

GNAIE

IFRS - Insurance Contracts

Insurance Contracts Discussion Points

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ISSUES COMMON TO LIFE AND NON-LIFE INSURANCE CONTRACTS

- **Measurement Model – *Contract* Fulfillment Value (“CFV”)**

NON-LIFE INSURANCE

- **Separate Models for Life and Non-life Insurance Contracts**
- **Explicit Risk Margins for Claim Reserves**

LIFE INSURANCE

- **Discount Rate for Life Insurance Contracts**
- **Explicit Risk Margins**
- **Transaction Costs**

APPENDIX

- **Comparison of IAS 37, Agenda Paper 35A and GNAIE Life Insurance and Non-Life Insurance Contracts Models**
- **Probability Weighted Cash Flows**
- **Discounting**

- **GNAIE Notion of Contract Fulfillment Value (CFV)**
 - Based on expected amount to settle with policyholder according to contractual terms
 - Unearned premium reserve (“UPR”) methodology applied to Non-Life Contracts in pre-claim period;
 - Non-Life Contracts post-claim reserves based on gross undiscounted actuarial best estimates;
 - Expected cash flows calibrated to initial premium to produce no gain at issue for Life Contracts;
 - **Remeasurement:**
 - GNAIE Non-Life Contracts model updated each reporting period; claim reserves remeasured with any positive or negative adjustments immediately recognized in earnings (provides maximum transparency to users);
 - GNAIE LIC model updated each reporting period and estimates revised where changes deemed significant and sustainable

- **IASB Notion of (Current Fulfillment Value) CFV**
 - Based on four building blocks
 - Probability weighted cash flows;
 - Time value of money;
 - Explicit risk margin;
 - Amount insurer requires for bearing uncertainty about the resources it will require to fulfill remaining obligation
 - Residual margin (calibration to no gain at issue)

- **IAS 37 – Not An Appropriate Measurement Basis for Insurance Contracts**
 - Requires calibration to transfer or cancellation values; typically not applicable to insurance;
 - Absent ability to transfer or cancel, IAS 37 fulfillment value measured as “amount the entity would rationally pay at the reporting date to be relieved of the present obligation”;
 - Paragraph B8 of IAS 37 addresses fulfillment value associated with service contracts:
 - **Measurement based on amount entity would rationally pay a contractor to undertake the service on its behalf; ostensibly a transfer or exit-based value**

See Page 10 for additional comparison of GNAIE and IASB CFV

Need for Separate Measurement Model for Non-Life Contracts

- Life Contracts and Non-Life Contracts address fundamentally different risks;
- Key attributes (e.g., coverage period, covered interests, contract construction) dissimilar:
 - **Non-Life Contracts (Primarily short-duration contracts)**
 - Coverage period typically 12 months or less;
 - IASB Proposal would require use of UPR for short-duration Non-Life Contracts during pre-claim period;
 - Claims on short-tail contracts (auto and homeowners) promptly reported and settled;
 - Highest claim volatility experienced in first two years; less variability in claims that settle beyond two years;
 - Claims on long-tail contracts (med-mal, business insurance) reported and settled over longer periods;
 - Lowest variability for claims that pay out quickly and more variability for claims that are reported and payout later;
 - Exposure to US litigation environment (e.g., expanding theories of legal liability); cannot be modeled (same issue as encountered in discussions on FASB Statement No. 5, *Accounting for Contingencies*)
 - GNAIE proposed Non-Life Contracts measurement model especially effective for Non-Life Contracts short-tail contracts
 - High claim volatility combined with short resolution period makes introduction of Explicit Risk Margins less useful;
 - Continuous remeasurement and immediate recognition of claim reserve changes obviates need for an ERM;
 - Quick run-off of claim reserves combined with volatility reduces need for, and value of, discounting
 - **Life Contracts (Primarily long-duration contracts)**
 - Coverage period typically greater than one year;
 - Life Contracts either lapse, expire, or a loss occurs upon death of policyholder;
 - For payout annuities, payments are made for as long as the annuitant is alive (which can be decades);
 - For deferred annuities, benefits include interest credits that are generally established on an annual basis;
 - Underwriting risks based on demographics, health, and lifestyle of policyholder; mortality tables (adjusted to reflect own-company experience) and lapse studies exist or are created to help model the impact of these risks

GNAIE View of Explicit Risk Margins for Non-Life Contracts Claim Reserves

- GNAIE does not support Explicit Risk Margins for Non-Life Contracts claim reserves
 - No well defined actuarial estimation methods to accomplish objective
 - No agreement within global actuarial profession on method of determination (e.g., should a confidence level be targeted? What level? etc.);
 - Explicit Risk Margins, if established, would only change if significant and sustainable changes in inputs emerge; would not occur at each reporting period for long-tail or long-duration products;
 - Explicit Risk Margins for Non-Life Contracts claim reserves are untested (and untestable) at this time
 - Until and unless actuarial estimation methods develop, GNAIE sees no basis to change existing globally recognized, well understood, and effectively functioning measurement methodology;
 - GNAIE believes Non-Life Contracts claim reserves include a provision for uncertainty as a result of the multiple reserve methodologies employed to develop reserve estimates. This process, which is supported by an annual actuarial opinion, is more relevant, reliable, comparable, and verifiable than theoretical computations contemplated in the Insurance Contracts Proposal

Further Discussion on Explicit Risk Margins for Non-Life Contracts Claim Reserves

● Insurance Contracts Four Building Block Proposal – Explicit Risk Margins

- Proposal largely statistical; ability to develop a relevant and reliable ERM depends on ability to reliably estimate probability weighted cash flows (“PWCF’s”) together with associated distributions and probabilities which we do not believe possible for most Non-Life Contracts;
 - No ERM methodology exists (e.g., should a confidence level be targeted? What level? etc.);
- In addition to above method that would mathematically derive Explicit Risk Margins based on variance and skew for a given probability distribution, some believe Explicit Risk Margins can be reliably determined using a cost of capital (“CoC”) approach;
 - GNAIE believes CoC approach not useful for a global insurance standard as capital requirements not consistent among implementing jurisdictions. Different levels of capital held by individual insurers (both regulatory minimum and excess) makes Explicit Risk Margins determined on a CoC basis non-comparable and not necessarily related to risk inherent in insurance contracts
- For Personal Lines Non-Life Contracts (e.g., auto and homeowners) where claims settle quickly; cost of developing and maintaining Explicit Risk Margins would exceed benefits to financial statement users
 - Alternative might be to provide historical standard deviation of claim reserves to illustrate inherent level of uncertainty in claim reserve cash flows (could be developed from Statutory Schedule P data);
 - Uncertainty more reliably measurable on ex-post basis as opposed to ex-ante basis; also more understandable for users
- GNAIE notes Explicit Risk Margins not required for other financial liabilities with uncertain cash flows (e.g., pensions); unclear as to why Explicit Risk Margins necessary for insurance

See Page 11 for additional discussion of PWCF’s

GNAIE supports general four building block concept for Life Insurance Contracts with the following modifications:

- **Expected Cash Flows (“ECF’s”)**
 - GNAIE believes “all cash flows within contract boundary” should be considered including future premiums, all expenses, and discretionary participation features on a probability weighted basis
 - Boundary exists where contractual risks are re-underwritten and subject to re-pricing
 - Formal stochastic modeling only required for financial risks (e.g., certain embedded derivatives);
 - ECF’s updated each reporting date to reflect all relevant current information;
 - Remeasurement – financial variables (e.g., interest rates) updated each period whereas non-financial variables (e.g., mortality, lapses, etc.) updated when changes considered significant and sustained (i.e., when vision of the future has changed)

Measurement of Life Insurance Contracts

- **Discount Rate**

- Should reflect assets that fund liability cash flows
 - Ignoring asset-liability management (“ALM”) results in highly volatile liability and equity values not representative of the actual business risks;
 - Using a risk-free rate could produce day one losses on contracts reasonably expected to be profitable, particularly immediate annuities and long-term care policies, both important to senior citizens in or near retirement

- **Explicit Risk Margins**

- GNAIE believes a single margin is all that is appropriate
 - further granular decomposition is primarily mechanical and/or arbitrary and would not provide information that is reliable, comparable, verifiable or decision-useful;
 - No ERM methodology exists (e.g., should a confidence level be targeted? What level? etc.);
- Single margin is referred to as a **composite margin**
 - Represents margin calibrated at inception to produce no gain at issue when taking into account all cash flows under the contract and an appropriate discount rate
 - Margin released as insurer released from risk
- Setting a risk margin that is calibrated to no gain at issue might work as a compromise

- **Current FASB-IASB proposal to expense all acquisition costs is a non-starter since it calibrates to no gain at issue without transaction costs**
 - DAC asset eliminated;
 - No offset to up-front transaction expenses with accelerated recognition of revenue; and
 - Proper handling would allow inclusion of acquisition/transaction expenses in calibrating the liability to premium at issue and coordination with no gain at issue. This is a simple solution and consistent with transaction costs on securities
- **Long duration insurance contracts have a unique combination of characteristics that make the proposed IASB model inappropriate**
 - High upfront transaction costs;
 - Contracts stay in place for 10 to 20+ years;
 - Upfront transaction costs incurred only if contract is sold;
 - Little or no revenue at inception under current proposed treatment for insurance
 - Revenue emerges over many years
- **Proposal would overstate insurance liabilities and understate equity**
 - Even US statutory reporting makes some allowance for acquisition costs
- **Companies would recognize large up-front losses when writing increased amounts of profitable Life Contracts and would show gains as sales decrease**

This is the original problem that US GAAP was devised to solve

IAS 37 Fulfillment Value Compared to January Agenda Paper 35A and to GNAIE Contract Fulfillment Value

		IAS 37 Proposal	Insurance Contracts Measurement Proposal		GNAIE Non-life CFV Post-claims		GNAIE Life CFV
Building Block #1		PWCF's	PWCF's		GNAIE supports use of expected cash flows that are not probability weighted		Same as Non-life with limited exceptions (e.g., MGDB's for annuities)
Building Block #2		Discount PWCF's using risk free ("RF") rate	Discount PWCF's using RF rate		GNAIE's Non-Life Contracts proposal does not reduce reserves by discounting See Slide 12		GNAIE's LIC proposal does not support discounting at risk-free rate See Slide 8
Building Block #3		Apply margins (e.g., risk, service, etc.)	Apply ERM adjustment		GNAIE's Non-Life Contracts proposal does not support Explicit Risk Margins on claims reserves See Slides 5 and 6		GNAIE's LIC proposal does not support Explicit Risk Margins (i.e., separate from composite margin) See Slide 8
Building Block #4			No gain at issue		No gain at issue inherent in UPR method		Calibrated to no gain at issue with transaction costs

Discussion Regarding Probability Weighted Cash Flows

- Given nature of Non-Life Contracts post-claim liabilities (i.e., imprecise range of potential settlement outcomes when claims initially reported as well as when they are incurred but not reported) GNAIE believes it best to utilize expected cash flows without probability weighting as a key input to the Insurance Contracts measurement proposal;
- GNAIE issue is not with estimating cash flows generally but rather with requirement to probability weight them as it is typically not possible to reliably predict probabilities associated with the entire range of possible settlement scenarios (which is infinite). Moreover, probabilities cannot be fully tested with sufficient data before environment changes enough to make past data irrelevant to evaluating current risk;
- Probability Weighted Cash Flows for Non-Life Contracts do not exist nor do we believe they can be reliably produced for use in a measurement paradigm designed for financial reporting purposes.
- **This is another reason there should be separate measurement models for Life Contracts and Non-Life Contracts**

- **GNAIE supports discounting where the amount and timing of cash flows is reliably determinable on an individual claim basis (consistent with the guidance in SEC Staff Accounting Bulletin No. 62)**
- GNAIE considers discounting the second building block of a four building block measurement paradigm where building blocks one and three are not suitable to apply to Non-Life Contracts claims. Application of building block two, independent of our issues with building blocks one and three, is not considered appropriate in terms of achieving a relevant measurement for Non-Life Contracts.
 - **Short-tail NLI Contracts**
 - Greatest claim uncertainty associated with two-thirds of claims that pay-out within two years; discounting would be both unreliable and not decision-useful
 - Remaining one-third that pay-out primarily in years 3 and 4 are typically less uncertain, however, the impact of discounting is insignificant and does not aid financial statement users' understanding of the business
 - **Long-tail NLI Contracts**
 - For many long-tail contracts, roughly half of claims pay out in the first two years; the relatively short pay-out period makes discounting unreliable, not decision-useful, and generally un-necessary. This statement does not include lines of business such as Worker's Compensation where the timing and amount of cash outflows is reliably determinable on an individual claim basis.
 - Remaining half of claims pay-out in year 3 and thereafter. These claims exhibit a high degree of variability which often makes discounting unreliable and not decision-useful