November 21, 2014

Mr. Russell G. Golden
Chairman
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, Connecticut 06856-5116

RE: Disclosure Requirements for Short Duration Insurance Contracts

Dear Chairman Golden,

On behalf of the American Academy of Actuaries'[1] Financial Reporting Committee, I would like to offer our feedback on the Financial Accounting Standards Board's (FASB) disclosure requirements for short duration insurance contracts. While the Academy is not part of the FASB's fatal flaw review process, the committee is aware of significant elements of the proposed disclosures from publicly available information.[2]

The committee applauds the intention to provide U.S. statutory Schedule P-type disclosures for losses; however, based on our review of the proposed Accounting Standards Update, Insurance Contracts (Topic 834), due process documents, and the FASB tentative Board decisions and meetings on the topic, the committee recommends that several items be reconsidered by the FASB:

- Claim counts and incurred but not reported (IBNR) reserves should be removed from the proposed disclosure. We understand that these items are included so that reported claim severities or the amounts of reserve per reported claim by accident year can be evaluated. We believe that the lack of data in certain cases and the lack of a consistent approach to counting claims net of reinsurance would make such a disclosure non-operational. In other cases, we believe disclosure of claim counts and IBNR (and the resulting calculated severities) on an aggregated basis could lead to potential misstatements by users and decision makers.

[1] The American Academy of Actuaries is an 18,000+ member professional association whose mission is to serve the public and the U.S. actuarial profession. The Academy assists public policymakers on all levels by providing leadership, objective expertise, and actuarial advice on risk and financial security issues. The Academy also sets qualification, practice, and professionalism standards for actuaries in the United States.
[2] Including a presentation made by FASB member Marc Siegel to the International Association of Insurance Supervisors' (IAIS) Accounting and Auditing Working Group.

- If the FASB decides to include IBNR in the disclosure requirements, we recommend that the definition of IBNR be pure IBNR[3] plus development on reported claims or claims in the course of settlement because most insurance companies—other than health—do not typically calculate pure IBNR directly.
- The technical appendix below describes particular cases in which some of the data required are not available. For example, for most companies that assume reinsurance, claim count information is not provided by the ceding entity to the assuming entity.
- Earned premiums by calendar period, such as those shown in U.S. statutory Schedule P disclosures, should be included in the proposed disclosure. This facilitates the calculation of loss ratios by accident year, providing some evaluation of the insurance company's exposure from underwriting business for the various levels of disaggregated information.
- The preparer should be required to provide its estimate of the expected payout pattern.

Each of these items is discussed in greater detail in the technical appendix.

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Thank you for this opportunity to provide our views on the FASB's disclosure requirements on short duration insurance contracts proposal. The committee welcomes the opportunity to discuss these points with the FASB and to comment on other parts of the proposal if the FASB is willing to share the detailed disclosure requirements document with the Academy. If you have any questions or would like to set up a meeting to discuss these issues in more detail, please contact Lauren Sarper, the Academy's senior policy analyst for Risk Management and Financial Reporting, at 202.223.8196 or sarper@actuary.org.

Sincerely,

Leonard Reback, MAAA, FSA
Chairperson, Financial Reporting Committee
Risk Management and Financial Reporting Council
American Academy of Actuaries

cc: James L. Kroeker, Vice Chairman
Daryl E. Buck, Board Member
Thomas J. Linsmeier, Board Member
R. Harold Schroeder, Board Member
Marc A. Siegel, Board Member
Lawrence W. Smith, Board Member
Susan M. Cosper, Technical Director and Chairman, Emerging Issues Task Force

[3] True IBNR reserves for claims yet to be reported to a company.

Technical Appendix

Claim Counts

The committee understands that the FASB has proposed a new disclosure for claim counts. We believe that the lack of data in certain cases and the lack of a consistent approach to counting claims net of reinsurance would make such a disclosure non-operational. In other cases, we are concerned that claim count data will be of no use in a general disclosure for reasons outlined in further detail below.

There are several situations in which only partial or incomplete claim data is available. Claim count data generally do not exist for the following business types:

- Assumed reinsurance contracts in which available loss reports show only aggregate losses (e.g., aggregate stop losses and some quota share contracts).
- Residual market pools processed as assumed reinsurance.[4]
- Fair Access to Insurance Requirements (FAIR) Plans–property residual market mechanisms–some of which are processed as direct insurance.

When claim counts are available, there is no clear way to count claims on a net of ceded reinsurance basis. For example, if you cede 50 percent of your liabilities under a quota share agreement, should you present only 50 percent of the preparer's claim counts? Or should the preparer "retain" 100 percent of the claim counts? There would be a significant difference in the reported average cost per claim dependent on the claim count procedure. In addition, more complex non-proportional reinsurance agreements would make it difficult to develop a consistent approach that would make information comparable between companies.

There are several other areas that need to be considered when presenting claim counts that make summarized reporting misleading in nearly all but the most basic cases. These include:

- (Casualty) Deductibles—Unlike deductibles for property business, the insurer adjusts the entire claim for casualty deductibles from initial reporting to final settlement as if there were no deductible. After adjusting and settling the claim, the insurer then obtains reimbursement from the policyholder for the deductible portion. This can result in many claims with a zero net value. Hence, a claim count for a casualty deductible policy does not necessarily represent a net liability for the insurance entity. If the proportion of deductible provisions stays constant to the overall claim settlement amounts over time, then this would not mislead the analysis; however, changes in the estimated claims between deductible and non-deductible policies or changes in deductible size would make raw data misleading to the financial statement user.
- Claim types—Claim count information is generally meaningful only if the claims being counted are homogeneous. For example, it is not informative to know that claim counts are steady if last year's homeowner's coverage counts contained 10,000 more roofing

[4] Many states provide auto and workers compensation insurance for those risks otherwise rejected by the marketplace via a pooling mechanism. The residual market pooling mechanism writes these rejected risks and then cedes the risks back to insurers participating in the market based on market share.

claims from hail storms than typical from homeowner coverages while this year's counts contained 10,000 more automobile physical damage claims than usual.

- Events versus claimants versus coverages versus notices—There are many different ways of generating a claim count. An insurer can generate one count per:
    - Claim event (e.g., an auto accident);
    - Claimant from an event (e.g., three people in the car that an insured hit); or
    - Coverage per claimant from an event (e.g., three people suing for injury, plus the driver suing for damage to their car).

  In addition, an insurer is sometimes notified of an event that may or may not generate a claim. These notices are sometimes counted as claims. The protocol for when to generate a claim count varies across entities and may even vary within an entity for different coverages.

Please note that there are circumstances for which actuaries use claim counts and severity information. Nevertheless, these circumstances arise when actuaries are evaluating claims at a much more disaggregated level of disclosure than proposed by the FASB. For automobile insurance, this typically would involve disaggregating business into type of claim (e.g., bodily injury, property damage, collision, etc.) and then into state groupings for at least the most significant states. Further adjustments would need to be made for changes in average policy limits, reinsurance terms, and potentially other factors. This level of disaggregation is not consistent with the information that would be presented in a financial statement.

We note that while current Schedule P statutory disclosures include claim count information, this information is rarely used for meaningful analysis because of the limitations we have described. One of those rare examples is personal auto liability for a carrier with a stable book of business (i.e., immaterial changes in policy deductibles, high level of policyholder persistency, and/or consistent claims handling over time). In this situation, such a disclosure will provide for meaningful information. In most cases, though, there is not a stable book of business and any analysis will be flawed. This could lead to poor decisions and potential misstatements by users.

Incurred But Not Reported

While the rationale for reporting of IBNR amounts is not entirely clear from the public discussions, we understand that one reason may be to provide sufficient information to enable the user to calculate and evaluate reported claim severities. Often, however, the reported claim values are not sufficient to cover the final settlement of a claim and need to be supplemented with a provision that covers expected development on reported claims.

The vast majority of insurers do not make separate estimates for pure IBNR; they make provision in their IBNR for pure IBNR plus expected development on reported claims. If insurers will be required to disclose the pure IBNR, separate processes will need to be established to estimate the pure IBNR. Even if such information were disclosed, the issues described above for claim counts (i.e., mix of business issues, changes in policy limits, and reinsurance terms) would equally apply to reported claim severities.

If the FASB was referring to a definition of IBNR that is broader—such as pure IBNR plus expected development on reported claims (e.g., claims in the course of settlement in health insurance companies), then the amounts generally are available for insurers. However, such

information likely would have limited usefulness or may be recorded on an inconsistent basis for the following reasons:

- Some entities or portions of entities do not establish case estimates for defense costs. In this case, IBNR would include all the estimated liability for defense costs. This is a material portion of the liability for some insurance coverage; and/or
- Case reserves plus IBNR equals the total unpaid claim reserves held by insurers. [5] Case reserves are set by claims adjusters for known claims. These are not accounting estimates. Some insurers have their adjusters set case reserve estimates at only a dollar for claims in dispute. Other possibilities for the measurement objective for the claim adjuster estimate include mode, probable minimum, probable maximum, and median. The objective of a claim adjuster estimate may vary even within an entity depending on the particular line, coverage, or branch. This potential variation is one reason why investigation of possible changes to the claim adjuster estimate process is part of the actuary's analysis protocol.

We do not believe that the level of IBNR reported by an entity is useful information, particularly without extensive analysis of the other components of the total reported claim liability.

Payment Patterns

The committee understands that the FASB proposals will include a payment pattern or duration disclosure of some type. We are uncertain as to what the intent of such disclosure would be, as there are several different types of payment patterns that could be considered:

- Accident year patterns—An estimate of the cash flow payment pattern for the ultimate incurred losses from a single year's claim-triggering events. These are subject to distortion from various one-time type events (e.g., hurricanes, tornados, severe winter weather) and also may be impacted by tort one-time events (e.g., the *Scott-Pontzer* decision of the Ohio Supreme Court).[6] They also are affected by the business mix in the accident year (e.g., a year with a high proportion of workers compensation liabilities will pay off slower than a year with a high proportion of auto insurance liabilities). Therefore, the pattern may vary by accident year.
- Projected future accident year pattern—The accident year pattern expected for the future accident year based on the expected business mix and event mix (e.g., hurricanes, winter weather, etc.). These patterns are generally used for estimating the profitability of future contracts, given a future loss ratio and underwriting expense level.
- Reserve runoff patterns—An estimate of the cash flow pattern for the runoff of the aggregate claim liability at a point in time, including all accident year claim liabilities outstanding at that point in time. The current Contractual Obligations Table required in 10-K filings includes such a pattern.

[5] The total claim and claim adjustment expense liability also includes an estimate for unallocated claim adjustment expense – generally the claim department salary and overhead costs associated with settling both reported and IBNR claims that have been incurred. This liability is not part of case reserves; hence, it would probably be included in IBNR.

[6] The *Scott-Pontzer* decision resulted in higher auto liability insurance premiums for businesses. The case expanded employer underinsured motorists coverage to apply in a crash even though the deceased (Pontzer) was not driving a company-owned vehicle nor was he engaged in company business at the time of the fatal crash.

Such estimated patterns can be very imprecise. Portions of the pattern may be amenable to reasonable precision (e.g., accuracy in the amount paid in a future year to within a few percentage points of the total payout), while other portions may be only amenable to very rough approximation (e.g., short term, medium term, or long term). [7] If any such disclosure is required, the committee recommends clear guidance on the desired measurement objective, [8] allowance for companies to estimate payout patterns for various levels of disaggregation rather than requiring a formulaic calculation, and investigation as to whether (or the extent to which) this is duplicative of pre-existing disclosures.[9] We also wish to emphasize that such patterns would be based on judgment and, if disclosed, should be based on the company's estimate of the pattern rather than a set calculation based on any specified paid loss table.

[7] Liabilities with the most uncertain timing are generally those arising from complex and/or very contentious litigation and excess contracts. These liabilities can be a signification portion of the total.
[8] Recognizing that this is not a precise exercise.
[9] It might also be helpful to determine the extent to which these pre-existing disclosures are considered useful.