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LETTER OF COMMENT NO. 56

August 24, 2006

Technical Director
Financial Accounting Standards Board
401 Merritt 7, P.O. Box 5116
Norwalk, CT 06856-5116

Via E-mail:

Attn: director@fasb.org
File Reference No. 1325-100

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

Dear Sir or Madam:

The St. Paul Travelers Companies, Inc. (St. Paul Travelers) appreciates the opportunity to comment on the Financial Accounting Standards Board's (the FASB or the "Board") Invitation to Comment (ITC) on *Bifurcation of Insurance and Reinsurance Contracts for Financial Reporting*.

St. Paul Travelers is a leading provider of property/casualty insurance products and services to a wide variety of businesses and organizations as well as to individuals. Our products are distributed primarily through independent insurance agents and brokers throughout the United States and in selected international markets.

We appreciate that the topic of risk transfer has received considerable coverage by the business press over the last three years, and that the Board's concerns led to a project, *Insurance Risk Transfer*, to address the accounting standards governing insurance and reinsurance contracts. In describing this project on its website, the Board stated that:

"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."

In contrast to its stated objective, we believe that the Board has developed a framework for possible approaches to bifurcating insurance and reinsurance contracts into financing and insurance components without providing meaningful guidance on risk transfer.

We do not believe that it was the Board's intent to significantly and substantively change the current insurance accounting model. Rather, it has been our expectation since *Insurance Risk Transfer* was added to the project calendar that the Board would first provide additional guidance on risk transfer and then, as a secondary issue, explore the notion of bifurcation.

We find that the ITC explores bifurcation of insurance and reinsurance contracts without a discussion of the issues surrounding risk transfer. The ITC merely changes the question that would face financial statement preparers and auditors from "How much risk transfer is required for a contract to be accounted for as insurance?" to "How much risk transfer is required for a contract to unequivocally transfer risk?" without addressing the determination of significant risk transfer. The ITC also introduces a new concept called "unequivocal transfer of significant risk" that not only does not address the determination of significant risk transfer but also confuses the concept of a single risk with a single exposure.

Given that the Board does not consider this project to be either a FASB-only or a joint FASB/International Accounting Standards Board (IASB) major standards project, we urge the Board to re-direct its attention to developing technical and implementation guidance that addresses risk transfer in the context of the current insurance accounting model. Additionally, we recommend that the Board avoid considering changes to the current accounting model until such time that it is ready to take up the insurance contracts project of the IASB.

Insurance: Pooling and Spreading Risk

Insurance is a business that is based upon the concept of pooling and spreading of risk and its core purpose¹ is to reduce the economic impact to a policyholder when a fortuitous event results in an economic loss.

¹ Insurance is a mechanism by which the financial impact of an economically adverse, fortuitous event is transferred from one party (the policyholders) to another (the insurer). The transfer of financial impact (also known as risk transfer) occurs by means of an insurance contract. Insurance contracts have the following characteristics: (1) indemnification, (2) conditional, (3) aleatory, and (4) utmost good faith.

- **Indemnification** – A contract of indemnity restores the insured to an economic position equivalent to that of prior to the occurrence of an insured event (subject to policy limits).
- **Conditional** – Insurance contracts are not fulfilled automatically and with certainty. Insurance performs on the condition that some additional event occurs. In insurance, the additional event is a covered loss.
- **Aleatory** – The additional event is not certain to occur. Rather, it is a probabilistic or chance event, such as a fortuitous loss. Since insurance contracts are conditional and aleatory, they are distinguished from most contracts, which are commutative.
- **Utmost good faith** – There is ample opportunity for fraud to occur in the buying and selling of insurance. Buyers may withhold relevant information. Sellers are merely promising to perform at some future date, conditional on the occurrence of certain insured events and the insurer's ability to pay at the time the event occurs.

In our view, the core accounting issue related to the project is risk transfer. The concept of risk transfer and the accounting principles governing risk transfer are integral to insurers' financial statements and paramount to the readers' understanding of those financial statements. Therefore, we recommend that the Board develop additional guidance on risk transfer either by augmenting the "Accounting for Reinsurance: Questions and Answers about Statement 113" or developing a FASB Staff Position. As a start, we recommend that the Board consider the AICPA paper on *Evaluating Risk Transfer in Reinsurance of Short-Duration Contracts*, which was submitted to the FASB in November 2003.

With regard to the idea of bifurcation as described in the ITC, we do not believe that it is theoretically sound and also believe that there are significant obstacles that make it impractical to apply in a manner that is representationally faithful to the underlying contracts.

Bifurcating Insurance Contracts

We believe that the fundamental, theoretical flaw of bifurcation as described in the ITC is the assumption that claims (both in frequency and severity) are reliably predictable at an individual contract level. This assumption is inconsistent with the concept of insurance. The single most important attribute of insurance is the aggregation of many individual contract risks and the spreading of the estimated cost of those risks to all policyholders in the insurer's portfolio of policies (the concept known as the "Law of Large Numbers"). This concept acknowledges that the probability of any possible event (even an unlikely one) occurring at least once in a series of events will increase as the number of events in the series also increases. This allows a more precise measurement of the likelihood that an estimate is closer to being correct as the population of events grows. Insurance claims are not reliably predictable at the individual contract level. Instead, claims are generally reliably estimable and reasonably predictable (with minimal volatility) at a portfolio level.

Various methods are used to estimate claims expectations that are invalid when applied at a contract level. It is similar to modeling consumer spending based on an average family size of 2.3 children, then applying the model to an individual family (which may have zero children or several children). This type of logic error is a form of the "Fallacy of Composition". The theory of property/casualty pricing is not that the models can accurately predict the expected losses for a contract, but that the portfolio's expected losses can be reasonably predicted and that a bias in an individual contract's expected losses relative to the portfolio cannot be predicted in a cost effective manner. In general, it is expected that a bias will exist, but it would cost too much to find out what the bias is and to remove it from the analysis.

The ITC suggests that a contract's past claims experience is predictive of future losses and, therefore, non-fortuitous. As discussed above, the expected losses are nothing more than an average of past claims for the portfolio as a whole. An insured event is fortuitous and

cannot be predicted with a high degree of certainty. Because the insurer cannot predict the occurrence of losses by contract, it is at risk for loss for every contract it writes. By accumulating a portfolio of risks (contracts), an insurer overwhelms possible variations in loss experience and reduces the aggregate cost of risk through certain economies of scale.

Whenever a single policyholder's claim volume is sufficient to make losses relatively predictable with minimal volatility at the contract level, the insurance concept fails on economic grounds in the marketplace and the incremental cost of obtaining insurance is no longer economical. The buyer of insurance purchases coverage only when there is a risk of economic loss, i.e., when the occurrence of events is highly uncertain and the potential economic loss is more than the buyer is willing or able to bear. This dynamic is constantly witnessed in the marketplace, whereby those entities with significant enough activity to have reasonably predictable entity-specific claims volumes retain this risk rather than insuring it, and restrict the purchase of insurance only at those claims levels that are inherently unpredictable at the entity level.

Dynamic Contracts

The ITC assumes that property/casualty contracts are essentially static, with all pertinent facts regarding exposure fixed at the inception of the contract. In reality, property/casualty contracts are dynamic, with the covered exposure potentially changing several times (if not continuously) throughout the policy period. For example, the table in Appendix B of the ITC presupposes that the number of automobiles insured is known and fixed at inception of a commercial automobile policy. In reality, insured businesses are constantly adding, removing and/or replacing their existing vehicles such that what may begin as a single automobile policy may become a multiple automobile policy by the time the contract expires (or vice versa). Similar situations exist with the number and type of insured locations, operations, employees, etc., with a full tallying of the exposure not known for some policies until a post-expiration policy audit is conducted.

One of the fundamental differences between property/casualty contracts and contracts of other industries is that property/casualty insurance contracts are generally written with the understanding that most contracts will generate significant profits relative to the premium charged to offset the even more significant losses relative to the premium charged on a few contracts. The contracts are written and priced with the understanding that the claim volume is not inherently predictable at a contract level, and with the understanding that the goal is not to accurately estimate expected claims for an individual contract, but to accurately estimate such claims for the portfolio of such contracts. Accordingly, property/casualty insurers cannot estimate the profitability of an individual contract.

The dynamic nature of risk exposures for a property/casualty contract would also require multiple valuations for certain contracts, and perhaps even retroactive valuation of past

transactions as additional facts are determined upon post-expiration premium audit for some commercial insured's policies.

Practical Considerations

There are significant obstacles that make it impractical to apply bifurcation as described in the ITC in a manner that is representationally faithful to the underlying contracts. A requirement to bifurcate insurance contracts would result in the use of inconsistent bifurcation methods among insurance companies and result in data that is neither reliable nor understandable. Paragraph 79 of the ITC states: "Models using historical data typically would be used to bifurcate reinsurance contracts." However, each insurer would be limited to its own historical data. Historical data for individual contracts is generally not as stable as the ITC implies, such that the proportion bifurcated under the proportional approach would be highly judgmental and would likely be inconsistent over time and among companies. The financial statements that result from this approach would, at best, be confusing and risk being misleading.

The administrative costs resulting from a requirement to bifurcate reinsurance contracts would outweigh the benefits. The effort required to evaluate all contracts for bifurcation would be enormous. The ongoing accounting for contracts that require bifurcation would also be considerable.

We believe that paragraph 49 of the ITC is an accurate portrayal of these issues:

49. Some believe that bifurcating insurance contracts would require arbitrary scopes, methods, and assumptions and that the resulting components would not provide reliable information. They believe that the contract is a single instrument constructed to provide a defined element of protection to the policyholder. The terms and price of the protection purchased are based on market factors and competition. To require that the price of a single contract be split into components characterizes insurance contracts as something that they are not—that is, bifurcated insurance and deposit components are neither representationally faithful nor verifiable.

We doubt that arbitrarily separating a contract into financing (deposit) and insurance components would provide decision-useful information. In the property/casualty insurance industry, the policyholder is not entitled to a return of the earned portion of the premium payment, which the term deposit suggests. Further, we do not believe that any predictive value is created by re-characterizing a portion of the premium payment as a deposit toward the repair of an automobile, the managing of medical care, or litigation expense. The re-characterization of a portion of the premium as a "deposit" is misleading and raises more accounting issues than it addresses. For example, what is the proper income recognition by an insurer of a deposit that is not returned when there is no loss event and the so-called

deposit is not returned to the policyholder? When does the policyholder recognize an expense for a deposit that is forfeited if there is no loss? If a loss occurs, how much of the loss is attributable to the insurance component versus the financing or deposit component? How will the servicing component of an insurance contract be addressed, e.g., would the servicing component be arbitrarily bifurcated to the financing and insurance components? The arbitrary nature of the allocation of a loss payment between the two components will call into question the relevance and verifiability of the information reported in the financial statements.

As stated in paragraph 121 of FASB Statement No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts*, "Insurance risk is fortuitous – the possibility of adverse events occurring is outside the control of the insured." Because of this reality, the legal system has evolved a rather distinct area of contract law specific to insurance which reflects the unique characteristics associated with insurance contracts. As a result, a contract is either insurance or not. Thus, the *pass-fail paradigm* in insurance accounting is a valid approach to evaluating insurance contracts. As stated in the ITC, "[this] places significant pressure on determining the minimum level of risk transfer that satisfies the significant risk transfer criterion." As a result, we believe that additional guidance is needed for the risk transfer criterion.

Conclusion

In summary, we believe the ITC fails to make a compelling case for the bifurcation of insurance contracts for the reasons discussed above. The ITC also introduces a new concept for testing risk transfer called "unequivocal transfer of significant risk." This concept is based upon the mistaken premise that a single risk is the same as a single exposure and does not address the core insurance accounting issue related to insurance and reinsurance contracts: the determination of significant risk transfer. The ITC, however, sorely demonstrates the need for additional guidance on risk transfer. As a result, we strongly urge the Board to re-direct its efforts to developing technical and implementation guidance that addresses risk transfer in the context of the current insurance accounting model. This could be accomplished by either augmenting the "Accounting for Reinsurance: Questions and Answers about Statement 113" or developing a FASB Staff Position. Lastly, we recommend that the Board avoid considering changes to the current accounting until such time that it is ready to take up consideration of the insurance contracts project currently underway by the IASB.

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Thank you again for allowing us the opportunity to share our views on the Invitation to Comment and to recommend an alternative course of action that we believe would result in meaningful guidance on the assessment of risk transfer of insurance and reinsurance contracts. Also, attached please find an appendix with our responses (in *italics*) to certain of the eleven issues presented in the Invitation to Comment. As always, we would be happy to discuss our comments and concerns with the Board and or staff.

Regards,



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Attachment: Appendix of Responses to Issues Presented in the Invitation to Comment

**Appendix of Responses to Issues Presented in the Invitation to Comment
The St. Paul Travelers Companies, Inc.
August 24, 2006**

Issue 1:

Does the IFRS 4 definition of insurance contract identify insurance contracts and sufficiently distinguish those contracts from other financial contracts?

Yes, because it recognizes the fortuitous nature of insurance. We recommend that the Board use this definition as the starting point for defining insurance under U.S. GAAP.

Does the GAAP definition of insurance risk identify and separate that risk from other risks such as financial risk?

Because insurance risk is fortuitous and involves financial risk to both insured and insurer, it would be difficult to separate financial risk from insurance risk. We note, however, that the ITC does not provide guidance or a definition of "financing" or "financial component".

Do the descriptions of finite insurance and reinsurance contracts, including the risk-limiting features, identify those contracts?

No. We believe a better approach would be to describe the nature and conditions of risk limiting features in the form of principles-based guidance rather than attempting to compile a list of contract terms that limit risk transfer.

How could the definitions and descriptions be improved?

Every insurance contract contains conditions and exclusions, but it is still considered an insurance contract if it indemnifies a policyholder for a specified, conditional, probabilistic event. If the Board is concerned about the retention of risk from the policyholder's perspective that is greater than is appropriate for the amount of premium paid, then consideration should be given to enhanced disclosures of an entity's risk management strategy and programs. Insurance is only one component of managing risk. Managing risk at the enterprise level goes well beyond the management of insurable risks.

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?

No. The underlying cash flows from a single insurance policy, including a policy with a large corporate policyholder, generally do not provide a credible basis for evaluating

risk transfer for a single contract. A reinsurance contract, however, generally covers a portfolio of insurance policies that provides sufficient data to credibly evaluate risk transfer.

If not, how can the Statement 113 guidance be modified or clarified to apply to insurance contracts?

The guidance contained in Statement 113 generally cannot be applied to an insurance contract in a credible manner due to the lack of sufficient data from a single contract. This is the result of the difference between insuring a single exposure versus insuring a portfolio of exposures. The Board should codify a definition of "insurance contract," which would recognize the nature of insurance and the differences between insuring a single exposure (which can result in multiple risks, e.g., loss due to fire, wind, or other perils) and a portfolio of exposures. Insurance is a mechanism by which the financial responsibility for an economically adverse, fortuitous event is indemnified by one party for another.

Although property/casualty insurance contracts indemnify a policyholder, workers' compensation contracts are given special status under state law and legally put the insurer in the place of the employer for any liability resulting from a work-related injury. This is different from other property/casualty contracts where the policyholder remains liable for damages and is able to recover some or all of the loss from the insurer. Workers' compensation insurers are responsible for payment of losses from the first dollar of a claim. Certain high deductible policy forms may provide for reimbursement to the insurer for a specified amount. In such situations, the high deductible results in the insurer having to pay claims and then having credit risk for the collection of the deductible from the policyholder.

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?

Bifurcating insurance contracts would require arbitrary scopes, methods, and assumptions and the resulting components would not provide reliable information. An insurance contract is a single integrated instrument constructed to provide a defined element of protection to the policyholder. To require that the price of a single contract be split into components characterizes insurance contracts as something that they are not. Bifurcated insurance and deposit components are neither representationally faithful nor verifiable.

The ITC's proposal would also result in non-comparable information across insurers, making the information less useful. Under the ITC's proposal, two insurers with similar portfolios of claim liabilities, but with different size contracts making up those portfolios, would have non-comparable accounting for their portfolios. What matters in the evaluation of a portfolio are the portfolio characteristics, and not the characteristics of the individual contracts contributing to the portfolio. Hence, bifurcation would make analysis of various insurance industry competitors more difficult, if not problematic.

We note also that the notion of bifurcation as described in the ITC does not address a component that is integral to all property/casualty contracts, i.e., the servicing component. In many types of claims, the insurer does not pay the insured for a claim; instead, the insurer incurs the cost to provide a service to the insured. For example, in cases involving a liability claim against the insured, the insured does not defend himself/herself. The insurer is obligated to defend the insured and makes the decision as to whether to incur legal fees or offer a settlement to the claimant.

Which qualitative characteristics most influence your decision?

See our response to the immediately preceding question.

Which approach more faithfully represents the economic substance of the contract?
Why?

As discussed in our cover letter, the pass-fail paradigm is closer to more faithfully representing the economic substance of an insurance contract than the arbitrary bifurcation of a contract.

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?

No. The approach as described in the ITC and illustrated in the flowchart confuses single exposure with single risk. A single exposure will generally present several risks, e.g., a homeowners policy has property risks from fire, wind, and other perils, along with liability exposure. A single risk is just that; the risk of a single, fortuitous peril.

In addition, insurance contracts frequently change during their policy term as the underlying exposure changes. This includes the purchase and/or sale of vehicles for an automobile policy, the acquisition/divestiture/shrinking/growing/start-up of operations within a corporation for a general liability policy, and the

hiring/attrition/layoffs/reassignment of employees in a workers' compensation policy. The suggested approach would require multiple evaluations of the same contract, and possible retroactive evaluation of a commercial insurance contract where a post-expiration audit is required to determine the ultimate exposure. We believe that the ITC proposal would cause significant operational costs to implement, even if it were feasible.

What changes would you propose?

We suggest a principles-based approach to identifying the nature and conditions of risk limiting features as discussed above.

Issue 5:

Do you agree with the characteristics identified for contracts that do or do not unequivocally transfer significant insurance risk?

No.

If not, why not?

No. The characteristics identified for contracts that do or do not unequivocally transfer significant insurance risk are based upon the confused distinction between a single exposure and a single risk and do not provide any guidance on significant risk transfer criterion for either insurance or reinsurance contracts. We also believe that the approach used in the ITC is overly rules-based and would result in contracts being designed around the terms contained in the ITC. A principles-based definition of "insurance contract" would be more appropriate.

Should other characteristics be added?

No.

Are the examples in Appendix B representative of the discussion in paragraphs 57–59?

As discussed above, we do not believe the examples are representative of the intended concept that is discussed in paragraphs 57 through 59 due to the confused distinction between a single exposure and a single risk. The examples used in the ITC to demonstrate are described as a single risk, when in fact they are a single exposure that has several risks.

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)?

No, for the same reason discussed in our response to Issue 5. Further, we do not believe that Statement 113 can be applied to primary insurance. A requirement to bifurcate insurance contracts would result in the use of inconsistent bifurcation methods among insurance companies and result in data that is neither reliable nor understandable. Paragraph 79 of the ITC states: "Models using historical data typically would be used to bifurcate reinsurance contracts." However, each insurer would be limited to its own historical data. Historical data for individual contracts is generally not as stable as the ITC implies, such that the proportion bifurcated under the proportional approach would be highly judgmental and would likely be inconsistent over time and among companies. The financial statements that result from this approach would, at best, be confusing and risk being misleading.

Issue 7:

Do you prefer Approach A or Approach B for identifying contracts subject to bifurcation? Why?

We prefer neither approach because we oppose the notion of bifurcation presented in the ITC on the theoretical and practical grounds discussed in our comment letter.

Do you believe that another approach would be superior?

Yes.

If so, how would you describe that approach?

We believe that the pass/fail paradigm is more representationally faithful to the reporting of insurance and reinsurance contracts but requires additional guidance on the risk transfer criterion.

Issue 8:

Should the criteria for bifurcation be different for insurance contracts and reinsurance contracts? Why?

Yes, because certain reinsurance contracts have several underlying insurance contracts, it may be possible to bifurcate such reinsurance contracts in certain cases. We do not believe that it would be theoretically correct to bifurcate individual insurance contracts based on the characteristics of the portfolio of contracts (i.e., attempting to ascribe the attributes of the whole population of contracts to each individual contract). Additionally, there are significant obstacles that make such an approach impractical.

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?

The ITC contained insufficient information to make an informed determination of conceptual merit; however, we found the approaches to generally be both arbitrary and artificial.

Please explain.

See our response to the previous question.

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?

Yes. We believe corporate policyholders would have insufficient information to apply the bifurcation methods; however, without additional information on the methods and guidance on their application, we cannot evaluate this issue in a credible manner.

Issue 10:

Would data availability limit the development of any of the bifurcation methods discussed in this Invitation to Comment?

Yes, this would be a problem for both insured and insurer. See the discussion on credible data in our comment letter.

To what extent are the models that would form the basis for these methods used to underwrite and price products?

The ITC does not provide enough practical explanation of the methods proposed. We do not believe the pricing models are relevant once insurance contracts are issued. Rather,

the primary determinants of the liability for unpaid claims are the claims data, actuarial methods used in estimating the liability and management's judgment applied to determine the recorded liability.

Would data availability (or lack thereof) affect only certain insurance forms, products, or lines of business? If so, which ones and why?

In general, the lack of data availability would be a pervasive problem.

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?

No. A re-evaluation of the current model will come in due course and in due time as the IASB insurance project continues. In the mean time, we believe there is a need for interpretative guidance on the existing risk transfer criteria. Such guidance should be developed either by augmenting the "Accounting for Reinsurance: Questions and Answers about Statement 113" or developing a FASB Staff Position.