October 31, 2003

Sir David Tweedie
Chairman
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Dear Sir David:

The American Academy of Actuaries appreciates the opportunity to comment on the Phase I proposals of the International Accounting Standards Board (IASB) in its effort to develop international accounting standards for insurance contracts. The proposals are embodied in the IASB's exposure draft "ED 5 Insurance Contracts", and the accompanying "Basis for Conclusions on Exposure Draft" and "Draft Implementation Guidance" documents. The Academy is the public policy voice for actuaries practicing in all specialties within the United States.

Reinsurance Accounting

The following comments address Question 7, regarding Reinsurance Purchased:

We believe the implementation of the proposals in paragraphs 18 and 19 regarding accounting by a cedant for reinsurance will result in an inappropriate disconnection between the accounting for direct and ceded reinsurance contracts for the same business. For the same reason changes in accounting for direct business have been deferred to Phase II of the Insurance Contracts Project, changes to accounting for ceded reinsurance should also be deferred until Phase II.

Paragraph 18 indicates that ceded balances should be accounted for as assets, not as offsets to liabilities (or "contra liabilities"). Paragraph 19 directs that the cedant apply International Accounting Standard (IAS) 36 Impairment of Assets to determine if the asset is impaired. IAS 36 indicates that an asset is impaired if the book value is less than the greater of the sale price or the value in use. Both of these latter concepts lead to discounting of any future reinsurance recovery. Hence, in countries where direct liabilities are not discounted, the end result will be a direct undiscounted liability that is often significantly greater than the discounted reinsurance asset. This will generally result in an artificial and often substantial loss at the outset of the transaction. This artificial loss will unwind as artificial profits in subsequent periods as the reinsurance asset grows to its proper level.

We also note that such a disconnect would greatly alter the structure and nature of reinsurance transactions during Phase I for countries where direct liabilities are not discounted. We don't believe such drastic changes are warranted.

This proposal would also require many companies to make significant systems enhancements, specifically for Phase I, which would probably not be needed for Phase II. The expense and effort associated with such enhancements is contrary to the key objectives of Phase I.

We believe the proposal in paragraphs 18 and 19 would be reasonable if the application of these rules were isolated solely to pure financial reinsurance.

We therefore recommend that, other than for pure financial reinsurance, the treatment of all aspects of reinsurance accounting be deferred, along with insurance accounting, until Phase II. This would allow for consistency between both Phase I and Phase II, and avoid anomalous and economically disruptive results during Phase I.

Unbundling of Deposit Components

The following comments address Question 6 regarding Unbundling:

Paragraph 7 regarding unbundling of deposit components is unclear about what transactions are subject to this treatment. The current language states a very general directive to unbundle deposit components of some insurance contracts and then carves out an exception for some life insurance contracts in paragraph 8.

We recommend that the requirements for unbundling should be rewritten to clearly enunciate the principles governing when transactions should be unbundled. We believe that unbundling should only be done when the unbundling process does not require disproportionate cost or effort, where the effect of unbundling is significant in terms of the economic characterization of the transaction, and where the contract does not involve significant risk transfer. We note that these principles mirror statements made in the Basis for Conclusions document. Paragraph BC34 states that "the draft IFRS proposes unbundling only when it is easiest to perform and the effect is likely to be greatest". Paragraph BC35 states that "the Board regards unbundling as appropriate for large customized contracts, such as some financial reinsurance contracts, if a failure to unbundle them could lead to the complete omission from the balance sheet of material contractual rights and obligations." We believe these expectations should be more fully enunciated in the ED 5 Insurance Contracts document. This approach would provide a much clearer picture of the objectives of unbundling and the circumstances under which unbundling is required.

As currently outlined in Paragraph 7, there are a variety of products in addition to the one life insurance exception mentioned that might fit the description of having some deposit component, but that should be excluded from application of unbundling. For example, liability or workers' compensation policies, such as swing-rated contracts, retrospective rating plans, and certain dividend plans, could be construed to have a deposit component. However, we do not believe it would be appropriate or even practical to bifurcate these types of transactions. These products involve significant risk transfer, and therefore may be structured in a way that makes bifurcation both unclear and extremely complex, leading to uncertain and widely varying results among companies. The complexity of such an approach bears inherent cost and is unlikely to improve the quality of the balance sheet for entities with which we are familiar.

We believe Paragraph 7 should be redrafted to more clearly outline the principles governing unbundling and replace the current generalized statement that is followed with specific exemptions for certain types of policies. As noted above, we believe that the paragraph should state that unbundling should only be done in circumstances when separation does not require undue cost or effort, where the effect of unbundling is significant in terms of the economic characterization of the transaction, and where the contract does not involve significant risk transfer.

And similar to our concerns with reinsurance accounting, we believe the current proposal may require many companies to make significant system enhancements for Phase I, which would probably not be needed for Phase II. This is contrary to one of the key objectives of Phase I.

Amount, Timing, and Uncertainty of Cash Flows

The following comments address Question 11 regarding Other Disclosures:

We believe that the discussion in paragraphs 28 and 29 would benefit from being more principles-based and from having more discussion of the objectives of claim runoff disclosures. For example, we would suggest that it might be stated that, "actual claim runoff should be presented in a manner that aids the user in understanding the reasonableness and risk of past estimates, as well as understanding the same for present estimates."

However, if the IASB believes it must maintain the current, prescriptive language, paragraph 29 should be expanded. Paragraph 28 calls for disclosures regarding the amount, timing and uncertainty of future cash flows. While the discussion of the disclosures in paragraph 29 is reasonable and the disclosures suggested are useful, these disclosures do not provide information on cash flows. The tabular claims development information discussed in 29 (c) iii would need to be expanded for general insurance for direct companies to include development of the amounts of claim payments in addition to changes in previous estimates in order to provide pertinent information on cash flows. Implementation guidelines could then provide more detailed information.

We also think that suggested disclosures should be more clearly labeled as illustrative rather than prescriptive. For example, the illustration shown in the implementation guidance (IG Example 4) indicates that information by underwriting year should be disclosed. Many insurers, including most direct general insurers, do not record information on an underwriting year. Data should be presented in the most appropriate categorization, given the insurer's circumstances.

Fair Valuing of Liabilities and Assets

The following comments address Question 10 regarding Disclosure of the Fair Value of Insurance Assets and Insurance Liabilities:

As proposed in paragraph 30 and discussed in paragraphs 30 through 34, disclosure of the fair value of insurance liabilities would be required as of December 31, 2006. Since two years of information must be shown in financial statements, this effectively requires that fair value information be available for December 2005. No agreed upon definition of fair value currently exists and it is recognized that there are several significant issues to be resolved, particularly concerning the fair value of liabilities.

Several reasons are given for this requirement. One is that insurers should be encouraged to begin work on fair value systems so that shorter transition periods will be necessary when Phase II is completed. Another is that the information will be relevant and reliable for investors.

It is already quite late for many insurers to begin designing system modifications for gathering 2005 data. Without a framework for determining fair value and lacking principles and guidance regarding how assumptions should be developed and what calculations should be performed, each company will have to determine exactly how fair values should be calculated. It is likely that results will not be at all comparable among different companies. This wide variation among insurers making this disclosure would not add any additional information for the reader of a financial report. We disagree that investors will be able to reach conclusions until there are accepted standards for producing the information. Additionally, the effort to prepare fair value systems changes will be significant. Systems would most likely have to be overhauled for a majority of companies in order to meet the 2005 data requirements. Moreover, many companies may find that their Phase I systems do not support the final requirements and that the costs to retool for Phase II are as high as the initial investment. We disagree that the transition time will be reduced significantly and think the industry costs will be much higher if disclosure is required before final specifications are published.

We think requiring fair value disclosure before the framework has been determined is costly, impractical, and will not provide meaningful information. We recommend delaying this disclosure until Phase II, when an orderly and understandable framework is in place. We further suggest that companies will require a minimum of two years to implement systems changes before the first fair value disclosures are to be made.

Tentative Conclusions for Phase II

Paragraphs BC6 through BC8 of the Basis for Conclusions document outline tentative conclusions for Phase II. We continue to question the feasibility of several of these items, including:

- Use of entity fair value as the measurement basis for insurance contracts assets and liabilities. We agree that market valuations do not exist for many items on the insurance balance sheet and that this would lead to the reliance on entity specific measurement for determining insurance contract and asset fair values. However, we believe that such values would be unreasonably subject to wide ranges of judgment, be subject to significant abuse, and may provide information that is not at all comparable among companies. The cause for this concern is the risk margin component of the fair value. Risk margins are clearly a part of market values for uncertain assets and liabilities, but with respect to many insurance contracts their value cannot be reliably calibrated to the market. Hence, a market-based valuation basis for them would produce irrelevant information. We think individual entity attempts to estimate them will provide chaotic, inconsistent, and potentially self-serving financial information to users.

- Use of an entity's own credit status in valuing its liabilities. In most cases, we believe this approach is inappropriate. Particularly in the case of general insurance, the valuation of liabilities is already an extremely challenging task. Further, obscuring the results of this estimation process by reducing the liabilities of impaired insurers makes identifying entities that need prompt regulatory, investor, or policyholder attention much more difficult. It is counterproductive and dangerous.

We agree that a risk margin may often be appropriate in the valuation of liabilities, especially those that reflect the time value of money. However, the absence of sufficient market transactions to determine this risk margin makes a fair value approach to risk margins an unreliable measurement standard. We also believe that the inability to calibrate models of the risk margin to market observations will make the use of entity specific estimates of risk margin an impractical alternative. Therefore, we recommend that the IASB consider alternatives to fair value when determining the measurement basis for insurance contract liabilities that are not traded or are infrequently traded.

The American Academy of Actuaries appreciates the opportunity to comment on the IASB's Exposure Draft "ED5 Insurance Contracts." Should you have any questions or need for clarification regarding our comments, please contact Ethan Sonnichsen, the Academy's policy analyst for financial reporting issues, at (202) 785-7866. We look forward to the IASB's continuing work concerning accounting for insurance contracts.

Sincerely,

Andrea M. Sweeny

Andrea M. Sweeny
Chairperson, Joint Financial Reporting Task Force
American Academy of Actuaries