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Exposure Draft Insurance Contracts: File Reference No. 2013-290

Exposure Draft Insurance Contracts: ED/2013/7

This letter is in response to the invitations to comment on the above-referenced exposure drafts.

By way of background I have been a security analyst following the both the life and property-casualty insurance industries for 40 years, so this letter can be classified as a user comment. I also have been a member of the IASB Working Group on Insurance Contracts since its inception in 2004.

I am currently a Managing Director of Assured Research LLC, a research and advisory firm concentrating on the property/casualty industry. However, the opinions expressed in this letter are my own and should not be considered the official opinions of Assured Research.

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

While I have some concerns with specific issues, I believe that taken as a whole the proposed accounting standards for insurance contracts expressed in these documents will make the sources of cash flows, profits and risks within the insurance quite transparent. I also, believe the proposals are an improvement from the generally accepted accounting principles in the US.

The chief reason I view the direction the Boards are taking positively is that, in my opinion, the proposed standards capture the way money is made on insurance contracts; that is, profits are a combination of differences in cash flows from expectations, changes of expected future cash flows and releases of margins. In addition, the use of current estimates will correct what I think of as the major fault of present accounting, particularly life insurance, which is that assumptions are locked in and not adjusted to current data

I have long believed that the main insurance accounting deficiencies are in the life insurance and it is, therefore, fitting that the most significant changes will affect that industry. While I agree with the comments of most analysts that property-casualty accounting "isn't broke so why change it" I also believe that the accounting can be improved upon chiefly by the discounting of loss reserves.

I recognize that believing property-casualty reserves should be discounted puts me in a minority (possibly a minority of one) but I view the time value of money as a fundamental economic concept that should be considered in financial reporting. As an analyst, I have long discounted reserves to calculate adjusted book values, so it seems the right approach to have the companies do it in their reporting.

No doubt there will be comparability issues between companies particularly because the concepts for releasing margins are not well established or understood and companies will undoubtedly take different approaches.

Also, the fact that the Boards will probably not converge their standards is disappointing. My research on the lack of convergence shows that the differences will be significant, chiefly because of the ability to offset future cash flow changes with the contractual service margin.

As for the concern that it will take considerable analytical time and effort to understand the new standards, I have no worries. I believe the insurers will do a good job of explaining the new financial concepts to analysts simply because it is in their best interest to do so. This was the case in Europe in 2004-2005. As the listed companies in the EU were faced with converting to IFRS at the beginning of 2005 they took considerable pains to explain the new accounting to analysts and this greatly eased the transition. I have no doubt this will happen with the insurance accounting standards.

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.

In an effort to relieve tedium and repetition I have refrained from use of the word I; as in "I believe."

FASB Question 1

Believe the proposed guidance should be applied to insurance contracts and not just insurance entities. However, the various exemptions make it difficult to determine for which products would be included and which would be excluded.

FASB Question 3

Yes; believe the proposed guidance will produce relevant information. The models proposed in the exposure drafts capture the way companies make money which is through a combination of margin releases, differences in cash flows from expectations and changes to future expected cash flows.

FASB Question 4

The most significant improvement is the components of the summarized margin which, as described in the answer to Question 3, I believe captures the way insurers make money.

FASB Question 5

Yes; believe there should be different models as the life and property-casualty business models are fundamentally different.

FASB Questions 6-7

Believe the premium allocation model should essentially apply to all property-casualty coverages. While the two requirements taken together seem to capture most of the industry, believe there should be somewhat more flexibility in the definition so all property-casualty contracts would be eligible for PAA.

While not a specific question for the IASB, believe PAA should be required and not just permitted.

FASB Question 13

Yes; believe changes in cash flows should be included in net income.

One of the major faults of current USGAAP is that changes in expectations are not reflected currently but are instead locked in unless sufficient enough to result in a premium deficiency. Therefore requiring changes to be reflected currently is an improvement.

FASB Question 14

Yes; believe discount rate should reflect the characteristics of the liability. If the discount rate reflected the assets than companies would have different liabilities depending on their investment strategies.

FASB Question 15

Believe the time value of money is a very basic economic concept that should be used in reporting cash flows that are expected to be paid in the future. Believe is true even when future cash flows are uncertain. At the same time, though, it is important for reporting purposes that the nominal amounts be disclosed so users can determine what the impact of discounting has been on the liability and on the income statement.

However, it is important to be aware that discounting incurred claims without a risk margin (adjustment) will accelerate the recognition of profits compared to current accounting.

While believe discounting should be applied to all cash flows, allowing reporting entities to choose not to discount claims expected to be paid in one year is a reasonable expedient.

FASB Question 16

Believe the decision whether or not changes in cash flow due to changes in the discount rate should be reported in other comprehensive income should be optional and not required. The reason for this is that in certain situations this might result in the better matching of assets and liabilities and companies should be allowed to make that determination themselves.

FASB Question 21

Yes; believe profit is derived from performing a service and not just selling a product.

FASB Question 22

Support the IASB approach.

Believe there is both an explicit risk adjustment and a contractual service margin. Insurance liabilities reflect varying degrees of uncertainty and this should be reflected in balance sheets which is done through a risk adjustment.

FASB Question 23

Do not think the contractual service margin should be adjusted for changes in cash flows. Believe that the goal of entire ED is to reflect changes currently and offsetting against the contractual service margin negates this benefit.

Agree that IASB should not specify acceptable approaches to determining risk adjustment. Determining the risk adjustment is a complicated theoretical exercise and no doubt companies will take different approaches. Limiting the release calculation to specific methods will stifle the possible development of other methodologies.

FASB Question 24

Yes ; agree losses should be recognized immediately.

FASB Question 31

Believe the margins and the margin releases are the most important information that comes out of the proposed standards and, therefore, disclosure of that information is critical. However, reporting an income statement that just reflects the margins omits important information that shows various activity indicators therefore believe contract revenues and expenses should be shown in the income statement.

FASB Question 32

Yes; the determination of what is revenue in the insurance business has long been an unsettled question as demonstrated by the differences between traditional and investment-oriented products, i.e. FAS 60 and FAS 97. The proposed approach distinguishes between what is revenue and what is a deposit.

FASB Question 33

Theoretically, if one believes that revenues and deposits should be separated, then for consistency the financing element in the PAA should be separated. However, that will take considerable effort for very little additional information, therefore as a practical expedient, suggest financing elements be ignored. In other words, do not believe the costs are warranted.

FASB Question 46

Believe that transition standards should be looked at quite closely by the Boards because this is the area where company decisions will have the most important impact on future profitability. Am not sure what information preparers have available for retrospective transition.

IASB Question 1

As discussed in the response to FASB Question 22, support the IASB view that there should be both an explicit risk adjustment and a contractual service margin.

However, do not agree that changes in future cash flow estimates should be offset against the contractual service margin. Believe that the goal of entire ED is to reflect changes currently and offsetting against the contractual service margin negates this benefit.

IASB Question 3

Agree; same as FASB Question 31

IASB Question 4

Believe use of OCI should be optional per FASB Question 16.

In conclusion, I applaud both Boards efforts to develop an insurance contracts standard as it has been a long and arduous journey. As a member of the Working Group for the last nine 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