



April 27, 2010

Mr. Robert Herz, Chairman  
Financial Accounting Standards Board

*Sent via email*

Sir David Tweedie, Chairman  
International Accounting Standards Board

Dear Sir David and Mr. Herz:

We are writing today to provide input to the boards in advance of your decision on which approach to margins will be used in the IFRS 4 phase II Exposure Draft. In this letter, we provide additional comments for consideration in your May 4 meeting with respect to non-life insurance contract liabilities.

Approximately \$600<sup>1</sup> billion of aggregate premiums were earned in the U.S. by life and non-life insurance companies on a combined basis in the year ended December 31, 2008. 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.

The nature and operation of non-life insurance contracts (“NLICs”) are fundamentally different from life insurance contracts<sup>3</sup> (“LICs”) and as such we do not believe the measurement and financial reporting proposals developed primarily for LICs to address persistent global measurement and reporting inconsistencies should be applied to NLICs which have not been plagued by the same issues. In contrast, the existence today of a globally consistent model for NLICs that is simple, transparent, comparable, and well understood by investors, regulators, and other financial statement users across the globe outweighs any perceived benefit of applying the same model to both NLICs and LICs, especially where application of a life insurance centric model would likely impair the

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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. Long-tail defined as 80% of total incurred claims settling *beyond* 36 months.

<sup>3</sup> 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, etc.;
- ❖ For auto and homeowners business (approximately 50% of total annual non-life earned premiums) within 24 months of the year of loss nearly all property and auto physical damage claims and 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)

- ❖ 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 insured; mortality tables model impact of this risk

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key attributes of simplicity, transparency, comparability and understandability that are present in the existing NLIC measurement model.

In contrast to the IASB's Four Building Blocks ("Building Blocks") 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 basic components of GNAIE's contract fulfillment value ("CFV")<sup>4</sup> measurement proposal for NLIC's are a UPR that is earned on a pro-rata basis over the coverage period<sup>5</sup> and as UPR is earned, incurred claims (reported and not reported) are recognized on a gross undiscounted basis together with claim expenses. GNAIE's CFV proposal as applied to short-duration, short-tail NLICs, which includes auto and homeowners contracts that together account for approximately 50% of all US premiums earned for NLICs, excludes the impact of both risk margins and discounting; information that is not considered decision-useful given the very short coverage and claim resolution periods for those products (see footnote 3 for claim settlement statistics). Similarly, discounting and explicit risk margins ("ERMs") are also not decision useful for short duration, long-tail NLICs due to the lack of reliable estimates of the timing and amount of cash outflows and the lack of a globally consistent method for estimating and remeasuring ERMs on a continuous basis.

The primary attributes of CFV for NLICs are as follows:

#### **I. Pre-claims Period – Unearned Premium Reserve**

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

NLICs are executory contracts that 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, no gain is recognizable at inception. All premium revenue is earned and all anticipated expenses and costs are recognized over the coverage period to provide an appropriate matching of revenues and expenses. In addition, UPR is evaluated for adequacy at the end of each reporting period.

Activities between the insured and insurer after expiration of the coverage period typically involve the insurer determining it fulfilled its obligations under the contract, and not the extension of additional risk protection or other services to the insured. Because risk protection is only provided during the coverage period for NLICs, we do not support any model would defer 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 non-life insurers***. Net investment income and income taxes are added to the underwriting result to produce net income. The periodic development of underwriting income (loss) is the mechanism through which margins implicit in UPR emerge in a non-life insurer's financial statements.

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<sup>4</sup> CFV represents the cost to an insurer of fulfilling its obligations over time according to the terms of an insurance contract. For NLICs, CFV is determined as the estimated gross cost of settling claims and does not include explicit risk or profit margins. The total (or "composite") margin implicit in a NLIC is contained within UPR and earned over the period risk protection services are provided. GNAIE sees no value in segmenting the margin contained within UPR into separately quantified components (including an explicit risk margin) as that would inappropriately suggest to investors a level of precision in predicting uncertain future events than exists.

<sup>5</sup> UPR is earned on a pro-rata basis over the coverage period. GNAIE's non-life insurance companies, which represent some of the largest non-life insurers in the world, have confirmed the absence of seasonal bias in their claim data. They note that homeowners insurance policies are typically "multi-peril" and as such claims for wind (hurricanes and tornados), fire, ice, etc. occur throughout the year at a fairly stable rate on an aggregate (i.e., country wide) basis.

## II. Post-claims Period – Estimated Gross Ultimate Losses (Not IASB’s Building Blocks)

### *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. The use of a variety of actuarial methods to estimate reserves at a very granular level (e.g., by state, by line, and coverage for auto and homeowners policies) combined with the application of professional judgment incorporates uncertainty into the estimation of cash flows. 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 do not support the use of PWCFs, which requires construction of the range of all possible future settlement amounts together with an assignment of probability weights to each possible future settlement amount, as it is typically not possible to reliably predict the probabilities associated with the entire range of potential 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.

### *Discounting*

GNAIE does not support discounting claim reserves (except where the timing and amount of claims is reliably determinable on an individual claim basis – which is typically the case for Workers Compensation claims – 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.

### *Explicit Risk & Residual Margins or Composite Margin*

Consistent with our long standing position, GNAIE does not support the introduction of ERMs to the measurement model for NLICs. Similarly, we do not support the positions set forth in either IASB-FASB Staff Paper 3A/43A, *Application of Risk Adjustment and Residual Margin* or Staff Paper 3B/43B, *Composite Margin*, which call for an explicit risk and residual margin, and a composite risk and residual margin, respectively.

Because the IASB’s Building Blocks 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. Insufficient data exists to support whether ERMs developed using a CoC approach is capable of producing decision-useful information. To the contrary, because neither capital requirements or the CoC are consistent within or across implementing jurisdictions, as individual insurers hold different levels of capital (both regulatory minimum and excess) and therefore experience different costs of capital, ERMs determined on a CoC basis are not likely to be 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 upon 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 which is simply not the case.

GNAIE also does not support the use of composite margins, which include both implicit risk and profit margins, in measuring NLICs. The recognition of composite margins over the claim payout period would be inappropriate for short duration insurance contracts as expected profit would be deferred over a period longer than the period over which risk protection services are provided. The fact that settlement of claim obligations may occur after the contract period should not defer the recognition of profit, as uncertainty is incorporated into the claim reserve measurement which is undiscounted and remeasured at each reporting date with all positive or negative development recognized directly in income.

The benefit of GNAIE's proposal for NLICs 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 in the U.S. on Statutory Schedule P, which serves as an independent source to verify the reasonableness of claim reserves. In addition, under the GNAIE proposal, claim and claim expense reserves and the implicit underlying risks<sup>6</sup> are re-evaluated at the each reporting date and all adjustments (both positive and negative) are immediately reflected in profit or loss.

Additionally, under the GNAIE proposal, if the estimated gross undiscounted cost of settling a claim remains unchanged from one period to the next, no change in the related claim reserve is recognized. In contrast, applying the IASB's Building Blocks proposal, even if the gross undiscounted cost of settling a claim remains unchanged from one period to the next, the related claim reserve may change due to changes in the related ERM, changes in the timing of payments, or due to changes in the level of interest rates. We believe that over time, as multiple vintage years of claims are aggregated, it would become exceedingly burdensome, if not impossible, for investors, regulators, and other financial statement users to understand the underlying drivers of periodic changes in reported claim reserves, and the existing linkage to Statutory Schedule P, whose value as a tool to verify the reasonableness of results, would be lost.

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

cc: Mel Anderson, Chair, NAIC International Accounting Standards Working Group  
Rob Esson, Chair, IAIS Insurance Contracts Subcommittee  
Peter Windsor, Secretariat, IAIS Insurance Contracts Subcommittee

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<sup>6</sup> The types of risks initially evaluated and continuously re-evaluated include the amount of incurred losses as well as claim and claim expense inflation. These risks are evaluated and re-evaluated using a variety of actuarial techniques.