

# **The Group of North American Insurance Enterprises**

## **Discussion Paper**

### **Settlement Value as a Measurement Attribute for Life Insurance**

#### **Introduction**

This discussion paper (“Settlement Value As A Measurement Attribute for Life Insurance”) has been developed by the GNAIE Technical Committees from a life insurance perspective in response to questions raised by the IASB staff in its Agenda Paper 3 for the April 1-2 meeting of the Insurance Working Group. (A separate discussion paper has been prepared by the GNAIE Technical Committees from a non-life insurance perspective.) In addition, IASB staff asked for any additional information on these topics that might be of assistance to them in advancing 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. This discussion paper and others will also be posted on the GNAIE Website, along with any other contributions of documents or ideas.

#### **Questions and Responses**

**Paragraph 28, Question 1: Should the Board consider adopting the notion of a settlement value as a measurement attribute for insurance liabilities? If you answer yes, please also answer the following questions:**

**(a) Is settlement value the right name for the notion you have in mind? If not, what name would you suggest, and why?**

No. We do not believe that the notion of settlement value that the Board generally uses is applicable to insurance contracts. We propose that the measurement attribute (for life insurance) should be the present value of all expected cash flows that the insurer anticipates over the future life of the contract, taking into account the most relevant and reliable available market and entity-specific information. Some comment letters that were sent to the Board referred to such a measurement basis in terms that include the notion of “settlement”. Before considering the issues presented in Agenda Paper 3 for the IWG meeting, it is **CRITICALLY IMPORTANT** to understand the differences between “settlement value” as the term is generally used by the Board and the expected cash flows from insurance contracts, which some respondents referenced in terms related to “settlement”.

The following two examples from recent IASB documents describe the notion of “settlement value” as we believe it is generally used by the Board.

1. According to the comments on “Liabilities amendments to IAS 37” in the February 2008 “IASB Update”, the Board tentatively decided “To clarify that ‘settle’ means to settle by paying the counterparty at the balance sheet date”.

2. In the material the IASB sent to external reviewers (February 11, 2008) for the standard-by-standard review that is part of the Fair Value Measurement project, “current exit price” is defined to be “the price that would be received to sell an asset or paid to transfer or settle a liability in an orderly transaction between market participants at the measurement date. If a liability is transferred to a third party, it is assumed to exist beyond the measurement date. If a liability is settled with the counterparty, it ceases to exist at the measurement date. This is similar to the SFAS 157 definition of fair value.”

In both of these examples, “settlement” requires a transaction at the measurement date in which the liability is extinguished. This notion of settlement is rarely applicable to insurance contracts, because of legal constraints in most countries and because of the commercial intent of both insurers and policyholders. An insurance liability continues beyond the measurement date, but the liability is rarely, and often cannot be, transferred.

Insurance contracts are generally settled between the insurer and the policyholder over a period of time following the measurement date. It is important to come up with a name for a measurement attribute that fits this expected basis of liability resolution in order to limit confusion with the settlement and transfer notions that are generally used by the Board. We suggest referring to such measurement as a “contract fulfillment value”; but other terms different than settlement value or transfer value, or current exit value, could also work.

This measurement basis is correctly described in Paragraph 9 of the Agenda Paper, as “a measurement that reflects the fact that the insurer intends (and in most cases must) settle the liability by paying policy benefits as they fall due, rather than by transferring the liability to a third party”. The Agenda Paper then notes (also correctly) that “some respondents use ‘settlement value’ or something similar to describe this notion”. We are concerned that attaching such names to this measurement basis results in confusion with “settlement value” as the term is generally used by the Board. Therefore, we have answered “NO” to Question 1(a) in Paragraph 28 of the Agenda Paper.

The Agenda Paper (also in Paragraph 9) notes that “no response gives anything like a rigorous definition of settlement value”. We believe the appropriate measurement basis (which we describe above as a “contract fulfillment value”) certainly CAN be described rigorously. In fact, we firmly believe that the measurement attribute above provides far better answers to the four questions in Paragraph 28(b) of the Agenda Paper than can be provided by the current exit value measurement basis described in the Discussion Paper. In addition, there are three reasons given in Paragraph 24 of the Agenda Paper for why it is important to define a measurement attribute “in a rigorous and concise way”. We will also demonstrate, in our response to Question 2 below, why the measurement basis that we propose addresses the criteria in Paragraph 24 better than they could be addressed by a current exit value.

We see no value in creating artificial transactions that do not exist, and that generally cannot exist in the market, to describe the measurement basis. Two such artificial creations are described in Paragraph 22 of the Agenda Paper (the “mirror image insurer” notion and the “amount the insurer would rationally pay at the reporting date to settle the liability with the policyholder or to transfer it to another insurer”). We think the “mirror image insurer” basis may lead to the same measured value as the measurement we propose; but we do not see benefits in

adding an artificial construction to something that could be valued based on actual observed experience. Additionally, we are concerned that there may be added complexity and costs in implementing and verifying/auditing results based on such an artificial construct.

**(b) How should that notion be defined?**

We would define the measurement attribute (for life insurance) as the present value of all expected cash flows that the insurer anticipates over the life of the contract, taking into account the most relevant and reliable available market and entity-specific information.

How would that definition result in an answer to the questions posed in paragraph 21:

**(i) What is the basis for deciding which cash flows are included?**

In all cases, the underlying principle should be that estimates and assumptions are to be developed in a manner consistent with the company's current best estimate of future experience, including consideration of relevant and reliable market and entity specific information. For life insurance, relevant and reliable market information may be available for interest rates and rates of inflation. If market information isn't available or isn't reliable, the values should be based on management's best estimate of the future, consistent with any relevant and reliable market indicators. Non-financial assumptions (e.g., mortality or expense rates) should be based on management's best estimates of the future. The company should disclose the bases for the principal assumptions and estimates it uses, including how it determined which basis is the most relevant and reliable.

Interdependencies among assumptions should be taken into account (e.g., contract persistency assumptions should be consistent with assumptions about economic conditions). Agenda Paper 3 focuses on expense assumptions in considering entity-specific information to be used in measuring settlement-based insurance liabilities. However, interdependencies between expense and other assumptions that are used to estimate cash flows should also be considered. For example, insurers often spend significant amounts to improve retention of in force contracts (e.g., for outreach to policyholders who have stopped paying premiums, or for higher levels of customer service). Thus the assumptions used for policy persistency (payment of future premiums) should be consistent with the expense assumptions that are used, and would consider entity-specific information. The mortality experience for a portfolio of life insurance contracts also depends upon which contracts persist and often on how much is spent on initial underwriting evaluation.

The current exit value measurement would use entity-specific assumptions for factors that are specific to the portfolio of insurance contracts, but not for assumptions that market participants would use for factors that are specific to the company but not to the portfolio of contracts. For example, the current exit value measurement as proposed in the Discussion Paper would generally use expense assumptions that hypothetical market participants would use, on the theory that these are the expenses that would apply following transfer to that market participant. However, there generally are not observable markets on which to base expense assumptions that market participants would use.

Assumptions based on the company's own experience would be more reliable and relevant than the alternative of using arbitrary rules or other surrogates to estimate assumptions that are attributed to hypothetical market participants. In practice, insurers would probably use their own expense assumptions unless they have reason to believe that their own expenses are materially higher or lower than those of other market participants.

**(ii) What is the margin intended to convey?**

The initial margin included in the liability for a life insurance contract is the difference between the insurer's best estimate of the present value of future cash flows into the company (e.g., premiums) and the present value of the future cash flows out of the company (e.g., benefits, expenses) expected over the life of the contract, using market and entity specific information based on the criteria explained in (i) above. Thus, the initial margin is a measure of the present value that an actual market participant (the insurer that issues the contract) expects to earn from an insurance contract that it sells, based on the price that another actual market participant (the policyholder) pays for the contract.

**(iii) Could gains arise at initial recognition?** We discuss on a detailed basis in a separate paper whether such gains, if they arise, should be recognized.

The reporting model should not permit gains at initial recognition. GNAIE believes that the initial margin should be calibrated to the only actual market transaction for most insurance contracts (its sales), and that the company should recognize gains only as it is released from risk under the contract. At the time the insurance contract is issued, the insurer has not been released from any of the insurance risk it has taken, and therefore no gain should be recognized at that time. In contrast, the answer to this question for the current exit value measurement attribute may be very inconsistent with this market information (i.e., the actual transaction price). As indicated in the Discussion Paper, further investigation may be needed if the current exit value results in a large gain at initial recognition.

**(iv) Would the credit characteristics of the liability affect its measurement?**

GNAIE believes that the credit standing of the insurance company should not be considered in valuing insurance liabilities – i.e., in estimating the present value of future cash flows, the company should not discount the value of benefit payments to reflect the possibility that it may not pay legitimate claims under the contract as they come due. Such discounting would result inappropriately in reduced liabilities and increased income and equity in the event the insurance company's credit standing deteriorates and other factors remain unchanged. Under the laws of most jurisdictions, the insurance company would not be able to realize such gains and remain a going-concern (e.g., by settlement with the policyholder or by transfer to another insurer at a price that reflects the reduced credit standing). In contrast, the current exit value measurement could result in recognition of gains attributable to a decline in the insurance company's credit standing. However, as noted above, the insurer would not be able to realize such a gain as a going-

concern; and it is difficult to see how reporting such a gain could be of value to investors or other users of financial information.

**Paragraph 29, Question 2: Paragraph 24 refers to two approaches to setting measurement requirements:**

**(a) List the building blocks to be used, without trying to come up with a single all-encompassing summary description of what the result means.**

**(b) Prescribe a consistent measurement attribute that can be described concisely. Paragraph 24 suggests three reasons why the latter approach is preferable: to provide a coherent framework to resolve new and emerging issues, to provide clearer communication with users and to provide measurements that are a faithful representation of some real-world economic attribute of the items being measured.**

**Which of these approaches do you prefer, and why?**

We agree that whatever approach is used for setting measurement requirements, it would be desirable to:

1. provide a coherent framework to resolve new and emerging issues;
2. provide clear communication with users; and,
3. provide measurements that are a faithful representation of some real-world economic attribute of the items being measured.

We believe that such results could be achieved with either of the two approaches listed above. The measurement basis that GNAIE recommends (for life insurance) could be characterized in either way, and could be used effectively to achieve the objectives listed above with either characterization. On the other hand, we think that the current exit value as described in the Discussion Paper would not really satisfy these criteria, due to the hypothetical assumptions and rules that would be required for current exit value estimates, and the absence of an observable market to which the results could be tied.

We believe that current exit value measurement has already been shown to be highly suspect as a basis for resolving issues, as demonstrated by the following examples:

1. Current exit value measurement places limits on cash flows that could be considered (e.g., for future premiums that may be dependent on beneficial policyholder behavior, or for non-guaranteed values that may not meet the definition of legal or constructive obligations) that are demonstrably different than the cash flows that market participants would consider.
2. Current exit value requires hypothetical assumptions (e.g., for expenses) that are inconsistent with cash flows that are actually expected over the life of insurance contracts, and that do not make use of all relevant and reliable information.; As noted above, use of such assumptions in place of entity specific information may lead to artificial reported gains or losses.



## Settlement Value as a Candidate Measurement Attribute for Life Insurance

We believe that communications with users will be clearer based on actual market transactions, instead of on hypothetical constructs that do not really exist. Valuation according to current exit value is based on a set of notions about what cash flows “ought to be” (using a collection of hypothetical assumptions); but measurement could instead be based on best estimates of all cash flows that are actually expected, using all available relevant and reliable market and entity specific information.

We contend that the measurement basis that we propose is indeed a faithful representation of a real-world economic attribute of the items being measured (i.e., the actual price that one market participant charges another market participant for the contract that is being valued), while the current exit value is nothing more than a hypothetical construct. We believe that current exit value would only be applied consistently based on a set of rules that would be, at least to some extent, arbitrary, and would not be a faithful representation of a real-world economic attribute.



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