of business (workers' compensation, general liability, automobile liability, property, directors and officers insurance, etc.) and layer for which the company purchases insurance.

There are several significant implementation issues with respect to this process:

- Capturing sufficient historical loss data for the estimation process would be a significant
 challenge for most insurance buyers. Companies may have some records for the claims they have
 retained, but they are much less likely to maintain records for the claims they have insured.
 Further, such companies might not have access to the amounts their insurers have paid or
 reserved for their past losses.
- The steps we described above are not exhaustive; rather, they are the minimum that would be required. For most companies, their own actual loss experience will not be fully credible, and, as such, it would be necessary to supplement their data with data from industry sources or that of similar companies. This type of information is typically available to insurance companies, who aggregate the data from many companies, but not to their policyholders. Further, the use of industry data introduces significant subjectivity to a company's internal analysis. In the case of startup companies or new operations within an existing company, for which there is no historical internal experience, the analysis would need to be based entirely on data from outside sources.
- This analysis should be performed by an actuary or another professional with strong knowledge of actuarial concepts. In general, the smaller the company, with potentially less credible data, the more difficult the analysis will become.
- In general, risk transfer cashflow tests and bifurcation methods will also require the estimation of some type of probabilistic loss distribution, and this requires a much more sophisticated level of actuarial expertise.
- While it is true that some non-insurance entities are skilled in quantifying their insurance liabilities, these buyers often elect to self-insure the portion of the risk for which management is comfortable. They rely on the commercial insurance market to evaluate and accept their risks above that level.
- The resulting estimate of expected loss for a given policyholder is not likely to be comparable to the estimate used by the insurance company in deriving the policy premiums, because most commercial insurance policies would be class-rated, not individually-rated. Class-rating depends on categorization to achieve homogeneity and statistical credibility, so that the expected loss for the class is the relevant loss statistic.
- Finally, even if the losses to an insured company were equal to the average losses of its class, the expense and profit/risk load components of the premium charged by the insurance company are

not comparable to those of the policyholder if it had retained the risks. An insurance company benefits from economies of scale by aggregating and diversifying its risks, and these economies are in some measure passed along through premiums.

In addition to the practical issues summarized above, we believe that the bifurcation of primary insurance contracts is not likely to yield more decision-useful information, for several reasons:

- The bifurcation of an insurance contract into deposit and risk transfer components does not consider the element of servicing, which is often a significant part of the price and motivation for purchasing insurance. For example, a retrospectively rated workers' compensation policy reflects self-funded layers and excess insurance layers. However, in both layers, the policyholder is acquiring claims handling, loss prevention, and mitigation services.
- Most corporate insurance contracts contain some level of expected loss, and in such contracts
 there are likely to be some recoveries each year. We do not believe that the expectation of some
 recoveries implies that the contract was purchased primarily for a reason other than the
 traditional insurance purposes of servicing and/or risk transfer. In fact, a primary purpose of
 insurance for corporations is to trade a premium whose amount is certain to obtain
 indemnification of losses for which the ultimate amount and timing of payments is highly
 variable.
- The relatively low statistical credibility of information for a given insurance buyer, and the amount of subjective judgment inherent in the bifurcation process, are likely to result in expected loss estimates that are not reliable in most instances.
- In many instances, we expect that bifurcation of primary insurance contracts may not have a material impact on the reporting company's financial statements.
- We expect that this process would be costly and confusing for most buyers of primary insurance. The incremental costs involved would include costs of management information systems, data entry, accounting reconciliations, actuarial studies, audit fees and management time to address these functions, and such incremental costs would likely be significant. For most of these buyers, it is not cost-effective to become experts in risk analysis, and as a result they outsource this function for their purchase of insurance. We believe that the low incidence of problematic primary insurance contracts does not justify the cost of implementing such a change.

Further, for most policyholders, insurance expense would typically be a relatively minor component of total operating expenses, and, therefore, the financial reporting effect of bifurcating insurance contracts in most cases would likely be even less significant.

Applying FAS 113 to Primary Insurance. The ITC asked whether the FAS 113 risk transfer standard should be applied to primary insurance. If the standard is interpreted to require cashflow testing for each contract, our objections to cashflow testing in the context of bifurcation apply. However, if FAS 113 and/or related guidance were modified to include screening by type of contract, and a carve-out was included in which cashflow testing is not required for contracts in which either risk transfer and/or an insurance servicing component are deemed to be reasonably self-evident, we believe the risk transfer requirements in FAS 113 could be applied to primary insurance. The concepts of screening contracts and defining "reasonably self-evident" are currently used by the NAIC in its CEO and CFO attestations for

reinsurance contracts, and we believe that the NAIC is in the process of developing further guidance on this topic for statutory reinsurance accounting.

Reinsurance. The data and expertise issues present in the context of primary insurance as described in the section above are typically less of a problem in the context of reinsurance, due to the relative sophistication of the buyer and seller. Most P&C insurance companies maintain the data described above, at least in enough detail to perform an analysis of loss reserves gross and net of reinsurance. P&C insurance companies have more expertise on the exposures and expected losses underlying their reinsured business than most corporations have for their insured exposures, although a bifurcation analysis may require more specialized actuarial expertise than many P&C insurance companies possess. Moreover, a risk transfer assessment is already required for reinsurance contracts under FAS 113. Finally, it is our impression, based on our experiences and publicly reported events, that the P&C reinsurance market has a higher incidence of problematic contracts than does the primary insurance market.

If the FASB intends to continue pursuing bifurcation despite the theoretical and pragmatic issues raised above, we have additional comments on the flowchart and methods presented in the ITC. The remainder of this letter summarizes our comments with respect to these areas.

Flowchart

Pages 14 through 20 of the ITC contain a flowchart depicting the proposed risk transfer and bifurcation testing process, as well as definitions of the terms used in the chart and discussion of possibilities of its implementation. Our comments on this section of the ITC are as follows:

The test of unequivocal risk transfer as described in the ITC hinges primarily on the number of risks insured and not by the overriding substance, and as such it would not include many traditional corporate contracts that are now widely accepted as unequivocally being insurance contracts. Under the definition in the ITC, a contract does not unequivocally transfer risk if it insures more than one risk (one automobile, one professional, one building, etc.). The test is very limited, and only a small percentage of commercial insurance or reinsurance contracts will meet it.

Furthermore, the accounting for two single-risk contracts would be different than the accounting for one combined contract that applies identical terms and insures the same two risks, even though the economics of the two situations are the same. In this case, we do not believe that it is appropriate to bifurcate in one situation and not in the other. Taken in a macro context, i.e., the aggregate of portfolios of contracts, this distinction would lead to arbitrary differences and a lack of comparability of financial statements across the spectrum of insurance companies.

We believe that the ITC test of unequivocal risk transfer has a similar purpose as the NAIC's concept of "reasonably self-evident." However, the focus of the ITC test is very different than the focus COPLFR will suggest in our work with the NAIC regarding risk transfer analysis and screening. As previously stated, this work is not yet complete but is anticipated to be available in the fall of 2006.

- The flowchart would extend application of the FAS 113 risk transfer test to include primary insurance contracts. As previously stated, we do not believe primary insurance contracts should be subject to FAS 113, unless cash flow testing is not required for contracts in which risk transfer and/or insurance servicing are deemed to be reasonably self-evident.
- Approach A, the first of two alternative bifurcation screens, is described in various places within the ITC as targeting "finite risk contracts only," "contracts that include a significant financing component," and "problematic contracts including those that resulted in allegations of abusive accounting." These are three overlapping but different categories to target.
 - The second part of the description in Approach A includes any contract with significant adjustable premiums or commissions. This is such a broad screen that it will capture a very large proportion of traditional insurance contracts, such as retrospectively rated workers' compensation contracts, which are entered into primarily for purposes of risk transfer and claims and loss control servicing. It is not clear to us from our reading of the ITC whether the first and second parts of Approach A are intended to be "and" or "or" conditions.
- Approach B would result in the bifurcation of essentially all insurance and reinsurance contracts that meet risk transfer testing and are not single-risk contracts. Therefore, all traditional insurance and reinsurance contracts, other than single-risk contracts, would be bifurcated.
 - Importantly, this would result in the bifurcation of unlimited quota-share contracts, so that a reinsurer who assumes 100% of premiums and losses on a portfolio of individual risk insurance contracts would not account for the portfolio in the same way as the ceding insurer would if it retained the portfolio. We believe that this is an inconsistent accounting result and would lead to less comparability among insurance company financial statements.

If bifurcation is to be considered, we believe it should only be considered for problematic contracts. We believe that the description in Approach A would require significant refining to be specific enough for there to be consistency among practitioners in the identification of problematic contracts. One possible improvement to this description would be to limit it to those contracts that are bundled, i.e., where the financing and insurance elements are clearly and unambiguously separable and the amounts determinable.

As we described above, we believe that Approach B expands the scope of the bifurcation concept to traditional and other non-problematic contracts and should not be considered.

Bifurcation Methods

Presuming bifurcation is to be considered only for problematic contracts, the methodology for bifurcating such contracts should depend on the nature, structure, and economic substance of the contract and the resulting manner in which the accounting under FAS 113 differs from the economics.

From our experience, the departure of accounting from economic substance for most problematic reinsurance contracts generally falls into three categories:

A contract whereby a ceding company spreads the effect of an adverse event or poor aggregate results that occur in one period over a multiple-year period.

- A prospective contract structured in a manner that effectively allows a ceding company to discount loss reserves once the claims have been incurred, while transferring only a minor portion of the risk associated with those reserves.
- A contract, such as a finite quota share, whereby a ceding company reduces its net premium to surplus ratio by ceding premium, but it retains most of the risk associated with the ceded premium.

A typical problematic contract may be structured to achieve one of these objectives but may still be able to meet the risk transfer requirements under FAS 113 because such requirements focus on the potential downside to the reinsurer's results. Contract structures are often unique; a contract can initially be either a proportional or non-proportional contract and may contain one or a number of the features often associated with finite risk agreements — loss caps, experience accounts, etc.

If bifurcation is used to better align the accounting with the economics for such contracts, the approach should (1) produce an accounting effect that accurately portrays the economics of the insurance/reinsurance portion of the transaction, and (2) remove the improper accounting benefit. In doing so, the bifurcation method would need to estimate what risk has actually been transferred, what premium was paid for it, and how that premium relates to the whole transaction. We believe that the appropriate method to bifurcate a contract is to disassemble it in the way that it was originally assembled. Therefore, no one method will work better than another method in all situations, and the accuracy of a method will depend on how well the method and underlying assumptions relate to the actual pricing and structuring of the transaction.

Our additional comments regarding the methods suggested in the ITC are as follows:

• The expected payout method focuses on "dollar trading," defined in the ITC as the "minimum amount of expected claim payments" or "any amount of claim payments that is highly probable of occurring." The presumption underlying an expected payout method is that the deposit component of a contract's premium is equal to the present value of the minimum expected payments, and the remainder of the premium is equal to the price paid for risk transfer.

This presumption does not consider the cost of the servicing function, which is typically significant for primary insurance contracts. With respect to reinsurance, although there is much less of a servicing function, the presumption may result in an accounting based on arbitrary distinctions between what is risk transfer and what is financing.

For example, an unlimited 100% quota-share contract on a predictable portfolio of business would have most of its cash flows accounted for as a deposit under the expected payout method if the portfolio is reinsured. However, had the insurance company retained the portfolio, the business would be accounted for as insurance in its entirety.

• The proportional method focuses on relative risk transfer, so that if the assuming entity has the same risk as the policyholder or insurance company would have had without insurance, then the contract is accounted for in its entirety as insurance. Under this method, the concept of dollar trading is not directly captured, so that even a significant expected payout each year would not necessarily result in the identification of a significant deposit accounting component.

For example, under the proportional method, an unlimited 100% quota-share contract on a

predictable portfolio of business, as described above, would have all of its cash flows accounted for as reinsurance.

The proportional method may be useful to identify significant risk limitations in certain contracts. However, the application of a proportional method to bifurcate a finite risk contract will not necessarily result in deposit and risk transfer components such that the accounting and the economics are aligned.

We do not understand the cash flow yield method sufficiently to comment on it.

In summary, the methods mentioned in the ITC may be able to achieve various purposes, but we do not believe any one of them is sufficient to address the goals outlined in the ITC for bifurcation for all types of contracts. There is no single bifurcation method that we know of that can separate the deposit and risk transfer components within any given contract, such that the accounting and the economics would be aligned. We would suggest that the efficacy of any method for a given purpose only be assessed after testing it on a wide variety of real-world insurance and reinsurance contracts.

We hope that the comments in this letter are useful to the FASB. We would be pleased to meet with you and discuss this issue in greater depth.

Sincerely,

Nancy Watkins, Chair

Jany P. Work

Committee on Property and Liability Financial Reporting