Property Casualty Insurers Association of America
Shaping the Future of American Insurance

James M. Olsen
Senior Director Accounting and Investment Policy

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Technical Director
FASB
401 Merritt 7
PO Box 5116
Norwalk, CT 06856-5116

Via email: director@fasb.org

Reference No. 1870-100 *Insurance Contracts*

Dear Technical Director:

Property Casualty Insurers Association of America (PCI) appreciates the opportunity to comment on the FASB Discussion Paper *Preliminary Views on Insurance Contracts* (DP).

Our most basic comment, which effectively colors all our other comments, is that PCI supports the use of a two-model approach for insurance contract accounting. The accounting for insurance contracts with short coverage periods should be separate from other insurance contracts. The existing U.S. GAAP Unearned Premium Reserve model has proven to be effective in providing reliable and understandable user information for both pre-claim and post-claim liabilities of short term contracts during varying economic environments. Under this model, only fixed and determinable long term post-claim liabilities are discounted, as the time value of money is a meaningful, relevant, and material component of the measurement of these liabilities.

While the proposed building block approach may provide investors useful information for insurance contracts with long coverage periods and long claims paying periods, there are fundamental contractual differences between these policies and the short coverage period contracts which represent the vast majority of contracts written by U.S. property casualty insurers. These differences support the use of two models to best reflect the economic reality of each type of contact.

We are very concerned with the aggressive timeline proposed by the IASB to finalize its guidance while key differences remain between the IASB and FASB preliminary views. We would encourage both standard-setting bodies to reach a single converged guidance even if this would result in an implementation delay.

The Appendix, which follows, contains our responses to the relevant questions asked in the DP.

PCI is composed of more than 1,000 member property/casualty insurance companies, representing the broadest cross-section of insurers of any national trade association. PCI members write more than $174 billion in annual premium, over 37 percent of the nation's property/casualty insurance.

If you have any questions or if PCI may be of any future assistance, please contact me at james.olsen@pciaa.net, or 847-553-3664.

Sincerely,

James M. Olsen
Senior Director Accounting and Investment Policy

Appendix:

Definition and Scope
Question 1: Are the proposed definitions of insurance contract and insurance risk (including the related guidance) understandable and operational?

Answer: We agree that for non-life insurance contracts the use of the term Indemnification in the definition used in the DP is understandable and operational.

Recognition and Measurement
Question 7: Do you agree with the use of the probability-weighted estimated cash flows to measure insurance contracts? Does that approach faithfully represent the economics of the insurance contract? Is it an improvement over existing U.S. GAAP?

Answer: There needs to be additional clarification regarding the concept of probability weighted cash flows needed to fulfill insurance contract obligations. There appear to be varying interpretations of this concept. We believe the measurement attribute should be more clearly defined as the statistical mean estimate of outcomes without identifying every possible scenario. It should be consistent with current actuarial standards and should allow actuaries to use their professional judgment to arrive at the appropriate measurement of the liability of the insurance contracts. As it is it currently defined it is not operational. There is no way all possible scenarios can be considered on the vast majority of short-term insurance contracts. It is not an improvement over U.S. GAAP as written.

Question 8: Do you think that an entity's estimate of the net cash flows should include a risk adjustment margin?

Answer: Under the two-model approach we support, there would be no risk or residual margins for the vast majority of short-term contracts. However, for those that would require a building block approach for measurement, the calculations to develop risk and residual margins would be based on very subjective assumptions making comparability difficult and possibly leading to manipulation. Therefore, we support the composite margin as proposed by the FASB, which eliminates the subjectivity and the difficulty in developing both risk and residual margins.

Question 9: Is the objective of the risk adjustment margin understandable? If so, do you think the techniques for estimating the risk adjustment margin (see paragraph 52(b)), faithfully represent the maximum amount that the insurer would rationally pay to be relieved of the risk that the ultimate fulfillment cash flows exceed the expected?

Answer: The reference to the maximum amount the insurer would rationally pay to be relieved of the risk that the ultimate fulfillment cash flows exceed those expected appears to be more indicative of an exit value measurement rather than a fulfillment measurement. Under the two-model approach we support, the undiscounted best estimate of the fulfillment cash flows would be used. See # 8 for the use of risk margins.

Question 10: Do you think that the risk adjustment margin would be comparable for entities that are exposed to similar risks?

Answer: Comparability is a necessary aspect of any high quality accounting model. Because the calculation of a risk margin is extremely subjective, we do not believe calculating a risk margin will enhance comparability among insurers reporting under the proposed guidance. See responses to #8 and #9.

<u>Question 11:</u> Do you agree with the description of cash flows that should be included in the measurement of an insurance contract? Is the proposed guidance operational?

Answer: The description of cash flows that should be included in the measurement of an insurance contract appears reasonable and is operational. However, we are concerned that for short term insurance contracts recognition on the bound date is problematic. The costs related to system changes required to implement the proposed guidance for recognizing property casualty policies at the bound date rather than the inception date would be significant but would not provide improved decision useful information for the financial statement users. Even if a property casualty policy is bound, no claim liabilities can be incurred before the inception date of coverage. Any cash received prior to the inception date is already recorded as a liability.

<u>Question 12:</u> Do you agree that the carrying amount of all insurance contracts should be discounted if the effect is material? Do you agree with the proposed guidance on the discount rate that should be used to measure the carrying a mount of insurance contracts? If not, which discount rate should be used.

Answer: Again the two-model approach we support does not include discounting for short-term insurance contracts. However, where used, the discount rate should reflect the characteristics of the insurance contract liability. It should be noted that the issue of the appropriate discount rate is a cross-cutting issue impacting many accounting valuations including pensions, financial instruments and insurance contracts and that any guidance provided should take this into consideration. We also believe the discount rate used should be consistent with the insurer's business model and must be adequately disclosed to allow for comparability.

<u>Question 13:</u> Do you think that acquisition costs should be included as one of the cash flows relating to the contract? If not, how would you account for acquisition costs?

Answer: Incremental acquisition costs should be treated as part of the cash flows from insurance contracts. However, we believe this should be done at the portfolio level rather than at the contract level. The guidance provided in FASB ASU 2010-26 can be used.

<u>Question 14:</u> Do you think acquisition costs included in the cash flows used in the measurement of insurance contract should be limited to those that are incremental at the individual contract level? If not, which acquisition costs, if any, would you include in the measurement of the insurance contract?

Answer: See response to #13.

<u>Question 15:</u> Do you agree with the use of either the composite approach or two-margin approach to measure the net insurance contract. Does either approach faithfully represent the economics of insurance contracts? Is either approach an improvement over the measurement used in current U.S. GAAP?

Answer: We support the use of a two-model approach for insurance contract accounting. The accounting for insurance contracts with short coverage periods and short claims paying periods should be separate from other insurance contracts. The existing U.S. GAAP Unearned Premium Reserve model has proven to be effective in providing reliable and understandable user information for both pre-claim and post-claim liabilities of short term contracts during varying economic environments. Under this model, only fixed and determinable long term post-claim liabilities are discounted, as the time value of money is a material component of the measurement of these liabilities.

While the proposed building block approach may provide investors useful information for insurance contracts with long coverage periods and long claims paying periods, there are fundamental contractual differences between these policies and the short coverage period contracts which represent the vast majority of contracts written by U.S. property casualty insurers. These differences support the use of two models to best reflect the economic reality of each type of contract.

<u>Question 16:</u> Do you think that composite margin should be recognized in earnings in subsequent periods using the ratio described in paragraph 83? If not, how would you recognize the composite margin?

Answer: For contracts requiring the use of the building blocks, a single composite margin released using the ratio method proposed by the FASB is appropriate. This allows the majority of the margin to be appropriately recognized into income as the premium is earned, with the remainder recognized on a proportional basis as the losses are paid out.

<u>Question 17:</u> Do you agree that interest should not be accreted on the composite margin? Why or why not?

Answer: No, we do not believe the accretion of interest on the composite margin provides decision useful information to the users of the financial statements.

<u>Question 18:</u> Do you think that all insurance contracts should be recognized and measured using one approach or that some insurance contracts should be recognized and measured using an alternative approach (for example, the modified approach)? Why or why not?

Answer: See answer to #15. For contracts not included in the short-term model, the board should permit but not require the use of a simplified premium allocation approach for the pre-claims liabilities of some short duration contracts.

<u>Question 19:</u> If an alternative approach is required for some insurance contracts, what recognition, measurement, and presentation provisions should be applied?

Answer: The use of an alternative approach is appropriate for portfolios of short term insurance contracts, including those that have long claims payment periods, and/or those contracts with coverage periods in excess of one year, if they share the same essential characteristics of a one year short duration contact. It is counterintuitive for two contracts that are managed as part of the same portfolio and are identical except for the coverage periods to be accounted for under different models. The result will be less useful and meaningful financial statements.

<u>Question 20:</u> Do both the building-block approach and the modified approach (with the latter approach applied only to certain short-duration contracts) produce relevant and decision useful information? Why or why not?

Answer: The building block approach using a composite margin can produce relevant information for long-term insurance contracts. The two-model approach we support, which would maintain current U.S.GAAP accounting for short term insurance contracts, would also provide relevant and decision useful information as it has for many years. It would also maintain comparability among reporting insurers by eliminating the subjectivity created by the use of risk margins.

<u>Question 21:</u> How should the scope of insurance products for each approach be defined (for example duration of coverage period, duration of claims payment period, or type of insurance)?

Answer: See #19

<u>Question 22:</u> Are there specific types of insurance contracts for which the approaches would not provide decision-useful information?

Answer: See #19 and 20

<u>Question 25:</u> What are the incremental costs of adopting the alternatives described in this Discussion Paper? Please separately describe the one-time costs and ongoing costs.

Answer: Estimates of time required will vary by insurer. In general, the implementation of the new standard will require significant and costly changes to the financial reporting operations of all insurers. One-time changes and costs will include:

- Actuarial and financial reporting system changes
- Consulting and/or additional actuarial and accounting resources during transition
- Additional external audit fees during transition
- Accounting and actuarial staff training
- Educating financial statement users regarding changes

Currently, actuarial reserving and financial reporting processes for insurance contracts required for U.S. GAAP and statutory reporting, as required by state regulators, are similar. Two separate systems or significant additional resources are not required to produce both U.S. GAAP and statutory financial statements. The proposed changes in the IASB ED and the FASB Discussion Paper are so significantly different from current statutory accounting that dual reporting and processes will be required. The costs required to maintain the two separate processes and reporting systems will be recurring costs. All to fix a reporting system for property casualty insurance contracts that is not broken.

Question 27: Should there be symmetry between the recognition and measurement of reinsurance contracts and the underlying contract ceded?

Answer: The measurement of reinsurance assets should be on the same basis as utiliized for the underlying direct insurance contracts.

Question 28: The margin presentation approach highlights the changes in the insurance liability. Rather than the current approach in U.S. GAAP, which presents among other items, premium revenues, benefits paid, operating costs, and changes in loss estimates. Would this change improve your understanding of the performance of an entity that provides insurance (for some types of insurance or for all)?

Answer: Relevant information regarding premiums, claims and other expenses related to insurance contracts should be shown in the income statement. This information is basic to analyzing the performance of an insurer and should be included in the income statement rather than as part of a disclosure. In addition, unearned premium reserves, claim reserves and uncollected premiums should be shown in the balance sheet to provide additional useful information for users of the financial statements. The summarized margin approach should be part of the financial statement disclosures.

Question 29: Should the insurance contracts measured under the building-block approach be presented using a margin presentation approach or a premium presentation approach that would require a true-up amount as described in paragraph 119 (for example, the written allocation presentation or the allocated premium presentation approach)?

Answer: The premium presentation approach with a true-up amount should be used. See #28

Question 30: Should short- and long-duration (or nonlife and life) contracts be presented in a similar manner even if such contracts are measured under different approaches?

Answer: All insurance contracts should be reported in a similar manner. Consistent presentation of relevant information is needed for high quality financial reporting. Any additional information need to enhance the usefulness of the information on the face of the financial statements should be included in the disclosures.

Question 31: Do you agree with the proposed disclosures in the IASB's Exposure Draft? Why or Why not? If not, what would you recommend and why?

Answer: We do not disagree with the IASB's proposed disclosure principles. However, the implementation required to meet that principle as outlined in the Exposure Draft will require massive complex disclosures. These disclosures will come at a significant cost and it is questionable whether they will provide an equally significant improvement in the benefit to users. In addition, we are concerned that the level of detail that appears to be required in the disclosures extends into proprietary and confidential information regarding an insurer's operations.

Question 32: After considering your views on the specific issues contained in this Discussion Paper and the IASB's Exposure Draft what do you think would represent the most appropriate improvement to U.S. GAAP?

a. Pursue an approach based on the IASB's Exposure Draft?
b. Pursue an approach based on the IASB's Exposure Draft with some changes? Please explain those changes.
c. Pursue an approach based on the Board's preliminary views in this Discussion Paper?
d. Pursue an approach based on the Board's preliminary views in this Discussion Paper with some changes? Please explain those changes.
e. Make targeted changes to address specific concerns about current U/.S. GAAP (for example, items included in paragraph 7)? Please describe those changes.

Answer: We believe that maintaining the two model approach used in current U. S. GAAP with targeted changes to address the issues raised in paragraph 7 is appropriate. As noted previously, the accounting for insurance contracts with short coverage periods and short claims paying periods should be separate from other insurance contracts. The existing U.S. GAAP Unearned Premium Reserve model has proven to be effective in providing reliable and understandable user information for both pre-claim and post-claim liabilities of short term contracts during varying economic environments. Under this model, only fixed and determinable long term post-claim liabilities are discounted, as the time value of money is a material component of the measurement of these liabilities.

While the proposed building block approach may provide investors useful information for insurance contracts with long coverage periods and long claims paying periods, there are fundamental contractual differences between these policies and the short coverage period contracts which represent the vast majority of contracts written by U.S. property casualty insurers. These differences support the use of two models to best reflect the economic reality of each type of contact.

Other than the differentiation between long-term and short-term contracts, the definition of an insurance contract using indemnification rather than compensation in the definition is understandable and operational.

Incremental acquisition costs should be treated as part of the cash flows from insurance contracts. However, we believe this should be done at the portfolio level rather than at the contract level. The guidance provided in FASB ASU 2010-26 can be used.

The discount rate, where appropriate, should reflect the characteristics of the insurance contract liability. It should be noted that the issue of the appropriate discount rate is a cross-cutting issue impacting many accounting decisions including pensions, financial instruments and insurance contracts and that any guidance provided should take this into consideration. We also believe the discount rate used should be consistent with the insurer's business model and must be adequately disclosed to allow for comparability.

The determination of the effective date for this new standard must take into consideration the significant amount of system changes, training, education, and testing that will need to be done to issue audited financial statements under the new guidance. In excess of 5 years from the issuance of the final standard will likely be needed to fully implement the new guidance.