STANDARD & POOR'S RATINGS SERVICES
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October 25, 2013

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

Dear Sir/Madam:

Re: Proposed Accounting Standards Update – Insurance Contracts (Topic 834)

Standard & Poor's Ratings Services (S&P Ratings Services) welcomes the opportunity to comment on the Financial Accounting Standards Board's (FASB) June 2013 Exposure Draft (ED) on Insurance Contracts.

We welcome the high degree of convergence that could emerge as a result of the ED, and that of the International Accounting Standards Board (IASB). However, we regret that they are unlikely to achieve a fully unified standard, with clear differences that would still leave accounting and financial reporting comparability issues across the globe. For 30 years, U.S. insurers have benefited from Generally Accepted Accounting Practices (GAAP) tailored to the industry's needs, but the main weakness is that it developed piecemeal, as new products entered the market. The FASB's exposure draft goes way beyond the more targeted improvements most U.S. insurers and investors hoped for; we therefore believe many U.S. insurers and investors may not perceive the need for significant changes. While we do not address all the concepts and questions included in the ED, we do highlight issues between the ED and that of the IASB's insurance contracts proposal that could create issues regarding comparability as we perform our global credit ratings process.

Please find attached our "Global Insurance Accounting Proposals Signal Radical Change, But Fall Short Of Complete Convergence," published Oct. 16, 2013, on RatingsDirect and sandp.com).

The views expressed in this letter and the attached article represent those of Standard & Poor's Ratings Services, and do not address, nor do we intend them to address, the views of any other affiliate or division of Standard & Poor's Financial Services, LLC. We intend our comments to address the analytical needs and expectations of our credit analysts.[1]

This letter and the article have been prepared by Standard & Poor's Ratings Services' Financial Services global credit ratings group. I trust that the comments made are helpful and of relevance to the FASB. Standard & Poor's Ratings Services is committed to continuing its dialogue with the FASB.

Should you have any questions regarding the contents of this letter or the article, please contact me or my colleagues listed in the article.

Yours faithfully,

Ron Joas, Director
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[1] The opinions stated herein are intended to represent S&P Ratings Services' views. Our current credit ratings criteria are not affected by our comments on the ED.

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Global Insurance Accounting Proposals Signal Radical Change, But Fall Short Of Complete Convergence

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Global Insurance Accounting Proposals Signal Radical Change, But Fall Short Of Complete Convergence

Standard & Poor's Ratings Services welcomes the high degree of convergence that could emerge as a result of the leading accounting standards setters' consultations on accounting for insurance contracts. Their proposals are long overdue and comprehensive, in our view. However, we regret that they are unlikely to achieve a fully unified standard, with clear differences that would still leave comparability issues across the globe. Nevertheless, the proposals represent a giant leap forward toward global consistency, compared with the current fragmented scenario. (Watch the related CreditMatters TV segment titled "Global Insurance Accounting Proposals Signal Radical Change, But Does It Fall Short Of Complete Convergence?," dated Oct. 17, 2013.)

For the past five years, the International Accounting Standards Board (IASB) and the U.S. Financial Accounting Standards Board (FASB) have been collaborating on comprehensive changes to the standards they issue--respectively, International Financial Reporting Standards (IFRS) and U.S. generally accepted accounting principles (U.S. GAAP). They have both recently published exposure drafts that close for comment on Oct. 25, 2013.

Highlights

- Global insurance accounting may soon undergo needed radical change, although planned convergence is not globally encompassing.
- We agree with the basic building blocks for insurance liabilities.
- The IASB's new exposure draft is improved in our view, significantly reducing volatility, but at the expense of added complexity.
- The FASB's exposure draft goes way beyond the more targeted improvements most U.S. insurers and investors hoped for.
- The changes are more likely to influence our ratings analysis, and less likely to directly affect the ratings.

Global Insurance Accounting Faces Need To Converge

Because the IASB's International Financial Reporting Standard 4 (IFRS 4) on insurance contracts is an interim standard, its needs are more urgent than those of the FASB. Its due process has advanced further; it has debated the subject for over a decade and published an earlier exposure draft in 2010. Its current exposure draft focuses on just five areas. The IASB anticipates publishing a final accounting standard in early 2015. We therefore anticipate that implementation will not occur before 2018.

The FASB has not progressed as far with its consultations; this is the first time it has outlined its proposals in an exposure draft and it is consulting broadly on its proposal. That said, although the FASB has not proposed an effective date, we anticipate that it will adopt timing consistent with that of the IASB.

We strongly encourage the boards to ensure that the effective dates for all standards affecting insurers coincide, including the proposed changes to the treatment of financial instruments (currently also converged, but not unified). Otherwise, insurers could face two major implementations in a short period of time.

In our view, the comprehensive changes proposed by the IASB and FASB signify a welcome, and long overdue, leap toward converging global standards. The boards have been working together on their insurance accounting projects since 2008. The resulting documents (exposure drafts) have recently been released for public commentary. Although they are similar, unfortunately, they are not the same.

In response to the industry lobby, the IASB has reduced much of the accounting volatility in the income statement (and, therefore, reported equity) that would have resulted from its 2010 exposure draft. Extensive use of other comprehensive income (OCI) in the income statement is proposed, which would remove further volatility at the net income level. The FASB exposure draft also uses OCI to mitigate volatility in net income.

Gaining buy-in for change could be harder for the FASB

IFRS 4 has been in force since 2005 and has successfully improved disclosure, achieved greater consistency on the asset-side of the balance sheet, and outlawed explicit profit-smoothing mechanisms. However, the liability side of insurers' balance sheets is governed by different national accounting practices, most of which adapt poorly to the insurance industry. Insurers reporting under IFRS still have many and varied concerns, but the IASB has responded positively to much of the feedback it received after the 2010 exposure draft.

U.S. insurers, by contrast, have benefited from GAAP tailored to the industry's needs for 30 years. The main weakness is that it developed in a piecemeal fashion, as new products entered the market. The FASB's exposure draft goes way beyond the targeted improvements most U.S. insurers and investors hoped for. In our opinion, many U.S. insurers and investors may not perceive the need for any significant changes.

We believe the comprehensive and far-reaching changes proposed in the exposure drafts are warranted, given the diversity of practices around the world.

Two Routes To A Similar End

In our view, the IASB's new exposure draft improves on the 2010 draft, but is more complex. The board is finessing its balance sheet proposals, but the main focus of this exposure draft is on income statement presentation and transition issues. We consider that the questions the IASB is posing reveal that it still has important decisions to make regarding how life insurance contracts are portrayed in the income statement.

The IASB has deliberated over its changes to insurance accounting standards for a long time. Its latest consultation is limited in scope, indicating that it has a fairly clear idea of its ultimate standard. It has not changed the basic building blocks for liabilities since its 2010 exposure draft, although some of the terminology has changed (see table). In addition, the IASB seems to have finalized its approach to presenting non-life contracts in the income statement.

Insurance Contract Liability Building Blocks

International Accounting Standards Board exposure draft	U.S. Financial Accounting Standards Board exposure draft
Future cash flows	Future cash flows
+ Risk adjustment	
– Discount adjustment*	– Discount adjustment*
+ Contractual service margin	+ Single margin

*The discount adjustment converts future cash flows into current amounts.

The IASB's risk adjustment assesses uncertainty regarding the amount of future cash flows and illustrates the most basic difference between the views of the boards. As the table indicates, the FASB disagreed with the IASB on having a risk adjustment as a separate component of liabilities. The FASB considered that insurers would be unable to determine the adjustment reliably enough. In its view, the single margin approach implicitly reflects both the elements of the risk adjustment and the contractual service margin proposed in the IASB exposure draft.

In our view, both approaches include an element of subjectivity, thus highlighting the need for clear and comprehensive implementation guidance and disclosure, regardless of the approach. We see this as an area where the boards could have converged their approaches, benefiting the insurance industry as a whole.

The IASB's contractual service margin (CSM; referred to as the residual margin in the 2010 exposure draft) and the FASB's single margin both represent deferred profit. Neither board wanted insurers to report profits at the inception date of an insurance contract. Therefore, on day one, the FASB's single margin would equal the IASB's CSM plus risk adjustment; liabilities would be identical under the two approaches. However, after day one the boards use different amortization rules:

- The IASB proposes that its CSM be amortized systematically over the coverage period, to reflect the remaining services under the contract.
- The FASB proposal requires amortization over both the coverage and settlement period, as the entity is released from risk.

Re-measuring of the two margins also differs (see "Reported equity volatility on life insurance contracts would be reduced using the contractual service margin" below).

While both boards incorporate a simplified approach to valuing short-duration (i.e., mainly non-life) contracts, they did not achieve convergence. We support valuing such liabilities before claims are made by using a premium allocation approach (PAA). This would allow insurers to continue to use the unearned premium reserve, which is already widely and consistently used around the world.

More Guidance May Help Reach The Goal

To varying degrees, insurers already recognize risk margins and discount in their liabilities implicitly, but we consider consistency and transparency to be poor. We therefore welcome the separation of insurance liabilities into the IASB's proposed components (see "Standard & Poor's Ratings Services Comments On IASB's And FASB's Insurance Contracts Proposals," Dec. 23, 2010). We expect this to provide greater transparency regarding the underlying performance of the business being written.

However, unlike the 2010 exposure draft, the IASB's new exposure draft offers no guidance for determining the risk adjustment; nor is there guidance that is widely accepted by the actuarial profession globally. We expect the profession to develop such guidance, allowing insurers to develop consistent practices over time. Concerns regarding the reliability of the risk adjustment partly explain the FASB's reluctance to pursue it.

Perhaps the most significant development since the 2010 exposure draft, and a welcome one in our view, enables insurers to choose how to discount liabilities. An insurer may now choose either:

- A "top-down" approach, based on its portfolio interest rate yield curve minus the market risk premium for credit risk; or
- A "bottom-up" approach, based on a risk-free interest rate yield curve plus market risk premium for liquidity risk.

Both boards offer these options, which we consider a sign of their pragmatism, following industry lobbying. By contrast, the EU's Solvency II directive does not allow the top-down approach.

Comparability issues may arise because of the complexity of calculating a discount rate; assumptions used will be subjective. In addition, although we expect market pressure to lead to some consistency, there may yet be a lack of transparency. Some insurers could decide that providing new information could compromise their competitive advantages in the marketplace. In our view, boards should require consistent disclosure on the assumptions being used, including sensitivity analysis.

The IASB's Mind Is Mostly Made Up

The IASB is only seeking feedback on five areas, involving proposals which:

- Reduce reported equity volatility for life insurance by using the CSM to absorb changes in future cash flow estimates;
- Reduce reported equity volatility on certain with-profit life insurance contracts;
- Reduce net income volatility by making extensive use of OCI to absorb changes over time in interest rates;
- Provide a new approach to reporting revenue for life insurance contracts; and
- Deal with the resulting issues at the date of transition to a new standard.

Reported equity volatility on life insurance contracts would be reduced using the contractual service margin

The new exposure draft proposes that the CSM absorbs the effect of changes in estimates relating to future coverage or service first, before any recognition in net income (i.e., CSM might be reduced to zero but would never be negative). The earlier exposure draft proposed that insurers immediately recognize all changes in cash flow estimates in net income. The FASB exposure draft retains this aspect of the IASB's earlier exposure draft and stipulates that changes relating to future coverage or service be recognized immediately in net income. This could create volatility in the income statement, and will also reflect a margin in earnings that may not be indicative of the true profit.

We consider the IASB's new proposal faithful to the long-term nature of most life insurance contracts. Changes in cash flows relating to incurred claims would continue to be recognized in net income. Therefore, this proposal would have little impact on most non-life insurance contracts.

Reported equity volatility would be reduced on certain with-profit life insurance contracts

The exposure draft proposes not using the building block approach (BBA) to valuing liabilities in certain cases; we consider the change positive. It would mainly affect some with-profit life insurance contracts. In these cases, the BBA would cause an accounting mismatch between the value of assets and liabilities. Such contracts have features that result in policyholders sharing directly in gains or losses on the underlying investments, and where the asset or liability valuation basis is specified in the contract or by law. As a result, no economic mismatch between related assets and liabilities is possible. The proposal allows insurers to "mirror" the relevant liability values with underlying asset values. However, disaggregating cash flows under these contracts may not be straightforward. The proposal would also affect some unit-linked contracts, although the departure from the BBA is less controversial here.

Reported net income volatility resulting from interest rate movements would be significantly smoothed using other comprehensive income

Alongside the discount rate option, we consider that the most significant change since the IASB's first exposure draft is the proposed extensive use of OCI, which would lead to significantly smoothed net income. According to the IASB's proposals, OCI may include:

- The liability value impact of discount rates changes;
- The asset value impact of changes in the new category of "fair value bonds through OCI" through proposed changes to IFRS 9; and
- Movements in the value of equity instruments not held for trading.

The income statement will therefore offer two views of profitability, which we think investors will find useful. Total comprehensive income disclosed in the financial statements will provide a view closer to the more market-consistent view envisaged under the first exposure draft, while net income will represent a significantly "smoothed" view of underlying profitability. However, not all potential accounting mismatches will be eliminated in net income.

The FASB also utilizes OCI in its proposal, to mitigate volatility in the income statement.

The proposed revenue recognition approach for life insurance contracts may not pass the cost/benefit test

The exposure draft includes an entirely new approach to recognizing life insurance revenue. In our view, the information produced by this approach could prove both burdensome to prepare and of limited value to users. The original exposure draft included a "summarized margin approach" for insurers' income statements. Market feedback indicated that users wanted volume information retained. The IASB's concern is that investors should be able to compare an insurer's revenues with those of other businesses, particularly deposit takers and asset managers. The new approach results in spreading life revenues based on future service (thereby excluding the investment component of life insurance premiums) over their coverage period by "grossing up" elements of total comprehensive income. The FASB exposure draft has also adopted this concept for life insurance revenue, noting its intention that financial information be comparable with that of other businesses.

In our view, the resulting revenue would not accurately reflect current levels of activity. Although some users may value this perspective, we would expect insurers to continue to disclose customary volume measures (premiums, new business, annual premium equivalent, and present value of new business premiums, etc.). We also understand that many insurers would find developing systems to produce the information costly.

Transition proposals simplify initial implementation

We welcome the proposals to allow a simplified initial implementation. If there were no transition proposals, each insurer would need to retrospectively determine each of the liability building blocks in its opening balance sheet as if the proposed standard had always applied. This would be burdensome for most life insurers.

Differences Remain That Will Impede Comparability

The IASB and FASB have collaborated closely for five years on their insurance projects. While they have unfortunately not published identical proposals, we see the planned convergence as valuable. Certain components of the exposure drafts have clear differences that will create comparability issues in analyzing insurance companies across the globe. Some have already been mentioned above. The main differences are:

- Margin measurement and recognition: The FASB and IASB exposure drafts would most likely produce different earning patterns. In addition to having two different and distinct definitions of how to recognize revenue, the IASB exposure draft also includes an explicit risk adjustment as well as requiring subsequent adjustment to reflect changes in cash flow estimates for future coverages or estimates; the FASB includes neither.
- Accounting models for short-term contracts: The FASB defines parameters on when to use either the PAA or the BBA, whereas the IASB regards the PAA as a simplification of the BBA and therefore views it as an option. As stated in "Standard & Poor's Ratings Services Comments On IASB's And FASB's Insurance Contracts Proposals", published on Dec. 23, 2010), we are concerned that some contracts currently considered short-duration may not meet the one-year requirement for the coverage period. Accordingly, we do not support the proposed requirement to use the PAA, but do support a limitation on the coverage period, similar to that currently applied, in practice, to U.S. GAAP short-duration contracts. We believe allowing a broader interpretation of the one-year limit will not significantly affect these contracts, and preserves useful information about revenue.
- Reinsurance: The IASB takes a more principles-based approach on assessing which accounting model to use for reinsurance; by contrast, the FASB exposure draft notes that the reinsurance model should mirror that of the direct policies. As such, under the FASB exposure draft, if a reinsurance contract applies to direct contracts that are accounted for under both BBA and PAA, insurers would have to allocate reinsurance cash flows on the basis of the relevant underlying contract measurement model.
- Change in estimation of fulfilment cash flows: The FASB exposure draft requires the change in cash flow estimates to be recorded in net income (excluding changes triggered by fluctuations in the discount rate, which are recorded in OCI). The IASB exposure draft notes that unless a contract is onerous, all changes in estimates related to future coverage or services should be offset against the CSM; this would reduce the volatility in the income statement.

The Changes May Influence Our Ratings Analysis

We expect the proposed changes, in their current form, to have a limited impact on our ratings globally. Because our analysis focuses on the fundamentals underlying financial statements, it should be immune to accounting changes over time. However, we would need to review our suite of ratios and some features of our capital adequacy model. In the past, accounting changes have rarely affected ratings; for example, in 2005, no ratings changed when IFRS 4 was implemented, even though the change had a significant impact on reported equity and profitability for some insurers.

However, some accounting changes lead to behavioral changes that affect our analysis. For example, preparers may change their business strategy or focus, may see a change in their cost of capital, or may find that banking covenants are breached. There can also be a regulatory effect where IFRS influences the numerator in the solvency ratio calculation.

The final standards will influence our analysis. For example, we would need to consider how to treat the risk adjustment, CSM, and single margin within total adjusted capital (TAC) in our capital adequacy model. We would also need to consider whether we should add risk-adjusted ratios (for example, an economic combined ratio reflecting discount and risk adjustment) to our suite of mostly "nominal" ratios, and whether and how to use the new definition of life revenues in our ratio analysis.

Boards Should Encourage Market Practices That Promote Comparability

Although market discipline will play an important role in how insurers ultimately apply the standard's principles, we hope the IASB and FASB will provide more examples and implementation guidance, to assist insurers in preparing financial statements and users in understanding the intent behind the proposed accounting principles.

We strongly support the boards' aim of converging insurance accounting globally to allow greater consistency and comparability in financial reporting of insurance contracts. That said, we are concerned about the differences between the boards' decisions and some aspects of the proposed accounting.

We see it as imperative that the boards agree on a converged solution to measure insurance contracts. As a global organization, we seek a common starting point for our credit analysis; investors and analysts with a global perspective have similar goals. Although a similar starting point for the measurement of insurance contracts may be achieved, we acknowledge that the proposed accounting could be interpreted and applied differently by preparers. Nevertheless, we believe comparability among insurers, to the greatest extent possible, should be a key goal.

It seems likely that the boards will not ultimately agree on common accounting standards for insurance contracts. We therefore consider it desirable to supplement each different requirement with disclosures that facilitate global comparisons.

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