

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

## Investment Spreads

### Introduction

In the Basis for Conclusion to ED 5, the IASB Board provides its tentative conclusions for phase II of the insurance project. Among the tentative conclusions is the statement in BC6(c) that:

“As implied by the definition of fair value:

“

- (ii) expectations about the performance of assets should not be incorporated into the measurement of an insurance contract, directly or indirectly (unless the amounts payable to a policyholder depend on the performance of specific assets).

...”

Most actuaries believe that a fair value measure, that is, one that is calibrated to transactions involving insurance contracts, must include some consideration of asset performance since product pricing, reinsurance and observed market transactions are observed to reflect this feature.

### Background

Market transactions involving insurance contracts are generally priced by actuarial appraisals or embedded valuation methods that calculate the value of inforce (VIF). These approaches, (which are equivalent if all assumptions are the same), calculate the VIF as the present value of the incremental contribution to the distributable earnings that the contracts can be expected to produce adjusted for risk based capital requirements – or risk adjusted capital expectations. Note that when embedded derivatives, options and guarantees are contained in the contracts, best valuation techniques reflect the extent to which they “are in the money” or “may come into the money”. From this perspective, the VIF is an intangible asset that represents the value of the ultimate cash flows as they become available to shareholders from the contracts; namely the amounts that could be paid in dividends to shareholder that are attributable to those contracts.

In addition, market evidence supports the view that a block of business is worth the value of its distributable earnings. The earnings projections in a VIF calculation usually include expected investment spreads.. It is the net cash flows of the insurance contracts that provide the investable funds, and the investment income is an essential part of the revenue required to meet the obligations of the contracts and to provide a profit to shareholders. Hence it is logical that they would be included in an assessment of VIF.

### Fair Value Accounting

We acknowledge that the Board has not been inclined to allow the recognition of a self-generated intangible asset, in part because the intangible asset depends on the measure of the liability. Yet in a business combination when the intangible asset is paid for, the Board does grant it recognition. The intangible asset might be seen in this light to be the difference between the carrying value of the liability and the fair value of the contracts. If so, a consistent fair value measure of the liability obviates the need for an

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intangible asset and reconciles the difference between originating entity and purchase accounting.

It is possible to calculate a fair value measure of liabilities using discounted cash flows by a method that can be equivalent to the actuarial appraisal method.<sup>1</sup> This method, known as the option pricing method ("OPM"), uses realistic cash flows with adjustments for risk in the discount rate. The cash flows do not include investment income. Rather, the discount rate is the risk-free rate plus a liability spread. But when calibrated to market pricing, the liability spread can be seen to include a portion of the asset spread. The parameters in the OPM can be set by market consideration as well as by entity – specific factors, if market information is not available. The use of entity-specific parameters should approximate market considerations as insurers operate in a competitive environment.

We acknowledge that the concepts of the fair value of insurance contracts are not fully developed or universally agreed inside the actuarial profession or inside the insurance industry and that there are many issues to be resolved before they can be put into application for financial reporting purposes. The objective should be to find an approach that provides a reliable measure of the market-view of liabilities that is free of bias and practical to implement. The IAA urges the IASB to conduct extensive, and comprehensive, field test of various methodologies before deciding on what constitutes acceptable fair valuation methods for insurance contracts.

We note that the actuarial appraisal methods referred to in this communication are those that have been observed in varied markets and may be different in some respects from those in use in achieved profits reporting in the UK and elsewhere, and from actuarial standards for appraisals in the United States. We expect that evolution, convergence and refinement of methods will occur as a result of the introduction of an insurance IFRS and the possible future introduction of international risk based capital requirements. Thus, the fair value of liabilities can be expected from time to time to be affected by future changes.

We believe that the approach discussed above is consistent with fair value guidance found in IAS 39. We recommend that the Board should not, without widespread field testing, commit itself to more prescriptive guidance than is already found in IAS 39. The Board should instead focus on how the principles embodied in that standard can find application to insurance contracts. The IAA intends to expose this concept further and wishes to collaborate with the Board. We believe that if we work together we can develop an approach to the valuation of insurance contracts that meets the objectives of the Board and can be seen by the insurance industry and the actuarial profession to be a reasonable and reliable measure of insurer's liabilities.

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<sup>1</sup> Girard, Luke N. 2202, Market Value of Insurance Liabilities: "Reconciling the Actuarial Appraisal and Option Pricing Methods," *The North American Actuarial Journal*, volume 4, No. 1: 31-62