October 24, 2013

Technical Director
Financial Accounting Standards Board
401 Merritt 7
PO Box 5116
Norwalk, CT 06856-5116

Subject: File Reference No. 2013-290, Insurance Contracts (Topic 834)

Dear Members of the Financial Accounting Standards Board,

On behalf of KeefeBruyette & Woods (“KBW”), I appreciate the opportunity to provide comments on the Financial Accounting Standards Board’s (“FASB”) Insurance Contracts (Topic 834) Exposure Draft (“ED”).

KBW is a full-service, boutique investment bank and broker-dealer that specializes in the financial services sector. We operate in North America and Europe, providing institutional & private investors and financial services companies with research, equity sales & trading, capital raising, and strategic advisory services. Our breadth of equity research of property & casualty insurance companies is one of the greatest in the industry with over 50 publicly-traded property & casualty (re)insurers and brokers under coverage, while our clients represent a wide array of users and preparers likely to be impacted by ED Insurance Contracts (Topic 834).

Following our review of the ED, we ask the Board to reject the proposed guidance, especially for short-duration property & casualty products. Our recommendation is founded first on the basis that current product-based accounting guidance has generally served users and preparers well, and second because we believe the proposed guidance will degrade the usefulness of financial data prepared in accordance with U.S. generally accepted accounting principles (“U.S. GAAP”) at a significantly higher cost for both preparers and users. Further, while the ED is rooted in sound economic theory, in practice its application will present false precision with more subjective, less verifiable, and less comparable inputs resulting in meaningless increased volatility. The following points summarize our most significant objections to the proposed guidance:

- **Introduction of “time value of money” concepts into establishing loss reserves:** While this may be an arguably legitimate academic approach, in practice the fair value of (re)insurers’ liabilities are most often reflected in nominal (i.e., undiscounted) terms as measured by both publicly-traded, and M&A deal valuations generally approximating reported book value. Application of “time value of money” concepts would therefore overstate the actual fair value of (re)insurers’ balance sheets.

- **Probability-weighted expected cash flow measurement of incurred claim liabilities:** Precision in establishing loss reserves is inherently difficult, and we value (re)insurers’ ability to apply conservative discretion in deterministic reserve setting. “Unbiased” probabilistic reserve setting methodologies will likely invoke greater volatility, hinder analysis, reduce comparability, and create the opportunity for diminished management ownership of results. These are all significant, and negatively impacted, factors for rating agencies, investors, creditors and other stakeholders.

- **Questionable comparability improvements between peers with significant destruction of comparability to historical results:** Relative to current guidance, comparison between peers will probably be more difficult under the ED proposals reflecting a myriad of internal assumptions, while users lose historical context in which to compare current results.

- **Burdensome expense without adequate return on “investment” for all stakeholders:** In the context of the above-mentioned short-comings of the proposed guidance, we cannot rationalize the required personnel and system upgrade expenses without meaningful improvement in the usefulness of presented financial data.
Introduction of “time value of money” concepts into establishing loss reserves:

We have four main objections to the proposed application of “time value of money” concepts for reserve setting:

1. Our greatest concern with the proposed shift to discounting loss reserves in an attempt to better reflect fair value is that public insurer valuations and M&A valuations in practice do not assign any measurable value to “the time value of money” aspect of delayed claim payments. With most publicly-traded valuations generally approximating reported book value, except in cases of ROE out/underperformance relative to required returns, we find it difficult to argue that the fair value of insurers’ liabilities should be reduced below what’s been assigned by the market. Further, even in M&A scenarios where buyers have access to the appropriate information needed to establish payment pattern expectations and therefore the opportunity to accurately attach higher value to the economic construct associated with delayed claims payments, we still see near book value valuations. We see this as further proof that the market assigns nominal value as fair value of insurers’ loss reserves, and at times even goes as far to assign greater liability value (i.e., lower book value) to certain insurers’ loss reserve estimates. Presenting loss reserves on a discounted basis would confound current valuation methodologies representing tangible fair value opposed to theoretical fair value.

2. A major aspect of investing in, and the regulation of, (re)insurance companies rests on solvency. Given the inherent uncertainty of payment patterns, the reflection of ultimate claims cost is a conservative step designed to help protect policyholders and other creditors, and we expect this aspect of regulation by state insurance commissioners to be therefore unchanged. In our view, further deviating from this regulatory reality diminishes the relevancy of U.S. GAAP financials.

3. While in theory the time value of money approach should help improve comparability, adding an additional layer of uncertain timing assumptions on top of already uncertain ultimate losses will likely render comparability worse than the current framework with the introduction of greater judgment/subjectivity and devaluing a major component of the ED.

4. 834-10-55-126 presents a poignant example of our concerns over unneeded volatility and opaque clarity arising from the addition of more “moving parts” within the accounting framework. We, and we believe users, prefer the undiscounted approach outlined in this example.

Probability-weighted expected cash flow measurement of incurred claim liabilities:

We see two issues that are likely to arise through a shift to probability-weighted cash flow measurement of incurred claim liabilities:

1. Property & casualty (re)insurers’ results are inherently volatile, particularly for those with exposure to natural and manmade catastrophe events. Earnings and/or book value volatility is understandable following catastrophe events, with much less volatility in periods of “normalcy”. Under the proposed guidance, (re)insurers’ will be required to incur meaningful losses resulting from the possibility that a high-severity/low frequency event occurs during the policy-period. We see downside to this requirement in both the presence and absence of a catastrophe event: In the absence of catastrophe events, insurers will be incurring and reversing losses, invoking earnings volatility in times of “normalcy”. In the presence of a high-severity catastrophe event, the initial probabilistic incurred loss estimate will likely prove woefully inadequate. We see this requirement as a “lose-lose” proposition that increases earnings volatility without tangible benefits or improved accuracy of initial loss estimates when catastrophe events do occur.

2. Under the current framework, insurers have the flexibility to apply judgment in selecting ultimate claim cost estimates, including a safety margin reflecting the potential for losses to exceed initial estimates. We see some insurers’ approach of reserving in the upper half of the actuarial range as a matter of prudence, and consistent with maintaining robust solvency. Companies with long-term track records of favorable reserve development will generally command greater confidence.
among investors and regulators. In our view, through the introduction of probabilistic reserve setting, there’s less opportunity for insurers to prudently establish conservative reserve positions. We also see the opportunity for less management ownership of adverse reserve development and an emergence of more aggressive assumptions in light of culpability being easily placed on “unbiased” statistical models. Last, while this method is intended to mitigate estimation bias, we believe that estimation bias has now simply shifted to other new variables in the process. We also question whether statistical probabilistic mean or deterministic “most likely” estimates have been more accurate over time.

**Questionable comparability improvements between peers with significant destruction of comparability to historical results:**

While the proposal seeks to alleviate the purported dilemmas associated with multiple models that vary based on the nature of the insurance contract with a “two sizes fit all” approach, the ED includes significant room for subjectivity and will likely impair the verifiability and comparability of financial statements by auditors and users. Also, and more importantly, property & casualty (re)insurance is an extremely cyclical business with much value gained from comparisons to past results at various milestones in the pricing cycle. Destruction of historical comparability would be a significant loss of decision useful information, especially since (re)insurers have already expressed an inability to restate historical financials consistent with the ED. We expect (re)insurers to increasingly utilize non-GAAP metrics in order to maintain continuity in historical metrics, helping to confirm that stakeholders prefer the current framework.

**Burdensome expense without adequate return on “investment” for all stakeholders:**

In our discussions with property & casualty (re)insurers regarding implementation, it’s become abundantly clear that significant personnel and system upgrade expenses will be required to meet the requirements of the proposal. In our view, this would be a perfectly reasonable “investment” with an improvement in decision useful information. However, with degraded usefulness, we see the added financial cost as an unjustifiable burden. Further, we see this burden greatest among smaller domestic insurers with scale disadvantages and an inapplicability of the “insurance is a global business” argument for IFRS convergence.

Costs however will not only be borne by filing companies. The investment community will be forced to reconstruct financial models, representing a significant time investment while rendering current models, representing years of work and historical comparison, near useless.

The ED states “cost is a pervasive constraint on the information that financial reporting can provide; the benefits of providing information that helps to achieve that objective should justify the related costs” (BC430), in our view, the ED fails this test on both accounts by degrading the usefulness of available financial information while forcing stakeholders to incur burdensome costs.

**Less reliance on U.S. GAAP financials:**

In our view, following the potential implementation of the ED, we expect investors to seek greater use of statutory financial statements, including projecting pro forma statutory results, which is not currently industry practice. This will significantly increase the time and expense required for users of property & casualty (re)insurance company financial data.
Multiple insurance models and applicability to non-insurance entities:

In the opening ED remarks, two potential issues are raised: First, that current U.S. GAAP is the result of evolution over many years in response to new products and terms/features. Second, that there’s a lack of applicability to non-insurance entities engaging in activities with substantially similar economic characteristics. In our view, the current product-specific accounting framework is preferred to an overly complex universal model. Second, non-applicability of current guidance to non-insurance entities seems of greater significance - we would recommend that new guidelines be established for the minority of non-insurance entities before negatively impacting the majority of bona fide (re)insurers.

Further, we see greater usefulness of universal models in Europe rather than the U.S. Insurance companies in the U.S. long ago embarked on a path of consolidating operations among either property & casualty or life insurance core competencies. On the other hand, it’s quite common for European insurers to offer a complete suite of property & casualty and life/annuity products, facilitating the need for a more universal accounting framework. Absent this factor in the U.S., product-specific accounting models should be maintained, in our view.

U.S. GAAP as starting point:

It was also noted in the ED that through the Invitation to Comment process, respondents commented that U.S. GAAP was “the most logical starting point”. We would echo those requests and highlight the ED’s greater departure from current U.S. GAAP rather than building on its already solid foundation as a disappointment.

Our recommendation:
For short-duration property & casualty (re)insurance products, we recommend that the current U.S. GAAP framework be maintained, with modest improvements, in favor of its proven strengths and familiarity among preparers, auditors, and users. Additional disclosures however would be helpful, including the ED’s prescribed actuarial range disclosures. We would also prefer to see additional disclosures regarding forward-looking loss cost inflation and claims payment assumptions by major product line underlying (re)insurers’ loss reserve estimates. Estimated reserve sensitivities around these metrics by product line would also be helpful.

Please feel free to contact me personally to discuss any of our comments.

Sincerely,

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