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Technical Director
Financial Accounting Standards Board
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State Farm Mutual Automobile Insurance Company and its affiliates (State Farm) appreciate the opportunity to provide comments to the FASB on the Preliminary Views on Insurance Contracts Discussion Paper. State Farm is a multi-line insurer group writing property and casualty, life, and health insurance throughout the United States and Canada with over 78 million policies in force. In existence since 1922, we are the largest writer of automobile and homeowners insurance and one of the top ten writers of life insurance in the United States.

State Farm, being a non-public company, is primarily interested in ensuring any new accounting standard is useful in helping to assure the financial strength and stability of the insurance industry is maintained. As the largest writer of personal lines insurance in the U.S., we pay the highest cost for insolvencies due to our required participation in the guaranty fund systems in place in each of the states. While we currently use Statutory Accounting Principles (SAP) as required by state insurance regulations, such principles have at their foundation the GAAP accounting models with any changes to GAAP considered for inclusion in SAP. It is important that any new measurement model should not detract from a user’s ability to assess changes in a company’s financial position. In this regard, our interests are closely aligned with other investors and regulators. Our objective is to ensure all users benefit from a robust and well accepted standard. The acceptance of a single set of financial statements by many audiences is a true measure of reliability, relevance and decision usefulness. State Farm believes that, to the extent possible, the same models used for general purpose financial reporting should be useful for regulatory and other purposes (i.e. solvency).

We support the development of a high quality financial reporting standard for insurance contracts that will provide reliable and decision-useful information to all users of financial statements. We greatly appreciate the Board recognizing there are still many unresolved issues and therefore issuing a discussion paper that allows for adequate due process for additional user and preparer input. We believe, however, that the principles as laid out in the DP are not complete and will not in their present form be an improvement upon the current measurement models used in the U.S. and Canada.
As a member of GNAIE, we support the views and concur with the concerns presented in their comment letter. In addition, we would like to emphasize items that we believe are critical in the development of an insurance contract accounting standard.

1. **Fundamental Differences in Property/Casualty and Life Insurance Dictate the Need for Two Measurement Models**

We believe it is very important that financial statements continue to accurately reflect the economic results of operations consistent with the industry’s distinct business models. The key difference between property/casualty and life insurance that mandates different accounting treatment is that investment income is a much larger component of pricing and profitability for life products. For property/casualty contracts underwriting classifications are the most critical component of pricing and profitability, and investment income, while important, is a secondary consideration. In addition, there is a significantly higher degree of uncertainty as to claim occurrence, the timing of loss reporting, amount of claim payment, and the timing of claim payments for property and casualty contracts compared to life contracts. These differences lead to significant concerns with applying the building block measurement model to property and casualty contracts, particularly as it relates to projected cash flows, discounting, and risk margins.

Regulators have also recognized these fundamental differences and as a result require a) separate legal entities to write property/casualty versus life insurance contracts, and b) different regulatory risk assessment, capital requirements, and performance statements and supporting schedules for property/casualty versus life insurance. The unique differences between property/casualty and life insurance contracts dictate the use of separate accounting measurement, presentation, and disclosure models.

2. **Concerns with Application of the DP to Property/Casualty Insurance Contracts**

**Building Blocks:**

State Farm is concerned with the application of the building blocks measurement model to property/casualty claim liabilities. The operational guidance should not require, or imply, the need for a probability-weighted methodology to calculate cash flows. If required on a granular contract by contract basis, due to the sheer volume of data, applying a range of scenarios that reflects the full range of possible outcomes is impractical, if not impossible, and would not increase relevance and comparability at a justifiable cost. There are many different ways to determine a single representative estimate of outcomes that do not require identification of the full range of possible scenarios.

Developing distribution curves for claims payments in order to apply stochastic methods would require more art than science due to the erratic nature of underlying frequency and severity trends and all of the environmental impacts and inputs into those trends. In determining cash flows, we suggest the DP language be modified to require best estimates of cash flows allowing a variety of techniques to calculate them including
stochastic methods where appropriate. The difficulty of applying stochastic methods to claims cash flows further leads to difficulties calculating the associated risk margins. If a separate risk adjustment is required, the financial reporting standard should provide general principles that the risk adjustment should meet, and allow the actuarial profession to determine methods for calculating the risk adjustment.

The reporting and tracking of changes in claim reserves is a critical aspect of financial reporting for property and casualty insurers. Therefore, users of their financial statements are best served by the most transparent view of the expected costs to settle claims. State Farm is concerned that the inclusion of discounting and risk margins in the measurement of claim liabilities will obfuscate the true picture of management’s ability to adequately predict ultimate claim settlement costs. The use of undiscounted actuarial estimates of claim liabilities accompanied by appropriately designed loss development schedules provides users with the most transparent, decision useful information. While not denying the time value of money, in this case the overriding consideration should be the most decision useful information - which we believe is the undiscounted claim estimates. The use of claim development schedules showing actual historical experience (which are a current U.S. regulatory requirement) provide a better indication of the degree of uncertainty of the liability and allow users to make such determinations themselves. This, we believe, is better than a company calculated risk margin based on the methodologies included in the DP and IASB’s ED.

The use of discounting and risk margins may alter the profit recognition patterns of a portfolio of property/casualty contracts by extending them over the claim payment period. We believe that profit or loss should be recognized over the coverage period (as risk protection services are provided). This would provide an earlier indication of the results of underwriting decisions made by the company which is fundamental to the property and casualty business model. Thus, such a measurement model would provide more decision useful information. While subsequent changes to claim liabilities may impact profit or loss in future periods, these would be reflected in the claim development schedules and disclosures and would be readily apparent to financial statement users.

**Modified Approach:**

We agree a simplified measurement approach should be applied as a separate model for property/casualty insurance contracts. However, we have concerns with the proposed premium allocation approach (PAA) as described in the IASB’s ED.

The proposed PAA represents a significant departure from the unearned premium reserve (UPR) approach recognized in the U.S. and Canada in that it adds significant operational complexity with no apparent compensating benefits. Accordingly, we strongly favor continuing the use of a UPR methodology which is already in place under GAAP. Key provisions included in the PAA that differ significantly from the UPR and which we believe do not improve the measurement model include:
• A requirement to discount premiums expected to be received later in the coverage period (i.e., within approximately twelve months or less);
• A requirement to net incremental acquisition costs against the pre-claim obligations (which is problematic as premium is a primary performance metric and measuring premiums net of acquisition costs could destroy comparability across the industry);
• A requirement to continuously compute the fulfillment cash flows, which includes an explicit risk adjustment, for purposes of supporting the adequacy of the reported liability; and
• A requirement to accrete interest on the pre-claim liability.

These requirements of the PAA eliminate any “simplification” benefits of the approach, and as such we strongly recommend retaining the current GAAP UPR methodology that is common in accounting standards in the U.S. and Canada. Furthermore, the more simplified GAAP UPR approach should be applied as a part of a separate model (for both pre-claim and claim liabilities). The UPR should be amortized into earned premium on a pro-rata basis over the coverage period consistent with the provision of insurance risk protection. Claims and related claims expenses would be measured as incurred on a nominal (i.e., undiscounted) basis. Such a model incorporates a matching principle that fits well with short duration contracts and provides current information to users about underwriting performance. Appropriately designed claim development tables should be constructed and presented to allow investors and other financial statement users the ability to assess the reliability of management’s reserve estimates over time. Use of these claim development tables can be more effective and transparent than theoretically calculated risk margins would be in portraying the relative riskiness of insurers’ reserve estimates.

During the recent and historical periods of economic stress, the existing GAAP approach, similar to that described above, for measuring property/casualty insurance contracts has proven to be successful and provides decision useful information about both pre-claim and post-claim liabilities for such contracts. Requiring property/casualty contracts to follow the building block approach outlined in the DP would be inconsistent with the economics of the business.

**Contract Boundaries:**

State Farm also has concerns with the Contract Boundary criteria in DP paragraph 46. From a practical standpoint there are times when, due to regulatory restrictions, some individual contracts cannot be re-priced to fully reflect the risk. However, on a portfolio basis, when such contracts are considered along with the remainder of the portfolio, the price of the portfolio fully reflects the risk of the portfolio. We would suggest that the wording of paragraph 46 be modified to include consideration of this aspect of contract boundaries on a portfolio basis. To allow such a determination on a portfolio basis would be consistent with the business model used by insurers.

**Recognition:**
We have concerns with the requirement in the DP regarding initial recognition of contract liabilities when the insurer becomes a party to the contract (DP paragraph 44). While in theory this may make sense, from a practical standpoint it will cause significant problems and result in extensive systems modification. Current practice results in recognition at coverage effective date or partial recognition if a monetary transaction (prepayment) takes place earlier. In this case, liabilities are carried equal to the value of that monetary transaction and can serve as a satisfactory proxy for the insurance liabilities. Other non-monetary indications of a binding contract (e.g. verbal binder given by an agent) are not currently captured statistically and would require system and process modifications to capture and record such information. Because coverage does not start until the effective date stated in the contract there is little benefit to be gained by recognizing the contract obligations prior to effective date other than for potentially onerous contracts, which would be infrequent since insurers generally would not intentionally issue onerous contracts. However, given the relatively short time period between a bound date and a coverage effective date, the benefits even for onerous contracts will not offset the cost to change systems or carry the additional data necessary for this purpose.

We are also concerned that such an approach will lead to the inappropriate duplication of coverage obligations where a replacement policy is bound prior to termination of the existing policy. It is common for coverage to be bound on a replacement policy (e.g. for a new home or car) prior to termination of an existing policy. Such duplication of coverage obligation would be inappropriate.

There are also questions as to whether an offer of renewal for an expiring contract effectively binds the insurer to the offered contract without an affirmative acceptance by the policyholder. The answer could be different depending on the jurisdiction.

To avoid all such issues, we recommend requiring initial recognition of insurance obligations at coverage effective date in all cases or at least no sooner than a monetary transaction date.

3. **Concerns with Application of the DP to Life Insurance Contracts**

Life insurance contracts are typically of long duration and pay a fixed benefit to compensate beneficiaries for a covered loss. A key element in pricing long duration life insurance contracts is the investment income expected to be earned on assets the insurer holds to back its liabilities under these contracts.

In general we support a building block measurement model for life insurance contracts. However, changes are needed in the IASB and FASB proposed models primarily in the calculation of probability-weighted cash flows, discount rate, and the two margin approach.

The operational guidance should not require, or imply, the need for a probability-weighted methodology to calculate cash flows. There are many different ways to
determine a single representative estimate of outcomes that do not require identification of the full range of possible scenarios.

Instead of explicitly requiring probability weighted cash flows, the final guidance should set forth the principles and allow the actuarial profession to determine the methods or approaches which align with the fundamental business model that should be used to meet this criterion. We also suggest the language be modified to indicate that stochastic methods are not required for all cash flow estimates.

Asset-liability management is a substantive part of life insurers’ management of risk and a primary driver of performance in fulfilling policyholder promises under long term contracts. As such, the discount rate should not only reflect the characteristics of the insurance contract liability, but also the economics of the insurance obligation with respect to nature, structure, and term. With respect to long duration contracts such as life insurance, the discount rate should be linked to the assets backing the liabilities. This asset-liability management concept is a fundamental business model objective that aims to match future policy liability cash flows with future asset cash flows to the extent feasible. The discount rate proposed in the DP, which ignores the assets backing the insurance liabilities, would result in accounting mismatch and surplus volatility. In addition, the use of a risk free discount rate could lead to early losses for some types of contracts that are otherwise expected to be profitable and, therefore, may result in unintended consequences such as changes to pricing, capital levels or product withdrawal.

If a separate risk adjustment is required, the financial reporting standard should provide general principles that the risk adjustment should meet, and allow the actuarial profession to determine methods for calculating the risk adjustment.

4. Other

Reinsurance:

Symmetry should exist between the recognition and measurement of ceded reinsurance contracts and the underlying direct business. The ED should specify that the measurement of the reinsurance contract should be consistent with measurement of the associated direct insurance.

The proposals would require some property/casualty ceded reinsurance contracts (which often have durations longer than one year) to be measured according to the building block approach while the underlying direct business would be measured under the modified approach for short duration contracts. Additional inconsistencies may arise due to differences in assumptions and timing of recognition (i.e. the reinsurance agreement covers direct insurance contracts not yet written or recognized by the ceding company).

The netting of reinsurance commissions against ceded reinsurance premiums would inappropriately alter the underwriting component metrics (loss ratios, expense ratios, and
underwriting profit ratios) between direct and net business, especially for quota share reinsurance arrangements.

Presentation/Disclosure:

The proposed margin presentation approach will not result in performance statements that would be relevant and useful in the decision making process for financial statement users. We are particularly concerned that this approach will not tie to the key performance measurement and information that support the industry’s distinct business models.

The face of the financial statements should include important information about revenue and expenses (i.e. premiums, expenses, claims, and benefits). These key performance metrics are used by investors, analysts and other users for determining the health of insurance entities and have been widely and historically accepted for determining top-line revenue, loss ratios and other financial measures relevant to insurance entities. Premiums, expenses, claims, and benefits represent financial statement items that are comparable among companies, well understood, and verifiable.

Furthermore, the proposed presentation requirements for the statement of financial position call for reporting either a net asset or net liability for each insurance portfolio. Users would benefit from separate reporting of claim reserves, unearned premium reserves, other pre-claim reserves, and uncollected premiums. Claim reserves and unearned premium reserves are generally two of the largest liabilities on property and casualty insurers’ balance sheets, while pre-claim reserves are generally the largest liabilities on life insurers’ balance sheets. There generally would not be a right of offset between assets receivable from one policyholder with a claim obligation owed to or on behalf of another policyholder. A net presentation of such items would result in a significant reduction of decision useful information on the face of the balance sheet.

The quantity and detail of the proposed disclosure requirements are excessive and would not be helpful to investors and other financial statement users in understanding the amount, timing, and uncertainty of actual cash flows. Many of the proposed disclosure requirements assume a degree of meaning and precision in the estimated risk adjustment that would not exist. Some of the required disclosures, most notably the sensitivity analysis, are too detailed and conceptual. Any requirements for such disclosure should be less specific, providing guidance to preparers that will allow flexibility to disclose information in a way that is consistent with how the business is managed and how sensitivities and risks are assessed.

5. Improvements to U.S. GAAP

With the greatest need being separate measurement models for property/casualty and life insurance, we believe appropriate improvements would be achieved for life contracts by pursuing an approach based on the FASB’s preliminary views in the DP with some changes (choice d), and for property/casualty contracts by incorporating targeted revisions to the current U.S. GAAP standard which is proven to be effective (choice e).
For life contracts, the changes to the approach based on FASB’s preliminary views could be very significant modifications, especially changes in the discount building block.

Conclusion:

Insurance is very important to the global and national economies. The insurance contracts standard imposes significant changes to insurers and such changes should not be made lightly without verifiable evidence to validate impacts and expected benefits. Additional field testing and analysis of results is also needed to ascertain unanticipated macroeconomic impacts. For example, changes in profit emergence patterns could have large scale impacts on the insurance industry’s ability to attract and efficiently utilize capital. Other potential impacts from changes to reported profitability could be on product offerings or withdrawals, product pricing, and potential changes in income tax rules and regulations.

State Farm supports a comprehensive high quality standard for insurance accounting that aligns with the underlying business model. We support a standard that is operational without undue cost to implement to avoid additional costs being passed on to policyholders. We believe current GAAP meets this criterion for property and casualty contracts. Significant modifications to the approach based on FASB’s preliminary view would be needed for an improved standard for life insurance.

Thank you for the opportunity to comment on the FASB Preliminary Views on Insurance Contracts Discussion Paper and for considering our concerns. For questions about this letter, please contact Julie M. Kirby at Julie.M.Kirby.al7n@statefarm.com.

Respectfully,

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