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Technical Director – File Reference 1325-100
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, Connecticut 06856-5116



LETTER OF COMMENT NO. 40

RE: Invitation to Comment on Bifurcation of Insurance and Reinsurance Contracts for Financial Reporting (File No. 1325-100)

Dear Technical Director:

XL Capital Ltd (XL, we or our) would like to thank you for the opportunity to respond to the Invitation to Comment on Bifurcation of Insurance and Reinsurance Contracts for Financial Reporting (the “ITC”). We are pleased to have the opportunity to comment on proposals that will have a significant impact on financial reporting in the insurance and reinsurance industry.

Whilst we do not oppose separating insurance contracts into clearly defined risk transfer and non-risk transfer coverages, which exists in current GAAP guidance (EITF D-34 ‘*Accounting for Reinsurance: Questions and Answers about FASB Statement No. 113*’), we believe that the proposed bifurcation approaches proposed in the ITC neither achieve the FASB’s objectives to improve the decision usefulness of financial reporting information nor are superior to today’s existing accounting regime. The rationale supporting this assertion is discussed in the remainder of this letter and in the attached appendix.

We do not believe that the principle based FAS 113 should be replaced with a rules based approach, as proposed in the ITC. We believe that the restatements related to the topic of risk transfer noted in the past several years are a result of misapplication of appropriate existing guidance. Accordingly, we believe the development of appropriate implementation guidance that specifically addresses the facts, features and circumstances underlying such arrangements and evaluation of risk transfer, as well as any other contracts that have been identified as critical as a result from the undertaking of this project, should be developed by the FASB. We also believe the adoption of the bifurcation framework proposed by the ITC could result in reducing the relevance, reliability, understandability, and decision usefulness of financial statements that would incorporate such techniques.



We have a number of concerns with the framework proposed in the ITC. Our concerns are primarily based around our belief that bifurcation, under such a proposed framework, will neither improve the decision usefulness of reported financial information nor be practical to implement. We further believe that the additional subjectivity that is proposed in the ITC will only act to increase the scope for divergent practices and reduce the comparability of financial information related to insurance and reinsurance contracts. Requiring bifurcation would presume that there is a discrete, identifiable point at which risk transfer ends and non-risk transfer begins. While this point might be clear in a limited number of contracts, in many other contracts it is a matter of significant judgment and therefore would result in significant diversity in practice.

Our responses to the specific questions raised by the ITC are attached in the Appendix. We appreciate the opportunity to comment on such an important issue and we would be pleased to discuss any of these issues with you in detail if this would be helpful. You may contact me on (441) 294-7385.

Yours sincerely

A handwritten signature in black ink, appearing to read 'S. Robb', with a large, sweeping flourish at the end.

Stephen Robb
Accounting Policy and SEC Reporting Officer
cc: Jerry de St. Paer, EVP & Chief Financial Officer
Simon Rich, SVP & Controller
Jenny Ross, VP, Accounting Research

Appendix

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 that the current definition of insurance under IFRS 4 could be enhanced by limiting compensation to the amount of the policyholder's loss, including the concept of timing risk which is a key component of insurance risk, and the inclusion of the concepts detailed in paragraph 10 (c) of FAS 133 which excludes price changes as representing financial risk. Paragraph 10 (c) defines a contract as a contract of insurance:

"if it entitles the holder to be compensated only if, as a result of an identifiable insurable event (other than a change in price), the holder incurs a liability or there is an adverse change in the value of a specific asset or liability for which the holder is at risk"

While we believe that the features noted in the description of finite insurance and reinsurance contracts in the ITC are indicative of certain components that would indicate a need for a rigorous assessment of risk transfer we do not believe that there is a necessity for a definition of a finite risk contract. The levels of risk associated with individual insurance and reinsurance contracts fall within a spectrum of frequency and severity from those contracts covering "working layer" exposures to those covering "catastrophic" exposures with an equally wide array of features available to strike the necessary balance between risk and reward for both the buyer and seller. Risk limiting features are often introduced because the risk addressed is unknown or unquantifiable. A prescribed definition of a "finite risk" contract would not add anything to the necessary assessment of risk transfer under paragraphs 9 and 10 of FAS 113.

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 the FAS 113 guidance is appropriate for use by all parties to insurance and reinsurance contracts. FAS 113 provides an appropriate principles based framework for the assessment of contracts and therefore instead of modification, we believe that improved practical guidance in applying FAS 113 could be developed for accountants, actuaries and underwriters with regard to the evaluating the substance of contracts, associated risk transfer and disclosure. The FASB might consider the inclusion of disclosure guidance similar to that included in paragraph 24 of FIN 46(r) which would require companies to disclose the existence, extent and nature of significant (material) insurance and reinsurance relationships with certain features. This type of more clearly defined disclosure requirement has been put in place by the NAIC as a result of the changes to SSAP 62 in 2005. For most corporate non-insurance entities, insurance related balances are not a significant item and do not result in separate disclosure. The separate classification of a portion of insurance premiums and recoveries as deposits is unlikely to result in useful information for financial statement users.

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 believe that the bifurcation of insurance and reinsurance contracts, as proposed in the ITC, may result in less understandable and relevant decision useful information. In addition to the complex, costly and onerous process requirements, bifurcation will insert yet another level of subjectivity into financial reporting. As such, the bifurcation proposals may contribute further to the incomparability of financial results between different companies. To date it is our belief that the restatements and disclosure issues that have been reported have related largely to inappropriately structuring contracts with the intent not to transfer risk either through design or extra contractual arrangements. An appropriate assessment under the current accounting guidance would have resulted in financial reporting consistent with the economic substance of the arrangements. While potential contract features may result in a certain degree of “dollar swapping”, which could be viewed as financing in nature, today’s contracts are often so complex that attempting to determine a distinct line between the two aspects of the arrangement is neither practical nor useful. Users of the financial statements will be subjected to further application of judgment and potential financial engineering in the design of contracts.

The practical ‘substance’ of a contract is a single priced transaction between two professional companies. Therefore, pricing and terms and conditions while potentially complex, all form part of one transaction. Under this view of “substance”, bifurcation creates a false situation and not one where a ‘true’ answer exists. It is fundamental to the nature of insurance that the insured and the insurer will have different views of the likely outcomes. The determination of the appropriate reflection of the ‘economic substance’ of a contract of insurance or reinsurance is an area currently under great scrutiny. A common view of what that economic substance is does not exist. To further complicate that question by requiring bifurcation is unnecessary. Currently users of the financial statements have developed their own view of the economic substance of businesses underwritten through the use of certain ratios and formulas applied in the assessment of results. While under the current guidance it is possible for two companies to come to different conclusions with respect to risk transfer of a contract as a whole, generally speaking, these areas of difference are limited to those contracts in which risk transfer of the entire contract is in question. Under a model which requires such an assessment of every contract (other than those which contain an “unequivocal transfer of risk” as outlined in the ITC; which in the reinsurance environment would be limited) including the point of bifurcation between the amount of risk exposed premium and financing component, the variation of results between companies with similar portfolios will be significant. This will result in the ratios which drive the users’ view of these portfolios containing potentially substantial differences as a consistent quantitative method of application would be almost impossible to define and monitor. Adding bifurcation, with all of its necessarily subjective elements, will result in a lack of comparability within financial results, thereby increasing inconsistency between companies’ reporting rather than improving consistency.

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 believe that the current accounting model includes an appropriate sequence for analyzing insurance and reinsurance contracts. This model requires only one assessment of the risk transfer associated with the contract and prescribes the accounting that follows from that assessment. Decision boxes a), c), d) and e) should be collapsed into one assessment of risk transfer and indemnity under FAS 113 while decision box b) relates to assessment driven by FAS 133 which is independent of this aspect of insurance contract bifurcation. We believe that collapsing these decisions is appropriate as the concept of an unequivocal insurance or reinsurance contract does not in any way modify the currently applicable assessment of risk and is not meaningful in the reinsurance context as it focuses on single risks. As noted above, we believe that the bifurcation required in decision box f) is also inappropriate and should be removed. These changes would result in a flowchart consistent with current guidance whereby the contract is either an insurance contract and accounted for as such, or an investment contract which will require deposit accounting.

A further theoretical inconsistency in the logic underlying the proposed flowchart is that the application of the requirement for bifurcation is largely one-sided. Contracts not meeting the risk transfer threshold would be accounted for as a deposit in their entirety although aspects of risk transfer may exist, whereas contracts that do meet the risk transfer threshold would still be subject to possible bifurcation.

Issue 5: Do you agree with the characteristics identified for contracts that do or do not unequivocally transfer significant insurance risk? If not, why not? Should other characteristics be added? Are the examples in Appendix B representative of the discussion in paragraphs 57–59?

We believe that the unequivocal test for insurance and reinsurance accounting in paragraphs 57-59 is not appropriate for determining bifurcation or deposit accounting requirements as it is too specifically focused on single risk and implies that premiums should not include a level of loss expectancy. While actuarial techniques allow for an estimation of possible outcomes in a portfolio of exposures that is substantially narrower than that possible for a single risk, there is no certainty as to the occurrence, severity or timing of any individual event in the portfolio and as such the treatment of the portfolio should not differ from the treatment of the single risk as the exposures are identical. The concept of risk aggregation and the benefits of risk diversification are common to both the insurer and the reinsurer and should not result in substantially different treatments.

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)?

As noted above we do not believe the concept of unequivocal insurance contracts is an improvement over the existing exemptions allowed under paragraph 11 of FAS 113. The assessment of an unequivocal contract is a narrow and rules based assessment which would result in many existing reinsurance and group insurance arrangements which are clearly risk bearing, and address the same risk as the single risk contracts of which they are composed, requiring further assessment and bifurcation. Such an assessment is contrary to the move towards principles based accounting and results in counterintuitive financial reporting. The required bifurcation would be difficult, costly and overly subjective, and will not result in improved clarity within the financial statements.



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?

We do not support a framework which requires the bifurcation of insurance and reinsurance contract as noted throughout this letter. While approach B is clearly more onerous we believe that both approaches would require unnecessary bifurcation of many risk bearing insurance and reinsurance contracts. We believe that the restatements related to the topic of risk transfer noted in the past several years are a result of misapplication of appropriate existing guidance. We believe that a change to a framework that involved bifurcation under either approach A or B would create a substantial amount of confusion in the investor, analyst and regulator community and would have a significant cost to both the company and those interested parties.

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 support a framework which requires the bifurcation of insurance and reinsurance contract as noted throughout this 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?

As stated above, we do not believe that bifurcation is appropriate under any of the models suggested in the ITC. All of the proposed methods require subjectivity regarding the mathematical metrics which can not be clearly defined or determinable, resulting in inconsistencies in application and reporting of financial results.

To be complete, such a method or analysis should incorporate other costs related to the reinsured business to compare the financial results between parties. If performed appropriately, such other costs would need to include the allocation of acquisition costs, overhead expenses, and the use of surplus. Such allocations require significant judgments, and are so complex that many companies do not allocate these costs by line of business, much less for individual contracts. The level of judgment that would be needed, coupled with the lack of specific industry standards for such allocations, leads us to believe that consistent results could not be achieved from such an analysis.

From a purely conceptual perspective, the proportional method appears to be the most appropriate methodology; however, it is also the most purely defined. It is unclear how a portion of the contract can be assigned risk limiting features and what mathematical metrics would be used to establish the proportionality. The expected payout method is inappropriate because the concept of highly probable claim payments is not clearly defined and may result in added inconsistencies between insurers and

reinsurers and large and small portfolios. The cash flow yield method would require a fundamental change in the conceptual framework underlying insurance accounting as a whole. In addition to this overall paradigm shift, not all types of contracts are underwritten based upon expected cash flows. Some types of contracts, such as property catastrophe covers, are priced based upon their expected losses with little or no regard to timing of payment or interest rate assumptions. These assumptions would be required under the cash flow yield method and as such, would result in subjective assumptions being applied which were not considered when the contract was underwritten.

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?

The extent to which data availability would limit the application of the proposed bifurcation methods varies by method and by type of business. Broadly, the limitations lie in the level of credibility that would be assigned to selection of assumptions in each of the models. While much of the necessary information needed to apply the bifurcation methodologies is the same as that used in underwriting, the availability of appropriate levels of quality data will differ in every circumstance. The differing availability of data will result in two companies writing the same product with the same insured, utilizing the same methodology arriving at different conclusions purely based on available data. New programs will have to be evaluated differently from those on which the insurer has experience and the assumptions used to bifurcate individual programs will change over time as data becomes more readily available. Certain the methodologies would result in the need for systems to track new information which is not required for underwriting, only for use in selecting bifurcation assumptions. This would have a significant cost and even more significant costs would be incurred modifying underwriting and reporting systems to facilitate new reporting requirements. Examples of such changes would include:

- Maintaining two premium amounts -- (1) representing financing components and (2) representing the insurance risk components. In addition, the expenses or acquisition costs will also have to be accounted for separately;
- Reviewing reported and paid claims data for each contract and determining whether the activity relates to the financing portion of the contract or the insurance portion;
- Splitting cash flows between financing and insurance components;
- Establishing new reporting to determine which portion of the ultimate premium is to be included in the determination of premiums receivable as opposed to remaining unrecorded until the "deposit" is received.

These costs would be significant and it is relevant that many companies are already committing to major systems expenditures to prepare for the potential changes associated with IAS implementation and the move towards convergence.

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?

Given the status of the FASB and IASB's Modified Joint Project and the pending Phase II insurance contracts discussion paper, we believe that considering any form of bifurcation of insurance contracts at



this point in time is not appropriate given the stated objective of accounting convergence with the IASB. Furthermore, we believe that the IASB has recently made a tentative decision to not support bifurcation or unbundling. If recognition and measurement of insurance contracts is likely to ultimately be adopted consistent with the fair value approaches being considered by the IASB the framework proposed in the ITC would need to be completely reassessed. Implementing two such significant, and in some ways contradictory areas of guidance would create confusion for both the preparers and users of the financial statements.