

Actuarial and Business Issues: Implications for Non-life Insurance Accounting

Educational Presentation to the IASB

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Group of North American Insurance Enterprises

Group of North American Insurance Enterprises (GNAIE)

- ACE
- AIG
- Allstate
- GE Employers Re
- General Re
- The Hartford
- Liberty Mutual
- Metropolitan Life
- New York Life
- Prudential Financial
- XL Capital
- Mission: To influence the development of IAS to insure they result in robust, high quality standards for insurance enterprises

Outline of Today's Topics

- Critical success factors for non-life insurers and implications for financial reporting - lessons from the U.S. market
- Accounting for non-life claims liabilities and the time value of money
- Non-life insurer financial reporting issues linked to other accounting standards projects

Why Pay Attention to US Insurance Accounting Issues?

- U.S. GAAP is the most widely used and tested model for non-life insurers, so it has lessons for any new non-life accounting model
- FASB and IASB committed to converge U.S. GAAP and IFRS
- Many non-U.S. insurers are active in U.S. non-life insurance market and use U.S. GAAP for their non-life business
- U.S. tort liability system is influencing litigation and therefore non-life insurance worldwide

Users of Non-life Insurer Financial Reports

- Equity investors
- Creditors, Customers
- Rating Agencies, Regulators
- Managers of non-life insurers

Users need to understand current profitability, prospects for future profitable growth, and financial strength

Non-life Insurers: Critical Success Factors

- Underwriting performance
- Selling products
- Managing risk of catastrophe
- Capital adequacy
- Liability estimation accuracy
- Access to capital markets

Underwriting Performance

- Measured by “combined ratio” - incurred claims costs and underwriting expenses divided by related premiums, expressed as a percentage
- Combined ratio does not include investment income
- Pricing and underwriting objective: combined ratio less than 100%, or “underwriting profit” (i.e., achieve a profit before investment results)

Selling Products

- Choice of distribution channels
- Motivating and managing distribution channels
- Integrating underwriting and marketing management
- Measure by growth in premium revenue

Managing Risk of Catastrophe

- Risk from natural disasters depends on portfolio of insurance exposures - evaluate using simulation modeling
- Risk of large claims depends on individual policy exposures
- Control risk through exposures written, coverage design, reinsurance program
- Risk information provided in disclosures

Capital Adequacy

- Evaluated by customers, regulators, and rating agencies
- If insurer capital adequacy is questioned, a slippery slope can lead to insurer failure due to policyholder fear of insolvency
- For non-life insurers, claims reserves are the key issue in determining capital adequacy

Liability Estimation Accuracy

- Critical to underwriting performance evaluation, pricing products, and capital adequacy
- Inaccurate claims liability estimation leads to inaccurate combined ratios, inaccurate prices, and inaccurate assessment of capital adequacy
- Test with reserve development schedules

Access to Capital Markets

- Capital required to support selling insurance
- Cyclical nature of non-life insurance markets and the opportunities for profitable growth
- To maintain access to capital, non-life insurers must demonstrate a robust liability estimation process that responds promptly and appropriately to new information

Factors that Miss the C.S.F. List for Non-life Insurers

- Investment Management - Needs to be done well, but underwriting miscues can wipe out multiples of annual investment income
- Asset / Liability Management - “Matching” is not the answer for non-life insurers. Non-life liability durations are short on average, so “matching” sacrifices more in investment return than it gains in risk reduction

Summary: Critical Success Factors and Financial Reporting

- U.S. GAAP provides underwriting accounts (premiums, claims, underwriting expenses) separate from investment income so that underwriting performance can be evaluated
- U.S. GAAP provides undiscounted claims liabilities so that liability estimation accuracy can be readily measured

Accounting for Claims: Why Undiscounted Reserves?

- Easy to evaluate accuracy of claims liability estimation with reserve development schedule (loss triangles)
- Change in liability used in combined ratio to measure underwriting performance
- If undiscounted reserve is accurate, includes an “implicit” risk margin when compared to “discounted” reserve value

What about Time Value of Money?

- Use time value of money for a “fixed and determinable” series of claims payments on an individual claim
- But actuarial loss development techniques apply to portfolios of claims and don’t produce “fixed and determinable” projected claims payout patterns, or even well-defined distributions of possible claims payments in future time periods

Issues with discounted reserves - yes, we can calculate “discounts”, but ...

- Estimation error is added by payout pattern parameter estimation
- “Noise” generated by changing discount factors makes evaluation of liability estimation accuracy harder
- Need to add back explicit risk margin to reflect uncertainty in claims payouts
- No way to measure “correct” explicit risk margin, even after the fact, so margins are subjective

No Markets to Trade Claims Liabilities

- Best evidence of fair value of assets are prices of trades on secondary markets
- But liabilities are not symmetric with assets and cannot be traded. What value would financial assets have if obligors were able to trade away their liabilities/obligations?
- So fair value for claims liabilities means “mark to unverifiable model of non-existent market”

Own Credit Standing Applied to Claims Liabilities?

- Liabilities settle - they don't trade on secondary markets - so obligor/insurer cannot "benefit" from deterioration in own credit standing
- Marking liabilities down for deteriorating credit standing makes balance sheet measures less useful to creditors, customers, and other financial statement users

Summary: Accounting for Claims Liabilities

- Undiscounted claims liabilities are useful in evaluating the critical success factors of non-life insurers
- A model with both discounting and explicit risk margins generates a noisy, unverifiable measure of claims liabilities
- "Mark to model" will create period-to-period and insurer-to-insurer inconsistencies in financial reporting, frustrating meaningful comparisons

Other Non-life Insurer Financial Reporting Issues

- Unit of account: Portfolio, not contract
- Non-life insurance may have a different accounting model than life insurance
- Non-life accounting may not be broken, but better disclosure standards may be possible
- Performance measurement project should facilitate underwriting performance measurement

Summary: Non-life Insurer Accounting Issues

- Undiscounted claims liabilities and U.S. GAAP accounting facilitate evaluation of critical success factors for non-life insurers
- Discounting and explicit risk margins focus attention on secondary matters, add noise and parameter estimation error, and are an unreliable “mark to model” approach
- Improved disclosure may be possible for the non-life insurer accounting model