Introduction and Background

When reporting under IAS, companies apply fair-value measures to many of their liabilities for reporting or for disclosure purposes. Liabilities related to investment contracts are either be measured at fair value or measured at amortised cost with fair values disclosed. For phase I, insurance contracts are measured under existing account policies, with fair value disclosures required as of 31 December 2006. The Board has tentatively concluded that insurance contracts will have a fair value measure for reporting dates in 2007 and beyond.

Existing guidance for fair value measure is found in IAS 39. The definition of fair value, which is consistent with other IFRS, is

“The amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm’s length transaction”.

This definition is often referred to as an exit value, as it places a value on the contracts as the amount that the entity would pay to settle its obligation or, in other words, to no longer be party to the contracts.

IAS 39 gives specific guidance for the fair value measure at inception of the contract. This is the fair value of the consideration received. This measure is called the entry-value. For insurance or investment contracts, the consideration received is the premium less the transaction costs. Transaction costs, as clarified by the Board in its July 2000 meeting, include “incremental costs that are directly attributable to the acquisition or disposal of a financial asset or financial liability”. By this definition there may be acquisition costs that are not transaction costs, such as costs that are fixed in nature and do not vary with the volume of contracts acquired. Such costs are priced for in the contracts, but are not considered in the entry-value measure of the contracts. Examples of expenses for which the designation as transaction costs is uncertain include home office expenses such as underwriting salaries, policy issue expenses and marketing overhead. Another example is the acquisition expense incurred by direct marketers that do not pay commissions to agents or brokers but rather sell by direct solicitation of customers. These costs are substantial and are roughly equivalent to commissions. In order for these expenses to be considered incremental, the definition of transaction costs must be applied to the issue of a number of contracts over a period of time, rather than to the issue of a single contract at the time of sale. Although initial value is expressed as a concept that relates to a single contract, we expect that insurers will consider transactions costs in the context of the production of a block of new business, and that transactions costs per contract will include some averages of certain expenses that relate to the block but may be difficult to attribute directly to any single contract. Examples include underwriting salaries and the expense of direct marketing.

IAS 39 links the concepts in the general guidance on fair value techniques that apply when there is no active market in the financial instruments, as is the case for insurance and investment contracts. This guidance includes the statement that “the valuation technique would be expected to result in an amount that equals the fair value of the consideration given or received”. (Paragraph 100A). This reinforces the idea that the fair value at inception is the consideration received.

But, consistent with the definition of fair value, the guidance goes on to say that

“If there is a valuation technique commonly used by market participants to price the instruments and that technique has been demonstrated to provide reliable estimates of prices obtained in actual market transactions, the entity uses that technique”.

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Exit Value May not Equal Entry Value

An issue arises when common pricing techniques produce a fair value measure at inception of the contract that is different from the fair value of the consideration received.

The chosen valuation technique may result in an initial value different from the consideration received. The difference relates to two possibilities,

- The pricing of the contracts may consider acquisition costs that are not transaction costs as defined by the Board. Hence, a model calibrated to pricing would produce a lower liability than the initial value.

- The entry-value uses a unit of account that is an individual contract whereas the term “market transactions” refers to those involving blocks of business or portfolios of contracts. A reinsurance session is an example of a wholesale transaction, and the price charged by the reinsurer reflects, among other things, that its cost structure is different from the direct writer.

There may be other contributing factors, such as a mix of coverage types or issue ages that is different from the mix that was assumed in pricing.

The first difference is one that is well understood. Companies are able to quantify the difference between acquisitions costs and transactions costs as a reconciling item between entry price and exit price value at inception.

The second difference is often attributed to the difference between the retail price and the wholesale price of contracts. In the retail market, which is direct sales of contracts to the public, a significant part of the value to the customer lies in the service provided at the time of sale. This value may not be fairly represented by the transaction costs. The wholesale prices reflect that the obligation to service the contracts and pay the benefits, but it does not include consideration for the additional value provided to the retail customer at the time of sale. This is most apparent in the prices reinsurers charge to direct writers, when compared to prices insurers charge to their retail customers. The value of the service provided at sale is often given as support for the appropriateness of recognising an intangible asset for the value of inforce in embedded value reporting.

Conclusion and Recommendation

We believe that applying commonly accepted actuarial practices follows the general guidance found in IAS 39. These practices can place a fair value on insurance and investment contracts, consistent with the definition of fair value, but the fair value at inception may be different from the entry value as defined by the Board. At the same time, we acknowledge, that the initial value is a useful measure for testing the reasonability of fair value models. It is an objective number and it provides a calibration point that can be used to validate models.

Entry can also be seen to reflect fair values in the markets in which the contracts are sold. That is, insurers that sell to the public can reasonably be expected to calibrate models to prices in the retail market, rather than to prices that they pay for reinsurance. The retail-to-wholesale spread or difference is earned over the life of the contracts, rather than at inception. At the same time, fair values of reinsurance ceded and reinsurance assumed should be calibrated to prices paid for reinsurance, which will correspond to the wholesale price.
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It is apparent that the use of entry or exit value relates to the issue of profit at issue. The use of entry value limits the profit at issue and generally will result in losses to the extent that some acquisition costs are not characterised as transaction costs.

Another key concept relates to how the use of entry value as fair value at inception will affect the fair value models at subsequent measurement dates. The re-measurement must incorporate changes in assumptions that are necessary because of revised expectations for key variables. It may be that there is a calibrating variable, such as a component of the discount rate or of adjustments to projected cash flows that, once determined, does not change or changes only with compelling evidence to support the change, as become apparent when calibrating models for new business.

For these reason we are in general agreement with the use of entry value as fair value, although there are many practical implementation issues that must be resolved. Among these, as noted, are the inclusion of certain expenses as transaction costs and the influence of the original calibration to entry value on fair value measures at reporting dates after the inception of the contracts.