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making financial sense of the future

IFRS – all clear now?

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The future of insurance accounting – IFRS 4 Phase II

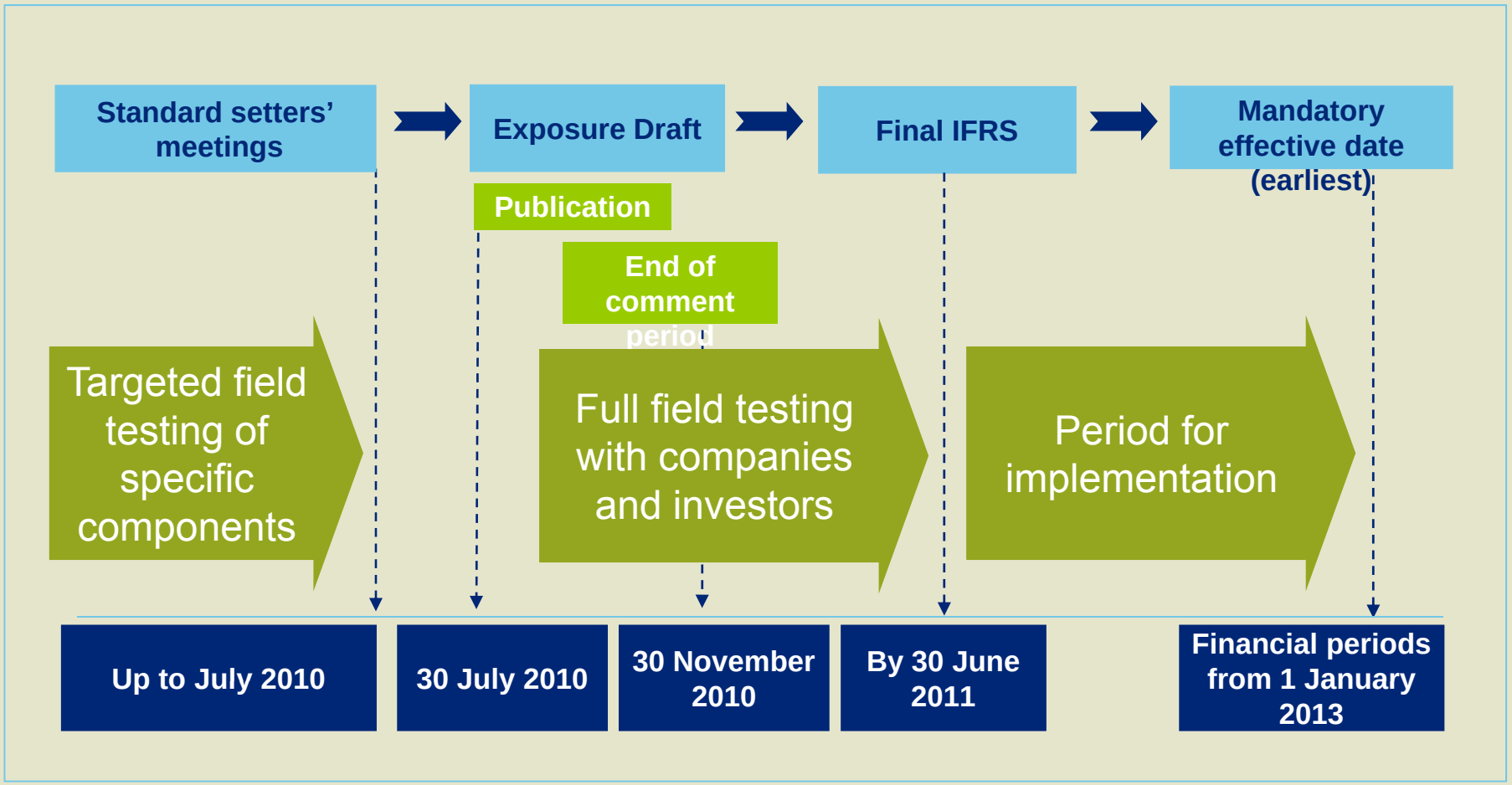
Insurance Accounting Project - Background

Insurance Accounting Project - Objectives

Insurance project

- The key objectives of the Phase II of the IASB's insurance project are:
  1. Introduce for the first time a single IFRS accounting model for all types of insurance contracts
  2. Make the new accounting model highly transparent and
  3. Align as much as possible insurance accounting with the general IFRS accounting of other industries
- After preliminary views published in 2007 based on a fair value approach, the Exposure Draft of the new IFRS delivered an entity specific current measurement model.
- The US FASB joined the insurance accounting project in late 2008 aiming at a potential replacement of the existing US GAAP for insurance with an identical or very similar standard to the one under IFRS.
- Some areas of disagreement remain, and resulted in the IASB publishing its exposure draft without the FASB.
- The FASB published a consultation paper on September 17, comments due December 15.

Insurance Accounting Project - Detailed timeline



IFRS 4 Phase II Exposure Draft – Key Concepts

Summary of the ED proposals

- Transaction based standard – Not an accounting model for insurance companies. Current IFRS 4 definition of “insurance” carried forward.
- Single prospective measurement model for all types of insurance and reinsurance contracts issued and for reinsurance contracts purchased – Policyholder accounting excluded for the time being
- Measurement model uses a “building block” approach:
    1. Expected present value of future cash flows; and
    2. Risk adjustment
- Measurement is always current
- Measurement objective is to represent the notion of the insurer’s “fulfilment of obligations under the contract”
- Prohibition of accounting profit on sale – a residual margin liability is added to defer any expected profit. However any day-one loss is recognised immediately through income
- Acquisition costs to be treated as contractual cash flows if incremental. All other sale costs are expensed

Measurement model

Measurement objective and approach

- Current assessment of insurer's rights and obligations under contract – single amount on financial statements representing the net contract fulfilment value.
- Use of "building block" approach, with a simplified approach required for short-duration contracts pre-claim liabilities.
- There are three building blocks to the measurement approach:

Block 1	Block 2	Block 3
Estimate of fulfilment cash flows	Discounting of fulfilment cash flows	Two components: a) Risk adjustment b) Residual margin

FASB / IASB Difference

- Alternative model for block 3 is a single composite margin
- No explicit measurement of uncertainty → capture risk together with future profit at inception based on policy price

Measurement model (cont.)

Building Block 1 : Cash Flows Estimate

A current, unbiased and probability weighted estimates of the contractual cash flows.

- An insurer should develop estimates of cash flows that:
  - are **current**, in other words, they correspond to conditions at the end of the reporting period;
  - incorporate, in an **unbiased** way, all available information about the amount, timing and uncertainty of all cash flows arising from the contractual obligations **as well as directly attributable and incremental acquisition costs;**
  - are as consistent as possible with observable **market** prices; and
  - include **entity-specific** cash flows (e.g. expenses).
- Acquisition costs that are not incremental and directly attributable to the sale of an individual policy cannot be treated as a component of the cash flows and would result in an expense as incurred
- The ED requires all of the sales costs that are not incremental to be presented as a separate line on the face of the income statement representing the IFRS new business strain

Observations

- The requirement to consider a range of outcomes and use all available information to arrive at the probability-weighted estimates is generally not used in current accounting models and will require model and system adjustments to produce timely financial information.
- The narrow definition of acquisition costs and the role that directly attributable and incremental costs will play in the new model may require adjustments in some insurer's expense allocation systems.
- Distribution models that are funded by directly attributable incremental expenses will receive a more favourable accounting treatment (no new business strain)

Measurement model (cont.)

Building Block 1 : Cash Flows Estimate

A current, unbiased and probability weighted estimates of the contractual cash flows.

- Cash flows should be included if they arise within the “contract boundary”:
  - Boundary is point at which insurer can terminate or re-underwrite a contract; and
  - Future premiums and claims/expenses related to those premiums.
- Cash flows re-assessed at each reporting period.
- Stochastic modelling may be required.

Measurement model (cont.)

Building Block 2 : Discount rate

The time value of money is taken into account by explicitly discounting all cash flows.

- Adjusts first building block for time value of money.
- Discount rate based on characteristics of the insurance liability:
  - Currency
  - Duration
  - Liquidity
- Measurement reflects characteristics of the assets backing insurance liability only if the amount, timing or uncertainty of contract cash flows depend on performance of assets, e.g. participating contracts;
  - Linkage may be reflected using a replicating portfolio.
- Discount rate is a market consistent interest rate based on a “risk free rate” plus an illiquidity premium based on the characteristics of liability cash flows.
- No further guidance on how to calculate the illiquidity premium
- Disclosures on discount rate, impact of illiquidity and sensitivities

Observations

- Insurers will need to develop their approach to determining the risk free rate and methodologies to determine the illiquidity premium.
- Systems and processes will need to be re-configured to discount insurance contracts based on liability characteristics.

Measurement model (cont.)

Building Block 3 : Margins - Risk Adjustment

A margin to reflect uncertainty in the estimate of fulfilment cash flows.

- Explicitly reported in the financial statements as a component of the insurance contract liability
- Defined as:

  "the maximum amount an insurer would rationally pay to be relieved of the risk that the ultimate fulfilment cash flows exceed those expected"
- Re-measured at each reporting period.
- Estimated at level of portfolio of insurance contracts – benefit of risk pooling allowed
- Effects of diversification across different portfolios of insurance contracts is not allowed.
- Three permitted techniques for estimating the risk adjustment:
  - Confidence Interval;
  - Conditional Tail Expectation (CTE); and
  - Cost of Capital

Observations

- The inclusion of an explicit risk adjustment is a substantial change from most current accounting models for insurance contracts where margins are implicit.
- Calculating probability distributions or stochastic models for insurance liabilities at the portfolio level and developing adequate support for assumptions will require robust and auditable processes that can bear the scrutiny of market disclosure.

Measurement model (cont.)

Building Block 3 : Margins - Risk Adjustment (permitted techniques)

- Confidence Interval:
  - Likelihood that the actual outcome will be within specified interval.
  - Sometimes referred to as Value at Risk (VaR).
  - Easier to communicate and calculate compared to other techniques
  - Not as useful for probability distributions that are not statistically normal.
- Conditional Tail Expectation (CTE or tail VaR):
  - Better reflection of extreme losses.
  - Focuses on the tail of the probability distribution → reflects aspects of insurance.
  - Judgement required to determine band and may need to change in future periods.
- Cost of Capital:
  - Applied in pricing, valuations and regulatory reporting, etc.
  - Reflects estimated cost of holding required capital to meet obligations with high confidence.
  - Need to determine capital rate that reflects risk relevant to liability.
  - Approach used in SII for risk margin.
- Guidance provided for when to use which technique based on the characteristics of the probability distribution

Observation

- Selecting the appropriate valuation technique from the three permitted, defining the correct level of aggregation and calibrating the technique to the portfolios could be a challenge for companies to implement and maintain.

Measurement model (cont.)

Building Block 3 : Margins - Residual Margin

A margin to eliminate any gain at inception of the contract.

- A residual margin arises when:

  PV of future cash inflows > PV of future cash outflows + risk adjustment

- Estimated at level of portfolio of insurance contracts, with same inception date and similar coverage duration (cohort).
- Calculated at initial recognition and earned over coverage period. It is also explicitly reported in the financial statements
- Cannot be negative. In the event of a negative value a loss must be recognised immediately through income
- Interest expense accretion required using discount rate locked-in at inception.

Observations

- Information captured with the residual margin offers an insight in the product profitability beyond the risk adjustment
- The requirement to aggregate residual margins by cohorts transparently reports “vintages” of product profitability

Measurement model (cont.)

Simplified method for short-duration contracts

- Pre-claims liability for all contracts that:
  - Have a coverage period of approximately one year or less; and
  - Do not contain embedded options or derivatives that significantly affect the variability of CFs.
- Measure pre-claims liability by allocating premiums over coverage:

  At initial recognition = premium received + expected PV of future premiums
  less incremental acquisition costs
- Full amount will be earned over the coverage period.
- The post-claims liability will be recognised as claims incurred measured using three building blocks.
- After the coverage period accounting models align with a post-claim liability based on building blocks.
- This results in simpler measurement for the pre-claim liability (first 12 months or less).

Observation

- The requirement to release revenue from the pre-claims liability in a manner that reflects the seasonality of expected claims is a revenue recognition approach which will be familiar to many insurers (particularly catastrophe reinsurers) buy may be new to others.

Contract boundary

- New concept, crucial to the proposed measurement model.
- Insurance contract is measured and presented as one balance to represent the bundle of rights and obligations.
- The measurement of insurance contract includes all rights and obligations, including policyholder options, if they fall within the contract boundary.
- The boundary of an insurance contract refers to a future point in time where one of these conditions is true:
  - The insurer is able to unilaterally cancel the contract; or
  - The insurer is able to re-price the contract to reflect the current assessment of insurance risks applicable to the specific policyholder.
- The inclusion of 'specific policyholder' allows insurers to re-price groups of policies without shortening the contract boundary.
- If insurance policy includes options, forwards or guarantees not falling within the existing contract boundary, they are accounted as new insurance contract or under other applicable standards.

Observation

- Actuarial models will need to be reviewed to ensure that the full benefit of future premiums is only counted to the extent that they fall within the contract boundary.

Recognition and derecognition

Recognition

- Rights and obligations are recognised when the insurer becomes a party to the contract.
- At the earlier of the insurer being “on risk” or the binding of the insurance contract.
- If the insurer can reassess the risk, and either cancel the contract or change the contract terms, the insurer is not likely to be considered “on risk”.

Observation

- Accounting for insurance contracts on this basis will require changes in all those cases where the insurer had used the “risk inception date” to recognise insurance contracts. This approach is particularly common among general insurers that underwrite property and casualty risks.

Derecognition

- Takes place, similar to IAS 39 for financial liability, at the point where the insurer is no longer “on risk”. Not a new concept or requirement compared to most existing practices

Other measurement characteristics

The ED introduces other requirements:

Foreign currency translation – The ED clarified that all accounting amounts associated with insurance contracts are monetary items that should be revalued at the FX rate in force at the reporting date.

This approach improves on the current practice of treating only certain amounts as monetary and eliminates the associated accounting inconsistency with investments.

Business combinations and portfolio transfers – The accounting for insurance contracts in these cases is identical to normal reporting.

Any difference with the fair value will respectively go to goodwill or as a loss in case it is negative. In the event it is positive it will be captured in a residual margin liability in both cases.

Insurer's non-performance risk – The ED requires ignoring the risk that the insurer does not perform under the contract (own credit risk being the most commonly known).

Accounting for this risk would have resulted in a scenario where claims and benefits are not paid and the expected value of the liability would have been lower in proportion to the associated probability of non-performance.

Ceded/Purchased Reinsurance

- Reinsurance contracts are measured using the building-blocks as insurance contracts.
- Reinsurance assets held by cedants should be measured with reference to the reinsured liability.
- Offsetting reinsurance assets and reinsured liabilities is prohibited unless the appropriate legal requirements are met. Similarly offsetting income and expense from reinsurance contracts is not permitted.
- Ceding commissions should be treated as a reduction in the reinsurance premium paid.

FASB / IASB Difference

- FASB view is that ceding commission should be treated as revenue to the extent that it offsets acquisition costs, with the remainder being classified as a reduction in reinsurance premium paid.

- Entity specific approach to the recognition of the building-blocks could create an asset that is larger than the premium paid (e.g. due to portfolio diversification).
- This case results in an immediate gain through income.
- In the event of a negative figure it would be capitalised as a ceded residual margin to be amortised over the reinsurance coverage.
- In addition to the building-block estimate the cedant must apply an expected credit loss adjustment to reflect present and future impairment on a probability weighted basis.
- This is similar to the new IASB proposal for loan impairment. **Different to current FAS 5 basis.**

Potential areas requiring clarification – Portfolio of insurance contracts

IASB's Exposure Draft (ED) issued late July 2010 – Comments due 30 Nov 2010

Overall Issues with IFRS ED for Insurance Contracts (Phase 2)

- **Major Gaps between principles and practicalities in how they are applied**
  - Several areas where details or examples are lacking
  - Inconsistent application among insurers seems likely

Specific Problem Areas for most types of insurance contracts

- **Definition of a Portfolio of Insurance Contracts**
  - "... *broadly similar risks, managed together as a pool*"
  - ED guidance limited to describing risk characteristics that are **not** broadly similar
  - ED is lacking in guidance on what is meant by "*managed together as a pool*"
  - Implication is to rationalise and justify why portfolio is managed together and has similar risk characteristics

IASB staff appears to welcome suggestions for enhancing the application guidance

Potential areas requiring clarification – Risk Adjustment 1

Specific Problem Areas for most types of insurance contracts

– **Definition of Risk Adjustment**

- "... ***maximum*** *amount the insurer would rationally pay to be relieved of the risk...*"
- No ED guidance on what is meant by "***maximum***"

– What Confidence Level is justified as the ***maximum***? 75th, 80th, 90th ?

– If 3 techniques are permitted, should the ***maximum*** *of the 3 be used* ?

– **Risk Adjustment: a stop loss concept? or a risk transfer notion?**

- "... *the risk that the ultimate fulfillment cash flows* ***exceed*** *those expected..*"
- What would an insurer be willing to pay to cap ultimate cash flows at expected?
- What would an insurer be willing to pay to fix the ultimate cash flows and be "relieved" of all of the risk – uncertain ultimate cash flows that could be above and below expected – for a fixed amount?

Potential areas requiring clarification – Risk Adjustment 2

– **Risk Adjustment: Is it rational to pay anything to be relieved of the risk?**

- Insurers pool risk, so why couldn't an insurer justify little, if any, risk adjustment for a well diversified portfolio of insurance contracts?
- An insurer prices portfolios of insurance contracts at a certain profit load. Doesn't that profit load suggest the maximum the insurer would rationally pay to be relieved of the risk for a portfolio of uncertain fulfillment cash flows with comparable probability distribution?

– **Risk Adjustment: Selecting the Confidence Level**

- Risk Adjustment depends on the Confidence Level and the Probability Distribution
- An insurer's Confidence Level can be different for different portfolios
- The Uncertainty of a given portfolio, relative to other portfolios, is affected by:

– Reliability of selected probability distribution type in representing the uncertainty?

– Degree of confidence placed in the parameters estimated for the selected probability distribution (e.g., company vs. industry data)?

– Is the selected probability distribution skewed?

- More Uncertainty –> Higher Confidence Level –> Higher Risk Adjustment

Potential areas requiring clarification – Risk Adjustment 3

Major Issues for application to General (Property/Casualty) Insurance

- **Application of Risk Adjustment for Claims Liability**

• For each portfolio of insurance contracts,

- determine the Probability Distribution Type for unpaid claim estimates (or for estimates of ultimate losses)
- select the risk adjustment method (Confidence Level, CTE, or Cost of Capital)
- select appropriate probability distribution parameters
- determine the appropriate risk adjustment parameters (e.g. Confidence Level)
- compute the risk adjustment for end of the calendar quarter
- consider risk adjustment for pre-claims and post-claims liability together

Potential areas requiring clarification – Risk Adjustment 4

Major Issues for application to General (Property/Casualty) Insurance

- **Application of Risk Adjustment for Residual Margin**

- For each new cohort of new contracts in each portfolio of insurance contracts,
- compute the risk adjustment at inception (similar to the steps for claims liabilities)
- if there is a positive result from Building Blocks 1, 2 & 3 for this cohort , then the positive result is the Residual Margin
- if there is a negative result from Building Blocks 1, 2 & 3 for this cohort , then the negative result is recorded as a loss in the Income Statement

- Compute the Residual Margin each calendar quarter for all new cohorts in the quarter
- Apply an established runoff formula for the Residual Margin to be released in the calendar quarter for each previous cohort that still has a Residual Margin remaining
- **NOTE: The Residual Margin for each cohort is not reduced after inception for changes in the estimates of the fulfilment cash flows (Building Blocks 1, 2 & 3)**
- Possible ED Response Comment: Shouldn't an additional portion of the remaining Residual Margin be released if the changes in the cash flow estimates reduce the ultimate profit for the cohort (Changes in estimates go through profit/loss) or recalibrate the residual margin at each period?

Scope of exposure draft

The ED applies to:

- All insurance / reinsurance contracts issued and reinsurance contracts held.
- Certain financial instruments with discretionary participation features if they participate in the performance of the same assets/contracts/entities as insurance contracts do.
- All financial guarantee contracts meeting the definition of an insurance contract. These will no longer be in the scope of financial instruments standards IAS 32, IAS 39, IFRS 7 and IFRS 9.

Scope exclusions

Main change from IFRS 4 Phase I:

- Fixed fee service contracts if the primary purpose of is provision of services, regardless of whether they meet the definition of insurance.

Other retained scope exclusions:

- Warranties issued directly by a manufacturer, dealer or retailer;
- Lessee's residual value guarantees embedded in a finance lease or provided by a manufacturer, dealer or retailer ;
- Employers' assets and liabilities under employee benefit plans and retirement benefit obligations reported by defined benefit retirement plans;
- Contingent consideration payable or receivable in a business combination; and
- Insurance contracts held.

Implementation Of Proposed Accounting Standard

Presentation

Three building blocks

- The new presentation model in the ED has been developed from two key conclusions:
    1. Presentation of an insurer's profit or loss is better expressed from the building-blocks model; and
    2. A margin approach is the most suited presentation to display the sources of profit from the building-blocks model.
- To ensure consistency in the application and greater comparability there are five minimum line items to be put on the face of the income statement:
    i. Underwriting margin;
    ii. Experience variances and changes in assumptions;
    iii. Day one losses on insurance sold and day one gain on reinsurance bought;
    iv. Acquisition expenses (non incremental); and
    v. Interest expense from discount unwinding (ideally paired with an asset investment income line to display an investment margin).
- All these lines have a link to the building blocks.
- Special lines will be added for the unearned premium method.

Observation

- Changes to general ledgers and underlying accounting systems will be needed to accommodate the new requirements.

Example statements of financial position and comprehensive income

Short term insurance contracts

Statement of financial position

Insurance contract assets	
Portfolio A	X
Reinsurance contract assets	
Portfolio B	X
Insurance contract liability	X

Observation

An insurance contract asset can not arise on the inception of a contract without an offsetting residual margin liability but could arise at a later date depending on changes to the best estimate contractual cashflows, the discount rate and risk adjustment.

Statement of comprehensive income

*Underwriting margin **	
Premium revenue**	X
Claims incurred **	X
Change in risk adjustment**	X
Expenses incurred **	X
Amortisation of acquisition costs	X
*Gains / losses at initial recognition**	
Losses on insurance contracts acquired** in a portfolio transfer **	X
Gains on reinsurance contracts bought by a cedant**	X
Losses at initial recognition of an insurance contract**	X
Changes in onerous contract liabilities*	X
Non-incremental acquisition costs*	X
*Experience variances and changes in assumptions **	
Differences between actual and estimated cash flows**	X
Changes in estimates of cash flows**	X
Changes in discount rates**	X
Impairment losses on reinsurance assets**	X
Interest on insurance contract liabilities*	X

Explanation of items in statement of comprehensive income for short duration contracts (1)

- SOCI contains a mixture of familiar and unfamiliar measures of income and expense. ED contains specific guidance for short duration contracts in addition to generic items required as appropriate for all insurance contracts. Some wording in ED is vague!
- ED does not specify where ceded reinsurance items are to be reported (but they cannot be offset).
- Items marked with a single * must be presented on the face of the SOCI
- Items marked with a double ** may be presented on the face of the SOCI or in the notes

Explanation of items in statement of comprehensive income for short duration contracts (2)

Comments on specific line items typical for short duration contracts:

- Premium revenue: This is the release of premium as earned – same as existing accounting practice
- Claims incurred: Actual and estimated claims incurred (including IBNR) – BUT measured using the three building blocks: cashflows, discounting and risk margin. KEY DIFFERENCE
- Change in risk margin: adjustments to the risk margin in the value of incurred claims – for short duration contracts the risk margin only arises as in the post claim obligation – changes may therefore be better presented in the experience adjustments.
- Expenses incurred: ED is unclear as to what expenses are included here, we assume the intention is to disclose claims expenses and claims handling expenses.
- Amortisation of deferred acquisition costs: Similar to existing accounting – DAC asset is offset against insurance contract liability on B/S but is shown separately in SOCI.
- Losses on insurance contracts acquired in portfolio transfer: It is not permitted to recognise day 1 gain on PT – instead set a residual margin would be added in to calibrate back to consideration received.

Explanationof items in statement of comprehensive income for short duration contracts (3)

- Gains on reinsurance contracts ceded: The ED permits, in principle, immediate recognition of gains on purchasing reinsurance – these must be disclosed separately.
- Losses on initial recognition of insurance contracts: ED requires that losses on insurance contracts deemed onerous on initial recognition should be reported separately.
- Changes in onerous contract liabilities: Specifically for short duration contracts, movements in such liabilities (similar to unexpired risk reserve or premium deficiency reserve) and the recognition of such liabilities post initial recognition shall be reported separately here
- Non incremental acquisition costs: Includes direct and indirect costs of selling, underwriting and initiating insurance contracts. Reported separately from other G&A type expense.
- Differences between actual and estimated cashflows: The differences between the estimated claims and claims expenses cashflows and the actual amounts paid.
- Changes in estimates of cashflows: Any adjustments to the entity's calculations of building block 1 for carried claims reserves to be reported separately.
- Changes in discount rate: the impact on the insurance liabilities in changes in the appropriate risk free rates is reported separately from changes in the underlying cashflows estimated by the entity.

Explanationof items in statement of comprehensive income for short duration contracts (4)

- **Impairment losses on reinsurance assets:** Calculated on an expected loss model (differs to current FAS 5 basis).
- **Interest on insurance contract liabilities:** The unwind of the discounting of the cashflows used in the calculation of the insurance contract liabilities.

Overall:

- A mix of existing and new information to be presented
- Decisions needed about whether to aggregate information in the SOCI
- What will the market want and how will practice evolve?
- Some lack of clarity in ED requirements – e.g why present change in risk margin in the underwriting margin sections?

Disclosure

- The ED has adopted the current IFRS disclosure principles for insurance and added more stringent requirements to ensure alignment with the building blocks model and consistency of minimal content in the notes.
- Aggregation is prohibited at a level greater than operating segment.
- There is great focus on two particular areas which have been expanded:
    1. Assumptions and their changes:
        - Focus on the block estimation;
        - Assessment of the impact on profit and equity; and
        - Disclosure of changes from prior period.
    2. Reconciliation of movements to balance sheet and income statement lines:
        - Specific minimum reconciling items set out (see next slide);
        - Tailored requirements for the simplified method;
        - All amounts before and after reinsurance; and
        - Focussed on the cash flows exchanged and their comparison with estimates.

Observation

- The added level of disclosure may require insurers to reassess the way that they capture and manage data as well as assessing their current systems capabilities.

Disclosure - reconciliations required for all insurance contracts

Reconciliations are required from the opening to closing balances for each of the following, if applicable:

1. Insurance contract liabilities and, separately, insurance contract assets.
2. Risk adjustments included in 1.
3. Residual margin included in 1 (no residual margin in short duration contracts).
4. Reinsurance assets arising from reinsurance contracts held by the insurer as cedant.
5. Risk adjustments included in 4.
6. Residual margin included in 4 (no residual margin in short duration contracts).
7. Impairment losses on reinsurance assets.

For each reconciliation the following should be shown, at a minimum, of applicable:

- Carrying amount brought forward.
- New contracts recognised during the period.
- Premiums received.
- Payments split into: claims and benefits; expenses; and, incremental acquisition costs.
- Other cash paid and, separately, other cash received.
- income and expenses.
- Amounts relating to contracts acquired from, or transferred to, other insurers in portfolio transfers or business combinations.
- Net exchange differences on the translation of foreign currency amounts.

Disclosure – breakdown analysis required for short duration insurance contracts

Reconciliations as per previous slide required to be presented separately for:

1. Pre – claim liabilities (i.e. unearned premium reserves).
2. Additional liabilities for onerous contracts (unexpired risk reserve/premium deficiency reserve).
3. Claims liabilities calculated using the 3 building blocks approach.

Disclosure – additional requirement for long-tail business

“For those contracts for which uncertainty about the amount and timing of claims payments is not typically resolved fully within one year an insurer shall disclose the claims and expenses incurred during the period”.

- Judgement required as to which contracts fall into these categories
- Additional to other aggregation requirements and reportable segments
- Information may be commercially sensitive

Transition and effective date

- The new standard is likely to be effective for periods beginning on or after 1 January 2013.
- The effective date will move in parallel with that of IFRS 9 “Financial Instruments”
- Early adoption will be permitted, but this fact will need to be disclosed.
- Same transitional provisions will apply for IFRS “first time” adopters and existing IFRS reporting entities.

On adoption

- Insurance liabilities will be calculated as the sum of blocks 1 and 2 plus the risk adjustment (even if a composite margin approach is finally selected).
- All insurance intangible balances (e.g. deferred acquisition costs, intangibles arising from existing insurance contracts assumed in a previous business combination) will be written off.
- All these adjustments will be recognised in opening retained earnings.

Observations

- The estimation of a proper risk adjustment on transition is crucial as it will determine the primary source of future accounting profits from the contracts in-force at the transition date.
- The existence of large, historic surpluses in participating funds held on balance sheets will further complicate the restatement of participating insurance and investment contracts.

FASB Discussion Paper: Some initial thoughts

Initial thoughts on the FASB discussion paper

- FASB discussion paper was issued on September 17, Public roundtables to discuss will be held in December and the consultation period will close on December 15.
- The discussion paper incorporates much of the material in the ED and includes comparison with current US GAAP.
- The paper is a preliminary document. No date for issuance of an ED or standard.
- Contains comments where the FASB have alternative views.

Observations

- FASB are clearly less developed in their thinking than IASB. A number of key IASB decisions are not concluded up by FASB or not even considered.
- There is a risk of accounting divergence when new IFRS adopted, both in principles and timing of adoption. Much of the existing similarity between IFRS 4 Phase I for P&C business and US GAAP may be removed.

FASB discussion paper – summary of comments affecting P&C business (1)

- Insurance contract definition and applicability to all entities: **FASB agrees** with the direction of these approaches.
- Discounting of short duration insurance liabilities: **FASB agrees** this is desirable.
- Acquisition costs: FASB **broadly agrees** with the approach in ED, **but, EITF 09-G may permit more costs to be deferred (for example, a portion of underwriting salaries).**
- Inclusion of deferred acquisition costs as reduction of pre-claims liability: **FASB has not decided on this point.**
- Use and applicability of a simplified short duration model: **FASB have not formed a preliminary view** yet**.**
- Use of UPR as proxy in pre-claims period in short duration model. **FASB agrees with IASB views.**

Observations

- FASB is at an early stage of considering whether and how a different model for short duration contracts should be applied and is seeking input from stakeholders.
- Discounting of ***all*** insurance liabilities is supported by both FASB and IASB.

FASB discussion paper – summary of comments affecting P&C business (2)

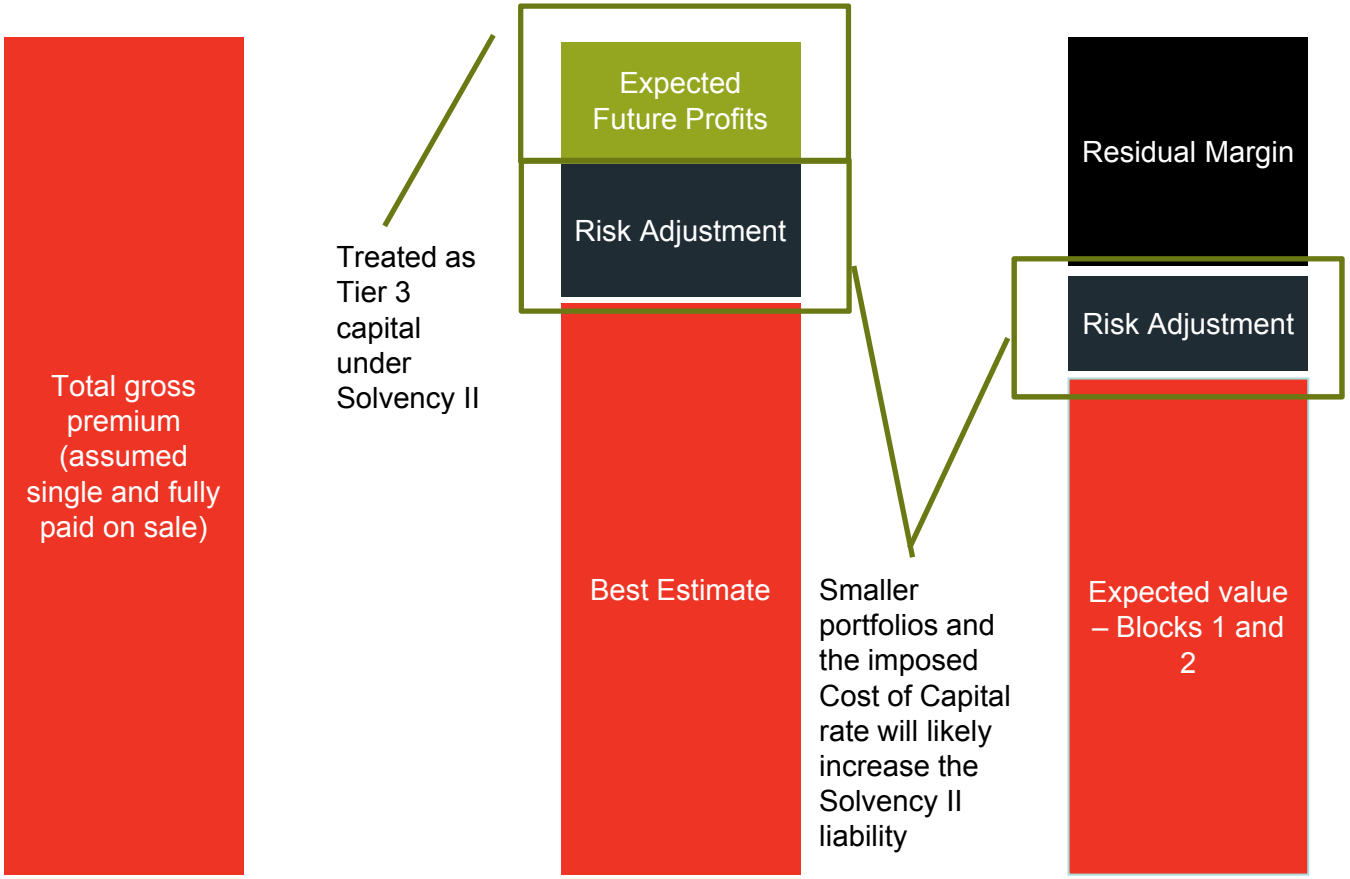
- Additional explicit risk margin added to discounted liabilities: **FASB fundamentally disagrees** with this point, and believes that risk is reflected in the probability weighted cashf lows. Post claim liabilities would therefore be discounted, but with no additional risk margin if the FASB adopted a similar short duration model.
- Presentation of comprehensive income for short duration contracts: **FASB supports a similar presentation for the specific items required for short duration contracts**, but has not formed a view on how incremental acquisition costs would be presented.
- Separate presentation of experience adjustments for short duration contracts in the statement of comprehensive income: **FASB is silent on this point.**

Observations

- If FASB adopts an approach similar to the IASB short duration model, post claims liabilities will be discounted, but without an additional risk margin
- Unclear as to whether FASB support experience adjustments on short duration liabilities being presented separately in statement of comprehensive income.

IFRS 4 Phase II & Solvency II

IFRS 4 Phase II and Solvency II – Summary diagram



Relative size of liabilities & margins are for illustration purposes only and could differ significantly by company / product line.

IFRS 4 Phase II and Solvency II – Differences and considerations

	IFRS 4 Phase II Exposure Draft	Solvency II	Practical considerations
Timeline	Earliest effective date may be for annual periods ending on or after 1 January 2013. The final date will be decided after the comment period closes on 30 November 2010.	Implementation date of 31 October 2012, which may be extended to 31 December 2012.	- Opportunities for synergies in modelling solution and processes. - Joint implementation projects. - Significant resource challenges.
Objective / purpose	Provides a consistent basis for accounting for insurance contracts to enhance comparability across entities, jurisdictions and capital markets.	EU solvency regime to protect policyholders / beneficiaries using a principle based regulation that relies on management's good risk management practices and a regime of transparent disclosure to markets and regulators	- For an EU group, both SII and IFRS may apply. Where a regime is deemed equivalent,this may lead to reconciliation challenges between the existing regulatory regime and IFRS. - Where there is an EU subgroup, IFRS may apply globally but SII will only apply to the EU subgroup, which could limit the scope of synergies and could necessitate separate programmes.
Scope	Insurance contracts as defined in IFRS and investment contracts with DPF issued from the same participating funds as insurance contracts.	Function of the entity's regulatory status as an authorised (re)insurer rather than the transfer of significant insurance risk.	- Reconciliation between IFRS and SII technical provisions is required under the SII disclosure provisions - The difference in scope is likely to result in significant valuation differences for unit-linked investment contracts (i.e. without insurance risk) which will be accounted for as banking deposits in IFRS with no credit for future fees

IFRS 4 Phase II and Solvency II – Differences and considerations (cont.)

	IFRS 4 Phase II Exposure Draft	Solvency II	Practical considerations
Measurement approach	Three building blocks with a calibration to add a residual margin liability if there is an accounting profit at the point of sale. UPR approach permitted for short duration.	Three building blocks	- SII and IFRS likely to run off the same models but with different assumptions. - Need to consider the process and timelines for the model runs given these will be generated by the same systems. - Clear reconciliation and explanation needed for Board review and approval and external disclosure.
Expenses	Include only incremental acquisition costs in the fulfilment cash flows	All costs which will be incurred in servicing all obligations related to existing contracts (including commissions) need to be included in technical provisions best estimate cash flows.	- Adjustments to expense allocation systems. - Implementation challenge to identify the incremental acquisition costs.
Contract boundary	The point at which the insurer has the right to re-assess the risk and re-price.	Similar definition included in QIS5 but not supported by CEIOPS Technical Advice where the proposal is that the best estimate cannot be an asset	- A point of significant controversy in the SII negotiations which increases the SII liability compared to that under IFRS – all other factors being equal

IFRS 4 Phase II and Solvency II – Differences and considerations (cont.)

	IFRS 4 Phase II Exposure Draft	Solvency II	Practical considerations
Time value of money	Discounting reflects the characteristics of the liability cash flows (duration, currency and liquidity).	Discounting is required using the risk free rate adjusted for illiquidity based on prescribed rules for a transitional period. Post transitional period the discount rate is a risk free rate without any illiquitiy premium	- The SII liabilites will be higher than IFRS – all other factors being equal - The assumptions for discounting are likely to be different, hence requiring separate modelling runs on a different assumption set. - Developing the approach to determining the discount rate, particularly the illiquidity premium, will involve significant financial / actuarial expertise and time. - Clarity in the disclosures around the discount rate is important, given its significance and the likelihood of varying practices in the market for IFRS. - Delinking the discount rate from the asset return may lead to more earnings volatility which will need to be explained carefully to the Board, analysts and investors.
Participating contracts	Discretionary benefits must be included in the best estimate cash flows.	Similar treatment as IFRS	- Both IFRS and SII have a signficant challenge of identifying the expected distribution to policyholders and shareholders.

IFRS 4 Phase II and Solvency II – Differences and considerations (cont.)

	IFRS 4 Phase II Exposure Draft	Solvency II	Practical considerations
Risk Margin	An entity specific measure of insurance uncertainty. One of three methods must be used to calculate the risk margin to capture the maximum value the insurer would pay to be relieved from the future uncertainty (VaR, CTE and CoC). Remeasured at each reporting date from portfolios that share the same risk characteristics and are managed as one portfolio.	An alleged market consistent measure of insurance uncertainty. The margin tries to capture the amount that a (re)insurer would be expected to pay to transfer the (re)insurance obligations. Only one method must be used: cost of capital based on the future SCR levels. In addition the cost of capital rate is fixed at 6%. Remeasured at each reporting date based on regulatory defined portfolios that represent the maximum aggregation permitted.	- The SII liability is likely to be higher than IFRS due to the imposed CoC rate and maximum aggregation of portfolios (lower diversification benefits) – all other factors being equal - Identification of the most appropriate method to calculate the risk margin which may differ depending on the nature of the insurance contract. - Complexity in defining the portfolios to maximise diversification benefit. - Different profit recognition patterns to communicate to Board and externally to analysts and investors. - Still need to calculate a VaR for IFRS disclosure even where CTE or CoC method is used. - VaR method requires additional modelling capabilities. Whilst there are not necessarily any synergies, it may help to address significant model changes at the same time as SII.
Residual margin	Designed to eliminate any gains on inception. It is calculated separately for each portfolio of insurance contracts with similar inception date and coverage period.	No residual margin liability	- Need to define the level of aggregation for the most efficient calculation of the residual margin.

IFRS 4 Phase II and Solvency II – Differences and considerations (cont.)

	IFRS 4 Phase II Exposure Draft	Solvency II	Practical considerations
Presentation of performance statement	The income statement will be fundamentally different using a margin based approach rather than the traditional premiums and claims analysis, similar to EV reporting.	Performance disclosed in Section A of the SFCR and RTS and limited disclosure in the QRTs. SII is a balance sheet, solvency focussed regulatory regime.	- Changes to the general ledger and underlying accounting systems required for IFRS reporting including interfaces with policy administration systems. - Processes will need to be updated to capture the more granular margin movements. - More detailed movement data will need to be organised to construct the income statement e.g. data on policies which have terminated during the year.
Short duration insurance contracts	For contracts with a duration of no more than one year, an unearned premium less deferred acquisition costs must be applied if certain criteria are met.	No such simplification provided in SII.	- An analysis is necessary to identify the areas where this simplification is required to limit the differences between SII and IFRS measurement approaches. - This approach is likely to be similar to current practices for IFRS but only relates to the pre claim liability. - An onerous contracts test must be developed based on the three building blocks (expected present value of cash flows plus risk adjustment)

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