IAA (draft) Comments on IASB's Exposure Draft 5 *Insurance Contracts*

Demand Deposit Floor

Introduction

In the Basis for Conclusions to ED 5, the Board express its intent to modify IAS 39 to make clear that the fair value of a financial liability with a demand feature is not less than the amount payable on demand ("APD").

BC117 (e) states

> "The fair value of a financial liability with a demand feature (e.g., an investment contract that the investor can cancel at any time) is not less than the amount payable on demand. This precludes a liability measurement based on expected surrender patterns… if the latter amount is less than the amount payable on demand."

We believe a minimum liability of the APD is not consistent with concepts of fair value for insurance contracts or long-duration investment contracts sold by insurers and not consistent with the existing guidance for fair-value measures found in IAS 39. The imposition of this requirement will cause insurers to present their financial position and financial performance in a way that is misleading. Our reasons for this view and our recommendation to the Board are given in the remainder of this section.

Background

Insurance and investment contracts issued by insurance enterprises are primarily sold for purposes that relate to protection or to systematic long-term savings. They are not sold to serve primarily as demand deposits. Insurance contracts are sold to mitigate the financial consequences associated with a contingent event. Investment contracts provide a long-term plan for savings, typically related to planning for retirement. Policyholders terminate contracts when their need for insurance or for long-term savings changes or when they desire to replace their contracts with similar financial instruments.

In short-duration contracts, such as motor insurance or homeowners insurance, the APD is the rescission value, which is a refund of the proportion of the premium representing the amount paid for the period of coverage remaining after the termination date.

In long-duration contracts, the APD is the cash surrender value, which represents the amount accumulated from past premiums for the purpose of funding the ultimate benefits. Traditional concepts of equity, competitive market-place considerations, and regulation all contribute to the determination of the amounts available to policyholders if they terminate their contracts before death or maturity.

Insurance and long –term investment contracts sold by insurers are not like checking or similar contracts that are commonly referred to as demand deposits. They are not repositories of money maintained for the purpose of frequent deposits and withdrawals or for ready access to cash. Accessing the cash value of an insurance or investment contracts typically requires terminating the contract, reducing the insurance benefits, or creating a policy loan. Penalties may apply and the policyholder may incur a tax liability.

Fair Value Concepts in IAS 39

IAS 39 provides general guidance on fair value methodology. For lack of an observable market for insurance and investment contracts, insurance enterprises are likely to use discounted cash flow models to calculate the fair value of liabilities. Consistent with the definition of fair value, IAS 39 states "The objective of using a valuation technique is to establish what the transaction price would have been on the measurement date in an arms-length exchange motivated by normal business conditions". This objective is supported by the general requirement in IAS 39 that "…an entity calibrates the valuation technique and tests it for validity using prices from actual transactions".

Valuation techniques for insurance and investment contracts depend on many assumptions, one of which is the rate at which contracts terminate or are surrendered. IAS 39 recognises that use of assumptions is necessary for fair value techniques and states, "In applying valuation techniques, an entity uses estimates and assumptions that are consistent with available information about the estimates and assumptions market participants would use in setting a price of financial instrument".

Applying IAS 39 Concepts to Insurance and Investment Contracts

Assumptions and scenarios

Market participants in transactions for these contracts are insurance enterprises. In pricing, they use realistic assumptions for expected contract terminations, based on studies of historic surrender patterns. A proper fair value method also considers the possibility of a contract terminating. When using discounted cash flows, the fair value is the weighted average of the present values of cash flows under a robust set of scenarios, taking into consideration all features of the contract and hence all possible cash flows.

Imposing a minimum liability of the APD is an artificial constraint on a fair value method that effectively places undue weight on one scenario and one feature, namely that one in which all policyholders terminate their contracts. This scenario is not a plausible one for an entity that is a going concern. Its use is not consistent with the expectation of the IASB Framework that the enterprise is a going concern.

Unit of Account

The market for investment and insurance contracts is for portfolios of contracts or blocks of business. Transactions include mergers, acquisitions and reinsurance. Fair value measures relate to groups of contracts with similar economic characteristics, rather than to individual contracts. Transactions involving single contracts, other than policy terminations, are rare. The settlement value on termination is set by contractual terms and cannot be considered to be arms-length.

The requirement of a minimum liability of a contract is the APD creates an ambiguous unit of account. An APD applies to a single contract, but the fair value measure relates to a group of contracts. The fair value of a single contract is only a notional amount; the proportionate part of the value of the portfolio. The fair value of portfolio has an underlying presumption that an entity has the ability to manage the portfolio to profitability and can, for example, diversify or hedge risk.

An individual must consider the value from a perspective different from that of the issuer. It is not correct to say that the best financial decision for the policyholder is to surrender the contract when the APD is greater than the insurer's notional fair value. in fact, the issuer's valuation is irrelevant to the policyholder. Because the issuer places a notional value on the contract does not mean that the policyholder can replace the contract for this amount. The policyholder is risk adverse and cannot take cash unless the contract can be replaced for the same or a smaller amount of money.

Assumptions about Economic Behaviour

In most cases, the assumptions for rates of termination are supported by abundant evidence of policyholder behaviour. The fact that policyholders do not always terminate their contracts when it might appear to be to their advantage to do so, and sometimes terminate their contracts when it may appear to be disadvantageous, can be explained by factors such as

- The influence of agents or others on an individual's decision making,
- A cash demand unrelated to the insurance or investment contract,
- Brand loyalty,
- Lack of initiative, and
- Lack of sufficient benefit to justify the effort

There are many other factors, some of which are not known. The phenomenon of policyholder behaviour is just an example of financial decision-making that is not always economically efficient. In behaviour economics, an increasingly popular field of economic study regarding economic behaviour, economists recognise that people frequently make decisions that cannot be explained by objective financial consideration alone. They give credence to what insurers have considered in pricing contracts for decades; namely, that there is a pattern or behaviour that is not fully explained by financial considerations but is sufficiently well understood to make reasonable assumptions for pricing and for valuation.

Consistency with Measurement of Assets

The constraint of an APD floor is not consistent with fair value approaches to financial assets. There is no corresponding requirement, for example, that the fair-value measure of mortgage loans be capped at the amount that would be received if the loans were prepaid. Neither is reinsurance receivable capped at the APD.

Intangible Asset

It is sometimes argued that there is an intangible asset that accounts for the difference between the APD and the calculated fair value. The intangible asset might represent the value of the customer relationship or renewal options rights. The difficulty with this view is that the pricing of contracts considers only the contractual cash flows, not cash flows for future sales or renewals beyond the contract period. That there is not an intangible asset is most apparent when the contracts are reinsured. The price for reinsurance is often less than the APD, even though the reinsurance agreement does not transfer the customer relationship or renewal possibility to the reinsurer. Further, the discounted cash flow measure is sometimes greater than the APD. To say that there is an intangible asset for the difference would mean that the intangible only has value in those economic scenarios that produce a discounted cash flow measure that is less than the APD. An intangible, if there is one, is independent of the value of the contract and cannot explain nor is necessarily related to the difference between the APD and the discounted cash flow measure.

Consequences

The use of a fair value measure that has a minimum value of the APD results in performance measurement that is driven by an accounting approach that is driven by one contract feature rather than by the totality of the contract and the events of the period. For example, in most economic environments, the movement in the value of a contract with a surrender charge that decreases with policy duration will reflect the decrease in the surrender charge rather than the effects of changes in interest rates during the period. This could lead to a liability that would be excessive in many economic scenarios compared to a realistic measure, leading to an understatement of equity. In such a situation, companies could be motivated to present supplemental non-GAAP information in order to provide users of financial statements with a more relevant measure of the financial performance of the company.

Conclusion

The view that the fair value of a financial liability should not be less than the amount payable demand is not one that the insurance industry or the actuarial profession would have reached, either based on common pricing practices or based on the existing fair-value guidance in IAS 39. It is not consistent with guidance for financial assets.

The imposition of a requirement that the value of a contract cannot be less than the amount in the APD places a significant constraint on the fair-valuation process that limits the ability to calibrate the valuation to market transactions, distancing it from fair-value concepts. Requiring the APD of a contract to be its fair value floor is not valid and the comparison should not be allowed to influence the measurement of the liability.

Imposing a minimum liability of an APD has the potential to create misleading financial statements. Companies are likely to seek alternative measures, presented in supplemental information, to provide more relevant information to users of the financial statements.

Recommendation

We recommend that the IASB Board reconsider its view of fair value and that that the Board should not impose the constraint of a minimum liability of the APD on the valuation of contracts that are not sold primarily for their demand deposit features. We recommend instead that the final guidance in IAS 39 should emphasise that fair value methods consider all contract features and be calibrated to transactions involving similar contracts.