The Need for Different Accounting Models for Life and Non-life Insurance Contracts

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The Group of North American Insurance Enterprises (GNAIE) consists of Chief Financial Officers of leading insurance companies including life insurers, property and casualty insurers, and reinsurers. GNAIE members include companies who are the largest global providers of insurance and substantial multi-national corporations. All are major participants in the US markets. (www.gnaie.net)

I. BACKGROUND

The International Accounting Standards Board ("IASB") and International Association of Insurance Supervisors ("IAIS") are separately, but concurrently, considering the adoption of new accounting models for both life and non-life insurance contracts. Thus far, both the <u>IASB and IAIS have tentatively endorsed the use of a single model for both life and non-life insurance contracts</u>. In contrast, <u>GNAIE believes very strongly that the unique features of life and non-life contracts require different accounting models</u> that give appropriate consideration to those unique features. Accordingly, GNAIE developed unique life and non-life accounting models that we believe represent an enhancement over the existing US GAAP and IFRS models. The principal rationale supporting the need for two unique accounting models is more fully articulated as follows.

II. THERE ARE SIGNIFICANT INHERENT DIFFERENCES BETWEEN LIFE AND NON-LIFE INSURANCE CONTRACTS

- <u>Life contracts are inherently more suitable for the application of discounted measurement techniques</u>. In most cases there is near perfect certainty that the policyholder will either die or surrender, the face amount of the basic contract is known, and the insurer possesses mortality tables and lapse studies that aid in predicting when mortality or lapse events are most likely to occur.

- <u>Non-life contracts are inherently much less suitable for the application of discounted measurement techniques</u>. The insurer cannot <u>**reliably**</u> predict losses, other than on a gross, undiscounted basis primarily due to the wide range of potential losses (i.e. any amount between zero and the contractual policy limits) , which can occur in any individual reporting period during which the policies provide coverage. The inability to reliably estimate non-life claims and related expenses for individual reporting periods over the life of the contracts (as opposed to life contracts where this is possible) is the principal reason that two unique accounting models are considered necessary.

III. EVALUATION OF THE UNIQUE FEATURES OF NON-LIFE CONTRACTS

- Premiums received (net of commissions and other expenses) are typically invested in interest-bearing instruments during the life of the contract. For that reason, non-life insurance contracts (both short and long duration) are priced, managed, and evaluated for performance based principally on underwriting results (i.e. underwriting income excluding interest income).

- The principal reason the time value of money has historically not been incorporated in the measurement of non-life reserve estimates or performance measures is attributable to the inability to reliably estimate cash flows for such contracts by individual reporting period. The range of potential claim outcomes for individual reporting periods is widely dispersed and further complicated by the fact that the period over which claims will ultimately be settled is also inherently uncertain as a portion of actual claim settlements are based on legal proceedings with indeterminate timing and outcomes.

- Pursuant to the above, the "time value of money" **cannot be reliably measured for non-life insurance contracts** due to the inability to reliably estimate cash flows by reporting period which must serve as the foundation for any discounting (i.e. time value of money) exercise. Any reserve estimation exercise must be built on a solid (i.e. reliable) foundation (i.e. estimated cash flows) for the output of the exercise to be relevant and reliable.

- In contrast to non-life contracts, life contracts possess qualitative features that allow the reliable estimation of their cash flows by individual reporting period using generally accepted actuarial techniques. As a result, life contracts typically contain an explicit interest element in pricing and are managed and evaluated for performance based on measures that specifically include interest income. Accordingly, the discounting of life reserves to reflect the time value of money is considered wholly appropriate.

- While non-life companies do invest net premiums and place importance on the earning of investment income, any exercise to specifically isolate the time value of money for non-life contracts would not provide decision useful information to financial statement users as the exercise cannot be built on a stable foundation in the absence of a reliable set of estimated cash flows by reporting period.

IV. KEY FEATURES OF GNAIE'S LIFE AND NON-LIFE PROPOSED ACCOUNTING MODELS

GNAIE Proposed Life Model – Key Features

- Full discounting applied to all reliably estimable net cash flows; consistent with present accounting.
- Utilization of risk margins to reflect the inherent risk of the estimated net cash flows; calibrated to produce no gain at issue.
- **Update reserve assumptions over time based on experience as new trends are confirmed; differs from present accounting**.

GNAIE Proposed Non-life Model – Key Features

- Pre-claims liability measured using the unearned premium reserve ("UPR"); consistent with the existing model that is executory in nature.
- Post-claims liability measured using the reporting entity's undiscounted best estimates; consistent with the current model based on incurred losses.
- No explicit risk margin due to absence of any reliable market-based source for this measure. An implicit risk margin does exist inasmuch as reserves are held on an undiscounted basis.

V. CONCLUSIONS

GNAIE believes that life and non-life insurance contracts are demonstrably different in terms of their key features and as such it is necessary to develop different accounting models to conform to those unique features. In the case of life insurance contracts, because cash flows can be reliably estimated by individual reporting period it is appropriate to discount estimated cash flows. It is also appropriate to continue the application of risk margins to life insurance cash flows consistent with historic practices; with the exception that risk margins should be calibrated to produce no gain at issue. In contrast, for non-life insurance contracts, because the cash flows cannot be reliably estimated by individual reporting period due to the inherent uncertainty of the related cash flows, GNAIE supports utilization of the UPR as the pre-claims liability and the post claim liability should be determined based on the reporting entity's undiscounted best estimate of incurred losses.