FASB Insurance Industry Forum

October 26, 2005

American Academy of Actuaries

IASB Insurance Project – Phase II issues

Opening Statements

- These slides represent issues and concerns and not necessarily the position of the Academy.
- Goal – To educate and to clarify options and their implications.
- The Academy offers its resources to support FASB's analysis of the issues.
- *Caveat: Many words in this presentation have different meanings in different contexts or to different individuals. Therefore, care should be exercised in interpreting them.*

Outline

Non-life focus

Risk Margins

Life focus

Gain/Loss at Issue

Risk Margins

Policyholder Behavior

Health – similar to "life" for some issues, "non-life" for others depending on the particular item (e.g. LTC policy reserve issues similar to Life, Medical claim reserving issues similar to P&C.)

Risk Margins (a.k.a. Risk Adjustments)

- Prelim. IASB direction for non-life claim liabilities – discount with risk adjustment
- If discounting, risk adjustment necessary to reflect economics
- Increases the liability
- Size varies from negligible to substantial
  - In some cases can be greater than time value discount.
  - Perhaps larger than expected payout.

MAJOR ISSUE FOR NON-LIFE

(along with decision on whether or not to discount)

Risk Margins - subjectivity

- Since no active secondary market exists - can't observe or calibrate. Must rely on subjective measures.
  - Two choices: "mark to model" or "mark to benchmark"
    - model approach - Australia,
    - benchmark approach - Canada
  - The most objective approaches readily available:
    - cost of capital method (but material judgment still involved)
    - “no gain at issue” (open question regarding day 2 values)
  - Lack of direct observation or calibration leads to potential auditing and consistency issues.

Risk Margins - transparency

- Disclosure can address some concerns with judgment, but only if transparent.
  - Advise against over-reliance on methodology and assumption disclosure.
    - Total recorded risk adjustment may be the result of dozens or hundreds of components, each potentially using a different method and different assumption set.
    - Many of the potential methods are complex, not readily understandable by users and very context dependent.
    - Method dynamics are a function of underlying data and exposures, but these vary materially across the industry.
    - How and where the method is applied frequently more important that the choice of method itself.

Risk Margins – transparency (cont.)

Conclusion: methodology and assumption-based disclosures may not lead to desired transparency

If discounting with risk adjustment

Recommend instead disclosure of aggregate:

- Undiscounted estimate
- Time value discount
- Risk Adjustment

In combination with MD&A disclosures and suitable claim runoff tables, these disclosures would aid transparency

Risk Margins – Income statement issues

- Where risk adjustment not based on entry price, when does it run off (and get recognized through earnings)?
  - Any runoff is somewhat arbitrary – can't track through cash transactions.
  - With claim liabilities, not even clear when remaining risk is zero.
  - Hence, clear guidance may be necessary regarding runoff timing.
- Can risk margin runoff ever be accelerated?
  - If something bad happens, should risk adjustment be decreased or increased?
    - Decreased, assumes potential bad news already realized.
    - Increased, assumes bad outcome is sign of increased risk.
  - Another potential area for future guidance

Life Insurance Reserves

- Life reserves are designed to pre-fund claims and expenses that have not yet occurred (rather than not yet paid)
- Life Reserves should be calculated as the present value of future costs less future income rather than as a retrospective accumulation of past transactions but current practice is not consistent
  - FAS 60 adds a provision for adverse deviation to a best estimate assumption about future experience – these are margins
  - FAS 97 uses cash values as the reserves
  - FAS 120 uses a statutory reserve basis to calculate reserves

Gain / Loss at Issue

- Normally there should be no gain or loss at issue
  - Consistent with notion that no insurance service has been provided so no profit has been earned
  - Consistent with pricing (no reason to have a loss on a product that is expected to be ultimately profitable)
- Gain at issue is very unlikely and would normally be absorbed by risk margins
- Loss at issue will only happen if there is conscious under-pricing or there is an error
  - Is liability adequacy test / loss recognition test with or without margins?
    - US GAAP test is without margins
    - Use of margins means profits are expected in the future

Risk Margins – Life Insurance

- Some issues are similar to P&C
  - No active, deep market
  - No commonly accepted standard solvency standard
  - Companies' risk "appetites" can vary significantly
- Other issues are much more relevant to Life
  - Risks are very complex
    - Correlations between risks are not always known
    - Policyholder behavior (to be discussed later) is a key element
  - Interest and economic risks are a key part of pricing all products
  - Risk sharing with policyholders is more common and complex to model

Risk Margins – Discount Rates

- Alternatives:
  - Risk-free rate (unadjusted)
  - Risk-free rate (adjusted for liquidity)
  - Actual portfolio rate, adjusted for default risk and expenses
  - No-gain at issue rate

Risk Margins - Discount Rate (cont.)

- Risk-free rate (unadjusted for liquidity premium)
  - Simple
  - Objective
  - Understates time value of money (liquidity premium)
  - Not consistent with pricing (market values) – leads to a loss at issue
  - May not exist in some countries
- Risk-free rate (adjusted for liquidity premium)
  - Somewhat subjective.
  - May not be consistent with pricing (market values)
  - May create a loss at issue

Risk Margins - Discount Rate (cont.)

- Actual portfolio projected returns (adjusted for default risk, expenses)
  - Consistent with pricing
  - Avoids loss at issue (ACLI/IAA paper)
  - Some may prefer a benchmark portfolio
    - A benchmark portfolio cannot be created to match the liability uncertainty
  - Provides consistent asset and liability measurement
  - Would allow higher risk margins on other risks than risk-free rate
- No gain at issue
  - Objective
  - Avoids loss at issue
  - Subsequent discount rates depend on movement of portfolio yields or market rates depending on asset valuation

Policyholder Behavior

- A complicated subject with many critical aspects and implications
- Some examples:
  - Renewal premiums
    - Inclusion in liability calculations
  - Terminations (Surrender and Lapse)
    - Recognition in liability calculations
  - Option utilization (e.g. annuitizations)
- Policyholder behavior is reflected in risk margins for most life products
  - There is not sufficient experience to be able to determine a probability distribution for all of these
  - Each of the items above may vary depending on interest or stock market return scenario

What's Next?

- The IAA and IAIS are putting together a group to develop recommendations for solvency and financial reporting

- Hope is to have an IAA report within 6 months, in time for discussion before the IASB issue paper