IAA IAS Insurance Committee Meeting, London 20-23 September, 2003

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1. General Remarks

- closing circle: in 1997 no equalisation reserves, discount rates reflecting market rates -> less prudence – now Loss Recognition Test
- Fair value: originally "The amount for which an asset could be ex-changed, or a liability settled, between knowledgeable, willing parties in an arm's length transaction" (IAS39) – now present value of future cash flows
- Next draft of the IAA response will be made very soon and be available for Groupe Consultatif meetings in Athens. Emphasis in the following is on the specific issues (some of them concerning more or only Phase II) that will be addressed in the IAA response in addition to the questions asked by the IASB – with respect to answers to IASB questions please refer to the next IAA draft that should be available in a matter of a few days.

Entry vs. exit value:

- Existing guidance for fair value measure is found in IAS 39 (see above)
- But, consistent with the definition of fair value, the guidance goes on to say that "If there is a valuation technique commonly used by market participants to price the instruments and that technique has been dem-onstrated to provide reliable estimates of prices obtained in actual mar-ket transactions, the entity uses that technique"(2).

2. 20 September afternoon

I arrived only on 20 September evening so nothing to report from that part (please see IAA draft response, preferably the latest version arriving before the Athens meeting).
Issues/questions 1 and 2 discussed were discussed then.
Continuance on some aspects on Monday:
- Weather derivatives: local GAAP should be used until Phase II
- In question 2 still ambiguity on what is significant and how that applies to different insurance contracts – main problem is that whatever the definition there will be contracts just on the line resulting in different ac-counting alternatives at least in Phase I. One aim of Phase I is that a con-tract now assumed to be an insurance contract is not transferred out of the scope of insurance contracts with the possibility of bringing it back to be treated as an insurance contract in Phase II. Therefore, there is more of a possibility to tighten the definition in Phase II than loosening it. A theoretical question of course is whether this makes any difference in Phase II as all contracts are then thought to be valued using fair value, therefore it should not be a matter whether a contract is an insurance contract, financial instrument or whatever in Phase II.

3. Question 3, Embedded Derivatives

- Some are very material even threatening solvency already when not in money

- Two different questions: in the money/out of the money or what is the value of an option, should be clarified in the IAA response
- If valued to fair value in local GAAP, is unbundling required?
- In local GAAP valuation a wide range of alternatives, why very narrow in derivatives?
- Is there a difference between option and derivative?
- What is the relation of Loss Recognition Test (LRT) to unbundling, should LRT be strengthened to take care of options/derivatives? Or, is LRT such that everything possible should be taken care of on a defined method and only the remaining part, as small as possible, with LRT?
- not all listed in ED 5 are embedded derivatives
- no theory for all derivatives.

4. Question 4 – Temporary exclusion from criteria in IAS 8

- Sunset clause maybe necessary to strengthen the impetus of the work, the Board can extend it for one year at a time if necessary
- Should be reconsidered when the Board sees what has happened in Phase II work before final Phase I is given
- Equalisation clause criticised but agreed, an equivalent needed in re-stricted equity
- LRT important, not FV in disguise, more guidance needed
- Collective pay-as-you-go pool (c.f. Finnish preliminary remarks) dis-cussed and written on the response. An important difference from rein-surance is that apparently the primary insurer is not responsible of any-thing if the 'reinsurer' (the pay-as-you-go pool fails). It seems that off-setting can be done.

5. Question 5 – Changes in accounting policies

- Asset-linked discount rates prohibited by the IASB but rates prescribed by authorities are not prohibited
- Problem for multinationals (16 (e)) addressed.
- Suggestion: in individual questions according to checklist 16, with overall change a change to generally better accepted.

6. Question 6 – Unbundling

- If two different contracts are stapled together they should be unbundled (substance over form)

7. Question 7 – Reinsurance purchased

- Reinsurance assets treated independently the corresponding liability, IAA strongly opposes this
- Contracts that are artificially unbundled should be bundled (funding dis-guised in the form of reinsurance, financial reinsurance)
- Rule for not showing profit at the beginning tries to solve problems with financial insurance but in the form stated applies to all 'ordinary' rein-surance, which should be commented.

8. Question 8 - Insurance contracts acquired in a business combination or portfolio transfer

- Basically agreed on the Boards draft but noted that fair value ideas ex-pressed here stress the idea that the Board should observe what is the fair value method used in such cases and take it into account in Phase II.

9. Question 9 – Discretionary participation features

- UK emphasis outspokenly criticised and new definition (more principles based) suggested to the board. In DSOP 7 draft also continental ques-tions were addressed. Discretionary participation feature is a universal phenomenon and different countries have devised different accounting methods to handle its consequences.
- Allocated maybe not means allocated to different policies, can also mean a constructive

obligation to allocate some time in the future – construc-tive obligation certainly is a liability
- Treated as a derivative, which is wrong (derivative creates risk, discre-tionary participation features lessen risk)
- No guidance on how to split unallocated surplus between liability and equity
- Concept of the fixed element (France tries to clarify) is not clear enough.

10. Question 10 – Disclosure of the fair value of insurance assets and insurance liabilities

- Initial draft of the IAA: You must be joking! (instead of this four-word sentence, also some four-letter words were in mind)
- The current version is made little more polite
- What is fair value of an insurance contract?
- How should it be disclosed?
- A question is: if the Board wants something like this, what would hap-pen if the actuarial profession would come up with a well-thought pro-posal for fair value before the end of 2006? Would the roles be changed, instead of actuaries devising alternatives and comments to the thoughts of the Board, the Board should start challenging the model of actuaries. Could we have resources for this?

11. Question 11 – Other disclosures

- Life insurance: varying products across the world even with similar names. ED 5 written with one specialised insurance company in mind, guidance does not help. Any reference to embedded value should be omitted as by its nature doesn't fit to IAS financial reporting. Random risk and pooling effects not well reported with the proposed disclosure.
- Non-life insurance: implementation guidance would lead to an overly ex-cessive amount of disclosure. When equalisation/catastrophe reserves omitted disclosure should reveal exposure to risks.
- Peter Clark: Implementation guide is not part of the standard. The stan-dard sets the principles, implementation guide is a suggestion how to ful-fil the requirements of the standard (materiality is the general principle)
- Business secrets: taken to comments, however acknowledged the tension between useful relevant information and business secrets
- Embedded value: comments related to this to be deleted from the draft

12. Question 12 – Financial guarantees by the transferor of a non-financial asset or liability

- Disagreement with the IASB: IAS 39 should not be applied if the guaran-tee meets the proposed definition of an insurance contract.

13. Question 13 – Other comments

- No other comments.

14. Specific recommendations to the IASB

- Important issues highlighted in the cover letter of the IAA re-sponse
- Timeframe
- Asset/liability consistency
- Minimum deposit floor
- Fair value issues
- Principles vs. rules
- Renewal and cancellation options
- Separate paper on unbundling
- Performance (or financial) reporting
- Performance linkage.
- Principles vs. rules: ED 5 is based on the idea of being principles based but it has some rules also (maybe rather arbitrary constraints, e.g. no profit from reinsurance at onset, zero profit at issue). Paul McCrossan had examples based on annuities written by differently rated insurance companies that lead to contradictions.

- In the Basis for Conclusions to ED 5, the Board expresses its intent to modify IAS 39 to make it clear that the fair value of a financial liabil-ity with a demand feature is not less than the amount payable on demand ("APD"). IAA believes a minimum liability consistent with the APD is not consistent with concepts of fair value and not consistent with the existing guidance for fair value measures found in IAS 39. The imposition of this requirement will cause companies to present their fi-nancial position and financial performance in a way that is misleading. Possibly an IAS 39 comment that needs to be taken to the Board in two weeks from the London meeting.
- Consistent with the definition of fair value, the IAS 39 guidance says that "If there is a valuation technique commonly used by market partici-pants to price the instruments and that technique has been demonstrated to provide reliable estimates of prices obtained in actual market transac-tions, the entity uses that technique" which can be called exit value. The IAA should recommend that the Board should clarify that this is not an expectation to fair value models to exactly reproduce the entry value, but rather, that the difference between the fair value at inception and the entry value should be reviewed: the valuation technique should be challenged for proper calibration to market prices, and changes neces-sary to bring the initial value in to a reasonable relationship with the en-try value deliberated. At least seemingly this is in contradiction with using own credit rating – the logic goes, however, that a weak insurer never would (voluntarily) sell to a strong insurer, as the weak insurer would improve the credit rating of the contract without getting any ad-vantage in return. The committee decided to say that valuation should be exit value but usually a good surrogate for this would be entry value. There are, however, substantial conceptual problems involved in this that need to be addressed in Phase II.
- Own credit rating question basically handled with respect to a draft of actuarial guidance. In IAS 39 the Board has taken the stance that own credit standing is taken into account in the valuation of financial liabili-ties. In insurance market there is little evidence that credit standing af-fects pricing (because of, say, regulation). It is unclear who has the onus of showing this. The Board has suggested a kind of 'supervisory mar-gin', but there is little guidance on this and the Board certainly needs to return to this issue. Can there be different discount rates within different markets (insurance markets, bond markets)?
- The treatment of renewal options and cancellation options is para-mount in phase II. The IASB Insurance Contracts Phase II Project Summary, issued in February 2003, paragraph 19 sets out the Board's tentative conclusion with respect to renewal premiums as follows:
- "The measurement of contractual rights and obligations associated with the closed book of insurance contracts should include future premiums specified in the contracts (and claims, benefits, expenses, and other additional cash flows resulting from those premiums) if, and only if:
- policyholders hold uncancellable continuation or renewal rights that significantly constrain the policy issuer's ability to reprice the contract to rates that would apply for new policyholders who have similar characteristics to the ex-isting policyholder; and
- Those rights will lapse if the policyholders stop paying premiums."
- The IAA believes (with respect to renewal and cancellation options) that (discussion of this continues, no consensus reached on second bullet point):
- The treatment of renewal and cancellation options should be independent of the underlying measurement basis i.e. the same definition should applied irrespective of whether the contracts are measured in accordance with either IAS 39 as either amortised cost or fair value.
- The recognition of renewal and cancellation options for in-surance contracts under phase II should be same with in-vestment contracts under IAS39 to avoid accounting arbi-trage between insurance and investment contracts and to ensure that the addition of a small quantum of insurance risk should not significantly change the accounting treat-ment of a contract.
- The IAA would encourage the phase II proposals to develop in such a way as to make unbundling unnecessary for all the reasons provided in BC33 of the draft IFRS and that the addition of a small quantum of in-surance risk should not significantly change the accounting treatment of a contract. Nevertheless, we note two particular issues that must be ad-dressed before the objective above can be made (If these issues cannot be overcome, then unbundling will be necessary in phase II and we would encourage the Board to adopt on pragmatic principles-based approach):
- The existence of the option to value a financial instrument at either amortised cost or fair value under IAS39 means that either both options should be available for the insur-ance

component or one of the options under IAS39 should be removed; and
- The Performance Reporting project must clearly outline the form of revenue recognition. If the revenue recognition for an insurance component differs from that for deposit component then unbundling may still be required.
- An adequate performance report for insurance business needs to con-sider the sources of performance in insurance business. Performance is based on sources and the ability to influence sources. The relevant source of performance from accepting insurance risk, i.e. of providing professional coverage based on portfolios of risk, is the deviation from the expected claim. Insurers charge a price for deviation risk in addition to the expected value of claims. In a portfolio, it is expected that the claims will in average amount to the expected value. The remaining per-formance of the insurer is based therefore on the difference between the expected value and the actual claim payments, compared with the price charged for that deviation risk. According to that theory, the premium up to the amount of the expected value is – from a portfolio perspective – not revenue but simply a pass-through amount like the saving pre-mium in insurance contracts with investment component. The saving part of the premium is the pass-through element on an individual con-tract basis, the expected value of claims the pass-through element on a portfolio basis. Just the part of the premium on top of the expected value is revenue. The part of the premium in excess of the expected claims and benefits in general covers normally not only the deviation risk but also any other necessary (and unnecessary) expenses of the entity and its required return on equity including taxes. Expenses are conse-quently any costs which are not triggered in value by the insured events and any payments triggered by the insured events deviating from the ex-pected value (advantageous deviations are negative expenses or the re-lated premium is additional revenue from the portfolio comparable to maturity values not claimed). A further part of performance is the as-sumed future performance of investing exceeding cash inflows up to their outflow (although it is usually assumed that the remaining amount in-creases always, i.e. current inflows are always higher than current out-flows), inherent in premium calculation. The unwinding of discount is an expense and the investment income is revenue. In both cases, with costs and investments, the insurer carries the full risk, since portfolio ef-fects ensuring that in average the expected value will be achieved do not work here. Neither for costs nor investments expected values actually exist, nor does there exist a portfolio, to which the Law of Large Num-bers could be applied. The same is true for earnings or losses resulting from policyholders' behaviour, like earnings from surrender charges or lapse losses. Such earnings and losses are revenues and expenses.
- The structure of the performance report follows roughly the structure as proposed in the draft DSOP. The first category is the net result of new business. Revenue (or expense in case of an initial liability) is the initial net asset of the initial measurement (before any premium payment), ex-penses are the whole acquisition cost qualified as transaction cost in the sense of IAS 39.10. Any share of a reinsurer or coinsurer shall be re-ported as well here as a separate item. The net amount is the improve-ment of the value of the portfolio, and in case of proper initial measure-ment this reflects as well the estimated improvement of the pooling ef-fect by additional business and the estimated effect of the initial risk se-lection.
- Performance-linkage is a legal or constructive obligation to provide payments (performance-linked cash outflow) or a right to receive pay-ments (performance-linked cash inflow) where the ultimate amount of the payment is determined by the occurrence of specific net cash inflows (covered cash inflow) of the obliged entity (the risk transferor), respec-tively net cash outflows (covered cash outflow) of the entitled entity (the chance transferor).
- As far as possible, in the reports of the transferor performance-linkage is separated from any other cash flow and recognised and measured consis-tently with the covered cash flow. In the reports of the transferee per-formance-linkage is recognised and measured in the same manner as the covered cash flow would have been recognised and measured, addition-ally credit risk of the transferor is considered in case of rights of the transferee, except if the covered cash flow has another economic meaning to the transferee than to the transferor.
- Constructive obligations are defined in IAS 37.10. However, a major problem arises in those cases, where the measurement includes to a sig-nificant extent assumptions about the future which depends on the fu-ture size of the business, e.g. considering economies of scale in future cost assumptions or effects to margins for risk and uncertainty from portfolio size in insurance business. Discretion or judgement is materi-ally influenced by competitive considerations. In many cases there is no legal or constructive obligation of providing payments but the entity is forced to uphold the level of the business size to achieve the

assump-tions made. This is contradictory. Either all necessary efforts to uphold the necessary business size required to achieve the assumptions are con-sidered in accounting even if the decision is not yet made and not cov-ered by legal or constructive obligations yet and such assumptions can be made in measurement, or assumptions have to be chosen assuming that no discretionary amounts are paid. Hence, it should be recom-mended to require not only the recognition of constructive obligations as described in IAS 37.10 but to extend the definition of "constructive" to any amount the payment of which is economically reasonable compared with the effects of the opposite. Recognition and measurement shall be based on the consistent assumption that the entity will act in future eco-nomically reasonably rather than referring to individual items without considering their interdependence from future discretionary decisions of the entity.

15. Actuarial implementation guidance

- Litigation memo: written for U.S practice and needs local expertise in other areas. However, similar litigation is regrettably spreading to other countries
- IAA standards will come to have a similar role as the standards of the Actuarial Standards Board, that is acknowledged standards of practice observed in the courts.
- The memo tries to teach the committee what expressions will lead in court practice to the possibility of using the standards against actuaries.
- It was discussed whether the subcommittee should draft standards that would not be binding anywhere, instead, national associations would use these as a basis to create standards suited to their local culture.
- Form of Actuarial Standards, four levels:
- Class 1 – mandatory
- Class 2 – voluntary
- Class 3 – recommended practice
- Class 4 – practice guidelines.
- Terminology an important matter – maybe necessitating a document to contain definitions
- Language questions occupied an excessive share of the time available. No consensus reached
- Other drafts distributed not discussed.

16. IAA Insurance Steering Committee Notes (Notes on the ACLI – IAA Joint Research Pro-ject)

- No time to discuss this in the meeting, refers to the paper distributed.
- "The work of science is to substitute facts for appearances and demon-strations for impressions" is the motto of the largest actuarial educa-tional organisation. In the absence of any field testing by the IASB of the consequences arising from phase 1 of the insurance contract reporting project and in the face of many industry objections to the consequences of phase 1 of the insurance accounting project, the ACLI and IAA felt it was worthwhile creating simple (but relevant) demonstrations of the po-tential effects that could arise from the interaction of the phase 1 insur-ance accounting standard with IAS 32 / 39 using simple, realistic, and common contracts.
- The IAS 32 / 39 standard is fundamentally flawed as it is applied to fi-nancial intermediaries. It allows for two acceptable liability measure-ment bases and four acceptable asset measurement categories that fall into three asset measurement bases:

Liability measurement bases	Asset measurement bases
Amortised Cost	Amortised cost (HTM & OL)
N/A	Available for Sale
Fair Value	Fair Value

- When financial liabilities are measured at AC, financial assets can be con-sistently measured at AC. When financial liabilities are measured at FV, financial assets can be consistently measured at FV. But when financial assets are measured as AFS, there is no consistent way in which to measure financial liabilities (including insurance liabilities).
- The Supplement to the joint Research Paper demonstrates that measur-ing assets as AFS will create a bias in the reported earnings and equity of a financial institution depending on

the level and trend in interest rates. The Supplement also demonstrates that the bias in equity from meas-urement inconsistency can be a significant proportion of (and in some cases greater than) the required risk based capital level of 8% - 10%.
- What interim measures should be considered?
- As long as insurance contracts and other financial liabili-ties can be measured on an amortised cost basis, changes should be made to the measurement of financial assets to permit them to be measured on a consistent basis. The ACLI – IAA Supplement suggests that a re-laxation be made to the tainting rules and the income recognition rules for assets falling in the HTM class that would accomplish this consistency.
- As long as financial assets can be measured at amortised cost, financial liabilities (including insurance liabilities) should be able to be consistency measured. The ACLI suggested that the IASB consider the development of an "HTM insurance liability (with loss recognition) meas-urement basis". At this stage, the IAA neither endorses nor opposes such a recommendation. However, such a recommendation would be consistent with the IAA's long standing recommendation in favour of financial re-porting systems being based on consistent measurement of assets and liabilities. Furthermore, our joint research to date suggests that a robust HTM liability basis can be developed.
- When should the interim amortised cost measurement alternatives be ended?
- At such a time as the IASB decides to require FV meas-urement for all financial assets and all financial liabilities (including insurance contracts) i.e. when IAS 39 allows only FV measures, it is logical to ensure that all other li-abilities similar to financial liabilities such as insurance contracts also be measured on a FV basis.
- Until the time that all financial intermediaries are re-quired to fully report on a FV basis, no segment in the highly competitive financial intermediary industry should be favoured or penalised by the consequences of inconsistent measurement of assets and liabilities.
- Finally, it is worth recording the concern of the IAA that the current Framework may not deal appropriately with the important issue of probability in respect of recognition and measurement. The Framework might have been appropriate in a world of historical cost fi-nancial reporting. It is doubtful that the Framework is appropriate in the world of a prospectively oriented FV financial reporting. The IAA is very concerned that the application of the current Framework to long term con-tracts involving many probabilistic events may lead to "unfair" fair values.

17. Next steps

- Drafters asked to provide the chairman with new drafts by next week-end, next version of comments with cover letter should be available by next Monday
- Berlin meeting: main topic will be actuarial standards, drafting group will have a conference call within next two or three weeks, a draft will be dis-tributed two or three weeks before Berlin.