The Actuarial Profession
making financial sense of the future

IASB Accounting Proposals and Actuarial Practice

34TH ANNUAL GIRO CONVENTION

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The Financial Reporting Group

The Profession’s Financial Reporting Group

- Is a channel for the concerns of members on financial reporting matters
- Leads the Profession’s work on financial reporting across all practice Boards
- Is preparing a UK specific response to the IASB’s Discussion Paper (“DP”)

General Insurers’ concerns are equally important as those of Life Insurers’.

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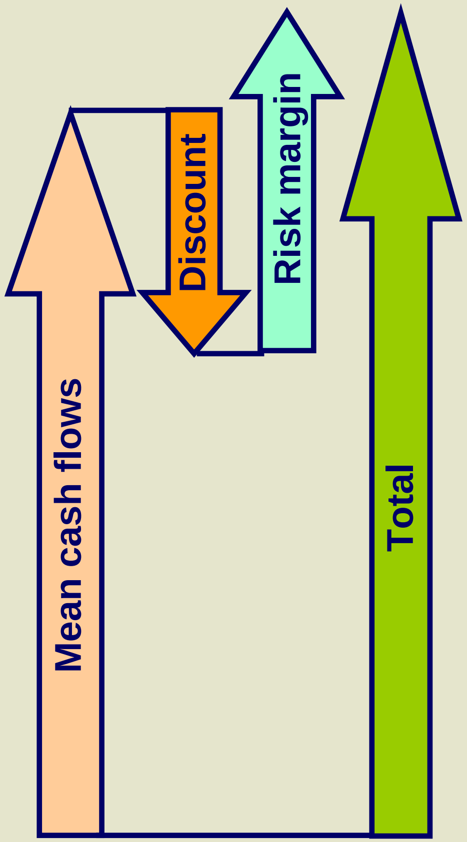
What does the DP cover?

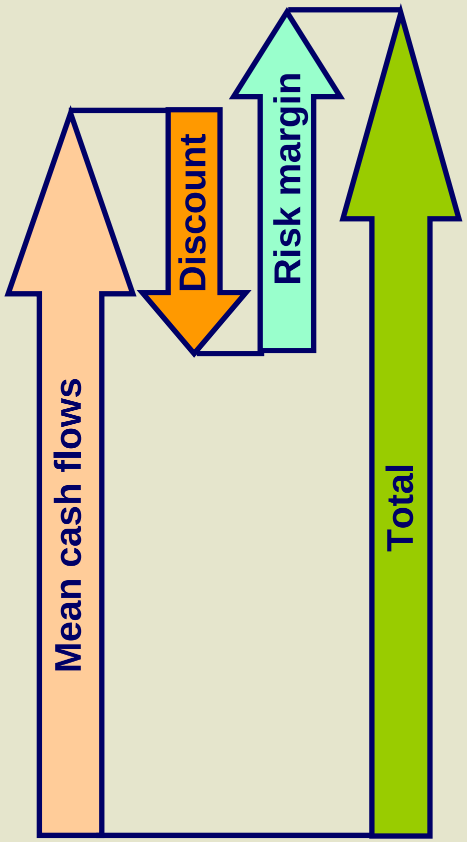
- Scope
- Recognition and derecognition of insurance contracts
- Measurement
- *Policyholder behaviour (*), customer relationships (*) and acquisition costs*
- *Policyholder participation (*)*
- Changes in insurance liabilities

(*) Primarily a Life issue

Measurement – the 3 Building blocks



Comparisons between the DP and current practice – Cash flows



Current practice → **DP**

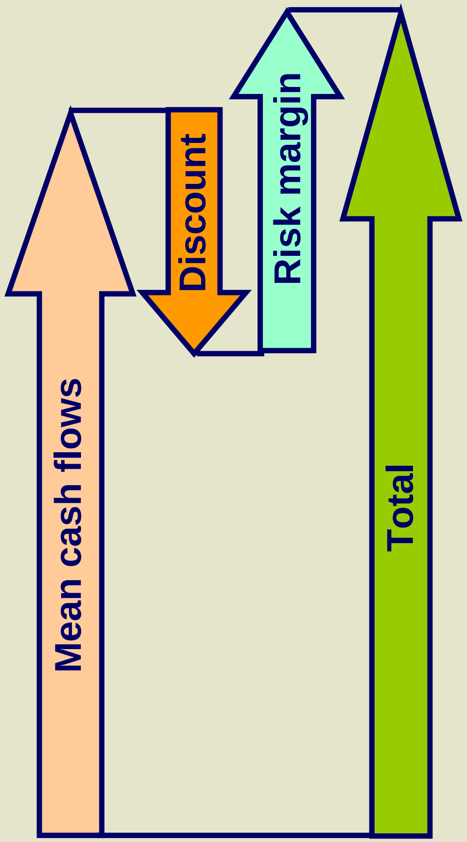
Current practice

- In practice can be no different to the mean
- Often downwards pressure on reserves from management
- Common for there to be no allowance for claims handling expenses
- Separate estimates for UPR and outstanding claims

DP

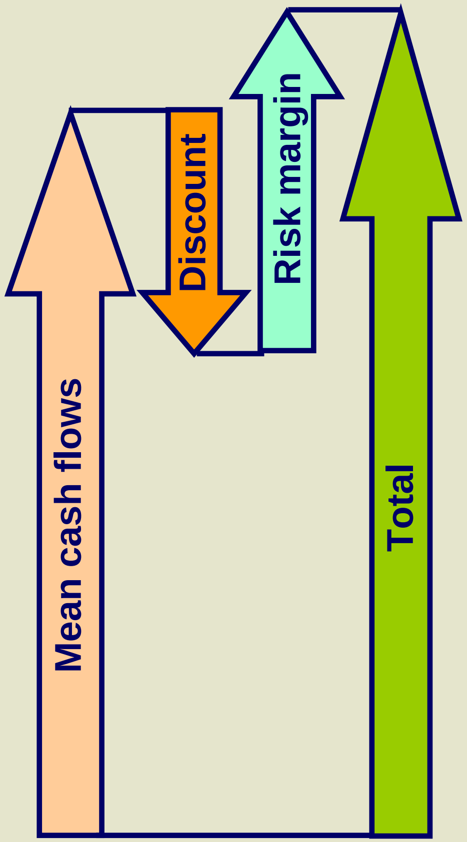
- Based on current insights of future conditions
- Must include all future cash flows, claims and run-off expenses
- No separation of estimates for UPR and outstanding claims
- Portfolio specific estimates, so no credit / loss from efficient / inefficient claim recovery operations

Comparisons between the DP and current practice – Discounting



Current practice	DP
• Discounting is commonly not applied • Permitted for “long” duration claims • Where used then the discount rate should reflect the yield from the backing assets	• Must discount • The discount rate to reflect the yields on investments of comparable “timing, currency and liquidity”

Comparisons between the DP and current practice – Risk Margin



Current practice	DP
• None	• "compensation for bearing risk" • What <u>market</u> participants require to tfr the contract to a third party (willing buyer / seller) • Not appropriate to substitute a nil discount rate

Risk margins – what do the market participants require?

We are still wondering - and how to audit it!

Setting the scene – as MD of a financially strong non-life insurer, you are responsible for looking after your shareholders' wealth…

Your insurance company

1. Financially strong: very close to AA, so not sweating the capital too hard.
2. Shareholders' funds £15 bn, quoted company, market value today £20 bn.
3. Across the group, you have a mixed portfolio of business, personal lines, commercial and reinsurance – some legacy / APH liabilities, but not a worry in the context of the group.

You have been offered the whole of a troublesome book of long tail run off business – the problems to consider are:

1. Estimating the mean, and how uncertain that estimate is.
2. Estimating the distribution, especially the adverse tails.
3. Deciding how much exposure you can take on; and what exposure this book represents.
4. Deciding what price, in terms of margin over discounted mean, you should charge. Remember this deal will absorb capital, and may put your rating at risk unless you can demonstrate it is a wise deal and likely to be profitable

THE BUSINESS– what margin above £3bn would you want?

1. Fairly nasty APH, with direct, reinsurance and retro. Only 10% of gross is now ceded
2. You are happy that as good a job as possible has been done of the reserving – you believe the discounted mean is a good estimate, but true expected mean could easily be +/- £1bn
3. You are nervous that the potential downside is not fullly understood by anyone, and you have raised all the percentile points to reflect the fact that "we don't know what the shape really is, but we know there's a human tendency to underestimate tails".

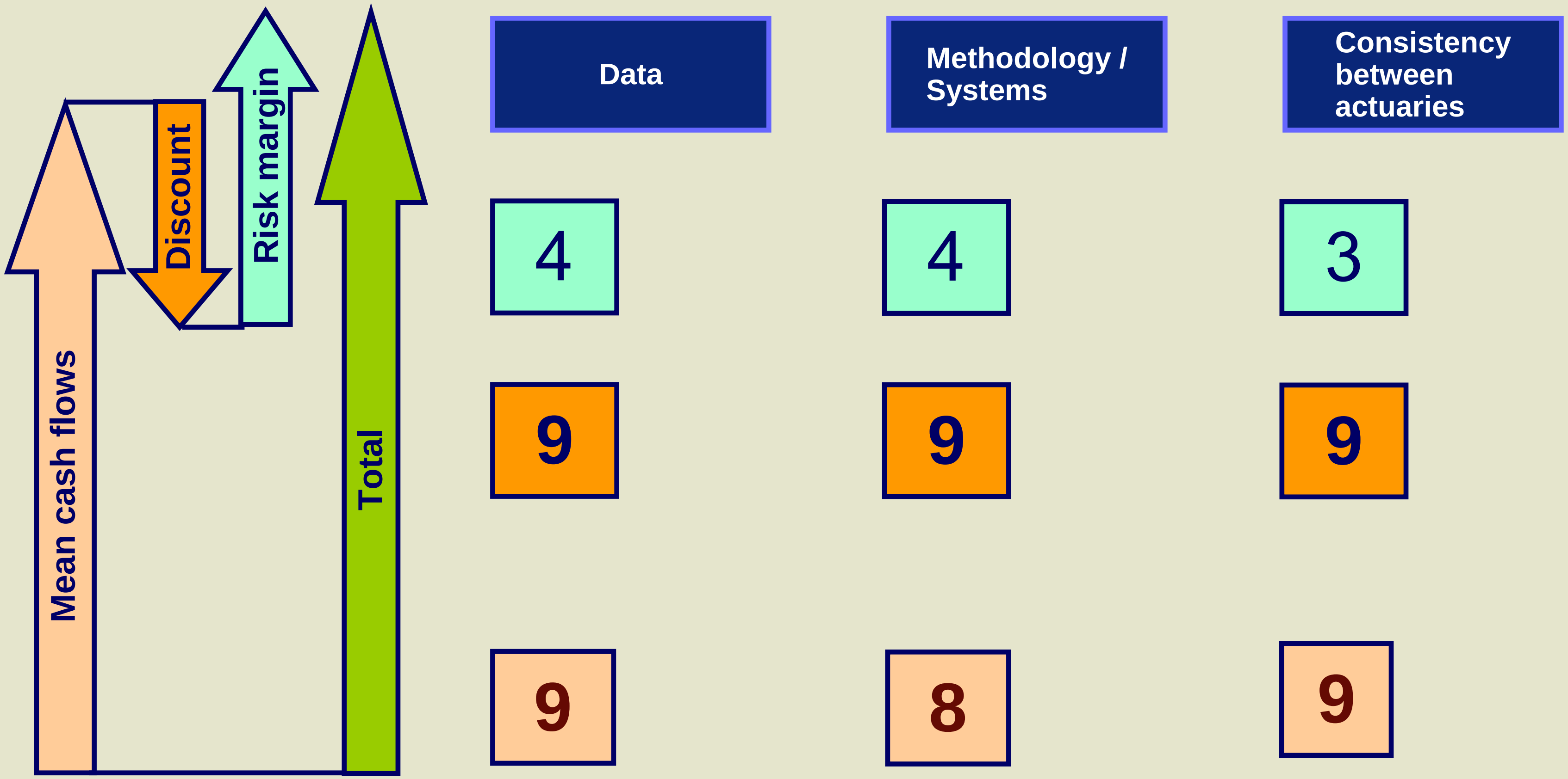
The estimated distribution of the reserve <u>outcome</u> looks like this

1. Discounted mean: £ 3bn
2. Median £2bn
3. 75% confident: £ 3.0bn (i.e. at the mean)
4. 90% confident: £ 5bn (mean + £2bn)
5. 95% confident £ 7bn (mean + £4bn
6. Expected value of outcomes >£5bn is around %9bn (mean + 6bn)
7. 99% confidence point – not sure! You can't impose a cap.

Remember what your own current position is: writing business, so not in run-off yourself, near AA rating, £15bn shareholders funds, and the market thinks you are worth £20. WHAT'S YOUR PRICE? – REMEMBER YOU ARE LOOKING AFTER YOUR SHAREHOLDERS' WEALTH!

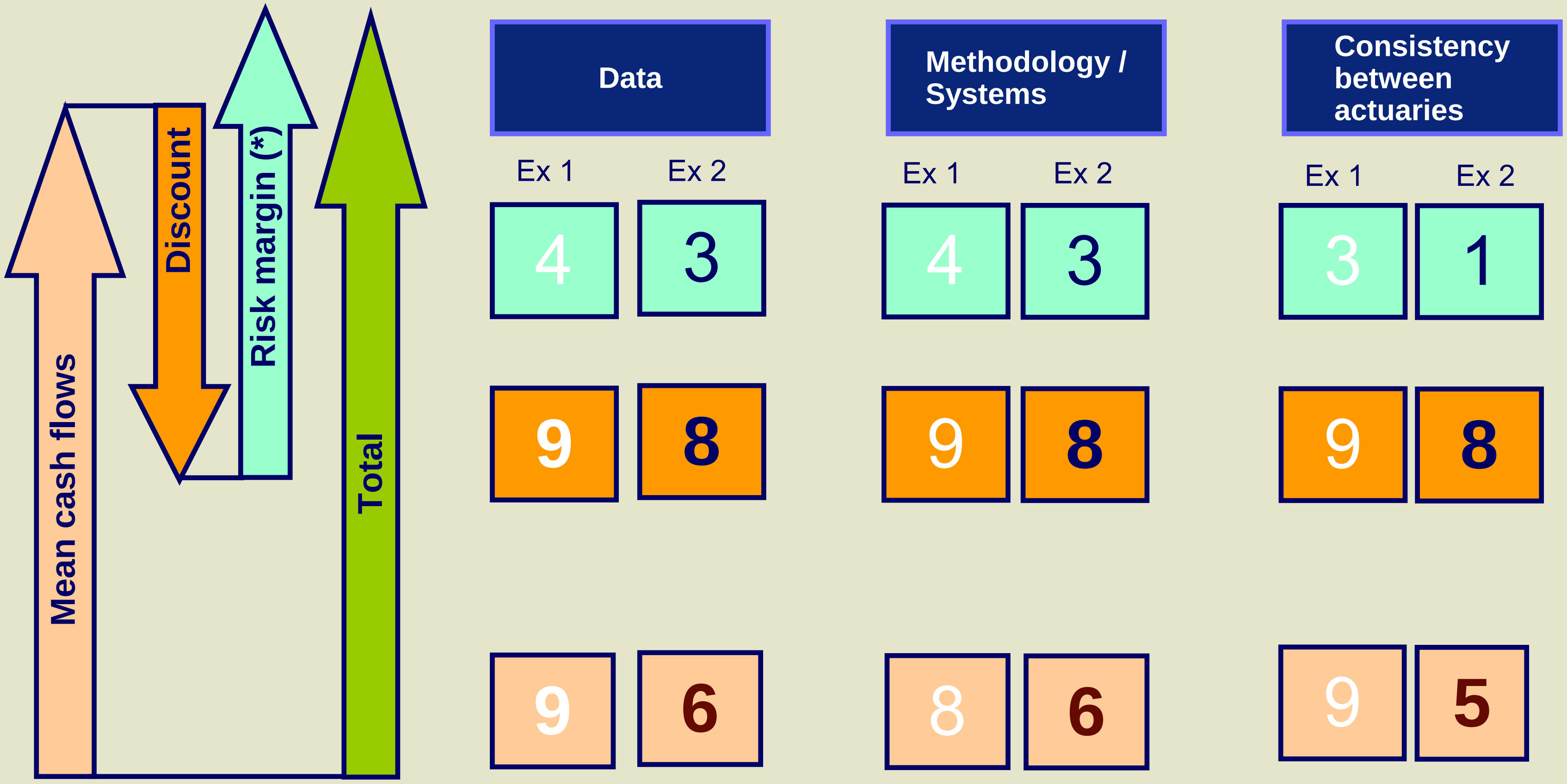
Example 1 – Household insurance

Scenario: Mature portfolio of household insurance policies



Example 2 – Less predictable business

Scenario: Mature portfolio of commercial insurance and reinsurance



Representing the Performance of insurers

Business model

Characteristics of insurance

1. Insurers accept risks from customers for a given price.
2. Insurers pool risks.
3. Insurers settle these risks over the term of the policy and any run-off.
4. The price of risk is uncertain and managed over a long time horizon.
5. Insurers act prudently to have sufficient monies to fulfil their obligations in good and bad times.

The accounting model in the DP

- ***Characteristics of the accounting model***
  - Based on the contract
  - “Insurance contracts are not dissimilar to a financial instrument in banks”
  - The measurement model is consistent with IAS 39 used for Financial Instruments i.e. a fair value.
  - Earnings is a consequence of the change in net assets between two balance sheet dates.
  - Presumptions that day 1 profits are exceptional.

What would you value from financial statements?

What do you need from financial statements & disclosures?

What would you value from financial statements?

What might the DP provide?

Movements in capital requirements

Information should be provided on the movement in capital requirements.

	£
Capital requirements at the start of the year	A
Release of requirements from existing business	(B)
Requirements from new business	C
Change in management's policy on capital requirements	D
Capital requirements at the end of the year	E

Other issues from the DP

Keep a watching brief on

- Presentation
- Own credit risk
- Reinsurance
- Service margin

Comparison with Solvency II

Solvency II	DP
• Conservative market value … to transfer the portfolio to a third party or to recapitalize …to ensure a proper run-off ?	The transfer value “willing buyer / seller” ?
• Best estimate cash flows √ • Entity specific cash flows X	• Best estimate cash flows √ • Portfolio specific cash flows X
• Discount at the risk free rate (“rfr”) √ • Prescribed definition of the rfr X	• Discount rate from investments of comparable “timing, currency and liquidity” √ • Not prescribed X
• Cost of capital X • Credit for diversification across high level product categories ?	• Not prescribed X • “not reflect the benefits of diversification between portfolios” ?