



September 15, 2008

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Re: Insurance Contracts – Clarification of GNAIE Positions

Dear Peter and Hans:

We read with great interest the Agenda Papers that have been posted for the Board's meeting next week. We look forward to the Board's discussion of insurance contracts and to further discussion at the Insurance Working Group meeting in November. We believe that Agenda Paper 14A (on Fulfillment value) correctly captures most key elements of GNAIE's positions; but we are concerned that there may be some misunderstanding of certain components. We hope the attached two papers (one focusing on life insurance and the other on non-life insurance) will help to clarify these points.

For both life and non-life insurance, we refer to a single, composite margin that we do not think of particularly as a "risk", "service", or any other specific type of margin. We support releasing this composite margin as the insurer is released from risk, which in most cases is likely to correspond to the pattern established at the time the contract is issued. We do not advocate using margins as a shock absorber to offset emerging favorable or unfavorable experience; and we provide numerical examples to illustrate this point in the attached paper on life insurance. For life insurance, if information emerges that is significantly different than expectations at issue (e.g., with respect to variability of cash flows), it may be appropriate to change the pattern of margin release to reflect such new information.

For non-life insurance, our position is that the composite margin at issue should be released over the coverage period (which is consistent with our position for life insurance). This margin is therefore included in the "pre-claim" liabilities. For most non-life insurance contracts, the insurer continues to have significant obligations to fulfill following the end of the coverage period; and these obligations are reflected in the claim liabilities. While our non-life insurance proposals do not include risk margins or discounting, it is important to note that the undiscounted anticipated costs of claims and claims expenses are continually analyzed to insure that the carrying value of the non-life claims and claims expense

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reserves represents a current estimate of the ultimate cash flows necessary to satisfy the performance obligations inherent in related insurance contracts.

For both life and non-life insurance, our position on margins appears to be very consistent with the view of margins reflected in the Revenue Recognition project, including Agenda Paper 10. One difference is that recommendations in that Agenda Paper appear to provide for locking the margin component at contract inception, while we provide the possibility of unlocking margins for life insurance, as noted above. Our recommendations also clearly provide for updating estimates of future cash flows at each reporting date.

We also note in the attached paper on life insurance that similar results could be achieved with margins based on the premium (customer consideration) or based on the cost of capital. In this regard, it is important to note that our concept of the cost of capital is different from that proposed by the CRO Forum, since we are requiring that the assumptions be calibrated to the actual premium at the outset. We prefer the customer consideration approach, which is based on an observable market transaction and it ties better to the direction of the Revenue Recognition project. We understand that insurance contracts may be outside the scope of the Revenue Recognition project; but we think that it would be desirable to reach consistent conclusions with respect to margins in both the Revenue Recognition and the Insurance Contracts project, unless there are compelling reasons to be inconsistent. As far as we are aware, a cost of capital type of approach is not being considered in the Revenue Recognition project.

In addition to our comments on margins, we also have one serious concern about the direction of the Revenue Recognition project (as described in Agenda Paper 10). We may be misinterpreting the intent of paragraphs 54 through 56 (on pages 15 and 16) of that Paper; but we are extremely concerned that the intent may be to apply different measurement approaches to performance obligations in a single insurance contract. We have consistently expressed our fundamental objection to bifurcation of insurance contracts, which we believe is highly likely to result in information that is not reliable or decision-useful.

We appreciate opportunities to provide our views to you, to the Board, and to the Insurance Working Group. We would be pleased to expand on the comments in this letter and in the attachments, and to provide other information that you, the Board, or the Insurance Working Group might find useful.

Sincerely,

A handwritten signature in black ink, appearing to read "Jerry A. St. Peter".

Executive Chairman

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“Risk” Margins for Non-Life Insurance

Margins in GNAIE’s Non-life Contract Fulfillment Value (“NL-CFV”) Model

Paragraph 42 of Agenda Paper 14A identifies key elements a description of fulfillment value should include if it is to be a viable measurement attribute candidate:

- **Price or Value** – NL-CFV is described as a **value**
- **Past, Present, or Future** – NL-CFV represents a **present estimate** of the ultimate cash flows necessary to satisfy the performance obligations inherent in insurance contracts. IASB Staff proposes changing the word “contract” to “current” to signify the measure includes the time value of money. GNAIE believes the modifier “contract” should be retained as it can be used to describe both a discounted and undiscounted measure (See Discounting and Risk Margins).
- **What** – This identifies what we are attempting to measure; i.e., the value assigned to working out the contract with the policyholder over time

After considering the “key elements”, IASB Staff described the measurement attribute as “**current fulfillment value**” which they define in paragraph 44 as “***the expected present value of the cost of fulfilling the obligation to the policyholder over time***”. In paragraph 45, IASB Staff acknowledges that respondents had differing views on margins and day one profits. The differing views related to non-life insurance contracts, as described by GNAIE, are as follows:

- **Approach A** – The cost of bearing risk is presented as an explicit risk margin separate from the value of the insurance contract
- **Approach B** – Contrary to the interpretations of NL-CFV expressed by IASB Staff in Paragraphs 45(b) and 47(b) of Agenda Paper 14A, GNAIE feels Approach B *does* include the cost of bearing risk as part of a composite margin (“CM”) residing in the Unearned Premium Reserve (“UPR”) during the contract period, which is earned over the period risk protection services are provided. Additionally, in contrast to the views expressed in Paragraph 45(b), GNAIE feels that the inherent CM *is* a critical attribute of any insurance liability measurement, and its consideration as such attribute should not be dismissed merely because it is not *presented* separately.

IASB Staff suggests that including the margin in the contract liability (i.e., UPR) does not flow naturally from the proposed definition of current fulfillment value. GNAIE, however, believes that for non-life insurance contracts it is important to consider two distinct contract phases (i.e., the pre-claims and the post-claims phases).

- In the pre-claims phase, UPR including a CM, is the most relevant and representationally faithful measurement of the insurer’s obligation under the contract as it represents the amount received from the policyholder in an arm’s length transaction for future risk protection services. GNAIE does not believe it appropriate to bifurcate UPR into separate cost and profit components before any risk protection services are provided as sufficient certainty does not exist to complete the bifurcation and allow the result to be reliable. In addition, the GNAIE model accounts for contract cancellations by the policyholder during the contractual coverage period, whereby any unearned premium is required to be returned to the policyholder.
- In the post-claims phase, risk protection services are provided and claims and claim expenses are incurred, even if not fully developed, and this information provides the objective, auditable, and verifiable data to support both the recognition of the composite margins embedded in the UPR, as further described below.

Non-Life Insurance

Description and Discussion of Composite Margins

GNAIE’s NL-CFV model includes a CM in UPR representing the total compensation for risk, servicing, and profit. The NL-CFV model does not present the risk, servicing, and profit components separately as that is not the way the contracts are priced or otherwise evaluated for performance. Moreover, we believe the subjectivity that would be necessary to compute the distinct measures would render them unreliable and non-comparable between insurers. The CM is included in the UPR or pre-claims liability at inception which is consistent with GNAIE’s “no gain at inception” position as well as the importance given to the premium at inception (which results from an arm’s-length exchange transaction).

In applying GNAIE’s NL-CFV proposal, UPR is recognized as earned premium as risk protection services are provided; typically pro-rata over the contract coverage period, as the insurer is “released from risk”. Quantitatively, on Day one, the CM can be calculated as 1 minus the sum of the expected combined ratio (loss ratio and expense ratio – both as further defined below), a measure that is frequently publicly disseminated. Qualitatively, the CM can be described as the expected underwriting income at contract inception, calculated as the difference between premiums earned from providing risk protection services and the sum of incurred claims (both reported and not reported), claim expenses, and other expenses.

At Inception or “Day One” Considerations

At inception, as the insurer has not yet provided any risk protection services, no portion of the UPR is recognized or otherwise earned. At the same time, GNAIE’s CFV model requires a continuous evaluation of the adequacy of recorded reserves (including UPR) and if experience or other facts and circumstances indicate a UPR or claim reserve deficiency, a loss is recognized immediately.

Consistency with Customer Consideration Approach

Under a customer consideration approach, UPR would be allocated to identified performance obligations to produce no gain at issue. The CM at issue is the difference between the UPR and the anticipated combined ratio. The CM runs off proportionate to the run off of the obligations to provide risk protection services over the term of the contract, what we call “release from risk”.

Day Two Considerations

On day two and thereafter, consistent with how risk protection services are provided over the term of the contract, UPR (including the CM) is recognized as earned premium (the denominator of the “combined ratio”), while the insurer simultaneously recognizes a corresponding post-claims liability for the expected value of future cash outflows to be incurred as a result of providing those risk protection service under the boundaries of the contract. The anticipated cash outflows include incurred claims (including both reported claims as well as those that have been incurred but not yet reported – or “IBNR”), incurred claim expenses (together with incurred claims represent the numerator of the “loss ratio”), all other “incurred” expenses (the numerator of the “expense ratio”), and development of reserves for prior accident years. For each reporting period, earned premium less incurred claims, claim expenses, and other expenses represents the underwriting result for the period.

Non-Life Insurance

Upon expiration of the contractual term of the insurance contract, no additional risk protection services are provided, however, there may be claim settlement activities that continue. In these situations, it is possible the final settlement of outstanding claims at the expiration of the contract protection period may prove to be either deficient or redundant. In the event claim and claim expense reserves are determined to be deficient, reserve strengthening must be recognized concurrent with the deficiency determination. Similarly, in the event claim and claim expense reserves are determined to be redundant, the redundant portion of the reserves is recognized as a reduction of reserves concurrent with the redundancy determination.

In this manner, post-claims liabilities are re-measured in response to the occurrence of unanticipated events that cause changes in expected ultimate cash flows. Reserve re-measurements that occur after the expiration of the insurance coverage period do not impact the CM included in the pre-claims liability, which is calibrated to premium cash flows at contract inception. This is consistent with the fact that the unanticipated events and/or circumstances leading to the reserve re-measurements would not have been known at contract inception. Regardless, disclosure of policy year performance data fully reflects all experience from inception through a particular reporting date.

GNAIE notes that the periodic underwriting result is typically the principal measure used to assess the performance of the business both internally and externally and incentive management.

Discounting and Risk Margins

In terms of discounting and risk margins, GNAIE's NL-CFV proposal can be summarized as follows:

Discounting

- Non-life/Short-tail
 - UPR – unnecessary to discount
 - Claims – not reliable or cost beneficial to discount
- Non-life/Long-tail
 - UPR – unnecessary to discount
 - Claims – timing of cash flows typically not reliably determinable

Risk Margins

- CM's included in UPR as described above

Financial Statement Presentation

In terms of financial statement presentation, GNAIE's NL-CFV proposal is as follows:

We believe premiums received on short-tail and long-tail non-life insurance contracts (which may include auto and homeowners policies, general liability, workers compensation, medical malpractice, surety, etc.) should all be classified as UPR on the balance sheet at inception and then recognized as earned premium in the income statement over the period that risk protection services are provided.

“Risk” Margins for Life Insurance

This note is in response to IASB Staff’s request to explain what a risk margin is under GNAIE’s principles. There are several ways to think about this issue, not all of which are directly responsive to the Staff’s request but which do, to some extent, reflect our thinking and the realities of the market. All these comments are specific to the life insurance business, since GNAIE does not espouse a specific risk margin for non-life insurance business.

Description 1: “Customer Consideration” Approach

Under a customer consideration approach, the premium for the policy is allocated to particular reporting periods proportionate to cost of the remaining obligations. Those costs are adjusted so that at issue they equal the value of the revenue (premium) to be received. The margin at issue is therefore the difference between the value of revenue for the product and the cost of the remaining obligations. This margin then runs off proportionate to the run off of future obligations and premiums, what we call “release from risk”.

It’s important to note that while the basic best estimate may be subject to re-measurement as often as desired, the margin will follow the value of future obligations and premiums. For this reason, a true “unlocking” of this risk margin is unlikely to happen; although the pattern of the run off will undoubtedly change over time.

Description 2: “Cost of Capital” Approach

When life insurers price a product, one typical approach is to set the premium to generate a particular return on economic capital. In this approach, the margin represents the cost of capital using economic capital and the company’s goal for return on economic capital. Under this approach, once again there is no gain at issue. If a gain at issue emerges, it means that either less than the economic capital is being used than was used in pricing the product or a lower required return on capital is being used. After the first year, the same cost of capital can be used assuming that the capital appropriately recognizes the remaining risk in the policy. Once again, this can be viewed as a release from risk approach.

An important consideration in our thinking is that no two companies’ risks are the same. While two companies may issue what look like identical products (e.g. a one-year auto policies or a 10 year term life policy), in fact the risks and required profits on them will be different. The risks will be different depending on the company’s underwriting, marketing and risk management profiles. Profits will differ depending on many factors, including the company’s appetite for taking risks, positive and negative effects and correlation with other business the company writes, and the company’s access to capital. For these reasons, we believe that any insurance standard must not specify how to specifically calculate a risk margin but, in fact, should simply require no gain at issue and run off of the margin based on the release from risk for the specific company.

Either of these descriptions fits the contract fulfillment value. In fact, the “customer consideration” method may even fit the unearned premium approach for non-life insurance.

Numerical Illustrations

While we believe that valuation of cash flows and margins for life insurance should reflect the time value of money, we don’t explicitly consider discounting in the following examples in order to keep the examples simple and to focus on key points regarding margins and release of margins.

Assume the policy term is ten years; and that at the time the policy is issued, the best estimate of the present value of the premiums is \$110, the best estimate of the present value of the liability is \$100, and the margin at issue is \$10 (no gain at issue). For the customer consideration approach, assume that the projected pattern at issue is to recognize premiums of \$11 in each year and to release \$10 of the liability and \$1 of margin in each year. Assume that the pattern emerges as expected for 3 years; but at the end of year 3, the best estimate of the present value of the remaining liability is reduced to \$56 (\$8 for each of the remaining 7 years). Unless there's a particular identifiable reason to change the margin pattern, the remaining margin is still \$7, and would continue to be released at the rate of \$1 per year. It's possible (but probably not likely) that there could be a reason to change the level and pattern of margin release. For example, there may have been a change that materially reduced the expected variability in mortality as well as reducing the absolute mortality rates, and the reduction in variability could lead to an earlier release of some of the remaining margin.

For the cost of capital approach, assume the patterns in the preceding example; and assume in addition that 10 units of capital are needed each year and that the cost of capital is 10% per year. These assumptions would also lead to a \$1 margin release each year. If there's no change in the amount of capital required or in the cost of capital for the first 3 years, the margin released in the cost of capital approach would also be \$1 in each of the first 3 years. Note that the CRO Forum recommends reassessing the cost of capital rate every 3-5 years. If that rate is reassessed at the end of year 3 and is changed from 10% to 12% per year, and nothing else changes, the margin required for year 4 would be \$1.20; and the margin expected for each subsequent year would also be \$1.20.