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IAIS Insurance Contracts Subcommittee Activities

Rob Esson

Second Liabilities Paper

- **IAIS issued First Liabilities Paper in May 2005**
- **Now working on a Second Liabilities Paper for issuance in May 2006**
- **In time for IASB discussion paper at end of 2006**

Current conclusions 1

- **The IAIS believes an exit model is preferable and that profit on inception should only be recognised where an appropriate and sufficiently reliable risk margin has been provided for in the value of liabilities**

Current conclusions 2

- **Similar risk should result in similar liabilities**
- **Valuation of insurance liabilities includes a settlement notion inherent even in a transfer environment**
- **The IAIS supports a components approach to modelling whereby observable financial market inputs are used to the extent possible, and other elements are modelled**

Current conclusions 3

- The IAIS does not believe that any one method for calculating the margin over current estimate should be prescribed
- The IAIS believes that a defined principal market for modelling is appropriate

Current conclusions 4

- Probabilities which reflect likely policyholder behaviour in respect of the contract as a whole – rather than in respect of each obligation in isolation – should be reflected to achieve meaningful results in the liability measurement

Current conclusions 5

- The IAIS considers there to be no requirement for the application of a surrender value floor to the measurement of insurance contract liabilities for general purpose financial reporting

Current conclusions 6

- The IAIS strongly believes that future cash inflows under a contract should be fully allowed for, where appropriate, in the measurement of the overall contract
- The IAIS does not seek allowance for premiums that will only be receivable on renewal of the contract as part of the continuing customer relationship, and which are not otherwise guaranteed by either party

Current conclusions 7

- The IAIS believes that the value of an insurance contract should be consistently reported as a net liability and that the value in respect of cash inflows should be offset against the value in respect of cash outflows

Current conclusions 8

- The IAIS would prefer an approach whereby acquisition costs are fully expensed at inception with full allowance then made in the prospective measurement of the contractual obligations for future premiums and other sources of revenue from which those acquisition costs are expected to be recovered

Current conclusions 9

- The IAIS believes that, where the amount or timing of future cash flow is uncertain, then probability is a crucial factor in measuring the cash flows relating to the contract

Current conclusions 10

- Liabilities in respect of discretionary participation features should be based upon the expected future cash flows
- Derivatives embedded in insurance contracts should be included in the valuation methodology (even when out of the money)

Current controversy

- Inter-portfolio diversification effects: all agree that these should be reflected in capital
- Intra-portfolio lack of diversification: most agree that this should be reflected capital, but at least one major jurisdiction believes that it should be reflected in insurance liabilities

Example

Company A	Term	50%
Company B	Term/Annuities	50% 50%
Company C	Annuities	50%

[It is assumed that the risks underlying Term policies and Annuity policies offset to some extent.]

Should $L_B = L_A + L_C$ (i.e. diversification in liabilities is zero)? IAIS view: Yes, and $TFR_B < TFR_A + TFR_C$ (Benefit in capital)

Example, cont'd

- All IAIS jurisdictions agree that a small, insufficiently diversified portfolio should attract a higher total financial resources requirement due to greater uncertainty than a larger diversified portfolio of the same types of risk. What if all policies are the same and the pool sizes are small for A & C?
- Is $L_B = L_A + L_C$ still? Majority: Yes

Future steps

- ICSC meeting in Madrid April 19-21 – last substantive meeting to revise the paper
- Consultation period with IAIS Technical Committee and Observers
- ICSC meeting in Ottawa May 29 with the aim of approval by Technical Committee May 31
- Present to IASB in June