



IASB Insurance Project Update

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October 2005

The Insurance Working Group (IWG) of the International Accounting Standards Board (IASB) met for the sixth time on September 28-29, 2005. The following is an executive summary of the discussions and presentations that took place during the meeting. More detail follows starting on page 2.

Project Timing Updated

The staff updated the participants on how it expects near term activities related to the project to occur over the next six months or so. Discussion at the Board level is expected to start in 2006 with some education sessions on particular subjects possibly occurring in December 2005.

A revised estimate of the timeline for completion of the project is as follows:

End date	Activity
Dec 2006	Release discussion draft
June 2007	Close comment period
June 2008	Release Exposure draft
June 2009	Final Standard
Jan 1, 2010	Implementation

Accounting Approaches Discussed

Four approaches for accounting for non-participating life insurance were described by staff. Of these, two based on locked-in assumptions did not receive much support from the participants and were not discussed. The remaining two, loosely based on fair value concepts, were discussed as possible ways forward.

European Embedded Value Presented

Representatives of the CFO Forum made a presentation on Embedded Values and an analyst described how they are used today. Subsequent discussion centered around what makes this measurement basis valuable to market participants and how the measurement or components of the measurement could be used in a future accounting system.

Risk Margins

Representatives of the International Actuarial Association (IAA) made a presentation on determining risk margins. Various approaches and various uses were presented and discussed. The IAA made the recommendation that risk margins for an accounting system be based on a cost of capital approach.

Additional Topics

Additional topics discussed included Unit-linked contracts, universal life contracts, assumption setting, embedded derivatives, acquisition costs and reinsurance.

The following is a more detailed summary of the items discussed during the September IWG meeting.

Update on Project Timing

The staff expects to bring discussions of life insurance to the Board early next year. They expect to start with an education session on the possible approaches to accounting for insurance and then have the Board discuss the components of the approaches at subsequent meetings. There may be additional Board education sessions on the three key topics of participating contracts, renewals and cancellation options, and reinsurance. A session regarding participating contracts is being planned for the December 2005 IASB meeting. The others are expected to take place in 2006. The IWG will likely have one or two more meetings before the Board starts their full discussions on insurance. A revised estimate of the timeline for completion of the project is as follows:

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Topics Discussed At IWG Meeting

This meeting focused on issues affecting life insurance contracts. The following topics were discussed at the meeting:

1. [Overview of possible accounting approaches](#)
2. [European embedded value \(presentation by CFO Forum\)](#)
3. [Unit-linked contracts](#)
4. [Universal life insurance](#)
5. [Embedded derivatives](#)
6. [Risk margins \(presentation by IAA\)](#)
7. [Assumptions](#)
8. [Acquisition costs](#)
9. [Reinsurance](#)

Overview of possible accounting approaches

Staff presented four accounting models for non-participating contracts:

- Approach A: Lock-in of assumptions at inception with a liability adequacy test
- Approach B: Lock-in approach with limited extension of amortized cost for assets
- Approach C: Current entry value - what an entity would charge today for the contract
- Approach D: Current exit value – what an entity would pay a third party to take over the contract

As there was no support voiced for approaches A or B, discussion centered on approaches C and D.

1. Approach C vs. Approach D

Staff explained that the difference between C and D is primarily in how risk margins are calibrated and whether they are unlocked at each valuation date. Approach C would calibrate the risk margin at inception and release it over time. Margins would not be recalibrated. Approach D would re-evaluate the risk margin needed at each valuation date. If the market price for risk changes, D would reflect this in valuation, but C would not.

Some questioned whether you could in fact find market evidence that would lead you to hold a different risk margin under approach D than approach C.

Some questioned whether approach C would require embedded derivatives to be separately valued from the host contract.

Some questioned whether it is desirable to have an approach (C) where pricing errors affect the liability measurement.

2. Accounting driving investment choices
Some voiced concern that approaches C and D would compel insurers to use only fixed instrument portfolios to back insurance liabilities in order to avoid fluctuations in income whereas it may be more economically advantageous to mix asset classes. Others disagreed with this assertion. Still others noted that this should not be an issue for participating contracts if the liability values would be dependent on the asset values.
3. Portfolio vs. individual pricing
Some felt that approaches C and D implicitly assume that insurance is priced on a contract by contract basis whereas in reality they are priced on a portfolio basis. In addition, the liability adequacy test is to be performed on a portfolio basis.
4. Accounting mismatch
There was consensus that accounting mismatches should be avoided, but that economic mismatches should be reported. Some favored approach D as it most closely matched how assets are valued and thus would limit the accounting mismatch. Some felt that approaches C and D could still lead to accounting mismatches between assets and liabilities. Several participants commented that the accounting rules should not be viewed as forcing companies not to take risk, but rather to show clearly the risks they are taking and incent them to manage that risk.
5. Liability adequacy test
Some felt that approach C should also require a liability adequacy test. Some

felt there is a need to explore this further in the context of all approaches. Specifically, topics such as how to handle lock-in of margins and embedded derivatives should be explored.

6. Disclosure
Several participants expressed the need for adequate disclosure of the basis of reported risk margins, and for sensitivity analysis to underlying assumption changes.
7. Additional examples
Some participants expressed support for a single model for all contract types. Toward this end, they asked for examples of how the proposed approaches would account for more products including participating and unit-linked contracts.

European embedded value

At the Staff's request a presentation on European Embedded Value was given by members of the CFO Forum. The presenters were Phil Broadley, CFO of Prudential (UK) and Hans Wagner, Corporate actuary of AXA. Mr. Wagner is chair of the CFO Forum's working party on embedded values. This was followed by a presentation from Dom Giuliano of Morgan Stanley on how he uses embedded value information in analyzing insurers.

Summary of presentation

Embedded Value (EV) information is provided as supplemental to main accounts.

Why are embedded values relevant?

- EVs provide information relevant to shareholder value that is not provided by traditional accounting
- EVs are consistent with management information and pricing
- EVs facilitate communication to analysts management actions, in a

manner that reflect their commercial reality

EVs measure:

- How much value is locked up in the company
- The profitability of new business
- The profitability of existing business
- The cost of regulatory capital tied up in the business

EVs are the dominant valuation method used by the investment community.

- Of the 38 investment firms that follow Prudential UK and AXA, 34 use EV as their primary valuation tool. The remaining 4 use earnings per share.
- 80% of European insurance analysts surveyed by PriceWaterhouseCoopers in January 2005 felt that EVs were more useful measures than IFRS Phase 1.
- More than 50% of the same analysts expressed a preference for EV as a basis for accounting over a fair value system.

EV is the present value of the shareholders interest in the distributable earnings of the covered business after sufficient allowance for the risks in the business.

- Not all business of the company may be included in the EV.
- EV does not include value from any future business
- EV equals present value of cash flows from in-force business, plus required capital less the cost of holding the capital, plus free surplus allocated to the covered business
- No risk margins are included in cash flows – risk is allowed for in other ways

EV calculation requires estimates of

- Entity-specific experience
- Future management actions

EVs use the portfolio as the unit of account

- EV reflects the pooled nature of pricing and risk management
- EV reflects value to the insurer/shareholder, not policyholder

Risk is reflected through

- Prudence of liability valuation – based on statutory reserves
- Stochastic valuation of financial options and guarantees
- Reflecting the cost of holding required capital
- Using a risk discount rate

Analysis of return on EV is a key aspect of the supplemental information. It highlights:

- Change in EV due to sale of new business
- Differences between expected cash flows and actual cash flows on in-force contracts
- Market-related experience as distinct from non-market experience factors
- Impact of changes in future assumptions on the value of future profits
- Impact of Capital transactions

The CFO Forum European Embedded Value (EEV) principles were introduced to

- Improve comparability
- Improve transparency
- Improve the valuation of risks such as options and guarantees

EV is not designed to meet the objectives of an accounting framework, because

- The financial liability is not measured directly
- EV would create inconsistencies with how investment contracts are measured
- EV places emphasis on relevance in contrast to reliability

Discussion of EEV presentation

1. Use of EV outside of Europe

Mr. Broadly noted that the insurance regulator in China will be requiring the calculation of embedded values for regulator purposes. The objective is to obtain better information on the profitability of new business. There are many fast-growing insurance companies in China and under the current accounting system it is not possible to determine who is selling profitable business and who is not.

2. Discount rates

A discussion of how discount rates are determined ensued. It was noted that different discount rates were used for each line of business and each market, reflecting the riskiness of the business. This is in part due to the use of regulatory capital in the calculation of EV. If economic capital were used instead, then there could be one discount rate used for all business that would reflect the weighted average cost of capital for the entity. Projected losses would then be discounted at the asset earnings rate.

3. EV as an accounting system

Staff asked what would be removed from EEV if they were to start with EEV and wanted to get to an accounting system.

Mr. Wagner noted that the CFO Forum has issued principles on both EEV and on Phase II accounting and that the primary difference between the two is that for Phase II accounting, a higher level of proof is required to recognize a gain at issue on new business.

Others indicated that the cost of capital might have to be removed.

Many felt that EV gives a better indication of performance than traditional accounting measures and captures interrelationships between contract elements. However the attribution of that performance to accounting periods and how the embedded value would be allocated among balance sheet items is not clear. How revenue recognition would work under an EV-based system is also not clear.

A Board member pointed out that the renewal/cancellation issue would still be a stumbling block.¹

Many felt that disclosure and sensitivity analysis were key elements of the EV information that make it relevant for users.

Unit-linked contracts

Several topics were discussed mostly focusing on the similarity of these contracts to other financial instruments offered in the market and how the insurance features might be valued.

1. Unbundling

- a. Should components be unbundled?

There was a discussion of whether the insurance and investment components of these contracts should be unbundled and accounted for separately with the insurance component valued according to

¹ In prior meetings of the IWG there have been discussions about whether renewal premiums fit the definition of an asset under the IASB's framework. In order to recognize an item as an asset, the IASB definition of an asset requires an entity to be able to control the future resources of that asset. Since in most cases the insurer cannot force the payment of a future premium, it is not clear that future premiums can be recognized in the measurement of an insurance contract.

the insurance standard and the investment component valued according to IAS 39 and IAS 18. Some questioned whether unbundling the liabilities would require a similar separation of the assets backing those liabilities and whether an amortized cost option for the assets backing the insurance component would be needed.

- b. Measurement in the absence of unbundling
There was a discussion of what accounting method might be used if unbundling was not required – whether it should be consistent with the accounting for other insurance contracts or consistent with accumulation products. Generally there was support for consistency with accumulation products but there was concern that there would be boundary issues. For example, insurance contract measurement and IAS 18 treat future fee revenues in different manners.

It was pointed out that in some contracts, policyholders can switch their money between the separate and general accounts. This can be problematic for applying consistent measurement.

- c. Sufficiency of IAS 39 and IAS 18
There was a discussion of whether the current IAS 39 and IAS 18 are sufficient for accounting for these contracts (or their investment component if unbundled). The sentiment was expressed that fees can be

collected from these contracts in different manners (e.g, front-end loads, back-end loads, management fees) but that how the fees are charged should not affect the accounting. The Staff noted that IAS 18 currently sets accounting requirements based on how fees are charged.

- d. Consistency with mutual fund accounting
There was a discussion of whether the accounting for unit-linked contracts should be consistent with the accounting for mutual funds. It was noted that ownership of the assets may be different (mutual funds are typically not owned by the mutual fund company whereas the separate account assets are owned by the insurer). There was a discussion about purchases of an insurer's own stock by a separate account and in what situations it would be deemed treasury stock.

2. Accounting for assets backing insurance liabilities

There was sentiment that the valuation methods for assets should be consistent with the valuation methods for liabilities so that no accounting mismatches occur. Most supported having an option for using fair value.

A Board member indicated that in order to create new accounting options the Board would have to go back and rework all asset valuation or put into the insurance standard an option for the valuation of assets where they are contractually linked to the policyholder's value. It was pointed out that under the current definition of

insurance contract (which is not expected to change in Phase II) some unit-linked contracts fall under IAS 39. IAS 39 may need to be reviewed for possible changes.

Universal life insurance

1. Unbundling

The topic of unbundling was discussed. Most supported an integrated valuation approach rather than an unbundled approach. Some felt that the accounting should be driven by how profits emerge.

Wayne Upton relayed the following concerns that FASB had with accounting for universal life insurance products when it developed SFAS 97.

- Up front profit recognition that could occur under SFAS 60 as it required profit to emerge in proportion to premium and universal life insurance contracts did not always require future premium payments
- Unbundling – the contract mechanics seemed to allow for it
- The policyholder's ability to vary premiums (increase, decrease or skip them)

2. Margin analysis

Many have expressed support for some type of margin analysis to be provided. The staff questioned whether the margin analysis should be included in the main accounts or should be a disclosure item.

3. Renewal and cancellation options

The Staff also noted that the renewals and cancellation option issue is more of an issue for the integrated approach vs. an unbundled approach.

Embedded derivatives

The staff categorized embedded derivatives in insurance products into three groups:

1. Financial derivatives
2. Insurance derivatives
3. Hybrid financial & insurance derivatives

It was pointed out that the use of the term derivative in this context included not just items whose value depends on the value of some other instrument but also options and guarantees embedded in insurance contracts.

1. Financial and insurance derivatives

There seemed to be general consensus that financial derivatives should be marked to market and insurance derivatives should be measured consistent with the measurement of the underlying contract. The question is how to measure the hybrid derivatives.

2. Intrinsic value vs. optionality

There was a discussion about whether the proper measurement objective for derivatives is their intrinsic value only or their intrinsic value plus the value of optionality, i.e., the extra value for the potential of the intrinsic value to change over time. Some felt that only the intrinsic value was realizable by the policyholder.

3. Policyholder behavior

A discussion of policyholder behavior followed. The term derivative gives one the feeling that there is a market value that can be observed. However, that is not true for all options and guarantees. Valuing financial options consistent with the efficient market hypothesis is reasonable, but insurance and hybrid options may require a different hypothesis. Rational policyholder behavior can be highly individualistic and difficult to measure. The Staff pointed out that the fair value option

was included in IAS 39 to allow the entire instrument to be valued at fair value as that might be more reliable than trying to value the option separately.

There was discussion of how an accounting measurement based on “inefficient” policyholder behavior would react to situations where public information (e.g., media reports of mispricing, etc.) prompts policyholders to start behaving in an “efficient” manner. Some felt the role of the liability adequacy test in this context should be explored further.

4. Sensitivity analysis

There was some discussion that point estimates of these liabilities may imply a higher level of certainty to the estimate than is warranted. There was some sentiment that added disclosures of sensitivity to assumption changes would be valuable. The Staff noted that the proposed changes to IFRS 7 are being exposed and requested comments.

Risk Margins

Sam Gutterman and Tony Coleman, members of the IWG, presented a paper on risk margins developed by the International Actuarial Association (IAA).

Presentation Summary

Considerations for risk margins include:

Objective of risk adjustment – (solvency vs. accounting, market consistency)

Types of risk to be included – (diversifiable vs. undiversifiable)

The presentation distinguishes two types of provision for risk:

Market value margins – set by reference to the value of risk as determined by observation of market transactions, updated regularly

Risk margins – set by reference to desired risk appetite or level of confidence/sufficiency. These might be market calibrated, but not necessarily at each valuation date

The paper sets forth several criteria for establishing risk margins:

- Excessive conservatism should be avoided in order to be consistent with accounting framework principles
- Risk margins should not be set solely by reference to historic patterns of claims costs as this may result in margins that are too low and will impact the functioning of the liability adequacy test and timely reporting of losses.
- The method should optimize reliability and consistency of comparisons between different insurance product types and insurers over time and foster transparency through appropriate disclosure.

The paper considers the pros and cons of various approaches to establishing risk margins including:

- Actuarial appraisal technique
- Cost of capital
- Confidence interval/statistical methods
 - Probability
 - Value at risk
 - Conditional tail expectation (CTE)
 - Expected policyholder deficit

The paper concludes that using a risk margin approach calibrated using a long term market-driven cost of capital provides the best outcome for determining risk margins consistent with the criteria noted above.

Additional recommendations of paper:

- Allowance for diversification between portfolios should be disclosed separately

- Risk margins should be appropriate for insurer's net (of reinsurance) liability although the elements could be reported separately
- Credit risk arising from reinsurance should be included in margins
- Contracts that pass risk from insurer back to policyholders should have correspondingly lower risk margins
- No single method for determining risk margins should be required. Flexibility should be allowed.

Discussion of paper and presentation

It is not clear how to use CTE level in an accounting model, especially when also calibrating to market data such as entry price.

If risk margins are calibrated to entry price this will include both financial and insurance risk in the margin. Is that what is wanted?

There is no entry price for claim liabilities.

Some participants expressed concerns about how the risk margin concept would spill over to other industries like banking where there currently is no such concept.

Capital could be defined to be regulatory capital, economic capital or the entity's actual capital. Some felt that using economic capital with a single discount rate equal to the weighted average cost of capital was the best approach. Some Board members questioned the reliability of such an approach. Some participants felt it would be difficult to allocate total capital down to the lines of business and products. Many felt that sensitivities and disclosures were needed to help users of financial statements understand the risk profiles, while others worried that such disclosures would be so technical in nature as to be useless to most users.

There is a question about whether a risk margin should include an element of profit.

The staff concluded that there is some skepticism of the cost of capital method among the group and that an off-line discussion on risk margins should take place prior to the next working group meeting.

Assumptions

There was a discussion of the conditions under which market observed data would not be used directly. Some pointed to the possibility of a temporary market upheaval on the reporting date that subsequently reverts prior to the release of the financial statements.

Acquisition Costs

These may also be known as contractual rights or recoverable acquisition costs. There is general consensus that these should be amortized on a non-arbitrary basis. There needs to be further consideration of the incremental cost definition as in IAS 39 versus the more than incremental cost definition used in many other accounting systems.

The presentation of the unamortized balance was discussed (as a separate asset or as a "negative" liability). There was some discussion of showing the surrender value separately from the contractual rights. It was agreed that this would be explored further in the discussion of renewals and cancellation rights.

Reinsurance

Issues discussed included:

1. Liability adequacy test – whether it be performed net or gross of reinsurance
2. Risk margins – whether the ceded component should mirror the direct liability
3. Reinsurance recoverable – does it fit the definition of asset under IFRS Framework?
4. Loss recognition test for reinsurance recoverable

Some felt that the loss recognition test to be applied should be consistent with the answer to

the whether the discount rate for liabilities should include a provision for the entity's own credit risk. Other complicating issues include:

- Timing difference between direct claim and reinsurance reimbursement
- Non-overlapping periods of coverage
- Reinstatement provisions in direct contracts
- Price guarantees on business to be written in the future
- Coverage of both losses already incurred and future losses
- Recapture and experience rating provisions in reinsurance contracts

If you would like more information on this topic please contact William Hines (+1 781 213 6228 or william.hines@milliman.com) or your local Milliman consultant. We also invite you to visit our website (www.milliman.com).