

Future IFRS accounting for insurance contracts

AMIS

Alexander Dollhopf

2 December 2009

Agenda

1 Introduction

2 Revenue recognition project

3 Liabilities project

4 Insurance contracts project

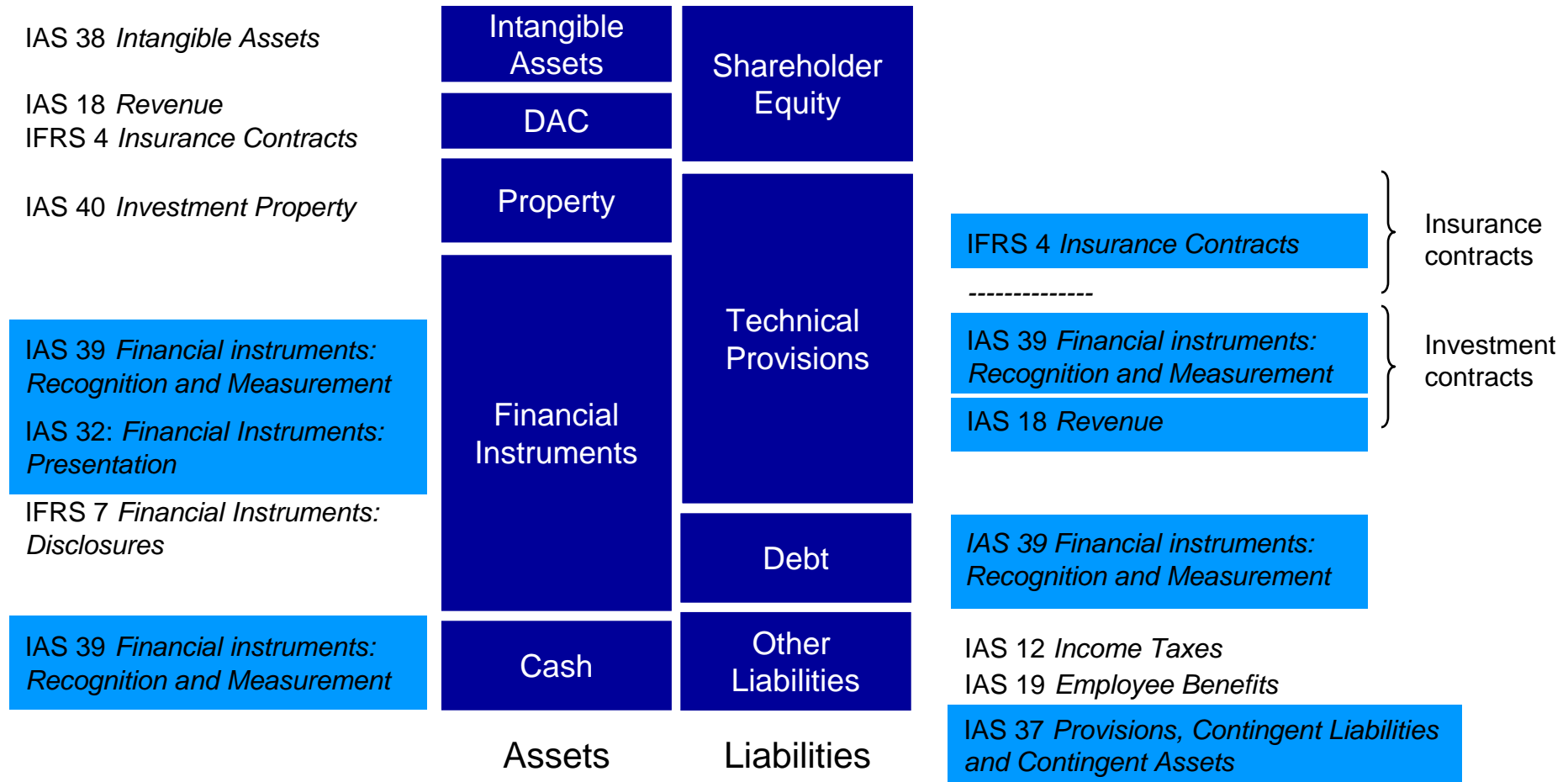
5 How much is it really worth?

6 How will it impact you?

Challenges within current insurance accounting

- Analysts treat insurance shares at a discount since they do not understand
 - How insurance business works
 - How it generates shareholder value and
 - How insurance company performance is assessed
- Current IFRS information is not perceived as being very useful to readers
 - Differing treatment of insurance contracts and investment contracts
 - Differing practices for valuation of insurance contracts across countries and companies
 - Relies on local practices
 - 'More reliable and relevant' criteria
 - Different types of liability adequacy tests
 - Insurance contracts liabilities often
 - Contain prudency margins
 - Do not reflect the time value of money
 - Do not reflect the value of embedded options, guarantees or other asymmetries
 - Asset liability accounting mismatches do not reflect economic reality
 - Deferral of acquisition costs does not reflect economic reality
- In the area of life insurance, embedded values are often used for communication

Many parts of an insurer's balance sheet are currently under revision



IASB Work Plan (excerpt)

	Estimated publication date							IASB-FASB Collaboration	
	2009 Q4	2010 Q1	2010 Q2	2010 Q3	2010 Q4	2011 H1	2011 H2	MoU	Joint
Financial crisis related projects									
Consolidation				IFRS				✓	✓
Fair value measurement guidance	RT			IFRS				✓	
Financial instruments (IAS 39 replacement)									
Classification and measurement	IFRS							✓	✓
Impairment	ED				IFRS			✓	✓
Hedge accounting		ED			IFRS			✓	✓
Memorandum of Understanding projects									
Financial statement presentation									
Statement of comprehensive income		ED			IFRS			✓	✓
Financial instruments with characteristics of equity			ED			IFRS		✓	✓
Post employment benefits		ED				IFRS		✓	
Revenue recognition			ED			IFRS		✓	✓
Other projects									
Insurance contracts			ED			IFRS			✓
Liabilities (IAS 37 amendments)	ED			IFRS					

Footnote: DP – Discussion Paper, ED – Exposure Draft, IFRS – International Financial Reporting Standard, RT – Round tables

Source: IASB, 6 November 2008

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Revenue Recognition project

December 2008

DISCUSSION PAPER

Preliminary Views on Revenue Recognition in Contracts with Customers

Comments to be submitted by 19 June 2009



- Scope
 - Contracts with customers
 - Exact scope might exclude some or all types of insurance contracts
- Contracts create performance obligations
- Initial liability measurement
 - Liability (at least) equal to initial revenue received
- Subsequent liability measurement
 - Run-off as performance obligations in the contract are expected to be satisfied (locked in)
 - Onerous contracts test
- Consequences
 - No day one gains
 - Locked-in approach (except if onerous)
 - Initial acquisition costs expensed when incurred

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Liabilities project

- Will replace IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*
- Provides guidance on recognising, measuring and disclosing liabilities that are not within the scope of other standards
- Proposed measurement model:

Amount that the entity would rationally pay to be relieved of the present obligation, which is the lowest of:

- The value the entity would gain if it did not have to fulfil the obligation
 - The amount the entity would have to pay the counterparty to cancel the obligation
 - The amount the entity would have to pay a third party to transfer the obligation to that party
- Next steps
 - Dec 2009: Exposure Draft of measurement guidance published
 - Jan/Feb 2010: Working draft of entire revised standard
 - Q3 2010: Revised standard

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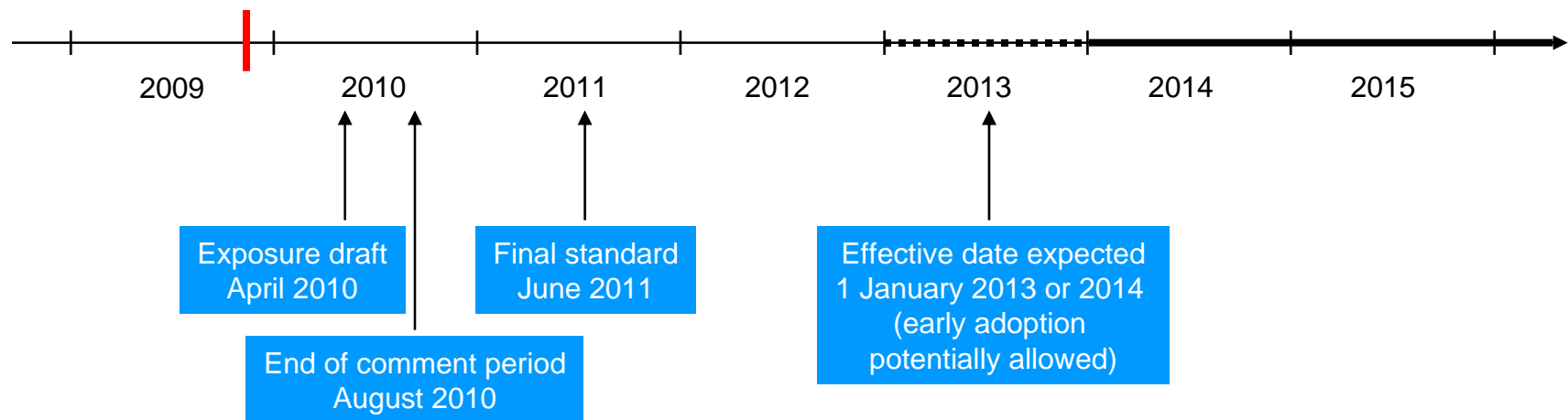
6 How will it impact you?

The history of the IASB's insurance accounting project

Date	Event
1997	Former IASC instigated a project to produce a standard for policyholder liabilities
November 1999	Issues paper published
June 2001	Draft Statement Of Principles (DSOP) published
May 2002	The project is split into Phase I and Phase II, recognising that it is not practical to have a full insurance IFRS in place for the European adoption of IFRS in 2005
March 2004	IFRS 4 <i>Insurance Contracts</i> published and Phase I concluded
September 2004	Phase II started
May 2007	Discussion Paper published
November 2007	Comment period ended
February 2008	IASB started review of responses to Discussion Paper
October 2008	US standard setter FASB decided to join the insurance project

Expected timeline

Exposure Draft of new accounting standard for insurance contracts announced to be published in April 2010 with a four month exposure period



The IASB is very keen to finalise the project by 2011, since a number of new countries will adopt IFRSs around that time and the Board has by then undergone a full rotation of its members

Insurance contracts definition

- Current definition
 - "An insurance contract is a contract under which the insurer accepts significant insurance risk from the policyholder by agreeing to compensate the policyholder if an insured event adversely affects the policyholder." [
 - "Insurance risk is risk other than financial risk transferred from the holder of a contract to the issuer."
 - "Insurance risk is significant if, and only if, an insured event could cause an insurer to pay significant additional benefits in any scenario, excluding scenarios that lacks commercial substance [...]"
- It is still unclear whether this definition will remain in its current form, or whether it will be revised.

Initial measurement of insurance contracts liabilities

Decisions taken to date

- The objective of the liability measurement is to report a value based on the insurer's fulfilment of its contractual obligations to its policyholders over time. (FASB)
- The objective of the liability measurement should be similar to the approach being developed in the project to amend IAS 37. (IASB)
- The measurement of the liability should be based on three building blocks: (IASB and FASB)
 - Cash flows
 - Discounting
 - Explicit margin
- No deposit floor is included in the measurement. (IASB)
- No day one gains should be recognised in profit and loss – this is achieved through calibrating the margin to the premium. (IASB+FASB)
- If the initial measurement of an insurance contract results in a day one loss, the insurer should recognise that day one loss in profit or loss. (IASB)
- The unearned premium approach is required for pre-claim liabilities of short-duration insurance contracts. (IASB)

Initial measurement of insurance contracts liabilities

Current fulfilment value

- **Expected present value of the cost of fulfilling the obligation to the policyholder over time**
- **Plus a composite margin based on the day one differences**
- A fulfilment value notion has been advocated by many respondents to the Discussion Paper (however including a risk margin)

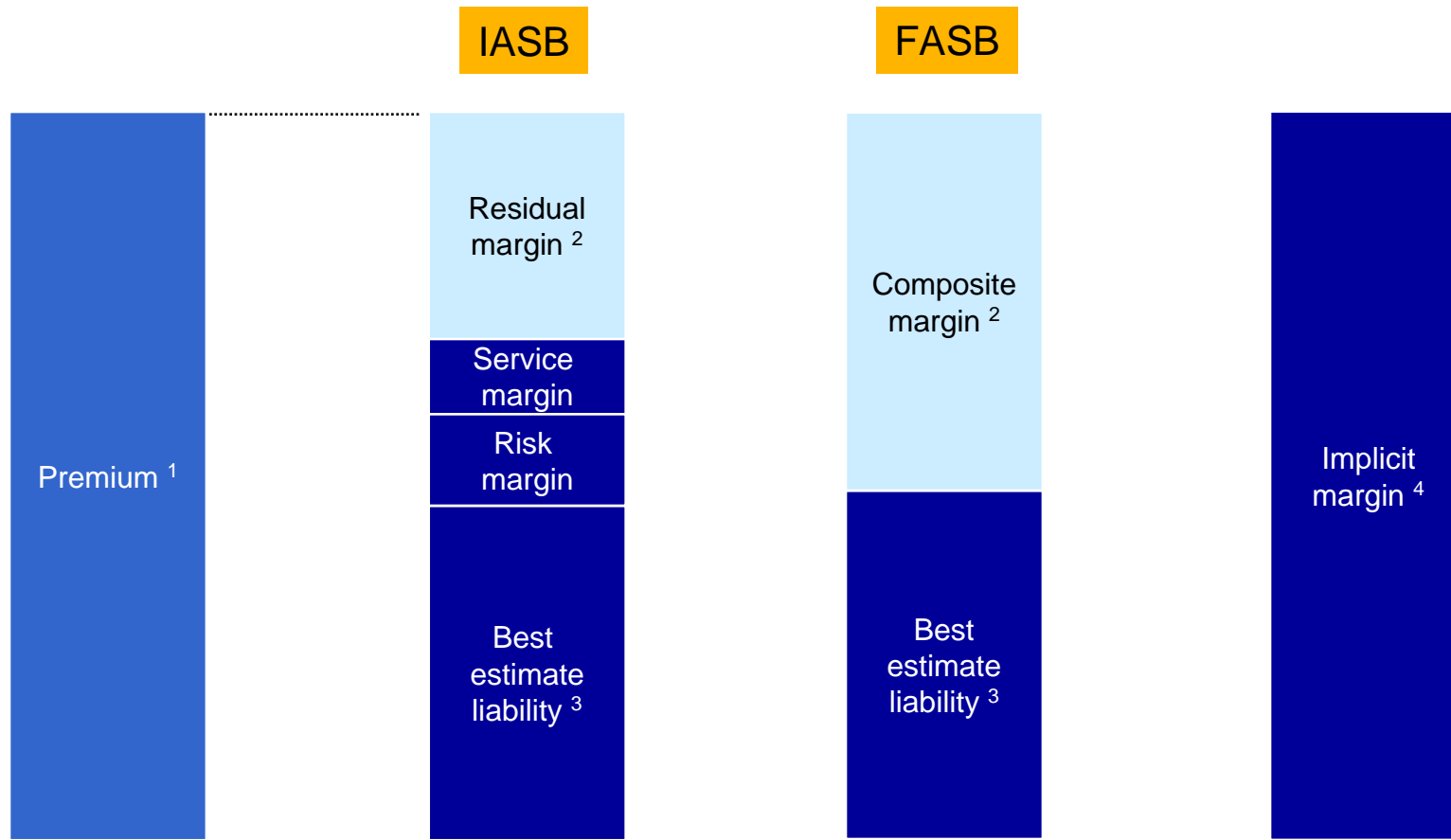
Initial measurement of insurance contracts liabilities

Updated IAS 37 model

- Based on the developments within the IASB's *Liabilities* project, the following measurement approach has been proposed for insurance contracts (the "updated IAS 37 model"):
 - **The amount the entity would rationally pay at the end of the reporting period to be relieved of the present obligation, which is the lowest of**
 - The value to the insurer of avoiding the future outflows expected to be required to fulfil the obligation (an entity-specific measure)
 - The price that the market would demand to assume the liability, if such a price exists
 - The price that the counterparty would demand to cancel (settle) the liability, if cancellation is possible
 - **Plus a residual margin based on the day one differences**
- The proposed guidance requires a risk margin if the amount or timing of the future cash flows affect the amount the entity would rationally pay to be relieved
- In the case of service activities, the model requires the reporting entity to base cash flows on the amount that a subcontractor would charge to undertake the services, including the profit that the subcontractor requires (giving rise to a service margin)

Initial measurement of insurance contracts liabilities

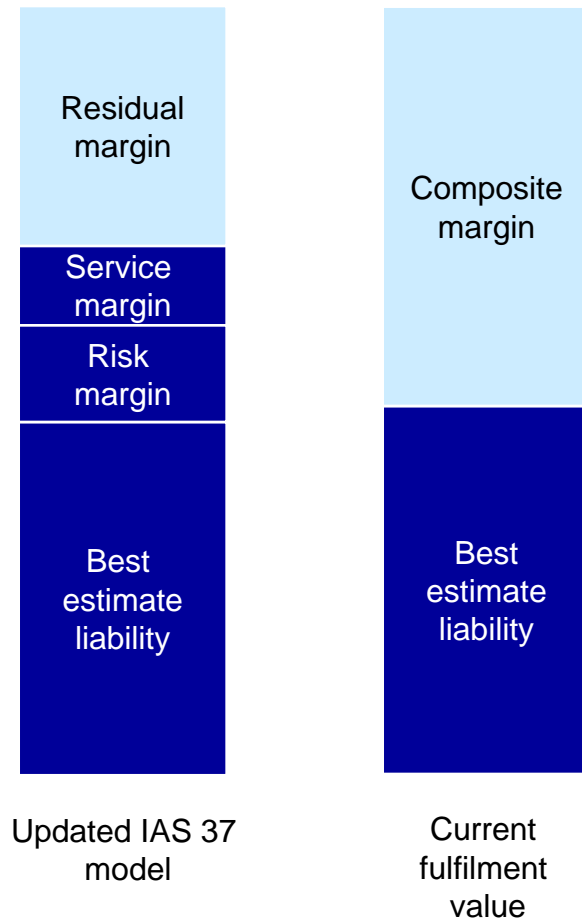
Candidate measurement approaches



- ¹ Present value of future premiums
- ² Working titles, might be changed later
- ³ Best estimate liabilities might differ slightly under the two approaches
- ⁴ Unearned premium approach required for pre-claim liabilities of short-duration insurance contracts (IASB)

Initial measurement of insurance contracts liabilities

Constituent parts of the liability



- Residual margin / composite margin
 - Margin to avoid day one gains from being recognised in profit or loss – can not be negative
 - Calibrated to premium
 - Released according to performance under the contract
- Service margin
 - The profit the insurer requires for undertaking services (estimated by considering the amount a subcontractor would charge for undertaking the service)
 - Remeasured at each reporting date
- Risk margin
 - The value to the entity of not having to bear the risk in the expected cash flows
 - Provides information about the uncertainty associated with the liability
 - Remeasured at each reporting date
- Best estimate liability
 - Current estimates of the expected present value of future cash flows (prospective measure)
 - Use explicit current estimates of the expected cash flows
 - Reflect the time value of money through discounting
 - Inputs for which observable market information is available (financial market variables) should be consistent with observable market prices
 - Other inputs should be the entity's estimate of the cash flows
 - Remeasured at each reporting date

Risk margins

Different reasons are named to justify a risk margin:

Reason	Explanation
Frictional cost of capital	Frictional cost of capital (cost of double taxation and investment management)
Volatility	Uncertainty resulting from volatility in the future cash flows to policyholders, resulting from the risks inherent in the contract – “I prefer a certain game”
Choice of assumptions	Uncertainty in correct choice of underlying assumptions when measuring cash flows – “I feel uncomfortable with whether the assumptions are correct”
Risk appetite	Risk appetite with an aversion for negative scenarios – “I prefer positive scenarios”
Remuneration for providing capital	Shareholders require a remuneration for providing regulatory or internal solvency capital: “I want a 15% return on capital!”
Unmodelled asymmetric risks	Risks that have been modelled on a deterministic basis have in reality an asymmetric impact on cash flows
Unmodelled correlations	Correlations exist between financial and non-financial risks, but have not been modelled
Unmodelled known risks	Known risks not included in the cash flows and impacting policyholder cash flows negatively (for example operational risk)
Unknown risks	Generally unknown risks impacting policyholder cash flows negatively
Prudency or shock absorber	Prudency or shock absorber
Empirical market evidence	Market evidence from transactions proves the existence of risk margins

Subsequent measurement of residual margin

- The driver selected for releasing the residual margins should result in recognising those margins in income in a systematic way that best depicts the insurer's performance under the contract. (IASB)
- It is expected that the margins are released to profit and loss (open point).
- Suitable drivers used for release of the margin (open point):
 - Release from risk
 - Passage of time
 - Expected benefit and claims payments
 - Premium receipts
 - Funds under management
- The residual margin should be released over the period during which the insurer is standing ready to accept valid claims (the coverage period); no release during the claims handling period. (IASB)
- The insurer should not adjust the residual margin in subsequent periods for changes in estimates. (IASB)

Discount rates

- The discount rate for an insurance contracts liability should conceptually adjust estimated future cash flows for the time value of money in a way that captures the characteristics of that liability rather than using a discount rate based on expected returns on actual assets backing those liabilities. (IASB)
- The standard should not give detailed guidance on how to determine the discount rate. (IASB)

Acquisition costs

- An insurer should recognise all acquisition costs as an expense when incurred (IASB+FASB)
- The insurer should not recognise any revenue (or income) at inception to offset acquisition costs incurred. (IASB+FASB)
- Deferral of acquisition costs through a DAC asset will probably not be allowed

Policyholder behaviour and contract boundaries

- The liability measurement should include the following expected (probability weighted) cash flows resulting from the contract, including those cash flows that depend on whether policyholders exercise options in the contracts (IASB):
 - Future premiums
 - Cash outflows resulting from those premiums, such as for example benefits and claims
- Insurer's ability to cancel or change the pricing or other terms of an individual contract is the starting point for determining boundaries between existing contracts and new contracts for accounting purposes. (IASB)
- IASB and FASB staff will develop more specific proposals for identifying the boundary.

Participating insurance contracts

- At their November 2009 joint meeting, the IASB and FASB discussed participating contracts.
- Staff presented two views:
 - View 1: The cash flows that arise from a participating feature are integral to measurement of the liability like any other contractual cash flow and should be included in the measurement of the liability on an expected present value basis. The participating feature is not considered separately for recognition, classification and measurement. This view is consistent with the boards' tentative decision that the measurement of an insurance contract includes all contractual expected (that means probability-weighted) cash flows.
 - View 2: A participating feature should be considered for recognition, classification and measurement separately.
- The IASB expressed an initial preference for view 1 and the FASB expressed an initial preference for view 2.
- The boards will continue their discussions on participating insurance contracts at a future meeting.

Timetable for Board discussions and Working group meetings

Topic	Date
Policyholder participation (classification and measurement)	Nov 2009
Recognition and derecognition	Nov 2009
Presentation, including the use of other comprehensive income	Dec 2009
Measurement, including objective, margins and embedded derivatives	Dec 2009
Unbundling	Dec 2009
Policyholder participation	Dec 2009
Margins (follow-up)	Jan 2010
Participating, unit-linked and index-linked insurance contracts and investment contracts and universal life contracts (including unbundling)	Jan 2010
Business combinations	Jan 2010
Definition and scope	Jan 2010
Disclosures	Jan / Feb 2010
Summary of field testing results	Feb 2010
Reinsurance	Feb 2010
Transition	March 2010
Publication of Exposure Draft	April 2010

Source: IASB

Key differences to Mexican GAAP

	Future IFRS	Mexico
Measurement	Building blocks: <ol style="list-style-type: none"> 1. Best estimate cash flows 2. Discounting 3. Explicit margins 	<ul style="list-style-type: none"> ■ Traditional valuation of liabilities with a minimum (surrender value) ■ Assumptions not necessarily best estimates ■ Margins not explicitly considered
Assumptions used in Best Estimate Liability	Market-specific for economic assumptions and entity-specific for others	Mix of market & entity & mandatory experience
Discounting	<ul style="list-style-type: none"> ■ (Approximately) risk free rate ■ No link to asset portfolio ■ Applies to P/C and life 	<ul style="list-style-type: none"> ■ Fixed, not necessarily related to risk free ■ Linked to interest earnings for adequacy test ■ No discounting for P/C

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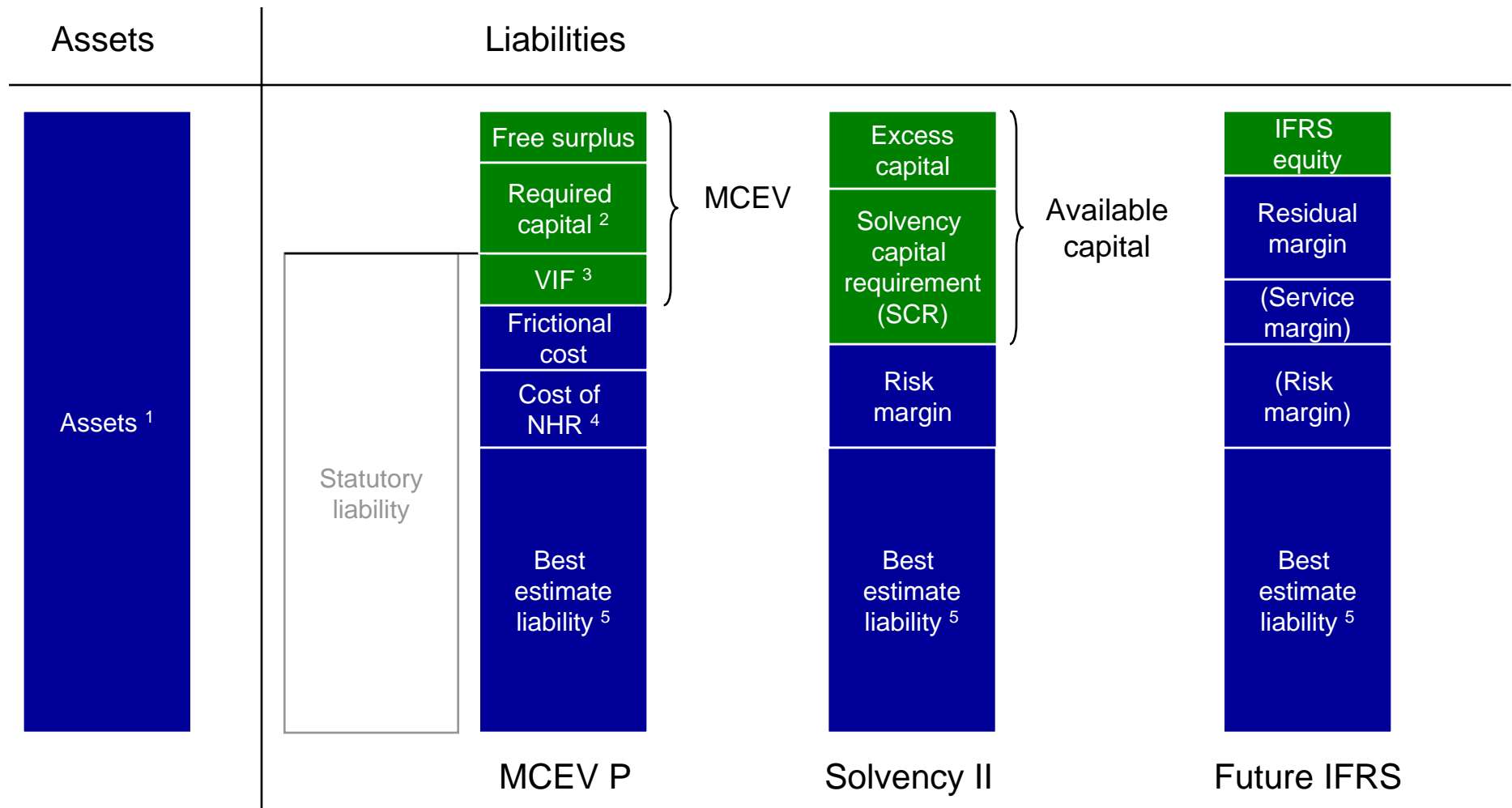
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"The objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to potential equity investors, lenders and other creditors in making decisions in their capacity as capital providers."

Source: Joint FASB/IASB Conceptual Framework Exposure Draft, May 2008

Comparison to MCEV and Solvency II



¹ Value of assets might differ between IFRS and the other two approaches

² Required capital often is the greater of regulatory and internal capital

³ VIF after allowing for frictional cost and cost of non-hedgeable risks

⁴ Cost of non-hedgeable risks

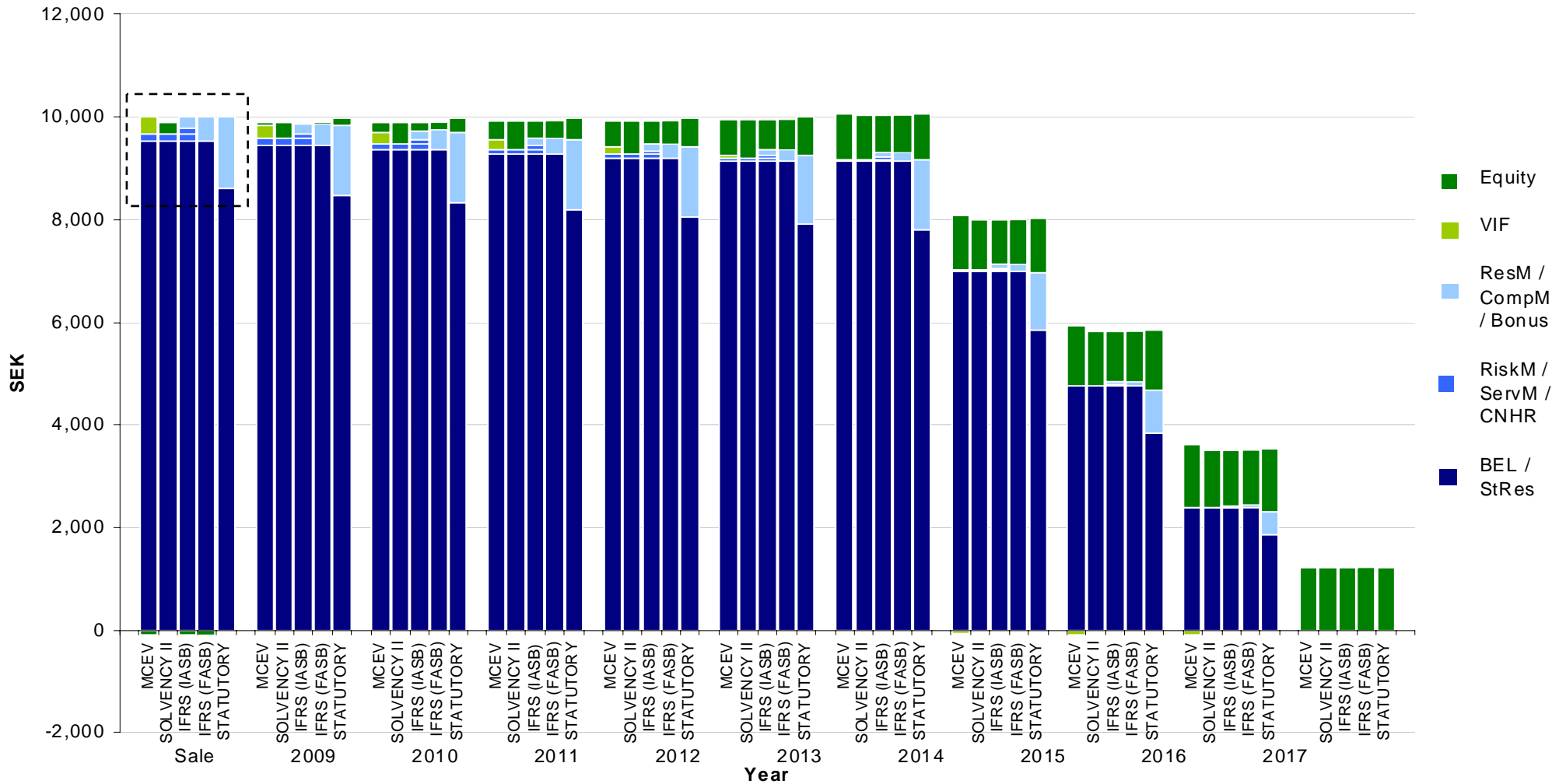
⁵ Best estimate liabilities might differ under the three approaches

Comparison to MCEV and Solvency II

	Future IFRS	MCEV P	Solvency II
Valuation principle	Hybrid approach combining economic and non-economic elements	Economic valuation	Economic valuation
Valuation of assets	Amortised cost or fair value (market value)	Market values	Market values
Valuation of liabilities	Amount the entity would rationally pay of being relieved of the obligation (IASB) Fulfilment value (FASB)	Typically fulfilment value (going concern)	Current exit value (transfer value)
Projected cash flows	Best estimates	Best estimates	Best estimates
Margins	Risk, service and residual margins (IASB) Composite margin (FASB)	Risk margin and frictional costs	Risk margin
Discount rate (including liquidity and own credit risk)	To be determined	Swap yield plus for certain liabilities liquidity premium – little calibration guidance provided	To be determined

Base scenario
Liabilities

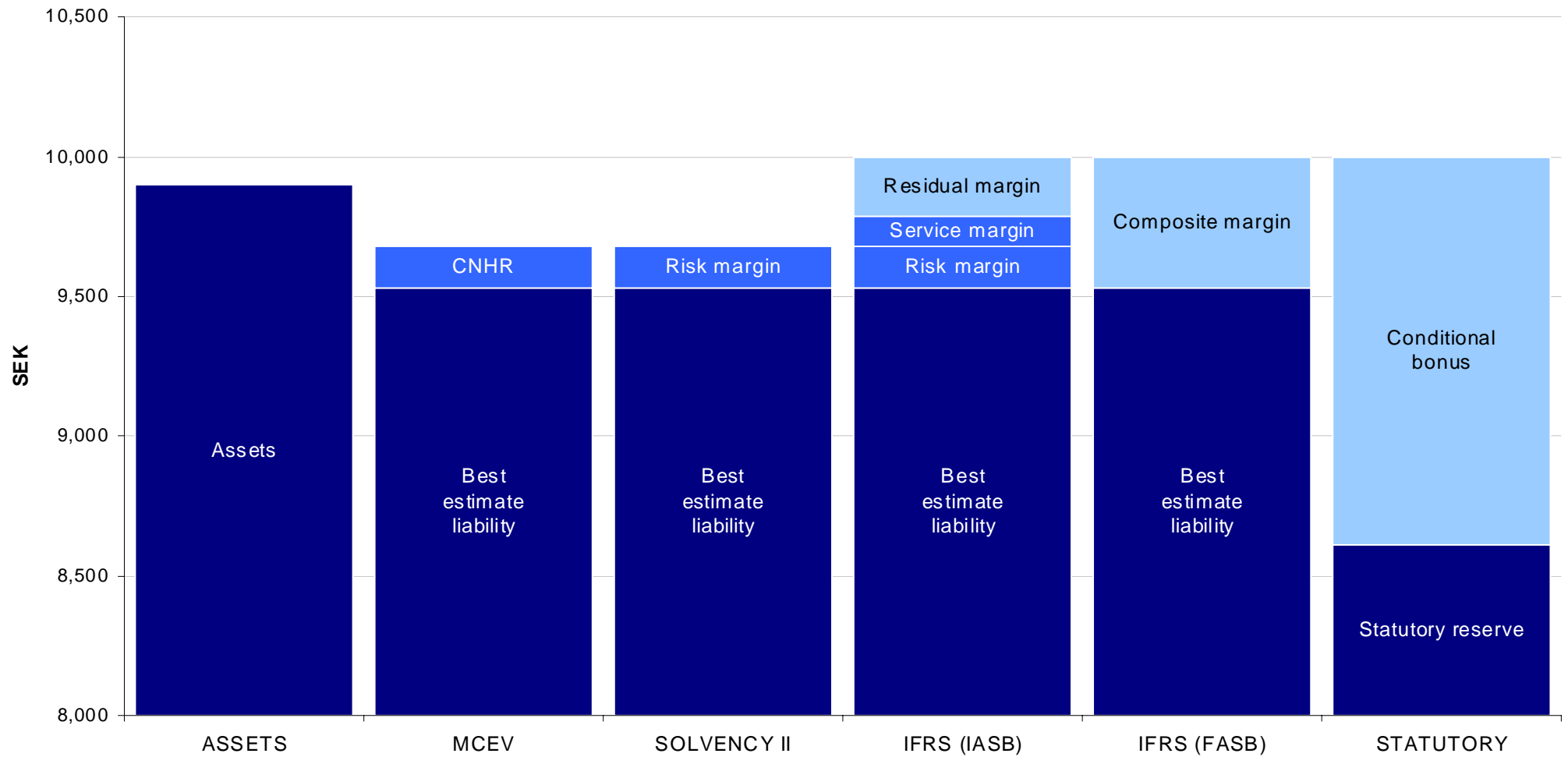
With-profit deferred annuity Sweden
Development of liabilities and equity



Base scenario

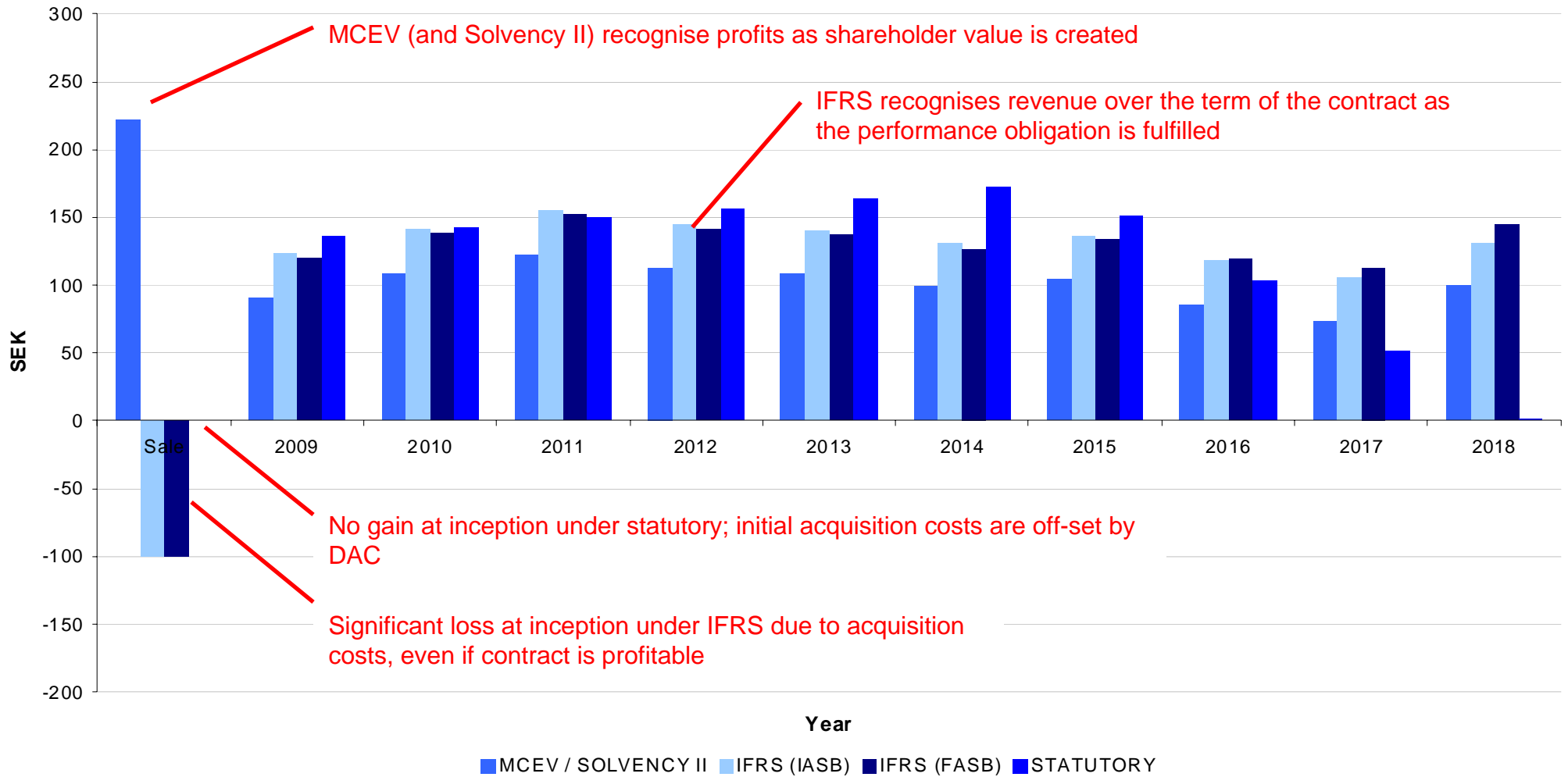
Initial balance sheet

With-profit deferred annuity Sweden Initial balance sheet



Base scenario
Profit profiles

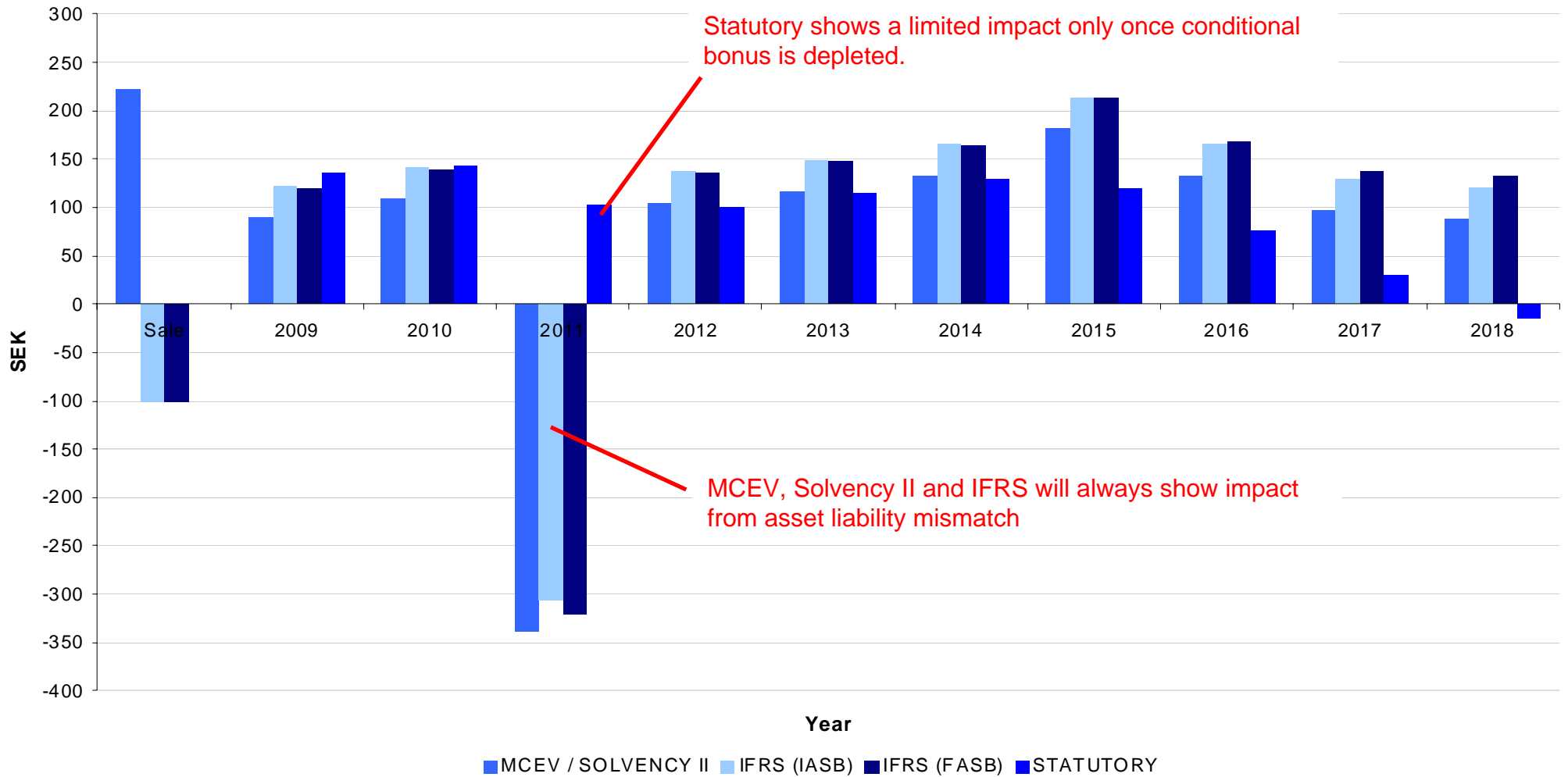
With-profit deferred annuity Sweden
Profit development



Instant fall in share prices in year three

Profit profiles

With-profit deferred annuity Sweden
Profit development

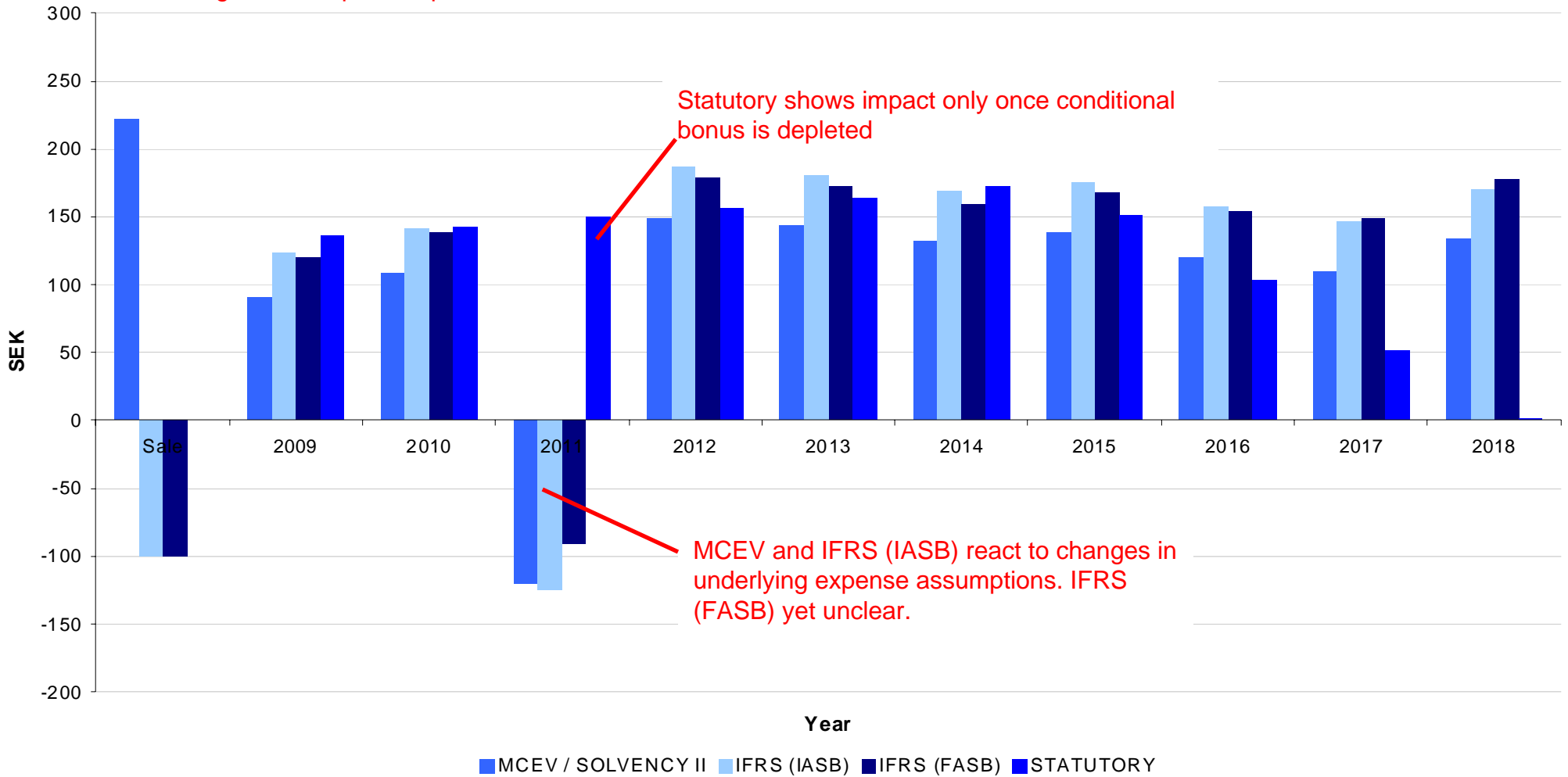


Change in expense assumptions year three

Profit profiles

With-profit deferred annuity Sweden
Profit development

... but significant impact on profit and loss



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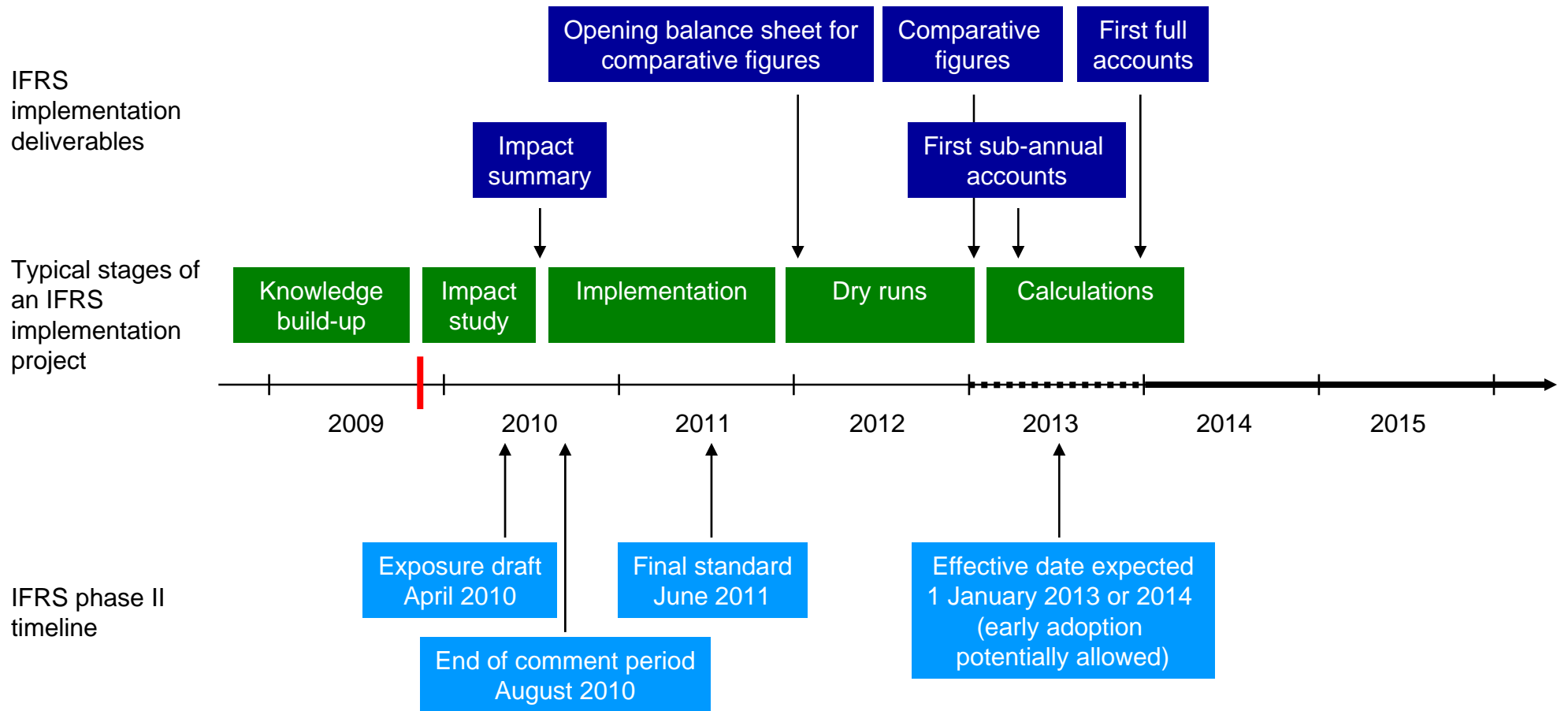
Implications for industry

- Together with Solvency II, phase 2 of the IASB's insurance contracts project will be a main area of change in the financial and regulatory reporting area for insurers during the coming years
- A co-ordinated approach with Solvency II (and MCEV if applicable) is beneficial
- Higher level of comparability between jurisdictions
- Changes to communication of business performance
- Increased focus on management of earnings volatility in financial reports
- Software implications
- Changes to product offerings
- Implementation requires close co-ordination between accountants, actuaries and management, resulting in a further strain on actuarial resources

Our recommendations to companies

1. Follow the developments and discussions closely
2. Provide feedback to the IASB and FASB once Exposure Draft has been published, either individually or through industry organisations
3. Understand how the proposed measurement model will impact your business
4. Understand similarities and differences between IFRS Phase 2, Solvency II and MCEV
5. Determine the profit profiles of your products under the different measures
6. Consider how to communicate the performance of your business using the different measures
7. Understand how to manage earnings volatility
8. Consider how to implement the related calculation routines
9. Start the planning of your implementation project
10. Ensure that sufficient resources are available

Typical implementation project



How can we help?

Project stages	Product offerings
Knowledge build-up	<ul style="list-style-type: none"> ■ Workshops for accountants and actuaries to understand state of discussions and technical issues, and bridge the gap between the two professions ■ Comparison to other economic valuation approaches such as Solvency II and MCEV
Impact study	<ul style="list-style-type: none"> ■ Earnings patterns of existing / new contracts ■ Pro-forma balance sheet and income statement ■ Impact study of first-time application
Implementation	<ul style="list-style-type: none"> ■ Modelling / systems ■ Embedding in full financial management / ERM framework ■ Development of disclosures and accounting principles ■ Actuarial resources for implementation project ■ Education of internal and external audiences
Dry runs and calculations	<ul style="list-style-type: none"> ■ Understanding and reviewing results ■ Development of communication strategy ■ Actuarial resources

Why Towers Perrin?

Commercial focus

- We help to make sense of the overall new financial reporting landscape (IFRS, MCEV, Solvency II)
- We focus on business implications and offer commercially-focussed solutions
- We help with education and insights for internal and external audiences

Independence

- We provide independent advice and help clients to shape their own views, prior to engaging with their auditors
- As an advisor, we do not face auditor conflict issues

Seamless implementation capabilities

- We offer financial modelling solutions and implementation support that will allow you to meet all the new requirements within one system

Strong technical capabilities

- To ensure we are able to provide a high level of support to our clients, we have invested substantial resources to become financial reporting thought leaders
- A number of our consultants are actively contributing to industry developments through discussions with the IASB and within international working groups (for example IAA and EFRAG)

Contact

Marcela Abraham

Country manager

Blvd. Avila Camacho No. 32
Piso 5, Torre Esmeralda 3
Col. Lomas de Chapultepec
CP 11000 Mexico, D.F.

Tel +52 55 5201 4611
marcela.abraham@towersperrin.com

Mike Lombardi

Managing Principal

175 Bloor St E
Toronto, Ontario M4W 3T6
Canada

Tel +1 416 960 7426
mike.lombardi@towersperrin.com

Alexander Dollhopf

Senior Consultant

Sveavägen 155
113 46 Stockholm
Sweden

Tel +46 8 506 417 73
alexander.dollhopf@towersperrin.com