

Valuation of Insurance Contracts

**Presentation to
Global Communications Group
4th Annual Strategic Planning Meeting
Kevin Spataro, Allstate
on behalf of the**

**Group of North American Insurance Enterprises
27 August 2008**

What is GNAIE?

- **GNAIE is an industry organization of US, Bermudian and Canadian based insurers and reinsurers.**
- Our Mission: 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.




GNAIE Member Companies



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Insurance Contracts – Measurement Issue

- For the purpose of this presentation, we are limiting our comparisons to the following international groups that have provided advice and input to the International Accounting Standards Board on the acceptable characteristics of a single, universally acceptable, measurement basis for insurance contracts:
 - International Association of Insurance Supervisors (“IAIS”)
 - Industry Groups – GNAIE and CFO Forum have both developed measurement principles for Life and Non-life insurance contracts
- Goal is a measurement model consistent with the economics of the business and understandable to users
 - Consistent for both solvency and general purpose financials
- IASB has proposed and the Second Liabilities Paper of the IAIS supported market consistent/transfer-based measurement principles
 - Challenge is absence of market observable data to validate key inputs (e.g., cash flows, risk margins, etc.) as no markets exist for insurance contracts – something acknowledged by the Discussion Paper

Measurement Candidates

- IASB – Current Exit Value (“CEV”)
 - CEV represents the insurer would expect to pay at the reporting date to transfer it’s remaining contractual rights and obligations immediately to another entity

[IASB will be considering other measurement alternatives at its September Educational Session. CEV , however, remains IASB’s existing measurement proposal]
- GNAIE – Contract Fulfillment Value (“CFV”)
 - CFV represents amount the insurer expects to pay to settle the obligation with the insured pursuant to the terms of the contract in the normal course. Separate models for life and non-life contracts
- CFO Forum – CFO Forum Principles (“CFOFP”)
 - CFOFP is present value of all future cash flows (reflecting management’s best estimate) with an allowance for inherent risk and uncertainty
- CFO Forum – Market Consistent Embedded Value (“MCEV”)
 - MCEV, which is disclosure based information, represents the present value of shareholders’ interests in the distributable earnings from assets allocated to covered business after allowance for risk. MCEV includes both a capital and risk charge
- Input from Regulators (e.g., IAIS) – Market Consistent Value (“MCV”)
 - MCV of insurance liabilities calibrated to value a third party insurer would require to take them over and settle with claimants. In absence of market inputs; use mark-to-model

Measurement Candidates – Key Attribute Comparison

Measurement Candidates

Measurement Attributes			CFV	CFV	CFOFP²
	MCV	CEV	Life	Non-Life	
One model for life and non-life	Yes	Yes	No	No	Yes
Settlement or transfer based	Transfer	Transfer	Settlement	Settlement	Settlement
Gain at issue allowed	Split ⁴	Yes	No ¹	No	Deferred
Own credit risk reflected	No	Yes	No	No	No
Explicit risk margins	Yes	Yes	Yes	No	Yes
Allows for entity-specific cash flows	Yes	No	Yes	Yes	Yes
Allows for entity specific expenses	Yes	No	Yes	Yes	Yes
Discount rates	Risk free	Risk free	Asset based	N/A ³	Risk free

¹: Life total margin (risk and profit) calibrated to initial premium to produce no gain at issue

²: CFO Forum also uses Market Consistent Embedded Value for disclosure purposes (mainly for life insurance contracts)

³: GNAIE non-life model does not allow discounting unless cash-flows are fixed and determinable on an individual claim basis

⁴: IAIS Comment Letter was split on its views on gain at issue

Key Attribute Comparison

Discussion Basis for Contract Fulfillment Value

- One model versus separate models for life and non-life
 - Key distinction between life and non-life?
 - Is management of life and non-life business similar enough to warrant one measurement model?
- Should model be settlement or transfer based?
 - Consistency with how business is managed
 - Absence of a market for insurance contracts
- Gain at issue (i.e., day one gains)
 - Should day one gains be permitted?
 - Have any services been provided or performance obligations fulfilled?
 - Enough information to reliably distinguish between risk and profit?
 - Is “we think we know the future” a sufficient profit recognition threshold?
 - Cross-cutting issue (revenue recognition)
 - Customer consideration or exit value
 - Re-measurement
- Own credit risk reflected in measurement
 - Why are we still debating this?

Key Attribute Comparison (cont)

Discussion Basis for Contract Fulfillment Value

- Should there be explicit risk margins?
 - Life insurance
 - Can risk margins be estimated separate from profit?
 - Questions regarding cost-of-capital measures
 - Uniform rate; are all companies capitalized similarly?
 - What are we attempting to isolate in terms of risk?
 - Impact of income taxes
 - Non-life insurance
 - Can risk margins be estimated in a consistent, reliable manner?
 - Are risk margins comparable and verifiable?
 - Are risk margins used to manage the business and hold management accountable for results?
- Should non-life insurance contracts be discounted?
 - Cost/benefit for short-tail property & casualty contracts?
 - Timing of cash flows reliably determinable for long-tail contracts?
 - Hold claim reserves at anticipated contract fulfillment amount
 - Discounting cannot be implemented independent of risk margins
- Discount Rate for Life Insurance Contracts
 - Earned rate, risk-free rate. Other?
- For more on the topic of discounting see 9 March 2007 GNAIE Presentation to IAIS at Appendix I

Key Attribute Comparison (cont)

Discussion Basis for Contract Fulfillment Value

- Market-consistent versus entity-specific cash flows
 - Availability of market-consistent cash flows? Reliability? Verifiability?
 - Differences between life and non-life insurance contracts
- Market-consistent versus entity-specific expenses
 - Availability of market-consistent cash flows? Reliability? Verifiability?
 - Differences between life and non-life insurance contracts
- Discount rate for life insurance contracts
 - Asset-earned
 - Permits valuation of insurance contract to be consistent with business economics that determined amount of premium at inception
 - Risk-free
 - Overstates value of insurance contracts; unless a transfer is imminent and market demands a risk-free discount rate

Cross-Cutting Issues

- Revenue Recognition
 - Customer consideration or exit value (Day 1)
 - Re-measurement (Day 2)
 - Period of revenue recognition
- Liabilities Research Project
- Financial Statement Presentation
 - Margin presentation for both life and non-life?
 - Underwriting presentation?
 - Consistency with management view
- Financial Instruments
 - One measurement model
- Conceptual Framework
 - Timing

Focus on Contract Fulfillment Value

- Analysis of CFV versus key measurement objectives:
 - Settlement with customer based measurement; consistent with the cash flows that are expected to occur in the normal course
 - CFV most consistent with how insurance contracts are managed
 - No gain at issue; consistent with fact that no services have been provided and with customer consideration model
 - Margins (risk and profit) calibrated to premium; no gain at issue for life
 - No explicit risk or profit margins (or discounting) for non-life
 - Short-tail – not cost beneficial to discount and gross up for risk
 - Long-tail – cash flow timing and risk margins typically not reliably determinable
 - Entity specific cash flows used for both losses and expenses
 - Discount rates
 - Life – asset earned rate (consistent with business economics underlying initial premium and does not overstate value of insurance obligation)
 - Non-life/Short-tail
 - UPR – unnecessary to discount
 - Claims – not reliable or cost beneficial to discount
 - Non-life/Long-tail
 - UPR – unnecessary to discount
 - Claims – timing of cash flows typically not reliably determinable
 - Does not reflect own-credit standing

Issues with Alternative Measurements

- MCV (IAIS – Second Liabilities)
 - One model for life and non-life
 - Transfer-based
 - Allows gains at issue
 - Explicit risk margins
 - Unclear that risk can be separately identified from profit
 - Use of risk-free rate for discounting
 - Inconsistent with business economics underlying initial premium
- CEV (IASB Phase II Discussion Paper)
 - Similar inputs as MCV, **plus**
 - Market consistent cash flows for expenses
 - Requirement to reflect own-credit standing
- CFOFP
 - Similar issues as MCV, **except**
 - No gain at issue
 - Settlement based
 - Greater use of entity specific cash-flows

GNAIE Conclusions

- CFV is the best measurement alternative
 - Meets most constituent objectives
 - Settlement with customer-based; consistent with management of business
 - Most understandable for financial statement users
- Separate measurement and reporting models for life and non-life are necessary
 - Measurement; discounting and risk margins for life
 - Presentation; margin presentation for life, underwriting for non-life
- Gains at issue should not be allowed
 - No services provided or performance obligations fulfilled
 - Cannot adequately distinguish profit from risk margin

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The Need for Different Accounting Models for Life and Non-life Insurance Contracts

Presentation to the International Association of Insurance Supervisors
Insurance Contracts Committee
March 9, 2007

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Co-Chairman, GNAIE Accounting Convergence Committee

The Group of North American Insurance Enterprises (GNAIE) consists of Chief Financial Officers of leading insurance companies including life insurers, property and casualty insurers, and reinsurers. GNAIE members include companies who are the largest global providers of insurance and substantial multi-national corporations. All are major participants in the US markets. (www.gnaie.net)



I. BACKGROUND

The International Accounting Standards Board (“IASB”) and International Association of Insurance Supervisors (“IAIS”) are separately, but concurrently, considering the adoption of new accounting models for both life and non-life insurance contracts. Thus far, both the IASB and IAIS have tentatively endorsed the use of a single model for both life and non-life insurance contracts. In contrast, GNAIE believes very strongly that the unique features of life and non-life contracts require different accounting models that give appropriate consideration to those unique features. Accordingly, GNAIE developed unique life and non-life accounting models that we believe represent an enhancement over the existing US GAAP and IFRS models. The principal rationale supporting the need for two unique accounting models is more fully articulated as follows.

II. THERE ARE SIGNIFICANT INHERENT DIFFERENCES BETWEEN LIFE AND NON-LIFE INSURANCE CONTRACTS

- ❖ Life contracts are inherently more suitable for the application of discounted measurement techniques. In most cases there is near perfect certainty that the policyholder will either die or surrender, the face amount of the basic contract is known, and the insurer possesses mortality tables and lapse studies that aid in predicting when mortality or lapse events are most likely to occur.
- ❖ Non-life contracts are inherently much less suitable for the application of discounted measurement techniques. The insurer cannot **reliably** predict losses, other than on a gross, undiscounted basis primarily due to the wide range of potential losses (i.e. any amount between zero and the contractual policy limits) , which can occur in any individual reporting period during which the policies provide coverage. The inability to reliably estimate non-life claims and related expenses for individual reporting periods over the life of the contracts (as opposed to life contracts where this is possible) is the principal reason that two unique accounting models are considered necessary.



III. EVALUATION OF THE UNIQUE FEATURES OF NON-LIFE CONTRACTS

- ❖ Premiums received (net of commissions and other expenses) are typically invested in interest-bearing instruments during the life of the contract. For that reason, non-life insurance contracts (both short and long duration) are priced, managed, and evaluated for performance based principally on underwriting results (i.e. underwriting income excluding interest income).
- ❖ The principal reason the time value of money has historically not been incorporated in the measurement of non-life reserve estimates or performance measures is attributable to the inability to reliably estimate cash flows for such contracts by individual reporting period. The range of potential claim outcomes for individual reporting periods is widely dispersed and further complicated by the fact that the period over which claims will ultimately be settled is also inherently uncertain as a portion of actual claim settlements are based on legal proceedings with indeterminate timing and outcomes.
- ❖ Pursuant to the above, the “time value of money” **cannot be reliably measured for non-life insurance contracts** due to the inability to reliably estimate cash flows by reporting period which must serve as the foundation for any discounting (i.e. time value of money) exercise. Any reserve estimation exercise must be built on a solid (i.e. reliable) foundation (i.e. estimated cash flows) for the output of the exercise to be relevant and reliable.
- ❖ In contrast to non-life contracts, life contracts possess qualitative features that allow the reliable estimation of their cash flows by individual reporting period using generally accepted actuarial techniques. As a result, life contracts typically contain an explicit interest element in pricing and are managed and evaluated for performance based on measures that specifically include interest income. Accordingly, the discounting of life reserves to reflect the time value of money is considered wholly appropriate.
- ❖ While non-life companies do invest net premiums and place importance on the earning of investment income, any exercise to specifically isolate the time value of money for non-life contracts would not provide decision useful information to financial statement users as the exercise cannot be built on a stable foundation in the absence of a reliable set of estimated cash flows by reporting period.



IV. KEY FEATURES OF GNAIE'S LIFE AND NON-LIFE PROPOSED ACCOUNTING MODELS

GNAIE Proposed Life Model - Key Features

- Full discounting applied to all reliably estimable net cash flows; consistent with present accounting.
- Utilization of risk margins to reflect the inherent risk of the estimated net cash flows; calibrated to produce no gain at issue.
- **Update reserve assumptions over time based on experience as new trends are confirmed; differs from present accounting.**

GNAIE Proposed Non-life Model - Key Features

- Pre-claims liability measured using the unearned premium reserve ("UPR"); consistent with the existing model that is executory in nature.
- Post-claims liability measured using the reporting entity's undiscounted best estimates; consistent with the current model based on incurred losses.
- No explicit risk margin due to absence of any reliable market-based source for this measure. An implicit risk margin does exist inasmuch as reserves are held on an undiscounted basis.

V. CONCLUSIONS

GNAIE believes that life and non-life insurance contracts are demonstrably different in terms of their key features and as such it is necessary to develop different accounting models to conform to those unique features. In the case of life insurance contracts, because cash flows can be reliably estimated by individual reporting period it is appropriate to discount estimated cash flows. It is also appropriate to continue the application of risk margins to life insurance cash flows consistent with historic practices; with the exception that risk margins should be calibrated to produce no gain at issue. In contrast, for non-life insurance contracts, because the cash flows cannot be reliably estimated by individual reporting period due to the inherent uncertainty of the related cash flows, GNAIE supports utilization of the UPR as the pre-claims liability and the post claim liability should be determined based on the reporting entity's undiscounted best estimate of incurred losses.