Actuarial Profession: Financial Report Group (FRG)

- Cross practice working group established in June 2011, with remit to:
  - Consider proposed changes to financial reporting standards affecting insurers
  - Support UK FR representation on the International Actuarial Association
- Membership is made up of senior industry practitioners in the area of financial reporting, with a mixture of experience in life / non-life insurance and pensions. Also includes two chartered accountants and one sell-side equity analyst.

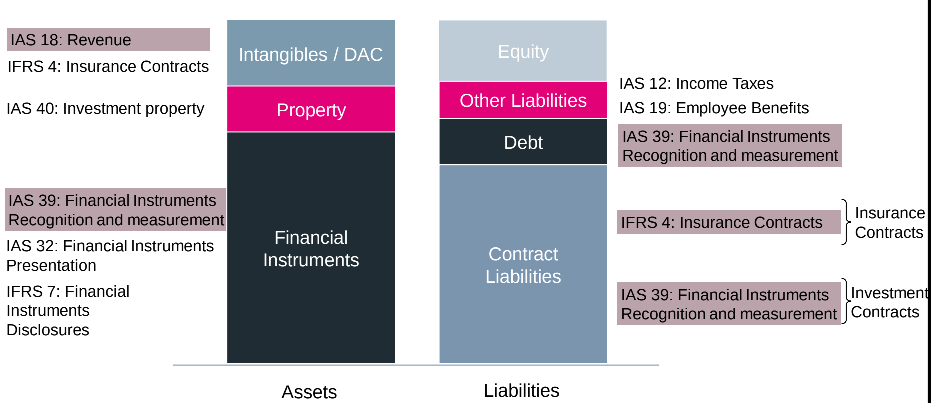
Members:

Anthony Coughlan	Gary Hibbard	Raymond Bennett
Christine Fairall	Kamran Foroughi (Chair)	Richard McPherson
Darren Clay	Martin Lowes	Richard Pereira
Derek Wright	Martin White	Simon Yeung
Erica Nicholson	Nigel Masters	Tony Silverman
Francesco Nagari	Peter Stirling (Secretary)	

Agenda

- **Existing and proposed IFRS (brief)**
- Update on IASB's insurance contracts (Phase II) project
- Views on the IASB's proposal
- Conclusions and Q&A

Existing IFRS



= standard undergoing major review with implications for insurers

- Other IASB standards also impact insurers, for example: IFRS 13 – Fair value measurement

Proposed IFRS – key developments

Insurance contracts standard (to replace IFRS 4)

- Ongoing IASB deliberations since July 2010 Exposure Draft (ED)
- New ED expected H1 2013

IFRS 9: Financial instruments (to replace IAS 39)

- Classification and measurement of financial assets - Fair value (P&L or OCI) or Amortised cost
- Liability deposit floor retained; affects business classified as "investment contracts"

Revenue recognition standard (to replace IAS 18)

- Affects business classified as "investment contracts"
- Retains DAC incremental at contract level (change in second ED)

IFRS 13: Fair value measurement (new standard defining how to fair value)

- *"... the price that would be received to sell an asset or transfer a liability in an **orderly transaction** between market participants at the measurement date"*
- The fair value of a liability should reflect the effect of non-performance risk (i.e. own credit risk)

Agenda

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International Financial Reporting Standards

IASB Update: Insurance contracts

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Today's topics

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- An overview of the IASB's proposals
- Main focus of the forthcoming exposure draft
- A closer look
- For more information…

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An overview of the IASB's proposals

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Core proposal: measurement of the insurance contracts liability

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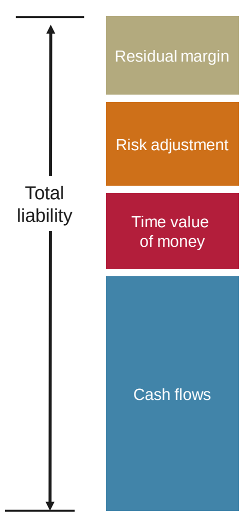

What each building block represents

Quantifies the unearned profit the insurer expects to earn as it fulfils the contract

Quantifies the difference between the certain and uncertain liability

An adjustment that reflects the time value of money

The amounts the insurer expects to collect from premiums and pay out as it acquires, services and settles the contract, estimated using up-to-date information

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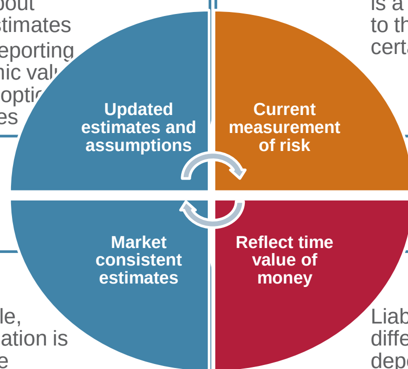
What we hope to achieve with this model

- Relevant, complete information about changes in estimates
- Transparent reporting of the economic val of embedded optic and guarantees

- An uncertain liability is a greater burden to the insurer than a certain liability



- When available, market information is more objective

Liabilities have different values depending on expected due dates

Presentation model linked to measurement model

ED proposals

- For life: All premiums treated as deposits, all payments as return of deposits
- For non-life: Gross up underwriting margin to present premium revenue
- All changes in estimate presented in profit and loss

Statement of comprehensive income

	20XX
Risk adjustment	X
Residual margin	X
Experience adjustments and changes in estimates	X
Underwriting result	X
Investment income	X
Interest on insurance liability	X
Net interest and investment	X
Profit or loss	X

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Main focus of the forthcoming exposure draft

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Timelines

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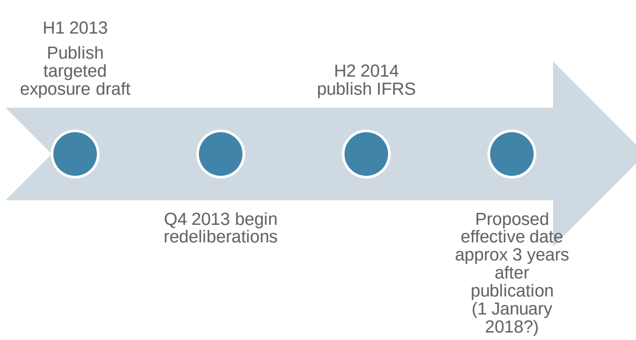

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What sort of changes has the IASB made?

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Type of change

- Reconsider alternative previously rejected in the Basis for Conclusions to the ED
- Make practical accommodation in applying principles in ED
- Clarify intentions in the ED (by articulating proposals differently or by adding guidance)
- Simplifies proposals in the ED

Drivers of change

- Relative weighting of arguments following review of the comment letters and outreach
- Response to concerns raised by interested parties

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How has the measurement model evolved since July 2010?

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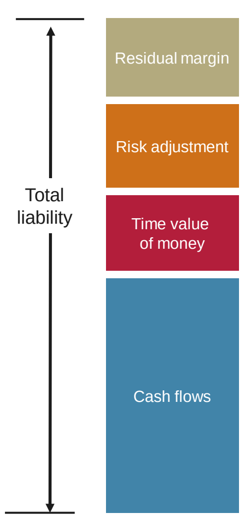

Main changes

Adjust residual margin prospectively for changes in estimates of cash flows (‘unlocking’)

Remove restriction of techniques
Reflect diversification to the extent considered by the insurer in assessing the compensation it requires for bearing risk

Add guidance that both ‘top down’ and ‘bottom up approach acceptable to meet principle that rate should exclude factors not relevant to the liability

Include all direct costs incurred in acquiring and originating a portfolio of insurance contracts

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Present: Statement of comprehensive income

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Tentative decisions

- Present premium revenue and incurred claims on face of statement of comprehensive income
- Premium revenue represents the price the insurer charged for coverage in that period
- Present in OCI changes in the insurance liability arising from changes in the discount rate (unless participating contracts decisions apply)

Statement of comprehensive income

	20XX
Premium revenue	X
Incurred claims and expenses	(X)
Underwriting result	X
Investment income	X
Interest on insurance liability, based on locked in discount rate	X
Net interest and investment	X
Profit or loss	X
Effect of discount rate changes in insurance contract liability	X
Total comprehensive income	X

Minor changes in other areas

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Exposure draft	Decisions so far
Definition and scope	No significant change from ED except partial scope exclusion for financial guarantee contracts
Which cash flows, including acquisition costs	Minor changes in response to comment letters • Included cash flows • Recognition point • Contract boundary
Discount rate	No change in principle, change in application guidance
Risk adjustment	Minor changes from ED in response to comment letters
Reinsurance	Minor changes from ED in response to comment letters
Premium allocation approach	Minor changes from ED in response to comment letters
Disclosures	Minor changes from ED in response to comment letters

Focus of targeted re-exposure

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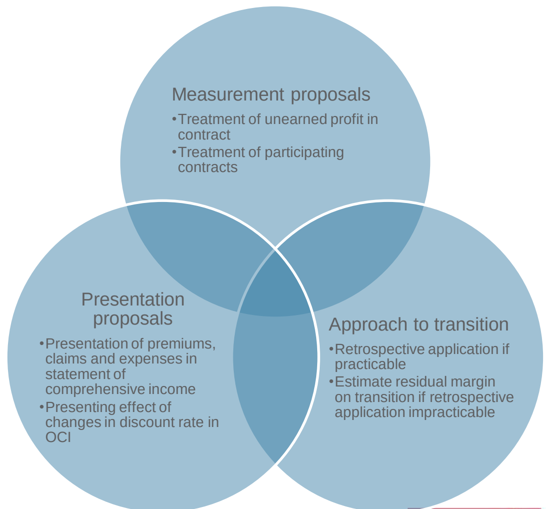

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A closer look

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We were told that information about premiums and claims/benefits is important

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- Why?

To provide information that can be used to assess growth or shrinkage

To give basic information about volume

To provide an approximation to cash collected

To give information about the amount of new business written in the year

To help assess profitability
(by permitting comparison of amount of activity required to generate net profit)

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We believe it is desirable to improve consistency with the concept of revenue

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Today, insurers measure revenue from insurance contracts in different ways….

- × May include deposit-like receipts
- × May not reflect timing of service provided by insurer
  - × May be included on a ‘cash-receivable’ basis
  - × May be included when contract is written
  - × May not reflect the compensation for risk borne in each period
- × Single premiums and recurring premiums given same weight

Total premiums may be an amalgam of premiums calculated on different bases

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Proposed approach for presenting premiums and claims

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- Premiums in the income statement should be consistent with the concept of revenue, ie
  - Exclude investment components
  - Reported as earned (not as billed, not as written)
- Premiums in the income statement should be consistent with the measurement model for insurance contract liabilities
- Claims/benefits should be reported as incurred

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ED proposed that all gains and losses be presented in profit and loss

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- ED proposed current value measurement of the insurance contract liability
- We were told that many were concerned about reporting the effects of period to period changes in discount rate in profit and loss
- Suggested solutions
  - Cost-based measurement
  - 'Locked-in' discount rate
  - Present effects of changes in discount rate in OCI

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We believe current value information about the insurance contract liability is useful

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- ✓ We confirmed the insurance contract liability should be discounted using a rate that:
  - Reflects only the characteristics of the insurance contract liability
  - Is current and updated each reporting period
- + We provided guidance on determining the discount rate
  - Do not prescribe method – 'top-down' and 'bottom-up' both acceptable
  - Remove any factors that influence observable rates not relevant to the liability
- ❖ We decided that changes arising from changes in the discount rate should be presented in other comprehensive income
  - Underwriting information is not overshadowed by effects of changes in discount rate
  - Changes that reverse over time are presented separately from other changes

Proposed approach to reporting performance

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Comprehensive income

A current view of performance

Profit or loss

Performance based on a locked in discount rate

OCI

Effect of changes in discount rate

At inception, the residual margin represents unearned profit

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- Residual margin determined at inception of contract
  - Represents the unearned profit in the contract at inception
  - Recognised as the insurer fulfils the contract
- ED proposed that changes in estimate would be recognised in profit and loss

→Inconsistent treatment of estimates made at inception and estimates made after inception

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We revised accounting for estimates to be consistent with measurement at inception

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- Offsetting changes in estimates of future cash flows in the residual margin maintains consistency after inception
  - Changes in estimates of future cash flows affect the unearned component of the residual margin (not recognised as immediate loss)
  - Cash flow experience adjustments recognised in profit or loss

→Anchors residual margin to the premium charged

→Residual margin represents unearned profit over contract term

→Avoids reporting profits in years after a change in estimate means contract expected to be loss-making

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Better depiction of the economics of participating contracts

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✓ Discount rate reflects dependence of cash flows on specific assets

❖ Introduced "mirroring approach" when liability contractually based on performance of underlying assets or groups of assets:

- Adjust cash flows to reflect the measurement basis of the items underlying participation
- Present changes in estimates consistently with equivalent changes in underlying item
- Options and guarantees measured at current value

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Transition: ED proposals

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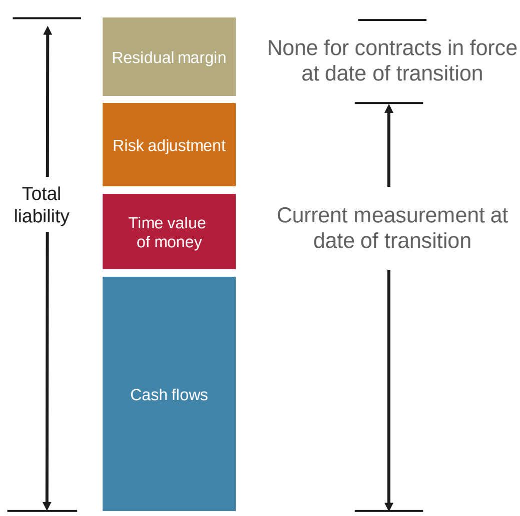

Most respondents to ED were concerned about lack of comparability between contracts that were written before transition and those written after

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IASB proposes to require insurers to determine residual margin on transition

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- Include margin retrospectively for in force contracts at date of transition if practicable. If not practicable:
  - Due to lack of objective data, estimate maximising use of objective data
  - For other reasons, determine by reference to previous carrying amount
- Reliefs provided for transition:
  - Modifications to designation requirements in IFRS 9
  - Assume all changes in estimates of cash flows known at initial recognition
  - Guidance provided for determining locked-in discount rate to adjust accumulated OCI at date of inception and subsequent interest expense in P&L

Effective date, early adoption and comparative information

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- Intend to allow approximately three years between publication of standard and mandatory effective date
- Early adoption permitted
- Restate comparatives

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For more information....

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Stay up to date

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Where to find out more

- Visit our website:
  - www.ifrs.org
  - go.ifrs.org/insurance_contracts
- Sign up for our email alert
- Email us: insurancecontracts@ifrs.org

Resources

- IASB Update
- Meeting webcasts
- Project podcasts
- Investor resources
- High level summary of progress on the project
- Detailed summary of boards' tentative decisions
- Topics reports on IASB's tentative decisions and working drafts

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Agenda

- Existing and proposed IFRS (brief)
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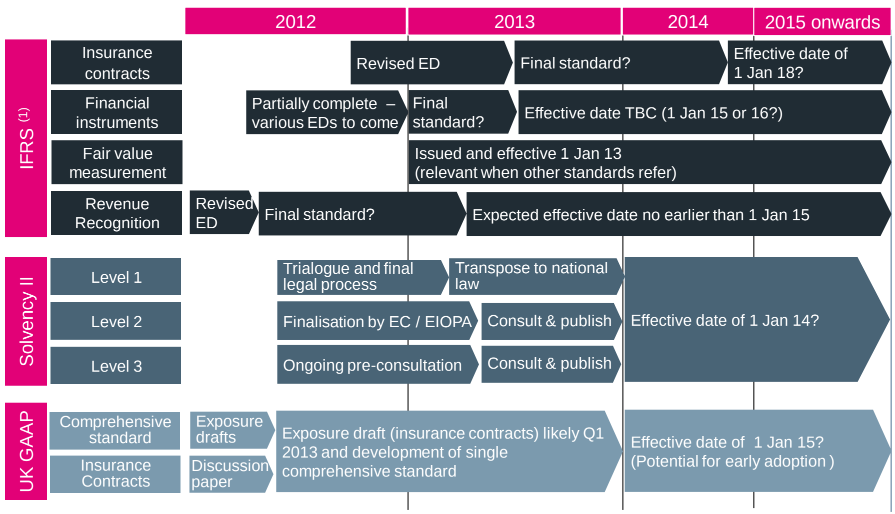
Overview

Welcome many aspects of the original insurance contracts ED and the subsequent progress by the IASB, including:

- Development of a single accounting practice and measurement model.
- Potential for greater consistency and transparency.
- Inclusion of expected cash flows and an explicit risk adjustment.
- Fulfilment objective of the risk adjustment with no limitation on techniques **(post ED)**.
- Entity specific assumptions for non-market variables.
- Clarification that a 'top down' approach to determine the discount rate is permitted **(post ED)**
- Transitional arrangement – retrospective application of the standard (though this will be a challenge for the industry to implement !) **(post ED)**

A possible timeline …

(taking into account information available up to early October 2012)



(1) The effective date of all IFRS standards is subject to EU endorsement

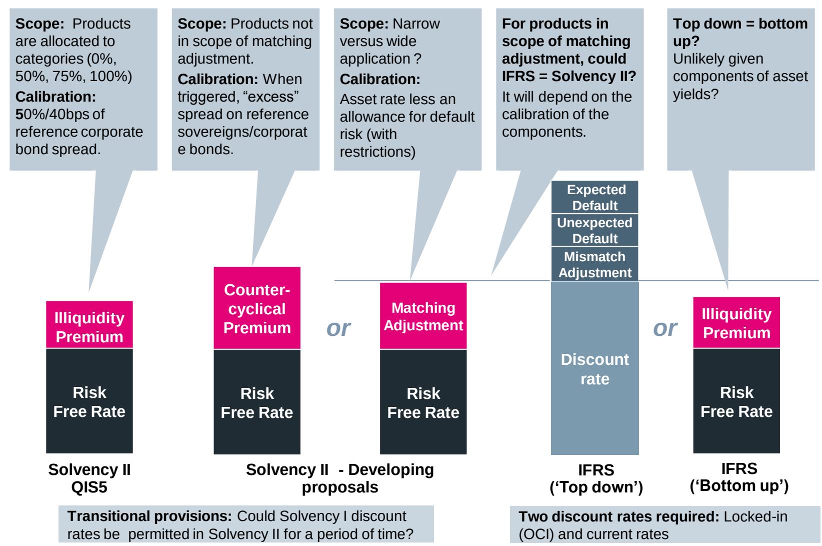
IFRS for insurance contracts versus Solvency II

(Our understanding as at October 2012)

Topic	IFRS	Solvency II
Purpose and target audience	Measure equity & performance over time	Demonstrate solvency to regulators
Contract boundary	Repricing – contract or portfolio level (depends)?	Repricing – contract or portfolio level (depends)? No projection of premiums for savings contracts
Discount rate	Top-down vs. bottom-up? Current & locked in rates (P&L/OCI split)	Matching Adjustment and Counter-cyclical premium?
Non-financial assumptions	Entity-specific best estimates, current as at valuation date (not locked in)	
Overhead expenses	Direct attributable overheads only included	Included in liability measurement
Acquisition expenses	All direct costs incremental at portfolio level in PV of cash flows	Expensed as incurred
Risk adjustment / margin	Fulfilment value from insurer's perspective	Transfer value from third party perspective (cost of capital)
Residual margin	Yes	No
Treatment of reinsurance	No offsetting	Gross with separate calculation

Comparison of discount rates

Solvency II versus IFRS



Measures to address volatility and other presentation related matters

Topic	Measure	Observations
Discount rate ('OCI' solution)	• Mandatory presentation of all changes in discount rate from inception in equity on the balance sheet (OCI) rather than in P&L.	• New approach for most UK based insurers. • As mandatory, introduces accounting mismatch for liabilities backed by assets measured at fair value through P&L (e.g. equities, derivatives, realised gains on bonds).
Residual margin ('Unlocking')	• All changes in estimates of future cash flows are absorbed by the residual margin and do not impact P&L.	• Which changes should be absorbed? (e.g. assumption changes, experience variances, changes in risk adjustment and changes in options & guarantees). • Can the residual margin be reinstated once exhausted?
Unbundling and presentation of revenue items on income statement	• Distinct investment components only unbundled. • Premiums and claims for non-distinct investment components excluded from income statement. • Volume measures for all other components are presented on the income statement following the earned premium approach.	• Limited unbundling in practice is welcomed. • Additional complexity from excluding items. • Why is unbundling in presentation required when it is not for the measurement? • Inclusion of volume measures is welcomed • Proposed approach is different to current IFRS for life insurers and may result in data and communication complexities.

Participating contracts
Initial views on October 2012 IASB staff paper 2F

- "Participating contracts" definition in paper apparently intended to include unit-linked insurance contracts but less clear that UK-style with-profits business is included!
- Cash flows measured and presented (e.g. through OCI or P&L) on same basis as underlying assets ('mirroring'), with mirroring taking precedence over OCI.
  - How to approach mirroring when the allocation of assets to liabilities is not clear?
  - IASB examples only simple vanilla policies backed by vanilla assets, not WP fund
- All cash flows arising from current contracts treated as liability (regardless of whether existing or future policyholders receive surplus):
  - Different treatment for cash flows dependent on / not dependent on asset cash flows
  - Estate forms part of equity not liability / equity movement forms part of "profit"?
  - Communication challenge?
- Additional volatility for with profits compared to Existing IFRS (declared bonuses):
  - Could "floating residual margin" help solve the problem?

It is unclear what the resulting "IFRS profit" means (either P&L or total profit) and this remains an area of concern for UK with-profits insurers.

Future role of supplementary reporting?
Initial views

- Existing supplementary reporting addresses gaps within existing primary and regulatory reporting.
- Most of these gaps expected to remain post-Phase II and Solvency II, suggesting a continuing need for the following:
  - IFRS profit drivers (thought required post-Phase II)
  - Shareholder value-based reporting (form of EV)
  - Linkage between EV, new business and free surplus ("cash")
  - Analysis of movement in EV/free surplus
  - Projected real-world distributable profits on in-force and new business, and related metrics (e.g. IRR).
- Continuing need for clear messaging and good reconciliation.
- Consistency of supplementary reporting across industry likely to remain key challenge (similar to primary and regulatory reporting).

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Conclusion

- Welcome progress by IASB compared to the original insurance contracts ED.
- There remain some significant areas to be resolved.
- Uncertainty in timetable: what to do if/when Solvency II is effective before proposed IFRS.
- What is the future role of supplementary reporting?
- FRG formulating plans for 2013 CPD:
  - Planning response to new Phase II ED
  - Feedback welcome.

Questions or comments?

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

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