

**The Group of North American Insurance Enterprises**  
**Discussion Paper**  
**Field Testing of Proposals for Insurance Contracts Accounting**

**Introduction**

This discussion paper provides GNAIE's views on why field testing must be an integral part of work on an international accounting standard for insurance contracts, how the field testing should be conducted, what the priorities should be, and what criteria should be used in determining the nature, scope, and timing of the field testing.

The paper has been developed by the GNAIE Technical Committees in response to the questions 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.

**Why field testing must be a critical part of the insurance contracts project**

- a. IASB preliminary views include fundamental changes from existing practices. If adopted, these changes would require many preparers to develop methods, models, and hypothetical assumptions that are vastly different from those they use today.
- b. There are wide variations in comments from experts on dislocations that are likely to result from a standard based on the IASB's preliminary views. There is tremendous potential for surprises and unintended consequences.
- c. There are also wide variations in views expressed about the relevance, complexity, costs and benefits of key aspects of the IASB's preliminary views.
- d. There are particular concerns about how results that are so dependent upon assumptions about hypothetical transactions that do not occur in actual markets could be verified and audited.

**How field testing should be conducted**

GNAIE recognizes that the IASB has many high-priority projects, and that IASB staff resources to work on field testing of any of these projects are very limited. However, we believe that most of the field testing described in this paper would not require significant use of IASB staff.

## Field Testing of Proposals for Insurance Contracts Accounting

- a. We agree that the priorities, objectives, cost, benefits, and risks of field testing (as well the risks of not doing particular tests) must be assessed carefully.
- b. There are opportunities to conduct targeted and more comprehensive tests based on information that is already available or obtainable reasonably easily. The Society of Actuaries study, Financial Reporting for Insurance Contracts under Possible Future International Accounting Standards, January 29, 2008, is one example.
- c. Analysis of existing information or collection and analysis of new information could be led by professional organizations or other independent parties (such as accounting or actuarial firms) to ensure the results are valid and credible.

### **Priorities for field testing**

GNAIE strongly believes that there is a separate and distinct need for comprehensive testing of the feasibility, economic relevance, and reliability of an accounting standard for insurance contracts. While such comprehensive testing is likely to add to the length of time required to finalize the standard, we believe that the additional time can be minimized with effective planning; and the reduction in risk and potential improvement in the resulting standard should overwhelmingly justify the time and resources that would be used in field testing. (GNAIE's views on the priorities and other considerations for particular targeted field tests are covered in an appendix to this paper.)

The comprehensive testing should help to establish an insurance accounting standard that will result in:

- a. Adequate insurance liabilities to satisfy obligations to policyholders in the normal course of business;
- b. Internally consistent revenue and expense recognition models;
- c. An appropriate level of disclosure to supplement and provide decision-useful information to users of financial statements;
- d. An accounting model that provides management with core metrics to enable them to manage the business, and for users to make informed investing and credit decisions; and,
- e. Operationally feasible guidance for insurers to implement at a reasonable cost.

Potential "fatal flaws" and unintended dire consequences could be identified and addressed before the standard is implemented. We believe that the potential for such flaws/consequences in the insurance contracts project is high for the reasons listed in the section above headed "Why field testing must be a critical part of the insurance contracts project". In particular, many concerns have been expressed in comment letters to the IASB that accounting according to the IASB's preliminary views would depend on hypothetical assumptions and models that are inconsistent with the underlying economics of insurance contracts. In the long run, we believe that overall use of IASB Board and staff time will be reduced as a result of addressing these issues and concerns through

testing before the standard becomes effective.

Comprehensive testing should be based on a fairly complete and well defined standard, which should follow deliberation of many of the key issues proposed for Board discussion; although the comprehensive testing could be done before an Exposure Draft for the standard is issued. In contrast, many of the targeted tests described in the appendix to this paper could and should be done relatively quickly and soon, and could provide very useful information for the Board to consider as it discusses the particular issues.

**Criteria to determine nature, scope, and timing of field testing**

- a. The risks of doing or not doing particular tests (e.g., potential delays to implement a standard and added use of scarce IASB resources vs. potential for a seriously flawed standard that is materially inconsistent with underlying economic values of insurance contracts).
- b. The monetary, staff, and other resources required, and alternatives for who could provide them.
- c. How the results would be used (e.g., for discussion by the Board of particular issues, for identification and assessment of potential “fatal flaws”), and how useful the results might be for these purposes.
- d. Availability of information that already exists or that is obtainable reasonably easily, and other opportunities that could potentially reduce resource requirements.

The IASB received over 160 comment letters on its Discussion Paper on Insurance Contracts. Most of these letters included comments field testing, and virtually all these comments strongly support the need for field testing. The IASB’s due process requires that the Board give careful consideration to such widespread and overwhelming support for field testing. The Board must also consider the need for field testing in relation to its other priorities and its resource constraints. However, as noted above, GNAIE believes that there are opportunities to conduct effective and credible field tests without significant use of IASB resources; and that there is a strong potential for such testing ultimately to reduce resources that the Board and IASB staff will devote to insurance contracts in the long run. GNAIE would be very pleased to discuss or otherwise assist the IASB as it considers needs and costs for field testing.

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Note: GNAIE’s views on the priorities and other considerations for particular targeted field tests follow in an appendix to this paper.

## **Appendix 1: Priorities for Targeted Field Testing**

1. Assess the practicality of quantifying potential gains and losses at issue, and the relevance and reliability of such information. We note that some observers and some Board members believe that potential gains at inception would be small, while others contend that they could be enormous (with this latter view based on concerns that gains and losses would be inconsistent with the underlying economics of the insurance contracts). The SOA report (referenced in the cover memo) and work of the CFO Forum may be useful existing sources of information on the potential size, variability, and reliability of reported gains at inception.
2. How to determine when a particular contract ends (and thus determine when to end estimates of future cash flows). In a field test, language for life, health, and property & casualty insurance, as well as investment contracts, from around the world could be collected to determine whether there would be problems in determining when a contract ends.
3. Beneficial policyholder behavior – Practical issues of identifying (and quantifying, if necessary) policyholder behavior that might be beneficial to the insurer. Assess whether exclusions of cash flows related to such beneficial policyholder behavior are consistent with the way market participants value insurance cash flows in the most closely observable related market transactions (e.g., block transfers, reinsurance). Identify situations in which the proper treatment of renewal premiums cannot be determined from the contract terms (also for consideration in #2 immediately above).
4. Practicality of estimating risk margins based on the proposed standards – The concept of “margins that market participants would require” is difficult to implement consistently, in view of the general absence of observable markets. The continuing work by the International Actuarial Association could be a starting point for further development.
5. Diversity in application of cost of capital – How to calibrate the amount of capital needed, the use of capital over the term of long duration liabilities, and the cost of capital rate. Such calibration, and whether it can be applied consistently and reliably, may be particularly important if the cost of capital becomes a key methodology for estimating risk margins.
6. Assess the scope and frequency required for stochastic modeling and other probability weighted concepts that would be applied, including cost/benefit considerations and implications for timeliness and reliability of reporting. Analyze existing studies of stochastic modeling of insurance contracts to assess the potential for results of probability weighting to be materially different from deterministic results.
7. Clarification of the discount rate to be used, including in situations where market risk free rates aren't available as a starting point (e.g., for very long duration liabilities), government bond rates vs. swap rates, liquidity premiums, and uncertainty of duration and amount of liability cash flows. Assess potential for “accounting mismatch” between asset and liability values based on discount rates, and evaluate ways to minimize such



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non-economic volatility.

8. Bases for estimating assumptions that market participants would use, which are not observable. It may be easiest to focus on expense assumptions; but inter-relationships between expenses and other assumptions (e.g., contract persistency for life insurance, claim costs for non-life) should also be assessed. Consider whether most companies would have to resort to using entity-specific information as a basis for such assumptions, if market based information proves to be unavailable or not sufficiently relevant.
9. How to estimate effects of the insurer's "own credit standing" or credit standing of the particular liability, with no observable market, regulatory constraints/prohibitions against settling with policyholders for anything less than full contract benefit amounts, and impact of protection mechanisms such as guarantee funds. Assess whether consideration of changes in such credit standing appears to be consistent with the way market participants value insurance cash flows in the most closely related observable market transactions (e.g., block transfers, reinsurance).
10. Cost, benefits, and practical implementation issues that must be addressed to quantify service margins as proposed in the Discussion Paper. Would quantification of such margins result in "double counting", as is indicated in some comment letters?
11. Identify situations in which contract features are considered to be separately measurable in ways that are not arbitrary; and assess the relevance, reliability, and decision-usefulness of the resulting measurement, especially where the value of the insurance liability is considered to be the difference between the liability value of the entire contract and the value of the non-insurance liabilities within the contract.



40 Exchange Place, Suite 1707  
New York, New York 10005  
Douglas Wm. Barnert  
Executive Director  
(212) 480-0808  
doug.barnert@gnaie.net