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An FASB Agenda Proposal: Accounting for Insurance Contracts by Insurers and Policyholders

This letter is in response to the Invitation to Comment on the above-referenced matter.

By way of background I have been a security analyst following the insurance industry for 35 years, so this letter can be classified as a user comment. I have been a member of the IASB Working Group on Insurance Contracts since 2004 and I am also a member of the FASB/IASB Financial Institutions Advisory Group.

I am currently Head of US Financial Strategies at Fox-Pitt Kelton Cochran Caronia Waller, a research and investment banking firm specializing in financial stocks. The opinions expressed in this letter are my own.

As an overview comment I have long believed that investors would benefit from a common international set of high-quality financial statements. Therefore, I applaud the convergence efforts of both the FASB and the IASB. I particularly believe that the FASB suggestions laid out before Congress on October 24, 2007 by Bob Herz regarding the potential transition to IFRS will be particularly helpful in moving this process along.

Consistent with that view I believe that insurance analysts and investors are hampered by the inconsistency regarding insurance accounting. This lack of comparability among countries has led investors to encourage companies to develop alternative reporting mechanisms specifically Embedded Value which is seen as being more informative than local GAAP.

Question 1

I believe there is a need for the FASB to comprehensively address accounting for insurance contracts. There are two reasons for this. First, the existing accounting standards are extremely fragmented, and, therefore, fraught with complexity. This forces preparers and users to be more concerned with technical details rather than broad principles. Second, as discussed below, there are areas where the accounting standards do not, in my opinion, faithfully reflect economic reality.

I believe there are several major areas where insurance accounting could be improved. Among the most important are:

- A reconsideration of FAS 5, Accounting for Contingencies,
- Recording short duration reserves at nominal value does not represent the value of the obligation,
- Allowing short duration liabilities to be recorded with costbased attributes creates an inconsistency with assets recorded at fair value,
- Locking in the assumptions on long duration liabilities do not allow financial statement users to understand current conditions,
- Adding a margin for adverse deviation to long duration contracts distorts the true value of the liability.

The most important of these is the first point. I have long believed that expressing a liability as the "best" single point estimate, as required under FAS 5, is an outdated concept that no longer reflects how reporting entities make decisions.

Thirty years after the issuance of FAS 5, investors have become more sophisticated about stochastic processes and are able to understand the significance of numbers reported in this manner. Keep in mind that when FAS 5 was issued the use of probability theory for decision making was in its early stages. For example, the Black-Scholes option pricing model had only been formulated in 1973.

Since that time the understanding of mathematics by investors has become much more advanced and financial statement users are now comfortable with stochastic models and the significance of probability-weighted numbers. In other words, we recognize that a liability measured on the basis of expected cash flows will likely not be the amount at which an obligation is ultimately settled.

The development of a common high-quality standard for insurance contracts is extremely important because the international nature of the industry means insurers compete for capital against industry competitors while investors have no comparable bases to make informed decisions.

Question 2

While I have some concerns with specific issues, I believe that taken as a whole the preliminary views on insurance accounting expressed in the IASB document are a significant improvement from current generally accepted accounting principles, and, therefore, a suitable starting point for the insurance contracts project.

I also believe that given time users will find considerable merit in the likely proposed IASB standards although because many of these concepts are new and different this will take time and education. However, considering that there are still several years before any standards will be effective, I believe there is adequate time for this education process.

As a financial statement user I am less sensitive to feasibility issues than would be the case for reporting companies. However, I am mindful of company statements of the practical difficulties regarding some of the issues in the IASB's Preliminary Views document.

I do not believe looking for alternatives to improve or simplify U.S. reporting is the best way to approach accounting for insurance contracts. Instead, I believe a joint project with the IASB to develop a common standard is the preferred route.

If, however, the FASB chooses not to institute a project on insurance contract accounting, I believe a reconsideration of FAS 5 is still in order.

Question 3

While accounting symmetry between policyholders and insurers is a useful goal, I do not believe this is a critical or urgent issue. I believe the accounting for policyholders is best left to a later date so as not to delay the insurance contracts project.

Question 4

Accounting standards setting requires constant evolution and many changes. If all projects were delayed to assure consistency with other pending projects nothing would ever get done. Therefore, I believe it best to proceed directly with the insurance contracts project.

With this in mind, though, I believe, if feasible, that the income statement portion of the insurance contracts project should be consistent with the eventual development of reporting practices in the financial statement presentation project. (I consider the financial statement presentation project to be the most important on the FASB agenda.)

Also, for practical considerations completing the risk transfer and financial guarantee projects before insurance contracts would likely require changes in those standards within a short period of time.

For further perspective on my views, I have attached a copy of my response to the IASB request for comments.

I would be happy to discuss these comments further.

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Discussion Paper-Preliminary Views on Insurance Contracts

This letter is in response to the Invitation to Comment on the above-referenced Discussion Paper.

By way of background I have been a security analyst following the insurance industry for 35 years, so this letter can be classified as a user comment. I have been a member of the IASB Working Group on Insurance Contracts since 2004 and I am also a member of the FASB/IASB Financial Institutions Advisory Group.

I am currently Head of US Financial Strategies at Fox-Pitt Kelton Cochran Caronia Waller, a research and investment banking firm specializing in financial stocks. The opinions expressed in this letter are my own.

As an overview comment, while I have some concerns with specific issues, I believe that taken as a whole the preliminary views on insurance accounting expressed in this document are a significant improvement from current generally accepted accounting principles, particularly those in the United States. I also believe that given time users will find considerable merit in the likely proposed standards although because many of these concepts are new and different this will take time and education. However, considering that there are still several years before any standards will be effective, I believe there is adequate time for this education process to occur.

As a financial statement user, I would note that I do not agree with one of the major concerns of the insurance industry that the potential greater volatility of reported results that might result from these standards would raise the industry's cost of capital. Instead, I believe that any increase in volatility would be more than offset by the increased level of transparency in the reported results.

While not requested as a specific question, I believe the underlying premise in the Preliminary Views that it is appropriate for all forms of insurance to be governed by a single model is correct. While each insurance segment has differing products and approaches they are all guided by a common goal; risk transfer through which an insured will pay a known amount to have the counter party (the insurer) assume a potentially larger unknown risk, However, while I believe a single governing principle is appropriate, I also believe that it may be

appropriate for the different types of insurance results (life and non-life) to be presented results using different income statement formats.

Furthermore, I also believe that there is a need for the Financial Accounting Standards Board to comprehensively address accounting for insurance contracts and that the preliminary views expressed by the IASB in this Discussion Paper are a suitable stating point. I will make these points known in a response to the FASB's Invitation to Comment.

Following are comments on the specific questions posed in Appendix A of the Preliminary Views. I have only commented on those where I have an opinion.

As a financial statement user I am less knowledgeable of and less sensitive to implementation issues then would be the case for reporting companies.

Question 2

In my opinion the proposed three building blocks are the appropriate measure for insurance liabilities. I believe explicit cash flows are the key building block of nominal reserves and I believe it is imperative that these cash flows be probability weighted.

I have long argued that expressing a liability as the "best" single point estimate (as required in the US under FAS 5) is an outdated concept that no longer reflects how reporting entities make decisions.

Thirty years after the issuance of FAS 5, investors have become more sophisticated about stochastic processes and are able to understand the significance of numbers reported in this manner. Keep in mind that when FAS 5 was issued the use of probability theory for decision making was in its early stages. For example, the Black-Scholes option pricing model had only been formulated in 1973.

Since that time the understanding of mathematics by investors has become much more advanced and financial statement users are now comfortable with stochastic models and the significance of probability-weighted numbers. In other words, we recognize that a liability measured on the basis of expected cash flows will likely not be the amount at which an obligation is ultimately settled.

I believe that risk margins communicate extremely useful information particularly regarding the uncertainty and volatility of reserve estimates. However, since this is not a common reporting practice (Australia being the chief exception) most investors, particularly those in the US, are not yet familiar with the concept.

I believe discounting results in a more faithful representation of the true economics than nominal reserves and I believe that the discount rate should be the risk free rate and should not take asset portfolio strategies into consideration.

As a financial statement user I am not well versed in the difficulties involved in determining market consistent exit prices but I am sensitive to company warnings that such data is difficult to develop. This suggests that some provision be adopted to allow for entity specific data, where appropriate. (I see this as being analogous to Level 3 financial instruments under FAS 157 Fair Value Measurements in the US.)

Questions 4 and 5

Insurance is a business where companies have to price their products before the loss costs are known with any degree of certainty. Thus, the pricing is not always reflective of the ultimate profitability of a product. In that case the premium charged is not consistent with the market-required margin. Hence, option C seems most appropriate.

That leads me to conclude that current exit value is an appropriate measure of an insurance liability.

I recognize that such an approach can result in Day 1 gains or losses. I am not uncomfortable with the concept of Day 1 gains or losses although this is clearly an area where adequate disclosure is imperative.

While the phrase "current exit value" is not presently one that investors easily grasp, I believe they will become more comfortable with the label as the concept of an "exit price" becomes more prevalent in the US as a result of the implementation of FAS 157.

Question 7

I believe that cash flows should include all that arise from existing contracts regardless of whether the insurer can enforce the cash flows.

I recognize that technically this would result in an "asset" that is inconsistent with the strict definition of an asset, but I believe that while companies cannot enforce all cash flows they do control the customer relationship and that they can influence behavior through policy design and management.

I also believe that companies have adequately demonstrated that they can predict policyholder behavior with a reasonable degree of accuracy.

Question 8

This, to me, is simply an issue of symmetry and consistency between the asset and the liability.

As an analyst I have long considered it vital to know how much a company is paying to acquire business. I place less emphasis on the amortization of acquisition costs since the methods of determining such amounts seem arbitrary and not necessarily reflective of the value of the asset.

Question 9

There does not seem to be any reason to treat contracts acquired in an acquisition differently from those generated internally.

Question 10

I have long believed that assets backing insurance contracts should be measured at fair value. With both insurance contract assets and liabilities reported at fair value, financial statement users will be able to appreciate the duration mismatches that will be evident through the changes in value.

Question 11

I believe risk margins should reflect the benefits (or the costs of) diversification.

While I realize this is inconsistent with the notion of a current exit price as the transfer of a liability to a third party, I also believe that risk diversification is at the heart of what insurance is all about. By assembling a portfolio of risks, insurers are able to reduce the volatility that would be inherent in an undiversified portfolio.

Question 12

My opinion is that reinsurance assets should be recorded on the same basis as the underlying insurance liabilities.

Question 14

While I recognize the arguments as to why the value of a liability should reflect the credit quality of the instrument, I cannot get comfortable with the concept.

I also believe that pursuing this line of reasoning will create such serious concerns in the minds of users that it could potentially undermine the credibility of the entire Insurance Contracts project.

Question 18

I believe the most important information for a financial statement user to know is the amount of new funds being received from policyholders. For that reason alone, I believe premiums should be presented as revenues on the face of the income statement.

We have experience with this in the US. Under FAS 97 receipts on non-traditional insurance policies are reported as an increase in liabilities. While the funds received can usually be tracked through either the cash flow statement, the footnotes, or the management discussion sections of company reports, I believe this diminishes the importance of the receipts in helping to project future cash flows.

Question 19

I believe it is premature to discuss income statement presentation at this time. This is because I believe any format should be consistent with those resulting from the joint FASB and IASB project on *Financial Statement Presentation*.

However, as noted earlier, while I believe that both life and non-life insurance can be covered by a single model, I also believe that the businesses are so different as to require separate types of income statements.

Question 20

While I believe that the change in the value of the insurance liabilities is the most important piece of information to be communicated to users, I also believe that in order to reduce the complexity on the face of the income statement, this information should be provided in footnotes. I would also note that in the case of insurance companies that already provide this type of data (specifically the Australian insurers) I consider the disclosures to be quite comprehensive.

I would also note regarding this question that as the US and the rest of the world move toward reporting in XBRL format the distinction between the face of the income statement and the supplemental data will become largely irrelevant.

Question 21

I recognize that the topic of disclosure will be more fully discussed in the future but I want to make one general comment.

Specifically, I believe that it is very important that users be able to take the financial statements as presented under the eventual IFRS and link them back to

what would have been reported under previous accounting principles. This would increase the comfort level with the new principles and foster user acceptance.

In conclusion, I applaud the IASB's efforts to develop an Insurance Contracts standard. As a member of the Working Group for the last three years I have been impressed by the diligence shown by the Board, the staff and by members of the committee and I believe all involved should be appreciative of the efforts undertaken by interested parties in contributing their time and effort to the project.

I would be happy to discuss these comments further.

Alan Zimmermann

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