



**Group of North American  
Insurance Enterprises**

# **A North America insurance industry view on the development of accounting standards and solvency requirements**

Presentation to the 12<sup>th</sup> Global Conference of Actuaries  
Hotel Intercontinental Lalit  
Mumbai, India  
February 19, 2010



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- **GNAIE is an industry organization of US, Bermuda and Canada based insurers and reinsurers.**
- Our Mission: to assist North American and global standard setters and regulators in cooperation with the global insurance industry and with insurance and other financial services industry trade associations:
  - To support high quality insurance accounting standards that are useful, understandable, comparable and reliable; that preserve the insurance industry's level-playing field access to global capital markets; and that provide good disclosure to the insurance industry's diverse constituencies;
  - To support high quality insurance solvency standards that provide useful and effective statutory solvency measures to protect the interests of policyholders and other stakeholders while encouraging competitive insurance markets; and
  - To enhance cooperation, education and communication regarding insurance accounting and solvency among the insurance industry's standards setters, regulators, and diverse constituencies.

- **GNAIE members are substantial writers in international markets.**
  - The new European Solvency framework will directly impact the current European operations of GNAIE members.
  - The IAIS Solvency Standards project will influence standards globally, and they have chosen European Solvency II as the baseline for the development of that global standard.
- **US efforts to converge to international accounting and solvency standards creates a direct link between standards undertaken by European regulators and insurers reporting to US regulators.**
  - The NAIC Solvency Modernization Initiative is the beginning of that process of reviewing European Solvency II and current NAIC standards.

- September.2004 - Ernst and Young “The Impact of Fair Value Accounting on Property/Casualty Insurers”
- October.2004 - “Development of Alternative Accounting Methodology for Life Insurance and Similar Products,” a research report by Watson Wyatt Worldwide
- March.2005 - Second Watson Wyatt report, “Alternative GAAP Issues,” that identifies and analyzes seven key issues surrounding an alternative accounting method.
- November 2007 - Study prepared by Ernst & Young on Market Value Margins for Insurance Liabilities, FAQ – Review of the use of Cost of Capital in the European Solvency II initiative

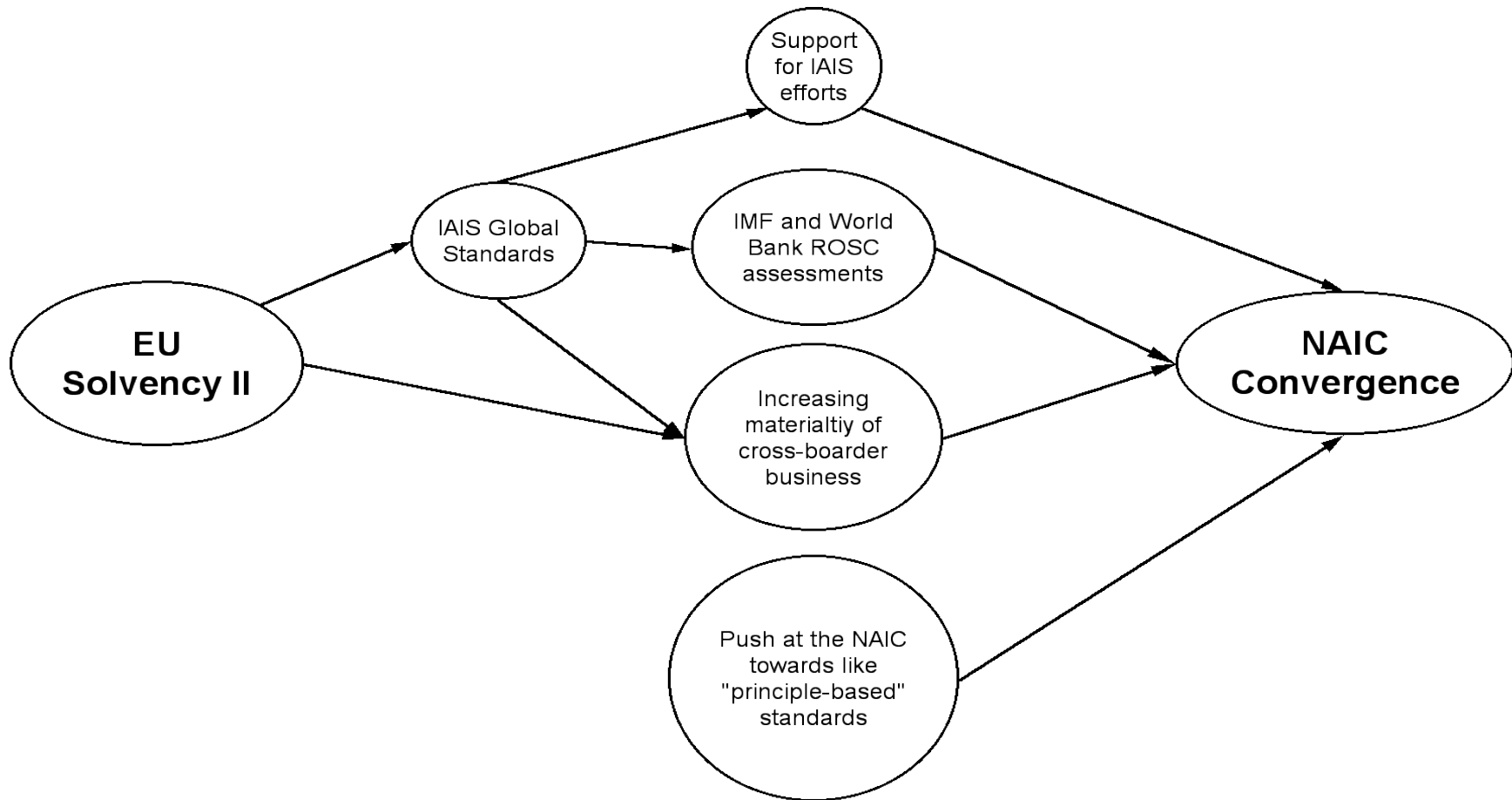
Reports are available at [www.gnaie.net](http://www.gnaie.net)

- April 2006 - U.S. and Japanese Insurers Present An International Accounting Standard for Life Insurance to the IASB
- June 2006 - International accounting principles for non-life insurance prepared by North American Insurers
- November 2007 - Response to the IASB Preliminary Views Document on Insurance Contracts Liabilities
- March 2008 - Study prepared by Ernst & Young: Summary of Comment Letters on IASB Discussion Paper Preliminary Views on Insurance Contracts
- September 2008 – GNAIE adopts Solvency Principles



## GNAIE Research Papers

- Continuously Revised Discussion Papers on:
  - Measurement Basis
  - Risk Margins
  - Asset Earned Rate
  - Risk of Discounting Non-Life Claim Reserves
  - Field Testing
  - Revenue Recognition



**Measurement Basis – Contract Fulfillment Approach or Exit Value**

- **GNAIE Contract Fulfillment Approach**
  - **Based on expected amount to settle with policyholder according to contractual terms**
- **Unearned premium reserve** (“UPR”) methodology applied to Non-Life Insurance Contracts in pre-claim period;
- **Non-Life post-claim reserves** based on gross undiscounted actuarial best estimates;
- **Expected cash flows** calibrated to initial premium to produce no gain at issue for Life Insurance;
- **Remeasurement:**
  - **GNAIE Non-Life model** updated each reporting period; claim reserves remeasured with any positive or negative adjustments
    - immediately recognized in earnings (provides maximum transparency to users);
  - **GNAIE Life model** updated each reporting period and estimates revised where changes deemed significant and sustainable





## Measurement Model Contract Fulfillment Value

### IAS 37 Fulfillment Value Compared to January Agenda Paper 35A and to GNAIE Contract Fulfillment Value

		IAS 37 Proposal		Insurance Contracts Measurement Proposal		GNAIE Non-life CFV Post-claims		GNAIE Life CFV
Building Block #1		Probability Weighted Cash Flows		Probability Weighted Cash Flows		GNAIE supports use of expected cash flows that are not probability weighted		Same as Non-life with limited exceptions (e.g., Minimum Guaranteed Death Benefits for annuities)
Building Block #2		Discount Probability Weighted Cash Flows using risk free rate		Discount Probability Weighted Cash Flows using Risk Free rate		GNAIE Non-Life proposal does not reduce reserves by discounting		GNAIE Life Insurance Contract proposal does not support discounting at risk-free rate
Building Block #3		Apply margins (e.g., risk, service, etc.)		Apply Explicit Risk Margin adjustment		GNAIE Non-Life proposal does not support Explicit Risk Margins for claim reserves		GNAIE Life Insurance Contracts proposal does not support Explicit Risk Margins (i.e., separate from composite margin)
Building Block #4				No gain at issue		No gain at issue inherent in UPR method		Calibrated to no gain at issue with transaction costs

- Given nature of Non-Life post-claim liabilities (i.e., imprecise range of potential settlement outcomes when claims initially reported as well as when they are incurred but not reported) GNAIE believes it best to utilize expected cash flows without probability weighting as a key input to the Insurance Contracts measurement proposal;
- GNAIE issue is not with estimating cash flows generally but rather with requirement to probability weight them as it is typically not possible to reliably predict probabilities associated with the entire range of possible settlement scenarios (which is infinite). Moreover, probabilities cannot be fully tested with sufficient data before environment changes enough to make past data irrelevant to evaluating current risk;
- Probability Weighted Cash Flows for Non-Life Contracts do not exist nor do we believe they can be reliably produced for use in a measurement paradigm designed for financial reporting purposes. We believe this is another reason there should be separate measurement models for Life Insurance and Non-Life Contracts

- **Life insurance contracts**

- The exposure is generally fixed (i.e. the face amount of the contract), and
- There are mainly three outcomes in any given period (i.e. policyholders will either lapse, die or expire)
- Life Contracts better suited to discounting measurement techniques
  - Serious debate between the use of a risk-free rate or an asset-earned rate.
    - Should reflect assets that fund liability cash flows
    - Ignoring asset-liability management (“ALM”) results in highly volatile liability and equity values not representative of the actual business risks;
    - Using a risk-free rate could produce day one losses on contracts reasonably expected to be profitable, particularly immediate annuities and long-term care policies, both important to senior citizens in or near retirement

## ▪ **Acquisition costs**

- Consistency with banking treatment of loan acquisition costs
- Consistency (no gain at issue) and inconsistency (re-measurement) with revenue recognition
- Accounting mismatch not addressed

## ▪ **Insurance Contract Valuation**

- Two models (life, non-life)
  - Support continued acceptance of UPR
  - Oppose Discounting Non-Life Claim Reserves
- Four Building Blocks – still needs examination
- Risk Margins
  - Explicit risk margins plus residual margin. Residual margin is a profit margin, which IASB/FASB members have not concluded their views.
  - Wide range of methods to quantify risk margin, could lead to a wide variety of results, not used by many insurers, not decision-useful or comparable

- **Current FASB-IASB proposal to expense all acquisition costs is a non-starter since it calibrates to no gain at issue without transaction costs**
  - DAC asset eliminated;
  - No offset to up-front transaction expenses with accelerated recognition of revenue; and
- **Proper handling would allow inclusion of acquisition/transaction expenses in calibrating the liability to premium at issue and coordination with no gain at issue. This is a simple solution and consistent with transaction costs on securities**
- **Long duration insurance contracts have a unique combination of characteristics**
  - High upfront transaction costs;
  - Contracts stay in place for 10 to 20+ years;
  - Upfront transaction costs incurred only if contract is sold;
  - Little or no revenue at inception under current proposed treatment for insurance
  - Revenue emerges over many years
- **Proposal would overstate insurance liabilities and understate equity**
  - Even US statutory reporting makes some allowance for acquisition costs
- **Companies would recognize large up-front losses when writing increased amounts of profitable Life Insurance Contracts and would show gains as sales decrease**

**This is the original problem that US GAAP was devised to solve**

- **Discount rate/asset earned rate**
  - Contract boundaries - Renewal premiums – The ability to use all anticipated cash flows in the valuation of an asset.
  - This includes participation features – (3-2 FASB vote to include cash flows that arise from participation features in the measurement only when they become required cash flows)
- **Probability weighted determination of expected cash flows**
  - A particular concern for non-life, but we also don't think probability weighting of cash flows should be required for all assumptions required to value life insurance
  - Outcome could be determined by the responses to the Exposure Draft of IAS 37, *Liabilities*.

Risk Free Rate	Risk Free Rate + Liquidity Premium	Corporate "A" Rate	Replicating Portfolio	Asset Earned
Least relevant		←	→	Most Relevant
Liquid financial instruments with no risk therefore not relevant	Some reflection of illiquid nature of liabilities but is not observable	Ensures Comparability and acknowledges basket of assets back liabilities	Enables comparability and is broadly consistent with business model	Most representative of business model
IAS 39 fair value adjusted for own credit risk	Solvency II and MCEV Non- GAAP measures in Europe			IFRS 9: Financial instruments at amortized cost (business Model

Approach currently being discussed internationally:

**Risk Free Rate + Liquidity Premium**  
**= Discount rate for insurance**

Liquidity premium is not:

- a) observable;
- b) not consistently applied;and
- c) is not reflective of business model

Would likely require significant supplemental guidance to derive; is it fixed at inception? How to justify changes?

“Top Down” approach that instead starts with asset linkage more appropriate as it is observable, more comparable and consistent with the business model



- **Take changes in financial assumptions of liabilities through OCI**
  - Consistency with banks that do not put changes in value of investments through earnings
  - A substantial majority of IASB members voted for no OCI.
  - Still an open issue with the FASB
  - Accounting mismatch - problem identified, but the boards haven't agreed on any solution (insurers could use fair value option for assets, but they'd be at a competitive disadvantage)
- **Recognition and derecognition**
  - (may be problematic for non-life contracts)
    - Recognition occurs at the earlier of: 1) entity being on the risk to provide coverage; and 2) signing of the insurance contract.
    - Derecognition occurs when the entity is no longer on the risk and no longer required to transfer any economic resources to meet its obligations.

**GNAIE supports discounting where the amount and timing of cash flows is reliably determinable on an individual claim basis (consistent with the guidance in SEC Staff Accounting Bulletin No. 62)**

**GNAIE considers discounting the second building block of a four building block measurement paradigm where building blocks one and three are not suitable to apply to Non-Life claims.**

- Application of building block two, independent of our issues with building blocks one and three, is not considered appropriate.
- Does not achieve a relevant measurement for Non-Life claims

## • Short-tail NLI Contracts

- Greatest claim uncertainty associated with two-thirds of claims that pay-out within two years; discounting would be both unreliable and not decision-useful
- Remaining one-third that pay-out primarily in years 3 and 4 are typically less uncertain, however, the impact of discounting is insignificant and does not aid financial statement users' understanding of the business

## • Long-tail NLI Contracts

- For many long-tail contracts, roughly half of claims pay out in the first two years; the relatively short pay-out period makes discounting unreliable, not decision-useful, and generally un-necessary. This statement does not include lines of business such as Worker's Compensation where the timing and amount of cash outflows is reliably determinable on an individual claim basis.
- Remaining half of claims pay-out in year 3 and thereafter. These claims exhibit a high degree of variability which often makes discounting unreliable and not decision-useful

## IASB Contract Fulfillment Approach

- Based on four building blocks
- Probability weighted cash flows;
- Time value of money;
- Explicit risk margin;
  - Amount insurer requires for bearing uncertainty about the resources it will require to fulfill remaining obligation
- Residual margin (calibration to no gain at issue)

- Requires calibration to transfer or cancellation values; typically not applicable to insurance;
- Absent ability to transfer or cancel, IAS 37 fulfillment value measured as “amount the entity would rationally pay at the reporting date to be relieved of the present obligation”;
- Paragraph B8 of IAS 37 addresses fulfillment value associated with service contracts:
  - Measurement based on amount entity would rationally pay a contractor to undertake the service on its behalf; ostensibly a transfer or exit value.



## Insurance Contracts Still be be Resolved

- **Financial Statement Presentation (*aka* Reporting Financial Performance)**

- IASB (and probably FASB) seems inclined to allow an earned premium presentation for short duration contracts (for which the liability is measured by UPR).
- Several board members seem to prefer margin or fee based approaches for other insurance contracts

- **Unbundling, embedded derivatives**

- Most IASB members agree that interdependent features of insurance contracts shouldn't be unbundled. FASB view is unclear/split.
- Both boards are split on whether embedded derivatives in insurance contracts should be bifurcated and measured separately (at fair value).

- **For non-life contracts, the exposure is variable**
  - For any given period we do not know
    - if a loss will occur;
    - the amount of the loss, and for many non-life claims;
    - when the loss will be paid;
    - when the loss will be reported to the insurer and then to the reinsurer; and
    - the number of claims can, in some instances, be unlimited!
  - Non-life claim liabilities possess greater inherent uncertainty than life contracts
    - In part due to time to settle, often related to vagary of the courts;
    - Conceptually a wide range of values;
    - True value known only after all claims settled; and
    - Complexities of the coverages involved

**This will carry over if  
solvency follows proposed accounting model**

- An increase in insurer insolvency in late 1980's
- Federal pressure for more formalised capital adequacy rules on state insurance regulators
- Risk-based capital already existed for banks in US and internationally (under Basel 1 rules).
- RBC standards for insurers introduced in early 90's, with extensive input from the insurance industry.
- Introduction of RBC led to more mergers and acquisitions and to changes in financial policy, including use of off-balance sheet and derivatives arrangements to lower RBC requirements.
- Rating agencies have developed more stringent requirements.

Will we learn from the US experience?



- The objectives of the solvency framework should be to:
  - a) Implement a principles-based framework where supervisors rely upon company risk management practices subject to appropriate levels of oversight;
  - b) Provide reasonable policyholder protection, without regard to size, geographic location, and legal form of the insurer;
  - c) Encourage insurers to use best practice risk management techniques;
  - d) Foster the transparency of solvency requirements to insurers;
  - e) Foster the transparency of insurers' capital adequacy to consumers;
  - f) Encourage harmonization of global supervisory solvency requirements, where appropriate, and cooperation among regulators; and
  - g) Promote a sound and competitive insurance market through an efficient and effective supervisory environment.



## European Solvency II Implementation

- Consistent framework to be designed for groups and single entities
- Risk-focused – with incentives for enhanced risk management / internal risk capital models
- Market-based valuation, may be in conflict with IFRS
- Appropriate prudence under debate following crisis
- Cross sector consistency of regulation to prevent regulatory arbitrage and eliminate gaps
- Data / field testing – a significant challenge for European Solvency II
- Supervisory structures, like CEIOPS, now to be government authority

- **Different horses for different courses.**
- Solvency regulation is scenario based, with graduated responses at different confidence and capital levels. While it is based on probabilities and ranges, regulators want to understand how our business will respond under diverse scenarios. Especially for non-life contracts, statutory solvency measurement considers a range of solutions – not a single best estimate.
- On the other hand, accounting looks to achieve a faithful representation of results of a company's performance; its operations and the financial position of a company at a period in time. It is not based on a set of "what if" scenarios using highly subjective and unverifiable assumptions.
- Although preparing different financial information for solvency and general reporting purposes adds complication and expense, we believe we should select and employ the methodology that serves the purpose of each requirement. We should not be overly influenced by the economics of executing and fulfilling diverse requirements.

The bottom line is that solvency methodologies serve different needs and GNAIE does not believe that this is the answer for general purpose financial reporting.

Solvency	Accounting
Liabilities based on probability ranges. Focus is on total balance sheet (liabilities + equity) measured against risks	Liabilities based on “best estimate”.
For <i>regulators</i> to focus on monitoring financial capacity to satisfy policyholder obligations	For <i>investors</i> to focus on performance, operating results and current financial position.

- Schapiro defended the SEC's progress. "It can take more time than one might have thought at the outset," she said. "We have to understand the real-life implications of what we're doing, the unintended consequences. We need to digest all the comments and all the economic analysis. And that leads us down a path that sometimes isn't 100% predictable at the beginning." SIFMA SmartBrief quoting the Washington Post, February 16, 2010.

“But more than a year after Schapiro took office, the SEC has not yet written into the Wall Street rulebook the short-selling limits -- or most of the other measures that the agency has proposed to more tightly regulate the financial system.

Among the proposals that have not been finalized are new rules to make it easier for shareholders to shape the upper echelons of corporate management, an overhaul of the credit-rating industry that judges the quality of investments and measures to curb corruption in state pension plans. Each of those measures is aimed at failings that became apparent during the past two years.

Whether Schapiro can achieve more of her reform agenda will be a test of how much she can change the SEC, which gained a reputation as a weak Wall Street regulator in the years leading up to the financial crisis. The commission's poor performance in part led the Bush and Obama administrations to consider stripping it of key powers, but Schapiro's ambitious vision for the agency has helped the SEC retain its authority.” Washington Post, February 16, 2010.

- **Would a question about the road map get the same answer?**

- GNAIE, Latin American, African, and Asian support, as EU and global market participants, will greatly add weight to acceptance and convergence with other country efforts to develop a global solvency framework.
  - That support at the IAIS will speed the development of a global standard substantially equivalent to European Solvency II.
  - Our efforts in the US could lead to convergence to an substantially equivalent standard in the US. We are actively participating in the Solvency Modernization Initiative.
- For either to occur, Latin American, African, Asian and North American constituents must feel that European Solvency II, generally, meets their needs and circumstance, and that the process of development is open and receptive to their comments.
- One way would be to open the financial advisory committee process to non-European entities. For instance, the CEIOPS Insurance Advisory Panel only has European members.

- **Trustee Recognition by appointing IASB Members**
  - China – Zhang Wei-guo
  - Brazil – Amaro Luiz de Oliveira Gomes
  - India – Prabhakar Kalavacherla ('PK')
- **Realization by Latin American Supervisors and Industry that they need to get more involved**
  - ASSAL Conferences educating countries and industry
  - Peru, Mexico, Chile, Brazil regulators have an Accounting Subcommittee to respond to Insurance Contracts and Solvency Projects
- **Asia is Behind the Curve**



# 亚洲保险会计准则研讨会

Asian Insurance Accounting Standards Information Exchange

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2008年6月5日-6日 北京  
5th-6th June 2008 Beijing

Date	Time	Activity
<b>Thursday 5 June 2008</b>		
	08:30 – 09:00	Coffee and Greetings
	09:00 – 09:15	Welcome and Introduction - Goals of the Meeting Jerry de St. Paer, GNAIE Executive Chairman
	09:15 – 09:45	Keynote Speaker – Jiang Xianxue, Deputy Director General, Financial and Accounting Department
	09:45 – 10:45	Session - Each company presents its preliminary views on the insurance contracts project
	10:45 – 11:00	Beverage Break
	11:00 – 12:30	Session continues
	12:30 – 14:00	Lunch – Sponsored by Tai Kang Life
	14:00 – 15:30	Session Continues
	15:30 – 16:00	Beverage Break
	16:00 – 17:30	Session continues
	18:30 – 19:00	Refreshments
	19:00 – 21:00	Dinner – Sponsored by China Life

<b>Friday 6 June 2008</b>		
	08:00 – 08:30	Coffee and Greetings
	08:30 – 08:45	Welcome and Summary of Thursday Sessions
	08:45 – 09:00	Discuss plans for the Day
	09:00 – 10:30	Companies discuss next steps in presenting their views to the various decision makers, e.g. IASB and IAIS.
	10:30 – 11:00	Beverage Break – Sponsored by New York Life
	11:00 – 12:15	Session Continues – companies discuss Asian Conference on Accounting Standards
	12:15 – 12:30	Summary of Sessions and Conclusion
	12:30 – 13:30	Farewell Lunch - Sponsored by GNAIE



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