

December 6, 2010

**Technical Director  
Financial Accounting Standards Board**

**Preliminary Views on Insurance Contracts  
File reference No. 1870-100**

This letter is in response to the Invitation to Comment on the above-referenced Discussion Paper.

By way of background I have been a security analyst following the insurance industry for 37 years, so this letter can be classified as a user comment. I have been a member of the IASB Working Group on Insurance Contracts since 2004 and I am also a member of the FASB/IASB Financial Institutions Advisory Group.

I am currently the global financial stocks coordinator at Macquarie Securities, the US investment banking subsidiary of Macquarie Group. The opinions expressed in this letter are my own.

As an overview comment I believe it is important that there be a single global standard for insurance contracts and I believe the IASB approach, as discussed in its Exposure Draft, should be the framework around which that standard is developed. Also, while the FASB is only at the Discussion Paper phase and has not issued an Exposure Draft, based on my participation in the Working Group and knowledge of various positions, I do not see the preliminary differences as being that significant that they cannot be reconciled.

A copy of my comment letter to the IASB is attached as an addendum to this comment.

Following are comments on the specific questions posed in the discussion paper. I have only commented on those where I have an opinion. The answers should be viewed in the context of my previous comment that the IASB approach should be the basis for a global standard.

**Question 2**

The scope should be based on the definition of a contract and not on the type of entity issuing the contract.

**Questions 3-5**

I agree with the scope exclusions although I believe-as does the IASB- that contracts with discretionary participation features should be included.

## **Question 7**

I believe that probability weighted estimates of future cash flows are a critical part of the building block process. Following is a repeat of the comments made on this subject in my letter to the IASB:

In my opinion the proposed building blocks are the appropriate measure for insurance liabilities. I believe explicit current cash flows are the key and I believe it is imperative that these cash flows be probability weighted.

Regarding the probability weighting, I have long argued that expressing a liability as the “best” single point estimate (as required in the US under FAS 5) is an outdated concept that no longer reflects how reporting entities make decisions.

Thirty-five years after the issuance of FAS 5, investors have become more sophisticated about stochastic processes and are able to understand the significance of numbers reported in this manner. Keep in mind that when FAS 5 was issued in 1975 the use of probability theory for decision making was in its early stages. For example, the Black-Scholes option pricing model had only been formulated in 1973.

Since then understanding of mathematics by investors has become much more advanced and financial statement users are now comfortable with stochastic models and the significance of probability-weighted numbers. In other words, we recognize that a liability measured on the basis of expected cash flows will likely not be the amount at which an obligation is ultimately settled.

## **Questions 8-10 and 15-17**

I believe the objective of the risk margin is perfectly understandable and that the approach accurately represents the economics of an insurance contract as I believe profits are derived as an entity is relieved of risk.

I believe that a separate risk adjustment communicates extremely useful information particularly regarding the uncertainty and volatility that management’s see in their reserve estimates and I prefer the IASB’s risk adjustment and residual margin approach rather than the FASB approach of having a single composite margin.

The reason for my preferring the two-margin approach is that requiring reporting entities to specifically determine their risk adjustment communicates considerable useful information to users about management’s view of the volatility of their reserves even recognizing that calculating the risk adjustment is fraught with difficulties.

Since there are many different ways to determine a risk adjustment, I see no reason to limit entities to just three methods as this may preclude other techniques from being developed.

While I recognize that companies will diverge in their approach to this calculation to me the key piece of information is the requirement that all amounts be related back to the confidence interval to which the risk adjustment corresponds. This will help with comparability.

If the FASB were to require the composite margin, I believe the recognition formula is appropriate.

I believe the entire discussion of whether interest should or should not be accreted on margins is an intellectual argument that has only a minimal impact on reported results but adds unnecessarily to the complexity of the debate. The whole matter should be dropped.

#### **Question 11**

I agree with the description of the cash flows.

#### **Question 12**

I believe that all insurance contracts should be discounted and I believe that the discount rate should be linked to the liabilities and should not take asset portfolio strategies into consideration (except for those contracts that specifically require participation in asset performance). However, I agree with many of the stated arguments that using the risk free rate (even adjusted for a liquidity premium) would result in considerable volatility driven by accounting not economics. For perspective see Appendix B in my IASB comment letter.

Others are more qualified than I to determine how the discount rate should be defined so I will defer on that issue.

#### **Questions 13-14**

I agree that incremental acquisition costs should be included as part of the insurance contract cash flows and that non-incremental costs should be expensed. To me this best reflects the economics of the business.

I believe that the definition of incremental costs to include those from selling, underwriting and issuing a contract is reasonable although I am mindful that companies that have commented on the subject have argued for a more expansive definition and I believe their points should be considered.

### **Questions 18-19**

I believe that all forms of insurance should be governed by a single model. While each insurance segment has differing products and approaches they are all guided by a common goal; risk transfer through which an insured will pay a known amount to have the counter party (the insurer) assume a potentially larger unknown risk.

However, while I believe a single governing principle is appropriate, I also believe that the results for different types of insurance results (life and non-life) should be presented using different income statement formats.

### **Question 20**

In my opinion the proposed building blocks are the appropriate measure for insurance liabilities. I believe explicit current cash flows are the key and, as previously noted, I believe it is imperative that these cash flows be probability weighted.

### **Question 26**

While intellectual consistency suggests policyholders and issuers should use the same accounting, expanding the project to include policyholder accounting would unnecessarily delay the project.

### **Question 27**

I do not believe that cedants should be able to recognize profit on the inception of a reinsurance contract. In my view this will just stimulate the use of reinsurance simply to generate an accounting result rather than for valid risk transfer reasons.

### **Questions 28-31**

I believe the summarized margin approach results in too little information for the user. This is particularly true for property-casualty companies where I consider premiums to be revenues.

Specifically, I also believe that it is very important that users be able to take the financial statements as presented under the eventual standard and link them back to what would have been reported under previous accounting principles. I believe this should also be a principle of the disclosures as this would increase the comfort level with the new principles and foster user acceptance.

### **Question 32**

As suggested in my opening comments, I believe the FASB should pursue an approach based on the IASB's Exposure Draft, with various modifications as noted in this comment

In conclusion, I applaud both the FASB's and IASB's efforts to develop an insurance contracts standard. As a member of the Working Group for the last six years I have been impressed by the diligence shown by the Boards, the staffs, and by members of the Working Group and I believe all should be appreciative of the efforts undertaken by interested parties (particularly the various actuarial groups) in contributing their time and effort to the project.

I would be happy to discuss these comments further.

Alan Zimmermann

Macquarie Securities

## **ADDENDUM**

November 30, 2010

International Accounting Standards Board  
30 Cannon Street  
London, EC4M 6XH  
United Kingdom

### **Exposure Draft Insurance Contracts ED 2010/8**

This letter is in response to the Invitation to Comment on the above-referenced exposure draft.

By way of background I have been a security analyst following the insurance industry for 37 years, so this letter can be classified as a user comment. I have been a member of the IASB Working Group on Insurance Contracts since 2004 and I am also a member of the FASB/IASB Financial Institutions Advisory Group.

I am currently the global financial stocks coordinator at Macquarie Securities, the US investment banking subsidiary of Macquarie Group Limited. The opinions expressed in this letter are my own and should not be considered the official opinions of Macquarie Group Limited, or any of its subsidiaries.

As an overview comment, while I have some concerns with specific issues, I believe that taken as a whole the proposed accounting standards for insurance contracts expressed in this document are a significant improvement from current generally accepted accounting principles, particularly those in the United States.

Before commenting on some of the specific questions as requested in the exposure draft, I will make some observations on the broader issues in the document.

### **Single Model**

I believe the underlying premise in the exposure draft that all forms of insurance should be governed by a single model is correct. While each insurance segment has differing products and approaches they are all guided by a common goal; risk transfer through which an insured will pay a known amount to have the counter party (the insurer) assume a potentially larger unknown risk. However, while I believe a single governing principle is appropriate, I also believe that the

results for different types of insurance results (life and non-life) should be presented using different income statement formats.

### **Building Blocks**

In my opinion the proposed building blocks are the appropriate measure for insurance liabilities. I believe explicit current cash flows are the key and I believe it is imperative that these cash flows be probability weighted.

Regarding the probability weighting, I have long argued that expressing a liability as the “best” single point estimate (as required in the US under FAS 5) is an outdated concept that no longer reflects how reporting entities make decisions.

Thirty-five years after the issuance of FAS 5, investors have become more sophisticated about stochastic processes and are able to understand the significance of numbers reported in this manner. Keep in mind that when FAS 5 was issued in 1975 the use of probability theory for decision making was in its early stages. For example, the Black-Scholes option pricing model had only been formulated in 1973.

Since that time the understanding of mathematics by investors has become much more advanced and financial statement users are now comfortable with stochastic models and the significance of probability-weighted numbers. In other words, we recognize that a liability measured on the basis of expected cash flows will likely not be the amount at which an obligation is ultimately settled.

### **Prefer the two margin approach**

I believe that a separate risk adjustment communicates extremely useful information particularly regarding the uncertainty and volatility that management’s see in their reserve estimates and I prefer the risk adjustment and residual margin approach to the FASB approach of having a single composite margin.

### **Appropriate discount rate**

I believe that the discount rate should be linked to the liabilities and should not take asset portfolio strategies into consideration (except for those contracts that specifically require participation in asset performance). However, I agree with many of the stated arguments that using the risk free rate (even adjusted for a liquidity premium) would result in considerable volatility driven by accounting not economics.

Others are more qualified than I to determine how the discount rate should be defined so I will defer on that issue.

### **Asset-liability mismatch**

Given the requirements of IFRS 9 there will be a serious mismatch between assets at amortized cost and liabilities adjusted for movements in interest rates. Even allowing assets to be recorded at fair value (consistent with the FASB exposure draft on financial instruments or using the fair value option) would still result in mismatches, and, therefore, consideration should be given to reporting some adjustments through other comprehensive income.

### **Specific answers to questions**

Following are comments on the specific questions posed in the exposure draft. I have only commented on those where I have an opinion. Some of the points may overlap with the introductory comments.

#### **Question 1: Relevant information for users**

In general, I support the proposed measurement model and believe it will provide relevant information to users, although there are some details which I believe can be refined, as discussed in this letter.

Overall, I believe the building blocks provide a useful measurement framework.

Regarding discounting, I have heard many comments in the course of this project that discounting reserves would lower the amount of reserves for a property-casualty company, thereby, increasing the risk of capital inadequacy.

I would note that my research on the issue shows that property-casualty reserves would generally be higher as the net result of the risk adjustment and the discount. For example, the charts in Appendix A show my calculation of the adjusted reserves versus nominal reserves for a major US property-casualty company for the period 1996-2009. Note how the amount of the risk margin exceeds the amount of the discount.

#### **Question 2: Fulfillment cash flows**

Requiring cash flows to be based on the amounts necessary to fulfill the contracts is a positive change from the original approach (per the preliminary views discussion paper) of basing amounts on the potential transfer to third parties since fulfillment is the way most insurance contracts are settled.

As noted previously, I believe the measurement of insurance contracts based on probability weighted future cash flows is a critical component of the exposure draft proposals. Also, requiring cash flows to be based on current estimates is a vast improvement from the lock-in approach in the US.

### **Question 3: Discount rate**

Agree that the discount rate used by the insurer for non-participating contracts should reflect the characteristics of the contract liability and not those of the assets backing the liability.

However, as noted previously, the use of the risk free rate, even with a liquidity adjustment, seems likely to create considerable volatility driven by accounting rather than economics.

Appendix B demonstrates this point by showing the income comparison for a sample company using both reported USGAAP and the IASB proposal incorporating the discount at the risk free rate. The first chart shows how the proposed results would be more volatile than at present and the second chart shows how closely the earnings differences are linked to changes in interest rates.

### **Questions 4 and 5: Risk adjustment versus composite margin**

I prefer the two margin approach with a risk adjustment and a residual margin determined separately.

My view is that requiring reporting entities to specifically determine their risk adjustment communicates considerable useful information to users about management's view of the volatility of their reserves even recognizing that calculating the risk adjustment is fraught with difficulties.

Since there are many different ways to determine a risk adjustment, I see no reason to limit entities to just three methods as this may preclude other techniques from being developed.

While I recognize that companies will diverge in their approach to this calculation to me the key piece of information is the requirement that all amounts be related back to the confidence interval to which the risk adjustment corresponds. This will help with comparability.

### **Question 6: Residual/ composite margin**

I do not believe that gains should be allowed on initial recognition but that profits should be recognized over the life of the contract.

I believe that losses should be recognized immediately as this represents an onerous contract.

I believe that the residual margin should be recognized over the contract period and I believe the residual margin should be locked in at inception to prevent it being used as a shock absorber.

While there is intellectual merit in accreting interest on the residual margin this is a minor amount that adds complexity to the standards with little or no impact on reported results. The requirement should be discarded.

### **Question 7: Acquisition costs**

I agree with the proposal that incremental acquisition costs should be included as part of the insurance contract cash flows and that non-incremental costs should be expensed. To me this best reflects the economics of the business.

I believe that the definition of incremental costs to include those from selling, underwriting and issuing a contract is reasonable although I am mindful that companies that have commented on the subject have argued for a more expansive definition and I believe their points should be considered.

### **Question 8: Premium allocation approach**

I support the premium allocation approach for pre-claims liabilities although like others expressing opinions I have some concerns with the one-year criteria since many types of contracts that can be viewed as short duration actually have contract terms greater than one year.

As discussed below, I believe the summarized margin approach to presentations results in too little information being reported on the face of the income statement and I see this as a useful alternative.

I believe the approach should be required rather than optional to allow for comparability among reporting entities.

### **Question 11: Definition and scope**

I believe financial guarantee contracts should be included within the scope of the standard.

### **Question 13: Presentation**

I believe the summarized margin approach results in too little information for the user. This is particularly true for property-casualty companies where I consider premiums to be revenues.

This is why I believe the premium allocation approach should be required per Question 8 and that premiums, benefits and claims should be shown on the face of the income statement.

### **Question 14: Disclosures**

I can't imagine that anyone would disagree with the disclosure principle of helping users understand the timing and uncertainty of cash flows.

Specifically, I also believe that it is very important that users be able to take the financial statements as presented under the eventual IFRS and link them back to what would have been reported under previous accounting principles. I believe this should also be a principle of the disclosures as this would increase the comfort level with the new principles and foster user acceptance.

### **Question 16: Reinsurance**

I do not believe that cedants should be able to recognize profit on the inception of a reinsurance contract. In my view this will just stimulate the use of reinsurance simply to generate an accounting result rather than for valid risk transfer reasons.

In conclusion, I applaud the IASB's efforts to develop an insurance contracts standard. As a member of the Working Group for the last six years I have been impressed by the diligence shown by the Board, the staff, by members of the Working Group and I believe all should be appreciative of the efforts undertaken by interested parties (particularly the various actuarial groups) in contributing their time and effort to the project.

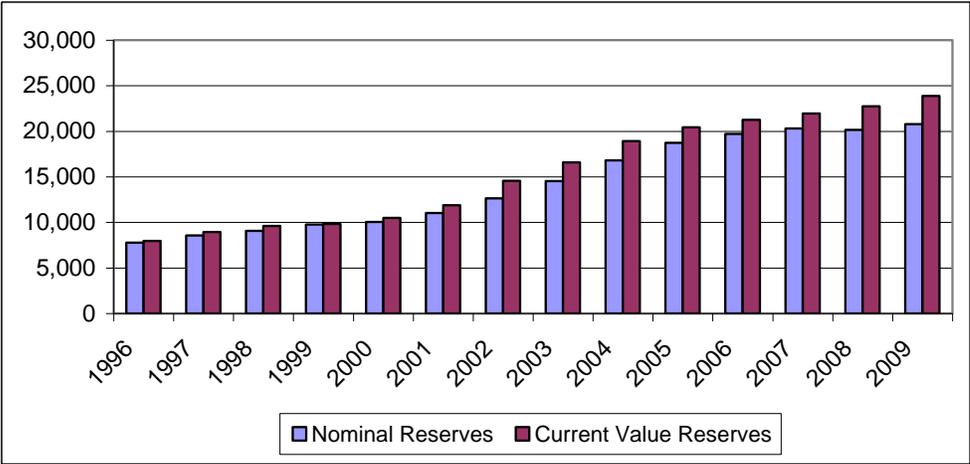
I would be happy to discuss these comments further.

Alan Zimmermann

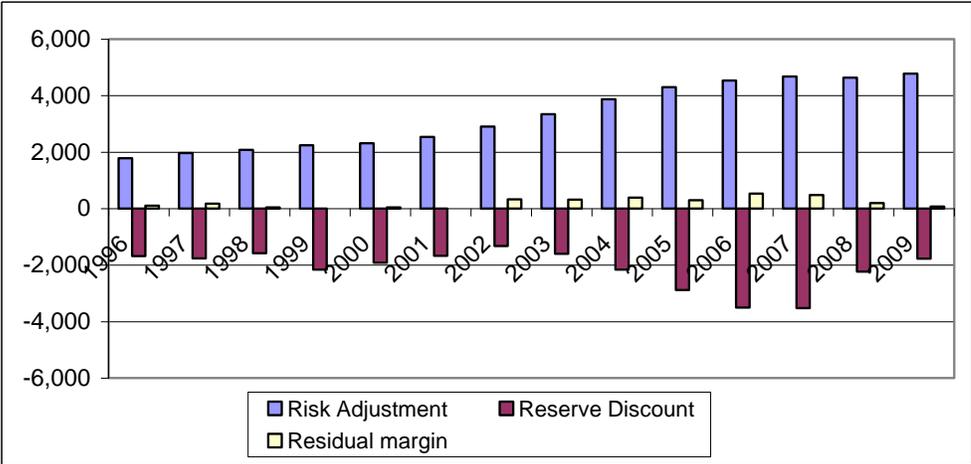
Macquarie Securities

**APPENDIX A**

**Nominal vs Current Value Reserves**

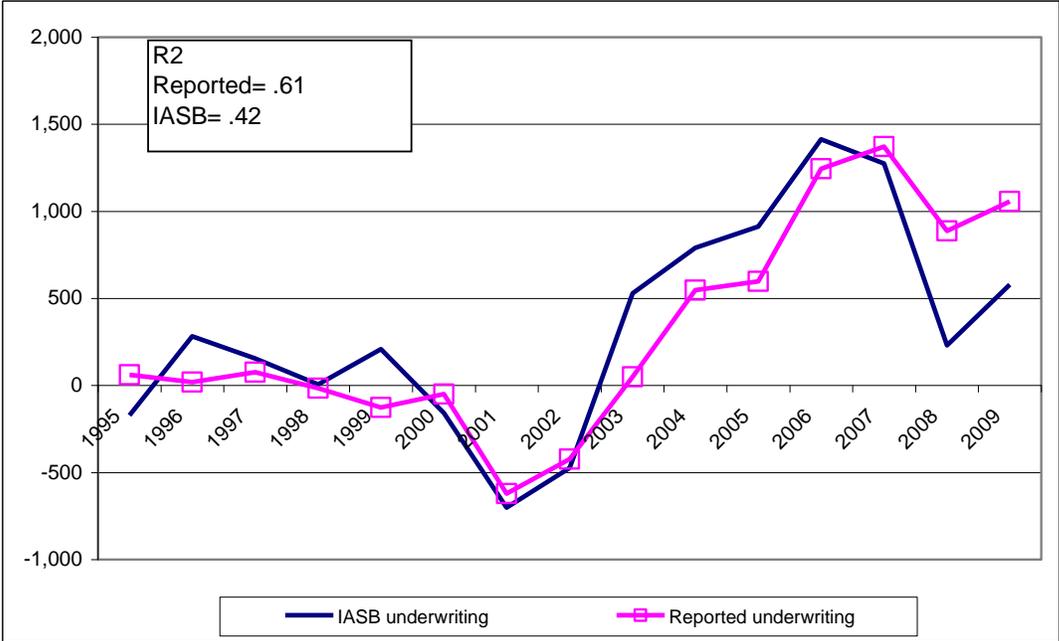


**Components of Reserve Changes**



**APPENDIX B**

**Underwriting Comparison: Reported results vs IASB Proposal**



**Underwriting Income Difference vs Change in Interest Rates**

