



LETTER OF COMMENT NO. 20

Fitch Ratings

55 East Monroe
Chicago, IL 60603

T 312 368 3100 / 800 48 FITCH
www.fitchratings.com

August 23, 2006

Technical Director – File Reference No. **1325-100**
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, Connecticut 06856-5116

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

Dear Technical Director:

We appreciate the opportunity to comment on the Financial Accounting Standards Board's ("FASB" or "Board") Invitation to Comment "*Bifurcation of Insurance and Reinsurance Contracts for Financial Reporting*."

Fitch has long argued that the use of finite risk reinsurance, even when adhering to both the letter of the law and accounting guidance, can be misleading and distort the financial statements. Fitch relies on the information provided to us by insurers or their agents, and/or that which is publicly available in its analysis of insurers, and attempts to capture and back-out the impact that finite risk arrangements have on a buyer's financial statements.

Overall, Fitch is satisfied with the current principles-based accounting guidance and does not feel that the bifurcation of contracts as outlined in the Invitation to Comment is warranted. However, Fitch would support the expansion of disclosures related to such contracts that would help to improve the transparency and understanding of financial statements.

Below are comments we would like to provide regarding specific issues posed by the Board in the Invitation to Comment.

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? (page 10)

The IFRS definition of insurance contract is very reasonable and improves upon the description of an insurance contract from paragraph 44 of FASB Statement No. 5. However, one change to improve the definition would be to replace the word 'compensate' with 'indemnify' to be clear that compensation is limited to the amount of the policyholder's loss (as is mentioned in paragraph 34 of the Invitation to Comment).

Fitch Ratings

August 23, 2006

Page Two

The GAAP definition of insurance risk in requiring the transfer of both underwriting risk and timing risk does identify and separate that risk from other financial risks.

The descriptions of finite contracts are accurate in identifying such contracts, particularly the risk limiting features (paragraph 36 b. (1) through (7)). While there is no simple definition for this complex product, Fitch defines finite risk reinsurance as follows:

Finite risk reinsurance is a form of reinsurance that explicitly considers the time value of money in addition to the expected amount of the loss payments in nominal dollars. The insurance risk assumed by a finite risk reinsurer is contractually limited so that the reinsurer's range of possible losses is relatively narrow. Thus, risk transfer is generally quite limited in a traditional sense. The primary emphasis is on risk financing rather than risk transfer, although finite risk transactions contain elements of both. The nature of the risk finance typically allows the ceding company to attain an accounting benefit similar to loss reserve discounting. Finite risk contracts often cover multiple years and multiple lines of business. Furthermore, it is common for the contracts to include a retrospective or dynamic pricing mechanism in which the ceding company is either refunded portions of its premium if experience is good, or is required to make supplemental premium payments if experience is poor. Typically, the margin earned by the reinsurer selling the contract is modest, and true economic revenues earned by the reinsurer are represented by a fee payment as opposed to the premium ceded.

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? (page 11)

Determining whether an arrangement is finite risk reinsurance or traditional reinsurance can be difficult, as there are many components of the arrangement to consider. Fitch recognizes that there are no bright lines in making the determination of whether the transferred risk of loss is certain or uncertain. To further complicate the issue, it is often not the mere presence, or absence, of the components that is the prime determinant, but the relative presence, or absence. At some level, determining when losses are certain and when they are not is an uncertain process itself. Nevertheless, in determining whether an insurance contract transfers significant insurance risk, we agree with the current principles-based standard that it is "reasonably possible that a reinsurer will realize a significant loss on a contract". We also think this guidance for reinsurers can be applied to corporate policyholders and insurers as well.

In practice, there are several rules of thumb as to what constitutes significant insurance risk. For a long time, the "10/10 rule" was considered sufficient. In other instances, Fitch has seen it argued that the standard is 15/15. Fitch asked the senior management of a finite risk writer for clarification and found that the standard is ultimately what the cedant's auditors and regulators say it is, and that it may vary from jurisdiction to jurisdiction and even from company to company. Thus, it can be very difficult to standardize a rules-based approach for a process that will always involve some level of subjective judgment. However, it would be beneficial for FASB to provide more official guidance on what constitutes significant insurance risk.

Fitch Ratings

August 23, 2006
Page Three

Fitch appreciates that the standards can only go so far in ensuring that risks are accounted for appropriately. As such, any changes to the accounting for finite contracts, however well meaning, will likely not catch flawed analyses by company management of the “significant risk transfer” required under FAS 113 using grossly conservative assumptions designed specifically to mislead auditors or others in order to obtain reinsurance accounting treatment. In addition, it is virtually impossible to uncover separate side agreements, many of which are illegal and intentionally hidden. Thus, the only way to really deal with these corporate governance issues is through attestations signed by the senior officers, similar to the new NAIC regulations that require the CEO and CFO to attest, under penalty of perjury, that all reinsurance contracts are accounted for properly and that there are no separate oral or written side agreements. Favorably, given the greater scrutiny and higher ethical standards imposed on financial service firms in recent years, Fitch believes that the appetite for side agreements has declined significantly.

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? (page 14)

Fitch is always looking to analyze a company’s true economic position regardless of the accounting used, such that the volatility of an insurer’s accounting results reflect the volatility of the underlying economic results. So to the extent that the financial statements are more reflective of a company’s true financial position, they are more reliable and useful to us and other financial statement users.

Fitch has long been vocal about its reservations with finite risk reinsurance. Finite reinsurance can distort the financial statements and make analyzing the company difficult at best and, without disclosure of the arrangement’s details, sometimes impossible. In addition, Fitch has concerns regarding asymmetrical accounting for the same contract, whereby one party accounts for the transaction as insurance (usually the ceding company), while the other side uses deposit accounting (usually the reinsurer). While this divergence may reflect legitimate differences in how each company views the level of risk transfer, it could also be a sign of misleading financial statements.

In its analyses, Fitch relies heavily on publicly available information as well as information provided to us by insurers or their agents. Thus we, like other financial statement users, rely on the quality, accuracy and completeness of disclosures made by the companies we rate. Fitch’s analytical practice has generally been to reverse the impact of finite risk reinsurance arrangements when conducting its rating reviews of insurance companies that are buyers of these products. Fitch recalculates earnings and surplus as if losses had not been ceded to the finite risk contracts and then recalculates the earnings and surplus adequacy ratios to determine the effect of the finite risk on its analysis.

Fitch Ratings

August 23, 2006

Page Four

When the effects of the finite risk are discernable, it may be possible to prepare pro forma financial statements to remove the effect of the finite risk reinsurance, after which normal analytical procedures can be applied. In other cases, when disclosures in the cedant's financial statements do not separate finite risk reinsurance from traditional reinsurance, the analysis of that cedant is complicated.

In general, Fitch considers that the current accounting guidance (FAS 113, SSAP 62) is reasonable to determine if risk transfer has taken place. However, Fitch believes that one of the problems in the current accounting rules for finite risk transactions may be that the test for risk transfer is binary. If a company meets the test, it accounts for 100% of the contract as reinsurance. Likewise, if it does not meet the test, then the entire contract is accounted for as a deposit. In theory, it may be preferable to bifurcate the accounting for insurance contracts. However, as a practical matter, it can be very difficult to implement consistently across companies that have finite contracts covering losses emanating from multiple accident years and multiple lines of business in such a way that will increase financial statement reliability, comparability and overall usefulness.

What may be more appropriate is that in cases where reinsurance accounting treatment is granted, yet there is not 100% risk transfer, it may be preferable to disclose standardized, key account metrics as if the arrangement did not exist. This could be similar to the new NAIC reporting requirements for additional disclosure by ceding companies in the 2005 annual statements, which include: summary of contract terms, description of management's intent and economic purpose of the contract, aggregate financial statement impact of such contracts on the balance sheet and income statement, and an explanation as to why any reinsurance contract is accounted differently for statutory vs. GAAP. This type of added information would be beneficial in providing more detailed information to users that allows for a better understanding of the contracts in place. Also, the increased transparency would enable the end user to adjust the financial statements and conduct a "find and unwind" pro forma analysis as they felt was appropriate.

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? (page 17)

Assuming bifurcation of insurance contracts is appropriate, the suggested sequence in the flowchart appears to be reasonable.

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? (page 18)

Assuming bifurcation of insurance contracts is appropriate, the characteristics identified for contracts that do or do not unequivocally transfer significant insurance risk appear to be reasonable.

Fitch Ratings

August 23, 2006
Page Five

However, we would also like to stress that most insurance and reinsurance is indeed valid risk transfer. In addition, some products that contain finite risk characteristics have legitimate uses that genuinely benefit all parties involved, without undue harm to others. Fitch's concern is with those that use finite for the accounting impact on the financial statements, distorting the true economic position of the company. Such abuse also gives us less comfort with the company's overall corporate governance and risk management practices.

An example of a legitimate use would be a cedant who believes its reserves are adequate and enters into a loss portfolio transfer merely to remove the effects of discontinued business from its financial statements, so that those statements only reflect ongoing business. This would differ from a cedant who already expects adverse loss development and enters into a loss portfolio transfer or an adverse loss development cover as a means to avoid its immediate recognition.

Furthermore, buyers are often entities under some form of regulatory capital pressure after suffering losses that would potentially impair statutory capital levels. Capital created through finite risk reinsurance contracts is given full capital credit by state regulators and the NAIC in risk-based capital ratio and the calculation of policyholders' surplus. Other potential buyers might include those who cannot find traditional reinsurance for the risks they face, but still do not want to experience the earnings volatility of going bare. This occurs from time to time following major market dislocations. As a result, finite risk reinsurance, rightly or wrongly, has been a source of financial flexibility for many small insurers and mutuals.

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)? (page 18)

Assuming bifurcation of insurance contracts is appropriate, the characteristics described appear to be an improvement in that they provide more specific guidance on the types of contracts and features that would be considered insurance risk

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? (page 20)

Assuming bifurcation of insurance contracts is appropriate, we prefer approach A in that it focuses on finite risk as a financing vehicle, which has been the primary issue surrounding finite insurance that has resulted in subpoenas and restatements of financial results to correct for past finite reinsurance transactions. Generally, abuses have not been with other types of reinsurance contracts, such as those group insurance contracts with dollar trading components, that would be potentially bifurcated under approach B.

Fitch Ratings

August 23, 2006
Page Six

While insurance risk transfer is the dominate concern in traditional reinsurance, the time value of money dominates in finite risk reinsurance. Thus, it is prudent to think of this type of finite risk reinsurance as a financing vehicle. This is particularly the case for retrospective reinsurance arrangements, which are almost always finite, since by their very nature retroactive coverages finance losses. A known loss that has already occurred cannot be insured or transferred in a traditional sense; the uncertainty is gone. Natural buyers of retroactive covers would include insurers with long-tailed business.

Fitch is concerned about instances in which the primary purpose is not true risk transfer in the traditional sense, but financial statement enhancement. These purchasers of finite risk reinsurance are driven less by risk transfer and more by a means to improve current period earnings, smooth earnings, effectively discount reserves and/or enhance capital.

Favorably, the attention that the industry experienced from prosecutors and regulators over the last several years has reduced demand for such finite risk products and has resulted in many companies commuting their finite risk contracts as more of the marketplace and regulators started to systematically “back out” the financial statement benefit of the arrangements, reducing the incentive to maintain such contracts. This certainly provides for a greater transparency of results and could result in a reduction of real economic costs to the ceding company that are typically associated with finite risk reinsurance.

Issue 8: Should the criteria for bifurcation be different for *insurance contracts* and *reinsurance contracts*? Why? If yes, what differences would you suggest? (page 20)

Finite risk reinsurance preceded finite risk insurance, in that the broad product group that Fitch is defining as finite risk reinsurance was sold by insurers to insurers before it was sold by insurers to noninsurers. However, the basic conclusions of our analysis of finite risk reinsurance also apply to finite risk insurance in general. Therefore, the criteria for bifurcation under an accounting standard should be the same for insurance contracts and reinsurance contracts.

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? (page 22)

Assuming bifurcation of insurance contracts is appropriate, Fitch would lean more toward the cash flow yield method. This approach seems to best dovetail with our definition of finite risk contracts as “explicitly considers the time value of money in addition to the expected amount of the loss payments in nominal dollars”.

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? (page 23)

Fitch Ratings

August 23, 2006
Page Seven

As this question is more directed at insurance companies and corporate policyholders, Fitch has no comments on this issue.

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? (page 24)

In general, Fitch supports convergence of US GAAP and International Financial Reporting Standards ("IFRS") and would like to see as much alignment of the two as possible. It seems unlikely, although not yet impossible, that the IASB would adopt bifurcation of insurance contracts if it goes down the "exit value" approach that seems to be favored currently. For insurance standards to converge, this suggests that if bifurcation were implemented by the FASB it would only be used as a temporary measure. Whether or not the FASB should be considering bifurcation of insurance contracts given the IASB's project on insurance contracts, therefore, depends on how quickly the standards on insurance contracts in the two accounting regimes are likely to be brought into line and whether the benefits of bifurcation to users such as Fitch will outweigh the costs to the preparers in the intervening period. Our answer to question 3 points out that bifurcation may not be the most pragmatic approach to providing the information Fitch would like to see regarding whether or not risk has been transferred, and that where reinsurance accounting treatment is granted, yet there is not 100% risk transfer, greater disclosure should provide us with appropriate information for analysis.

We look forward to discussing these comments with the Board at the appropriate time. The undersigned and members of our Credit Policy Group will be happy to answer any questions on our comments above.

Sincerely,

Julie Burke
Managing Director
Insurance
Fitch Ratings
Chicago

Brian Schneider
Director
Insurance
Fitch Ratings
Chicago