October 24, 2013

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

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

On behalf of the American Academy of Actuaries'[1] International Accounting Standards Task Force, I offer the following comments to the Financial Accounting Standards Board (FASB) concerning File Reference No. 2013-290 – Exposure Draft, *Insurance Contracts.* Members of our task force are senior actuaries with extensive financial reporting experience with life, health, and general insurance companies.

We fully agree with the objective of the new standard to provide better clarity and uniformity regarding the presentation of financial results and related risks in a way that provides more useful information. Actuaries are involved in preparing or assessing financial statements of insurers , serving as preparers, auditors, and users of financial statements. Our comments represent the views of actuaries in all of these roles, and we hope these perspectives will help achieve the goals of the new standard.

Actuaries have provided perspectives to the FASB throughout the development of the insurance contracts model, and we commend the FASB for its responsiveness demonstrated by changes to the *Preliminary Views* draft from 2010. We hope that our comments on the current ED also will be useful to FASB.

We encourage the FASB to continue working with the IASB toward convergence on a worldwide accounting standard. Convergence is an important step in achieving uniformity in the reporting of insurance contracts.

Our specific comments are incorporated in our responses to the questions posed in the discussion paper. We have commented on many issues, and have indicated "no comment" in those areas in which we have no opinion. 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.

[1] The American Academy of Actuaries ("Academy") is a 17,500-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.

Sincerely,

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Risk Management and Financial Reporting Council
American Academy of Actuaries

I. Responses to questions in the exposure draft (ED)

Question 1: Do you agree with the scope and scope exceptions of this proposed guidance, including its applicability to contracts written by noninsurance entities? If not, what types of contracts or transactions also should be included or excluded from the scope and why?

Response: We agree with the scope and exceptions.

Question 2: Do you agree with the requirements included in this proposed Update for when noninsurance components of an insurance contract, including embedded derivatives, distinct investment components, and distinct performance obligations to provide goods or services, should be separately accounted for under other applicable Topics? If not, why?

Response: We agree, with two exceptions.

The first exception relates to reinsurance ceded on a modified coinsurance basis. In the U.S., the FASB has ruled that a modified coinsurance agreement creates an embedded derivative that should be separated from the rest of the agreement. The ED should maintain this position. In current International Financial Reporting Standard (IFRS) No. 4, there is a provision that allows companies to opt to value the assets associated with the policies involved in the modified coinsurance agreement at fair value. This allows a company's financials to match the embedded derivative and its corresponding assets, holding both at fair value. In the ED, this option has been removed. To have a financial statement that is more understandable to users, it will be necessary to restore the option to allow companies to fair value the affected assets.

The second exception relates to the situation in which an insurance contract includes a service that is a necessary part of fulfilling obligations under the insurance contract[2]—to the extent that the entity would not sell a contract covering insurance risk while excluding the service—but for which the entity also sells the service separately. An example is the claims-processing and network access services included in a typical U.S. health insurance contract. These services, while integral to the health insurance contract, also are sold frequently on a standalone basis (i.e., "administrative services only" or "ASO" contracts) to large employers that are comfortable retaining insurance risk. Similar examples exist within the property and casualty insurance.

Example 5 of the ED discusses health insurance and concludes that the entity should not separate the services from the insurance contract. However, that example explicitly assumes that "the claims-processing and network access service are not sold separately by the insurer." We are concerned that, in light of 834-10-25-5(a) and 834-10-25-6, the ED might be interpreted as requiring that these claims-processing and network services would need to be separated from the health insurance contract whether the insurer separately sells the services. Doing so would distort the presentation of a health insurer's income statement in a manner that would not provide value to users.

[2] In paragraph 834-10-25-7(a) this is referred to as a necessary input to the output of the insurance contract.

This uncertainty could be resolved if FASB were to incorporate the following language found in paragraph B35 of the IASB ED[3]: "A performance obligation to provide a good or service is not distinct if the cash flows and risks associated with the good or service are highly interrelated with the cash flows and risks associated with the insurance components in the contract, and the entity provides a significant service of integrating the good or service with the insurance components."

Question 3: Will the proposed measurement model produce relevant information that will help users of an entity's financial statements make economic decisions? If not, what changes do you recommend and why?

Response: We agree for contracts measured using the building blocks approach (BBA). Some actuaries believe, however, that the premium allocation approach has been unduly complicated by applying long-term rules to claim reserves under short-term contracts in ways that will add preparation expense but provide little relevant information.

Question 4: Which aspects of the proposed measurement model most significantly improve the information that will be used in making economic decisions and why?

Response: Several aspects of the measurement model represent significant improvements. Those listed below are the most significant:

- Stating the measurement objective as the mean or average rather than not stating it or using the term "best estimate." Statement of the measurement objective is of particular importance to actuaries because many different objectives can be used for measurement of an uncertain amount. Specifying that the objective is the statistical mean rather than "best estimate" or "most likely" is an improvement.
- Uniform use of the BBA for all long-term contracts. This improves on the mixture of several measurement models used in the past.
- The calibration of the margin to eliminate gains at issue.
- The use of current assumptions that are reviewed and, as appropriate, updated every reporting period.
- The replacement of the "deferred acquisition cost" asset for long duration contracts with appropriate adjustments to liability measurement.

Question 5: Do you agree that entities should apply different approaches to contracts with different characteristics, described as the building block approach and the premium allocation approach? If not, which model do you think should apply and do you think there should be any changes made to that model?

Response: We agree that separate approaches should be applied, specifically the described BBA and premium allocation approach (PAA).

As described, the BBA and PAA have the potential to produce significantly different results due the treatment of the margin and its amortization over the claim settlement period under the BBA

[3] http://www.ifrs.org/Current-Projects/IASB-Projects/Insurance-Contracts/Exposure-Draft-June-2013/Documents/ED-Insurance-Contracts-June-2013.pdf

but not under the PAA. This inconsistency is difficult to justify, especially if the different models are applied to similar products or to similar claims. This potential problem would be alleviated if a risk adjustment (implicit or explicit) were added to the claim liability in the PAA model. This matter is discussed in greater detail in our response to Question 15.

There is also an inconsistency in the ED with respect to certain forms of reinsurance. In particular, the guidance discusses the criteria that determine when the PAA must be used. In another part of the guidance it requires that the approach used to account for reinsurance ceded must be the same approach as is used for the underlying contract. The conflict arises when a long-term contract is covered by a one-year stop-loss agreement. On the one hand, this type of reinsurance fits under the requirement to use the PAA, but on the other, the guidance requires the same approach that is used for the directly written contract. The best approach would be to use assumptions consistent on both the written and ceded business, but to use the accounting basis that is appropriate for the directly written insurance contract for that contract and the accounting basis appropriate for the reinsurance contract for the reinsurance contract.

Question 6: Do you agree that entities should be required to apply the premium allocation approach if the coverage period of the insurance contract, considering the contract boundary guidance, is one year or less? If not, what would you recommend and why?

Response: We would suggest that use of the PAA be optional. There are numerous situations in which an option would be appropriate. For example, a small part of a portfolio may be of less than one-year duration and, under the mandatory treatment, would need to be separated. Companies that write contracts typically falling under the BBA should have the option to use BBA in all cases.

Question 7: Do you agree that entities should be required to apply the premium allocation approach if, at contract inception, it is unlikely that during the period before a claim is incurred there will be significant variability in the expected value of the net cash flows required to fulfill the contract? If not, what do you recommend and why?

Response: In general, we agree with this guidance as a criteria requirement for contracts longer than one year to be accounted for under the PAA. The guidance could be enhanced with a principle that states that the longer a contract is beyond one year, the more difficult it would be for the contract to meet the criteria for the PAA model.

It is our view that preparers should use the same model for insurance contracts that preparers think are substantially similar. Most property and casualty contracts have policy terms that are one year or less. However, in certain situations companies may write the same contracts for somewhat longer terms than 12 months. In most of these cases, the contracts are written only for multiple years if it is unlikely that information would emerge in the pre-claims period that would significantly affect the expected cash flows of future claims under the contract.

It is a common practice for property and casualty insurance that in a book of one-year policies, there can be some proportion of policies written using a three-year term. This also can occur in a book of group life or group health contracts. While there may be cases in which these do not

meet the requirements to use the PAA as written in the ED, a requirement to separate these policies and apply the BBA would seem a burdensome requirement relative to its value.

Question 8: Do you agree with the definition of a portfolio of insurance contracts as included in this proposed Update? If not, what do you recommend and why?

Response: We agree that contracts in a portfolio should be subject to similar risks. With regard to the other requirements, however, we have concerns.

First, the requirement that contracts be priced similarly only applies when dealing with pre-claim liabilities. Even for pre-claim liabilities, contract pricing could be different, for instance, for contracts with issue age 5 and those with issue age 80. There is no need to hold them in separate portfolios.

There is no need for similar pricing when measuring claim liabilities.

We understand that the requirement of similar duration is intended to provide assurance that the margin runs off when the liability expires. However, a requirement of similar duration will lead to division of groups of otherwise similar contracts into separate portfolios, even though doing so will have virtually no effect on measurement, will create many more portfolios than warranted, and will create administrative complexity.

Therefore, we do not agree that contracts in a portfolio must be similar in duration in order to achieve the objective of the update that the margin runs off when the contract expires. This is of concern especially to life insurers that issue contracts at a wide range of ages. Life insurance contracts issued at young ages could be viewed as having a longer duration than life insurance contracts issued at older ages. The definition of a portfolio would require a group of such contracts to be divided into many different portfolio sub-groups, even though such division would have little if any effect on measurement and would create administrative complexity.

This requirement arose because the amortization of the margin is to be based on expected patterns of release from risk or reduction in variability of cash flows. It might be considered necessary for contracts of different durations to be in separate groups to amortize their margin in that way. However, that is not the case as long as the contracts are “priced similarly relative to the risk assumed” as stated in the definition of portfolio.

If all contracts in a group are priced similarly relative to the risk assumed, and the margin is to be amortized based on the pattern of release from risk, then the same pattern of margin amortization will be obtained regardless of whether the amortization is done separately for each contract or if it is done in the aggregate for all contracts. This is true even if the contracts have different durations. Consider the following example.

An insurer issues 100 contracts with a 10-year term and 100 contracts with a 20-year term. Risks under the contracts are constant and level in every year, based on the amount insured. Pricing relative to risk is the same for all contracts, so the 20-year contracts have larger initial margins than the 10-year contracts. Suppose that the total group of 200 contracts has a margin of 300.

This could be amortized in relation to release from risk at the rate of 0.1 per contract per year. Since there are 200 contracts for the first 10 years and 100 contracts for the second 10 years, the amortization would be 20 per year for the first 10 years and 10 per year for the second 10 years. This amortization would not change if the contracts were divided into two separate portfolios, as long as the pricing and margins relative to risk were the same. The portfolio of 20-year contracts would have a margin of 200, amortized at 10 per year over 20 years. The portfolio of 10-year contracts would have a margin of 100, amortized at 10 per year over 10 years. The total amortization would be the same as if all contracts were included in one portfolio.

In light of this example, we believe that a portfolio should be defined as a group of contracts that are subject to similar risks and priced similarly relative to the risk assumed. Thus, the requirement of similar duration should be removed.

The definition of a portfolio has an effect mainly when presenting portfolios in an asset position separately from those in a liability position. With this in mind, we note that contracts under the PAA are almost always in a liability position, so the definition of a portfolio has little practical effect for such contracts. In addition, considerations regarding original pricing are irrelevant when grouping post-claim liabilities into portfolios under the PAA.

Question 9: Do you agree with the requirements included in this proposed Update on contract boundary (that is, the requirements that establish how to identify the future cash flows that will arise as the insurer fulfills its obligations)? If not, what do you recommend and why?

Response: We agree with the proposed language on contract boundary.

Question 10: Do you agree with the types of cash flows that would be included in the measurement of the fulfillment cash flows, including embedded options and guarantees related to the insurance coverage under existing insurance contracts that are not separated and accounted for as embedded derivatives? If not, what cash flows do you think also should be included or excluded and why?

Response: We agree with the types of cash flows included.

Question 11: Do you agree that the assumptions used in the measurement of the fulfillment cash flows should be updated each reporting period? If not, what do you recommend and why?

Response: We agree that the assumptions should be updated each reporting period.

Question 12: Do you agree that the fulfillment cash flows for contracts measured using the building block approach and the liability for incurred claims for contracts measured using the premium allocation approach should be based on an explicit, unbiased, and probability-weighted estimate (that is, the mean) of the future cash flows, as of the reporting date, expected to arise as the entity fulfills the contract, adjusted to reflect any contractual linkage between the contract and any underlying assets? If not, what do you recommend and why?

Response: We agree with this concept for measurement of cash flows. We observe that a wide variety of methods will be used in practice to implement this concept. In some cases, a single central estimate will be used rather than applying probability weights to multiple potential outcomes. When that is done, it will be done with the understanding that the central estimate must be an estimate of the mean rather than an estimate of the most likely outcome.

This needs to be viewed in the context of the measurement of cash flows as part of the measurement of a liability. The economic concepts of discounting for the time value of money and adjusting for the market value of risk also have a place in measurement of a liability. In particular, as discussed again in our response to Question 15, many believe it is inappropriate to measure the cash flows associated with incurred claims for contracts measured using the PAA on a discounted basis when not accompanied by a simultaneous adjustment for the value of risk.

In regard to paragraphs **834-10-55-54, 834-10-55-55, 834-10-55-56, and 834-10-55-76** concerning the unbiased probability-weighted expected value (statistical mean), we suggest changing certain language (in the suggested rewrite below) to clarify the ED. We also suggest deleting certain language to avoid misinterpretations that we believe are unintended. These specific suggestions are intended to clarify that it should be unnecessary in certain cases to explicitly identify specific scenarios, a range of scenarios, explicit unbiased probability estimates of each scenario, or a probability distribution that represents the probabilities of various outcomes. For many types of insurance there is considerable actuarial literature that will be used to estimate the mean, such as the actuarial central estimate, without the need to develop explicit scenarios or probabilities, although in all such cases the range of possible outcomes is considered. We suggest deleting the language concerning the need for explicit scenarios and the determination of whether there are a sufficient number of scenarios to the estimate of the mean.

Our suggested rewrites for these paragraphs are as follows:

> ***834-10-55-54*** *The objective in estimating cash flows is the expected value, or statistical mean of the full range of possible outcomes. Conceptually, the expected value reflects the full probability distribution of outcomes, or a sufficiently robust set of scenarios with associated unbiased probability estimates.*
>
> ***834-10-55-55*** *In practice, it is not always necessary to develop explicit scenarios or to use explicit probabilities, if the resulting estimate is consistent with the measurement objective of considering all relevant information in determining the mean. For example,*
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> 1. *If an entity determines that the statistical mean can be estimated in a way that is consistent with the objective of appropriately considering the full range of possible outcomes and the associated unbiased probabilities, it is acceptable to estimate the statistical mean without explicit scenarios and explicit probabilities.*
> 2. *If an entity estimates that the probability distribution of outcomes is consistent with a probability distribution that can be described completely with a small number of parameters, it will be acceptable to estimate those parameters.*
>
> *Similarly, in some cases, relatively simple modeling may provide an estimate of the mean within a tolerable range of precision, without the need for a large number of detailed scenarios or statistical simulations.*

However, in some cases, the cash flows may be driven by complex underlying factors and respond in a highly nonlinear fashion to changes in economic conditions (for example, if the cash flows reflect a series of interrelated implicit or explicit options). In these cases, more sophisticated stochastic modeling may be needed, including the identification of scenarios that specify the amount and timing of the cash flows for specified outcomes and the estimated probability of those outcomes.

834-10-55-56 *The estimate of the mean of future cash flows should reflect conditions at the end of the reporting period (for purposes of measuring the portfolio of insurance contracts at that date).*

834-10-55-76 *In estimating the cash flows from an insurance contract, an entity should reflect future events that might affect the cash flows without changing the nature of the obligation. The entity should consider how such future events would affect the expected present value of the future cash flows. Such considerations may, or may not, require identifying explicit scenarios and explicit probabilities.*

We believe that the measurement objective is clearly stated in terms of the expected value being an unbiased estimate, representing a probability-weighted average, and should provide sufficient guidance for preparers, actuaries and auditors.

Question 13: Do you agree with the approach in this proposed Update to recognize changes in estimates of cash flows (other than the effect of changes in the liability arising from changes in the discount rates) in net income in the reporting period? If not, what do you recommend and why?

Response: We disagree with the proposed approach. It would be more appropriate to re-measure the single margin for changes in estimates of future expected cash flows. This appropriately allocates the release of the single margin to the period in which future performance of the contracts is expected to occur.

In addition, the effect of a change in the credit quality of reinsurers should be included with the effect of other changes in estimates when re-measuring the margin.

Question 14: Do you agree that the discount rates used by the entity for nonparticipating contracts should reflect the characteristics of the insurance contract liability and not those of the assets backing that liability? Why or why not?

Response: We agree that the discount rates for nonparticipating contracts should reflect the characteristics of the insurance contract liability and not those of the assets backing the liability. This will help realize the objective of improving the consistency of reporting for insurance contracts. If the discount rates were to reflect the assets backing the liability, then differences in investment strategy between entities would create differences in the measurement of otherwise similar insurance contracts, creating an inconsistency that should be avoided. Furthermore, we agree that appropriate application of either the “bottom-up” or “top-down” approach described in the ED will achieve this goal.

While we agree with the treatment of discount rates as stated in the standard, there is significant room for judgment and interpretation in its application. We wish to state our understanding of setting the discount rate in the context of long term contracts with cash flows that do not depend on underlying assets. To illustrate this understanding, we use an example of an annuity contract that provides fixed monthly payments for the remainder of the contract owner's lifetime.

The discount rate can be determined using a "top-down" approach. This approach sets the discount rate equal to expected returns on assets with two adjustments. As explained in Paragraph BC151, the two adjustments are made to adjust for:

a. differences between the timing of the cash flows to ensure that the assets in the portfolio (actual or reference) selected as a starting point are matched with the duration of the liability cash flows, and
b. risks inherent in the assets that are not inherent in the liability such as expected and unexpected losses (the risk of losses exceeding the expected value).

Our concern is with adjustment b) for the risk of expected and unexpected credit losses. In our view, this adjustment refers to losses in the future that may or may not occur. The estimation of such future events is similar to a level 3 fair value estimate and, therefore, should put more weight on long-term estimates than on short-term fluctuations. Our interpretation is that the adjustment for the risk of expected and unexpected losses should emphasize long-term estimates and not be constrained to reflect the short-term fluctuations in credit spreads implicit in transaction prices that occur in the day-to-day market. This approach is required to alleviate concerns that current period fluctuations in discount rates exaggerate the volatility of long-term liabilities.

Paragraph BC151 already echoes this approach, but might be read to imply that it should only be applied only for periods beyond the maturity of financial instruments with readily observable market prices. We believe this approach - the use of a stable long-term estimate for credit spreads to be deducted in the "top-down" approach - should be applied across the entire yield curve, for all maturities.

The result of not applying this approach will be to introduce widely fluctuating valuations of unknown future losses into the measurement of net worth on the balance sheet. The fluctuating valuations of future losses will flow into net worth because they will be included in the measurement of assets but not the measurement of liabilities. Fluctuations in credit spreads will be removed from the discount rate for liabilities, but not from the market valuation of corresponding assets of the company.

It is well known that market credit spreads are both larger and much more volatile than actual credit losses. We do not agree that the effect of market volatility in such spreads should flow immediately to net worth. The effect of such volatility is to introduce fluctuations in net worth that are known to be both larger and more volatile than actual credit losses.

Net worth reported based on such fluctuating valuations of future credit losses is not useful information. If, instead, the credit spreads removed from the discount rate for liabilities represent stable long-term estimates, then the discount rates for both assets and liabilities will move in

parallel. The volatility in net worth due to changing valuation of unknown future losses will be reduced significantly. The resulting information will be more useful to the user of financial statements.

In addition, we note that Paragraph BC151 states that if there are no observable market prices for determining the discount rate, "an entity should use an estimate that is consistent with existing U.S. GAAP guidance on fair value measurement, particularly for Level 3 fair value measurement." We agree with the comment in Paragraph BC151 that "because forecasts of unobservable inputs tend to put more weight on longer term estimates than on short-term fluctuations that would counteract concerns that current period fluctuations in discount rates exaggerate the volatility of very long-term liabilities." We note that this does not address situations in which there are observable inputs at the long end of the yield curve, but that data is based on markets that are not as deep or liquid as the shorter end of the yield curve. For such inputs, the guidance should permit an estimate consistent with level 3 fair value estimates. Such estimates would likely put some weight on the observable inputs but also would incorporate long-term estimates to some degree. This would mitigate the effect of short-term fluctuations in less reliable points of the yield curve that can have a substantial impact on the insurance contract liability.

Question 15: For contracts measured using the premium allocation approach, do you agree that an entity should discount the liability for incurred claims? Do you agree that an entity should be allowed to elect not to discount portfolios when the incurred claims are expected to be paid within one year of the insured event? Why or why not? If not, what would you recommend and why?

Response: We understand that the proposal directs preparers to discount unpaid claim estimates since the time value of money is viewed as a basic tenet of finance. We agree with this basic tenet. However, we are concerned that the discounting approach for claim liabilities as indicated in the proposed update ignores another basic tenet of finance, that the value of fixed and certain cash flows is not the same as the value of uncertain cash flows without appropriate reflection of the risk and uncertainty associated with those cash flows.

There are alternatives that potentially could be used to reflect risk and uncertainty:

a. Through an explicit risk adjustment, either as an increase to the unpaid claim estimates, such as proposed by the IASB, or as an adjustment to the yield curve that is used to present value the liabilities; or

b. Through an implicit margin (a provision for adverse deviation), such as currently applied in the accounting model under U.S. GAAP for short-duration contracts, during which the amount of discount is offset implicitly by an adjustment for uncertainty via not discounting or restricting the extent of the discounting.

There are advantages and disadvantages to the above approaches:

a. Explicit risk adjustments can be tailored to better reflect the amount of uncertainty in the unpaid claim estimates in a transparent manner, and the existence of such in U.S. GAAP likely would make the financial reporting under U.S. GAAP more consistent with future IFRS. On the other hand, explicit risk adjustments may not be consistent among preparers, and such amounts cannot be back-tested that is, it is not possible to observe whether a risk adjustment is a reasonably appropriate amount or whether it is too much or not enough.

b. Implicit margins which, in substance, are consistent with today's U.S. GAAP accounting model for short-duration contracts, are not tailored to the degree of uncertainty inherent in the applicable claims. However, the current accounting model is simple, well understood, more easily audited than the proposed model, and has generally proven to be acceptable to both preparers and users. This is partly due to the extensive disclosure on claim estimate runoff included within current U.S. GAAP and statutory reporting, providing information on historical claim estimate reliability and risks that formed the basis of reported claim liabilities.

While these approaches that reflect uncertainty have limitations, they are preferable to ignoring the existence of uncertainty.

We also considered the possible use of explicit margins to reflect risk and uncertainty, in which such amounts are set at contract inception and decreased as the company is released from risk. In our view, this approach would be unlikely to produce decision useful information for users. While such explicit margins might produce more consistency among preparers, they are not responsive to the degree of uncertainty of the estimates and can cause many practical difficulties for more erratic and/or longer tail liabilities.

We also note that the most important balance sheet component for understanding the financial reports of a property/casualty insurer is the estimate of the claim liability. In general, it is the estimate on an undiscounted basis without risk margin that is most important for this understanding, as this is the amount that can be reliably tested on a runoff basis. As such, any inclusion of discount and/or risk margin should not impair the transparency of these undiscounted estimates.

Question 16: Do you agree that an entity should segregate the effects of underwriting performance from the effects of changes in discount rates (which would reverse over time) by recognizing changes in the present value of the fulfillment cash flows due to changes in the discount rates in other comprehensive income? If not, do you think that the effect of changes in the discount rates should be presented in net income? Please explain your reasoning.

Response: We agree that it is generally appropriate to recognize the change in present value of the fulfillment cash flows due to changes in the discount rates in other comprehensive income (OCI); however, we do not believe the use of OCI should be required. Given that the FASB's position is to use current discount rates for insurance liabilities measured under the BBA, having an option to use OCI is necessary to avoid obscuring the impact to net income of underwriting results with potentially significant changes to the liability from changes in discount rates. Given

the long duration of many insurance liabilities, and the unlikelihood of matching the asset and liability cash flows in many cases, the use of current discount rates can cause large fluctuations in comprehensive income that would often be several times greater than the impact of underwriting results. This is particularly the case when changes in interest rates reverse over time. Even if asset and liability cash flows are matched, the fact that the FASB's position is that the liability discount rate should not be equal to the yield on the assets backing the liability means that when interest rates change, the impact to asset and liability values will be different, creating unwarranted volatility.[4] As such, it is important for many insurance contracts to separate the effect of changes in discount rate and show the change in OCI, similar to the use of OCI for many financial instruments.

OCI is particularly important for many insurance contracts given decisions to use OCI in a parallel manner for many financial instruments and to remove the option to measure insurance contracts at fair value. For insurance contracts to show net income in a manner consistent with that of other financial instruments not held for trading, it is necessary for OCI to be used so that net income is consistently shown on an amortized cost basis.

The use of OCI should not be a strict requirement, however, since there are circumstances in which use of OCI will create an accounting mismatch or it is not a meaningful adjustment. For example, for unpaid claim estimates related to contracts under the PAA, the current rate, and not the discount rate at inception, should be used for discounting and interest accretion. This would provide more relevant information and still allow for separation of underwriting and investment performance, provide information in a manner that is more consistent with the business model of contracts under the PAA, and would be far simpler from an implementation and disclosure perspective.

Insurance contracts eligible for the PAA are principally property/casualty contracts, for which the business model is not an interest rate spread model. Rather, its business model is principally a claims management model. Claims settlement decisions do not depend on what interest rate was in effect at the time the contract that generated the claim was issued. While investment income is considered in the performance evaluation of property/casualty insurance companies and their claims function, the model is not an interest spread model due to the relative unpredictability of the amount needed for and timing of claims. A typical approach taken to operate a property/casualty company is to manage the difference in durations between estimated claims payout and invested assets in the aggregate, while maintaining current liquidity to cover large settlements, catastrophic events, and similar sources of volatility.

Further, this issue is more pronounced for those property/casualty insurance and reinsurance products that have claim emergence and settlement periods spanning many years, such as workers compensation, excess liability, directors and officers, and casualty excess of loss

[4] For example, assume that both assets and liabilities have cash flows of Currency Units (CU) 10 per year for 20 years. Assume the asset yield is 6 percent and that the liability discount rate is determined to be 5.6 percent, producing an asset value of CU 114.7 and a liability value of CU 118.5. Because Macaulay duration is a function of both the cash flows and the discount rate, the assets would have a Macaulay duration of 8.605 years and the liabilities would have a Macaulay duration of 8.723 years, a more than 0.1 year mismatch. If interest rates declined by 1 percent, affecting assets and liabilities equally, the asset value would increase by CU 9.9 while the liability value would increase by CU 10.4, creating a mismatch in income despite the perfectly matched cash flows.

reinsurance. For many larger insurance and reinsurance companies, a large portion of their unpaid claim liabilities arise from these contracts. Claims for these coverages tend to emerge differently from that expected at contract issuance. There often are cases of initial claim recognition and changes in unpaid claim estimates many years, even decades, after the original contract was issued. For example, most liabilities for asbestos related claims were only recognized and established decades after contract issuance. In these cases, discounting using the yield curves that existed at the issuance of the contract can produce both irrelevant and useless information. In fact, discounting current changes in estimates using interest rates that existed in a different yield curve era has the potential to produce misleading income statement information.

We note that using current rates is far simpler than having to track separate calculations, maintain differences through OCI and then struggle to explain the effect of such differences to users of the financial statements, particularly when such differences are almost certainly due to mechanical changes and not due to the economics of the business model.

For example, suppose there are two spinal cord cases outstanding, one with a locked in discount rate of 8 percent and another with a locked in discount rate of 4 percent, and the allocation of the expected claims shifts between the two contracts, without impacting the overall expected claim costs or the timing of expected claims. There will be a net income effect due to the fact that the different claims are being discounted at different rates for net income purposes. But since the economics of the situations are unaffected by a mere re-allocation of claim costs among different contracts, such a net income effect is inconsistent with the business model.

Another circumstance under which OCI may not provide reliable, representationally faithful information is if the liability that does not qualify for mirroring and the assets backing the liability are required to be held at fair value with changes in fair value recorded in net income. If a significant portion of the assets backing the liability are required to be held at fair value without OCI, but the liability is required to use OCI, then OCI will create an accounting mismatch. This can be addressed by providing an option to exclude OCI on a contract if doing so would mitigate an accounting mismatch, similar to the fair value option criteria being proposed in the financial instruments project.

For the above reasons, we suggest two ways in which OCI can be applied in a manner that insures that it is available when necessary but not required when it would generate results that are not relevant or representationally faithful:

1. OCI would be the default case. However, in cases in which OCI is not consistent with the business model or would exacerbate an accounting mismatch on a portfolio, the reporting entity would be permitted (or required) to not use OCI for that portfolio.
2. OCI would not be the default case. However, in cases in which OCI is consistent with the business model and would mitigate an accounting mismatch, use of OCI would be required (or permitted).

A related concern is the impact of OCI (and, if adopted, a floating margin) when risks within an insurance contract are hedged using derivatives and OCI is otherwise appropriate for that contract. Since the unit of account for insurance contracts is a portfolio, a portfolio often remains open for some time after inception, and hedging can often only be effectively done at a portfolio

level, Topic 815 makes it difficult to achieve hedge accounting for hedged risks within a portfolio of insurance contracts. This could be addressed effectively within the insurance contracts standard by permitting a version of hedge accounting for insurance contracts.

If a hedged risk would qualify for hedge accounting under Topic 815, other than for issues related to being part of a portfolio, then that risk could qualify for a version of hedge accounting within the insurance standard. Subject to similar documentation requirements as for hedge accounting under Topic 815, the cash flows related to the hedged risk within an insurance contract would not apply OCI and would not be subject to any unlocking of the margin (if FASB were to adopt a floating margin). This would be similar to treating hedged risks within financial instruments at fair value through net income.

Question 17: Because the proposed guidance includes the approach under which changes in the insurance liability arising from changes in the discount rates should be recorded in other comprehensive income, do you think that a test should be required to trigger recognition in net income of some or all of the amounts in accumulated other comprehensive income (that is, a loss recognition test based on asset-liability mismatches)? Why or why not?

Response: As long as the loss is recognized in OCI, a separate loss recognition test is not necessary. A loss recognition test also would be inconsistent with the reporting for financial instrument liabilities, for which there may not be a loss reflected in OCI, and, as such, should not be necessary for insurance contracts. Amounts held in OCI will reverse into income as policies terminate.

Question 18: Do you agree that the method for calculating the discount rates should not be prescribed? Is the proposed guidance on determining the discount rates understandable and operable? If not, what do you recommend?

Response: We agree that the method for calculating discount rates should not be prescribed. The proposed guidance is based on principles that actuaries understand and, as such, is understandable and operable.

Question 19: Do you agree that interest expense generally should be based on the discount rates determined at the date the portfolio of contracts was initially recognized? Why or why not? If not, what do you recommend?

Response: We agree with locking in the discount rate at inception for BBA contracts without participation features, subject to the exceptions noted in our response to Question 16. In most cases, such an approach would not be appropriate for contracts accounted for under the PAA.

When locking in a discount rate, it should not be necessary to lock in a full yield curve, since that is more complex than the single effective yield that is used for valuing the amortized cost of financial instruments. Using a full yield curve also can create a situation in which OCI is generated, even though the market yield curve has not changed, as a result of cash flows within a contract rolling through the locked in curve. While using a full yield curve may be appropriate in some circumstances, it should not be required in circumstances in which it would require more

cost or effort than the benefit of the information. Rather, using a single effective yield should be permitted. This often will be the case for many contracts that use the PAA.

Question 20: Do you agree that upon any change in expectations of the crediting rates used to measure the insurance contract liability for insurance contracts with discretionary participation features, the interest accretion rates should be reset in a manner that recognizes any changes in estimated interest crediting and related expected cash flows on a level-yield basis over the remaining life of the contracts? If not, what do you recommend?

Response: We agree that the method proposed for updating the interest accretion rate for contracts with discretionary participation features is a good starting point. It reflects the impact of the change in interest rates through OCI at the time of the change. However, using a single interest accretion rate creates anomalies in future income, since the single interest accretion rate is not consistent with the pattern of future expected credited rates on the contract. Often when interest rates decline, the adjusted interest accretion rate will be lower than the projected credited rates in the near term but higher than the projected credited rates further in the future, and vice versa. This, in turn, can cause a pattern in which expected net income in the near term increases (decreases) and expected net income further in the future decreases (increases) when interest rates decline (rise). Such effects are not consistent with the economics of the contract.

This situation can be avoided by adjusting the approach such that the interest accretion rates are calculated to be consistent with the pattern of projected future credited rates. Instead of calculating a single effective yield, a constant spread (which could be positive or negative) would be calculated based on projected credited rates so that the value of the liability used for net income purposes after the change in both credited rates and interest accretion rates equaled the value of that liability before the changes in rates.[5]

This approach would reflect the economics of the contract, in that the projected credited rates is a characteristic of the liability. Although this approach is slightly different than the calculation typically used for amortized cost bonds, it is different in a way that is consistent with the difference in the economics of the two types of contracts. Bonds generally have a single expected credited rate at any time—even indexed bonds generally would not project changes in future credited rates resulting from changes in the index as of any given valuation date. But the nature of many universal life-type and participating insurance contracts is to have credited rates that are expected to change over time, even if the interest rate environment remains constant. This is a result of the fact that the credited rate typically moves only part of the way towards current market rates in any one period. And, such projected credited rates are the rates used to project the future cash flows within the BBA. Thus it is consistent with the characteristics of such liabilities to reflect the expected future changes in credited rates when determining the interest accretion rates.

Question 21: Do you agree that an insurer should not recognize a gain at initial recognition of an insurance contract (such a gain would arise when the expected present value of the cash outflows

[5] It may be possible to interpret the existing wording of the proposed Update to permit a path of interest accretion rates based on the path of expected future credited rates. However, even if this is the case, it would be helpful to clarify that point in order to make it more explicit and avoid confusion.

is less than the expected present value of the cash inflows) but, rather, should defer that amount as profit to be recognized in the future? Why or why not?

Response: We agree for the reasons stated in the basis for conclusions in the proposed update.

Question 22: Do you support using a one-margin approach, as is included in this proposed guidance, or an explicit risk adjustment and a contractual service margin (as the IASB proposes)? Please explain the reason(s) for your view.

Response: First, given our support of convergence, it would be useful to come to a common view on this subject.

However, for contracts accounted for under the BBA, there are varying perspectives on which approach provides more meaningful financial information to the user. On one hand, it may be more appropriate to include a separate risk adjustment and contractual service margin (CSM) for the following reasons:

1. It is logical to separate these two elements as they are of a very different nature.

2. The method used to amortize the single margin is unproven and has never been applied. There is no guarantee that the results, as applied by different entities, will be comparable.

3. Whatever the size of the risk adjustment, the relative size and risk/uncertainty associated with the underlying risks of the insurance contract provides useful information to the user.

4. The proposed standard treats the liability during the claims period in an inconsistent manner for contracts for which liability is measured using the BBA and those for which liability is measured using the PAA because there is a margin in the former but not in the latter. Thus, the same claims obligation would be assigned different values.

On the other hand, it may be more appropriate to use a single margin for the following reasons:

1. The incorporation of two margins results in an unnecessarily complex model, with relatively limited meaningful information provided.

2. In most long-duration contracts, the adjustment for risk will be relatively small compared with the overall liability; therefore, separating them will not be worth the additional complexity and cost associated with their separate measurements.

3. The expected diversity in approach to be used to measure the adjustment for risk will reduce its value. Thus, the split between the risk adjustment and CSM would be somewhat subjective.

4. A risk adjustment should not be allowed to make a contract appear to be onerous, because the risk adjustment will likely be released at a later time into net income.

5. The claims expense is biased if it includes the amount of the risk adjustment. If there is a risk adjustment it would be preferable for it to be treated as deferred revenue.

For contracts accounted for under the PAA, it is appropriate to include either an explicit risk adjustment or an implicit margin (by recording such amounts undiscounted) during the period over which claims are settled. We provide greater detail on this issue in our response to Question 15.

Question 23: If you support a risk adjustment and a contractual service margin, do you agree with the IASB's approach to adjust the contractual service margin for changes in estimates of cash flows? Why or why not? Do you agree with the IASB's approach to not specify acceptable approaches to determine the risk adjustment? Why or why not?

Response: We agree with the IASB's approach for the reasons cited in the response to Question 13.

Question 24: Do you agree that a loss at initial recognition of a portfolio of insurance contracts should be recognized immediately in net income (such a loss would arise when the expected present value of the cash outflows exceeds the expected present value of cash inflows)? Why or why not?

Response: A loss should be recognized at the time a contract is recognized that is not expected to generate a profit over its lifetime unless it is part of a portfolio that is in total expected to be profitable.

Question 25: Do you agree with the proposed method(s) of recognizing the margin (that is, as the entity is released from risk under the insurance contracts as evidenced by a reduction in the variability of cash outflows)? If not, what do you suggest and why?

Response: The composition of the margins incorporates many elements of performance and risk associated with the fulfillment of the entity's obligations under the contract. Although risk is an important element, its relative significance will vary across contracts considerably. Nevertheless, without introducing the equivalent of a split CSM and adjustment for risk, such an approach is a practical one.

Alternative methods should be allowed under this standard to release the margin based on risk and severity other than the standard deviation approach as shown in Example 16.

Question 26: Do you agree that interest should be accreted on the margin and therefore affect insurance contract revenue? If not, why?

Response: The time value of money is inherent in measuring the value of future cash flows, and the margin results from discounting the future cash flows of the contract. As a result, that interest should be accreted on the margin.

Question 27: Do you agree that if the expected cash outflows (including qualifying acquisition costs) of a portfolio of insurance contracts will exceed the expected cash inflows, an entity should recognize the remaining margin immediately in net income? Why or why not?

Response: It is not appropriate to recognize a gain by releasing the margin at the time the expected cash outflows exceed the expected cash inflows. This gain does not represent the economics of the situation, and may mislead the users of the financial statements.

In addition, such a test would add burdensome record keeping and calculation costs. Although the BBA is intended to be a prospective calculation, this test would require tracking historical cash flows related to each portfolio and combining them with the projected cash flows to generate the test result.

Any need for this test would be eliminated if the FASB would permit unlocking the margin. Then the margin would be released as adverse changes to assumptions generate changes to expected cash flows, rather than in a lump sum at a random point in time. However, even if the FASB does not agree to unlock the margin, there should be no special exception for unlocking the margin at the point when expected cash outflows exceed expected cash inflows.

Question 28: Do you agree that the direct acquisition costs presented with the margin should include only the costs directly related to the entity's selling efforts that result in obtaining the contracts in the portfolio and that all other acquisition costs should be recognized as expenses when incurred? If not, what do you recommend and why?

Response: We do not agree with limiting direct acquisition costs to successful sales. This would create an inconsistency in reporting between organizations with different sales distribution methods. Sales distribution methods can vary widely in the proportion of sales attempts that are successful, and not vary much in the total cost per successful sale. Some insurers sell through independent brokers, others through a captive agency force. Some insurers pay by commission (a variable cost), others use a salaried distribution staff (a largely fixed cost). Some insurance is marketed to business, some to individuals through an employment relationship, and some directly to individuals. Limiting direct acquisition costs only to those directly related to successful sales will result in different accounting results.

Simplicity is particularly important for contracts under the PAA in which the effect of amortization is relatively small. Any one of three simple options could be specified:

a) immediate recognition of all acquisition expenses,
b) deferral of acquisition expenses for all sales efforts, or
c) deferral of only commission and taxes.

We feel that convergence with the IASB is particularly important in this area so that acquisition expenses are treated in the same way by both FASB and IASB.

Question 29: Do you agree that the measurement of the margin for contracts measured using the building block approach and the liability for remaining coverage for contracts measured using

the premium allocation approach should be reduced for direct acquisition costs incurred? If not, what do you recommend?

Response: We agree that this approach is reasonable. We also would be satisfied with the IASB approach, and we encourage convergence.

Question 30: Do you agree that an entity should recognize acquisition costs as an expense in net income in the same pattern that it recognizes the margin for contracts measured using the building block approach or in the same pattern that it reduces the liability for remaining coverage under the premium allocation approach? If not, why not?

Response: We agree that this approach is reasonable. We agree that the IASB approach also is reasonable, and we encourage convergence.

Question 31: Do you agree that users of financial statements would obtain relevant information that faithfully represents the entity's financial position and performance if, in net income, for all insurance contracts, an entity presents insurance contract revenue and incurred expenses, rather than only information about changes in margins (that is, the net profit)? If not, why not?

Response: We agree that the financial statements should include contract revenue and expenses.

Question 32: Do you agree that, for all contracts, revenue should exclude any amounts received that an entity is obligated to pay to policyholders or their beneficiaries regardless of whether an insured event occurs and that expenses should exclude the corresponding repayment of those amounts? If not, what do you recommend? Please specify whether your view depends on the type of contract.

Response: The discussion in Paragraphs BC94 through BC99 suggests that the FASB's main objective behind the separation of estimated returnable amounts is to "enhance comparability between entities issuing insurance contracts and financial type contracts" (quoting from BC96) and, therefore, to require disclosure of "the amounts payable on demand to policyholders" (quoting from BC99). However, as Example 19 illustrates, the apparent scope of 834-10-35-14 goes beyond those insurance contracts that involve amounts payable on demand to policyholders or that are, in a broad sense, competing with contracts accounted for as financial instruments.

For contract types, such as permanent life insurance, that have an explicit amount payable on demand to the policyholder, we neither agree nor disagree with excluding this estimated returnable amount from revenue and expense. However, it should be recognized that while such amounts must be reported in the current period, they are often based on estimates that depend on policyholder choices that will be made several years in the future and eventually may be found to vary from the estimate substantially. For example, determining the revenue component for a block of permanent life insurance contracts depends on an estimate as to how many policyholders will surrender their contracts before death and how many will hold their contract until death. If the number of policyholders that surrender before death is over-estimated, revenue will be under-estimated in the current period.

For other contract types that do not have an explicit amount payable on demand to the policyholder, but for which a portion of premiums may be returnable to the policyholder based on claims experience, we need to distinguish between two cases.

The first case is one in which a contractual provision states a portion of premiums may be returned to the policyholder based on the claims experience under that specific contract. Although Example 19 in the ED discusses an example from property/casualty reinsurance, these experience-rated contracts also arise on the direct side. This is most notable with respect to health insurance and/or workers compensation contracts issued to large employers. Applying 834-10-35-14 to experience-rated health contracts may lead to confusing results. For instance, suppose that an insurer has two identical one-year group health contracts, each of which is priced under the assumption that 92 percent of premiums will be paid out in the form of benefits. If exactly one of the contracts is modified to include a provision whereby the insurer agrees to limit its upside profit potential by giving the policyholder a partial return of premium in the event that the ratio of benefits to premium falls below 90 percent, then under 834-10-35-14, the insurer would report one-tenth as much revenue on that contract than it does on the other. We have concerns that this form of reporting would not provide useful information or would be understandable to most financial statement users. Moreover, we do not see how this form of reporting relates to the objectives discussed in Paragraphs BC94 through BC99.

The second case involves the situation in which, by law, the insurer may be required to return a portion of premiums to the policyholder based not on the policyholder's own claims experience, but instead on the overall claims experience of a pool of contracts to which the policyholder is assigned. For example, under the Affordable Care Act, the annual volume of premiums for U.S. health insurance contracts subject to requirements of this type—often referred to as MLR (medical loss ratio) rebate requirements—is measured in the hundreds of billions of dollars. It is unclear whether the estimated returnable amount concept was intended to apply to this situation—noting that, for any particular contract, the question of whether the entity would pay an amount to that policyholder regardless of whether an insured event occurs on that particular contract is dependent on the overall experience of the pool in which the contract resides (a level of granularity defined in regulation, and probably more granular than the ED's notion of portfolio). Users would receive no benefit if U.S. health insurers were required to apply the requirements of 834-10-35-14 to its core portfolios of health insurance contracts.

Question 33: For contracts measured using the premium allocation approach, do you agree that if the contract has a financing component that is significant to the contract, an entity should adjust the liability for remaining coverage to reflect the time value of money and recognize the accretion of interest with insurance revenue? Do you agree with the practical expedient that an entity should not be required to reflect the time value of money in measuring the liability for remaining coverage (that is, if the entity expects, at contract inception, that the time period between when the policyholder pays all or substantially all of the premium and when the entity provides the corresponding part of the coverage is one year or less)? If not, what do you recommend and why?

Response: We agree with the guidance as described.

Question 34: For contracts measured using the building block approach, does this proposed Update contain sufficient guidance on how to determine insurance contract revenue in accordance with the principle that it should be allocated between reporting periods as performance obligations are satisfied over time (that is, to allocate consideration between periods by reference to the relative value of the services provided in each period)? If not, explain what additional guidance is necessary.

Response: There appears to be sufficient guidance for the calculation of the amount of insurance contract revenue as specified through the exclusion of estimated returnable amounts.

Question 35: Do you agree that participation features that are contractually dependent on the performance of other assets or liabilities of the insurer or the performance of the entity itself should be measured on the same basis used to measure the underlying items and changes in the measurement should be presented in the same statements (that is, net income or other comprehensive income)? Do you agree that this approach should be limited to only participating features for which the amount of the performance of the underlying items passed through to policyholders is contractually determined and not extended to participating features that allow an entity discretion about the amount of the performance of the underlying item to pass through to the policyholders? If not, what do you recommend and why?

Response: We agree with the FASB approach for contractually linked participation features. Any other cash flows within such contracts and contracts with discretionary participation features are more appropriately valued using the BBA, and applying the OCI treatment proposed in the ED, subject to the revision suggested in the response to Question 20.

This approach also avoids the complexities introduced by splitting cash flows as illustrated in Paragraphs B85 and B86 of the IASB exposure draft. Further, this approach avoids anomalies that can be created regarding cash flows that are directly related but not contractually linked to an underlying item. An example would be a general account fund within a variable annuity. The cash flows from the fund are not contractually linked to the underlying assets, but they are directly related and would qualify for mirroring under the IASB approach – but only if the contract also contains separate account funds that are contractually linked to the underlying separate account assets. In contrast, cash flows from an otherwise identical general account fund that are within a contract that does not also contains contractually linked separate account funds would not qualify for mirroring.

Question 36: Do you agree that a cedant should record a margin if the expected present value of the cedant's future cash inflows exceed the expected present value of the cedant's future cash outflows (thus prohibiting the recognition of a gain at inception upon entering into a reinsurance arrangement) for (a) retrospective reinsurance contracts accounted for using either the building block approach or the premium allocation approach and (b) prospective reinsurance contracts accounted for using the building block approach? If not, what do you recommend and why?

Response: For prospective reinsurance contracts, we agree that the approach taken in the ED provides a consistent picture of the economic transactions that are occurring. At inception of such a contract, the guidance requires that gains or losses be amortized into income over the life

of the business. This method allows the recognition of the impact of the reinsurance over the period the coverage is being provided. Just as there should not be a gain/loss at the inception of the agreement, however, we believe that this same logic applies to a change in assumptions in a renewal period. Margins created at the time of a contract's inception, as described in the question, are subsequently amortized over time and are based upon a certain set of assumptions. When the assumptions change the impact should be to adjust the margins that were created at inception so that the changes in assumptions do not impact current earnings, but rather would appear over time as risk is released.

Guidance should allow a practical expedient when data is not available to construct a building blocks cash flow model, such as old ceded indemnity reinsurance contracts for which the reinsurer administers the business. Alternatively, guidance could allow for the adoption of FASB transition guidance. In this example, the ceding company has limited data to construct a building block cash flow model, and the reinsurer may not be required under the existing reinsurance contract to provide the data. We recommend that the guidance have a practical expedient similar to that found in FASB Interpretation No. 46 to allow carryover of pre-transition accounting for these situations.

Question 37: Do you agree that a cedant should estimate the fulfillment cash flows (including the ceded premium) for a reinsurance contract using assumptions consistent with those used to measure the corresponding fulfillment cash flows for the underlying insurance contract or contracts, without reference to the margin on the underlying contracts? If not, what would you recommend and why?

Response: For the calculation of the business ceded, we agree that using consistent assumptions is appropriate. The method of calculation should be based on the nature of the underlying contract. Thus, if you have a long-term contract reinsured using a one-year stop-loss agreement, then the long-term contract should use the BBA, and the stop-loss agreement could use the PAA. In both instances the assumptions (i.e., mortality, morbidity, incidence of catastrophes, etc.) are the same, and the measurement should be based on the nature of the underlying contract.

Question 38: Do you agree that entities should record a loss at the acquisition date in the amount by which any excess of the asset and liability balances related to insurance contracts measured in accordance with the guidance in this proposed Update exceeds the fair value of those assets and liabilities? Do you agree that entities should record a margin (not an immediate gain) for the amount that the fair value of the asset and liability balances exceeds those assets and liabilities measured in accordance with the guidance in this proposed Update? If not, do you think an entity should instead increase or decrease goodwill for the differences between the fair value and the measurement in accordance with the guidance in this proposed Update on those assets and liabilities? Why or why not?

Response: We agree that the described approach is appropriate. If contracts are purchased at a price that makes them inherently onerous, this should not be obfuscated by reflecting the deficiency in goodwill. There is no intangible value that arises and no resulting basis for goodwill. This analysis will be difficult when it is not readily apparent which assets support the

insurance liabilities involved— for example, if a business combination includes many parts that are found together in the purchased businesses. We nonetheless support the proposal.

Question 39: Do you agree that for a substantial modification (a) an entity should recognize a gain or loss as the difference between the measurement of the modified contract using the current entity-specific price that the entity would hypothetically charge the policyholder for a contract equivalent to the new contract and the carrying amount of the existing contract and (b) that the carrying amount of the existing contract should be derecognized? If not, what do you recommend?

Response: Such recognition is not appropriate. First, it would be unnecessarily complex and arbitrary to derive such a hypothetical value, especially if the contract was not issued recently. We would suggest an approach analogous to the one used in business combinations—the value of the liability at the date of the acquisition becomes the basis for the modified contract and the basis for re-measuring the margin. If the contract is onerous from this perspective, a loss should be recognized.

Question 40: Do you agree with the presentation requirements included in this proposed Update? If not, what would you recommend and why?

Response: With one exception, we take no position on the proposals regarding presentation of insurance contract revenue and expense. Useful information can be provided under any of the general approaches that have been discussed, including the due premium approach, the earned premium approach, and the summarized margin approach. The disclosed roll-forward of insurance liabilities provides information that can be used to reconcile all of the different approaches.

The exception noted relates to proportional reinsurance contracts and the treatment of ceding commissions, for which we recommend two changes. First, ceding commissions should continue to be accounted for gross of ceded premiums. This treatment will enable ceding and assuming companies to have similar financial reporting results and more comparable key metrics (e.g., revenue, loss ratio, expense ratio, combined ratio). Second, we disagree that fixed reinsurance ceding commissions should be offset against reinsurance premiums and that experience-rated ceding commissions should be combined with reinsurance claim reimbursements. These recommendations address concerns we have identified that reduce the usability of the information provided.

- The treatment of ceding commissions in the proposed update would result in a different presentation model for ceded reinsurance contracts than for direct and assumed contracts. Given that industry practice (including insurers and investors) is to evaluate gross and net information in comparisons between insurers and for the industry aggregate, this proposal would reduce the usefulness and transparency of the financial statements. The gross and net results of insurers with different mixes of direct/assumed versus ceded would no longer be comparable, even though they are comparable under current accounting rules.

- The current net premium metric is a commonly used and effective measure of both earned revenue and exposure to risk. By doing away with "net premium," and by netting commissions against reinsurance premium (so that only net-of-commission ceded numbers are available), the proposal eliminates the net premium as a measure of exposure to risk. The elimination of a separate ceded commission expense eliminates the relative comparability of risk exposure due to the impact on expected loss ratios.

As an alternative, we recommend that assumed and ceded premiums under proportional reinsurance contracts be stated gross of ceding commissions. An additional entry in the income statement would then include ceding commissions. This would allow for net premiums to be a consistent measure of both net revenue and exposure to risk, and for direct and assuming companies writing the same risk to have comparable loss ratios.

For all types of business, the requirement to present portfolios in an asset position separate from those in a liability position will not, in our view, provide useful information. It is common for a portfolio to move between an asset position and a liability position over its lifetime. Especially for entities with a large number of portfolios and subsidiaries, this presentation requirement will create cumbersome procedures to create information of little value.

Question 41: Do you agree with the disclosure requirements included in this proposed Update? If not, which disclosure requirement(s) would you change and why? Are there any additional disclosures that would provide decision-useful information and why? Do you think that any of the disclosure requirements included in this proposed Update would not provide decision-useful information and should not be required? If so, which ones and why?

Response: We note the increase in the volume of required disclosures in the proposed update relative to current practice. Not only will there be a significant increase in effort required to produce these disclosures; but, users of the financial statements may be overwhelmed given the large number of disclosures being provided.

We appreciate, however, the flexibility permitted in Paragraph 834-10-50-2. We think this flexibility is important to maximize the utility of the disclosures.

We note that Paragraph 834-10-50-31 includes a sensitivity analysis requirement related to any changes in risk variables that are reasonably possible. Further, the paragraph requires sensitivity analysis around methods and inputs used. The number of reasonably possible changes in risk variables as well as alternative methodologies that could be used in the calculations is considerable. We also note that an entity’s actuarial software may be based on a single methodology for inputs and calculations. To be able to quantify the use of alternative approaches in the actuarial software will require considerable expense relative to the value such information may provide.

In Paragraphs 834-10-50-23 through 834-10-50-27, an entity is required to disclose information about significant judgments and changes in judgments. These disclosures include the methods and processes followed to estimate inputs used in setting assumptions, separate measurement of the financial effect of any material changes, and a narrative description of the sensitivity of

balances including interrelationships between inputs. We are concerned that this paragraph may result in a significant volume of information for the financial statement user that is not decision-useful. We also have concerns related to the time and expense required to produce such information.

If the presentation requirements of the proposed update are not revised to present reinsurance premiums gross of ceding commissions and claims gross of variable ceding commissions (as we recommend in our response to Question 40), then an additional disclosure would be needed. This disclosure would show the reinsurance premiums and reimbursed claims separately from the ceding commissions.

Question 42: The Board will establish the effective date of the requirements when it issues the final amendments. However, the Board is interested in determining the key drivers affecting the timing of implementation. What are those key drivers? How do those drivers affect the time it will take to implement this proposed guidance?

Response: An important consideration is the need to develop models to estimate cash flows for contracts under the BBA. These models will be complex and will need to be applied to valuation and reporting of many separate cohorts of contracts within any portfolio of contracts. Development and testing of these systems will lengthen the time it will take to implement this proposed guidance.

For contracts that fall under the PAA, the additional complexity of the discounting process and the need to separate OCI from net income suggest that extra time will be needed for implementation.

We suggest that at least three years should be allowed between finalization of the standard and the effective date for implementation. In addition, robust field testing should be carried out prior to implementation to uncover issues that may not have been fully addressed in the draft standard.

Question 43: Do you think the effective date should be the same for both public and nonpublic entities? Do you think the effective date should be the same for regulated insurance entities and other entities that issue insurance contracts within the scope of this proposed guidance? Why or why not?

Response: We have no comment.

Question 44: Do you agree that the practical expedients relating to transition included in this proposed guidance are sufficient for retrospective application (that is, are the transition provisions in this proposed guidance operable)? If not, what would you recommend and why?

Response: We agree. While we understand that in some cases estimates will need to be made without full information, we agree that the results of good-faith estimates will provide more useful information than an approach to transition that would not allow them to be used. We suggest that robust field testing should be carried out to develop better understanding of the nature and effect of such estimates.

Question 45: For business combinations that occurred before the transition date, is the requirement included in this proposed Update on reallocating the fair value of the asset and liability balances related to insurance contracts between the expected fulfillment cash flows and the margin operable? Why or why not? If not, what would you recommend and why?

Response: Yes, this guidance is operable, but field testing should be done to verify this. While we understand that in some cases estimates will need to be made without full information, we agree that the results of good-faith estimates will provide more useful information than an approach to transition that would not allow them to be used.

Question 46: Do you agree that the proposed approach to transition would provide users of financial statements with relevant information that faithfully represents the entity's financial position and performance in a way that appropriately balances comparability with verifiability? Why or why not?

Response: We agree. While we understand that in some cases estimates will need to be made without full information, we believe that the use of good faith estimates adds value in terms of comparability that outweighs any loss of verifiability in this context.

Question 47: Describe the nature of the incremental costs of adopting the guidance in this proposed Update, distinguishing between one-time costs and ongoing costs. Explain which aspects of the guidance in this proposed Update are driving those costs and include ideas to make the proposal more cost effective.

Response: The one-time costs of adopting this guidance will be significant because of the changes made to measurement of liabilities for insurance contracts. The models needed to project cash flows and amortize margins under the BBA are extremely complex and expensive to develop. The discounting added to the PAA, especially the measurement of OCI using locked-in discount rates, will also be expensive to develop.

In addition, the costs of implementing the various changes to presentation will require major changes to accounting systems, particularly to general ledger systems. The increase in the extent of the required disclosures also will require extensive system changes to capture the required information at the level of detail required.

Ongoing costs will be higher especially for contracts under the BBA because the measurement process on each reporting date is more complex. Not only does the model used to project cash flows require substantially more input data than in the past, but all assumptions must be reviewed and potentially reset on each reporting date. This involves carrying out decision-making and oversight processes that were not required previously. The control environment will need enhancement to encompass these new processes. There is some concern among preparers that the timeframe for preparation of financial statements may need to be lengthened by a week or more to allow for these new processes.

Small insurance companies are especially likely to need to add resource and expense to carry out the new processes. The increased complexity of this guidance represents an incremental increase in the barriers to entry into the insurance business.

The incremental costs for contracts under the PAA could be eliminated largely by removing the discounting that was introduced in this proposed update. Our response to Question 15 explains that the introduction of discounting without an offsetting risk margin creates measurement distortion for claim reserves.

Question 48: Describe the nature of the incremental costs of auditing the financial reporting requirements included in this proposed Update, distinguishing between one-time and ongoing costs. Explain which aspects of the model in this proposed Update are driving those costs.

Response: The one-time costs of auditing the transition to this new standard will be significant. The transition involves retrospective application of the standard, a process that involves review of many previous time periods. For contracts that fall under the BBA, not only will the retrospective application of the standard need review, but the models themselves will need to be audited to ensure that they operate accurately and with appropriate controls.

The ongoing costs will be greater due to the need to review data supporting reset of measurement assumptions under the BBA and the need to review newly required discounting calculations under both the BBA and PAA.

We expect that a more granular approach will be required, especially with regard to auditing disclosures, and that will further increase the ongoing costs.