



Traditional Measurement Approach

Technical position of the HUB Group on Insurance Contracts

The following report on allowing the “Traditional Measurement Approach” reflects a proposal by the HUB global insurance group. This technical paper is being provided to members and staff of the IASB and FASB to assist them in understanding the proposal prior to the Insurance Working Group meeting on 24 March 2011.

This paper provides additional detail on why the traditional measurement approach should be allowed referencing back to the HUB Group’s Insurance Industry Proposal Discussion Draft dated 22 March 2011.

As with all our documents, comments from the public are welcome.

I. Objective

We support the Building Blocks Approach (BBA) for P&C business under the condition that the traditional measurement approach, which we refer to in the following as the Unearned Premium Approach (UPA)¹, is made available. Either approach must be applied consistent with the business model of the insurer.

- ❖ The traditional UPA approach is time tested, well understood, accepted and not broken.
- ❖ The undiscounted underwriting margin is the most important and relevant key performance indicator of the P&C industry and forms the basis of the most relevant KPI combined ratio.
- ❖ Accounting should follow the business model. Insurers applying an undiscounted business model should be allowed to measure short-duration insurance contracts in a manner consistent with existing global practice. Discounting P&C claims reserves is not necessary in order to provide useful information and should be required only when it reflects the P&C business model used by a company (as explained in the Business Model paper).
- ❖ For companies who have been using the UPA for many years, the operational costs of converting systems and procedures to the BBA will far outweigh the benefits. Allowing the UPA as an alternative also addresses the operational difficulties of explaining interest rate volatility in externally reported results, when the business is not managed on a discounted basis for internal management purposes.
- ❖ The BBA method proposed by the IASB is feasible but entails operational difficulties and only provides additional relevant and reliable information for investors on P&C business when the business is managed on a discounted basis:

¹ Some refer to the UPA only regarding the pre-claims liability. However, in this paper the term UPA is used for the pre-claims liability and the claims reserves. On an undiscounted basis, without an explicit risk margin, we consider this as the traditional measurement approach.

- Discounting of short-tail liabilities is costly and, due to the small impact, inconsequential.
- Long-tail liabilities arising from claims such as asbestos, personal injuries, professional liabilities are characterized by long and difficult to project payment patterns as well as highly volatile claim amounts. Both characteristics limit the information value of the discount.
- Duration mismatch, which becomes visible through discounting, is the wrong measure to assess the quality of the asset-liability management for P&C insurance. In fact, showing the mismatch can overshadow the volatility of cash flows which is the more important measure of the P&C business.

In summary, a measurement approach that is theoretically correct but which does not produce additional useful information, should not be mandatory. P&C entities must be granted the alternative to stay with their existing measurement approach (which includes the UPA) that faithfully reflects their business model. The use of the traditional measurement approach should be unconditional and irrevocable, unless the business model changes (considered to be a rare occurrence).

II. The well understood, tested and accepted accounting model for P&C, the Unearned Premium Approach (UPA), is not broken.

The insurance industry has been using the UPA for the P&C business for many years. The combination of (a) Unearned Premium Reserve (UPR), which leads to revenue recognition over the coverage period as risk protection is provided, and (b) undiscounted claims reserves based on historical experience, is well understood by users, and leads to appropriate accounting and reporting of performance results.

Since the IASB Exposure Draft (“the ED” and “ED”) did not ask constituents about their opinion regarding the traditional UPA, comment letters tended not to specifically address it. However, several important constituents raised significant concerns regarding the proposed Premium Allocation Approach (PAA) and the criteria for its application. A sample of comments reveal the following excerpts from comment letters indicating that the approach proposed for P&C business in the ED is complex and controversial:

- ❖ The European Federation of Financial Analyst Societies (EFFAS) states that they: “[...] would be in favour of requiring a modified measurement approach for short term nonlife liabilities. It does not make much sense to want to discount liabilities which do not run very long. By requiring this approach we assure that there is comparability.” (CL140, p6)
- ❖ The German Accounting Standards Board (GASB) does not see the premium allocation approach, as proposed in the ED, as a simplified approach. One reason for this is that discounting is required. The GASB believes: “[...] that the benefit of mandatory discounting of future premiums arising within insurance contracts with a coverage period of approximately one year or less does not exceed any reasonable cost-benefit threshold.” (CL213, p18)
- ❖ KPMG suggests: “To remove some of the added complexities, we suggest removing the requirement for discounting the present value of premiums in the pre-claims period and similarly removing the requirement to accrete interest on the pre-claims liability.” (CL149, p22)

- ❖ The Group of North American Insurance Enterprises (GNAIE) states: “[...] the PAA is not a simplified approach, and it is likely to produce results that do not differ materially from the current Unearned Premium Reserve (UPR) approach, which does not consider discounting or interest accretion. The PAA is overly complicated with no reporting benefits or insights compared to the well known UPR approach applied throughout the world. [...] the PAA should be simplified to remove the discounting and interest accretion, neither of which contribute materially to the result for short duration contracts [...] Accordingly, we strongly favor continuing the use of a UPR methodology which is already in place around the globe.” (CL1A, p5, 26)

III. The undiscounted underwriting margin is the most important performance indicator and has to stay unchanged. It should not be replaced by a complicated² accounting model.

In general, financial statement users rely primarily on ultimate (i.e., undiscounted) values, particularly where such measurements are consistent with the underwriting, monitoring, incentive management, and reporting of the insurer, and because ultimate values are more understandable, reliable, and comparable as they are unaffected by periodic interest rate fluctuations. In line with that, many insurance companies manage their P&C business based on performance metrics calculated on an undiscounted basis. For these companies, the undiscounted underwriting margin is the key performance indicator, both internally and externally communicated, which is universally regarded as decision useful information. This is supported by the comment letter quotes mentioned above.

Additionally, performance measurement should not be driven by something that is not within the control of the insurer. For example, calculated premium and underwriting decisions are under the entity’s control. On the other hand, while it can be argued that time value of money may be indirectly included in pricing for some lines of business, and some may argue that it is theoretically more sound, the more persuasive counter-argument is that the time value of money is not under the control of the entity and thus changes in the time value of money would cause random distortions to performance measurement and would not provide decision-useful information to investors. The following sections provide several interesting examples of distorted performance due to discounting.

IV. Discounting, even for long-tail liabilities, does not provide decision useful information since payout periods are long, and reliable claim payments estimations are not available.

In staff paper 3E/58E, the staff recommends that discounting should be required for long-tail claims notwithstanding that it is questionable *if* the insurer will have to pay, *when* it will have to pay, or *how much* it will pay. The main reason for this recommendation is, that the staff believes that “insurers do maintain data and produce claim payment development tables” and in consequence, those liabilities are reasonably determinable so that discounting is justified. Based on this, the IASB and FASB unanimously decided tentatively on their meeting on March 1-2, 2011 to require discounting for all non-life long-tail claims.³

² The Premium Allocation Approach, as proposed in the ED, has been criticized as too complicated in particular for the following reasons: Discounting the unearned premium reserve, introduction of a risk margin, accretion of interest on the risk margin, complex onerous contract test, current measurement for UPR, recognition principle.

³ IASB Update 1 and 2 March 2011, and staff paper 3E/58E Discounting Non-life Contract Liabilities for the IASB meetings in February and March 2011, in particular par. 29-33.

While an insurance company maintains historical development tables based on incurred and paid claims, it does not maintain claim development tables that reflect *expected* payment dates. The following example illustrates that a typical situation is one in which reliable and/or relevant claim payment estimations or development tables do not exist and therefore future cash flow timing is not reasonably determinable. This is relevant for most volatile long-tail businesses with long and quite variable payout periods, e.g., medical malpractice, product liability, excess of loss reinsurance, personal injury, etc.

For example, assume a portfolio of asbestos claims where the claims might be between 1 million and 1 billion and paid some time within 15 years, but there is no additional information and it is clear that more substantiated information will not be available for several years. Based on actuarial techniques, the nominal claim reserve is estimated at 100 million, payable in 12 years. If that amount is discounted with an observed current interest rate of 3%, the present value to be reported is a claims reserve of 70.1 million. If, at the next reporting date the interest rate is decreased to 2.5%, the new liability would be 74.4 million, i.e. a loss of 4.3 million is reported.⁴ Additionally, if there is an increase in the interest rate back to 3% at the next reporting date, a gain would be recognized. Therefore, considering the aggregate of the two measurement periods overall, nothing of economic substance occurred but significant income statement volatility would have been recognized which would not aid an investors understanding of the business.

Furthermore, it could come up in period 5 that the claims are to be settled in year 17 instead of in year 12. Assuming a discount rate of 3%, this means that claim reserves will be reduced to 68.1 million instead of 81.3 million which were the value without this change in assumptions in period 5. The magnitude of this adjustment is even more significant than the previously illustrated discounting impact.

This example shows that discounting P&C claims reserves does not always produce relevant information for the following reasons:

- ❖ As explained above, a P&C insurer's performance assessment should not be driven by something that is not in the control of the insurer. The discounting impact is only temporary and will unwind over time. Once claims becomes due, the insurer has to settle the ultimate amount of the claim. Also changes in discount rate will be offset once the trend of interest rates changes again.
- ❖ P&C insurers do not necessarily have the intent to be duration matched. In the above example, any claim could become payable at any time within the next 15 years. If an insurer intended to be duration matched to the degree possible, that insurer would probably invest in assets with a duration reflecting the most likely point of time claims becomes due, e.g. 12 years. But this does not happening in practice because any particular claim can become payable at any time and thus, a P&C insurer must hold a significant cash flow buffer. It therefore invests in assets with shorter durations and creates a duration mismatch. In consequence, duration mismatch is a wrongly considered part of the performance measurement relative to a P&C insurer. The asset-liability management of a P&C insurer must reflect the highly volatile payment estimation of P&C liabilities. Due to the high variance of expected cash flows, the duration value is merely a mathematical value, which cannot be used for opera-

⁴ This example has been taken with very similar numbers from Engeländer/Kölschbach (KPMG), Discounting of Insurance Contract Liabilities.

tional purposes. The economic value of duration mismatch does not provide additional useful information for investors.

Moreover, the interest rate used in the discounting process is, to some extent, based on current interest rate curves. It is noteworthy that since January 1, 2000, of the 44 calendar quarters within this period, there have been 42 quarterly interest rate changes in the United States alone and the variations from high to low have exceeded several hundreds of basis points. That has occurred directionally twice, i.e., there have been two extremes of peaks and valleys. Thus, the estimate of anticipated future investment income has a wider band of variability than commonly assumed. That volatility is not reflective of management performance.

Some have claimed that discounted values have been around for a while in certain countries, with few if any resulting problems. An analysis of one such country has found companies that are updating the liability due to changing yields are offsetting the impacts with changes in selected risk margins. Hence, we are sceptical that anyone has found the proposed discounting approach with its inherent added volatility to the key underwriting performance measures due to interest rate fluctuations, decision-useful. This process only adds complexity for both the preparer and the users, and the latter will undoubtedly have to spend a lot of time analyzing changes in balance sheet positions to assess whether any ‘real’ change (e.g. actual payouts differing from original estimates) occurred.

V. The traditional UPA delivers very reasonable results. This is because the duration mismatch, which becomes transparent through discounting, is of minor usefulness compared to the volatility of cash flows. The duration is simply a mathematical value which does not provide decision-useful information.

The following example demonstrates that the UPA delivers very reasonable results when considering changes in assumptions. The following two changes will be considered: The interest rate decreases from 5% to 3.5% in t2. Second, in t3, the cash flow assumptions for period t4 and t5 changes as well. Instead of 50 and 25, cash outflows of 85 and 60 will be expected.

The impact of these changes will be considered in the using the following accounting alternatives:

- Alternative 1:** BBA in combination with assets at fair value through P&L (current – current)
- Alternative 2:** BBA through OCI in combination with assets at fair value through OCI (OCI – OCI)
- Alternative 3:** UPA in combination with measuring assets at amortized cost according to IFRS 9
- Alternative 4:** BBA in combination with measuring assets at amortized cost according to IFRS 9

The following table shows the cash flow pattern for the example:

Table 1: Cash flow pattern for the example

	Inception	t1	t2	t3	t4	t5	t6	Total
Premium inflow	1000	0	0	0	0	0	0	1000
Claims payment	0	-300	-200	-100	-50	-25	-25	-700
Increase in cash flows	0	-300	-200	-100	-85	-60	-25	-770

As seen in the tables below, these two changes illustrate that change in the interest rate has a relatively low impact compared to the change in cash flows. In consequence it is rather questionable whether the operational effort for introducing discounting into the systems is justifiable. It is rather important to make changes in cash flow expectations transparent.

In the example, it is assumed that the portfolio is fully duration matched on the asset side by zero coupon bonds. The example is for illustrative purposes and therefore simplified; for example, no risk adjustment is considered. The following table shows P&L and Balance Sheet for the base case using the UPA, which assumes expected and actual cash flows are equivalent:

Table 2: Base case using the UPA (no discounting)

	Inception	t1	t2	t3	t4	t5	t6	Total
P&L								
Premiums earned	0	1000	0	0	0	0	0	1000
Claims expense	0	-700	0	0	0	0	0	-700
Underwriting margin	0	300	0	0	0	0	0	300
Interest earned	0	35	22	13	8	6	5	90
Net income	0	335	22	13	8	6	5	390
Balance sheet								
Assets (Bond, Cash)	1000	435	257	170	128	109	90	
Unearned premium reserve	-1000	0	0	0	0	0	0	
Claims reserve	0	-400	-200	-100	-50	-25	0	
Liabilities	-1000	-400	-200	-100	-50	-25	0	
Equity	0	35	57	70	78	84	90	

The following table shows P&L and Balance Sheet for the base case using the BBA:

Table 3: Base case using the BBA

	Inception	t1	t2	t3	t4	t5	t6	Total
P&L								
Release residual margin	0	367	0	0	0	0	0	367
Underwriting margin	0	367	0	0	0	0	0	367
Accretion of interest	0	-32	-18	-9	-5	-2	-1	-67
Interest earned from assets	0	35	22	13	8	6	5	90
Net income	0	370	4	4	4	4	4	390
Balance sheet								
Assets (Bond, Cash)	1000	435	257	170	128	109	90	
BEL (Claims reserve)	-633	-365	-183	-92	-46	-24	0	
Residual margin	-367	0	0	0	0	0	0	
Liabilities	-1000	-365	-183	-92	-46	-24	0	
Equity	0	70	74	78	82	86	90	

Below, based on these base cases and considering various accounting alternatives (UPA and BBA in combination with assets at fair value through P&L, through OCI, and at amortized cost), the following analyzes the impact of the changes in assumptions: The change in interest rate leads to an increase in the insurance liability of 5. This will be compensated by a change of fair value of assets of 9, in cases where assets are held at fair value. The change in cash flow assumptions leads to a much higher increase of the liability of 66.

Alternative 1: BBA in combination with assets at fair value through P&L (current – current):

The impact from discount rate movements makes the duration mismatch visible in the P&L. However, in P&C, depending on the portfolio, the variability of the projected cash flows is very high. Because of this, the duration becomes less relevant and only a mathematical value. It does not provide useful information about the ability of the insurer to cover the risk of changes in the cash flows, to settle future claims, or to deal with a duration mismatch that may occur due to changes in the cash flows. Therefore it is not useful to reflect those changes in P&L, especially as regards cost-benefit considerations. In addition, the P&L is subject to short-term volatility resulting from unusual market

movements (e.g. high corporate bond spreads, government spreads). This is generally criticized as outlined in the HUB paper.

The following example demonstrates that in period 2 the discount rate decreases from 5% to 3.5%. This leads to a net increase of net income of 4 in period 2. In period 3 it becomes known that the cash outflows will be in total 10% higher than originally expected. The change in estimates leads to a decrease of net income of 66. Compared to the impact of the interest rate shift, this is a very high impact and it is questionable whether it is meaningful to additionally show the impact from the interest rate shift at all. Also, this additional information will generate additional costs to implement discounting into electronic systems. Because the impact is comparably low, this seems to be unjustifiable.

Table 4: Current-current measurement with a decrease of the interest rate from 5% to 3.5% in t₂ and an increase of expected claims payments in t₃

	Inception	t1	t2	t3	t4	t5	t6	Total
P&L								
Release of residual margin	0	367	0	0	0	0	0	367
Change in estimates (Cash flows)	0	0	0	-66	0	0	0	-66
Underwriting margin	0	367	0	-66	0	0	0	301
Accretion of interest	0	-32	-18	-7	-6	-3	-1	-66
Change in estimates (Interest rate)	0	0	-5	0	0	0	0	-5
Interest earned from assets	0	35	22	13	8	6	5	90
Change in fair value	0	0	9	0	0	0	-9	0
Net income	0	370	8	-60	3	4	-5	320
Change in % compared to scenario without the change in interest and cash flows			124%	-1728%				
Balance sheet								
Assets (Bond, Cash)	1000	435	266	179	102	49	20	
BEL (Claims reserve)	-633	-365	-188	-161	-81	-24	0	
Residual margin	-367	0	0	0	0	0	0	
Liabilities	-1000	-365	-188	-161	-81	-24	0	
Equity	0	70	78	18	21	25	20	

Alternative 2: BBA through OCI in combination with assets at fair value through OCI (OCI – OCI): This alternative is similar to Alternative 1 but the interest rate change would be shown in OCI. This is possible as the equity is larger and therefore better able to digest volatility. However, the explanation is the same: it would not lead to more meaningful information to show any duration mismatch in the P&C business.

Alternative 3: UPA in combination with measuring assets at amortized cost according to IFRS 9: This alternative is not sensitive to interest rate movements and is therefore acknowledging that the duration mismatch in the P&C business is not very meaningful. In contrast, changes in cash flows would still be visible in this alternative which should be more decision-useful. Therefore, it is appropriate not to discount.

The following example, including the same changes in discount rate and cash flow estimation demonstrates that the change in discount rate plays a minor role and does not make the information more useful.

Table 5: Measurement using the UPA in combination with assets at amortized cost; decrease of the interest rate from 5% to 3.5% in t₂ and increase of expected claims payments in t₃

	Inception	t1	t2	t3	t4	t5	t6	Total
P&L								
Premiums earned	0	1000	0	0	0	0	0	1000
Claims expense	0	-700	0	0	0	0	0	-700
Change in estimates	0	0	0	-70	0	0	0	-70
Underwriting margin	0	300	0	-70	0	0	0	230
Interest earned	0	35	22	13	8	6	5	90
Net income	0	335	22	-57	8	6	5	320
Balance sheet								
Assets (Bond, Cash)	1000	435	257	170	93	39	20	
Unearned premium reserve	-1000	0	0	0	0	0	0	
Claims reserve	0	-400	-200	-170	-85	-25	0	
Liabilities	-1000	-400	-200	-170	-85	-25	0	
Equity	0	35	57	0	8	14	20	

Alternative 4: BBA in combination with measuring assets at amortized cost according to IFRS 9: In contrast to alternative 3, the BBA can be applied. However, even if changes in the discount rate take place, the BBA would come to quite similar results as the UPA because the change in discount rate is relatively small compared to the change in cash flows. Therefore it is not appropriate to require discounting.

Table 6: Measurement using the BBA in combination with assets at amortized cost; decrease of the interest rate from 5% to 3.5% in t₂ and increase of expected claims payments in t₃

	Inception	t1	t2	t3	t4	t5	t6	Total
P&L								
Release of residual margin	0	367	0	0	0	0	0	367
Change in estimates (Cash flows)	0	0	0	-66	0	0	0	-66
Underwriting margin	0	367	0	-66	0	0	0	301
Accretion of interest	0	-32	-18	-7	-6	-3	-1	-66
Change in estimates (Interest rate)	0	0	-5	0	0	0	0	-5
Interest earned from assets	0	35	22	13	8	6	5	90
Net income	0	370	-1	-60	3	4	5	320
Balance sheet								
Assets (Bond, Cash)	1000	435	257	170	93	39	20	
BEL (Claims reserve)	-633	-365	-188	-161	-81	-24	0	
Residual margin	-367	0	0	0	0	0	0	
Liabilities	-1000	-365	-188	-161	-81	-24	0	
Equity	0	70	69	9	12	15	20	

Indeed, depending on an entity's business model, BBA and UPA deliver relevant, reliable and understandable results in terms of P&L and value of liabilities. However, for those companies who manages its P&C business on an ultimate basis, discounting P&C claims reserves is not justifiable for the following reasons:

- ❖ Generally, discounting adds complexity to the already existing accounting model.
- ❖ The impact of changes in discount rate is usually relatively small compared to changes in cash flows because P&C claims liabilities are usually difficult to estimate. In consequence it is more relevant for users to get information on changes in cash flows.

- ❖ Discounting makes the duration mismatch transparent. As explained above, P&C insurers are usually not duration matched in order to adequately address the possibility of changes in cash flows. In consequence it is the wrong measure for P&C insurers and should not be required.
- ❖ As the above example shows, discounting and the information about change in discount rates is of limited usefulness. In consequence the costs of changing current accounting practices do not outweigh the benefits.

VI. Business models differ and should determine whether a company needs to show the discounting impact

These examples demonstrate that discounting is not necessary at all and may not even lead to relevant information. However, some companies do discount today and would like to use the BBA. Business models do matter and should define how a company reports its results. As such, we support granting an alternative to allow an entity to continue using its existing UPA approach, based on its business model, as outlined in the Business Model paper.