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Subject: Proposed Accounting For Insurance Contracts

This letter is in response to the Exposure Draft on Insurance Contracts issued by FASB on June 27, 2013.

My Background and Use of Financial Statements

1. I have been involved in analysis of the insurance industry—primarily property casualty—for over 35 years, and have been a security analyst for the past 20+ years, including time at Conning & Company, Fox-Pitt, Kelton, and currently Dowling & Partners. I have an M.A. in Mathematics from the University of Washington and am a Fellow of the Casualty Actuarial Society.
2. I frequently use and analyze the financial statements of both public and privately held insurance companies, and I am familiar with the current accounting and disclosure practices of insurers. Although my focus has generally been on the property casualty industry, I am familiar with many of the accounting issues at life and health insurers.

Overall Comments on the FASB Exposure Draft (ED)

3. My comments will primarily address my overall view on the appropriateness of the ED as applied to property casualty insurance. Rather than respond to specific questions, I have discussed my overall reactions to the ED. The views expressed are my own.
4. **FASB has long been heading toward a more complete “fair value” approach to insurance accounting for many years, yet analysts tend to remove these adjustments.** Fair values on the balance sheet are ephemeral values that are usually reported on 4 calendar dates per year and can often change materially between a measurement date and a reporting date, at which time the information may already have lost its usefulness. I understand and appreciate the theoretical consistency of having everything at fair value. However, in practice, many fair value metrics have not proven useful, and as an analyst, I end up removing the effects of these adjustments before beginning an analysis of an insurer’s operations. Insurers assist in this effort by often providing many non-GAAP disclosures.
5. **Analysts want to understand the portion of an insurer’s operations that is within management’s control and repeatable, i.e. what is useful for estimating future performance.** Premiums, loss ratios and expense ratios have become the core pieces of information for property casualty insurance analysis because they reflect management’s ability to produce and retain business, price the business properly, control the claim settlement process, and manage the cost

structure. Fair value changes are often outside of management's control, which is why analysts often ignore them in making projections of future financial performance.

- 6. Accounting that assists in understanding the way management thinks about the business and helps understand the underlying insurance contracts is most useful.** While it may seem obvious, amounts paid by customers to insurers for coverage should be premiums. Claims paid to those customers should be incurred losses. Expenses paid or reimbursed through reinsurance should be expenses. Investment income should be the full result of the investment department. Accounting that shifts these amounts around (say, treating ceding commissions as negative premium, or reserve discount accruals as negative investment income) obscures rather than clarifies the basic nature of the insurance or reinsurance contract and does not reflect how managements conceive or think about the contract. While the time value of money is an important concept in insurance, the concept of insurance risk and a management's ability to control that risk is often far more important, occupying managements' attention and reflecting the essence of the economics of property casualty insurance.
- 7. As long term observers of the insurance industry, Dowling & Partners has long emphasized that property casualty insurance company financial statements are always wrong.** Because of the uncertainty of loss reserve development, stated earnings and book values are always either too high or too low, sometimes by very significant amounts. We estimate that over the past 30 years, using the ten years of development available in Schedule P, that the industry has on average had a reserve deficiency of ~12% of reserves, with a standard deviation of ~15% of reserves. The range of results (again using only the available 10 years of development) is from a 44% deficiency in 1984 to a more recent peak redundancy in 2007, which we currently estimate (subject to further adjustment) is somewhat above the 5.8% of favorable development to date. And these are the industry numbers. Individual companies have seen much larger ranges for their reserve position and much larger standard deviations. **Discounting of these reserves, as in the proposed ED, is likely to compound the problem of adverse reserve development.**
- 8. Conservatism has been a hallmark of successful insurance companies.** Given the historical level of reserve deficiency for the industry, the most successful companies have been those that have maintained some degree of conservatism, so that when loss trends turn adverse, there is a sufficient cushion to absorb any shock losses.
- 9. Discounting reserves as in the ED is the opposite of conservatism (Question 15).** While discounting reserves may make sense in many circumstances, doing so without some form of risk margin that allows the reserves to fall within a high percentage confidence interval is not conservative. The ED suggests only a mean reserve (likely close to a 50% confidence interval) without any further conservatism. Perhaps insurers will find an approach that allows more conservatism, but the ED does not seem to encourage it. In addition, discounting will front-load more of the insurance profits, also the opposite of conservatism. **I would more likely agree with the concept of discounting if a specific risk margin were added that made the reserves reach closer to a theoretical 90% confidence interval.**
- 10. The identification of specific scenarios and probabilities in estimating future cash flows implies far more precision than the real world allows.** The science of determining insurance loss distributions has been the subject of numerous actuarial studies over many years. These are largely

theoretical. While many actuaries are willing to identify means, variations, and confidence intervals of reserve estimates, the parameter risk for any models used is huge. Liability losses in some lines can shift significantly because of one court precedent or one successful class action suit, and such risks can only be incorporated judgmentally. While the ED perhaps supposes companies will assume some additional adverse scenarios, adversity in insurance often tends to be worse than anything that can be foreseen. (See paragraph 7.) **This is why I would encourage the use of a risk margin on the reserves in conjunction with any discounting.**

11. Discount accretion should be treated as an incurred loss. (Question 16) The ED says that discount accretion should be included in investment income. Yet, as noted in paragraph 6, there is much more clarity if a claim amount paid to an insured or to a claimant is treated as an incurred loss. It is more consistent with the operation and general understanding of the underlying contract. If this provision of the ED were adopted, I would be more likely to remove it and request managements to provide non-GAAP disclosures to provide it for us. Again, I believe premiums should be premiums, losses should be losses, and expenses should be expenses.

12. The onerous contract charge, as proposed, does not add value. The ED provides an example in section 834-10-55-136, which suggests that an onerous contract charge could be taken just because there is a hurricane on the horizon, even if analysts know it doesn't strike land by the time the financial statements are completed. The ED would require companies (particularly reinsurers writing property catastrophe covers) to take an onerous contract charge in one quarter if there is a looming hurricane, only to reverse it in the next quarter if it doesn't make landfall. It is hard to see how this is useful information to anyone. By the time the financial statements are reported, everyone will know the actual result.

I think of the concept of premium deficiency or onerous contract as one where the pricing of the product has systematically missed the mark. For catastrophe reinsurance when losses are large but fully contemplated within the pricing of the product, there is nothing unusual about having a hurricane cause a loss. Since the example uses September, a third quarter onerous contract charge would be a common occurrence under the proposal. I do not think this would add any value at all to the financial statements.

13. The treatment of loss sensitive features and ceding commissions also obscures rather than clarifies the nature of the reinsurance transaction. As mentioned above, I believe in treating cash flows as they are treated in the actual insurance contracts. Amounts that are treated as premiums should be premiums, amounts that are offsets to expenses should be expenses and amounts that are losses should be losses. This allows analysts and users of financial statements to adjust the numbers according to their own preferences or analysis.

While I see the point of treating reinstatement premium as a loss, combining the reinstatement with the loss obscures rather than clarifies what is actually going on in the contract. Also, treating ceding commissions as a net against premium obscures the purpose of these commissions = an offset to expenses providing statutory surplus relief. **I find it much more useful to report results in a way that is faithful to the purpose and economics of the underlying contract, not in a way that tries to reduce the transaction to pure financial terms.**

14. Overall, if this FASB proposal is adopted in some form, the result will be more non-GAAP disclosures. Analysts will still want loss and combined ratios excluding discounting; we will want the real net premiums written, unaffected by revised treatments of ceding commissions; we will want total investment income reflecting the overall investment operations, not conflated with reserve discounting; we will want operating earnings that don't attempt to include the probability of a hurricane making landfall in the subsequent quarter. In short, we will likely turn back more toward statutory accounting as more useful, and ask insurers to report non-GAAP results according to how they run the business. **The current FASB ED, from our perspective, does not improve financial reporting and is likely to obscure rather than clarify the nature of the underlying contracts.**

I would be happy to discuss any of my comments with FASB. Thank you for the opportunity to respond.

Sincerely,

Gary Ransom