



AMERICAN ACADEMY *of* ACTUARIES

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November 30, 2010

Technical Director  
Financial Accounting Standards Board  
401 Merritt 7  
PO Box 5116  
Norwalk, CT 06856-5116

Re: File Reference No. 1870-100 – Discussion Paper, *Preliminary Views on Insurance Contracts*

The American Academy of Actuaries<sup>1</sup> International Financial Reporting Task Force offers the following comments to the Financial Accounting Standards Board (FASB) concerning File Reference No. 1870-100 - Discussion Paper (DP), *Preliminary Views on Insurance Contracts*.

Actuaries are involved in designing, pricing and measuring the value of insurance contracts and have provided our perspectives to the FASB throughout the development of its insurance contracts model. We applaud the Board for its work on the insurance contracts model, and its commitment to improving overall accounting for insurance.

Our specific comments are incorporated in our responses below to selected questions posed by the discussion paper. We have commented on the issues that we feel are most important. While we have not attempted to answer all of the questions contained in the paper, we have referenced those questions that relate to our comments. We may have additional comments to submit in the near future. If you have any questions, please contact Tina Getachew, Senior Policy Analyst, Risk Management and Financial Reporting Council, by phone (+1 202/223-8196) or email (getachew@actuary.org). Thank you again for this opportunity to provide input.

Sincerely,

William C. Hines  
Chairperson, International Financial Reporting Standards Task Force  
American Academy of Actuaries  
Risk Management and Financial Reporting Council

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<sup>1</sup> The American Academy of Actuaries (“Academy”) is a 17,000-member professional association whose mission is to serve the public on behalf of 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.

## **Interaction with Financial Instruments Standards (Proposed ASU to Topic 825 and Topic 815)**

**Question 20:** *Do both the building-block approach and the modified approach (with the latter approach applied only to certain short-duration contracts) produce relevant and decision-useful information? Why or why not?*

In order to produce financial statements that faithfully reflect the economics of how insurance contracts are priced and managed, the contract liabilities and the assets backing those liabilities need to be measured on a consistent basis. If they are not, the financial statements could show income and changes in equity that are not fully reflective of the economics and may potentially mislead users of the financial statements.

For example, consider a guaranteed annuity contract that pays a single sum in three years and may not be surrendered before that time. An insurer could invest the proceeds received to exactly match the certain liability cash flow and remove any risk associated with changes in interest rates between the valuation date and date the benefit is to be paid. Thus, on an economic basis there is no risk to the insurer should interest rates change over the three year period. Income should emerge as the difference between the investment income earned on the assets and the interest required to support the liabilities. However, if the assets were valued at market value and the liabilities were valued at amortized cost, the value of the assets would change as the level of interest rates changed causing swings in profit and loss that are not reflective of the economics but instead result from the differences in the accounting values. The same would be true if the liability were measured at fair value and the assets at amortized cost.<sup>2</sup>

### **Unbundling**

**Question 6:** *Do you support the approach for determining when noninsurance components of contracts should be unbundled? Why or why not?*

We have no concerns regarding unbundling for the purposes of presentation of results. We do, however, have some concerns regarding unbundling for measurement purposes. In general we believe that unbundling should be required only in those cases where two otherwise independent contracts were put together for non-economic reasons. We also believe that unbundling should be allowed in order to achieve a better accounting match between the measurement of the contract and the assets backing the contract.

The criteria for account value driven products is not clear. The use of universal life as an example implies that these products should be unbundled. However, most universal life contracts sold in the United States would fail the criteria of having to pass on all investment experience.

Insurers sell some services (e.g., premium collection and benefit payment services) on a stand-alone basis and also packaged with an insurance contract. It is not clear from the unbundling guidance in the DP whether these services should be bundled together when sold separately as if

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<sup>2</sup> The topic of accounting mismatch complete with numerical examples is treated more completely in the ACLI/IAA Second Joint Report dated June 3, 2003 and available at:  
[http://actuaries.org/LIBRARY/papers/ACLI\\_IAA\\_Second\\_Joint\\_Report.pdf](http://actuaries.org/LIBRARY/papers/ACLI_IAA_Second_Joint_Report.pdf)

they were one contract. We are also unclear whether if they were sold in a single contract the services and insurance coverage should be unbundled and valued separately. We recommend the final standard provide an objective for unbundling which provides more clarity on this topic.

### **Recognition and Measurement**

**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?*

We agree with the use of probability-weighted estimates of net cash flows. However, we believe that the objective should be to estimate the expected value (in a statistical sense, i.e., mean) of the present value of the cash flows arising from the contract. We are concerned that the wording in the current DP overemphasizes the term “probability-weighted” and may imply that identification of and assigning probabilities to every scenario of commercial substance may be required. There are many ways of producing appropriate estimates of mean value measures including methods that do not involve explicit identification of and assigning probabilities to every scenario and we do not see why preparers should be restricted in their approaches. Any approach used should be appropriately disclosed.

In order to produce measurements of insurance contracts that faithfully represent the economics of the business when scenarios are used, there must be consistency, within a given scenario, between the economic assumptions used to produce the future cash flows and the discount rate used to calculate the present value of those cash flows. We recommend that this requirement be included in the standard or in the application guidance. If this consistency is not achieved, the resulting measurement may be misstated.

We recommend adding the following as application guidance:

Where fulfillment cash flows depend on the performance of specific assets, the discount rate also depends on the expected performance of those assets. If that asset performance depends on uncertain future variables (such as market interest rates), then it may be necessary to determine the expected value using the present value of possible cash flows at discount rates that reflect the interest rates underlying the asset performance for different scenarios, rather than first estimating expected cash flows under all scenarios and then discounting the expected cash flows using a single set of discount rates that do not reflect the different underlying scenarios of asset performance.

Similarly, where scenarios reflect different future economic conditions such as future inflation impacts on the amount or timing of fulfillment cash flows, then the discount rates applicable to such scenarios should be reflective of the future economic conditions underlying a specific scenario.

**Question 9:** *Is the objective of the risk adjustment margin understandable?*

We have three concerns regarding the objective of the risk adjustment as stated in paragraph 55 of the DP and 35 of the International Accounting Standards Board’s (IASB) ED.

1. It does not appear to fully reflect the uncertainty associated with the underlying fulfillment cash flows and seems to be inconsistent with the objective expressed in paragraphs 17a and 22c, and in appendix A of the IASB's ED.
2. It does not appear to appropriately capture timing risk
3. The term "maximum" may be misinterpreted.

The objective refers to the risk that the ultimate fulfillment cash flows exceed the expected cash flows. It does not refer to the risk that the ultimate fulfillment cash flows are less than the expected cash flows. The maximum amount an insurer would rationally pay to be relieved of all of the uncertainty (both less than and more than the expected cash flows) would be very different from the amount to be relieved of only the unfavorable uncertainty. If the measurement uses an expected value – which by definition is measured across all potential outcomes, both lower and higher than expected, plus a risk adjustment that only accounts for the risk of higher than expected outcomes, the risk of lower than expected deviations would not be reflected in the measurement at all.

We believe the desired measurement objective is better represented by "eliminating uncertainty" than by being "relieved of the risk that the cash flows exceed those expected" and would thereby be consistent with the overall measurement objective. Paragraph 17 (a) of the ED states that the initial measurement of an insurance contract should be "adjusted for the effects of uncertainty about the amount and timing of those future cash flows..." Paragraph 22 (c) has a similar reference; "an explicit estimate of the effects of uncertainty about the amount and timing of those future cash flows..." Both paragraphs refer to uncertainty without any qualification limiting it to higher than expected uncertainty.

We recommend replacing the word "exceed" in the objective with the words "differ from." Alternatively, we recommend using the wording from the definition of risk adjustment in Appendix A of the ED, "to capture the effect of uncertainty about the amount and timing of the ultimate fulfillment cash flows" by reflecting the amount the insurer would rationally pay to "eliminate the uncertainty about the amount and timing of the ultimate fulfillment cash flows."

We note that the objective for the risk adjustment does not directly refer to present values but instead refers to ultimate cash flows. The ED's definition of insurance contract includes within its scope contracts whose payment amount is certain but the timing of such payment is uncertain. These contracts have uncertain cash flows, but it is not clear that the timing risk is captured in the risk adjustment objective. The reference to "ultimate" cash flows seems to indicate that the time value of money is not reflected in the risk adjustment. We believe this timing risk should be captured in the objective. We recommend that the word "ultimate" is removed or changed to "actual".

We have concerns that the reference to the word "maximum" in the measurement objective can be easily misunderstood. The measurement objective needs to be clear that the amount that the insurer would rationally pay should not be set at some arbitrary low value because the insurer would certainly pay a low amount to be relieved of the risk (or to eliminate the uncertainty). However, by specifying a "maximum amount" in the ED, the application of the

techniques may be inappropriately interpreted to be some maximum confidence level, CTE, capital amount, capital rate, or some other determination of a maximum value. Since the purpose of the risk adjustment amount is “to capture the effect of uncertainty,” the risk adjustment amount should reflect an amount that might be paid to obtain cash flows that are certain versus keeping the cash flows that are uncertain. We recognize that the risk adjustment will reflect the insurer’s specific risk preferences for the various characteristics of uncertainty. For example, there will be some cases where there is little model risk or slight parameter risk, but the probability distribution is quite skewed, or other situations where there is substantial uncertainty in the estimation of the parameters (such as the mean estimate), but the probability distribution model is symmetrical.

In other words, the insurer’s risk adjustment should depict the amount that reflects the tradeoff between paying a certain amount versus an uncertain amount(s). In concept, this is similar to the tradeoff made in the purchase of insurance by a policyholder or in the purchase of reinsurance by an insurer at a guaranteed rate. Consequently, for an insurer who has a very large diversified portfolio of similar risks managed together in a pool, the risk adjustment might be de minimus.

We recommend that the measurement objective be better articulated by replacing the word “maximum” with wording that refers to an equivalent amount where the insurer is indifferent between paying a certain amount (to eliminate the uncertainty) and keeping the uncertain cash flows. Suggested wording: “The risk adjustment should depict an amount the insurer would rationally pay to eliminate the uncertainty about the timing and amount of the ultimate fulfillment cash flows, where the insurer is indifferent between paying such an amount that is certain versus paying the uncertain cash flows.”

*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?*

These three techniques could be used to compute a value but that value would not necessarily satisfy the measurement objective as it is currently stated. Specifically, the criteria given to evaluate the techniques can be satisfied without satisfying the objective.

Paragraph B91 of the IASB ED states “Paragraph B72 sets out the characteristics that a risk adjustment must have in order to satisfy the objective (i.e., to estimate the amount an insurer would rationally pay to be relieved of the risk that the actual fulfillment cash flows may exceed those expected).” The criteria set out in paragraph B72 are all desirable characteristics of a risk adjustment but none of them directly relate to how much an insurer would pay to be relieved of a risk. They describe how a risk adjustment’s size should relate to the underlying risk exposure and the underlying experience.

For example, one could determine a risk adjustment using a confidence interval and set the confidence level at an artificially low level and still have:

- higher risk adjustments for risks with low frequency and high severity vs. adjustments for risks with high frequency and low severity,
- higher risk adjustments for contracts with longer durations vs. adjustments for contracts with shorter durations,
- higher risk adjustments for risks with wide probability distributions vs. risks with narrower probability distributions,
- higher risk adjustments for risks about which less is known vs. adjustments for risks where more is known, and
- lower risk adjustments to the extent indicated by emerging experience.

If a risk adjustment is included in the final standard we recommend the standard require these criteria be considered when choosing a measurement technique but the wording of the final standard should be clarified that these criteria alone are not sufficient to meet the measurement objective for the risk adjustment. For each portfolio, the selection of one or more techniques, the calibration of the selected techniques, the selection of assumptions or comparables to parameterize the techniques, and the selection of an appropriate percentile, or capital amount and capital rate, should consider the insurer's specific circumstances within each portfolio.

In addition we do not agree with limiting the techniques that could be used in estimating risk adjustments. We believe that while there are situations where the three techniques noted in the ED could be used to properly estimate a risk adjustment, there are other methods that could also be used and there are other situations where none of three methods may be appropriate.

Actuaries have significant experience in estimating the value of insurance contract liabilities with uncertainty in a principle-based environment. Experience working in this environment has shown that standardized estimation techniques do not necessarily result in comparable estimates, and in some cases can make comparable estimates nearly impossible to achieve. This is because any method or model has inherent strengths and weaknesses, as well as inherent differences in data, assumptions and resource needs. No one method works well in every situation, and in a particular situation with particular facts and circumstances, no one method will work perfectly. It is standard actuarial practice to consider multiple methods. For example Actuarial Standard of Practice Number 43 - Property/Casualty Unpaid Claim Estimates (applicable for U.S. practice) states an actuary should consider multiple methods unless there is a clear rationale to do otherwise.

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

The apparent intention of limiting the techniques that could be used is to achieve some level of comparability between entities or to prevent manipulation of the results by selecting techniques that achieve a certain result. We do not believe that comparability or prevention of manipulation would be achieved by such limitations, but we do think that the limitations could prevent some insurers from using risk adjustments that they believe

reflect the risks to which they are exposed. Each of the techniques defined in the ED require the estimation of parameters and an assumption as to what level of uncertainty should be included in the measurement. Since the guidance provided in the ED does not limit the preparer with regard to developing estimates or selecting the level of uncertainty, each preparer will make their own judgment, likely resulting in different risk adjustments being calculated for similar or the same risks.

Comparability in principle-based estimates is best achieved by providing a clear measurement objective, and then allowing the preparer to select the estimation method that best achieves that objective based on the particular facts and circumstances for the valuation (i.e., estimation) with an important emphasis on appropriate and robust disclosure.

**Question 11:** *Do you agree with the description of cash flows that should be included in the measurement of an insurance contract? Is the proposed guidance operational?*

We believe the measurement of an insurance contract should include the expected present value of all relevant cash outflows less cash inflows that will arise as the insurer fulfills the insurance contract. The DP defines incremental cash flows in relation to the individual contract. This definition ignores the pooling concept that is fundamental to the business of insurance, including the pooling of acquisition costs. Not recognizing certain cash flows in the measurement (e.g., non-incremental acquisition) reduces the relevance of the financial statements to users. We also believe that the DP definition will result in different liability amounts being held depending on the form of the compensation used to distribute the same product. We do not believe this is appropriate, nor do we think this was the intention of the Board.

It is common for insurers to distribute the same product through different distribution systems. If incremental acquisition costs are defined at the contract level, insurers that issue the same product through different distribution systems may hold different insurance liabilities. For example, some insurers have agents who are employees of the company and compensated in part through salary and in part commissions. Commissions are paid only if the contract is issued and thus are incremental, but the salary component of compensation would not be considered incremental under the DP model. Insurers also distribute products through third parties where the compensation is entirely through a commission structure. The commission would be paid only if a contract was issued and thus would qualify as an incremental expense under the DP. In a competitive market the amount built into the pricing of a product for distribution costs will be similar across distribution systems. Thus, for a given insurance product the cash flows used to value the product will be dependent on the distribution system used, producing different liability income amounts both at issue and over the life of the product. The form of compensation to the distributor does not affect how the insurer fulfills the obligation taken on and should not, therefore, affect the liability held or the income recognized.

### **Discounting**

**Question 12:** *Do you agree that the carrying amount of all insurance contracts should be discounted if the effect is material? Do you agree with the proposed guidance on the discount*

*rate that should be used to measure the carrying amount of insurance contracts? If not, which discount rate should be used?*

We agree that the carrying amount of all insurance contracts should be discounted if the effect is material. We note that for long-duration contracts, the time value of money is a critical component in the economic characteristics of the contract, and feature prominently in the pricing and design elements of the contract.

We believe in all cases the discount rate used by the insurer should reflect the characteristics of the insurance contract. The characteristics of the insurance contract include many items. Liquidity, currency and timing are three characteristics, but there are others as well. For example, some non-participating insurance contracts include non-guaranteed elements that introduce a degree of investment-related risk (such as credit or interest rate risks) into the contract. Some people also believe that tax status is a characteristic of the contract. We urge the FASB to make it clear in the final standard that all characteristics of insurance contracts need to be considered and that the three mentioned may not be the only ones affecting the choice of a discount rate.

We believe there are many ways to arrive at an appropriately risk adjusted expected present value of a set of cash flows. Adjustment to the risk-free rate to reflect the characteristics of the contract is only one such method. There are others methods which are equally appropriate (please refer to our letter to you dated September 15, 2009 on this subject). Three methods mentioned there are described below. We encourage creation of guidance making it clear that alternate techniques such as these are allowed:

- Use of the expected earned rate as the discount rate, with downward adjustment to reflect any investment-related risk retained by the insurer. For example, the insurer may retain default risk or interest rate risk due to a cash flow mismatch between the investments and the liability. One could base the adjustment for these risks on the cost of the capital needed to provide for them, although other methods could be used. Whatever method is used, the adjustment would generally be less than the full spread between the expected earned rate and the risk free rate, since the risk free rate would not reflect the illiquidity in an insurance contract. This approach can be described as starting with the expected earned rate and adjusting downward to reflect characteristics of the contract, rather than starting from the risk-free rate and adjusting upward to reflect characteristics of the contract. In either case, the discount rate reflects the characteristics of the contract and does not reflect investment-related risk retained by the insurer, if any.
- Making an adjustment for risk through the use of alternative probability weighting of scenarios rather than through adjustments to the discount rate. The Black-Scholes method is one example.
- Use of a different discount rate in each economic scenario. Scenario-specific discounting is commonly used when contract cash flows depend upon economic conditions, and is required to properly reflect that dependence.



The risk of insurer performance is, in most cases, not a characteristic of the insurance contract and, as such, should not be considered in the choice of a discount rate.

### **Acquisition Costs**

**Question 13:** *Do you think that acquisition costs should be included as one of the cash flows relating to the contract? If not, how would you account for acquisition costs?*

The measurement of an insurance contract should include the expected present value of all relevant cash outflows less cash inflows that will arise as the insurer fulfills the insurance contract. In our view, acquisition costs should be included as they are relevant to the insurance contract.

**Question 14:** *Do you agree that acquisition costs included in the cash flows used in the measurement of the insurance contract should be limited to those that are incremental at the individual contract level? If not, which acquisition costs, if any, would you include in the measurement of the insurance contract?*

We recommend that “incremental” be defined in relation to the portfolio of contracts, which by definition, are managed together as a pool.

To achieve this we recommend that incremental acquisition costs should be defined in relation to the portfolio of contracts that are bound within a similar time period. The fact that pooling is fundamental to the nature of insurance is clear. We believe that this is consistent with how insurers price and manage their business.

Inherent in the pooling of insurance risk and the creation of portfolios of insurance contracts is a need to underwrite a large number of applications so that they can be appropriately evaluated based on characteristics of the risk and that sufficient volume is achieved for pooling to work. In that process, it is expected that a portion of the applications will not result in the placement of an insurance contract, either because the application will be rejected by the insuring entity or the applicant will refuse the final offer made by the insuring entity. That portion can be estimated with sufficient reliability to include, in the price of a product, the expense of processing all applications, whether placed or not.

As a result, the cost of originating the contracts includes incremental acquisition costs that can be measured reliably at the portfolio level, not just those incurred at the individual contract level.

We recommend the same treatment proposed for incremental acquisition costs also be applied to all other incremental costs, where such costs are either deducted from the premium cash flows, or otherwise directly incurred as a result of contract activities related to one or more portfolios of contracts, at the approximate time period that the contracts are bound.

### **Margins**

**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?*

The composite margin should be recognized over the coverage period of the contract. However, we have concerns about the prescriptive nature of the ratio in paragraph 83. In particular, we are concerned that the ratio may result in significant deferral of profits for long-duration contracts. We suggest that the guidance be adjusted to allow for an appropriate selection of method for amortization. Paragraph 83 may be rewritten as follows:

83. To reflect the uncertainties about the amount and timing of expected net cash flows, an insurer shall recognize the composite margin determined at initial recognition as income in profit or loss over the coverage period in a systematic way that best reflects the exposure from providing insurance coverage, as follows:

- (a) on the basis of the passage of time, but
- (b) adjusted for known seasonal patterns of incurred claims and benefits.

Paragraphs 84 – 88 could then be deleted.

#### **Modified Measurement Approach**

**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?*

We recommend that the final standard should permit but not require a modified measurement approach for the pre-claims liabilities of some short-duration contracts. A test for onerous contracts should be applied at inception if the modified method is used. However, we note that the modified approach, as currently specified, is overly complex. The requirement to discount additional future premiums, update interest each quarter, reflect seasonality, and perform a test for onerous contract make this method as much or more work than measuring the contract using the building block approach with little or no benefit. We believe the traditional, internationally accepted, basis for calculating an Unearned Premium Reserve would be a better approach for this purpose.

**Question 23:** *What are the implications of the recent U.S. healthcare reform to the application of the proposed contract boundary principle, including whether health insurance contracts written under the new reforms would meet the conditions in the proposed guidance to be accounted for under the modified approach?*

The proposed boundary principle works well for many individual life insurance and annuity contracts. However, there are a number of health insurance and some property & casualty products offered in the United States whose premium rates are subject to approval by regulation for which this boundary may cause significant application difficulties, which may have a significant effect on how these contracts are measured. These contracts would meet the

definition of a short term contract in the ED, except for regulations or laws that impose limitations on non-renewal and restrictions on premium rates, where there may be a limited ability for an insurer to re-price the renewal of a short term individual contract, to fully reflect the risk of the particular policyholder.

We recommend that paragraph 27 (b) be adjusted as follows:

- (b) has the right or the practical ability to set a price that either:
  - (1) fully reflects the risk of the particular policyholder; or
  - (2) may not fully reflect the risk of each particular policyholder but does, in conjunction with prices set for other contracts in the same portfolio with similar date of inception, fully reflect the risk of that portfolio, or
- (c) has limited or restricted rights, due to regulatory restrictions, to non-renew and to set a price at renewal that fully reflects the risk of the particular policyholder, but has the practical ability to set a price where such limitations or restrictions still allow the insurer to reflect the risk of the particular policyholder according to the allowable price applicable to the risk.