March 5, 2004

Mr. Robert Herz, Chairman
Financial Accounting Standards Board
P.O. Box 5116
Norwalk, Connecticut 06856-5116

Re: AICPA paper entitled "Evaluating Risk Transfer in Reinsurance of Short-Duration Contracts"

Dear Mr. Herz:

This letter represents the initial joint comments of the members of the American Council of Life Insurers, National Association of Mutual Insurance Companies, Property Casualty Insurers Association of America and Reinsurance Association of America. These trade associations represent companies that write a majority of the life and health and property and casualty insurance and reinsurance premiums written in the United States.

The AICPA Paper

As you know, by letter dated November 18, 2003, the chairs of two committees of the American Institute of Certified Public Accountants sent a paper to you entitled "Evaluating Risk Transfer in Reinsurance of Short-Duration Contracts" (the "AICPA Paper"), and requested that the Financial Accounting Standards Board "quickly" address the issues identified by that paper.

The AICPA Paper was the result of a closed-door process within AICPA. Despite repeated requests over several years from members of the insurance industry, AICPA chose not to open that process up for wider comment before completing the paper and making its request to you. As a result, the AICPA Paper represents the views of a small group within the AICPA and does not take into account the views of many preparers and users of financial statements. The AICPA Paper therefore represents, at best, a somewhat narrow view of the issues it addresses.

We understand that, in response to the AICPA request, the FASB will place the risk transfer issue on its agenda as a FASB Staff Position project (as opposed to consideration of amendments to SFAS 113). That is welcome news, since we anticipate that the FASB process provides members of the affected public the opportunity to comment that the AICPA process did not. While we of course expect to comment in due course on the FASB Staff Position when published, we thought it might be useful to you and to the staff if we provided some preliminary comments on the AICPA Paper prior to the official period for comment.

This letter will describe our general concerns with respect to the AICPA paper as well as our strong disagreement with several of its views. In the interest of time, and due to the challenges associated with obtaining quick consensus among several trade associations and their members, this letter will not address each and every view contained in the AICPA paper. Instead, this letter will focus on the general implications of the most objectionable views in the AICPA Paper. This letter also includes specific comments on the principal topics addressed in the AICPA Paper.

Introduction

We believe the current guidance in SFAS 113 provides comprehensive, principles-based guidance that is more than adequate. We do not believe that it is necessary or desirable for the FASB to promulgate additional interpretive guidance that would move the standard towards a "bright-line" or rules-based approach to evaluating risk transfer in reinsurance contracts. The existing GAAP guidance shows that this approach was previously considered by FASB and rejected.

The current principles-based approach used in SFAS 113 is consistent with the overall direction of the FASB and of other bodies promoting international convergence of accounting guidance. The issuance of additional guidance by the FASB related to the specific proposals contained within the AICPA Paper would definitely move the FASB farther away from the IASB's proposed guidance for defining insurance and reinsurance contracts.

A corollary of principles-based accounting standards is that preparers and their auditors may have different interpretations of the accounting treatment for a given set of facts and circumstances. While it may be desirable to reduce the existing divergence in practice in evaluating risk transfer in reinsurance contracts, the proposals represented by the more extreme views in the AICPA Paper would unnecessarily undo effective accounting guidance that has stood the test of time. An approach that relies on form over substance is doomed to failure as has been the case for other overly specific GAAP guidance. We believe that preparers and auditors of financial statements can and should continue to use the time-tested guidance of SFAS 113 that requires an evaluation of the specific facts and circumstances and the application of professional judgment in determining risk transfer in reinsurance contracts.

If the most stringent views in the AICPA Paper were adopted it would have a significant negative effect on the insurance and reinsurance market. A broad application of these particularly conservative views would negatively affect the market for relatively common reinsurance contracts. Nearly every insurance and reinsurance agreement contains loss-limiting features because insurers and reinsurers are not willing to risk their entire existence on a single contract. Contractual limits in reinsurance contracts are not new. Requiring deposit accounting or bifurcation of contracts containing these features will unnecessarily increase the cost of reinsurance. Reducing risk is not the same as eliminating risk and we urge the FASB to reject the views that move away from the premise of evaluating all terms and conditions to determine whether sufficient risk transfer is present.

Principles Versus Rules

The proponents of certain views in the AICPA Paper would have the FASB take a step backwards and prescribe specific rules that would provide that certain contract features "per se" preclude risk transfer. We disagree. We believe that FASB's adoption of SFAS 113 was a good example of "principles-based" rather than "rules-based" accounting.

Instead of prescribing detailed, specific rules narrowly addressing specific contract terms and conditions, SFAS 113 intentionally states a broad principle of what constitutes transfer of insurance risk: the reinsurer must assume significant insurance risk (i.e. underwriting and timing risk) under the portions of the underlying insurance policies that it reinsures, and it must be reasonably possible that the reinsurer may realize a significant loss from the transaction. SFAS 113 then requires preparers of financial statements and auditors to exercise professional judgment and evaluate all of the facts and circumstances of a reinsurance transaction, including the effect of the transaction under all reasonably possible cash flow scenarios, before concluding that the transaction transfers insurance risk and may be accounted for as reinsurance.

This approach is consistent with the FASB's current direction of promulgating principles-based guidance as the FASB and IASB work toward convergence of global accounting standards. Paragraph 43 of SFAS 113 states the following:

> ...[B]ecause the Board concluded that the cost of implementing very detailed standards for reinsurance accounting would outweigh the benefits, the overall approach of providing general rather than detailed guidance was retained.

In the eleven years since SFAS 113 was issued, the FASB has adhered to this principle, as they (or related rulemaking bodies) have generally refrained from issuing additional detailed guidance or modifications. The only exceptions related to immediate interpretive guidance in *FASB Status Report*, February 26, 1993, "Accounting for Reinsurance: Questions and Answers About Statement 113" ("Q & A") and EITF 93-6 (with its related EITF Topic D-35), as well as resolving conflicts with other literature (i.e., APB16) in EITF Topic D-54. Apart from that, it is our understanding that the FASB and EITF have generally resisted providing additional detailed guidance on reinsurance accounting. We believe that the main reasons are those delineated in paragraph 43 of SFAS 113 regarding costs outweighing benefits of *detailed* guidance.

Furthermore, there is general recognition that applying the individual facts and circumstances of a specific transaction to the general provisions of SFAS 113, is preferable to the creation of a "do's and don'ts laundry list." Such a list runs the significant risk of being defeated by form over substance issues, as the list cannot possibly list all the permutations of reinsurance transactions. Therefore, we feel that the AICPA Paper, by addressing a very narrow set of circumstances in a very detailed way, is contrary to the basic intent of SFAS 113 that clearly rejected such a detailed approach to reinsurance accounting.

International Convergence

Certain views in the AICPA Paper posit that certain risk limiting features in reinsurance contracts would "per se" result in non-reinsurance accounting. If adopted by the FASB, this specific guidance would move U.S. GAAP farther away from existing and proposed international accounting standards. Currently, in most jurisdictions, reinsurance accounting is granted if either underwriting or timing risk is present. The IASB Exposure Draft ED5 *Insurance Contracts* is only slightly more rigorous. ED5 includes reinsurance contracts in the definition of insurance contracts and defines insurance contracts as follows:

> A contract under which one party (the **insurer**) accepts significant **insurance risk** from another party (the **policyholder**) by agreeing to compensate the policyholder or other beneficiary if a specified uncertain event (the **insured event**) adversely affects the policyholder or other beneficiary. (Emphasis in original)

ED5 further defines significant insurance risk as follows:

> Insurance risk is significant if, and only if, it is plausible that an insured event will cause a significant adverse change in the present value of the insurer's net cash flows arising from that contract (before considering possible reinsurance recoveries, because the insurer accounts for these separately). This condition is met even if the insured event is extremely unlikely or if the present value of contingent cash flows is a small proportion of the expected (i.e. probability-weighted) present value of all the contractual cash flows. (ED5 paragraph B21)
>
> Insurance risk is not significant if the occurrence of the insured event would cause a trivial change in the present value of the insurer's contractual cash flows in all plausible scenarios. An insurer shall assess the significance of insurance risk contract by contract, rather than by reference to materiality to the financial statements. Thus insurance risk may be significant even if there is a minimal probability of material losses for a whole book of contracts. (ED5 paragraph B22)
>
> Paragraph B21 refers to the present value of cash flows. This reference addresses contracts where the amount of the loss, and the resulting payment by the insurer are known, but their timing is unknown. If the loss occurs earlier than expected, the insurer will suffer a loss…. (ED5 Paragraph B24)

Current and proposed international accounting guidance is less strict with respect to the definition of insurance and reinsurance contracts than existing U.S. GAAP. International accounting standards is intended to be principles-based, and we view the current SFAS 113 guidance as similarly designed. If the FASB were to adopt certain views in the AICPA Paper, it would move U.S. GAAP another order of magnitude away from international convergence.

Preliminary Comments on Specific Sections of the AICPA Paper

Page 1 - Summary of Issue

The "Summary of Issue" found at page 1 of the AICPA Paper narrowly concentrates on paragraph 9a of SFAS 113. We think that paragraphs 9, 10 and 11 need to be read together to understand the risk transfer principle of SFAS 113. In addition, there appears to be a belief on the part of some of the drafters of the paper that combining different layers or coverages in the same contract requires treatment of those layers or coverages as separate and distinct reinsurance contracts from an accounting perspective. For the reasons stated below, we disagree.

Pages 2- 4 - Risk Transfer Guidance

At page 3, the drafters of the AICPA Paper interpret the so called paragraph 9.a. test in SFAS 113 by reciting the explanatory material in paragraph 62 of SFAS 113 and indicate that "…there is a requirement that **both the amount and timing** of the reinsurer's payments [must] depend on and vary directly with the **amount and timing** of claims settled under the reinsured contracts….". (Emphasis in original.)

What their interpretation does not consider is the somewhat contradictory language in the penultimate sentence of paragraph 9 of SFAS 113:

> A reinsurer shall not be considered to have assumed significant insurance risk under the reinsured contracts if the probability of a significant variation in either the amount or timing of payments by the reinsurer is remote.

In addition, their interpretation does not consider how the 9.a. test is viewed by financial statement preparers. The practical meaning that has evolved over the last eleven years is that there cannot be a predetermined, unvarying pattern to the amount and timing of the reinsurer's payments (for example, like a loan transaction). It means that the reinsurer must be exposed to fortuitous loss arising out of the reinsured insurance policies. It does not mean that there must be a fixed and determinable relationship between the amount and timing of the cedant's losses and the amount and timing of the reinsurer's losses.

Pages 4-6 – Description of Contract Provisions

The first paragraph of this section of the AICPA Paper states:

> …[m]any reinsurance contracts contain terms that are intended to **limit** (but not necessarily eliminate) the **variability** in underwriting results in order to limit business risks associated with the reinsurance contract. (Emphasis added.)

It is true that most reinsurance contracts do not provide for unlimited liability for the reinsurer – just like most insurance policies do not provide for unlimited liability for the insurer. Reinsurance contracts often contain features that limit the reinsurer's total exposure to loss. Those features come in various types, such as aggregate limits, sub limits for various kinds of losses, or so-called "loss corridors", where the cedant retains liability for losses above a certain threshold and below another threshold.

Those features certainly do limit the reinsurer's losses under the contract in one way or another (and in most cases it would be imprudent to do otherwise). However, they certainly do not, and are not intended to, limit the variability of the reinsurer's underwriting results within the reinsurance contract limits

Many of the of so-called "risk limiting" provisions cited in the second and third paragraphs of this section of the AICPA Paper are in fact variations on a theme: the cedant will get the benefit of a portion of the reinsurer's underwriting profits (but won't share in the reinsurer's underwriting loss). Sliding scale or other adjustable commission payments and experience refunds generally provide that if the reinsurer does well, the cedant will get something back. In true mathematical and economic substance, these so-called "risk limiting" provisions are often merely equivalent to certain of the retrospective rating mechanisms commonly used in the rating and risk pricing for both insurance and reinsurance. Such retrospective rating mechanisms have been well established and accepted by the industry and government regulators (e.g., Rating Boards and Bureaus, IRS acceptance for tax purposes) for many decades.

Other provisions cited in fact do limit the reinsurer's risk – like caps or loss corridors. However, there is no requirement in SFAS 113 that a reinsurer must accept unlimited risk in order for a reinsurance contract to transfer risk.

Paragraph 8 of SFAS 113 provides that:

> Determining whether a contract with a reinsurer provides indemnification against loss or liability relating to insurance risk requires a complete understanding of that contract and other contracts or agreements between the ceding enterprise and related reinsurers. A complete understanding includes an evaluation of all contractual features that (a) limit the amount of insurance risk to which the reinsurer is subject (such as through experience refunds, cancellation provisions, adjustable features, or additions of profitable lines of business to the reinsurance contract) or (b) delay the timely reimbursement of claims by the reinsurer (such as through payment schedules or accumulating retentions from multiple years).

Read together with paragraphs 9, 10 and 11, the objective is clear – reinsurers can't have a guaranteed economic result.

The means of testing whether the objective has been met is also clear. It is necessarily a facts and circumstances determination that must be made on a contract-by-contract basis. The effect that identically worded caps or loss corridors or other such provisions will have on risk transfer may be different, depending on the nature of the business reinsured and the language of the rest of the reinsurance contract.

What is required is the exercise of judgment to determine whether the present value of all cash flows, after giving full effect to all of the provisions of the reinsurance contract (including those provisions which limit the reinsurer's risk) under reasonably possible outcomes, results in a reasonable possibility of a significant loss to the reinsurer. If so, then there is risk transfer and the contract is accounted for as reinsurance. If not, it is accounted for as a deposit. No new "bright line" rule can substitute for that exercise of judgment.

Pages 10-15 – Section 1: Definition of a Contract – Whether a Single Contract Should Be Bifurcated

Some of the views expressed in the AICPA Paper suggest that quota share reinsurance agreements containing loss ratio corridors should be bifurcated above and below the corridor along with a separate evaluation of risk transfer for each portion of the contract. Intrinsic in this view are either or both of the following:

1. An agreement containing a loss ratio corridor is, in substance, two contracts;
2. The financing element of a reinsurance contract can and should be separately identified and accounted for as a "non-risk transfer coverage";

Those views raise the issue of whether two or more contracts, in substance, constitute one for accounting purposes. In paragraphs 57 through 59 of SFAS 113 and in Q & A #13, the FASB indicated that it is not appropriate to combine multiple contracts into a "program" for the purpose of evaluating risk transfer. We believe an example of this is the combination of a highly funded casualty (non risk transfer) layer and a remote property catastrophe (risk transfer) layer into a single excess of loss contract. As such, we think the use of the word "combine" refers to effectively unrelated exposures versus identical exposures, as is the case in a quota share contract. A knowledgeable review of all the related contract terms, and an exercise in professional judgment is needed – rather than an arbitrary distinction between the words "program" and "coverages" and whether some risks are "related" or "unrelated." Also, SFAS 113 provides guidance regarding multiple contracts that are intended to reimburse for losses on other contracts. With respect to whether one contract should be two or more, Q & A #13 says the following:

> The legal form and substance of a reinsurance contract will generally be the same, so that the risks reinsured under a single legal contract would constitute a single contract for accounting purposes. However, that may not always be the case. Accordingly, careful judgment may be required to determine the boundaries of a contract for account purposes.
>
> 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.

The inference here is that a single legal document is to be treated as one contract for accounting purposes. This presumption can be defeated if risk transfer and non-risk transfer *coverages* are combined into a single document. The proponents of certain views in the AICPA Paper would suggest that the portion below the corridor is a "non risk transfer *coverage*." While the word, "coverage," is not specifically defined, one can interpret the proponent's position that the financing component/element constitutes a non-risk transfer coverage.

That notion would be inconsistent with Paragraphs 94 of SFAS 113. The opening sentence of Paragraph 94 clearly states:

> Contracts that meet the conditions for reinsurance accounting also may include elements of a financing arrangement. Existing pronouncements do not provide guidance that would allow an insurer to identify the separate elements and costs of reinsurance.

This paragraph means that: (i) the financing element is a component/element of the cost of reinsurance and not a separate "coverage" and (ii) it is not appropriate to account for the financing element separately. Therefore, we believe bifurcation in the manner suggested in this view was not intended by the FASB. This makes sense because otherwise there would be significant unintended consequences of interpreting the financing component as a "non risk transfer coverage."

For example, consider an uncapped/uncorridored quota share, where the expected loss ratio is 65%. Also, assume that it is extremely unlikely (remote) that the loss ratio would be below 50%. Under the logic of the proponents of the bifurcation view, the amount up to a 50% loss ratio, the reinsured will collect exactly 50% plus ceding commission. Since there is only a remote chance of significant variation, that portion is financing, has no risk transfer, and should be deposit accounted. The amount above 50% would be reviewed for risk transfer and accounted for accordingly. Clearly, this is not the practice employed today. If the above transaction were to now have a corridor (say at a 70% loss ratio), but still subject the reinsurer to potential variation in amount and timing of losses (including the reasonable possibility of a significant loss) it would be incongruous to require a whole different accounting; the financing element is basically the same whether or not there is a corridor. Thus, we believe that bifurcation because of the existence of a corridor (calling the part below the corridor non risk transfer coverage) would create an arbitrary distinction inconsistent with the language and intent of SFAS 113.

Pages 16 – 23 – Section 2: Determining Significant Insurance Risk

In stating Issues 1 and 2 and the various views as to each of those issues, the drafters of the AICPA Paper have gone to great lengths to parse what seems to us to be a readily understood principle: paragraph 9 of SFAS 113 means what it says.

If the present value of all cash flows, after giving full effect to all of the provisions of that individual reinsurance contract (including those provisions which limit the reinsurer's risk) under reasonably possible outcomes, results in a reasonable possibility of a significant loss to the reinsurer, then there is risk transfer and the contract is accounted for as reinsurance. If not, it is accounted for as a deposit.

As to Issue 3, we also think that Paragraph 62 means what it says: (a) reinsurer assumption of insurance risk requires that both the amount and timing of the reinsurer's payments must depend on and vary directly with the amount and timing of claims settled under the reinsured insurance polices, and (b) contractual features that delay timely reimbursement prevent the reinsurer's payments from directly varying with the claims settled under the reinsured insurance policies.

As to (a), to us that means that the reinsurer's duty to pay must be triggered by the cedant's payment of a loss under a policy covered by the reinsurance contract, and presentation of a valid claim to the reinsurer for indemnification of that loss in accordance with the terms of the reinsurance contract.

Because there is generally no one-to-one correlation between the gross loss of the cedant and the portion of the loss ceded to a particular reinsurer (an unlimited first dollar quota share with no contractual exclusions being the only possible exception), and because of lags in reporting of losses by cedants to reinsurers, there can be no credible argument that there must be a high – much less an exact - correlation between the amount and timing of the cedant's losses and the amount and timing of the reinsurer's losses.

As to (b), it means that payment schedules and similar features that delay timely reimbursement will defeat risk transfer. As a practical matter this is a non-issue. SFAS 113 and SSAP No. 62 (the statutory analog to SFAS 113) have worked. Because of those requirements, virtually every US reinsurance contract provides for settlements of reinsurance balances at least quarterly, and virtually none provide for payment schedules or other features that delay timely reimbursement. The few that do are, or certainly should be accounted for as deposits.

Both a knowledgeable review of involved contract terms and the exercise of professional judgment are needed to ensure that the appropriate principles are upheld by the contract terms and that the accounting dictated by the conclusion is consistent with that conclusion. This is in contrast to rules-based apparatus that creates wholly arbitrary distinctions.

Pages 24 – 26 - Section 3: Paragraph 11 exception

We do not believe that any further guidance with respect to the Paragraph 11 exception is necessary as the current guidance is clear.

Conclusion

Reinsurance in its various forms that meet the requirements as set forth in SFAS 113 is a critical and legitimate element of a company's capital and risk management structure. In some cases, up to 25 - 30% of a company's capital may be derived from reinsurance. The industry is already capital constrained with the current premium growth tied to rate increases and the drop in surplus tied to reserve increases on prior years (e.g., environmental and asbestos). The proposed accounting incorporated in some of the views in the AICPA Paper is inconsistent with the economic reality of the way in which risk is transferred under reinsurance agreements. The current accounting that has evolved under SFAS 113 is more consistent with reality. Furthermore, we believe that SFAS 113 has prevented many of the alleged abuses of reinsurance (e.g., HIH and Independent Insurance Company) that we read about in other jurisdictions (e.g., UK and Australia) because the reinsurance requirements in those jurisdictions are not as strict in requiring as SFAS 113 which requires both timing and underwriting risk.

The requirements of paragraphs 8, 9, 10, and 11 of SFAS 113 are clear to both the preparers of financial statements and to auditors. They have been in effect since 1992, have stood the test of time, and worked well in the situations in which they have been properly applied. What they require is the exercise of professional judgment to determine whether the present value of all cash flows, after giving full effect to all of the provisions of the reinsurance contract (including those provisions which limit the reinsurer's risk) under reasonably possible outcomes, results in a reasonable possibility of a significant loss to the reinsurer. If so, then there is risk transfer and the contract is accounted for as reinsurance. If not, it is accounted for as a deposit. No new "bright line" rule can substitute for that exercise of judgment.

SFAS 113 neither requires, nor should it be interpreted to require, bifurcation and treatment of each layer or coverage (of an individual reinsurance contract that contains different layers or coverages) as a separate reinsurance contract for risk transfer and accounting purposes.

SFAS 113 is a good example of "principles-based" accounting that has worked well, and as intended, since its adoption eleven years ago. Because it is generally well understood, many contracts have been worded with a view to complying with SFAS 113 as written. We therefore urge you to carefully consider whether any further modifications or interpretations of SFAS 113 are necessary. It is our view that the principles-based guidance in SFAS 113 is adequate and effective.

Sincerely,

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