



LETTER OF COMMENT NO.

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RAA

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Via Electronic Mail

Technical Director – File Reference No. 1325-100
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

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

Dear Sir or Madam:

The Reinsurance Association of America (RAA) appreciates the opportunity to comment on the Financial Accounting Standards Board's (FASB) May 26, 2006 Invitation to Comment (ITC) on *Bifurcation of Insurance and Reinsurance Contracts for Financial Reporting*.

The RAA is a national trade association representing property and casualty organizations that specialize in reinsurance. The RAA membership is diverse, including large and small, broker and direct, U.S. companies and subsidiaries of foreign companies. Together RAA members write nearly two-thirds of the gross reinsurance coverage provided by U.S. property and casualty reinsurers and affiliates.

The RAA has actively participated in the recent discourse between U.S. and international insurance regulators, the Internal Revenue Service and the FASB with regard to insurance and reinsurance risk transfer and accounting and disclosure of insurance and reinsurance contracts with "finite" characteristics. We appreciate the FASB's interest in this topic, which has been the subject of so much discussion recently.

We understand that the FASB's purpose of issuing the ITC is to receive input from buyers and sellers of insurance and reinsurance contracts as well as the users of financial statements regarding the possible bifurcation of those contracts. We also understand that other future steps in this project involve clarifying current risk transfer guidance and evaluating improvements and expansion of related disclosure requirements.

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.

Introductory Comments

The core question raised in the ITC is whether or not the bifurcation methods and approaches described in the ITC would provide users with more decision useful and understandable information. We strongly believe that it will not provide better information for users of financial statements of reinsurers, insurers or commercial policyholders and thus it fails to meet the FASB's objectives for financial reporting as described in Concepts Statement No. 2 and the recently exposed Preliminary Views document on the conceptual framework for financial reporting.

As fully described in our response to issues No. 3, 5 and 9, the ITC would result in materially different accounting treatment for substantially identical economic transactions. The ITC results in accounting that is driven by specific rules defining which contracts would be bifurcated and by how individual exposures are aggregated rather than at the portfolio or line of business level at which companies underwrite risks. Users of financial statements evaluate insurance entities based on their aggregate risk profile, not based on individual policy characteristics. If the proposals contained in the ITC were implemented, reliability and comparability would suffer, as entities with similar aggregate risk profiles would report substantially different financial information solely dependent on how their portfolio of risks was assembled. We illustrate how the other qualitative objectives of financial reporting are not met by the ITC proposals in our detailed comments.

The RAA does not agree that the bifurcation proposals in the ITC would result in reporting more understandable and relevant information by commercial policyholders. The ITC presumes that the amount of premium recorded provides decision useful information about the risks insured or retained by these commercial entities. Our comments explain why this information is not relevant, is likely immaterial and why it does not contribute to an understanding of the risks insured or retained by these entities. In addition, limitations on the data available to non insurance enterprises and limits on the level of expertise these companies have to evaluate cash flow probabilities will likely result in information that is inconsistent and not comparable among these entities and between these entities and their insurers.

As an organization representing reinsurers, we have long held the belief that SFAS 113, when properly applied, results in accounting and reporting that accurately reflects the economic substance of reinsurance transactions. We believe this because SFAS 113 is *appropriately designed as a principles-based standard*. With very few exceptions, managements and their independent auditors have done a good job of applying this guidance effectively since its promulgation in 1992. A fundamental problem with the ITC is that it is a rules-based approach that uses far too many specific rules to define which contracts are “finite,” which contracts unequivocally transfer risk, etc. As discussed below, the corollary of principles-based standards is that preparers and their auditors will sometimes have different interpretations of the appropriate accounting treatment for a *given set of facts and circumstances*. The natural consequence of rules-based standards is accounting that does not match the economic substance of transactions as well as the potential for financial engineering that would violate form over substance.

We recognize that the FASB necessarily must place limited emphasis on the effects on the marketplace of new or revised accounting standards. It is the duty of the FASB to promulgate standards that benefit users by providing decision useful information that *often will be costly to implement or that may in some instances have unintended negative market consequences*. Nevertheless, we believe this comment letter would not be complete unless we addressed our concerns in this regard.

We believe the proposals in the ITC would require bifurcation of most commercial insurance contracts and nearly all reinsurance contracts. This would represent a significant change from existing GAAP and a substantial difference between GAAP, IFRS and statutory accounting. Since many reinsurers in particular operate globally, many U.S. based reinsurers would have to keep three sets of records (for at least some period of time before convergence) of detailed transaction level financial information. More importantly however, the requirement to bifurcate insurance and reinsurance contracts will result in accounting “penalties” for certain types of transactions. These penalties could reduce the legitimate use of insurance and reinsurance and may promote corporate and individual behavior that is inconsistent with appropriate risk management practices. In addition, since reinsurance is a global business and since non-U.S. reinsurers would not be subject to bifurcation, the proposal is likely to have anti-competitive effects that are difficult to discern or evaluate currently. We do not address market effects elsewhere in this comment letter because we believe our other substantive arguments convincingly support our position that the ITC proposals do not improve GAAP accounting for financial statement users.

The FASB ITC has significant implications regarding convergence with IFRS accounting. As described in our response to Issue No. 1, we believe that the proposals contained in the ITC would move GAAP further away from convergence with IFRS with respect to risk transfer and to contracts accounted for as insurance or reinsurance. In our comment on Issue No. 11, we note that it seems inappropriate for the FASB to be considering such a significant change to GAAP accounting so nearly ahead of what appears to be likely convergence with IFRS. Such an approach would result in two significant system changes within a short period of time.

In summary, we believe the approaches contained in the ITC would not improve GAAP accounting, are inappropriate for commercial policyholders, incorporate a flawed rules-based approach, may have unintended market consequences and are unnecessary in light of likely convergence with IFRS. In our opinion, a better approach would be to provide more practical GAAP guidance on evaluating risk transfer and risk transfer testing and to develop improved disclosures for contracts where sufficient insurance risk transfer may be in doubt.

The 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?* (page 10)

We believe that the IFRS 4 definition of insurance contract is sufficient from the perspective of an accounting model that will ultimately be based on a current value approach (i.e. discounting with a risk margin). However, in the context of the current U.S. GAAP model, it is clearly inadequate and incorporates a much lower standard of sufficient insurance risk necessary to qualify for insurance or reinsurance accounting treatment.

The IFRS 4 definition was drafted not as a stand-alone definition, but rather in the context of distinguishing insurance risk under IFRS 4 from financial risk applicable under IAS 39. Paragraph B8 simply defines insurance risk as other than financial risk. IFRS 4 also requires significant insurance risk but the threshold is lower than the U.S. GAAP threshold. IFRS 4 paragraph B 23 describes significant as when the insured event could cause an insurer to pay significant benefits under ANY scenario, excluding scenarios that lack commercial substance. This paragraph notes that the significant criteria may be met even if the insured event is extremely unlikely or even if the expected present value of contingent cash flows is a small proportion of all contractual cash flows. In defining commercial substance, paragraphs B 23 and BC 36 simply define it as a discernable effect on the economics of the transaction. Similar to our understanding of current GAAP in many non-U.S. jurisdictions, IFRS 4 also does not require both underwriting and timing risk in its definition of insurance risk.

SFAS 113 in paragraphs 9 a and b requires that the reinsurer assume significant insurance risk (both underwriting and timing risk) and requires that it is reasonably possible that the reinsurer may realize a significant loss from the transaction. Over the years, practice has developed that reasonably possible means other than remote and that significant means at least a 10% loss. Thus, the 10/10 rule of thumb developed as an informal practice. The RAA believes that this standard, in the context of the other significant U.S. GAAP

guidance in the remainder of SFAS 113, several related EITF's, SFAS 5, 60, etc., is a much higher threshold for distinguishing insurance and reinsurance from financing transactions. We believe the proposed ITC would move U.S. GAAP further away from IFRS standards because it would significantly narrow the scope and proportion of individual insurance and reinsurance contracts treated as insurance.

The 10/10 rule of thumb has been a controversial subject in the recent public discussions regarding reinsurance risk transfer. Some industry observers are on record stating that 10/10 equals a 1% expected loss. Others have criticized it because they view this unofficial threshold as a bright line standard or because it represents too low of a threshold necessary to account for a reinsurance contract wholly as reinsurance. We will use this opportunity to respond to these assertions.

First, much of the misperception about the 10/10 rule arises because of an inaccurate notion that it is intended to be applied to many different types of reinsurance contracts. This industry practice arose following the implementation of SFAS 113 in 1992 as a way to address risk transfer in specific nontraditional contracts about which the FASB was then concerned. As is clear in the basis for conclusions in paragraph 40 of Appendix A of SFAS 113, the FASB adopted SFAS 113 to address the *"increasing diversity and complexity of reinsurance arrangements and the proliferation of nontraditional reinsurance contracts."* Detailed risk transfer testing and use of the 10/10 rule was never intended to apply to all types of reinsurance contracts; the FASB and practitioners were primarily concerned with nontraditional reinsurance. It is worth noting that the ITC goes far beyond the intent of SFAS 113 by considering approaches that would bifurcate most traditional reinsurance contracts, for which many practitioners believe the existing guidance is adequate.

We strongly disagree with the contention that the 10/10 threshold equals a 1% expected loss. The 10/10 rule as (is most often) correctly applied means *at least* a 10% chance of a 10% *or greater* loss. The 10/10 threshold is but one point on the frequency/severity continuum. Under the 10/10 rule, contract must meet this threshold loss at that probability, but the potential for losses in the "right tail" is significantly higher. For example, a contract that meets the 10/10 threshold modeled in a frequency and severity analysis may have a 1% chance of a 200% loss and a 0.5% chance of a 1000% loss. Additionally, two separate contracts, each of which is expected to experience a 10% loss at the 90th percentile (and therefore pass the 10/10 rule) may have significantly different expected results above and below that probability. This concept also explains why the 10/10 rule of thumb is not a bright line test for the specific types of contracts for which it is applicable.

In addition, in a report presented to the NAIC by a leading reinsurance intermediary, it was demonstrated using accepted actuarial analysis applicable to reinsurance contracts that the 10/10 threshold is a reasonable test of risk transfer. We believe the same analysis was presented to the FASB staff last year. The analysis showed that a quota share contract written to meet the 10/10 threshold and that matched the underwriting performance of the entire P&C industry in 2003 would have a loss distribution that

predicts a 32% chance of a loss to the reinsurer. The analysis also shows that this contract would equate to a 11.4% return on equity to the reinsurer and that higher thresholds such as 10/15 or 10/20 would severely limit reinsurers' returns to unreasonable levels. A related analysis prepared by a working party of the Casualty Actuarial Society in a report on risk transfer testing in August 2005 noted that the predicted volatility in a reinsurance contract that meets the 10/10 threshold is greater than the volatility in the S&P 500 as indicated by the CBOE volatility index (VIX). Clearly then there is significant insurance risk in reinsurance contracts that meet this threshold. As a result, we conclude that the 10/10 approach is both a reasonable measure of risk transfer and not too low a threshold for certain types of reinsurance contracts.

To reiterate a point made earlier in this letter, the Casualty Actuarial Society's working party report also contains other approaches and tests for evaluating risk transfer that are more applicable to traditional reinsurance contracts. We encourage FASB to consider these approaches for as a better alternative to the proposals contained in the ITC.

Regarding how the U.S. GAAP definition of insurance risk could be improved, we believe that the current definition in SFAS 113 for reinsurance contracts is adequate. SFAS 113 was designed as a principles-based standard that requires the evaluation of the specific facts and circumstances and the use of professional judgment to determine the appropriate accounting for specific transactions. With very few, but widely reported exceptions, this principles based standard has worked very well for over 13 years. The FASB is on record favoring more principles-based standards. We believe that the corollary of principles-based standards is that preparers and their auditors will sometimes have different interpretations of the appropriate accounting treatment for a given set of facts and circumstances. However, as discussed in more detail under Issue No. 3, we believe that the subjective judgments necessary to implement any of the proposed bifurcation methods would significantly increase variability and reduce both comparability and verifiability of financial statements. We do not believe that the relatively few known errors applying this guidance warrants a wholesale and significant change to the U.S. GAAP model for defining insurance, bifurcating transactions and evaluating insurance risk transfer.

With respect to whether the current U.S. GAAP definition of insurance is adequate, we believe it is sufficient under the current deferral and matching accounting model. While the U.S. GAAP guidance was developed piecemeal and while it is focused on insurers rather than insurance contracts (i.e. IFRS 4), we believe that history shows that insurers and non-insurance entities have used appropriate professional judgment to ensure that the vast majority of reported financial information faithfully represents the underlying economics of insurance transactions. We believe that any significant changes to the U.S. GAAP definitions of insurance and reinsurance should only be addressed in the context of a comprehensive review of the U.S. model as part of convergence with international accounting standards.

Paragraph 36 of the ITC attempts to define "finite" insurance and reinsurance and lists several characteristics that may limit risk transfer. 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.

Following are but a few examples of the problems with this list. Item b (1) applies to essentially every insurance and reinsurance contract. Limits on aggregate claims, item b (4), are common in virtually all reinsurance contracts because reinsurers are unwilling to risk their continuing existence on any single contract. It appears that policy limits on common individual insurance contracts are economically similar and would thus qualify as finite under this paragraph. Item b (3), coverage periods that extend beyond one year, is a common approach in catastrophe risk insurance because it allows the insured to spread risk over time as well as over a geographic area. Multi-year contracts in general allow better diversification of risks, save time and cost vs. negotiating annual contracts, and provide more certainty for both capacity and cost for insurance buyers, thus leading to more efficient capital management.

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?* (page 11)

As stated above, we believe that the existing principles-based guidance in SFAS 113, when properly applied, results in accounting that accurately reflects the economic substance of reinsurance transactions. In principle, corporate policyholders and insurers could apply this guidance. However, we doubt that such an approach would meet FASB’s objectives for more decision useful financial reporting.

SFAS 113 works well for transactions between insurers and reinsurers who are principally engaged in the insurance business and for whom insurance premiums and insurance losses are a material element of their financial statements. The same approach may not be practical and is arguably unnecessary for corporate policyholders. For most corporate policyholders, insurance premiums, insured losses and insurance recoveries are immaterial to the financial statements and are aggregated in selling, general and administrative expenses without separate disclosure. Classifying a portion of insurance

premiums and recoveries as deposits is unlikely to result in decision useful information for users of their financial statements.

The application of the risk transfer guidance of SFAS 113 requires extensive actuarial expertise to estimate the probability of loss and for insurers and reinsurers involves the use comprehensive historical data that is typically not available to corporate policyholders. We doubt that most corporate policyholders will have the capability or data necessary to adequately prepare cash flow analyses inherent in sophisticated risk transfer testing and bifurcation.

With regard to the potential changes to SFAS 113 requiring bifurcation contemplated in the ITC, we believe such rules are unnecessary for corporate policyholders. In frequent references to dollar-trading in the ITC, the FASB expresses concern regarding the appropriate amount of premium being recorded vs. deposit accounting. We believe that the focus on premiums is much less important for corporate policyholders due to its immaterial nature. Moreover, paragraph 44 of the ITC erroneously infers that information about the amount of insurance premium incurred by corporate policyholders would be decision useful. The amount of insurance premium recorded will provide little or no insight about the risks transferred or risk retained by a corporate policyholder. For example, the same amount of premium cost could be incurred for insuring a lesser amount of an exposure that is more likely to occur as for insuring a much larger (e.g. catastrophic) amount of an exposure that is much less likely to occur.

In addition, the insurance industry experiences cycles that dramatically change the price of coverage. An individual policyholder's premium expense may increase dramatically year to year due to events (e.g. Katrina, Wilma & Rita hurricanes in 2005) that did not directly affect them. Thus, not only is premium expense not comparable between companies, it is not even comparable for a single company year to year. Segregating premium amounts from deposits through bifurcation will not make this information more relevant to users or provide predictive value regarding potential insured or uninsured exposures.

It is also appropriate to consider comparability when considering application of FAS 113 and the bifurcation proposals in the ITC to corporate policyholders. Because of differences in risk evaluation capability and particularly access to data, corporate policyholders are likely to reach very different conclusions than an insurer about the accounting treatment for the same transaction.

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?* (page 14)

In our view, this is the most critical question raised by the ITC. Will bifurcation of insurance and reinsurance contracts meet FASB's objectives of improving financial reporting of insurance and reinsurance contracts? We believe strongly that the answer is no.

As a starting point, we wish to make clear that the RAA does not oppose bifurcation as an accounting concept. Bifurcation currently exists in U.S. GAAP for reinsurance contracts in EITF D-34 *Accounting for Reinsurance: Questions and Answers about FASB Statement No. 113*. Q&A number 13 discusses what is an insurance contract and states in part:

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

However, we do not believe the bifurcation approaches contained in the ITC will provide more understandable and decision-useful information. The following discussion provides general reasons why we believe this and separately addresses several of the qualitative characteristics of decision useful information contained in FASB Concept Statement No. 2 and in the July 6, 2006 Preliminary Views document on the conceptual framework for financial reporting.

We do not believe that the proposed accounting approach in the ITC correctly recognizes the true nature of the underlying insurance and reinsurance business. Bifurcating material deposit elements and recording them in the balance sheet infers that the underlying cash flows possess the same stability and predictability associated with loan arrangements. This treatment ignores the actual volatility and uncertainty of these elements, which by their very nature are subject to higher risk than cash flows associated with lending transactions.

Insurance and reinsurance contracts are designed and priced as single transactions. Contrary to what may have been reported in the general media, they are designed not to achieve a particular accounting result, but rather to efficiently transfer insurance risk from one party to another. Commonly and by economic necessity, these contracts have loss limiting, adjustable, multi-year and other features. These features are necessary for the issuer of the policy to protect its capital base and its claims paying ability. These features are necessary for the purchaser to economically spread and transfer risk over the larger capital base of the insurance and reinsurance industry at an affordable price. Bifurcation of some elements of these transactions is an artificial construct that fails to recognize the unity of the contract.

We believe that bifurcation as proposed in this ITC would distort the reliability and comparability of reported financial information as it would require many more complex assumptions and calculations involving individual discretion and judgment. These assumptions depend heavily on the available financial information and accounting and actuarial expertise to predict expected losses and other probable future cash flows. Ultimately, such an approach is likely to lead to arbitrary bifurcation based on subjective judgments.

There are other comparability problems with respect to the way the ITC defines contracts that unequivocally transfer risk and thus may not be subject to bifurcation. For example, the ITC defines a single contract for a single risk as unequivocal. Yet an aggregation of exactly similar contracts, because it arguably has an expected loss, would be subject to bifurcation. Aggregation does not create an expected loss; it is merely the sum of the expected losses on individual risks. What aggregation does is to reduce the variability around that expected loss so that the probability of the outcome being close to the expected loss increases. A straight Quota Share reinsurance contract pays losses on the individual contracts (not on the aggregation of those contracts) and thus is economically identical. Yet, the ITC would require bifurcation of the reinsurance contract and not the underlying contracts. This approach will create inconsistent accounting for identical economic transactions.

Similarly, because many commercial insurance contracts have features that would require bifurcation, the financial statements of a personal lines writer would look completely different than that of a commercial writer of insurance. We do not believe this is a rational approach since both types of entities are principally engaged in assuming insurance risk from the public. Further, a commercial insurance enterprise will be subject to what one RAA member coined as “bifurcation squared.” Reinsurers and commercial insurers will be required to bifurcate many of the insurance contracts issued and will also be required to bifurcate reinsurance purchased. A personal lines insurer typically will only bifurcate outgoing reinsurance. A similar anomaly would likely apply to life insurers who only write individual policies vs. those that write primarily group coverage. We do not believe the economics of these transactions and particularly the portfolio of risks that result are fundamentally different.

We believe that the ITC makes the erroneous assumption that management and users of financial statements focus on individual contracts. This is not the case as insurers and reinsurers are managed by reference to a portfolio of contracts. At the portfolio level, all insurance has an expected level of losses. Whether an entity is a commercial writer, personal lines writer or a reinsurer, the business is priced based on an expected level of losses, timing of cash flows, etc. It will not provide decision useful information to management or other users of financial statements if some contracts are bifurcated and some are not solely based on the line of business or whether an arbitrary unequivocal test requires it. Finally, it bears noting that many insurance professionals believe that every individual insurance policy has an expected loss associated with it, even if policyholders in particular ignore it. From an actuarial point of view, the premium for every insurance contract written has a component to cover expected loss because every contract has some nonzero probability of loss associated with it. The idea of expected loss being used to differentiate accounting treatment is a false standard and an erroneous basis for a significant change in GAAP treatment of insurance.

We believe that the ITC moves away from principles-based standards toward more rules-based standards and thus creates more opportunity for circumvention through financial engineering and arbitrage. The best way to illustrate this potential problem is with

examples. First, the expected level of losses is a core element of bifurcation. However because the probability level of cash flows will vary with the population size to which bifurcation is applied, a relatively large contract could be split into separate small contracts to reduce the amount of highly likely cash flows and consequently reduce the deposit component. Similarly, a common 20% quota share reinsurance contract would be subject to bifurcation under the ITC. However, the contract could be structured as an automatic facultative contract on 20% of the related direct business. This contract form would not be subject to bifurcation under the specific rules of the ITC and thus might be used to avoid its requirements. We understand that the qualitative characteristics of decision useful information including faithful representation are intended to address these concerns. However, standards should not be drafted so specifically as to invite the abuse of form over substance.

The ITC would require that certain fractions of premium, losses and commissions be designated as financing elements and recorded in the balance sheet without initial income statement impact. Although the curtailment of these income statement items will change the composition (e.g. premium vs. interest expense) it can be presumed that overall net income will be generally unchanged as the amount of premium income reduction and loss expense reduction (or premium expense reduction and insurance recovery reduction for the insured) should be roughly the same. Therefore, bifurcation will not provide better information to the users of financial statements. In fact, this presentation may decrease the fair presentation of insurers' and reinsurers' growth performance since it would eliminate that premium income accounted for as financing.

The understandability of common income statement items as well as common insurance ratios will be less relevant and have less predictive and confirmatory value than under current U.S. GAAP. For example, under current GAAP accounting, a ceding insurer which transfers a portion of its risk under a unrestricted quota share contract would record net premiums that equal gross premiums less the percentage ceded to its reinsurer. Under the ITC, net premiums would not equal gross less ceded because a portion of the ceded premiums will be recorded as a deposit. Further disclosure of the composition of net premiums will be necessary to understand the financial statements.

Similarly, since the ITC would also require bifurcation of premiums written, the referenced ceding insurer would also report less insurance premium to recognize the bifurcated portion of business written. Premiums written is a baseline measure of growth and is used as well for premium taxes, comparisons of market share, evaluation of participation in specific lines of business in various jurisdictions, etc. Some measure of these elements would need to be reconstructed in the footnotes to provide information needed by the users of the financial statements.

Further, bifurcation of insurance and reinsurance contracts as proposed in the ITC would make useless many ratios that are commonly used by insurance industry observers. Loss ratio's (aggregate and line of business) expense ratios, combined ratios leverage ratios are all based on written or earned premiums. These ratios are very useful to gauge the relative performance and profitability of insurers and the quality of management.

Grossing up the balance sheet for the financing elements of portions of insurance and reinsurance contracts will come at the price of losing much more valuable information. *Because the bifurcation approaches incorporate bright lines as well as significant subjective judgments, the result would be not only to destroy the comparability with past results but it would open these ratios and other useful measures to potential manipulation.*

We have addressed several of GAAP's qualitative characteristics of decision useful accounting information above. The following discussion addresses these elements specifically and references both Concepts Statement No. 2 as well as the July 6, 2006 Preliminary Views document (PV).

The introduction to the PV states that standard setters presume that financial statement preparers will use due care in implementing financial reporting requirements, that preparers will apply the requirements properly and present information clearly and concisely. While this characteristic is intended as an introduction in the PV, it is relevant to the discussion of the ITC.

The proposals in the ITC presume that current GAAP for insurance and reinsurance fails to present decision useful information, either because preparers have not applied them properly or because the information presented is not clear and concise. The ITC also presumes that bifurcation will improve financial reporting and be more clear and concise. We believe that both presumptions are incorrect. We believe that current GAAP for insurance and reinsurance does provide a principles-based model that, when properly applied, accurately reflects the economic substance of these transactions. It is a principles-based standard that has resulted in clear and concise reporting of insurance and reinsurance under the current U.S. deferral and matching model for insurance. Only in extremely rare circumstances has there been any evidence that preparers have failed to apply the current guidance properly.

The ITC is far more likely to result in an accounting model that is difficult to properly apply than current GAAP, particularly for insurers and most especially for commercial purchasers of insurance. We also believe that the resulting financial information will be less clear and concise than current U.S. GAAP. We have addressed the reasons why in the above examples of the effects of bifurcation on reported premiums, financial ratios and in the discussion of comparability.

Relevance. Relevant financial information is capable of making a difference in the decisions of users and includes information that has predictive or confirmatory value that is timely. It is difficult for us to discern how the ITC contributes to more relevant financial information. As noted above, the focus of the ITC appears to be on ensuring that the "correct" amount of insurance premium has been recorded and that any financing component is put up in the balance sheet so that users can better gauge whether the amount of premium expense appropriately corresponds to the amount of insurance risk transferred by the insurance contract. As described previously with examples, the amount of premium expense or the amount of deposit on the balance sheet will not provide better information about the risks transferred or retained by the reporting entity.

Another problem with the ITC is that it fails to differentiate between transactions with similar economic characteristics (e.g. individual policies and reinsurance of those same policies) and because it would require far too many insurance and reinsurance contracts to be artificially bifurcated based on arbitrary rules-based criteria. We do not believe that bifurcating insurance and reinsurance contracts would provide more predictive information than the current model, which preserves the traditional measure of insurance premium for contracts that transfer enough insurance risk to be accounted wholly as insurance or reinsurance.

Faithful Representation. Accounting information should faithfully represent the economics of the transactions it represents. Faithful representation includes the concept of substance over form and requires that accounting information be verifiable, neutral and complete. As already stated, we believe the current GAAP model for reinsurance faithfully represents those transactions. We have discussed how the rules-based approach in the ITC does not match the economic basis of similar contracts that would be treated differently solely because they do not meet the rules-based criteria of unequivocal transfer of risk. We have discussed how the rules-based approach invites undesirable financial engineering aimed at circumventing the accounting rules. We believe that the real world substance of insurance and reinsurance contracts is that they often do have elements of a financing, but that the structures and features of the contracts are so intertwined, that they cannot be reasonably bifurcated. Instead, the current approach of typically accounting for a contract as either wholly an insurance or reinsurance contract or wholly a deposit more faithfully represents the economics of these transactions.

Verifiability implies different and knowledgeable independent observers would reach a general consensus that the accounting information represents the relevant economic phenomena and that the chosen recognition method has been applied without material error or bias. The PV discusses direct and indirect methods of verification. Indirect verification implies that knowledgeable users could recalculate outputs from the available information and reach the same conclusions. We do not believe that the ITC, which is unnecessarily complex and which would require many more subjective judgments than are currently required, would meet the standard of indirect verification. We believe the current GAAP guidance for reinsurance does meet that standard. Direct verification does not apply to insurance and reinsurance contracts that cannot be physically observed.

Neutrality is the absence of bias intended to attain a particular accounting result. We do believe that the current guidance better meets the requirement for neutrality than the proposals in the ITC because it better reflects the economic substance of the transaction. Some might argue that the current guidance allows the engineering of transactions to achieve a particular accounting result (e.g. engineering the transaction to just meet the 10/10 threshold). We would respond that such a transaction does not comply with the current guidance and current practice that requires *at least* a 10% chance of a 10% *or greater* loss. In all but a few instances this has been proven not to be a problem. The current principles-based standard has worked well because preparers and their auditors have used due care in exercising the professional judgment required in SFAS 113.

We do not believe that the ITC improves the current standard with respect to completeness. Current GAAP could be improved through improved disclosure about insurance reinsurance contracts where the amount of risk transfer is in question. We believe that improved disclosure is a better approach to for improving existing GAAP than the bifurcation proposal.

Comparability. Comparability is the quality of information that enables users to identify similarities and differences in two or more sets of economic phenomena. Comparability includes consistency, which refers to the use of the same accounting policies and procedures between accounting periods and among different accounting entities. We have described above why we do not believe that the ITC will result in consistent and comparable information. In essence the arbitrary rules contained in the ITC will cause like economic events to be accounted for differently and the difficulty in applying these rules and related judgments will create less consistency among reporting entities.

Understandability. Understandability is the quality of financial information that enables reasonably knowledgeable users to comprehend its meaning. We do not believe that the ITC would improve the understandability of insurance and non-insurance financial statements. One reason is that it adds further complexity to financial reporting where none is needed. Insurance and reinsurance transactions are necessarily complex because they address complex business risks in the most economical manner (i.e. lowest premium) possible. Artificially bifurcating single contracts into risk transfer and financing components will add complexity and will not improve the representational faithfulness of the information presented. Second, we have described how bifurcation would throw out the window many standardized and widely used metrics for evaluating insurance enterprises. Users of the financial statements of commercial policyholders will not benefit from a further dissection of information that is rarely separately reported. Further, bifurcation is unlikely to provide any better information on the risks insured or retained by these entities.

Materiality and Cost vs. Benefits. The above qualitative characteristics are subject to the overriding characteristics of materiality and to the idea that the benefits of the accounting model justify its cost. We have stated that with respect to applying the SFAS 113 guidance to the ITC to commercial policyholders is unnecessary because insurance premiums are generally immaterial. Clearly, the issue of risk transfer and accounting for insurance and reinsurance is material for those entities engaged in the insurance industry.

With regard to costs and benefits, we understand that the FASB takes a broad view (i.e. what may be costly for preparers may engender significant benefits to users of financial statements, including the management of insurance enterprises). Given this broad view, we still do not believe that the benefits of the bifurcation proposals contained in the ITC outweigh the costs. We do not believe that the bifurcation proposals will improve financial reporting for users for the reasons stated above.

With the exception of large insurance and reinsurance transactions, management would not use this information as the basis for decisions since they typically review and monitor the business on a portfolio basis. Of course, the pricing of reinsurance contracts for example does involve a consideration of probable expected losses at the inception of the contract, but the consideration is not whether some portion is a financing, but rather what is the likely return or loss on an individual contract and how it fits within the total risk exposures and returns of the entity. We believe that the requirement to bifurcate many insurance contracts and virtually all reinsurance contracts will be costly, complex and will involve significant changes to systems, procedures and internal controls by insurers and reinsurers.

Thus in our opinion, the costs to users of financial statements includes less transparent and arbitrary treatment of insurance and reinsurance that is not more representationally faithful or decision useful. The costs to preparers will also be significant both in terms of actual implementation costs and the cost of less useful information on which to base decisions. There are few benefits to the proposal, which do not outweigh these costs.

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? (page 17)*

In general, the requirement to further separate insurance contracts that unequivocally transfer insurance risk from contracts that do not involves specific bright line rules. However, as stated in paragraph 58 of the ITC, it also will likely involve considerable subjective judgment in its application. These characteristics will likely complicate the accounting for these contracts and will impair the comparability of financial statements.

The flowchart presents two significant problems. The first is that it essentially renders the existing SFAS 113 risk transfer tests irrelevant. Once a contract has been identified as insurance in screen (a), the decision of whether it “unequivocally” transfers significant insurance risk, screen (c), ignores the existing SFAS 113 risk transfer test entirely. Instead, as described in paragraphs 57 through 59 of the ITC, the identification of “unequivocal” insurance contracts is a rules-based approach that relies on the existence of “required characteristics”. Since “unequivocal” contracts are the only contracts that avoid bifurcation on their own merit rather than through an exemption, the rules-based definition of “unequivocal” becomes the de facto test and definition of insurance.

The existing SFAS 113 risk transfer tests, which appear in screen (d), are relegated to a minor role. Although not explicitly stated in the flowchart, they exist solely to determine whether an insurance contract should be accounted for wholly as a deposit and will be irrelevant in determining the accounting treatment of any other contract. This can be demonstrated as follows:

An insurance contract is subjected to the analysis described in the flowchart. Assume it meets the definition of insurance (screen (a)), does not contain an embedded derivative (screen (b)) and does not unequivocally transfer significant insurance risk (screen (c)). Screen (d) is now applied. If the contract does not meet the existing SFAS 113 risk transfer tests, it will be accounted for wholly as a deposit. If it does, then it will be bifurcated into “components that transfer significant insurance risk and those that do not (deposits)”. However, the phrase “transfer significant insurance risk” is used in screen (c) in reference to “unequivocal” insurance contracts. To maintain consistency, any bifurcation method chosen should result in the “insurance” component of a bifurcated contract looking like an “unequivocal” contract. Since an “unequivocal” contract is determined under a rules based approach, which relies on “required characteristics” rather than by reference to the existing principles based SFAS 113 risk transfer tests, the latter will not influence how the contract is bifurcated. Hence, the existing SFAS 113 risk transfer tests will only be operative when determining whether an insurance contract should be accounted for wholly as a deposit.

This leads to the second significant problem with the flowchart: contracts not meeting the risk transfer threshold of SFAS 113 would be accounted for as a deposit in their entirety. This does not appear to be consistent with the overall bifurcation approach contained in the ITC since the insurance component still might be material even though the overall contract fails the SFAS 113 test. As a result, the premium relating to this “pure” insurance element would be ignored in the income statement of the reporting entity and thus distort their performance. Given these two problems, it is unclear where the existing principles-based standard in SFAS 113 has an operable place in the proposed model.

An additional problem exists with respect to screen (e), which has not been defined but is contemplated to be a rules-based requirement. In paragraph 56 (e) this screen is expected to screen contracts out (or in) based on either specified contractual terms or features, or contracts described or defined as finite risk contracts. We believe it will be exceedingly difficult to define finite, which we view as dependent on the degree of economic impact rather than specific feature that are typically common of “traditional” insurance and reinsurance contracts. We reiterate that bright line-rules have no place in a modern accounting standard.

In summary the flowchart renders the current SFAS 113 risk transfer tests meaningless while introducing both bright line rules and further ambiguous tests that will not likely lead to more decision useful financial information.

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? (page 18)*

We do not agree with the characteristics identified for contracts that do or do not unequivocally transfer insurance risk. We do not believe that the concept has value

because these characteristics by nature involve a rules-based approach that will never result in like accounting for like economic events or substitute for the professional judgment that is necessary for this complex accounting question.

The nature of the problem is clearly illustrated in the types of contracts and required characteristics used to define this subset of contracts. As it is constructed, applying required characteristics d. and f.; only single risk insurance contracts would meet the unequivocal test for insurance accounting. This means that an insurer would apply the test to individual contracts and in many cases might reach the conclusion that the contract unequivocally transfers insurance risk. On the other hand, a reinsurer assuming a percentage of the risk in each individual policy through an unrestricted quota share would have to bifurcate the contract because the aggregation of these risks has an associated expected loss.

The problem with this approach is that 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.

Since aggregation, the pooling and mitigation of risk through the operation of the law of large numbers, is fundamental to insurance both insurers and reinsurers evaluate portfolios of insurance contracts rather than individual contracts. Therefore, the requirement that the contract is not likely to result in any claims, while meaningful to a single non-insurance enterprise ceding risk, is not meaningful to an insurance enterprise that focuses on portfolios of contracts rather than individual contracts. Both the insurer and the reinsurer are aggregating the risks and enjoying the benefits of a diversified portfolio of insurance with the exact same economic characteristics. However, in one case it is treated wholly as insurance and in the other it is bifurcated into insurance and deposit components.

To provide but a single example of why the required characteristics are inappropriately rules-based and do not necessarily relate to the transfer of risk, we offer the following related to paragraph 58. e. Paragraph 58. e. states: "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." Profit sharing or no claims bonuses have been used in traditional reinsurance for many years and do not limit the risk; these features only limit the reinsurer's upside not their downside risk. It is not uncommon for the insured and reinsurer to disagree on what is the expected amount of loss. When differences of opinion occur certain features are sometimes used to bridge the gap between the insurer's viewpoint and the reinsurer's viewpoint so that each side feels it is getting a fair price.

The company purchasing reinsurance is rewarded for good results based on good underwriting, loss mitigation, and claims handling. In an effort to avoid the costly complex bifurcation procedures certain insureds may decide to forgo a profit commission. This characteristic only serves to penalize the insured by forcing it to pay more for insurance or reinsurance coverage and has little direct bearing on the amount of insurance risk transferred.

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)?* (page 18)

No, we do not believe the characteristics described in paragraph 58 for unequivocal insurance contracts are an improvement over paragraph 11 of SFAS 113. The purpose and effect of each set of guidance is different. Paragraph 58 of the ITC attempts, using specific contract types and characteristics, to identify a narrow set of insurance contracts that have negligible non-insurance features that then will be eligible for insurance accounting treatment. The paragraph 11 exception of SFAS 113 requires professional judgment to evaluate whether the reinsurer has assumed substantially all of the insurance risk relating to the reinsured portions of the underlying contracts. The existing guidance is more effective because it is principles-based and requires professional judgment to evaluate the true nature of the reinsurance arrangement regardless of form.

The effect of paragraph 58 of the ITC differs substantially from the existing paragraph 11 guidance in SFAS 113. The ITC in paragraphs 58 and 59 creates a very narrow category of contracts that unequivocally transfer risk by defining them as only single risk contracts without an expected level of losses. The narrow nature of this category would require further testing and evaluation of many reinsurance contracts that meet the current paragraph 11 exception because the only reinsurance contracts that would seem to qualify under ITC paragraph 58 are single risk facultative contracts.

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?* (page 20)

We prefer neither Approach A or B for identifying contracts subject to bifurcation. We do not believe either approach represents an operationally sound approach because both rely on specific rules relating to the existence of specific contract features or characteristics. Both approaches appear as if they would require bifurcation of many insurance and reinsurance contracts including so-called traditional contracts that transfer significant insurance risk simply because of the existence of one contract feature or another. We do not believe that the FASB's intent in Approach A to identify "finite" insurance contracts is achievable using a rules-based approach.

While we do not support bifurcation as described in the ITC, Approach A would be improved if the specific rules were removed and it was more reliant on professional judgment in the first part of paragraph 62 where it discusses significant financing or insignificant insurance components.

Approach B would bifurcate all contracts not screened out for deposit accounting in their entirety. As stated in our response to Issue 4, it is possible that the insurance component still might be material even though the overall contract fails the SFAS 113 test or is not unequivocal. As a result, the premium relating to the insurance element would be ignored in the income statement of the reporting entity and thus distort their performance. This approach fails the FASB's qualitative characteristic of neutrality since it requires more conservative deposit treatment for the entirety of any contract not screened out for deposit treatment even though their may be a material insurance component. It seems that the FASB concepts are better met if these contracts were also bifurcated.

We remain skeptical that any of the bifurcation approaches proposed in the ITC would result in more decision useful financial information and reiterate that the current principles based approach has worked well for the vast majority of transactions.

Issue 8: *Should the criteria for bifurcation be different for insurance contracts and reinsurance contracts? Why? If yes, what differences would you suggest? (page 20)*

We do not believe that bifurcation as proposed in the ITC is operational or would result in more decision useful information. We do not believe that the bifurcation methods proposed in the ITC are any more or less applicable to insurance contracts than reinsurance contracts.

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? (page 22)*

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. A reinsurance contract should not have different accounting treatment because the contract aggregates individual smaller policies. This concept presumes that an insurance company or other commercial risk taking enterprise would actually underwrite a single policy or contract.

Individual personal lines risks are generally not priced, underwritten or otherwise managed policy by policy. In fact, most states prohibit practices that price or select policy by policy as discriminatory. Consequently, most insurance companies manage books of insurance contracts in groups or books that aggregate risks at a level at which reinsurers generally underwrite. Without this principle comparability between companies suffers greatly as companies with similar aggregate risk profiles would have vastly different financials depending not on the characteristics of their aggregate portfolio but rather in how the portfolio was assembled.

The user of the financial statements is interested in the aggregate figures, not the individual policy characteristics. Without the above characteristic perverse incentives may be created to unbundled contracts into smaller components for those who wish greater insurance premium and less deposit premium.

The expected payout method fails this test. Companies that had smaller contracts would tend to have a higher proportion of their premiums reported as insurance than companies with larger policies/contracts. What would the readers of the financials gain? They could not assume that the companies with smaller premiums and larger deposits had less risk because the method is measuring individual contract volatility which may or may not contribute to aggregate portfolio volatility depending on whether the risks in the individual contract are diversifiable or not. In addition, reinsurance contracts would tend to have a much higher portion of the premium reported as deposit than the corresponding portfolio of subject business. This is true even in cases where the risk transferred in the reinsurance contract is greater than the risk inherent in the subject business such as certain working layer excess of loss contracts. The perception of the user of the financial statements could well be that the ceding company is retaining significantly more risk than is actually the case.

The proportional method as described in the ITC appears confusing and inadequately defined. The description refers to insured risk retained by the policyholder after applying the terms of the insurance contract. This appears to be a meaningless concept since if it is retained by the policyholder, then it is not insured. The terms of the insurance contract define the insured risk. If the intention is to measure what would have been ceded in the absence of risk limiting features that seems unattainable and irrelevant. Virtually all contracts have risk limiting features including exclusions, deductibles and limits of coverage. Risk limiting features are often introduced because the risk addressed is unknown or unquantifiable. It does not seem practical or meaningful to compare the “insured risk” without exclusions, limits and other risk limiting features to that with such features. Though it is not clear how this would be applied it may also have similar problems to the expected payout method.

The cash flow yield method would satisfy the criteria put forth in the first paragraph above assuming it was applied to all insurance contracts without exception. However, it would totally redefine insurance as a derivative of the current concept of insurance. The value of this newly defined insurance would depend on the positive or negative variance in cash flows from expected. If the current accounting format were maintained both

positive and negative insurance losses would be possible. Most insurance premiums would be accounted for as deposits and only the profit margins would be accounted for as premiums. This type of change would be such a radical departure from the current understanding of insurance that long established revenue and expense concepts of insurance accounting would be effectively abandoned. The risk-transfer issue is not so complex as to require such comprehensive change.

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? (page 23)*

Yes. Data availability would limit the development of the bifurcation methods described in this ITC. As described in our comments in response to Issues No.'s 3 and 9, insurance contracts are designed and priced as a unit and are managed and evaluated on a portfolio or book of business basis. The data necessary to bifurcate the elements of individual contracts is not available currently. The bifurcation approaches outlined likely would require significant and costly system changes that are irrelevant to management's decision making and the needs of financial statement users.

Many reinsurance contracts are estimated using small amounts of data or are underwritten on new books of business where there is no underlying data. These situations make the variability of the potential losses quite high and would make any bifurcation estimate dependent on significant underlying assumptions. This variability could affect small insurers more than large ones because their small dataset is less reliable. These data limitations would also affect specialty lines of business more than standard lines such as auto, property and general liability lines of business.

For similar reasons, data availability also would limit the application of the bifurcation methods described in this ITC for commercial purchasers of insurance. As described in our response to Issue No. 2, these entities are not principally engaged in insurance and often would not have access to sufficient or reliable data. Neither is it likely that these entities would have the same capability to evaluate projected future cash flows to evaluate risk transfer, much less make decisions on how to bifurcate various elements of insurance contracts.

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? (page 24)*

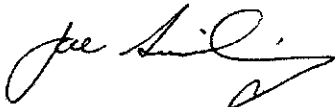
We do not believe that the FASB should consider bifurcation of insurance and reinsurance contracts at this time if it is considered likely that the FASB will adopt a recognition and measurement approach for insurance contracts that is substantially

similar to the IASB's phase II project. Regardless of our disagreement with the approaches for bifurcation contained in this ITC, it makes little practical sense to address this issue now if the FASB plans to adopt a "current value" approach that would treat insurance contracts similar to other financial instruments. Such a path would only serve to require two costly systems changes in a relatively brief period of time.

We disagree with those who believe that the issues in this ITC should be addressed currently to address revenue recognition of premiums vs. deposits. The IASB recently rejected the concept of enforced unbundling of insurance contracts, though they may revisit the issue. From the standpoint of reinsurers that operate on a global basis, it would be preferable in a globally converged accounting environment if there were fewer differences between U.S. GAAP and IFRS.

We appreciate the opportunity to share our views and present our recommendations regarding the Invitation to Comment. Should you have questions or require further explanation about the information contained in this letter, please contact me.

Sincerely,

A handwritten signature in cursive script, appearing to read "Joe Sieverling".

Joseph B. Sieverling
Senior Vice President
Reinsurance Association of America