The Actuarial Profession
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Life conference and exhibition 2010

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IFRS 4 Phase II:
Friend or Foe?

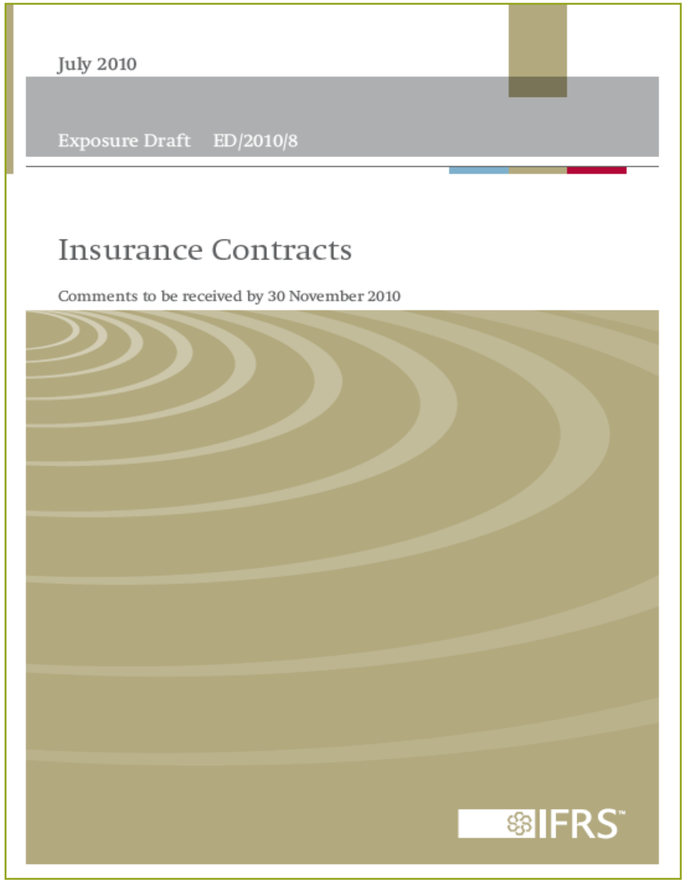
9 November 2010

Agenda

- Introduction and scope
- Measurement models
- Profit and liability profiles
- Contrasting IFRS II and Solvency II
- Implementing the changes

Introduction and scope

Setting the scene: IASB objectives


July 2010

Exposure Draft ED/2010/8

Insurance Contracts

Comments to be received by 30 November 2010

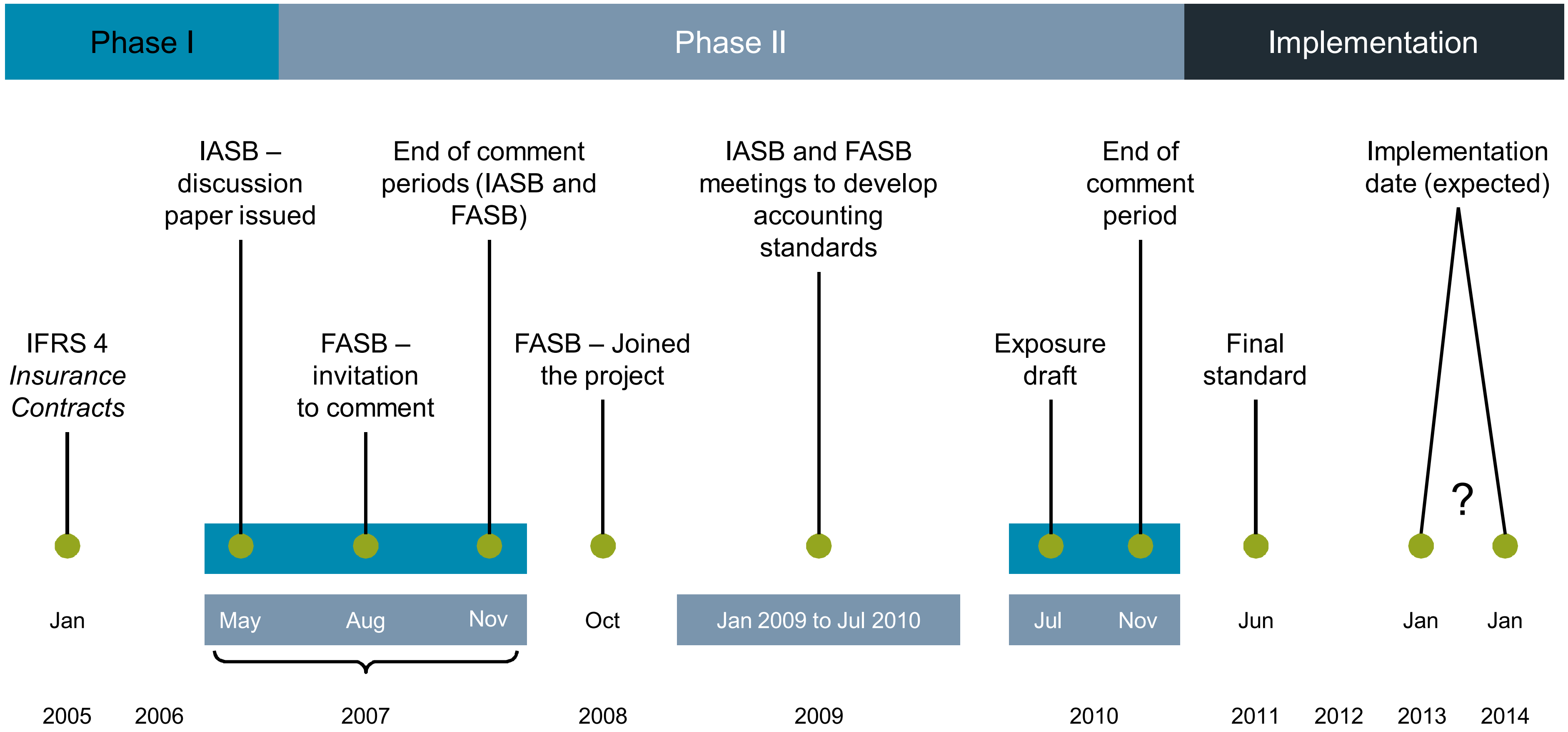
IFRS

- The International Accounting Standards Board (IASB) has published the exposure draft Insurance Contracts:

‘*to propose significant* improvements to the accounting for insurance contracts. Such improvements are needed urgently. Many users of financial statements describe insurance accounting today as a ‘black box’ that does not provide them with relevant information about an insurer’s financial position and financial performance.’

- The proposals in the exposure draft, if confirmed, would:
    a. Provide a comprehensive framework that will require insurers to provide information that is relevant to users of financial statements for economic decision-making
    b. Eliminate inconsistencies and weaknesses in existing practices, by replacing IFRS 4 *Insurance Contracts*
    c. Provide comparability across entities, jurisdictions and capital markets

Project timelines



Project scope

- The exposure draft excludes from its scope:
  - Warranties issued by a manufacturer, dealer or retailer as part of the sale of a product (stand-alone warranties are in scope)
  - Residual value guarantees embedded in a lease or provided by a manufacturer, dealer or retailer
  - Employee benefit plans
  - Contingent consideration in a business combination
  - Excludes fixed-fee service contract
- The exposure draft includes in its scope:
  - Financial guarantee contracts stay within the scope of IFRS 4
  - Mortgage guarantee insurance contracts
  - Credit insurance contracts

Definition of insurance contract

- The ED retains the IFRS 4 definition of an insurance contract and related guidance. Specifically:
  - An insurance contract is a contract where the insurer accepts significant insurance risk from the policyholder by agreeing to compensate the policyholder if specified uncertain future events adversely affect the policyholder
  - The guidance in IFRS 4 will be used to determine whether the insurance risk is significant. Significance of insurance risk is based on present value, rather than an absolute value
  - Contractual terms that delay the timely reimbursement to the policyholder can significantly reduce insurance risk
  - The definition does not capture:
    - Contracts that pay out on a change in credit rating or change in credit index, rather than on the failure of a specified debtor to make payments when due
    - Contracts that pay out regardless of whether the counterparty holds the underlying debt instrument

Unbundling

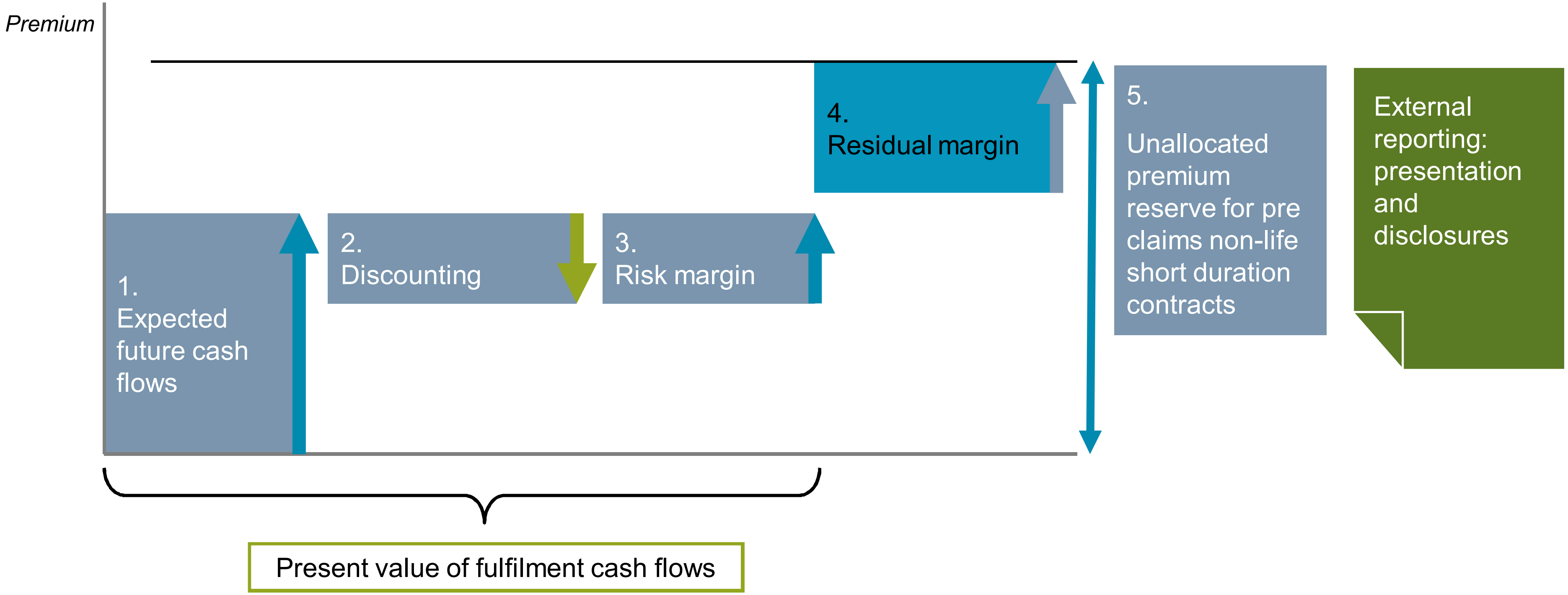
- Any components that are not closely related relate to the insurance coverage
  - Account balance that meets both conditions:
    - Account balance that is credited with explicit return
    - Crediting rate is based on investment performance of underlying assets
  - Embedded derivatives
  - Goods and services not closely related
- No unbundling of components closely related to the insurance coverage

Measurement models

Phase II highlights

Building block approach

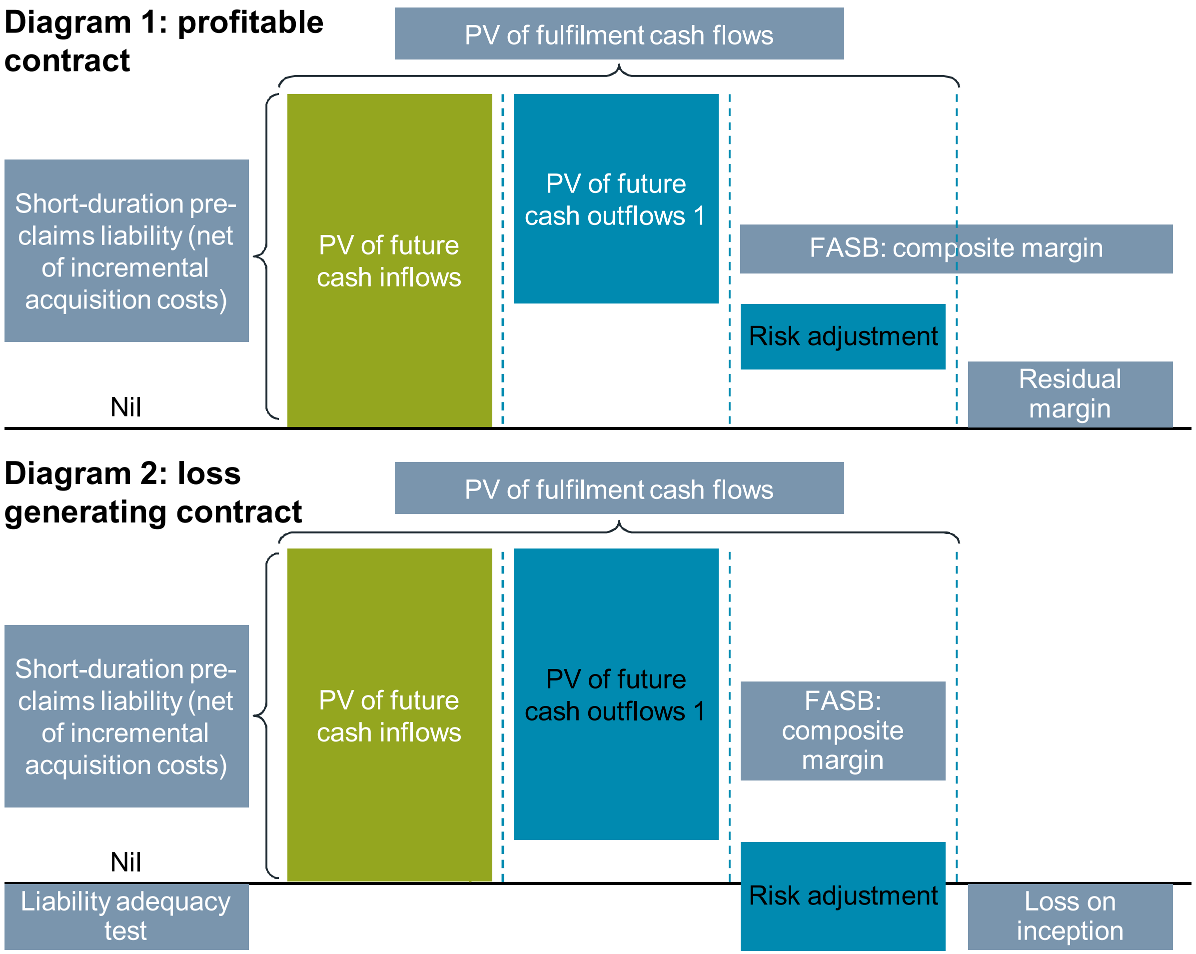
IASB model:



Phase II highlights: IASB model

	1. Cash flows	2. Discounting	3. Risk adjustment	4. Residual margin	5. Pre-claims liability
Initial	• Recognise when 'on risk' • Unbiased probability weighted cash flows • At contract/portfolio level • At inception includes incremental acquisition costs	• Reflect characteristics of contract • Exclude 'own credit risk' • Risk free rate plus allowance for illiquidity	• Cost of capital, conditional tail expectation or confidence level methodologies • Portfolio level • No diversification between portfolios	• Eliminate day 1 gain • Interest accretion • Cohort level (date of inception and duration of policies) • Effectively reduced by day 1 incremental acquisition cash flows	• Mandated for contracts less than one year coverage • Amortise incremental acquisition costs • Onerous contract test based on fulfilment cash flows • Contract level
Subsequent	• Re-measured	• Re-measured	• Re-measured	• Not re-measured • Release over 'coverage period' • Interest at inception rates	• Release over 'coverage period' • Onerous contract test • Once claim incurred or accrued use fulfilment model for that part of liability
Presentation and disclosures	• Reconcile opening to closing balance • Present separately changes in experience and estimates • Disclosures currently in IFRS 4 and 7	• Need to disclose discount rate applied • Present changes in discount rate and interest accretion	• Reconcile opening to closing balance • Present changes in risk adjustment • Disclose the methodology basis, inputs to calculate risk margin and the equivalent confidence level	• Reconcile opening to closing balance	• Reconcile opening to closing balance including premiums, claims, expenses and amortisation of acquisition expenses • Disclosure of additional liabilities for onerous contracts

IFRS 4 Ph II Model – how does it work?



Cash inflows

- Premiums, including initial premiums and instalments
- Potential recoveries (e.g., salvage and subrogation)

Cash outflows

- Costs of selling, underwriting, and initiating successful insurance contracts
- Transaction-based taxes and levies
- Payments to (or on behalf of) policyholders, including payments in kind
- Claim handling costs
- Cash flows that will result from options and guarantees embedded in the contract
- Policy administration and maintenance costs
- Payments to policyholders as a result of a contractual participation term

Discounting

- Reflect the characteristics of the contract, rather than the characteristics of assets backing the contract (unless the contract and asset share those characteristics):
  - Consistent with observable market prices for cash flows with same characteristics (timing, currency, liquidity)
  - Adjust observed market prices for risks and liquidity characteristics of the insurance contract
  - If the amount, timing or uncertainty of cash flows for the insurance contracts depends, wholly or partly, on the performance of specific assets, the measurement of these contracts should consider that fact
  - Not include risk that is accounted for elsewhere (expected cash flows or risk adjustment)
  - Re-measured every reporting period and changes in P&L

- Non-performance risk by the insurer
  - The measurement of an insurance liability should not be updated for changes in the risk of non-performance by the insurer

Risk adjustment

- Maximum amount the insurer would rationally pay to be released from risk
- Risk adjustment should be re-measured every reporting period (through P&L)
- Three methods allowed, depending on the circumstances:
  - Confidence level
  - Conditional tail expectation
  - Cost of capital
- Level of measurement is portfolio of insurance contracts
  - No diversification or negative correlation between portfolios

Contrasting IASB and FASB models

- The building block measurement approach for insurance contracts should ‘portray a current assessment of the insurer’s obligation’ using a framework with significant market consistent components

IASB	FASB
Unbiased, probability-weighted average of future cash flows expected to arise as the insurer fulfils the obligation	Unbiased, probability-weighted average of future cash flows expected to arise as the insurer fulfils the obligation
Time value of money (discount)	Time value of money (discount)
Risk adjustment	An amount that eliminates any gain at inception of the contract (composite margin)
Residual margin	

- A risk adjustment for the insurer’s view of the uncertainty (amount and timing) associated with the future cash flows to be relieved of risk (IAS 37)
- The residual margin represents an amount that eliminates any gain at inception of the contract minus an amount equal to the incremental acquisition cost

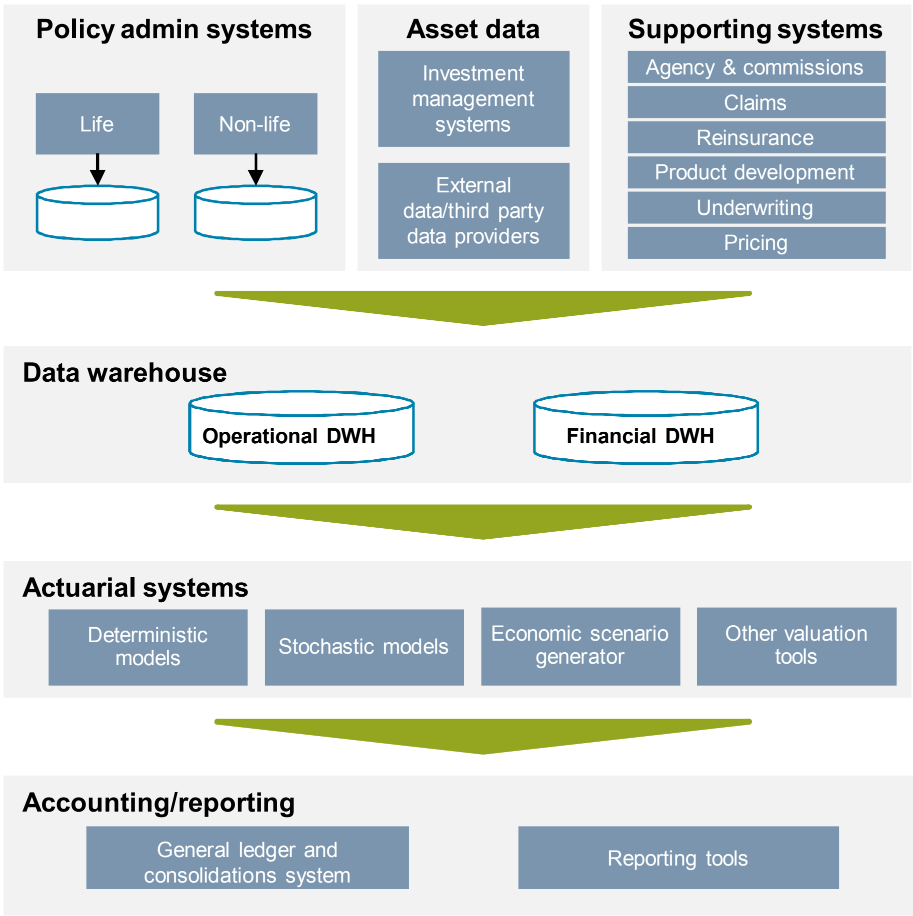
High level impacts IFRS 4 phase II

Multiple dimensions affected

Policies	• Additional/changes to IFRS policies • Anticipation of changes to product features due to changes in profit signatures, regulatory capital
Governance	• Common policies and procedures over assumptions (e.g., discount rates) at geographical and line of business level • Governance and controls frameworks updated
Process and controls	• Significant changes to financial statement presentation and disclosures; new processes and controls • Prior year comparison and restatement process
Performance management and MI	• Alignment of financial and management reporting metrics and processes • 'Capital' and 'earnings/profit' metrics will become more aligned
People	• Multiple stakeholder management (internal and external) • Training and communication • Resource management (BAU vs. Project)

High level impacts IFRS 4 phase II

Key data and systems impacts



Data

- Policy data at IFRS 4 portfolio level
- Data to support unbundling of contracts
- Cash flows to model options and guarantees
- Reconciliation of data between systems (interfacing)

Modelling

- New models to calculate residual margin
- Amortisation engine to model release to income over coverage period
- Flexibility to update assumptions and to re-run cash flows
- Discounting of non-life cash flows

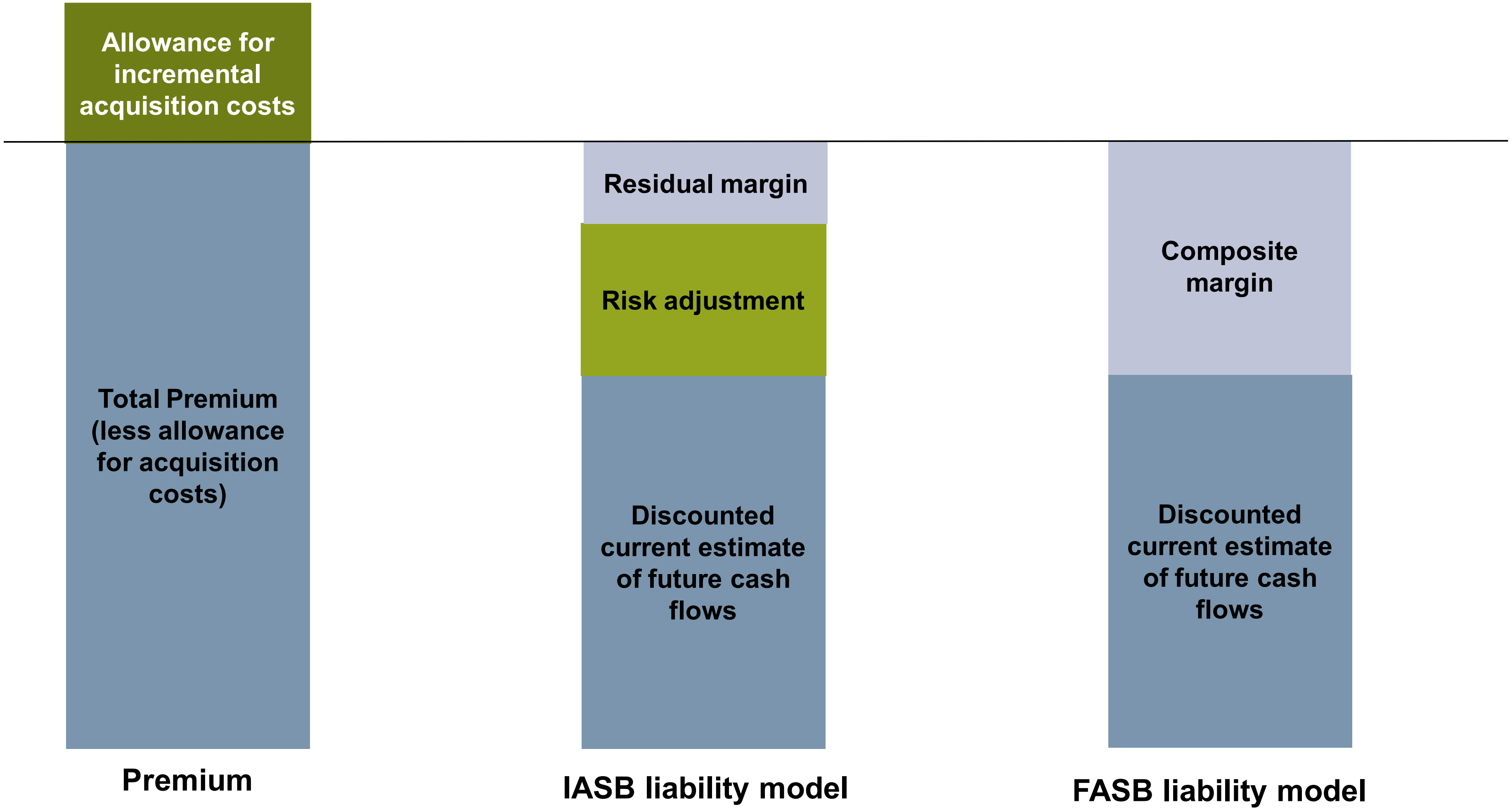
Reporting and disclosures

- Chart of Accounts changes to reflect the new presentation format and disclosures
- Updates to business unit reporting packs and consolidation tools
- Capability to analyse result

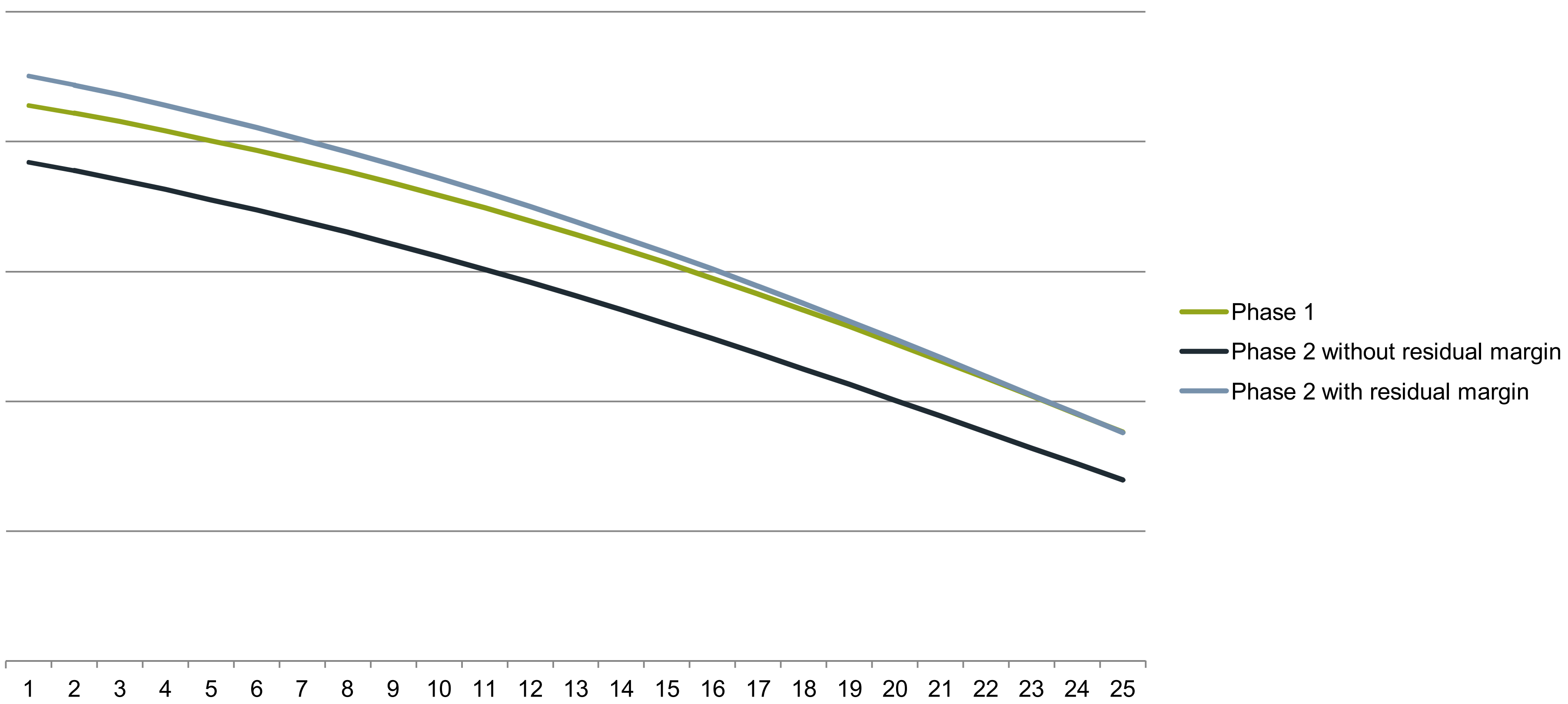
Profit and liability profiles

Valuation of liabilities

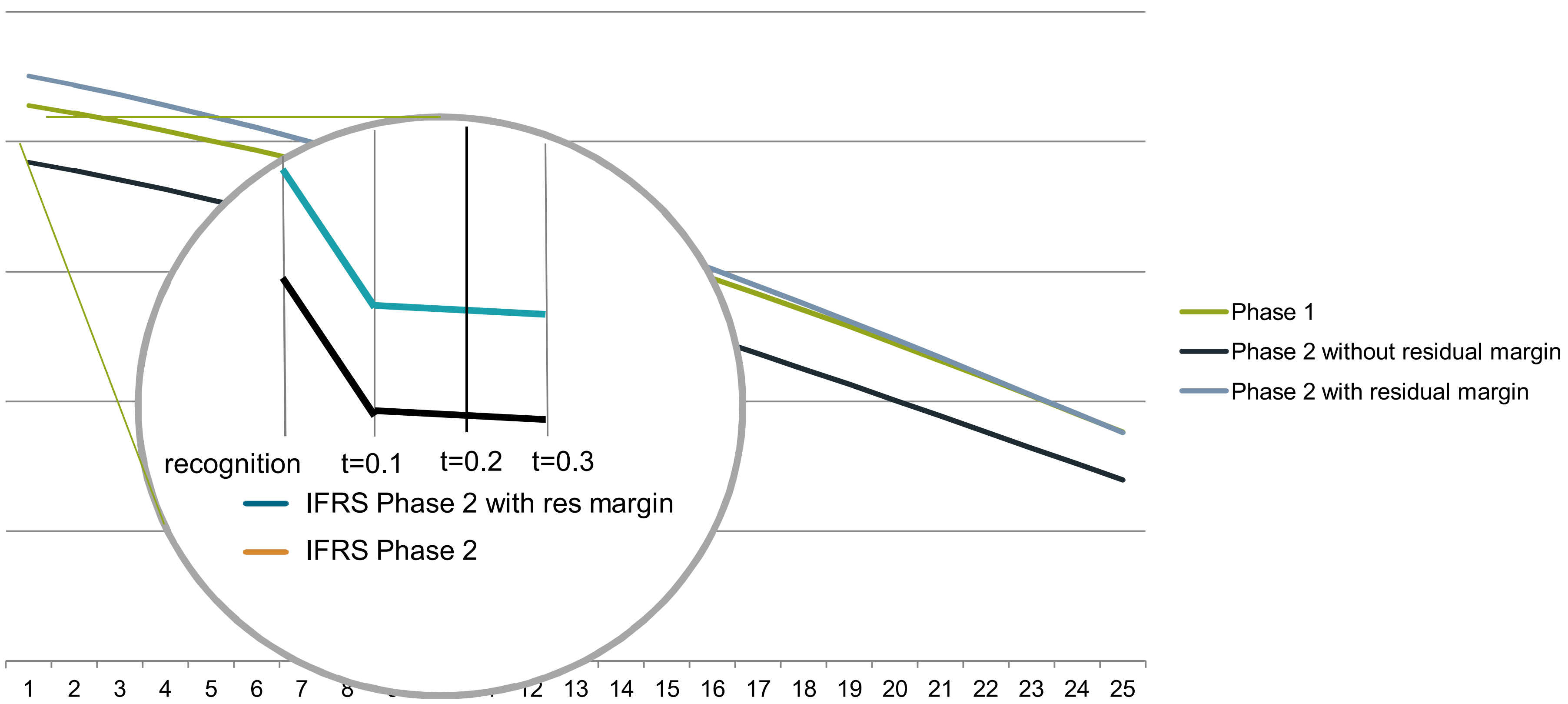
Liability models



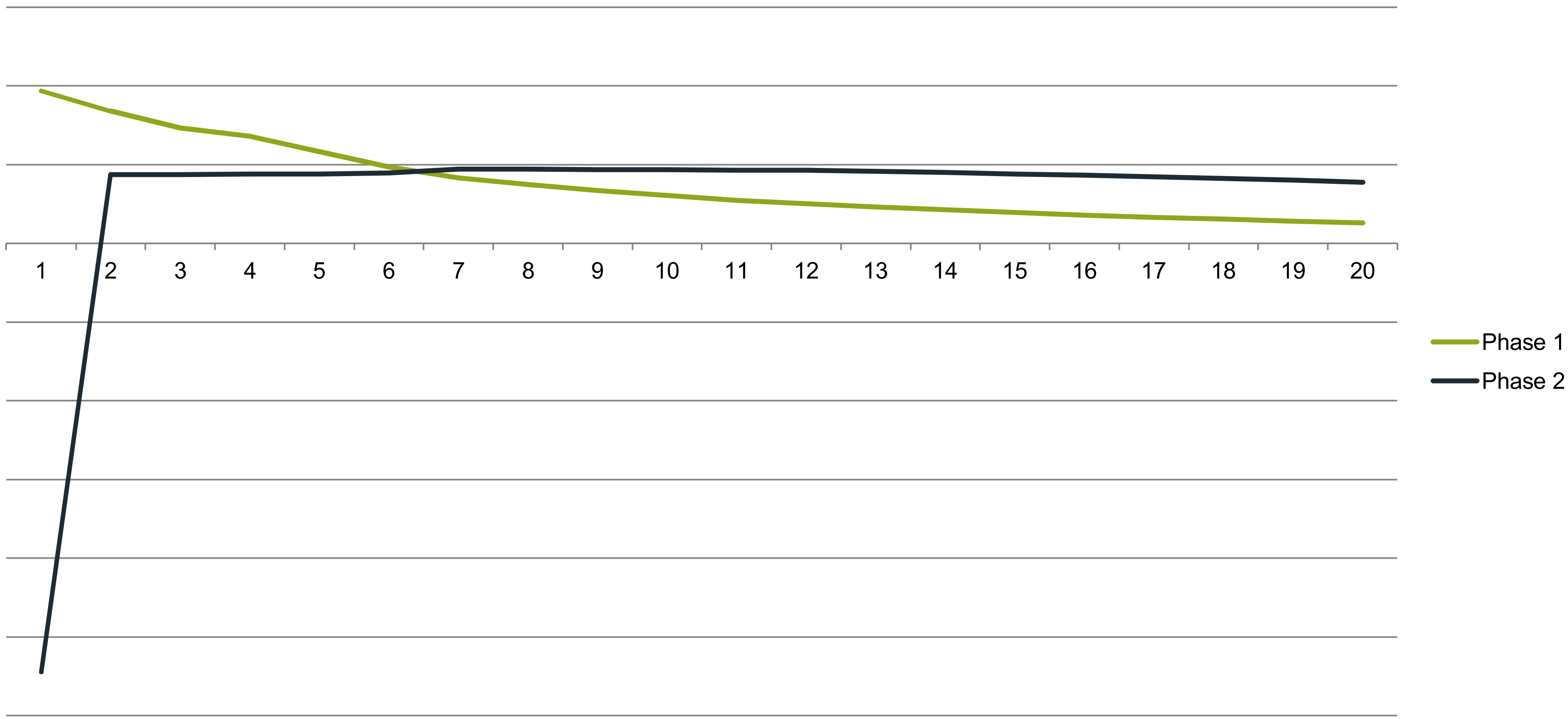
Annuity liability



Annuity liability



Protection – profit profile

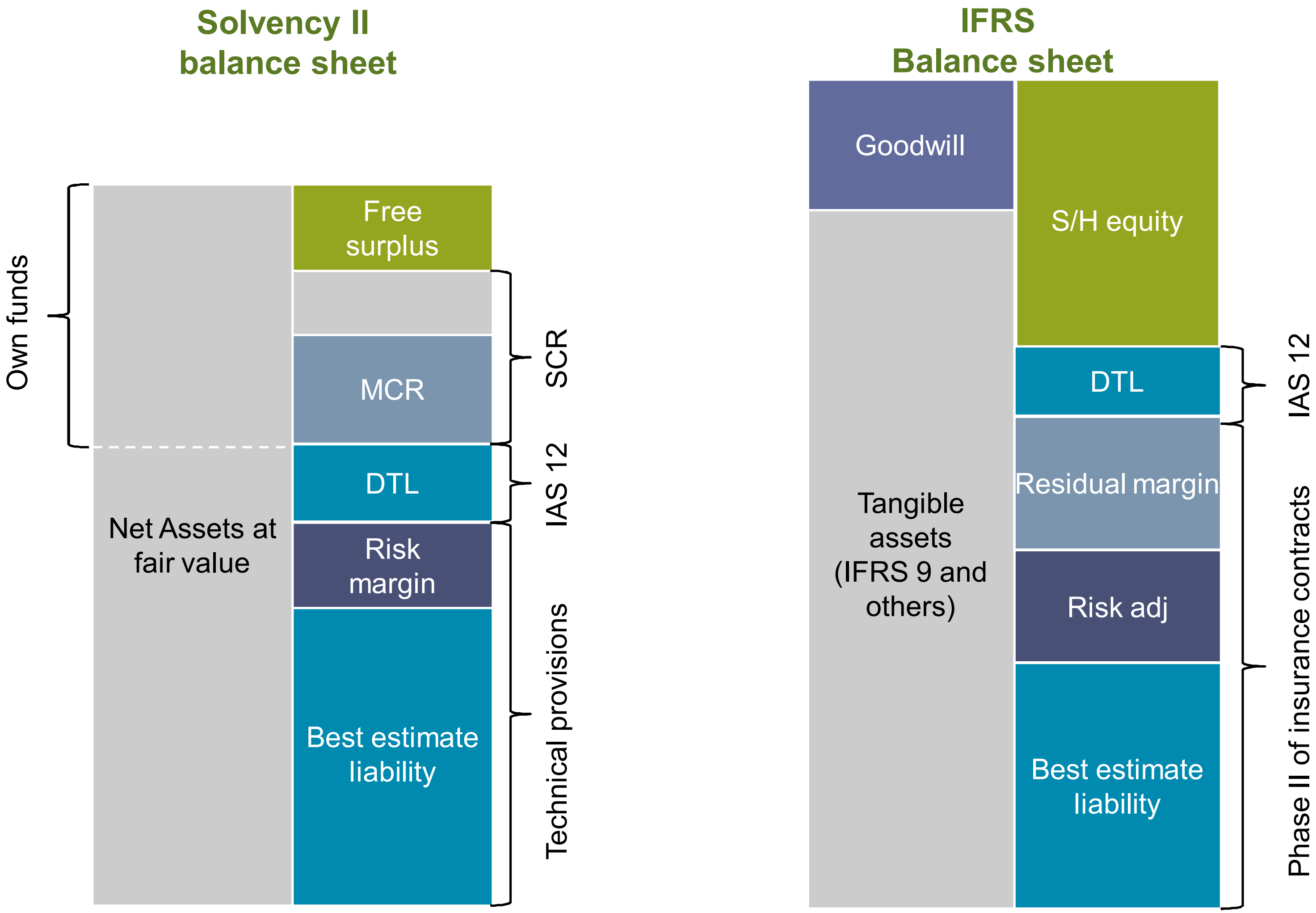


Analysis of Profit – Insurance Contracts

IFRS Phase 2	IFRS 4 (profit drivers)	MCEV
Existing Business	***Existing Business***	***Existing Business***
Change in the risk adjustment		
Release of residual margin		
	(Amortisation of DAC)	
	Expected release of margins	Unwind of discount rate (VIF)
Cash flow variances (v liabilities)	Cash flow variances (v liabilities)	Cash flow variances (v VIF)
Changes in estimate (liabilities)	Changes in estimate (liabilities)	Changes in estimate (liabs & VIF)
New Business	***New Business***	***New Business***
Losses on initial recognition	New business strain / surplus	New business value added
Non-incremental acquisition costs		
+/- Investment Volatility	***+/- Investment Volatility***	***+/- Investment Volatility***
Profit (insurance contracts)	**Profit (insurance contracts)**	**Profit (insurance contracts)**

Contrasting IFRS II and Solvency II

IFRS 4 Phase II and Solvency II



Key differences between Phase II and Solvency II

Risk margin

IFRS permits three methods for the risk adjustment, but firms likely to use Cost of Capital approach for consistency with Solvency II. However, key differences exist regarding the level of diversification benefits, with Solvency II setting these at legal entity level, but IFRS limiting diversification to within a portfolio of contracts.

Unbundling and contract boundary

IFRS introduces mandatory unbundling requirements for components of the insurance contract which are not considered to be "closely related" to the insurance coverage. The recognition of regular premiums is likely to vary on some contracts, eg, Group risk and reviewable term.

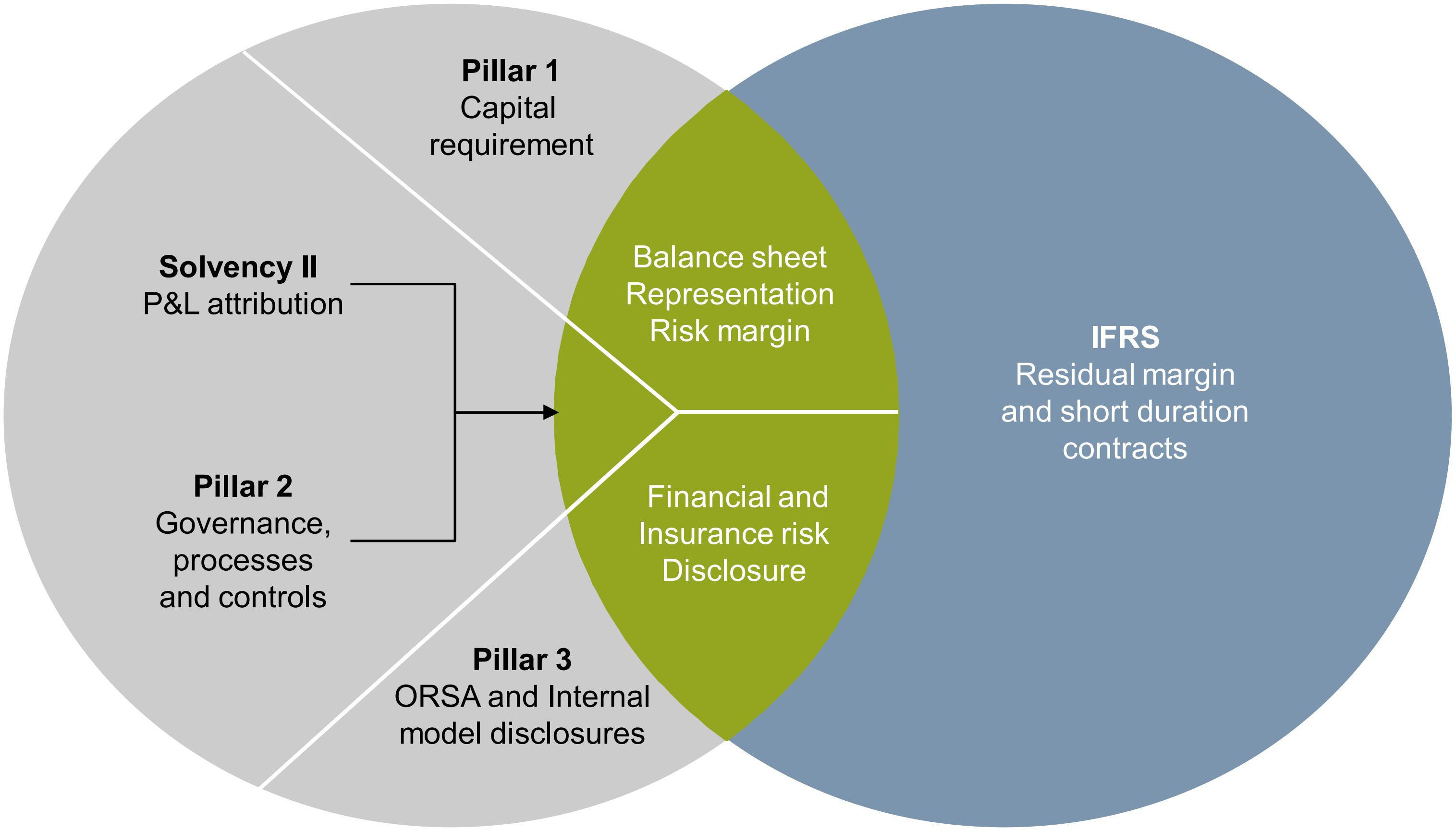
Expenses

Phase II requires only the costs related to managing the insurance contracts to be included within the liability measurement. This would exclude overhead expenses and possibly investment expenses arising from risk contracts. Phase II would require firms to 'look through' to actual expenses within the Group rather use fee arrangements.

Discount rate and liquidity premium

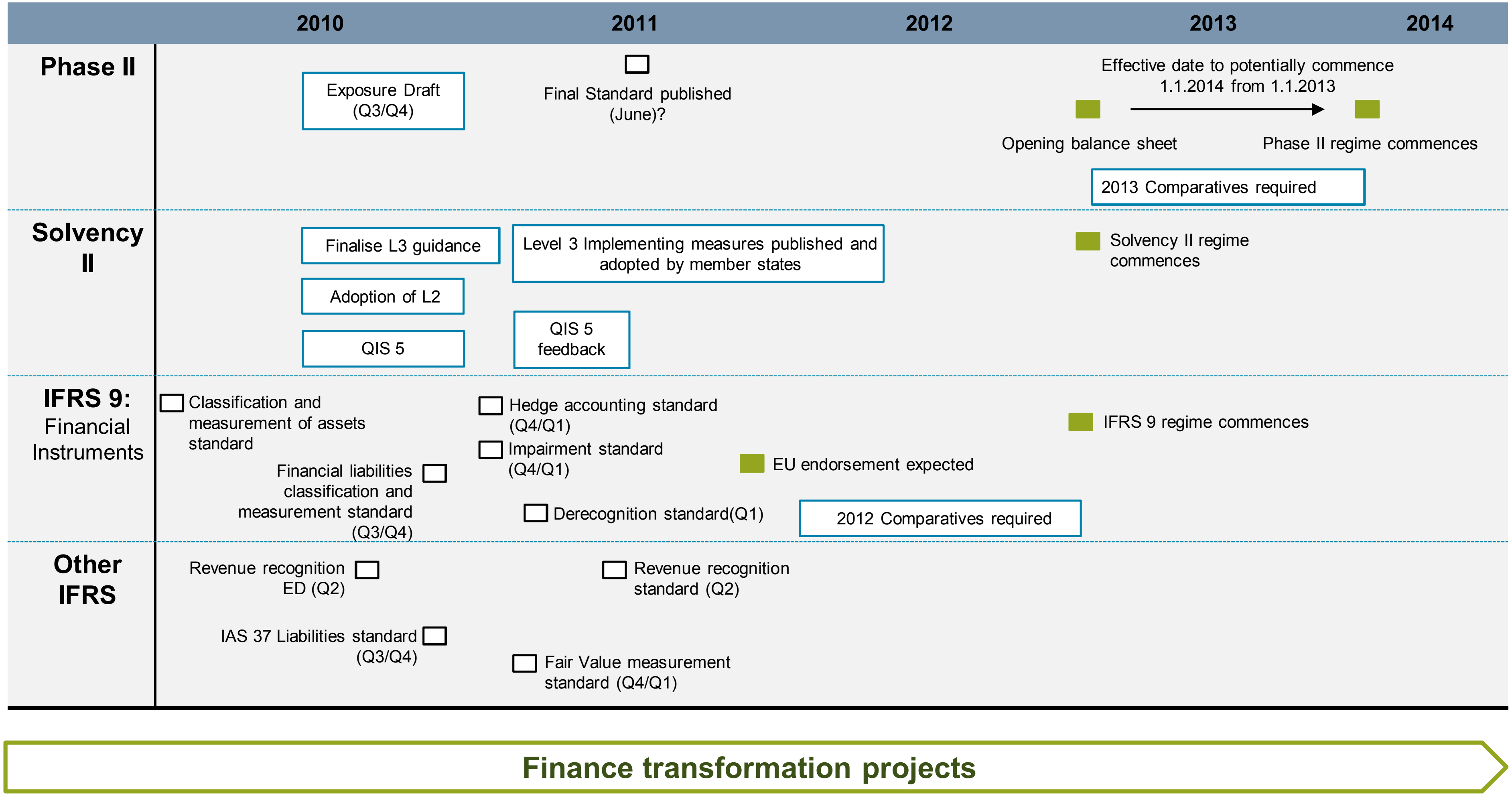
Solvency II QIS5 has used a risk free rate based on Swaps - 10bps, with a prescribed liquidity premium. For Phase II the liquidity premium will be justified relative to the characteristics of the liabilities. Whilst the relative positions are still under debate it is likely the final positions will differ.

Overlaps between Solvency II and IFRS



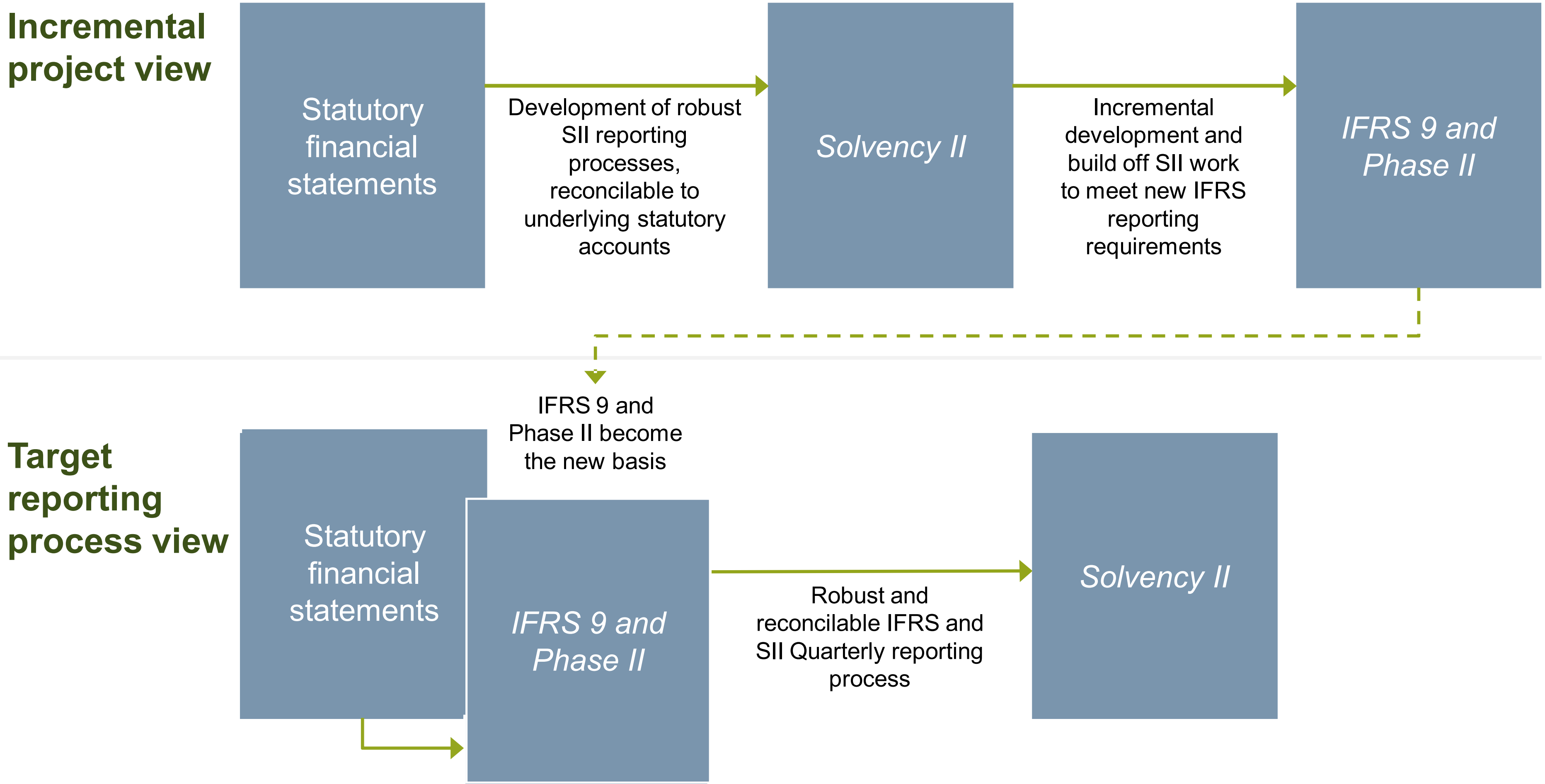
Implementing the changes

Insurers face multiple other challenges
Significant overlaps in timetables



The incremental challenge

Moving to SII and then to IFRS 4 Phase 2



Managing synergies and interdependencies

Indicative program structures

Portfolio and program management
(Steerage and inter-dependency management)

Change management
(Organisational preparation and resource management)

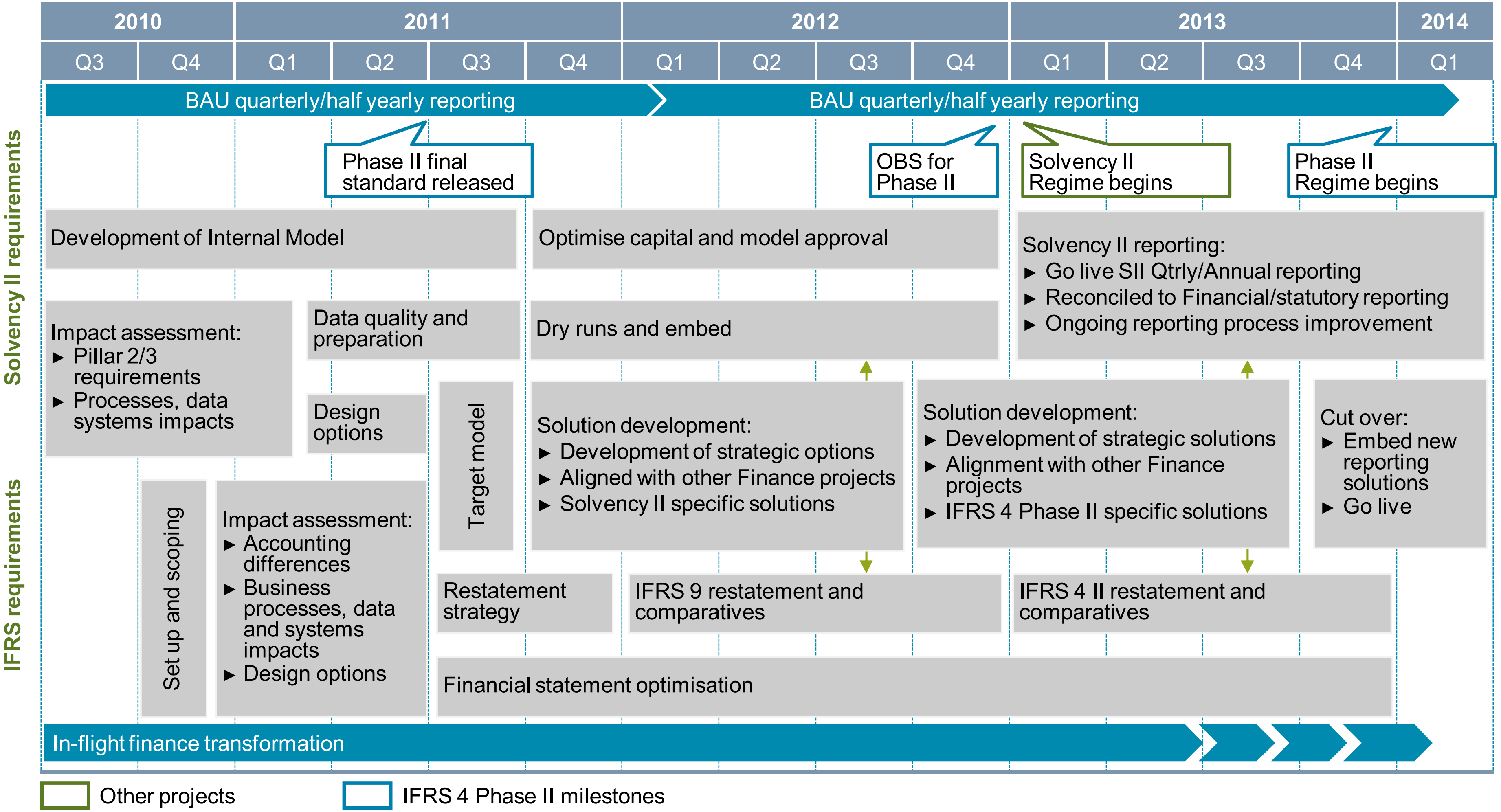
Solvency II	IFRS 4 Phase II	Transformation projects
Project management	Project management	Project management
Define business requirements	Define business requirements	Define business requirements
Data and systems interface	Data and systems interface	Data and systems interface

Data and systems
(Systems architecture and IT implementation)

Financial controls framework
(Standards and documentation)

Indicative integrated roadmap

Leveraging synergies and inter-dependencies



Questions or comments?

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Thank you

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