



LETTER OF COMMENT NO. 8

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Financial Accounting Standards Board  
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Dear Ladies and Gentlemen

**Invitation to comment: Bifurcation of insurance and reinsurance contracts for financial reporting purposes**

We welcome the opportunity to respond to the Invitation to Comment in Financial Accounting Series No. 1325-100 dated May 26, 2006 on bifurcation of insurance and reinsurance contracts for financial reporting purposes, which applies to policyholders, insurers and reinsurers. In the appendix to this letter we set out our comments on each of the issues in the Invitation to Comment.

The CFO Forum is a high-level discussion group formed and attended by the Chief Financial Officers of major European insurance companies. Its aim is to discuss issues relating to financial reporting developments for their businesses and how they can create greater transparency for investors. The CFO Forum was created in 2002.

More information on the CFO Forum, its Elaborated Principles for IFRS Phase II Insurance Contract Accounting is available at [www.cfoforum.nl](http://www.cfoforum.nl).

We strongly encourage the FASB not to pursue the bifurcation of insurance contracts accounted for under US GAAP. We believe that bifurcation is both unnecessary and potentially misleading and we instead suggest that the FASB focus on collaborating with the IASB in developing a comprehensive accounting standard for insurance contracts.

The CFO Forum is committed to the development of a full IFRS for insurance contracts including an appropriate measurement basis. As part of this commitment, the CFO Forum published its Elaborated Principles for Measurement of Insurance Contracts in June 2006. Consistent with the IASB's tentative decision not to require bifurcation (unbundling) of insurance contracts for liability measurement (ref. IASB Update April 2006), the CFO Forum believes that insurers should not be required to bifurcate insurance contracts. Instead the present value of all obligations and rights arising from insurance contracts should be recognised on a market consistent basis eliminating the need for bifurcation.

The CFO Forum supports global convergence of financial reporting standards. As well as preparing financial statements under IFRS, the majority of the members of the CFO Forum prepare accounts under US GAAP either for foreign private issuer SEC filings or as an underlying basis for insurance contract accounting. Given the IASB's commitment to developing a full measurement standard for insurance contracts, we believe that this is not an appropriate time for the FASB to be addressing alternative accounting approaches. The CFO Forum recommends that the FASB work with the IASB, as already agreed, to consider the overall accounting framework for insurance contracts.

On the specific issue of the IFRS 4 definition for insurance contracts including the IFRS 4 definition for significant risk transfer, the experience of CFO Forum members reporting in accordance with IFRS has demonstrated the suitability of the IASB's definition in practice and that this approach is sufficiently able to distinguish insurance contracts from other financial contracts.

If you have any questions that you would like to raise in connection with our response, please feel free to contact me.

Yours sincerely

Signed  
Dr. Helmut Perlet

Chairman  
European Insurance CFO Forum

Enclosure

## **APPENDIX: Responses to issues**

### **Issue 1**

*Does the IFRS 4 definition of an 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 IFRS 4 and US GAAP definitions are both used in practice by companies for financial reporting purposes. The Invitation to Comment brings together the IFRS 4 definition of an insurance contract with the Statement 113 definition for significant risk. IFRS also provides a definition for assessment of significant risk transfer.

The CFO Forum is comprised of 20 companies that have applied the IFRS 4 definition for insurance contracts including the IFRS 4 definition for significant risk transfer in practice and find this approach is sufficiently able to distinguish insurance contracts from other financial contracts.

Combining the IFRS 4 definition of an insurance contract with the Statement 113 definition for significant risk may provide a short-term solution for US GAAP but will need to be reconsidered in the context of the convergence project between the FASB and the IASB.

The terminology associated with contracts that assume lower levels of insurance risk is confusing and misleading: finite reinsurance, financial reinsurance, structured deals, non-traditional reinsurance, etc. None of these terms are absolutely defined across the industry nor do their descriptions necessarily refer to the level of risk transfer. For instance, very few insurance contracts provide infinite risk cover hence almost all insurance contracts could be described as finite.

The CFO Forum supports the recognition of insurance contracts as a range of products that contain a combination of insurance risk and financial risk as defined by IFRS 4. Financial reporting of all insurance contracts and contracts with similar characteristics should reflect all the rights and obligations under those contracts through an appropriate measurement basis.

### **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?*

IFRS 4 provides a better definition for insurance risk transfer.

The requirements of the Statement 113 draw a distinction between short-duration and long-duration contracts. This requires separate definitions to distinguish these two classifications. This is particularly significant as the requirement for short-duration contracts requires "significant variation in both the amount **and** timing of payments" whilst for long-duration contracts risk transfer is determined by "significant loss from assuming insurance risk".

The IFRS 4 definition of insurance contracts provides one definition for insurance contracts so it does not provide a definition split between short-duration and long-duration contracts. Given the increasing number of contracts that blur the boundary, for example multi-year non-life insurance policies and group life insurance covers, the CFO Forum favours the single definition of insurance contracts in IFRS 4 and a basis for assessing risk transfer that can be applied to all contracts.

The definition of an insurance contract should consider the relationship between the policyholder (cedant) and the insurer (reinsurer/retrocessionaire) rather than focusing on the position of one party to the transaction, as is the case in FAS 113. Whether a contract is insurance or not should not differ depending on whether it is considered by a policyholder, cedant, insurer or reinsurer. Measurement may differ between parties due to the different circumstances of each but these circumstances should not affect the definition of the contract.

Circular arrangements may not be identified correctly if the definition of an insurance contract differs when defined from the perspective of the policyholder (or cedant) compared with the position of the insurer (or reinsurer). Bifurcation would further exacerbate inconsistent recognition of contracts comprising circular arrangements due to the selection of different assumption when related contracts are viewed from the different perspectives of insurer (or reinsurer) and cedant.

### **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?*

An aggregate valuation basis is the only approach that can ensure faithful representation of the economic substance of most insurance contracts.

Financial reporting of insurance contracts will be less reliable and less comparable when different measurement bases are applied for insurance and reinsurance contracts. The same principles should apply consistently to all contracts that transfer insurance risk. For many such contracts there is no clear dividing line between the insurance and deposit components. Attempting to separately identify insurance and deposit elements sets an arbitrary line based on subjective judgement.

Showing separate measurement of the financial and insurance components of insurance contracts provides the users of accounts with misleading information. Separate measurement of such assets and liabilities fails to reflect the contractual interaction of the financial and insurance risks. The measurement of insurance contracts should be based on an aggregate valuation approach that takes into account the interdependencies of the financial and insurance components.

Financial components are appropriately recognised when future cash flows are discounted for the time value of money. This can be achieved without bifurcation. Insurance contracts should be measured on a discounted basis.

The current US GAAP deposit accounting model is most suitable for accounting for bank and similar deposits but does not consider the additional requirements of contract where future cash flows are subject to some timing or underwriting risk. Extending the scope of contracts to which deposit accounting applies will lead to less reliable measurement.

### **Issue 4**

*The flowchart suggests a sequence for analysing 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?*

A measurement basis that recognises all the rights and obligations under insurance contracts would not require bifurcation therefore arduous sequential analysis of insurance contracts would not be necessary.

To distinguish currently between insurance and investment contracts introduces subjective judgements to determine the level of risk transfer implicit in each contract or category of

contracts. Sequential testing of contracts multiplies the number of assumptions and hence the subjectivity of the approach. Further the complexity and the number of steps in the proposed approach is likely to lead to inconsistent application due to the cumulative effect of slightly different decisions being made in response to each criterion.

The CFO Forum favours a principle based approach to recognition and measurement of insurance contracts based on the substance of the transaction under the contract. An appropriate measurement basis that reflects the time value of money will remove the need for stringent rules-based recognition.

#### **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 CFO Forum does not agree with the characteristics identified for contracts that do or do not unequivocally transfer significant insurance risk.

The proposed characteristics raise more questions than they resolve, including:

- “market equivalent level of premium” – what is this and how should it be assessed given the individual nature of many insurance contracts and portfolios?
- “the premium is not a substantial percentage of the maximum coverage provided” – what is substantial? It should also be noted that for some policies the maximum coverage may be huge but the policy is rated based on a maximum expected loss due to the diversification of liabilities for one insured/cedant.
- “is not likely to result in any claims” – what is the definition of “not likely” and how does this compare with the requirement for significant risk transfer in the definition of an insurance contract?

The complexity of the proposed rules will lead to inconsistent application making financial statements less transparent and less comparable.

The examples in Appendix B of the invitation to comment show that the characteristics can be applied in those instances but there is no consideration of any life insurance products.

#### **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 (summarised in paragraph 37(c) of this Invitation to Comment)?*

Both these approaches are trying to subdivide the definition of an insurance contract. It is naïve to consider that it is possible to identify an unequivocal measure for risk transfer. Wherever you draw the line there will always be some contracts that are very similar being measured on different bases for financial reporting purposes.

If the measurement bases are not consistent for contracts falling into different classifications, there is a significant risk that there will be a rise in the proportion of contracts designed to “just meet” the rules for the more favourable accounting basis.

The CFO Forum recommends focussing on achieving consistent measurement of contracts assuming different proportions of insurance risk and financial risk, regardless of the definition of such contracts.

#### **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 describe that approach? Would your preferred approach be operational? Would it make the financial statements more decisions useful?*

Neither Approach A or B is preferable. The interdependent nature of the financial and insurance risks in insurance contracts means that investment and insurance elements need to be considered together. Separate valuation of the two components could result in inconsistent measurement.

The CFO Forum believes that the superior approach is to implement a measurement basis that puts a value on all the rights and obligations arising under insurance contracts, including all options and guarantees. Such a measurement basis should be consistent with the measurement of similar contracts that are accounted for as financial instruments. The CFO Forum has developed a set of Elaborated Principles (published 22 June 2006) which presents the way it believes that the appropriate aggregate measurement of insurance contracts can be achieved for financial reporting purposes.

Only a few types of insurance contracts can be easily split between the investment and insurance elements. In most cases the investment and insurance characteristics are closely linked and any attempt to bifurcate introduces more assumptions and increased subjectivity and uncertainty to the valuation approach. The estimates of deposit and insurance elements become less reliable than an aggregate estimate and will be exposed to greater variability at subsequent valuation dates.

#### **Issue 8**

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

The CFO Forum comprises insurance and reinsurance companies and has concluded that the same measurement principles can be applied to both insurance and reinsurance contracts. Insurance contracts and reinsurance contracts should not be bifurcated for financial reporting purposes.

#### **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?*

None of the three methods of bifurcation proposed in the Invitation to Comment have more merit than the development of a measurement basis that can be applied to all insurance contracts and reinsurance contracts without requiring bifurcation. All the methods proposed introduce increased subjectivity and uncertainty to the valuation basis because they fail to recognise the interdependency between the financial and insurance components and seek to define an arbitrary split.

Policyholders may find it more difficult to evaluate insurance contracts given their limited access to appropriate, relevant modelling data. It might be expected that policyholders (and some cedants) will look to their insurer (or reinsurer) or to external market consultancies, to provide support in valuing individual contracts. A policyholder's valuation of a particular contract is likely to differ from the valuation by an insurer of the same contract as an insurer's expectation of future losses will be based on a portfolio of similar contracts whilst a policyholder's valuation will be influenced by their own situation.

#### **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?*

The reliability of any assessment depends on the reliability of the data it is based on. Measurement of insurance risks will be subject to many sources of potential error including errors arising from low volumes of data, changing practices, changing underwriting and contract terms and conditions, changing risk factors, policyholder behaviour as well as environmental and economic factors. The more assumptions required the greater the uncertainty attaching to any conclusions reached.

Currently most insurers and reinsurers do not have their systems set up to collate the level of information required to apply the bifurcation approaches considered in the Invitation to Comment. The development of systems would require significant investment and it would take time to build up an adequate volume of relevant historical data. Most insurers consider the aggregate product for underwriting and pricing purposes and post-sale contract management. Bifurcation is not a feature of day-to-day contract management.

In the market currently the types of contracts that are most likely to need to be assessed for bifurcation are large specialist contracts that have been tailored to fulfil a specific purpose. Often the reason for the design of the contract is because the aggregate insurance risk is extremely difficult to assess and, whilst the policyholder wishes to find a way to manage its risk, the reinsurer wants to limit the potential downside risk being assumed. Consequently the data is likely to be limited in some way, for example small volumes of losses are not suitable for credible analysis. The bifurcation proposals will place heavy reliance on this sort of data as a basis for distinguishing between the financial and insurance characteristics of such contracts.

The CFO Forum does not consider bifurcation will lead to more reliable and relevant financial reporting of these contracts.

#### **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?*

No. Given the IASB's commitment to developing a full measurement standard for insurance contracts this is not an appropriate time for the FASB to be addressing alternative accounting approaches. The CFO Forum recommends that the FASB should work with the IASB, as already agreed, to consider the overall accounting framework for insurance contracts.