

A Non-Life Insurance Illustration

Illustration of GNAIE Extended
Non-life Principles and Fair Value

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Objective

- The objective of this illustration is to comparatively evaluate the key attributes of the GNAIE proposed non-life principles with an alternative fair value¹ accounting paradigm and determine which model provides more relevant, reliable, decision-useful information.
- The illustrative examples contained herein focus on the auto and homeowner insurance businesses. While other non-life insurance businesses (e.g. multi-year long-tail commercial liability covers) would exaggerate the differences between the GNAIE proposed non-life principles and a fair value accounting paradigm, analyzing a single-year short-tail cover effectively illustrates the fundamental issues that GNAIE believes exist with a fair value paradigm inasmuch as it produces results that vary significantly from those emerging from the GNAIE proposed non-life principles which places more reliance on verifiable inputs and recognizes premium revenue in a manner consistent with the provision of insurance protection services under the contract.
- The illustration supports GNAIE's general presumption that fair value is not the most appropriate measurement basis for non-life insurance contracts due to (a) the general absence of sufficient, reliable market observable data necessary to calibrate assumption changes over time (which correspondingly limits the relevance and reliability of "fair value" estimates generated without the availability of such information), and (b) GNAIE's belief that any accounting model that does not recognize contract (i.e. premium) revenues over a period consistent with the provision of insurance protection services is not representationally faithful.

¹: Fair value, as hereinafter described, is not meant to replicate any particular authoritative body's interpretation of fair value, but rather is meant to be representative of the theoretical construct.

Typical Auto and Property Products

- **Auto Insurance**

- Provides coverage for bodily injury (“BI” – i.e. liability and medical) and physical damage (“PD” – i.e. collision, comprehensive, and property damage).
 - Coverage is typically for a 6 or 12 month period.

- **Property Insurance**

- Provides coverage for liability, dwelling, identified personal property, etc.
 - Coverage is typically for a 12 month period
- Umbrella policies (which are generally included within the property category) provide liability protection beyond limits on individual auto or property policies

Key Features of Non-Life Insurance Contracts

- The consumer pays in advance (or periodically in installments) a guaranteed price for indemnification of covered losses and expenses under the contract.
- The insurer attempts to match the consumer/insured with the right coverage at the right price, consistent with the insurers product offerings and the consumer's insurance protection needs.
- Prices are set by insurers to produce targeted returns on capital, subject to regulatory review and approval as well as competitive factors and constraints.
- Total costs and expenses associated with the issuance of new policies are actuarially estimated based on historical trends but are not known with any certainty at the time an individual product is issued. Accordingly, the most appropriate unit of account is a pools or block of similar contracts, and not an individual contract.
- Policy coverage terms, conditions, and limits define the available financial protection/indemnification.

Non-life Insurance Contract Economics

- Profits arise from underwriting results (i.e. gains and losses from premiums earned less losses incurred, related loss expenses, and contract maintenance expenses) as well as investment income earned on retained cash flow and capital necessary to support the business.
- Premiums (i.e. contract revenues) are collected prior to (or during) the policy period if customers are on a monthly installment payment plan. Losses occurring within the coverage period are estimated and settled over the time period necessary to fully adjudicate the claim. Premium cash flows not used to pay for losses or expenses are invested.

Factors that Influence the Performance of Non-life Insurance Contracts

- **Distribution (“proprietary”)**
 - Used to gather prospects and initially screen risks
- **Risk Management Strategies**
 - Final risk selection & pricing
 - Investigation of credit and claim history
- **Policy Design & Coverage**
- **Analysis of Statistical Data for Pricing/Expense Estimates**
- **Policy Renewal, Re-pricing, and Cancellation Decisions**
- **Investment Portfolio Management**
- **Claims Handling**
 - Investigation/adjusting practices
 - Proprietary loss estimation processes
 - Litigation/negotiation management
 - Segmentation and centralization of the handling of certain losses
 - Fraud mitigation measures
 - Loss fulfillment management
- **Operating Cost Management**
- **Tax planning**

Non-life Insurance Contracts - Example Cash Flow Illustration

(\$ in millions)	2006				2007	2008	2009	2010	2011	2012	Total
	Qtr 1	Qtr 2	Qtr 3	Qtr 4							
Premium Received	\$ 100.0	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 100.0
Losses Paid	\$ (7.3)	\$ (7.3)	\$ (7.3)	\$ (7.3)	\$ (21.9)	\$ (7.3)	\$ (5.8)	\$ (4.4)	\$ (2.9)	\$ (1.5)	\$ (73.0)
Acquisition Costs Paid	\$ (13.0)	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ (13.0)
Expenses Paid	\$ (2.3)	\$ (2.3)	\$ (2.3)	\$ (2.3)	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ (9.0)
Underwriting Cash Flow	\$ 77.5	\$ (9.6)	\$ (9.6)	\$ (9.6)	\$ (21.9)	\$ (7.3)	\$ (5.8)	\$ (4.4)	\$ (2.9)	\$ (1.5)	\$ 5.0
Investment Income Received											
Retained Cash Flow	\$ 1.2	\$ 1.0	\$ 0.9	\$ 0.7	\$ 1.8	\$ 1.4	\$ 1.2	\$ 1.0	\$ 0.8	\$ 0.8	\$ 10.8
Capital	\$ 0.8	\$ 0.8	\$ 0.8	\$ 0.8	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 3.0
	\$ 1.9	\$ 1.8	\$ 1.6	\$ 1.5	\$ 1.8	\$ 1.4	\$ 1.2	\$ 1.0	\$ 0.8	\$ 0.8	\$ 13.8
Total Pretax Cash Flow	\$ 79.4	\$ (7.8)	\$ (7.9)	\$ (8.1)	\$ (20.1)	\$ (5.9)	\$ (4.7)	\$ (3.4)	\$ (2.1)	\$ (0.7)	\$ 18.8

Assumptions

(All cash flow assumptions based on a typical portfolio of auto and homeowners contracts)

- \$100 million of premium effective 1/1/06
- Premium paid in full on effective date
- Loss ratio 73%, expense 22%, combined 95%
 - Acquisition expenses 13%
 - Targeted underwriting profit of 5%
- Underwriting cash flows beginning of period
- All other cash flows at end of period
- Loss payout by year
 - 40%, 30%, 10%, 8%, 6%, 4%, 2%
- Investment return of 6%
 - Retained cash flow
 - Capital 50% of premium (or \$50.0) only required in policy year
- Income tax effective rate 30%



Non-Life Insurance Contracts – Revenue Recognition

GNAIE Proposed Non-life Principles

- Written premium is recorded on the effective date of the policy and classified as Unearned Premium (“UPR”).
- Premiums are earned pro-rata over the policy coverage period consistent with the provision of insurance protection services and the release from risk.
- The mechanics of the revenue recognition process in the GNAIE proposed non-life principles is a periodic reclassification from UPR on the balance sheet to Earned Premium on the income statement as risk protection services are provided over the policy (i.e. exposure) period of the contract.

Fair Value (Incorporating GNAIE Observations)

- In a fair value model (either entry or exit value) premium revenue is recognized when written (i.e. at contract inception). GNAIE does not believe this is appropriate as at contract inception, the insurer has provided no insurance protection services from which revenues would be earned or otherwise recognizable (this is also consistent with IAS 18). Moreover, in the event the policyholder were to cancel the contract on “Day 2” it would be entitled to a return of substantially all of its initial premium. Accordingly, GNAIE believes revenue should be recognized in a manner consistent with the provision of insurance protection services (i.e. release from risk).

Non-life Insurance Contracts – Incurred Losses

GNAIE Proposed Non-life Principles

- Incurred losses are recognized based on the estimated ultimate cost of claims that have been incurred at each reporting date, including those that have not yet been reported (“IBNR”).
 - Incurred losses consist of cumulative payments made to settle claims and changes in reserve estimates for claims not yet settled.
 - The cost of claims adjudication (claim employees and related overhead) is also reported as a component of incurred losses.
- Reserve estimates for the cost of claims not yet settled consist of two primary components:
 - **Reported Reserves** - for claims that have been reported, but not settled, and
 - **IBNR** - for claims that have occurred but have not been reported to the reporting entity.
- Reported reserves generally consist of “case-based” reserve estimates set by claim adjustors on individual claims. In addition to case-based reserves, there are generally statistically determined (i.e. based on historical data) supplemental reserves that are held in addition to case reserves. Reported reserves are actuarially determined using generally accepted actuarial methods such as the “chain-ladder” or “Bornhuetter/ Ferguson” methods of estimating ultimate losses from which the amount of losses paid to date are deducted to arrive at reported reserves.
- As payments are made on reported losses, the related reserves are released. Additionally, as claims are reported within a policy period, IBNR reserves are reclassified to reported reserves.
- Reserves are adjusted upward or downward as actual loss experience differs from previously estimated ultimate loss experience (this constitutes “positive” or “negative” reserve development, depending on the direction of the adjustment).
- The impact on calendar year incurred losses from development of prior years’ losses is used as a measure of reserve adequacy and balance sheet strength.
- The ratio of incurred losses to earned premium is commonly referred to the “**Loss Ratio**”.

Non-life Insurance Contracts – Incurred Losses, cont.

Fair Value (Incorporating GNAIE Observations)

- When premiums are written for groups of insurance contracts, the ultimate claim and claim expense estimates are scheduled out on a gross basis. Once the gross cash flows are determined, the following two adjustments are made:
 - The cash flows are “grossed-up” using a risk margin that is theoretically equal to the risk charge that a market participant would require if responsibility for settling the underlying potential claims were transferred to that party. This adjustment would have the affect of increasing reserves – which is consistent with the notion that “additional cash” would be needed to adequately compensate a market participant if the reserves together with the related inherent risks were transferred to a market participant (assuming one existed).
 - In a fair value model, nominal cash flows would also be discounted to reflect the time value of money. There currently exists no perfect clarity as to how this amount should be determined. That is, some have suggested that a risk-free rate be used; however the primary issue is that there should not be any double-counting between the risk margin above the reserve discount factor applied to the estimated nominal reserves.
- In addition to the risk margins and discounting there is also the issue of reserve re-estimates (positive and negative that affect the periodic estimates of nominal reserves as well as the amounts adjusted for risk margins and discount rates).
- Given the inherent uncertainties in the amount and timing of nominal cash flows for non-life insurance contracts, the relatively short period over which they occur, and the fact that there exists no market from which risk margins can be calibrated at contract initiation or any point thereafter, GNAIE believes that nominal reserves should neither be discounted nor should risk margins be applied. The general belief is that the introduction of these factors would only lead to a general decline in the understandability and usefulness of reported information due to the necessary heavy reliance on entity-specific data that would lead to non-comparability between reporting entities and situations where it may be difficult for financial statement readers to readily discern the composition of earnings measures in terms of the amounts generated by actual changes in facts and circumstances as opposed to the correction of prior period estimation errors.

Non-life Insurance Contracts – Acquisition Expenses/Customer Intangible

GNAIE Proposed Non-life Principles

- A customer intangible asset should be established when a policy (or block of policies) is issued, and amortized over time into earnings in relation to the coverage period as the insurer is released from risk.
- The customer intangible reflects the initial investment in the customer relationship provided it can be recovered from future earnings.
- The amount of the customer intangible is limited to the amount of up-front costs that vary with and are primarily related to the acquisition of new and renewal insurance contracts. The costs to acquire auto and homeowners insurance contracts consist primarily of (a) agent remuneration (i.e. commissions), (b) inspection reports (e.g. home inspections, motor vehicle reports, and (c) premium taxes.
- The customer intangible is established as an asset and amortized to expense over the policy coverage period (unless renewal is guaranteed, which is typically not the case with auto and homeowners policies) in the same proportion as premiums are earned.

Fair Value (Incorporating GNAIE Observations)

- Acquisition costs would typically be expensed as incurred as they do not meet the definition of an asset in the IASB's Conceptual Framework. In certain situations, another asset (i.e. customer intangible) may be recognized concurrent with the issuance of a new insurance contract as is described more fully above. At this time, it is unclear whether the amounts that would be deferrable under a customer intangible/fair value model would be equal to that which would be deferrable under the GNAIE proposal.

Non-life Insurance Contracts – Operating Costs and Expenses

GNAIE Proposed Non-life Principles

- Operating costs and expenses (i.e. all expenses other than customer intangible amortization, loss costs, and loss adjustment expenses) are recognized in the income statement as incurred. These costs and expenses primarily include:
 - Salary and benefits of non-claim and non-agent employees;
 - General and administrative costs such as supplies, postage, building depreciation or rent, utilities, equipment, etc.
- The ratio resulting from dividing the sum of operating costs and expenses and the amortization of deferred policy acquisition costs by premiums earned is commonly referred to as the “**Expense Ratio**”

Fair Value (Including GNAIE Observations)

- The nominal cash flows associated with operating costs and expenses (i.e. all expenses other than DAC, loss costs, and loss adjustment expenses) would be scheduled out and discounted in a manner similar to loss and loss adjustment costs. Accordingly, these amounts would be similarly impacted by discounting (but not risk margins) and GNAIE would take a similar position to that which was previously articulated for loss and loss adjustment expenses which is that we would not support the application of discounting as we believe that sufficient uncertainty as it relates to the timing and amount of cash flows exists that would render the resulting measures misleading to financial statement users.

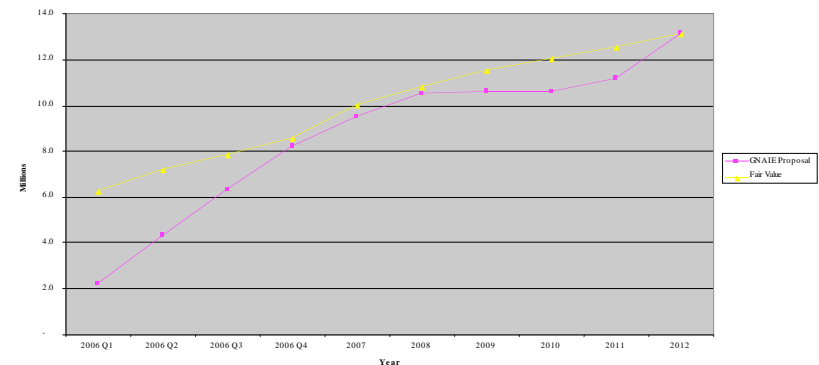
Non-life Insurance Contracts – Underlying Model Assumptions

Assumption		Assumption Basis
GNAIE Non-life Proposal	Fair Value	
\$100 premium written	\$100 premium written	-
Premiums earned pro -rata over policy protection period	Premiums earned when written (discounted if received over time)	Current practice
Loss ratio 73% • 64% losses, 9% expenses	• Same as GNAIE Proposal	Historical experience
Expense ratio 22% • Acquisition expenses 13%	• Same as GNAIE Proposal	Historical experience
Combined ratio 95% • Targeted underwriting profit 5%	• Same as GNAIE Proposal	Historical experience
Cash flows as previously depicted	• Same as GNAIE Proposal	Historical experience
Reserve development • 74% in '09, 75% in '10, 73% in 12 • Prior year development impacts current year	• Same as GNAIE Proposal	Historical experience
-	Discount rate (time value of money)	Treasury yield curve
-	Risk Margin • Stand Ready Obligation 5% • Claims Incurred 2 %	Hypothetical proxy – no market exists to calibrate reasonableness
Investment return 6%	• Same as GNAIE Proposal	Market assumption
Income tax rate 30%	• Same as GNAIE Proposal	Historical experience

Accounting Illustration – GNAIE Non-life Proposed Principles

(\$ in millions)	2006				2007	2008	2009	2010	2011	2012	Total
	Qtr 1	Qtr 2	Qtr 3	Qtr 4							
Written Premium	\$ 100.0	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 100.0
Earned Premium	\$ 25.0	\$ 25.0	\$ 25.0	\$ 25.0	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 100.0
Incurred Losses	\$ 18.3	\$ 18.3	\$ 18.3	\$ 18.3	\$ -	\$ -	\$ 1.0	\$ 1.0	\$ -	\$ (2.0)	\$ 73.0
Amortization of DAC	\$ 3.3	\$ 3.3	\$ 3.3	\$ 3.3	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 13.0
Operating Costs & Expenses	\$ 2.3	\$ 2.3	\$ 2.3	\$ 2.3	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 9.0
	<u>\$ 5.5</u>	<u>\$ 5.5</u>	<u>\$ 5.5</u>	<u>\$ 5.5</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 22.0</u>
Underwriting income/(loss)	\$ 1.3	\$ 1.3	\$ 1.3	\$ 1.3	\$ -	\$ -	\$ (1.0)	\$ (1.0)	\$ -	\$ 2.0	\$ 5.0
Investment Income											
Retained Cash Flow	\$ 1.2	\$ 1.0	\$ 0.9	\$ 0.7	\$ 1.8	\$ 1.4	\$ 1.2	\$ 1.0	\$ 0.8	\$ 0.8	\$ 10.8
Capital	\$ 0.8	\$ 0.8	\$ 0.8	\$ 0.8	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 3.0
	<u>\$ 1.9</u>	<u>\$ 1.8</u>	<u>\$ 1.6</u>	<u>\$ 1.5</u>	<u>\$ 1.8</u>	<u>\$ 1.4</u>	<u>\$ 1.2</u>	<u>\$ 1.0</u>	<u>\$ 0.8</u>	<u>\$ 0.8</u>	<u>\$ 13.8</u>
Total Income Before Taxes	\$ 3.2	\$ 3.0	\$ 2.9	\$ 2.7	\$ 1.8	\$ 1.4	\$ 0.2	\$ (0.0)	\$ 0.8	\$ 2.8	\$ 18.8
Income taxes	\$ 0.9	\$ 0.9	\$ 0.9	\$ 0.8	\$ 0.5	\$ 0.4	\$ 0.0	\$ (0.0)	\$ 0.3	\$ 0.8	\$ 5.6
Net Income	\$ 2.2	\$ 2.1	\$ 2.0	\$ 1.9	\$ 1.3	\$ 1.0	\$ 0.1	\$ (0.0)	\$ 0.6	\$ 2.0	\$ 13.2

Cumulative Net Income



Cumulative ROE	2006 Q1	2006 Q2	2006 Q3	2006 Q4	2007	2008	2009	2010	2011	2012
GNAIE Proposal	4.2%	8.0%	11.3%	14.2%	16.0%	17.4%	17.5%	17.5%	18.3%	20.8%
Fair Value	11.2%	12.6%	13.6%	14.7%	16.7%	17.8%	18.7%	19.5%	20.1%	20.8%



Accounting Illustration – Fair Value

(\$ in millions)	2006				2007	2008	2009	2010	2011	2012	Total													
	1/1/2006	Qtr 1	Qtr 2	Qtr 3								Qtr 4												
Balance Sheet																								
Cash & Investments	\$	77.5	\$	67.9	\$	58.4	\$	48.8	\$	30.2	\$	24.1	\$	19.3	\$	16.0	\$	14.1	\$	13.2				
Stand Ready																								
Best Estimate	\$	(73.0)	\$	(54.8)	\$	(36.5)	\$	(18.3)	\$	-	\$	-	\$	-	\$	-	\$	-	\$	-	\$	-		
Discounting	\$	3.6	\$	3.0	\$	2.1	\$	1.0	\$	-	\$	-	\$	-	\$	-	\$	-	\$	-	\$	-		
Risk Margin	\$	(1.4)	\$	(1.0)	\$	(0.7)	\$	(0.3)	\$	-	\$	-	\$	-	\$	-	\$	-	\$	-	\$	-		
Claims Provision																								
Best Estimate	\$	-	\$	(11.0)	\$	(21.9)	\$	(32.9)	\$	(43.8)	\$	(21.9)	\$	(14.6)	\$	(9.8)	\$	(6.4)	\$	(3.5)	\$	-		
Discounting	\$	-	\$	0.6	\$	1.2	\$	1.8	\$	2.6	\$	1.7	\$	1.1	\$	0.7	\$	0.4	\$	0.1	\$	-		
Risk Margin	\$	-	\$	(0.5)	\$	(1.0)	\$	(1.6)	\$	(2.1)	\$	(1.0)	\$	(0.7)	\$	(0.5)	\$	(0.3)	\$	(0.2)	\$	-		
Equity	\$	13.8	\$	11.1	\$	8.2	\$	5.5	\$	9.0	\$	9.9	\$	9.8	\$	9.7	\$	10.6	\$	13.2				
Written Premium	\$	100.0	\$	-	\$	-	\$	-	\$	-	\$	-	\$	-	\$	-	\$	-	\$	-	\$	-	\$	100.0
Stand Ready	\$	(70.8)	\$	10.9	\$	10.8	\$	10.9	\$	10.7	\$	-	\$	-	\$	-	\$	-	\$	-	\$	-	\$	(27.5)
Unwind Discount Rate	\$	(0.6)	\$	(0.9)	\$	(1.1)	\$	(1.0)	\$	-	\$	-	\$	-	\$	-	\$	-	\$	-	\$	-	\$	(3.6)
Release from Risk Margin	\$	0.4	\$	0.3	\$	0.3	\$	0.3	\$	-	\$	-	\$	-	\$	-	\$	-	\$	-	\$	-	\$	1.4
Claims Expense Incurred	\$	-	\$	(10.9)	\$	(10.8)	\$	(10.9)	\$	(10.7)	\$	-	\$	-	\$	-	\$	-	\$	-	\$	-	\$	(43.3)
Unwind Discount Rate	\$	0.6	\$	0.6	\$	0.6	\$	0.8	\$	(0.9)	\$	(0.6)	\$	(0.4)	\$	(0.3)	\$	(0.3)	\$	(0.3)	\$	(0.1)	\$	-
Release from Risk Margin	\$	(0.5)	\$	(0.5)	\$	(0.5)	\$	(0.5)	\$	1.1	\$	0.3	\$	0.2	\$	0.2	\$	0.1	\$	0.2	\$	-	\$	-
DAC	\$	13.0	\$	-	\$	-	\$	-	\$	-	\$	-	\$	-	\$	-	\$	-	\$	-	\$	-	\$	13.0
Operating Costs & Expenses	\$	8.9	\$	0.0	\$	0.0	\$	-	\$	-	\$	-	\$	-	\$	-	\$	-	\$	-	\$	-	\$	9.0
	\$	21.9	\$	0.0	\$	0.0	\$	-	\$	-	\$	-	\$	-	\$	-	\$	-	\$	-	\$	-	\$	22.0
Underwriting income/(loss)	\$	7.3	\$	(0.2)	\$	(0.4)	\$	(0.7)	\$	(0.4)	\$	0.2	\$	(0.3)	\$	(0.2)	\$	(0.1)	\$	(0.1)	\$	0.0	\$	5.0
Investment Income																								
Retained Cash Flow	\$	-	\$	1.2	\$	1.0	\$	0.9	\$	0.7	\$	1.8	\$	1.4	\$	1.2	\$	1.0	\$	0.8	\$	0.8	\$	10.8
Capital	\$	-	\$	0.8	\$	0.8	\$	0.8	\$	0.8	\$	-	\$	-	\$	-	\$	-	\$	-	\$	-	\$	3.0
	\$	-	\$	1.9	\$	1.8	\$	1.6	\$	1.5	\$	1.8	\$	1.4	\$	1.2	\$	1.0	\$	0.8	\$	0.8	\$	13.8
Total Income Before Taxes	\$	7.3	\$	1.7	\$	1.3	\$	0.9	\$	1.1	\$	2.0	\$	1.1	\$	1.0	\$	0.8	\$	0.7	\$	0.8	\$	18.8
Income taxes	\$	2.2	\$	0.5	\$	0.4	\$	0.3	\$	0.3	\$	0.6	\$	0.3	\$	0.3	\$	0.2	\$	0.2	\$	0.2	\$	5.6
Net Income - Fair Value	\$	5.1	\$	1.2	\$	0.9	\$	0.7	\$	0.8	\$	1.4	\$	0.8	\$	0.7	\$	0.6	\$	0.5	\$	0.6	\$	13.2
Net Income - GNAIE Proposal	\$	-	\$	2.2	\$	2.1	\$	2.0	\$	1.9	\$	1.3	\$	1.0	\$	0.1	\$	(0.0)	\$	0.6	\$	2.0	\$	13.2

See Observations Re: Accounting Illustration at Page 17

The above example was not designed to address “excess” covers wherein the fair value of an excess writer’s risk is directly affected by loss events that occur in retained or subordinate layers.



Observations Re: Accounting Illustrations

- **Income Recognition**
 - Application of the fair value paradigm results in the recognition of up-front profit before such time as any insurance protection services are provided by the insurance company. GNAIE does not believe this is appropriate and that contract premium should be recognized in a manner consistent with the provision of insurance protection services.
 - The recognition of income prior to the provision of insurance protection services is inconsistent with IAS 18.
 - Recognition of total contract premium on “day 1” (as opposed to over the coverage/contract period) ignores the fact that premiums are generally proportionally rebateable at any time to the customer upon cancellation of the contract prior to its contractual expiration.
- **Fair Value Assumptions**
 - Key underlying assumptions such as the “margin for risk” are neither directly or indirectly observable in the market and as such to the extent they are used must be estimated using principally entity specific data that is neither verifiable by reference to market observable data nor is it neutral (to the extent it is entity specific).
- **Relevance and Reliability**
 - The inability to calibrate fair value assumptions with market observable data results in the production of periodic modeled results which are of questionable relevance and reliability. Moreover, due to the reliance on entity-specific factors, GNAIE assumes comparability between companies would also be an issue.

Conclusion

**Fair Value – Appropriate Measurement
Basis for Investments but not for
Insurance Contracts**

Fair Value – Appropriate Measurement Basis for Investments but not Non-life Insurance Contracts

- Fair value is an appropriate measurement basis whenever there are (a) quoted prices for identical assets and liabilities in active markets or (b) there are quoted (i.e. observable market) prices available for similar assets and liabilities from which fair values may be calibrated.
- In the absence of the above, fair value must be estimated using models that attempt to replicate hypothetical transactions in hypothetical markets between hypothetical market participants.
- GNAIE does not believe the latter measurement basis should be applied to non-life insurance contracts as it does not meet a minimum reliability threshold as it would not be either verifiable or neutral.

Non-life Insurance and Investment Risk

- Little correlation between investment risk and insurance risk
- **Investments** - Underlying risks affecting the value of most investments are generally directly or indirectly observable in the marketplace (See Page 21 for inventory of investment risks). Because of the existence of market observable data inputs, investment valuation models yield measurements that are inherently reliable.
- **Insurance** – Underlying risks affecting the value of most insurance contracts are generally not directly or indirectly observable in the marketplace (See page 22 for inventory of insurance risks). Uncertainty as to the timing and amount of insurance cash flows and the lack of observable market data inputs renders insurance valuation models inherently much less reliable than investment valuation models.

Investment Risk Factors

- Inflation
- Interest rate level
- Yield curve steepness
- Call/prepayment
- Credit default
- Credit spread
- Liquidity
- Equity
- Currency spot rates
- Currency forward rates
- Real estate
- Counterparty
- Basis risk
- Correlation

Non-life Insurance Risk Factors

- Claim risks
 - Catastrophe
 - Long term trend
 - Uncertain level
 - Volatility
- Persistency
 - Premium payment
 - Partial withdrawal
- Legal risk
 - Reinterpretation of contracts
 - Changing regulation
- Distribution risks
 - Customer selection
 - Agent influence
 - Sales volume/mix
- Customer behavior
 - Antiselection at point of sale
 - Exercise of options
 - Ancillary benefits
- Expense risk
 - Underwriting
 - Claim settlement

Relevance of Fair Value – Investments v. Non-life Insurance

- **Applying a fair value measurement attribute to investments is highly relevant (i.e. it provides decision-useful information to financial statement users).**
 - Presence of observable market transactions for the same or similar contracts after issuance.
 - Presence of observable market inputs to valuation models, if no direct observable transactions.
- **Applying a fair value measurement attribute to insurance contracts lacks relevance (i.e. it does not provide decision-useful information to financial statement users).**
 - Lack of observable market transactions for the same or similar contracts after issuance. Inputs must then be entity specific which results in them not being neutral.
 - Significant inputs to the valuation models are unobservable (more so for non-life than life) and therefore not verifiable.
 - Most insurance contracts are settled (with the claimant or beneficiary), rather than legally transferred to another insurer.
 - GNAIE believes that for information to be relevant it must meet a minimum threshold of reliability that would not be met when fair valuing insurance contracts.