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Technical Director  
Financial Accounting Standards Board  
401 Merritt 7  
PO Box 5116  
Norwalk, CT 06856-5116  
Sent via e-mail to: [director@fasb.org](mailto:director@fasb.org)

Re: File Reference No. 1870-100 – Preliminary Views on Insurance Contracts

The American Insurance Association (“AIA”) is pleased to provide its response to the Preliminary Views on Insurance Contracts discussion paper that was issued by the Financial Accounting Standards Board (“FASB”) on September 17, 2010. As an organization that represents major property & casualty insurance companies that are based in North America and Europe, AIA is particularly interested in developing a high-quality, global insurance accounting standard that properly reflects the nature and business of insurance. AIA is concurrently submitting comments to the International Accounting Standards Board (“IASB”) regarding its exposure draft on insurance contracts (“ED”). That comment letter on the IASB exposure draft has been appended to this letter. We have provided more commentary in our response to the IASB’s ED.

The focus of this letter is to respond to two of the FASB’s stated reasons for issuing the discussion paper:

- a. *“During their recent deliberations on the insurance contracts project, the Boards did not explicitly evaluate whether the model proposed in the IASB’s Exposure Draft would represent an improvement to U.S. GAAP. Consequently, the FASB is seeking input from its stakeholders on this issue.”*
- b. *“The Board would like additional input from stakeholders on whether different types of insurance contracts warrant different recognition, measurement, and presentation and, if so, what the criteria should be for determining which, if any, types of insurance contracts would use each model.”*

Improvement to U.S. GAAP. The AIA member companies represent a wide spectrum of interests – companies that are U.S GAAP filers and IFRS filers, companies that are publicly traded and mutual insurers, and companies that have significant life and property-casualty

operations. Understandably, they have also provided a wide spectrum of viewpoints. However, AIA member companies are in agreement that the ED does not improve U.S. GAAP, primarily because the ED guidance would replace a framework that is time tested and works well. Other concerns expressed by AIA members are:

- The ED does not adequately reflect the characteristics of short-duration contracts of the property-casualty industry.
- The building blocks approach is not the best way to measure property-casualty insurance liabilities.
- The ED would impose disclosure requirements that are not meaningful to the users of property-casualty financial statements, while eliminating metrics and other information that users have historically valued.

While we believe the ED does not improve U.S. GAAP, we welcome the opportunity to work with the FASB in identifying areas within the existing insurance accounting framework that can be improved.

Separate Accounting Model. AIA has long advocated that the accounting model must reflect the business model. AIA believes that a suitable insurance contract accounting framework should reflect the following principles:

- The framework reflects the legal and business environment of the insurance model, the effects of diversification, and the management of claims on a portfolio basis;
- The framework provides a clear definition of insurance contracts and the scope of the guidance;
- The framework applies a measurement objective that reflects how property-casualty insurance contracts are settled; and
- The framework measures pre-claims liabilities using the unearned premium reserve.

The building blocks approach does not satisfy these principles. Our concern is that the ED guidance is attempting to impose a long-duration accounting framework onto property-casualty insurers whose products are generally short-duration contracts. If the IASB and the FASB intend to pursue a building blocks approach, AIA supports a separate accounting model for the insurance contracts that are written by property-casualty insurers. Of course there is an issue of identifying the criteria for determining which types of insurance contracts would use each model. AIA member companies continue to discuss that issue and we expect to provide a follow-up letter in that regard.

If you have any questions, we would be happy to discuss our views further.

Sincerely,



Phillip L. Carson  
Assistant General Counsel

## ADDENDUM

November 30, 2010

International Accounting Standards Board (IASB)  
1<sup>st</sup> Floor, 30 Cannon Street  
London EC4M 6XH  
United Kingdom

Via IFRS Foundation website: [www.ifrs.org](http://www.ifrs.org)

Re: **IASB Insurance Contracts Exposure Draft ED/2010/8**

The American Insurance Association (“AIA”) is the leading U.S. property-casualty insurance trade organization, representing approximately 300 insurers that write more than \$117 billion in premiums each year. AIA member companies offer all types of property - casualty insurance, including personal and commercial auto insurance, commercial property and liability coverage for small businesses, workers' compensation, homeowners' insurance, medical malpractice coverage, and product liability insurance. AIA commented on the *Preliminary Views on Insurance Contracts* document that was issued by the International Accounting Standards Board (“IASB”) in 2007. We appreciate this opportunity to comment further on the Insurance Contracts Exposure Draft (“ED”).

AIA is concerned that the ED fails to adequately recognize important distinctions between property & casualty insurance contracts and life insurance contracts. Life insurance contracts provide coverage for longer periods of time and the expected cash inflows and outflows for life products are more reliably determinable. Thus, the business model of a life insurance company tends to focus on investing the premiums in order to generate sufficient investment income to fund the insurance liability and to provide a return to the insurer. Insurance contracts issued by a property-casualty insurance company, on the other hand, cover a short period of time, usually a year or less, so investment income is not a driving factor of the property-casualty business model.

The building blocks approach of the ED suggests a certain level of specificity and certainty that does not actually exist in the property-casualty insurance sector. Requiring the calculation and presentation of an inherently subjective array of probability-weighted cash flows will not add certainty to those aspects of property-casualty insurance products that are, by their nature, uncertain. For example, significant uncertainty surrounds the claim-generating occurrence, the timing of claim presentation, the cost of defending the insured, the amount to satisfy the claim, and the timing of the claim payment. In effect, the proposed building blocks approach would require omniscience in order to apply the ED guidance.

AIA believes a high quality accounting standard for insurance contracts must reflect business reality, and therefore must be flexible enough to allow for the variations in the legal, economic and business environments that exist around the world. The basic business model for property-

casualty insurance involves the aggregation of similar individual contract risks into portfolios of risk, and spreading the cost of that pool to the policyholders within the respective risk pool. Reviewing the historical behavior of the portfolio of risks over time allows actuaries to draw conclusions or make forecasts about the behavior of the portfolio and, accordingly, to estimate the cost to underwrite the insurance portfolio.

From this estimate of cost, insurers can develop pricing by which the premium payment is determined. For example, an automobile insurer would not know whether an individual policyholder would have a car accident within the coverage period. However, for a portfolio consisting of all commuters within a given metropolitan area, the likelihood that an accident will occur within that portfolio of risks is quite high, and thus, the insurer can make some assumptions about claims costs relating to the portfolio and assess an appropriate premium based on those portfolio assumptions. The auto example highlights the fact that property-casualty insurers manage their business by pooling risks into portfolios of similar risks.

The property-casualty business model involves the sale of a product before the cost of that product is known. Thus, determining the cash outflows of a property-casualty insurer is problematic. Until claims are settled, the property-casualty insurer does not actually know what the claims costs will be for a portfolio of risks. Accordingly, the amount and timing of claim payments may remain uncertain for a considerable period of time – particularly for liability insurance products. The uncertainty of the cash outflows is a major distinguishing point between property-casualty and life insurance contracts.

Most property-casualty policies are short-duration contracts, in that the premiums from the pool of similar risks are intended to cover expected claim costs resulting from insured events occurring during a fixed period of short duration. The underwriting activity is the primary focus for short-duration contracts, rather than the earning of investment income. Thus, a distinguishing characteristic between short-duration contracts and long-duration contracts is the different emphasis on investment income.

The remainder of this letter will focus on specific topics that are of particular concern to AIA member companies as property-casualty insurers.

#### *Pre-claims Liability for Short-Duration Contracts*

AIA appreciates that the IASB has acknowledged that for short-duration contracts, the building blocks approach is not necessary for measuring an insurer's standby obligation to pay valid claims prior to the realization of a loss by its policyholders. The ED provides a modified measurement approach, referred to as the Premium Allocation approach. AIA believes the measurement of the pre-claims liability should be the unearned premium reserve, which AIA considers to be a better approximation of the insurer's obligation to the policyholder. The modified approach, as proposed, creates unnecessary confusion with its definitions for pre-claims liability and pre-claims obligation. AIA recommends that the guidance be simplified to provide only for a pre-claims liability.

In addition, AIA believes the "bright-line" one-year-or-less duration criterion for identifying contracts that are eligible for the modified approach is arbitrary. Using this criterion could lead to inconsistent results for functionally equivalent contracts. For example, there are some property-casualty products that are offered on a multi-year basis because it is more cost effective to issue the policy for multiple years, rather than annually executing new contracts when the risk environment has not or is not likely to change. Under the ED, an insurance

product with a one-year contract term that is renewed annually, would be measured under the premium allocation approach, while the functionally equivalent, but multi-year policy would be subject to the building blocks approach. Therefore, we recommend the IASB adopt a principles-based definition for short-duration contracts based on the characteristics of the contract, rather than the contract term. We believe this definition should include contracts that provide insurance protection for a fixed period of short duration and enable the insurer to cancel the contract or to adjust the provisions of the contract at the end of any contract period, such as adjusting the premiums charged or coverage provided. We believe that this definition would result in a more consistent accounting treatment for property-casualty insurance contracts that have similar attributes.

The ED requires testing for an onerous contract by applying the building blocks approach, but doing so could effectively negate the benefit of using the modified approach. To be meaningful, testing for an onerous contract under the property-casualty business model should be applied at the same level at which the risks are managed, i.e., at a portfolio or higher level, and should only be required when qualitative factors exist to suggest the possibility of onerous contracts. Insurers manage portfolios so that risks may be offset or increased across different portfolios. Thus, diversification across portfolios should also be reflected in an onerous contract test. The applicable qualitative factors will vary according to the insurance product and the relevant economic environment

#### *Post-claims Liability – Applying the Building Blocks Approach*

The central principle that pervades throughout the ED is that all insurance liabilities, if not subject to the premium allocation method, can be best measured as the present value of the fulfillment cash flows, plus a residual margin. Conceptually, we agree with this theoretical approach for measuring insurance liabilities. However, an inherent weakness of the ED is that it does not evaluate the building blocks approach against other measurement approaches. Since countries have different legal and regulatory environments, insurance contracts that may appear similar may actually exhibit different economic characteristics, leading to varying measurements of claims liabilities. AIA believes there are better and more conceptually sound methods already in practice, and urges the IASB to compare and field test its proposed building block approach against these other approaches.

An accounting standard should not seek to avoid varying results; those differing results may provide distinguishing information about the reporting enterprise. Instead, an accounting standard should be sufficiently flexible to reflect differences among different companies, as well as the differences that arise from the various business and legal environment in which the insurance contracts operate. Indeed, it is the differences among insurers – many arising because of individual business strategies and cost structures unique to each insurer -- that are useful to financial statement users.

Each building block creates a concern that the AIA would like the IASB to consider in developing the final insurance contracts standard.

- Explicit, unbiased, probability-weighted cash flows: if the principle behind this building block requirement is to reflect the expected cash flows, the IASB should not dictate the actuarial method by which the estimate of cash flows is determined. For property-casualty insurers, a variety of well-accepted actuarial methods are currently used to establish a statistical mean estimate of claims liabilities, rather than the ED requirement of probability-weighting all possible cash flow scenarios. The subjectivity and uncertainty associated with assigning the

appropriate probability-weights to all possible, yet unknown, cash flow scenarios could far exceed the subjectivity and uncertainty associated with estimating an actuarially acceptable mean. Rather than dictating a particular approach, the guidance of the ED should state as a principle that the measurement of liabilities should include an estimate of expected cash flows. The specific methodology for applying that principle should be left to the insurers and their actuaries.

AIA agrees that an estimate of cash flows should be the starting point for estimating the insurance liability. However, for property-casualty insurance products – especially in the area of liability coverage -- actuaries would not normally know the full array of cash flow patterns that could emerge, and certainly would not be able to ascertain the probability that any of the possible cash flow patterns would occur. Such a determination, however, is not necessary, given that there are better actuarial techniques available to property-casualty insurers for estimating cash flows.

- **Discount rate:** As a principle, we believe that discounting should be required only when the cash flows can be reliably estimated and when material. The rationale behind present value concepts is that a dollar today can be invested to produce something more in the future, and using nominal dollars over a period of time may not fully reflect an insurer's financial position. AIA agrees that there is a time value of money, but the application of discounting principles is not always meaningful, especially for short periods of time. Whether discounting should be applied depends on the dynamics of the claims liabilities. For example, workers compensation insurance in the United States is a product for which the period of time between the start of coverage and the incurrence of a claim is typically very short. However, the claims payment period can be much longer. Because the amount and timing of the workers' compensation can be reliably determined in advance, discounting concepts can be readily applied. For most other property-casualty insurance products, however, the short duration of the coverage period, the uncertainty of the claims settlement period, and the wide variability of payment amounts make discounting impractical and not meaningful.

AIA disagrees with the Basis of Conclusion BC92 (a), which states with respect to non-life insurance contracts that “discount rates and the amount and timing of future of cash flows can generally be estimated in a sufficiently reliable and objective way at a reasonable cost.” The paradox of this statement is that it does not provide a basis for that very conclusion. Unfortunately, this statement also reflects a continuing misunderstanding of the role that property-casualty contracts play – they are tools for better managing risks and limiting potentially devastating financial effects that certain risks may pose to the policyholder. Property-casualty insurance contracts are not intended or designed to be capital market instruments, so the liability that arises from insurance contracts is not driven by investment activities. The circumstances and exigencies of the policyholder's economic and legal environment drive the ultimate liability that arises under property-casualty contracts.

In those situations where circumstances permit a reasonable application of discounting principles, deciding upon a representative discount rate is problematic. Within the AIA membership, there are mixed views on this question. An accounting standard that prescribes the discount rate, such as a risk-free rate, would force preparers to use the same rate and therefore create more comparability. The downside of this approach, however, is that the prescribed rate may not reflect the economic circumstances of the insurer. Fundamentally, there is no practical way to determine an appropriate rate for property-casualty liabilities and still achieve the competing goals of recognizing the time value of money, providing comparability among insurers, and reflecting the underlying economics of the insurance liability. AIA encourages the IASB to conduct field testing among property-

casualty companies to determine whether particular discount rates are appropriate for property-casualty insurers.

- Risk Adjustment and Residual Margin: the definition of risk adjustment according to the ED is “the maximum amount the insurer would rationally pay to be relieved of the risk that the ultimate fulfillment cash flows exceed those expected.” This definition re-introduces an exit value concept, which AIA believes is inconsistent with a fulfillment approach, and should not be included in an insurance accounting standard that covers property-casualty contracts.

AIA acknowledges that presenting a risk adjustment plus a residual margin versus a composite margin has generated considerable discussion within the insurance industry, and AIA member companies are no exception. It is not clear whether there can ever be concurrence, in that the building blocks model presumes that all insurance liabilities can be reliably deconstructed into components that can be accurately separated, identified, measured, and reported. However, each building block component requires subjective judgment, which, in turn, will raise questions of comparability. The ED fails to address the fundamental question about margins, which is not whether a two-margin or a composite margin should be used; the real question is whether either margin approach can be calculated in a manner that provides useful information.

### Recognition

It is unclear how the “bound” concept in paragraph 14 of the ED is intended to work in practice and raises concerns of whether paragraph 14 is operational. Property-casualty insurers manage their business according to portfolios of risks, where policy inception dates occur throughout the calendar year. It is not the business practice of property-casualty insurers to establish a “bound” date. Property-casualty insurers will not be “at risk” prior to the start of the coverage period. However, the language of paragraph 14(a) suggests recognition could possibly occur prior to the start of the coverage period and would create significant compliance and systems cost to implement a concept that has no relevance to the property-casualty insurance business model.

The operational concern is further complicated by the fact that the paragraph 14 guidance is inconsistent with the definition of coverage. Furthermore, it is unclear how the paragraph 14 guidance should be applied to reinsurance contracts and what constitutes the “bound date” with respect to the reinsurance contract.

Paragraphs 26 and 27 introduce the concept of “contract boundary” within the measurement provisions of the ED. In reviewing the ED, there was confusion about the paragraph 14 concept of being “bound by the terms of the contract” and the “contract boundary” concept in paragraphs 26 and 27. For clarity, the IASB should align these concepts with the recognition and derecognition provisions of the ED.

### Presentation and Disclosure

AIA encourages the IASB to reconsider the proposed guidance on presentation and disclosure, and address the following issues:

- Presenting a margin analysis of every portfolio adds unnecessary complexity to the balance sheet. In addition, presentation by portfolio does not show diversification of risk, which is an essential part of the property-casualty business model for managing risk.
- Required disclosures in the footnotes would be too voluminous, especially the requirement for sensitivity analysis, which seems better suited for the *Management's*

*Discussion and Analysis* section in the quarterly and annual filings with the U.S. Securities and Exchange Commission.

- There are inconsistent requirements as to the presentation treatment of acquisition costs: although incremental acquisition costs are not required to be presented on the balance sheet, the guidance requires amortization of acquisition costs in the income statement.
- Guidance is needed for presenting information regarding ceded items relating to premiums, claims, and claims adjustment expense.
- Reconciliation of the onerous contract liability calculation would be burdensome and not cost justified, especially since it is only a point-in-time calculation.

Any presentation and disclosure model should first be field-tested among preparers and users before definitive decisions are made by the IASB.

### Transition

In order to evaluate all the transition implications of a new standard, we need to see what that standard will be. As we note below, the IASB should make the final standard available for review prior to adoption because resolution of transition issues will be critical to the successful implementation of the new insurance accounting standard.

If the building blocks approach is adopted by the IASB and FASB, sufficient time must be allowed during the transition period to allow for the development of information systems that would support comparative financial statements under a building blocks framework. In the U.S., public companies normally report three years of comparative financial statements; thus, the transition period must allow sufficient time to make the required changes to information systems, and provide for three years worth of information. Unfortunately, this approach imposes considerable cost on preparers, who will be forced to maintain dual accounting systems.

It is also recommended that the transition guidance should provide for not only the building blocks approach, but should also address those short-duration contracts that would qualify for the modified measurement approach.

### Conclusion

AIA's concerns and recommendations are summarized in the following points:

- The ED guidance is written primarily from the perspective of life insurance contracts, which consist mostly of long-duration contracts, and does not adequately address the characteristics of property-casualty contracts, which consist mostly of short-duration contracts. Property-casualty insurers focus on underwriting activity in order to manage their liabilities and to generate a profit; investment income is a secondary consideration. The final insurance accounting standard should reflect that distinction.
- AIA supports a modified approach for the pre-claims liability of short-duration contracts, but believes the better measurement of the pre-claims liability is the unearned premium reserve. Whether a contract is of short-duration should be determined based on the principle of whether the insurer has the right to cancel the contract or to adjust the contract terms after the end of the fixed period of duration, rather than the arbitrary one year or less criterion proposed by the ED.



- Applying the building blocks approach to the post-claims liability is problematic because of the inherently subjective assumptions underlying each building block. AIA does not believe the building block approach provides useful information for short-duration contracts.
- The ED guidance on presentation and disclosure would be burdensome and generate excessive information that may not be material or relevant to financial users. The IASB should review these requirements from a cost/benefit perspective.
- Appropriate transition guidance can be determined when a final draft standard has been made available to all stakeholders prior to adoption by the IASB.

Finally, we would like to comment on the exposure process. As we have stated in earlier communications, the ED is not structured in the conventional form of a proposed standard, in that it cannot be adopted as currently drafted. There are a number of open issues, the resolution of which could lead to a variety of alternatives for measurement and presentation. Although the comments and multiple roundtables may facilitate the ultimate resolution of these open issues, the current schedule does not yet provide an opportunity for relevant constituencies to review and evaluate one comprehensive standard.

After the IASB (as well as the FASB) has reviewed the comment letters and received additional input from the roundtables to assist in making decisions for completing a final draft of an insurance contracts standard, AIA believes that, at a minimum, the IASB should expose the revised proposed draft so that all stakeholders may have an opportunity to review, test and comment on the actual standard that would be considered for adoption. We believe the goal of developing a high quality global standard on insurance contracts certainly warrants the opportunity for a full and open evaluation of the final draft standard.

We appreciate the opportunity to provide the Board with comments on the ED. Please let us know if you have any questions or if we can provide additional information.

Sincerely,

A handwritten signature in cursive script that reads "Phillip L. Carson". The signature is written in dark ink and is positioned above the printed name and title.

Phillip L. Carson  
Assistant General Counsel