



November 18, 2009

Sir David Tweedie
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Dear Sir David and Mr. Herz:

In its October 20 meeting, the IASB directed staff to develop a more detailed explanation of the notion of interdependence among components of insurance contracts.

We believe that components of insurance contracts are interdependent if the value of each component depends materially on the value of the other components. The following examples should be helpful in clarifying this principle. These examples are simplified in order to highlight the points concerning interdependence.

Example 1. (Universal life) The policyholder pays CU 1000 initially for a death benefit of CU 100,000, and is expected to pay CU 1000 in each subsequent year. However, the policyholder has the flexibility to pay more or less in premiums. The contract value accumulated is credited with interest, and is the source of funding for insurance benefits and expense charges according to the terms of the contract. The contract terminates at any time the accumulated contract value is not sufficient to provide payments required by the contract. If the insured dies while the contract is in effect, the total death benefit is CU 100,000. So for example, if the contract value at the time of death is CU 20,000, the insurer incurs a mortality cost of CU 80,000 (not CU 100,000, because the accumulated contract value is included in the death benefit; i.e., no contract value remains after the death benefit is paid).

The contract in this example provides a death benefit and a surrender value (that is available while the insured is still alive). However, the two values are integrally interdependent. The payments required for current insurance coverage depend on the value accumulated in the contract. For example, the payment required for mortality in a month in which the contract value is CU 20,000 is based on a “net amount at risk” of CU 80,000 (i.e., if the insured dies during this month, the contract value is the source of CU 20,000 of the death benefit). Thus the accumulated value in the contract is an essential element in calculating the insurance liability (because the “net amount at risk” is the difference between the total death benefit and the accumulated value), and the “net amount at risk” is an essential element in calculating the accumulated value in the contract (and thus the surrender value if the policyholder decides to terminate the contract), because payments are required from the accumulated value based on the “net amount at risk”.

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Attempting to “unbundle” such interdependent values becomes particularly complex if the value of one or both benefits is/are determined based on probability weighted estimates of cash flows. In addition, it is not clear how some contract expenses (e.g., for acquisition, retention, customer service, reporting contract results) or taxes should be allocated in determining component liabilities (if they are “unbundled”). The liability values of the “unbundled” components would be arbitrary (both because the components are interdependent and the “unbundling” would require arbitrary allocations), expensive to produce, and of questionable value to the company and to users of financial statements.

In any given period of the contract, the contract either terminates in death or lapse (with payment of a surrender value, if any), or the contract continues in effect through the end of the period. The possibilities of surrendering the contract or continuing it are dependent on continued survival of the insured. There are no business reasons for entering into separate contracts for insurance of the “net amount at risk” and accumulation of a separate contract value, and the calculation of charges for mortality and the accumulated value of the contract are interdependent. As such, the insurer’s obligations under such a contract should be accounted for as one liability.

Example 2. (Automobile physical damage) The policyholder pays CU 300 for one year protection against physical damage loss to his/her automobile. If the policyholder sustains a loss during the coverage period and files a valid claim, the insurer makes payment in the amount of the covered loss. For some types of non-life policies (e.g., for automobile liability insurance), the insurer is typically obligated contractually to provide legal defense for the insured against losses up to the amount covered. The insurer may also decide to do additional claims investigation (e.g., regarding the cost to repair the auto, the possibility of recovery from another driver or insurer, or the validity of the claim) if the insurer thinks it is in its economic best interest to do so (i.e., the resulting reduction in claim cost is expected to exceed the additional cost of investigation).

The premium paid for this insurance is a deposit only in the sense that it is a prepayment that is utilized as coverage is provided (similar to a rent payment for an apartment or office, which is due at the start of a rental period). If the policyholder decides to terminate the policy before the end of the coverage period, he/she is entitled to a return of a portion of the premium, but without any interest credit. It is likely that no claims will be incurred for most of the policies during a particular coverage period; but the claim amounts for the policies that do experience claims could be large multiples of the premiums in that period for those policies. The policyholder should only expect to be compensated for his/her loss, and should not expect a return on its premium (notwithstanding contract termination).

The preceding examples are simplified illustrations of common insurance situations. There are sound business and financial reasons for insurance benefits and obligations to be structured in these ways. There are no clear reasons for an insurance contract to be constructed in the way described in the next example. But this example is included because such circumstances have been discussed in IASB meetings on insurance contracts.



Example 3. The policyholder pays CU 5,000 for a benefit of CU 20,000 if the insured dies while the contract is in effect over the next 10 years, and for an airline ticket from Location X to Location Y at the end of each of the next 10 years (whether or not the insured is still alive at that time). There is no cash value available to the policyholder if he/she wants to surrender the policy before the end of the tenth year.

In this example, there is no interdependency between the value of the death benefit and the value of the airlines tickets, or the liability that the insurer has for each of these benefits. The same airline ticket is generated at the end of each year, whether the insured lives or dies. These benefits clearly are not interdependent.

We believe that insurance contract typically either include only one benefit component, or include multiple components that are interdependent based on the definition underlined in the opening paragraph above (i.e., the value of each component depends materially on the value(s) of the other component(s)). We note further that existing accounting guidance (e.g., the DIG K1 guidance for derivatives) requires that various components be valued together rather than “unbundled”.

Sincerely,

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

Kevin Spataro
Chairman, GNAIE Accounting Convergence Committee

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