

FASB Invitation to Comment, *Bifurcation of Insurance and Reinsurance Contracts for Financial Reporting*,
Comment Letter Summary

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INTRODUCTION

1. This document presents the staff’s summary of the comment letters received in response to the FASB Invitation to Comment, *Bifurcation of Insurance and Reinsurance Contracts for Financial Reporting*. This memorandum provides information that will be useful to the Board during the deliberations of the issues underlying the Invitation to Comment.

2. As of the completion of this summary, the Board has received 66 comment letters (counting separately four letters from the financial reporting committees of the American Academy of Actuaries). The comment period ended August 24, 2006.
3. This analysis provides a summary of the respondents' positions on various issues and their recommendations to address those issues. The analysis includes issues raised in the Invitation to Comment, as well as other issues that were not specifically addressed in the Invitation to Comment.

PROFILE OF RESPONDENTS

4. This memorandum includes an analysis of the comment letters submitted by 63 organizations and individuals. The respondents included academics, rating agencies, accounting organizations, accounting firms of all sizes, actuaries, insurance companies, insurance trade organizations, non-insurance companies (referred to as corporate policyholders), and non-insurance trade organizations. The following table summarizes the types of entities that submitted comment letters:

Respondents by Category

| Category | Number |
|--|-----------|
| Academic Individual or Association | 1 |
| Users, Analysts, and Rating Companies | 2 |
| Accounting Organization (e.g., AICPA) | 3 |
| Big Four Accounting Firm | 4 |
| National Accounting Firm | 1 |
| Smaller Accounting Firm | 1 |
| Actuarial Organization, Firm, or Individual* | 7 |
| Insurance Company | 24 |
| Insurance Association or Organization | 12 |
| Insurance Regulators | 1 |
| Non-Insurance Company | 8 |
| Non-Insurance Association or Organization | 2 |
| Total | 66 |

*Four letters received from the financial reporting committees of the American Academy of Actuaries are counted separately

OVERALL POSITION

- Overall, the bifurcation of insurance and reinsurance contracts did not receive support from respondents. Many respondents supported improved disclosure on contracts where the level of risk transfer is in question and issuance of practical guidance regarding risk transfer testing in lieu of a bifurcation approach. The following comment from the Reinsurance Association of America (letter 3) summarizes the overall view of many respondents to the Invitation to Comment:

While the RAA does not oppose separating reinsurance contracts into clearly defined risk transfer and non-risk transfer coverages, which we believe exists in current GAAP guidance (EITF D-34), we do not believe that the proposed bifurcation approaches contained in the ITC, will meet FASB objectives to improve the decision usefulness of reported financial information. We believe that the FASB should instead focus its efforts in two areas that would improve the decision usefulness of financial reporting. First, the

FASB should incorporate in GAAP improved practical guidance regarding risk transfer testing and alternative approaches for evaluating sufficient risk transfer. Second, the FASB should improve and expand GAAP disclosures, especially for insurance and reinsurance contracts that transfer limited amounts of insurance risk. In this regard, the FASB could leverage the work already completed or currently underway at the NAIC, within the actuarial profession and among international insurance regulators.

POSITION ON SPECIFIC ISSUES

6. The remainder of this memorandum addresses the various issues identified in the Invitation to Comment.

01A: Definition of Insurance Contract

Does the IFRS 4, Insurance Contracts, definition of insurance contract identify insurance contracts and sufficiently distinguish those contracts from other financial contracts? How could the definition be improved?

7. About two-thirds of the respondents addressed the adequacy of the definition of insurance contract. Roughly half of those who responded agreed with the definition and half disagreed.
8. Approximately half suggested that the definition could be improved by including the concept of indemnification rather than compensation in order to limit the amount the insured can receive to the amount of the loss. Standard & Poor's Rating Services (letter 61) explains why the definition should be limited to indemnification:

The IFRS 4 definition of insurance contracts is overly broad insofar as its reference to 'compensation' based on uncertain future events that 'adversely affect' the policyholder, but does not limit the compensation to

losses incurred by the policyholder as a result of the occurrence of fortuitous events, both of which are elements to what is commonly understood to be insurance. We believe the definition of an insurance contract should embed the concept of indemnification, wherein a policyholder does not have an opportunity to realize a gain from the contract; rather, the focus is on placing the policyholder in essentially the same financial position as before the loss event (or up to that position subject to deductibles, caps or partial coverage).

The IFRS 4 definition may be broadly interpreted to include contracts providing coverage for financial risk or otherwise affording the policyholder the opportunity to realize a financial gain from the contract. As a result, contracts that heretofore would not have been considered insurance might be considered insurance under this definition.

9. Other suggestions from respondents included the following:
 - a. The definition should include contractual relationships and not just the contract itself.
 - b. The definition should include a grouping of policies and not just an individual policy.
 - c. The definition should allow for other beneficiaries beside the policyholder (for example, employees in group health insurance contracts).
 - d. The term *uncertain future event* needs to be modified to allow for an unknown or uncertain past event (for example, pollution or product liability insurance for the discovery of an event that happened in the past, or an unexpected development on a known past event).
 - e. The definition should include clarification of the meaning of the term *significant*.
 - f. The definition should distinguish prospective contracts from retroactive contracts.
 - g. The definition should include the notions of both underwriting risk and timing risk.

01B: Definition of Insurance Risk

Does the GAAP definition of insurance risk identify and separate that risk from other risks such as financial risk? How could the definition be improved?

10. About one-half of the respondents addressed the adequacy of the definition of insurance risk. Approximately two-thirds of those respondents agreed with the definition. Suggestions from respondents included the following:

- a. The definition needs modification because the possibility of adverse events occurring is not completely outside the control of insured (for example, a business can implement a safety program to reduce the possibility of a work-related accident).
- b. The definition needs to be modified to fit better with the definition of insurance found in IFRS 4.
- c. The IFRS definition of insurance risk should be adopted entirely if the IFRS definition of insurance contract is used.
- d. The definition may need modification because financial risk is inseparable from insurance risk (presumably all insurance risk involves some degree of financial risk).

01C: Descriptions of Finite Insurance and Reinsurance Contracts

Do the descriptions of finite insurance and reinsurance contracts, including the risk-limiting features, identify those contracts? How could the descriptions be improved?

11. About one-half of the respondents addressed the adequacy of the descriptions of finite insurance and reinsurance contracts. More than three-quarters of those responders felt that the descriptions were not adequate. In addition, nearly two-thirds of responders said there was no need to define

finite insurance and reinsurance contracts. Responders expressed the following views:

- a. The descriptions were too broad and would classify too many contracts as finite.
- b. The descriptions were rules-based and it would be better to describe the nature and conditions in a more principles-based fashion.
- c. It would be better to define situations where risk transfer was self-evident rather than those where it was not.

12. In addition, American International Group (letter 41) suggested that other features could be added to the list, including the following:

- a. Claims bonuses or sliding scale commissions
- b. Funds held provisions other than those pursuant to local law or regulation
- c. Any provision for coverage of events that are known to have occurred (retroactive), excluding "roll forward" provisions within the termination clause of an agreement
- d. Contracts that are required to be renewed or that mandate the exercise of extended reporting provisions
- e. 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
- f. The contract contains an embedded derivative, as defined in FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*
- g. 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.

13. In contrast, the Reinsurance Association of America (letter 3) states:

We do not believe that it is useful to attempt to define finite nor do we believe that a laundry list of features is appropriate in developing accounting standards. The use of a rules-based approach to attempt to segregate "traditional" from "finite" for accounting purposes is not practical since risk-limiting features are an integral part of nearly all insurance contracts. Nevertheless, such a list might be useful in determining the scope of disclosure or for triggering contracts for more detailed review of risk transfer. This is the approach taken recently by the NAIC and some insurance rating agencies.

The descriptions and features in paragraph 36b would identify some contracts typically perceived as "finite," but the list is not operable because it will not separate "finite" from traditional insurance and reinsurance contracts. The problem with defining finite with specific terms is that practitioners recognize that the contract features in "finite" contracts have more impact on the economics of the transaction. It is a matter of degree rather than of the existence of the features themselves.

14. Fitch Ratings (letter 20) states the following:

While insurance risk transfer is the dominate concern in traditional reinsurance, the time value of money dominates in finite risk reinsurance. Thus, it is prudent to think of this type of finite risk reinsurance as a financing vehicle. This is particularly the case for retrospective reinsurance arrangements, which are almost always finite, since by their very nature retroactive coverages finance losses. A known loss that has already occurred cannot be insured or transferred in a traditional sense; the uncertainty is gone. Natural buyers of retroactive covers would include insurers with long-tailed business.

Fitch is concerned about instances in which the primary purpose is not true risk transfer in the traditional sense, but financial statement enhancement.

02: Application of Risk Transfer Guidance to Corporate Policyholders

Can the FASB Statement No. 113, Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts, 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?

15. About two-thirds of the respondents addressed whether the risk transfer guidance could be applied by corporate policyholders. Approximately one-fourth of those respondents did not think it could be applied by corporate policyholders. Roughly two-thirds felt that it could be applied and a few felt that it could be applied with some modifications. Approximately one-fourth said that non-insurers would be unable to apply the guidance due to lack of data and expertise. Respondents expressed the following views:

- a. Much more guidance would be required if the risk transfer guidance were applied to non-insurers.
- b. Much more guidance on risk transfer is needed anyway regardless of its application to corporate policyholders.
- c. An actuarial basis should be used for risk transfer.
- d. The guidance could be better applied qualitatively by corporate policyholders instead of quantitatively (according to American Electric Power Company in letter 35, it is already being applied qualitatively by corporate policyholders).
- e. It would be applicable assuming that more policies held by corporate policyholders would be exempted from the risk transfer tests because they are considered to unequivocally transfer insurance risk.

- f. Since only a few single policies are held by most corporate policyholders, the limited number of policies would not provide a credible basis to evaluate risk using the guidance in Statement 113.
- g. Additional guidance should be given that would be equally applicable to low probability/high severity contracts as to high probability/low severity contracts (for example, catastrophic contracts).

16. The following statement by the Property Casualty Insurers Association of America (letter 10) typifies the response to this issue:

PCI believes it would be both unnecessary and extremely difficult for corporate policyholders to apply the Statement 113 risk transfer guidance to ordinary insurance contracts. In the great majority of cases, there should be no question that commercial insurance policies transfer significant insurance risk under current GAAP guidance. In the rare cases where there is a question, we doubt whether reclassifying contracts as deposit arrangements will be material to business policyholders' financial statements. Premiums paid by policyholders are not necessarily a helpful method for users of financial statements to measure the risk that those policyholders are assuming or retaining. In return for minimal if any gain in understanding policyholder financial statements, we note the application of Statement 113's risk transfer test often requires significant amounts of data to which commercial policyholders may not have access, and actuarial and stochastic modeling expertise that they likely do not have.

In concept there may be no reason why the risk transfer analysis for insurance and reinsurance contracts should be significantly different. We believe that the current GAAP guidance for insurers works well, however, and significant change at this point will not increase the clarity and comparability of insurer financial statements.

03: Whether Bifurcation Provides More Decision-Useful Information

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?

17. Virtually all of the respondents addressed whether bifurcation of insurance contracts provides more decision-useful information. Virtually all of the respondents opposed bifurcation of insurance and reinsurance contracts. Approximately one-eighth said they might support bifurcation if modifications were made, including narrowing the number of contracts potentially subject to bifurcation.

18. Respondents opposed bifurcation for the following reasons:

- a. Approximately two-fifths of respondents felt that bifurcation places too much emphasis on the ability to identify and separate different contractual elements, which is an artificial demarcation and implies exactness in the financial statements. It could be misleading because the amount of the deposit element is really a subjective determination and cannot be reasonably estimated.
- b. Approximately half of the respondents said that bifurcation would be too costly and difficult to implement since it would require increased internal costs for additional personnel and systems modifications and increased external costs for auditors and actuaries.
- c. Approximately half of the respondents said that bifurcation is too complex and difficult to understand and that it would make financial statements less understandable.

- d. Approximately one-sixth of the respondents said that bifurcation would decrease comparability by making historical data and ratios useless and reduce comparability between companies since companies might apply the guidance inconsistently and arrive at different accounting approaches or different measurement results for contracts with nearly identical terms.
- e. Some respondents felt that bifurcation still doesn't reflect the true economics of insurance contracts and that it could result in inconsistent accounting treatment for economically identical transactions.
- f. Approximately one-sixth of the respondents said that contracts are considered as a whole when they are priced and that they shouldn't be artificially separated because the various components are most often interrelated and would typically not be found as standalone transactions in the marketplace.
- g. Approximately one-sixth of the respondents said that corporate policyholders would not have the expertise or data to bifurcate.
- h. Some respondents felt that bifurcation is not appropriate because it might result in mismatched accounting between direct and assumed and ceded (re)insurance.
- i. Some respondents were concerned that bifurcation would be too difficult to audit and enforce.
- j. Some respondents felt that the amount of the deposit element for most contracts (especially those held by corporate policyholders) would be immaterial and that a bifurcation analysis would require a lot of work with almost no impact to the financial statements and very little (if any) benefit.
- k. Some respondents felt that bifurcation would be an unwarranted overhaul of insurance accounting and would be applied to contracts in which risk transfer is not in question, and that the issues raised by the recent misstatements could be addressed simply by providing more implementation guidance.

- l. Some respondents felt that bifurcation for all insurance contracts is unjustified because the alleged abuses were not pervasive and resulted from misapplication of existing accounting guidance and not from the guidance itself.
- m. Some respondents felt that the time and resources that would be necessary to complete a broad scope project on bifurcation will delay timely resolution of practice problems.

19. American Re-Insurance Company (letter 16) states:

We feel that bifurcation, as proposed in this ITC, would require significantly more complex and arbitrary estimates and assumptions. The concept of bifurcation, as proposed within the ITC, implies a level of precision that belies the complexity of insurance and reinsurance pricing and loss estimation. The proposed approach and methods will likely result in an artificial bifurcation which would not accurately represent the economic substance of the transaction, could result in more varied practice than currently exists and a greater disparity of practice among insurance and reinsurance companies. This would have the effect of significantly increasing variability and further distorting the reliability and comparability of the reported financial information.

20. Many respondents suggested alternatives that the Board could pursue to address the reporting issues without requiring changes that would have as dramatic an impact as bifurcation. These suggestions included the following:
- a. Bifurcation could be useful if it were only applied to a very limited number of contracts (for example, standard group health insurance plans should be exempted).
 - b. Additional disclosure would be a good temporary fix until a new and comprehensive insurance accounting model is developed, and the Board could require additional disclosures similar to the NAIC disclosures

(including methods and assumptions used and any limiting features of contracts) whenever risk transfer is in question.

- c. The Board could provide more guidance on significant insurance risk and risk transfer instead of bifurcation.
- d. A new insurance accounting model could be developed that would require reporting of the present value of obligations and rights because it would be better than just bifurcation alone.

21. Financial Executives International (letter 29) states that if the FASB is to address insurance accounting "...it would be more appropriate to concentrate [on] developing a framework that assists in defining or identifying risk transfer under FAS 113 due to recent abuses of insurance accounting rather than a complete overhaul of the insurance accounting model."

22. Fitch Ratings (letter 20) states:

In general, Fitch considers that the current accounting guidance (FAS 113...) is reasonable to determine if risk transfer has taken place. However, Fitch believes that one of the problems in the current accounting rules for finite risk transactions may be that the test for risk transfer is binary. If a company meets the test, it accounts for 100% of the contract as reinsurance. Likewise, if it does not meet the test, then the entire contract is accounted for as a deposit. In theory, it may be preferable to bifurcate the accounting for insurance contracts. However, as a practical matter, it can be very difficult to implement consistently across companies that have finite contracts covering losses emanating from multiple accident years and multiple lines of business in such a way that will increase financial statement reliability, comparability and overall usefulness.

What may be more appropriate is that in cases where reinsurance accounting treatment is granted, yet there is not 100% risk transfer, it may be preferable to disclose standardized, key account metrics as if the

arrangement did not exist. This could be similar to the new NAIC reporting requirements for additional disclosure by ceding companies...

23. Standard & Poor's Rating Services (letter 61) states the following, which summarizes the view of many respondents:

...if the Board wishes to pursue bifurcation, we recommend the application be limited to those contracts with elements that are indicative of deposits (and provide for more expansive disclosure requirements) while pursuing a comprehensive longer-term solution.

Bifurcating significant financing elements and reflecting them as deposits is appropriate for certain contracts within a limited scope where certain deposit elements are sufficiently dominant and serve to modify the predominant economic characteristics of the arrangement. We are concerned that applying the bifurcation notion to a broader population of contracts could serve to diminish, rather than improve, the decision usefulness of financial statements.

...as contracts often contain numerous features and provisions, bifurcating contracts without providing sufficient supplementary information in the disclosures would be insufficient.

24. Some respondents gave suggestions for criteria that could be used to reduce the number of contracts that might be subject to bifurcation. Respondents suggested that the bifurcation analysis could be limited to contracts:

a. That contain the following features (E&Y, letter 63):

(1) Features that guarantee a value to the policyholder. That is, contracts that have profit sharing arrangements where the policyholder is guaranteed to receive its premium (or a significant portion of the premium), less claims and any fee.

(2) Features intended to alter items covered under the reinsured contracts to limit or reduce the overall exposure of the reinsurer based on overall aggregate results. Examples include, but are not limited to, quota-share reinsurance contracts with loss corridors, loss caps (except for caps that are set at levels that are expected to be remote of occurring), or deductibles that do not correspond to the deductibles in underlying reinsured contracts.

(3) Features that impact the cash flows between the policyholder and insurer that could adjust the initial premium or initial retention of claims/losses by an amount greater than 10% of the initial or provisional premium. An example would be a retrospectively rated policy or reinsurance contract, including multiple year contracts.

- b. In which asymmetrical accounting could result where one party accounts for it as insurance and the other party accounts for it as a deposit (Fitch Ratings, letter 20).
- c. Where certain deposit elements are sufficiently dominant and serve to modify the predominant economic characteristics of the arrangement (S&P, letter 61).
- d. That include both significant risk sharing provisions, such as adjustments to premiums or loss coverage based on loss experience, and relatively low policy limits as evidenced by a high proportion of maximum premium assessments to loss limits (ACE Limited, letter 47).
- e. That include multiple contractual and qualitative elements that do not individually indicate a lack of risk transfer but when combined may result in the economics of the contract being more akin to a deposit such as (S&P, letter 61):

- (1) Side letter agreements changing the risk transfer characteristics of the contract
 - (2) Retrocession arrangements to the original cedant or an affiliate of the cedant
 - (3) Commutation clauses allowing for a refund of substantially all of the premiums paid
 - (4) Experience refund or profit sharing agreements
 - (5) Sublimits on exposures
 - (6) Aggregate loss-ratio caps
 - (7) Loss corridors reducing the exposure of the assuming company for a range of specific loss ratios
 - (8) Multiple-year terms
 - (9) Significant deficit or experience refund accounts
 - (10) The intent of the parties entering into the contract (for example, delaying recognition of losses over a specific time period or true risk transfer)
 - (11) The probability the agreement will be commuted.
- f. Where risk transfer is not self-evident, including contracts that include the following criteria (ACE Limited, letter 47):
- (1) Highly funded contracts where contractual premiums inclusive of installments and adjustable premiums represent a significant portion of policy limits

- (2) Multi-year contracts where the coverage period is two years or greater and experience from one year could affect other years with respect to the amount of premiums paid (that is, experience account balances), commissions (that is, deficit carry forwards), or loss coverage (that is, available limits)
 - (3) Contracts that have loss mitigating features that reduce the (re)insurance entity's net cash outflows when losses emerge under the contract, such as loss corridors, retrospectively rated premiums, etc.
 - (4) Multiple contracts executed simultaneously with the same entity where one contract transfers a risk and another contract transfers all or a portion of that risk back to the client
 - (5) Contracts including distinct coverages for two or more lines of business, where one coverage may not meet risk transfer criteria if evaluated separately
 - (6) Contracts with features that delay loss payment—or schedule claims payment (thereby reducing "timing risk")
 - (7) Retroactive loss coverages where insured claims are known at the inception of the contract.
 - (8) That have contractual components that actually function as a borrowing (for example, premiums paid to the insurer that must be repaid to the insured pursuant to the terms of the contract or contractual premiums certain to be returned to the insured regardless of loss experience)
- g. That have provisions that require an experience refund or similar repayment to be made to the insured/ceding company if experience is

positive (or loss reimbursement payment if experience is not), which is effectively a specified fixed payment provision (PWC, letter 42)

- h. That create an arrangement that explicitly or effectively substantially guarantees (not merely "makes likely") one of the following two outcomes (America's Health Insurance Plans, letter 48):
 - (1) The contract holder will reimburse the contract issuer to the extent that covered losses exceed the issuer's premium less certain defined expenses so the issuer is indemnified against any net loss and no risk is transferred.
 - (2) The issuer will pay benefits whose amount and timing are both effectively fixed by the contract and, therefore, do not incorporate the uncertainty required for insurance risk.

04: Appropriateness of the Flowchart

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?

25. About one-half of the respondents addressed whether the sequencing and integration of the flowchart were appropriate. About three quarters of those respondents did not feel it was appropriate. The remainder felt it would be appropriate or that it might be appropriate with modifications. Some of the specific comments included the following:

- a. Another screen should be added to determine if there is more than one "substantive" contract for accounting purposes and each of them should be analyzed.

- b. Another screen should be added that would exempt contracts that meet both of the following conditions:
 - (1) The maximum premiums receivable are not a substantial percentage of the maximum coverage provided, and
 - (2) With respect to the portions of risk insured, there are no provisions that reduce the likelihood of loss to the insurer compared to the likelihood of loss to the insured had it not entered into the agreement.
- c. The flowchart does not contain a filter for the additional assessment criteria required by EITF Issue No. 93-6, "Accounting for Multiple-Year Retrospectively Rated Contracts by Ceding and Assuming Enterprises".
- d. Contracts that failed risk transfer would be accounted for entirely as a deposit and this would not be consistent since those contracts also might have material insurance components that should be treated as insurance and not as a deposit.

05: Characteristics of Unequivocal Insurance Contracts

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?

26. About three-quarters of the respondents addressed whether the characteristics identified for contracts that unequivocally transfer significant insurance risk were appropriate. Virtually all of those respondents felt that the characteristics were inappropriate.

27. The criteria listed in paragraph 58 of the Invitation to Comment are:

Type of Contract

- a. A single personal insurance contract for (1) a single risk (for example, individual whole or term life) or (2) a group of similar coverages related to a single asset, liability, or event for which the policyholder is at risk (for example, personal auto or homeowners insurance).
- b. A single commercial insurance contract for a noninsurance company that has single-risk characteristics, such as single-premise property and liability insurance.
- c. A single-risk reinsurance contract under which all the insurance risk in the reinsured portion of an underlying insurance contract is reviewed by the reinsurer who may decline coverage for that risk.

Required Characteristics

- d. The contract has a market-equivalent level of premium and the premium 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.
- e. 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.
- f. The contract is not likely to result in any claims (for life insurance, although death is certain, the timing of the death and the existence of insurance coverage at the time of death are not).

28. Most respondents stated that individual insurance contracts shouldn't be treated differently than group contracts because group contracts are simply several individual contracts in aggregate. These respondents stated that every individual contract has an expected loss (albeit very small). They also felt that it would be inappropriate to treat a group policy differently than a bunch of individual policies if they are insuring the same risk. The following comment from the Reinsurance Association of America (letter 3) typifies that response:

...every individual policy has an expected loss, however small that may be for a single contract. Aggregation, the writing of multiple policies, does not create the expected loss (which remains the sum of the expected losses on the individual contracts), rather it merely makes the total expected loss less variable and more predictable through the operation of the law of large numbers. This law operates the same regardless of whether the risks were acquired individually by an insurer through direct writings or in total by a reinsurer through a quota share. Accordingly, there appears to be no theoretical justification of the different accounting treatment, since the portfolio of risks held by the reinsurer and insurer in this example are identical.

Any accounting principle or rule should be independent of how exposures are grouped in insurance and reinsurance contracts. If 10 individual insureds have the same aggregate risk characteristics as a larger multiple-location insured the accounting for the two should be identical.

29. Some of the other specific comments included the following:

- a. The definition is too restrictive and virtually no contracts would qualify as unequivocally transferring significant insurance risk.
- b. The type of contract is irrelevant (criteria a–c) and only the characteristics of the contract (criteria d–f) should be used in determining unequivocal risk transfer.
- c. The term *market terms* is too ambiguous.
- d. Criterion (f) should be removed or modified by replacing the words “not likely” with “remote” or changing it to a notion that states that it is reasonably possible that the contract will not result in any claims.

30. American International Group (letter 41) also suggested the following definition for determining unequivocal risk transfer:

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.

06: Whether Unequivocal Insurance Is an Improvement

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)?

31. Approximately one-half of respondents addressed whether the characteristics for unequivocal insurance contracts were an improvement over the exemption from cash flow testing in paragraph 11 of Statement 113. About four-fifths of these respondents stated that these characteristics are not an improvement. The remainder felt that they are an improvement or that they would be an improvement if modified by the suggestions mentioned in issue 5.

07A: Preferability of Approach A (Narrow) or Approach B (Broad)

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

32. Approximately one-half of respondents addressed whether they preferred Approach A (narrow) or Approach B (broad). Approximately half of those respondents said they preferred Approach A if the Board decided to require

bifurcation. Very few preferred Approach B. The remainder did not have a preferred approach because they felt that (a) bifurcation was not appropriate, (b) there was insufficient information about the approaches to make a decision, or (c) that Approach A could be applied if it were narrowed more.

07B: Superiority of Another Approach

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?

33. Approximately one-third of respondents addressed whether they felt that another approach would be superior. Approximately one-third of those respondents felt another approach would be better. Some suggested that using a measurement basis that puts a value on all the rights and obligations in the contract would be a better approach. Others felt that a simple pass-fail test (similar to existing standards) would be better. Still others felt that providing clarification on Statement 113 would be a better approach.

08: Differences in Bifurcation Criteria for Insurance/Reinsurance

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

34. Approximately one-half of respondents addressed whether the criteria for bifurcation should be different for insurance contracts and reinsurance contracts. Approximately four-fifths of those respondents felt that the criteria should not be different. Many felt the criteria should not be different because both types of contracts serve the same purpose—indemnification of the insured. Some respondents stated that while theoretically the criteria for both types of contracts should be the same, some differences may be necessary to make the application of the criteria more practical if a broad approach to

bifurcation is contemplated. Similarly, some noted that the purchasers of insurance contracts would have more difficulty doing analysis of the contracts and bifurcating them due to lack of expertise and data.

09: Preferability of Bifurcation Methods

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?

35. Approximately one-half of respondents addressed which of the methods for bifurcation has the most conceptual merit. Approximately two-thirds of those respondents did not feel that any of the methods had conceptual merit because they opposed bifurcation. Of those who preferred a method, the proportional method was preferred more than the other two methods. Some respondents suggested that the Board should not require a specific method but rather allow several possible methods and simply require that the model used be consistent with the model used for pricing and valuation. One felt that the proportional method would only be marginally more difficult to apply than the current risk transfer approaches.

10: Data Availability

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?

36. Approximately one-half of respondents addressed whether data availability would limit the development of any of the bifurcation methods. Nearly all of those respondents felt it would limit the development of the methods. Some felt that data availability would especially be an issue for corporate policyholders. Some felt that even insurers and reinsurers would have difficulty obtaining the data and developing the systems and models needed to apply the bifurcation methods. Some felt that data availability would especially be a problem in specialty lines.

11: International Convergence

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?

37. Approximately two-thirds of respondents addressed whether the FASB should be considering bifurcation of insurance contracts. Approximately four-fifths of those respondents felt the FASB should not be considering bifurcation at this time. The remainder felt that either the FASB should be considering it or that the FASB should be considering it with modifications to the approach. Suggestions from respondents included the following:

- a. Changes should be limited and should include enhanced disclosure until more comprehensive changes are made in conjunction with the IASB.
- b. Additional guidance on risk transfer evaluation should be issued until more comprehensive changes are made in conjunction with the IASB.
- c. Bifurcation should only be pursued by the Board if it would only be applied to a very limited number of potentially abusive contracts.

38. Standard and Poor's Rating Services (letter 61) stated that "...if bifurcation is pursued independent of a comprehensive solution, it should be done on a limited basis. We recommend the Board pursue a longer-term project focusing

on implementing guidance that would fully reflect the economic substance of insurance contracts, whether utilizing a fair value or other applicable model.”

RESPONDENT RECOMMENDATIONS

39. Respondents gave recommendations on what actions the Board should pursue to achieve its objectives with regard to insurance accounting. Respondents suggested the following:

- a. Address practice issues by refocusing the project to a limited scope providing guidance utilizing risk transfer principles that already exist in U.S. GAAP.
- b. Pursue a more comprehensive accounting and disclosure model with the IASB but in the meantime enhance disclosures.
- c. Clarify the following issues by providing additional guidance:
 - (1) Should refundable premiums (that is, premiums that are certain to be returned through claim payments or return of premium) be bifurcated as deposits?
 - (2) Should distinct components of loss coverage with separate aggregate policy limits be bifurcated for purposes of assessing risk transfer?
 - (3) Clarify practice issues regarding Statement 113 indemnification tests, including the 9a and 9b tests, specifically addressing the relationship between the probability and severity of loss when assessing risk transfer (for example, low probability/high severity contracts such as catastrophe insurance or certain single exposure policies).

- (4) Define contracts for which risk transfer is self-evident so as to avoid performance of a formal quantitative risk transfer analysis.
- d. Provide improved practical guidance regarding risk transfer testing including alternative approaches for evaluating sufficient risk transfer.
 - e. Provide additional guidance for determining whether significant insurance risk has been transferred. Some basic tenets may include the following:
 - (1) Further defining "reasonably possible" and "significant loss" in Statement 113
 - (2) Considering qualitative versus quantitative information
 - (3) Requiring documentation or representations
 - (4) Describing how common risk-limiting features affect risk transfer assessment.
 - f. Clarify the principle(s) that 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 9(a) of Statement 113 (AICPA, letter 37):
 - (1) When assessing the risk transfer guidance in paragraph 9(a) of Statement 113, what constitutes the reinsured portions of the underlying contracts?
 - (2) What type of qualitative or quantitative analysis is required to determine whether the reinsurer has assumed significant insurance risk under the contract?
 - (3) Clarify how the phrase "directly vary" in paragraph 62 of Statement 113 should be applied, specifically addressing what amount of correlation is

- needed between the ceding company's and the 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?
- g. Provide expanded guidance on the conditions that qualify for the exception to cash flow testing under paragraph 11 of Statement 113 and clarify whether the exception in that paragraph is meant to apply in very limited circumstances in which the reinsurer's economic position is virtually equivalent to having written the insurance contracts directly.
 - h. Provide additional guidance on what constitutes a contract for accounting purposes (including evaluation of risk transfer testing) and clarify the circumstances under which certain elements of individual contracts should be bifurcated; for instance, when should multiple contracts with the same counterparty be considered together, and when should separate coverages under a single contract be accounted for together or separately?
 - i. Clarify whether the concepts in Issue 93-6 regarding accrual of amounts receivable or payable under the contract based on experience-to-date are applicable to interim periods within single-year contracts.
 - j. Provide guidance regarding the appropriate accounting treatment for reinstatement premiums and similar provisions.
 - k. Address the application of existing guidance on evaluating risk transfer in determining the accounting for insurance arrangements by non-insurance enterprises.
 - l. Address financial guaranty insurance and credit default swaps.

- m. Develop implementation guidance that specifically addresses the facts and circumstances underlying contracts where there was a misapplication of existing accounting principles, as well as any others that have been identified as critical as a result of undertaking this project.

RESPONDENT DISCLOSURE SUGGESTIONS

40. Respondents also gave suggestions on the scope and content of disclosures regarding insurance contracts. Respondents recommended the following:

- a. In cases where (re)insurance accounting treatment for material contracts is granted, yet there is not a 100 percent risk transfer, companies should be required to disclose standardized key account metrics as if the arrangement did not exist.
- b. Required disclosure should be similar to the new NAIC reporting requirements for additional disclosure by ceding companies in the 2005 annual statements, which include:
 - (1) Summary of contract terms
 - (2) Description of management's intent and economic purpose of the contract
 - (3) Aggregate financial statement impact of such contracts on the balance sheet and income statement
 - (4) An explanation as to why any reinsurance contract is accounted differently for statutory vs. GAAP.

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- c. The FASB should improve and expand GAAP disclosures for insurance contracts and could leverage not only the work of the NAIC, but also the actuarial profession and international insurance regulators.

- d. The FASB should enhance the disclosure of methods (including reserving methodology), assumptions (including data at various confidence intervals), and risk-based capital information used to determine that certain risks have been transferred, focusing the requirement for enhanced disclosure on abusive areas.