# IAIS Second Liabilities Paper



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# Outline of Presentation

1. Activity & process since First Liabilities Paper
2. Second Liabilities Paper - key principles and observations
3. Areas of contention
4. Future cooperation with the IASB

# Activity since first Liabilities Paper

- First Liabilities Paper published May 2005
- 2nd Paper a result of 8 meetings lasting 16½ days over 11 months
- Paper approved unanimously by IAIS with wide support from international organizations & many observers
- Strong interaction with IAA Risk Margin Working Group
- Second Liabilities paper is principles-based: it does not seek to advise on detailed algorithms

# Second Liabilities Paper – over-riding principle

- The IAIS believes that it is most desirable that the methodologies for calculating items in general purpose financial reports can be used for, or are substantially consistent with, the methodologies used for regulatory reporting purposes, with as few changes as possible to satisfy regulatory reporting requirements.

# Second Liabilities Paper - key principles and observations

Split into 4 types of observations

- Full agreement with current Board tentative decisions
- Agreement with Board but with expansion or elaboration
- No known tentative Board consensus
- Disagreement with current Board tentative decisions

# Second Liabilities Paper - key principles and observations – full agreement with current Board decisions

- The IAIS supports an approach to modelling whereby observable inputs from deep liquid markets are used to the fullest extent possible, and the remaining elements are modelled.
- Similar obligations with similar risk profiles should result in similar liabilities (Note – IAIS believes the entry value & no profit on inception notions are *inconsistent* with this principle)
- The margin should be determined in such a way as to promote transparency and comparability between different insurers and markets in an objective manner.
- Derivatives embedded in insurance contracts should be taken into account in the valuation methodology.

# Second Liabilities Paper - key principles and observations – agreement with Board with elaboration

- Measurement of an insurance liability should be based upon the future cash flows relating to full settlement with the claimant/beneficiary
- An exit model is preferable but profit on inception should be recognised only where an appropriate and sufficiently reliable risk margin has been provided for in the liability measurement.
- Risk margins should share certain characteristics (see para 59)

# Second Liabilities Paper - key principles and observations – no known Board tentative consensus

- A common framework is appropriate to model non-observable inputs as objectively as possible.
- Where the amount or timing of future cash flows is uncertain, probability is a crucial factor in measuring the cash flows relating to the contract.
- Probabilities which reflect policyholder behavior regarding the contracts as a whole are needed to achieve meaningful results (cf. obligations viewed in isolation).
- No <u>necessity</u> for application of surrender value floor to insurance liabilities for general purpose accounting.

# Second Liabilities Paper - key principles and observations – no known Board tentative consensus (cont'd)

- Future cash inflows should be taken into account in the measurement, if integral to the obligations under the contract.
- Value of an insurance contract should be measured with cash inflows offset against outflows (i.e. Not unbundled)
- The IAIS would prefer full expensing of acquisition costs at inception with allowance in the prospective measure for the future premiums from which those costs are expected to be recovered.

# Second Liabilities Paper - key principles and observations – disagreement with Board

- Discretionary benefits should be treated as liabilities based upon expected future cash flows, as treatment as equity would misrepresent the financial position.
- The credit standing of an insurer is not relevant to, and would be misleading in, the valuation of insurance liabilities.

# Areas of contention

- Notwithstanding widespread support overall, be aware that some trade associations have opposed parts of the paper
- 'Market consistent' approach
- Exit vs. Entry value & concern over profit on inception
- Utility of explicit current estimate & explicit risk margin
- Difficulties of measuring risk margins – non-life discounting and the Goldilocks principle

# Future cooperation with the IASB

- The subcommittee's future work is based on providing input to the Board on Supervisors' views regarding Phase II, Financial Instruments & Revenue Recognition
- Further work identified in paper (para 101)
- Output from IAA Risk Margin Working Group will guide IAIS
- IAIS will consider IASB developments, and will share the work on the IAIS Solvency initiatives which are consistent with the 2nd Liabilities Paper & EU Solvency II