



December 3, 2009

Mr. Robert Herz, Chairman
Financial Accounting Standards Board
401 Merritt 7
Norwalk, CT 06856

Sir David Tweedie, Chairman
International Accounting Standards Board
30 Cannon Street, First Floor
London EC4M 6XH
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Dear Chairmen:

We understand that a recent FASB education session included a presentation by Sam Gutterman on his paper, "The Role of Risk Margins in a Fulfillment Accounting Objective" (September 20, 2009). Several FASB members referred to that presentation and paper in the joint IASB/FASB discussion of insurance contracts on October 28, 2009. Because Mr. Gutterman's presentation and paper may significantly affect Board member views on measurement of insurance liabilities, we would like to emphasize our views on the paper, with respect to measurement of both life and non-life insurance liabilities.

The basic conclusions of the Gutterman paper, as stated in the Summary on p.10, are:

- 1) An adjustment for uncertainty is appropriate, whether the applicable accounting objective for the liability for insurance contracts is expressed in terms of a contract fulfillment or transfer value.
- 2) In order to reflect all aspects of uncertainty in the measurement of the liability, it is necessary to provide an adjustment for uncertainty (a risk margin).
- 3) In the building block approach to measurement, it would be incorporated in building block 3.

Our comments will address these conclusions specifically.

Life Insurance Contracts.

While we are doubtful that "all aspects" of uncertainty¹ can be measured in the liability, we have no objection to the conclusions listed above for measurement of life insurance liabilities (although as described below, we do have substantial objections to these conclusions for measurement of non-life insurance liabilities in the post-claim period). However, we strongly believe that the adjustment for uncertainty should be included within a composite margin, and that there should be no requirement to quantify a specific risk margin separately within the composite margin. While it is possible to define methods for assigning values to risk margins, we believe that these are theoretical calculations that have little if any practical meaning. Moreover, the theoretical calculations would not be independently verifiable (cannot be calibrated to an independently existing value) or comparable among life insurers other than through their inclusion in the premium charged for the risk; thus calling into question the decision-usefulness of the information. In

¹ There is a terminology issue that needs to be kept in mind regarding the distinction between "uncertainty" and "volatility". It is not so much that our estimates are uncertain as they are subject to volatile results in actuality. In this letter, however, we will use uncertainty to be consistent with the Gutterman paper.

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contrast, the composite margin information would be more concise, verifiable, and transparent, and should focus on the total margin available in the reserve rather than on theoretical calculations.²

In its Discussion Paper, “Preliminary Views on Insurance Contracts” (May, 2007), the IASB stated (in Paragraph 86(c), on p.55) that “it does not intend to prescribe specific techniques for developing risk margins. Instead, the Board intends to explain the attributes of techniques that will enable risk margins to convey useful information to users about the uncertainty associated with risk margins”. Appendix F from the Discussion Paper contains a draft description of such attributes, one of which is that if more than one approach is compatible with the criteria, it is preferable to select an approach that builds on models that the insurer uses to run its business (this attribute is covered in sub-paragraph F3(i)). GNAIE believes that insurers should not be prevented from using a composite margin approach in their financial reporting if such an approach builds on the models the insurers use to run their businesses.

Mr. Gutterman states in his paper (on p.10) that “All pricing methodologies that we are familiar with include a provision for uncertainty, although some aggregate it with provision for expected profit.” In many parts of the world including the US, the methods that life insurers use for pricing and other business processes often do not distinguish a provision for uncertainty from other margins included in premiums, because these insurers do not believe that there is presently a reliable and decision-useful way to isolate such a provision.

As noted above, we do not dispute the need for including provision for uncertainty. In fact, we expect that the value of building block 1, current estimates of future cash flow, will provide for uncertainty at the expected value level. Our objection is to a requirement to attempt to quantify an additional provision for uncertainty and volatility separately within the third building block.

Mr. Gutterman states (on p.9 of his paper) that “Several actuarial methods have been used to measure risk margins for different purposes. These will continue to be refined as the need arises to apply them in financial reporting. Although it is outside the scope of this paper to describe them, needless to say we feel confident that methodologies and techniques will continue to be developed and enhanced to enable them to be used for this purpose.” We agree that there are several methods that could be used to assign values to risk margins, and that new methodologies and techniques may be developed and enhanced in the future. However, we do not agree that any combination of existing or likely future methods necessarily would provide a more useful basis for calibrating risk margins or for making decisions on the basis of such calibration than simply using a composite margin. We believe that standards may ultimately emerge that would allow for reliable estimation of margins (and perhaps even margin components such as risk margins); but that a principles based accounting standard should not require separate identification of a risk margin or particular combinations of approaches to assign values to such margins.

An important issue (which is covered on p.7 of Mr. Gutterman’s paper) is whether the third building block should be re-measured subsequent to the initial measurement of an insurance contract liability. We have no objection to a principle within the insurance contract standard that would provide for such re-measurement of life insurance margins based on new information regarding changes in the need for such margins. In general, we agree with Mr. Gutterman’s comment (on p.7 of his paper) that it would be most appropriate to release margins according to the driver(s) of the uncertainty. We have characterized this process as releasing margins as the insurer is released from risk and we would expect the margin to decrease (or possibly increase in certain circumstances) over time as the risks in the product change. The entire margin would be released by the end of the coverage period for life insurance (which may be at the time of death of the insured or surrender of the policy). We do not see the margin as a shock absorber, which could decrease to zero before the end of the coverage period to offset adverse changes in the expected cash flows.

² It is important to keep in mind that all margins included in a premium, or in a liability, are available both to cover future benefits if developments are less favorable than expected and to become profit if things go according to or better than plan. To a user concerned about expected future profits or the solvency of the insurer, it doesn’t matter what label is put on a margin.

Non-Life Insurance Contracts.

The accounting for non-life insurance contracts is separated into two distinct phases – a pre-claim and a post-claim phase. In the pre-claim phase, the liabilities for short-duration non-life insurance contracts are measured as the amount of the unearned premium reserve (“UPR”). The UPR contains an implicit composite margin that covers the anticipated uncertainty of the ultimate cash flows at contract inception. The UPR, including the implicit composite margin, is released as risk protection services are provided during the policy coverage period.

At the conclusion of the risk protection (i.e., coverage) period, non-life insurers have incurred claims outstanding that have not been reported or paid. As it relates to measuring non-life insurance contracts in the post-claim period, we have consistently expressed our opposition to the three building block approach, as we believe it would require the application of subjective judgments in developing probability distributions at a sufficiently granular level to use as inputs in the proposed statistical model that would be used to separately quantify a measure of uncertainty. Because the information described is not currently used to manage the business or for any other reason, it cannot be tested or validated sufficiently to ensure it would produce measurements that are reliable, verifiable, comparable, understandable, and decision-useful. In addition, we note the absence of a consensus within the global actuarial profession about what methods could or should be used, or if a statistical methodology were to replace the time tested existing methodology, how that method would be tested and its results validated.

In contrast to the IASB’s theoretically-based three building block proposal, we note that existing non-life post-claim reserves are determined by reference to actuarially determined best estimates. It is also important to note that actuarially determined best estimates implicitly incorporate a measure of uncertainty. More specifically, actuarially determined best estimates typically result from the application of historical development factors that incorporate actual historical realized variability as well as consideration of a range of possible reserve values determined using different actuarial techniques from which the actuarial best estimate is selected. Because the value selected as the best estimate is not biased to the low end of the range of estimates, we believe that post-claim reserves as currently determined through the use of actuarial best estimates includes an appropriate provision for uncertainty given the consideration of both historical realized variability as well as potential claim reserve outcomes applying multiple actuarial techniques.

In terms of remeasurement, it is useful to note that the existing non-life insurance model is updated each reporting period and claim reserves are remeasured each period and the positive or negative adjustment is immediately recognized in the operating statement.

Given the lack of global consensus on how the three building blocks could be implemented for non-life insurance post-claim liabilities, we believe it would be inappropriate for the proposed accounting standard to require changes in measurement and reporting of non-life insurance contracts in the post-claim phase that would be based on unproven theory. While actuarial methodologies and techniques may be developed and enhanced in the future to enable them to be used for such purposes, as Mr. Gutterman states in his paper, we believe that at least at present, there is no basis to change a globally recognized, well understood, and effectively functioning claim reserve measurement methodology.

We would be happy to provide you with additional information on measurement approaches for life and for non-life insurance contracts.

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