IFRS Phase II ...
Changing our Future?

"Our Changing Future" meeting
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Marylène Lanari-Boisclair
Deloitte Insurance Centre of Excellence

Audit . Tax . Consulting . Corporate Finance .

Agenda

- Background to IASB's insurance project
- Summary of discussion paper
- Issues and views from industry
- Likely impacts for insurers
- Questions / discussion

Introduction and background

- Reasons for change:
  - Insurance contracts not dealt with comprehensively in rest of IFRS
  - Too much diversity between countries – need for comparability
  - Need for more reliable and relevant information for users
- Phase I: IFRS 4 effective January 2005
  - Specific definition of insurance contract
  - Temporary dispensation from certain standards
  - Guidance on implementation
- Phase II: earliest 2012
  - Discussion paper “Preliminary Views on Insurance Contracts”
  - Accounting model for all insurance contracts
  - FASB invited comment on the DP
  - Definition of insurance contract from IFRS 4 **not** readdressed before ED

Objectives of IFRS for Insurance Contracts

- Develop an IFRS on accounting for insurance contracts
- Address accounting for both insurers and policyholders

Phase I (IFRS 4)

- Definition of an insurance contract
- Disclosures
- Restrictions on changing accounting policies and use of existing GAAP

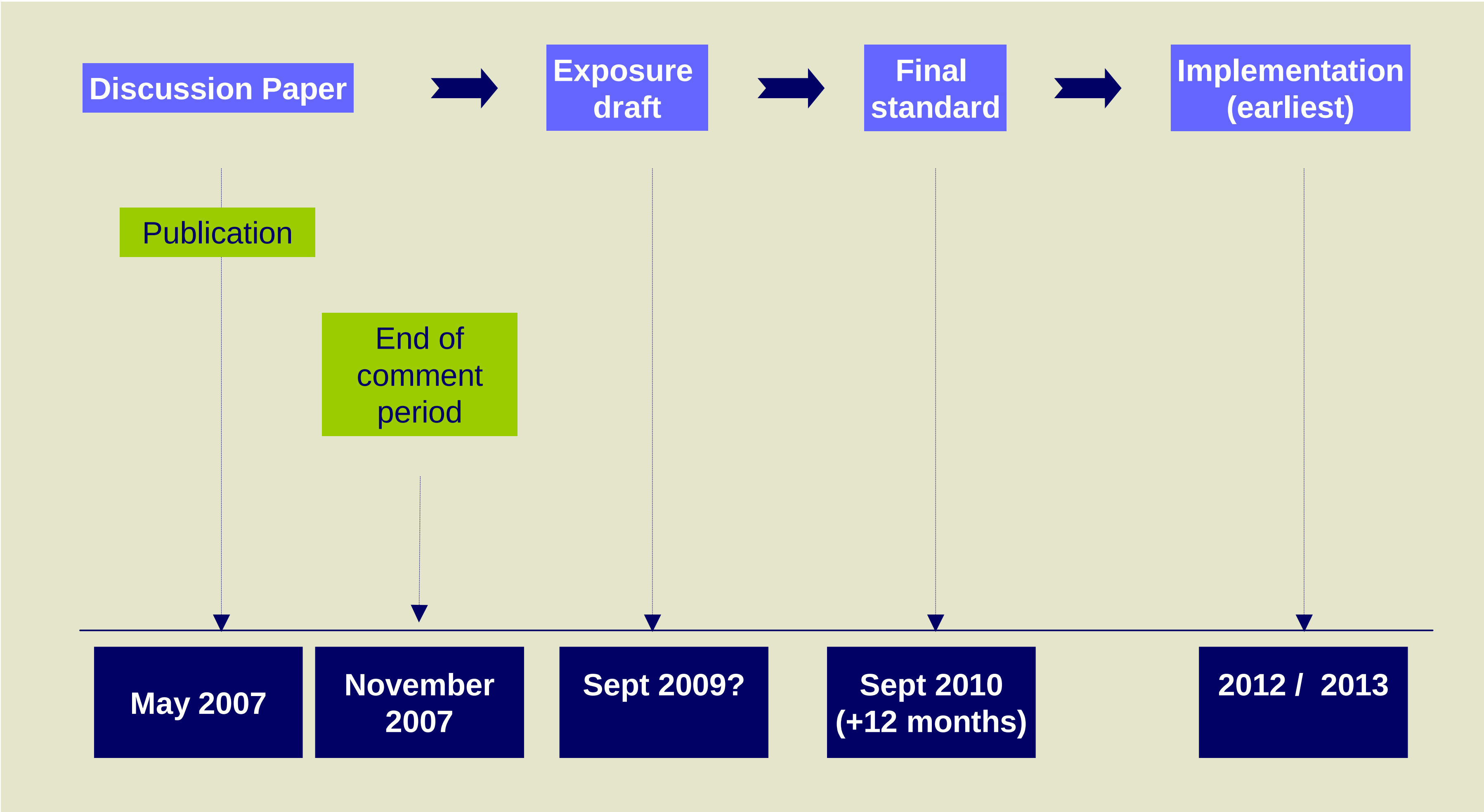
Phase II

- Accounting by both insurers and policyholders
- Recognition and derecognition
- Measurement
- Presentation

IFRS 4 Summary

Temporary measure to continue until Phase II standard emerges

Phase II timeline



Consultation

- Parties involved:
  - Insurers (e.g. CFO Forum, GNAIE);
  - EU (e.g. Solvency II);
  - Regulators (e.g. CEIOPS, IAIS);
  - Actuarial & Accounting Professions;
  - FASB;
  - Users, including analysts and auditors.

- Involvement of FASB for convergence with US GAAP.

Format of the Discussion Paper

- Part 1:Invitation to comment and main text
  - Chapter 1: Background
  - Chapter 2: Recognition and derecognition
  - Chapter 3: Measurement – core issues
  - Chapter 4: Policyholder behaviour, customer relationships and acquisition costs
  - Chapter 5: Measurement – other issues
  - Chapter 6: Policyholder participation
  - Chapter 7: Changes in insurance liabilities
- Part 2: Appendices
  - A: Questions
  - B: Comparison with IAS 39
  - C: Other relevant IASB projects
  - D: Issues not covered in this DP
  - E: Estimates of future cash flows
  - F: Risk margins
  - G: Examples
  - H: Credit characteristics of insurance liabilities

Key features of proposed model

Single measurement model

For life and non-life insurance and reinsurance

For pre claim and post claim stages of an insurance contract

Prospective valuation

Valuation of insurance contract
=
Probability Weighted present value of all currently expected future cashflows

The 'current exit value' = "market-consistent current value"

The amount the insurer would expect to pay to another entity if it transferred all its remaining obligations and contractual rights.

'Current exit value' is not intended to imply that the insurer can, will, or should transfer the liability to a third party.

Purpose is to provide useful and cost-effective information that will help users to make economic decisions.

The proposed Current Exit Value model

3 building blocks to measure insurance liabilities :

Explicit, unbiased, market-consistent, probability weighted and current estimates of the contractual cash flows;

Current market discount rates that adjust the estimated cash flows for the time value of money;

An explicit and unbiased estimate of the margin that market participants require for:

- Bearing risk (a risk margin); and
- Providing other services (a service margin)

1st building block: Cash Flows

Explicit, unbiased, market-consistent, probability weighted and current estimates of the contractual cash flows.

An insurer should develop estimates of cash flows that:

- are **explicit**;
- are as consistent as possible with observable **market** prices;
- incorporate, in an **unbiased** way, all available information about the amount, timing and uncertainty of all cash flows arising from the contractual obligations;
- are **current**, in other words, they correspond to conditions at the end of the reporting period;
- exclude **entity-specific** cash flows. Cash flows are entity specific if they would not arise for other entities holding an identical obligation.

Cash flows' estimates

Sources of estimates:

- Information about claims reported by policyholders;
- Other information about the known or estimated characteristics of the book of insurance contracts;
- Historical data about the insurer's own experience, adjusted where necessary;
- Recent market prices for transfers of insurance contracts or instruments covering similar risks (e.g. catastrophe bonds and weather derivatives)

Using current estimates:

- Use all available information about conditions at the end of the reporting period.

2nd building block: Discounting

The time value of money is taken into account by explicitly discounting all liability cash flows - life and non life

The discount rate should

- NOT be influenced by the assets held to match the liabilities (unless there is a contractual link with the assets)
- Be consistent with observable market rates for cash flows that match the characteristics of the expected cash flows i.e. timing, currency and liquidity;
- Not reflect the risk inherent in the cash flows (this is included in the risk margin)

IASB does not intend to issue detailed guidance on the selection of the discount rate.

3rd building block: Risk and Service margins

Risk and service margins should reflect the uncertainty in the estimated cash flows.

The **risk margin**

- should reflect the **market rate** for bearing risk;
- cannot be observed in the absence of a market;
- must be estimated at inception and subsequently;
- is not a shock absorber;
- should be updated at each reporting date;
- should be explicit and unbiased.

The **service margin:**

- Unbiased estimate of what market participants require for rendering other services

Proposed approaches to risk margins

- Explicit confidence level / Quantile approach
- Conditional Tail Expectation (CTE)
- Explicit margin within specified range
- Cost of capital

Calibrating the Risk Margin

A. Premium less acquisition costs = risk margin (subject to a LAT)

- **No** profit at inception but LAT could identify a loss
- Need to define acquisition costs
- Risk margin amortised/increased as quantity of risk expires/increases but **no** remeasurement of risk price as locked at inception price

B. Risk margin not calibrated to premium less acquisition costs

- Can have **profit** at inception (subject to evidence to support risk margin)
- No need to define acquisition costs as all costs expensed
- Risk margin amortised/increased as quantity of risk expires/increases but **with** remeasurement of risk price

Service Margin

- Insurers provide other services
- In practice, likely to be estimated using own costs
- Insurers expect a profit... not clear how treated in the CEV model
  - Is it released on day 1, OR
  - as the risk margin expires OR
  - profit margin included within the service margin?

Other Measurement Issues

Day 1 profit

Future premiums and policyholder behaviour

Policyholder participation

Customer relationship

Day 1 Profit

- Should be possible to recognise a net gain at inception
- Big debate on this Day 1 profit recognition
- Board concluded " …..useful as a reasonableness check on the initial insurance liability, should not over-ride an unbiased estimate…."
- Day 1 profit recognition inconsistent with IAS 18 as would be recognised without any service being delivered
- CFO Forum proposes use of exit value but not recognition of Day 1 profits – a separate margin should be recognised as a liability.

Future premiums and policyholder behaviour

The concept of "guaranteed insurability"

The cashflows used in measuring the insurance liability should include those future premiums to the extent that any of the following conditions is satisfied:

- PV (future premium) < PV (resulting additional benefit payments);
- Insurer has an unconditional contractual right to enforce payment of the premium; and
- The policyholder must pay the premiums to retain a right to guaranteed insurability (a right that permits continued coverage without reconfirmation of the policyholder's risk profile, at a price that is contractually constrained).

FFA and Policyholder participation rights

Policyholder participation rights create a liability only when the insurer has an unconditional obligation that compels the insurer to transfer economic benefits to policyholders.

- If no unconditional obligation exists, an insurer should not recognise a liability
- As regards assessing whether an insurer has a constructive obligation to pay dividends to participating policyholders the Board will rely on definitions being developed in its conceptual framework and IAS 37 projects.
- An obligation may be enforceable in various ways, including legal action or intervention by the regulator. However, economic compulsion is not sufficient to create an enforceable obligation.

Policyholder behaviour and customer relationships

- An insurer has an asset relating to its ability to derive net economic benefits from future premiums that the policyholder must pay to retain guaranteed insurability.
- Guaranteed insurability is a right that permits continued coverage without reconfirmation of the policyholder's risk profile and at a price that is contractually constrained.
- The insurer should recognise that asset, and measure it at current exit value. But the insurer should present that asset as part of the related insurance liability.
- The recognition of non contractual benefits under the "guaranteed insurability" proposals is a significant departure from current IFRS and may have wider implications. It also differs from the current Solvency II proposals.

Other Measurement Issues

Unit of account

Reinsurance

Unbundling

Credit characteristics

Investment contracts

Deloitte.

Industry response to IASB.


Deloitte.

Deloitte Touche Tohmatsu
Hill House
1 Little New Street
London EC4A 3TR
United Kingdom

Tel: National +44 20 7936 3000
Direct Telephone: +44 20 7007 0907
Direct Fax: +44 20 7007 0158
www.deloitte.com
www.iasplus.com

22 November 2007

Mr Peter Clark
International Accounting Standards Board
30 Cannon Street
London

Audit.Tax.Consulting.Corporate Finance.

Summary of views

- Around **160 responses** submitted
- Strong **support** in developing an international insurance accounting standard
- Broad agreement to measuring with the three **building blocks**
- Strong objection to “**transfer value**” as a measurement attribute
- General preference for “**fulfilment value**” concept
- More guidance required on **margins**
- Mixed views on **Day 1 profit**
- Generally oppose **unbundling**
- Generally against reflecting **credit characteristics** in liabilities
- Concern over impact on **other industries**

Labelling the measurement attribute

- Many disagree with the term “**current exit value**” and transfer approach
- Insurers generally fulfil their commitments until their **obligations extinguished**
- Users are more interested in “current best estimate” of the insurers’ obligations

=> Generally would support “**fulfilment value**” concept

Expected cash flows

- Some objection to requirement for **probability weighted** cash flows
- Most disagree with **"guaranteed insurability"** test:
  - expected **future premiums** on renewable contracts should be expected cash flows
  - would not work with some contract types
  - few suggested an alternative
- Most favour **entity-specific** cash flows
- Entity-specific **expenses** should be included in expected cash-flow
- Majority wants to include all expected future cash flows, including:
  - those arising from beneficial **policyholder behaviour**;
  - expected **future bonuses**/dividends on with-profits/participating policies

Use of market based data

- More guidance required for assumptions from **hypothetical transfers**
- Most in agreement with **discounting** using market rates
- North American insurers prefer expected portfolio yields, as per current practice
- Require further guidance on rates to avoid different interpretations

Risk and service margins

- Despite FAQ guidance in October the IASB view is not clear
- Most respondents expressed concern over **service margins**
- Further work is required to determine **methodologies** for
  - the release of risk and service margins and
  - accounting for gains and losses on insurance contracts
- Mixed views on **calibrating** margins to premium

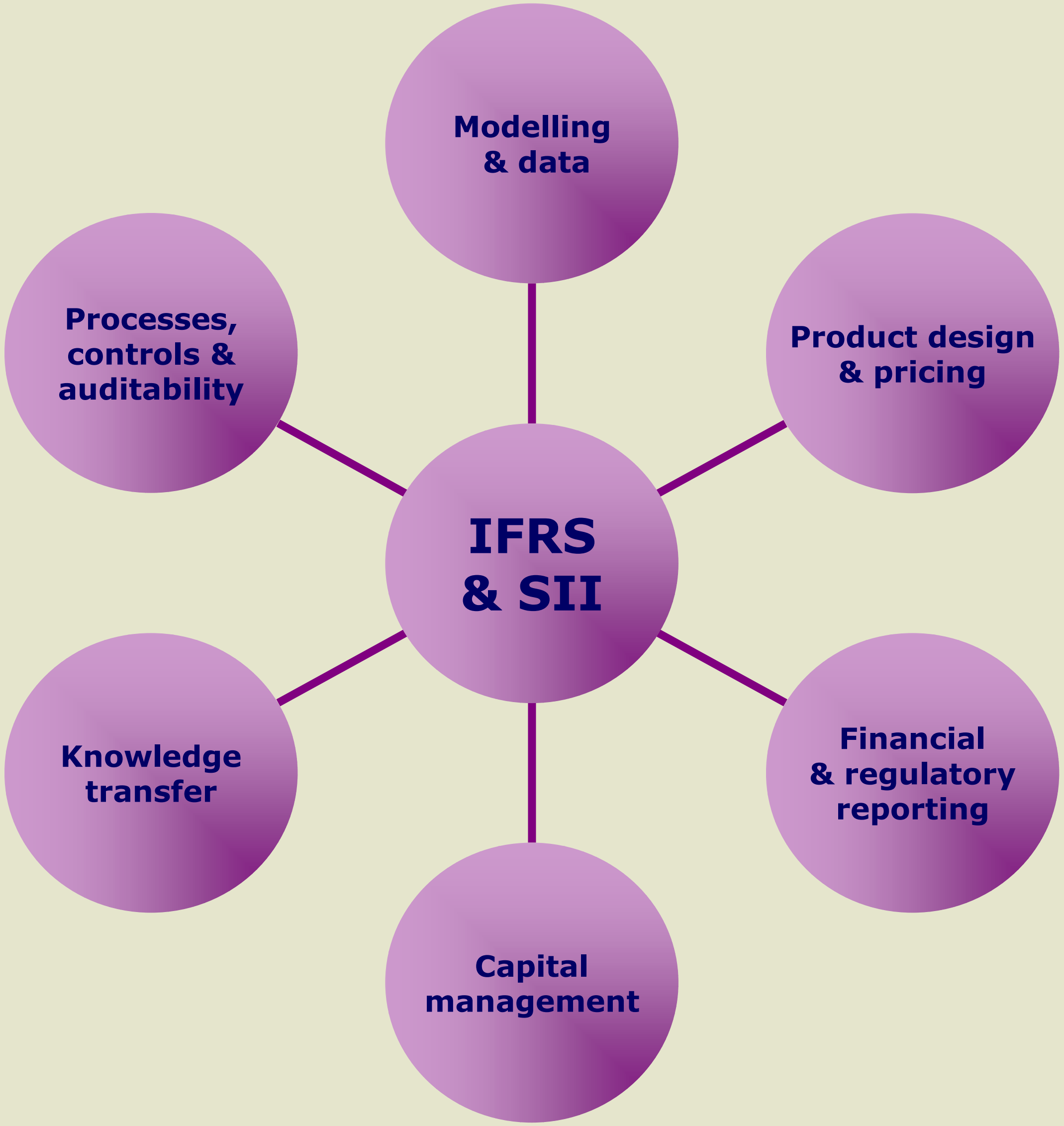
Day one gains and losses

- **IASB's view** was that Day 1 profits would be small
- Many think Day 1 profits could be significant
- Mixed **views**:
  - Recognise Day 1 profits; or
  - Defer profits; or
  - Set up a separate deferred profit liability.
- Most agree that **expected loss** should be recognised at inception

Other views

- Most disagree with requirement to **unbundle**
- Most disagree with considering **credit characteristics** when measuring liabilities
- General agreement to expense **acquisition costs** as they are incurred
- Mixed views on recognising **premiums** as revenue or deposits

Impacts for insurance business



Life insurers – DP effect on financial statements

- **Technical provisions**
  - Block 1 will differ from MSSB
  - Market participant rather than portfolio assumptions (e.g. expenses)
  - Discounting at risk free rate, not asset rate
  - Risk margin required
  - Possible inclusion of profit required on transfer to a market participant
- **Reinsurers' share of technical provisions**
  - R/I share of gross liability plus credit exposure margin
- **No DAC or R/I share of DAC**
  - all expensed
- **Unbundling of investment components required** (subject to conditions)

Life insurers – DP effect on financial statements

- **Guaranteed insurability**
  - Criteria may not match current basis
- **Participating business**
  - Uncertain whether liability criteria will match current realistic reporting basis
- **Profit recognition**
  - Possible day 1 profit
  - Risk margin unwind (risk based) over entire period from contract recognition to settlement
  - Service margin unwind over entire period from contract recognition to settlement
- **Business recognition**
  - Required from entering into the contract not inception of policy
- **Many areas of subjective judgement**

Summary of Phase II

CEV using 3 building blocks – single measurement model for all insurance contracts.

Significant change to the way liabilities are valued and is likely to increase the costs of reporting for both life and non-life companies.

The challenge would be to estimate the risk and service margins in practice and the development of market practice.

The implications of the “guaranteed insurability” proposals is a significant departure from current IFRS and may have wider implications.

Will new systems be used throughout the business or just for IFRS?

Summary of Phase II

The recognition of Day 1 profits can prove difficult in the absence of a market in which the profits recognised could be easily be calibrated.

Under the current proposals, it is likely that profits will be recognised more quickly and be more volatile than currently.

Educating users of financial statements on the implications of this new model for a particular business will be important.

Detailed disclosures of assumptions and methodologies will be key to developing market practice.

The ideal would be for Solvency II, US GAAP and IFRS Phase II to converge for insurance contracts BUT differences are likely to remain.

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