August 30, 2006

Lawrence W. Smith
Director – Technical Application and Implementation Activities and EITF Chair
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

Dear Mr. Smith:

1. The Planning Subcommittee of the Accounting Standards Executive Committee and the Insurance Expert Panel, both of the AICPA, appreciate the opportunity to comment on the FASB Invitation to Comment, Bifurcation of Insurance and Reinsurance Contracts for Financial Reporting.

2. Overall, we agree that the FASB should provide guidance or clarification on the numerous issues surrounding the assessment of risk transfer of insurance and reinsurance contracts. We believe that the FASB should address areas of diversity in practice relating to the assessment of risk transfer, but do not believe it is appropriate to require insurers or corporate policyholders to bifurcate all insurance and reinsurance contracts not screened out for insurance or deposit accounting in their entirety. We strongly believe that using a broad approach of applying bifurcation to all contracts not screened out for insurance or deposit accounting in their entirety (Approach B in the Invitation to Comment) would result in significant changes to the current insurance model. Given the timing of the Board’s evaluation of the model currently being developed by the IASB and the potential for future changes to our current insurance accounting model, the implementation of such broad changes resulting from Approach B is difficult to justify. We also observe that the Invitation to Comment does not provide a persuasive explanation of why broad bifurcation would make financial statements more understandable or decision-useful. We also believe that if the FASB were to take a broad approach to bifurcation, this change in accounting should require a new standard. Use of a broad approach also raises several concerns for corporate policyholders, such as; justifying the cost / benefit and the availability of the data to implement a bifurcation approach.

3. In November 2003, AcSEC and the Insurance Expert Panel submitted a paper to the FASB titled, Evaluating Risk Transfer in Reinsurance of Short-Duration Contracts, (see Appendix A for attached paper) that raised several questions relating to risk transfer that we again would ask be considered by the FASB in conjunction with this current effort.

4. We recommend that the FASB take a narrow approach to bifurcation and only require bifurcation for those contracts with significant risk-limiting features (starting with Approach A in the Invitation to Comment). To ensure consistent application, the FASB should further define the nature of conditions or circumstances that would require
bifurcation. To provide guidance that goes beyond the contracts and features in use today, we believe that the FASB should address the nature of these conditions and circumstances in the form of principles rather than a prescriptive list of contract features or provisions. Members of the Insurance Expert Panel would be happy to participate on a working group, comprised of insurers, corporate policyholders, users of financial statements and auditors to help with the difficult task of identifying the nature of significant risk-limiting features that would require bifurcation within a narrow approach.

5. We believe there is not enough underlying guidance included in the Invitation to Comment to be able to provide meaningful feedback on the three different bifurcation methods proposed. It is difficult to determine the appropriateness of specific bifurcation approaches without examples so that we may truly understand the methods. We also are unable to determine how each bifurcation approach would depict the economic substance of different contracts. If the FASB continues to pursue bifurcation, we believe that the FASB should not require all entities to use one bifurcation method, but rather provide criteria to consider and guidance on what objectives should be achieved through a bifurcation methodology. Different bifurcation methodologies may be more appropriate in different contract situations; however, we would expect companies to establish accounting policies for consistent application of bifurcation methods by appropriate groupings.

6. We agree with the FASB's concept of identifying contracts that unequivocally transfer significant insurance risk, and believe such an approach would be essential if the risk transfer criteria of Statement 113 are required to be applied by corporate policyholders. This approach should include formalization of the practice of insurance and reinsurance accounting for contracts with low possibility of occurrence but high potential severity of loss. We are not aware of diversity in practice in the insurance industry, but we believe that this concept may need clarification to enable corporate policyholders to apply it in practice as well. In conjunction with our recommendation that the FASB take a narrow approach to bifurcation, we support the concept of identifying contracts that unequivocally transfer significant risk but believe that the definition of contracts that unequivocally transfer significant risk should be expanded. In particular, we disagree with the conclusion in paragraph 59 that group contracts "would not qualify as contracts that are unequivocally insurance." We believe that some group contracts should be eligible for the category of contracts that unequivocally transfer significant insurance risk. Additionally, we believe that long-duration contracts should be excluded from the scope of any proposed guidance that would require bifurcation. The concerns about insurance accounting, including the publicized misapplications and alleged abuses, have involved short-duration contracts.

7. The paper referred to above entitled Evaluating Risk Transfer in Reinsurance of Short Duration Contracts, prepared in November 2003 by AcSEC and the Insurance Expert Panel, outlines several significant issues that we believe still exist in practice and ask the FASB to consider in conjunction with this current effort:
   • What principle(s) should be applied in determining whether significant insurance risk has been assumed as it relates to the reinsured portions of the underlying contracts under paragraph 9a of Statement 113,
     ➢ When assessing the risk transfer guidance in paragraph 9a of Statement 113, what constitutes the reinsured portions of the underlying contracts?
     ➢ What type of qualitative or quantitative analysis is required to determine whether the reinsurer has assumed significant insurance risk under the contract?
What amount of correlation is needed between the ceding company’s and reinsurer’s cash flows to meet the requirement that the reinsurer’s payments “directly vary” with the amount and timing of the ceding company’s cash flows under the reinsured portions of the contracts?

- Clarification that the exception in paragraph 11 of Statement 113 was meant to apply in very limited circumstances in which the reinsurer’s economic position is virtually equivalent to having written the insurance contracts directly.

8. We believe that primarily focusing on bifurcation overlooks some significant areas where diversity in practice exists that may have ramifications on the issues the FASB is currently trying to address in its project relating to the depiction of insurance risk associated with contracts that include terms or features that significantly limit the actual amount of risk transferred. We would request that the FASB consider providing guidance on the following within its current project:

- Additional guidance on what constitutes a contract for accounting purposes (including evaluation of risk-transfer testing); for instance, when should multiple contracts with the same counter party be considered together, and when should separate coverages under a single contract be accounted for together or separately?
- Clarification whether the concepts in EITF Issue No. 93-6, *Accounting for Multiple-Year Retrospectively Rated Contracts by Ceding and Assuming Enterprises*, regarding accrual of amounts receivable or payable under the contract based on experience-to-date are applicable to periods within single year contracts.

We would be happy to provide further explanation or details on any of these areas that we believe contain diversity in practice sufficient to warrant the FASB’s attention.

We have not addressed every issue raised in the Invitation to Comment, but, for ease in summarizing, we have included Appendix B with a cross-reference to the significant issues discussed in our comment letter by paragraph number.

Representatives of the Planning Subcommittee of AcSEC or the Insurance Expert Panel are available to discuss our comments with the Board members and staff.

Yours truly,

Ben Neuhausen, Chair
Planning Subcommittee of the Accounting Standards Executive Committee

Darryl Briley, Chair
Insurance Expert Panel
Evaluating Risk Transfer in Reinsurance of Short-Duration Contracts

Summary of Issue

This paper deals with several issues surrounding the assessment of risk transfer in reinsurance contracts, focusing principally on the risk transfer test in paragraph 9.a. of FASB Statement No. 113, Accounting and Reporting for Reinsurance of Short-Duration and Long Duration Contracts (FAS 113). In assessing risk transfer in certain types of reinsurance contract structures, an issue arises as to whether a single contract should be treated as two separate contracts for purposes of applying the risk transfer test and accounting for the contract(s). In addition to the 9.a. test issues, a separate but related issue has arisen regarding the interpretation of FAS 113, paragraph 11, which provides an exception to the FAS 113 paragraph 9.b. risk transfer test in very limited circumstances.

This paper is separated into a Background section, Section 1 Issues, Section 2 Issues, and Section 3 issues. Section 1 deals with the question of whether it is appropriate to split (bifurcate) a reinsurance contract that is in form one contract into two or more separate contracts for accounting purposes, due to a gap in reinsurance coverage in the middle of the contract (e.g., due to a “loss corridor” type feature). Section 2 deals with the interpretation of “the 9.a. test” in assessing risk transfer. Section 3 deals with an interpretation of paragraph 11 of FAS 113.

The Background section provides a description of various reinsurance contract provisions and references to relevant authoritative literature relating to the issues discussed in this paper.
Background

Risk transfer guidance:

Reinsurance contracts must indemnify the ceding enterprise against loss or liability relating to insurance risk to qualify for reinsurance accounting under FAS 113. To determine if reinsurance contracts indemnify a ceding enterprise against loss or liability, paragraph 8 of FAS 113 notes that a complete understanding of the reinsurance contract provisions is required, including those contract provisions that may limit the amount of insurance risk to which the reinsurer is subject, or delay the timely reimbursement of claims by the reinsurer.

Paragraph 9 of FAS 113 outlines two tests that must be passed in order for reinsurance of short-duration contracts to be considered to indemnify the ceding company against loss or liability. These two tests, which are often referred to as the “risk transfer” tests, are as follows:

A. “The reinsurer assumes significant insurance risk under the reinsured portions of the underlying contracts.

B. It is reasonably possible that the reinsurer may realize a significant loss from the transaction.

A reinsurer shall not be considered to have assumed significant insurance risk under the reinsured contracts if the probability of a significant variation in either the amount or timing of payments by the reinsurer is remote. Contractual provisions that delay timely reimbursement to the ceding enterprise would prevent this condition from being met.”

With regard to the evaluation of paragraph 9.a., paragraph 62 (FAS 113 – Basis for Conclusions) provides additional guidance. Paragraph 62 states: “The Board concluded that two conditions must be met for reinsurance of a short-duration contract to indemnify the ceding enterprise against loss or liability relating to insurance risk. First, the reinsurer must assume significant insurance risk under the reinsured portions of the underlying contracts. Implicit in this condition is the requirement that both the amount and timing of the reinsurer’s payments depend on and

A ceding enterprise may reinsure only part of the risks associated with the underlying contracts. For example, a proportionate share of all risks or only specified risks may be reinsured. The conditions for reinsurance accounting are evaluated in relation to the reinsured portions of the underlying insurance contracts, rather than all aspects of those contracts.
directly vary with the amount and timing of claims settled under the reinsured contracts. Contractual features that delay timely reimbursement to the ceding enterprise prevent the reinsurer's payments from directly varying with the claims settled under the reinsured contracts."

EITF Topic D-35, Question 11, provides the following guidance on evaluating underwriting risk:

"Q--How should the transfer of underwriting risk be evaluated?

A--Underwriting risk is defined in paragraph 121 of FAS 113 as "uncertainties about the ultimate amount of net cash flows from premiums, commissions, claims, and claim settlement expenses paid under a contract...." Therefore, whether underwriting risk has transferred to the reinsurer depends on how much uncertainty about those amounts has been transferred to the reinsurer."

Paragraph 62 of FAS 113 indicates that insurance risk transfer requires that both the amount and timing of the reinsurer's payments depend on, and directly vary with, the amount and timing of claims settled under the reinsured contracts. Accordingly, the significance of the amount of underwriting risk transferred should be evaluated in relation to the ceding enterprise's claims payments.

As noted above, in order to evaluate if the reinsurer assumes significant insurance risk under the reinsured portions of the underlying contracts in accordance with paragraph 9.a. of FAS 113, there is a requirement that both the amount and timing of the reinsurer's payments depend on and directly vary with the amount and timing of claims settled under the reinsured contracts. However, FASB literature specifically focuses on contractual features that delay timely reimbursement and not the amount of the reimbursement. In EITF Topic D-34, Accounting for Reinsurance: Questions and Answers About FASB Statement No. 113, Question 21 states that contracts with features such as payment schedules or accumulating retentions cause the contracts to fail the requirement that the timing of the reinsurer's payments should correlate with those of the ceding company for the reinsured contracts. In D-34, the FASB staff did not specifically address contract features that affect the correlation of the amount of the claim payments between the reinsurer and ceding company, such as aggregate caps and loss corridors (further described below).
Description of Contract Provisions:

Many reinsurance contracts contain terms that are intended to limit (but not necessarily eliminate) the variability in underwriting results in order to limit business risks associated with the reinsurance contract. Paragraph 8 of FAS 113 acknowledges the existence of such risk limiting features and therefore a complete understanding and evaluation of such features is required as part of the risk transfer analysis.

Common risk limiting features include sliding scale and other adjustable commissions, profit sharing formulas, experience accounts, and limits (caps). Sliding scale commissions and profit sharing formulas typically adjust cash flows between the ceding and assuming company based on loss experience (for example, increasing payments back to the ceding company as losses decrease, and decreasing payments back as losses increase, subject to maximum and minimum limits). Experience refund arrangements allow the ceding company to share in the favorable experience of the underlying contracts by reference to an “experience account” that typically notionally tracks premiums paid, less commissions, less losses incurred, plus interest. Experience provisions can also require the ceding company to share in unfavorable experience by requiring additional payments to the reinsurer in the event that the notional experience account is negative. Caps are used to limit the assuming company’s aggregate exposure by imposing a dollar limit, or a limit expressed as a loss ratio, on the amount of claims to be paid by the reinsurer (e.g., reinsurer will not be responsible for claims beyond a 150% loss ratio).

A relatively newer form of risk limiting feature is a “loss corridor.” This feature, which may exist in various forms, serves to eliminate or limit the risk of loss for a specified percentage or dollar amount of claims within the contract coverage. One example is a contract that has some of the characteristics of a traditional quota share contract (where the reinsurer shares proportionally in premiums and losses) but has additional provisions whereby aggregate losses within a certain specified range would not be covered by the contract. The range is often expressed in terms of a loss ratio; for example, losses will not be covered between a 70% and 80% loss ratio. An aggregate excess of loss contract also could be written with an attachment point within the expected loss amounts and a loss corridor that would serve to limit losses to the reinsurer.
In some cases, the loss corridor is implicit, for example the contract will state that the reinsurance contract is net of inuring reinsurance, whether or not collectible. This means that if the other inuring reinsurance fails to pay for any reason, such as a claim dispute or other reinsurer credit issues, the "quota share" reinsurance will not pay for any losses that were subject to that inuring reinsurance. A sliding scale commission also can be structured such that it has the same impact as a loss corridor. For example, each point of loss ratio in excess of a defined amount leads to a reduction (point for point or otherwise) in the sliding scale commission down to a minimum commission payable. Such a provision implicitly limits a reinsurer's loss for a specified loss ratio range within a contract.

Some contracts may be written such that they combine several risk limiting features. For example, a contract may have a loss corridor (explicit or implicit), an aggregate limit ("cap") and an experience refund under which all or a portion of profits earned in the event loss experience is favorable is refunded to the ceding company. As a result, there is limited variability in cash flows for the portion of payments under the contract that will be repaid to the ceding company through loss reimbursements and experience refunds and reduced variability in the loss payments to be made by the reinsurer due to the loss corridor and cap.

The loss limiting features noted above have the effect of reducing the risk transferred to the reinsurer without a corresponding reduction in ceded premium. This has the impact of lowering the ceding company's statutory net premiums, which is an important factor in computing various ratios used by regulators and analysts in assessing the financial condition of an insurance company. For example, statutory net premium is one of the factors used in computing a company's required risk based capital, which is then compared to the company's actual surplus to determine whether sufficient surplus exists for the amount of business being written. Statutory net premium also is used in the net premiums to surplus ratio to achieve a similar comparison to the risk based capital calculation noted above. These ratios are used by regulators and analysts to evaluate the overall risk retained by and financial condition of the insurer. In addition to the impact on certain statutory ratios used to evaluate financial condition, from a GAAP perspective, one implication is that the reduction in earned premium will impact the total premium revenue amount in the GAAP income statement and thus will impact any computed ratios or comparisons between revenues and income that an investor might use to determine the volume of business needed to generate such income.
'Definition of a Contract' guidance:

In considering the issues highlighted in Section 1 of this document, the following guidance is pertinent.

EITF D-34, "Accounting for Reinsurance: Questions and Answers about FASB Statement No. 113," Question 13 and EITF D-35, FASB Staff Views on Issue No. 93-6, “Accounting for Multiple-Year Retrospectively Rated Contracts by Ceding and Assuming Enterprises,” Question 3, interpret FAS 113 as to determining what constitutes a contract for applying the criteria in the Statement. In the response, the staff indicates:

"The legal form and substance of a reinsurance contract generally will be the same, so that the risks reinsured under a single legal document would constitute a single contract for accounting purposes. However, that may not always be the case. Accordingly, careful judgment may be required to determine the boundaries of a contract for accounting purposes.

If an agreement with a reinsurer consists of both risk and nonrisk transfer coverages that have been combined into a single legal document, those coverages must be considered separately for accounting purposes."

The responses also reference paragraphs 59 and 60 of FAS 113, which note that:

"59. Reinsurance programs often entail the reinsurance of various layers [emphasis added] of exposure through multiple reinsurance contracts. The Board concluded that indemnification against loss or liability relating to insurance risk should be determined in relation to the provisions of the individual reinsurance contract being evaluated. That is, to meet the conditions for reinsurance accounting, the terms of the individual reinsurance contract must indemnify the ceding enterprise against loss or liability relating to insurance risk.”

"60. Several respondents to the Exposure Draft observed that this requirement could result in different accounting for similar transactions depending on the contractual structure of the transactions. Those respondents recommended that the conditions for reinsurance accounting be evaluated based on whether a reinsurance program, taken as a whole, indemnifies the insurer against loss or liability related to insurance risk. That approach was rejected because it would
not have been practicable to define what constitutes a reinsurance program. Further, contracts that are not, in substance, reinsurance could meet the conditions for reinsurance accounting by being designated as part of a program that, as a whole, met those conditions.”

FAS 113, paragraph 18a indicates that “to the extent that a reinsurance contract does not, despite its form, provide for indemnification of the ceding enterprise by the reinsurer against loss or liability,” deposit accounting is required.

**FAS 113, Paragraph 11 guidance:**

In considering Section 3 of this document, the following guidance is pertinent.

“Significance of loss shall be evaluated by comparing the present value of all cash flows, determined as described in paragraph 10, with the present value of the amounts paid or deemed to have been paid to the reinsurer. If, based on this comparison, the reinsurer is not exposed to the reasonable possibility of significant loss, the ceding enterprise shall be considered indemnified against loss or liability relating to insurance risk only if substantially all of the insurance risk relating to the reinsured portions of the underlying insurance contracts has been assumed by the reinsurer.”

**FAS 113, Paragraph 67:**

“Under very limited circumstances, the reinsurer need not be exposed to the reasonable possibility of significant loss for a contract to meet the conditions for reinsurance accounting. For example, applying the "reasonable possibility of significant loss" condition is problematic when the underlying insurance contracts themselves do not result in the reasonable possibility of significant loss to the ceding enterprise. The Board concluded that, when the reinsurer has

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3 Payments and receipts under a reinsurance contract may be settled net. The ceding enterprise may withhold funds as collateral or may be entitled to compensation other than recovery of claims. Determining the amounts paid or deemed to have been paid (hereafter referred to as "amounts paid") for reinsurance requires an understanding of all contract provisions.

4 This condition is met only if insignificant insurance risk is retained by the ceding enterprise on the reinsured portions of the underlying insurance contracts. The term insignificant is defined in paragraph 8 of FASB Statement No. 97, Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments, to mean "having little or no importance; trivial" and is used in the same sense in this Statement.
assumed substantially all of the insurance risk in the reinsured portions of the underlying policies, even if that risk does not result in the reasonable possibility of significant loss, the transaction meets the conditions for reinsurance accounting. In this narrow circumstance, the reinsurer's economic position is virtually equivalent to having written the insurance contract directly. The risks retained by the ceding enterprise are insignificant, so that the reinsurer's exposure to loss is essentially the same as the insurer's.”

EITF Topic D-34, Q&A No. 24:

“Q-In determining whether a reinsurance contract qualifies under the exception in paragraph 11, how should the economic position of the reinsurer be assessed in relation to that of the ceding company?

A-The assessment should be made by comparing the net cash flows of the reinsurer under the reinsurance contract with the net cash flows of the ceding company on the reinsured portions of the underlying insurance contracts. This may be relatively easy for reinsurance of individual risks or for unlimited-risk quota-share reinsurance, because the premiums and losses on these types of reinsurance generally are the same as the premiums and losses on the reinsured portions of the underlying insurance policies.

In other types of reinsurance, determining the reinsurer's net cash flows relative to the insurer is likely to be substantially more difficult. For example, it generally would be difficult to demonstrate that the ceding company's premiums and losses for a particular layer of insurance are the same as the reinsurer's premiums and losses related to that layer. If the economic position of the reinsurer relative to the insurer cannot be determined, the contract would not qualify under the exception in paragraph 11.”

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Section 1: Definition of a Contract – Whether a Single Contract should be Bifurcated:

Issues:

Issue 1: What constitutes a “contract” for purposes of the FAS 113 risk transfer test and FAS 113 accounting? What is meant by “risk and nonrisk transfer coverages” in EITF D-34 and D-35? For example, does the existence of a loss corridor provision lead to bifurcation of a reinsurance contract into two separate contracts for purposes of applying the FAS 113 risk transfer criteria and accounting for the contract?

Issue 2: As a follow-on to Issue 1, assume a situation where the reinsurance contract being evaluated (Contract A) does not itself contain a “loss corridor” or similar provision that eliminates coverage for a certain specified amount of losses. However, assume that the ceding company has entered into a separate contract with a different third party reinsurer (Contract B Reinsurer) that effectively eliminates Contract A Reinsurer’s risk in the same corridor. Should Contract A be bifurcated?

Issue 3: If the gap in coverage resulted from a sliding scale commission rather than a loss corridor, should the contract be bifurcated?

Issue 4: Does the existence of a loss corridor provision lead to bifurcation of a reinsurance contract into two or more separate contracts when the loss corridor provisions result in a substantial reduction, but not a complete elimination of coverage in the loss corridor?

Issues and Alternative Views:

Issue 1: What constitutes a “contract” for purposes of the FAS 113 risk transfer test and FAS 113 accounting? What is meant by “risk and nonrisk transfer coverages” in EITF D-34 and D-35”? For example, does the existence of a loss corridor provision lead to bifurcation of a reinsurance contract into two separate contracts for purposes of applying the FAS 113 risk transfer criteria and accounting for the contract?
Below is an example of how differing interpretations lead to different conclusions on the accounting for a reinsurance arrangement.

**Example 1:** Loss corridor: 40% "quota share" contract; reinsurer will not assume losses between a 70% and 80% loss ratio (ratio of losses to premiums).

**View A:** Yes, the corridor provides a natural split into what are in substance two contracts providing coverage for different layers of protection – one contract for the portion below the corridor and one contract for the portion above the corridor; within the corridor there is no coverage. Question 13 of EITF D-34 and Question 3 of D-35 indicate that although the legal form and substance of a reinsurance contract generally will be the same, this may not always be the case, and careful judgment is required to determine the boundaries of a contract for accounting purposes. The reinsurance contract may contain several layers of both risk transfer and non-risk transfer coverages, and each layer should be evaluated separately for risk transfer and accounted for accordingly. For example, a contract that provides a 100% experience refund and a loss ratio limit at, or near, the net ceded consideration received significantly reduces risk in the lower layer and thus the lower layer would fail the risk transfer criteria and would be classified as a deposit. If the overall premium can be bifurcated to the lower and upper layers and the upper layer passed risk transfer, the net impact of the bifurcation accounting would be to treat the upper layer of the contract as an excess of loss contract. If the overall premium cannot be bifurcated, the entire contract would be treated as a deposit.

**View B:** No, the existence of a loss corridor provision should not lead to bifurcation of a reinsurance contract into two separate contracts for purposes of applying the FAS 113 risk transfer criteria and accounting for the contract. FAS 113 does not require or permit accounting for the separate components of reinsurance contracts (i.e., insurance risk, financing, servicing, etc.) Although FAS 113 requires separate accounting for risk and non-risk portions related to different types of exposures, the existence of the separate components (i.e., insurance risk, financing, servicing, etc.) within a reinsurance arrangement does not automatically meet the criteria for separate accounting. Judgment must be applied to facts and circumstances to determine if different underlying exposures have been combined to meet risk transfer criteria. For example, in the case of a single exposure type (e.g., auto property) or in an aggregate
book of business, the losses below the loss corridor and expected loss amount would generally not meet the definition of nonrisk transfer coverage.

**Issue 2:** As a follow-on to Issue 1, assume a situation where the reinsurance contract being evaluated (Contract A) does not itself contain a “loss corridor” or similar provision that eliminates coverage for a certain specified amount of losses. However, assume that the ceding company has entered into a separate contract with a different third party reinsurer (Contract B Reinsurer) that effectively eliminates Contract A Reinsurer’s risk in the same corridor. Should Contract A be bifurcated?

**Example 2:** Contract A is a 40% “quota share” contract. Contract B is an excess of loss contract that attaches at a 70% loss ratio and has a limit at an 80% loss ratio. Contract A states that payments of losses under Contract A are “net of inuring reinsurance, whether or not collectible.” That is, if Contract B Reinsurer fails to make payments under its contract in the 70% to 80% loss ratio range, Contract A Reinsurer will not be responsible for such losses. Contract A also states that if other inuring reinsurance is cancelled (e.g., including Contract B) Contract A will also be cancelled.

**View A:** Yes, Contract A should be bifurcated because the existence of Contract B creates an implicit corridor that in substance achieves the same result to the ceding company as the explicit corridor in Example 1. The rationale and accounting for the contract on a bifurcated basis are the same as in View A of Issue 1. Because Contract A Reinsurer will never pay on a loss in the 70-80% loss ratio range, Contract A Reinsurer has not provided any coverage for this portion of the ceding company’s losses, and this fact creates a non-insured layer that separates Contract A into two separate layers.

However, if the inuring reinsurance is on an individual excess of loss basis rather than aggregate loss ratio basis, this would not create a corridor.

**View B:** No, Contract A should not be bifurcated for the reasons noted in View B of Issue 1. Furthermore, quota share contracts are often written “net of inuring reinsurance” and in many cases “net of inuring reinsurance, whether or not collectible.” Even when written without the term: “whether or not collectible,” there usually are other contract
terms that eliminate the quota share reinsurer’s exposure to the risk that the other reinsurers will not pay. Credit risk is not an element of insurance risk and therefore elimination of the provision so far as it relates to credit risk should not impact the accounting. Also, regardless of the collectibility issue, if the allocation of premium in the quota share contract is based on the net premium after the cost of such inuring reinsurance, the proportionate share of risk and reward has been removed and therefore the remaining risks are being shared via the quota share agreement.

**View C:** No, Contract A should not be bifurcated in Example 2. Proponents of this view support View A in Example 1, but believe that the facts in Example 2 are substantively different. They believe there is a substantive difference between a contract that has an explicit corridor and one that does not. In the former, the contract itself explicitly states that losses in a specified loss ratio range will not be paid. In the latter, it is the existence of other third party reinsurers that results in “the corridor.” This separate contract between the ceding company and Reinsurer B should not impact the accounting under Contract A. Also, regardless of the collectibility issue, if the allocation of premium in the quota share contract is based on the net premium after the cost of such inuring reinsurance, the proportionate share of risk and reward has been removed and therefore the remaining risks are being shared via the quota share agreement.

**View D:** Possibly. Contract A should not be bifurcated in Example 2 if the premium on which the quota share percentage is determined is after giving effect to the specific third party reinsurance. If the premium is determined before giving effect to the specific third party reinsurance, Contract A should be bifurcated. Proponents of this view support View A in Example 1, but believe that the facts in Example 2 are substantively different. They believe there is a difference between a contract that has an explicit corridor and a situation where the ceding company has purchased reinsurance and the pricing of the reinsurance contract reflects the cost of such other reinsurance. In the former, the contract itself explicitly states that losses in a specified loss ratio range will not be paid. In the latter, it is the existence of other third party reinsurers that results in “the corridor.” This separate contract between the ceding company and Reinsurer B should not impact the accounting under Contract A.

**Issue 3:** If the gap in coverage resulted from a sliding scale commission rather than a loss corridor, should the contract be bifurcated?
Appendix A – November 2003 paper submitted to the FASB by AcSEC and the Insurance Expert Panel

Example 3: Rather than a “loss corridor” between 70% and 80%, the Contract A provides for an initial ceding commission of 25%. The ceding commission will be reduced by one percentage point for every one percentage point increase in the loss ratio over 70%, with a minimum ceding commission of 15%.

View A: Yes, the contract should be bifurcated. The rationale and accounting described in View A of Issue 1 is the same for a loss corridor, a sliding scale commission, or any other contract provision that eliminates coverage for a portion of exposure to ceding company losses.

View B: No, the contract should not be bifurcated for the reasons noted in View B of Issue 1. A sliding scale commission does not eliminate coverage for a portion of the contract but merely provides for profit and loss sharing within the contract.

View C: No, the contract should not be bifurcated in Example 3. Proponents of this view support View A in Example 1, but believe that the facts in Example 3 are substantively different. In Example 3, Contract A is legally obligated to reimburse the ceding company for losses, including those in the loss ratio range from 70% to 80%. As a separate contract provision, the ceding company will be required to repay a calculated amount of the initial ceding commission based on profits generated under the contract. Legally, the cash flows under the loss reimbursement component of the contract and the ceding commission adjustment component of the contract are separate. That is, if the timing of the two are not simultaneous and are not subject to right of offset, the Reinsurer could legally be in a position of having paid the losses without yet having received his ceding commission reimbursement.

Issue 4: Does the existence of a loss corridor provision lead to bifurcation of a reinsurance contract into two or more separate contracts when the loss corridor provisions result in a substantial reduction, but not a complete elimination of coverage in the loss corridor?

Example: Loss corridor: 40% “quota share” contract; reinsurer will assume 5% of losses between a 70% and 80% loss ratio rather than the 40% losses assumed below and above the corridor.
View A: Similar to View A in Issue 1, the contract should be split, but in this case there would be three separate contracts, the component below the 70% loss ratio, the component between 70% and 80%, and the component above 80%. This split would be required whenever the coverage in the loss corridor differed from that below and above the corridor, no matter how insignificant the difference (i.e., split the contracts even if the loss corridor coverage is, for example, 39% and remainder above and below the corridor is 40%)

View B: Same as View B in Issue 1.

View C: The contract should be split into three different contracts, (the component below the 70% loss ratio, the component between 70% and 80%, and the component above 80%) only where the coverage in the loss corridor is significantly less than that below and above the corridor. Judgment would be applied to determine whether the coverage in the loss corridor was considered to be significantly less. If not significantly less, analyze as one contract.
Section 2: Determining Significant Insurance Risk:

Issues:

Issue 1: When assessing the risk transfer guidance in paragraph 9.a. of FAS 113, what constitutes the reinsured portions of the underlying contracts?

Issue 2: What type of qualitative or quantitative analysis is required to determine whether the reinsurer has assumed significant insurance risk under the contract? Which cash flows should be used in the analysis?

Issue 3: Under the requirements of paragraph 62 of FAS 113, what amount of correlation is needed between the ceding company’s and reinsurer’s cash flows to meet the requirement that the reinsurer’s payments “directly vary” with the amount and timing of the ceding company’s cash flows under the reinsured portions of the contracts?

Issues and Alternative Views:

Issue 1: When assessing the risk transfer guidance in paragraph 9.a. of FAS 113, what constitutes the reinsured portions of the underlying contracts?

View A: The proponents of View A believe the reinsured portions of the underlying reinsured contracts only include the portions of the losses that are subject to reimbursement under the reinsurance contract. Furthermore, the reinsured portions can be limited due to loss limiting features in the reinsurance contract. Therefore, reinsurance contract features that effectively exclude certain losses (i.e., loss corridors, aggregate limits and deductibles) will impact the reinsured portions of the underlying business reinsured. For example, a quota share contract with a feature that excludes certain losses (e.g., aggregate losses from a certain loss ratio to another loss ratio, known as a loss corridor) that absent the loss-limiting feature would have to be reimbursed under the reinsurance contract redefines the reinsured portions. Specifically, the “reinsured portion” for purposes of the 9.a. test is limited to only the portion of the underlying losses that the reinsurer reimburses the ceding company after consideration is given to any loss
limiting feature included in the reinsurance contract. Accordingly, a quota share contract with a loss corridor from an 80% loss ratio to a 90% loss ratio would result in the reinsured portion being losses from a 0 loss ratio to a 79% loss ratio and losses from a 91% loss ratio and above. Proponents of this view argue that while the corridor is part of the reinsurance contract, it would not be considered part of the “reinsured portions of the contract.” If an aggregate limit (“cap”) existed, losses above the cap also would be excluded from the reinsured portion. Furthermore, proponents of View A believe that an entire risk, for example, asbestos, may be completely excluded from a proportional or non-proportional reinsurance contract and therefore would not form part of the reinsured portions of the underlying contracts.

Proponents of View A also believe that only a contract feature that specifically modifies the amount of losses covered under the reinsurance contract can impact the reinsured portions. Therefore, a contract feature that adjusted another component of the contract and not losses, for example, a sliding scale commission, does not cause a portion of the losses from being considered as part of the reinsured portion of a contract. Therefore, for a reinsurance contract with a one point reduction in the ceding commission for each point increase in losses from an 80% loss ratio a 90% loss ratio, losses in the 80% to 90% loss ratio range would be included in the reinsured portions of underlying contracts when evaluating the 9.a. test. If an experience refund provision existed for losses from 0% to a 80% loss ratio, losses in that range would still be considered to be part of the reinsured contract because the experience refund provision is viewed separately from the loss reimbursements component of the contract (i.e. claims are paid in that range, and then a separate contract provision provides for reimbursement of certain amounts based on experience.)

View B: Proponents of this view agree with View A, except as it relates to the treatment of contracts with loss corridors, as described in Section 1. If a contract contains a loss corridor, View B proponents believe the contract would be bifurcated into two separate contracts, with one contract being that that reinsures losses below the corridor and a separate contract for the portion that reinsures losses above the corridor. The corridor itself would not be part of either contract, as it provides no coverage. Proponents of View B believe that View A is contradictory in that it states that the loss corridor is part of the reinsurance contract, yet it would not be considered part of the “reinsured portions of the contract.” Proponents of View B believe that an entire risk, for example, asbestos, may be completely excluded from a proportional or non-proportional reinsurance contract and therefore would not form part of the reinsured portions of the underlying contracts.
Appendix A – November 2003 paper submitted to the FASB by AcSEC and the Insurance Expert Panel

**View C:** Reinsurance contracts contain features that alter the cash flow amounts and types of risk that are covered under a reinsurance contract. Proponents of View C do not believe certain contract features that result in the exclusion of certain losses should alter the determination of reinsured portions for purposes of evaluating the 9.a. test. The inclusion of loss corridors, caps or deductibles that impose loss limits to the reinsurer reduce the risk to the reinsurer but those features do not change the fact that the risk is reinsured under the contract. Therefore, proponents of View C would conclude that the reinsured portions of a quota share contract with a loss corridor from an 80% loss ratio to a 90% loss ratio would include all losses (i.e., the losses in the loss corridor would not be excluded). If an aggregate cap existed, losses above the cap also would not be excluded from the reinsured portion. If an experience refund provision existed for losses from 0% to an 80% loss ratio, losses in that range would be considered to be part of the reinsured contract. Furthermore, the proponents of View C would concur with the proponents of View A in that a reinsurance contract that requires a portion of a ceding commission to be returned (i.e., sliding scale commission), impacts the amount of cash flows between the ceding and assuming parties, but does not redefine the reinsured portions of the underlying contracts. Consistent with Views A and B, proponents of View C believe that an entire risk, for example, asbestos, may be completely excluded from a proportional or non-proportional reinsurance contract and therefore would not form part of the reinsured portions of the underlying contracts.

Under some risk management strategies ceding companies may purchase other specific reinsurance that would inure to the benefit of both the ceding and assuming companies and cover certain losses before the application of another reinsurance contract. In those situations, the reinsured portions will be the losses on the underlying contracts after giving effect to the inuring reinsurance.

The proponents of View C believe that the above-mentioned view for defining the reinsured portions of the underlying contracts would be applied to both proportional and non-proportional reinsurance contracts.

**Issue 2:** What type of qualitative or quantitative analysis is required to determine whether the reinsurer has assumed significant insurance risk under the contract? Which cash flows should be used in the analysis?
Appendix A – November 2003 paper submitted to the FASB by AcSEC and the Insurance Expert Panel

**View A:** Insurance risk is comprised of both underwriting risk (uncertainty as to amount) and timing risk (uncertainty as to timing of payment). To determine if the reinsurer has assumed significant insurance risk under the reinsured portions of the underlying insurance contracts, the ceding company and reinsurer should evaluate the amount of variability in the reinsurer’s expected cash flows from claim and claim adjustment expenses and from adjustable features that are based on loss experience (such as additional premiums or adjustable commissions), by comparing such cash flows under various loss scenarios. Consideration also should be given to whether the reinsurer’s payments depend on and directly vary with the timing of claims settled under the reinsured contracts. For the underwriting portion of the insurance risk test, the View A analysis therefore focuses on comparing cash flows of the reinsurer in various loss scenarios rather than comparing the amount of cash flows of the ceding company versus those of the reinsurer (as described in View B and C). It is only for the timing risk portion of the test that View A supporters believe a comparison to ceding company cash flows is required.

**View B:** Paragraph 9.a. requires that the reinsurer must assume significant insurance risk under the reinsured portions of the underlying contracts. Paragraph 62 of FAS 113 notes that implicit in the 9.a. condition is the requirement that both the amount and timing of the reinsurer's payments depend on and directly vary with the amount and timing of claims settled under the reinsured contracts. In addition, EITF D-35, Q&A, Question 11, notes the following with regard to determining how the transfer of underwriting risk should be evaluated:

"Underwriting risk is defined in paragraph 121 of Statement 113 as “uncertainties about the ultimate amount of net cash flows from premiums, commissions, claims, and claim settlement expenses paid under a contract...” Therefore, whether underwriting risk has transferred to the reinsurer depends on how much uncertainty about those amounts has been transferred to the reinsurer.

Paragraph 62 of Statement 113 indicates that insurance risk transfer requires that both the amount and timing of the reinsurer’s payments depend on, and directly vary with, the amount and timing of claims settled under the reinsured contracts. Accordingly, the significance of the amount of underwriting risk transferred should be evaluated in relation to the ceding enterprise’s claim payments.”

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Based on the above guidance, View B proponents believe that the 9.a. test requires a comparison of the amount and timing of net cash flows of the ceding company versus those of the reinsurer. View A proponents believe that the first paragraph of the Question 11 response, coupled with paragraph 62 guidance, requires a comparison of the amount and timing of the net cash flows (premiums, commissions, claims, and claim settlement expenses, however characterized) of the ceding company under the reinsured portions of the contract, with those of the net cash flows of the reinsurer under various scenarios. The second paragraph of Question 11 and paragraph 62, in referring more narrowly only to "amount and timing of claims" and "claim payments" rather than "net cash flows" could be interpreted literally as requiring a comparison of only claim payment cash flows (rather than all net cash flows) of the two parties in assessing underwriting risk. However, View B proponents believe that contracts can be constructed to reduce underwriting risk through adjustable premiums, commissions, or other adjustable features and thus all the cash flows need to be considered in assessing underwriting risk. In addition, while Question 11 and the glossary definition of net cash flows do not explicitly include reference to other costs related to the business reinsured (such as acquisition costs other than commissions and other operating expenses for which the reinsurer may reimburse the ceding company through a ceding commission or otherwise), such expenses also should be included in the net cash flows to be compared, as further described below.

Proponents of View B believe that to determine if the reinsurer has assumed significant insurance risk under the reinsured portions of the underlying insurance contracts, the net financial result (premiums less losses, commissions and other costs related to the business reinsured) of the direct business should be compared to the net financial result of the reinsurer under the reinsurance contract. This analysis would typically involve a comparison of the following:

- Ceding company financial results for reinsured portion of direct business (net of other inuring reinsurance)
- Reinsurer net financial results
- Ceding company net financial results for reinsured portion, after giving effect for the reinsurance contract.

Proponents of View B also believe that judgment should be used when selecting the acquisition and other operating expenses to be included in the analysis to determine if the reinsurer assumes significant insurance risk, and the type of insurance contract (proportional vs. non-proportional) will impact those expenses. For example, a proportional contract that covers 50% or less of a particular business may have to use the variable acquisition cost associated with
that business. But, if a proportional contract covers 100% of a particular business the expenses used may need to include both the variable acquisition cost and the fixed cost related to that business. Reinsurance contacts that cede more than 50% will require judgment as to the appropriate expenses to be included based on the specific facts relating to the underlying business. For non-proportional reinsurance contracts there are often no ceding commissions; however, for non-proportional reinsurance contracts that contain ceding commissions, for purposes of the analysis to determine if the reinsurer has assumed significant risk, such ceding commissions should be evaluated in a manner similar to ceding commissions on proportional reinsurance contracts.

The above analysis would be performed to evaluate the reinsurance contract for underwriting risk. To satisfy the timing risk analysis, the contract terms would also need to be evaluated to ensure that there are no timing delays in reimbursement of claims, either explicitly or implicitly.

**View C:** Proponents of this view believe that if a contract passes the 9.b. “reasonable possibility of significant loss” test, and assuming that the underlying contracts being reinsured have insurance risk, the underwriting risk component of the 9.a. test has also implicitly been passed. Therefore, proponents of View C believe that the only additional test required by 9.a. is to ensure that no contractual provisions exist that would delay timely reimbursement of claims. (Some observers note that this view may occur in practice).

**View D:** Similar to View B, proponents of this view believe that the 9a test requires a comparison of the amount and timing of cash flows of the ceding the company versus those of the reinsurer. However, proponents of this view believe that, when applying the 9a test, the relevant cash flows of the ceding company are the claim payments made by the ceding company under the reinsured portions of the contract. These claims payments should be compared to the cash flows between the ceding company and the reinsurer, under the contract, when evaluating the contract under the 9a test. The fundamental characteristic of insurance is the indemnification of the insured party against loss or liability. The net cash flows under the reinsurance contract represent the cost of indemnifying the ceding company for the claim payments.
**Issue 3:** Under the requirements of paragraph 62 of FAS 113, what amount of correlation is needed between the ceding company’s and reinsurer’s cash flows to meet the requirement that the reinsurer’s payments “directly vary” with the amount and timing of the ceding company’s cash flows under the reinsured portions of the contracts?

**View A:** This issue is not applicable for the proponents of View A of Issue 2, as that view does not require a comparison of the amount of ceding company and reinsurer cash flows. However, proponents of View A of Issue 2 believe that consideration should be given to whether the reinsurer’s payments depend on and directly vary with the timing of claims settled under the reinsured contracts.

**View B:** To document that the contract passes the 9.a. test, despite the existence of any risk limiting features, the ceding company should be able to demonstrate that there is a **high correlation** in amount and timing of ceding company and reinsurer cash flows (as defined in Issue 2 of this section) for a **substantial portion** of the expected contract cash flows. In contrast, if the correlation was low, or if high correlation existed only for a small portion of total expected cash flows, the 9.a. test would not be met.

**View C:** Proponent of View C believe that a company would need to demonstrate that the ceding company and assuming company cash flows moved in the **same direction**, (e.g., if ceding company direct losses, covered by the reinsurance contract increased, the assuming company would make a loss payment), but such payments would not need to be fully correlated (i.e., exactly proportional). Also, as long as this correlation could be demonstrated for **some portion of the contract cash flows that were more than insignificant**, the 9.a. test would be met.

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Section 3: Paragraph 11 exception

Issues:

Issue 1: Would a contract fail the paragraph 11 exception requirement to transfer “substantially all of the insurance risk relating to the reinsured portions of the underlying insurance contracts” if it includes an experience refund or similar provision that returns more than insignificant favorable experience to the ceding company?

View A: No. The existence of such a provision would not automatically cause a contract to fail the paragraph 11 exception requirement. Paragraph 11 requires that substantially all the expected losses relating to the reinsured portions of the underlying insurance contracts be assumed by the reinsurer, but it does not require that substantially all expected gains be transferred.

View B: Yes, unless the potential experience refund under any scenario was insignificant. Paragraph 67 notes that the paragraph 11 exception was meant to apply in very limited circumstances, and notes that “the reinsurer’s economic position is virtually equivalent to having written the insurance contracts directly.” This has often been referred to in practice as the reinsurer “stepping into the shoes” of the ceding company. Having an economic position that is virtually equivalent to having written the insurance contracts directly implies a concept of passing not only substantially all the risks but also the rewards of the contracts. Therefore, the existence of an experience refund provision would make the contract ineligible for the paragraph 11 exception. In addition, Question 24 of EITF D-34 specifically requires that the assessment of the reinsurer’s economic position in relation to that of the ceding company be made by comparing the net cash flows of the reinsurer under the reinsurance contract with the net cash flows of the ceding company on the reinsured portions of the underlying contracts. This implies that the “virtually equivalent” cash flows refer to both gains and losses, not just losses. Otherwise, the test would only have required comparison of the losses of the reinsurer versus that of the ceding company.

(The Insurance Expert Panel unanimously agrees with View B)

Issue 2: Would the existence of a contract limit cause a contract to fail the paragraph 11 exception requirements; for example, a quota share contract with an aggregate limit (loss ratio cap) on claim payments in the event that loss experience was unfavorable?
View A: No, the mere existence of such a cap would not cause the contract to fail the paragraph 11 exception. As long as it was considered remote that the cap would be reached, it would still qualify for the exception, even if in the remote scenario(s), the cap would cause more than an insignificant difference between the net cash flows of the ceding company and those of the reinsurer.

View B: No, the mere existence of such a cap would not cause the contract to fail the paragraph 11 exception. Because paragraph 11 requires that substantially all of the insurance risk relating to the reinsured portions of the underlying insurance contracts has been assumed by the reinsurer, losses above the cap would not be included in the comparison of net cash flows of ceding versus assuming company. Therefore, the analysis would include net cash flows of the ceding company versus the reinsurer, excluding losses above the cap. Opponents of this view note that as described in Question 24 of EITF Topic D-34, determining the premium component of the net cash flows of the ceding company relating only to the reinsured portions of such a contract would be difficult.

View C: Yes, the existence of such a cap would cause the contract to fail the paragraph 11 exception, unless it could be demonstrated that only a trivial amount of risk would be retained by the ceding company as a result of the cap under any scenario, no matter how remote the likelihood of occurrence. That is, the test would not involve any consideration of the probability that the cap would be met. Even if the likelihood of reaching the cap were remote or extremely remote, the fact that the contract could potentially result in a different loss to the reinsurer than the ceding company that was more than trivial would prevent the paragraph 11 exception from being met.

This exception was meant to be applied in very limited circumstances. Furthermore, Question 24 of EITF Topic No. D-34 notes that the FAS 113, paragraph 11 cash flow analysis requires a comparison of the ceding company’s premiums and losses relating only to the reinsured portions of the contract with the premiums and losses of the reinsurer, and acknowledges that this comparison may be difficult in other than unlimited risk quota share reinsurance. This is because it would generally be difficult to determine the ceding company’s premiums for the reinsured portions of the underlying insurance policies.
View D: Possibly, further analysis would be required to determine whether the existence of the cap would result in all but a trivial amount of the insurance risk on the reinsured portions of the contract from being transferred. This analysis would consider both the likelihood that the cap would be reached in combination with the magnitude of risk retained when the cap is reached. That is, a probability weighted analysis would be performed in assessing the insignificance of the retained risk. For example, if the likelihood that the cap would be reached was considered extremely remote, but the dollar amount of the risk retained by the ceding company was more than insignificant in that scenario, the probability weighted amount, along with the probability weighting of various other scenarios, would need to be considered to determine whether the amount of risk retained in all probability weighted scenarios was trivial. The analysis could also be accomplished by assessing whether the pricing would change in response to an increase in the cap from that being proposed. For example, if the cap was a 150% loss ratio, and raising the cap to a 200% loss ratio would cause a change in the net amount paid to the reinsurer (premiums less commissions) that was more than trivial, then the cap of 150% would not pass the insignificance test.
Appendix – Relevant Terms

Pro rata reinsurance

"Pro rata reinsurance is a sharing, on a predetermined basis, by the insurer and the reinsurer of premiums and losses on a risk, class of risks, or particular portion of the insurer's business. In consideration of a predetermined portion of the insurer's premium or premiums, the reinsurer agrees to pay a similar portion of claims and claim-adjustment expenses incurred on the business reinsured. The reinsurer's participation in the claims is set without regard to the actual frequency and severity of claims. Pro rata reinsurance can be effected by means of quota share or surplus share reinsurance."

"Quota share reinsurance is a kind of pro rata reinsurance in which the ceding company cedes a proportional part (a percentage) of risks to the reinsurer, and in turn will recover from the reinsurer the same percentage of all losses on those risks. For example, under a 50-percent-quota-share treaty the reinsurer receives 50 percent of the insurer's premiums, less ceding commissions, and is obligated to pay 50 percent of each claim as well as the claim-adjustment expense incurred by the insurer. Such reinsurance is frequently used for new lines or by new companies; for example, a company just entering the casualty field may arrange for quota share reinsurance only for its casualty business."

"Surplus share reinsurance is insurance that reinsures on a pro rata basis only those risks on which the coverage exceeds a stated amount. Under a surplus treaty, an insurer might reinsure what it considers to be surplus exposure under each large dwelling policy that it writes. For example, the insurer might reinsure the amount of each dwelling policy above $25,000; the insurer would reinsure $15,000 on a dwelling policy for $40,000. Premiums and losses are shared by the reinsurer and the insurer on a pro-rata basis in proportion to the amount of risk insured or reinsured by each. The reinsurer would not participate at all in any losses incurred on policies with limits of $25,000 or less."

Excess of loss reinsurance

"Under excess reinsurance, the insurer limits its liability to all or a particular portion of the amount in excess of a predetermined deductible or retention. Thus, the reinsurer's portion of the loss depends on the size of the loss. The relationship between the premium and claims of the insurer and the reinsurer is not proportional. Excess reinsurance takes three basic forms: per risk basis, per occurrence basis, and aggregate basis."
"Excess of loss per risk reinsurance requires the insurer to pay all claims up to a stated amount or retention limit on each risk covered under the reinsurance, such as all fire policies written. The reinsurer reimburses the insured for the portion of any claim in excess of the insurer’s retention, subject to the limit stated in the reinsurance agreement."

Excess of loss per occurrence reinsurance requires the insurer to pay all claims up to a stated amount or retention limit on all losses arising from a single occurrence. The reinsurer pays claims in excess of the limits. One purpose of obtaining per occurrence excess reinsurance is to protect a company from the accumulation of losses arising from earthquakes, tornadoes, or similar occurrences. Such reinsurance is also referred to as catastrophe reinsurance.

"Aggregate excess of loss reinsurance requires the insurer to pay all claims during a specified period up to a predetermined limit for the period on all its business or any definable portion of the claim. This is usually expressed as a loss ratio (for example, reinsurance against losses that would cause a company’s loss ratio to exceed 75 percent). Such reinsurance is also referred to as stop loss reinsurance."

**Insurance Risk**

"The risk arising from uncertainties about both (a) the ultimate amount of net cash flows from premiums, commissions, claims, and claim settlement expenses paid under a contract (often referred to as underwriting risk) and (b) the timing of the receipt and payment of those cash flows (often referred to as timing risk). Actual or imputed investment returns are not an element of insurance risk. Insurance risk is fortuitous— the possibility of adverse events occurring is outside the control of the insured."
Appendix B: Cross-reference to significant issues discussed in comment letter by paragraph number

**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 Statement 113 guidance be modified or clarified to apply to insurance contracts?

See discussion in paragraphs 3, 6, 7 and 8 of the comment letter.

**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?

See discussion in paragraph 2 of the comment letter.

**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 discussions in paragraphs 57 – 59?

See discussion in paragraph 6 of the comment letter.

**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?

See discussion in paragraph 6 of the comment letter.

**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?

See discussion in paragraphs 2 and 4 of the comment letter.

**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?

See discussion in paragraph 5 of the comment letter.

**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?

See discussion in paragraph 2 of the comment letter.