making progress . . . together

M E M O R A N D U M

DATE: August 7, 2007

TO: Commissioner Al Gross; Ramon Calderon

CC: International Solvency & Accounting Working Group

FROM: Rob Esson

RE: Profit on inception for insurance contracts

The possibility of recording profit on inception for an insurance contract has been controversial for some while. The IAIS finally agreed that profit on the inception should not be forbidden based upon an overriding principle that "similar obligations with similar risk profiles should result in similar liabilities". If two different companies charge different amounts of premium for the same risk then an entry model, which would calibrate the risk margins to the premium, could not result in the liabilities being similar. Hence the IAIS decided that the entry value methodology could not be the correct principle and therefore decided that an exit model was appropriate. An exit model allows the possibility of profit on inception; however, the second liabilities paper states that "a profit on inception should be recognized only where an appropriate and sufficiently reliable risk margin has been provided for in the value of liabilities". The concept of 'sufficiently reliable' constitutes an additional test prior to the recognition of profits from inception.

In the first liabilities paper, paragraph 46 states: "The IAIS notes that uncertainty is an inherent and unavoidable facet of the insurance business, much more so than in almost any other business. Accordingly, recognition of up front profits on a basis that does not make appropriate allowance for this uncertainty is imprudent, and may lead to reporting that is intrinsically and unavoidably unreliable. Consistent with the previously mentioned time release of risk margin, profits should only be recognised as their existence becomes more reliable. This latter conclusion is consistent with the measurement application guidance of IAS39 (paragraph AG76A) regarding recognition of gain or loss after initial recognition. This is achieved through the release of the additional margins arising from any floor amount in a consistent manner over time."

The general expectation at the IAIS was that profit on inception would be both rare and tend to be small. At the insurance contracts subcommittee meeting on August 2, a presentation by Denis Duverne of the CFO Forum and CFO of Axa indicated that that he believed that there is a significant initial profit margin. 11 CFO forum members had published market consistent embedded value calculations that indicated a profit on inception of €5.2bn or approximately $7.2bn. This would imply a greater initial profit if extended across all 20 CFO Forum members. The presentation implied that these figures would be consistent with both Solvency II and an IASB Phase II implementation of an exit model. M. Duverne stated that the initial profit margin would not transfer in a transfer market. I challenge this assertion: if the market is approximately equilibrated, other participants would demand the same margin, so I suspect that it would transfer.

Additionally, given that the risk margin had been calculated using a cost of capital approach, I made the point that if the entire market was making these profits indicated that the wrong return on capital was being used in the cost of capital calculation, because it implied that the market actually required a higher return on capital. I did not get a good answer to this point, other than a suggestion that the results were (apparently) consistent with QIS3 – which would lead me to conclude that QIS3 is wrong too.

I also asked why – if these figures were correct – companies were not reducing their premiums to compete and take on market share. M. Duverne replied that the market was not efficient. I find this a very unsatisfactory response. If it is true, would this almost be tantamount to suggesting that the largest insurers in Europe are colluding in a premium setting (or price fixing) cartel? I doubt that that would have been M. Duverne's intention! Nonetheless, I suggest that if we continue to hear these sorts of amounts as representing true profits on inception, we might challenge our colleagues in the EU to demonstrate why competition is not reducing the premiums.

I also spoke to the GNAIE folks about this issue. They, of course, have consistently held that there should be no profits on inception. Not surprisingly, they were very averse to any suggestion that European companies should be able to move $7bn+ into equity, and Jerry de St Paer stated that this would enable European companies to come into the US with a lower cost of capital and undercut US companies. While I am not totally convinced by this particular argument, I share the discomfort with such levels of profit on inception which I believe defy common sense.

At the subcommittee, most members shared this discomfort, with the possible exception of the UK, which argued for sticking with the principle of an exit value and allowing the figures to come out whatever way they do. I told Shamim Diouman that figures like $7bn would likely change the position of US regulators, and might also reverse the narrow majority (7:6 with 1 abstention) at the IASB in favor of an exit value. I also said that I could see the possibility that these types of figures would be used to increase support for an AG76 type solution. [Paragraph AG76 of IAS39 states – in part – that: "The best evidence of the fair value of a financial instrument at initial recognition is the transaction price … unless the fair value of that instrument is evidenced by comparison with other observable current market transactions in the same instrument … or a valuation technique whose variables include only data from observable markets" – such a restriction in insurance would generally create an entry type model as profits on initial recognition could only be recorded where there was an *observable* alternative market, e.g. wholesale vs. retail].

It is entirely possible, if not maybe somewhat probable, that the disclosure of this figure was designed to cause exactly this reaction. The prior CFO Forum position on profits on inception was to forbid them. It would appear that there is now a split in the Forum between those that would like to show them and those that wouldn't. Those against showing profits on inception may have ensured that the $7bn figure would be disclosed to try to bolster their position that there should not be any by breeding panic and consternation regarding the levels of such profit.