Executive summary

The IAIS believes that it would be most preferable if the methodologies for calculating items in public, financial reports are able to be used for, or are substantially consistent with, the methodologies used for regulatory reporting purposes, with as few changes as possible to satisfy prudential reporting requirements.

This paper provides initial IAIS observations on identified measurement themes common to both financial and regulatory reporting that the IASB is likely to address in its consideration of Phase II of its Insurance Contracts Project, if a prospective asset/liability model with time value of money adjustments and risk margin are adopted.

The summary of the initial IAIS observations on some of the issues, as set out in this paper, includes:

i. The Board should consider measurement criteria that can result in answers at the individual contract level that are consistent with those obtained when those contracts are measured at the portfolio level.

ii. The IAIS believes that for prudential regulatory purposes it would be inappropriate to require total financial resources (net liability plus equity) backing an insurance contract at less than its current surrender value. The Board may wish to consider whether incorporating the current surrender value directly into the policy liability measurement should also be required for the purposes of general purpose financial reporting.
iii. Reliable fair value measurements of insurance liabilities and consistent and reliable measurements of risk margins are difficult to achieve in some circumstances, but models incorporating risk margins and time decay are currently in use or being implemented in a number of jurisdictions. However, the IAIS has not yet examined such models nor formed a view of best practice. The IAIS will continue to work on these issues and share its progress with the Board.

iv. Allowing for own credit worthiness is inconsistent with the valuation of insurance liabilities in a going concern. The IAIS most strongly recommends that the Board consider this issue very carefully, as any adjustment of the valuation of insurance liabilities for own credit worthiness will be unacceptable for prudential purposes, and the IAIS feels strongly that it should also be unacceptable for general purpose accounting statements.

v. Asset/liability measurement consistency is especially important in the insurance sector and the IAIS believes that the Board should aim to adopt an approach that ensures that economic mismatch is reported, but avoids artificial volatility in financial statements that does not reflect the underlying economic reality of the business (i.e. accounting mismatch).

vi. A bottom-up methodology for the initial recognition of liabilities is preferable. Profit should only be recognised where an appropriate and sufficiently reliable risk margin has been provided for in the value of liabilities.

vii. When discounting insurance liabilities, a risk free discount rate determined utilising the entire yield curve is appropriate, except where the benefits are contractually dependent upon the performance of the underlying assets. For prudential purposes, the expected earning rate should be verified against the discount rate to ensure that insurers have the ability to meet their obligations.

viii. The IAIS recommends that the Board consider carefully the extent to which the charges that are expected to recoup acquisition costs may have an observable market value and therefore be recognized in a prospective asset/liability model in a suitably reliable way.

ix. Dialogue between prudential supervisors and the Board should be maintained and broadened.

It is expected that further issues will arise during the IASB’s consideration of Phase II, and the IAIS would expect to continue to provide input to the IASB throughout the project, both at the meetings of the IASB's Insurance Working Group and through formal comment papers.
Introduction

1. In March 2004, the IAIS Technical Committee discussed the International Accounting Standards Board (IASB) project on insurance contracts. As a result, the then IAIS Accounting Subcommittee, and subsequently the Insurance Contracts Subcommittee received a mandate from the Technical Committee to study the possibility of using an IAS compatible model as a basis for prudential supervision, taking into account the likely outcome of the IASB work in Phase II of its Insurance Contracts Project. More precisely, the mandate asked the question “What methodologies for determining insurance liabilities, consistent with the likely outcomes of the ongoing IASB work, could be acceptable for prudent supervision?”

2. To address this mandate it was necessary to make some assumptions regarding the likely direction of future IASB work, and these assumptions have been subject to revision as a result of information received through the IAIS’s status as an official observer at the IASB Insurance Working Group.

3. In performing this work the IAIS aims more actively to engage the IASB with useful input as Phase II progresses, in its aim towards the objective of facilitating consistent prudential and general purpose financial reporting. However, the IAIS specifically states that, at this stage, neither the association nor its member jurisdictions are committed to adopting any particular measurement standards.

4. The IAIS believes that it would be most preferable if the methodologies for calculating items in public, financial reports are able to be used for, or are substantially consistent with, the methodologies used for regulatory reporting purposes, with as few changes as possible to satisfy prudential reporting requirements. Indeed many, but not all, IAIS jurisdictions currently base their prudential reporting requirements on general-purpose financial statements, or at least equivalent quantities determined using the same methodologies as those financial statements. Hence, the IAIS and other international regulatory organizations believe that it is essential that there is a robust but constructive dialogue between the IASB and prudential standard setters. As an example, the General Manager of the Bank for International Settlements in a speech to the IAIS recently stated “The process of convergence within the global financial system across markets, across institutions and across national jurisdictions puts a premium on a shared understanding of problems and on a shared formulation and implementation of solutions. For insurance supervisors, this implies the need for greater cooperation across national jurisdictions and with other key actors in the policymaking community, particularly with banking supervisors and accounting standard setters [emphasis added]. While much has been accomplished in recent years, there is clearly scope to intensify and broaden this dialogue further.”

5. This paper provides initial IAIS observations on identified measurement themes common to both financial and regulatory reporting. It is expected that further issues

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1 Referred to henceforth as ‘Phase II’.

will arise during the IASB’s consideration of Phase II, and the IAIS and its Insurance Contracts Subcommittee would expect to continue to provide input to the IASB throughout the project, both at the meetings of the IASB’s Insurance Working Group and through formal comment papers.

6. The IAIS is also currently engaged in an ambitious project to define an international framework for solvency assessment. The IAIS has issued for consultation a paper entitled “A new framework for insurance supervision” and a follow up paper entitled “Towards a common structure and common standards for the assessment of insurer solvency: Cornerstones for the formulation of regulatory financial requirements” (referred to as “the Cornerstones paper”). Many of the issues and challenges that will face the IASB in Phase II, and that are identified in this paper, are also encompassed within the Cornerstones and the associated work of that project. The IAIS stands ready to share the benefit of its considerations with the IASB as the issues and challenges are addressed.

Assumptions

7. This paper assumes that the more likely outcome of Phase II is a prospective asset/liability model with time value of money adjustments and risk margins. Therefore the themes addressed by the IAIS in this paper flow from the question: “If we assume a prospective asset/liability model with time value of money adjustments and risk margins then what would be the characteristics of a workable regulatory approach to an insurance contracts measurement model, and what characteristics should not be in a model?”

8. Although it is clearly preferable for the insurance contracts measurement model for prudential reporting to be consistent with that used for public financial reporting, this may not be possible or appropriate in all cases. However, the IAIS believes that it is essential that differences between prudential reporting requirements and general purpose public reporting are reconcilable and that these differences are publicly explained. Otherwise there is a risk that public confusion will call into question the credibility of both reporting regimes. Therefore this paper highlights a number of the areas where the IAIS believes differences may develop and whether they would be insurmountable or not.

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3 The different scopes of this paper and the Cornerstones Paper should however be noted. The purpose of this paper is to provide, in line with IAIS thinking, initial input to the IASB in connection with Phase II, with reference in particular to the valuation of insurance liabilities. The Cornerstones Paper has a wider scope, setting out key elements for the formation of regulatory financial requirements within a framework for insurance supervision, which the IAIS is currently developing, in which there is a common structure and common standards for the assessment of insurer solvency.

4 At the IAS Board meeting on 17 May 2005, the Board agreed to narrow the initial scope of its investigations into insurance contract accounting to models consistent with this assumption.
Identified themes

9. The IAIS identified for the purposes of this initial paper a number of themes as follows:

   i. Policyholder behaviour and concomitant recognition and measurement characteristics
   ii. Possible use of some form of fair value type model in general
   iii. Marketability of insurance liabilities and implications for fair value measurement
   iv. Asset/liability consistency
   v. Initial recognition of liabilities
   vi. The appropriateness of discounting and the appropriate methods for discounting
   vii. Acquisition costs

Policyholder behaviour and concomitant recognition and measurement characteristics

10. We understand that the Board and staff initially attempted to tackle the issues of recognition and measurement in insurance contracts by applying "more probable than not" (or 50%) criteria. Whilst we appreciate the need to analyse the issues into their component parts and to focus on the main aspects, such an approach can easily lead to inappropriate results by failing to recognize and measure characteristics of a portfolio where a percentage of a portfolio of contracts may apparently have a characteristic that is not "more probable than not" at the individual contract level, but is nevertheless material.

11. Such characteristics may arise because the future liability cash flows are subject to policyholder behaviour. This issue is not unique to insurance contracts, although with insurers its impact is more substantial because the contract liabilities represent a significant proportion of the balance sheet. Furthermore, in the insurance context it causes particular problems due to the fact that insurance contracts often contain several elements that are bundled together – basic insurance elements, management service components, multiple investment components, with embedded options and discretionary features, and often on a recurring basis. Policyholder decisions to lapse or surrender a policy, or change the level of renewal premiums, can affect the value of the components in different ways. Ignoring evident policyholder behaviour, or assuming a particular behaviour based on the circumstances of only one component, therefore has the potential to distort the measurement of the contract as a whole.

12. Fundamentally, this issue requires an allowance for probability of cash flows incorporated into the concept of measurement of assets and liabilities, to reflect the reality that there is uncertainty in the cash flows, and not only in their recognition.
This would then more naturally accommodate a measurement of insurance liabilities (which must include, at the very least, allowance for the probability of insured events) while also providing the structure whereby the behaviour of parties to a variety of contracts can be realistically accommodated. While this would require an allowance for probability of cash flows to be incorporated into the concept of measurement of assets and liabilities, the IAIS recognises the particular difficulties associated with bundled contracts and is aware that it can be problematic to model policyholders' behaviour reliably.

13. In the absence of such a change, and recognising the particular difficulties associated with bundled contracts such as insurance, the IAIS believes that it is more appropriate to consider the future cash flows in respect of a portfolio of policies, so that the measurement result can appropriately reflect allowance for policyholder behaviour. Further, we are of the view that it is possible to utilize measurement criteria that provide the same result even if only a single policy is considered. We therefore believe that it is particularly important that this is achieved, and note that this would also result in an elegant solution to some thorny issues involving surrender values, the deposit floor, and participating contracts, together potentially with other issues where policyholders or asset holders possess an option.

14. One issue associated with policyholder behaviour is whether a cash value floor is needed. A liability equal to the cash value floor is equivalent to the assumption that policyholders behave in such a way that all policyholders whose cash value is higher than the liability surrender at the current time and all other policyholders do not currently surrender. Where a long term insurance contract contains a savings element a surrender value is commonly provided on early termination of the contract to recognise this. The policyholder therefore may have the option to cash in his policy immediately for the amount of the surrender value. Policyholders’ actions to cash in their contracts may be highly correlated especially where the financial strength of the insurer is in doubt. Such surrender value underpins the value of the contract from the policyholder's point of view. The above assumption might not be appropriate for a calculation of insurance liabilities in general-purpose financial statements. When policyholders take out a long term insurance contract, it is usually with a long term view as they are buying insurance protection.

Imposing a cash value floor reflects one of the obligations under the policy. Under a solvency and capital adequacy regime where sufficient total financial resources are

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5 There are a number of ways to achieve this end. We have considered an extension to classical recognition methodology which has the major advantage of being a true characteristic of the real world, although unfortunately it tends quite unnecessarily to frighten people! It is called superposition of states, and it occurs when an object simultaneously "possesses" two or more often apparently incompatible values for an observable quantity. This can best be explained with an example. If, for example, a portfolio of policies is expected on the basis of prior experience and history to have a 5% lapse rate, then in a superposition of states, any particular contract would be both 95% unlapsed and 5% lapsed. Hence, it should be recognized in the same way, and lapses do not become an issue of recognition based on a 50% probability criterion. It is only upon the actual observation and subsequent measurement of each contract that each one crystallises into either a lapsed or an unlapsed state. By using this method, the net result will be the same whether one measures one contract or a portfolio of contracts in that the actual observation and subsequent measurement for, say, 100 contracts – resulting in the crystallization phenomenon – will result in the observation of 5 being lapsed and 95 unlapsed. Although this may apparently be a similar result to the use of fuzzy logic, it is based much more on reality and should not require any change – other than in shading – to the Board’s conceptual framework.
required to be held to meet its current obligations to policyholders a cash value floor on the total financial resources is a means of providing protection against a high level of surrenders.

15. Also, within a pool of similar insurance contracts which have been in force for some years there will be a mixture of policyholders who may not be able to get the same insurance coverage from other companies, due to deterioration in their health, and others who will. Because some of the healthy lives will choose to surrender, the assumptions in the insurance liability valuation calculation have to be appropriate to cover this contingency. This is but one example of why it is important to consider all aspects of policyholder behaviour other than solely financial ones.

16. The IAIS therefore believes strongly that for prudential regulatory purposes it would be inappropriate to require total financial resources (net liability plus equity) backing an insurance contract at less than its current surrender value. This might give rise to a reconciling adjustment between the financial reports prepared for prudential regulatory and public reporting requirements.

17. Some jurisdictions believe the valuation of insurance liabilities should cover the current surrender values of all insurance contracts, while other jurisdictions do not. But all the latter jurisdictions believe that total financial resources should be available to cover the current surrender values of all insurance contracts. It is fundamental to prudential regulation that an insurance company can demonstrate that it has enough total financial resources to meet its current obligations to policyholders.

Possible use of a some form of fair value type model in general

18. Although we recognize that the IASB is not committed definitively to a prospective asset/liability model per se, the IAIS is assuming that, having regard to the overall direction of the IASB's thinking, the IASB is likely to regard such a model as preferable if the problems and difficulties with enunciating such a model for insurance can be overcome.

19. The IAIS has also assumed that the definition of 'fair value' in IAS32 would remain substantially unchanged as: “The amount for which an asset could be exchanged or a liability settled, between knowledgeable, willing parties in an arm’s length transaction.”

20. Many assets can readily be assigned a fair value. The value of actively, publicly traded bonds and equities can readily be determined by reference to the active, deep public markets. Determining the value of other assets, such as real estate, mortgages, private placements, thinly traded bonds and equities etc., require other methods, such as appraisals or comparisons to current transactions in these assets.

21. The determination of the fair value of insurance liabilities is not as easy as the determination of the fair value of most assets. There are no markets in which insurance liabilities are traded. The following are types of transactions that could be of relevance when considering how to arrive at the methodology to determine the fair value of insurance liabilities:
i. A sale of a block of business: Occasionally blocks of business are sold from one insurer to another. With rare exceptions, such sales take the form of assumption reinsurance without a novation, meaning the policyholders still have recourse to the original insurer. The pricing of such a sale would be based on the discounted value of all the net future cash flows, including appropriate risk margins. Depending on the circumstances, the buyer may factor in anticipated economies of scale and diversification effects.

ii. A sale of a company: This happens on a regular, but not overly frequent, basis. In this case, novation is not an issue, and it is a true permanent sale. Similar to the case above, the pricing of the sale would be based on the discounted value of all the net future cash flows, including appropriate risk margins. The sale price may also include a value for anticipated future sales, but this feature should not be part of a fair value of liabilities for financial statement purposes.

iii. Indemnity reinsurance: The pricing of indemnity reinsurance, principally for mortality risk in life insurance, happens frequently. Such pricing again may be based on the discounted value of all future cash flows for the risks that have been reinsured. However, prices in reinsurance markets do not reflect the full fair value of the underlying insurance liabilities because not all associated risks are transferred. Moreover, markets – and reinsurance markets in particular – do not always price rationally, and hence caution is needed in linking liability measures to such prices.

iv. New sales: A new sale involves a contract between the policyholder and the insurer. The insurer does the pricing based on future cash flows. However, the assumptions used are not necessarily reflective of the experience to be expected from in-force policies.

22. While all the above represent real transactions, they cannot be used directly for the fair valuation of insurance liabilities because they do not represent the amount at which liabilities could be settled between willing knowledgeable parties in an arm's length transaction. Nevertheless they may be relevant as benchmarks in assessing fair value. However, all the above transactions do share the following similarities, which the IAIS believes should be reflected in any future IASB fair value valuation methodology for insurance contracts:

i. There should be a consistent measurement basis for assets and liabilities. The fair value of assets held by insurers, as determined from the observed investment markets, is presumed to be based on the value of their future risk adjusted expected cash flows, discounted at an appropriate market-derived discount rate. The same methodology should apply for liability valuation.

ii. Valuation should be based on a forward-looking approach. All the above methods use estimates of future policy cash flows.

iii. Valuation should explicitly take into account the totality of cash flows that are expected to arise from each policy or contract. Therefore, it should include future gross premiums, policy benefits, expenses, policyholder dividends, and any other policy cash flows.
iv. Valuations should be based upon assumptions that reflect the best estimates (i.e. probability weighted expected values that reflect what is known of the probability distribution functions) of expected future experience taking into account the specific features and characteristics of the contracts. Experience rates for the same experience element (e.g. mortality) vary from one company to another depending upon client base, product design, marketing method, etc. It is appropriate for these differences to be reflected in the liabilities since they will affect the cost to the company of satisfying its obligations and, with the principal exception of expense levels, would be unlikely to vary on transfer of the business to another party. Fair value pricing, in practice, should recognize the expected future experience rates based on the characteristics of the particular block of business.

v. The best estimate assumptions should be updated in each reporting period to reflect changes that have occurred in actual experience and which are expected to continue into the future. This is consistent with a fair value calculation that always uses the current best estimate assumptions.

vi. The liability measurement should include some risk margins. Because many insurance contracts cover a long period of time, it is likely that actual future experience will differ from the best estimates. This is consistent with the four types of transaction shown above. It is standard practice that a buyer would include some reasonable margins in an offer to buy any financial instrument, including insurance contracts and that the level of these margins reflect what is known about the probability distribution functions of the contingencies underwritten as well as their possible rates of change. This may be especially important either for contingencies of a long term nature or for contingencies with low frequency and high severity.

23. Notwithstanding the above, there are circumstances where it is difficult to identify separately the best estimate assumptions from the risk margin assumptions due to data constraints or contingency behaviour. In such cases alternative methodologies may be used and it may be desirable to indicate the approximate level of confidence that is desired in the combined assumptions such as by using concepts such as a specified conditional tail expectation level, or by requiring the use of what is known about the moments of the underlying probability distribution function, or by specifying other similar statistical techniques to try to obtain consistency of liability measurement.

24. The IAIS is aware of recent presentations to the IASB indicating the difficulties of consistent and reliable measurement of risk margins. However, we are also aware that approaches that include explicit determination of risk margins are currently in use or being implemented in a number of jurisdictions. One possible approach involves the setting of a specified additional confidence level above the mean or best estimate such that the difference between the 50% confidence level and the higher confidence level is the explicit risk margin. However, we are also aware that this methodology may not be feasible in some cases, and there are some insurance products for which a well-behaved probability distribution is difficult to derive.

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6 For example, by the Casualty Actuarial Society, February 2005 Board meeting.
25. The IAIS is also aware that a well-behaved risk margin will undergo time decay. As a liability approaches settlement, the settlement amount may – in many cases – become clearer and, to the extent that the risk margin represents an allowance for uncertainty, this will presumably decrease as the date of the cash outflow becomes nearer. Although models incorporating such time decay are currently in use or being implemented in a number of jurisdictions, the IAIS has not yet examined such models nor formed a view of best practice.

26. The work emanating from the previously mentioned Cornerstones paper is likely to tackle these same issues regarding probability distributions and time decay, albeit allowing for the level of prudence in aggregate financial resources (the combination of technical provisions and required equity) that is appropriate to the solvency and capital adequacy regime rather than necessarily making direct comparison with the market. As the IAIS makes progress in its work on these issues, it will share this with the IASB.

Marketability of insurance liabilities and implications for fair value measurement

27. Novation markets are very rare in insurance and therefore direct determination of market value in respect of an observed market is only very rarely possible.

28. Components of a fair value transaction include ‘willing’ and ‘able’ parties. As insurers are unable readily to execute a trade of insurance liabilities, the fair value component of ‘able’ parties is generally not present within the insurance industry.

29. Consideration should be given to the individuality of novation transactions as these occurrences are extremely specific and should not be considered representative of the market.

30. Insurance liabilities could be thought of as a bundled or synthetic product consisting of (1) a fully tradable novatable liability and (2) a non-cancellable put option written by the insurer to the policyholder. The put option enables the policyholder to put back the contract and cancel the contractual obligations, but absent its exercise, the policyholder retains those contract rights irrespective of whether the insurer then trades item (1) - which in the absence of the exercise of the put, is the equivalent of reinsurance. A functionally equivalent alternate way of considering the issue is that reinsurance is similar to a market novation except to the extent that the reinsurer retains a default put, which enables it to put the policy back to the ceding company in the event of default.

31. These issues have great relevance to the consideration of the appropriateness of adjusting insurance liabilities for changes in credit worthiness of the issuer. The IAIS understands that the Board’s consideration of the own credit worthiness issue relates specifically to credit worthiness of the instrument, although where the instruments are not traded (as in the case of insurance contracts), this in itself is a difficult issue. The IAIS understands also that the Board will soon start to consider in greater depth
the issue of own credit worthiness in so far as it is relevant to the measurement of insurance liabilities.

32. The view of the IAIS is that allowing for own credit worthiness is inconsistent with the valuation of insurance liabilities in a going concern. In a number of jurisdictions, consistently endeavouring to settle policyholder liabilities at a lower level due to credit rating changes would violate policyholder protection laws such as unfair trade practices, and could ultimately lead to regulatory intervention up to and including receivership or liquidation. As such, the IAIS believes that settlement of liabilities at consistently low levels due to credit standing could breach the underlying going concern assumption within the IASB Framework. The IAIS is aware that once equity has reduced to zero, the liabilities to policyholders clearly reduce in relation to the negative credit standing of the insurer, which at that stage should be in liquidation.

33. Insurers cannot exit their liabilities except through settlement with the policyholder/claimant. If they try to do so in a manner that reflects their credit standing, then as indicated above they generally violate laws that cover unfair trade practices. Therefore, the actual exit price for an insurer’s liabilities cannot in practice reflect its credit standing.

34. The IAIS believes that – to the extent that market evidence exists – business to customer valuations of insurance liabilities are insensitive to insurer credit standings. Generally the only cases that involve sensitivity to insurer credit standings are companies on the brink of insolvency in reinsurance arrangements. These do not constitute willing buyer to willing seller arrangements.

35. The IAIS most strongly recommends that the Board consider this issue very carefully, as any adjustment of the valuation of insurance liabilities for own credit worthiness will be unacceptable for prudential purposes, and the IAIS feels strongly that it should also be unacceptable for general purpose accounting statements.

36. The IAIS would be pleased to discuss this subject further with the Board as it considers the issues in greater depth.

Asset/liability consistency

37. Insurers generally manage their assets and liabilities having regard to the characteristics of different product segments within their business, rather than in totality for the company. Each product segment or class of liability has, at least notionally, a set of assets to back it. Indeed, the investment plan of an insurance company tends to be based on such asset/liability management. Short term insurance typically requires short duration and liquid assets. Long-term policies may require combinations of short duration assets, long duration bonds, mortgages, real estate and equities. For each segment, the assets should be managed consistently within a sound risk management policy and measured on a valuation basis which is consistent with the nature and characteristics of the liability measurement basis.

38. Thus the accounting for the assets should also take into account the accounting for the segment of liabilities which they are (notionally or actually) supporting on a
consistent basis. This concept of “managing together” already exists in bank accounting in some jurisdictions.

39. Managing the assets and liability segments together is also essential for good asset liability management of any mismatch risks. If good asset liability management is in place, then the carrying amount of the assets and liabilities would be expected to rise and fall consistently when there are changes in the interest rate used in the calculation of fair value. Consistent measurement of assets and liabilities should also then identify the financial consequences of the asset and liability position (also known as "economic mismatch"). The IAIS notes the interaction of IAS 39 ("Financial Instruments: Recognition and Measurement") with a standard on insurance contracts, and the need for these standards to work in harmony with each other.

40. The accounting rules should be such that they do not create situations where there are artificial inconsistencies in measurement between assets and liabilities that are managed together. The IAIS believes that the financial statements should reflect the underlying economic reality of the business and it is therefore important to avoid artificial volatility in the financial statements that does not reflect that reality ("accounting mismatch"). The IAIS believes, however, that economic mismatches should be reported.

**Initial recognition of liabilities**

41. Among the possible measurement bases for liabilities upon initial recognition are two approaches referred to as top down and bottom up, which are also akin to entry and exit values.

42. A top down approach is likely to set the measurement valuation criteria based on the observed market price of a transaction, implying that the fair value of a policy on initial recognition would be based on the premium charged. An argument can be made that the top down approach constitutes a form of transaction price evidence at initial recognition. However, caution is recommended regarding this issue as the underwriting cycle clearly affects premium pricing.

43. A bottom up approach would require an estimation of the expected cashflows from the policy (presumably discounted to take account of the time value of money) with the addition of a risk margin. A bottom up approach may lead to initial recognition of a profit, or a loss, depending on the pricing of the contract.

44. The IAIS believes that a bottom up methodology is preferable. However, we are concerned that up front profit recognition in an industry with uncertain claim costs may not be reliable.

45. The liability measurement needs to allow not only for the statistical measure of uncertainty, but also for the general reliability of the measure and the associated profit recognition. Profit should only be recognised where an appropriate and sufficiently reliable risk margin has been provided for in the value of liabilities. This would address the profits on inception problem, while at the same time helping to ensure that inappropriate underwriting in a soft market leads to immediate
recognition of an expected loss. In practice some jurisdictions prefer to see this as a bottom up approach with a top down floor, and others in terms of adjustment to the risk margin.

46. The IAIS notes that uncertainty is an inherent and unavoidable facet of the insurance business, much more so than in almost any other business. Accordingly, recognition of up front profits on a basis that does not make appropriate allowance for this uncertainty is imprudent, and may lead to reporting that is intrinsically and unavoidably unreliable. Consistent with the previously mentioned time release of risk margin, profits should only be recognised as their existence becomes more reliable. This latter conclusion is consistent with the measurement application guidance of IAS39 (paragraph AG76A) regarding recognition of gain or loss after initial recognition. This is achieved through the release of the additional margins arising from any floor amount in a consistent manner over time.

The appropriateness of discounting and the appropriate methods for discounting

47. As indicated in paragraph 7 it is assumed that the IASB will require the recognition of the time value of money, and as such, the IAIS expects that there will be a requirement for discounting. The IAIS believes that, when a deep liquid market of appropriate term exists, a risk free rate is appropriate, except where benefits are dependent on the performance of the underlying assets, and that discounting should utilize the entire yield curve, rather than an average rate. When a deep liquid risk free market of appropriate term does not exist, reference should be made to the highest quality and deep liquid markets that do exist such as swap or other derivatives markets, markets for long term utility debt, markets for high quality long term corporate debt etc. Some jurisdictions would prefer a discount rate below the risk free rate.

48. For prudential purposes the expected asset earning rate should be verified against the discount rate to ensure that insurers have the ability to meet their obligations. Supervisors’ approaches to address this issue differ. For example, absent this test, some jurisdictions would not support any discounting of liabilities in general purpose accounting statements, whilst other jurisdictions would, if necessary, adjust asset values for prudential purposes.

Acquisition costs

49. Under a forward-looking accounting model, a retroactively calculated deferred acquisition cost, such as is used in US GAAP, would be out of place, and the IAIS has tentatively assumed that this would be the case for the IASB standard. Indeed, in a properly developed prospective asset/liability approach separate consideration of acquisition costs may not be necessary. The IAIS also notes that any deferability of acquisition costs should be consistent between insurance contracts and financial instruments, to avoid arbitrage arising from contract classification.
50. When an insurance policy is sold, especially in the life insurance industry, there are often high up-front acquisition expenses, such as agent commissions and underwriting costs, which may be expensed in that accounting period in the income statement. However, the future premiums include a charge whose present value is normally enough to cover the initial acquisition costs. If the acquisition costs are expensed in the year incurred, but no credit given for the future expense charges, some would argue that the income statements of insurers may give an inaccurate picture of the financial position for general purpose financial statements.

51. In practice it is possible to securitize the future expense charges in the market place, and thus they may have a fair value in the market. There is therefore a case that they should be recognized in a prospective asset/liability accounting framework.

52. This issue interrelates with the surrender value/cash value floor and initial recognition issues previously discussed.

Areas identified for further work

53. The IAIS will continue to provide input to the IASB throughout Phase II. In particular, we expect to undertake further consideration of and provide comment on unusual or uncommon products, renewal rights and long-term premium flows, initial and subsequent recognition (Day 1/Day 2) and the appropriate treatment of discretionary participation features.

Summary of initial observations

54. This paper provides initial IAIS observations on identified measurement themes common to both financial and regulatory reporting that the IASB is likely to address in its consideration of Phase II, if a prospective asset/liability model with time value of money adjustments and risk margin are adopted. As we have indicated, the IAIS is also engaged in an ambitious project to formulate a common structure and common standards for solvency assessment. Many of the issues and challenges that will face the IASB in Phase II of its Insurance Contracts Project, and that are identified in this paper, are encompassed within that work. The IAIS looks forward to sharing the benefits of its considerations with the IASB as it further develops its work in these areas.

55. The summary of the initial IAIS observations on some of the issues, as set out in this paper, includes:

i. The Board should consider measurement criteria that can result in answers at the individual contract level that are consistent with those obtained when those contracts are measured at the portfolio level.

ii. The IAIS believes that for prudential regulatory purposes it would be inappropriate to require total financial resources (net liability plus equity) backing an insurance contract at less than its current surrender value. The Board may
wish to consider whether incorporating the current surrender value directly into the policy liability measurement should also be required for the purposes of general purpose financial reporting

iii. Reliable fair value measurements of insurance liabilities and consistent and reliable measurements of risk margins are difficult to achieve in some circumstances, but models incorporating risk margins and time decay are currently in use or being implemented in a number of jurisdictions. However, the IAIS has not yet examined such models or formed a view of best practice. The IAIS will continue to work on these issues and share its progress with the Board.

iv. Allowing for own credit worthiness is inconsistent with the valuation of insurance liabilities in a going concern. The IAIS most strongly recommends that the Board consider this issue very carefully, as any adjustment of the valuation of insurance liabilities for own credit worthiness will be unacceptable for prudential purposes, and the IAIS feels strongly that it should also be unacceptable for general purpose accounting statements.

v. Asset/liability measurement consistency is especially important in the insurance sector and the IAIS believes that the Board should aim to adopt an approach that ensures that economic mismatch is reported, but avoids artificial volatility in financial statements that does not reflect the underlying economic reality of the business (i.e. accounting mismatch).

vi. A bottom-up methodology for the initial recognition of liabilities is preferable. Profit should only be recognised where an appropriate and sufficiently reliable risk margin has been provided for in the value of liabilities.

vii. When discounting insurance liabilities, a risk free discount rate determined utilising the entire yield curve is appropriate, except where the benefits are contractually dependent upon the performance of the underlying assets. For prudential purposes, the expected earning rate should be verified against the discount rate to ensure that insurers have the ability to meet their obligations.

viii. The IAIS recommends that the Board consider carefully the extent to which the charges that are expected to recoup acquisition costs may have an observable market value and therefore be recognized in a prospective asset/liability model in a suitably reliable way.

ix. Dialogue between prudential supervisors and the Board should be maintained and broadened.

56. The IAIS will continue its work on these and other issues in this area. We welcome the opportunity to provide further reports to the Board in an endeavour to enhance the dialogue between the IASB and IAIS on these matters and work towards an objective of facilitating consistent prudential and general purpose financial reporting.