The Actuarial Profession
making financial sense of the future

Life conference and exhibition 2010
Members of the IFRS working party, plus guest Sandra Hack of IASB

Insurance accounting

Phase II and implications

8 November 2010

Agenda and speakers for life convention IFRS Hot Topics session, Monday 8 November

Agenda	Slot 1 3.30 – 4.30 pm	Slot 2 4.40 – 5.40 pm
Chairman's introduction	Steve Corfield	Kamran Foroughi
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Preliminary views in advance of Staple Inn sessional meeting, Monday 11 April 2011

International Financial Reporting Standards

Exposure Draft
Insurance Contracts

Sandra Hack
Assistant Technical Manager

The views expressed in this presentation are those of the presenter, not necessarily those of the IASB or IFRS Foundation

IFRS

Please note

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Expressions of individual views by members of the IASB and its staff are encouraged. The views expressed in this presentation are those of the presenter. Official positions of the IASB on accounting matters are determined only after extensive due process and deliberation.

IFRS

Project basics

Project history

- IFRS 4 *Insurance Contracts*
  - – started in 1997
  - – standard issued in 2004 ('Phase I')
    - – aimed at making only limited improvements
- Discussion Paper *Preliminary Views on Insurance Contracts* ('Phase II')
  - – issued in 2007
  - – further discussed since early 2008
  - – 162 comment letters received

Why are we doing this project? Accounting for insurance contracts TODAY

- IFRS 4 (Phase I) temporary solution
- Wide variety of
  - – accounting practices for different contract types and jurisdictions
  - – measurement models

→lack of comparability and transparency

→current insurance accounting does not provide users with relevant information

Insurance accounting TODAY is a black box

What did respondents tell us about the Discussion Paper?

- Measurement model: current exit value ☒ ED
  - Typically no transfer, but fulfilment
- Non-performance risk ☒ ED
  - Should not be reflected
- Building block approach to measurement ☑ ED
  - Supported, but some concerns

What did respondents tell us about the Discussion Paper? continued

- Current estimates based on observable market prices for interest rates and equity prices ☑ ED
  - Generally supported
  - Market consistent where available, if not, entity's own inputs
- Explicit risk margin ☑ ED
  - Generally supported
  - For comparability reasons, limited number of techniques

Measurement model

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- Current measurement of an insurance contract
  - remeasured each reporting period
  - not locked-in
  - not updated for own credit risk
- Reflect insurer's perspective of the contract
- Building block approach
  - Four (or three) building blocks
- No deposit floor

IFRS

Measurement model continued

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- Building blocks
  - Expected (probability-weighted) future incremental cash flows (that arise from the contract)
  - Time value of money
  - Risk adjustment

Cash flows	Discounting	Risk adjustment	Margin

- No day one gains: residual margin
- Day one losses recognised in profit or loss

IFRS

Measurement model continued

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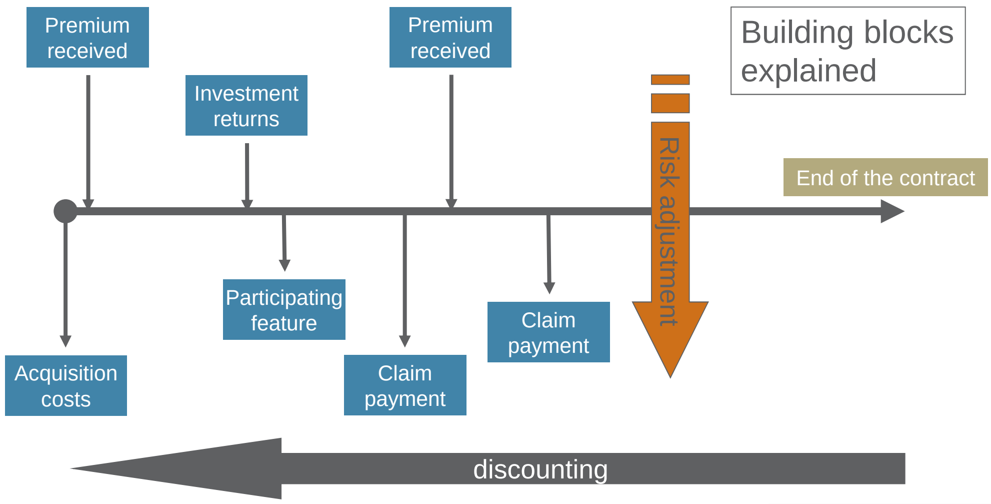

What are the next steps?

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- ED published: 30th July 2010
- FASB issued a Discussion Paper: 17th September 2010
- Outreach: Working Group, field tests, roundtables
- Comment period ends: 30th November 2010
- Final standard by mid-2011

How can you get involved?

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Staying up to date

- www.ifrs.org
- go.ifrs.org/ insurance_contracts
- IASB Update
- Board meeting webcasts
- Project webcasts and podcasts

Contacts

- Andrea Pryde
  Senior Technical Manager
  apryde@ifrs.org
- Sandra Hack
  Assistant Technical Manager
  shack@ifrs.org

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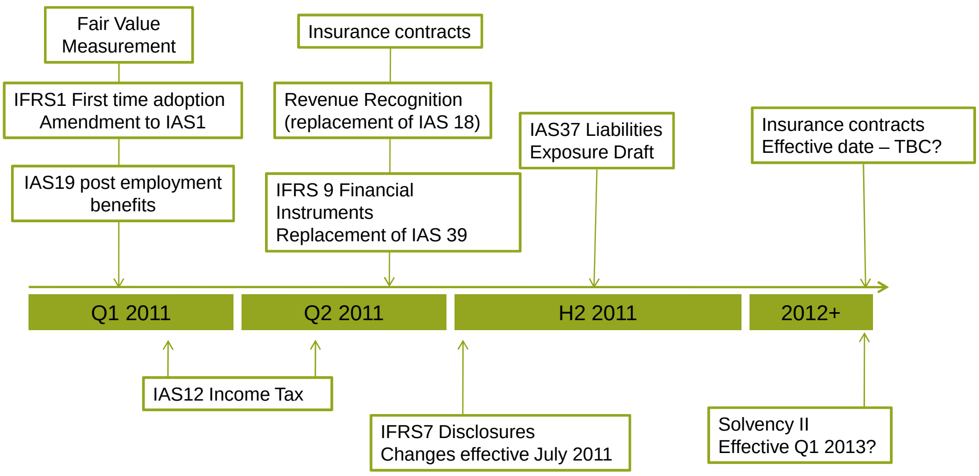
Overview

We welcome many aspects of the Exposure Draft 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.
- Margins will be explicitly shown.
- Current estimates based on observable market prices.
- Entity specific assumptions for non-market variables.
- Current accounting mismatches will be reduced.

Timeline



Impact of the different timelines?

Unbundling

- Unbundling required where components are not *"closely related"* to the insurance coverage. Three specific examples provided.
- Unbundled components measured under relevant IFRS standard. Other cash flows remain under the insurance contracts standard.

Working Party observations

- No definition of closely related – Open to interpretation? Three cases only versus exhaustive search?
- Scope could have a significant impact on the measurement model – e.g. amortised cost?
- Good and services – Are investment management services required to be unbundled?
- Practical system and data issues – e.g. allocating cash flows to components?
- No equivalent concept under Solvency II.

Residual margin

- Margin to eliminate gain at inception
- Cannot be negative => loss recognised immediately
- Estimated at cohort level of portfolio of insurance contracts, i.e. : same inception date and similar coverage period
- Calculated at initial recognition and earned over coverage period (no re-measurement)

Working Party observations

- Unit of measurement => impact on model and data requirements
- Locking-in => Introduces volatility?
- Amortisation patterns will need road testing
- No Solvency II equivalent

Expense cash flows

Include in the cash flows only those that are incremental within the contract boundary at the following levels:

Portfolio level:

Claims handling costs

Policy and maintenance costs

Contract level:

Acquisition costs

Excluded:

General Overheads

Non incremental acquisition costs

Working Party observations

- Excluded costs expensed as incurred => part of new business strain and ongoing profit or loss
- Impact on different distribution models from definition of acquisition costs
- Data available for allocation to different portfolios / successfully sold?

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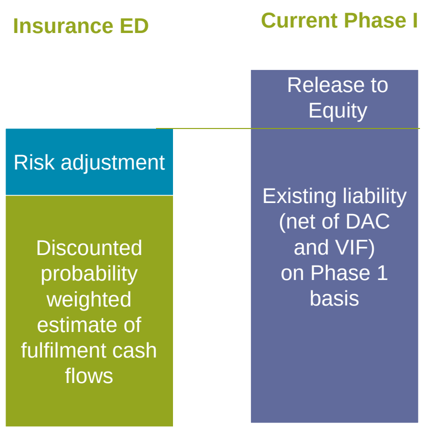
Transitional arrangements



- Effective date to be confirmed.
- Early adoption permitted with disclosure?

Working Party observations

- Loss of historic profits on existing business
- Restatement challenges, if a residual margin was permitted – which is by no means clear !
- Interaction with Solvency II and other IFRS timeline

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Participating business

- Participating contracts are within the scope of the insurance standard if they transfer significant insurance risk or are investment contracts, but meet the "pooling" requirement.
- Para 32: *"… the measurement …. shall reflect that dependence (cash flows depending on asset performance). In some circumstances, the most appropriate way … might be to use a replicating portfolio technique"*
- Para B61(j): *"… payments to current or future policyholders as a result of a contractual participation feature … "*

Working Party observations

- Dividing line for "pooling" requirement?
- Treatment of participating contracts outside the insurance contract standards?
- Reflecting the asset dependence?
- Treatment of the "estate" - Allocation between liability and equity?
- Impact of different contract boundary and residual margin amortisation?

Other Working Party observations

Topic	Working party observations
Discount rate	• No prescription and no grandfathering arrangements unlike QIS 5.
Risk adjustment	• Three permissible methods with a confidence level disclosure. • Cost of capital approach potentially different to Solvency II?
Short duration contracts (Premium allocation approach for pre-claims liabilities)	• Required, rather than permitted for contracts meeting the two conditions. Appears to include certain contracts written by life insurers such as renewable term and group life contracts. • How much of a simplification is the approach? • No equivalent requirements under Solvency II
Disclosures	• Implementation challenges with extensive requirements • Likely to be significantly different to current disclosures
Volatility from current measurement approach	• Methods to reduce volatility - Cost option, recalibration of residual margin, use of OCI?

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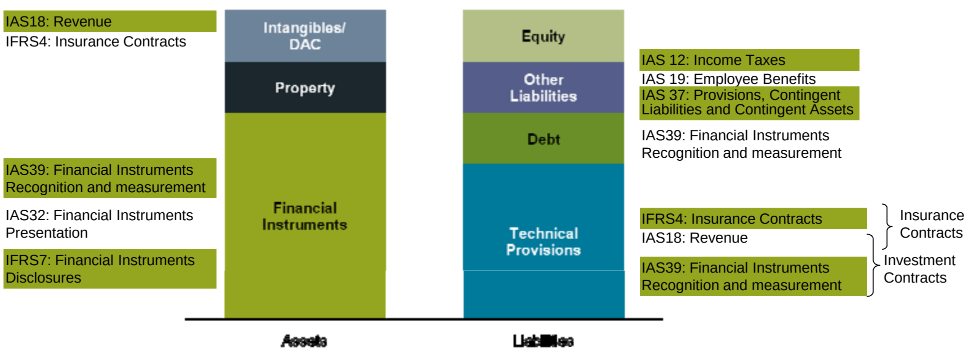
Forthcoming accounting changes impact most parts of the balance sheet

Schematic of the existing standards in the process of being revised, or recently revised:

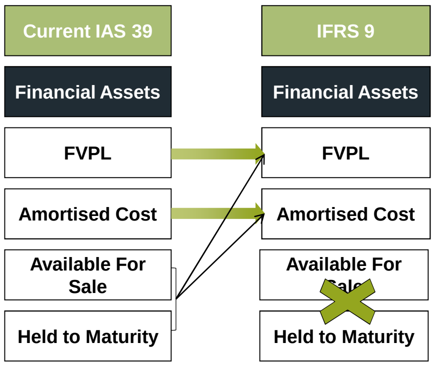


- In addition, changes are being made, or planned, in other more general areas, which will impact insurers either directly or through knock-on effects on the drafting of insurance-related standards, e.g.
  - Fair value measurement framework
  - Disclosures, in particular to the Statement of Comprehensive Income

IFRS 9: Financial instruments

Classification and measurement - Assets

- Financial assets classified as either Fair Value through Profit or Loss (FVPL) or Amortised Cost



Other Future Changes within IFRS 9

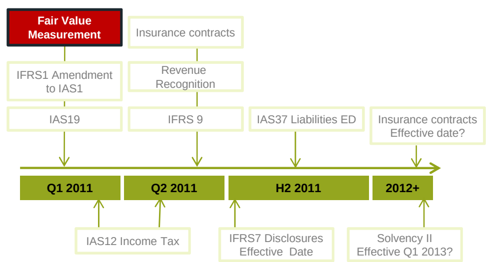
- Changes to the fair value option for financial liabilities
  - Own credit risk continues to be required in the valuation
- Impairment: uses an expected loss rather than incurred loss model
  - Likely to result in earlier recognition of credit losses
- Changes to the hedge accounting rules: Exposure draft due Q4 2010

Other Recent Potential Changes

Fair value measurement developments

- Core principle:

  *"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"*
- Includes guidance on what constitutes a disorderly market and how to apply fair value
- "Orderly transaction" principle is inconsistent with the Insurance contracts ED requirement to always calibrate to market prices
- Solvency II QIS 5 economic calibration does not seem to have considered these developments
- Requirement for assets backing insurance liabilities to be valued at bid continues – creating a non-level playing field with other industries

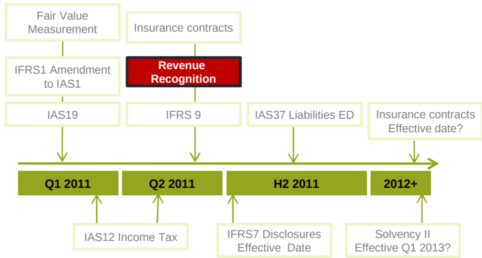


Source: August 2010 Staff Draft Fair Value Measurement IFRS; same as May 2009 ED

Other Recent Potential Changes

Revenue Recognition Project

- Exposure Draft : “Revenue from Contracts with Customers” published in June 2010
- Contract acquisition costs would be expensed as incurred
- No DAC asset would be allowable
- Inconsistent with the Insurance Contracts ED which effectively defers incremental acquisition costs
- Significant change in earnings profiles for liabilities classified as “investment contracts”



Source: August 2010 Staff Draft Fair Value Measurement IFRS; same as May 2009 ED

Comparison with MCEV and Solvency II

	IFRS Phase II	MCEV	Solvency II (QIS 5)
Asset Valuation	Amortised cost or fair value	Fair value	Fair value
Scope of liabilities	All insurance + Investment with DPF	Covered business	All
Contract boundary	Repricing, contract level	Expected premiums	Repricing, portfolio level
Market-consistent financial assumptions driving best-estimate liability	Yes	Yes	Yes
Liquidity premium included	Yes	Yes	Yes
Risk adjustment / Margin	Exit value from insurer's perspective (3 possible calibration approaches)	Residual non-hedgeable risk & optional charge for uncertainty	Exit value from third-party perspective (cost of capital approach required)
Residual margin	Yes	No	No
Reflect best estimate policyholder benefits	Yes	Yes	Yes
Overhead expenses	Excluded from liability measurement	Included to extent allocated to in–force business	Included in liability measurement
Diversification between portfolios	No	Yes	Yes
Valuation of own debt	Amortised cost or fair value	Fair Value	Entry value with updated risk-free rate
Discounting permitted of tax/liabilities	No	Yes	No
Frictional cost on total required capital	No	Yes	No

Future Role of Supplementary Reporting (1)

Insurer focus appears to be shifting towards an emphasis on IFRS earnings…

- Several companies have moved to emphasise IFRS earnings as a headline metric in disclosures compared with EEV earnings
  - In addition a number of companies have developed IFRS supplementaries, making it clearer where earnings arise
- Recently (last 2-3 years), investors have increased focus on amount and timing of cash flows
  - In response supplementary EVs often include a number of wider metrics based on distributable earnings

    e.g. In-force expected capital generation, new business strain and earnings patterns, IRRs, payback period
- IFRS earnings profiles based on the exposure draft will be significantly different from those based on the current IFRS 4
  - Will the focus on IFRS earnings survive the shift to Phase II, and if so, how will changes be communicated?

Future Role of Supplementary Reporting (2)

- There are many areas where existing Phase II or Solvency II proposals will not produce a realistic measure of shareholder value
  - Phase II is much more transparent than Solvency II in this respect
- Companies face a dilemma between practical constraints and regular, effective, communication of value
- Purer EV/MCEV-type information is still highly sought in M&As, IPOs, new business pricing and risk management
- MCEV Principles-style analysis of movement is generally welcomed by users as it contains extra information not in Phase II proposals – there is no Solvency II equivalent publication requirement
- What will be the future role of supplementary reporting?
  - Is there still a role for realistic, market consistent, supplementary reporting?
  - Is there still a role for wider reporting metrics?
  - How to analyse movement in equity?
  - How to disclose differences, or reconcile, between solvency II and IFRS (and a more realistic measure)?

Q&A / Panel discussion

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