Group of North American Insurance Enterprises

Douglas Wm. Barnert
Executive Director

40 Exchange Place, Suite 1707
New York, NY 10005
United States

++1-212-480-0808
info@gnaie.net
www.gnaie.net

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Rob Esson
Chairman
Insurance Contracts Subcommittee
International Association of Insurance Supervisors
c/o Bank for International Settlements
CH-4002 Basel
Switzerland

Comments on IAIS Second Liabilities Paper -April 27 Version

Dear Chairman Esson:

The Group of North American Insurance Companies ("GNAIE") has reviewed the April 27 Version of the IAIS Second Liabilities Paper and would like to share the attached comments with the Subcommittee on the paper.

We would be happy to discuss any of the individual observations in more detail if the Subcommittee so desires and plan to attend the May meeting of the Subcommittee in Ottawa.

Sincerely,

Douglas Wm. Barnert

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Executive Director
The Group of North American Insurance Enterprises

Attachment

Insurance Contracts Subcommittee

Second IAIS 'Liabilities Paper' – Draft dated 27 April 2006

[Comments from IAIS members and observers
- due by close of business on 19 May 2006]

Name/ Jurisdiction	**Paragraph reference**	**Comment**	**Resolution**
GNAIE-USA	General	The Second Liabilities paper has failed to recommend to the IASB an accounting system which will work in the existing non-life insurance market place by: • Recommending the use a loosely defined, unproven and untested theory of valuation of non-life liabilities, • Accepting a market value precept for the difficult calculations of non-life insurance liabilities which will overlaying existing problematic valuations with additional uncertainty; and by • Recommending an exit value model for insurance accounting which depends upon the hypothetical concept of transfer of liabilities, even though the Paper itself says measurement should be based upon settlement. In addition, it is nearly impossible to calibrate such an exit value. Regarding life insurance, GNAIE is in general agreement with the principles that liabilities related thereto should be calculated based on the present value of future cash flows; however we disagree that an exit value model is the best method for measuring that liability~~.~~... There is clearly a distinction between our positions on life and non-life insurance liabilities. This is due to the unique nature of these two distinct types of insurance and their different characteristics regarding the definitive nature and amount of losses and the timing of their payment. Part of the reason for the timing uncertainty of non-life loss payments as opposed to life loss payments is the relatively greater uncertainty as to *when* a loss-triggering event will occur, if at all. However, an even greater uncertainty exists because life losses overwhelmingly tend to settle relatively quickly after the triggering event whereas non-life claims, particularly for some long-tailed lines of business, may only be *reported* to insurers after lengthy periods and	

		then may have a protracted "negotiation of settlement" period thereafter. Another factor is that relative to life insurance where the ultimate payout is definite and defined, for non-life insurance, liabilities are not definite nor are the ultimate amounts of losses defined. These differences spill over into considerations about risk margins. Accordingly, we believe that the life/non-life aspects of insurance are fundamentally two different industries. That is why, traditionally, insurance entities tend, either by law or custom, to deal in one type of business or the other within a legal entity structure. We suggest again, as we have said repeatedly to the Subcommittee, that two different models be explored.	
GNAIE USA	Executive Summary Para 2 Para 3	In light of our opening comments, we suggest that the opening sentence be reworded as follows: "The IAIS believes that it is preferable for the methods used for preparation of general purpose financial statements be the same as, or at least substantially similar to, the methods used for regulatory purposes." Our comments on the various bullet points will be included in the section of the report where each is stated. If the IAIS adopts our comments, there may need to be equivalent changes to the Executive Summary. We would also offer a few technical comments on this section: We recommend a review of the usage of the term methodology throughout the Paper, possibly substituting "method" or "methods". In the second bullet, "market unobservable inputs" should be "unobservable market inputs". We make this same comment relative to the "boxed" item at the top of page 6 of the Paper. In the 12^{th} bullet, the bullet should lead off: "The IAIS prefers…"	
GNAIE-USA	1	As we commented in our opening remarks, we are concerned that the IAIS is formulating its comments "taking into account the likely outcome of Phase II…" The IAIS should instead recommend its preferable outcome for General Purpose Accounting for Insurance Liabilities. In addition, we have frequently commented that "the likely outcome" of Phase II is not known at this point.	
GNAIE-USA	2	In the second sentence, the reference to "the Association" is the first such reference in the Paper. We believe that it should be changed to "the IAIS" here and anywhere else it's used.	

GNAIE-USA	3	As noted above, we think this paragraph needs to be strengthened as to the primacy of regulatory reporting standards. We would suggest that regulatory regimes do not “base” their reporting requirements on general purpose financial statements, but rather attempt to use general purpose financial statements as a starting point.	
GNAIE-USA	7	We reiterate our comment that the likely outcome of Phase II is not known yet.	
GNAIE-USA	Principle before 15	We would restate the first part of the second sentence of the principle to read, “Since the inputs that are not observable in the market play an essential role ...” However, we are not clear that such a common reference framework either exists or can be reliably determined. Accordingly, we recommend that this second sentence of the principle be deleted.	
GNAIE-USA	15	We would switch the order of paragraphs 15 and 16.	
GNAIE-USA	16	We believe that sales of blocks of business do not provide a real benchmark regarding valuation of insurance liabilities. Such sales usually have strategic elements that cannot be assumed to pertain to any other entity’s liability calculation.	
GNAIE-USA	18-19	These paragraphs suggest that the distinction between financial and non-financial risk is very clear. We suggest that the distinction is not that clear in practice and may often be intertwined (e.g. the effect of termination rates on the value of a guaranteed surrender value).	
GNAIE-USA	20	We would reword the sentence to be more definitive since a substantial number of the inputs to the valuation of insurance liabilities will always need to be modelled depending upon the insurance product being valued. One possible rewording is, "Some of the inputs, especially any unobservable ones, will always need to be modeled within any valuation of insurance liabilities system."	
GNAIE-USA	21	We do not believe it will be possible to develop a common reference framework that will achieve the necessary comparability and reliability.	
GNAIE-USA	22	The Paper indicates that “(t)he IAIS will further consider the steps which might be put into practice to promote such a common framework.” Inasmuch as there are likely several possible outcomes from IAIS considerations, the appropriate phrasing for this paragraph is: “The IAIS will continue its consideration of the steps which could be put into practice to promote a common reference framework.”	.

GNAIE-USA	Principle before 23	It is precisely the relatively low reliability of the uncertain timing pattern and amount of future cash flows that makes the premise of the proposed valuation scheme untenable for non-life insurance enterprises' financial statements.	
GNAIE-USA	29	We would urge the IAIS to separate the last sentence of this paragraph into its own paragraph for emphasis since we do not know the outcome of IAS 37 changes.	
GNAIE-USA	32	The final clause of this paragraph is better understood as being a modifier to the prior thought if the word "since" replaces "as" in the phrase "as the level."	
GNAIE-USA	34	Notwithstanding that the IASB "has *tentatively* decided to *explore approaches to* insurance contracts that would reflect unbiased estimates of future cash flows, reflect the time value of money, and include adjustments to reflects risks," this paper is suggesting adopting this approach <u>prior to the completion of that exploration and without testing.</u> We believe a more effective approach is to consider risk margins as an element of solvency measurement or part of a risk-based capital regime.	
GNAIE-USA	36	The second sentence is unclear. If it's a comment on credibility, we suggest the sentence read: "The IAIS believes that the credibility of past experience be recognized in the choice of assumptions." Otherwise, we'd suggest removing the sentence. It is not necessary for every assumption to be based on 100% credible experience because that often is not possible.	
GNAIE-USA	37	We disagree with the conclusion of paragraph 37 for accounting for non-life insurance since it is likely that the result will produce financial statements that are not transparent and would be less meaningful to statement users. Margin calculations are likely to be so subjective (especially in a principles-based system that abjures rules) as to allow manipulation by reporting entities or otherwise decrease comparability amongst entities. GNAIE does agree that margins should reflect risk. However, margins also need to reflect potential profits, as well as the cost of capital and other items. The level of uncertainty is not the only factor that margins need to reflect.	
GNAIE-USA	Principle before 40; 40-44	The principle on which the paragraphs 40-44 are based is flawed in that there is no generally accepted method to determine that an "appropriate and sufficiently reliable" risk margin is included in the liability. The key issue that is addressed here is whether a gain at issue should be allowed. We have studied this issue at length and concluded that	

		allowing gain at issue is an invitation to the minimalization of margins in reserves. We believe that earnings should be based on the release of the insurer from risk since the insurer would then be compensated for services provided and not on the basis of some projected results. We agree with the tone of paragraph 41 although we don't believe that such evidence can ever be produced since the future can never be proven. We therefore urge that this principle be modified as follows and the discussion should reflect the points above: "A model that reflects the current best estimate of future experience is preferred. Furthermore, profits should be earned as the insurer is released from risk (i.e. as services are provided). There should be no gain allowed at issue and the margins over current estimates should be calibrated accordingly."	
GNAIE-USA	45	In the second bullet item of paragraph 45, it is not only likely that "actual future experience will differ from the current estimate", it is a virtual certainty that such a deviation will occur. The current methods for estimating insurance liabilities, most particularly non-life insurance liabilities, already recognize such uncertainty.	
GNAIE-USA	48-49	Before the IAIS adopts the position in paragraphs 48 and 49, we strongly urge that models of the various risks be produced. It is our belief that eliminating the company specific risks from liabilities would create a significant gain at issue for almost every life insurance company. As we noted above, all these distinctions are made moot if the requirement for no gain at issue is adopted. In that case, the types of margins discussed here could become the basis for a minimum margin used only for liability adequacy testing.	
GNAIE-USA	50-54	Paragraphs 50-54 reflect more of a solvency assessment regime as opposed to a statement liability calculation method. We are not certain that the use of risk margins as described in the paper are appropriate for public accounting as we have said earlier. However, as we've also noted above, if this approach is used, overall margins should be calibrated so that there is no gain or loss at issue. This makes most of this section moot and, in any event, it probably contains more detail than is required in an accounting standard.	
GNAIE-USA	56	Paragraph 56 contains a footnote reference, but no explanation appears on the page.	
GNAIE-USA	57	We do not understand how the alluded to calibration process could possibly be implemented without a transfer market.	

GNAIE-USA	59	Again, we think this theoretical discussion of margins is interesting but the use of it would create so much opportunity for up-front profit that it would generate results that are not comparable among companies. This kind of discussion is useful in pricing of products but only because the final result (the premium) is then adjusted to market levels. Nevertheless, we think the principles in Paragraph 59 are generally acceptable as guidance for how margins should be spread among risk elements; however, we would note that the last bullet needs interpretation. As experience reduces uncertainty, the best estimates may change. If not to reduce the margin would result in recognition of a one-time gain that cannot be justified objectively. How much uncertainty has been eliminated and how would one measure it? We urge the IAIS to remember that we are always talking about the future and we can never be certain what the future will be. Risk margins will decrease as business is settled; margins should not be arbitrarily released because a company *thinks* the future has become clearer. On a technical note: In paragraph 59 the use of the phrase “would be expected” is conditional with no conditions expressed. We suggest substituting “are generally expected”.	
GNAIE-USA	60	As to paragraph 60, a method probably will not promote reliability and verifiability since, as noted above, the process is likely to be quite subjective.	
GNAIE-USA	62	We believe that this paragraph makes an important point regarding disclosure in financial statements. This will be more valuable than subjective input to non-life insurance liability calculation.	
GNAIE-USA	63 -65	The IAIS has limited the options to only two methods. It would seem important to review any other potential options that were reviewed and the reasons for their rejection. The reference to two main methodologies refers to an early draft of an IAA paper that has not yet been completed or vetted, among the IAA risk margins task force members. Thus, we don’t believe that paragraphs 63-65 belong in the paper until further analysis has been completed.	
GNAIE-USA	72	We agree that a single set of assumptions is required for life insurance reserves and that what is important is the result that the set produces rather than any particular item in the set.	

GNAIE-USA	88	We disagree with the Paper’s conclusion that no asset should be recognized for deferred acquisition costs and that the direct acquisition costs should be subsumed or offset within the insurance liabilities calculation. We believe that our position is more in line with the general IASB direction of avoiding asset/liability offsets.	
GNAIE-USA	Principle before 90	We would suggest that the first sentence of paragraph 97 should be the principle upon which the section is based rather than the somewhat more vaguely worded principle in the box before paragraph 90. We believe that this presentation is clear and in accord with the calculation of the remainder of the liability.	