



The Group of North American Insurance Enterprises

Discussion Paper

I. Background

In advance of discussing candidates for insurance contract liability measurement attributes, this paper highlights areas where key differences exist among the candidates discussed by the IASB and IWG in October and November 2008 and summarizes GNAIE's views as it relates to **NLI contracts**. Additional information is available on GNAIE's website (www.gnaie.net) or directly through a GNAIE representative.

GNAIE notes that while certain constituents support a single model for both Life and NLI contracts, such a model would produce measurements fundamentally inconsistent with the economics of the unique contracts. Agenda Paper 3C for the October 2008 Board meeting provided a tabular comparison of the candidate measurement approaches. All measurement candidates (except the unearned premium reserve) are based on the three building blocks (i.e., expected cash flows, margins, and discount rates).

GNAIE supports the building block approach for life insurance ("LI") contracts (although it has concerns about how the building blocks are defined and determined)¹. Candidate 4 is the most similar to GNAIE's contract fulfillment value ("CFV") proposal for LI contracts.

GNAIE does not support the building block approach for NLI contracts which we believe are service-type contracts and thus are most appropriately measured using an unearned premium approach for pre-claim liabilities ("PR-CL"); with no explicit risk or service margin. Similarly, post-claim liabilities ("PO-CL") are measured based on the undiscounted best estimate of amounts necessary to fully adjudicate open claims (i.e., with no risk or service margins and no discounting unless the cash flows and payment patterns can be reliably determined on an individual claim basis). The result is a "**contract fulfillment value**" ("CFV") measurement attribute for NLI contracts which assumes fulfillment of the contractual terms with policyholders "in the normal course" pursuant to the terms of the contract; not a hypothetical settlement with a hypothetical market participant at the reporting date. GNAIE believes CFV is the most appropriate measurement attribute for NLI contracts and far superior to Current Exit Value ("CEV") as described in the *Discussion Paper* which we believe is unnecessarily complex for NLI contracts.

¹ The IASB and FASB are working on several other projects, including Conceptual Framework, Revenue Recognition, Fair Value Measurement, and Proposed amendments to IAS 37, that could significantly affect decisions regarding measurement of insurance contracts, and could be affected by decisions made in the Insurance Contracts project. Our comments may need to be updated as work progresses on all of these projects.

In summarizing the measurement candidates the Board described the notion of settlement value in terms of a **current** settlement value (“CSV”) which GNAIE believes is fundamentally different than CFV. In its February 2008 *IASB Update*, the Board clarified that “settle” means to settle by paying the counterparty at the balance sheet date. GNAIE observes that in terms of NLI contracts, CSV would be equivalent to a commutation, which seldom occurs. That is, NLI contracts are rarely settled by making payment to the insured at the measurement date outside the normal terms of the 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. Both of the preceding notions (i.e., current settlement and transfer) are rarely applicable to NLI contracts, both because of legal constraints in most countries and because of the commercial intent of both insurers and policyholders.

II. Comparison of CFV to Building Blocks

❖ Expected Cash flows

- a. Basis for assumptions – There is generally no active secondary market for NLI contracts. GNAIE does not support a “current settlement” or “transfer” based measurement model that in almost all cases would not occur and therefore must be based on hypothetical market assumptions. Alternatively, GNAIE advocates liability valuation based on management’s best estimate of cash flows expected to occur. Market assumptions are of particular concern with respect to expenses. For example, if assumed expense cash flows are based on hypothetical market assumptions rather than actual expectations, **inefficient entities would show artificial gains** (because they price for costs that would be higher than market assumptions implicit in the liability). Accordingly, **efficient entities would show artificial losses which would reverse as the insurer services the contracts and actual expenses are incurred**. In addition, for the following reasons, using hypothetical market assumptions will not reflect the future cash flows of the insurer.
 - i. Different insurers have different products, business models and operating strategies. For example, different product offerings combined with differing levels of importance placed on service levels, fraud detection, and claim settlement practices result in not only differing levels of premium charged but also different expense structures and claim experience.
 - ii. The settlement of claims for certain NLI contracts can involve negotiation between the insured or litigant and the insurer; a situation uncommon for LI contracts. NLI claims are not homogenous. Even for auto policies, the geographic location of an accident or policy influences the estimated settlement value of a claim. Moreover, different geographic locations may also involve court systems with different views of litigation. Accordingly,

assumed market averages will most likely not be a relevant measure when applied to a specific insurer's book of business.

- iii. As another example, for surety products, some companies provide significantly more upfront services to policyholders which increase expense ratios but has the tendency to lower loss ratios. The use a hypothetical market average would adversely impact the insurer with this strategy since they would be forced to carry greater reserves.
- b. Probability-weighting – The best estimate should reflect the expected value of cash flows. Probability weighting, perhaps with stochastic modeling in some cases, could be appropriate and useful for estimates of some liabilities. However, in many cases, a more straight forward determination of best estimates would be more timely, understandable, and sufficiently accurate. In addition, attempting to probability weight reserves for NLI contracts will yield results that appear substantially more precise than they actually are. In many cases, there is simply not enough information on the cases to determine the likely probabilities and, in addition, cases can be correlated which can greatly skew the possible outcomes. The very fact that many property and casualty settlements are determined through negotiation and litigation makes determining a probability distribution an unsupportable exercise.
- c. Own credit standing – The insurance regulatory structure in most of the world provides payment priority for insurance contracts over the insurer's other obligations. GNAIE believes the credit standing of the insurance company should not be considered in valuing insurance liabilities as we believe a going concern assumption for insurers would assume NLI contracts would not be reduced to reflect the possibility on non-payment of legitimate claims or transfer of claims to another insurer at a price reflecting a reduced credit standing.

❖ Margins

GNAIE's proposed CFV measurement model for NLI contracts, similar to its CFV measurement model for LI contracts, calibrates reserves (in the case of NLI contracts the unearned premium reserve) to initial premiums which does not allow the recognition of gains at initial recognition. For NLI contracts, GNAIE does not support the computation of explicit margins as this is not done in practice and would be of no use as NLI contracts are priced and managed, and management is compensated in some cases, based on underwriting statistics which include earned premiums and incurred expenses and losses. Such underwriting metrics are also commonly used by investors and other financial statement users as performance indicators and to provide comparability across companies. When an insurance contract is issued, the insurer has not been released from any assumed insurance risk, 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 CEV measurement attribute may be very inconsistent with this market information, and the *Discussion Paper* indicates that further investigation may be needed if CEV results in a large gain at initial recognition. Moreover, GNAIE believe the CEV measurement attribute is overly complex and thus inconsistent with standard setter's desire to reduce complexity in accounting and financial reporting and would result in a loss of the historical performance metrics that financial statement users understand and have grown accustomed to receiving.

❖ **Discount rates.**

GNAIE believes the presentation of gross liability values is most appropriate because CFV presumes NLI 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 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 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, NLI contracts are not implicitly or explicitly interest-bearing and thus we believe a discounted presentation would be misleading to financial statement users.

III. Conclusion

GNAIE believes that undiscounted non-life claim reserves are already very subjective and to further subject them to additional measurement adjustments such as discounting and risk margins adds unnecessary complexity and leads to an obfuscation of results. This in turn leads to less decision useful information for investors and other financial statement users. Accordingly, we believe these two important issues deserve further Board consideration before any decisions are made concerning the measurement candidates.