AKTUARVEREINIGUNG
ÖSTERREICHS (AVÖ)

Vienna, 28.Oct.2003

Mr. Peter Clark
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International Accounting Standards Board (IASB)
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Comments on the Exposure Draft 5 on Insurance Contracts

Dear Mr. Clark,

the Austrian Actuarial Association (AVÖ) represents the actuarial profession in Austria.

The AVÖ is observing the discussions around a new accounting standard for insurance contracts with respect and attention. Respect because of the dimension of this project and attention because of the changing role of policyholder, company and investor.

The actuarial profession is of course that profession which is most affected by this development, because there would be a big impact from new accounting to product development, tariff pricing, reserve valuation and so on. It is in the responsibility of the actuary to ensure that the risk transfer from the policyholder to the insurance company is fair and safe.

So it will be our main interest to have some clear rules based on actuarial principles to protect both the policyholder and the company from adverse market scenarios.

In this sense we try to give some support to this development of the new accounting rule.

Yours faithfully,

Helmut Holzer

President of the AVÖ

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Comments on the ED 5 Insurance Contracts

Some general remarks

There is a common understanding in the Austrian Actuarial Association (AVÖ) that local accounting is not useful for investors in a world of globalization. It is easy to see, that there is a lack of risk measurement in the local accounting standards, so the AVÖ supports in general the idea of risk-based accounting systems. But as a community of experts in risk evaluation, the AVÖ did not find some general model to face all the risks the insurance business is confronted with. The AVÖ is of the opinion, that it is impossible for an accounting scheme to give an investor, who is not really involved in the insurance business, sufficient information of the risk and return situation of the insurance company. All of the information demand in the balance sheet and the disclosure is not understandable for a non-expert and not sufficient for an expert.

As a consequence there are many practical and theoretical problems arising with the ED 5. So the AVÖ tries to give some constructive comments to help avoiding additional confusion in the capital markets.

Fair Value principles of insurance contracts

Fair valuation is a principle, which should give to the investor the value of some contract or portfolio in an environment of actual market situations. Because this environment will change in each moment the fair value also will change continuously. But there are some economic principles that cannot change so quick, because they are (nearly) economic invariants. One of these economic invariants is the “eternal interest rate” which is seen in most of the well known interest rate models as constant over time. Similarily mortality rates are very inert and just slowly moving. So life and annuity insurance – if it is seen as a long-duration business – deals with very slowly moving parameters and thus the “fair value” also should change very slowly. It is comparable with the comparison of strategic and tactical asset allocations, where life insurance is similar to a strategic investment over a very long period. In IAS 39, there are concepts of “trading” and “held-to-maturity” investments, in terms of insurance contracts it translates in “short-duration” and “long-duration” contracts. So different valuation principles should be used also for different insurance contracts as for different financial contracts.

We recommend to use the fair value concept which is highly related to a volatile trading valuation just for the short-duration insurance business.

Fair Value Reporting

While in phase I insurance contracts can be measured at amortised costs, par. 30 - par. 32 already asks for a fair-value report for 2006. The Board gives no hints how these figures might be calculated but mentions that "insurers can begin preparing for a fair value measurement before the Board answers all these questions". Up to now the Board itself could not make up it's mind to give any guidance concerning the basic problems in calculation fair-values of insurance liabilities.

However, a reporting in absence of this guidance will have quite unfavourable consequences:

- Insurances are forced to develop market-adequate risk measures for non-traded liabilities. Given the variety of acceptable methods a subjective choice is necessary. Inevitably any choice will be suspect of subjective manipulation.
- Heterogeneously calculated fair values will lead to different ratings of insurances. Incommensurable determined figures imply a misleading comparison of enterprises.
- Any aberration between the fair value approach applied in 2006 and the one required in phase II implies a structural break in the reporting, which hardly could be quantified by any qualified analyst. The users of these reports are forced to misleading conclusions about the development of the companies.

We recommend not asking insurers to develop a fair-value-measurement by trial and error as long as no phase II guidelines are available. Par. 30 to par. 32 of ED 5 should be deleted. The risks arising from information smog are too large.

Measurement of policyholder participation under Fair Value Accounting

Austrian insurance companies usually regulate how to participate policyholders in insurance conditions or special insurance conditions. Normally there is a minimum participation rate of annual pre-tax or after-tax profits in those conditions.

In the current local GAAP profit and loss account the volatility of yearly profits is rather small. Thus insurance companies give a high minimum participation ratio to policyholders and could keep risk based capital rather small, as equity is still keeping unrealised capital gains. Being competitive forces companies to declare a high participation ratio.

In future we have to apply Fair Value Accounting, which means that profits arise in a different way they did it before. We expect that volatility of profits will increase. As a consequence of that, measurement of risk based capital will become very important. Applying the new rules we expect an increase of risk based capital within the insurance industry.

The question is, how could we find an approach between the given rules of participation within the current insurance conditions and the rules of measuring profitability from the new principals. One solution could be that we still keep the statutory mathematical reserves and the local GAAP rules only for the measurement of policyholder participation purposes, but there are other approaches as well. May be a legal change within the whole market from the regulator according to all kinds of policyholder participation.

Changing participation rules means that consumer organisations have a strong need of information and may be even more. The final question is about market and clients. For the time being they do expect low volatility in profits from life business, in the future this could change rapidly. Could we loose client-confidence as central European life insurance markets in changing to the new world of volatility?

Reserves for Equalization and Catatrophes

The question whether equalization reserves are reserves or equity just arises because of the decision to value contracts instead of portfolios. Insurance valuation is only driven from the law of large numbers and it makes clearly no sense to give a statistical valuation to a single contract. If this has been recognised, it is clear that there is some need of "premium reserves" or "equalization reserves" for portfolios in fluctuating insurance business lines like hail insurance, to cover risks evolving later in time. It would be a heavy mistake to consider this fluctuation premiums as a gain. It is very difficult on a single contract base to face the "real" risk and to calculate reserves for IBNR claims and similar items.

So the AVÖ will stress furthermore the fact that evaluating single insurance contracts makes primarily no sense and gives wrong signals to the investors.

Disclosures

The disclosure - requirements formulated in the current draft are extremely poorly conceived.

Only the requirement to explain the figures reported in the balance sheet and income statement (par. 26 and par. 27) makes sense. All other paragraphs are formulated so diffuse, that no comparable information could be expected from these disclosures. It would be favourable just to invite the management to present its point of view in the disclosures, than forcing insurances to give a mass of detailed misleading information.

Typical critical elements of the draft's requirement are:

- **Relevant items**: IG 09 clarifies, that ED 5 does not require disclosures of specific items. A substantial advice to clarify how detailed the portfolio should be structured is missing. Referring to IAS18, par.35 its only mentions that "each significant category of revenue" (IG 15) should be reported. As "several methods for recognising revenues and various models exist" (IG 15) a consistent method is not recommended.
- **Description Scheme**: ED 5 neglects to specify any schedule, structure, or rough design of the disclosures (IG 11). This might allow the accounting managers to feel some freedom of expression but guarantees incomparable enterprise reports.
- **Dubious model presentation**: If "practicable" (IG 19) the underlying model and assumptions should be described, quantified and motivated by the process used to determine the assumption. This requirement is limited to assumptions with "the greatest effect on the measurement". To illustrate this, IG 19 mentions, that "it may not be practicable" to present quantified assumptions underlying the applied mortality tables so that only their actuarial engineering might be described. Similarly disclosures on general insurance might require information on the applied economic and statistical models, distributional assumptions, the analysed database and the handling and identification of outliers. Manual corrections and

excursions from the pure model results might also be documented. As it's almost impossible to identify which of these factors has the "the greatest effect", a full disclosure will be appropriated.

- **Undefined aggregation level**: A rough uniform classification of classes as applied by insurance supervision would be favourable. The Board only mentions that an "excessive disaggregation could be costly, lead to information overload and reveal commercially sensitive information" (BC 128) but gives no limit for satisfying users that might be interested in specific lines of business or contracts. With respect to par. 27, the Board explains, that "an insurer discloses assumptions at a level of aggregation that is useful to users of the financial statement" (IG 22). Thus, depending on the presumed users, it will be necessary to structure the report according to lines of business or distribution systems, regions, duration of policies, combined ratios and any other criteria. As long as no single classification scheme is privileged by the IASB, each might be relevant and necessary.
- **Sensitivity analysis**: ED 5 requires sensitivity analysis of the model used to determine actual figures (par. 27c and d) as well as for the forecasting - and risk-analysis model (par. 29c.i). Although these calculations offer only insight in the sensibility of a mathematical model they will undoubted be misunderstood as information about the stability of the insurance. Nonlinear Models with unstationary distributions, varying parameters, hetogenous or even unbound volatility might describe the underlying risk processes much better, but will in general show higher risk than simple stationary or even static projection-models. However, with respect to the requirements of ED 5 the latter will appear to be superior: it will not only show less uncertainty but could also demonstrate, that this enterprise can cope with external shocks much better that other ones.
  The required sensitivity analysis of individual firm-specific models is neither useful to illustrate the risk of the insurance nor to enable any comparison between insurance companies. As long as the chosen approach is not compared to one reference-model, these disclosures will only provide misleading information.
- **Sensitivity analysis of one's reinsurance**: The draft requires "information about risk exposures reports exposures both gross and net of reinsurance" (IG 40.b). However, the reinsured component implies no insurance risks for the direct insurer. Whenever a correct separation and unbundling of reinsured risk components from the net risk is possible, only the net risk component should be treated under the scope of that draft. Everything else would contradict the principles of BC 20 and BC 21: As "the financial statement should reflect economic substance and not merely legal form, …, the Board decided that contracts described in the previous paragraphs", - i.e. such ones with trivial insurance risk - "should not be treated as insurance contracts for accounting purposes" (BC 21).
- **Lack of an uniform risk measure**: The Board neglects to specify at least one comparable risk measure (IG 46). This might - as the Board explains - "be more efficient in adapting to the continuing change in risk measurement" (IG 31.b), as it allows to replace measurements that show an unfavourable development by more appealing analysis.
  Discussing a probably maximum loss (PLM) indicator, BC 136 explains, that „given the lack of widely agreed definitions of PML, the Board concludes, that it is not feasible to require disclosures of PML or similar measures."

Nevertheless, with respect to par. 29 the Board demands some type of "improbable maximum loss"- analysis: It should be checked how the insurance liabilities cash flows of the entire enterprise "would change if each policyholder exercised lapse or surrender options in the way that is least beneficial to the insurer" (IG 39.b). This maximum potential loss analysis should be summarised in a "narrative description" (IG 39.b). Why should all insurers declare that they might be ruined in a case scenario?

- **Describing unexpected instead of rare events**: According to the principle "not to include specific requirements that may not be appropriate in every case" (BC 133) the Board mentions to ask for analyses, which are appropriated in (almost) no cases: It is expected that insurers include information about unexpected events (IG 44 in discussion par. 29.c.ii). This covers as well unexpected changes in trends, mortality or in policyholder behaviour (IG 44.c) as well as unexpected striking minimum-interest guaranties (IG 44.d). As the Guidance offers no exhaustive list, any unexpected event that might concern the business might be described.
- **Risk management**: par. 29.a requires that insurers have to disclose their "objectives in managing risks" and their "policies of migration". The illustrative examples given in IG 37 cover a wide field of detailed information concerning sensitive commercially information: Underwriting and rating strategies (IG 37a), retention limits and reinsurance policy (IG 37c) as well as applied risk-management and ALM methods (IG 37.b and d). Taking that requirement seriously implies to externalise very sensitive internal information. It would be quite exceptional to ask enterprises of other branches to disclose similar information about the applied technical and chemical procedures in ones financial statement.

The draft on disclosures is far away from giving any clear recommendation. After all, the basic principle underlying the disclosures is subjective self-description: "Disclosures should be consistent with how management perceives its activities and risks …. This is likely to have more predictive value than information based on assumptions and techniques that are not those used by the management, for instance, in predicting the ability of insurers to react to adverse situations." (IG 31b).

In contrast to that principle we mention, that disclosures should be consistent with one reference model to allow similar reports. The users should be able to compare which risk different companies have to face. This is likely to have more predictive value than an overload of information based on heterogeneously assumptions and incommensurable techniques. The accounting should permit the user to judge whether an insurance has the ability to react to adverse situations. Judgements based on the subjective views of a managers who have to demonstrate their abilities, seem less appealing.

We would strongly recommend the Board to render the disclosure requirements more precisely and to refer more precisely to methods and reporting schedules that are already widely accepted in insurance industry. The draft on disclosures should be largely revised to offer clearer definitions and uniform specified requirements.