



American Insurance Association

1130 Connecticut Ave. NW

Suite 1000

Washington, DC 20036

202-828-7100

Fax 202-293-1219

www.aiadc.org

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LETTER OF COMMENT NO. 57

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

Via E-mail:

Attn: director@fasb.org
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Re: Invitation To Comment: Bifurcation of Insurance and Reinsurance Contracts
For Financial Reporting

The American Insurance Association (AIA) is a leading property-casualty insurance trade association, representing approximately 400 insurers that collectively write more than \$120 billion in premiums each year. AIA member companies offer all types of property-casualty insurance, including personal and commercial auto insurance, commercial property and liability coverage, workers' compensation, homeowners' insurance, medical malpractice coverage, and product liability insurance. We appreciate this opportunity to respond to the Invitation to Comment ("ITC") on the bifurcation of insurance and reinsurance contracts. We hope the board finds our comments helpful as it gathers additional information and evaluates additional steps, if any, that should taken.

The topic of insurance has received considerable public attention over the last three years, and we recognize the Financial Accounting Standards Board's ("Board") legitimate concern that accounting standards governing insurance and reinsurance should be sufficient to provide useful information to financial statement users. However, we believe the ITC not only fails in providing a framework for improving the usefulness of financial statement information, it would lead to the development of information that no longer mirrors economic reality, while confounding even the most sophisticated of financial statement users. We urge the Board to not embark on a bifurcation project and, instead, defer any concerns regarding accounting for insurance contracts to such point in time that it is ready to take up the insurance contracts project of the International Accounting Standards Board (IASB).

Our comments, which focus primarily on insurance contracts, are divided into two sections:

- Section One lists and discusses overall concerns with the ITC; and
- Section Two provides responses to the specific issues raised in the ITC and listed in Appendix A to the ITC.

Section One: Overall Concerns

The unique and fundamental characteristic of insurance is the pooling and spreading of risk and must be an integral part of any discussion about insurance contracts. The ITC unfortunately fails to integrate this fundamental principle into its analysis.

The 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 risk pool. Insurers are able to do this because of the "Law of Large Numbers," a fundamental concept that allows insurers to effectively manage their risk portfolios. This concept acknowledges that the probability of any possible event (even an unlikely one) occurring at least once in a series will increase as the number of events in the series also increases. In particular, it permits a more precise measurement of the likelihood that an estimate is close to the "right" number as the population grows.

For example, the odds that a specific person will win the lottery are very low; however, the odds that someone will win the lottery are quite good, provided that a large enough number of people purchases lottery tickets. From a property-casualty insurer's perspective, the odds that a specific insurance contract will result in a loss claim is low; but there is a greater probability that there will be a loss claim as the risk pool of insurance contracts grows larger. This principle can be extrapolated to allow insurers to draw conclusions or make forecasts regarding a portfolio of risks that otherwise would be impossible to do at the contract level.

A large pool of risks allows an insurer to estimate the cost of the claims for that pool and extrapolate a premium level sufficient to cover the estimated cost. Thus, the estimated cost of the future claims is effectively spread to the policyholders of the particular pool through the premiums charged to all the policyholders in that pool. Paragraph 10 of the ITC states that the "pooling or spreading" of risks (the more appropriate statement is "pooling **and** spreading" of risks) is an important function. We believe the ITC understates this characteristic – the pooling and spreading of risk is more than an important function – it is the *fundamental* characteristic of insurance that distinguishes it from any other business model.

The pooling concept refers to the need for many similar risks in order to apply the "Law of Large Numbers" and make the total amount reasonably estimable. The "spreading" concept refers to the requirement that not all pool members incur a loss at the same time. For example, a pool of insureds that all live in the same flood plain does not represent a spreading of risk; even if the losses for the pool are more estimable. Hence, both pooling **and** spreading are necessary for a true insurance mechanism to occur.

Unfortunately, the ITC mentions this fundamental characteristic of insurance only once, in paragraph 10, and fails to tie this attribute to any of the subsequent analysis in the ITC. We believe no evaluation of insurance contracts is complete without incorporating into that evaluation the basic concepts of insurance of pooling and spreading risks.

To be clear, the language used in the discussion of risk transfer may also lead to some misunderstanding. Insurance contracts shift the economic burden that results when a risk becomes a loss as a result of an insured event occurring. For example, the risk that a drunken driver could cross the median and collide with an insured driver is not changed simply because the insured driver has an insurance contract. The car will still be damaged and the insured

driver may still be injured with or without the insurance contract. What does change when the insurance contract is executed is that the insurer will step in to absorb the financial burden of the loss, to the extent provided in the contract, so as to protect the policyholder from financial ruin. By aggregating the risks, the insurer is better able to estimate the likely costs to be realized from the aggregated portfolios (the effect of pooling) and is more capable of absorbing those costs with the aggregated premiums (the effect of spreading).

The insurance contract allows the parties – the policyholder and the insurer – to allocate the economic burden between them, in the event a risk becomes an economic loss. Typically, the policyholder attempts to transfer the economic burden of the risks that the policyholder is unable or unwilling to bear. As such, the policyholder retains the economic burden of the risks that are less likely to cause financial ruin, or that the policyholder views as highly speculative.

It is important that an analysis about risk transfer include the fact that the insurance contract shifts the economic burden, as opposed to the risk itself. Thus, it may be more worthwhile to focus the analysis on the amount of economic burden that is transferred, rather than the risk retained, which conceptually could be unlimited.

The ITC makes a number of inherent assumptions that may not be valid, and therefore leads to conclusions that are not valid.

Finite Risk Contracts. Some initial ITC assumptions are flawed, resulting in possibly inaccurate or inappropriate conclusions. In paragraph 3, as an example, the ITC identifies “finite risk contracts” (a term that has no widely accepted definition) as contracts that transfer only limited insurance risk. The corollary assumption of that statement is that insurance contracts that are **not** “finite risk contracts” presumably transfer unlimited insurance risk. The reality, however, is that all insurance contracts will limit the amount of risk that will be transferred from the policyholder to the insurer. Commonly recognized risk limiting provisions are exclusions, deductibles and policy limits.

Since all insurance contracts, in fact, limit the amount of risk transferred to the insurer, defining the so-called “finite risk contracts” in terms of risk limitations is an inadequate approach for distinguishing the types of contract that have received considerable publicity over the past few years from other more traditional forms of insurance contracts. It also creates the impression that more traditional forms of insurance contracts should not limit risk, a conclusion that is inconsistent with reality. We do not think it is a worthwhile effort to create what would ultimately be an artificial distinction for the so-called “finite risk contracts.” Such distinctions may lead to inaccurate conclusions.

Insurance Premiums. Although we agree that a principal factor in setting premium rates is the estimated cost of claims, we disagree with the paragraph 15 assumption that an insurance contract’s price is determined by “an estimate of the expected claims for that contract.” The property/casualty insurer’s business model is premised upon the Law of Large Numbers. The estimation of claims cost is done – and can only be done – at the portfolio level, and not at the individual contract level. Therefore, the distinction between a contract approach and a portfolio approach is a critical one in evaluating property-casualty insurance contracts. Because the ITC incorrectly assumes that an individual contract premium is based on an individual contract’s estimated costs, the ITC’s discussion of bifurcation methods, which are based on a contract-by-contract analysis, is also flawed. For property/casualty insurers, the ITC must recognize in its

analysis that property-casualty insurers aggregate risk, and determine costs and premiums at the aggregate (portfolio) level.

Premium as Measurement of Risk. Paragraph 17 of the ITC states, in part: “The amount of risk not insured or partially insured by the policyholder may not be discernible by a user of its financial statements. Risk-limiting features could result in retention of risk that is greater than would be reflected by the premium paid.”

The above statement assumes that the premium paid should measure the risk that is transferred to the insurer. There is another underlying assumption that retained risks should somehow be reflected in the financial statements of the policyholder. Both assumptions are incorrect.

Businesses and individuals are exposed to unlimited amounts of risk every day. They will seek out insurance to assume the economic burden of risks that they are unable or unwilling to bear. The risk retained will still be unlimited, but in the policyholder’s judgment, acceptable. It would be impossible to quantify all risks retained. A bifurcation regime would not change that fact.

The premium paid by the policyholder represents the policyholder’s share of the estimated costs of the pool of risks. That premium amount is not determined by the individual contract, but on the overall pool of risks. Only the insurer would know what the estimated costs are for the pool and would not likely share that information with the policyholder since it is sensitive and competitive information. The amount of economic burden represented by that premium would not be known until the policyholder incurred a loss event. Of course the policyholder would know the outside limits of that value: it would be the coverage limits of the policy.

In sum, the ITC should not assume that the amount of risk insured and the amount of risk retained are clearly observable in either the premium or the financial statements.

Bifurcation. We think that bifurcating insurance contracts would lead to the application of inconsistent bifurcation methods among insurance companies and therefore lead to 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 insurance company would be limited to its own historical data. Historical data for such individual contracts is generally not as stable as this proposal implies, such that the proportion bifurcated under the proportional approach would be highly judgmental (i.e., a guess) and would likely be inconsistent across time and among companies. This could result in confusing the reader of financial statements.

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

Section Two: Specific Responses to the ITC Issues

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?

We can appreciate the difficulty in approaching the ITC project without a GAAP definition of insurance contract. GAAP literature focuses upon insurance risk. The IFRS 4 definition of insurance contract, however, incorporates a definition of insurance risk that is itself a default definition, i.e., insurance risk is any risk other than financial risk. We do not object to a default approach as long as it is focused on fortuitous events and is consistent with the concepts that we discuss in Section One of this letter. In addition, the GAAP definition of insurance risk incorporates the concept of indemnification, which we believe more appropriately reflects the nature of insurance, in that insurance contracts shift the economic burden when a loss occurs, but not in unlimited measure. We believe the ITC's attempt to construct an insurance contract definition is acceptable for purposes of this ITC, if the word "compensate" is replaced with the word "indemnify" and if the GAAP meaning of "insurance risk" is incorporated into the definition.

As we stated in Section One, the ITC's attempt to distinguish so-called finite insurance contracts from other insurance contracts is not meaningful. Nor do we consider it necessary. As we have already stated, limitation of transferred risk is a characteristic of nearly all insurance contracts. We believe the existing accounting guidance is sufficient to guide issuers in their accounting and reporting responsibilities for both insurance and reinsurance contracts.

The real issue is not the sufficiency of the accounting standards, but one of compliance. The Board is not a regulator and should not be engaged in the enforcement of its standards. Given the sensitivity and high visibility that insurance and reinsurance contracts have received recently, we are convinced that auditors, along with state and federal regulators, are fully capable of ensuring that financial statement issuers comply with the existing accounting guidance.

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?*

Statement 113 is intended to apply to transactions between an insurer and reinsurer, both of which, by their very nature, understand the concept of pooling and spreading risks. Analysis of expected cash flows would be a necessary function of their underwriting business. The motivations for entering into a reinsurance relationship may be to better manage future expected cash flows, or to create greater capacity for writing more insurance, or to rebalance their respective risk portfolios. Those motivations are integral parts of the insurance business model, i.e., the concept of pooling and spreading risk. Hence, the Statement 113 criteria, including the cash flow testing requirements, make sense with respect to the relationship between an insurer and reinsurer.

However, the motivations for a non-insurance policyholder to enter into a contract with an insurer are different. For policyholders, insurance is sought as a mechanism to protect the policyholder's interests from risks that may be economically unsustainable by the policyholder. The probability of an event occurring may be very low, but the occurrence itself could be financially disastrous. In that case, the decision will not be based on the policyholder's analysis of expected cash flows, but on a desire for peace of mind and the security of knowing that a loss event will not financially impair or bankrupt the policyholder. Of course sophisticated corporate

policyholders do prepare cash flow analyses, but such analyses are usually prepared in the context of **which** insurance program to adopt, rather than **whether** an insurance program should be adopted.

As we have mentioned before, the insurer performs its risk analysis and the attendant cash flow analyses for the **portfolio** of similar risks, and not for the **individual contract**. Thus, it would be inappropriate to apply a Statement 113 type of approach an insurance contract between the policyholder and the insurer.

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?*

Responding to this issue relies on understanding the nature of insurance: it is an agreement to take on the economic burden resulting from an indemnifiable event. In our earlier car accident example, the insurer not only takes on the burden of repairing or replacing the damaged automobile, but, depending on the terms of the contract, the insurer may also oversee the medical care of the policyholder or third parties who are injured as a result of that accident. And if litigation arises, the insurer would not only bear the litigation cost, but may also manage the case as well. In exchange for the comfort and security of knowing these benefits will be available in the event of a loss, the policyholder is willing to pay a premium to the insurer to shift the economic burden of the loss event to the insurer.

It is difficult to see how breaking down this contract into deposit or 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 might suggest. The fact that the premium is not returned is more consistent with a *pooling and spreading scenario*.

It is not clear what purpose would be served by bifurcating the contract in the car example above – and that leads us to questions about relevance. We do not see what feedback or predictive value is created by re-characterizing the premium payment as a deposit toward the repair of the automobile, medical care, or litigation support. The re-characterization only begs the question of how the “deposit” amount should be accounted for and reported by the insurer and the policyholder if there is no loss event. When would the property-casualty insurer recognize it as income? Would it be forfeited deposit expense for the policyholder? And if so, why would that awkward characterization be more relevant than calling it insurance expense? Bifurcation in this case would be an unnecessary complication added to the financial statements, without providing an incremental value to users of the financial statements.

Assuming a bifurcated contract, subsequent claim payments raise issues regarding the allocation of the payment – should it be applied against the deposit amount or treated as an insurance recovery? The possible arbitrary nature of the allocation will call into question the qualitative characteristic of reliability because of the lack of verifiability.

From the insurer’s perspective, much time, cost and effort must be invested to apply bifurcation at inception and for the processing of claims payments. We do not see a sufficient benefit to justify the additional cost, which would be substantial because of the many systems changes

that would be required. The total obligation to policyholders would not change, so we believe the additional information would not be useful.

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?*

The case has not been made that bifurcation of direct insurance contracts would ever be meaningful. The risks and motivation for entering the contract are different from those for a reinsurance contract. If, however, a bifurcation of insurance contracts became a requirement, the ITC should present a separate flowchart analyses for insurance and reinsurance, with specific versions for the buyer and the seller. Thus, four different flowchart analyses may be necessary to capture the necessary steps for analyzing the decision process for a buyer of an insurance contract, a seller of an insurance contract, a buyer of a reinsurance contract, and a seller of a reinsurance contract.

For discussion purposes, we assume the flowchart presented in the ITC applies to the buyer of reinsurance. As a separate screening step, the ITC introduces a new concept for testing the contract: the unequivocal transfer of significant risk. However, this step is superfluous and redundant, in that it appears before applying the Statement 113 risk transfer criteria. This new concept adds nothing of value that would facilitate or improve the Statement 113 analysis. If anything, it complicates the analysis further.

In sum, we believe the suggested “unequivocal transfer of significant risk” standard is a meaningless, complication that adds nothing to a process that itself is unnecessary.

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?*

We do not believe the unequivocal transfer of significant risk approach is helpful, and therefore we disagree with the notion that there could be – or should be – a checklist of characteristics that would determine whether a contract qualified as satisfying this new standard. In addition, the checklist approach seems contrary to the objective of moving toward principles-based standards.

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)?*

As we have stated earlier, we disagree with the concept of unequivocal transfer of significant risk, and therefore would not support the identified characteristics, or any other characteristics, because the underlying analysis is flawed.

Issue 7: *Do you prefer Approach A or Approach B for identifying contracts subject to bifurcation? Why? Do you believe that another approach would be superior? If so, how would*

you describe that approach? Would your preferred approach be operational? Would it make financial statements more decision useful?

We do not prefer either approach because we disagree with the notion that insurance contracts can be broken into separate insurance and financing components, and accounted for separately. The ITC fails to provide guidance as to what aspects of the insurance contract would constitute a financing component. For that matter, the ITC does not define financing in the context of an insurance contract.

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

There should be no bifurcation of insurance contracts and therefore, no criteria would be necessary.

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?*

The bifurcation methods are inherently flawed because they assume that risk transfer analysis can be performed for direct insurance contracts on a contract-by-contract basis, an assumption that is contrary to the insurance business model.

In addition, the bifurcation methods are presented from the perspective that insurance contracts are financing arrangements. If one assumes that the contract is financing, it is fairly safe to say that one will conclude that it is a financing arrangement. And that is the fallacy behind the bifurcation discussion in the ITC. Consequently, the results determined under each method seem arbitrary at best. We see no rationale between the mathematical gyrations of each method and the ultimate conclusion that a portion of the premium payment should be treated as a deposit, while the remaining portion should be treated as premium. Carrying this accounting illusion further, it would be illogical for a policyholder to pay a deposit which, for a property-casualty contract, will not be returned when there is no loss event.

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?*

Data is the life blood of insurance companies and would be an important concern in implementing a bifurcation system. However, bifurcation is essentially a reallocation of premium data. Thus, one must question the usefulness of the new bifurcated data. It would be expensive to maintain and serve no other purpose other than to comply with an arbitrary accounting rule.

From the policyholder's perspective, it is unclear from where the data would be derived. We suspect the policyholder would need to incur great expense in order to acquire the necessary data to perform bifurcation. A policyholder is primarily concerned with transferring potentially crippling economic burden to someone who is better equipped to absorb that risk. Once that is achieved, it seems counter-intuitive that the policyholder should incur additional and significant cost to simply account for that transaction.

Issue 11: *In view of the IASB's project on insurance contracts, should the FASB be considering bifurcation of insurance contracts based on transfer of insurance risk?*

We think it is premature for the FASB to consider any major changes to insurance accounting until it concludes its activities with respect to the IASB's insurance contracts project. It is our understanding that the IASB plans to issue a discussion document toward the end of this year or the beginning of next year with its preliminary views on the accounting for insurance contracts. It is also our understanding that the FASB will issue an Invitation To Comment with respect to the IASB document, and based on that feedback, will decide on pursuing a joint project with the IASB on insurance contracts. With those plans in mind, it seems contradictory to develop a major standard on the bifurcation of insurance contracts with the IASB project so close at hand.

We urge the Board to defer any further discussion about bifurcation until it reaches the point of deciding whether to commit to a joint project with the IASB on insurance contracts.

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In summary, we believe this Invitation To Comment begins with flawed assumptions which lead to invalid conclusions about the nature of insurance and the appropriate accounting and reporting of insurance contracts within a bifurcation model. We believe the resulting information produced by bifurcation would be inordinately expensive to produce, while providing no user benefits. We also believe it is premature for the Board to be considering a bifurcation project, given the on-going activities with the International Accounting Standards Board and its insurance contracts project. We believe the existing accounting guidance is sufficient and that relevant enforcement authorities are well apprised of the risk transfer issues to ensure compliance with the guidance.

Thank you for this opportunity to provide comments. As always, we are happy to discuss our comments in further detail with the Board or its staff.

Sincerely,

Phillip L. Carson
Assistant General Counsel