

The Group of North American Insurance Enterprises

Discussion Paper

Settlement Value as a Measurement Attribute for Non-Life Insurance

Introduction

This discussion paper (“Settlement Value As A Candidate Measurement Attribute for Non-Life Insurance”) has been developed by the GNAIE Technical Committees from a non-life insurance perspective in response to questions raised by the IASB staff in its Agenda Paper 3 for the April 1-2 meeting of the Insurance Working Group. (A separate discussion paper has been prepared by the GNAIE Technical Committees from a life insurance perspective.) In addition, IASB staff asked for any additional information on these topics that might be of assistance to them in advancing the issues.

At the request of the members of the Working Group during the meeting, we have copied all the members. Please feel free to circulate these to any others you feel may benefit from the discussion. This discussion paper and others will also be posted on the GNAIE Website, along with any other contributions of documents or ideas.

General Observations

GNAIE’s non-life focused insurers generally believe that in drafting the Insurance Contracts Discussion Paper (“ICDP”), the International Accounting Standards Board (“IASB”) appears to have focused their attention primarily on life insurance contracts. The logic behind this approach appears to be that it is the accounting for life insurance contracts that is in the most critical need of reconsideration due to the basic underlying complexity of life insurance contracts and the fundamental differences in the life insurance accounting models that exist throughout the world. This makes the measurement, reporting, and comparison of life insurance contracts on a global basis very challenging.

By contrast, for most non-life insurance business, the underlying contracts are less complex and there is considerably less variation in the accounting models in use through-out the world. This makes the comparison of non-life insurance contracts on a global basis a much less challenging task.

Despite the preceding, the IASB, in their desire to standardize and simplify the accounting for insurance contracts developed a single model for all insurance (i.e. life and non-life) as well as reinsurance contracts. In doing so, the IASB appears to have placed less weight on the fundamental characteristic differences between life insurance, non-life insurance, and reinsurance contracts and placed comparatively more weight on the adoption of a single model.

The consequences of this approach, considering that the IASB’s proposed model appears to be life insurance focused, is that the unique elements of non-life insurance contracts are not fully considered or must otherwise be intentionally modified to conform with the life insurance focused measurement model.



Questions and Responses

Paragraph 28, Question 1: Should the Board consider adopting the notion of a settlement value as a measurement attribute for insurance liabilities? If you answer yes, please also answer the following questions: (a) Is settlement value the right name for the notion you have in mind? If not, what name would you suggest, and why?

No. We do not believe the notion of settlement value that the Board generally uses is applicable to insurance contracts (including non-life insurance contracts). GNAIE believes the proper measurement attribute (or basis) for non-life insurance contract liabilities is contract fulfillment value ("CFV"). The notion of CFV set forth by GNAIE, in the context of non-life insurance contracts assumes fulfillment of the contractual terms with policyholders "in the normal course" pursuant to the terms of the underlying contracts and not a hypothetical settlement with a hypothetical market participant at the reporting date. CFV would utilize an unearned premium reserve ("UPR") for pre-claims liabilities, no explicit risk or service margin for claims liabilities, and no discounting unless the cash flows and payment patterns can be reliably determined on an individual claim basis (e.g. workers compensation claims).

Under CFV, claim liabilities would be based on the best estimate of amounts necessary to fully adjudicate open claims with customers at the reporting date pursuant to the terms of the underlying contracts. This results in non-life insurance contracts being held at an amount we have previously described as "full settlement value". However, in order to more clearly distinguish this notion of settlement from that which is advanced by the Board we can also describe our proposed measurement attribute as CFV to make it clear that it is not a current transfer based value but rather an amount based on fulfilling the contract with the customer based on the underlying contractual terms..

We understand that certain comment letters to the Board referred to a measurement basis in terms that included the notion of "settlement". GNAIE believes (for the purposes of non-life insurance contracts) that it is CRITICALLY IMPORTANT to understand the differences between "settlement value", as the term is generally used by the Board, and the meaning we ascribed to CFV.

Following are two examples from recent IASB documents that describe the notion of "settlement value" as we believe it is generally used by the Board.

1. According to comments on "Liabilities amendments to IAS 37" in the February 2008 "IASB Update", the Board tentatively decided "To clarify that 'settle' means to settle by paying the counterparty at the balance sheet date". In terms of non-life insurance contracts, this settlement would be equivalent to a commutation which seldom occur.
2. In the material the IASB sent to external reviewers (February 11, 2008) for the standard-by-standard review that is part of the Fair Value Measurement project, "current exit price" is defined to be "the price that would be received to sell an asset or paid to transfer or settle a liability in an orderly transaction between market participants at the measurement date. If a liability is transferred to a third party, it is assumed to exist beyond the measurement date. If a liability is settled with the counterparty, it ceases to exist at the measurement date. This is similar to the SFAS 157 definition of fair value."



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Again, in terms of non-life insurance contracts, this notion of settlement would again be equivalent to a novation or commutation, both of which seldom occur.

In both of the above examples, the notion of “settlement” requires a transaction at the measurement date in which the liability is extinguished with the policyholder, which as stated above, is a very rare occurrence for non-life insurance contracts. Moreover, as noted in the second example, in a “transfer”, the liability continues to exist beyond the measurement date. Both of the preceding notions of (i.e. both settlement and transfer) are rarely applicable to insurance contracts, both because of legal constraints in most countries and because of the commercial intent of both insurers and policyholders. That is, insurance liabilities are rarely settled by making payment to the insured at the measurement date outside the normal contractual terms of the underlying insurance contract. Similarly, policyholder liabilities are rarely settled by way of a transfer to an unrelated third party as there are typically statutory restrictions in place which prohibit transfers from taking place without prior regulatory approval.

In contrast to the notions of settlement advanced by the IASB, we believe non-life insurance contracts are typically “fulfilled” or “executed” over the life of the contract in a manner consistent with their contractual terms. Accordingly, in identifying the measurement attribute that we believe best describes the economic estimate of the remaining obligation associated with a pool of non-life insurance contracts at the measurement date, we believe the term “contract fulfillment value”, provides the most accurate description.

We believe the spirit and intent of a CFV based measurement basis is appropriately described in Paragraph 9 of the Agenda Paper, as “a measurement that reflects the fact that the insurer intends (and in most cases must) settle the liability by paying policy benefits as they fall due [pursuant to the terms of the contract], rather than by transferring the liability to a third party”. The Agenda Paper also correctly notes that “some respondents use “settlement value” or something similar to describe this notion”. Despite agreeing with the mechanics of the preceding, we are nonetheless concerned with attaching a name to this measurement basis that potentially results in confusion with “settlement value” as described by the Board. Accordingly, we answered “NO” to Question 1(a) in Paragraph 28 of the Agenda Paper.

Paragraph 9 of the Agenda Paper also indicates that “no response gives anything like a rigorous definition of settlement value”. In this respect, we believe the appropriate measurement basis (which we describe as CFV) certainly CAN be rigorously defined. In fact, we firmly believe this measurement basis provides far better answers to the four questions in Paragraph 28(b) of the Agenda Paper than can be provided by the current exit value (“CEV”) measurement basis described in the ICDP. In addition, there are three reasons given in Paragraph 24 of the Agenda Paper for why it is important to define a measurement attribute “in a rigorous and concise way”. We will demonstrate, in our response to Question 2, why the measurement basis we propose for non-life insurance contracts addresses the criteria in Paragraph 24 in a much clearer and rigorous manner than CEV.

Paragraph 22 of the Agenda Paper addresses the notion of a “mirror image insurer” and the “amount the insurer would rationally pay at the reporting date to settle the liability with the policyholder or to transfer it to another insurer”; we see no value in creating artificial transactions that do not, and generally cannot, exist in the market, to describe the measurement



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basis. Moreover, while the concept of a “mirror image insurer” might possibly lead to a measurement similar to that which we propose, we see no benefit in adding an artificial construct to something that could be valued directly based on actual observed experience. We are similarly concerned that there would be added cost and complexity in implementing, verifying, and auditing results based on any such artificial construct.

(b) How should that notion be defined?

GNAIE believes the proper measurement basis for non-life insurance contracts is CFV. This would result in non-life insurance contracts being held at CFV, which in the context of non-life insurance contracts assumes settlement with the policyholders “in the normal course” pursuant to the terms of the underlying contracts and not a hypothetical settlement with a hypothetical market participant at the reporting date. CFV would utilize an unearned premium reserve (“UPR”) for pre-claims liabilities, with no explicit risk or service margin for pre-claims liabilities, and no discounting unless the cash flows and payment patterns can be reliably determined on an individual claim basis. Incurred claims liabilities (i.e., both reported and not reported; i.e., IBNR) would be based on the best estimate of the amounts necessary to fully adjudicate open incurred claims.. GNAIE believes the CFV measurement basis set forth is considerably more rigorous, succinct, reliable, and relevant than CEV. Moreover, we believe it would require considerably fewer arbitrary rules to implement, and would generally provide more complete and practical answers to the questions listed below.

How would that definition result in an answer to the questions posed in paragraph 21:

a. What is the basis for deciding which cash flows are included?

In all cases, the underlying principle should be that estimates and assumptions are to be developed in a manner consistent with the company’s current best estimate of future experience, including consideration of relevant and reliable market and entity-specific information. For non-life insurance contracts, the most appropriate estimate of expected cash flows should assume a “fulfillment” by the insurer of contractual obligations with the underlying policyholder in the normal course of business, and not a transfer of such obligations to another insurer, which is not normal, expected, or even possible in many cases.

As it relates to discounting, GNAIE believes the presentation of gross pre-claim and post-claim values is most appropriate because CFV presumes non-life insurance contracts are settled with underlying customers in the future pursuant to the terms of the underlying contracts and not a transfer of all remaining rights and obligations to an unrelated third party on the reporting date. GNAIE understands that a transfer of all remaining rights and obligations associated with a block of non-life insurance contracts on the reporting date would likely involve discounting as it would be assumed that a transferee would invest cash backing reserves in interest-bearing financial instruments until settlement with the customer occurs and as such the transferor would likely negotiate a cash transfer amount that would be less than the anticipated CFV.

While discounting is theoretically understandable in a transfer based model, in a CFV model (assuming settlement with the customer per the terms of the underlying insurance contracts), unless the amount and timing of the anticipated CFV cash outflows are reliably estimable on an individual claim basis, discounting would not be appropriate as the absence of reliable inputs to

any discounted cash flow model would result in the model outputs not being reliable, verifiable, comparable, or relevant. In addition, non-life insurance contracts are not implicitly or explicitly interest-bearing and as such we believe a discounted presentation would be misleading to financial statement users.

Financial assumptions (e.g., rates of inflation) should be based on market information where available and reliable. If market information is not available or is otherwise not reliable, the values should be based on management's best estimate of the future, consistent with any relevant market information. Non-financial assumptions (e.g., expense rates) should be based on management's best estimates of the future. The reporting entity should disclose the basis for its principal underlying estimates and assumptions, including how it determined which basis (i.e., market versus entity-specific) is the most relevant and reliable.

Interdependencies among assumptions should be taken into account (e.g., assumptions should be consistent with expectations about economic conditions). The Agenda Paper focuses on expense assumptions in considering entity specific information to be used in measuring settlement-based insurance liabilities; however, interdependencies between expense and other assumptions used to estimate future cash flows should also be considered. For example, non-life insurers often spend significant amounts to improve fraud detection capabilities that increase expenses and at the same time drive down claim costs.

GNAIE observes that a CEV measurement would use entity-specific assumptions for factors specific to a portfolio of insurance contracts (e.g., loss estimates); but assumptions that market participants would use for factors that are specific to the company (e.g., servicing costs). However, as noted in the preceding paragraph, there may be interdependencies among expenses and claim experience for a portfolio of non-life insurance contracts. In addition, since there generally are no observable markets on which to base expense assumptions that market participants would use, assumptions based on a reporting entity's own experience may be both more reliable and relevant than the alternative of applying somewhat arbitrary rules or other surrogates to estimate assumptions that might be made by hypothetical market participants.

b. What is the margin intended to convey?

For non-life insurance contracts, GNAIE supports the continued use of implicit as opposed to explicit margins. The underlying rationale is that explicit margins are not calculated, analyzed, or otherwise used to measure the performance of individual insurance contracts or groups of insurance contracts. Moreover, because this information is not calculated or used internally to manage the business or to hold management accountable for business results, we do not believe it should be introduced in an accounting measurement model. In contrast to explicit hypothetical risk margins, non-life insurers use underwriting statistics to assess periodic performance. Underwriting statistics measure the amount of losses and expenses incurred for each dollar of insurance premium earned. For non-life insurance contracts, the determination of periodic losses and expenses is a relatively straight-forward exercise for most products, notwithstanding certain exposures such as litigation risk that is difficult to estimate regardless of the measurement model. The area where the most significant judgment is required is the estimation of losses that have been incurred but not yet reported ("IBNR"). IBNR reserves are estimated using a variety of sophisticated actuarial techniques that are applied consistently from period to period.



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We believe it is important to understand that the reason why explicit risk margins are not calculated for non-life insurance contracts is not that it is too difficult a task but rather is considered too judgmental a process as the insurer, for example, typically has no basis to accurately measure, or more importantly, verify the risk margin for individual non-life insurance contracts or blocks on non-life insurance contracts. More specifically, for most non-life insurance contracts the principal insurance risk resides in the tail of the distribution which makes any particular estimation very difficult to verify. Accordingly, due to the inherent variability in the timing and amount of anticipated cash outflows, the periodic calculation and subsequent refinement of explicit non-life risk margins would subject non-life insurers to the use of significant subjective inputs that would fluctuate significantly from period to period. In contrast, using periodic underwriting statistics to reflect experience to date and future expectations based on historical (i.e., incurred) experience is vastly less complex and less judgmental as it relies principally on incurred statistical data as opposed to projected data about the tails of insurance risk distributions.

While GNAIE's proposed non-life insurance model does not make use of discounting and risk margins, it does provide for periodic income and expense recognition in the following manner:

- Premium income is recognized as insurance protection services would be provided over the stated term of the contract (e.g. typically six months for auto policies and one year for homeowners policies);
- Expenses (including the amortization of acquisition costs and other administrative expenses) would be recognized as incurred or as attributable to the stated term of the contract.
- Losses (including allocated loss adjustment expenses) would be recognized as incurred over the stated term of the contract.

Income, expenses, and losses would be recognized over the stated term of the contract as loss protection services are provided. At the end of the contractual term it is common for reserves to remain that relate both to IBNR as well as reported losses that remain in the settlement process. For those reserves, the reporting entity continues to engage in settlement actions and reserve adjustments (i.e., reserve strengthening and releases) are recognized as appropriate. Non-life insurers note that while subsequent reserve adjustments are common and can be significant, the adjustments exhibit a statistical randomness (i.e., we are aware of no statistical patterns that support any systemic under or over reserving).

Theoretically, GNAIE believes its proposed non-life income, expense, and loss recognition model, which is based on a presumed fulfillment of insurance obligations with the customer per the terms of the contract over its contractual life, is a more appropriate model than a model based on projected amounts derived by reference to hypothetical transfers to hypothetical market participants. GNAIE also believes its model is vastly superior from a practical perspective which will make it easier to implement and explain than the CEV model proposed in the ICDP, which is based on hypothetical margins that market participants would require, which are not observable and would not likely be implemented in consistent ways without very specific rules to prescribe how to arrive at and update such theoretical values.

c. Would gains be permitted at initial recognition?

GNAIE's proposed non-life accounting and reporting model would not allow the recognition of gains at contract inception. At the time an insurance contract is issued, the insurer has not been released from any of the insurance risk it has taken, and therefore no gain should be recognized at that time. GNAIE believes its answer to this question is not only rigorous and succinct; but it is also most consistent with the only actual market transaction for most non-life insurance contracts. In contrast, the answer to this question for the current exit value measurement attribute may be very inconsistent with this market information, and the ICDP indicates that further investigation may be needed if the current exit value results in a large gain at initial recognition.

d. Would the credit characteristics of the liability affect its measurement?

GNAIE believes the credit standing of the insurance company should not be considered in valuing insurance liabilities as we do not believe non-life insurance contracts should ever be reduced to reflect the possibility that the insurance company may not pay legitimate claims under the contract as they come due. Under the laws of most jurisdictions, the insurance company would not be able to realize such gains and remain a going-concern (e.g., by settlement with the policyholder or by transfer to another insurer at a price that reflects the reduced credit standing).

Paragraph 29, Question 2: Paragraph 24 refers to two approaches to setting measurement requirements:

(a) List the building blocks to be used, without trying to come up with a single all-encompassing summary description of what the result means.

(b) Prescribe a consistent measurement attribute that can be described concisely.

Paragraph 24 suggests three reasons why the latter approach is preferable: to provide a coherent framework to resolve new and emerging issues, to provide clearer communication with users and to provide measurements that are a faithful representation of some real-world economic attribute of the items being measured.

Which of these approaches do you prefer, and why?

We agree that whatever approach is used for setting measurement requirements, it would be desirable to:

- 1) provide a coherent framework to resolve new and emerging issues;
- 2) provide clear communication with users; and,
- 3) provide measurements that are a faithful representation of some real-world economic attribute of the items being measured.

We believe that such results could be achieved with either of the two approaches listed above. The measurement basis GNAIE has recommended for non-life insurance could be characterized in either way, and could be used effectively to achieve the objectives listed above with either characterization. In contrast, we believe that the CEV as described in the ICDP would not fully satisfy these criteria, due to the hypothetical assumptions and rules that would be required for CEV estimates, and the absence of an observable market to which the results could be calibrated or otherwise verified.



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We believe that CEV measurement has already been shown to be highly suspect as a basis for resolving issues for the following key reasons:

- 1.) CEV, if applied to non-life insurance contracts would require reporting entities to place a disproportional significance on the earning of interest income on the investment of contract premiums as opposed to the earning underwriting profits (which by definition exclude interest income).
- 2.) A CEV-based measurement model also requires consideration of hypothetical assumptions (e.g., for expenses) that are inconsistent with cash flows that are actually expected over the life of insurance contracts; and as noted above, use of such assumptions in place of entity specific information may lead to artificial reported gains or losses.

In addition to the preceding, we believe communications with users will be clearer based on actual market transactions and incurred experience as opposed to hypothetical constructs that do not exist. More specifically, CEV is based on a set of notions about what cash flows “ought to be” (using a collection of hypothetical assumptions); but measurement could instead be based on best estimates of all cash flows that are actually expected, using all available relevant and reliable market and entity specific information.

We contend that the measurement basis that we propose is indeed a much more faithful representation of a real-world economic attribute of the items being measured (i.e., the actual price that one market participant charges another market participant for the contract that is being valued), while CEV is nothing more than a hypothetical construct. We also believe that CEV would only be applied consistently based on a set of rules that would be, at least to some extent, arbitrary, and would not be a faithful representation of a real-world economic attribute.



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