



Swiss Re



LETTER OF COMMENT NO. **23**

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**Comments on the Invitation to Comment "Bifurcation of insurance and reinsurance contracts for financial reporting"**

Swiss Re, as the leading global reinsurer, supports the FASB in developing high-quality US GAAP pronouncements.

Currently, Swiss Re's consolidated financial statements are prepared in accordance with Swiss GAAP. Swiss Re will change its accounting basis from Swiss GAAP to US GAAP in the consolidated financial statements for the year ending 31 December 2006.

We have the following comments on the Invitation to Comment (ITC).

**1. Bifurcation of insurance contracts**

We do not agree with the proposal to bifurcate insurance contracts for the reasons set out below.

Many reinsurance contracts contain risk limiting features which are closely interlinked with risk taking features. More complex insurance contracts will frequently include elements of profit sharing. This is often also the case in direct insurance (e.g. bonus/malus experience rating system in motor insurance). All insurance contracts contain an element of financing as premiums are typically received before losses are paid.

We believe that bifurcation would require judgments that are even more complex and subjective than the judgments made today. We are concerned that this would render financial statements less understandable and reliable.

The current deposit accounting model has weaknesses as most contracts which do not meet the risk transfer requirements are typically subject to either timing or underwriting risk and are thus conceptually different from true bank deposits. The scope of deposit accounting should not be enlarged further by the bifurcation proposal.

We believe that adopting a bifurcation model prior to the IASB completing Phase II of their insurance accounting project would be premature. If adopted, the currently deliberated Phase II approach will reduce the gap between the accounting models for insurance contracts and financial instruments in terms of recognition and measurement.

We do not think that the issues that the ITC attempts to remedy have been caused by the current US GAAP insurance accounting model. Contracts which meet the existing risk transfer requirements are correctly accounted for as insurance, while those that do not are correctly accounted for as deposits. For multiple-year retrospectively rated contracts, EITF 93-6 and EITF 93-14 already ensure that assets, liabilities and net income are recognised in the appropriate accounting period. In our view, bifurcation would be an unnecessary overreaction to a potential failure to apply adequately the existing guidance. Unfortunately this cannot be remedied by an accounting pronouncement and can only be addressed by greater vigilance and better systems of internal control over financial reporting. Prior to IFRS Phase II, focus should be directed towards ensuring that the existing risk transfer requirements are appropriately interpreted and applied.

## **2. Conditions for bifurcation**

The ITC proposes a set of tests to identify contracts that are subject to bifurcation. We do not believe that these are appropriate for the following reasons.

Under the existing guidance, if an agreement with a reinsurer consists of both risk transfer and nonrisk transfer coverages that have been combined into a single legal document, those coverages must be considered separately for accounting purposes. The proposed bifurcation requirements are based on rules which represent a significant shift from the principles-based approach in the existing guidance.

Most reinsurance contracts reinsure portfolios of underlying contracts and are not single indemnifications. Therefore most reinsurance contracts would fail the unequivocal test of insurance accounting and may need to be bifurcated. The arbitrary nature of the proposals is illustrated in Appendix B of the ITC, where professional liability covers with sole practitioners fall on one side of the line, whereas "large" partnerships fall on the other. It is unclear how small or medium partnerships would be treated.

In addition to this arbitrary aspect, exempting contracts with single insureds while applying tests for contracts with two or more insureds raises the conceptual issue about the unit of account in the accounting model.

We feel that the proposals are rule-based and open to potential manipulation. Small groups could enter into multiple individual contracts rather than a single group contract. In the hands of the insurer the only difference is one of administrative convenience, presumably reflected in the price. This raises another issue, a corollary of the previous paragraph, that it is the policyholder's overall risk position that should determine the treatment and not each individual risk (and the terms of any insurance contract that seeks to offset it) in isolation.

The proposal would treat the financial reporting of reinsurers differently than insurers. An insurer acts as an intermediary for the risk it cedes and as a risk taker for the risk it retains. There is here no conceptual difference between the risk taking role of insurers and reinsurers.

For example, an insurer writing individual motor insurance policies will recognise revenue (over the risk period) for the full premium charged to the policyholders. In contrast, according to the proposal in the ITC, when the insurer reinsures the portfolio, the reinsurance contract would require bifurcation. This would result in the vast majority of the consideration paid/received for the reinsurance coverage being recorded as a receivable/payable by the insurer/reinsurer, and only a small portion of the consideration being recognised as a decrease/increase in premium revenue by the insurer/reinsurer.

This would distort the reporting of the relative performance and underlying risks of the direct insurer compared to the reinsurer. It would place the reinsurer in a similar accounting framework to a bank (a deposit taker), while allowing the direct insurer to overstate revenue, even if it retained little or no insurance risk. The direct insurer's roles of an intermediary and a risk taker would not be properly reflected in the financial statements.

A portfolio of motor insurance policies written by a direct insurer also has an expected loss (and there is an expected loss within any line of business and across all lines of business) regardless of the fact that the portfolio was assembled by entering into individual contracts.

### **3. Definition of insurance contracts**

We believe that a common definition of insurance contracts and common risk transfer requirements under US GAAP and IFRS are prerequisites for the potential adoption of a common insurance accounting model in Phase II.

Adopting the IFRS 4 definition of insurance contracts has significant conceptual implications as it integrates the concepts of significant insurance risk and uncertain future events which in turn define the IFRS 4 risk transfer requirements. In particular, under IFRS 4, a significant loss does not have to be "reasonably possible" and a contract does not have to transfer both underwriting and timing risk for it to be accounted for as insurance. As a result, contracts that transfer only significant timing risk may be accounted for as insurance under IFRS and should be accounted for as deposits under US GAAP.

However, the FASB could adopt the IFRS 4 definition of insurance contracts in the short term if this is "detached" from the risk transfer requirements in IFRS 4 and "attached" to the risk transfer requirements in FAS 113. Then changes to the risk transfer requirements in FAS 113 and/or IFRS 4 could be considered and exposed for comment in a separate project, or as part of Phase II.

An alternative would be to consider adopting simultaneously the definitions of insurance contracts, significant insurance risk and uncertain future event in IFRS 4. In addition, the FASB could provide further guidance on the application of the existing bifurcation requirements.

### **4. Direct insurance**

We agree that direct/primary insurance should in principle be subject to the same risk transfer requirements as reinsurance, especially where direct insurance contracts contain risk-limiting features.

We appreciate the opportunity to comment on the ITC. Please contact me if you have any questions about our comments. We are also happy to assist further by providing some example transactions to help explain the comments which we have made above.

Yours sincerely,

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