

Minutes

ISWGNA Meeting OECD, Paris October 2, 2007

Participants:

Eurostat: Christian Ravets

IMF: Kim Zieschang (Chair)

OECD: Charles Aspden

UNSD: Viet Vu

UNECE: Not present

World Bank: Barbro Hexeberg

1993 SNA Update Project: Carol Carson (Project Manager), Anne Harrison (Editor)

1. Insurance and dividends

ISWGNA:NA discussed substantive issues on insurance and on the time of recording dividends. The basis of the discussion and the positions reached are described in the first attachment. The background note setting the context for the discussion on insurance is in the second attachment.

2. SNA revision work program through the end of the year

The codes proposed by Eurostat and commented by OECD and IMF were submitted to the Editor for incorporation into the *1993 SNA, Rev. 1* text. ISWGNA:NA agreed it would be desirable to develop a core data model encompassing and correlating the concepts of the forthcoming *1993 SNA, Rev. 1*, the *Government Finance Statistics Manual 2001*, the *Monetary and Financial Statistics Manual 2000*, and the forthcoming *Balance of Payments and International Investment Position Manual (BPM6)*. The core data model would be taken up after the first deliverable of the *1993 SNA, Rev. 1* is made to the UNSC.

Given the limited time to complete the first deliverable, the ISWGNA restated its position that the editor will decide whether and how to incorporate comments made on the draft chapters that the ISWGNA has classified in the "editor" category.

For the 2009 deliverable, the Editor will prepare the tables of contents for AEG comment.

The Project Manager previewed her presentation to the OECD National Accounts Meeting on the work program on the *1993 SNA, Rev. 1* to the ISWGNA:NA.

It was agreed to meet informally with members of the Advisory Expert Group attending the OECD National Accounts Meeting to get a reading on ISWGNA:NA proposals on several aspects, including for compressing the comment periods to 30-45 days to speed delivery of the second deliverable. The meeting was arranged for lunch Thursday, October 4. (The informal discussion at this meeting the following day produced the following reactions: favorable to compressing the comment period; and generally favorable on the commenting process, with the request, accepted, that the ISWGNA:NA incorporate schedules of peak workload from the AEG members into its schedule of chapter review and issue consideration requests to the AEG.

3. Next meetings

The next meeting of the ISWGNA:NA will be face to face on November 1-2, 2007 at the IMF Headquarters in Washington. The tentative agenda is

- Outline of Chapters 1 and 2
- Disposition of substantive comments on Chapters 3, 4, 5, 7 Add. 1, 8 Add. 1, 9 Add. 1, 16, and 17
- The content of the second deliverable of the *1993 SNA, Rev. 1*.
- The future focus of the Advisory Expert Group vis-à-vis, for example, the Research Program and clarification issues arising.

5. To-do list

Action	By when	Responsible	Status
Report on the High Level Group considering future directions for the national accounts	End October	UNSD	Pending
Outline of Chapters 1 and 2	October 19	Anne Harrison (Editor)	Pending
AEG preview of Chapters 1 and 2	November 1	AEG members	Pending
Timeline for delivery of the implementation strategy to UNSC	October 15	Kim Zieschang (IMF)	Pending
Timeline for preparing the report to the UNSC	October 19	UNSD	Pending
Processed comments on Chapters 3, 4, 5, 7 Add. 1, 8 Add. 1, 9 Add. 1, 16, and 17	October 12	Agencies and editor	Pending
Revised codes to the Editor by end-September	September 28	Christian Ravets (Eurostat) Charles Aspden (OECD) Kim Zieschang (IMF) Ivo Havinga (UNSD)	Done
Chapter 6: Disposition of comments on treatment of central bank output	End-August 2007	Kim Zieschang (IMF)	Done
The Project Manager will prepare a draft letter to the ECB about ECB's comments on the mapping of taxes from the classification in the GFSM and the OECD's Revenue Statistics	End-July 2007	Carol Carson (Project Manager)	On hold
Chapter 12. Draft text on the properties of the "general price index" for distinguishing real and nominal holding gains in the holding gains and losses account for the research agenda.	End-September 2007	Ivo Havinga (UNSD) Kim Zieschang (IMF)	Pending
Update of the Full Set of Consolidated Recommendations (44 issues document) to incorporate changes and UNSC decisions	When possible	Anne Harrison (Editor)	Pending
Add-ons to draft chapters 6 and 17	End October	Anne Harrison (Editor)	Pending
Prepare a document for discussion on insurance	Before Paris	Anne Harrison (Editor)	Done

Action	By when	Responsible	Status
Organize an informal meeting with the AEG members present at the OECD meeting	Mid-September 2007	Kim Zieschang (IMF) Charles Aspden (OECD)	Done

Items marked as 'Done' in this to-do list will be omitted in the following to-do list.

Discussion and conclusions on insurance and time of recording of dividends

Anne Harrison, Editor

The group discussed two areas of substance, one concerning insurance and one concerning the time of recording of dividends.

Insurance

The background for this item was a note prepared by the Editor (attached). The topics discussed had arisen in the context of comments made on the draft with both the IMF and ECB expressing strong reservations with the treatment of equalisation provisions. Because of the perceived connection between equalisation provisions and handling exceptional claims, other matters bearing on the financing of exceptional claims were also addressed.

Equalisation provisions

On the first point, the ISWGNA readily agreed that equalisation provisions should not be included with insurance technical reserves for the reasons given in the background note. Eurostat confirmed that there was little comparability in the coverage of equalisation provisions across EU countries and that inclusion led to less not more comparable measures of technical reserves.

Given that the content of insurance technical reserves would not now change, it was agreed that the change of terminology was unnecessary and the word “reserves” should be kept and not replaced by “provisions”.

It was noted that it could still be useful to show equalisation provisions as a memorandum item and that the item would be used when insurance output is derived using the “accounting” approach described in the updated text.

Reinsurance

The ISWGNA also agreed that when insurance output is derived using the “statistical” approach, the time series of claims from which adjusted claims is derived should reflect the fact that a direct insurer only has to fund actual claims less any excess of reinsurance claims received over reinsurance premiums paid. The formula for deriving insurance output, however, is unchanged.

Asymmetries caused by the capital transfer option

Once the formula for calculating insurance output is amended to include expected claims rather than actual claims, output is invariant to the level of actual claims and there is no variation in net premiums attributable to this. The problem that under the 1993 SNA

guidelines output declines as claims increase disappears. The remaining question is, if actual claims exceed expected claims, at what level and for what reason are some of these claims recorded as capital rather than current claims. The ISWGNA spent some time trying to identify the sorts of incidents that would give rise to exceptional claims but eventually concluded that it is difficult to find a rationalisation to explain why one occurrence of a particular claim gives rise to a current transfer but multiple occurrences involve some capital transfers.

The ISWGNA concluded that the case for paying claims as capital transfers depended on the way in which premium levels are set. The object in devising the formula for measuring insurance output indirectly is to mimic the premium-setting process of the insurance company. It must be presumed that normally premiums are intended to cover normal or expected claims. If the insurance company misjudges the level of claims, the difference between actual claims and expected claims leads to greater or less disposable income and saving for the insurance company and negative saving will lead to a reduction in net wealth. Treating some claims as capital in nature does not alter the eventual changes in net wealth between the insurance company and policy holders but does change the relative size of disposable income and saving for all parties.

The only rationale the ISWGNA found convincing for treating some claims as giving rise to capital transfers was the possible if uncommon situation where an insurance company deliberately set the premiums at such a low level that it expected to have to meet some claims from a run-down of wealth. Such a situation might occur in a year following an initial disaster where the company fears a repeated year of heavy claims but feels unable to raise premiums all at once to the new, higher level required to cover these claims entirely.

When any claims are treated as capital transfers, the ISWGNA recommends that all claims be partitioned between current and capital transfers in the proportion of the total being paid by each sort of transfer.

The ISWGNA considered that the instances when reinsurance companies would set premiums below expected claims were sufficiently unlikely that it was not necessary to make a formal exception and restrict the possible recording of claims as capital transfers to direct insurance only.

Output estimated by the sum of costs

The ISWGNA stated that estimated insurance output as the sum of costs is very much a last resort because costs are likely to vary with actual claims, not expected claims and output will be higher in a high claim year than in a low claim year, which is counter-intuitive. The notion that insurance output remains fairly constant from year to year, regardless of the number of claims, is more applicable to a volume measure of output than to a current value including operating surplus. The question of how best to estimate prices for insurance output is still open to debate.

Time of recording of dividends

The AEG recommended changing the time of recording of dividends from the time when they were actually paid to the time when they are declared payable. Normally a share value incorporates the discounted value of expected future dividends. Just after the next dividend is announced, the share price drops and is referred to as being “ex-dividend” because the payment of the dividend is effectively separated from the share. Even if the share is sold from A to B in the period between when the share “goes ex-div” and when the dividend is actually paid, it is A who receives the dividend, not B. Once the dividend is paid, the share price drops the “ex div” label and trades as before.

The editor had understood that shares went ex-dividend virtually immediately the dividend was declared payable. It turns out this is not so and there are some complications with the recommendation to record the dividend as payable the time it is declared payable. Since the share may trade between the date the dividend is announced and the date the share goes ex-div, the unit that will actually receive the dividend is unknown at the declaration date. Further, in this short period, the value of the share still includes the value of the impending dividend so to include the share at full value and the dividend also as a payable would lead to double-counting. The IMF alerted me to this problem and , in consultation with IMF staff, we suggest both SNA and BPM6 be changed to say that dividends are recorded at the time their value goes ex-dividend. The ISWGNA agreed to this proposal.

Background note on Insurance

Anne Harrison, Editor

Insurance

There are three major issues the ISWGNA should consider. The first of these concerns equalisation provisions. At the last AEG the Editor expressed unease about the proposed treatment but was unable to convince others there was a problem. Now both the IMF and ECB have expressed misgivings with the proposal to include equalisation provisions along with the previous technical reserves and suggest it be revisited. The first part of this note explains the background to the proposal and the reservations. This proposal leads to suggesting a change to a previous decision on the grounds that it is now recognised that the decision is inconsistent with other internationally agreed guidelines (on debt).

The second issue concerns the impact of reinsurance on the measurement of the output of direct insurers. This is a consistency issue.

The third issue concerns the acceptance that claims may sometimes be recorded as capital transfers rather than current transfers. This proposal risks introducing asymmetry both within the domestic economy and with the rest of the world which is currently avoided. The Editor believes we should consider whether this risk if asymmetry exists and, if so, whether it should remain in the system.

Equalisation provisions

The AEG agreed that three formulations of the measure of insurance output were acceptable. One of these, the accounting approach, refers to “additions to less withdrawals from equalisation provisions and additions to less withdrawals from own funds, where necessary.”

In part because of this, equalisation provisions were suggested for inclusion with prepaid premiums, claims incurred but not yet paid, claims incurred but not yet reported and claims not yet incurred as part of technical reserves, to be renamed technical provisions. This implies that equalisation provisions are treated as being a liability of the insurance company to the policy holders.

It is true that some claims, especially unexpectedly large ones, are made out from equalisation provisions but where the provisions are insufficient to meet the claim,, it is met from own funds, as the quote above acknowledges.

Unlike the amounts previously treated as technical reserves, equalisation provisions are not built up from transactions as the balance of interaction between the policy holders and an insurance company in respect of premiums and claims. Rather, they are established at the discretion of the insurance company subject to two administrative constraints. One of

these is when such provisions must by law be established (especially for credit insurance) and one restricts the amounts that may be added or deducted to the equalisation provisions . The latter restriction is connected with the fact that changes in equalisation provisions are usually subject to special taxation treatments. The restriction is intended to prevent equalisation provisions being used as a means of smoothing profits from one period to another.

The appeal of treating equalisation provisions in a manner similar to unearned premiums or claims incurred but not yet paid is the assumption that these provisions “match” in some way the exceptional claims that may be treated as capital transfers. However, there is no certainty that this match exists and that it is exact. Exceptional claims may be met from normal technical reserves, in whole or in part; they may be met by claims receivable from reinsurers, they may be met from a draw-down of own funds. Many equalisation provisions relate to credit insurance and may not apply to events such as natural disasters.

Even if there is some sort of match between equalisation provisions and exceptional claims, the payments of the claims are recorded as a transaction but the creation of the provisions is recorded as an other change in the volume of assets account. It is not related to premiums and does not represent a liability towards the policy holders and an asset of the latter.

This situation sits uneasily with the normal relationship between the payment of claims out of premiums but is not the main cause of concern from the IMF and ECB. The internationally agreed guidance on the definition of debt does not allow for debt to be created (or reduced) by an allocation of funds to one of the debt categories (which insurance technical reserves are) by a unilateral declaration by the institutional unit concerned (which is how an other volume change must be regarded).

Proposal:

The previous AEG agreement to include equalisation provisions with technical reserves should be reversed. These means the provisions would not be treated as a liability of the insurance company and an asset of the policy holder and would not be part of debt. If information on equalisation provisions is available, it may be shown as a supplementary item in the accounts of insurance companies. Note there is no proposal to change the definition of output or the use of equalisation provisions as a means of deriving output when using an accounting approach.

If this proposal is accepted, do we still change the terminology of insurance technical reserves to insurance technical provisions or keep to the former terminology?

Note: The following is the text from the original AEG discussion paper discussing equalisation provisions:

Equalisation provisions are amounts set aside in compliance with legal or administrative requirements to equalise fluctuations in loss ratios in future years, often with respect to special risks. These would be particularly relevant in connection with catastrophe business. These provisions, therefore, relate to future events causing claims. The provisions in this respect are comparable to the provisions for unearned premiums and the provisions for unexpired claim.

In many countries and in ESA 1995, but not the 1993 SNA, they are included in technical reserves.

According to the 1993 SNA, they should not be recognized as transfers or liabilities to policyholders because there is no liability to pay the policyholders until an uncertain future event occurs, i.e. they are contingent liabilities. Contingent assets and liabilities are excluded from the 1993 SNA framework and internal accounting entries do not qualify as transactions. However, the equalisation provision concerns the situation where the insurer takes account of the fact that a future high claim (set of claims) might show itself. To avoid the effect thereof on the insurer's profit, the insurer sets part of the financial year's premiums aside in a dedicated provision. This is comparable to treatment of the non-earned part of the written premiums.

Although this is an argument for not recording equalisation reserves as liabilities on insurers' balance sheets, it could be argued that the income on these reserves should be included in premium supplements. Similarly, there may be arguments for including them in the calculation of insurance services.

The 1993 SNA approach of not treating equalization provisions as technical reserves means that when reserves are built up, insurers will be shown as saving, when they are used for claims, they will appear as a run-down of insurance saving and transfer to policyholders.

Under ESA 1995's paragraphs that describe financial accounts, technical reserves are explicitly extended to include equalization provision. However, this extension is not explicitly mentioned in the formula that describes the compilation of output, but a recent Eurostat task force on insurance measurement confirmed that the ESA should be interpreted as including these provisions in its recommended measure of output

However, the discussion paper does not note that even among EU countries there is very great variability on what may and what may not be included in equalisation provisions. It is also worth noting that the IASB states that these provisions are not to be treated as liabilities. If we maintain the existing decision to treat these provisions as liabilities of the insurance companies, what reasoning do we use to exclude provisions for bad debts that seem to have the same characteristics?

The impact of reinsurance on expected claims

The insurance task force considered how to change the formula for insurance output by using expected claims in place of actual claims before considering the matter of reinsurance but did not return to consider whether the revised treatment of reinsurance had consequences for the earlier recommendation.

Reinsurance is one way in which the volatility of claims is suppressed by direct insurers (and other reinsurers). There are two forms of reinsurance, one is excess of loss and the other proportionate loss but both mean that the level of claims the direct insurer has to find himself is either capped or reduced proportionately by the existence of a reinsurance policy. The reduction in claims can be expressed as the excess of reinsurance claims receivable over [net] reinsurance premiums payable. This would suggest that the adjusted claims figure to be used in the definition of output should be derived from a time

series of actual claims adjusted for the smoothing effect of reinsurance. The adjusted claims figure would then be based on total claims met by the direct insurer less the excess of those claims payable by the reinsurer over the premiums paid to the reinsurer. The statement of the basic measurement of insurance output as net premiums less adjusted claims (adjusted for changes in reserves) would not be altered, just the means of deriving adjusted claims.

Question:

Is this clarification correct and acceptable?

Asymmetry problem

Background

The problem to be discussed arises from the possibility introduced into the SNA that some claims could be recorded as capital transfers rather than current transfers. The proposal was made in the following way in the AEG discussion paper.

Changing the formula for the calculation of insurance output to use adjusted claims rather than actual claims means that the two transactions showing redistribution brought about by non-life insurance, net premiums and claims, are no longer equal. Thus if claims are larger than net premiums, the disposable income (and hence saving) of insurance companies is now reduced by the excess of claims over net premiums while the reverse is true for the policy holders.

Some participants in the insurance task force felt that the difference between net premiums (now equal to expected claims) and actual claims should not affect disposable income but should appear in the capital account as a form of capital transfer. This was particularly the case when the level of unexpected claims is large and positive and is met from equalisation provisions and own funds. The discussion paper goes on

... it is proposed that, in the accounting framework, differences between “normal claims due” and expected claims is treated in the current account, as a difference between claims and net premiums, while a difference between “very exceptional claims” due and expected claims is treated as a capital transfer.

Recommendation 11: the introduction of expected claims and expected premium supplements in the calculation of production will result in a decoupling of non-life insurance claims (D72) and the corresponding imputed net non-life insurance premiums (D71). D71 will be equal to expected claims plus the difference between actual premium supplements and expected premium supplements. In the case of catastrophes, where the difference between D71 and D72 may be deemed too important to affect current disposable income of policy holders, the difference attributed to the catastrophe can be treated as a capital transfer, to avoid affecting disposable income.

No guidance was given about when actual claims should be treated as “normal” and when as “very exceptional”. Nor was it noted that with the capital transfer treatment, saving becomes more positive than otherwise even though the circumstances are exactly those where a use of financial assets is needed to meet the exceptional claims. Further, not only is the insurance companies’ disposable income and saving overstated in the year of an exceptional loss, this is never offset in other years as one would expect with any sort of “smoothing” mechanism.

Claims as current or capital transfers

The normal case for non-life insurance is that both premiums and claims are recorded as current transfers, regardless of the nature of the claim. Consider an individual policy holder whose house has burnt down. The claim is associated with the destruction of one asset and the probable acquisition of another and reflects a large and infrequent event. These are the sort of criteria associated with capital transfers but because we insist that a transfer must be recorded as current for both parties or capital for both parties, we record the claim for the house as a current transfer, in the normal course of events.

Suppose now there is a major forest fire and so many homes are destroyed that this becomes an exceptional loss for the insurance company. Under the proposal above, in this case some of the claims may be recorded by the insurance company as capital transfers. In order to preserve the balance of both current and capital transfers, we must record a similar amount of claims as being received by the policy holders as capital transfers rather than as current transfers. What advice should be given to national accounts compilers? Suppose 20 per cent of total claims are treated as capital transfers. Should all claims in the year be recorded as 80 per cent current and 20 per cent capital? Should an attempt be made to identify the 20 per cent of claims most likely to be associated with the exceptional event? This latter sounds initially appealing but given some of the claims associated with a disaster may have time delays in final settlement a messy situation over accruals arises and the former may be a more pragmatic solution.

To date we have only considered that the rationale for treating an insurance claim as a capital transfer is that the insurance company is faced with exceptional losses in total. The perspective of the policy holder about the nature of the transfer is ignored as the first example of the single house destroyed by fire illustrates.

The AEG recommended that the same latitude to record some claims as capital be applied to reinsurance as well as to direct insurance. This means that it is the reinsurer that determines when claims are sufficiently exceptional to be treated as capital rather than current transfers. Since the bulk of reinsurance involves transactions with non-resident units, the economy where the direct insurer is resident cannot determine whether the claim is a current or capital transfer (just as the house owner cannot decide whether his claim is current or capital transfer) but would need information from the economy where the reinsurer is resident to make a correct decision. The difficulties this raises are likely to add to the problem of global imbalances within the balance of payments.

There is a further consequence for the direct insurer. Even if a direct insurer determines that his claims are exceptional and treats some as capital transfers payable to his policy holders, the reinsurance claims that he receives may still be treated as current transfers because for the reinsurer the direct insurer's claims are not exceptional. Assuming again that the reinsurer is non-resident vis-à-vis the direct insurer, the latter will have even higher saving than on the basis of the direct insurance transactions only, possibly to the point where the saving (including the reinsurance claim receivable) are sufficient to meet even the exceptional claim without a call on equalisation provisions or own funds.

Questions:

1. Assuming we adhere to the decision to allow some claims to be recorded as capital transfers, should we give an indication of when the “very exceptional” treatment is appropriate?
2. What advice do we provide about which claims are met by capital transfers and how to identify the policy holders affected?
3. Even if we adhere to the decision to allow some claims to be recorded as capital transfers in the case of direct insurance, is there a case to be made to say that this treatment does not apply to reinsurance? If we continue to allow the treatment to apply to reinsurance there is flexibility introduced into the level of national disposable income depending on the reliability and objectiveness of identifying which reinsurance claims the reinsurance companies treat as exceptional and thus capital rather than current transfers.