



Insurance Accounting – A Paradigm Shift Underway

A CFO's perspective

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Many thanks to Rob and the IAIS for this opportunity to present the views of the North American insurance industry on this important subject.

Key areas where the global insurance industry is in agreement... . . . Refer to handout

- The profile of “release from risk” should determine the pattern of profit recognition for insurance contracts
- On initial measurement, there should be no gains or accounting losses (i.e. no “day 1” profit)
- Measurement should be on a portfolio basis
- No unbundling
- “Own credit risk” is not appropriate in liability valuation
- A separate customer intangible asset should be recognized
- Liabilities should include the best estimate of future policyholder benefits and expenses
- Insurance fair values – there is no exit market, so calculations must be based on settlement

Principal difference is fair value of non-life liabilities!

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The Group of North American Insurance Enterprises (GNAIE), of which XL is a member,

the European CFO Forum, of which ING is a member, and the four largest Japanese life insurers

made a joint presentation to IASB regarding insurance accounting. Copies of this presentation should be available to you on the table at the entrance. If not, I'd be happy to email you a copy. As you can see, the global insurance industry is in broad agreement, except regarding non-life liabilities.

To benchmark this group presenting to the IASB: the US, EU and Japan make up 85% of the world's life insurance market and the US and EU make up 80% of the world's non-life insurance market.

Representing North America, GNAIE's members are 12 of the largest insurers in North America. The GNAIE non-life members unanimously endorse the views I'm about to express. In addition to XL, these GNAIE members include such significant non-life companies as AIG, ACE, The Hartford, and Allstate.

GNAIE strongly believes that discounting and the use of explicit risk margins for non-life liabilities will not produce verifiable, market consistent fair-values for those liabilities and will instead produce less reliable, less transparent, less comparable and less robust measurement of these liabilities.

We are significantly concerned about the possibility of de-strengthening the industry's balance sheet if discounting is introduced.

From a conceptual standpoint the attraction of the IASB's conceptual framework of market-consistent fair value is appealing. We understand that – and, we do not disagree relative to life insurance contracts; but, plainly,

GNAIE believes it fails in the case of non-life contracts.



Differences between life and non-life...

- For life contracts,
 - the exposure is fixed (i.e. the face amount of the contract), and
 - there are only two fixed outcomes in any given period (i.e. policyholders will either lapse or die)

- For non-life contracts, the exposure is variable (i.e. from zero to the contract limit), as for any given period we do not know
 - if a loss will occur,
 - the amount of the loss, and for many non-life claims
 - when the loss will be paidIn addition, the number of claims can, in some instances, be unlimited!

- Non-life insurance contracts possess greater inherent uncertainty than life contracts
 - Inherent uncertainty -
 - In part due to time to settle, often related to vaguery of the courts
 - Conceptually a wide range of values
 - True value known only after all claims settled

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We distinguish between life and non-life liabilities. I won't dwell on the differences but have noted them on this slide for your reference.

The bottom line? Non life contracts possess significantly more inherent uncertainty:

• The range of values of outcomes is often impossible to estimate with any accuracy. For our solvency and economic capital calculations we reflect the wide range of values with associated probability estimates – but, this fails the test for general purpose, market consistent financials. More later on solvency models and their relationship with general purpose financials.

• Even when you get the values reasonably estimated, times required to settle claims are widely variable. The actual settlement is often based on legal proceedings with indeterminate timing and outcome, typically where the time value of money is significantly less instrumental in the claim amounts than views of juries.

What is the “fair value / exit value” approach?...

- An “exit” value approach is based on the price required to settle / exit from the liability
- Best evidence of the exit values are prices of trades on secondary markets
 - there are NO such markets for insurance liabilities!
 - So, exit value for insurance liabilities means unverifiable “mark to model of a non-existent market”
- There are NO market-based
 - cash flow patterns,
 - discount factors, or
 - risk margins

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Gerard de la Martiniere of the CEA said yesterday, there is no secondary market for insurance liabilities. Insurance contracts are sold by us and purchased by our policyholders with the intention of both parties that they will be settled, not transferred. Insurance is not just a product – it is also a service including risk management, claims servicing, and the confidence that comes from financial strength and integrity.

- **The policyholder is paying for the stand-by promise of the insurer to settle claims under the policy in case an insured loss occurs during the policy period.**
- **The insurer typically intends to hold it to maturity and settle claims. Not to sell it into some non-existent secondary market.**

There are NO market-based or market consistent cash flow patterns, discount factors or risk margins to feed into a model for non-life contracts. The IAA has been struggling in vain so far to propose generally accepted methodologies for discount factors and risk margins.

And, given the absence of a secondary market, the only way to fair value these liabilities is by using a “mark to model” analysis that is unverifiable against a non-existent market. I know that this may seem like a cheap shot, but it’s the thought that comes to me at this point. This really reminds me of Enron accounting!

GNAIE Non-Life Position...

- **Different models for life and non-life insurance contracts**
 - Estimated cash flow's are less stable for non-life vs life contracts
- **Standby liability -- measured using unearned premium reserve**
- **Actual Claims -- no discounting of claim reserves, other than fixed and determinable reserves (e.g. workers' compensation)**
 - To discount claims reserves, the timing pattern of the expected cash outflows should be reliable, which is often not the case
- **No explicit risk margins**
 - Challenges are same for life and non-life contracts, but are exaggerated for non-life contracts

So, what does GNAIE propose for non-life liabilities:

For non-life contracts, other than those with reasonably predictable reserves, such as worker's compensation, we propose –

- **The pre-claims liability should be measured using the unearned premium reserve**
- **The post-claims liability should be measured using best estimates, as at present.**
- **No explicit risk margin beyond prudence in making estimates.**
- **No unreliable estimating and discounting of cash flows.**

Discounting - we can do it, but ...

- Payout pattern -- estimation error is increased by often arbitrary assumptions used
- Discount factors -- liability estimation is unreliable due to "Noise" generated by changing factors
- Reduced comparability -- wide cash flow pattern variations by line of business and across companies
- May result in profits being inaccurately recognized too quickly before the liability is settled or released from risk
- Users focus on core underwriting and investment return separately via use of combined ratios to assess performance
- Need to add back explicit risk margin to reflect uncertainty in claims payouts
- Risk margins -- no way to measure "correct" explicit risk margin, even after the fact, so margins are subjective

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Some of us already discount non-life liabilities for our economic capital models and for our submissions to regulators for solvency purposes, such as ICAS in the UK. While we might find it useful for capital planning and understand its value in solvency regulation, we don't believe it is appropriate for general purpose financial statements. As promised, more on the comparison of general purpose vs solvency measures in a moment.

Focusing here on general purpose financial statements, discounting has major shortcomings:

- **Payout pattern – assumptions are often arbitrary and will result in non-comparability**
- **Discount factors – debate rages on cost of capital and other possible methodologies. No proposed methodology is reliable, consistent and non-arbitrary**
- **Risk margin – the IAA has been delegated the task of proposing a methodology. Despite a lot of effort, they have yet to propose one that meets the IASB's tentative principles.**

Users focus separately on core underwriting and investment income – combined ratios. This allows a proper focus on solid underwriting performance. Cash flow underwriting, which relies on investment income to make up for inadequate underwriting of risks, has typically been the handmaiden of understated liabilities and weak financial performance.

Risk Margins ...

No consensus on an appropriate level of risk margins within technical reserves and unlikely to be any such consensus for some time...

WHY?

- Calibration difficulties -- data used is necessarily entity-specific
- Methodology -- no reliable method for quantifying the risk margin on non-life claim liabilities, especially for long-tailed business
- Comparability -- insurers approach to risk in pricing and profitability analyses vary widely, which hinders comparability e.g. a conservative pricing/liberal investing company and vice versa
- Relies solely on the expected value of the liabilities and ignores the potential variability in outcomes as losses run off
- The cost of capital approach is based on an assumption about the amount of capital needed to cover the inherent uncertainty of claim payments which cannot be reliably determined
- Solvency methodologies are not the answer for books of record



This slide sets forth the reasons why a consensus proposal on risk margins has yet to be presented to the IASB. No such proposal seems to be in sight. Why?

- **Data used must of necessity be entity specific, creating significant calibration difficulties**
- **Even if you could calibrate, there's no reliable method, especially for long tail business, which all of us at GNAIE write. It happens to be a big percentage of XL's book of business, so we're particularly concerned about this**
- **The cost of capital methodology is fundamentally flawed, in GNAIE's judgment.**

GNAIE believes adequate field testing is absolutely essential for any new accounting model . Given that the insurance industry is the largest most important worldwide industry in terms of the individuals it protects, the individuals it employs, as well as the impact it has in terms of being the largest investor in public and private debt, we believe that any proposed fundamental change to the insurance accounting model should only be triggered after sufficient field testing and evaluation of whether the proposed model achieves its stated principles.

The bottom line is that solvency methodologies are not the answer for books of record.

Solvency, differs from accounting...

- Solvency -- necessarily based on probability ranges where unreliability in estimates, especially of non-life liabilities, is a given and a range of solutions is considered. No single "best estimate"
- Regulators are responsible for financial capacity to satisfy obligations to policyholders in varieties of scenarios
- General-purpose financial reporting focuses on single "best estimate" of operating results and the current financial position of the company
- While it is important that the accounting definition of liabilities and that used for solvency are consistent and reconcilable it should be recognized that they are often not be the same
- There is a need for performance measurement which drives the investor perspective
- The risk premium demanded by providers of capital may differ from what regulators consider is an appropriate level of capital
- Key is developing 'best practice' approach to solvency that is accepted globally by regulators!

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Finally, the promised discussion of solvency versus accounting.

Solvency regulation is scenario based, with graduated responses at different confidence limits and capital levels. It is necessarily based on probabilities and ranges. The regulator wants to understand how our books will respond under diverse scenarios. Especially for non-life, statutory/solvency reporting considers a range of solutions – not a single best estimate.

Yesterday Gerard and Francis made a strong point that it is generally accepted that there should be one set of statements for general purpose and statutory reporting. They represented that this is generally accepted by the industry. With all due respect, GNAIE strongly disagrees. The CFO Forum is not unanimous in its views in this regard, and some of them agree with GNAIE.

Yes, preparing two sets of statements, which we do at the moment, adds complication, especially since we also compute separate tax financials in every jurisdiction in which we operate.

We should pick the methodology that serves the purpose of each requirement! We should not be guided by unimportant economies of execution.

Failings of Exit Value as a Recognition Attribute...

Relevance

- To be useful, information must be relevant to the decision-making needs of users
 - * Analysts generally disregard the effect of changes in fair value, e.g. FAS 115 and credit derivatives
 - * Disconnect between our legal obligation to policyholders and hypothetical cession to an independent party (insurance regulations do not allow unilateral cancellation or assignment)

Reliability

- To be useful, information must also be reliable
 - * Insurance liabilities do not have an observable secondary market.
 - * Insurance liabilities will generally fall to the bottom rung of the FV hierarchy
 - * Modeled FV involves numerous subjective assumptions (non-observable inputs)

Comparability

- Users must be able to compare the financial statements of an enterprise through time in order to identify trends in its financial position and performance
 - * Significant number of subjective FV assumptions will impair comparability amongst industry
 - * Changes in FV assumptions impairs an individual company's period to period comparison

Understandability

- An essential quality of the information provided in financial statements is that it is readily understandable by reasonably knowledgeable users
 - * Number of varying subjective FV factors inherent in financials renders statements unreadable to even the moderately sophisticated reader
 - * Lack of transparency

Fails to Meet the Basic Qualitative Characteristics of Financial Statements

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This slide is for your reference. In our view, Exit Value fails to meet the above noted qualitative characteristics of financial statements. Copies of these slides are in your CD.

GNAIE concerns with exit value...

- **The objective of the exit value approach is to improve transparency and provide decision useful information...this will not be achieved with exit value accounting for non-life liabilities**

Here's why...

- Exit value is inconsistent with the current revenue recognition project proposals
- Earnings would just fall out
 - Substantial variability in recorded profitability due to 'exit value' accounting measurement rather than economic reality
 - Exit value can create "day 1 gains"!
- Higher cost of capital -- artificially created variability/volatility will cause a need for additional capital support, at a cost borne by consumers either through higher prices and/or lower availability of product
- Substantial increase in auditor scope -- cash flow assumptions, risk margin assumptions; discount factors; verifiability of "day 1 gains" etc!
- IASB's interpretation of reliability is 'best guess'
- Exit values are highly theoretical, are not representative of an insurer's intent or ability to settle its liabilities, do not reflect the insurer as a going concern, and do not reflect consistency with any secondary market valuations.

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Summing up. GNAIE strongly urges for consideration by the IAIS that for non-life contracts the exit value or fair value approach will neither achieve the improved transparency desired nor will it provide decision useful information.

Please note here that:

- **Exit value is inconsistent with current revenue recognition project proposals**
- **Earnings would reflect significant variability due to accounting measurement rather than real economics and could create day-1 gains**
- **The artificial volatility and possibly weakened reserves could adversely impact our cost of capital, creating an unlevel playing field**
- **Auditing and actuarial complexity will create even more incomparability and inefficiency, and**
- **We would be using highly theoretical figures in our financials that would neither reflect market valuations (because there aren't any such valuations) nor the insurer's intent or ability to settle its liabilities.**

The North American non-life insurance industry strongly recommends against the use of exit values and discounting in the calculation of non-life insurance liabilities.

Thank you for your consideration of our concerns.

