

Financial Reporting – Business Implications of IFRS Phase 2

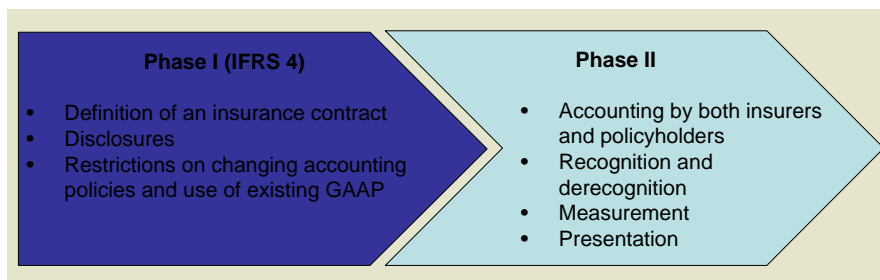
Mike Brien & Shreyas Shah
3 October 2007

Agenda

- Overview of Phase II
- Discussion of Key Points
 - Risk and service margins
 - Discounting
 - Profit emergence and issues
 - Guaranteed insurability
 - Reinsurance

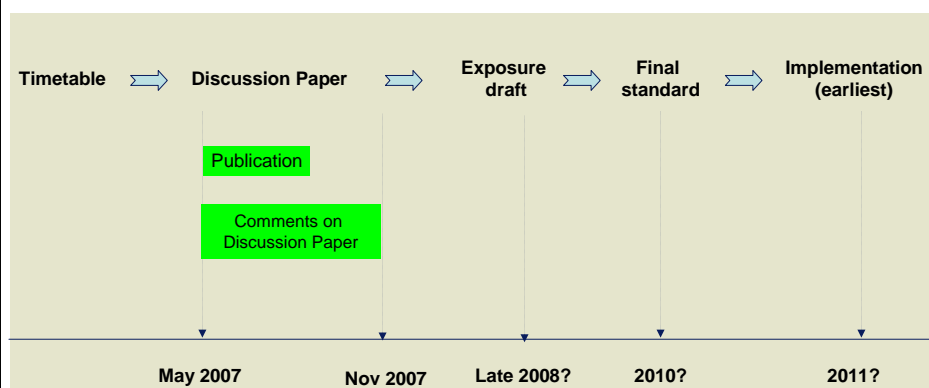
Objectives of IFRS Insurance Contracts

- To develop an IFRS on accounting for insurance contracts
- The purpose is to provide useful and cost-effective information that will help users to make economic decisions.
- IFRS4 was issued as a temporary measure in 2004 and will continue until the phase II standard emerges (DP)



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Phase II Next steps and timeline



- FASB involvement?

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Summary of Issues in the DP

Measurement Issues

- Measurement – 3 building blocks
- Unit of account
- Reinsurance
- Definition of insurance contracts
- Policyholder behaviour, customer relationships and acquisition costs
- Credit characteristics of insurance liabilities

IFRS Insurance Phase II

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Core Measurement Issues – 3 key features

A single measurement model

For life and non-life insurance and reinsurance

For pre claim and post claim stages of an insurance contract

Prospective valuation

Valuation of insurance contract

=

Probability Weighted present value of all currently expected future cashflows

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

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

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

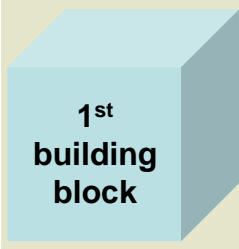
Current exit value is built up from 3 Building Blocks.

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Core Measurement Issues – Overview

- Prospective valuation – no lock in of assumptions - based on current estimates of future cash flows.
- Discounting is not widely used in the UK for non-life companies.
- Current exit value is based on a theoretical transaction with a market participant.
- Significant change to the way liabilities are valued and is likely to increase the costs of reporting.

Core Measurement Issues (continued) Cash Flows



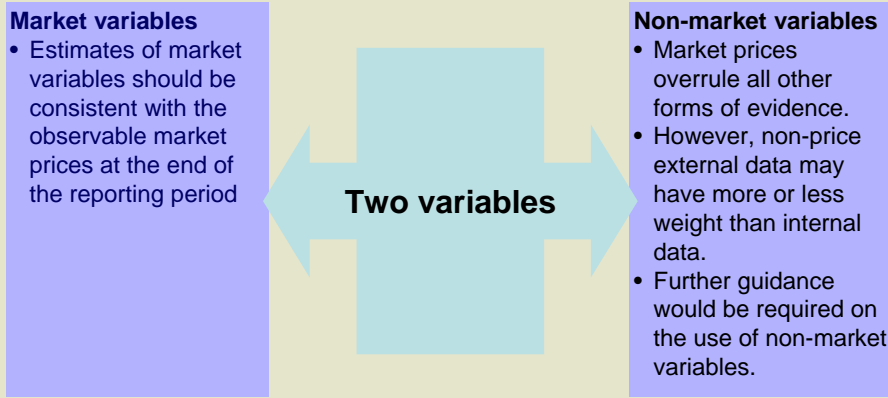
Explicit, unbiased, market-consistent, probability weighted and current estimates of the contractual cash flows.

An insurer should develop estimates of cash flows that:

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

Core Measurement Issues Cash Flows (continued)

Consistency with current market prices:



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Core Measurement Issues Cash Flows

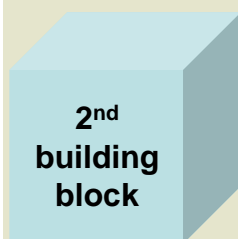
Entity-specific cash flows:

- Measurement should exclude entity-specific cash flows, i.e. cash flows that are specific to the insurer and would not arise for other market participants holding an obligation that is identical in all respects.
- There is a distinction between entity-specific issues and portfolio-specific issues.
- The fact that they are portfolio-specific does not make them entity-specific.
- The approach to claims handling is portfolio specific.
- Efficiency in claims handling is entity specific.
- Entity specific cash flows are expensed as they arise – they are not included in liability measurement.

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Core Measurement Issues

Discounting



The time value of money is taken into account by explicitly discounting all liability cash flows - life and non life (subject to materiality for very short term cash flows)

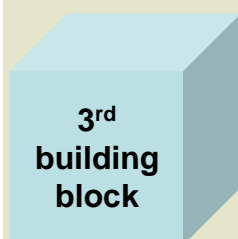
The discount rate should

- NOT be influenced by the assets held to match the liabilities (unless there is a contractual link with the assets)
- Be consistent with observable market rates for cash flows that match the characteristics of the expected cash flows i.e. timing, currency and liquidity;
- Be a risk free discount rate – It should not reflect the risk inherent in the cash flows (this is included in the risk margin)
- Debate on whether a single discount rate or a yield curve would be most appropriate
- IASB does not intend to issue detailed guidance on the selection of the discount rate.

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Core Measurement Issues

Risk and service margins



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

The risk margin should

- should reflect the **market rate** for bearing risk;
- cannot be observed in the absence of a market
- must be estimated at inception and subsequently by using market data and internal information
- is not a shock absorber.
- should be updated at each reporting date.
- should be explicit and unbiased;
- IASB does not intend to issue detailed guidance on the selection of the discount rate.

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Core Measurement Issues

Risk and service margins

Risk margin

– explicit and unbiased estimate of the margin that market participants require for bearing risk

- Characteristics:
 - The less that is known about the current estimate and its trend, the higher the risk margin should be;
 - Risks with low frequency and high severity will have higher risk margins than risks with high frequency and low severity;
 - For similar risks, long duration contracts will have higher risk margins than those of shorter duration;
 - Risks with a wide probability distributions will have higher risk margins than those with a narrower distribution;
 - To the extent that emerging experience reduces uncertainty, risk margins will decrease and vice versa.

Core Measurement Issues

Risk and service margins

Risk margin (continued)

- Approaches to determining risk margins:
 - Explicit confidence level / Quantile approach (e.g. 75 % probability of sufficiency or minimum confidence level).
 - Cost of capital approach – the margin would be calculated using the following inputs:
 - Amount of capital needed to give policyholders comfort that valid claims will be paid and to comply with regulatory capital requirements.
 - Length of time that the capital needs to be held.
 - Calculated at portfolio level (broadly similar risks managed together)
 - Diversification between portfolios not taken into account
- Approaches not meeting criteria proposed
 - Use of conservative assumptions ('sufficiency', 'provision for risk of adverse deviations', 'prudence').

Core Measurement Issues

Risk and service margins

Risk margin (continued)

Two alternatives for calibrating the risk margin

- A. Premium less acquisition costs = risk margin (subject to a LAT)
 - **No** profit at inception but LAT could identify a loss
 - Need to define acquisition costs
 - Risk margin amortised/increased as quantity of risk expires/increases but **no** remeasurement of risk price as locked at inception price
- B. Risk margin not calibrated to premium less acquisition costs
 - Can have profit at inception (subject to evidence to support risk margin)
 - No need to define acquisition costs as all costs expensed
 - Risk margin amortised/increased as quantity of risk expires/increases but with remeasurement of risk price

Core Measurement Issues

Risk and service margins

Service margin

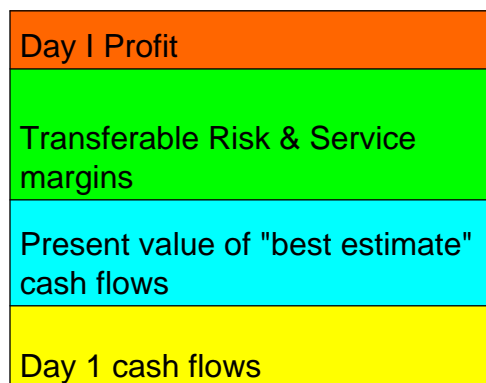
- Many insurance contracts require an insurer to provide other services (e.g. investment management services on unit linked contracts). If so the current exit value will need to include a service margin to reflect the price a market participant would require for delivering that service.
- In practice any such margin is likely to be estimated using the insurers own costs unless clear indication that they differ from the market norm.
- Insurers expect a profit. The risk margin will contain an element of profit but it is not clear how any additional profit is to be treated in the CEV model.
 - Is it released on day 1 or as the risk margin expires OR
 - Is there expected to be an profit margin included within the service margin (in addition to any profit required for other services)

Core Measurement Issues

Day 1 Profit

- IASB is proposing that it should be possible to recognise a net gain at inception of the insurance contract but there is a big debate on this Day One profit recognition.
- One input to be used in measuring an insurance liability is a margin. The margin does not need to be calibrated to the observed price for the transaction with the policyholder. Board concluded “useful as a reasonableness check on the initial insurance liability, should not over-ride an unbiased estimate....”
- Day One profit recognition for insurance contracts will be inconsistent with IAS 18. Profit would be recognised without any service being delivered.
- CFO Forum proposes use of exit value but not recognition of Day One profits – a separate margin should be recognised as a liability.

The Premium



Core Measurement Issues (continued)

Unearned premium

- The DP acknowledges that for short term duration non life contracts unearned premium approaches (with unearned premium calculated net of acquisition costs) may give a reasonable approximation to CEV where
 - Circumstances have not changed significantly since inception and
 - the contracts are not significantly profitable or unprofitable.

Core Measurement Issues (continued)

Credit characteristics

- Current exit value should reflect the liability's credit characteristics and an insurer should disclose the effect that the credit characteristics have on its initial measurements and subsequent changes in their effect.
- The main argument that current exit value should reflect the credit characteristics is that there is no reason to treat insurance liabilities different from a debt issued for cash.
- If we are using the current exit value which is similar to a fair value model, the CEV should reflect the credit characteristics.
- This is a contentious issue because when the insurer's credit ratings decline, the value of its liabilities would decrease.

Other Issues (continued)

Reinsurance assets

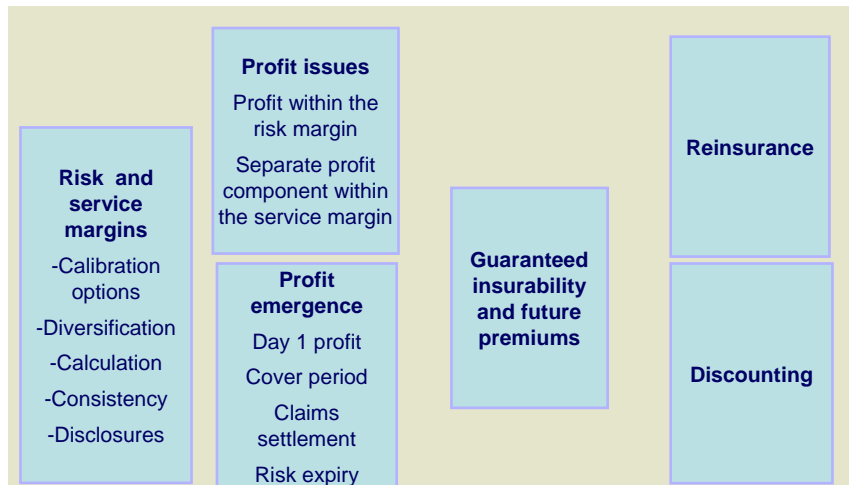
- Use of current exit value based on share of the gross liability
- Note the practical issues for non proportional reinsurance of allocating the components of CEV (especially risk margin)
- Incorporates a reduction for the expected (probability weighted) present value of losses from defaults or disputes, with a further reduction for the margin that market participants would require for bearing the risk that defaults or disputes exceed the expected value.
- This differs from the current incurred loss model for recognising reinsurance asset impairment.
- The DP does not address issues arising from the purchase of non-coterminous X/L reinsurance or X/L protection purchased that will protect business not written at the balance sheet date.

Other Issues (continued)

Policyholder behaviour and customer relationships

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

Discussion points



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Risk and Service Margins

- What is it for?
- Calibration to price?
- Methods
 - Cost of capital
 - Percentiles
- Amortisation / Reassessment
- Diversification benefit
- Sign-off / Auditability

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Day One Profit / Loss

- Niche market
- Loss leader
- Market cycle

Day 1 Profit

Transferable Risk &
Service margins

Present value of "best
estimate" cash flows

Day 1 cash flows

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Profit Emergence

- Cover and settlement period
- Risk margin run-off (Unwind/Pricing)
- Service margin run-off (Unwind/Pricing)
- Expected cash-flows variance
- Discounting variance
 - Unwind
 - Rate change

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Discounting

- Spot rates or single rate?
- View from the US
- Case reserves: full allowance for inflation / exclude implicit discounting?
- Cash-flow / settlement pattern
- Prudence

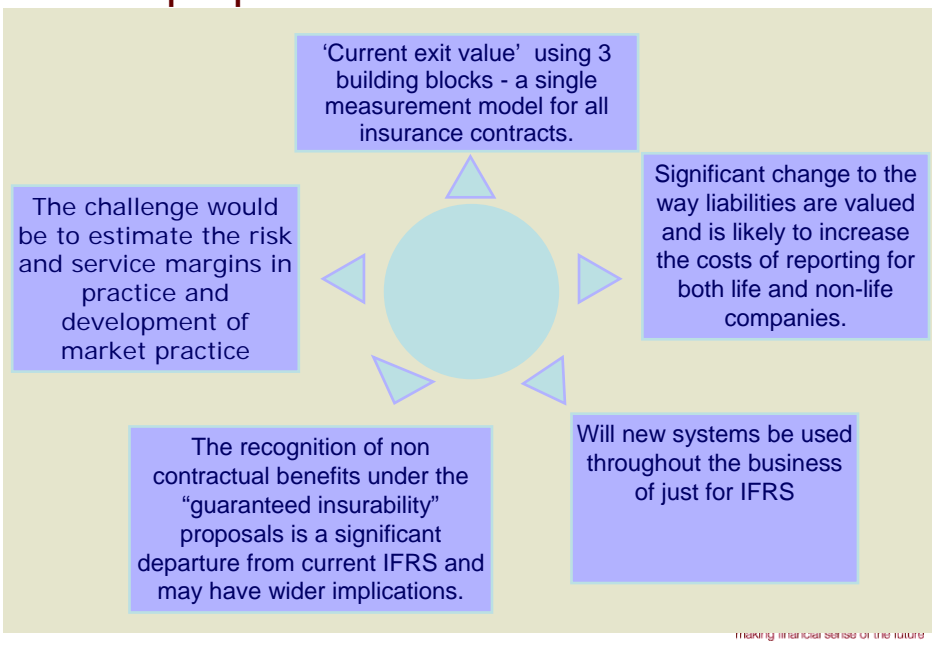
Guaranteed insurability

- Current proposal
- Existing contracts – no re-underwriting & constrained price
- New business
- Annual cancellation: changing terms & conditions
- Fixed price / Discounted price

Reinsurance

- Non-proportional – individual risk XOL
- “Losses occurring during” cover provisioning

9. Wrap up



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