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Subject: Financial Accounting Standards Board (“FASB”) Invitation to Comment on Bifurcation of Insurance and Reinsurance Contracts for Financial Reporting (“ITC”)

Dear Technical Director:

The Group of North American Insurance Enterprises¹ (“GNAIE”) appreciates this opportunity to share our thoughts and comments with you on the FASB’s Bifurcation ITC.

Our general view of the ITC is that while we understand the reason for its development, we do not believe it would, if adopted, result in an accounting paradigm for insurance and reinsurance contracts that is preferable to the existing well-tested and understood principles-based model that has functioned very effectively for many years. The details supporting this assertion are set forth in the balance of this letter, however, the principal rationale underlying our views are summarized as follows:

- Insurance and reinsurance contracts should not be bifurcated as bifurcation presumes the existence of a discrete, identifiable point where risk transfer ends and non-risk transfer begins. This is only true in an exceedingly limited number of contracts. In contrast, for the vast majority of insurance and reinsurance contracts that would fall within the scope of the ITC, bifurcation would be extremely complex and costly to apply and would require significant entity-specific judgments that would likely result in a level of practice diversity that far

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¹ GNAIE consists of Chief Financial Officers of leading insurance companies including life insurers, property and casualty insurers, and reinsurers. GNAIE members include companies who are the largest global providers of insurance and substantial multi-national corporations. All are major participants in the US markets. The goals of GNAIE are to influence accounting standards to ensure that they result in high quality accounting standards for insurance companies and, to that end, to increase communication between insurers doing business in North America and the International Accounting Standards Board and the US Financial Accounting Standards Board. GNAIE works to meet its goals through modeling of proposed accounting standards, analysis, comment, and coordination with various end users of financial reports.

- exceeds that which is perceived to currently exist in the application of the principles-based guidance in FAS 113.
- We do not believe application of the ITC would meet the FASB's objectives of improving the accounting and financial reporting of insurance and reinsurance contracts.
 - Bifurcation of insurance and reinsurance contracts into separate theoretical pieces that are not separately enforceable pursuant to the terms of the legal agreements would not provide decision-useful information to financial statement users.
 - Because bifurcation would require the identification and separation of unique contract components that are not, nor were they ever intended to be, separable pursuant to the terms of the legal agreements, the theoretical judgments of reasonably competent financial statement preparers will likely differ which will result in a lack of comparability between providers and purchasers of insurance and reinsurance and a lack of representational faithfulness as additional entity-specific judgments and assessments would enter extensively into the bifurcation process; both of which would likely impair the relevance of the affected financial statements.
 - As a consequence of the preceding, we believe application of the ITC would also impair the understandability of the financial statements of providers and purchasers of insurance and reinsurance.
 - While we believe the bifurcation of insurance and reinsurance contracts should not be pursued, we encourage the FASB to use the information and insights obtained throughout this project to more comprehensively address, with quantitative and qualitative examples, how reporting entities should evaluate the existence of significant insurance risk as well as the existence of a reasonable possibility that the reinsurer may realize a significant loss, both as required in FASB Statement No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts* ("FAS 113").
 - In addition to the preceding, we do not believe a decision to require the bifurcation of insurance and reinsurance contracts should precede the completion of the FASB and IASB's Modified Joint Project on Insurance Contracts, but rather, if necessary, should be a component of that project.

The assumed rationale behind the ITC was the identification of a limited number of principally reinsurance contracts where there was determined to be a misapplication of existing accounting principles. Accordingly, we believe the development of implementation guidance that specifically addresses the facts and circumstances underlying those contracts, as well as any others that have been identified as critical as a result of undertaking this project, should be developed by the FASB and disseminated in the form of a FASB Staff Position ("FSP") to provide application guidance for FAS 113. In contrast, we believe the extensive bifurcation suggested in the ITC would have the unintended impact of impairing the relevance, representational faithfulness, comparability, understandability, and decision usefulness of financial statements that would incorporate the bifurcation techniques set forth in the ITC.

In summary, we do not support the bifurcation of insurance and reinsurance contracts, however, we do believe that given the existence of certain instances where the guidance in FAS 113 and related implementation guidance was inappropriately applied, the development of additional FAS 113 application guidance in the form of a FSP that specifically addresses the previous miss-applications of FAS 113 appears warranted.



See Appendix for specific responses to the individual issues identified in the ITC.

If you have any questions regarding the contents of this letter, please contact us at anytime to discuss our comments.

Respectfully submitted,

A handwritten signature in black ink that reads "Douglas Wm. Barnert". The signature is written in a cursive, flowing style.

Douglas Wm. Barnert
Executive Director
The Group of North American Insurance Enterprises

DWB:PS:mtf

Appendix

Issue No. 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?

GNAIE Response:

- We believe that the IFRS 4 definition of insurance is sufficient from the perspective of an entity reporting under IFRS. However, we also believe that for US GAAP, the notion of “indemnification” (which is generally assumed to be limited to policyholder losses) that exists in FASB Statement No. 5, *Accounting for Contingencies*, is more appropriate than the notion of “compensation” in IFRS 4 which may extend beyond policyholder losses and incorporate other non-insurance related losses potentially related to derivative or other financial (i.e. non-insurance) risks
- We believe the definition of insurance risk in FAS 113 adequately identifies and separates underwriting and timing risk (the principal components of insurance risk) from financial risk.
- We believe it is un-necessary to specifically describe “finite” insurance and reinsurance contracts inasmuch as that term refers to insurance contracts that lie on both sides of the significant insurance risk continuum and as such has a tendency to add more confusion than clarity to the evaluation of the insurance risks inherent in insurance and reinsurance contracts. As opposed to defining “finite” insurance and reinsurance contracts, refinement of the criteria to evaluate significant risk transfer and the presence of a reasonable possibility of a significant loss would be more helpful in evaluating when an insurance contract meets the definition of assuming significant insurance risk in FAS 113, with any contracts not meeting that definition, finite or otherwise, defaulting to deposit accounting.
- We believe the definitions and descriptions are sufficient as general characteristics, however, we do not believe a definition of finite insurance and reinsurance is necessary as it is the default when adequate risk transfer is not demonstrated. 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 and reinsurance contracts.

Issue No. 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?

GNAIE Response:

We believe that the existing principles-based guidance in FAS 113 results in accounting that accurately reflects the economic reality and substance of reinsurance transactions. FAS 113 appropriately reflects transactions between insurers and reinsurers who are principally engaged in the insurance business and for whom insurance premiums and insurance losses are a material part of their financial statements. The same approach may not be practical, and is arguably unnecessary for corporate policyholders, as for most corporate policyholders, insurance premiums, insured losses and insurance recoveries are immaterial to the financial statements and as such are not separately disclosed. Accordingly, classifying a portion of insurance premiums and recoveries as deposits is unlikely to result in decision useful information for users of corporate policyholder's financial statements.

Further, we do not believe that most corporate policyholders possess the financial sophistication or financial modeling tools necessary to accomplish the bifurcation objectives as proposed in the ITC. Moreover, insurance companies, which are at the same time significant investors in corporate debt and equity and also one of the few investor groups with sufficient knowledge to interpret the application of the ITC by corporate policyholders, do not perceive any decision-useful need for that information presuming the acquisition of insurance by most corporate policyholders is not a core operating activity or otherwise material to their on-going operating activities.

Issue No. 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?

GNAIE Response:

- We do not support the bifurcation of insurance and reinsurance contracts. Requiring bifurcation presumes there is a discrete, identifiable point at which risk transfer ends and non-risk transfer begins. While this point might be clear in an exceedingly limited number of contracts, in most contracts it would likely be a matter of significant entity-specific judgments and therefore likely result in significant diversity in practice. Moreover, we do not believe that the principle-based FAS 113 should be replaced with a rules-based approach. Instead, we believe that improved practical guidance in applying FAS 113 could be developed with regard to the evaluation of risk transfer, the analysis of the substance of insurance and reinsurance contracts, and the corresponding financial reporting and disclosure of such contracts.
- We do not believe the accounting approach proposed in the ITC properly recognizes the economic realities of the insurance and reinsurance business. More specifically, bifurcating material deposit elements and recording them in the balance sheet suggests that the underlying cash flows possess a relative level of stability and predictability similar to loan arrangements, which is clearly not the case, as the inherent risk and uncertainty associated with insurance and reinsurance contracts is substantially greater than that which exists in loan arrangements.
- We do support bifurcation in the limited situations where it is currently required pursuant to the guidance in EITF Topic D-34, *Accounting for Reinsurance: Questions and Answers about FASB Statement No. 113*; Q&A Number 13 wherein it states that, "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”. In contrast, insurance and reinsurance contracts are typically developed, priced and executed as a single contract and its individual components are not legally separable, transferable, or otherwise separately enforceable by either party to the contract (i.e. either the insured or the insurer). Accordingly, the practice of bifurcation, while it may be theoretically and conceptually interesting, generally leads to a result which has no relevance as it relates to the rights and obligations of the insured and insurer.

- The qualitative characteristics that most influence our views on bifurcation are the characteristics of relevance, representational faithfulness, comparability, and understandability. More specifically, because the contracts are not legally separable, nor are their components separately enforceable, we do not believe that any theoretical bifurcation would produce information that is representationally faithful or comparable between entities as the judgments and estimates underlying the bifurcation would be highly judgmental and entity-specific, thereby also making the information very difficult to understand for financial statement users. Accordingly, we do not believe these estimates would have relevance in terms of representing decision useful information due to the subjectivity of the underlying estimates used in the bifurcation exercise. In addition, such estimates would be difficult to verify objectively, thereby undermining their representational faithfulness, as the contracts themselves are not designed to be bifurcated.
- Non-bifurcation and accounting and financial reporting pursuant to the guidance in FAS 60, 97, 113 or 120 as these standards were developed to allow accounting and financial reporting to be consistent with the operation of the underlying insurance contracts.

Issue No. 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?

GNAIE Response:

We do not support the sequencing and integration in the proposed flowchart. More specifically, the flowchart places too much reliance on the determination of whether an insurance contract has “unequivocally” transferred significant insurance risk, and if so the contract would avoid bifurcation. We believe the existing framework that exists within FAS 113 and other interpretive standards are more appropriate for analyzing contracts and determining whether they contain significant insurance risk and as such do not believe the flowchart is necessary. We would, however, support enhancements to the guidance for FAS 113 evaluation of significant insurance risk.

The flowchart ignores the FAS 113 risk transfer test and renders it irrelevant by introducing rules-based (as opposed to principles-based) tests that will not lead to more decision-useful information.

Issue No. 5:

Do you agree with the characteristics identified for contracts that do or do not unequivocally transfer significant insurance risk? If not, why not? Are the examples in Appendix B representative of the discussion in paragraphs 57-59?

GNAIE Response:

We believe introduction of the notion of unequivocal (or “absolute”) insurance risk is inappropriate and unnecessary as discussed further below. Moreover, we found the examples in Appendix B to be generally unclear or otherwise confusing. In contrast, we believe the existing framework could be enhanced or otherwise modified (mostly through examples as to how the guidance is to be applied).

We believe the unequivocal test for insurance and reinsurance accounting in paragraphs 57-59 is not appropriate for determining bifurcation or deposit accounting requirements as it focuses too narrowly on a single risk and implies that premiums should not include a level of loss expectancy. While actuarial techniques allow for an estimation of probable outcomes in a portfolio of similar exposures, the results would not be appropriate to apply to a single risk exposure in the portfolio. Stated differently, the application of actuarial estimation techniques to a portfolio of similar exposures does not in any way suggest the attainment of a level of certainty as to the occurrence, severity, or timing of any individual event in the portfolio. The concept of risk aggregation, as described in the preceding sentences, is applicable to both insurers and reinsurers, only the composition of what is being aggregated differs between the entities.

Issue No. 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)?

GNAIE Response:

We do not believe the characteristics described in paragraph 58 for unequivocal insurance contracts are an improvement over paragraph 11 of FAS 113. Moreover, it is important to note that the objectives of paragraph 58 of the ITC and paragraph 11 of FAS 113 are entirely different. More specifically, the objective of paragraph 58 is to identify the contracts that have negligible non-insurance features whereas the objective of paragraph 11 of FAS 113 is to identify situations where, even where there was not a reasonable possibility of a significant loss, if all risks in an insurance contract were transferred to the reinsurer, the agreement would qualify for treatment as reinsurance.

The evaluation process to be applied to individual insurance contracts to determine whether they meet the requirements to be considered “unequivocal insurance contracts” is a very narrow and overly prescriptive rules-based assessment and may result in many existing reinsurance arrangements (which are clearly risk bearing) not being classified as unequivocal contracts whereas applying the same set of criteria to underlying contracts at a more granular level may lead to a different determination concerning whether the contracts are unequivocal. We believe the potential for such an outcome is inconsistent with a move towards more principles-based accounting and results in financial reporting that is not decision-useful.

Issue No. 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?

GNAIE Response:

We prefer neither Approach A or B for identifying contracts subject to bifurcation. We believe that both Approaches (A+B) would have to rely heavily on entity-specific assumptions (thereby likely impairing comparability), would be very onerous, costly, and time consuming to implement and account for and would not provide decision-useful information to the financial statement user (and otherwise may be considered misleading as it would not reflect the rights and obligations of the parties to the contract).

We remain unconvinced that any of the bifurcation approaches proposed in the ITC would result in an improved in financial reporting model and reiterate that the current principles-based approach have worked well for the vast majority of transactions.

Issue No. 8:

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

GNAIE Response:

Again, we do not support bifurcation. Irrespective, we see no reason why insurance and reinsurance contracts should be treated any differently with respect to bifurcation as both fundamentally contain a financing element (i.e. the acceptance of cash that is invested and maintained by the insurer to pay possible claims and earn investment income). We believe consistency is important from the perspective of preparing financial statements that contain information that is understandable and decision-useful.

Issue No. 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?

GNAIE Response:

We do not believe that bifurcation is appropriate under any of the models suggested in the ITC. All of the proposed methods require subjectivity regarding the mathematical metrics, which cannot be clearly defined and would result in application and financial reporting inconsistencies.

In the proportional method it is unclear how a portion of the contract can be assigned risk limiting features and what mathematical metrics would be used to establish the proportionality? The expected payout method is inappropriate because the concept of highly probable claim payments is not clearly defined and may result in added inconsistencies between insurers and reinsurers as well as large and small portfolios. The cash flow yield method would require a fundamental change in the conceptual framework underlying insurance accounting as a whole. In addition to this overall paradigm shift, not all types of contracts are underwritten based upon expected cash flows. Some types of contracts are priced based upon their expected losses with no regard to timing of payment or interest rate assumptions. These assumptions would be required under the cash flow yield method and as such, would result in subjective assumptions being applied, which were not considered when the contract was underwritten.

We believe that the proposed methods lack conceptual and practical merit as they result in financial reporting of insurance contracts in a manner that is inconsistent with the rights and obligations of the insured and insurer. Moreover, the proposed methods are so fundamentally different from the model in use today that they would presumably have to undergo significant field testing and evaluation to determine whether they could be operational.

We fundamentally believe that bifurcation should not be pursued as there should be an all or nothing test of whether a contract (insurance and reinsurance) meets the definition of insurance and if it meets the definition it should be accounted for under FAS 60, 97, 113, or 120, as appropriate. In the event the contract does not meet the definition of an insurance contract it should be accounted for as a deposit.

Issue No. 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?

GNAIE Response:

We believe that data availability would limit the development of the bifurcation methods described in this ITC. More specifically, data availability would be a significant challenge in most situations where bifurcation might be pursued, and would vary by method and type of business. New information would need to be captured to complete a bifurcation analysis based on either the expected payout, proportional, or cash flow yield method. Moreover, it is also likely that bifurcation methods would have to rely heavily on entity-specific information and estimates and as such may not be verifiable, representationally faithful, auditable, or comparable between different reporting entities.

Broadly, the data limitations lie in both the lack of availability and the level of credibility that would be assigned to selection of assumptions. For insurers and reinsurers, the information needed to apply the bifurcation methodologies and the availability of appropriate levels of quality data will differ in every circumstance. The differing availability of data will result in two companies writing the same product with the same insured, utilizing the same methodology arriving at different conclusions purely based on available data. Bifurcation accounting requirements would result in the need for systems to track new information only for use in selecting bifurcation assumptions, which is not required today for underwriting or accounting. This would have a significant cost implication in addition to significant costs related to modifying existing underwriting and accounting systems to facilitate new reporting requirements.

Issue No. 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?

GNAIE Response:

Given the status of the FASB-IASB Modified Joint Project (MJP) and the pending discussion document, we believe it is not appropriate to change the insurance accounting model at this time. We understand that the IASB has reached a tentative decision to not support "unbundling" which is the same general notion as "bifurcation". However, we understand that the IASB does not support bifurcation for an entirely different reason (i.e. it views it as unnecessary in a fair value model that utilizes exit values). Thus, regardless of the reason, under the MJP, the insurance and reinsurance accounting model could change again in the near future. Because of the associated cost and disruption, as well as confusion to users of financial statements, we strongly urge the FASB to change fundamental accounting models infrequently and never in circumstances when another known project may subsequently change that decision.

In the meantime, we believe that modifications can be made to body of interpretive guidance that supports FAS 60, 97, 113 or 120 as it relates to the determination of what constitutes significant insurance risk. For most contracts there are no significant classification issues, but for those where significant judgment is required we believe that aids can be developed to aid in the evaluation and classification of contracts as either entirely insurance or deposit contracts.