LETTER OF COMMENT NO. 11

From: Breckenridge, John [mailto:John.Breckenridge@abi.org.uk]
Sent: Tuesday, August 22, 2006 6:12 AM
To: Director - FASB
Cc: Vipond, Peter; Wright, Deryck
Subject: Bifurcation of Insurance Contracts - File Reference No. 1325-100

I attach comments by the Association of British Insurers on FASB's discussion paper 'Bifurcation of Insurance and Reinsurance Contracts for Financial Reporting' (File Reference 1325-100).

We would be happy to discuss if you have any queries.

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RESPONSE OF THE ASSOCIATION OF BRITISH INSURERS TO FINANCIAL ACCOUNTING SERIES NO 1325-100 "BIFURCATION OF INSURANCE CONTRACTS FOR FINANCIAL REPORTING"

Introduction

The Association of British Insurers (ABI) represents about 400 UK insurers accounting for some 94% of the business transacted by UK insurance companies. ABI member companies also account for almost 20 per cent of investments in the London stock market (and for significant investments in other capital markets). Some ABI members have operating subsidiaries in the United States and some are themselves UK subsidiaries of large international financial services groups. In virtue of this and in virtue of the London markets for international insurance and finance, the deliberations and decisions of the FASB are of great significance to much of our membership. ABI members are both significant users and preparers of financial reporting information and have a strong interest in ensuring that financial statements are relevant and reliable and meet the needs of investors and other accounts users.

Our comments are from the perspective of financial reporting by insurance and reinsurance entities. We have four main areas of concern. These are:

- The timing of the FASB proposals
- Is it appropriate to bifurcate contracts issued by insurers?
- Is bifurcation likely to be helpful to the users of financial statements?
- Is there any satisfactory way to undertake bifurcation?

The timing of the FASB proposals

Given the current work by the IASB to develop a globally acceptable accounting standard for insurance contracts under Phase II of its insurance project, we think it would be better for FASB to work with the IASB rather than seeking to bring forward its own proposals before the IASB work is complete.

Is it appropriate to bifurcate contracts issued by insurers?

We accept that contracts that do not transfer material amounts of risk should not be accounted for as insurance contracts but as investment contracts. In this regard we believe the definition of an insurance contract in IFRS 4 is adequate and does not require any augmentation or change.

We think there is also enough material in this standard to enable a judgement to be made on the extent to which risk has been transferred. The inclusion of any fixed quantitative measure or guide on the amount and probability of insurance risk introduces an element of prescription. This is at variance with principles-based financial reporting that is now generally regarded as being less open to manipulation than rules-based systems.

Contracts sold by insurers are generally sold as a single product. They are priced and managed on that basis. The investment and insurance characteristics are closely interlinked and as a result the cash flows are inextricably interwoven and cannot be separated in a way that does not involve subjective assumptions.

We assume that, provided there is consistent measurement of assets and liabilities having regard to expected future cash flows, the question of whether or not bifurcation is appropriate is essentially one of accounting presentation. In this regard, we do not think that such theoretical arguments as there may be for bifurcation are sufficiently strong to justify the significant changes that might be needed to financial reporting, the confusion that this might create in the minds of accounts users and the considerable amount of additional work and expense – in particular systems changes – that would be required.

In IFRS 4, the IASB has recognised that there should be no requirement to unbundle any deposit element in an insurance contract, provided the insurer's accounting policies require it to recognise all obligations and rights arising from the deposit component.

Is bifurcation likely to be helpful to accounts users?

We consider that bifurcation would be a source of unnecessary confusion in financial statements that are already subject to a high degree of complexity. Accounts users will appreciate the accounting distinction between insurance and investment contracts. This having been achieved however, we think that any further information needed – for example where there is significant insurance risk transfer but also a material financing element - could be provided by non-quantitative narrative disclosures. This would be preferable to changing the shape of the financial statements in a way that may reduce their relevance and reliability.

Apart from this we think that bifurcation has the capacity to mislead as it imputes a spurious accuracy in determining the split between the investment and insurance elements. Accounts users are accustomed to insurance contracts being accounted for in a particular way. Adopting bifurcation for all or substantially all contracts issued by insurers is therefore likely to be a source of confusion without adding any useful additional information.

Is there any way to satisfactorily undertake bifurcation?

In our view, this will not be possible in any but the most clear-cut circumstances. As we said previously, the cash flows for many types of insurance contract are inextricably interwoven and cannot therefore be reliably separated.

Association of British Insurers
August 2006