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LETTER OF COMMENT NO. 41

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August 24, 2006

Mr. Lawrence Smith  
Director of Technical Applications and Implementation Activities  
Financial Accounting Standards Board  
401 Merritt 7, P.O. Box 5116  
Norwalk, CT 06856-5116

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

File Reference No. 1325-100

American International Group, Inc. (AIG) appreciates the opportunity to respond to the May 26, 2006 FASB Invitation to Comment on *Bifurcation of Insurance and Reinsurance Contracts for Financial Reporting* (the "ITC").

AIG is the world's leading international insurance and financial services organization, with operations in more than 130 countries and jurisdictions. AIG member companies serve commercial, institutional, and individual customers through the most extensive worldwide property casualty and life insurance networks of any insurer.

We understand the Board's concerns that have prompted a reconsideration of the existing accounting for certain insurance and reinsurance contracts in an effort to improve financial reporting. Nevertheless, we have some significant reservations regarding the ITC's proposed framework.

We have included our responses to the specific questions in the ITC in Appendix A of this letter. Our responses reflect the following general comments and observations:

- We believe existing principles-based guidance in Statement 113 and its interpretive literature is adequate and effective for analyzing insurance risk transfer for both insurance and reinsurance contracts. We have recently worked quite extensively to improve our enterprise-wide risk transfer policy, which we believe is extremely thorough and adequately addresses the variety of contracts that our organization is a party to. We would encourage authoritative guidance, perhaps in the form of an FSP or FASB Interpretation that clarifies the definition of

insurance and provides additional guidelines for determining whether significant insurance risk has been transferred. Some basic tenets may include the following:

- Further defining “reasonably possible” and “significant loss”
  - Addressing low frequency, high severity exposures
  - Considering qualitative versus quantitative information
  - Requiring documentation or representations
  - Describing how common risk limiting features affect risk transfer assessment
- We do not believe that a principle can be developed that would adequately distinguish contracts with significant risk-limiting features to narrow down the applicability of the bifurcation model to “finite-risk type” products.
  - We would not be in support of a bifurcation approach for insurance contracts because we believe, in most cases, bifurcation (a) would not provide more understandable or decision useful information for financial statement users, (b) would be impractical for most, if not all, companies to implement and (c) would likely result in decreased consistency and comparability in financial reporting. In addition, we believe that the initial and ongoing costs associated with a bifurcation approach, both from a preparer standpoint in collecting and processing the necessary information and from a user standpoint in meaningfully analyzing and interpreting that information, far outweigh the benefits that could ever be derived.
  - We believe that it is more appropriate to evaluate a contract in its entirety, because the various components are most often interrelated and would typically not be found as standalone transactions in the marketplace. Policyholders are willing to pay for protection against unanticipated cash outflows including uncertainty regarding both timing and amount. Coverage for timing risk is intrinsic in the construction of every insurance policy thereby making identification and bifurcation of the portion of premiums relating to timing risk (that is, the financing component) impracticable or arbitrary at best.
  - Finally, it would be premature to consider adopting a broad change in GAAP methodology while the IASB is currently developing a model for insurance contracts that eventually will become a joint project with the FASB.

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If you have any questions regarding the contents of this letter, please contact myself at 212-773-6463, and we would be pleased to discuss our comments with the Board or the FASB staff at your convenience.

Very truly yours,

/s/ Mr. Anthony Valoroso  
Deputy Comptroller  
Director of Accounting Policy

cc:

Steven Bensinger  
Executive Vice President and Chief Financial Officer

David Herzog  
Senior Vice President and Comptroller

## Appendix A

### 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?**

We believe the IFRS 4 definition of *insurance contract* does sufficiently distinguish those contracts from other financial contracts. However, we believe the definition could be enhanced to acknowledge that a contract need not be an individual policy. It could also encompass a grouping of policies linked in an overall governing contract with the policyholder. While individual policies within such a program may not have sufficient insurance risk to qualify for insurance accounting, the overall program may.

Even if the list of risk limiting features were expanded upon, we believe the descriptions of risk limiting features are not definitive, and they do not provide a means for specifically identifying those contracts. Almost all insurance and reinsurance contracts contain features that limit risk, including policy limits, deductibles, exclusions, etc. The contract terms and features that are cited in the ITC as limiting risk transfer include some of those that have been used in finite reinsurance business, however some of these same features or terms can also be used in contracts that would not be considered to be finite.

Authoritative guidance that acknowledges common contractual terms that can limit the transfer of insurance risk can be helpful to the reporting entity in applying the risk transfer “test” in Statement 113. If the contract terms and features listed in the ITC are used for that purpose, we believe the following additional features could be added to the list to make it more comprehensive:

- 1) Claims bonuses or sliding scale commissions
- 2) Funds held provisions other than those pursuant to local law or regulation.
- 3) Any provision for coverage of events that are known to have occurred (retroactive), excluding “roll forward” provisions within the termination clause of an agreement.
- 4) Contracts that are required to be renewed or that mandate the exercise of extended reporting provisions.

- 5) Contracts where a loss is “covered” only upon the occurrence of more than one loss event and /or the combination of a covered loss event with other qualifying conditions.
- 6) The contract contains an embedded derivative, as defined in Statement 133.
- 7) Contracts between an insurance company and a third party where it is known that the third-party does, or intends to, retrocede back to an affiliate of the insurance company.

**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?**

We believe that corporate policyholders and insurers should be able to apply the risk transfer guidance in Statement 113 to insurance contracts where there is a reasonable possibility of significant losses, such as a D&O or workers’ compensation policy. This is generally the case when the policy covers multiple risks and/or multiple locations. However, the Statement 113 risk transfer guidance will need to be updated for insurance policies covering a single asset or operation or a single event, for example, where the amount of loss may be significant (high severity) but the probability of a loss occurring is remote (low frequency), unless such policies can be made exempt from the risk transfer tests because they are deemed to unequivocally transfer insurance risk.

**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?**

We would not be in support of bifurcating insurance contracts for financial reporting purposes because we believe, in most cases, bifurcation (a) would not provide more understandable or decision useful information for financial statement users, (b) would be impractical for most, if not all, companies to implement and (c) would likely result in decreased consistency and comparability in financial reporting. An insurance model inherently incorporates a degree of financing. We believe US GAAP insurance accounting is appropriate and understandable and faithfully represents the underlying economics.

We believe that it is more appropriate to evaluate a contract in its entirety, because the various components are most often interrelated and would typically not be found as standalone transactions in the marketplace. Policyholders are willing to pay for protection against unanticipated cash outflows including uncertainty regarding both timing and amount. Coverage for timing risk is intrinsic in the construction of every insurance policy thereby making identification and bifurcation of the portion of premiums relating to timing risk (that is, the financing component) impracticable or arbitrary at best.

*Non-life contracts*

It is our opinion that bifurcating insurance contracts into insurance and deposit components would be impractical, confusing and inconsistent among insurers as well as policyholders. Large commercial risks for many coverages, including workers compensation, general liability, and commercial auto liability (among others), typically incorporate policyholders' belief that a loss of some degree will occur. It would be impractical to attempt to bifurcate and exclude from insurance accounting a portion of the losses for every such insurance contract. Administratively this would be a monumental effort, even if all the data were available, not to mention the ongoing separation of accounting of results each quarter for the separately bifurcated components for every contract. Different insurers would undoubtedly develop their own techniques for bifurcation, resulting in confusing and inconsistent comparisons of results among insurers.

*Life contracts*

Specifically with regard to life insurance contracts, cash flow estimates used to determine the deposit and insurance portions of the contract cannot be made with any degree of certainty at the individual contract level. Even at the group level, accumulated assets may be used to fund future death claims, or to fund other optional benefits such as life income or disability waiver of premium, or to fund future cash surrender payments. Investment income generated at the group level is a material contributor to funding all the future benefits for long duration contracts. There are often cross subsidies between insurance risk charges, service fees, and credited interest. A dividing line between assets funding future withdrawals and assets funding future claims would depend on unverifiable estimates of uncertain policyholder behavior. At any given point in time, it is indiscernible as to whether a customer is ultimately funding his own savings, his own future death benefits, or another policyholder's future death benefits. The use of customer's "account value" to pay part of the death claim seems very different from a discretionary withdrawal of a deposit.

*Qualitative Analysis*

The qualitative characteristics that most influenced our decision were understandability and cost benefit considerations. We do not believe that bifurcation of insurance contracts will provide financial statement users with information that is easily understood. The basic long and short duration insurance models have been understood by financial statement users for decades, notwithstanding modifications to the accounting guidance that has evolved over the years as the industry and the marketplace has developed to meet policyholder needs. Additionally, we believe that the initial and ongoing costs associated with a bifurcation approach, both from a preparer standpoint in collecting and processing the necessary information and from a user standpoint in meaningfully analyzing and interpreting that information, far outweigh the benefits that could ever be derived.

**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?**

We do not favor a bifurcation approach as discussed earlier in this letter (see Issue 3 comments).

**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?**

We do not believe that the unequivocal transfer of insurance risk should be limited only to those policy types identified. The existence of policies that only cover a single risk, or all risks related to a single asset or event, is limited. Thus, the guidance, as proposed, would essentially limit the applicability of this provision to personal lines property insurance and individual life insurance, when there are many commercial insurance policies that we believe unequivocally transfer significant insurance risk. In addition, we suggest that the characteristic requiring no expectation of a claim be replaced by a more principles-based characteristic (see below).

In addition, the terms "a substantial percentage of the maximum coverage provided" and "standard market terms" would be subject to the judgment of individual insurers and their definition could vary substantially from company to company, so we have suggested modifications to those criteria. AIG's business reflects many non-standard exposures and it is not practical to suggest that any risk which has unusual limits or deductibles would fail to meet the required characteristics.

*Principles-based analysis*

We believe that an insurance contract, regardless of the type of coverage, unequivocally transfers significant insurance risk if it meets the following characteristics:

- a. The contract has a level of premium that is not a substantial percentage of the maximum coverage provided. Any deductibles and coverage limits are fixed and also are based on standard market terms, if applicable.
- b. The contract has no risk-limiting features that adjust the profit or loss on the contract based on the claim loss experience of the contract.
- c. The contract must solely rely on the “pooling” of risks to be economically feasible for the insurance company to enter into the contract.

To expand on part (c) above, if the insurance company must enter into a large number of similar contracts with other policyholders in order to expect to make a profit from writing that policy, it is a strong indication that the policy transfers risk. This “law of large numbers” concept is the cornerstone of the insurance model. Policyholders pay premiums based on fair underwriting estimates (pools of risks). If there were no pooling, the policyholder would essentially be funding his own account, and the amount paid to the insurer would unequivocally represent a deposit. For long duration individual life contracts, one person’s death claim will partly be funded with premiums paid by others, and also with a significant amount of interest income generated by the premiums paid by everyone in the pool. For short duration property and casualty contracts, one insured’s loss is funded with premiums paid by others in that policy period.

**Are the examples in Appendix B representative of the discussion in paragraphs 57–59?**

Yes, but they are not representative of the discussion, as modified by our above commentary and suggested modifications to the characteristics identified for contracts that do unequivocally transfer significant insurance risk.

**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)?**

We believe the characteristics with our suggested modifications are an improvement over paragraph 11 of Statement 113.

**Issue 7:**

**Do you prefer Approach A or Approach B for identifying contracts subject to bifurcation? Why?**

**If so, how would you describe that approach?**

**Would your preferred approach be operational?**

**Would it make financial statements more decision useful?**

**Do you believe that another approach would be superior?**

We do not favor a bifurcation approach as discussed earlier in this letter (see Issue 3 comments). Nevertheless, and only given the choice between Approach A (bifurcation in limited circumstances) and Approach B (bifurcation in all cases where risk transfer is not unequivocal), we would opt for Approach A.

Our view is that bifurcation is not practical and should not be adopted. We do not believe it would make financial statements more decision useful. Of the two alternatives presented, Approach A is clearly less problematic than Approach B. However, a more robust definition of "significant risk limiting features" would be needed in order for companies to at least attempt to apply the same approach.

**Issue 8:**

**Should the criteria for bifurcation be different for insurance contracts and reinsurance contracts? Why?**

**If yes, what differences would you suggest?**

We do not favor a bifurcation approach as discussed earlier in this letter (see Issue 3 comments). However, we believe that any criteria that may be developed should be the same for insurance and reinsurance. The difference, in this case, is the unit of account upon which the risk transfer test is applied. Presumably, the requirement to bifurcate would be much more likely to occur in a reinsurance contract as opposed to an insurance contract, primarily due to the pooling of risks and expected losses inherent in every reinsurance contract that would cause every reinsurance contract to automatically "fail" the unequivocal transfer of significant insurance risk screen. That said, a reinsurance contract that transfers substantially all of the insurance risk related to underlying life insurance contracts (i.e. Statement 113 paragraph 11 exemption) should not require bifurcation or even a risk transfer analysis.

**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?**

We do not favor a bifurcation approach as discussed earlier in this letter (see Issue 3 comments). However, we have the following comments regarding the bifurcation methods identified in the ITC.

The expected payout method would only be reasonable if the contract has clearly delineated sections with some sections easily identified as the financing portion and others easily identified as transferring insurance risk. This would allow the cash flows to easily be split into the deposit portion and the insurance portion.

The proportional method would be reasonable if there is no simple way to split the contract into sections. In this case, a proportional allocation of the entire cash flows of the contract only works if you could reasonably determine a percentage split of the contract between policyholder risk and insurance risk. The calculation of this split would likely be very difficult and arbitrary, with inconsistent methods used by different companies.

The cash flow yield method has the most conceptual merit of the approaches presented. It is the simplest to understand and implement. However, this approach artificially “backs into” the insurance element by pulling out an implicit loan. As a result, the simplicity and comparability this approach may afford would be at the expense of the most representatively faithful presentation, because interest and time value are fundamental concepts within the insurance model and should not be removed, in their entirety from the insurance portion.

**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?**

AIG and, to our knowledge, other insurance companies do not use any of the methods presented in the ITC to price or underwrite their property/casualty products. Thus, an entirely new set of calculations would have to be performed for every contract for which any new requirements were imposed to test for bifurcation.

Data is not generally available at the individual contract level to provide the basis for the type of analysis that is suggested by the proposed methods. Thus, a requirement to account for contracts on a bifurcated basis would impose procedures that would have to take into account the data availability limitations. The data availability issues would affect most if not all of our commercial insurance lines of business.

Furthermore, data availability would be particularly difficult in cases where new products are introduced with little or no historical information on their performance. Models for pricing are used to a limited extent since data is not arrayed in a fashion conducive to dividing premium into its component parts.

The cost, complexity and potential for inconsistencies and misapplications are all quite significant.

**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?**

In our view, it would be premature to consider adopting a broad change in GAAP methodology while the IASB is currently developing a model for insurance contracts that eventually will become a joint project with the FASB Board.