



August 22, 2006

Financial Accounting Standards Board Financial Accounting Foundation 401 Merrit 7 P.O. Box 5116 Norwalk, CT 06856-5116

RE: INVITATION TO COMMENT (ITC)—File Reference #1325-100
BIFURCATION OF INSURANCE AND REINSURANCE CONTRACTS FOR
FINANCIAL REPORTING

To Whom it May Concern:

The ITC is inquiring whether the bifurcation proposed in the above captioned document would result in more accurate reporting. We are responding on behalf of Towers Perrin because Towers Perrin believes that this is a very important issue.

Towers is one of the largest Actuarial, Reinsurance Intermediaries and Risk Management Consulting firms in the world. We assist clients in liability measurement and management and in addressing a variety of financial reporting issues.

In our opinion, bifurcation (regardless of the method used), would significantly reduce the reliability of financial statements. We believe this because any bifurcation methods would require extensive, complex actuarial assumptions and estimation that would add further subjectivity and uncertainty to the valuation and accounting of an asset on the balance sheet. The current nominal valuation of a reinsurance recoverable, presupposing adequate risk transfer in the contract, is more objective and subject to fewer complicated and potentially arbitrary judgments than any of the proposed bifurcation methods. One simply has to calculate the covered loss amount rather than what percentage of such covered loss amount should be recognized as a reinsurance recoverable.

The amount of reinsurance recoverable now varies based on changes in the subject direct loss amount, which itself is subject to uncertainty in its actuarial estimation. Under the proposed bifurcation, the amount of recoverable, which would be split between a deposit and a reinsurance loss recoverable, is subject to numerous judgments that vary the amount of reinsurance credit; as a result, bifurcation would reduce the comparability of the financial statements. Specifically, the reinsurance recoverables would vary according to changes in numerous assumptions followed in the bifurcation method utilized (including actuarial assumptions of premium rates, loss trends, loss

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Financial Accounting Standards Board August 22, 2006 Page 2.



development factors, loss probability, distribution expected losses, standard deviations, etc. as well as payment patterns, interest rate, etc.) Adding many more assumptions would result in more subjective judgment and vary the results reported by the company; consequently, financial strements would become less reliable.

There is no simple, practical, accurate and objective way to separate the two elements of insurance: timing/financing and underwriting risk. This is why there was no proposal of bifurcation when FASB 113 was adopted. Establishing a quantification between elements of a (re)insurance contract will: (i) be unreliable because of the parameter risk; (ii) create major divergences between entities looking at similar contracts due to the amount of actuarial judgment; and/or (iii) create significantly more potential bright line tests that can be manipulated. A transaction is either reinsurance or it is not reinsurance (i.e., binary evaluation), and is accounted either as reinsurance or as a deposit. If bifurcation is adopted, one would have the same fact patterns underlying business and history and current exposures for the company buyers of reinsurance with the same reinsurance purchases and have little to no chance of reporting similar financial impacts from the same purchase. In addition, ceding companies and reinsurers would have less comparability of results from the same transaction. The buyer's income would never match the reinsurer's loss.

The nominal value of the reinsurance recoverable is appropriate because it represents the receivable due from the reinsurer, regardless of the timing of the payment. It is not a note with a stipulated payment period and interest rate. It is more than that economically because the uncertainty surrounding the timing of payment and the amount of payment tied to the ceded subject losses (i.e, timing and underwriting risk) have been assumed by the reinsurer. The risk passed on to the reinsurer validates the nominal valuation.

Trying to do a better job in defining insurance and reinsurance is not the issue. Making the accounting frameworks more consistent is a worthy goal, as reinsurance is just a form of insurance. That said, many practitioners like to compare insurance to other types of financial instruments and consider a fair value approach (and the bifurcation concepts discussed later contain elements of that fair value approach). In that comparison, one must bear several points in mind. While other forms of financial instruments have a one-sided payoff like insurance, most other forms do not require that something happen to the party itself, requiring the payoff to be an indemnity rather than a return. Also, insurance contracts are typically subject to "tail event" scenarios; that is, the unknown element or parameter risk, which is almost always transferred to the indemnifying party. That parameter risk, by definition, is not well understood or easily quantified. To believe that parameter risk can be reliably quantified would be to assume we know more about risk than we really do.

Because (re)insurance differs from other types of financial instruments it calls for a differing accounting treatment, reflecting the "value" of the contract as a reimbursement of a loss rather than a change in fair value. The requirement to maintain an "indemnification" standard rather than a "compensation" standard adequately separates insurance contracts from other financial instruments. To maintain that accounting paradigm, we need a more stringent definition of insurance than the IFRS standard. Of course, there are many forms of contracts that indemnify this insurance risk. As discussed later, once it has been established that a contract provides that indemnification, it does not provide any value to users of financial statements to apply differing accounting models to those different forms of indemnification. Rather than making more models to reflect contracts of indemnity of insurance risk, the models should be consolidated.

Paragraph 36 of the ITC strongly implies that "finite risk is different." This notion poses several problems, both practical and theoretical. From a practical standpoint, the authors of the ITC note themselves that there is no "common definition" of finite risk, because "finite risk" is much more a term of art than an actual definition. In practice, it was defined more by who wrote it (e.g., which department of a (re)insurer) than the nature of the product itself. In fact, most of the features outlined in the ITC are often found in "traditional" reinsurance products as well. The extent or preponderance of those features may differ, but even there, no bright line test exists. To attempt to distinguish "finite risk" from "traditional" reinsurance (even if that was desired) will either be easily structured around or be so broad as to capture most, if not all, reinsurances.

From a theoretical standpoint, there is an implication that the ITC (and any resulting standard) would be geared toward correcting a perceived abuse. We believe this is not the role of accounting standards, but rather is a regulatory function. To separate contracts (where separation is difficult), particularly in the hope of correcting a perceived abuse, lessens accounting standards in general. Statement 113 is very clear in its principle that a contract must transfer significant insurance risk in order to be considered reinsurance and be accounted as such. The attempt to carve out particular types of transactions and impose different models lacks theoretical basis and creates a different type of accounting for a contract that is the same at its core (in that it indemnifies for insurance risk and that indemnification is significant). All types of (re)insurance have levels of "financing" and "economic transfer," but as discussed later, it is extremely difficult to measure each with precision. The current requirement that economic transfer must be a significant component is an appropriate standard; it is not practical or advisable to direct the reporting more finely.

Furthermore, bifurcation would not have created any "better" result in the restatements that occurred in the past several years. Paragraph 30 refers to the belief that these

Financial Accounting Standards Board August 22, 2006 Page 4.

6.0



reporting problems resulted from the misapplication of the existing standards rather than problems with the standards themselves. The restatements themselves, by definition, acknowledge that the companies misapplied the standards. We cannot see how bifurcation would have prevented these problems, since the restatements were a result of reinsurance versus deposit accounting of the entire agreement or simply fraud via undisclosed side agreements.

In general, treating contracts that are the same at their core (once defined as insurance and therefore contracts of indemnity) differently because of their form lessens the overall quality of the financial reporting model. Clarifying the principles and/or increasing the disclosure requirements will, in our opinion, be far more useful to users of financial statements than a complex bifurcation accounting model. Again, the notion that bifurcation would be restricted to "finite risk" (Approach A) is neither practical (because of definition issues) nor advisable (treating insurance contracts differently), so one would have to assume that the requirements would apply broadly across (re)insurance contracts.

Proponents of bifurcation would argue that reliability is different than precision, and that information need not be precise. However, if the different elements cannot be reliably quantified, it certainly raises significant questions about whether there would be a faithful representation of the deposit element versus the risk element and how much risk is "retained" versus "transferred." The proponents also suggest that there are already significant estimates in insurer financial statements, so bifurcation should not be a problem. However, most of those estimates refer to the past (which is difficult enough); bifurcation involves estimates of the future, which is that much less reliable.

Relevance refers to whether information has the capacity to make a difference, enabling users to form predictions about the outcomes of past, present or future events or confirm or correct prior expectations. Even if one believes that bifurcation passes the tests of reliability and understanding, it is difficult to see how it is more relevant than the current accounting model. Just because the elements of a contract are divided does not mean that approach provides significant additional information about past, present or future outcomes. One could argue that it could provide information about the extent to which reinsurance has "deposit" elements, but it is difficult to see how that would be interpreted by users. Increasing transparency through additional disclosure would provide far more relevant information than changing the accounting model.

The costs of implementing bifurcation will be relatively high. Because of the complexity, many companies will not have the internal resources to implement this approach. Even if they do, additional actuarial resources will need to be diverted to bifurcation evaluation. Given that the reporting model can be sufficiently improved with additional disclosure



and perhaps some additional guidance as to the meaning of "significant insurance risk" (e.g., stipulating that both frequency and severity must be considered), we do not believe that bifurcation is appropriate from a cost/benefit perspective.

In conclusion, subjecting the accounting of the elements of a reinsurance transaction to bifurcation is counterproductive to producing more reliable financial statements. We appreciate the opportunity to provide comments on the important issue. Any questions or comments should be directed to the signors below.

Respectfully Submitted,

**TOWERS PERRIN** 

Stephen Lowe Property/Casualty Insurance Global Practice leader James W. B. Hole Global Product Management Officer Reinsurance Business of Towers Perrin

/WBHole

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Attachments: Specific Answers to Issues Raised in FASB ITC

VIA OVERNIGHT MAIL

# Specific Answers to Issues Raised in FASB Invitation to Comment (ITC)

#### Issue 1

- The IFRS 4 definition of an insurance contract permits a very low level of Insurance risk to qualify a contract as insurance. In the context of an accounting regime like US GAAP, under which a significant difference can arise between the measurement of insurance liability and financial liability, such a low level of insurance risk is an inappropriate threshold.
- We believe that the current approach under US GAAP to test for the existence of a material transfer of insurance risk is appropriate. However, more detailed implementation guidance could help make the approach less subjective and result in improved consistency of treatment across the industry.
- We see no need to attempt to define finite insurance and reinsurance contracts. The criteria in paragraph 36 (b) are certainly not fit for that purpose as item (1) is generally applicable to all insurance contracts and items (3) and (4) can apply to many standard insurance contracts.

#### Issue 2

Yes, it can be applied. However, detailed implementation guidance can be introduced to improve consistency of treatment in the industry by companies and their auditors. Such refinements would only affect the very small minority of policyholders for whom insurance accounting is material.

### Issue 3

- Entire contracts should be treated either as (re)insurance or as deposits without bifurcation, except where contracts have been artificially combined (which is already addressed by existing bifurcation requirements). We believe that additional disclosures would be a significant improvement in allowing financial statement readers to understand the limiting features of (re)insurance contracts.
- Accounting should move towards economic reality, not away from it. Bifurcation as proposed in the ITC attempts to segregate insurance contracts into components that are not naturally delineated (similar to requiring the accounting of a stock as a combination of calls and puts, or segregating bond accounting between the portion that is "guaranteed" [investors will still get a fraction of the face value in bankruptcies] and the portion "at risk" of default.
- Problems with bifurcation as proposed in the ITC include:
  - Mismatched accounting between direct and assumed and ceded (re)insurance impact;
  - Determination of the financing and insurance portions of contracts would necessarily be subjective, relying on complex and frequently arbitrary assumptions, making financial reporting less reliable and comparisons across companies more difficult;
  - Separation of financing and insurance portions of contracts is not how contracts are modeled and priced;
  - 4. Determination of which contracts should be bifurcated would also be subjective and this would make financial reporting less reliable and comparable;
  - 5. Added complexity would reduce transparency.

### issue 4

There is no uniformly consistent way to screen contracts that unequivocally transfer significant insurance risk as defined in the ITC. Judgment is needed, as all contracts have varying degrees of risk transfer present. This is not always obvious or clear, which is why one must perform actual risk transfer tests to determine whether risk transfer is significant or not. A test or labeling or description is inadequate, and it would be impractical to draw a line unless we introduce specific formulas by type and line of business. Under the ITC proposals, bifurcation could affect significant amounts of business that pass risk transfer tests.

### Issue 5

- Contracts cannot be so clearly defined as "unequivocally transferring insurance risk." All insurance contracts have some expected loss, whether they are single risk contracts or contracts covering a large group of risks. The most basic insurance pricing concept indicates that [premium = expected loss + risk load + expenses + profit]. If there is no chance of loss, then insurance is not purchased (e.g., an individual who does not drive does not purchase auto insurance). In our opinion, the FAS ITC seems to be confusing the concept of expected loss with the concept of loss variance (or variability). Because each individual risk has a low probability of loss and a high loss variance, the definition is met. Yet, this has nothing to do with whether a contract "unequivocally transfers risk." The contract features and risk transfer tests should determine whether risk is transferred, regardless of the expected loss level and variability of that expected loss.
- What happens to the professional liability example when the sole practitioner joins a practice with 10 other professionals? Is this still "unequivocal risk transfer"? What if the group grows to 50 professionals or 100 professionals? Is there some cut-off in size, level of expected loss or reduced variability level that will be included in bifurcation guidance so that accounting and insurance professionals know when to treat the contract as possibly requiring bifurcation?
- Why would a fleet of 100 automobiles be treated differently from a fleet of two to four automobiles (a family's automobile policy)?
- Quota share reinsurance (with no risk-limiting features) of a portfolio of individual risk policies will exhibit the same exact risk profile as the underlying portfolio of contracts. Why should the accounting be different? This contract would still "unequivocally transfer risk" in substance. For example, why should quota share reinsurance of primary personal lines business be accounted differently from co-insurance of the same business? The economic substance of both transactions (apart from credit risk, which is typically excluded from the analysis of insurance risk transfer) is the same. Under the proposals, the reinsurance would be bifurcated but the coinsurance would qualify as insurance that unequivocally transfers risk.

# Issue 6

No, as discussed above, there are major problems with the "unequivocal" definition and therefore it is not an improvement over the FAS 113 paragraph 11 exemption.

### Issue 7

We do not prefer either approach to identifying contracts for bifurcation. A clarified version of FAS 113 with detailed implementation guidance could result in a much better approach for financial reporting, without the unintended consequences of unreliability associated with bifurcation. If FAS 113 were complied with on this basis, financial reporting of full value (nominal) reporting would make financial statements more useful/understandable than the proposed method of bifurcation.

## Issue 8

Whatever decisions are ultimately made regarding bifurcation, there should be no difference between the treatment of insurance and reinsurance from an accounting perspective.

### Issue 9

- The concept of splitting insurance contracts into trading of dollars, financing and insurance components is unduly complex for the purpose of financial reporting. There are no easy uniform screen tests, and therefore bifurcation as proposed in the ITC would be excessively applied.
- Comparability, consistency and clarity of financial reporting would also suffer.
- Significant costs will be imposed on companies, insurers and reinsurers to analyze every (re)insurance contract in order to implement any of the proposed bifurcation concepts.

#### Issue 10

Actuarial analysis used for pricing and underwriting does not generally separate the insurance and financing components of contracts. While the time value of money is typically recognized (and even required in certain states [e.g. Florida]), the cash flows are contemplated in total, regardless of their characterization. There is typically no attempt in the actuarial pricing/modeling process to segregate out certain cash flows as those that represent purely financing and those that represent risk transfer. To do so would require additional data and new models to perform the analysis required to support bifurcation as proposed in the ITC. Such new models would require numerous judgments regarding actuarial assumptions for losses, loss volatility, and payment patterns that would directly influence the credit for (re)insurance coverage and result in less reliability.

# Issue 11

■ FASB should coordinate with the IASB, as we are moving forward towards global accounting standards.