



May 11, 2012

Ms. Leslie Seidman, Chairman  
Financial Accounting Standards Board  
401 Merritt 7  
Norwalk, CT 06856

**Subject:** Accounting for Short-duration Non-life Insurance Contracts

## **INTRODUCTION AND BACKGROUND**

We are writing as a member of the U.S. Property-Casualty insurance industry, the largest non-life insurance industry in the world with annual earned premiums approaching one-half trillion dollars. Allstate is the largest publicly-held personal lines insurer in the United States and while we also have a significant life insurance operation, this letter is focused on our property-casualty business.

We have followed the FASB-IASB Joint Project on Insurance Contracts and support the FASB's participation in the development of a global accounting standard for insurance contracts. An effective insurance accounting standard should achieve comparability, be understandable, and most of all, produce decision-useful information for investors. Investors, analysts, and preparers with whom we have spoken, consider the underlying businesses of life and non-life insurers to be fundamentally different thereby necessitating different accounting and reporting models to produce decision-useful information.

Tentative decisions of the FASB represent major changes to the accounting and reporting of U.S. non-life insurers. The significance of the potential changes warrants comprehensive field testing to validate the efficacy of the tentative decisions. We urge the Board to thoroughly review the field test results with preparers, investors, analysts, and other users to determine whether they believe the new standard enhances the effectiveness of financial reporting for non-life insurers.

## **SEC INTEGRATED DISCLOSURE REQUIREMENTS**

Focusing on the unique characteristics of short-duration non-life insurance contracts and the needs of investors, the Securities and Exchange Commission ("SEC") developed an integrated set of disclosures designed to allow investors to better understand the process through which reserve estimates are developed, key judgment areas within that process, and the amount of reserve development (positive and negative) in each reporting period. The SEC requirements complement and integrate with U.S. Statutory requirements which measure non-life insurance contracts on a largely consistent basis with U.S. GAAP.

A summary of the SEC's integrated disclosure requirements for non-life insurers include:

- **Ten-year reserve/claims development table;**
  - Identifies reserve development, both positive and negative, for each calendar year
  - Information complements ten-year reserve development information provided by line of business in Statutory Schedule P on a net of reinsurance basis
  - Reserve development explained in Management's Discussion and Analysis ("MD&A")

- **Requirement to disclose Critical Accounting Estimates (“CAE”) in MD&A**
  - CAE comprises areas (e.g., claim reserves) where registrants make subjective and complex judgments that require estimates about inherently uncertain matters where material changes in estimates may occur. The policies, estimates and related judgments are discussed in the CAE
  - Claim reserve variability (presented in terms of reestimates on a nominal and average basis) is required to be presented as a percentage of net income and claim reserves
  - Claim reserve variability (presented in terms of the standard deviation of reported reserves)
- **Presentation of reserve development metrics**
  - Reserve development disclosed as a percentage of net income and effect on combined ratio
  - Accompanying disclosures provide rationale for material reserve development in terms of frequency and severity (e.g., more or less claims, cost of claims increasing or decreasing)
- **Contractual obligations/cash flows table;**
  - Provides information about the anticipated timing of claim reserve cash flows

The experience of non-life insurers who complete the integrated disclosures has been that few questions arise from investors on the contractual obligations and reserve development tables, CAE, or reserve re-estimates calibrated to net income and the combined ratio. Other complementary U.S. GAAP disclosures, including the reserve roll-forward and reinsurance disclosures, also aid investors in understanding the most critical balance sheet measurement for issuers of short-duration insurance contracts; i.e., claim and claim expense reserves. It appears the thoughtfully constructed disclosures have achieved the right mix of information necessary for non-life investors to assess the reasons for periodic reserve fluctuations and the adequacy of claim and claim expense reserves at the reporting date.

#### **PREPARER AND USER CONCERNS**

Fundamental differences in the life and non-life insurance businesses necessitate development of separate accounting and reporting models. Separate accounting models for life and non-life insurance contracts are overwhelmingly supported by preparers, investors, analysts and other financial statement users. Supporters of separate models for life and non-life contracts point to the fact that the businesses are faced with different unknowns. For issuers of long-duration life insurance contracts, a principal unknown is how long the insured will live and the amount of premiums that will ultimately be received over the life of the contract as the continuation of future premiums (and coverage) during the insured’s lifetime is at the discretion of the policyholder. In addition, a critical source of cash flow variability for life insurers is investment results. In contrast, for issuers of short-duration non-life insurance contracts, the principal unknown is the number and amount of claims that will be incurred and the principal sources of cash flow variability are the frequency and severity of claims. Interest income, while important, is a secondary consideration as underwriting issues, due to the short-duration of the contracts, must be addressed through the underwriting process as opposed to modified investment strategies.

We are concerned with the possibility of the IASB’s building block approach, which was designed for life insurance, or a derivation of the building block approach, being applied to non-life insurance contracts due to the potential for unintended consequences. The existing accounting model for the U.S. non-life insurance industry has been in place and performed well for decades without criticism from investors. Moreover, during the 2008 credit crisis and certain mega-catastrophe situations such as September 11, 2001 and Hurricane Katrina, the U.S. non-life insurance industry was able to efficiently recapitalize, which in part was facilitated by investor comfort with the industry’s highly transparent accounting and reporting model. Our concern is that potential changes to the U.S. non-life accounting model could diminish its transparency, increase insurer’s cost of capital, and cause the price of insurance contracts to increase or their availability to decrease.

Investors in insurers that issue short-duration non-life insurance contracts have identified claim and claim expense reserves determined on an ultimate basis (i.e., undiscounted and without risk margins) as the most

critical measure. The focus on claim and claim expense reserves is supported by the fact that historically, two-thirds of all non-life insurer insolvencies are driven by inadequate reserves. Claims and claims expenses represent the key component of the combined ratio; it demonstrates the effectiveness of management to underwrite profitable business and accurately set reserves. Investors' desire to obtain claim and claim expense reserve information on an ultimate basis is due to their focus on the amount the insurer expects to pay to settle all outstanding claims. Preparers note that regardless of whether non-life insurance claim and claim expense reserves are modified to include discounting and risk margins they will continue to be estimated as they are today. That is, best estimates will be developed on an undiscounted basis without risk margins using accepted actuarial methods and judgments designed to achieve a mean estimate of ultimate amounts to settle all outstanding claims. Therefore, if discounting and risk margins are applied to the best estimate for claims, the measure considered most critical to investors, its informational value would be diminished by additional layers of complexity and opaque judgments.

## PREFERRED ACCOUNTING MODEL

The accounting model preferred by U.S. preparers, investors, and analysts is one that recognizes, using all available information, all underwriting revenues and expenses during the coverage period in which all insurance protection services are provided, and produces an underwriting result which is the key business performance metric. In the post coverage period, as new information about claims emerges, claim and claim expense reserve development (positive or negative) is recognized immediately in underwriting in the period the new information emerges. Model components include:

- A transparent method of accounting for all revenue (e.g., insurance premiums) during the coverage period similar to the unearned premium reserve (“UPR”) methodology which has been in use globally for over a century, with no application issues having been observed. UPR exists during the coverage period and represents the unfulfilled executory obligation to provide insurance protection services to the policyholder. Similarly, UPR represents the amount owed to the policyholder (without interest) if the policy is terminated; which it can be at any time and for any reason during the coverage period.
- A method for determining claim and claim expense reserves consistent with business practices:
  - **Discounting**

Requires discounting of claim and claim expense reserves where the amount and timing of cash flows is sufficiently certain to support the reliability/decision-usefulness of discounted amounts for investors.

    - The amount and timing of cash flows for **settled claims** (e.g., workers' compensation indemnity not including medical, settlement agreements, claims approved for payment, etc.) would be sufficiently certain to support discounting;
    - The amount and timing of cash flows for **claims under investigation** (e.g., case, development, and incurred but not reported reserves) would not be sufficiently certain to support discounting. This is the period during which additional information is gathered, the existence of coverage is determined, the existence and nature of the required indemnification is determined (e.g., duty to defend, tow, repair, replace, lost wages, medical bills, pain and suffering, etc.), and for IBNR, the existence of specific claims is determined.
  - **Risk Margins**
    - Risk margins are unnecessary where the amount and timing of cash flows are sufficiently certain such that discounting is required. Rationale – no material uncertainty exists with respect to the timing and amount of claim cash flows.
    - Risk margins are also unnecessary where the amount and timing of cash flows are not sufficiently certain such that discounting is not required. U.S investors and preparers believe the best estimate (which represents a mean) of the ultimate amount of claims to be paid is

the most important metric for non-life insurers. Risk margins are by nature highly subjective and would diminish the transparency of this critical estimate and thereby diminish the understandability and comparability of estimated claim reserves. Instead, investors rely on the integrated set of disclosures developed by the SEC and FASB, and which is further augmented by information provided to Statutory authorities.

○ **Cash Flows**

- Claim and claim expense cash flow estimates represent a mean estimate determined using estimating methodologies acceptable to the non-life actuarial profession.

**SUMMARY COMMENTS AND REQUESTS**

As a member of the U.S. non-life industry interested in its long-term stability we believe it is critically important that any new accounting standard affecting the U.S. non-life insurance industry be fully transparent, capable of consistent application, reflective of the way the business is managed, and produce decision-useful information for investors. We strongly advocate the field testing of any proposal to determine if it produces superior results in all situations as compared to the current accounting model preferred by preparers, investors, and other financial statement users.

We ask the Board to consider our proposal which we believe contains all the key attributes of a high quality accounting standard in that it promotes comparability, is understandable, is consistent with the business practices of non-life insurers, and produces decision-useful information desired by investors.

We recognize the Board's commitment to outreach activities and ask that a U.S. non-life insurance preparer and user forum be convened prior to the Board's drafting of an insurance contracts exposure draft to discuss the issues and recommendations outlined in this letter. Allstate stands ready to participate in both the discussion and any field testing related to the project.

Acknowledging the importance to the Boards of addressing the accounting for life insurance contracts and the progress that has been achieved in addressing issues relating to life insurance, the Board may consider separating the project on the basis of life and non-life insurance. This would allow the Board to conduct further outreach with the U.S. non-life insurance industry while moving ahead with an exposure draft for life insurance contracts.

Sincerely,

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