IAA (DRAFT) COMMENTS ON IASB'S EXPOSURE DRAFT 5 *INSURANCE CONTRACTS*

FAIR VALUES

Introduction

Fair-value measures are not currently in wide use in the insurance industry. Indeed, the proper application of fair-value methods to accounting, while it has generated much interest and debate, has not been settled. With the advent of IAS 39, fair value measures will be applied to the liabilities of investment contracts and portions of many insurance contracts. When classified as trading, investment contracts are measured at fair value. They must be re-measured at each reporting date with the change in their fair value going through income. The IASB Board in its ED 5 has currently concluded that the fair value of insurance contracts should be disclosed no later than as of 31 December 2006 and it may be that fair-value measures of insurance contracts will appear in the balance sheet beginning in 2007.

The application of fair value techniques to insurance and investment contracts will challenge many issuers of those contracts with the degree of challenge reflecting their current accounting policies and systems. While there is currently no commonly accepted view as to what constitutes fair value of a liability in the insurance industry and related professions, there are standard approaches in the industry to cash flow projections and discounted cash flow measures. For purposes of reporting under IFRSs, practices should evolve to follow a common set of fair-value estimation principles. We believe that this can be accomplished by focusing on how exiting modelling capabilities in the industry can be used to meet the expectations of IAS 39.

Background

Existing guidance for fair value measure is found in IAS 39. Its definition is:

"The amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction".

IAS 39 does not prescribe a specific fair-value methodology but provides some considerations in paragraphs 98-100. The key points are:

- fair value should be based on the presumption of a going concern
- the best evidence of fair value is a quoted price in an active market
- when there is an active market with quoted prices, the fair value is measured seriatim
- when there is not an active market the best evidence is obtained by recent market transactions, adjusted for changes in market conditions
- when there is not sufficient market evidence, other valuation techniques may be used.

As insurance and investment contracts issued by insurers are not traded in active markets and as market evidence related to transactions of reasonably comparable contracts is sparse,

insurers are likely to use the approaches described in paragraph 100A-D under the caption *No Active Market: Valuation Techniques.*

100A. If an entity cannot otherwise determine fair value, it uses a valuation technique to estimate fair value. The objective of using a valuation technique is to establish what the transaction price would have been on the measurement date in an arm's length exchange motivated by normal business considerations. Therefore, a valuation technique (a) incorporates all factors that market participants would consider in setting a price and (b) is consistent with accepted economic methodologies for pricing financial instruments. An entity calibrates the valuation technique and tests it for validity using prices from actual transactions. For example, when the instrument being valued is purchased or sold in an arm's length transaction, the valuation technique would be expected to result in an amount that equals the fair value of the consideration given or received.

100B. Valuation Techniques that are well established in financial markets include reference to the current market value of another instrument that is substantially the same, discounted cash flow analysis, and option pricing models. If there is a valuation technique commonly used by market participants to price the instrument and that technique has been demonstrated to provide reliable estimates of prices obtained in actual market transactions, the entity uses that technique.

100C. 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 for the financial instrument. In applying discounted cash flow analysis, an entity uses the discount rate(s) equal to the prevailing rate of return for financial instruments having substantially the same terms and characteristics, including the credit worthiness of the debtor, the remaining terms over which the contractual interest rate is fixed, the remaining term to repayment of the principal, and the currency in which payments are to be made. When the term of an instrument extends beyond the period for which market prices are available, the valuation technique uses market prices for the period they are available and reasonable extrapolations of those market prices for later periods on the basis of historical experience of price changes under normal market conditions and all other available information. In particular, any assumed change in market prices is supported by reasonable evidence consistent with any available market forward prices.

100D. The initial acquisition or origination of a financial asset or incurrence of a financial liability is a market transaction that provides a foundation for estimating the fair value of the financial instrument…

Paragraphs 100A and 100D suggest that part of the calibration is the comparison of fair value to net proceeds at inception. The statement "the valuation technique would be expected to result in an amount that equals the fair value of the consideration given or received…" may not require that the initial fair value exactly equal the net proceeds, but suggests that a large discrepancy may indicate a problem with the valuation technique, assumptions, or discount rates. It does seem to imply that a valid methodology reproduce contract prices.

Discussion

A practical approach

The guidance regarding fair value is limited, but encourages practitioners to use accepted methods. Paragraph 100A establishes the principle that fair value should relate to transaction prices and requires calibration to market transactions. For insurers the best available market evidence in stable markets may be found in the prices that they charge to their customers at issue, as well as in reinsurance agreements and purchases of blocks of business or of companies after issue. Note that it can be argued that the unique character of certain contracts or blocks of business can cause prices for sales of business to reflect considerations not normally thought to be part of fair value methodology.

However, in cyclical markets, there are strongly held views that the best available entry price is not the price charged to a customer and that use of these prices may impart irrelevant information to the investor. The IAA offers the observations of one of its well known experts in cyclical markets for the consideration of the Board.

"The issue may be that the usual retail general insurance transaction (and most reinsurance transactions as well) violates the implied assumptions of equal eagerness and equal bargaining power in the hypothetical transaction that defines fair value.

Part of the explanation for this lies in the fundamental asymmetry that underlies the concept of insurance and makes it viable – the value to the insured of the reduction of uncertainty achieved by insurance is much less than the corresponding cost to the insurer of the much lower relative uncertainty assumed by the insurance pool. I find it helpful, in explaining this to non-actuaries, to use a numerical example.

Consider a pool of 1,000 independent, identically distributed risks, each with gamma distributed losses (i.e., a relatively "fat tail") with expected value $10,000 and standard deviation $31,623. If this pool is prepared to accept a 0.01% probability of failure in a given year, it needs capital of $4.153 million, over and above the expected amount of losses ($10 million). Assuming that it can obtain this capital at a net cost (over its earnings on investing this capital) of 5% per annum, it needs to charge a profit margin of $208 per risk. For any individual risk, however, the amount needed to ensure the same 0.01% probability of failure, is $531,624, with a cost of capital of $26,581 per risk. Even if the individual is prepared to accept a higher probability of failure, say 1%, the cost of capital is $7,942. It is not till the acceptable probability of failure is about 5% that the cost of capital, at $2,902, is close to the transaction costs of the insurance, which might be around 25% of the expected losses, or around $2,500.

The other part of the explanation lies in the insurance cycle. When there is excess capital chasing imaginary profits, prices in the general insurance market are driven down. Where risk premiums are reasonably well known, this effect is relatively small, but for long-tail classes with highly diverse risks the premiums charged can easily be less than 80% of what, with hindsight, turns out to be the cost of claims alone. Those insurers that recognize that premiums are too low are in a bind. If they do not follow the market down, they will lose

contact with their customer base and find it very hard to write business in the subsequent hard market. They have little choice but to try to minimize losses by selective underwriting. In effect, the bargaining power of potential insureds is greatly increased by the presence of naive competition.

When enough naive capital is burnt out of the market, the survivors raise their prices to well above what, again with hindsight, turns out to be needed, profits are reported, which in turn attracts more naive capital and the cycle starts again. During the hard phase of the market, the balance of bargaining power swings to the insurers. Because their prices remain below, in most cases, the perceived value of the uncertainty that insureds are trying to lay off, the demand for insurance is relatively inelastic.

While it is arguable that Fair Value should track these swings, accounting on this basis for general insurance would be an absolute disaster. It would reinforce the impressions of the naive investors who drive the insurance cycle, increase the amplitude of the price swings, and result in a substantially higher level of insolvencies each time that the true costs are recognized and the cycle turns up. It is absolutely vital, for a stable industry, that general insurance provisions should be based on reasonable estimates of the probable cost of claims, independently of what are usually distorted prices."

While there has been significant investigation into the subject of fair value measures for insurance and investment contracts, there is no commonly accepted practice for the application of the concepts and there are many theoretical and practical implementation issues that are not resolved. A practical approach to meeting the expectations of IAS 39 within the current state of the art of cash flow modelling could be to focus on the initial value, or the fair value of considerations received in stable markets.

One approach would use the discounted cash flows at issue as calibrated to the initial value by means of an adjustment to cash flows or by an adjustment to the discount rate. This adjustment factor would become a part of the basis for future valuations of the subject contracts as credible evidence expectations about material contingencies are changed. The adjustment to cash flows or discount rates would only change if there was compelling evidence that the market prices for similar contracts would have a different calibrating factor. The use of initial values must of course be supported by the view that the methods and assumptions in the calibrating models can be seen to be reasonable.

However, for markets that are observed to be cyclical, a different method of establishing the initial fair value will likely be required. Valuable research in these markets is being conducted in a number of jurisdictions of which Australia appears well advanced.

Prescriptive guidance

At various times in its deliberations the Board has expressed its views about certain factors that must be considered in a fair value measurement. Among these are the statements that the fair value of a financial liability cannot be less than the amount payable on demand and that the fair value measurement should not take into consideration the performance of invested assets. While there are many specific aspects of fair-value measures that must be considered and resolved, it is difficult to address them individually, as in the end the results must be seen to be consistent with the market view. It is important therefore that the specific issues be considered collectively as part of a model that is intended to model the markets, and that the final decision about the resolution of the individual issues should be decided based on how they contribute to the validity of the models as tested against the markets.

Recommendation

We believe that fair value measures can be developed within the guidance of IAS 39. We are committed to exploring approaches such as calibration to prices of insurance and investment contracts observed in the markets for stable markets and risk modelling in cyclical markets. We recommend that the Board affirm the principles it has expressed in IAS 39 and not give prescriptive guidance that can have the effect of requiring valuations that deviate from the more general principles found in IAS 39.