GNAIE

Group of North American Insurance Enterprises

International Accounting Standards
The GNAIE Perspective

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What is GNAIE?

- GNAIE is an industry organization of US, Bermudian and Canadian based insurers.

- The mission of the GNAIE is to assist North American and global standard setters and regulators in cooperation with the global insurance industry and with insurance and other financial services industry trade associations:
  - To support high quality insurance accounting standards that are useful, understandable, comparable and reliable; that preserve the insurance industry's level-playing field access to global capital markets; and that provide good disclosure to the insurance industry's diverse constituencies;
  - To support high quality insurance solvency standards that provide useful and effective statutory solvency measures to protect the interests of policyholders and other stakeholders while encouraging competitive insurance markets; and
  - To enhance cooperation, education and communication regarding insurance accounting and solvency among the insurance industry's standards setters, regulators, and diverse constituencies.

Who are the Members?

GNAIE Favors a Globally Accepted Accounting Standard

- We are in favor of globally accepted accounting standards that
  - are high-quality, robust, reliable and understandable,
  - promote transparency and comparability in general purpose financial statements, and
  - are decision-useful to analysts, shareholders, policyholders, management and others.
- Broadly speaking these principles are similar to the goals of the IASB.
- We have developed and published accounting principles that meet these goals. There is broad agreement within the insurance industry on most of these principles.

Discussion Paper (DP)

- We have identified significant issues with certain preliminary positions set out in the DP
  - In general, the positions proposed in the DP are inconsistent with the Life and Non-life principles proposed by GNAIE.
  - While we are still working on our response, in close co-operation with the CFO Forum and the Japanese life insurance companies, a summary of our preliminary observations concerning the proposed measurement model in the DP are as follows:

- We believe that the DP accounting proposals:
  - Are not representative of the way that insurers manage their business,
  - Are not representative of the way users evaluate and analyze our business,
  - Do not measure or reflect the economic reality of our insurance business,
  - Are potentially misleading,
  - Are open to potential manipulation,
  - Are no more ‘market consistent’ than many of today’s existing practices,
  - Disregard key, well understood performance metrics valued by users,
  - Are difficult to use and to interpret.

Key GNAIE Principles

- The "One Model" approach is inappropriate for insurance:
  - Insurance is not the same as manufacturing widgets or banking
    - Actual costs are known long after the insurance product has been sold, not before
    - Insurance contracts are not **readily transferable** or traded
  - Accounting and solvency are fundamentally different for insurance; and accounting models should reflect these differences
  - Fundamental differences between life and non-life insurance contracts should be appropriately considered and accounted for
- Due to the inherent uncertainty and significant future service obligations in insurance liabilities, profit recognition should occur as risk is released, not recognised upfront! No Gain or Loss at Issue should be the fundamental building block for any general purpose insurance accounting or solvency standard.
- For non-life, discounting reserves is appropriate when the expected cash flows are fixed and reliably determinable.
- For non-life liabilities where the incidence, amount and timing of losses are all uncertain, reserving based on ultimate payout – i.e. full reserves – is most appropriate.

Typical Features Life vs Non-life

	Life	Non-Life
Period of Coverage	Typically long	Typically short – fixed duration: Annual policies
Data	More empirical data;	Less available predictable data; Particularly for "unknown; Unknown" events e.g. 9/11, Hurricane Katrina
Interest Income Impact on Product	Essential	Unrelated to underwriting results
Probability of Insured Event Occurring	More certain than non-life; Eventually; "One life claim"	Unknown; "None or many claims"
Amount of Loss if Insured Event Occurs	Fixed	Unknown
Timing of Loss Payments	More predictable	Often unpredictable
Loss Settlement Period	Short	Long
Uncertainty of Estimated Ultimate Claim Payments	Low	Extremely High

Main Issues

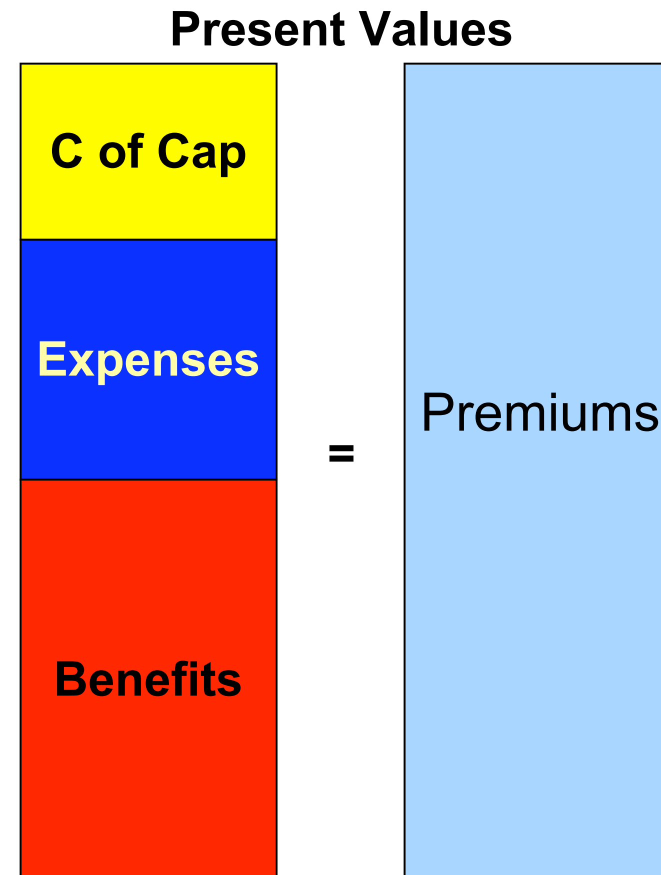
- Potential for significant gain at issue before services have been provided, costs known and before uncertainties have been resolved
- Use of so called ‘market consistent assumptions’ e.g. arbitrary 6% cost of capital rate
- DP puts improper limits on liability measurement
- Discounting, risk and service margins for non-life liabilities – reliability and calibration concerns
- Onerous unbundling requirements
- Use of own credit risk
- Insufficient focus on performance reporting and other related projects

So Why Does a Gain at Issue Arise?

- Possible Answers:
  - Different ratings
  - Different markets
  - Niche markets

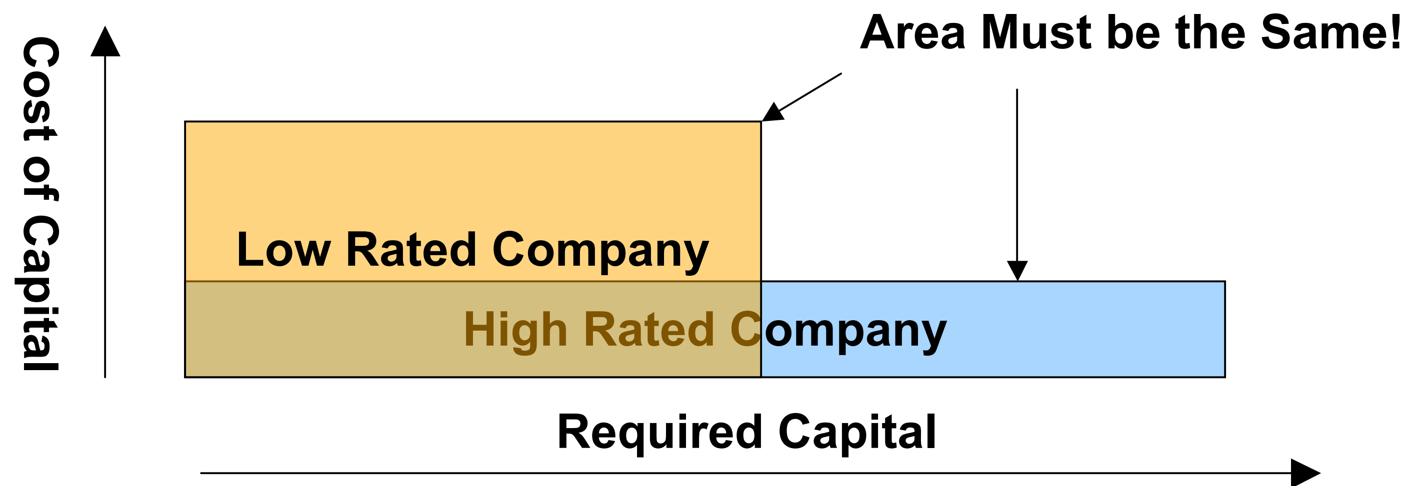
Background – Life Insurance Pricing

- Life Insurance is priced using best estimate assumptions plus cost of capital margin
- Cost of capital is based on company's own required capital and own cost of capital (required return)
  - Own required capital based on rating desired
  - Cost of capital based on company's rating



Different Ratings is Not a Reason

- Regardless of rating, cost of capital margin is the same for all Companies
- Companies with low rating have high cost of capital but low required capital
- Opposite for companies with high rating
- Result must be the same – the market-clearing price



There is no Wholesale / Retail Distinction in Insurance

- Reinsurance is not a wholesale market
  - Distribution cost must be reimbursed for there to be a transfer
  - Best estimate assumptions must be similar for there to be a transfer
  - Therefore no different cost from direct seller
- Wholesale might be group insurance but assumptions are not comparable
- Retail might be life settlement market but not relevant to large company values
- Niche markets may generate gains at issue temporarily – not major

So Why Does a Gain at Issue Arise?

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- The Real Problems
  - Use of ‘market average experience’ – ignores insurer’s actual experience!
  - Understated cost of capital

Best Estimate Assumptions can cause a Gain

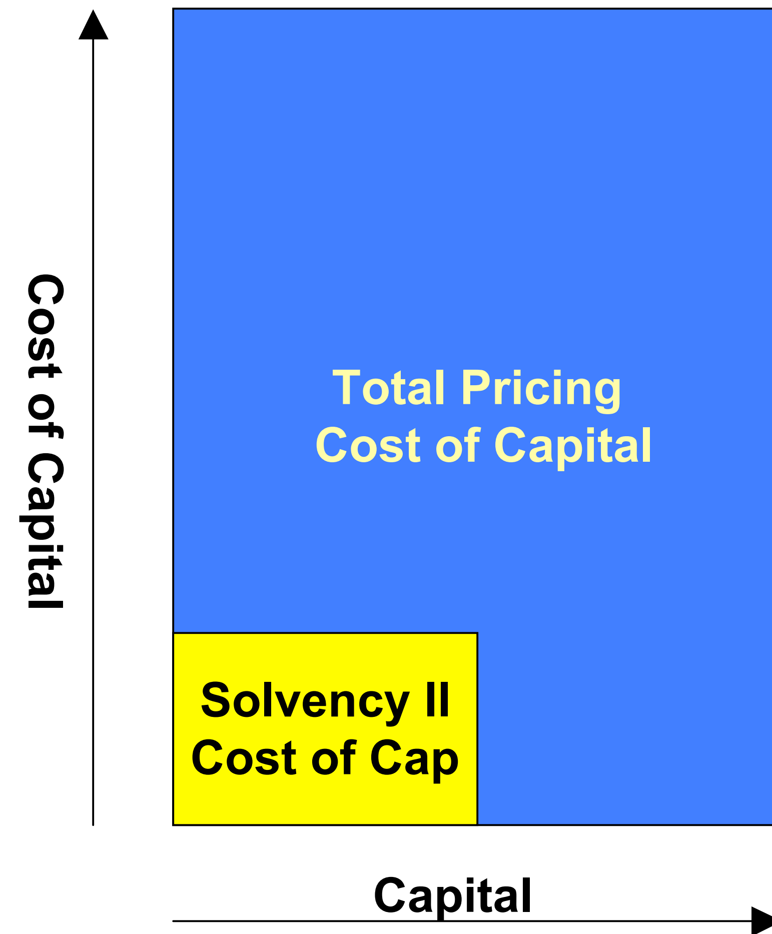
- Estimates of costs may be understated
  - Undue optimism – not to be encouraged!
  - Limits on expenses
    - What are entity specific costs?
    - What are market consistent expenses?
  - Limits on policyholder dividends or other non-guaranteed elements
  - Limits on renewal premiums may cause a non-economic loss at issue on certain products

Relationship between Solvency II and IFRS

- Solvency II is based on an economic balance sheet approach
  - Assets at market value
  - Technical provisions – 'current exit value' i.e. market consistent
    - Which ignores the unique settlement features of insurance liabilities
  - Which, is identical sounding to the IFRS DP proposals
    - Without concern for accounting issues (e.g. profit recognition)
  - But, Solvency and Accounting objectives do differ!
- Current Solvency II proposals result in lower technical insurance liabilities than IFRS proposals with no gain at issue
  - Arguably, it should be the other way round…
  - But, recognition of artificial profit margins on day one is not the way to lower accounting technical liabilities
  - More important to get the objective and measurement of Solvency II right!

Understated Cost of Capital

- Pricing cost of capital reflects
  - Own required capital
  - Own cost of capital
- Solvency II may reflect
  - Regulatory minimum capital
  - Only certain parts of capital
  - Arbitrary 6% cost of capital rate



Gain at Issue is a Bad Idea

- We believe the current proposals will result in significant gains at issue
- Not a limited problem as DP suggests
- Other examples where modeled earnings at issue caused problems
  - Enron

DP places Improper Limits on Liability Measurement

- Even trying to use current exit value as an accounting goal, DP doesn't execute it correctly
  - Limits use of renewal premium
  - Limits non-guaranteed benefits on UL policies
  - Limits policyholder dividends
  - Limits certain expenses
- All these conflict with our principles
- Confuse recognition with measurement

Non-life Liabilities

- Determining a risk margin for non-life
  - Cost of capital approach and other suggested methodologies do not appropriately capture the riskiness of ‘unknown, unknown’ liabilities
    - The cost of capital approach is no more ‘market consistent’ than today’s existing established practices.
    - There are significant differences between ‘transfer’ and ‘settlement’
  - Of course, practically, possible to discount claim reserves
  - However, expected cash flow timing is uncertain, far more so than for most life benefits.
- In summary, it will create less reliability, understandability and comparability in reported earnings without providing an increase in transparency and decision usefulness information.

Unbundling

- To GNAIE, unbundling only adds complexity to financial statements
- No improvement in transparency
  - May actually make it worse
- Board’s proposal is accounting for accounting’s sake

Own Credit Risk

- We understand theory behind including own credit risk but:
  - Using it causes strange results (e.g. large gains right before insolvency)
  - Difficult to determine effect
    - Regulation and guaranty funds limit the effect
- Even DP says the effect is small – if so, why add another confusing element?

Summary

- We have significant concerns with the preliminary positions in the DP because:
  - It allows gains at issue,
  - It doesn't allow proper measurement of the liability by limiting renewal premiums, policyholder dividends and other non-guaranteed elements,
  - It permits use of so called 'market', not entity, specific assumptions,
  - It requires discounting and explicit risk margins for non-life reserves,
  - It requires meaningless unbundling, and
  - It requires inclusion of the own credit risk of the liability to no purpose.
- We think implementing the positions reached in the DP could have significant unintended consequences for the insurance industry.
- GNAIE's desire is to continue to work closely with our international counterparts and other concerned parties on global accounting and solvency issues in order to reach the proper accounting standard.

The Way Forward – Working Together

- The global insurance industry is in a unique position as it relates to the IASB, FASB, IAIS, NAIC and other initiatives
  - Preparers of financial statements
  - Users of financial statements
- How might GNAIE be able to assist and work closer with the NAIC in these important endeavors?