**Introduction**

As mentioned in our response to sub-issue 7H of the IASC Insurance Issues Paper (the IASC Paper), the IAA agrees with the IASC Insurance Steering Committee’s tentative view as given in paragraph 357 that equalization provisions should not be recognized as a liability.

However, the issue of whether, in an IAS, an insurer should be required, permitted or prohibited to recognize catastrophe provisions is in our opinion of a different nature and hence an important one in the context of the recognition and measurement of an insurer’s liabilities. While the IAA has not reached broad agreement on a position on this, we do offer discussion of the issue which should help the Steering Committee in its deliberations.

This introduction defines the issue, followed by considerations in addition to the views given in the IASC Paper in paragraphs 353 to 355, with particular emphasis on areas where we believe that actuarial science may offer some additional insight.

In the property/casualty field, an insurer deals with “normal claims” and claims resulting from disasters. The difference between these claim types is twofold:

- Normal claims concern relatively high frequency, low to moderate severity events. Catastrophe claims concern low frequency, high severity events.

- Normal claims result from a number of independent events, whereas catastrophe claims result from a single event.

For “normal claims” the insurer stabilizes its financial results through application of the mathematical “law of large numbers”, by spatially – usually over a one year time period - gathering a large number of such contracts. In essence this is an application of the ”law of large numbers” to insured objects. While the insurer cannot identify which insureds will become claimants, it is able to spread the overall losses over all insureds.

A natural disaster or catastrophe is rarer and does not occur as a result of independent events, but as a result of one event affecting several insured objects at the same time. As a result of that difference, the “law of large numbers” does not apply in the same way as with “normal claims”. Given the nature of disasters or catastrophes, the “law of large numbers” relates to insured events (and not to insured objects as in “normal claims”). That would imply that the losses be spread over a sufficiently long time period of - for example – a twenty year time period.

**Considerations**

The following considerations are intended to offer additional insight to the IASC Committee on catastrophe provisions. These considerations correspond to the arguments set forth in paragraphs 353 – 355 of the IASC Paper.
1. **Is an amount reported as a catastrophe provision a liability as defined in the IASC Framework?**
   A liability in the IASC Framework is defined as “a present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow from the enterprise of resources embodying economic benefits”. Those who do not favor recognition of catastrophe provisions argue that a catastrophe provision is neither a present obligation nor the result of a past event. This argument typically defines a past event as an occurrence that, by contract wording, results in an obligation to pay a certain specific amount to the policyholder. It does not recognize that it is the element of risk, and not the event itself, that triggers an obligation of the enterprise. Therefore, it would be deemed appropriate to consider as the past event the insurance company’s acceptance of risk by receiving the premium.

2. **Is an amount reported as a catastrophe provision a constructive obligation as defined in IAS 37?**
   In IAS 37, a constructive obligation is defined as "an obligation that derives from the enterprise's actions where (a) by an established pattern of past practice, published policies or a sufficiently specific current statement, it has indicated to other parties that it will accept certain responsibilities; and (b) as a result, it has created a valid expectation on the part of those other parties that it will discharge those responsibilities". In several countries insurers are obliged by law or regulation to offer coverage for catastrophic events in order to stay in business. Our opinion is that such a legal obligation constitutes a constructive obligation as defined in IAS 37. Also, we believe that the economically long-term nature of these contracts, as described in our response to paragraph 191 of the IASC Paper, may demonstrate that these contracts are embraced by this definition. Moreover, as is noted in # 3, the portion of the premium intended to provide for catastrophic events is calculated on an event occurrence (multi-year) basis, providing “evidence” of a constructive obligation. Otherwise it would be illogical to calculate the premium in this manner.

3. **Does a catastrophe provision represent a deferral of unearned premiums?**
   Many property/casualty insurance premiums comprise two elements: (1) a provision for “normal” independent events that will occur during the premium period, and (2) a provision for events (like storms and natural disasters) that affect several insured objects at the same time. Both are calculated taking into account the law of large numbers - the first on an insured objects basis (usually spatially over a short period) and the second on an insured events basis (usually on a multi-year basis). So, in a traditional reporting environment, deferred recognition of the unearned portion of the premium associated with the second part is in order. In this way, establishment of catastrophe provisions is triggered by the fact that the loading for this risk has to be retained to meet the obligation when a catastrophe occurs. The mere fact that it is not easy to distinguish between “normal” and catastrophe risks and that catastrophe risk is not easy to measure

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1 In conjunction with our Introductory paper on Insurance features and the Introduction to our response on Basic Issue 7 of the IASC Paper

2 In some case insurers are required to segregate catastrophe premiums from ordinary premiums when they file their premium rates for supervisor’s approval.
reflects only the difficulty in setting premium rates and does not negate the need for a catastrophe provision. (Note that in some jurisdictions the insurer is required to split the premiums in the “normal” element and the catastrophe element.)

We acknowledge that determination of a liability, as the accumulation of past-unused premiums is inconsistent with fair value reporting. In the absence of a better estimate of the amount of such a provision, an open-year model or a zero-balance model would also be alternatively appropriate for the fair value of the provision.

IAS 18 requires that “revenue should not be recognized until the costs of the transaction (including future costs) can be measured reliably”. Since, as is noted in our response to paragraph 191 of the IASC Paper (we refer also to other responses as mentioned in footnote 1), both in economic substance and policyholder expectations, general insurance contracts represent a long-term relationship, IAS 18 also applies to contracts covering catastrophic events.

Finally, we note that, in a fair value assessment consistent with our response to paragraph 191 (open book renewal approach), the appropriate catastrophe provision is included implicitly, as fair value includes the present value of future expected catastrophic claims reduced by the present value of that portion of the premium needed to cover the expected cost of a catastrophe.

4. **Is there a need to have similarity in patterns of reported income comparable to those that would result through reinsurance?**

As stated in paragraph 354d of the IASC Paper, opponents reject the comparison with reinsurance contracts because, in their view, reinsurance changes the insurer’s risk profile. Despite the fact that the insurer’s risk profile may be different, prohibition of catastrophe provisions might well compel insurers to buy reinsurance, which would otherwise be unnecessary (not economically driven, but rather driven by accounting rules), to avoid undesirable annual financial fluctuations. We feel the economics of managing risks, not the financial reporting requirements, should be the primary influence of management decisions. Moreover, prohibition of catastrophe provisions for insurers would also imply similar disallowance for reinsurers. If this were the case, reinsurers might not accept catastrophe risks, resulting in an artificial reduction in the capacity of the insurance market. Thus, accounting rules might impair the economic system of insurance against catastrophic events.

5. **Does recognizing catastrophe provisions inform or mislead the users of a financial statement?**

This issue relates to the awareness of the users of the financial statements with respect to catastrophic risk exposure. Consider a company that sells policies worldwide, but with a focus on the Caribbean. The company has decided not to reinsure catastrophic losses. Presumably high profits are realized in years when there are no hurricanes in the Caribbean. However, are the users of its financial statements aware of the risks this company is running? If so, they apparently also accept that the insurer is exposed to severe earnings fluctuations and hence are willing to take that risk. In such a case catastrophe provisions would diminish earnings volatility and hence might be considered misleading.
On the other hand, if users are not aware of these risks or, if they are aware that the insurer covers catastrophic events in the Caribbean but not that the insurer does not reinsure them, then recognition of a catastrophe provision would help users better understand the company’s ongoing risk profile. Without catastrophe provisions, the financial results of a general insurance company may be misleading, since it will appear to be more profitable (as anticipated in rates) in some years and less in others, than the company is likely to be over the long term. Is it, without any allowance for catastrophe provisions, fair reporting to shareholders and policyholders when a catastrophe, having occurred, has more effect than they expected or even results in bankruptcy?

6. Does the recognition of a provision for catastrophes have similarities in other accounting areas?

In paragraph 354g of the IASC Paper, it is stated that catastrophe and equalization provisions attempt to address fluctuations in losses and the practice of diversifying risks over time. Those who are opposed to catastrophe and equalization provisions state that this is similar to lending operations of a bank where losses are expected to fluctuate over time. In this case, IAS 30 indicates that it is not considered appropriate to set aside amounts for losses on future loans and advances, even to existing borrowers. We acknowledge the similarity with equalization provisions. However, we do not see the similarity with catastrophe provisions. A bank’s lending activities are similar to the “normal claims” business of a property/casualty insurer, using the same “law of large numbers approach” on objects. As discussed earlier, with catastrophes or disasters, application of the “law of large numbers” is different in that it is applied to events. Note, one can argue that a similar split in “normal claims” and catastrophes or disasters (as in property/casualty) can be made for the lending operations of banks. For example an economic crises is one event affecting more objects (borrowers).

Summary and Conclusions

The following observations can be made:

- In several countries, insurers are obliged to offer coverage for catastrophic events and/or charge the catastrophe premiums implicitly or explicitly to the current policyholders, in order to stay in business. If such an obligation is required by law or regulation, a constructive obligation as defined in IAS 37 may be indicated.

- Both in economic substance and in policyholder expectations, general insurance contracts often represent a long-term relationship.

- Premiums are set implicitly or explicitly, taking into account the expected occurrence of catastrophes, by applying the law of large numbers on an insured-event basis. This requires the allocation to events (usually multi-year) approach towards matching of revenues and costs.

- In a fair value assessment consistent with our response to paragraph 191 of the IASC Paper, the appropriate catastrophe provision would be included implicitly as the fair value includes the present value of future expected catastrophic claims reduced by the
present value of that portion of the premiums anticipated to be used to cover the expected costs of catastrophes.

Given the volatility of financial results caused by catastrophic events, appropriate disclosure is necessary.

If the IASC decides that catastrophe provisions are required or permitted, the calculation process should employ a realistic approach regarding risk assessment, reinsurance options and other available alternatives. To prevent manipulation, full disclosure of the calculation methods and assumptions should be required. It might be helpful to set standards for the models to be used to assess the risk, at least on a country specific basis. The IAA offers support in the development of a framework for such standards.

31 May 2000