

IASC INSURANCE ISSUES PAPER

EXECUTIVE SUMMARY OF IAA COMMENTS

The International Actuarial Association (IAA), as well as all other parties interested in the development and maintenance of a set of quality international accounting standards for insurance contracts, appreciates the opportunity to express our views on the Insurance Issues Paper (the IASC Paper) prepared by the International Accounting Standards Committee (IASC). The IAA has found it to be a well thought through document that sets forth clearly the most important issues that must be addressed in the development of such a standard. We look forward to participating in the further steps in this project, which we hope will lead to future international convergence of accounting standards for insurance.

The accompanying set of papers presents the IAA's current views regarding the issues raised and the preliminary views expressed in the IASC Paper. They are organized in the following way:

- **Basic issues response.** This portion responds directly to the issues raised in the *Insurance Issues Paper*. For ease of use by the IASC, our discussion of these issues follows the format provided in Appendix E of the *Insurance Issues Paper* document. Note that occasionally one set of comments addresses more than one paragraph.

- **Separate issues papers.** This portion presents enhancements of our comments on the Basic Issues in (2) covering selected important topics in individual issues papers. The issues commented on cover the following topics (including the relevant Basic Issue or Sub-issue):
 1. Features of insurance contracts (Sub-issue 1B)
 2. General overview of a possible approach to insurance liabilities – valuation and capital requirements (Basic Issues 4, 5, 6 and 11)
 3. Valuation of risk adjusted cash flows and the setting of discount rates – theory and practice (Basic Issues 5 and 11)
 4. Future investment margins (Basic Issue 5 and Sub-issue 11G)
 5. Market expectations regarding experience assumptions (Sub-issue 6D)
 6. Insurance contract renewals (Sub-issue 6A)
 7. Catastrophe provisions (Sub-issue 7H)
 8. Minimum liability floor (Sub-issue 8D)
 9. Effect of insurer's credit standing on insurance liability (Sub-issue 11I)
 10. Role of the actuary.

This Executive Summary provides the highlights of the IAA's current conclusions.

Approach to the Valuation of the Liability of Insurance Contracts

The IAA believes that the valuation of the liability of insurance contracts should be based on a **prospective** view of these liabilities, reflecting an **asset / liability approach**. Recognizing that there is currently no deep and active market in these liabilities, it is appropriate to measure such liabilities through the application of a **present value model**, reflecting **expected values of all relevant sources of future cash flows**, incorporating

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appropriate provisions for risk and uncertainty (**market value margins**). These cash flows should reflect the estimated effect of all options, future benefits, and profit sharing / bonuses associated with the contracts. These values should correspond to the amount for which a liability could be settled, between knowledgeable, willing parties in an arm's length transaction and hence would take into account adjustments for risk and uncertainty in the liability cash flows.

In order to present the most meaningful financial statements, it is important to maintain **consistency** in a number of different ways:

- **With the IASC Framework.** In this way, a consistent and comprehensive approach to accounting can be maintained, optimizing transparency of the financial effect of what is often a highly complicated financial instrument.
- **With accounting recognition and measurement treatment of other assets and liabilities** on an enterprise's balance sheet. For example, the fair value of liabilities should be the objective of an accounting system in which assets are presented on the basis of fair values.
- Models applied should provide **demonstrated continuity between** (insurance and non-insurance) **products which differ from each other by the addition** (or subtraction) **of specific product features**, either within an insurer or between other financial service enterprises (insurance and banking).
- Similar accounting treatment **across industries**, e.g., insurance and banking. As industries and their products converge, it is important that the accounting models applied to them also are similar.
- Similar accounting treatment **across companies** facing similar prospective obligations. The need for this consistency would imply that historical-based accounting treatments would not be appropriate.

We believe that such consistency will lead to improved business decision-making and will minimize accounting arbitrage, i.e., actions taken just to take advantage of the most favorable accounting treatment available or to avoid undesired financial reporting results.

We recognize that a number of important practical issues need to be addressed with the introduction of an entirely new set of accounting standards for insurance contracts. These include the consideration of potential income tax effects in a number of countries, coordination with insurance regulators, education of a wide range of potential users, transition concerns, and sufficient lead-time provided for implementation. Nonetheless, in view of the potential benefits of having an international accounting standard, we encourage speedy progress on this project.

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Important Features of Insurance Contracts

Although we believe that it is reasonable to define insurance, for the purpose of this project, as those products that transfer risk to a separate party, we nonetheless believe that risk transfer is not the single distinguishing element of insurance. We believe that the pooling of risk, both from a contract-owner and an insurer perspective, and the long-term nature of many aspects of a number of such contracts, particularly including guaranteed insurability, help distinguish insurance in a number of ways from other financial instruments. In addition, these features also reflect several outside factors that directly affect the measurement of insurance liabilities, including insurance regulation and the limited markets for the liabilities of insurance contracts.

The combination of several of the following features characterizes most insurance contracts, some of which may significantly influence decisions relating to the development and maintenance of a set of accounting standards that satisfy the key elements as described in the IASC Framework. A discussion of these features is included in our paper entitled “Features of Insurance Contracts.”

1. Transfer of risk (which by definition is required for all insurance contracts).
2. Pooling of risk. Both from the insured’s and insurer’s perspective, the continued guarantee of membership in such an insurance pool can be an important aspect of insurance contracts.
3. Guarantees of a long-term nature, including guaranteed insurability.
4. Bundle of real and financial options that can be complicated and difficult to separate.
5. Restrictions may exist for entry and re-entry into a pool of risk.
6. A continuous option to terminate on the part of one or both parties to many insurance contracts.
7. Policyholder expectations regarding insurer actions.
8. Insurance contracts and insurance enterprises are highly regulated.
9. The insurer may be constrained from utilizing certain of its options, based on regulatory restrictions or contract-owner expectations.
10. Expected use of contract options is reflected in entry and exit prices.
11. Exit value to contract-owners (as opposed to the exit value to the insurer) may not be related to economic value at time of exit.
12. Relevant contingent events may occur that result in one or more benefit payments.
13. Assets may accumulate as a result of a difference in timing of benefit payments and revenues and in some cases a non-level expected cost over the period of the insurance contract.
14. Many insurance contract-owners participate in the profits generated by the contract or pool of contracts.
15. Markets for insurance liabilities are usually incomplete, either relatively non-liquid or inactive.

It should be noted that since the nature of insurance is to provide insurance benefits, the starting point for the determination of the appropriate accounting treatment for insurance contracts should be the contract and its resulting liabilities and not the insurer’s assets.

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Because insurance cash flows are uncertain with respect to the timing and the amount to be paid, there is a need to risk-adjust the valuation process.

Issue-specific comments

In addition to the above general comments, the following paragraphs provide additional highlights of our views on a number of the significant issues raised in the IASC Paper.

Issue 1

The IAA believes that it is appropriate to focus this project on the proper accounting for groups of insurance contracts. Risk transfer is an acceptable element from which to determine the specific limits of this project. Nevertheless, there are a number of similar products whose treatment should be considered in the Steering Committee's deliberations. For example, just because benefit payments are made in kind does not imply that such contracts should be treated differently.

Given the close relationship, even interdependence, of what are often a number of options in an insurance contract, unbundling of such contracts will often prove to be impractical. Even if practical, the sum of the resulting values for the separate parts including embedded options is unlikely to equal to the combined value and will therefore not be meaningful. We note that, if the separate parts are calculated on a sequential basis, the combined value may not be affected, but the values of the separate parts will depend on the order in which the separate parts are calculated.

We do not believe that the type of insurance should affect the accounting treatment of insurance contracts. The conceptual approach for all insurance products should be the same.

Issue 4

Interests of different user groups overlap while at same time there are differences. Nonetheless, they all share a need for understandable, relevant, reliable, and comparable information. As a result, we support the Steering Committee's goal of developing a single approach to general purpose financial statements that will be applied in a uniform manner in all circumstances. We encourage the IASC to continue to engage in active dialogue with insurance supervisors (the IAIS) to develop a mutually acceptable accounting approach. The IAA is willing to provide assistance to such efforts.

A fair value accounting environment in which liabilities are established on the basis of expected value assumptions together with "market value margins" does not by itself provide sufficient information to assess fully the solvency, adequacy of capital and financial condition of the insurer. All users, whether investors, customers or regulators, need such information. It is our view that such general purpose financial statements should be enhanced by the incorporation of disclosure regarding the company's financial

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position from a solvency perspective including, for example, the development of a robust risk-based capital measurement system integrated with the general purpose accounts.

Our paper entitled “Insurance Liabilities – Valuation and Capital Requirements, General Overview of a Possible Approach” discusses a possible approach for assessing capital requirements in a manner consistent with the determination of the fair value of liabilities.

Issue 5

The measurement basis for insurance liabilities should be consistent with the one adopted for assets. We assume that by the time this project is complete, a fair value accounting system for assets will be in place. As a result, liabilities should also be measured at fair values. Consequently, we consider it appropriate if the fair value of insurance liabilities is measured on a basis not reflecting the actual assets or their expected return. However, the measurement of the liability cash flows for contracts whose benefits are directly influenced by the return on specified assets should reflect such relationship. In addition, we note that in a non-fair value accounting environment, the value of the liabilities must reflect the value of the actual assets that are held to support them.

Issue 6

Given the pooling of risk feature of insurance contracts, the basis for recognition and measurement of insurance contract liabilities should be groups or portfolios rather than the individual contract or claim.

We favor a closed book approach to reflect the existence of renewals. However, this is based on including continuations of existing contracts as part of the closed book. If a fair value regime is used, we believe that the market assigns a value to the continuation of existing contracts that is tangible in nature, due to contract-owners’ expectations, the existence of regulatory constraints, and possible accounting arbitrage that may result due to the substantive similarity between contract expiry and termination. For a more detailed discussion, please refer to our paper entitled “Insurance Contract Renewals.”

The assumptions employed should be explicitly based on all material contingent events and reflect current information regarding all future events, since this is in line with the prospective view required for valuing insurance contracts.

We believe that it is appropriate to reflect both the characteristics of the inforce insurance contracts, combined with a market based objective estimation of expected future experience, which would reflect the current operating environment. For a more detailed discussion, please refer to our paper entitled “Market Expectations Regarding Experience Assumptions.”

Given the long-term nature of insurance contracts and the inherent uncertainties in the projection of the cash flows, the fair value measurement of insurance liabilities should

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include provisions for risk and uncertainty and thereby reflect the risks as perceived by the market.

Issues 7 and 8

We recommend that no distinction be made between general insurance and life insurance in designing a set of accounting standards for all insurance contracts. Rather than try to divide insurance contracts for the purpose of financial reporting into two distinct classes which do not meaningfully exist, we suggest that it would be preferable to use a consistent approach for all insurance contracts. Note that most of the conclusions reached in Basic Issue 7 are carried over to Basic Issue 8, which is consistent with our view. Further, we recommend that all insurance contracts be valued based on the expected future experience, including provisions for risks and uncertainties of appropriate groups of contracts.

There is no reason to prohibit a gain or loss on sale of the contract, provided that in the measurement, all risks – as perceived by the market – are adequately taken into account.

As the IASC Paper indicates, the issue of requiring, permitting or prohibiting equalization and catastrophe provisions has been controversial within the IASC Insurance Steering Committee. It has been similarly controversial within the actuarial community. We notice that the difference between catastrophe provisions and equalization reserves has not always been clear. The IAA committee believes it is necessary to differentiate clearly between the two types of provisions.

Equalization provisions should not be recognized as a liability. However, catastrophe provisions are of a different nature and hence an important one in the context of the recognition and measurement of an insurer's liabilities. We present a balanced discussion of the issues, with particular emphasis on areas where actuarial science may offer some additional insight to the IASC Steering Committee in our paper entitled "Comments on Catastrophe Provisions."

We strongly disagree with any requirement to impose a minimum floor to liabilities associated with insurance contracts. We direct your attention to our paper entitled "Minimum Liability Floor".

Issue 9

Any unallocated surplus that is not classified as a liability should be classified as equity. However, we believe that equity should be allocated into the following categories – 'shareholder', 'policyholder' and in rare cases, 'unattributed'. Such an approach would help achieve consistency in reporting between mutual and proprietary companies.

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Issue 10

We believe that direct insurance and reinsurance should be treated consistently. With respect to presentation, there may be strong reasons favoring offsetting ceded reinsurance amounts against the corresponding liabilities. However, we note that a fair value approach would consider the credit standing of the reinsurer, reflecting the probability of being unable to recover reinsured amounts.

Issue 11

Insurance contracts are either financial instruments or should be treated as if they were financial instruments (e.g., in those cases in which benefits are paid in kind). Fair value should be based on pools of similar contracts.

We have considered whether various methods (direct and indirect) could be used to determine the fair value of insurance liabilities. Provided that the methodologies are correctly and consistently applied and produce the same results, either should be permitted. Therefore, we have concluded that the standard should not prescribe a methodology, but rather should describe the required outcome of any methodology to be used.

Our paper entitled “Insurance Liabilities – Valuation and Capital Requirements, General Overview of a Possible Approach” discusses an approach that could be employed to satisfy the requirements of measurement of insurance liabilities on a fair value basis. The approach described recognizes that the cash flows would be risk-adjusted and discounted at rates consistent with the expected timing and characteristics of the fulfillment of the insurer’s obligations, either by using forward rates or indirectly through returns on an asset portfolio whose cash flows mirror the risk-adjusted liability cash flows as closely as possible (the replicating portfolio). Where the liability cash flows are interest sensitive (e.g., unit-linked or participating), the same applies, except the actual portfolio is used as the replicating portfolio. We note that the calculations involving indirect (embedded value type) methods can, if necessary, be refined to accommodate the concept of a replicating portfolio.

We believe that recognition of future investment returns in the measurement of a liability is consistent with the IASC Framework and is necessary in order to recognize all future cash flows associated with the contract. Not to recognize these would generate internal inconsistencies within the valuation of assets and liabilities by reflecting some cash flows while not reflecting others, and could lead to illogical results. Some of the concern regarding this issue may result from of a misinterpretation of what these investment margins are. Please refer to our paper entitled “Future Investment Margins” for clarification of this issue.

A thorough discussion of the pros and cons of whether to recognize the credit standing of the insurer in the measurement of an insurer’s liabilities is included in our paper entitled “Effect of Credit Standing on Insurer’s Liability”. Although there are good arguments on

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both sides of this issue, on balance the IAA believes that it is not appropriate to reflect credit standing in insurance liabilities. We note that it is appropriate to reflect credit standing in the measurement of assets, such as for ceded reinsurance. We encourage the Steering Committee to coordinate its further consideration of this issue with that of the Joint Working Group and other subsequent IASC discussions.

Issue 12

We believe that the current value of future income taxes should be measured and presented on a discounted basis.

Issues 18 – 20

It is premature at this stage to recommend disclosure and presentation details before a better view of the accounting approach to be applied becomes available. We are prepared to work with the IASC's Steering Committee to design key elements of disclosure rules that should assist in producing more meaningful accounts for insurers. We believe that financial statements should be presented in such a way as to be more transparent to their users than is currently the case, including an analysis of results to be included in the notes to the accounts.

Role of the Actuary

Our profession has taken such a very active part in the discussions to this point because our experience and education renders us qualified to develop the estimates necessary to make a comprehensive accounting model work. We are committed to continue working with the IASC on the future developments of this project. We stand ready to develop appropriate actuarial standards of practice to provide practicing actuaries with the structure and guidance that will assure that the IAS on insurance contracts can be applied in an objective and comparable manner. Please refer to our paper entitled "The Role of the Actuary" for a more complete discussion.

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