



April 13, 2010

Peter Windsor
International Association of Insurance Supervisors
c/o Bank for International Settlements
CH-4002 Basel
Switzerland

RE: Risk Adjustment

Dear Mr. Windsor:

The Group of North American Insurance Enterprises (GNAIE) appreciates the opportunity to comment on the important issues covered in your e-mail of April 1 (Subject: IAS 37 letter and questions on risk margin and acquisition costs). As we have stated on many previous occasions, GNAIE believes strongly that the key considerations for many of the issues that must be resolved in establishing a meaningful accounting standard for insurance contracts are different for life and non-life insurance contracts. Therefore, we are including attachments to this letter, which focus separately on life and non-life insurance. In this cover letter, we highlight a few critical points that we think are applicable to both life and non-life contracts.

GNAIE has consistently maintained that, while it is possible to calculate numbers that could be represented as risk margins for insurance contracts, we do not believe that those calculations result in decision-useful information.

There are a wide variety of methods that could potentially be used for such calculations, and the calculations are generally based on theoretical and/or non-observable assumptions. A principles-based standard that requires an explicit risk margin is likely to result in wide ranges of practices that are not comparable among entities. In fact, our expectation is that many users would remove them from the filed income statements in order to get a more comparable and useful presentation.

On the other hand, a rules-based standard is likely to result in numeric results that are not meaningful for many insurance enterprises or for users of financial information about such enterprises. We believe that most FASB members and many IASB members, after considering the agenda paper on Insurance Contracts Risk Adjustment (IASB agenda reference 6D, FASB agenda reference 41D) for the March joint Board meeting, now share this view.

While a majority (or plurality) of IASB members still favors a separate risk adjustment, we believe that the comments in your e-mail of April 1 correctly capture the current position of both Boards.

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Executive Chair

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Executive Director

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- The FASB tentatively decided that the measurement of an insurance contract should not include a separate risk adjustment. Instead, the measurement should include one single composite margin.
- The FASB position is also representative of a significant minority of IASB member's views. The vote for a single margin was 7-8 at the IASB, with one IASB member prepared to switch his vote if necessary to achieve convergence.

If required calculation of an explicit risk margin does not result in information that is decision-useful or comparable among entities, as we believe would be the case, the questions about the objective of risk adjustment become theoretical and not meaningful. In the attachments to this letter, we include specific comments with respect to life and non-life insurance contract measurement that will further clarify our thoughts on this matter. While we favor a composite margin approach for life insurance contracts, we believe that any explicit margin would not be decision-useful for non-life insurance contracts, given the nature of the liabilities that arise from such contracts.

When you provide comments to the IASB on risk adjustment, we suggest that it would also be appropriate to ask the Board to reflect on submissions it received on this subject in the field tests that it conducted in late 2009. We believe that the only publicly available information on results of those tests is the agenda paper from the February 18, 2010 joint Board meeting (IASB agenda reference 14F, FASB agenda reference 39F). Obviously, the Boards have access to more complete information. Based on the summary agenda paper, participating companies expressed a variety of different concerns about risk margins; but we think that the following are particularly noteworthy.

- Even those participants familiar with the calculation of a risk margin commented that modifications to models would be required and that it would result in significant computational costs and present an audit challenge.
- Some participants thought that the calculation of a risk margin using the cost of capital approach would be complex and time consuming. One questioned what the real cost of capital is and how volatility is assessed where experience is limited and the environment is changing.
- Two participants thought that splitting the margin into separate risk and residual margin components would be an arbitrary exercise that would not result in meaningful information.

We think that the exhibit on "acquisition costs and residual margin" that was attached to your e-mail of April 1 demonstrates important points about the potential for contracts that are expected to be profitable to appear unprofitable at inception as a result of unmatched treatment of revenue and expenses. We are concerned, however, that the presentation in the exhibit is based on a concept of residual margins, with which we do not agree and with which most FASB members and many IASB members do not agree, as noted above. To have the greatest effect on Board members, we therefore think it would be helpful to adjust this presentation to be more neutral on the issue of residual and composite margins.



Please let us know if you would like to discuss any of these points further with us, or if you would like us to provide you with more information.

Sincerely,

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

Kevin Spataro
Chairman, Accounting Convergence Committee
kk:wes

CC: Rob Esson
Rob Curtis

Life Insurance Appendix

Consistent with our long standing position, the Group of North American Insurance Enterprises (GNAIE) favors a composite margin in measurement of life insurance contract liabilities. The composite margin we favor is calibrated to result in no gain at inception of an insurance contract, and that margin runs off over the term (coverage period) of the contract. The coverage period for many of these contracts is very long. While the composite margin could be adjusted during the contract period to reflect new information, it generally will run off in an orderly pattern. Disclosures that accompany financial statements that contain significant liabilities that are valued on such a basis could include the amount of the composite margin that remains and the basis on which the entity establishes, evaluates, and runs off the margin. Alternatively, we would not object to showing the composite margin separately on the balance sheet if users find such a presentation to be more useful.

As indicated in the cover letter, we do not believe that requirements for a separately calculated risk margin would provide information about insurance liabilities that is decision-useful. We therefore do not think it would be productive to analyze what the objective of a calculated risk margin should be. Nevertheless, we attempt below to answer the questions on risk adjustment in your e-mail with respect to life insurance.

- 1) *(b) For those jurisdictions that believe that a composite margin is appropriate, they should approach the question of the risk margin from the point of view that if there is to be a separate risk margin, what would be the best objective for that risk margin.*

We advocate a contract fulfillment value objective for measuring insurance liabilities – i.e., the value an insurer must provide to fulfill its obligations over time according to the terms of an insurance contract. For life insurance, we believe that such value should be determined from the present value of all expected future cash flows, and should include a margin that is calibrated at issue to avoid a non-economic gain or loss at issue. We do not see value in segmenting that margin into separately quantified components (i.e., risk margin and residual margin components).

However, as defined in the question, if there is to be a separate risk margin, the objective would presumably be to quantify as many elements of risk as could be reasonably quantified. The risk elements could include the risks that are listed in the sub-points in the comments below in response to question 2). While possible methods have been identified for quantifying risk margins, the calculations would depend largely on speculative assumptions and could result in a wide range of answers, depending on the method and the assumptions chosen.

- 2) *For those jurisdictions proposing a composite margin, how would you characterize the objective of a composite margin? Would it be the objective for measurement of insurance contracts, being a fulfillment notion? A precise statement of the proposed objective would be helpful.*

The objective of the composite margin is to capture in the liability value all elements not included in the present value of expected cash flows. These elements could potentially include:

- Recognizing the risk of uncertain timing, and in some cases uncertain amount, of payment according to the terms of the contract.
- Recognizing the risk that the contract will persist better or worse than expected, or that the insured will live longer or shorter than expected.
- Recognizing financial risks (e.g., inflation, economic downturn).
- Recognizing technological risks (e.g., systems inadequacy, loss of information).
- Providing for use of other resources of the entity that are required for fulfillment of contract obligations, but that are not included in the expected cash flows.
- Providing for recognition of gains (release of the margin) as the insurer provides services according to the contract (i.e., as it provides coverage and is released from risk).

Life insurers typically take all these risks into account in establishing premiums for their products. By calibrating the composite margin at issue to avoid gain or loss, we are effectively incorporating the company's view of these risks into the composite margin.

- 3) *It would also be helpful for those jurisdictions advocating a composite margin calibrated to premium to detail how they would ensure adequacy of the liabilities so measured in cases where insurers under-price the risks. Detailing the objective for this liability adequacy test and how that would differ from the objective for a risk margin would be helpful.*

At inception and at any other time, the liability for a life insurance contract must at least be equal to the present value of the expected cash flows under the contract. Therefore, since we advocate a current measurement of future cash flows at all times, a liability adequacy test is not needed – the liability is always at least adequate to meet future cash flows on a best estimate basis. It is possible that a regulator might require a margin on top of the best estimate of the present value of future expected cash flows; but we think that such a requirement would be largely arbitrary. If an insurer under-prices its obligations, the loss at issue would then flow immediately to the income statement through the increase in the liability value. Entities should disclose the amount of the composite margin and the basis on which it establishes, evaluates, and runs off that margin as part of their MD&A.

Non-life Insurance Appendix

By way of background, roughly \$600¹ billion of aggregate premiums were earned in the U.S. by life and non-life insurance companies in the year ended December 31, 2008, on a combined basis. Approximately \$450 billion (or 75% of the \$600 billion total) relates to non-life business, 50% of which is attributable to auto and homeowners insurance and another 27% is attributable to other short-tail² lines of business.

Consistent with our long standing position, GNAIE's Non-Life Insurers ("NLIs") do not support the introduction of explicit risk margins ("ERMs") to the measurement model for non-life insurance contracts ("NLICs").

As a general principle, GNAIE believes life insurance contracts and NLICs are sufficiently different so as to warrant separate accounting models. The measurement objective we propose for NLICs is contract fulfillment value ("CFV"). The primary attributes of CFV for NLICs are as follows:

Pre-claims Period – Unearned Premium Reserve

(a) Unearned premium reserve ("UPR") for short-duration contracts in pre-claim period

GNAIE's NLIs consider NLICs executory service contracts to provide risk protection to policyholders over a predetermined coverage period. Because NLICs are executory in nature and no insurance protection services are provided at inception, there is no gain recognizable at inception. We believe all premium revenue should be earned and all anticipated expenses and costs recognized over the coverage period to provide an appropriate matching of revenues and expenses. UPR is evaluated for adequacy at each reporting date (or "at the end of each reporting period").

Activities between the insured and insurer after the coverage period typically involve the insurer determining it has fulfilled its obligations under the contract, and not the extension of additional risk protection or other services to the customer. Because risk protection is only provided during the coverage period for NLICs, we do not support any model that defers expected profit over a period longer than the period over which risk protection services are provided.

As UPR is released, incurred claims (reported and not reported), claim expenses, and operating expenses are recognized; the net of which is commonly described as ***underwriting income (loss)*** – the key performance metric for NLIs. Net investment income and income taxes are added to underwriting results to produce net income. The periodic development of underwriting income (loss) is the mechanism through which margins implicit in UPR emerge in a NLI's financial statements.

Post-claims Period – Estimated Gross Ultimate Losses (Not Four Building Blocks)

¹ Industry statistics obtained from Best's Aggregates and the American Council of Life Insurers

² Short-tail is defined for purposes of this response as those insurance contracts that have a coverage period of one year or less and for which at least 80% of total incurred claims are settled within three years (i.e., 36 months) following the year of loss. Long-tail defined as 80% of total incurred claims settling beyond 36 months.

(a) Use of actuarial best estimates as opposed to probability weighted cash flows (“PWCFs”)

Best estimate refers to a number of different actuarial methodologies used to create reserve development factors that are applied to very granular reserve data to estimate the ultimate cost of incurred claims. For automobile claims, development factors are determined by line of business, coverage, state, etc. Over time, development factors incorporate the effect of actual experience as it emerges.

GNAIE does not support the use of PWCFs due to the nature of post-claim liabilities associated with NLICs (i.e., the infinite range of potential settlement outcomes when claims are initially reported as well as when they are incurred but not reported). We believe it is wholly impractical to require the use of PWCFs which require construction of the range of all possible future settlement amounts together with an assignment of probability weights to each possible future settlement amount. GNAIE notes it is typically not possible to reliably predict the probabilities associated with the entire range of possible settlement scenarios (which is infinite). Moreover, any probabilities assigned cannot be fully tested with sufficient data before the environment changes enough to make the past data irrelevant to estimating the current risk.

(b) Discounting

GNAIE does not support discounting claim reserves (except where the timing and amount of claims is reliably determinable on an individual claim basis – consistent with SEC Staff Accounting Bulletin No. 62) for either short-tail contracts, as the effect of discounting is insignificant, or long-tail NLICs where the timing and amount of cash flows allocable to individual time periods is typically not reliably determinable.

(c) Explicit Risk & Residual Margins or Composite Margin

Because the building block proposal is largely statistical in nature the ability to quantify a relevant and reliable ERM is dependent upon the ability to reliably develop PWCF’s (together with associated distributions and probabilities) which we do not believe is possible for NLICs.

In addition to mathematically measuring the variance and skew (which together form the basis of a risk margin) from a given probability distribution, there are some who believe an ERM can be reliably determined using a cost of capital (“CoC”) approach. We believe ERMs developed using a CoC approach would not produce decision-useful information since neither capital requirements or the CoC are consistent within or across implementing jurisdictions. Accordingly, as individual insurers hold different levels of capital (both regulatory minimum and excess) and experience different costs of capital, ERMs determined on a CoC basis are not comparable and not necessarily related to the risk inherent in NLICs.

As a result of the preceding, the GNAIE NLI do not support ERMs in the measurement of short or long-tail claim reserves for NLICs. In both cases we note the absence of a global consensus on a preferred method of determining ERMs at inception or their periodic re-measurement nor is there any objective evidence that ERMs can be implemented and subsequently administered in a manner that produces comparable, understandable, transparent information for investors, regulators or other users. In addition, the introduction of ERM's inappropriately suggests to investors a level of precision in predicting uncertain future events (presumably through the use of financial modeling) which is simply not the case.

In contrast to the IASB proposal, the GNAIE NLI support the use of a simple measurement and reporting model that has been in use for decades for both short-duration, short-tail and short-duration, long-tail NLICs. While we support discounting in situations where the timing and amount of cash flows are reliably determinable on an individual claim basis (e.g., Worker's Compensation), for most short and long-tail lines of business this is not the case. As it relates to ERMs, we believe their introduction would not provide relevant, decision-useful information to investors due to the nature of the underlying risk, which is not reliably measurable on an ex-ante basis, and the inputs that would be necessary to develop relevant, reliable, comparable risk margins simply do not exist.

The benefit of the GNAIE proposal is its long history of producing reliable, transparent information that is both easy to understand, capable of being verified/audited, and is consistent with the rich historical information provided on Statutory Schedule P, which serves as an independent source to verify the reasonableness of claim reserves.

In contrast, either a four building blocks model (with separate risk and residual margins) or a three building blocks model (with a composite margin) has no history to substantiate its ability to produce information for investors, regulators and others that is reliable, verifiable, comparable, relevant and decision-useful.

As indicated in the cover letter, we do not believe the requirements for a separately calculated risk margin would provide information about insurance liabilities that is decision-useful. We therefore do not think it would be productive to analyze what the objective of a calculated risk margin should be. Nevertheless, we attempt below to answer the questions on risk adjustment in your e-mail with respect to NLICs.

- 1) (b) *For those jurisdictions that believe that a composite margin is appropriate, they should approach the question of the risk margin from the point of view that if there is to be a separate risk margin, what would be the best objective for that risk margin.*

We advocate a CFV objective for measuring NLICs – i.e., the cost to an insurer of fulfilling its obligations over time according to the terms of an insurance contract. For NLICs, we believe that amount should be determined as the estimated gross cost of settling the claim and should not include a separate risk or profit margin. In contrast, the total composite margin implicit in a NLIC is included in the UPR and

earned/recognized over the period risk protection services are provided to the policyholder. While we see no value in segmenting that margin into separately quantified components (including a risk margin component), if an ERM were required, its objective would presumably be to quantify the risk inherent in the estimation of claim and claim expense reserves. That said, we believe ERMs inappropriately suggest to investors a level of precision in predicting uncertain future events (presumably through the use of financial modeling) which is not the case.

- 2) *For those jurisdictions proposing a composite margin, how would you characterize the objective of a composite margin? Would it be the objective for measurement of insurance contracts, being a fulfillment notion? A precise statement of the proposed objective would be helpful.*

The GNAIE NLI's do not advocate the identification of a separate composite margin but rather note that the entire margin associated with NLICs is implicit in UPR. UPR is then earned in its entirety over the coverage period (i.e., no deferral of any components of UPR) and claim and claim expense reserves are concurrently established as claims are incurred at their gross undiscounted values. Prospectively, claim and claim expense reserves are evaluated on a quarterly basis and all adjustments (positive and negative) are immediately reflected in profit or loss.

The types of risks that are initially evaluated and continuously re-evaluated through the use of a variety of actuarial techniques and judgment include the following:

- Amount of incurred losses;
- Claim and claim expense inflation, etc.

- 3) *It would also be helpful for those jurisdictions advocating a composite margin calibrated to premium to detail how they would ensure adequacy of the liabilities so measured in cases where insurers under-price the risks. Detailing the objective for this liability adequacy test and how that would differ from the objective for a risk margin would be helpful.*

At inception and at each succeeding reporting period, UPR and claim and claim expense reserves are evaluated [together with the amount of unamortized deferred acquisition costs (“DAC”)] against the gross amount of expected cash outflows under the NLICs. In situations where anticipated cash outflows exceed the combination of reserves and unamortized DAC, the deficiency is recognized as a reduction of DAC until such time as DAC is reduced to zero and any remaining deficiency is recognized through an increase in claim and claim expense reserves.