

## AMERICAN ACADEMY of ACTUARIES

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Technical Director – File Reference No. 1325-100
Financial Accounting Standards Board
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Via email to: director@fasb.org, File Reference No. 1325-100

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LETTER OF COMMENT NO. 49 C

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

Dear Sir/Madam:

On behalf of the American Academy of Actuaries' Life Financial Reporting Committee, I'd like to thank you for this opportunity to comment on the publication titled "Bifurcation of Insurance and Reinsurance Contracts for Financial Reporting".

The Committee does not believe bifurcation would improve financial reporting. We believe the issues this FASB statement seeks to address can be done so more effectively through enhanced disclosure requirements. The Committee believes that the proposal will be ineffective because it will introduce unnecessary subjectivity into financial statements, which will cause confusion among the users and reduce comparability between or among entities.

The vast majority of life insurance contracts are sold through retail markets to private individuals who do not file financial statements with the Securities and Exchange Commission SEC). Financial Accounting Statement (FAS) 60, FAS 97, and FAS 120 were written to address these individual contracts. These reporting standards accurately convey the financial consequences of the inherent risks to financial -statement users. The current reporting framework does an excellent job of distinguishing between insurance-type contracts and deposit-type contracts. Since the current framework also minimizes subjective opinions in categorizing revenue, the resulting financial statements make corporate comparisons reliable. The current framework also has the advantage of being widely understood and very familiar to readers of financial statements.

The American Academy of Actuaries is a national organization formed in 1965 to bring together, in a single entity, actuaries of all specializations within the United States. A major purpose of the Academy is to act as a public information organization for the profession. Academy committees, task forces and work groups regularly prepare testimony and provide information to Congress and senior federal policy-makers, comment on proposed federal and state regulations, and work closely with the National Association of Insurance Commissioners and state officials on issues related to insurance, pensions and other forms of risk financing. The Academy establishes qualification standards for the actuarial profession in the United States and supports two independent boards. The Actuarial Standards Board promulgates standards of practice for the profession, and the Actuarial Board for Counseling and Discipline helps to ensure high standards of professional conduct are met. The Academy also supports the Joint Committee for the Code of Professional Conduct, which develops standards of conduct for the U.S. actuarial profession.

Where the current reporting framework may be interpreted by some as falling short is in addressing the contracts that cover insurance risks that are individually negotiated between large corporate entities. For most individually negotiated contracts written by the insurance industry, the current framework does an excellent job of conveying the important financial consequences of risk to the users of the financial statements. The potential shortfall occurs among a tiny fraction of individually negotiated contracts when a deposit-type liability is mischaracterized as insurance. This is unquestionably a problem in the current framework, but it is one of communicating quality of risk, not quantity. We believe an enhanced disclosure requirement will more effectively communicate the needed information to users of financial statements.

If in the unlikely event it is determined that the potential benefits of implementing a bifurcation solution outweigh the considerable costs of changing the entire insurance reporting framework and retraining the analyst community in the new rules, the Committee would strongly urge the FASB to limit the scope of any standard to contracts negotiated between large corporate entities. The current framework produces results that are useful, relevant, reliable, and comparable for the vast majority of contracts written by insurance enterprises.

Finally, the Committee will briefly comment on the specific issues contained in the proposal:

**Issue 1:** Does the IFRS 4 definition of insurance contract identify insurance contracts and sufficiently distinguish those contracts from other financial contracts? Does the GAAP definition of insurance risk identify and separate that risk from other risks such as financial risk? Do the descriptions of finite insurance and reinsurance contracts, including the risk-limiting features, identify those contracts? How could the definitions and descriptions be improved?

The Committee believes that the IFRS 4 definition of insurance is sufficient and that indemnification need not be specifically referenced.

**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?

The Committee doubts that corporate policyholders possess the expertise needed to apply subjective characterizations of risk consistently. Further, we doubt they possess the ability to bifurcate premiums into risk and deposit components. The 10/10 rule is the insurance industry consensus of "reasonable" that emerged in the absence of guidance on the meaning of "reasonable." Absent further guidance from FASB as to the meaning of "reasonable," it is very likely that the 10/10 rule will continue to be de facto guidance, whether it is applied to insurance contracts or not.

Issue 3: Does classifying an entire contract as insurance or bifurcating that contract into insurance and deposit contracts provide more understandable and decision-useful information? Which qualitative characteristics most influence your decision? Which approach most faithfully represents the economic substance of the contact?

The Committee believes the current framework of characterizing contracts as 100 percent deposit or 100 percent insurance serves financial statement users well in their efforts to understand the risks a company writes and compare similar companies. We are concerned the subjectivity in the implementation of a

bifurcation proposal will cause unnecessary confusion and diminish comparability among like companies. Historically, contracts have either been characterized as insurance contracts or non-insurance contracts. This approach faithfully represents the economic substance of the contract. To acknowledge the fact that some contracts transfer more risk than others does not diminish this.

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 integrations are appropriate? What changes would you propose?

The Committee believes the hierarchy is unnecessary for the vast majority of all insurance contracts. We are intentionally not answering the question because we do not want to be seen as giving an endorsement to the hierarchy. (Our reasons are given above).

**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?

The Committee believes the characteristics are overly restrictive. For instance, we believe that participating whole life products sold by mutual insurance enterprises unequivocally transfer significant insurance risk. So do indeterminate premium term insurance products. However, criteria "e" in paragraph 58 reaches a different conclusion.

**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)?

The Committee does not believe the criteria are an improvement over FAS 113 because they are overly restrictive.

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?

The Committee believes bifurcation is unnecessary for the vast majority of contracts written by insurance enterprises. We would favor whichever approach narrows the scope as much as possible.

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

The Committee believes the criteria for insurance and reinsurance should be the same. If a bifurcation standard is implemented, we believe it should apply only to individually negotiated contracts between large corporate entities. This would encompass 100 percent of all reinsurance treaties and a number of insurance contracts for which the quality of the risks transferred should be described in the financial statement disclosures.

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?

We hesitate to endorse any method, but some of our members have said they found the cash flow yield method least objectionable. This, however, was not a unanimous sentiment.

**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?

We are unprepared to comment on the effects of data availability on any particular proposed method.

**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?

The Committee has stated it does not believe bifurcation will improve financial reporting. If the FASB ultimately decides that it believes bifurcation is needed, the Committee would encourage FASB to try to influence the IASB to incorporate bifurcation in its Phase II proposal.

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Again, we thank you for this opportunity to comment on this proposal. Even though we do not believe the suggested proposal will improve reporting overall, we value the exchange of ideas this has generated and believe that this alone is a positive development. We are available to answer any questions you may have regarding our comments. If there are any questions regarding these comments, please contact Tina Getachew at <a href="mailto:getachew@actuary.org">getachew@actuary.org</a> or at (202) 223-8196.

Sincerely,

Darin Zimmerman

Chair, Life Financial Reporting Committee

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American Academy of Actuaries