



LETTER OF COMMENT NO. 18



August 24, 2006

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

Via e-mail: director@fasb.org

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

Dear Technical Director and Board:

The Hartford Financial Services Group, Inc. (The Hartford) is pleased to provide comments on the Invitation to Comment, *Bifurcation of Insurance and Reinsurance Contracts for Financial Reporting*.

Our letter is organized around three main points, below, and in an appendix we have provided brief comments on the specific issues raised.

Our three main points are:

- As part of the move toward international accounting convergence, the FASB has stated its intent to join in the International Accounting Standards Board's (IASB's) comprehensive project to address accounting by insurers and policyholders. The FASB should not pre-empt that effort by introducing a major, and potentially temporary, accounting change such as bifurcation ahead of any that may come out of the international project.
- Bifurcation would provide less meaningful information to financial statement readers and significantly increase the cost and complexity of accounting by insurers and policyholders. Bifurcation would produce significantly different accounting for contracts of similar substance. Where an entity has single risk exposures and then buys group risk reinsurance or insurance coverage, bifurcation would: (1) distort net written premium measures in the income statements for insurance companies; (2) result in a deposit and a balance sheet gross-up for corporations (policyholders) that does not reflect the economic substance of the insurance coverage; and (3) result in earnings volatility for insurers and policyholders for imputed interest that does not reflect the economic substance. There would be significant cost incurred to pay actuaries to impute deposit components and to establish processes and systems to account for contracts in their imputed components, burdening policyholders, insurers and reinsurers.

- Existing accounting rules are well thought out and provide comprehensive guidance in how to evaluate and account for insurance contracts. Existing accounting rules contemplate side agreements, deposit elements, experience adjustments and other risk-limiting features. We would be open to assist the FASB in analyzing where the existing insurance accounting guidance could be improved to minimize the misapplication evidenced by the recent publicized restatements. We appreciate that the FASB has been prompted by public pressure to explore an accounting remedy in response to recent corporate misstatements. However, we do not believe the insurance accounting model was the failing in the publicized restatements and we do not support bifurcation.

As part of the move toward international accounting convergence, the FASB has stated its intent to join in the IASB's comprehensive project to address accounting by insurers and policyholders. The FASB should not pre-empt that effort by introducing a major, and potentially temporary, accounting change such as bifurcation ahead of any that may come out of the international project.

The IASB's Insurance Contracts (Phase II) project will develop an International Financial Reporting Standard (IFRS) on accounting for insurance contracts, by both insurers and policyholders. As stated in the Invitation to Comment, the IASB will issue for public comment a Discussion Paper containing tentative decisions on accounting for insurance contracts that is currently expected to be issued in the fourth quarter of 2006. An FASB Invitation to Comment would be issued sometime after the Discussion Paper's release. The IASB's project is a comprehensive look at insurance accounting and tentative conclusions include measuring insurance liabilities at a current value that reflects discounted cash flows and an explicit margin for the risks associated with the cash flows. We understand that the IASB plans to consider bifurcation as part of that project.

The IASB insurance project may significantly change the insurance accounting model and the new model may not include bifurcation or may require a different method of bifurcation. Given that the IASB expects to issue its final IFRS on insurance accounting in 2009, it would be premature for the FASB to recommend bifurcation of contracts under the existing accounting model. In addition to not having a long-term benefit, adopting a bifurcation approach would cause short-term disruption due to the potential for negative effects on required regulatory capital or the tax deductibility of premiums paid. Companies would incur the cost of implementing a change to bifurcation that could prove to be obsolete by 2009 when the IASB expects to issue its final IFRS.

In addition, we would expect that under its tentative conclusions, the IASB would find bifurcation to be unnecessary under a current value approach, just as the IASB has indicated in its tentative conclusions that a current value approach will provide the benefit of less (and perhaps no) need to separate embedded derivatives. This is because when the entire contract is stated at current value, there would be no need to measure the parts separately.

Bifurcation would provide less meaningful information to financial statement readers and significantly increase the cost and complexity of accounting by insurers and policyholders. Bifurcation would produce significantly different accounting for contracts of similar substance. Where an entity has single risk exposures and then buys group risk reinsurance or insurance coverage, bifurcation would: (1) distort net written premium measures in the income statements for insurance companies; (2) result in a deposit and a balance sheet gross-up for corporations that does not reflect the economic substance of the insurance coverage; and (3) result in earnings volatility for insurers and policyholders for imputed interest that does not reflect the economic substance. There would be significant cost incurred to pay actuaries to impute deposit components and to establish processes and systems to account for contracts in their imputed components, burdening policyholders, insurers and reinsurers.

The bifurcation proposal would have a contract holder impute a deposit component based on an expected level of losses for direct policies and reinsurance contracts that cover a pool of risks. Under the proposed guidance, an insurer would use insurance accounting and recognize loss expense for probable and estimable losses from the direct business that they write (provided the "single-risk" characteristic is met). Similarly, a policyholder would use SFAS 5, *Accounting for Contingencies* (SFAS 5), accounting and recognize loss expense for probable and estimable losses from the direct exposures that they bear (provided the "single-risk" characteristic is met). However, both the insurer and the policyholder would be required to use deposit accounting for all or a portion of the premium paid and losses recovered when they lay that risk off to others. Under a quota share reinsurance agreement, the reinsurer is economically in the same position as the policyholder for the portion of the risks covered by the contract and, therefore, should account for the assumed risks in the same manner as the ceding company.

Similarly, bifurcation would result in different accounting treatment for the straight pro-rata reinsurance of a book of business versus writing a portion of that same business on a syndicated basis. A company looking to enter a line of business could either write 100% of the direct exposure and then quota share 50% to a reinsurer, or only write 50% of the direct exposure and retain all of it. In the first example, the reinsurance cession would be bifurcated to treat the expected loss component of the 50% cession as a deposit, thereby creating much higher net written premium than in the second example where the company would record only the 50% of the exposure written as insurance. Although these two approaches serve the same economic intent of the company and result in the same economics, bifurcation would result in significantly different financial reporting. Bifurcation would also distort the economic results of a corporation buying an insurance policy to cover a group of risks. Despite being a highly effective hedge of incurred losses – one that pays the corporation the amount of a loss at the time the loss cost is payable by the corporation - the corporation would have to account for a significant portion of the premium as a deposit on the balance sheet, resulting in a gross-up of the balance sheet that does not reflect the economic substance of the insurance coverage.

Furthermore, the cost to estimate and account for the imputed deposit and insurance components would be significant. Policyholders and insurers would likely make different assumptions about the portion of premium that should be recorded as a deposit. While the accounting does not necessarily need to be symmetrical, insurers would likely have access to much more information in making their estimate than the policyholder has, including information about incurred losses for the insurer's entire portfolio of contracts. An insurer would not provide its own estimate of expected losses to the insured since that information is a factor used in determining the premium charged for the product. The insured would need to hire actuaries to estimate the deposit and insurance components. And, depending on the subsequent accounting, which the Invitation to Comment did not speak to, reinsureds and insureds would most likely need to add actuarial methods and processes to measure and account for the components from inception through settlement using retrospective interest methods. These methods might require purchasing or developing systems to track the paid and incurred losses for each policy year and accident year. In addition, commercial insurers and reinsurers would have to develop system capabilities to handle the volume of contracts. Under existing accounting, the policyholder has the convenience and efficiency of recognizing the cost of the insured risk by ratably expensing the premium paid over the period of risk, which is appropriate because that premium represents the established cost of a highly effective indemnification. Therefore, not only does bifurcation fail to match the economics of the transaction; but, it would be highly burdensome to policyholders, insurers and reinsurers.

Existing accounting rules are well thought out and provide comprehensive guidance in how to evaluate and account for insurance contracts. Existing accounting rules contemplate side agreements, deposit elements, experience adjustments and other risk-limiting features. We would be open to assist the FASB in analyzing where the existing insurance accounting guidance could be improved to minimize the misapplication evidenced by the recent publicized restatements.

Accounting problems with "finite" (re)insurance have been few in number and are not pervasive throughout the industry. We believe the FASB is embarking to fix an accounting model that is not broken. There is no evidence to suggest there has been widespread misapplication or abuse. The recent reports of abuse of reinsurance transactions appear to implicate management behavior rather than accounting inadequacy and we do not believe that changing the accounting standards would lessen the risk of abuse.

SFAS 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts* (SFAS 113), issued in 1992, was written, in part, because of "concerns about the effect of reinsurance accounting for contracts that do not indemnify the ceding enterprise against loss or liability". It was a thorough exploration and resulted in a well conceived model for evaluating risk transfer in reinsurance contracts. As indicated in footnote 9a in SFAS 5, the FASB suggests that insureds analogize to SFAS 113 for determining whether a contract provides indemnification against loss and should be accounted for as (re)insurance. SFAS 113, together with SFAS 60, *Accounting and Reporting by Insurance Enterprises* (SFAS 60), and SFAS 5, represent a significant body

of accounting rules around (re)insurance that have stood the test of time. This existing literature adequately addresses the accounting for contractual elements that have been the subject of concern with “finite” contracts, including:

- **Side agreements** –Side agreements should be considered part of the total agreement in determining the accounting and the accounting for reinsurance explicitly requires consideration of side agreements. Under paragraph 8 of SFAS 113, evaluation of a contract “requires a complete understanding of that contract and other contracts or agreements between the ceding enterprise and related reinsurers.” Paragraph 58 expands on the requirement: “Although an individual contract may appear to indemnify the ceding enterprise, the risk assumed by the reinsurer through one reinsurance contract may have been offset by other contracts or agreements. A contract does not meet the condition for reinsurance accounting if features of the reinsurance contract or other contracts or agreements directly or indirectly compensate the reinsurer or related reinsurers for losses.”
- **Deposit elements** - The accounting for a pre-funded deductible is already bifurcated. With large deductible workers’ compensation policies, premiums are determined after consideration of the deductible. Losses within the deductible, if funded or prepaid, are not recorded by the insurer as premium, but rather as a funds held deposit. SFAS 60, paragraph 44 provides for this accounting: “...if, regardless of form, their substance is that all or part of the premium paid by the insured or ceding company is a deposit, it shall be accounted for as such.”
- **Experience adjustments and other risk-limiting features** – Experience adjustments should be accrued based on experience under the contract and should be considered in evaluating whether the contract transfers significant insurance risk to the (re)insurer. Paragraph 44 of SFAS 60 provides that “If retrospective commission or experience refund arrangements exist under experience-rated insurance contracts, a separate liability shall be accrued for those amounts, based on experience and the provisions of the contract.” Paragraph 10 of SFAS 113 requires a consideration of “all cash flows between the ceding and assuming enterprises under reasonably possible outcomes, without regard to how the individual cash flows are characterized” and evaluates the significance of the potential loss on a present value basis. Paragraph 58 of SFAS 113 expands on this, in providing that “A contract does not meet the conditions for reinsurance accounting if features of the reinsurance contract or other contracts or agreements directly or indirectly compensate the reinsurer or related reinsurers for losses....That compensation may take many forms, and an understanding of the substance of the contracts or agreements is required to determine whether the ceding enterprise has been indemnified against loss or liability relating to insurance risk. For example, contractual features may limit the reinsurer’s exposure to insurance risk or delay the reimbursement of claims so that investment income mitigates exposure to insurance risk.” Paragraph 9 of SFAS 113 prohibits any delay in the timely reimbursement of reinsured losses.

SFAS 113, based in SFAS 60 and SFAS 5, prescribes that a contract be evaluated as a whole and the mere presence of an adjustable feature does not dictate deposit accounting

treatment when the contract, in substance, transfers significant insurance risk. Since adjustable features limiting risk are already considered in the risk transfer evaluation, it is not appropriate to then separately account for an imputed deposit element. If a contract is bifurcated, the risk transfer test is really of no consequence. And yet, the risk transfer test is of paramount importance in determining the economic substance of the agreement. We disagree with the implication in the Invitation to Comment that, despite transferring significant risk, a contract must have a "financing component" if there are adjustable features. Generally speaking, the intent of adjustable features is not to achieve minimal risk transfer, but to adjust the compensation commensurate with the amount of risk transferred.

SFAS 113 risk transfer guidelines may or may not be appropriate for evaluating risk transfer on direct policies; however, we do not believe it is practical or advisable to require insurers and insurance purchasers to perform SFAS 113 risk transfer testing for the multitude of direct policies. Rather, the test should be simply that the contract provides indemnification against loss – that there is a possibility that the insured could receive recoveries in excess of payments. Any provisions that adjust premiums or coverage to reduce the transfer of risk should be accounted for currently based on experience and the provisions of the contract. Whether the charge to income is labeled as loss expense or insurance expense is not likely to be of significant consequence or benefit, as long as the insured accounts for experience currently. The cost to perform risk transfer testing on the many insurance contracts by the many insurers and insureds would be significant – involving large amounts of loss data and actuarial expertise – and would exceed the benefit.

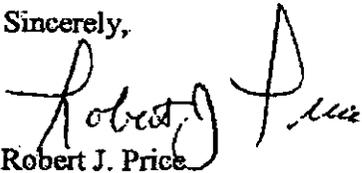
The guidance in paragraph 44 of SFAS 5 directs insureds to account for contracts or elements of contracts that are deposits as deposits. That guidance could be expanded to include the provision in paragraph 44 of SFAS 60 to require that experience adjustments be accounted for currently. Combined that guidance would read:

"To the extent that an insurance contract or reinsurance contract does not, despite its form, provide for indemnification of the insured or the ceding company by the insurer or reinsurer against loss or liability, the premium paid less the amount of the premium to be retained by the insurer or reinsurer shall be accounted for as a deposit by the insured or the ceding company. Those contracts may be structured in various ways, but if, regardless of form, their substance is that all or part of the premium paid by the insured or the ceding company is a deposit, it shall be accounted for as such. If retrospective commission or experience refund arrangements exist under experience-rated insurance contracts, a separate [asset or] liability shall be accrued for those amounts, based on experience and the provisions of the contract. Income in any period shall not include any amounts that are expected to be paid to [or received from] agents or others in the form of experience refunds or additional commissions. Contingent commissions receivable or payable shall be accrued over the period in which related income is recognized."

In summary, the FASB should not pre-empt the IASB's insurance accounting project or lay aside the existing accounting rules that have provided a strong framework for evaluating insurance and reinsurance contracts as a whole. Bifurcation would provide less meaningful information to financial statement readers and would significantly increase the cost and complexity of accounting by insurers and policyholders.

We would be happy to discuss our comments, in more detail, with the Board or its staff. Please feel free to call me at (860) 547-8495.

Sincerely,



Robert J. Price
Senior Vice President and Controller
The Hartford Financial Services Group, Inc.

Comments on Specific Issues

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?

The IFRS 4 definition of insurance could be improved by replacing **compensate** with **indemnify** in the part of the definition that reads “agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder”. We agree with the comment in the Invitation to Comment that indemnification is more stringent than compensation. This is because indemnification is payment in the amount of loss and compensation may be more, which is beyond the purpose of insurance.

The GAAP definition of insurance risk presented in the Invitation to Comment appropriately addresses the amount and timing risk, which is integral to there being indemnification. The GAAP definition could be improved by stating that insurable events are losses from property, casualty, mortality, morbidity or survival exposures. We understand that financial guarantees and credit derivatives can be confusing under GAAP and may deserve a specific carve-out from the definition.

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?

As discussed on page 6, we do not believe it is practical or advisable to require insurers and insurance purchasers to perform risk transfer testing for the multitude of direct policies. Current guidance for non-insurance companies could be improved to require that any provisions that adjust premiums or coverage to reduce the transfer of risk should be accounted for currently based on experience and the provisions of the contract. The cost of performing the SFAS 113 risk transfer testing would exceed the benefit.

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?

As discussed in our second main point beginning on page 2, we believe that bifurcation would provide less meaningful information to financial statement readers. Bifurcation could produce significantly different accounting for contracts of similar substance and

create non-economic variability in the income statements for insurance companies and corporations that have single risk exposures and then buy group risk insurance coverage.

We believe that classifying a contract in its entirety as either insurance or a deposit provides more understandable and decision-useful information and appropriately conveys the true economics of the transaction. A contract can only be evaluated for risk transfer in its entirety—either it has sufficient risk transfer or it does not. To convey otherwise, would be misleading. Allocating a portion of the premium paid as a deposit could only be done in an arbitrary manner and would falsely convey that some of the insured risk is exposed to loss and some is not.

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?

The flowchart first screens out single risk contracts. Next, it requires contracts that do not pass SFAS 113 risk transfer to be accounted for entirely as deposits. Then, using a to-be-determined screen, the flowchart will specify which of the remaining contracts (including all group and all reinsurance contracts other than facultative (single risk reinsurance)) should be bifurcated. We do not believe it is appropriate to bifurcate contracts that pass the SFAS 113 risk transfer criteria.

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

We do not agree with the characteristics identified for contracts that do or do not unequivocally transfer significant insurance risks. The Invitation to Comment inappropriately infers that a contract has inherently less risk transfer if there are no possible loss outcomes of zero. This approach fails to recognize that insurance risk is uncertainty as to both the amount and timing of a loss. Whether or not a contract has “single risk characteristics” is not relevant to a determination of whether the contract indemnifies the insured or ceding company.

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 37c) of this Invitation to Comment)?

We do not believe the characteristics described for unequivocal insurance contracts are an improvement over the exemption from cash flow testing in paragraph 11 of Statement 113. As currently provided for under SFAS 113, if a reinsurer is economically in the same position as the insurer and the direct insurance passes risk transfer, then the transaction should be accounted for as reinsurance. Where cash flow testing does not

show that a contract has a significant risk of a significant loss, paragraph 11 of SFAS 113 permits insurance accounting if a reinsurer insures substantially all of the ceding company's risk relating to the reinsured portion of the contract as long as an insignificant risk is retained by the ceding company on the reinsured portion of the contract.

The Invitation to Comment further indicates that in order to be considered an unequivocal transfer of risk; these contracts must have a "market-equivalent level" of premium, have no risk-limiting features and not be likely to result in a claim. However, there are many contracts with negligible non-insurance features that do not meet these criteria, including straight quota share agreements and property catastrophe contracts that cover multiple risks resulting in losses from one event. Risk transfer is not a function of how many risks are covered by the policy or what likelihood there is of a scenario with no losses. Risk transfer is a function of the *variability* in expected losses, their amount and timing, and the insurer or assuming insurer's willingness to take on the risk of paying out up to full policy limits in return for an established premium. If there is at least a reasonable possibility that the reinsurer can lose a significant amount of money on a present value basis or there is a full transfer of risk for the portion of the risk reinsured, then there is risk transfer.

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?

Neither approach is appropriate. Deposit accounting is not appropriate for a portion of a contract, unless a deposit component is contractually separate such as in the case of a funded deductible for a workers' compensation policy or an investment fund in a universal life-type insurance policy. Imputed deposit accounting should only be applied to finite risk arrangements such as those described in paragraph 36 b (1) - when there is an expected loss that is subject to very little possible variability and the premiums plus anticipated income is expected to equal the sum of expected losses and expenses and a profit margin, and, we would add, the contract does not meet the SFAS 113 paragraph 11 exception - in that case, the contract should be accounted for in its entirety as a deposit.

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

Bifurcation of an insurance policy or reinsurance contract is not appropriate unless a deposit component is contractually separate.

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 methods discussed in this Invitation to Comment?

We believe all three methods are arbitrary, would be complex to understand and implement and would involve additional estimation in companies' financial statements, thereby obscuring the economics of the transactions and reducing comparability among companies and financial statement clarity.

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?

Data and models would likely come at a considerable cost. To perform any one of the three bifurcation methods, policyholders would have to perform a significant amount of data modeling. Only the most sophisticated policyholders would readily have the information to perform this modeling. Among other things, the modeling would require sufficient data on historical exposures and losses, the effect of changes in limits and coverage, and the effect of changes in assumptions to adjust historical losses for current trends. Insurers have access to industry data that policyholders may not have. In addition, insurers use sophisticated pricing models that incorporate loss simulations. This issue affects many commercial property and casualty policies, including policies covering workers' compensation, general liability, auto liability and property exposures; and, group benefit policies such as those covering life and disability. We believe the cost to develop and continually apply bifurcation is unjustified.

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?

As further discussed in our first main point beginning on page 2, the FASB should not pre-empt the effort underway by the IASB by introducing a major accounting change such as bifurcation ahead of any that may come out of the international project. Delaying consideration of this topic would allow for a more efficient implementation in response to a joint project with the IASB on accounting for insurance contracts. We believe the FASB should address the issue as part of international convergence.