

Minutes of the Sixth Meeting of the Insurance Working Group

28-29 September 2005

Crowne Plaza London – The City Hotel, London

Present:

Members

Phil Arthur, Ernst & Young (29 September only)
Norbert Barth, DZ Bank
Philip Broadley, Prudential Corporation (UK) (28 September and 29 September am only)
Richard Carbone, Prudential Financial (US) (28 September and 29 September am only)
Tony Coleman, Insurance Australia Group
Sam Gutterman, International Actuarial Association (IAA)
Rob Jones, Standard & Poors
Patrick O’Sullivan, Zurich Financial Services
Hitesh Patel, KPMG
Jörg Schneider, Munich Re (28 September only)
Joseph Streppel, Aegon
Mark Swallow, Swiss Re (29 September only)
Yoshikazu Takeda, Nippon Life
David Wheat, ING Financial Services
Hiroyuki Yamaguchi, Sompo Japan Insurance
Alan Zimmermann, GA Zimmermann Associates

Observers

Tomoko Amaya, International Association of Insurance Supervisors (IAIS)
Rob Esson, International Association of Insurance Supervisors (IAIS)
Michael Crooch, Financial Accounting Standards Board (FASB)
Jeffrey Cropsey, Financial Accounting Standards Board (FASB)
Catherine Guttman, European Financial Reporting Action Group (EFRAG)
Georgene Palacky, International Organization of Securities Commissions (IOSCO)

Invited presenters

Dom Guiliano, Morgan Stanley (28 September only)
Hans Wagner, AXA (28 September only)

IASB

Tony Cope, Board member
Jan Engström, Board member
Warren McGregor, Board member
Tricia O’Malley, Board member (28 September and 29 September am only)
David Tweedie, Chairman
Geoffrey Whittington, Board member
Tatsumi Yamada, Board member
Wayne Upton, Director of Research (28 September only)
Peter Clark, Senior Project Manager
Andrea Pryde, Project Manager

Angus Thomson, Australian Accounting Standards Board (AASB)

Regrets:

Jerry de St Paer, XL Capital

Denis Duverne, AXA

Marc Meiches, GE Insurance Solutions

Helmut Perlet, Allianz

Christina Habal, Australian Accounting Standards Board

Nature of these minutes

1. These minutes attempt to capture views and arguments expressed during the meeting, without attributing views to individuals. They do not attempt to assess the extent of support for each item.

Introduction

2. Warren McGregor welcomed participants to the 6th meeting of the insurance working group. He introduced Michael Crooch, FASB Board member and Angus Thomson, AASB staff, attending their first meeting. He noted that Angus Thomson was standing in for Christina Habal, who was on maternity leave.
3. Warren McGregor welcomed guest presenters from the CFO Forum (Dom Giuliano and Hans Wagner).

AP 1 Overview of papers for this meeting and AP 1A Status of discussions

4. The staff reminded participants that the Board had not yet discussed life insurance issues for Phase II of the insurance project. The staff expected such discussions to begin early in 2006, starting with an education session giving an overview of the possible approaches and followed by discussion of the components of the approaches over the next 2 or 3 meetings.
5. There would be additional Board education sessions on participating contracts, renewals and cancellation options and reinsurance in the remainder of 2005. No further education on non-participating life contracts was planned.
6. The Board had decided tentatively in May 2005 to pursue two approaches to non-life insurance in parallel, pending developments in the revenue project. There was no specific progress to report at this stage. Therefore, the discussion at this meeting would focus on life insurance, though many of the issues discussed were also likely to be relevant for non-life insurance.
7. Participants were reminded that the staff did not intend that the discussion paper would cover all aspects of insurance accounting. The level of detail envisaged in the discussion paper is similar to that set out in the table in Agenda Paper 1A.

AP 2 Unit-linked contracts

8. The group discussed Agenda paper 2. The group was directed to focus on the simplest case of investment-linked contracts where the policyholder bears all the investment risk. Such contracts had no possibility of mismatch.
9. In response to Question 1 on whether the contracts should be unbundled, participants made the following comments:
 - (a) How would you deal with contracts where the total return is eventually passed back to policyholders, but over the life of the contract? If the mark-to-market loss is not passed immediately to the policyholder, a policyholder leaving early may not bear the risk. Thus, there may be a mismatch between the policyholders at the time the return is earned and the policyholders receiving the benefit of the return. However, in reality, policyholders do not monitor the contract with the aim of exiting if risks exist that will be passed to policyholders later.
 - (b) Risks other than insurance risk should be unbundled.
 - (c) For unit-linked contracts, guarantees, such as guaranteed minimum benefits are important. It seems clear that these should be unbundled, but is it possible to do so?
 - (d) There should be one accounting model for traditional and unit-linked contracts, otherwise boundaries will need to be drawn and rules developed to identify the contracts and components.
 - (e) Unbundling only serves a purpose if there is sufficiently different accounting between investment and insurance accounting.
10. Question 2 asked whether IAS 39 and IAS 18 should apply to an investment contract component that has been unbundled from a unit-linked insurance contract. This question was particularly relevant to the recognition of fees. Participants made the following comments:
 - (a) In Australia, all fees have essentially been treated in the same way because the different ways of extracting fees should not affect the accounting. This applies even if the different types of fees have different risks. IAS 18 tries to achieve the same approach.
 - (b) IAS 39 is more of a problem than IAS 18 because it does not take account of the unit of account, which might be of some importance for investment contracts.
 - (c) IAS 18 is a revenue standard that is also used to address cost. As a result, it is hard to work with IAS 18, particularly with back-loaded products where the entity has not received (and may never receive) the consideration. There were mixed views on what IAS 18 requires.
 - (d) It is unclear what amortised cost in IAS 39 means for unit-linked contracts. It is also unclear how deferred tax and the unit price affected the liability valuation. It appears that the unit price reflected in the liability measurement is adjusted for the present value of deferred tax

on unrealised gains. However, the deferred tax liability in the financial statements is not a present value.

- (e) It is unclear how the fair valuation measurement hierarchy and valuation technique rules in IAS 39 should be applied to the valuation of the liability. This may be worth debating at a future meeting. Guidance in a standard would be useful.

11. Question 3 asked whether the accounting for unit-linked contracts sold by life insurers should be consistent with the accounting used for mutual funds managed by non-insurers. Participants made the following comments:

- (a) Is there a difference in the nature of the assets? Are they controlled by the policyholder? (If so, they should not be on the insurer's balance sheet.) Is there a difference between assets sitting within a separate fund in which the insurer is only a fund manager? An insurer would still own the asset if the policyholder surrendered the contract, so the assets should be on the insurer's balance sheet. This is not the same as mutual fund management.
- (b) The question arises when the insurer has control of the assets, but the total return belongs to the policyholder. If you can leverage off the assets then they should stay on the balance sheet, but if you can't then they shouldn't. The separate account treatment in the US is a half-way house.
- (c) Some of the structures may be more like pass through structures, as discussed in the derecognition section of IAS 39. Thus, it maybe instructive to consider the terms of unit-linked contracts in light of the criteria for derecognition in IAS 39. Ownership issues are not determinative for the derecognition criteria. There are also fiduciary issues to be considered.
- (d) The staff asked if Insurer X buys 1,000 of its own stock and puts 500 in the separate account and 500 in the general account, are either considered treasury stock transactions?

Participants gave the following responses and observations.

- (i) In the US, the general account shares are treasury shares, but the separate account shares are not treated as treasury shares.
 - (ii) In the UK, all are treated as treasury shares.
 - (iii) Treating the shares in the separate account as treasury shares would allow manipulation of EPS
- (e) The staff noted that there may be a distinction between two cases:
- (i) The return on the liability is contractually linked to a specified pool of assets held by the insurer and those assets may (or must) include the insurer's own shares.
 - (ii) The liability pays a return that is linked to an external index; the index includes the insurer's own shares. The insurer may choose to hedge the liability by buying its own shares, but it is not contractually required to do so.

12. If unit-linked insurance contracts are not unbundled, Question 4 asked whether the accounting for such contracts should be consistent with the accounting for other insurance contracts. Participants noted that an accumulation approach could lead to very different results from the prospective approach. There have been presentation problems in the past when European products are transferred to US GAAP.
13. The staff noted that in theory, most would support being able to use an accumulation approach, but it would give rise to boundary issues, which could be quite complicated.
14. Question 5 asked how the assets supporting unit-linked contracts should be accounted for. Participants made the following comments:
- (a) Fair value should not be required for all assets, because some might be difficult to fair value. A question was whether we should permit use of fair value in all cases.
 - (b) As unit-linked contracts have market prices there is no reason to give insurers the option of accounting at cost. Other participants rejected this view as the question addressed the underlying assets rather than the units themselves.
 - (c) Assets should be measured in the same way as the liability. When assets, but not the insurance liability, are marked to market, this creates “artificial” volatility for the insurer.
 - (d) As a principle, the measurement of the liability is not linked to the measurement of the assets. The Board should either consider amending all standards dealing with assets that might be linked to insurance liabilities, or be specific on which assets might be considered for an exception.
 - (i) The key question was how to ensure that a *contractual* link between the assets and liabilities exists.
 - (ii) A Board member noted that it might be appropriate to extend investment property accounting to owner-occupied property, but in a broader context, not just for owner-occupied property backing insurance liabilities.
 - (iii) It might be difficult to define when an exception should apply. For example, the AICPA criteria for separate account presentation might be difficult to work with for non-life contracts.
 - (e) Many unit-linked contracts would fall into IAS 39, rather than an insurance standard.

AP 3 Universal life insurance

15. The group discussed agenda paper 3. The basic accounting question is an unbundling question. Participants made the following comments:
- (a) An integrated prospective approach is preferable, recognising that the whole contract is an insurance contract. Universal life contracts are bought for insurance purposes and should not

be unbundled. The presence of the investment component is a side issue that exists only for tax reasons. There is no other reason to wrap up the investment in an insurance contract.

- (b) From an analyst's point of view, it would not make sense to account for universal life contracts as integrated products.
- (c) A universal life contract can be sold either as an investment product, or as an insurance product. The customer wants both features. However, the tax treatment cannot be obtained when the product is sold as an investment contract.
- (d) Universal life contracts are increasing in prevalence in Asia, where they are sold primarily as investment products. Many policyholders regard universal life contracts as a substitute for endowments.
- (e) The profit drivers should determine whether the contract is unbundled. These vary considerably around the world, including areas where there is a level cost of insurance, and no cost of insurance, but the cost is provided by investment loads.
- (f) The income statement of a life insurer today provides no information about the key drivers of profitability. The group should consider whether a model should provide that sort of information, perhaps through margin analysis.

16. The staff noted that outside the US, the classification issue is very difficult. The staff noted that it would be useful to think about issues that motivated the FASB when they wrote FAS 97, as these are the same issues the group is debating at this meeting.

- (a) Issue 1: upfront profit recognition. The SEC/FASB were very concerned about this issue at the time. With universal life, all the premium could be paid in the first year. A premium-based income recognition model would lead to much of the income being recognised then.
- (b) Issue 2: Unbundling. universal life contracts allow you to unbundle pieces of the contract
- (c) Issue 3: the ability to vary premiums. In practice however, policyholders do not vary the premium streams in the way originally feared.

17. The staff noted that the question of renewal premiums was also relevant. Accounting for flexible premiums would be even more difficult than accounting for contractually agreed, but not enforceable premiums. The staff plan to discuss the conceptual issues around cancellation, continuation and renewal options with the Board before bringing them back to the group.

AP 4 Embedded derivatives (including embedded options and guarantees)

18. The group discussed agenda paper 4. Participants made the following comments:

- (a) A participant asked whether all the options and guarantees were derivatives. The staff responded that the agenda paper took a broad view of derivatives. Some of the payoff patterns of a guarantee have similar characteristics to those of derivatives.

- (b) Using the term “derivative” implies that a market price exists. We need to distinguish what we might want to do from what is possible in terms of measurement. The staff acknowledged that not all derivatives have market analogues and noted that the fair value option in IAS 39 allows measuring the whole instrument including the derivative.
- (c) The measurement of the option or guarantee should only include the intrinsic value (ie the extent to which the option is in or out of the money) because this is the only amount that the policyholder can access. The staff noted that an option also has time value, derived from the potential for changing circumstances or expectations and intrinsic value does not reflect this time value. The staff noted that ‘optionality’ might be a clearer label than ‘time value’ for this component of the total value.
- (d) Optionality is not always reflected in pricing today. In principle, everything should be priced, but there are problems for valuing non-marketable and long-term options and guarantees. The standard should try to force the insurer to price contracts properly, ie taking into account optionality.
- (e) The insurer cannot realise a gain on embedded options and guarantees. The objective is to match cost against revenue over time.
- (f) Policyholder behaviour is not always rational. However, what is rational to the policyholder and his circumstances may not be rational to the insurer. The problem is how to predict what will happen to large groups of products over time. Taking into account customer behaviour reflects economics better than mark to market.
- (g) Some information may not be auditable. Given the Sarbanes-Oxley requirements, it may be more appropriate to report a range of outcomes, rather than a single number.
- (h) Users need education to explain that changes in estimates do not necessarily mean that previous estimates were errors.
- (i) The value of an option or guarantee is not zero. If you agree these things should be valued, then leaving them out means that you are valuing them at zero. A reasonably good attempt to value them is better than not trying.
- (j) In general, probabilistic measures of contracts should be taken into account and it should not be necessary to measure every single option in every single contract. However, there may be a difference between the day-to-day policyholder behaviour, and the policyholder behaviour when facing extreme events, for example in the case of Equitable Life in the UK, all options should have been measured. Another participant noted that even Equitable Life’s policyholders didn’t exhibit 100% consistent behaviour. Some didn’t know about its troubles. Others decided not to risk the company not being around in the future.

(k) Do you use a market mechanism to determine policyholder behaviour or management's best estimate?

19. The staff noted that we will need to look in the future at how to determine the time value.

AP 5 European embedded value

20. The group received a presentation on European Embedded Value (EEV) from Philip Broadley, Hans Wagner and Dom Guiliano (see slides). EEV is intended to measure the value of a life insurance company (or a book of life insurance business). It equals the present value of future distributable cash flows for a insurer's current book of business (ie the in-force covered business, including renewals but excluding future new contracts) plus the insurer's required capital less the insurer's cost of holding that capital plus any free capital allocated to the covered book of business.

21. During the presentation, Philip Broadley announced that the CFO Forum will publish on 31 October 2005 additional guidance on minimum required disclosures of sensitivities and other items. The guidance will further standardise the disclosures among member companies and enable analysts to better understand the underlying assumptions and dynamics of the EEV results. The additional guidance will become an integral part of the EEV principles for the year ending 31 December 2006. Following the publication of this additional guidance, the CFO Forum does not intend to publish further guidance or revise the EEV principles before 2007 at the earliest. (See <http://www.cfoforum.nl/eev.html>)

22. Following the presentations, participants made the following comments:

(a) Embedded value picks the central tendency from a range of outcomes. While we might ignore the other possible outcomes for measurement, the variability is the interesting part for options. The presenters noted that the key to measure of dispersion is by reporting the best estimate and then providing information about the dispersion through sensitivity information.

(b) What is the appropriate discount rate? Should one rate apply to all components? The presenters noted that a range of discount rates would be used depending on the risk of the particular business. Other participants noted:

(i) Different entities use different ways to reflect risk in a way that simplifies the valuation. Some adjust different elements of the margin. Other might adjust the discount rate to take into account some level of risk. However, it was peculiar to discount investments at a rate that would lead to a measurement that implicitly measures the assets at more or less than their fair value. Another way would be to use market consistent embedded value, which is intended to be calibrated so that it is consistent with market prices.

- (ii) The discount rate should be the entity's weighted average cost of capital
 - (iii) The discount rate is a hurdle rate – a required return. It's the return on capital that the investor requires.
- (c) Why are transactions taking place at a price that differs from embedded value?
- (i) Embedded value is just a discounted cash flow calculation. The valuation of options hasn't been taken into account in traditional embedded value. Therefore there has been a substantial discount to embedded value.
 - (ii) Two-thirds of the value of a life insurer is in future business, not in embedded value. EEV excludes the value of future profits.
- (d) EEV was developed as a supplementary disclosure because current financial reporting for life insurance in Europe is considered inadequate. Would EEV be appropriate for use as a basis for an accounting model?
- (i) There are concerns about the verifiability of embedded value. The trade off is between relevance and reliability.
 - (ii) An analyst noted that the disclosures provided about EEV are sufficient. Analysts use very little of the other information in financial statements, because they are not comparable across countries, and not based on the economics of the insurer. Phase II should give consistency and improve the basis on the numbers in the financial statements.
 - (iii) Embedded value sometimes highlights deficiencies in statutory reserves. However, it can give a misleading view of solvency.
 - (iv) The reliability of EEV disclosures should improve as time passes.
 - (v) Aligning the accounting model to embedded value will reduce the use of non-GAAP measures.
- (e) The staff noted that EEV had been developed for life insurance. Would it have a value for non-life business? Participants noted that there could be some value, and this was under research. However, there are concerns about reliability. Moreover, the main benefit of embedded value is for long-term contracts. For short-term contracts, embedded value may not provide as much additional information.
- (f) The claims development table for non-life insurance does not include capital costs.
- (g) The auditors in the group were asked to comment on the auditability of EEV. They noted that audit firms have issued audit reports on EV in the UK in the past, based on the methodology, calculations and assumptions. For those bank insurers who include embedded value in their balance sheets, a true and fair opinion is given. The challenge in auditability is

the valuation of options and guarantees, however, the measurement of insurance liabilities will always require the use of judgement.

23. The staff asked how extensively embedded value was used in other parts of the world.

Participants noted:

- (a) Embedded value is not yet used externally in the US. This may be because the US has had a codified basis of accounting across the industry for 20 years and has not needed something like embedded value. However, embedded value is being used more frequently internally and, although not being used now, it would be used in the future.
- (b) In Canada, embedded value is published. In the US it is used only internally for management purposes.
- (c) In Japan, embedded value is not common. It is not clear what discount rate or assumptions are being used. It may be used internally, but incomplete information is disclosed.

24. The staff asked what adjustments would need to be made if EEV is taken as a starting point for financial reporting. Participants made the following comments:

- (a) The value in EEV is not legally regarded as distributable. Some account needed to be taken of the greater level of prudence required for distribution.
- (b) EEV reflects the value of new business, but Phase II is likely to require a higher standard of proof.
- (c) EEV includes a deduction for the cost of capital, which is not an expense. Otherwise, use EEV since investors are using it and it is being used to manage risks.
- (d) EV gives a better indication of performance. This would be a desirable aim for GAAP measures.
- (e) EEV may provide information useful to shareholders, but not to policyholders. Embedded value may show a positive value for 10-20 years, but this is not relevant to policyholders if there are liquidity issues. This is a question of the purpose of general purpose financial statements, which may not be a basis for policyholder reporting.

25. A Board member noted that Dom Guiliano's presentation indicated that embedded value itself did not necessarily provide useful information. What was useful was the sensitivity disclosures that were presented with EEV. Participants also asked detailed questions about the components of embedded value:

- (a) The value in embedded value comes from 2 sources – putting new business on the books and management efficiencies to derive value from in-force business.
- (b) The capital approach may not be a good way to get to the risk margin. EV is not as tied to a realisation notion as might be thought.

- (c) The value of new business is related to the issue of continuation options. The value of new business does not try to value the lifetime of the customer, only one contract with one customer that is paid in instalments.
- (d) Embedded value is not a statutory model. It's the amount of cash capital that has to be held by the insurer.
- (e) Regulatory capital is reflected as a cost in embedded value to reflect the fact that the insurer cannot access this capital. The investor applies a discount for the lack of liquidity. Some participants disagreed with this concept, as regulatory capital is not "taken away" – only required to be left in the business.
- (f) What is the value of the movement analysis? Eg consider a group of contracts with a surrender value and an assumed lapse rate of 10%. Suppose 80% of contracts lapses instead. What should you show in performance? A loss (as shown in EV) or a gain (shown in measurement models that assume 100% lapse)?
- (g) Embedded value may reflect actions that management represents that it will take in some extreme scenarios. Some may question whether management will always be able to take those actions if the need arises.

AP 6 Life insurance

AP 6A Overview of possible accounting approaches

26. The staff noted that GNAIE and the CFO Forum had circulated alternatives to the approaches in advance of the meeting. However, the staff believed these alternatives to be quite close to approach C or perhaps to approach B, ie they were within the range already discussed in the paper. As a result, the staff had not included these approaches within the paper as a separate approach.
27. Participants made the following comments:
- (a) Approaches A and B have a lot of problems, previously discussed at other meetings. In particular, there are problems with embedded derivatives. Approach A is not appropriate for long-duration contracts. Approaches A and B are not relevant and should be discarded. The issues remaining in approaches C and D are whether there is a need to separate embedded derivatives and whether to unbundle.
 - (b) The frustration with approach A is that changes don't get reflected in the reported results. US analysts could get more comfortable with approaches C and D as they correct the biggest flaw of the existing approach. We should to see a growing preference in the US for approaches C and D.

- (c) Approaches C and D lack consideration of asset management effects and the long-term interests of the policyholder and national economies. The policyholder expects insurers to maximise returns on assets backing insurance liabilities and to maximise the risk-return profile. The widely fluctuating liabilities reported in approaches C and D may improve usefulness for financial statement users, but not for policyholder users. These approaches may cause a large disturbance in equity markets and the national economy.
- (i) Some participants disagree that approach C would lead to a different way of asset allocation from current practice. Others noted that the approach in Australia is close to approach C and had not caused a dislocation of the asset markets as suggested.
 - (ii) A Board member observed that the question is whether short-term fluctuations in equity are relevant for a long term liability. One participant suggested that long term interests would be better served by not showing short-term economic mismatches. There is too much emphasis on fair value, rather than on the policyholder. The liability cash flows are stable and fair value does not take into account the timing matching of cash flows.
- (d) Approaches C and D could reveal an economic mismatch between the assets and liabilities, which would not necessarily move together, thus creating volatility. An insurer could make a conscious business decision to accept volatility. In the US, some non-life profits result from the economic mismatch for two reasons. First, invested assets typically exceed claims liabilities. Second, the cash float created by the receipt of premiums in advance of claims payments can be invested in longer maturity securities than the maturity of the claims liabilities because at least some portion of the float is quasi-permanent, ie based on a continual cash flow of premiums coming in, followed by claims payments going out.
- (e) If we have reliable and relevant ways to calibrate margins we should use approach D. Where this is not possible, Approach C should be used. Both approaches are needed.
- (f) Some participants commented that regulators prefer to see a match between the assets and long-term liabilities. That may not be in the best interest of the shareholder. A participant who was a regulator noted that regulators would like insurers to control economic and accounting mismatches, but do not expect them to *eliminate* it. They also expect them to control economic mismatches in a way that benefits the policyholder. A Board member observed that most people are fixated on minimising risk. However, insurers should take risk, because otherwise no money would be made. The key is to explain and disclose the risk to demonstrate that the insurer has the necessary capital to avoid insolvency.
- (g) The IAIS assumes that the Board will move to a prospective asset/liability model, ie approach C or D. The IAIS would prefer approach D, but recognises that it is the most difficult to compute.

- (h) The SEC staff is inclined to prefer approaches C or D, while realising that there remain issues to be discussed.
 - (i) European analysts are already focussing on embedded value, which is similar to approach D. US analysts may be persuaded to do so as well. However, what analysts most need are lots of disclosures with sensitivities.
 - (j) The accounting model is not going to give us a solvency model. We should try to copy Solvency II into an accounting model. The intention of solvency II is to ensure risks are recognised and the solvency capital is there to deal with the risks recognised. It is hoped that the number of differences between the accounting and solvency models could be minimised – eg there is no reason they should have different measurement models
28. The group discussed the differences between approaches C and D in more detail:
- (a) As written, approach C does not necessarily include a liability adequacy test, but it should. What should that test be? The test in IAS 37 might not be appropriate.
 - (b) The staff observed that approaches C and D appear similar, but there is a conceptual difference. Approach C uses an imputed margin and sees how it runs off. The main difference in approaches C and D occurs when the market price for risk changes dramatically. Such a change would be reflected in approach D, but not approach C.
 - (c) Would approach C or D be more consistent with EEV and thus result in fewer systems changes? Participants noted that EEV is a mixture of approaches C and D. Approach D may be closer to EEV, but approach C produces fewer verifiability issues.
29. The group noted that it would be helpful to look at how models like approaches C and D worked around the world. Before choosing between these approaches, the group should look at more products, not just a 5 year term contract. The staff noted that we would need help in developing further examples. Examples would need to illustrate two aspects:
- (a) The basic mechanics of how the approaches work.
 - (b) Methods for determining risk margins.
30. Participants stressed that there should not be different models for different products – under current US GAAP small contractual differences can result in significant accounting differences.
31. The group did not explicitly discuss agenda papers 6B-6D, which were provided for background to discussions on the other papers on life insurance.

AP 6E Assumptions

32. The group discussed agenda paper 6E. In particular, the staff asked whether the description in appendix A3 reflected the discussions at the July meeting on unlocking of assumptions. Participants made the following comments:

- (a) This approach to changing assumptions is consistent with an actuarial approach.
 - (b) This approach is appropriate for non-financial assumptions only.
 - (c) The package of assumptions needs to be considered together.
 - (d) The approach may give insurers an excuse to ignore bad experience. The draft needs to be clearer that insurers should consider all available evidence and that assumptions have to be unlocked if there is a definite indication of a trend. The staff expects to address trends in material to be drafted on estimating cash flows. **[Action: staff]**
 - (e) Consider a drafting change to the first sentence of paragraph A3, to clarify that it would not typically be appropriate to conform assumptions immediately to be identical to the most recent actual **short-term** experience.
33. Participants discussed whether projected interest rates should be based on market consistent forward interest rates or on management's view of future interest rates. The following comments were made:
- (a) While normal circumstances would require insurers to use the market consistent rates, it may not be appropriate in all circumstances.
 - (b) One solution might be to include a rebuttable presumption that the market value should be used.
 - (c) A similar approach to the fair value measurement hierarchy may be appropriate.
 - (d) If management hedges against interest rates, but uses a measurement that does not reflect market rates, an accounting mismatch would arise.
34. The staff concluded that most participants supported using the most recent market data. The staff also noted that it would be very hard to come up with words that constrain appropriately any exceptions for abnormal cases.
35. No participants objected to the notion that expected values result in a better measurement than point estimates (Q 15).

AP6F Acquisition costs

36. The group discussed agenda paper 6F. The staff referred to previous discussions on initial measurement of insurance liabilities (and related recoverable acquisition costs, if presented as a separate asset). The staff noted that participants had generally felt that this initial measurement should reflect not only incremental costs, but a broader range of acquisition costs. The staff intended to return to that subject at a future meeting.
37. For this meeting, the staff wished to focus on whether recoverable acquisition costs should be presented as a separate asset or included in the measurement of the liability. Participants had suggested in July that recoverable acquisition costs should be amortised on a basis that is not

arbitrary. The staff observed that most methods of recognising margins would make it difficult to amortise recoverable acquisition costs, except by determining an overall net margin and then working back on a basis that would inevitably be arbitrary. Given that, the staff could see no informational benefit in presenting recoverable acquisition costs separately, rather than considering them in the measurement of the liability. Participants did not object to that conclusion.

38. The staff suggested that there might be some merit in investigating at a future meeting whether some contractual rights and obligations should be presented separately. For example, one possibility might present any cash surrender value as one liability and the remaining rights and obligations as one or more separate net asset(s) or net liability(ies). (The staff noted that any separate [net] asset identified would not (except by coincidence) equal the recoverable acquisition costs incurred).
39. In response, a participant objected to separating the surrender value on the grounds that this would place undue emphasis on one aspect.

AP 7 Risk margins

40. The group discussed agenda paper 7, noting that it represented work in progress and did not necessarily represent the view of the IAA. Participants made the following comments:
- (a) In discussing the risk margin, we need to determine what risk is being captured. Insurers look at product risk, both financial and non-financial, not just insurance risk. It may not be appropriate to reflect that in the liability.
 - (b) The risk margin is just the required return. It doesn't matter where it is taken into account.
 - (c) The unit of account is important in determining risk margins. Different insurers have different coefficients of variation depending on the size of their portfolio. Thus, two insurers with the same capital and the same returns might have very different risks.
 - (i) The staff was concerned that the method was entity-specific – if the level of risk capital depended on the entity's risk appetite, it would not be comparable between entities. It seems counterintuitive that the liability recorded in financial statements would be different depending on the insurer.
 - (ii) Different insurers will have different probabilities of sufficiency. Extensive disclosures are required to enable comparisons between insurers.
 - (iii) Insurers could be asked to report their liabilities using a uniform probability of sufficiency that is the same for all insurers, regardless of whether this is the appropriate risk margin. The AASB in Australia considered such a disclosure, but decided not to require it because they had kept part of a deferral and matching model. Australian

insurers are required to disclose the probability of sufficiency and the amount of risk margin instead.

(d) Using cost of capital as the measurement basis for the risk margin may be the current best practice for determining the risk margin. However, this would require a uniform definition of economic capital for comparability.

(i) Economic capital is a summation of different parts of the business and is different for different products. It is difficult to determine and calibrate.

(ii) Conceptually, the cost of capital is intended to be an objective benchmark from the market. Theoretically changes in the market would cause fluctuations. In practice it is difficult to get to a market-based cost of capital as it is a function of the risk level and depends on other investment opportunities. It's generally in the ball park of the risk-free rate plus 4-5%.

(iii) Some insurers use a cost of capital model for very complex situations, so it can be done.

(iv) There is no unique accepted method to determine the cost and amount of capital required, but there is a solid base of experience of estimating it.

(v) The approach is mathematically correct, but also tries to evaluate risk and the value of the risk that might be asked by a participant. This approach needs to be reconciled to what the market would require for the risk.

(vi) It would be inefficient for an insurer to hold more capital than it is economically required to. This situation should not arise or the insurer would be operating sub-optimally. Another participant noted that it would be difficult to apply the modelled approach. There will always be other constraints; therefore the actual capital is always greater than the economic capital. One participant noted that his company targeted an AA rating and the ability to survive a one in thousand loss event. The economic capital is based on the rating target.

(e) Diversification effects should be included in the valuation of the liability.

(f) There are questions over the reliability in determining the risk margin. However, there are also questions over the reliability in estimating provisions. More information about the method will help dispel some concerns about reliability.

(g) It is unreasonable to require insurers to disclose different scenarios and not to do the same for non-insurance entities.

41. Some participants questioned whether the boundary between liabilities and equities is blurred by using cost of capital in measuring liabilities. The staff noted that the purpose of including margins in the measurement of the liability is:

- (a) to report to users useful information about rights and obligations
 - (b) not to report uncertain liabilities in the same way as certain ones.
42. The staff summarised some disadvantages and advantages of using cost of capital to determine risk margins:
- (a) Disadvantages:
 - (i) The level of capital required depends on the targeted level of assurance (for example, one needed to maintain a specified credit rating). Because there is no objective way to set this target, the measurement will be entity-specific component, which may not be the most useful result for users.
 - (ii) A weighted average cost of capital is a blend of the return that market participants require for each of the entity's activities. Arguably, a different cost of capital would be needed for each line of business. Some may argue that variations in the level of risk are sufficiently reflected through different levels of capital, but the staff is not yet convinced that this is the case.
 - (b) Advantages:
 - (i) The approach is implementable, relatively easily described and produces simple disclosures that can be benchmarked against what other insurers are doing.
 - (ii) The approach is close to the way people think for pricing.
43. In view of the significant questions about determining both the amount of capital and its cost that indicated a need for further discussion of the cost of capital approach to selecting risk margins, and about the appropriateness of this approach, the staff suggested that it was premature to limit future exploration to only this approach.
44. The staff proposed further discussions via a subgroup in advance of the next IWG meeting in January. The staff would welcome input on best way to form this subgroup and, in particular, on the best way to proceed with the model and potential alternatives. **[Action: participants]** The staff asked participants to inform the staff if they are aware of any groups discussing similar issues. **[Action: participants]** Sam Gutterman noted that the IAA plans to discuss the paper further in November and will develop the approach further.
45. The group was asked to reflect on the models in agenda paper 6 in the light of the risk margins discussion. Participants made the following comments:
- (a) We should look at a slightly more complicated example for approaches C and D taking the model to the next stage, and showing differences in components of risk. The model should show the effect of different risk drivers. It may be best to do this after answering the question of what the risk margin is first.

- (b) A subgroup should be formed to work on and refine the models. A first step might be to have a small group meeting to brainstorm some of the approaches and see if there are any other possibilities.
 - (i) It would be beneficial to consider illustrations of participating contracts over 20 years.
 - (ii) Approaches C and D are almost a single model except that one has a risk margin at day 1 calibrated to the price. The challenge is more to come up with a case study that provides useful illustration.

46. Participants also noted:

- (a) On introducing an economic capital model in Australia, Australian insurers spent a lot of effort in educating analysts.
- (b) In the US, there is only vague awareness of what's coming, and there is a natural resistance to change. There is increased interest in the US due to the convergence project.
- (c) In Europe, this is hardly discussed and does not affect the stock market. Most are resistant at the moment. However, analysts will learn – they need a clearer picture of the liabilities.
- (d) It would take 5 years for an insurer to get confident with an economic capital model.
- (e) Swiss Re recently published a paper (Sigma 3/2005 *Insurers' cost of capital and economic value creation*) on cost of capital for insurers. The CRO Forum (the forum for Chief Risk Officers of companies in the CFO Forum) is also doing some work in this area.

47. The staff plans to update the analysis for the non-life side for the January meeting (**Action: Staff**)

AP 8 Unbundling

48. The group did not discuss Agenda paper 8. Participants noted that many of the issues relating to unbundling had been covered in earlier discussions. The staff would welcome comments.

[Action: participants]

AP 9 Reinsurance

AP9A Reinsurance assumed

49. The group discussed agenda paper 9A. The staff had not yet identified any differences that indicate a need for different approaches to reinsurance. Participants made the following comments:

- (a) Should the liability adequacy test be a net (or reinsurance) or gross calculation? The staff noted that this would be discussed later, but the staff had assumed it uncontroversial that reinsurance should be presented gross.

- (b) Issues like reinstatement premiums and adjusted clauses are not specific to reinsurance, though they are more common. They should not lead to an accounting difference, but might have to be considered specifically.
- (c) The staff noted that no specific action seemed necessary at this stage, but some of the features more common in reinsurance might need to be specifically addressed.

AP9B Reinsurance ceded

50. The group discussed agenda paper 9B, in particular the questions in paragraphs 9 and 10 on whether there is an implication that the risk margin should mirror the underlying business as ceded out. The staff noted that gains arising from reinsurance arrangements are not an issue if the liability is properly measured. A participant suggested that it would be premature to conclude on risk adjustments to the reinsurance asset arising from the risk in the underlying direct insurance contract if the measurement attribute for the reinsurance asset is not specified.
51. On the subject of impairment, participants noted:
- (a) The reinsurance asset is collectible in the future. A standard credit model should be used. The staff noted that the requirement to use IAS 39 achieves this.
 - (b) All agree that there should be some type of impairment test – some want expected loss, some want incurred loss. Views are divided.
 - (i) It is difficult to apply an expected loss model because it would require the direct insurer to assess the financial health of reinsurers.
 - (ii) It may be too late to wait for incurred losses. The question is whether the amount to be paid should mirror what the other person records as an asset.
 - (iii) A third step is needed - sometimes the reinsurer doesn't settle for years. This is part of the credit risk and suggests an expected loss model is appropriate.
52. Participants discussed the recognition by cedants of rights under reinsurance contracts if the periods of cover differ from those of the underlying direct contracts. Participants may the following comments:
- (a) The cedant has an asset that qualifies for recognition at inception of the reinsurance contract (ie the unconditional right to obtain cover for contracts issued during the specified period).
 - (b) The cedant should not recognise a gain in these circumstances. The measurements would not be reliable and the benefits would not justify the costs.
 - (c) The cedant has an asset and should recognise it, with a corresponding credit to equity, which would be recycled to the income statement as the underlying direct contracts affect profit or loss. The transaction is similar to a cash flow hedge.

AP 10 Premium recognition

53. The group did not discuss Agenda paper 10. The staff would welcome comments. [**Action: participants**]

AP 11 Update on other relevant projects

54. The group did not discuss Agenda paper 11.

Closing remarks and next meeting

55. Warren Macgregor noted that this was Yoshikazu Takeda's last meeting and thanked him on behalf of the group and Board for his participation.

56. The next meeting is on 12 and 13 January 2006, in London.