In November 1999, the International Accounting Standards Committee published an Issues Paper on accounting for Insurance. This was prepared by IASC's Insurance Steering Committee and called for comments by 31 May 2000.

After reviewing the public response to this Issues Paper, the Steering Committee will publish specific proposals for public comment in a Draft Statement of Principles (DSOP). The Steering Committee will review the public response to the DSOP and then develop an Exposure Draft of a proposed International Accounting Standard. On approval by the IASC Board, the Exposure Draft will be issued for public comment. The Steering Committee will consider responses to the Exposure Draft and then prepare an International Accounting Standard for Board approval.

The outcome of this project is of vital interest to general insurance actuaries, because of the wide overlap between accounting and actuarial concerns in this area. Indeed, actuarial techniques are essential for the reliable estimation of long and medium tail liabilities. It is, therefore, vital that any accounting standards in this area be compatible with sound actuarial practice. It is equally vital that those standards be able to cope with the idiosyncrasies of all classes of general insurance business.

The Issues Paper spans a wide range of issues, covering both life and general insurance. It is organised into a number of major sections, as follows.

Introduction
Scope*
Project Timetable
Recognition and Measurement**
Participating (With Profits) Contracts
Reinsurance*
Fair Value Issues**
Deferred Tax
Reporting Enterprise, Consolidation and Business Combinations
Interim Financial Reports
Presentation and Disclosure*

This paper summarises the issues and tentative conclusions in the marked sections, and comments further on the sections marked with a double asterisk.
In this paper, commentary on the issues is in Arial type, while italic type is reserved for passages quoted from the Issues Paper. This material is copyright by the International Accounting Standards Committee, 166 Fleet Street, London EC4A 2DY, United Kingdom. Telephone +44 (171) 353 0565, Fax +44 (171) 353 0562, E-mail iasc@iasc.org.uk, Internet: http://www.iasc.org.uk

The full text of the Issues Paper is available on the web site at
http://www.iasc.org.uk/frame/cen3_113.htm
Comments are being posted to
http://www.iasc.org.uk/frame/cen10_4.htm

Definitions

Disclosure and Recognition

Recognition is used in the technical accounting sense. An item is recognised in the accounts by including a numerical value in the balance sheet and/or income statement, as appropriate.

Disclosure includes recognition, but also extends to the inclusion of a figure or discussion of an issue in the notes to the accounts.

Materiality and Significance

Materiality is used here in the technical accounting sense. A difference is material if it would change the opinion of a typical user of the accounts.

Significance is used here in the technical statistical sense. A difference is significant if the probability, that the alternative values could arise at random out of the same probability distribution, is less than a given confidence level, usually taken to be 5%, if not stated otherwise.

Other terms, such as large or substantial, are used where neither technical meaning is intended.

It is possible, even common, for differences to be material but not significant, or vice versa. Material, non-significant differences lie at the heart of the problems found in adapting deterministic accounting concepts to stochastic enterprises, such as general insurance.
SCOPE

Two basic issues are identified

**Basic issue 1**  Should the Project Cover all Aspects of Accounting by Insurers (Insurance Enterprises) or should it Focus Mainly on Insurance Contracts of all Enterprises?

**Basic issue 2**  Should the Project Deal with Financial Instruments (Other than Insurance Contracts) held by Insurers?

Basic issue 1 includes a number of sub-issues concerned with the definition of insurance. The principal tentative conclusions are set out in the executive summary as follows.

(a) the project should deal mainly with accounting for insurance contracts (or groups of contracts), rather than all aspects of accounting by insurance enterprises. In particular, the project should not deal with accounting for investments held by insurance enterprises;

(b) an insurance contract should be defined as a contract under which one party (the insurer) accepts an insurance risk by agreeing with another party (the policyholder) to make payment if a specified uncertain future event occurs (other than an event that is only a change in a specified interest rate, security price, commodity price, foreign exchange rate, index of prices or rates, a credit rating or credit index, or similar variable);

In sub-issue 1C, the Steering Committee notes that certain reinsurance contracts do not actually transfer risk to the reinsurer and are therefore outside the scope of the insurance project. There are also borderline cases. This will not be a problem if the proposed insurance standard is consistent with that for financial instruments.

In sub-issue 1K, the Steering Committee proposes that it should prepare separate standards for life and general insurance, defining life insurance as insurance where the insurer is committed to a pricing structure for more than twelve months. This definition may need refinement. Further comment and a suggested definition is attached as Appendix C.

The real issue, here, seems to be whether part or all of renewal premiums should be valued as an asset. This is not a uniquely life insurance, or even long-term, matter.

An alternative approach, which may be preferable, is not to have separate standards. To the extent that there are aspects of some classes of insurance with no counterpart in other classes, a joint standard would include sections which are of only limited application. A single standard would avoid the danger that separate standards might prove inconsistent, when applied to lines of business near the boundary between life and general insurance.
RECOGNITION AND MEASUREMENT

Five basic issues are identified

Basic Issue 4 What should be the Overall Objectives of a Recognition and Measurement System for Insurance Contracts?

Basic Issue 5 To what extent should the Measurement of an Insurer's Assets Affect the Measurement of its Liabilities?

Basic Issue 6 What Assumptions and Conventions should be used in Measuring Insurance Liabilities?

Basic Issue 7 What Assumptions and Conventions should be used in Accounting for General Insurance Contracts?

Basic Issue 8 What Assumptions and Conventions should be used in Accounting for Life Insurance Contracts?

Each of these is divided into a number of sub-issues. With the exception of basic issue 8, these are discussed below. The principal tentative conclusions are set out in the executive summary as follows.

(c) the objective should be to measure the assets and liabilities that arise from insurance contracts (an asset-and-liability measurement approach), rather than to defer income and expense so that they can be matched with each other (a deferral-and-matching approach). Table 2 [attached here as Appendix A] summarises the two approaches;

(d) insurance liabilities (both general insurance and life insurance) should be discounted

(e) the measurement of insurance liabilities should be based on current estimates of future cash flows from the current contract. Estimated future cash flows from renewals are:

(i) included if the current contract commits the insurer to pricing for those renewals; and

(ii) excluded if the insurer retains full discretion to change pricing

(f) in the view of a majority of the Steering Committee, catastrophe and equalisation reserves are not liabilities under IASC's Framework. There may be a need for specific disclosures about low-frequency, high-severity risks - perhaps by segregating a separate component of equity;
(g) the measurement of insurance liabilities should reflect risk to the extent that risk would be reflected in the price of an arm's length transaction between knowledgeable, willing parties. It follows that the sale of a long-term insurance contract may lead in some cases to the immediate recognition of income. The Steering Committee recognises that some may have reservations about changing current practice in this way;

(h) overstatement of insurance liabilities should not be used to impose implicit solvency or capital adequacy requirements;

(i) acquisition costs should not be deferred as an asset;

(j) all changes in the carrying amount of insurance liabilities should be recognised as they arise. In deciding what components of these changes should be presented or disclosed separately, the Steering Committee will monitor progress by the Joint Working Group on Financial Instruments;

(m) for participating and with-profits policies

(i) where the insurer does not control allocation of the surplus, unallocated surplus should be classified as a liability; and

(ii) where the insurer controls allocation of the surplus, unallocated surplus should be classified as equity (except to the extent that the insurer has a legal or constructive obligation to allocate part of the surplus to policyholders).

Liability classification is the default, to be used unless there is clear evidence that the insurer controls allocation of the surplus;

(n) for investment-linked insurance contracts, premiums received may need to be split into a risk component (revenue) and an investment component (deposit);

Basic Issue 4 What should be the Overall Objectives of a Recognition and Measurement System for Insurance Contracts?

Sub-issue 4A Should the Project Focus on General Purpose Financial Statements?

Sub-issue 4A asks whether the Insurance Accounting project should focus on general purpose financial statements, to which the Steering Committee says yes, while noting that any changes in standards for general purpose statements will have implications for insurance supervisors and other users of special purpose statements. This is important, not because there was ever any doubt, but because it establishes the basis for subsequent discussion.
Sub-issue 4B  Should IASC use the IASC Framework as a Basis for Developing an International Accounting Standard on Insurance?

The Steering Committee view on sub-issue 4B is equally unsurprising: that the IASC Framework should be used as a basis for any International Accounting Standard on Insurance.

Another way of looking at this issue is that insurance, an essentially stochastic activity, provides a good test for the IASC Framework, which is more usually applied to activities where a deterministic approach is adequate. Since insurance is not unique in its stochastic nature, it is important that the IASC Framework should be amended, if it proves incompatible with insurance. One desirable change relates to the treatment of improbable outcomes, discussed under sub-issue 6A.

Sub-issue 4C  What should be the Overall Objectives of Recognition and Measurement in Accounting for Insurance Contracts?

Having resolved these preliminary questions, sub-issue 4C returns to the substance of basic issue 4. The Steering Committee considered two basic approaches:

- Deferral and Matching;
- Asset and Liability Measurement.

The deferral and matching approach is to defer income until the associated expenses are expected to arise. This approach is most clearly seen in the use of an unearned premium provision to defer premium income and release it over the policy term.

The asset and liability measurement approach goes directly to estimation of the liability to policyholder. Under this approach, premium income is recognised immediately and an unexpired risk provision established.

The Steering Committee clearly sees this as a key issue to be resolved - perhaps the key issue. In an extensive table (reproduced as Appendix A), they compare deferral and matching with three versions of asset and liability - generic, recommended (non-fair value) and recommended (fair value) - and show how this choice relates to some of the other issues which they discuss. The main areas of difference identified, for general insurance, are:

- unearned premium v. unexpired risk (sub-issue 7C)
- catastrophe and equalisation reserves (sub-issue 7H)
- deferred acquisition costs (sub-issue 7D)
- discounting (sub-issue 7I)
- discount rate (sub-issue 11G)

These are discussed further under the sub-issues shown.
For general insurance, what is described as deferral and matching is really a mixture of the two approaches, lacking logical coherence, but reflecting current practice in many jurisdictions. Outstanding claim provisions, in particular, are an asset and liability measurement concept.

Deferred acquisition costs involve double deferral. First, that part of the premium which relates to acquisition costs is deferred, along with the rest, even though the acquisition costs have been paid. Then, the acquisition costs are deferred to match the deferred premium.

In coming down in favour of the asset and liability approach, the Committee is largely constrained by the IASC Framework, which is based on the asset and liability concept. A more substantial argument can be found in the fact that, with the possible exception of Lloyds accounting, deferral and matching is not applied beyond the policy term in general insurance accounting and, then, it is overridden if the unearned premium provision is seen to be inadequate, relative to the estimated liability. The market clearly recognises the primacy of the asset and liability approach.

Even the Bornheutter-Ferguson approach to estimation, which looks superficially like deferral, is really a liability estimation technique, since it includes an assessment of and adjustment for the adequacy of the premiums charged, which are its starting point.

What is not stated in the Issues Paper, is that the reason why this question arises at all is the stochastic nature of insurance. In a deterministic framework, income and expenditure, assets and liabilities can be measured and are connected by simple relationships to profit and equity. In a stochastic framework estimation is needed. It is not necessarily true that the most reliable estimates of these quantities are consistent with each other. In addition to the estimated profit in respect of transactions in the current period, profit emerges from the re-estimation of the results of prior periods. A separate problem is that, in the absence of a single right answer, it is tempting to adopt the most favourable reasonable answer.

This leads, in the stochastic context, to a tension, which does not exist in a deterministic context, between the revenue account and the balance sheet. Put simplistically, deferral and matching emphasises the revenue account, while the asset and liability approach emphasises the balance sheet. A proper stochastic approach recognises the uncertainty inherent in both. It is therefore necessary either to stretch the accounting framework to accommodate stochastic concepts, or to find a way of coping with stochastic issues within the deterministic framework. While an expanded framework is an ideal, it would require a level of statistical sophistication which is not generally available, at this stage, among accountants, let alone the general public. The best compromise, now, is probably to work within the existing framework, plus some additional disclosure relating to uncertainty.

It is not obvious whether the general run of users of general purpose accounts are better served, in the face of large uncertainties, by an emphasis on revenue or balance sheet items. The ideal is probably a compromise, since undue emphasis on one will result in spurious volatility in the other.
Basic Issue 5  To what extent should the Measurement of an Insurer's Assets Affect the Measurement of its Liabilities?

The Steering Committee takes the view that assets and liabilities should be measured consistently. Unless the liabilities are denominated in terms of the assets, the value of the liabilities should not depend on the assets held. This issue re-emerges, and is discussed in more detail, under basic issue 11.

Basic Issue 6  What Assumptions and Conventions should be used in Measuring Insurance Liabilities?

This combines a number of general issues relating to assumptions and accounting conventions.

Sub-issue 6A  Should the Unit of Account be Individual Contracts or Groups of Similar Contracts?

In sub-issue 6A, the issue is whether the basic unit is the individual contract or the portfolio. The Steering Committee favours grouping of similar contracts.

One reason why this is an issue is that accounting concepts incorporate a threshold of probability, below which assets and liabilities are not recognised. On a contract by contract basis, much of an insurer's business would fall below this threshold. The portfolio basis is a fiddle to get around this concept.

This is an example of the problems of fitting a stochastic business into a deterministic accounting framework. A better solution would be to modify the concept, so that bread and butter transactions, no matter how improbable a particular individual outcome, and no matter how difficult the task of estimation, are recognised, while large, unique exposures, outside the normal run of an entity's business, must be disclosed as contingent assets or liabilities and should, if the expected value can be reliably estimated and is material, be recognised.

Under the same sub-issue, it is stated that future renewals should not be recognised in general insurance. No comment is made about instalment and adjustment premiums under existing contracts. It would seem appropriate for both to be recognised and that adjustment premiums should be measured on a basis consistent with that used for the corresponding liabilities. The question of the form of this recognition needs to be addressed.

Sub-issue 6B  Should there be an Implicit or an Explicit Approach to Assumptions?

Sub-issue 6B is about the use of implicit assumptions and strongly favours explicit assumptions. The distinction drawn is that explicit assumptions can be related back to individual features of the experience while implicit assumptions imply relationships which may or may not exist. The example given is "implicit discounting" where inflation is offset against discounting.
While this particular practice is objectionable, the problem is not so much that the assumption is implicit, as that it is untested and, worse, that it is seldom correct. Most actuarial models are riddled with implicit assumptions, of which the most important is that the model chosen will continue to represent reality reasonably well. Indeed, the only model free of implicit assumptions is the "wait and see" model, which requires no assumptions at all, but is totally useless for projecting the future.

Any practical projection model involves simplification. And each simplification introduces implicit assumptions. These assumptions introduce the risk that the model will prove to be inappropriate, while the simplifications reduce the risk that random fluctuations in the past will distort the model parameters. The art of the actuary is to build or select a model which is likely to fairly represent the probable future experience. As a general rule, the more complex models perform better, but only if supported by enough data. Small portfolios demand simple models, as do highly volatile ones.

A general rule against implicit assumptions is undesirable. It cannot be applied strictly. Looser, but still general, application would unduly constrain the actuary's choice of model.

What would be desirable is a requirement for certain assumptions to be explicitly stated. For general insurance, these could be

- discount rate(s)
- inflation
- superimposed inflation
- indirect claim management expenses

Because of the intimate connection between the choice of model, the derivation of model parameters and the selection of assumptions, however, this whole area is more properly one for actuarial, rather than accounting, standards. Care is needed, to avoid rules which, because they were framed to suit a particular model or family of models, implicitly proscribe other actuarial models.

Sub-issue 6C Should Assumptions Reflect Current Information at the Date of the Financial Statements or Long-term Expectations?

Sub-issue 6C is about smoothing. The Steering Committee expresses the view that, if any smoothing is done, the unsmoothed results should be presented, along with explicit smoothing adjustments.

In the discussion, there seems to be an explicit assumption that current experience can be reliably measured. Where this is the case, implicit smoothing clearly involves a distortion of the results and is best avoided.

This is not always the case, however. General insurance often exhibits highly volatile results, which can be very difficult to interpret. It is often difficult to know whether the most recent experience is a random aberration, a one-off change, the start of a new trend or some combination. The results of these different interpretations can be grossly different.
Under these circumstances, taking too much of a current view is likely to result in spurious fluctuations in the results, which is at least as undesirable as spurious smoothness. The most reliable results are likely to be given by techniques, such as Bayesian Credibility, which blend the latest experience and feelings into the longer term background, on the basis of the extent to which they are credible.

Even where current conditions can be reliably measured, there is also the question of whether they should be extrapolated into the future. This is particularly an issue for long term and long tail insurance. While short term projections can reasonably be based on current conditions, longer term projections need to look ahead and should reflect current expectations of future conditions.

Again, this is an area better suited to actuarial guidance.

**Sub-issue 6D** Should Measurement Reflect the Market's Expectations or the Insurer's Expectations?

In sub-issue 6D, the Steering Committee takes the view that assumptions should be based on market, rather than insurer, expectations. This is one aspect of a rather broader issue.

Expectations, generally, are based on information and shaped by attitudes. The discussion in the issues paper seems to centre on attitudes. This is, perhaps, proper, since this is the aspect of the issue which lies within the domain of accounting philosophy. It should be noted that, when we talk about market expectations, we should be talking about market expectations for the particular insurer, rather than for the market as a whole.

The other aspect is more a matter of actuarial technique and concerns the use of insurer or market information. In some cases, the insurer information can stand on its own and a particular assumption can be chosen on the basis of insurer information. More often, insurer information is less than fully credible. If detailed market information is available, then Bayesian Credibility provides tools for blending the two sources. If not, there is little choice but to go with the insurer information and try to interpret this in the light of whatever market information is available.

A related point is that assumptions should, as far as possible, be based on information. Interpretation of that information is essential, but interpretation should not be regarded as an acceptable substitute for information, if that information is reasonably available.

**Sub-issue 6E** Should Assumptions Reflect All Future Events that will affect the Amount and Timing of Cash Flows?

In sub-issue 6E, the Steering Committee takes the view that the valuation should, as far as is practical, reflect all future events to the extent of their respective probabilities, assessed as at the valuation date, without the benefit of hindsight. Where highly material events occur after the valuation date, they should be disclosed, but not recognised.
Sub-Issue 6F  Should the Measurement of Assets and Liabilities arising from Insurance Contracts Reflect Risk and Uncertainty?

In sub-issue 6F, the Steering Committee takes the view that the valuation should include provision for risk and uncertainty, on the basis that would be found in an arm's length transaction between knowledgeable willing parties (i.e. fair value). The extent of this provision should be disclosed (possibly even recognised).

As the Committee recognises, in the absence of an active market for such transactions, this is a difficult technical problem. It is also an area where actuaries should be able to make a major contribution, in terms of the technical tools needed to assess the value of risk and uncertainty.

The Committee also takes the view that, proportionally, the risk adjustment should be the same for small and large portfolios. If transaction costs are ignored, this is actually a consequence of the fair value approach, since the hypothetical market would take into account the potential for combining small portfolios. This issue is less important than one might at first think, because prudent insurers structure their reinsurance to be commensurate with their portfolio size.

A number of approaches to quantifying the risk adjustment have been suggested.

(a) Set the risk adjustment at the level required to finance the risk-based capital needed to support the uncertainty in the net liabilities.

(b) Set the risk adjustment at the level which equates the provision adopted to the certainty equivalent of the uncertain net liabilities, under an appropriate utility function.

(c) Set the risk adjustment at the level required to give an appropriately high probability that the net liabilities can be met.

(d) Set the risk adjustment at a suitable percentage of the standard error of the net expected value.

(e) Set the risk adjustment at a suitable percentage (dependent on the class of business and, perhaps, other factors) of the net expected value.

(f) Adjust for risk using the Capital Assets Pricing Model.

(g) Adjust for risk by reducing the discount rate.

(h) Adjust for risk using the Proportional Hazards model.

Suggestion (a), on the face of it, seems to be a theoretically correct answer. It gives the price that a rational purchaser can justify, but poses two questions. How much capital is needed? What rate of return on that capital is appropriate? Answers to these questions are subjective and should, in a fair value context, be related to how a typical insurer would react. A fair degree of guidance can be gleaned from the asset markets, as to rates of return, relative to risk and capital.
Suggestion (b) also has theoretical appeal. It avoids direct reference to capital and return on capital by relying on a suitable utility function. This, however, is just another way of asking the same questions. Given a utility function, it is possible to arrive at answers to the capital/rates of return question. As a practical matter, however, it is probably only possible to infer the utility function from observations as to what the market regards as appropriate combinations of capital and return on capital. These two approaches are, in fact, equivalent.

Suggestions (c), (d) and (e) offer rules of thumb which, if the parameters are properly chosen, should give much the same answer. Suggestion (c), in particular, can be shown to be equivalent to (a) if, for a given rate of return, the required capital is defined in terms of a (much higher) probability of adequacy and the probability distribution has constant shape. Likewise, for probability distributions of constant shape, (c) and (d) are equivalent. For adequately reinsured portfolios, it is reasonable to expect similar shapes and similar coefficients of uncertainty within a class of business, so that (e) can also give roughly equivalent results, if the parameters are chosen appropriately.

An entirely different approach (g) is to apply the Capital Assets Pricing Model. CAPM suggests that the risk adjustment depends, not on the standard error, but on beta, the correlation between the particular liability and capital markets generally. It is generally accepted that some insurance classes are counter-cyclical. For example, motor claims go down when the market goes down. This would imply that the risk adjustment for such classes should be negative.

This result is counter-intuitive, but can quite reasonably be argued on general grounds. A more serious objection, however, is that, in the admittedly thin market for such things, it does not seem to happen. The problem, almost certainly, arises from the assumptions on which CAPM is built – that:

- markets are fully efficient;
- risks are either fully correlated to the market or fully diversifiable across an infinite pool of risks; and
- there are no transaction costs.

In the context of insurance liabilities, all of these are suspect. Even those most intimately concerned with a particular insurance liability portfolio only have a limited understanding of its behaviour. For long-tail classes, this understanding is often very limited. Long-tail claims, in particular, also exhibit systemic behaviour which is driven by social, rather than economic considerations, on a non-trivial scale, relative to the whole economy.

It is common practice to risk-adjust certain types of assets by increasing the discount rate. The market has well-developed benchmarks for the discount rate adjustment appropriate for different grades of risk. For liabilities, the equivalent is a decrease in the discount rate (h). Again, benchmarks would be needed, according to the degree of risk. This is not greatly different in concept from a set of standard percentage adjustments (f).
The proportional hazards model (i) is a mathematical transform of the probability distribution. The provision is the expected under the transformed distribution. The advantage of the particular transformation is that, for a particular value of the transformation parameter, the resulting provisions are additive. Since the certainty equivalent, under utility theory, is also the expected value under a transformation, defined by the utility function, of the probability distribution, this is a special case of (b).

Sub-issue 6G  When and How Should an Insurer Account for Changes in Assumptions about Future Cash Flows and Actual Experience that Differs from Assumptions?

In sub-issue 6G, the Steering Committee considers a variety of approaches to successive valuations.

The fresh-start approach is based on best estimate assumptions at each successive valuation;

The prospective approach spreads the effect of a change in assumptions over the remaining life of the liabilities;

The catch-up approach is a variant of the fresh-start approach, in which the discount rate is held constant;

The retrospective approach, which revisits the previous valuation on the basis of the latest experience;

The lock-in approach, which holds the original assumptions for each cohort of business.

The Committee favours the fresh-start approach. The other approaches have largely been used in life insurance.

It is desirable to distinguish, in the fresh-start approach, between the valuations, each of which is assessed independently, and the valuation assumptions where, particularly if the experience is highly volatile, the best estimate for some parameters may be found by blending recent experience into the previous assumption, using techniques such as Bayesian Credibility.

Basic Issue 7  What Assumptions and Conventions should be used in Accounting for General Insurance Contracts?

Basic Issue 7 addresses matters specific to general insurance.

Sub-issue 7A  Should Alternatives to the Annual Basis of Accounting be Prohibited, Permitted or Required?

In sub-issue 7A, the Steering Committee looks at three accounting models

periodic, where premiums are brought to revenue as they are earned and claims are estimated and charged to expense as they arise;
open-year, where premiums are held back as liabilities until, in concept, the resulting
claims can all be reliably measured, at which time the claims are charged to expense;
zero-balance, where premiums are initially held back as liabilities and brought to
revenue as the corresponding claim payments and estimates are made and charged to
expense.

The Committee generally favours the periodic model, but would allow the zero-balance model
where estimates cannot be made with sufficient reliability.

It is surprising that the Committee does not mention, here, the model which they favour
elsewhere - asset and liability. Under this model, premiums are brought to revenue
as they are received, at which time the best available estimate of the corresponding
claim cost is charged to expense.

It can be argued that there is no need to explicitly refer to the zero-balance model, as
this is equivalent to (but reported differently from) a special case of the asset and
liability model, in which the best available estimate of the outstanding claim cost is
premiums less payments to date.

Liabilities and Assets Arising under General Insurance Contracts

Sub-issue 7B Should an Insurer Recognise a Liability for Claims Payable?

In sub-issue 7B, the Steering Committee concludes that a liability for claims payable should be
recognised. This comprises active or reported claims, IBNR claims and claim handling expenses.
Future development of active claims and the potential for reopening claims now finalised are not
mentioned but, in the light of comments elsewhere, are implicit.

Sub-issue 7C Should an Insurer Recognise a Liability for Unexpired Risk?

In sub-issue 7C, the Steering Committee, favouring the asset and liability model, prefers
unexpired risk over unearned premium plus, if applicable, premium deficiency. It explicitly
recognises that this may result in recognition of an immediate profit when a policy is sold.

Sub-issue 7D Should Acquisition Costs be Deferred and Recognised as an Asset?

In sub-issue 7D, the Steering Committee concludes that acquisition costs should be recognised
as an expense, not deferred and spread over the policy term.
Sub-issue 7E  If Acquisition Costs are Deferred and Recognised as an Asset, how should they be Measured?

In the light of the conclusion under 7D, sub-issue 7E does not arise.

Sub-issue 7F  How should an Insurer Account for Recoveries Related to Claims?

In sub-issue 7F, the Steering Committee takes the view that salvage and subrogation recoveries occur at the same time as the settlement of the claim and should, therefore, be recognised as a reduction in its net liability to the policyholder, rather than as an asset.

Recoveries should be estimated consistently with the corresponding claims. Once salvage and/or subrogation rights vest in the insurer, they should be treated as assets.

Reinsurance is dealt with under basic issue 10. Sharing is not mentioned. It is not clear whether this is an oversight or whether sharing is regarded as included in subrogation or reinsurance. It is also not clear whether the Steering Committee's view relates to whether recoveries should be recognised as assets or as negative liabilities to be set off against gross claim liabilities, or whether they should be separately recognised at all, or simply recognised as a net liability.

While the legal position is that the right to salvage or third-party recovery vests in the insurer when the policyholder is paid, it is common practice for the insurer to seek recovery earlier as agent for the insured. In practice, recoveries may be made before, after, or at the same time as the corresponding claim payments. There is often considerable uncertainty, even after the corresponding payment is made, whether and how much recovery will be made. The two largest sources of this uncertainty are forensic (whether the insurer can establish its case against the third party) and capacity to pay.

In view of the, sometimes large, uncertainty, some way is needed around the unfortunate references to virtual certainty in paragraphs 53 and 56 of IAS37, which makes explicit reference to insurance. Recoveries, as with claim payments, should be assessed on an expected value basis, with appropriate risk adjustment.

Because of the similar treatment of amounts recoverable at various stages, it would be helpful if it were not necessary to distinguish between recoveries before and after settlement.

Because there are conceptual difficulties in relating the value of risk and uncertainty separately for gross and recoveries, there is merit in regarding recoveries as negative liabilities, rather than on the opposite side of the balance sheet, as assets, and requiring separate risk adjustment.

Whether or not recoveries are recognised separately, they should be disclosed separately.
Sub-issue 7G  How should an Insurer Account for Retrospectively-Rated Contracts?

In sub-issue 7G, the Steering Committee takes the view that an asset and liability approach should be taken to adjustable premiums and notes that, in some cases, these may eliminate insurance risk and require special treatment for the whole insurance.

There are also presentation issues, analogous to recoveries. Indeed, the dividing line between premium adjustments and claims and recoveries is rather thin. There is little, if any, difference in substance between, for example, a coinsurance clause, which deducts a percentage from the claim, and a burner, which adds a percentage of the claim to the premium.

Sub-issue 7H  Should Provisions for Catastrophes or Equalisation be Required, Permitted or Prohibited?

In sub-issue 7H, the Steering Committee is divided over whether catastrophe and equalisation reserves should or should not be recognised as liabilities. The majority view is that they do not and that, if required, they form part of equity. The Committee seeks comment on this and on the related issue of how best to convey information about low-frequency, high-severity risks and about random fluctuations of claims.

This is a contentious issue, at least in relation to catastrophe reserves. The problem is that catastrophe and equalisation reserves do not satisfy the criteria for liabilities in the IASC’s accounting framework, implying that both are part of equity. Catastrophe reserves, in particular, however, perform a valuable economic function. They provide a mechanism for spreading the fluctuations, resulting from very large and very rare events, over a period longer than one year. In the absence of such a mechanism, direct insurers would need to cede more premium to reinsurers and reinsurers would have to lower their capacity. Both would be placed under greater pressure to return needed capital to their shareholders and would pay tax that may not be recoverable when the catastrophe occurs.

A further consideration relates to earthquakes. This can be illustrated by reference to structures such as the San Andreas Fault. This accumulates strain over a period of many years and releases it at irregular intervals in the form of smaller or larger earthquakes. As a general rule, the longer the time since the last release, the greater both the likelihood and the probable severity. There is a clear analogy with traditional life insurance, where part of a level premium must be set aside in the early years, to provide for the higher risk in the later years.

Sub-issue 7I  Should General Insurance Liabilities be Measured using Present Value (Discounting) Techniques?

In sub-issue 7I, the Steering Committee takes the view that liabilities should be discounted.
While this view will be controversial in non-discounting jurisdictions, it is difficult to mount sound arguments against it, while assets are recognised at market value. Inflation, underestimation and the value of risk and uncertainty should all be measured explicitly, rather than implicitly offset against future interest. There is no reason to suppose that this offset is universally correct.

Indeed, given that the gap between interest and inflation can vary over time, that different classes of insurance are subject to different rates of inflation (or, in some cases, no inflation) and that different classes of insurance have risk profiles which sometimes do and sometimes do not relate to their respective mean terms, there is every reason to expect that non-discounting is a rather poor proxy.

Sub-issue 7J  If Present Value Techniques are used, what Discount Rate is Appropriate?

Sub-issue 7J relates to the choice of discount rate. The general conclusion is that a risk free rate is appropriate if the projected cash flows are risk-adjusted, and vice versa. This topic is explored in greater depth in relation to fair value (sub-issue 11G).

It should be noted that there can be interactions between the choice of discount rate and other elements of the valuation basis. For example, some techniques for valuing risk involve an explicit adjustment to the discount rate. While it is appropriate for accounting standards should give guidance on the choice of discount rate, they should not be so prescriptive as to preclude what might otherwise be the most appropriate actuarial techniques.
REINSURANCE

The Basic Issue identified here is

Basic Issue 10 Are there any Specific Accounting Issues for Reinsurance Contracts?

This is discussed under a number of sub-issues. The major conclusions are:

(o) the accounting for reinsurance by a reinsurer should be the same as the accounting for direct insurance by a direct insurer;

(p) amounts due from reinsurers should not be offset against related insurance liabilities;

Sub-issue 10A Is the Distinction between Direct Insurance and Reinsurance Important Enough to Warrant Different Accounting Treatments?

Under sub-issue 10A, the Steering Committee states that it failed to find any reason to set different accounting standards for reinsurers.

Sub-issue 10B Should a Ceding Insurer Recognise Gains or Losses when it Enters into a Reinsurance Transaction?

Under sub-issue 10B, the Steering Committee adopts the view that, as for inward business, the asset and liability model implies that gains or losses may arise at outset on outwards reinsurance and, if so, should be recognised at that time.

Sub-issue 10C Should a Ceding Insurer Recognise Separate Assets and Liabilities arising from Reinsurance Arrangements, or should Amounts be Offset against Related Ceded Liabilities?

Under sub-issue 10C, the Steering Committee is of the view that reinsurance recoveries must be separately recognised. This relates to the discussion under sub-issue 7F.

Reinsurance is a form of gearing, which allows an insurer to take on greater exposure to risk than it could support with its own capital. Some reinsurance recoveries can be related directly to individual claims and can be regarded as a special form of third party recovery. Some, such as catastrophe excess of loss, relate to groups of claims. In some cases, the relationship to claims is even more tenuous.

There are also conceptual issues relating to the risk adjustment of gross liabilities and recoveries. These are discussed in the commentary on sub-issue 11H.
Sub-issue 10D  How Should a Ceding Insurer Report Revenue and Expenses from Reinsurance Arrangements?

Under sub-issue 10D, the Steering Committee has a bit of an each-way bet, but seems to favour showing reinsurance premiums and recoveries as expenses and revenue respectively, rather than setting them off against direct expenses and claims. If a net presentation is used, the reinsurance amounts should be disclosed in notes to the accounts.

Sub-issue 10E  When, if Ever, should a Reinsurance Arrangement be Treated as an Extinguishment of Liabilities?

Under sub-issue 10E, the Steering Committee notes that this is part of a wider issue affecting all financial instruments, but takes the view that derecognition is only appropriate if the reinsurer fully takes over the liability and deals directly with the claimant, as distinct from indemnity, where the liability is simply reimbursed in full.

Sub-issue 10F  Are there any Special Considerations in Measuring Assets and Liabilities under Reinsurance Contracts?

For the time being, the Steering Committee notes sub-issue 10F, but considers that all important issues are covered elsewhere.
FAIR VALUE ISSUES

Basic Issue 11 What Issues are Raised by the Use of Fair Value in the Measurement of Insurance Obligations?

This is discussed under a number of sub-issues. The major conclusions identified are:

(k) the Steering Committee is working on the assumption that IAS 39, Financial Instruments: Recognition and Measurement, will be replaced, before the end of the Insurance project, by a new International Accounting Standard that will require full fair value accounting for the substantial majority of financial assets and liabilities. The Steering Committee believes that;

(i) if such a standard exists, portfolios of insurance contracts should also be measured at fair value. IASC defines fair value as "the amount for which an asset could be exchanged or a liability settled between knowledgeable, willing parties in an arm's length transaction";

(ii) in a fair value accounting model, the liability under a life insurance contract that has an explicit or implicit account balance may be less than the account balance; and

(iii) determining the fair value of insurance liabilities on a reliable, objective and verifiable basis poses difficult conceptual and practical issues, because there is generally no liquid and active secondary market in liabilities and assets arising from insurance contracts. To avoid excessive detail, this Issues Paper discusses measurement issues in fairly general terms. The Steering Committee will develop more specific guidance on measurement issues at a later stage in the project;

(l) pending further discussion, the Steering Committee is evenly divided on the effect of future investment margins. Some members believe that future investment margins should be reflected in determining the fair value of insurance liabilities. Other members believe that they should not;

Background

Fair value is defined by the IASC as the amount for which an asset could be exchanged or a liability settled between knowledgeable, willing parties in an arm's length transaction.
It is commonly thought that, in a deep and liquid market, fair value is market value. Given the way in which actual markets behave, this cannot be true. The fallacy lies in the assumption that market prices depend on rational analysis of what is known. While this may account for the long-term trends, the large fluctuations about those trends are driven more by hope, fear and momentum, than by fundamentals. Nevertheless, market transactions do provide an objective basis for valuation.

An unavoidable feature of actual market transactions is that they take place between particular counterparties, each with its own idiosyncrasies. The differing counterparties in particular transactions contribute to the variation of market value about the long-term trend. At certain times, actual transactions tend to be biased:

- towards sellers who need the money urgently, or who want to get out of a falling market; or
- towards buyers keen to ride a bull market; or
- in other ways.

Actual insurance liability transactions have, until recently, been dominated (if dominated is the word for such a thin market) by cases where the selling party is in some sort of trouble. More recently, there has been some securitisation of insurance liabilities, but only in certain market segments.

If fair value is to be well-defined, with a single value, it cannot depend on the idiosyncrasies of particular counterparties. Some sort of standard is needed. For portfolios of insurance liabilities, the potential market comprises insurance companies, reinsurers and securitisers of insurance. If we refer to these, generically, as insurers, assume that all are knowledgeable and note that generic insurers are, by definition, acting at arms length and that the level of willingness is the same on both sides, we can define the fair value of insurance liabilities as the price at which insurance liabilities would change hands between typical insurers.

If this definition is accepted, it follows that the fair value of insurance liabilities is independent of the particular insurer. It also follows that, since a typical insurer would embed any purchase within a larger portfolio, and adjust its reinsurances appropriately that the percentage risk adjustment does not vary if the only change is the number of claims.

An alternative potential market exists, for individual claims, comprising claimants or potential claimants, and those who might wish to purchase their entitlements. It should be noted that trades in this market are between claimants, with no change of insurer. Between insurers, there is no change of claimant. Since what is traded in the two markets is different, what is fair value to a claimant need not be the same thing as fair value to an insurer.
Sub-issue 11A  Are Insurance Contracts Financial Instruments?

In sub-issue 11A, the Steering Committee concludes that insurance contracts are basically financial instruments and should be accounted for as such.

Sub-issue 11B  Should Insurance Contracts be Included in a Fair Value Standard?

In sub-issue 11B, the Steering Committee assumes that the IASC will adopt a fair value approach to all financial instruments. Insurance contracts should be subject to this approach, but under a specialised standard. The Committee recognises the difficulties in establishing fair value for insurance and seeks suggestions for practical guidelines.

The actuarial profession is perhaps best placed to provide such suggestions, particularly those members with an interest in financial economics. In general insurance, where there has been considerable reluctance to adopt a present value approach in most jurisdictions, Australia has been subject to a discounting standard for some years. This has focussed attention on valuation margins, albeit on an ad hoc, rather than a fair value basis. The Australian Prudential Regulatory Authority is currently seeking to develop a fair value approach to statutory accounting.

Fair Value in an Insurance Context

Sub-issue 11C  What should be the General Approach in Applying Fair Value to Insurance Contracts?

In sub-issue 11C, the Steering Committee favours the approach adopted in IAS37. In summary, this is based on expected cash flows, including allowance for unknown future events, adjusted for risk and discounted. While not explicitly fair value, IAS37 refers to what an enterprise would rationally pay to settle...or to transfer it to a third party.

Sub-issue 11D  Should the Fair Value of an Insurance Contract Include the Fair Value of Intangibles and Other Items Related to the Insurance Contract?

Sub-issue 11D, in the general insurance context, relates to the value of customer relationships and similar intangibles. The Steering Committee takes the view that, while these may be reflected in market transactions, their value is not part of the value of the insurance contracts.
Sub-issue 11E  Should the Fair Value of Insurance Contracts be based on Individual Contracts or Books of Similar Contracts?

Sub-issue 11E revisits sub-issue 6A and comes to the same conclusion: books of similar contracts.

Sub-issue 11F  Should the Fair Value of Insurance Contracts be Estimated using Entry or Exit Values and should the application of Fair Value Measurements result in a Gain or Loss on the Sale of Insurance Contracts?

In sub-issue 11F, the Steering Committee considers that exit values should be used. This is a prospective approach which looks to what might be paid now, rather than what the policy holder actually paid (entry value). It implies that a gain or loss may be recognised when an insurance contract is sold. This is consistent with usual actuarial practice.

Sub-issue 11G  Should Fair Value of Insurance Contracts be Estimated using Rates of Return on the Insurer’s Assets or using some other Discount Rate?

The Steering Committee is divided on sub-issue 11G. Some believe that the rate should be based on the actual assets held by the insurer, while others believe that it should be independent of them. This appears to cut across sub-issue 7J, where they take the view that the risk-free rate should be used where an explicit risk adjustment is made.

There would appear to be three main options for the discount rate:

- the risk-free rate, based on the actual liability portfolio;
- the rate that a typical insurer would earn, based on the actual liability portfolio;
- or
- the rate that the particular insurer would earn on its actual asset portfolio.

If we look at the definition of fair value, it is clear that fair value is based on the hypothetical behaviour of typical insurers and is, therefore, independent of any particular insurer. This would, on the face of it, eliminate the actual asset basis for the discount rate, unless the liability is denominated in terms of the actual assets. Actual liability transfers mostly arise when one party is under stress and so give only limited guidance on fair value.

If we are to avoid anomalies, it is arguable that the discount rate should be the typical insurer rate. This is, perhaps, not too significant in general insurance. For immediate annuities, however, where the uncertainty is low, prices are typically set on the basis of very thin margins and corporate bond yields, which are substantially higher than sovereign risk yields, because they do not offer the same liquidity.
Looking at things in another way, in theory, the discount rate chosen should not affect the fair value. Fair value comprises expected value plus a risk adjustment. The risk adjustment is dependent on the discount rate used and, since fair value is independent of the insurer, must compensate for the choice of discount rate. That this is plausible, may be seen by noting that the market value of assets also comprises an expected value plus a risk adjustment, and that similar questions about the choice of discount rate arise.

As noted under sub-issue 7G, the choice of discount rate should not be so tightly prescribed as to preclude the use of otherwise appropriate actuarial judgement.

Sub-issue IIH  Should the Estimated Fair Value of Insurance Contracts include a Provision for the Risk Inherent in those Contracts?

Sub-issue IIH revisits sub-issue 6F, in the fair value context. The conclusion, that a market-based adjustment for risk and uncertainty should be included, is unchanged.

In addition to the difficulty in estimating the risk adjustment, discussed under 6F, there is another issue, which relates to the discount rate question. This can be seen most clearly by considering the fair value of a package comprising assets and liabilities. This comprises expected value plus risk and can be further broken down into five components:

- the expected value of the assets;
- the expected value of the liabilities;
- the value of asset risk (which is independent of the liabilities);
- the value of liability risk (which is independent of the assets);
- the value of the asset/liability interaction risk.

The issue is: what to do with the asset/liability interaction component. Unlike the others, which fit comfortably within the accounting framework, the interaction term has no natural home. More importantly, it needs to be recognised that the existence of this term upsets the comfortable assumption that the fair value of assets and liabilities is equal to the fair value of the assets minus the fair value of the liabilities. It is not even clear where the boundaries between the various risk adjustment terms fall.

It is superficially attractive to think of the value of the liabilities in isolation. In this case, the liability risk adjustment would fully reflect the uncertainty of future investment earnings and the asset/liability interaction term would be of the opposite sign, reflecting the degree of matching. Alternatively, if the value of the liabilities is assessed in the context of matching assets, the liability risk adjustment has no component for uncertain investment earnings and the asset/liability term is of the same sign, and reflects the degree of mismatching.
Arguments can be mounted that the interaction term:

- belongs in the assets, because the liabilities are given and the value of the asset/liability interaction varies according to the choice of assets;
- belongs in goodwill or embedded value, because it derives from management policy;
- belongs in equity, because it would otherwise capitalise future benefits which are subject to future management decisions; or
- belongs in the liabilities, because assets are shown at market value and there is nowhere else to put it.

Similar problems arise in relation to recoveries. Again, we have:

- the expected value of gross payments;
- the expected value of recoveries;
- the value of uncertainty in the gross payments;
- the value of uncertainty in the recoveries; and
- the value of the correlation between the two.

The value of the net uncertainty is the (properly signed) sum of the three uncertainty terms. If this is disclosed, together with the expected values, or if the correlation term is disclosed separately, there is no particular problem. If, however, we seek to show uncertainty-adjusted values for gross, recoveries and net, there is nowhere sensible for the correlation term to go.

Sub-issue 111 Should the Estimated Fair Value of Insurance Contracts reflect the Insurer's Credit Standing?

The Steering Committee recognises that sub-issue 111 extends beyond insurance. It expresses no view on how this issue should be resolved.

This issue revolves around another interaction term, between liabilities and equity. It is arguable that social policy demands that no entity should factor its own risk of default into its own liabilities. A possible exception to this is when there is an established market in which the liabilities are actively traded. In that case, it is arguable that the market price should be used. This is not normally relevant to insurance liabilities.

At the very least, if the value of that risk is recognised, it should be recognised explicitly, as a separate item. No supervisory regime should accept recognition of particular default risk for liabilities.
Including a full credit risk adjustment in any entity's valuation of its own liabilities, implies that there is no such thing as insolvency. The liabilities could never exceed what is available. If there is any uncertainty, then there must be a positive difference between assets and liabilities. While this makes a twisted sort of sense from a shareholder's perspective, it makes a mockery of any concept of financial responsibility.

To take a fair value approach to this issue, it is necessary to decide what is to be notionally traded. Does the notional transfer of liability, on which fair value is defined, carry the particular insurer's credit risk or not. If the notional transfer is between two typical insurers, it does not. The default risk attaches to the insurer, rather than to the liabilities. It is arguable that all liabilities should allow for a market-typical default risk. In a well-supervised market, this should not be material.

If, however, we were to seek to value the claim as an asset in the hands of the claimant, the opposite conclusion follows. The default risk attaches to the insurer, and is not changed in a transfer between notional claimants, because the insurer does not changed.

While particular default risk should not be recognised, it should be disclosed, if material.

**Sub-issue 11J  Does a Fair Value Accounting System for Insurance Contracts include Deferred Acquisition Costs?**

In sub-issue 11J, the Steering Committee takes the view, consistent with 7D, that acquisition costs should be expensed rather than deferred.

**Sub-issue 11K  Is the Embedded-Value Method an Appropriate Approach to use in Estimating and Reporting the Fair Value of Insurance Assets and Liabilities?**

Sub-issue 11K relates more to life than to general insurance. The Steering Committee takes the view that, in a fair value system, embedded values should be factored into the measurement of liability, but that some additional disclosure may be needed.

**Sub-issue 11L  Should Decisions about the Fair Value of an Insurer's Financial Assets and Liabilities be extended to other Assets and Liabilities of an Insurer?**

Sub-issue 11L relates to things such as non-investment property, plant and equipment. This lies outside the scope of the project.
PRESENTATION AND DISCLOSURE

The basic issues discussed here are

Basic Issue 18  How Should Insurance Contracts be Presented in the Financial Statements?

Basic Issue 19  How Should Income and Expense from Insurance Contracts be Presented?

Basic Issue 20  What Disclosures Should he Required about Insurance Contracts?

Each of these is divided into a number of sub-issues. The principal tentative conclusions are set out in the executive summary as follows.

(f)  in the view of a majority of the Steering Committee, catastrophe and equalisation reserves are not liabilities under IASC’s Framework. There may be a need for specific disclosures about low-frequency, high-severity risks - perhaps by segregating a separate component of equity;

(q)  most of the disclosures required by IAS 32, Financial Instruments: Disclosure and Presentation, and IAS 37, Provisions, Contingent Liabilities and Contingent Assets, are likely to be relevant for insurance contracts. Some of the disclosures required by IAS 39, Financial Instruments: Recognition and Measurement, may not be needed in a fair value context. Other items that may require disclosure are regulatory solvency margins, key performance indicators (such as sum insured in life, retention/lapse rates), information about risk adjustments and information about value-at-risk and sensitivity.

Basic Issue 18  How Should Insurance Contracts be Presented in the Financial Statements?


Under sub-issue 18A, the Steering Committee considers that there may be some insurance specific items required in the accounts, and recommends that illustrative formats be included in an appendix to the proposed standard.
Sub-issue 18B  Should an Insurer Make the Current/Non-current Distinction in its Balance Sheet?

Under sub-issue 18B, the Steering Committee concludes that the current/non-current distinction is not appropriate to insurance.

Sub-issue 18C  Should IAS 7, Cash Flow Statements, be Amended for Insurers?

Under sub-issue 18C, the Steering Committee concludes that cash flow statements should be required for insurance. It has not fully explored this issue and seeks comment on what disclosures should be required.

Sub-issue 18D  Should Policyholder Interests be shown Separately from Stockholder Interests on the Face of the Balance Sheet, Income Statement and Cash Flow Statement?

Sub-issue 18D relates primarily to life insurance, where separate funds may be maintained. The Steering Committee takes the view that information about these funds should be disclosed and that separate recognition should be allowed.

Basic Issue 19  How Should Income and Expense from Insurance Contracts be Presented?

This is discussed under a number of sub-issues.

Sub-issue 19A  How should an Enterprise Present Income and Expense arising from Insurance Contracts?

Under sub-issue 19A, the Steering Committee discusses work currently under way in the broader context and defers its own consideration until this work progresses further.

Sub-issue 19B  Should an Enterprise Present Premium Revenue and Claims Expense on the Face of the Income Statement?

Under sub-issue 19B, the Steering Committee concludes that premiums and claims should be presented as a single item each, rather than the underlying cash payments and movement in provisions.
Sub-issue 19C  Should an Insurer Present Unwinding of the Discount as Operating Expense or as Finance Expense?

Under sub-issue 19C, the Steering Committee concludes that the unwinding of discounting should be presented as interest expense (or income).

Sub-issue 19D  How should an Insurer Present the Effect of Experience Adjustments and Changes in Assumptions?

The Steering Committee has not formed a view on sub-issue 19D and refers to ongoing work in other IASC projects.

Sub-issue 19E  Should an Insurer Include All, Part or None of its Investment Return in Operating Activities?

Under sub-issue 19E, the Steering Committee considers that all investment income (including unrealised movements, to the extent recognised) should be included in the results of operating activities.

Sub-issue 19F  Should Income and Expense be Presented in the Income Statement Separately for Life Insurance Contracts and for General Insurance Contracts?

Under sub-issue 19F, the Steering Committee believes that the main income statement should combine life and general insurance, with separate disclosure in the notes.

Sub-Issue 19G  Should Taxes and Levies be Included in Premium Income?

Under sub-issue 19G, the Steering Committee considers that IAS 18 should apply. Items collected on behalf of and remitted to third parties, should be excluded from revenue. Amounts collected to fund obligations of the insurer should be included. Which are which should be disclosed.

Basic Issue 20  What Disclosures Should be Required about Insurance Contracts?

This is discussed under a number of sub-issues.
Background

There are various levels of disclosure. Broadly, there are:

- recognition as a separate item in the main statements;
- recognition in combination with other items;
- disclosure in the notes;
- disclosure elsewhere, as in a director's or management report.

Disclosure and recognition are related to materiality. Generally, the greater the materiality, the higher the level of disclosure needed. The Steering Committee invites comment about where particular items are most appropriately disclosed.

Sub-issue 20A  Should the Disclosures about Financial Instruments in IAS 32 and IAS 39 be Extended to Cover Insurance Contracts?

Under sub-issue 20A, the Steering Committee considers that the IAS32 disclosures are also likely to be relevant for insurance companies. These cover financial risk management, the nature of financial assets and liabilities, interest rate risk, credit risk, fair value and hedging. It considers that the IAS39 disclosures are specific to IAS39, but that analogous disclosures may be needed for insurance contracts. These are mainly in the form of a more detailed exposition of particular IAS32 disclosure requirements. Obvious candidates are reinsurance and matching.

Sub-Issue 20B  Should IASC extend IAS 37's Disclosure Requirements about Provisions to Cover Insurance Contracts?

Under sub-issue 20B, the Steering Committee considers that the IAS37 disclosures should be extended to cover insurance contracts. These cover provisions, their nature, amount and development, and contingent liabilities. The committee intends to give further guidance on the application of these disclosures to insurance contracts. In particular, it considers that disclosure of risk adjustments may be useful.

Sub-Issue 20C  Should an Insurer Disclose Details of Claims Development?

Under sub-issue 20C, The Steering Committee considers that claim development disclosures would be useful for general insurance activities.
Sub-issue 20D  Should Disclosures of Solvency be made in the Financial Statements?

Under sub-issue 20D, the Steering Committee recognises that the disclosure of regulatory solvency margins may be very voluminous, or aggregated at such a high level that it is not meaningful. They recommend that an insurer should disclose how much of its equity is not available for distribution to stockholders, distinguishing between regulatory and other needs.

Sub-Issue 20E  Does IAS 14 give Sufficient Guidance on Segmental Reporting by Insurers?

Under sub-issue 20E, the Steering Committee intends to develop guidance on segment reporting, on the basis of IAS14. Specific requirements for insurance might go beyond IAS14. Because the financial statements of insurers are widely used, segment reporting should be extended to all insurers, not just those that have publicly traded debt or equity.

Sub-issue 20F  Should Disclosures be Required About Key Performance Indicators?

Under sub-issue 20F, the Steering Committee believes that insurers should disclose key performance indicators and seeks input on what is appropriate. They will investigate whether specific disclosure about low frequency, high severity risks is needed.

Sub-issue 20G  Should Disclosures be Required About Sensitivity?

Under sub-issue 20G, the Steering Committee believes that sensitivity disclosure is valuable and plans to develop this area further.

Sub-issue 20H  Should any Other Disclosures be Required About Insurance Contracts?

Sub-issue 20H is a catch-all for other suggestions.
Risk and Uncertainty

The most important area of insurance-specific disclosure, particularly for long-tail and upper-tail insurance, is risk and uncertainty. While this is recognised in the form of a margin for risk and uncertainty, recognition is inherently in the form of a single figure, incorporated in the provision for liabilities. An understanding of uncertainty requires more than a single figure. What is needed is discussion in the notes. It is not easy to decide how much discussion is needed, or what form that discussion should take if it is to adequately inform the statistically aware user, without hopelessly confusing the unsophisticated.

One suggestion, which would also address the disclosure of run-off information, is to present a table showing the developing results for each accident (or underwriting) period along with the corresponding uncertainty. Appendix B shows how this might be presented, for the current year and for subsequent years.

Expected Policyholder Deficit

This is a measure of credit risk that the insurer poses to its policyholders. It is the expected value of the shortfall in payments on its existing liabilities. This combines the probability of failure with a measure of severity. For a sound insurer, it is a very small fraction of a percent.
**Appendix A**

**Table 2 - Overview of Different Approaches**

This table gives an overview of four approaches to accounting for insurance contracts.

(a) **Deferral and matching** - This is the most common form of approach found today. There are a number of different ways of implementing such an approach. The Steering Committee has tentatively rejected deferral and matching approaches.

(b) **Asset and liability measurement** - This column of the table illustrates a range of possibilities, depending on the measurement objective specified. Possible measurement objectives range from cost-based measures to fair value. The Steering Committee has tentatively decided to adopt an asset and liability measurement approach.

(b) (i) **Steering Committee proposals** (non-fair value) - This column shows the Steering Committee's tentative proposals under an asset and liability measurement approach, if fair value is not adopted as the measurement objective.

(b) (ii) **Fair value** - This column shows the Steering Committee's tentative proposals under an asset and liability measurement approach, if fair value is adopted as the measurement objective.

<table>
<thead>
<tr>
<th>Topic (Basic Issue or Sub-issue in parentheses)</th>
<th>(a) Deferral and Matching</th>
<th>(b) Asset and liability measurement</th>
<th>(b) Asset and liability - tentative Steering Committee proposals</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Defer income and expense so that they can be matched with each other</td>
<td>Measure assets and liabilities that arise from insurance contracts</td>
<td>Measure assets and liabilities that arise from insurance contracts</td>
</tr>
<tr>
<td>Does measurement of assets affect measurement of insurance liabilities? (5)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>&gt; General insurance</td>
<td>No</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>&gt; Life - unit-linked and similar</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>&gt; Life - other</td>
<td>In practice, often yes (see discussion of discount rate)</td>
<td>Possibly (for example, in embedded value approach)</td>
<td>No</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>No (but see 11G below on treatment of future investment margins)</td>
</tr>
<tr>
<td>Topic (Basic Issue or Sub-issue in parentheses)</td>
<td>(a) Deferral and Matching</td>
<td>(b) Asset and liability measurement</td>
<td>(b) Asset and liability - tentative Steering Committee proposals</td>
</tr>
<tr>
<td>------------------------------------------------</td>
<td>--------------------------</td>
<td>---------------------------------</td>
<td>---------------------------------------------------------------</td>
</tr>
<tr>
<td>Assumptions (6B-E)</td>
<td>Various. May be:</td>
<td>Various. May be:</td>
<td>Current best estimate of all future events that will affect amount and timing of cash flows (including legislation and lapse)</td>
</tr>
<tr>
<td></td>
<td>&gt; locked-in at inception</td>
<td>&gt; locked-in at inception</td>
<td>Current best estimate of all future events that will affect amount and timing of cash flows (including legislation and lapse)</td>
</tr>
<tr>
<td></td>
<td>&gt; locked-in at inception, but subject to loss recognition test</td>
<td>&gt; locked-in at inception, but subject to loss recognition test</td>
<td></td>
</tr>
<tr>
<td></td>
<td>&gt; current best estimate</td>
<td>&gt; current best estimate</td>
<td></td>
</tr>
<tr>
<td></td>
<td>&gt; long-term trend</td>
<td>&gt; long-term trend</td>
<td></td>
</tr>
<tr>
<td></td>
<td>&gt; mandated by supervisor</td>
<td>&gt; mandated by supervisor</td>
<td></td>
</tr>
<tr>
<td></td>
<td>&gt; some combination of the above</td>
<td>&gt; some combination of the above</td>
<td></td>
</tr>
<tr>
<td>Risk reflected in measurement of general and life insurance liabilities? (6F)</td>
<td>Usually May exceed market value margin (note 1)</td>
<td>Possibly</td>
<td>Yes - market value margin</td>
</tr>
<tr>
<td>Measurement reflects insurer's own credit standing:</td>
<td>Yes (may be implicit in transaction price)</td>
<td>Yes (may be implicit in transaction price)</td>
<td>Yes (may be implicit in transaction price)</td>
</tr>
<tr>
<td>&gt; At inception of contract?</td>
<td>Yes (may be implicit in transaction price)</td>
<td>Yes (may be implicit in transaction price)</td>
<td>Yes (may be implicit in transaction price)</td>
</tr>
<tr>
<td>&gt; Subsequent changes? (111)</td>
<td>No</td>
<td>Possibly</td>
<td>To be decided (may be implicit in definition of fair value)</td>
</tr>
<tr>
<td>Changes in carrying amount of insurance liabilities (6G)</td>
<td>Generally recognised immediately in the income statement</td>
<td>Generally recognised immediately in the income statement (note 2)</td>
<td>Recognised immediately in the income statement (assuming same basis for financial instruments)</td>
</tr>
</tbody>
</table>

Note 1 **Market value margin** = risk that would be reflected in the price of an arm's length transaction between knowledgeable, willing parties.

Note 2 Some might argue that some components of changes in carrying amount should be recognised in equity or in a second performance statement, not in the income statement.
<table>
<thead>
<tr>
<th>Topic (Basic Issue or Sub-issue in parentheses)</th>
<th>(a) Deferral and Matching</th>
<th>(b) Asset and liability measurement</th>
<th>(b) Asset and liability - tentative Steering Committee proposals</th>
</tr>
</thead>
<tbody>
<tr>
<td>General insurance liability includes:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>&gt; claims payable, including IBNR? (7B)</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>&gt; expected claim handling costs? (7B)</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>&gt; deferral of unearned premium for unexpired part of contract period? (7C)</td>
<td>Yes (amount deferred may exceed present value of claims)</td>
<td>No (but see unexpired risk)</td>
<td>No (but see unexpired risk)</td>
</tr>
<tr>
<td>&gt; provision for unexpired risk (7C)</td>
<td>Yes (if unearned premium is not enough to cover claims during unexpired part of contract period)</td>
<td>Yes (present value of expected claims for unexpired part of contract period)</td>
<td>Yes (present value of expected claims for unexpired part of contract period)</td>
</tr>
<tr>
<td>&gt; catastrophe and equalisation reserves? (7H)</td>
<td>Possibly</td>
<td>No (majority view)</td>
<td>No (majority view)</td>
</tr>
<tr>
<td>Acquisition costs (7D)</td>
<td>Generally deferred, subject to loss recognition test</td>
<td>Not deferred (but some view acquisition costs as the cost of an intangible asset that should be recognised at cost)</td>
<td>Not deferred</td>
</tr>
<tr>
<td>Discounting used:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>&gt; general insurance? (7I)</td>
<td>Usually not in current practice</td>
<td>Probably</td>
<td>Yes</td>
</tr>
<tr>
<td>&gt; life insurance? (8A)</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Topic (Basic Issue or Sub-issue in parentheses)</td>
<td>(a) Deferral and Matching</td>
<td>(b) Asset and liability measurement</td>
<td>(b) Asset and liability - tentative Steering Committee proposals</td>
</tr>
<tr>
<td>-------------------------------------------------</td>
<td>---------------------------</td>
<td>-----------------------------------</td>
<td>---------------------------------------------------------------</td>
</tr>
<tr>
<td>Discount rate (7J / 11G)</td>
<td>Often based on expected long-term earnings on actual or notional investments backing the liability</td>
<td>Various possibilities. Rate based on actual investments is not acceptable if liabilities and assets are measured independently.</td>
<td>Risk-free, adjusted for any risk not reflected in cash flows</td>
</tr>
<tr>
<td>Income from long-term contract (7C / 8A / 11F)</td>
<td>Emerges based on predetermined attribution pattern.</td>
<td>Some income or loss emerges at the point of sale. Rest emerges as the insurer is released from risk and as actual experience differs from expected experience.</td>
<td>Some income or loss emerges at the point of sale. Rest emerges as the insurer is released from risk and as actual experience differs from expected experience.</td>
</tr>
<tr>
<td>Include cash flows from future renewals: (8B)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>&gt; if current contract commits insurer to pricing (typical life insurance contract)?</td>
<td>Possibly</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>&gt; if the insurer retains full pricing discretion (typical general insurance contract)?</td>
<td>No</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Basis for measuring liability for a life insurance contract that has an explicit or implicit account balance (8D)</td>
<td>Practice varies. Liability may or may not be less than the account balance.</td>
<td>Different approaches are possible. Liability is based on future cash flows and may or may not be less than the account balance.</td>
<td>Liability is based on future cash flows, but cannot be less than the account balance.</td>
</tr>
<tr>
<td>Topic (Basic Issue or Sub-issue in parentheses)</td>
<td>(a) Deferral and Matching</td>
<td>(b) Asset and liability measurement</td>
<td>(b) Asset and liability - tentative Steering Committee proposals</td>
</tr>
<tr>
<td>------------------------------------------------</td>
<td>---------------------------</td>
<td>-----------------------------------</td>
<td>---------------------------------------------------------------</td>
</tr>
<tr>
<td>Future investment margins affect measurement of insurance liabilities? (5 / 11G)</td>
<td></td>
<td></td>
<td>(i) (non-fair value) (ii) (fair value)</td>
</tr>
<tr>
<td>General insurance</td>
<td>No (except where recognition is reduced by future investment returns)</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Life</td>
<td>In practice, often yes (see discussion of discount rate).</td>
<td>Possibly (for example, in embedded value approach)</td>
<td>No</td>
</tr>
<tr>
<td>Premium revenue (19)</td>
<td>Recognised as earned - unearned premium is deferred.</td>
<td>Recognised when due, whether or not earned. Recognise a separate expense for lapse during the current premium period.</td>
<td>Recognised when due, whether or not earned. Recognise a separate expense for lapse during the current premium period.</td>
</tr>
<tr>
<td>Claims expense (19)</td>
<td>Estimate recognised as insured events occur. Additional amounts recognised when there is a premium deficiency.</td>
<td>Estimate recognised when premium is received. Changes in estimate recognised when they occur.</td>
<td>Estimate recognised when premium is received. Changes in estimate recognised when they occur.</td>
</tr>
</tbody>
</table>

Note 3 In a fair value model, some may favour reporting just a net change in fair value, without separate reporting of premium and claim information.
## Appendix B

### Suggested Presentation of Claim Development and Uncertainty

<table>
<thead>
<tr>
<th></th>
<th>Current Year</th>
<th>...</th>
<th>Recent Year</th>
<th>...</th>
<th>Older Year</th>
</tr>
</thead>
<tbody>
<tr>
<td>Estimated Surplus at Start</td>
<td></td>
<td></td>
<td>(50)</td>
<td></td>
<td>175</td>
</tr>
<tr>
<td>Uncertainty at Start</td>
<td></td>
<td></td>
<td>540</td>
<td></td>
<td>42</td>
</tr>
<tr>
<td>Claim Liability at Start</td>
<td></td>
<td></td>
<td>2,570</td>
<td></td>
<td>200</td>
</tr>
<tr>
<td>Premium Revenue</td>
<td>5,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Policy Expenses</td>
<td>(1,000)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Investment Income</td>
<td>120</td>
<td></td>
<td>140</td>
<td></td>
<td>12</td>
</tr>
<tr>
<td>Claim Payments</td>
<td>(50)</td>
<td></td>
<td>(720)</td>
<td></td>
<td>(75)</td>
</tr>
<tr>
<td>Claim Expenses</td>
<td>(140)</td>
<td></td>
<td>(40)</td>
<td></td>
<td>(4)</td>
</tr>
<tr>
<td>Balance at End</td>
<td>3,870</td>
<td></td>
<td>1,900</td>
<td></td>
<td>308</td>
</tr>
<tr>
<td>Claim Liability at End</td>
<td>(3,600)</td>
<td></td>
<td>(1,875)</td>
<td></td>
<td>(140)</td>
</tr>
<tr>
<td>Estimated Surplus</td>
<td>270</td>
<td></td>
<td>25</td>
<td></td>
<td>168</td>
</tr>
<tr>
<td>Uncertainty</td>
<td>756</td>
<td></td>
<td>394</td>
<td></td>
<td>29</td>
</tr>
</tbody>
</table>

In this table, premium revenue and claim payments are actual. Expenses could be either based on an apportionment of actual expenses, or loaded expenses, with a separate comparison of actual expenses with total loaded expenses. Similarly, investment income could be either based on an apportionment of actual investment results or on investment assumptions, with a separate comparison of actual and assumed.

The claim liability shown in these tables is on an expected value basis.

Uncertainty could be presented on any one of a variety of bases. In the example, a single figure, which might be the margin for uncertainty in the provisions, or might be an estimate of the standard error, has been spread in proportion to the estimated liability. A more sophisticated approach could attempt to distinguish varying relative uncertainties by development year.
Appendix C

Suggested Definition of Short and Long Tail Business

If it is to be made at all, the distinction made in paragraph 84 needs further work. Certain contracts, such as single premium annuities, are clearly life insurance, while retrospectively rated liability insurance contracts, clearly general insurance, have pricing structures which extend well past one year.

One part of the solution may be to define long and short term insurance, rather than life and general. This sidesteps the part of the problem which arises because life and general insurance have established - if not well-defined - meanings which cut across that proposed.

The essence of long term insurance is that it provides a guaranteed pricing structure in respect of claim-triggering events over an extended period. Short term insurance covers claim-triggering events over a limited period and includes no guarantee of renewal other than on the terms which would apply to a new contract.

For most purposes, it is reasonable to treat anything longer than a year as an extended period and anything shorter as a limited period. There are, however, exceptions. Where a particular type of insurance is offered over a range of terms, there should be an option to stretch the definitions. For example, one-year (or even shorter period) term life insurance, written as part of a portfolio typically covering longer periods, should be treated as a special case of long term insurance, as should single premium annuities. Conversely, property or liability insurance written on a project basis for a single fixed term should be treated as short term insurance in most cases.

Where periodic premiums or premium installments in the early periods of an insurance contract anticipate a rising risk pattern, that is long term insurance.

A suggested wording is

(a) Insurance should normally be treated as long term for financial reporting purposes if the insurer is committed to a pricing structure in respect of claim-triggering events over a period of two years or more.

(b) Insurance should normally be treated as short term for financial reporting purposes if the insurer is not committed to a pricing structure in respect of claim-triggering events over a period of more than one year.

(c) Where a portfolio of similar insurances falls mainly under (a) above, the entire portfolio may be treated as long term.

(d) Where a portfolio of similar insurances falls mainly under (b) above, insurances in respect of claim-triggering events over a period of not more than three years may be treated as short term.

All other insurances should be treated as long term.