

August 24, 2006

Mr. Lawrence W. Smith
Director - Technical Application and Implementation Activities
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116



LETTER OF COMMENT NO. 39

File Reference No. 1325-100

Re: FASB Invitation to Comment on *Bifurcation of Insurance and Reinsurance Contracts for Financial Reporting*

Dear Mr. Smith:

Deloitte & Touche LLP is pleased to respond to the May 26, 2006, FASB Invitation to Comment on *Bifurcation of Insurance and Reinsurance Contracts for Financial Reporting* (the "Invitation to Comment" or "ITC"). In general, we agree that a requirement to bifurcate insurance contracts into their financing and insurance components has certain advantages when compared to the existing pass-fail paradigm. However, we have a number of concerns with certain provisions of the ITC. Many of those are outlined in our responses to the questions posed in the ITC, which we have included as an Appendix to this letter. However, two primary concerns highlighted below relate to (1) the difficulties we believe policyholders and insurers will experience in seeking to implement a bifurcation approach and (2) whether the Board can develop a bifurcation approach that will result in transactions with similar economics being accounted for in the same manner.

Implementation Challenges

Requiring a bifurcation approach will have a pervasive impact on the financial reporting of buyers and sellers of insurance. We understand that the IASB is currently developing an accounting standard for insurance contracts in its consideration of Phase II of IFRS 4, *Insurance Contracts* that likewise could significantly change the current insurance accounting paradigm. We believe that a bifurcation requirement (particularly Approach B, which requires all insurance contracts not exempted by the screens outlined in the ITC to be bifurcated) will require both buyers and sellers of insurance to establish new methodologies and systems capable of performing the bifurcation analysis. Buyers in particular will likely experience a significant learning curve in determining how to perform this analysis, and it is unclear whether many companies will be capable of applying the methodologies described in the ITC to determine what portion of a given contract should be bifurcated. Furthermore, the approach outlined in the ITC requires each insurance contract to be separately analyzed. This approach differs significantly from current practice. Performing analysis at the individual contract level may pose challenges for insurance companies that typically manage risks on a portfolio basis. Thus, we anticipate that both buyers and sellers of insurance may experience substantial difficulty in making certain provisions of the ITC operational.

We are aware that it is typical for the introduction of a new accounting standard to raise similar education and systems challenges. However, we question whether the Board should pursue a

project that has such potentially significant financial reporting and transition cost consequences when preparers might have to address additional education and systems challenges in the not too distant future to apply a standard converged with IFRS. In light of these concerns, we recommend that the Board take a measured approach with this project and defer consideration of any provisions that are likely to have a significant, pervasive impact on practice until the IASB completes Phase II of the IFRS 4 project. If the Board determines that interim guidance is needed to address the recent reporting issues identified in the ITC, it should consider a more limited scope project that seeks to improve consistency in implementation of the existing insurance accounting model. In particular, we encourage the Board to focus on providing more guidance on what is meant by “significant” as that term is used in paragraphs 9(a) and 9(b) of FASB Statement No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts*.

Comparability Concerns

One of the characteristics of decision-useful information described in the Board’s Conceptual Framework is comparability — the premise that similar transactions and events should be accounted for similarly. We question whether the approach outlined in the ITC will improve comparability vis-à-vis the current accounting model. As our discussion in the Appendix indicates, in certain circumstances the ITC’s model appears to account for similar risk exposures in different ways. Furthermore, the screens described in the ITC require significant judgment to apply. Such discretion also could impair comparability.

As noted previously, the Appendix below contains our responses to the questions raised in the Invitation to Comment.

We appreciate the opportunity to respond to the Invitation to Comment. If you have any questions concerning our comments, please contact Mark Bolton at 203-761-3171.

Yours truly,

Deloitte & Touche LLP

cc: Carrie Bloomer
James A. Johnson
Mark Parkin

Appendix
Deloitte & Touche LLP
Responses to Questions in Invitation to Comment

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?

We believe the IFRS 4 definition of “insurance contract” adopted by the ITC generally is acceptable; however, we believe the final standard should discuss the accounting ramifications of a contract that allows the insured to recover an amount greater than its actual losses (i.e., how is the accounting affected when a compensation model is followed instead of an indemnification model).

We support the ITC’s adoption of the U.S. GAAP definition of “insurance risk.”

We believe the ITC’s description of “finite insurance” as contracts that “limit the amount of insurance risk (both underwriting and timing) transferred from the policyholder to the insurer” is too broad. Risk limiting features, such as deductibles, policy limits on claims, and exclusions are a component of virtually every insurance contract. Therefore, including a listing of risk-limiting features does not necessarily distinguish a finite insurance contract. Providing examples of features that limit the transfer of insurance risk is helpful, but there is sufficient ambiguity in those examples to allow a contract to be structured to avoid finite classification when it still results in significant economic retention of risk. We believe the cash flow analysis required by Statement 113 is the best method for determining whether significant insurance risk has been transferred.

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?

We believe the Statement 113 guidance can be applied to insurance contracts and, in many cases, is already being applied by insurance companies. However, we believe it will be difficult for many corporate policyholders to apply the guidance. Much of the information needed to perform the cash flow analysis is based on actuarial assumptions and is not readily available to a policyholder that does not operate in the insurance industry. Furthermore, for insurers, much of the data underlying existing cash flow analyses is based on assumptions about an entire pool of policies and may not be appropriate to use for an individual policy.

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?

We agree that there is conceptual appeal in accounting for the financing components of insurance contracts as deposits and accounting for those components that transfer risk as insurance, and believe that such a model, in theory, will more faithfully represent the economic substance of the contract. However, we believe that preparers and users of financial statements, including credit analysts, can best answer whether the information that would be produced by the model proposed in the ITC is useful for decision making purposes.

As acknowledged by the ITC, bifurcating insurance contracts will significantly change current practice, and that change could be pervasive, since any contractual right or obligation involving future cash flows contains a financing element. Preparers, users, and auditors of financial reports of non-insurance-company policyholders would likely experience a significant learning curve associated with compiling and analyzing the bifurcated information, and it is unclear whether the benefits provided by such information would outweigh the costs incurred to gather that information.

We also are concerned about the reliability of the information produced by the bifurcation model. Significant judgment will be required to apply the screens described in the ITC and to measure the portion of the contract that should be bifurcated; this level of judgment may negatively affect the information's verifiability. Furthermore, as described in our response to Issue 5, it appears that the model could treat group contracts and portfolio reinsurance differently from an aggregation of individual contracts. We question whether this outcome is representationally faithful, since similar risks would be accounted for differently.

We encourage the Board to review the comments of financial statement users to gauge whether those constituents believe that the bifurcation model will produce information that is, on the whole, more understandable and decision useful.

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?

We believe that the sequencing and integration depicted in the flowchart are appropriate. As noted in subsequent responses, we have some concerns with respect to the details of how certain steps in the flowchart, as described in the ITC, would be applied in practice.

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?

We generally agree with the required characteristics for contracts that unequivocally transfer significant insurance risk, except for the requirement, in paragraph 58(f), that the contract is not likely to result in any claims. We are concerned that this criterion may result in similar risk exposures being accounted for differently.

For example, it appears that group contracts would be treated differently under the model proposed in the ITC from a portfolio of individual contracts. Assume an insurer holds a portfolio of individual insurance contracts, and each contract in the portfolio, when analyzed separately, meets the criteria for unequivocally transferring significant insurance risk. Under the model described in the ITC, the insurer would not have to bifurcate any of those individual contracts

even though the insurer believes that it is likely that some claims losses will be experienced by the portfolio as a whole. If, however, all of those insured were covered by a single group contract, and a level of claims losses was anticipated that was identical to the amount of claims estimated by the insurer for its portfolio of individual contracts, that group contract would fail the unequivocal-transfer-of-significant-insurance-risk test. It is unclear why similar economic risks should receive different accounting treatment under the model.

Similarly, reinsuring a portfolio of contracts that individually would be considered to “unequivocally transfer significant insurance risk” would result in different accounting treatment. For example if an insurer writes 1,000 individual policies with no risk-limiting features, both the insurer and the insureds will qualify for insurance accounting under the “unequivocally transfer significant insurance risk” screen. The insurer then purchases a reinsurance policy covering this entire portfolio with no risk-limiting features. The reinsurance contract would not meet the criteria of unequivocally transferring significant insurance risk since losses would be expected for the portfolio as a whole even though the risks are the same.

We believe the majority of the examples outlined in Appendix B of the ITC are consistent with the characteristics described in paragraph 58; however, we question the conclusion provided for the individual accident and health policy. We think it is likely that such a policy would receive claims for routine physicals or visits to a doctor to obtain a prescription due to illness, thus it would appear to violate the “not likely to result in any claims” requirement of paragraph 58(f).

We also believe it would be helpful if the final Standard clarified what is meant by “single risk” policy, as that term is used in paragraphs 58(a)–(c) of the ITC. Some might argue that a policy with multiple coverages addresses more than a single risk, even if only a single location is insured.

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)?

We agree that it is appropriate to identify those characteristics that indicate the occurrence of an unequivocal transfer of insurance risk. As noted in our response to Issue 5, we have some concerns about the application of criterion 58(f). Also, it would be helpful if the final standard provided some discussion in its basis for conclusions on whether it would be considered rare for a contract to have all of the characteristics described in paragraphs 58(d) through 58(f). In practice, the paragraph 11 exemption in Statement 113 has been applied very narrowly; it is unclear if the model proposed in the ITC would expand the use of this exemption.

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?

Of the two approaches outlined in the ITC, we prefer Approach A until the IASB completes Phase II of the IFRS 4 project. As noted above, we do not endorse an approach that would have a pervasive effect on existing practice if it is likely that additional changes could be required in the future as part of a subsequent convergence project. Accordingly, we do not support Approach B. We believe the more limited approach encompassed by Approach A would help to address some of the recent reporting issues discussed in the ITC. To make Approach A more operational, the

Board will need to provide additional guidance on what constitutes a “significant financing component.”

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

There does not appear to be a conceptual basis for establishing different bifurcation criteria for insurance and reinsurance contracts. However, the Board will still need to resolve the issues previously raised in Issue 5 and 6 regarding paragraph 58(f) in the ITC.

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 do not believe the ITC provides sufficient detail for us to fully understand how the proportional method and the cash flow yield method would be applied in practice; accordingly, it is difficult to express a preference for any of the methods described in the ITC. The final Standard should include examples of how to apply the permissible bifurcation methodologies. Application of the expected payout method (and most likely the proportional method) requires actuarial computations; therefore, we believe that most corporate policyholders will need to hire outside experts to apply that methodology. In selecting a final method, the Board should seek to encourage operational simplicity.

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?

Because we do not have a complete understanding of the methodologies described, it is difficult to respond to this issue. We encourage the Board to fully consider any points raised by preparer constituents in their comment letters on the ITC.

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?

As discussed above, we encourage the Board to adopt a measured approach in its current project. We do not endorse the Board’s issuance of guidance that would have a pervasive effect until the IASB completes Phase II of its IFRS 4 project.