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Technical Director
Financial Accounting Standards Board
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Members of the Financial Accounting Standards Board:

The American Family Insurance Group appreciates the opportunity to comment on FASB’s Proposed Accounting Standards Update – Insurance Contracts – Topic 834 (hereto referenced as the “ED”) issued June 27, 2013.

We are writing as a member of the U.S. property-casualty (P&C) insurance industry, the largest non-life insurance industry in the world with annual earned premiums approaching one-half trillion dollars. The American Family Insurance Group is the 4th-largest mutual P&C insurer and 14th-largest P&C insurer in the U.S. While the American Family Insurance Group also has a life insurance operation, this letter is focused on our P&C insurance 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. The goal of an effective insurance accounting standard, however, should be to produce decision-useful information for users that is comparable and understandable. Goals, we believe, that have not been achieved in the current form of the ED.

We believe there are fundamental differences in the underlying businesses of life and non-life insurers that necessitate 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. Moreover, the current accounting and financial reporting model used by P&C insurers in the U.S. and throughout much of the world has been tested, proven, and improved upon for years, and is supported by users.

The changes proposed by the FASB ED represent major changes to the accounting and reporting of U.S. non-life insurers which could diminish transparency and not be representative of the overall business model of the P&C industry. The proposal will create unnecessary challenges, significant costs, and reduce historical comparability while yielding little, if any, benefits to the users of P&C financial statements. Overall, the ED does not meet the goals of an effective standard that would result in improved decision usefulness, comparability, and understandability. We believe that the provisions in the ED would not improve current insurance accounting and financial reporting practice.
GENERAL CONCERNS

Convergence:

A critical perceived goal of the FASB-IASB Joint project on Insurance Contracts was to develop a robust global accounting standard for insurance contracts. Based on the number of divergent views and definitions noted within the ED and the IASB's Insurance Contracts Exposure Draft (the "IASB ED" and, together with the ED, the "proposals"), it is apparent that this goal has not been and will not be realized. As such, given that there is an existing time-tested and proven standard in place for U.S. GAAP, if the goal of convergence is not going to be accomplished and the proposals are not seen by preparers, users and regulators as an improvement over existing guidance, the Board must reconsider whether this project should continue. Continuation of the project would simply create new areas for non-comparability between the FASB and IASB at significant cost and uncertainty to members of the P&C insurance industry and to the users of their financial statements.

Clarity and consistency of the ED:

There are numerous issues noted throughout the ED as it relates to clarity of key terms and their consistent application throughout the ED.

The ED is comprised of two measurement models. The building block approach ("BBA"), is the model applicable to most life, annuity, and long-term health contracts. The premium allocation approach ("PAA") is mandatory for contracts with a coverage period of one year or less, or an estimated value of net fulfillment cash flows unlikely to change significantly before a claim is incurred. Short-term contracts would include most property-casualty contracts and annual health contracts. Our concern is with the clarity of the second criteria for contracts with a coverage period in excess of a year. In the Basis for Conclusions, FASB implies that the intent of the criterion was to limit the use of the PAA model to short-duration contracts under existing U.S. GAAP and contracts over a year with similar characteristics; however, in discussion with industry peers and associations, we have encountered widely differing interpretations of how this criterion would be applied. This language could be read to include all property-casualty contracts under the PAA or to include none of them.

For example, P&C insurers have predictable cash flows before claims are incurred. They underwrite and issue policies, receive premiums, and pay acquisition costs to agents. It is only when a claim is incurred that there are variable contractual outflows. Using this analysis, all P&C contracts would qualify for the PAA.

Conversely, P&C insurers often learn about wildfires, storm fronts or other weather patterns that could serve to increase the "expected" value of net cash flows. If the "period before a claim is incurred" is defined to include even very short periods of time, such as days or hours, there is often information available that would result in a significant amount of variability in expected cash flows in the hours before they occur. The accuracy of these predictions, however, is questionable and the estimated loss is quickly replaced by real damage information. Disqualifying P&C contracts for terms longer than one-year under this scenario would not make sense as this characteristic would apply to contracts for terms less than one year.

Finally, if there is information that is available to a P&C insurer that increases the potential risk of the policyholder or of the property insured, there are underwriting and loss control actions that insurers take to address that risk. This PAA factor does not seem to consider actions that would be taken to address such risks.
A second definition that requires clarity and consistency enhancements is that of the FASB's definition of "portfolio of contracts." The criteria include groups of contracts that (i) have similar risks and that are priced similarly, and (ii) have similar duration and similar expected patterns of release from risk. The configuration of portfolios under this definition vary significantly by company under these criteria, and since the definition drives all other measurements in the ED it is very important that this definition is clear, which would allow for consistent and comparable application.

While the definition is confusing, it is compounded by inconsistent application throughout the ED. While "portfolio of contracts" is applied to measure revenues in the cash flow equation, there are problems with measuring liabilities in a similar manner. P&C claims and reserves are currently aggregated on an accident-year basis, not a contract year as described in the ED. The ED references a "portfolio of claims" in sections describing the measurement of liabilities without defining this alternative portfolio. Additionally, the ED requires use of discount rates relating back to the year of inception of the contract.

Non-comparability between entities resulting from a lack of consistency is one of the most concerning aspects of the ED. In addition to the definition of portfolio and application of the PAA to some but not all P&C contracts that have similar characteristics with exception of the contract period, as noted above, additional issues that will create inconsistencies include different methodologies for and uncertainty about determining the appropriate discount rate, as well as potential differences in application of the claims reserving practical expedient.

Presentation of financial statements:

As noted in the Basis of Conclusions, the objective of the amended guidance is to improve, simplify and enhance the financial reporting requirements for insurance contracts and to provide investors with decision-useful information. Under the proposed guidance, information reported on the face of the financial statements (net asset/liability on a portfolio basis) distinctly differs from existing U.S. GAAP, which focuses on premium and loss and loss expense reserves, and provides optionality on the information presented on the face of the financial statements. In terms of consistency, comparability and transparency, the revised presentation will not result in improvements to users of the financial statements' ability to understand the activities and financial position of companies issuing insurance contracts.

Disclosures should supplement reported key performance information and should not be considered an adequate substitute for reporting on the face of the financial statements. In other words, degrading the face of the balance sheet and supplementing it with more voluminous disclosures is not an improvement. One disclosure item that we would support, however, would be the inclusion of undiscounted claims development information as it is critical in allowing users to understand an insurer's ability to properly underwrite and anticipate claims. This disclosure would be able to be completed without significant additional cost and complexity as this information is already presented under statutory regulations.

Costs compared to benefits:

We perceive the benefits of the ED to be limited. We believe that the costs, which are expected to be significant and cover several categories (not all of which are financial), significantly outweigh these perceived benefits.
a) Loss of decision-useful accounting data:

One of the most critical non-financial costs of the proposal is the loss of decision-useful historical accounting data. The current alignment between U.S. GAAP, Statutory Accounting Principles (SAP) and tax reporting will be lost. Current practice provides granular, rich information that users and preparers can access to assess the performance or quality of a P&C insurance company's results of operations and financial position. The proposed guidance and presentation changes will all but destroy comparability to a wealth of historic earnings information accumulated under a well understood accounting regime. In addition to this loss of comparable historical accounting data, the interaction of the new “portfolio of contracts” definition, “estimated” cash flow patterns by portfolio, and applying a subjective discount rate to the “estimated” cash flow pattern will contribute to the degradation of decision-useful and comparable information of the proposed guidance relative to the current standard.

b) Cost of converting to unbiased probability weighted cash-flow reserving:

For issuers of short-duration contracts, the requirement to move to unbiased probability-weighted cash flow reserving is the item that will increase cost the most and provide the least benefit. To implement, companies will have to hire more actuaries, accountants and systems experts or engage more consultants because the reserving process itself will require a complete overhaul for most P&C insurers. Currently, reserving processes focus on determining the ultimate nominal loss and, from that, the appropriate loss reserve to book. In other words, the focus is on the ultimate loss and not the timing or amounts of incremental losses. P&C actuaries will need to develop, test and validate new methodologies to address these reserving estimation requirements. More accounting experts will be required to track the many new variables introduced and explain the complex drivers of financial results to users. Companies will need to change IT systems and processes to shift to a cash flow approach. Many new information technology systems, software and employees will be required to set up and monitor the new processes and track the new variables required by the ED.

Even after implementation, companies will continue to incur added costs to properly apply the proposed guidance and reestablish the significance of the data reflected by the new information produced. Independent auditors will be far more costly as they will need to audit not only the financial reporting but also the actuarial processes implemented. The need for talent to address the reserving changes will be not only a transitional, but an ongoing and expensive cost consideration. The exact costs are very difficult to determine with accuracy, but it will likely be much greater than anyone is currently anticipating. The costs will be very, very significant, indeed.

Another significant, but less measureable, cost related to the revised reserving methodology is the loss of the connection between GAAP and statutory accounting. Statutory accounting (SAP) explicitly mandates conservatism in reserve estimation so it is unlikely that insurance regulators and the NAIC SAPWG will adopt the revisions set forth in the ED. Application of the ED will likely result in P&C insurers carrying different nominal GAAP and SAP reserves. Maintaining reserves on different methods of accounting will cost time and resources. The ED would degrade the link between loss reserves presented in GAAP financial statements and SAP claims development information presented in Schedule P of the Annual Statement currently used by users of the financial statements.
c) Cost to determine discount rates:

P&C insurers currently do not maintain the expertise to determine appropriate yield curves for various insurance contract portfolios, nor do they have systems in place to maintain discount rates at contract inception or to apply discounting on a scale required by the ED. Discounting on short-duration contracts is inconsistent with the business model of P&C insurers. Appropriate discount rate setting is not a precise science and minor errors in determining an appropriate rate can have a significant impact on the adequacy of reserves and thus, on the solvency of the entity. A.M. Best notes that inadequate reserves remain the number one reason for insurer insolvencies. In addition to the costs noted above, additional costs would be levied on the P&C industry as a result of the potential insolvencies that could result. Insurers are required to participate in guaranty funds at the state level to pay the claims of insolvent insurance companies, thus the insolvency of others from inadequate reserving practices affects the industry as a whole. The change in reserving practices and application of the discounting that the ED proposes gives a misguided impression of increased precision and meticulous application of economic theory, while the result provides no incremental information about cash flows or cash flow uncertainty and artificially increases volatility in earnings and financial position measurements.

Industry impact:

As noted earlier, the changes in standards will result in the loss of historical accounting data that is seen by users as decision-useful, along with degrading the link between loss reserves presented in GAAP financial statements and SAP claims development information presented in Schedule P of the Annual Statement currently used by users of the financial statements.

In addition, the proposed ED restrains P&C insurers' ability to communicate with users of our financial statements based on several factors:

1. The ED is inconsistent with the business-model employed by P&C insurers
2. The ED results in an overly complex reserve development and measurement basis in comparison to current practice.
3. The interaction of discounting with an uncertain payout pattern will distort the true liabilities of the entity.
4. Aggregation by portfolio reduces information concerning company operations and will lead to less comparability between entities as many entities manage their business and measure profitability on a different basis.

SPECIFIC CONCERNS

Onorous contracts:

The ED proposes changes to the evaluation, accounting and reporting for premium deficiency reserves and subsequent events. Current interpretation and identification of onerous contracts (premium deficiency reserves) typically occurs when the events that give rise to the onerous contract are both probable and reliably estimable. The proposed guidance removes the probability threshold thereby expanding the situations and events to those that could produce an expected loss.
In our opinion, insurers should not recognize the anticipated impact of low frequency/high severity events at the reporting date, regardless of their nature, that have not occurred or that are not both probable and reasonably estimable. Using a probabilistic approach to measurement of these low frequency/high severity events would lead to non-comparability as there are no independent data sources that exist for use in developing and corroborating probabilities of these events.

As a result, we would recommend that existing premium deficiency reserve and subsequent event evaluation, recognition and reporting guidelines be retained as they appropriately address low frequency/high severity events.

**Unbiased probability weighted cash flows:**

The proposals move from a deterministic actuarial reserve measurement approach that has been time-tested and decision-useful to one that is probabilistic. Actuarial methods currently applied by P&C actuaries produce an estimate of ultimate losses within a reasonable range which are evaluated by auditors and regulators for consistency of the target reference point maintained over time.

A probabilistic approach is best suited to situations with high levels of uncertainty combined with an ability to develop appropriate probability weights. P&C insurers do not typically meet those criteria as either a deterministic approach provides a more reliable estimate due to the ability to apply historical claim development experience to current claims or the uncertainty in the reserves is such that probability weights cannot be reliably determined. Probabilistic-based reserving may be appropriate for life insurance contracts but has not been validated as a suitable replacement for the deterministic-based reserving that is typically applied to portfolios of P&C claim and claim expense reserves. Without testing and validation, it is unclear how the probabilistic reserving should be conducted and whether it can produce results that are understandable and reliable.

The estimation of ultimate losses is an exercise which requires assumptions and calculations concerning two variables; the occurrence of a claim (frequency) and the ultimate value of that claim (severity). Estimating a payment pattern requires assumptions and variables of a third variable; the timing of the payment of a claim (if any). A liability accounting measure based on measuring cash flows rather than the ultimate liability that will be settled introduces more judgment, subjectivity and variation.

The measurement objective should be to determine an estimate of claims reserves that represents the amount at which the insurer expects the claims to be settled with the policyholder. Reserving actuaries utilize a variety of time-tested reserving practices and techniques and apply complex actuarial judgment to arrive at measurements of amounts at which outstanding claims will be settled with the policyholder. The judgments rendered by reserve actuaries are informed by a variety of sources beyond physical data, including legal issues, changes in claims handling/settlement processes, unique events, catastrophes and limitations on obtaining information to assess losses, etc. All of this information is combined in arriving at the estimated amounts at which outstanding claims will be settled with the policyholder.

While the intent of the board may have been to allow current practice in building block number one (BB1) for P&C insurers, P&C actuaries have indicated that as drafted, BB1 equates to a measurement that includes no implicit provision for uncertainty and therefore would produce deficient claim reserves on a more than infrequent basis, which they consider to be an unacceptable outcome. Targeting the mean of statistical distribution with no margin for uncertainty is considered by many to be unsound actuarial, business or regulatory practice. Additionally, performance of a calculation of the statistical mean gives the appearance of more precision and less uncertainty while the estimate itself is more uncertain than what current practice would produce.
If the intent of the guidance was to provide for a mechanism to eliminate accounting management bias by adjusting the reserves provided by the actuaries, we believe this can be achieved by replacing the unbiased probability weighted cash flow terminology and language with language that follows Actuarial Standard of Practice No. 43, Property/Casualty Unpaid Claim Estimates. This would serve the purpose of eliminating potential accounting management bias by requiring the reserve be recorded at what is determined by the actuaries, would allow for adequate reserve estimates to be developed for both GAAP and STAT and allow for continuation of the application of the robust, time-tested deterministic actuarial methods and practices currently in use in the U.S. and elsewhere.

Discounting:

While we agree with the theoretical concept of the time value of money, in application, discounting of reserves is useful only where the amount and timing of cash flows is sufficiently certain to support the reliability and decision-usefulness of discounted amounts for investors. For example, the amount and timing of cash flows for settled claims in the case of workers’ compensation would be sufficiently certain to support discounting, whereas the amount and timing of cash flows for claims under investigation in the case of case development and incurred but not reported (IBNR) reserves would not be sufficiently certain and therefore would not support discounting.

The FASB noted that an exception should not be made for a sector of the insurance industry as it relates to reflecting the time value of money in measurement of their liabilities, observing that other industries are required to reflect this; however, other industries do not experience the uncertainty in the timing and amount of cash flows which the P&C insurance industry has. It is precisely because the timing and amount of cash flows are so much more uncertain that an exception should be made. Complex accounting for “current value” was rejected for banks on the grounds that measuring loans and deposits at “current value” is inconsistent with their business model and would not provide information that is decision-useful to investors. We believe the same conclusion should be reached with the proposed guidance. A current value model for insurers may not be verifiable by independent audit as it would be analogous with a level three fair value (unobservable input).

The majority of P&C claim and claim expense reserves would likely be discounted unless the definition of a portfolio is modified to distinguish between a portfolio of claims and a portfolio of contracts. For claims that must be discounted, insurers will be required to select and retain a yield curve for each insurance contract or group of contracts that would serve as the reference point for all future discounting as the claim ages and interest rates change and the difference between the historical rate and the current rate is classified in other comprehensive income (OCI). Additionally, the proposal suggests that P&C insurers may be required to individually discount each probability-weighted outcome which would add substantial complexity, notwithstanding the consideration of the OCI requirements. Most existing claim administration systems are set up on an accident year basis as opposed to contract inception; a change which would be costly to implement.

The proposed OCI treatment would introduce significant reporting complexity for P&C insurers based on its application to incurred but not reported (IBNR) reserves which are typically not estimated at the policy level as well as related to events that have not yet occurred as determined under onerous contract provisions. This will require insurers to modify their claim reporting systems to accommodate the new requirements, the cost of which may be enormous.
If P&C entities are required to perform discounting, which we strongly urge against, a practical expedient should be considered in the form of a composite rate rather than the top-down or bottom-up approaches noted in the ED. This rate, perhaps a AA corporate bond rate, could apply to all liabilities on a period basis, thus reducing the number of variables needed and reduce complexity. Additionally, we agree with segregating the effects of underwriting performance from the effects of changes in discount rates by reporting changes in discount rates in OCI on a conceptual level; however, in practice, tracking and retaining discount rates will require significant system changes and updating quarterly would be unnecessarily burdensome. As such, we recommend that OCI treatment for discount rate movements be made available upon an affirmative accounting policy election to effect such treatment.

Discounting reserves would integrate investing activities into the underwriting model which would make reserve information much less decision-useful users of the financial statements.

One could question what the discount rate is supposed to actually represent as the rate is probably not representative of the rate that would be used if the company were to be valued. Each entity would require its own unique rate to reflect its own unique risks. It would appear that discounting is being required for the sake of discounting only and not because there is any particular meaning or value associated with the resulting liability. It would be far better, and our recommendation, to retain current short-duration contracts guidance with targeted improvements such as what the entity’s best estimate of the uncertain loss payout pattern will be to allow users to perform their own discounting exercise with their own assumptions and aggregations.

**Definition of portfolio:**

The definition of portfolio is determined by the proposal to be “a group of insurance contracts that are: 1) subject to similar risks and priced similarly relative to risk taken on, and 2) have similar duration and similar expected patterns of release from risk. The definition is intended to produce more disaggregation than existing guidance; however, there is a lack of specificity as to how the new guidance should be interpreted and applied. This may lead to inconsistent interpretations and application. Additional clarification should be provided on the determination of a portfolio and whether it must only be applied on a contract basis versus a claim basis.

The ED defines portfolios in terms of “contracts.” The most widely used P&C reserving methodologies employ calendar year premiums and accident year losses. Non-life companies group “claims” by accident years, not contracts. The calendar-year aggregation does not match the premiums and losses (cash flow) on a contract basis.

Under the definition in the ED, some insurers could apply a very granular approach to developing portfolios, such as a portfolio for each rating territory in each state (not priced similarly), portfolios separating personal lines from commercial lines (managed separately), portfolios separating property from casualty risk (different releases from risk). Other insurers may keep all P&C contracts in a single large portfolio. A difference in applying this definition leads to diversity in practice and incomparability. More and disparate disaggregation will increase the likelihood that “onerous contract portfolios” will be identified which could lead to a change in the earnings pattern where losses are recognized up front followed by gains thereafter, and a reduced ability to compare performance across time and between insurers.

We would instead recommend working within the construct of the current standard to provide additional segmentation or clarification instead of creating a completely new grouping definition if enhancements to current GAAP are required.
Acquisition costs:

Classifying acquisition costs as a component of the liability for unexpired coverage (formerly unearned premium reserve) decreases transparency and does not meet the existing accounting criteria for net presentation.

It also results in a lack of symmetry in presentation because, while acquisition costs are presented separately in the income statement, no acquisition costs will be presented on the balance sheet as they are lumped in with the liability for unexpired coverage. This also increases complexity because the two components netted on the balance sheet need to be tracked separately for presentation in the income statement and disclosure.

Reinsurance:

The proposed guidance would incorporate a lower threshold for risk transfer, allowing insurance treatment for contracts that do not expose the reinsurer to the possibility of a significant loss. The blending of different products rather than separate identification (accounting and reporting) for reinsurance transactions that meet the insurance definition and those that do not does not improve the ability of users to effectively understand a reporting entity's operations and financial position.
CONCLUSION

We strongly believe that life and P&C insurance industries, including strategy, economics, products pricing, and the resultant financial reporting information needs, are fundamentally different. As a result, we agree that life and P&C insurance should have different accounting and reporting models that meet their unique characteristics. We prefer the accounting model currently in place for short-duration, P&C insurance contracts over the model proposed for such contracts in the ED. The fundamental components of the existing system are measured and reported in a manner that is very well understood by financial statement users and contains no unnecessary complexity. In addition, the alignment with GAAP, SAP, and tax reporting allows for the existence of very granular, rich information that users and preparers can access to assess the performance or quality of a P&C insurance company's results of operations and financial position.

Based on the high costs involved in implementation and lack of a true benefit or improvement over the current system, we strongly urge the retention of the current U.S. GAAP standard for short-duration insurance contract financial reporting with only targeted improvements to current standards. Current GAAP has worked well and has provided decision-useful information for decades and should only be altered with changes that improve decision-making information for users of the statements. The impacts of not addressing the concerns that members of the P&C industry have with the ED would be far reaching and significantly detrimental to those members and its consumers.

Sincerely,

Kari E. Grasee
Vice President, Controller
American Family Insurance Group