



<b>Date:</b>	April 19, 2010
<b>To:</b>	Rob Esson, Julie Gann, Dan Daveline, NAIC
<b>From:</b>	Kevin Spataro, Chair, GNAIE Accounting Convergence Committee
<b>Subj:</b>	Response to NAIC IASWG questions

There are a number of follow up items as a result of last week's meeting of the International Accounting Standards Working Group, and in preparation for the forthcoming interim meeting on April 29 & 30 in New York.

### 1. Extended exposure of IAS37:

At the National Meeting it was reported that the comment deadline for the Exposure Draft of IAS37 had been extended to May 19. Concern has been expressed that the scope of the working draft (which is not officially the exposure, per se) will cause problems. The attached IAIS letter has not addressed this issue as yet. Comments on the exposure draft, and any other matters related to the working draft are encouraged from Working Group members and interested parties. Please supply your comments by April 19 to NAIC staff, in preparation for the interim meeting on April 29 & 30.

#### **GNAIE Response:**

We have a number of significant concerns with the Exposure Draft, *Measurement of Liabilities in IAS 37* ("IAS 37 or ED") summarized as follows:

- The scope of the ED which is limited to measurement is inappropriate given that it has been approximately five years since the original proposal was disseminated. During that time, developments have emerged as the result of other standard setting activities that require a full reconsideration of all elements of IAS 37.
- Eliminating the probability criterion in recognizing liabilities will not produce more reliable estimates of anticipated future cash outflows and therefore the resulting measurements will not be decision useful. In situations where liability outcomes are not associated with a normal distribution and cannot be reliably estimated using statistical techniques the potential outcomes should be disclosed until such time as the amount of the cash outflow is probable and capable of reliable estimation.
- The introduction of profit margins in the measurement of liabilities that a reporting entity intends to settle with internal resources is inappropriate. While we understand that choices (such as settling a liability with internal resources, transferring it to a third party, or exiting it by other means) necessarily involves a range of opportunity costs, those potential costs should not affect the measurement of the liability. In contrast, the measurement should only reflect the manner in which the reporting entity intends to settle the liability. Where settlement with internal resources will occur, no profit margin should be incorporated as that would not reflect an actual cash outflow but rather a subjective hypothetical value related to the opportunity cost of settling the liability with internal resources.

Jerry M. de St. Paer  
Executive Chair

Douglas Wm. Barnert  
Executive Director

**Group of North American Insurance Enterprises**  
40 Exchange Place, Suite 1707  
New York, NY 10005  
UNITED STATES

++1-212-480-0808  
info@гнаie.net  
www.гнаie.net

- Estimating the probability weighted average of the present values of outflows for all possible outcomes, as required by the ED, is not possible for most liabilities. For example, for litigation related liabilities it is not possible to either identify all possible outcomes or to probability weight them with either the use of internal resources or external experts.
- The requirement to add explicit risk factors in the measurement of liabilities would not produce reliable, comparable, decision useful information.
- We do not support the discounting of estimated cash outflows in the measurement of liabilities except in circumstances where the timing and amount of cash outflows are reliably determinable for discrete liabilities.

**2. Exposure draft of Financial Assets: Amortised Cost and Impairment: The next meeting of the IASB's Expert Advisory Panel will be on April 26 & 27 in London.**

As mentioned at the meeting, Rob Esson represents the insurance sector prudential supervisors as an official IAIS observer at this panel. He would welcome input and suggestions from Working Group members and interested parties on the practicality of the proposals, together with comments on the Panel's further work on an issue regarding "open" and "closed" books of business, refining the definition of an expected loss, and refining the balance sheet implications of the measurement of expected losses on financial assets. There will also be an investigation as to whether so-called decoupling of the expected loss method and the effective interest rate may yield a less complex result. Please supply your comments direct to Rob Esson, preferably by April 19.

**GNAIE Response:**

We have a number of concerns with the IASB's Exposure Draft, *Impairment of Financial Assets at Amortized Cost* ("Impairment ED") summarized as follows:

- The Financial Crisis Advisory Group identified delayed recognition of loan losses as a primary weakness in accounting standards and recommended the IASB and FASB identify alternatives to estimate and recognize losses using forward looking information.
- The IASB issued its Impairment ED in November 2009 which includes an expected loss model ("ELM").
- Under the ELM interest income on loans is computed based on expected cash flows that are net of expected credit losses. The difference between interest income computed based on contractual cash flows and expected cash flows net of impairments is recognized in an allowance for loan losses.
- Changes attributable to actual losses being different from expected losses and changing estimates of future expected losses are recognized in income in the period of change.
- We do not support the proposed methodology in the Impairment ED on the basis of the following:
  - The recognition of interest income and the recognition of loan impairment should be separate processes; and
  - Impairment should be attributable to either past events or current conditions and should not incorporate future events unless the possibility of occurrence meets the probable threshold.

**3. IAIS Draft ICP 14: Valuation for Solvency Purposes:**

ICP14 and its related standard are open for comment until April 30 at the IAIS. In order to provide input from the NAIC, this issue will be discussed at the forthcoming interim meeting on April 28 & 29. Please supply your comments by April 19 to NAIC staff, in preparation for the interim meeting.

#### 4. Margining: discussion of NAIC staff draft, and comments:

At the National Meeting, the March 10 staff draft suggestion on margins was discussed together with some clarifications, and some industry comments. Further comment and, in particular, suggestions for alternative methodologies are requested from Working Group members and interested parties. In particular, such suggestions should be predicated upon two assumptions: firstly, that the Boards will likely retain their current view that the attribute for insurance contract measurement should include an adjustment for the time value of money (i.e. claims will be discounted), and secondly that the Boards will retain their current tentative view that a single measurement methodology should be utilized for all insurance contracts (i.e. life, P&C, and health)

##### **GNAIE Non-Life Response:**

By way of background, roughly \$600<sup>1</sup> billion of aggregate premiums were earned 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-tail<sup>2</sup> lines of business.

We believe two inappropriate assumptions are presented as the foundation of this question:

- (a) That the IASB will retain its current view, and persuade the FASB which has yet to resolve this issue for short-duration non-life insurance contracts (“NLICs”), that measurement of insurance contracts should include an adjustment for the time value of money; and
- (b) That the IASB will retain its current tentative view, and persuade the FASB which has yet to resolve this issue for short-duration NLICs, that a single measurement methodology should be used for all insurance contracts (i.e., both life and non-life).

As it relates to the above assumptions we believe that it is wholly inappropriate to apply the same measurement methodology to both life insurance contracts (“LICs”) and NLICs as they possess unique attributes e.g., coverage period, covered interests, contract construction) and address fundamentally different risks. More specifically:

##### ***NLIC’s (Short-duration contracts)***

- ❖ Coverage period typically 12 months or less;
- ❖ Individual contracts may or may not incur a loss and loss amount, if any, varies;
- ❖ Underwriting risk based on coverage levels, geographic location, policyholder behavior, weather patterns, etc.;
- ❖ For auto and homeowners business (which comprises approximately 50% of total annual non-life earned premiums) within 24 months of the year of loss almost all property and auto physical damage claims and almost 84% of auto related medical claims are settled;
- ❖ Exposure to US litigation environment (i.e., expanding theories of legal liability); cannot be modeled (same issue as encountered in discussions on FASB Statement No. 5, Accounting for Contingencies)

##### ***LIC’s (Long-duration contracts)***

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<sup>1</sup> Industry statistics obtained from Best’s Aggregates and the American Council of Life Insurers

<sup>2</sup> 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. In contrast, long-tail incurred claims would settle beyond 36 months.

- ❖ Coverage period typically greater than one year;
- ❖ LIC's either lapse, expire, or a loss occurs upon death of policyholder;
- ❖ Underwriting risks based on demographics, health, and lifestyle of policyholder; mortality tables exist to model the impact of this risk

GNAIE's measurement proposal considers NLICs service contracts (the service provided is insurance protection). NLICs are executory in nature (i.e., premiums are fully refundable throughout coverage period for any reason) and as such no insurance protection services are provided at inception and there is no gain recognizable at inception. UPR is evaluated for adequacy at each reporting period.

The IASB's requirement that UPR be applied to the pre-claim liabilities for short-duration insurance contracts that meet certain conditions typically associated with NLICs and not LICs is an indication that a single model is not an optimal outcome.

The nature and operation of NLICs are fundamentally different from LICs and as such we do not believe the measurement and financial reporting proposals developed primarily for LICs should be applied to NLICs. In our view the existence today of a globally consistent model for NLICs that is simple, transparent, comparable, and well understood by financial statement users should outweigh any perceived benefits from applying the same model to both NLICs and LICs if simplicity, transparency, comparability and understandability are impaired.

The underlying rationale for GNAIE's long-standing proposal on the measurement of NLICs is that insurance is a service contract with a customer to provide risk protection over the coverage period. All premium revenue is earned and all anticipated expenses and costs recognized over the coverage period to provide an appropriate matching of revenues and expenses.

Activities between the insured and insurer after the coverage period typically involve the insurer determining that 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, profit should be recognized over the coverage period and not over a period longer than the period risk protection services are provided.

GNAIE does not support discounting claim reserves (except in situations 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 not reliably determinable.

We view the IASB's four building block proposal as largely statistical in nature and as such the ability to quantify a relevant and reliable explicit risk margin ("ERM") is dependent upon the ability to reliably develop probability weighted cash flows ("PWCFs") 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) some believe ERMs can be reliably determined using a cost of capital ("CoC") approach. We believe ERMs developed using a CoC approach do not produce decision-useful information as 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, GNAIE does 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, GNAIE supports 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. 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.

#### **5. Other IASB/FASB issues:**

At the National Meeting, the Working Group asked that a summary of major decisions be prepared so that discussion of NAIC positions can take place before the Exposure Draft is published. Attached is a table based on the IASB/FASB staff's memoranda and expanded to update it for the decisions at the March joint Board meetings and for known and prior IAIS and NAIC positions. Comments from Working Group members and interested parties are encouraged. Please supply your comments by April 19 to NAIC staff, in preparation for the interim meeting. Discussion and testimony will be taken at the interim meeting on these issues on the basis of the written comments.

This will leave the rest of the time for discussion of the Insurance Contracts issues. Given the pre-existing commonality of views in many areas with the IAIS, there are only two areas that I believe need extensive discussion at this stage: margins, and discount rate. The bulk of the meeting will be spent discussing these items.