Wednesday, April 19, 2006

Sir David Tweedie
Chairman
International Accounting Standards Board
30 Cannon Street, First Floor
London EC4M 6XH Originally sent by email

Dear Sir David:

As the IASB continues to make tentative decisions with regard to discrete pieces of an Insurance Contracts Standard, our organizations have refined and extended the reasoning behind what we believe to be the principles of a relevant, reliable and comparable model of insurance accounting.

The extended principles attached are an expansion upon of those sent to you in July of last year. They include Bases of Conclusion (B.C.) and Implementation Guidance (I.G.) that illuminate the theoretical and practical foundation of the principles and the interaction of the model as a whole.

We would be pleased to discuss these principles with you and the Board at any time. They have already formed the basis for our comments at the Insurance Working Group and our recent comments to the board in anticipation of the discussion of insurance related issues.

Sincerely,

Group of North American Insurance Enterprises

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Prudential Financial, Inc.

Jerry M. de St. Paer, Vice Chair, CFO
XL Capital, Ltd.

Philip Bancroft, CFO
ACE Ltd.

Steven J. Bensinger, CFO
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An International Accounting Standard for Life Insurance

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Introduction

This paper presents a set of principles and guidance for an international accounting standard for life insurance. It has been endorsed by the Board of Directors of the Group of North American Insurance Enterprises and the Executive Officers of the four Japanese Life Insurers.

While results oriented, this paper also includes the reasoning behind positions set forth. Accordingly, there are three different types of paragraphs in the paper: Principles, Bases for Conclusions and Implementation Guidance. All three types are grouped together by subject matter so that the reader can evaluate all related material together. For this reason, Principles are stated in **bold face**, Bases for Conclusions in normal typeface and Implementation Guidance in *italics*.

This paper builds upon itself and must be considered as a whole. Issues that seem unresolved in early parts may be dealt with later on. At the same time, this paper is designed to deal with principles and a principle based system. Any such system will by its nature not answer every possible question that may arise although the paper is intended to be fairly complete.

Scope

This paper is limited to the measurement of liabilities for life insurance, annuities and certain types of health insurance for General Purpose Reporting. Requirements for reporting for solvency regulation may be different (e.g. a cash value floor might be required).

Products whose contract terms cover more than a single year of exposure will generally be included under these principles. Therefore, almost all life insurance and annuity contracts that qualify as insurance are included as are Long Term Care Insurance, Disability Insurance and other types of non-cancelable or guaranteed renewable health insurance contracts whether issued by a Life insurance or non-Life company. For similar reasons, Group Term Life and Group Health coverages have characteristics similar to non-life coverages and so are largely outside the scope of this paper.

This accounting guidance does not give detailed guidance for establishing either the assumptions or margins used to calculate insurance liabilities. We believe that the IASB should not focus on setting technical rules for this.

Also this paper does not deal with the unique characteristics of reinsurance contracts.

The Basic Model

Principle 1: The Net Insurance Liability (or "Liability") should be based on the present value of all future cash flows associated with the portfolio of insurance contracts being valued.

Sub-Principle 1.01: The Net Insurance Liability should be equal to the present value of future benefits and expenses, without exception, less the present value of future gross premiums.

Sub-Principle 1.02: The basic assumptions should be developed in a manner consistent with the company's current best estimates of future experience.

Principle 2: The Net Insurance Liability at all times must be sufficient to provide for payment of all expected future obligations with adequate provision for risk and uncertainty.

BC 1: All Liability measurements are prospective only. This implies that while the past is an indicator or guide to future results, management still has the obligation to reflect its view of the future in supportable assumptions and to value the liabilities accordingly.

BC 2: Financial assumptions should be based on market information where available and reliable. Otherwise, financial assumptions should reflect management's best estimate of the future consistent with any relevant market information.

BC 3: Financial assumptions such as ultra long-term interest rate are not necessarily observable in an active market and may inevitably depend on management's estimate.

BC 4: For non-financial assumptions (e.g. mortality, lapsation, expenses), there is no market to provide a consensus view of future experience so the most relevant estimate is that developed by management.

BC 5: Additional guidance on setting margins and assumptions is given below.

BC 6: Principle 2 implies that Liability Adequacy Tests are applied to the Net Insurance Liability at issue only because we unlock assumptions of best estimates and margins as described in Principle 7.

Measurement

Principle 3: Profit should be recognized in line with the release from risk

Sub-Principle 3.01: Release of risk will generally be established based on expectations and margins inherent in the profit profile of the product (generally as reflected in pricing models).

Sub-Principle 3.02: For claim reserve liabilities for which no margin is anticipated in pricing, the margin, if any, should reflect the risk inherent in the estimation technique.

BC 7: The only point in a contract where the risk can be measured on an objective, market-validated basis is at sale. Outside of the initial sale, there is no broad-based market for such a transaction.

BC 8: Insurance companies provide services to policyholders continuously over the term of each contract and profit should be recognized accordingly. These services may take any of several forms but in each case the insurer's aggregate expected risk with respect to a portfolio of insurance policies normally decreases with time. The decrease in this aggregate risk, when measured against actual results, gives rise to profits or losses.

BC 8.01 Types of risk include mortality, morbidity, lapsation, investment return and other elements essential to pricing an insurance contract. However, it is the overall risk in the insurance contract that is important, not the individual risk elements by themselves. The liability value is a result of considering all of these risks together, and there may be inter-relationships between the risks (e.g., between lapsation and investment returns) that would lead to a total result that is different than the sum of the parts.

BC 9: In pricing certain products, such as Long Term Care Insurance or Disability Insurance, the estimated future claim costs for reported claims have margins built in. For those claim reserves, margins should continue to be reflected as the reserve runs out over time. For products where the amount of the claim is not in doubt, such as for life insurance, the only risk in the claim reserve is with respect to the estimating technique (including estimates of the times at which the claims will be paid). For liabilities calculated by inventory, such as certain claims in course of settlement, no margin may be needed.

Initial Measurement

Principle 4: On initial issue there should be no accounting gain or loss.

Sub-Principle 4.01: In the event that an insurer issued a contract on which it anticipates an ultimate loss over the term of the contract, that loss should be recognized at issue and there should be no expected gain in future years.

Sub-Principle 4.02: The initial margins used for establishing the liability will therefore be those margins that result in no gain or loss at issue (except in the rare cases covered by Sub-Principles 4.01).

BC 10: This principle asserts that the best measurement of the net liability of the insurer at issue is based on the present value of the expected premium stream agreed upon with the policyholder. This is the only place in the lifetime of an insurance policy where there is consistently a true market transaction.

BC 10.01 Some may think that a life settlement transaction is also a true market transaction. However, such transactions are all individually priced and therefore this market does not give a relevant price for those policies that have not settled. Furthermore, the current life settlement market is highly undeveloped so the prices being paid may not be true fair value prices.

BC 11: There will only be a loss on issue if the policy is expected to lose money over its lifetime. This will normally only happen in the event a policy is intended to be a loss leader or if it is determined prior to initial measurement that the pricing was in error. In either event, the present value of future premium will be less than the present value of future expenses and benefits without margins.

Principle 5: A policyholder intangible (or Deferred Acquisition Cost) asset should be established when a policy (or block of policies) is issued and amortized over time into earnings in line with the policy's profit profile.

Sub-Principle 5.01: The Net Insurance Liability equals the net of the liability for future benefits and expenses and any unamortized Deferred Acquisition Costs (or similar asset) reflected on the balance sheet.

Sub-Principle 5.02: The policyholder intangible reflects the initial investment made in the customer relationship provided it can be recovered from future profits.

Sub-Principle 5.03: The amount of this asset should be limited to the amount of the upfront acquisition costs a company incurs that are directly related to and vary with the production of new insurance contracts.

Sub-Principle 5.04: Recovery of DAC should not go beyond the term of the policy. Therefore, the possibility of a policy renewal beyond the current policy's duration should not affect the amortization.

BC 12: There is ample support in the Framework and other standards to consider DAC as an asset of the insurer (e.g. in IAS 18, IAS 39 or IAS 2).

BC 13: Application of Principles 1 and 2 will assure that the DAC is always recoverable.

BC 14: Deferrable Expenses should be those that are related to and vary directly with the acquisition of new business.

Risk and Uncertainty (Margins)

Principle 6: Insurance liabilities should reflect the inherent risk and uncertainty of future cash flows.

Sub-Principle 6.01: Best estimate assumptions should be equal to the mean estimate (probability weighted average) so that the liability valuation should consider both the amount and likelihood of future cash flows.

Sub-Principle 6.02: Margins for risk and uncertainty should be set according to Principle 4. Therefore there is no gain or loss at issue except in exceptional cases.

Sub-Principle 6.03: Margins should only increase a liability.

Sub-Principle 6.04: Margins should be changed if there is any conclusive evidence that margins are inadequate.

BC 15: Best Estimate means different things to different people and is defined in various ways. For the purposes of these principles, best estimate is defined as in Sub-Principle 6.01.

BC 15.01 Management's best estimate of the future should not include any margins for risk and uncertainty since an additional allowance for risk and uncertainty is included separately in the liability valuation.

BC 15.02 The term best estimate refers to the valuation of future cash flows in aggregate, not to each individual assumption. In practice it can be very difficult to determine whether an individual assumption is a best estimate. In many cases it is not the individual assumption that is important but its relationship with other assumptions.

BC 16: All estimates of the future have an inherent uncertainty. Accordingly, some margin in an estimate is appropriate. However, there is no reliable way to determine a market level of appropriate risk margin after the point of initial sale. Accordingly, in normal situations (i.e. absent an initial gain or loss situation) the margins should be calibrated so there is no gain or loss at issue.

IG 1: While the IASB should not give detailed guidance for establishing margins, the following principles should be followed:

IG 1.01 Margins should be released over time as the risk in the policy declines.

IG 1.02 Annual margins should not decline by policy year; they should either increase or stay level over time. This reflects that we cannot be more certain of experience far in the future than we are of experience in the next year.

IG 1.03 Margins should be expressed relative to one or more experience assumptions and/or in the discount rate as a basis point reduction to the rate.

IG 1.04 It is appropriate for risk factors to be aggregated for use in financial reporting. Therefore not every assumption needs to have a margin associated with it so long as the aggregate margin makes adequate provision for future risks. Furthermore, the aggregate risk will generally be less than the sum of the risks associated with each risk element.

IG 1.05 The appropriate level of aggregation at which margins are established is the level at which a portfolio of insurance contracts is managed.

Review of Assumptions and Margins (Unlocking)

Principle 7: Assumptions underlying the measurement of insurance liabilities and intangible assets should be periodically reviewed and changed, if appropriate.

Sub-Principle 7.01: All assumptions should be reviewed at least annually. This review should take into account relevant market information and management's best estimate of the future.

Sub-Principle 7.02: Financial assumptions are changed based on market information where available and reliable. Otherwise, financial assumptions are changed only if management's best estimate of the future consistent with any relevant market information has changed and the change is expected to be sustainable and significant.

Sub-Principle 7.03: Non-financial assumptions are only changed if management's view of the future has changed.

Sub-Principle 7.04: Non-financial assumptions should be changed only if the changes are expected to be sustainable and significant.

Sub-Principle 7.05: To the extent there are interdependencies among assumptions, the corresponding impact of those interdependencies should be taken into account when updating assumptions.

Sub-Principle 7.06: It is not necessary to unlock every time actual experience and expected experience differ. Such differences are expected and those differences are properly reflected in the current year's earnings.

BC 17: Reserve assumption changes bring future expected results into the current year's results, thereby potentially distorting period-to-period patterns of results. Accordingly, such changes should be made only when necessary, when the change is expected to be sustained and significant, and with appropriate disclosure. Companies may often elect not to change assumptions and margins unless a loss recognition situation has occurred, preferring to allow experience to be reflected in annual earnings and disclose the difference between expected and actual results in disclosures.

IG 2: Appropriate information must be included in the disclosures so users can understand the company's policies and the emerging differences between expected and actual results. Such disclosures should include

(a) A description of the reason for and the value of any assumption (and margin if explicit) change included in the current earnings

(b) A comparison of expected and actual results for the year by key profit driver for the business

Financial Obligations and Guarantees

Principle 8: Liabilities should reflect the value of all financial options and guarantees.

Sub-Principle 8.01: Market information should be used to value financial options and guarantees when available and reliable. Otherwise, financial obligations and guarantees should be based on management's best estimate.

BC 18: Under Principles 1 and 2 it immediately follows that there should be a provision for all guarantees. However, such guarantees should not be valued separately unless they are clearly unrelated to the basic contract.

IG 3: Due to the wide range of options and guarantees available in the various markets, the measurement of the liability may be based on deterministic, stochastic or other techniques as prescribed by the Actuaries.

IG 4: As protection, future purchase options, amounts necessary to support level premiums and other service elements are bundled in one insurance contract, insurance liabilities will often reflect the value of options and guarantees. The measurement of the options and guarantee should be based on current credible experience for the exercise of those options and guarantees, including credible assumptions for policyholder behavior as stated in Principle 10. Where no such experience exists, management's current best estimate for exercise of such options and guarantees should be used.

Unit of Account

Principle 9: Measurement should be based on a portfolio of exposures

> **Sub-Principle 9.01: A portfolio is a group of contracts that are managed together when assessing risk. A portfolio may include one or many contracts but typically will comprise many contacts reflecting the pooling of risks inherent in the insurance business model.**

> **Sub-Principle 9.02: Portfolios should be defined and measured on a consistent basis in successive reporting periods.**

BC 19: Actuarial methodologies only apply when the law of large numbers can be invoked. Accordingly, measuring liabilities at the individual contract level is not appropriate unless the contract itself is a portfolio of exposures. This can happen in certain group situations.

BC 20: Decisions concerning margins and unlocking should be made based on blocks of business related to the way the company manages its business. Indicators that a group of policies are managed together may include:

- Consistent pricing or underwriting strategy
- Internal management reporting bases
- Capital Management
- Reinsurance strategy

Policyholder Behavior

Principle 10: Policyholder behavior should be reflected in the measurement of all liabilities

> **Sub-Principle 10.01: There should not be a cash value floor to the Net Insurance Liability.**

BC 21: A cash value floor provides for all policyholders surrendering their policies on the same day; this would not be a reasonable estimate of future cash flows as required by Principle 1.02. A requirement for a cash value floor is a requirement to use an assumption that is vastly different from any reasonable expectation of the results that will emerge, and violates the principle that policyholder behavior should be reflected in the Net Insurance Liability.

BC 22: Imposing a cash value floor could result in showing artificial losses on policies that are expected to be profitable, with such losses offset by inflated subsequent reported profits.

BC 23: An individual might still value a policy as equal to its cash value. However, the principle to value policies on a portfolio basis rather than an individual policy basis allows for the liability held by the insurer to be different from the asset held by the individual.

Principle 11: Renewal options or provisions that obligate the insurer to continue to provide coverages should be recognized to the extent they are included in the contract or required by law or regulation.

Sub-Principle 11.01: Renewal premiums should be recognized in liabilities if:

a) The contract is for longer than one year and

b) There are meaningful limitations on the rights of the insurer to increase future premiums or to cancel (or non-renew) contracts that the insurer believes are likely to be unprofitable.

BC 24: Normally renewal premiums on life insurance policies will be reflected in the calculation of the Net Insurance Liability. Premiums are generally guaranteed or have a maximum.

BC 25: Renewal premiums are often included in valuing liabilities for health insurance. However, for policies where there is an unlimited ability to increase premiums, any liability for future premiums and costs do not need to be reflected in the Liability.

BC 26: In this discussion, we have assumed all premiums are paid annually. For policies that have modal (e.g. monthly) premiums, the remaining modal premium for the current policy year and associated benefits and expenses would also be included in the measurement of the liability.

Own Credit Standing

Principle 12: The credit standing of an entity should not be considered in the valuation of insurance liabilities.

BC 27: Insurance regulation and other mechanisms in most jurisdictions guarantee payments to policyholders. Thus, a policyholder, in general, would not accept less than the contractual, or face, amount owed.

BC 28: The insurance industry guarantee mechanisms provide greater security to policyholders than bondholders or other debt holders. Accordingly, the credit spread on a company's debt would not be an appropriate indicator of the credit risk, if any, associated with policyholder liabilities.

BC 29: Since policyholder interests are met before debt holders (debt is subordinate to policyholder obligations), even in insolvency companies are often able to pay all their policyholder obligations while debt holders may receive substantially less than the face value of their investments, if they receive anything.

Asset-Liability Measurement

Principle 13: Entities should have the ability to measure assets and liabilities on a consistent basis to reflect the way companies manage risk.

> **Sub-Principle 13.01: The discount rate should reflect current interest rates and the company's investment strategy.**
>
> **Sub-Principle 13.02: The discount rate will also reflect the margins determined as required under Sub-Principle 4.02.**

Principle 14: Liabilities supported by a separate account, a unit-linked fund or a similar dedicated portfolio should reflect the expected returns on that portfolio.

BC 30: Insurance liabilities are obligations to deliver economic resources (assets) or provide services; they are not securities. When the obligation is difficult to value or settle, it would be unreasonable to ignore attributes (i.e. the yield rates and cash flow schedule) of the assets actually dedicated to settling the obligation in the future.

BC 31: Use of these rates allows the liability to move in parallel with the movement of the assets.

BC 32: Use of a risk-free rate for a non-participating contract's liabilities is inconsistent with pricing methodology and with the general methodology for establishing assumptions. It also would require a reported loss for many contracts at issue, and would not be practical in countries with a limited fixed income securities market. Companies also have very solid bases for expecting that such contracts will be profitable, and the reported losses at issue will be offset by artificially inflated subsequent reported profits.

IG 5: The actual discount rate should start with either the expected earnings rate on the existing portfolio or the expected return on new local investments depending on how the supporting assets are measured. Either return should be net of investment expenses and expected defaults, if appropriate, and will have a margin for risk and uncertainty applied to it in accordance with Principle 6.

IG 6: The attributes of the investment portfolio that should be used in determining a liability discount rate include:

- *(a) carrying value of the assets;*
- *(b) expected coupon, yield and principal payment schedule,*
- *(c) expected default, liquidity, trading and management costs.*

IG 7: Where reinvestment will be required to settle claim obligations, the liability discount rate should also depend on reinvestment at a reasonable achievable rate of return.

Participating Contracts

Principle 15: Liabilities for participating contracts must include provision for the expected payout of policyholder dividends, additional benefits provided or any other result of the participating mechanism.

Sub-Principle 15.01: It is not necessary for there to be a liability for future policyholder dividends separate from the liability for other future benefits and expenses unless such policyholder dividends are actually declared or otherwise determinable by a fixed formula.

Sub-Principle 15.02: If there is a fixed formula for determining the policyholder's share of earnings or assets, that formula should be reflected in calculating the liability. If management has reasons to believe that the policyholder's share will exceed that amount (e.g. the formula is a minimum and the company has traditionally paid more than the minimum) the excess should also be reflected in the liability measurement.

Sub-Principle 15.03: If there is no such fixed formula, management's best estimates should be used, and the basis for such estimates should be disclosed.

Sub-Principle 15.04: Amounts that are expected to be paid as participating dividends in future periods should not be reported first as profit or increases to equity.

Sub-Principle 15.05: For policies inside a Closed Block established as a result of a demutualization, the liability is always equal to the value of the Closed Block assets, subject to a loss recognition test.

Sub-Principle 15.06: If experience varies from expected, margins on participating contracts may be changed to reflect the expected extent to which those changes in assumption will be absorbed by changes in future policyholder dividends.

Sub-Principle 15.07: For certain assumptions on participating products it may be necessary to have implicit rather than explicit margins.

BC 33: Benefits provided through participating mechanisms in participating policies are not different from other benefits. In some cases they may be thought of as premium refunds, in others as extra benefits provided. Every jurisdiction has one or more varieties of participating mechanism and the rules for dealing with each may be different.

BC 34: If dividends are designed to pay out actual results based on experience, it is appropriate that earnings not be affected by changes in experience unless dividends will not be used to absorb the change.

IG 8: The company should disclose its treatment of obligations to participating policyholders but is not obliged to discuss the formula used for allocating current dividends to individual *policyholders. The effect of any changes to earnings due to changes in dividend policies and formulae should also be disclosed.*

Unbundling

Principle 16: Insurance policies with flexible premiums should only be unbundled in the event that the separation would result in material differences in the overall value of the contract and either

a) The deposit and insurance components of the contract are separately priced and separately managed by the insurer; or

b) Separate measurement of a deposit component is necessary to recognize rights and obligations of the insurer and the policyholder

BC 35: In general, insurers price insurance policies on an integrated basis. It would be extremely rare that an insurer prices and manages each of these components separately or that the separate measurement would be materially different.