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Financial Accounting Standards Board
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RE: File Ref. No. 1870-100
Preliminary Views on Insurance Contracts

Members of the Board:

On behalf of Sandler O'Neill + Partners, L.P., I am commenting on the Board’s Discussion Paper, Preliminary Views on Insurance Contracts (September 17, 2010), which was published pursuant to a joint project with the International Accounting Standards Board to revise accounting for insurance contracts. The IASB had previously published an Exposure Draft, Insurance Contracts, on July 30, 2010.

These two documents reflect a similar approach to revising accounting for insurance contracts that would significantly alter financial reporting by insurers. We note that the Board has discussed rather than proposed its variant of the IASB’s proposed approach, but for simplicity of reference in this letter we refer to the Board’s variant approach as its “proposal.”

Sandler O'Neill is a full-service investment-banking firm focused on the financial services sector.¹ Our clients include a wide variety of financial firms, including many insurance companies. We address the Board not as accountants but as a firm of financial professionals who work closely with many financial firms, including insurance companies.

Overview

If the Board takes any action, we urge it to limit itself to what it terms “targeted improvements” to accounting for insurance contracts. To do otherwise and follow the IASB’s lead would result in a radical, counterproductive revision to U.S.

¹ For further information on Sandler O'Neill + Partners, L.P., see http://www.sandleroneill.com/.
GAAP that would be at loggerheads with the business model of insurers. Even as modified in the Board’s preliminary views, the IASB’s proposal would:

- increase the volatility of insurers’ equity and earnings dramatically, and often procyclically,
- degrade the granularity, transparency, and relevance of insurers’ financial statements for investors and other users,
- increase the cost and reduce the availability of capital to insurers, and
- distort business decisions by insurers, reducing the availability of long-term financing to a variety of entities.

We note that even the superficially discrete step of redefining the term insurance contract as proposed would not be a “targeted improvement” because of the linkage between the definition and its larger, operational context.

**Summary of the Proposal**

The Board and the IASB propose to define the term insurance contract to be “a contract under which one party (the insurer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder if a specified future event (the insured event) adversely affects the policyholder.” The definition would provide the basis for newly standardized accounting for insurance contracts, including reinsurance contracts, by reference to the characteristics of the instrument rather than the identity of the issuer.

So defined, the Board has requested “stakeholders’ views on how best to improve accounting for insurance contracts in the United States, whether through a fundamental and comprehensive reconsideration or through targeted improvements.” Fundamental, comprehensive reconsideration would apply a variant of the IASB’s “building-block” approach to measuring long-duration insurance contracts. The Board’s approach consists of the present value of a probability-weighted estimate of future cash flows, but with a composite margin rather than the IASB’s bifurcated risk-adjustment and residual margins.

While details of the proposed measurement models for insurance contracts differ, the Board and the IASB both contemplate using the expected present value of probability-weighted fulfillment cash flows to measure insurance contracts after unbundling components not closely related to the insurance coverage specified in the contract. As well, both boards would include in future cash outflows only
incremental acquisition costs incurred in the issuance of specific insurance contracts. Non-incremental acquisition costs would be expensed as incurred.

Future cash flows would be discounted using a current risk-free rate adjusted for illiquidity that reflects the characteristics of the liabilities, except that for participating policies the discount rate could reflect the return on the pool of assets that determines the rate paid to the policyholder. While not technically fair-value accounting because not based on estimated exit prices, this core building block of the measurement model is very much like fair-value accounting in its reliance on discounted estimated future cash flows to determine present values. Expected probability-weighted cash flows would be re-measured each reporting period, with any changes in value recorded in earnings.

The Board’s measurement model uses an undiscounted composite margin to reflect the risk and uncertainty of fulfillment cash flows, excludes any accretion of interest on the implicit risk-adjustment and residual margins, and defers profits (avoiding day-one gains but not losses). The composite margin would be released into earnings over the coverage and claims-handling periods based on the ratio of the sum of premiums allocated and claims and benefits paid to date to the sum of such cash flows ultimately expected.²

The Board has requested comment on whether a modified model should be applied to short-duration insurance contracts, and the IASB has proposed such an approach for contracts with a coverage period of one year or less that do not contain embedded options or other derivatives. Under the IASB approach, a premium allocation method of measurement would apply in the pre-claim period (supplemented as necessary by loss recognition for “onerous” contracts), and the building-block, present-value method would apply in the post-claim period.

The Nexus of Business Models, Investors, and Accounting Principles

The fundamental flaw in the Board’s and IASB’s present-value approach to measuring insurance contracts is that it is divorced from the business model of

² By contrast, the IASB proposes separate risk-adjustment and residual margins. The risk-adjustment margin would be re-measured each reporting period, with any changes in value recognized in earnings over the coverage and claims-handling periods, while the residual margin would be fixed at inception and recognized in earnings over the coverage period. Like the Board’s composite margin, the residual margin would be calibrated to avoid day-one gains, but unlike the Board’s composite margin, interest would be accreted on the residual margin.
the firms to which it would apply, including both life insurers and property and casualty insurers.

Both life insurers and P&C insurers collect and invest policy premiums to fund policy obligations, but while investment income primarily drives the profitability of the former, premium income primarily drives the profitability of the latter. More specifically, investment results (return on assets less amounts credited to policyholders) drive the profitability of life insurers, while underwriting results (premiums less claim costs and expenses) drive the profitability of P&C insurers.

Because the policy liabilities of life insurers consist largely of very long-term, illiquid contracts, balance sheet management consists of maintaining a portfolio of assets whose cash inflows match, as best as possible, the expected cash outflows of insurance contracts, increased by margins for adverse deviation. Projected asset cash flows are reduced for credit losses and other risks as a means of fine-tuning the cash-flow matches of assets and liabilities. Embedded asset-issuer options, such as prepayment options, are avoided or minimized to enhance the matching of cash flows. Investment in long-term, illiquid assets offers the advantages of better matching with policy liabilities as well as higher yields. Because the durations of assets seldom approach those of liabilities, reinvestment risk must also be managed, as must liquidity risk.

Investment income is more important to the profitability of life insurers because life insurance has a very long “tail” – the typical time elapsed between initial policy issuance and payment of the related claim. By contrast, property insurance is a short-tailed line of business in which claims are usually handled quickly. Casualty insurance is longer tailed than property insurance – because lawsuits can take years – but generally shorter tailed than life insurance.

In short, the relative importance of investment income to life, property, and casualty lines of business is a function of the length of time available to the insurer to invest cash received from the payment of premiums. As the importance of investment income decreases for insurance lines of business, premiums become a more important source of profitability, including the ability to increase premiums promptly in response to unfavorable market or reserve development (the recognition of claim losses not previously assumed).

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3 Investment income is also more important to life insurers because life insurance is a lower margin line of business, reflecting the greater predictability of mortality compared to other insured risks.
The implications of this business model for what investors want to know and the information accounting principles should endeavor to provide are straightforward. Broadly, investors in life insurers tend to value these companies based on Price/Earnings multiples because of the relative stability of earnings compared to P&C insurers, whereas investors in P&C insurers tend to value them based on Price/Book Value multiples relative to Return On Equity. In assessing the quality of earnings, investors in both life and P&C insurers tend to look at operating earnings, or net income excluding realized gains and losses on investments.

The common thread in what investors in insurers want to know is current earnings and expected future earnings, particularly operating earnings. Because of the earnings volatility of P&C insurers, investors pay attention to the relationship between ROE and P/BV multiples. Investors in P&C insurers consider the fair value of their investments because they are a source of liquidity, but investors are less interested in the fair value of the investments of life insurers because they understand that what drives their profitability is the managed spread relationships between policy obligations and investments funded by premiums. The present value of policy liabilities is of less concern than the adequacy of claim reserves for P&C insurers and the credit quality of assets for life insurers.

Therefore, GAAP accounting principles applicable to insurance contracts and investments generally should not focus on their liquidation values (actual or speculative), but, rather, on how fee and investment income is managed to fund the payout of policy obligations.

We note that the IASB’s proposal is redundant for U.S. insurers because they are subject to a regime of statutory accounting designed to provide liquidation values to supervisors and other interested stakeholders, including investors. By contrast, current U.S. GAAP is reasonably calibrated to provide investors and other stakeholders with information useful to the analysis and valuation of insurers as going concerns, as we discuss more fully below.

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4 At this most general level of analysis, insurers and banks are alike in their dependence on fee and spread income, with the difference that while banks match liabilities to assets, insurers match assets to liabilities.
In addition to being redundant, the IASB’s proposal would be inferior to statutory accounting, which rests upon the firm foundation of historically derived and time-tested actuarial concepts as opposed to the highly theoretical, nonoperational constructs of the IASB’s proposal.

In short, adoption of the Board’s variant of the IASB’s a priori proposal would do double damage to accounting principles applicable to U.S. insurers: it would impose a redundant, inferior regime of liquidation accounting, and it would deprive investors and other stakeholders of established GAAP reasonably calibrated to provide granular, transparent, and relevant financial information helpful to the assessment of insurers as going concerns.

**Key Operational Defects**

There are numerous, severe operational defects in the IASB’s overreaching proposal, including the Board’s variant of it. Because excellent comment letters already posted to the boards’ websites have discussed these problems in detail, we will limit our comments to the three salient defects arising from the radical discontinuity between the proposal and the business model of insurers. These defects are the determination of the discount rate, the definition of the term insurance contract, and the aggregation of financial data.

**Determination of Discount Rate**

Current U.S. GAAP measures long-duration insurance contracts by reference to present value, but in a manner very different from the IASB’s proposal. Currently, the liability for future policy benefits is measured as the present value of estimated future policy benefits to be paid and related expenses less the present value of estimated future net premiums to be collected, and is recorded on the balance sheet when premium revenue is recognized. Premium revenue generally is recognized when due from policyholders, and claim costs are recognized when insured events occur.

The discount rate is based on the estimated pre-tax investment yields (net of related investment expenses) expected at the contract issue date, adjusted for adverse deviation. Assumptions for measuring traditional life insurance benefit liabilities are locked in at inception. By referring to expected investment yields to derive a discount rate at inception and generally not resetting that rate, U.S. GAAP reflects the integrated management of long-term asset and liability cash
flows at the core of the life-insurance business model and minimizes material accounting mismatches.

By contrast, the accounting construct of the IASB’s proposal would ignore the matched relationship between assets and liabilities by using a current risk-free rate adjusted for illiquidity that would attempt to reflect the characteristics of the liabilities, and then re-measure liabilities each reporting period, with any changes in value recorded in earnings.

Putting aside the real-world challenges of identifying a risk-free rate for liabilities whose cash flows can extend over forty years or more and then adjusting it for illiquidity, the quarterly extension of the current term structure of the yield curve decades into the future betrays misguided, impractical academic thinking. Extreme volatility of equity and earnings arising from material accounting mismatches between assets and liabilities is a certainty, as is the fact that such accounting volatility would be devoid of economic or financial relevance – hence useless to investors and other users.

Definition of Insurance Contract

Under current U.S. GAAP an insurance contract is a contract in which an insurance entity unconditionally undertakes a legal obligation to provide specified benefits to specific individuals in return for a fixed consideration or premium. As a consequence, identical or quite similar financial instruments are insurance contracts or not depending on the identity of the issuer: insurers issue insurance contracts, others issue financial instruments.

As redefined in the proposal, an insurance contract would be a contract under which one party accepts significant insurance risk from another party by agreeing to compensate that party if a specified future event adversely affects that party. Thus, the proposed redefinition would define insurance contracts by reference to the characteristics of the instrument rather than the identity of the issuer.

As intuitively appealing and unobjectionable as the proposed redefinition of insurance contract seems, it is extremely problematic because of the term’s operational integration into the manner in which current U.S. GAAP reflects the business model of insurers. Specifically, the discount rate for present valuing policy liabilities currently derives from the yields of matched, supporting assets. As a result, adopting the proposed redefinition without also adopting the IASB’s larger proposal would result in non-insurer issuers of financial instruments
deemed to be "insurance contracts" having no point of reference for deriving a discount rate because they would lack the matched book of assets of insurers.

In short, the redefinition of the term insurance contract is not a "targeted improvement" to U.S. GAAP capable of adoption unbundled from the IASB's larger proposal.

**Aggregation of Financial Data**

The Board proposes that each portfolio of insurance contracts would be presented in the statement of financial position as a single net item within insurance-contract assets or liabilities.

In the statement of comprehensive income, a majority of the Board's members prefers not to present revenues and claims and benefits expenses separately for insurance contracts subject to the building-block approach to measurement. Instead, earnings would present changes in the composite margin.

While consistent with the Board's variant of the IASB's proposal, the margin-presentation approach preferred for the statement of comprehensive income would sacrifice line items of great importance to the business model and to insurance analysts, investors, and supervisors, including premium revenues, claim costs, and expenses. The result would be materially degraded granularity, transparency, and relevance of financial information.

**Unnecessary Costs, Unintended Consequences**

There are numerous requirements in the Board's variant of the IASB's present-value approach, such as a probability-weighted estimate of future cash flows, that would unnecessarily impose considerable incremental reporting costs on insurers, and to no helpful purpose.

In addition to these direct costs of compliance, there would be significant indirect costs in the form of unintended consequences for insurers.

These include higher cost of capital and reduced availability of capital arising from dramatically increased volatility in the equity and earnings of life insurers and some P&C insurers. (We note that this volatility would often be procyclical, exacerbating the business cycle.) The degraded granularity, transparency, and relevance of insurers' financial statements, combined with increased procyclical
volatility, would necessarily raise the cost of capital to insurers and reduce its availability.

Another important, entirely foreseeable adverse consequence would be reduced availability of long-term financing to a variety of entities as insurers increasingly issued shorter-term insurance contracts and shunned longer-term assets in order to minimize the material accounting mismatches the proposal entails. Insurers could no longer be looked to as reliable buyers of long-term debt.

What the Board Should Do

Statement of Financial Accounting Concepts No. 8, *Conceptual Framework for Financial Reporting* (September 2010), provides the standard for action the Board has set for itself:

The objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders, and other creditors ["primary users" (OB5)] in making decisions about providing resources to the entity (OB2).

General purpose financial reports are not designed to show the value of a reporting entity; but they provide information to help existing and potential investors, lenders, and other creditors to estimate the value of the reporting entity (OB7).

If financial information is to be useful, it must be relevant and faithfully represent what it purports to represent. The usefulness of financial information is enhanced if it is comparable, verifiable, and understandable (QC4).

We believe that the Board's proposal demonstrably fails these touchstones for action, and that the majority of letters commenting on the IASB's exposure draft and the Board's discussion paper will drive home this conclusion. Specifically, the proposal would generate a highly theoretical estimate of the value of insurance contracts that would

- promote neither comparability nor verifiability,
- lack transparency and relevance in its aggregation of balance-sheet and income-statement information important to primary users, and
- lack utility because of its unfaithful representation of the business model of insurers.
For these reasons, we also believe that letters filed by insurers, their trade associations, and the primary users of insurers’ financial reports – investors, lenders, and other creditors – will overwhelmingly oppose the IASB’s proposed approach and the Board’s variant of it. Indeed, we are unaware of any significant support from these groups.

Finally, we believe these counterfactuals would be even more pronounced had the Board issued its exposure document as an exposure draft rather than a discussion paper.

Accordingly, we urge the Board to take the opportunity presented by the comments it receives on its discussion paper to commit itself to “targeted improvements” to accounting for insurance contracts and otherwise leave well enough alone.

Very truly yours,

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