

August 28, 2013

Technical Director  
Financial Accounting Standards Board  
of the Financial Accounting Foundation  
401 Merritt 7,  
P.O.Box 5116,  
Norwalk, CT 06856-5116

Re: File Reference No. 2013-290

I appreciate the Financial Accounting Standards Board accepting commentary on proposed changes to GAAP financial statement guidance as it relates to Insurance Contracts (Topic 834).

I will limit my comments to just a few of the questions and comments on the exposure draft. My perspective is from the property and casualty insurance industry and, in particular, reinsurance assumed. While I understand the document incorporates the life side of the insurance business there are sufficient differences between life and non-life that should be recognized.

#### Loss Sensitive Feature

I do not disagree with your definition of loss sensitive contracts except with respects to reinstatement provisions being considered in this category. While additional premium is paid to reinstate limits under a reinsurance agreement and is done on the contingency of a loss under the treaty, it is not a penalty. It simply triggers additional coverage when it is needed. We have had many instances where ceding companies have experienced multiple losses in a contract period thus triggering immediate availability of additional limits. When multiple losses have occurred, the client will sometimes return to the market to purchase additional coverage for the unexpired period of the contract. While multiple automatic reinstatements provisions are available, the most common is to have only a single reinstatement. The automatic nature of reinstatement provisions are a convenience for both parties and it would be unfortunate if they were lumped into the generic category of loss sensitive penalties. Automatic reinstatements in reinsurance are one of the very few times in either insurance or reinsurance where one does not have to buy the coverage until the time you need it, albeit for a future loss.

#### Question 32 (834-10-35-36)

To the extent this question deals with loss sensitive contracts on the non-life side, I respectfully disagree as there is nothing inherently wrong with the current accounting treatment. Loss sensitive contract wording (and specifically reinsurance contracts) can, depending on the agreement, impact loss, expense, or premium. A loss corridor, for example, impacts loss by increasing a ceding companies exposure to loss but does not trigger a return of funds should the loss not occur; only some additional participation in the loss by the ceding company. A "no claims bonus" typically triggers a return of premium so it would impact revenue. Most loss sensitive contracts today, however, trigger an expense payment/reserve. Loss sensitive policies, whether it be a no claims bonus, contingent commission or commission slide, tend to align the interest of the parties by encouraging management support for loss control in a tangible way. Especially where there is a great deal of uncertainty in loss cost expectations, contingent commission payments allow for more precision when charging fair and adequate prices for insurance or reinsurance.

It would not serve any useful purpose to bifurcate premium between pure risk transfer and potential for expense recoupment for favorable experience. Reinsurers that issue loss sensitive insurance products establish contingent commission reserves for expected payments and ceding companies do likewise as mirror accounting principles would suggest is proper. If bifurcation were to be allowed, it would only serve to eliminate such loss sensitive contracts as it would be considered a deposit from the party



beneficiary standpoint. If the draft is saying that all loss sensitive payments should affect revenue and not expense, the reinsurer would need to set up a "contingent premium reserve" that would essentially serve the same purpose as a contingent commission reserve (until such time as the funds were paid). One could potentially make this part of the unearned premium reserve, but what would be gained other than needless complexity that would impair comparability?

Also, as with a sliding scale commission, the portion that is loss sensitive is difficult to discern when additional funds can be charged as well as recouped. Additional premium charges due to loss activity are considered earned revenue just as premium adjustments based on exposure according to the contracts language. There is nothing inherently evil with these types of contracts which allow the insured party or the reassured party to share in the fortunes of the coverage they buy just as they would with a loss corridor.

If loss sensitive contracts with the possibility of return funds were eliminated, the result would probably result in contract language being redrafted to offer discounts in subsequent contract periods. This would serve to create a mismatch between the revenue and loss which would be, I presume, an unintended consequence.

Our mutual company parent offers policyholders, as owners of the company; dividends based either on experience of a group of policyholders or on an individual policyholder basis. I presume this would not disqualify contracts from the premium allocation approach, all other things being equal, or would an original policyholder need to consider a portion of the policy as loss sensitive? While policyholders are considered owners of the company, reinsured clients would not be eligible for policyholder dividends.

#### Question 6

I would suggest greater flexibility with regard to the timeline by expanding the one year date. As a reinsurer, we often witness the desire by ceding companies to have staggered effective and expiration dates for reinsurance contracts similar to a fixed investment maturity ladder. It would be unfortunate, if a two or three year commitment on rates by the reinsurer would change the accounting treatment for either the ceding company or the reinsurer. Multi-year policies and multi-year reinsurance agreements often facilitate stabilization of coverage and price. Many insurers still utilize 3-year annual installment policies primarily for expense control or there are certain practical needs for extended policies such as for multi-year construction projects and builders risk coverages.

Also, reinsurance contracts can be limited to one year but there are two main types; loss occurring (the loss must occur during the policy period) and policies attaching (the loss must arise out of a policy incepting during the term of the reinsurance contract). For example, you may have a loss attaching contract with a policy period of July 1, 2013 to July 1, 2014 but you have the possibility of a date of loss in 2015. In other words, the premium is not fully earned until July 1, 2015 if, in fact, the original policies being attached are limited to one year contracts.

#### Loss Discounting - Question 15 (834-10-35-32)

With over 50% of P & C insurance company insolvencies caused primarily by chronic inadequate loss reserve discipline, it would be unfortunate if loss reserve discounting were introduced as a requirement. It would serve only to postpone corrective action (voluntarily or involuntarily) and inevitably lead to more volatility with results. Asbestos, environmental and abuse claims, for example, continue to impact insurers and reinsurers from policies written in the 60s, 70s & 80s (if they were in business during this time period). In 2012 alone, the U.S. Insurers reported 1 year development of 2002 and prior accident years of over \$2.25 billion and 2-year development of nearly \$4.46 billion.

Discounting of loss reserves is fundamentally incompatible with writing U.S. casualty business. A good indicator of this is the Industry's consolidated one-year development to surplus ratios that tend to vary with the competitive market cycles. During the 5-year period from 2002 through 2006, for example, total 1-year development to surplus amounted to over \$40 billion as compared with an Industry surplus of \$518 billion at year-end 2006. Also, companies vary considerably as to their development ratios and one can easily visualize the introduction of loss discounting would only magnify the extent of under-reserving following



extended periods of soft market conditions. This is not good for our Industry and it is certainly not good for consumers who rely on the strength of Industry to be there to pay claims when they come due.

Consider also, for the period 2002 to 2012, while Industry overall development was favorable toward the latter half of that period, the total amounts reported for "Prior periods" (meaning 10 years or more before the current period) is a staggering \$55.4 billion dollars. It is indeed fortunate that more current reserves were overestimated, so the Industry was able to absorb the drain from "prior years" on more recent year periods. What would happen if those more recent reserves were exactly on target such that their redundancy could not be used as supplement for "Prior" periods? Or, worse, what would happen if another serious and widespread latent disease began to manifest itself similar to asbestos.

The May 1990 GAO report which led to changes in insurance regulation after publication of the Dingell "Failed Promises" report quoted the Reinsurance Association of America that insurers "know" (meaning losses have been reported and appropriately reserved) of 35% of their General Liability claims after 1 year and "know" of 90% after the fourth year. Reinsurers, on the other hand, "know" of only 3% of their losses after 1 year and only 25% after 4 years. For these reasons alone, it is vitally important that reinsurers reserve responsibly for the "unknown" so "Failed Promises" to ceding companies is not ascribed to reinsurers in the long term. Historically, reinsurers have generally experienced less favorable development to surplus than primary insurers. Loss discounting would only result in less conservative estimations which, if chronic, will inevitably lead to solvency issues.

Aside from the reserve position of the industry, however, is the fact that less than ultimate reserving is not accretive to revenue & expense matching. Loss discounting resulting in enhanced margin is an anticipatory event that may or may not occur in the future. For many years, domestic public company insurer common stocks lagged those of start-up companies because of "legacy issues". New companies did not have legacy issues. If loss discounting is required, legacy issues will be intensified. For instance, would you invest in a company that has \$1 billion in surplus but has an unfunded liability of \$200 million by virtue of loss discounting or a similar sized start-up company with neither past performance obligations nor any unfunded obligations due in the coming years? Loss discounting will only encourage incessant churning of market leaders.

Does the industry currently ignore the effects of time value of money and mislead investors? No. We simply add premium and current period investment return and get an operating ratio. If we were to count future earned investment income as current income (or negative loss), it would be very reminiscent of the Enron auditors allowing Enron to quantify future benefits and earn those benefits in their income statement in force when their ideas were first conceived. Discounting loss amounts for the expected time value of money would lead to less solid financial condition of companies and an unlevel playing field with new market entrants. It might be accretive to bonus payments to executives in the short term but at the expense of greater volatility and less margin for error on the reserve side. Granted, if discounting is required, responsible companies would probably seek greater conservatism in risk charges so what has been accomplished other than greater complexity, decreased comparability, and increased potential for higher accounting firm audit fees?

#### Question 12

A mandate to require unbiased probability weighted estimation would not result in improved estimation or have prevented development for "Prior periods" in my opinion. Asbestos and other latent reported losses were so far beyond the range of outcomes and realistically known probabilities to significantly alter estimates derived as a result of the traditional management's best estimate. U.S. Casualty business, as it relates specifically to the latent exposures, has befuddled many since contracts were basically interpreted differently from the intent of their drafters. The problem does not rest with reasoned estimation of normal casualty loss emergence. The problem rests primarily with contracts that were drafted naively in the 60s, 70s, & early 80s when the Industry transitioned from an accident trigger to an occurrence trigger without anticipating the ramifications; ramifications that are ongoing but hopefully not without end. Changing estimation techniques and/or discounting of casualty reserves would simply add to the false sense of accuracy.



Summary

If reserves for loss are prescribed by accounting mandates for the supposed sake of comparability, it would seem we are only introducing complexity for complexity sake. Reserving for ultimate loss is largely a science and more scientific means of achieving better accuracy that have or will prove to work for individual companies should not be preempted by overreliance on loss ratio expectations and a single cash flow inspired model methodology.

I would encourage a very cautious approach to drastically changing the GAAP accounting guidance that appears to be inspired by International Accounting standards principles. International Accounting standards principles are anything but consistent country to country and have virtually no comparability as GAAP, along with statutory accounting, currently does. It is better to keep things simple and consistent with the past and possibly consider only incremental change if there is wide insurance industry agreement.

The proposed drastic accounting guidance changes would not be a model for better financial statement perfection and comparability nor would it be good for reinsurers, insurers or their policyholders. We currently have a good accounting model that balances the needs for conservatism, comparability, simplicity and practicality. Analysts have access to every company's financial ratios and net income within a few weeks of quarter close of over 3,000 companies in the U.S. Does this degree of comparability and transparency exist with the insurers and reinsurers in the EU countries? If the answer is "no", may I suggest we wait for the Europeans to catch up before we make drastic changes to our current accounting performance measures.

Sincerely,

A handwritten signature in black ink that reads "Ron Hallenbeck". The signature is written in a cursive, slightly slanted style.

Ron Hallenbeck