August 18, 2006

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

RE: INVITATION TO COMMENT (ITC)
BIFURCATION OF INSURANCE AND REINSURANCE CONTRACTS FOR
FINANCIAL REPORTING

I am writing to you as an accounting practitioner with approximately 17 years in
insurance and reinsurance, including roles in: accounting/auditing, corporate finance,
underwriting, and broking. While I will specifically refer to the issues raised in the
ITC, generally speaking, I do not feel that bifurcation would lead to any improvement
in the representational faithfulness in the financial reporting of (re)insurance entities.
To the contrary, the reduction in reliability, comparability, as well as the substantially
increased costs make bifurcation unworkable in my view; the bifurcation of insurance
and reinsurance contracts requires significant assumptions, many of which would
imply that we know more about risk than we really do. In addition, I cannot help but
notice that the ITC is largely a reaction to a perceived abuse of accounting standards
as per some high-profile accounting restatements. However, it seems to me that: (i)
had the existing standards within Statement 113 been applied properly, there would
not have been a problem (i.e. there was not a problem with the standard, just the
application thereof) and (ii) given the preceding, it would not seem appropriate to
enact accounting standards in reaction.

While the proponents of bifurcation have gone to considerable lengths to justify their
position, I truly believe that there would not be an improvement in the financial
reporting for (re)insurance transactions if it were adopted. Rather than change the
accounting framework, I would suggest two things: (i) enhanced disclosure of
reinsurance transactions in GAAP financial statements, along the lines of what is
now required by the NAIC and (ii) some additional guidance of the practical
application of the existing risk transfer standards,

The following reflects my comments based upon the first three issues raised in the
ITC, as I believe those to be the most critical. I did not comment on the other issues
because either I did not have a strong opinion on the issue; (ii) my views were
adequately stated in response to the first three issues; or (iii) (as in the case of the differing bifurcation methods) I did not believe in the “condition precedent” point.

**Insurance and Reinsurance:**

There is no problem with trying to do a better job in defining insurance and reinsurance. In my view, it is probably a good idea in trying to have the accounting frameworks be more consistent, 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, there are several points which one must bear in mind. While other forms of financial instruments have a one-sided payoff like insurance, most other forms do not require something to happen to the party itself, requiring the payoff to be an *indemnity* rather than a *return*. Also, insurance contracts are typically subject to the “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 the quantification of parameter risk can be done reliably would be to believe we know more about risk than we really do.

These elements separate (re)insurance from other types of financial instruments and hence the differing accounting treatment, reflecting the “value” of the contract as a reimbursement of a loss rather than a change in fair value. To obtain that type of accounting, the requirement to maintain an “indemnification” standard rather than a “compensation” standard adequately separates insurance contracts from other financial instruments. I believe that there should be the more stringent definition than the IFRS standard to maintain that accounting paradigm. Of course, there are many forms of contract that indemnify this insurance risk. As discussed later, once it has been established that a contract provides that indemnification, it does not appear add 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.

**Finite Risk**

In paragraph 36 of the ITC, there is a strong implication that “finite risk is different”. There are several problems with this notion of both the practical and theoretical varieties. From a practical standpoint, the authors of the ITC note themselves that there is no “common definition” of finite risk; that is because “finite risk” is much more a term of art than an actual definition. In practice, it was/is 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 (even if that
was desired) “finite risk” from “traditional” reinsurance will either be easily structured around or be so broad as to capture most, if not all, reinsurance.

From a conceptual standpoint, there is an implication that the ITC (and any resulting standard) would be geared toward correcting a perceived abuse. I do not believe that is the role of accounting standards, but is a regulatory function. To diverge from theoretical underpinnings (which I believe is a consequence of bifurcation and/or treating one form of (re)insurance differently from another) 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. To attempt to carve out particular transaction and impose a different models lacks theoretical basis and creates a different type of accounting for a contract that is the same at its core (in that 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 the latter must be a significant component separates (re)insurance from other financial instruments; I believe that is an appropriate standard, and it is not practical or advisable to delineate more finely.

Furthermore, I am at a loss to understand how bifurcation would have created any “better” result in the restatements that occurred in the past several years. Paragraph 30 refers to the belief that these reporting problems resulted from the misapplication of the existing standards rather than problems with the standards themselves. I fully agree with this notion. By virtue of the restatements themselves, there is the acknowledgement that the companies misapplied the standards. It quite unclear to me how bifurcation would have prevented these problems. More to the point, the actual problems have stemmed from the practical application of the bright-line test (the so-called “10 and 10” rule) and the lack of transparency about the types of reinsurance purchased. In the case of the former, it created incentives to structure around a bright line test rather than the principle (the letter of the law rather than the spirit). In bifurcation, it seems to me that there would be more bright line tests rather than less. Also, in terms of transparency, bifurcation does not solve that problem either.

**Application to Corporate Policyholders**

It would be inconsistent of me to say that there should not be more conformity between corporate policyholders and reinsureds. As contracts of indemnity, they should be treated in a consistent framework.

**Bifurcation**

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. Clarification of the principles and/or increasing the disclosure requirements will, in my 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. From that standpoint, I do not believe that it would result in an improvement to the financial reporting model.

In considering bifurcation in the context of Statement of Concepts 2, in my opinion, bifurcation is less preferable than the current model in terms of: understandability, reliability, and does not add very much in terms of relevance.

Understandability
Proponents of bifurcation believe that understandability of financial statements would be improved by separating the “deposit” elements from the “risk” elements in a reinsurance contract. Specifically, it would shed more light on risk management practices. Bifurcation would actually provide very little (if any) additional insight into the risk management practices of an entity; instead, the disclosure of the risk management practices and material reinsurance contracts would provide significantly more information about that than any bifurcation requirement. As pointed out by proponents of not bifurcating, because of the complexity of methods to bifurcate, it would be very difficult for users of financial statements to draw any additional implications about future cash flows from the bifurcation. Additional disclosure would do far more along those lines.

Reliability
Reliability refers to whether the financial statements faithfully represent what they purport to represent. That is, there is a reasonable level of assurance that the financial statement elements have representational quality and can be verified (as evidenced by a high degree of consensus of independent measurers using similar methods). To differentiate the deposit component of a (re)insurance contract from the “risk” component, in most cases, requires significant actuarial judgment with potentially wide variation of answers among practitioners using very similar methods. To believe otherwise is believe we know more about the nature of insurance risk than we really do. Frequently, separation of the elements would require significant inferences about the past (regarding which there will often be very different views) and its impact on future insured losses. Actuarial practitioners using the very same data can easily draw very different conclusions. In addition, the element of parameter risk, how the future may or may not behave like the past, is very difficult to estimate with meaningful precision. The best evidence of this is the use of catastrophe models. Such models create very similar levels of “expected” losses among companies pricing catastrophe risk. Because of this parameter risk, they are now believed to have been inadequate in predicting the 2004 and 2005 hurricane seasons.

Establishing a quantification between elements of a (re)insurance contract with any degree of precision will be: (i) 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.
Proponents of bifurcation would argue that reliability is different than precision, and that information need not be precise. However, if one cannot reliably formulate the quantification of the different elements, 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
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 understand how it is more relevant than the current accounting model. Just because the elements of a contract are divided does not mean it 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. It seems to me that increasing transparency through additional disclosure would provide far more relevant information than changing the accounting model.

Cost/Benefit
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 the fact 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 the both frequency and severity must be considered), it would not appear to me that bifurcation is appropriate from a cost/benefit perspective.

Unequivocally Transferring Risk

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.

Arbitrary Delineations of Whether or Not Bifurcation Should be Considered

The ITC discusses some potential delineation of contracts that should be “tested” for bifurcation and those that should not. I comment on these points not because I
believe they are something to consider, but more to demonstrate the flawed nature of the proponents' arguments.

• 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)?

These examples illustrate that it would be very difficult to separate out contracts for bifurcation. This would lead one to the conclusion that all contracts would have to be subject to these provisions if any were. For the reasons previously discussed, I do not think that to be advisable.

In conclusion, subjecting the accounting of the elements of a reinsurance transaction to bifurcation is counterproductive to producing more reliable financial statements. I can be reached for any questions or comments.

Respectfully submitted,

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