

# GNAIE Extended Principles for Non-Life Insurance

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## Introduction

This paper presents a proposed set of principles, basis for conclusions and implementation guidance for an extended International Financial Reporting Principles for non-life insurance.

This paper builds upon itself and should be considered as a whole. This paper addresses key aspects of a principles-based framework and as such, excludes references to detailed accounting guidance. Although the extended principles are intended to be complete, any such approach by its nature will not answer every possible question that might arise in practice.

There are three different types of paragraphs in the paper namely principles, basis for conclusions ('BC') and implementation guidance ('IG'). All three types are grouped together by subject matter so that the reader may evaluate all related material together. Not all sections have all three types. Principles are stated in **bold face**, basis for conclusions in normal typeface and implementation guidance in *italics*.

### Reasons for Separate Non-life Principles

There are fundamental differences between non-life and life contracts that render the application of one uniform accounting model to both types of contracts inappropriate.

Firstly, the severity of the volatility of claim amounts is more uncertain for non-life relative to some life contracts. In contrast to many life contracts for which the amount of the payment from the insurer to the insured is generally certain (i.e. the "face amount" of the policy), non-life contracts only require a payment be made from the insurer to the insured if an insured event were to occur, and often expire without any such loss payment being made or only a portion of the policy limit paid. Therefore, for many life contracts there is generally uncertainty only on the timing of the claim, whereas, for non-life contracts there is uncertainty as to both the timing and settlement amount of loss payments.

Secondly, on an aggregate book of business, the level of uncertainty in timing of payments to insureds is greater for non-life than some life contracts for the following reasons:

- Key factors influencing the timing of payments for life contracts tend to be more stable relative to the key factors for non-life contracts. For many life contracts, key factors affecting the timing of loss payments in a given year, such as deaths, lapses, or withdrawals, are less susceptible to significant deviation from external factors from period to period. The timing of loss payments for non-life contracts is highly unpredictable and more susceptible to significant deviation from period to period due to factors such as the effect of global claim settlements, reinsurance commutations, weather, catastrophic events, the legal environment, the business environment, technology and claim settlement strategies. For example, for auto insurance there is uncertainty as to whether an insured would be involved in an auto accident in any given year, not to

mention the challenge in predicting accurately the severity of any potential loss if an accident were to occur.

- Once losses are incurred, payments on non-life contracts tend to be far less predictable relative to life contracts. Many life related claims tend to settle relatively quicker, whereas non-life claims, particularly for long-tailed business, may not be reported until many years after the loss is incurred and even then may have protracted negotiation and/or settlement periods (e.g. asbestos and environmental claims).
- For many non-life contracts, the insurer has an obligation inherent in the contract to defend the policyholder. Such obligation affects the amount and timing of payments. This is not a factor for most life contracts.

These distinct differences and features must be factored into the development of extended principles for both life and non-life insurance contracts. Based on these differences we believe that it would not be appropriate to use the same measurement attributes for both life and non-life insurance contracts. Specifically, given the greater uncertainty of both the amount and timing of payments for non-life relative to most life contracts certain variable estimates, such as a discount and explicit risk margin, are inherently less reliably measured for non-life relative to life contracts.

## Scope

The accounting principles as described herein are not intended to provide guidance for establishing the assumptions and methodologies used to calculate insurance claim liabilities. We believe that the International Accounting Standards Board should not focus on setting technical rules in these areas.

These principles address an accounting model for non-life contracts that meet the definition of insurance for accounting purposes. These principles do not attempt to define either insurance or risk transfer considerations to determine whether or not a contract should be defined as insurance for accounting purposes. Furthermore, the unique characteristics of reinsurance contracts are not addressed.

These principles cover non life products such as:

- Automobile liability, which provide coverage for bodily injury (i.e. liability and medical) and physical damage (i.e. collision, comprehensive, and property damage).
- Property insurance, which provide coverage for fire, marine and casualty etc. Umbrella policies are generally included within the property category and provide liability protection beyond limits on individual automobile or property policies.
- Public liability, which is intended to encompass the liability exposures of an individual or business firm, other than liability to employees or arising out of the ownership use of automobiles and aircraft.
- Coverages that typically are for a 6 or 12 month period and are contracts of indemnity.

This list is intended to be illustrative only, and accordingly, there are contracts that do not fall within the above description for non-life insurance.

## The Basic Model

**Principle 1: The total insurance liability for non-life contracts consists of two types of liabilities; the pre-claims liability and the post-claims liability.**

**Sub-Principle 1.01: The pre-claims liability is the stand-ready obligation under existing contracts to pay claims for insured events occurring subsequent to the reporting date (i.e. the unearned premium reserve).**

**Sub-Principle 1.02: The post-claims liability is the liability to pay claims for insured events that have already incurred at the reporting date, including claims incurred but not reported (IBNR).**

**Principle 2: Both the pre-claims and post-claims liability must be sufficient to provide for payment of expected obligations.**

**Sub-Principle 2.01: Together with anticipated future investment income, the pre-claims liability is sufficient to provide for claim payments and related expenses on all claims expected to be incurred between the reporting date and the end of the contract period.**

**Sub-Principle 2.02: The post-claims liability must be sufficient to provide for claim payments and all related policy and claim expenses (including overhead), for which the insured event has already occurred at the reporting date.**

BC 1: Claim payments include expected allocated and unallocated loss adjustment expenses (e.g. expenses related to claim adjustors, defense containment costs, etc.) incurred in the settlement of claims.

BC 2: All liability measurements are prospective only. This implies that while historical experience is one basis to estimate claim liabilities, management should adjust historical experience to reflect current trends if necessary, using information that can be reasonably known at the reporting date and measure its liabilities accordingly.

BC 3: During the post-claims liability settlement period, the insurer is at risk of the incurred claims varying in amount and timing of payment. During the period between the point at which a loss has occurred and the final loss settlement amount is determined, periodic estimates of the final loss settlement amount related to a single loss may vary considerably as to both timing and amount.

## Unit of Account

**Principle 3: All measurements with respect to non-life insurance contracts should be based on a portfolio of exposures.**

**Sub-Principle 3.01: A portfolio is a group of contracts that are managed together when assessing risk. A portfolio may include one or many contracts but typically will comprise many contracts reflecting the pooling of risks inherent in the insurance business model. The law of large numbers is critical to the economics of insurance.**

**Sub-Principle 3.02: Portfolios should be defined and measured on a consistent basis in successive reporting periods.**

BC 4: Actuarial methodologies only apply when the law of large numbers can be invoked. Accordingly, measuring liabilities at the individual contract level is not appropriate unless the contract itself is a portfolio of exposures.

BC 5: Decisions concerning assumptions setting, loss recognition and reserving should be made based on blocks of business related to the way the company manages its business. Indicators that a group of policies are managed together may include:

- consistent pricing or underwriting strategy,
- policy design and coverage,
- internal management reporting bases,
- capital management,
- reinsurance strategy, and
- expense estimation.

*IG 1: For example, an appropriate definition of 'unit of account' may be "groupings of insurance contracts consistent with the enterprise's manner of acquiring, servicing and measuring the profitability of its insurance contracts".*

## Initial Measurement

**Principle 4: On initial issue there should be no accounting gain or loss.**

**Sub-Principle 4.01: The pre-claim liability at contract inception is the amount that results in no gain or loss at issue (i.e. the portion of premium charged for the forthcoming coverage period).**

BC 6: Because premiums are determined in an arm's-length manner and insureds have the ability to obtain coverage from a variety of unrelated providers, it follows that the premium represents the most relevant and reliable measurement attribute at issue and accordingly, there should be no gain or loss at issue.

BC 7: The most relevant and reliable measurement of the total liability of the insurer at issue is the premium received (or to be received) under the contract at inception. This is the only instance within the duration of the insurance policy when there is evidence of the fair value of the contract based on observable market data, given that premiums are determined in an arm's-length manner and insureds have the ability to obtain coverage from a variety of unrelated insurers. No gain at issue has been assumed given the lack of an active market for insurance contracts. Because there is no active market, the insurer should assume that other market participants would have made the same assumptions to price the liability, including assumptions about the amount market participants would demand to assume the uncertainty inherent in the unobservable inputs of a pricing model.

BC 8: For most non-life insurance contracts all or the majority of the premium is agreed at the outset of the contract and is contractually and legally due to the insurer whether it is paid in installment or paid as a single upfront payment. The initial premium is recorded as the initial pre-claims liability with a receivable recognized for future installments not yet collected.

BC 9: Some might argue that a reinsurance commutation transaction is also a true market transaction. However, such transactions are generally individually priced and occur infrequently. Therefore the market does not give consistent, relevant and reliable prices for those policies that have not settled. Furthermore, the market for loss reserve sales is highly undeveloped so the price being paid may not be the most relevant and reliable measurement attribute. Additionally, an insurer pays a premium to reinsure direct business since the reinsurer did not underwrite the risks.

## Subsequent Measurement

### **Principle 5: Profit should be recognized in line with the release from risk.**

#### **Sub-Principle 5.01: The release of risk should be recognised in proportion to the insurance coverage provided over the exposure period of the contract.**

BC 10: Premium income should not be recognized in total when written, given that the insurer has not provided any services from which income would be earned or otherwise recognizable. The limited coverage period for non-life contracts significantly lessens the probability that releasing the profit on a pro rata basis would be significantly different than any alternate method. In addition, for many lines of business, there would typically not be sufficient development of reported losses within the policy period to significantly change the reporting entity's view of ultimate expected loss costs assumed at the time the product was priced. The short-duration of the contract period also lessens the probability that the premium charged for similar policies would change significantly during the period. When the risks of the contract do not occur ratably over the contract period, premium income should be recognised in a manner consistent with the risk profile over the exposure period. Moreover, recognizing income ratably over the exposure period achieves a transparent, relevant and reliable measurement of the pre-claims liability.

BC 11: Insurers provide different types of risk coverage to policyholders over time. Such coverage may take any of several forms but in each case the insurer's aggregate expected risk with respect to a portfolio of insurance policies decreases over time with the periodic expiration of the contract term. The decrease in this aggregate risk, when measured against actual results, gives rise to profits or losses. Typically this has an effect on the pre-claims liability. Profit is not typically recognized over the period the claims are incurred because the term of the contract has expired and no risk mitigation services are being provided during that time period. Furthermore, comparability issues might arise from the variability associated with predicting unknown future claim settlement patterns.

BC 11.01 Types of risks include frequency, severity, timing, risk profile (underwriting), reinsurance costs and other elements essential to pricing an insurance contract.

BC 12: The pre-claims liability (sub- principle 2.01) is subject to a liability adequacy test. The post-claim liability would not need a liability adequacy test since the post-claims liability should always reflect the current best estimate of ultimate loss costs.

BC 12.01 The purpose of the liability adequacy test is to determine if the sum of the established liability plus associated expected investment income is sufficient to cover expected claim costs and claim adjustment expenses, customer intangible (i.e. acquisition costs) and maintenance costs.

*IG 2: A probable loss on insurance contracts exists if there is a deficiency relating to the contract. The level of aggregation of contracts for the purposes of performing the liability adequacy test is to be based on the following guidance.*

*IG 3: A deficiency on the pre-claims liability should be recognised if the sum of expected claim costs and claim adjustment expenses, unamortized customer intangible assets and maintenance costs exceeds the related pre-claims liability plus investment income. Disclosure is required regarding whether the insurer considers anticipated investment income, in determining if a deficiency relating to non-life contracts exists.*

*IG 4: A deficiency should first be recognised by charging any unamortized customer intangible assets to expense to the extent required to eliminate the deficiency. If the deficiency is greater than the unamortized customer intangible acquisition costs, the pre-claims liability shall be increased for the excess deficiency.*

## Customer Intangible Asset

**Principle 6: A customer intangible asset should be established when a policy (or block of policies) is issued, and amortized over time into earnings in relation to the coverage period as the insurer is released from risk.**

**Sub-Principle 6.01: The customer intangible reflects the initial investment in the customer relationship provided it can be recovered from future earnings.**

**Sub-Principle 6.02: The amount of this asset should be limited to the amount of the upfront acquisition costs a company incurs that is primarily related to and varies with the production of new insurance contracts.**

**Sub-Principle 6.03: Amortization of the customer intangible asset should not exceed the contract coverage term of the policy, unless renewal is guaranteed. Therefore, the possibility of a policy renewal beyond the current policy's duration should not affect the amortization period.**

BC 13: There is ample support in the Framework and other standards to consider the customer intangible asset as an asset of the insurer (e.g. in IAS 2, IAS 17, IAS 18 or IAS 39). For example, such an asset is conceptually similar to that permitted for future management services under IAS 18. Deferred income reserve may continue to be recorded for investment management service business under IAS 18.

BC 13.01 Recoverability testing takes place at the inception of business. It aims to determine if expenses classified as acquisition costs on new issues or renewals are ultimately recoverable from future earnings. After inception, the process of considering whether the level of the customer intangible asset is recoverable is maintained as part of the liability adequacy test.

*IG 5: Customer intangible assets, which comprise commission and other expenses that vary with and primarily relate to the production of new business, are costs incurred in the acquisition of new business.*

*IG 6: Those costs which do not vary directly with and are not primarily related to the acquisition of business, for example, the collection of premiums, general advertising, bad debts,*

*depreciation and general administrative expenses, must not be deferred but charged to expenses in the period in which they are incurred.*

## Risk and Uncertainty (Risk Margins) and Discounting

**Principle 7: The post-claim liability should be based on the management's current best and unbiased estimates of future cash flows without an explicit margin for risk and uncertainty or discounting.**

**Principle 8: For fixed, known and determinable liabilities (e.g. contracts that have highly predictable annuity-like payment patterns) discounting the expected cash flows is the appropriate measurement.**

BC 14: The term best estimate refers to the valuation of future cash flows in aggregate, not to each individual assumption. In practice it can be impractical to determine whether an individual assumption is a best estimate. In many cases, it is not the individual assumption that is important but its relationship with other assumptions.

BC 15: The post-claims liability should be calculated without an explicit margin for risk and uncertainty or discount. Given the uniqueness of each line of business and susceptibility to changes in external factors, a credible explicit risk margin can only be determined at contract inception. The pre-claims liability inherently includes a risk margin or profit margin, and this risk margin is recognized pro-rata over the coverage period in accordance with Principle 5. As discussed in Principle 5, typically, the risk margin within the pre-claims liability does not need to be re-valued due to the short-duration of the non-life contract and because there is no market from which to derive a better estimate of the risk margin. This approach is widely understood and is the most relevant, reliable and transparent method to measure insurance liabilities for financial reporting purposes.

BC 16: Discounting the post-claims liability is inappropriate due to the highly unpredictable payment patterns of most claims. By adding additional variables such as variable claim payment patterns and reinvestment rates which may be largely judgmental, the reliability of the post-claims liability might be compromised. Furthermore the adequacy of the claims liability would become less transparent to users, investors and other third parties. Some of the factors that support using a non-discounted model are as follows:

BC 16.01 The underlying cash flows are very uncertain as to timing and amount. Non-life insurers are exposed to latent exposures such as asbestos, silica, breast implants and lead paint. The timing of large settlements, the changing litigation environment (especially in the United States), and a rapidly changing judicial environment (i.e. new interpretations of policy coverage) results in highly unpredictable claim payment patterns. Even if explicit risk margins and discounting are used, slight alterations in the timing of estimated cash flows could substantially increase the volatility in reported earnings without significant benefits for users, investors and other third parties.

BC 16.02 Even if explicit risk margins were deemed to be conceptually more relevant and reliable, a broad-based consensus has not been reached as to the appropriate explicit risk

margins by class of business or type of exposure. As a result, the debate still appears to be in its infancy with issues such as whether diversifiable risks should be included still being discussed. Additionally, any change in nominal reserves, interest rates and claim payment patterns engenders extreme volatility. This might result in additional capital requirements with additional capital costs passed on to consumers, through higher prices, for no discernible benefit to consumers.

BC 16.03 In addition, a broad-based consensus has not been reached as to the determination of an appropriate discount rate. Some have suggested a risk free rate, which does not appear to incorporate all the risks to a policyholder. Others are advocating the use of the company's own credit standing, which does not take into consideration the legal priority of insurance liabilities or the existence of guarantee funds. The process of determining the appropriate risk spread of insurance liabilities should include a period of field testing prior to the adoption of such a fundamental change to existing accounting practice.

BC 16.04 Furthermore attempting to calculate a reserve for non-life claim liabilities by determining cash flows, discounting and applying explicit risk margins will be impracticable, inconsistent and would lead to a significant cost burden on the preparer for little, if any, additional benefit to the user. The calculation of explicit risk margins and economic risk based capital is a new and emerging risk management discipline. The significant choices required to carry out and allocate an estimate of economic capital appear no more reliable than the more traditional real-world stochastic modeling approach for market risk exposures. Furthermore, a risk margin analysis implies that companies can calculate a statistical range and agree on a consistently-applied confidence level to book within that range. To date, the actuarial community has not agreed on methodologies to calculate a statistical range across multiple lines of business. Additional work and field testing would have to be performed to determine if this is feasible.

BC 16.05 The absence of discounting and explicit risk margins helps better facilitate comparisons between estimated reserves and actual payments. This also helps avoid comparability issues that might arise if different insurers make different assumptions about timing and use different discount rates.

*IG 7: There are times when an estimate is more useful when it does not include speculations that by themselves materially impact the estimate. In such a case, disclosure is more useful than recording a speculation, allowing the user to make their own judgment as to how to incorporate the risks that are not reasonably estimable.*

## Review of Assumptions (Unlocking)

**Principle 9: Assumptions underlying the measurement of the post claim-liability and intangible assets should be periodically reviewed and changed, if appropriate.**

BC 17: Post-claim liability assumption changes bring future expected results into the current year's results, thereby potentially distorting period-to-period patterns of results. Accordingly, such changes should be made only when necessary, when the change is expected to be sustained and significant, and with appropriate disclosure.

*IG 8: Appropriate information must be included in the disclosures so users can understand the emerging differences between expected and actual results. Such disclosures should include a description of the reason for and the value of any assumption change included in the current earnings.*

*IG 9: While adding risks margins and discounts to the recorded liability is not appropriate, companies should provide disclosures describing the uncertainty and potential volatility in the ultimate amount and timing of claim payments.*

## Financial Obligations and Guarantees

**Principle 10: The measurement of claim liabilities should incorporate all related financial options and guarantees.**

**Sub-Principle 10.01: Market information should be used to determine the effect of financial options and guarantees on the claim liability measurements when available and reliable. Otherwise, the effect of financial options and guarantees should be based on management's best estimate.**

BC 18: Under Principles 1 and 2 it immediately follows that there should be a provision for all guarantees. However, such guarantees should not be valued separately unless they are clearly unrelated to the basic contract.

*IG 10: Due to the wide range of options and guarantees available in the various markets, the measurement of the liability may be based on deterministic, stochastic or other techniques as prescribed by the specialized professional organizations.*

## Policyholder Behavior

**Principle 11: Policyholder behavior should be reflected in the measurement of all liabilities.**

**Sub-Principle 11.01: For non-life coverages, policyholder behavior is primarily reflected in the estimation of post-claim liabilities.**

**Sub-Principle 11.02: Typically non-life contracts cover a defined short-term exposure period and future premiums are within the contractual control of the insurer to raise or reduce. Therefore no revenue or expense beyond the contract term should be recognised in the current period**

## Own Credit Standing

**Principle 12: The credit standing of a liability should not be considered in the valuation of insurance liabilities.**

BC 19: Insurance regulation and other mechanisms in most jurisdictions indirectly guarantee all payments to policyholders. Thus, a policyholder, in general, would not accept less than the contractual, or face, amount owed.

BC 20: The insurance industry guarantee mechanisms provide greater security to policyholders than bondholders or other debt holders. Accordingly, the credit spread on a company's debt would not be an appropriate indicator of the credit risk, if any, associated with policyholder liabilities.

BC 21: Since policyholder interests are met before debt holders (debt is subordinate to policyholder obligations), even insolvent companies are often able to pay all their policyholder obligations while debt holders may receive substantially less than the face value of their investments, if they receive anything.

## Unbundling

**Principle 13: Insurance policies with flexible premiums should only be unbundled in the event that the separation would result in material differences in the overall value of the contract and either**

- i) The deposit and insurance components of the contract are separately priced and separately managed by the insurer; or**
- ii) Separate measurement of a deposit component is necessary to recognize rights and obligations of the insurer and the policyholder**

BC 22: In general, insurers price insurance policies on an integrated basis. It would be extremely rare that an insurer prices and manages each of these components separately or that the separate management would be materially different.