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LETTER OF COMMENT NO. 6

Attached please find my response to the May 26, 2006 FASB ITC on Bifurcation of Insurance and Reinsurance Contracts for Financial Reporting.

I appreciate the opportunity to share my personal views and recommendations with the FASB regarding the possible bifurcation of insurance and reinsurance contracts for financial reporting.

If you have any questions or require further explanation about any of the comments contained in the attached document, please do not hesitate to contact me.

Sincerely,

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**RESPONSE TO FASB INVITATION TO COMMENT (“ITC”)
ON BIFURCATION OF INSURANCE AND REINSURANCE CONTRACTS
FOR FINANCIAL REPORTING
SUBMITTED BY DAVID KOEGEL
AUGUST 17, 2006**

Introduction

This paper is intended to respond as directly as possible to the 11 Issues raised by the FASB in its ITC on Bifurcation of Insurance and Reinsurance Contracts for Financial Reporting dated May 26, 2006. Please note that the contents of this paper represent my own personal views and not necessarily the views of my employer, Imagine Advisors Inc. or its affiliates.

Under the premise that the FASB and/or other accounting rule makers are inclined to adopt standards for bifurcation of (re)insurance contracts for financial reporting, this paper advocates the following:

- (1) Proposed criteria for exemption from bifurcation applicable to all (re)insurance contracts (see responses to Issues 4 and 7) without necessarily introducing an additional test for unequivocal risk transfer (see response to Issues 5 and 6); and
- (2) Preference for a relative risk transfer bifurcation methodology that would also be consistently used, when necessary, to assist in confirming whether or not the conditional exemption from cash flow testing and/or the risk transfer tests of Statement 113 have been satisfied (see response to Issue 9).

Responses to the 11 Issues Raised in the ITC

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?

Response: The combined IFRS 4 definition of *insurance contract* and GAAP definition of *insurance risk* adequately describes what an insurance contract is, sufficiently distinguishes those contracts from other financial contracts and adequately identifies insurance risk apart from other risks. The descriptions in the ITC of finite insurance and reinsurance contracts, including the risk-limiting features, adequately identify those contracts as they are commonly known today.

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?*

Response: Yes. However, more comprehensive industry standards of practice (actuarial or otherwise) for insurance risk transfer testing are still needed so that the Statement 113 risk transfer guidance can be more readily and consistently applied to both insurance and reinsurance contracts alike when determining whether significant insurance risk has been transferred.

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?*

Response: When the relative risk positions of the counterparties with respect to the portions of risk (re)insured are materially different, bifurcating a contract into its insurance and deposit components can provide more understandable and decision-useful information to the financial statement user. In such cases, bifurcation may more faithfully represent the contract's impact on related premium expense and loss recoverable recognition in the contract holder's financial statements. Otherwise, faithful representation of economic substance of (re)insurance contracts is adequately addressed by existing GAAP. Notwithstanding, until more comprehensive and sensible industry standards of practice (actuarial or otherwise) are developed for both risk

transfer and bifurcation testing, bifurcation, in and of itself, is not likely to result in a more faithful or verifiable representation of (re)insurance contracts in financial statements.

Issue 4 – *The flowchart (on page 16 of the ITC) 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?*

Response: The sequencing and integration indicated in the Risk Transfer and Bifurcation Testing flowchart on page 16 of the ITC are appropriate. However, I would propose wording changes (shown in Appendix A of this paper) that attempt to clarify the questions/instructions contained in screens (c), (e) and (f). Furthermore, as called for by screen (e) of the flowchart, I would propose the following simplified criteria for determining exemption from bifurcation:

A (re)insurance contract that meets the Statement 113 risk transfer tests is exempted from bifurcation only if both of the following two conditions are satisfied:

- (1) Maximum premiums received or receivable by the (re)insurer under the contract are not a substantial percentage of the maximum coverage provided; and
- (2) With respect to the portions of risk (re)insured, there are no provisions in the contract that reduce the likelihood of loss to the (re)insurer compared to the likelihood of loss to the (re)insured had it not entered into the (re)insurance agreement.

Maximum premiums received or receivable by the (re)insurer, subject to condition (1) above, include any retrospective adjustments, reinstatement premiums or other additional consideration (after deducting any commission paid or payable by the (re)insurer) without regard to how such premium or other consideration are described or characterized. The level above which maximum premiums received or receivable by the (re)insurer are determined to be substantial relative to the maximum coverage provided will vary between insurance forms, products or lines of business and should also consider the ratio of premiums to coverage provided relative to similar coverage on a market-equivalent basis, if available. As indicated in paragraph 40 of the ITC, existing GAAP uses an array of probability levels in determining the appropriate accounting for a

transaction or event. Similarly, an array of materiality levels and professional judgment should be used in determining whether maximum premiums received or receivable by the (re)insurer are substantial relative to the maximum coverage provided taking into account all relevant facts and circumstances on a case by case basis.

Provisions in a (re)insurance contract, subject to condition (2) above, that reduce the likelihood of loss to the (re)insurer can be readily identified using professional judgment. Such provisions are deemed not to include exclusive contractual rights of the (re)insured that may be exercised only at its sole option and not under the control or direction of the (re)insurer (e.g., unilateral right of the (re)insured to commute/reassume the (re)insurance obligation for a refund if experience is favorable). Such rights are typically present in a contract to provide the contract holder with a potentially significant cost savings relative to alternative coverages generally available in the marketplace. Entitlement to an experience refund, in and of itself, has no affect whatsoever on the likelihood of loss to the (re)insurer and should therefore not be a determining factor in assessing whether sufficient risk has been transferred or whether bifurcation should be applied.

Issues 5 and 6 - *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? 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)?*

Response: I do not believe that establishing standards concerning a separate test for unequivocal transfer of insurance risk, including listing types of insurance contracts and required characteristics, will be an effective screen to achieve the reduced cost objective as stated in paragraph 57 of the ITC. Having to perform such a test (even with illustrative examples such as those shown in Appendix B of the ITC) would not necessarily be an improvement over the exemption from cash flow testing in paragraph 11 of Statement 113 and is likely to create more ambiguity than clarity on the issue of whether the condition for that cash flow testing exemption has been met. The conditional exemption in paragraph 11 of Statement 113 is simply stated and

is operational in practice in that it is met only when there is no reasonable doubt that substantially all of the insurance risk relating to the (re)insured portions of the underlying exposure has been assumed by the (re)insurer. With respect to contracts for which a credible, albeit not “unequivocal”, argument can be made that substantially all of the risk has been transferred, professional judgment can still be the primary determinant of the extent to which cash flow testing is necessary to conclude whether the Statement 113 risk transfer tests have been met.

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?*

Response: I prefer Approach B under which bifurcation applies to all contracts that (i) are not screened out for insurance or deposit accounting in their entirety and (ii) do not satisfy the criteria for exemption from bifurcation. So long as criteria for exemption from bifurcation are sensible and the prescribed bifurcation methodology is conceptually sound, Approach B would be preferable to Approach A as described in the ITC under which bifurcation would apply only to contracts with “risk-limiting terms or features”. Applying bifurcation only to contracts defined as, or deemed to be defined as, “finite risk” would be ill-advised because no static definition exists for those types of contracts nor can an exhaustive list of all possible “risk-limiting terms or features” be delineated. Additionally, the statement in Paragraph 66 of the ITC regarding consistent accounting provides further support for a preference of adopting Approach B over Approach A. Notwithstanding the foregoing, whether any approach to bifurcation would be operational or make financial statements more decision useful is a debatable matter and one about which a universal consensus is not necessarily attainable.

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

Response: There should be no substantive differences in criteria for bifurcation between insurance and reinsurance contracts because, by definition, insurance and reinsurance

substantively serve the same fundamental purposes to the contract holder (i.e., indemnification of the insured or reinsured against loss or liability).

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?*

Response: Of the approaches identified in the ITC, the “Proportional Method” of bifurcation has the most conceptual merit and is only marginally more difficult to apply than current risk transfer testing approaches. Illustrative Proportional Method approaches to risk transfer and bifurcation testing can be found in Appendix 2: Risk Transfer Alternatives contained in the August 2005 report of the American Academy of Actuaries, Committee on Property and Liability Financial Reporting entitled “*Risk Transfer in P&C Reinsurance: Report to the Casualty Actuarial Task Force of the National Association of Insurance Commissioners*” (a copy of which can be found at: http://www.actuary.org/pdf/casualty/risk_transfer.pdf).

Estimating the relative, rather than absolute, risk positions of the counterparties with and without the effect of the (re)insurance contract would appear to be the most sensible approach to addressing many of the Issues raised in the ITC for several reasons. The Proportional Method would be a conceptual expansion of, and not inconsistent with, the conditional exemption from cash flow testing as stated in paragraph 11 of Statement 113. In cases where applicability of the Statement 113 cash flow testing exemption is not reasonably self-evident using professional judgment, the Proportional Method could serve the two-fold purpose of confirming (or refuting) whether the Statement 113 cash flow testing exemption condition and risk transfer tests were met. Furthermore, a proportional or relative risk transfer and bifurcation testing methodology would be most consistent with existing GAAP in that it would not attempt to quantify specific qualifying probability level thresholds. Paragraph 40 of the ITC provides confirmation that “existing GAAP uses an array of probability levels in determining the appropriate accounting for a transaction or event”. This fact supports the thesis that, within each sequence of increasing probability levels, numeric criteria cannot and should not be established that specify acceptable

thresholds above which the Statement 113 “reasonably possible” risk transfer test is satisfied. Accordingly, any bifurcation or risk transfer measure that relies primarily on estimating cash flows at specified levels of probability in absolute terms would be less consistent with existing GAAP than a Proportional Method which relies more on relative rather than absolute estimates of both probability and significance of loss.

Notwithstanding the foregoing, mandatory bifurcation of insurance and reinsurance contracts (regardless of prescribed methodology) would constitute a significant change to existing insurance and reinsurance accounting practice that could materially affect the financial statements of counterparties to many insurance and reinsurance contracts. This would present an implementation challenge to corporate policyholders, insurers and reinsurers that may necessitate a multiple year phase-in period to avoid or minimize any potential resulting short-term disruptions in availability and/or affordability of global insurance and reinsurance risk capacity.

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?

Response: Data availability would not limit the development of any bifurcation methods discussed in the ITC any more than data availability currently limits the ability to determine whether or not the Statement 113 risk transfer tests have been satisfied. Volume and credibility of available data notwithstanding, it is important to note that an inextricable link exists between appropriate methodologies for determining adequate levels of risk transfer and bifurcation of a contract into its financing and insurance and components. Therefore, as indicated in the response to Issue 9 above, any models that would form the basis for bifurcation methods would and should be substantively similar to those used to evaluate risk transfer. Such models could also be used as a supplemental tool to assist in the underwriting and pricing of products. Furthermore, there should be no material differences on the affects of data availability (or lack thereof) between insurance forms, products, or lines of business.

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?*

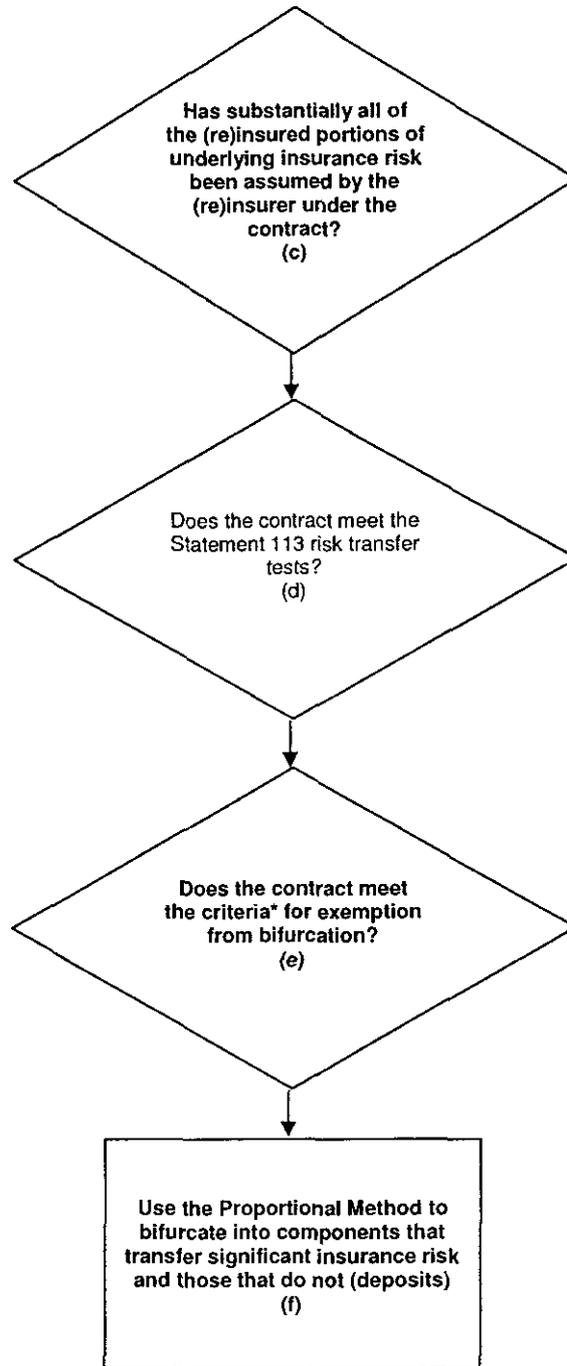
Response: For the reasons cited in paragraph 85 of the ITC, the FASB should continue its consideration of bifurcation of (re)insurance contracts based on transfer of insurance risk concurrent with the IASB's project on insurance contracts. Additionally, and irrespective of the results of the IASB's phase II standard, it would appear sensible to maintain at least some distinction between accounting for financial instruments and accounting for (re)insurance. Such distinction should be maintained particularly for contracts involving the transfer of insurance risk that cannot otherwise be packaged into liquid securities readily tradable in financial markets.

Conclusion

In summary, any accounting standard for bifurcation of insurance and reinsurance contract needs to be developed in a careful and deliberate fashion consistent with accounting standards for risk transfer. The two preferred overall approaches to bifurcation this paper advocates can be summarized as follows: (1) creation of sensible criteria for exemption from bifurcation (Issue 4) that apply to all contracts not clearly exempt from Statement 113 risk transfer cash flow testing rather than having bifurcation apply only to contracts with specified "risk-limiting terms or features" (Issue 7); and (2) use of a proportional or relative risk transfer method for bifurcating insurance and reinsurance contracts (Issue 9) rather than more absolute methods that rely directly on specified probability levels of claims activity or cash flow elements of analogous financial instruments.

I hope the views and comments contained in this paper are helpful to the FASB in its further deliberations concerning the issues raised in the ITC as well as in the development of any future accounting standards for bifurcation of insurance and reinsurance contracts for reporting purposes.

Appendix A
Proposed Revisions to
Screens (c), (e) and (f) of the Risk Transfer and Bifurcation Testing flowchart



* See proposed criteria in response to Issue 4 of the ITC.