

Gary Ransom
Dowling & Partners Securities, LLC
190 Farmington Avenue
Farmington CT 06032

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Technical Director
Financial Accounting Standards Board
direct@fasb.org

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Subject: Preliminary Views on Insurance Contracts

This letter is in response to the Discussion Paper issued by FASB on September 17, 2010.

My Background and Use of Financial Statements

1. I have been involved in analysis of the insurance industry—primarily property casualty—for over 30 years, and have been a security analyst for the past 18 years, including time at Conning & Company, Fox-Pitt, Kelton, and currently Dowling & Partners. I have an M.A. in Mathematics from the University of Washington and am a Fellow of the Casualty Actuarial Society.
2. I frequently use and analyze the financial statements of both public and privately held insurance companies, and I am familiar with the current accounting and disclosure practices of insurers. Although my focus has generally been on the property casualty industry, I am familiar with many of the accounting issues at life and health insurers.

Overall Comments on the IFRS Exposure Draft (ED) and the FASB Discussion Paper (DP)

3. **The accounting models proposed in the ED and DP represent a dramatic departure from current GAAP.** So much so that it is hard to see through all the potential ramifications of the proposal. While I like to believe that insurance managements operate on pure economics, in practice, accounting has a noticeable impact on how managements operate. It is entirely conceivable that new business practices would arise to either avoid or exploit portions of this new measurement model. As one particular observation, it appears that reinsurance usage might be encouraged by this proposal as a means of capital management. The proposal is sufficiently dramatic that FASB should move carefully and meticulously to fully understand the potential impact of the changes before proceeding.
4. **There is no need to force property casualty (PC) and life insurance into the same measurement model.** IFRS has already tacitly acknowledged the difficulty of forcing PC accounting into the new measurement model by crafting an exception for PC insurance. From an analyst's perspective, there are numerous differences between life and PC businesses that suggest different measurement models are entirely acceptable, and preferable if the goal is to deliver meaningful information to investors. Some of these differences include:

- a. Risks for PC insurance primarily reside on the liability side of the balance sheet, while for life it is more on the asset side,
- b. For PC, the largest liability is generally the “post-claim” liability, while for life insurance, policyholder liabilities are mostly “pre-claim” liabilities,
- c. life insurance products, because they must be proactively sold to customers, generally contain more optionality in the product structure resulting in many more measurement issues than for PC products,
- d. underwriting risk is far more variable and more skewed in PC than in life insurance, and
- e. basic metrics used by managements to discuss operations are different: PC managements speak in terms of combined ratios, while life managements speak in terms of sales and deposits.

Accounting should match as closely as feasible the underlying economics of the business. If two different businesses have differing economics (which I believe is true for PC and life), there is neither need nor value in forcing both into the same model.

5. **The concept of the residual margin or the composite margin is problematic.** The IFRS measurement model (which I would characterize as close to a “fair value” model when considering just the cash flows, discounting, and risk margin) precludes a gain at inception with the residual margin. There appears to be no rationale set forth for this requirement (i.e. no gain at inception) other than what IFRS says in BC121: it would be inconsistent with other accounting rules (BC121a) or insurers might make an error (BC121b). Yet, life insurers often emphasize sales in their discussions precisely because they are related to the economic gains embedded in those sales. If the accounting is designed to match the economics, then the residual margin (by virtue of being merely a plug to add to zero) seems inconsistent with the other building block concepts which attempt to measure true financial values.
6. **The composite margin recognition of the FASB could produce odd results for PC insurers.** The denominator of the recognition formula could rise unexpectedly (say a large reserve charge, or a 4th quarter hurricane loss after recognizing 3rd quarter profits) leading to a compounding of the financial implications of the event, both the event itself and the unwinding of previously recognized profits. From my perspective, this moves us away from economic reality rather than closer.

Responses to Specific Questions in DP

7. **Question 7.** Do you agree with the use of the probability-weighted estimate of net cash flows to measure insurance contracts? Does that approach faithfully represent the economics of insurance contracts? Is it an improvement over existing U.S. GAAP?

For PC insurers, the idea of a probability weighted distribution, while theoretically enticing, is likely to generate a wide variation of calculations in practice. While I agree that this is what reserves should represent, the variations of elements such as loss distributions, the parameters of those distributions, discount rates, and payment patterns, may limit the ability to make comparisons across companies. I am not sure this is a sufficient improvement over GAAP to warrant costs to the industry of the change.

8. **Question 8:** Do you think an entity's estimate of net cash flows should include a risk adjustment margin?

If the reserves are to be discounted, then they also need a risk margin. Historically the U.S. PC industry's reserves have been deficient except for a relatively few number of years. In a sense, current GAAP implicitly has a risk margin by virtue of the lack of broad discounting. To segregate this risk and embed it in a composite margin (as in DP) separates integral components of the liability making it less clear to analysts what a fair liability should be.

9. **Question 9:** Is the objective of the risk adjustment margin understandable? If so, do you think that the techniques for estimating the risk adjustment margin (see paragraph 52(b)), faithfully represent the maximum amount that the insurer would rationally pay to be relieved of the risk that the ultimate fulfillment cash flows exceed those expected?

The concept of the margin is understandable and I think the estimating techniques are reasonable.

10. **Question 10:** Do you think that the risk adjustment margin would be comparable for entities that are exposed to similar risks?

I believe there is substantial risk that this method would limit comparisons across companies and/or make it difficult to discern the key differences in methods or assumptions across companies.

11. **Question 15:** Do you agree with the use of either the composite margin approach or two-margin approach to measure the net insurance contract? Does either approach faithfully represent the economics of insurance contracts? Is either approach an improvement over the measurement used in current U.S. GAAP?

As mentioned above in my overall comments, I do not believe these margins faithfully represent the economics of the PC insurance business. Between the two, I prefer the two margin approach because the risk margin is an important component of the overall reserve estimates and the recognition of the residual margin occurs over the life of the policy rather than over an extended payment period. The FASB's proposed recognition of the composite margin potentially adds volatility to the reported results that do not faithfully represent the underlying economics.

12. **Question 16:** Do you think that the composite margin should be recognized in earnings in subsequent periods using the ratio described in paragraph 83? If not, how would you recognize the composite margin in earnings?

As mentioned above, I believe the formula is flawed because of the likelihood of de-recognizing part of the margin after recognizing it in previous periods (if the estimate of ultimate payments rises materially). Whatever margin is used, it is better to recognize it over the period when a fortuitous event can trigger the coverage. Subsequent to that period, the changes in the loss estimates alone best reflect the underlying economics of the business.

13. **Question 18:** Do you think that all insurance contracts should be recognized and measured using one approach or that some insurance contracts should be recognized and measured using an alternative approach (for example, the modified approach)? Why or why not?

As mentioned in my overall comments, I see no reason to force all contracts that transfer risk into the same measurement model, when the variations of those risks are so significant across the industry. I greatly prefer a revenue recognition model for PC insurers because the premium (with some exceptions) is generally fixed and is determined at inception. Aggregating accounting items that are known with reasonable certainty (premiums) with other items that are uncertain (reserves) would tend to obscure the underlying economics.

14. **Question 32:** After considering your views on the specific issues contained in this Discussion Paper and the IASB's Exposure Draft, what do you think would represent the most appropriate improvement to U.S. GAAP?

I do not believe that current GAAP accounting is in such need of reform that the U.S. should immediately move toward a new model. The IFRS model is clearly designed with life insurers in mind. PC insurers do not need to have the same model. I think disclosures on loss reserve discounts and appropriate risk charges would be an improvement to U.S. GAAP, but the current premium recognition model works well, is understandable, and reflects the underlying economics. I would be in favor of more targeted changes to U.S. GAAP.

I would be happy to discuss any of my comments with FASB. Thank you for the opportunity to respond.

Sincerely,

Gary Ransom