The Group of North American Insurance Enterprises
Discussion Paper
Day One Profit (and Loss)

Introduction

This discussion paper has been developed by the GNAIE Technical Committees in response to the "Day One Profit and Loss" issues raised by the IASB staff in their February papers and further discussed at the April 1-2 meeting of the Insurance Working Group. In addition, IASB staff asked for any additional information on these topics that might be of assistance to them in progressing the issues.

At the request of the members of the Working Group during the meeting, we have copied all the members. Please feel free to circulate these to any others you feel may benefit from the discussion. They will also be posted on the GNAIE Website, along with any other contributions of documents or ideas.

General Observations

1) The premiums that insurers charge for their life insurance products result from complex actuarial pricing models. Those models reflect all the economic expectations arising from the contract, including all costs and revenues, and providing for expected profit (or increase to surplus) over the life of the contracts.

2) Many of the comment letters sent to the IASB on the DP took strong positions for or against allowing recognition of profits at the inception of insurance contracts. In general, support for immediate recognition of profit or loss at inception came from respondents who believe that net day one profits would not normally be significant, except in niche markets and similar cases. Opposition to immediate recognition of such profits in profit or loss generally came from respondents who believe that day one profits would be significant for much broader than niche markets.

3) The people who state that day one profits based on CEV would be significant in broad parts of the insurance market include virtually all of the respondents routinely engaged in pricing life insurance contracts, namely the actuarial profession and insurance companies themselves. They understand the theory that underlies CEV but are concerned that the assumptions needed to determine CEV will be inconsistent with economic expectations and that these inconsistencies will lead to large reported gains at inception that could well reverse over the life of the contract.

4) Furthermore, some contracts that companies expect to be profitable over their lifetime could show significant losses at issue under the ICDP's proposals that would be reversed by gains in future years. This kind of result could have a negative impact on the industry's willingness to sell certain products that are otherwise of demand in the market.

5) We submit that it is irresponsible to proceed, without further testing and analysis, to implement an accounting standard for which there are such substantial unresolved questions. Furthermore, we suggest that studies already exist, and that others that could be developed without great difficulty, to further assess the potential magnitude of gains at inception and the reasons for such gains.

6) Agenda Paper 7D for the April IWG meeting does mention the concerns described above (e.g., in paragraph 7). However, we think that the paper is more focused on the theoretical reasons for why gains at inception could arise, based on a starting assumption that CEV is closely related to the underlying economics of insurance contracts. We suggest that it is not useful to continue discussion of the theory of gain at inception; rather, what is needed is conclusive determination of whether such large gains would arise or not under a CEV-based measurement model. If they do, as we think they will, then changes are required to the measurement model.

7) GNAIE recommends that margins be calibrated to premium so that artificial gains and losses at issue would not exist (absent a situation in which a policy is expected to lose money over its lifetime). Furthermore, this would set the liability to the only market-determined value in its lifetime, namely the value at sale.

8) If it is agreed that large gains are not appropriate, and there is a reluctance to calibrate directly to premium, the accounting standard could be based on a "rebuttable presumption" that there are no gains or losses at inception, in the absence of strong market evidence to the contrary.

As noted in Agenda Paper 7D (in paragraph 4d)) and in paragraph 2 above, support for immediate recognition of profit or loss at inception came from respondents who believe that net day one profits would not normally be significant, except in niche markets and similar cases. We do not believe that this view is correct. But if it is reasonably valid, the "rebuttable presumption" described above would result in close to the same gain at inception in most cases as would result from CEV. The "rebuttable presumption" basis for the result would be far easier to understand, explain, and audit than the current proposal.

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