The Actuarial Profession

making financial sense of the future

Life Conference 2011

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IFRS 4 Phase 2

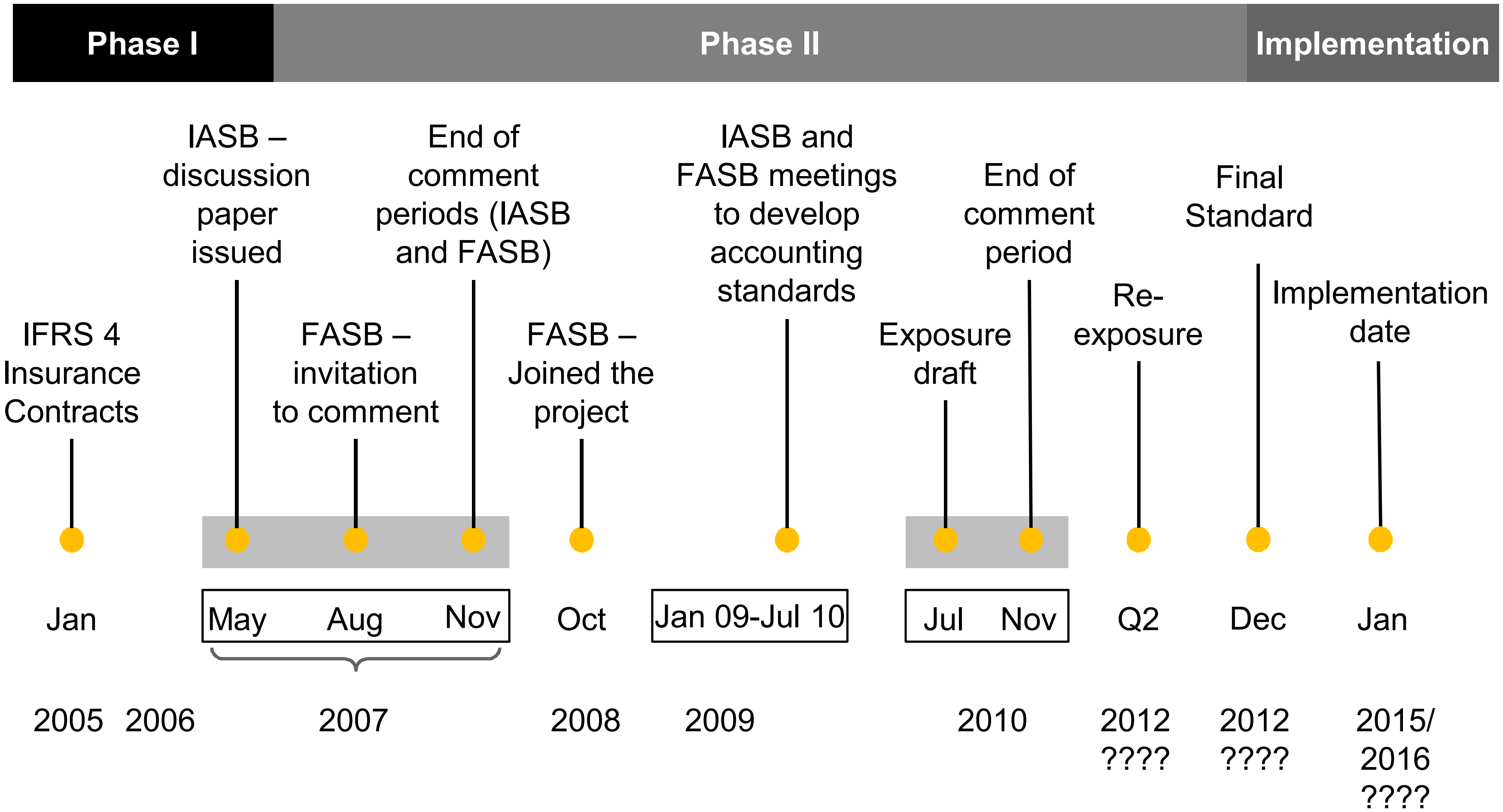
It's time to get serious

21 November 2011

Agenda

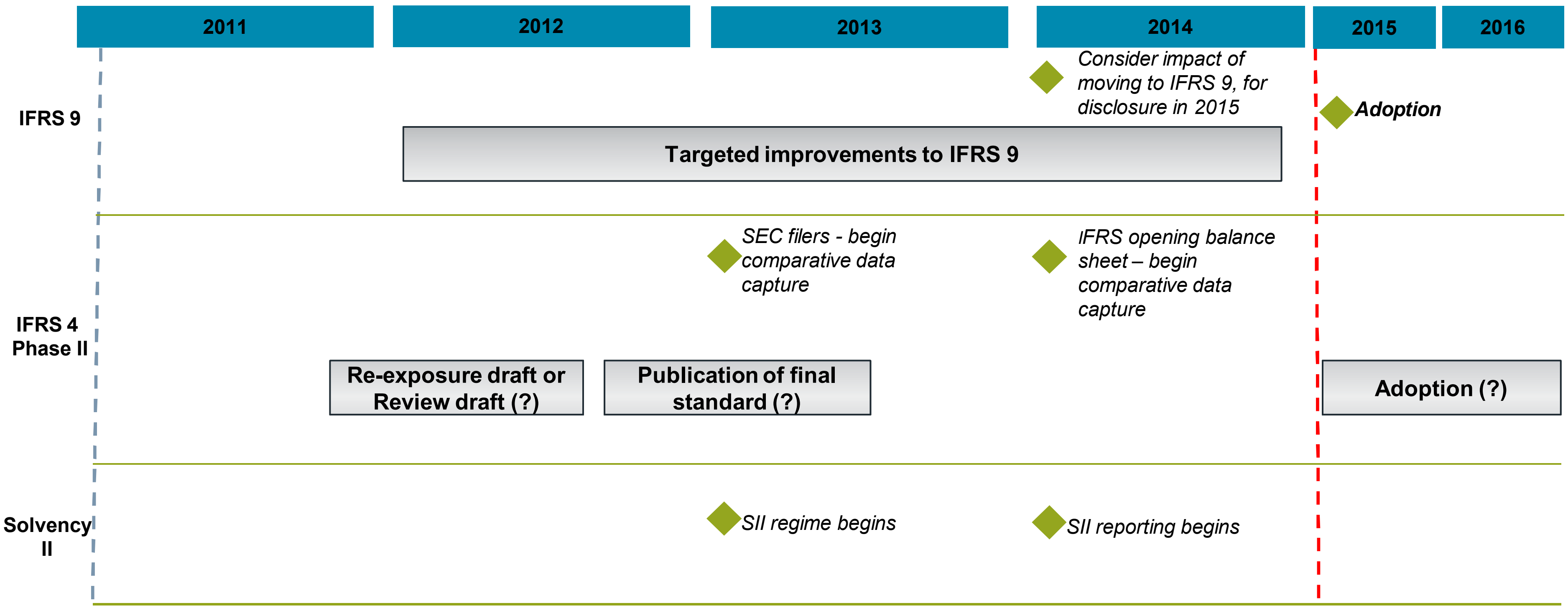
1. Project timeline

IFRS 4 project timelines

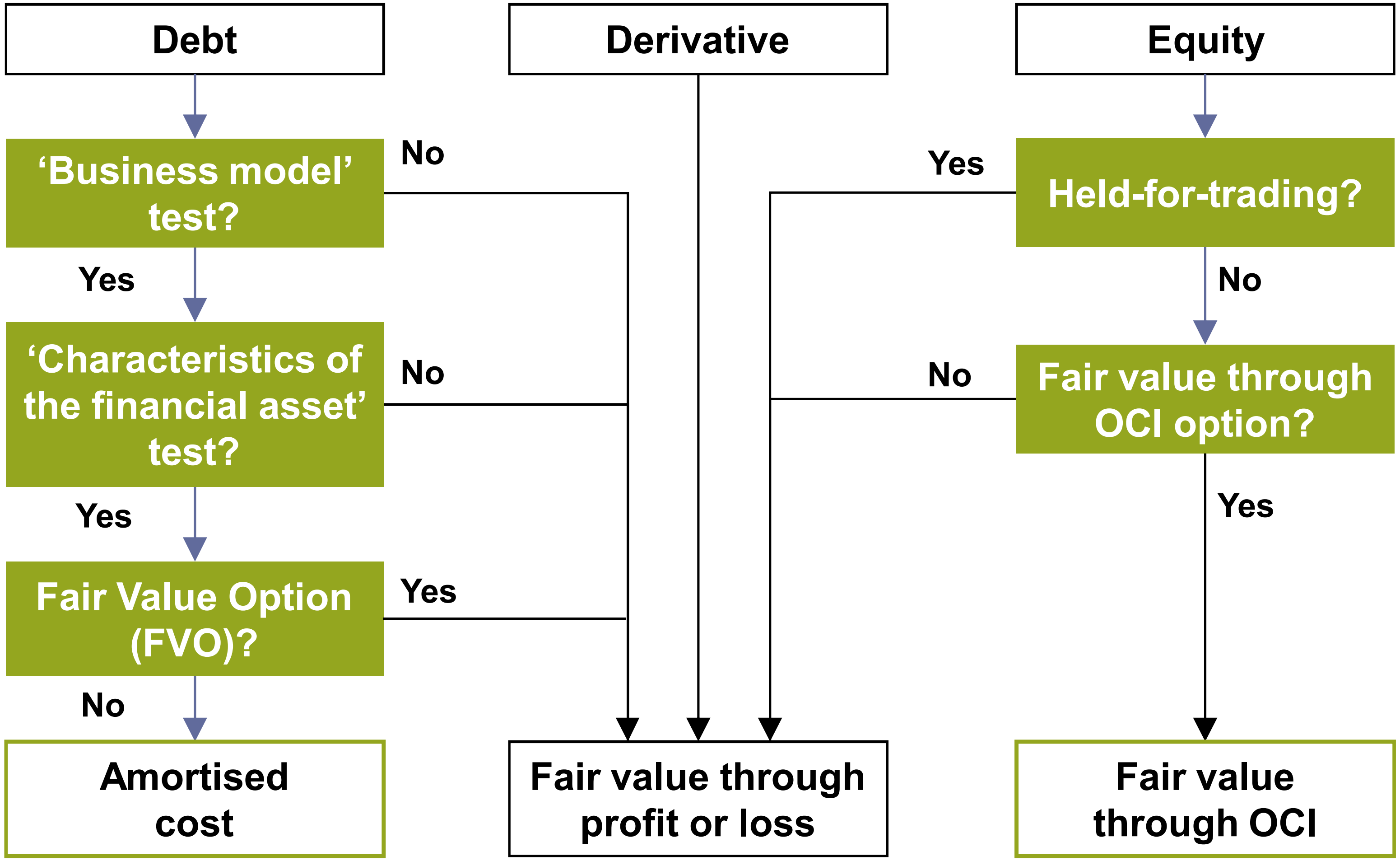


IFRS 4, IFRS 9 (Financial Instruments) and Solvency II

Many possible implementation scenarios



IFRS 9 Classification and measurement
Financial assets

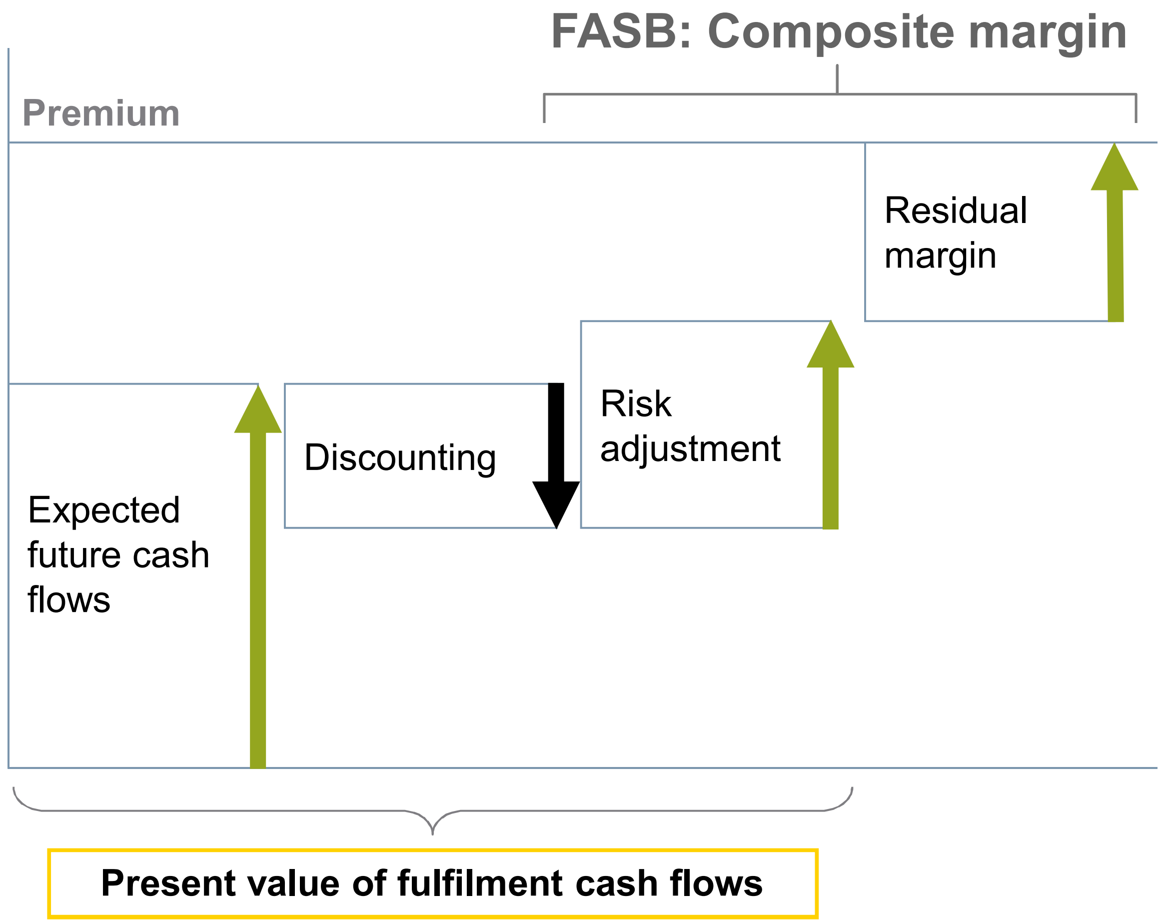


2. Recent developments (and comparison to Solvency II)

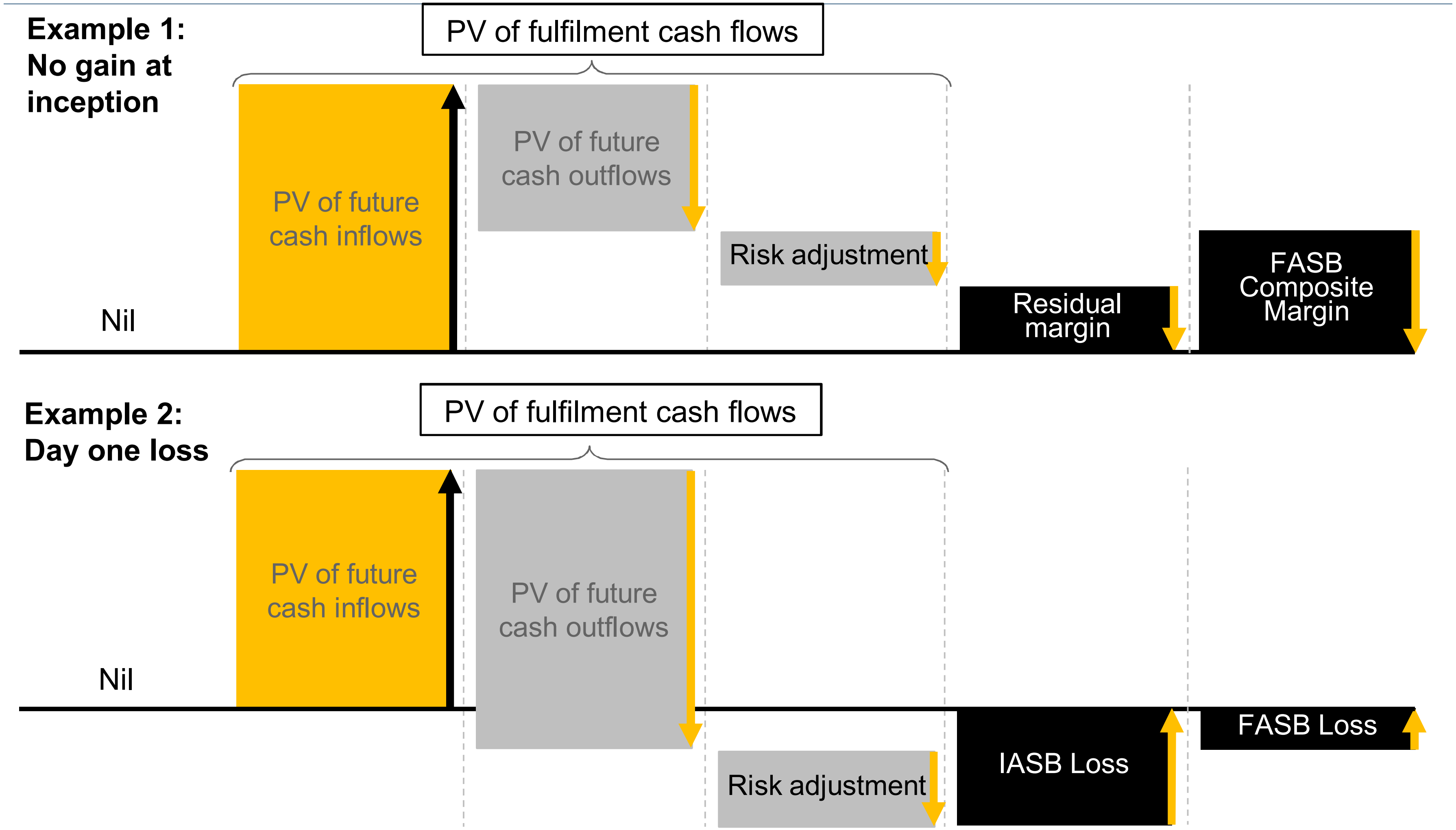
Recent developments and comparison to Solvency II

- Recap on measurement model
- Recognition
- Contract boundaries
- Cash flows
- Discount rate
- Risk adjustment
- Residual margin
- Reinsurance

Recap - IFRS 4 Phase II measurement model



Recap - IFRS 4 Phase II measurement model



Recognition

IASB update

- Insurance contract assets and liabilities should be recognised when the coverage period begins.
  - Onerous liabilities are recognised in pre-coverage period, if management aware.

Solvency II

- Insurance undertakings shall recognise an insurance or reinsurance obligation at whichever is the earlier of the date the undertaking becomes a party to the contract that gives rise to the obligation or the date the insurance cover begins.

Difference in emphasis during pre-coverage period

Contract boundaries

IASB update

- A new contract is when the:
  - Insurer is no longer required to provide coverage; or
  - Existing contract does not confer substantive rights on the policyholder.
- Contract does not confer substantive rights when:
  - Insurer has right or practical ability to reassess risk of particular policyholder and so set a price that fully reflects that risk; and
  - If pricing of premiums does not include risks relating to future periods, when insurer has right or practical ability to reassess risk of portfolio and so set a price that fully reflects risk of portfolio.

Solvency II

- The boundaries of the contract shall be defined as, where the insurer has at a future date:
  - (i) a unilateral right to terminate the contract,
  - (ii) a unilateral right to reject premiums payable under the contract, or
  - (iii) a unilateral right to amend the premiums or the benefits payable under the contract in such a way that the premiums fully reflect the risks,
- any insurance obligations provided after that date do not belong to the contract, unless the undertaking can compel the policy holder to pay the premium for those obligations

Need to interpret above, and assess contract wording

Cash flows – IASB update

- Current estimates of the future cash flows to fulfil the obligations of an insurance contract:
  - Explicit and current
  - Perspective of the entity
  - Unbiased, probability-weighted, relevant information
- No need to identify all possible scenarios
- Measurement objective of expected value refers to the mean
- Includes all direct costs that an insurer will incur directly in fulfilling a portfolio of contracts
  - Estimated at the portfolio level, including an allocation of costs that are directly attributable to contract activities
  - Other costs expensed as incurred

Similarities to Solvency II; differences for expenses

Acquisition costs – IASB vs FASB

- Allowable acquisition costs included in cash flows used to derive residual margin – and so are effectively deferred.
- No explicit DAC.
- IASB tentatively decided to include all the directly attributable costs that the insurer will incur in acquiring a portfolio of insurance contracts (successful and unsuccessful).
- FASB tentatively decided to include those costs related to successful acquisition efforts and direct costs that are related to the acquisition of a portfolio of contracts.
- IASB and FASB confirmed the decision in the ED/DP to expense all other cost.

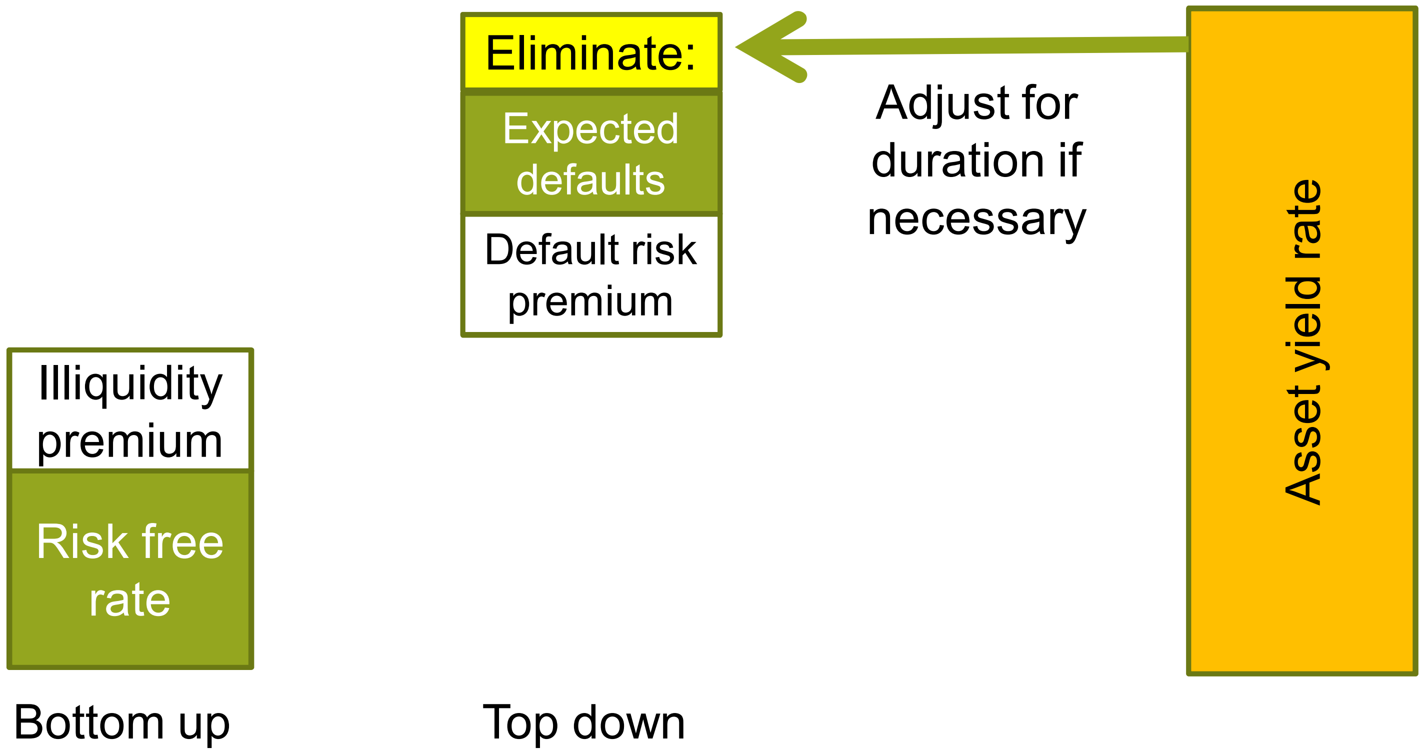
Discount rate – IASB update

- Reflect the characteristics of the insurance contracts, rather than those of assets backing the contract
  - Consistent with observable market prices for cash flows with same characteristics
  - Adjust observed market prices to reflect the characteristics of the liability
  - Re-measured every reporting period - changes in P&L
  - “Top-down” or “bottom-up” method
- Participating contracts
  - To the extent cash flows depend on certain asset performance, discount at a rate that reflects that dependence
- Discounting is not required when immaterial
- No inclusion of non-performance risk by the insurer (‘own credit risk’)

Less prescriptive than Solvency II
Likely to be differences in discount rates IFRS vs SII

Two methods for assessing a discount rate

In theory, they should give the same outcome……



Risk adjustment – IASB update

- The Boards tentatively decided that if there are techniques that could faithfully represent the risk inherent in insurance liabilities then the inclusion of an explicit risk adjustment would provide relevant information to users.
- The objective of a risk adjustment should be the compensation an insurer requires to bear the risk that the ultimate cash flows could exceed those expected.
- The Boards plan to discuss techniques to calculate the risk adjustment at future meetings.
- Risk adjustment should be re-measured every reporting period (through P&L).
- Methods set out in exposure draft become examples:
  - Confidence level
  - Conditional tail expectation
  - Cost of capital
- FASB continue to propose a single margin.

Cost of capital approach available – similar to Solvency II
Parameters may differ, diversification likely to differ

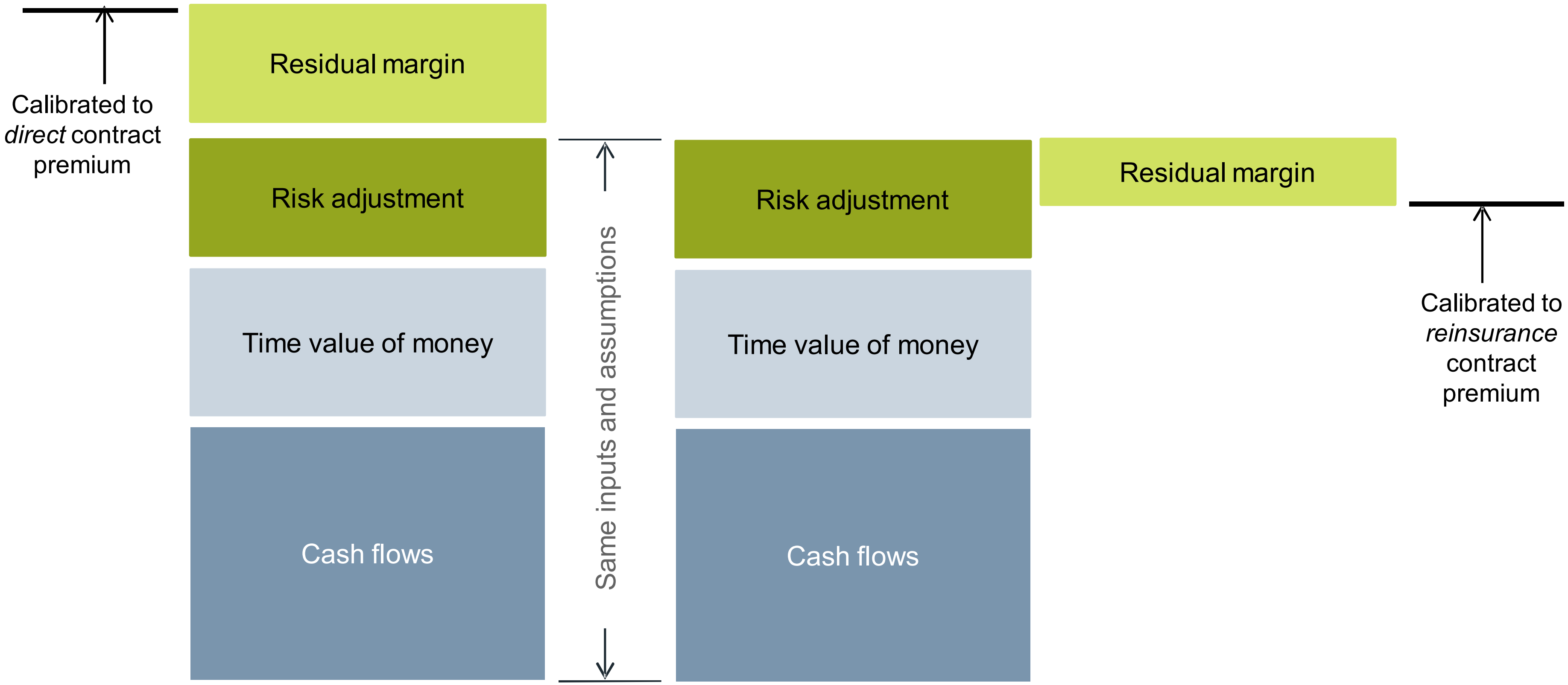
Residual margin – IASB update

- Eliminates any gains on inception
- Deferred and released over time of the contract
- Subsequent ‘unlocking’
  - Changes in future cash flow estimates
  - Favourable and unfavourable
  - ‘Floor’ of zero
  - Applied prospectively
- Released over time, reflecting pattern of services provided
- Determined at a ‘cohort’ level

New concept – will need new methodologies, processes, systems…
Residual margin on transition likely to be needed – how to calculate?

Reinsurance

No longer allowed a day 1 profit



Reinsured part of cedant's *liability*

Cedant's *reinsurance asset*

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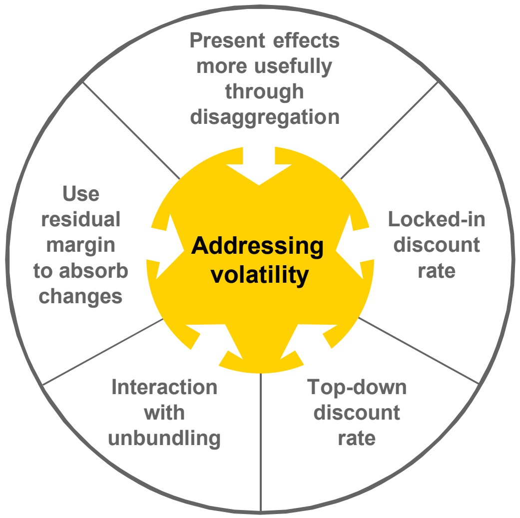
3. Presentation and disclosures

Volatility

The Boards are monitoring the effects of their decisions on reported volatility. There are five areas, listed below, identified by the Boards that would have an effect on volatility

1. **Selection of the discount rate** – Insurers can decided on the approach used so the discount rate reflects the characteristics of the insurance liability
2. **Locking in the discount rate at inception** – Discount rate should be a current rate that is updated each reporting period
3. **Presentation** – Presenting the effects of volatility separately or by defining a measure of 'operating profit' for insurers. No decisions have been reached
4. **Unlocking the composite/residual margin** – Whether and how to unlock the composite/ residual margin. No decisions have been reached
5. **Extensive unbundling** – Investment components measured at amortized cost. No decisions have been reached



ED model: Income statement presentation

Summarised margin model

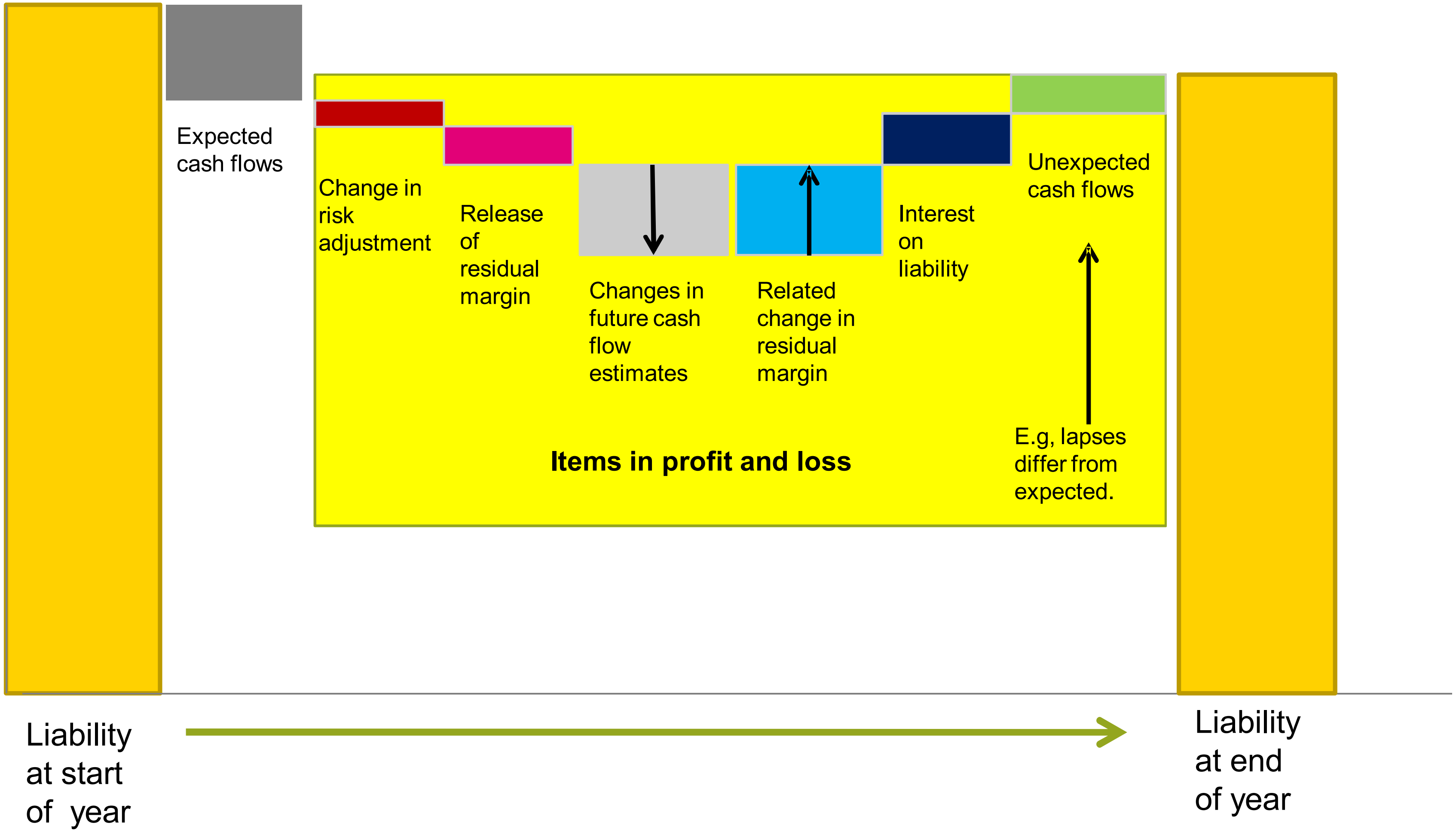
Income statement	*20XX*
Risk adjustment	X
Residual margin	X
Underwriting margin	**X**
Losses on initial recognition	X
Experience adjustment	X
Changes in estimates	X
Interest on insurance liability	X
Investment income	X
Net interest and investment	**X**
Profit/Loss	**X**

Experience adjustment expanded to show:		
Premiums due	X	
Less premiums expected	(X)	
		X
Actual benefits	(X)	
Less benefits expected	X	
		X
Actual expenses	(X)	
Less expenses expected	X	
		X
Experience adjustment		**X**

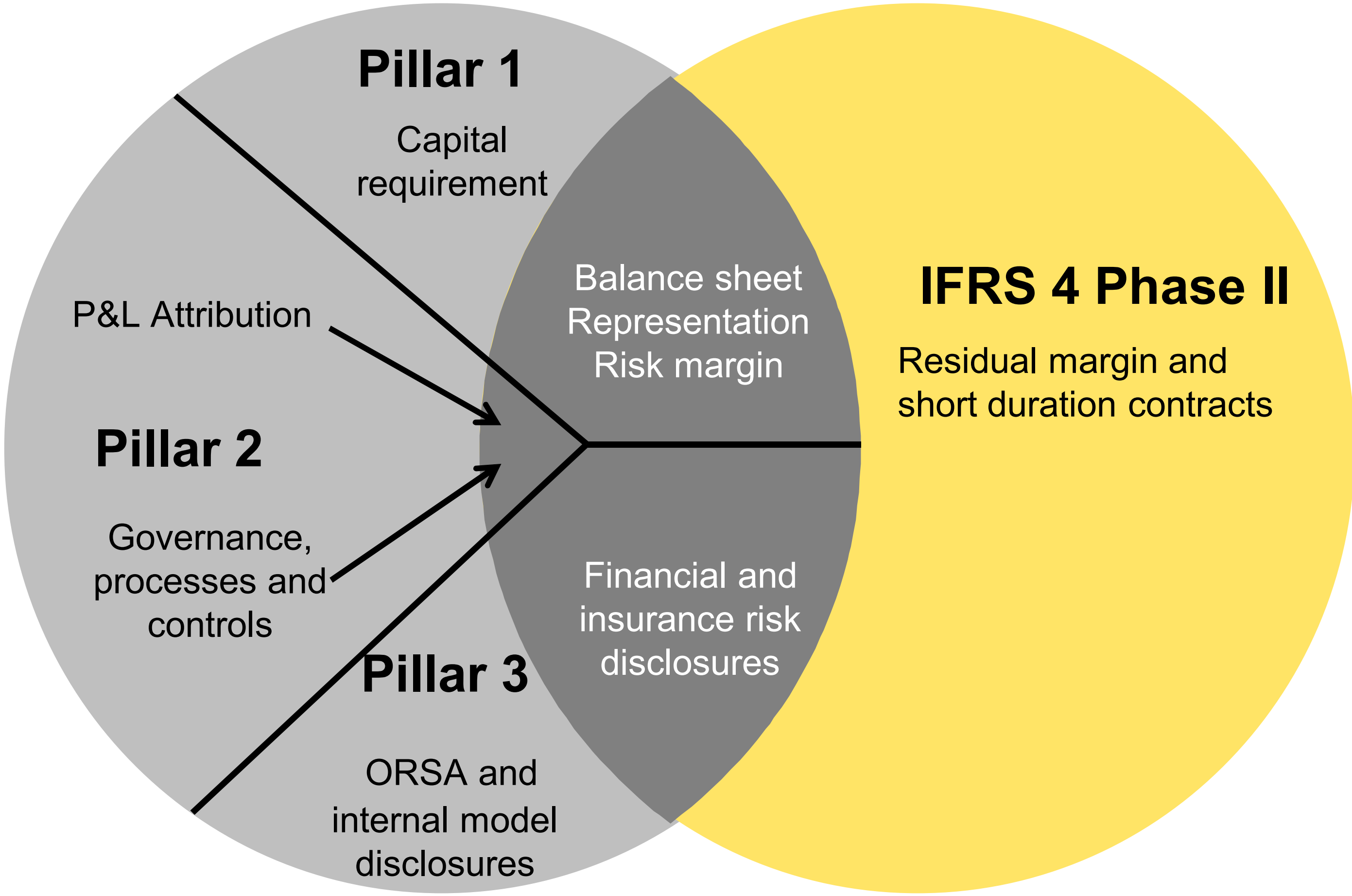
Exploring whether some changes should be presented in other comprehensive income

How it fits together
Assuming the residual margin is unlocked

The building block approach generates information about the changes in the insurance liability and its performance during the period



Overlaps between Solvency II and IFRS 4 Phase II



Continuing role for EV reporting?

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4. Next steps

Next steps

Discussions:

- Short duration contracts
- Use of other comprehensive income
- Presentation and disclosure
- Transition
- Harmonisation (?) IASB/FASB

Re-exposure or final standard

Questions or comments?

Expressions of individual views by members of The Actuarial Profession and its staff are encouraged.

The views expressed in this presentation are those of the presenter.