



The Group of North American Insurance Enterprises

Discussion Paper

In preparation for discussing candidates for insurance contract liability measurement attributes in early 2009, this paper highlights key differences among the candidates that were discussed by the IASB and IWG in October and November 2008; and presents, in summary, GNAIE's position on these points **with respect to life insurance contracts**. Additional information on each of these positions is available on the GNAIE web site (gnaie.net), and GNAIE would be happy to discuss any/all of these points further. GNAIE contends that some positions that have strong advocates would lead to conclusions that are clearly contrary to economic results (see bolded highlights below). All of the candidates (except for the unearned premium reserve attribute) are based on the three building blocks of expected cash flows, margins, and discount rates. GNAIE supports this building block approach for life insurance liabilities; but as described below, GNAIE has several concerns about how these building blocks are defined and determined.¹

1) Cash flows.

- a) Basis for assumptions. There is generally no active market for insurance contract liabilities; and therefore, a measurement model based on transfers that in almost all cases cannot occur must be based on actuarial assumptions. GNAIE believes that liability valuation should be based on management's best estimate of cash flows that are actually expected to occur. This is of particular concern with respect to expenses. If assumed expense cash flows are based on hypothetical market assumptions rather than on the expenses the company actually expects to incur, **inefficient entities would show artificial gains** (because they price for costs that are higher than the supposed market assumptions used for measuring the liability); and **efficient entities would show artificial losses**. **Such artificial gains/losses would reverse as the insurer continues to retain the contracts and actual expenses are incurred.**

Furthermore, there are interrelationships between assumptions that would not be reflected if some of them are based on hypothetical market rates that are unlikely to be experienced. For example, marketing, customer service, and retention efforts of individual entities have significant effects on contract persistency results. Therefore, a measurement that uses supposed market assumptions for expenses and portfolio assumptions for contract persistency is likely to lead to inappropriate results.

¹ We understand that the IASB and FASB are working on several other projects, including the conceptual framework (phase C: measurement), revenue recognition, fair value measurement, and proposed amendments to IAS 37, that could significantly affect decisions regarding measurement of insurance contracts, and that in turn could be affected by decisions that are made in the insurance contracts project. Our comments in this paper may need to be updated as work progresses on all of these projects.

- b) Probability-weighting. The best estimate should reflect the expected value of cash flows; but GNAIE believes that it is impractical, unnecessary, and redundant to use probability-weighted estimates in many cases to achieve appropriate results. Even if such probability weighting were to be based on variations in only the assumptions that are most significant in estimating the liabilities, the calculations would be very complex and time-consuming, even using the most current technology. Probability weighting, perhaps with stochastic modeling in some cases, could be appropriate and useful for estimates of some liabilities. However, in many cases, more straight forward determination of best estimates would be more timely and understandable, as well as at least as accurate. Furthermore, the introduction of probability weighting implies the addition of a risk margin which is a separate building block. When stochastic methods are used to estimate liabilities, uniform probabilities should be applied to all runs.
- c) Own credit standing. The insurance regulatory structure in most of the world provides payment priority for insurance contract obligations over the insurer's other obligations. In general, the insurer is not allowed to negotiate payment to policyholders for less than the full value determined from the insurance contract, or otherwise reduce these obligations and still continue as a going concern. The insurer cannot transfer a reduced credit standing for these obligations to another market participant. Therefore, even if the credit standing of the insurer is materially reduced, it is unlikely that the credit standing of its insurance obligations would be reduced materially, if at all. As a result, **a measurement attribute that allows for reduction of the liability value if the credit standing (of the obligation) were assumed to be reduced would lead to reporting of counter-intuitive and unrealizable gains for the insurer**. We therefore oppose such adjustments in valuing insurance liabilities.
- 2) Margins. Several methods and theories have been proposed for margins to be included in valuing insurance contract liabilities. Some would require hypothetical assumptions that cannot be validated as appropriate for all entities (or perhaps for any entity). The use of such margins can result in significant reported gains or losses at inception, based on hypothetical assumptions. GNAIE supports testing for loss recognition, and recognizing losses based on economic expectations. However, other than in such loss recognition circumstances, GNAIE believes that gains and losses should be recognized over the life of insurance contracts as the insurer is released from risk. This logical result is achieved by recognizing no gain at inception by calibrating initial margins to the actual market transaction in which the insurer sells the contract to the policyholder. At the very least, GNAIE believes there should be a "rebuttable presumption" that this is the appropriate initial margin, in the absence of actual market or entity evidence that a materially different margin would be more



appropriate. After inception, the pattern of margin release over the life of the contract could be adjusted if evidence of such a material difference emerges.

3) Discount rates.

Consistent measurement bases should be used for assets and liabilities in order to minimize uneconomic accounting measurement mismatches. Such consistency would not be achieved if discounting based on “risk free” rates is used to value the insurance liabilities, while different (generally higher) discount rates are used in valuing associated assets. In many cases, use of such discount rates would lead to reported initial losses on contracts that are expected to be profitable. Such liability valuation would also be inconsistent with how market participants value and price insurance contracts (e.g., in block sale transactions). GNAIE recommends using an objective framework to determine representative asset portfolios and current market based discount rates, net of investment expenses and expected defaults. Life insurers typically have long-term, illiquid obligations, and both the intent and ability to hold assets that match their obligations. Discount rates used to measure insurance liabilities should reflect this reality and the reality that insurance companies have historically earned more than the risk free rate on their investments.

For those contracts where the policyholder liability is dependent on investment returns (e.g., unit linked, universal or participating whole life, most deferred annuities, and all variable life and annuity products), the discount rate should reflect the assumed earnings on the policyholder funds.