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making financial sense of the future

IFRS Phase II
Accounting for Non-life Insurance Contracts

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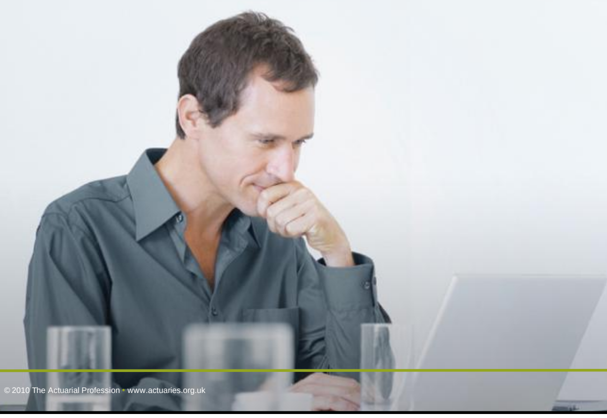

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Agenda

- **Introduction**
- **Recognition and measurement**
- **Presentation and disclosure**
- **Current status**

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Introduction

IFRS 4 – phase I
- Only intended to be an interim standard
- Permits the continuation of a wide range of previous accounting practices
- Requires specific disclosures about insurance contracts

IFRS 4 – phase II
- Single measurement approach with some moderations for non-life contracts
- Likely to require changes to the way that profits arising from insurance contracts are presented

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Definition of an insurance contract

IFRS 4 – phase II

- No change to definition of an insurance contract
- Changes to definition of significant insurance risk:

The effect of the time value of money must be taken into account when determining the significance of benefits payable on an insured event

There must be a scenario in which the present value of net cash outflows can exceed the present value of the premiums

Additional guidance for reinsurers:
If a reinsurance contract does not expose the reinsurer to a loss, the contract is nevertheless deemed to transfer significant insurance risk if substantially all of the insurance risk relating to the reinsured portions of the underlying insurance contract is assumed by the reinsurer

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Scope

SCOPE:

- Insurance and reinsurance contracts
- Not policyholder accounting – except for ceded reinsurance
- Financial instruments containing discretionary participation features

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Scope: Accounting for warranties

WARRANTIES

➢Warranties issued by an insurance company are within the scope of the phase II standard

➢Fixed fee service contracts that provide service as their primary purpose and are not priced on an assessment of the risk associated with an individual customer are excluded from the scope

➢Warranties issued directly by a manufacturer, dealer or retailer are outside the scope of the standard.

- ➢ Standard warranty – no deferral of profit but warranty cost provision recognised at inception under IAS 37
- ➢ Extended warranty – separate performance obligation under IAS 18 (or new revenue recognition standard) - revenue recognised over term of warranty and provision for claims recognised as incurred

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Recognition – current proposals

- The proposals included in the ED were thought to be problematic for reinsurers and issuers of short-duration contracts in particular.
- The Boards have re-deliberated these proposals and have made the following tentative decisions:

1 **Insurance contract assets and liabilities should be recognised when coverage begins**

2 **Recognise additional liability if management becomes aware of onerous contracts in the pre-coverage period**

How to apply an onerous contracts test in the pre-coverage period has yet to be determined

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Proposed measurement model
The four 'building blocks'

Proposed IASB model	Proposed FASB model
Unbiased **probability-weighted current estimates of future cash flows**	
Discounted using current rates to reflect the time value of money	
Risk adjustment *To adjust for the effects of uncertainty about the amount and timing of future cash flows*	**Composite margin** *To eliminate any gain at inception and released over time (not remeasured)*
Residual margin *To eliminate any gain at inception and released over time (remeasured)*	

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Short -duration contracts: modified approach

Pre-claims	Post-claims
Modified approach is **required** for contracts that meet **both** of the following definitions: ▪ The coverage period is approximately 12 months or less ▪ The contract does not contain embedded options or other derivatives that significantly affect the variability of cash flows	**Building block approach** but with no residual margin

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Modified approach
Premium allocation approach

Pre claims obligation at inception

Initial premium

Plus

Present value of future premiums in boundary of contract

Less

Acquisition costs

- Pre-claims obligation is released over the coverage period in a systematic way either:
  - on the basis of the passage of time; but
  - on the basis of the expected timing of incurred claims and benefits if this pattern differs significantly from the passage of time
- Pre-claims liability = pre-claims obligation less PV future premiums in boundary of contract
- Interest should be accreted on the carrying amount of the pre-claims liability using a current discount rate

Note: essentially this is similar to the current UPR approach except for the requirement to discount future premiums and to accrete interest on the carrying amount of the pre-claims liability

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Acquisition Costs

Definition
Acquisition costs included in fulfilment cash flows should be:

Direct costs that are related to the acquisition of a portfolio of insurance contracts* (only)

* Includes employee's benefits relating to new business activities – but not attributable overheads (eg occupancy; IT related; equipment and maintenance costs)

As a consequence of this tentative decision the definition of attributable costs will not be the same for acquisition costs as for maintenance costs (to be confirmed)

Successful and unsuccessful efforts
IASB
Costs would not be limited to costs related to successful acquisition efforts
FASB
Costs would relate only to successful acquisition efforts

The FASB position is essentially consistent with new USGAAP guidance that is effective in 2012

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Modified approach
Premium allocation approach

Onerous contracts

- Calculate the expected present value of the fulfilment cash flows using the building block approach
- Compare with the carrying amount of the pre-claim obligations
- Recognise any excess as an additional liability and expense

Foreign exchange

- Treat the pre-claims liability as a monetary item for the purposes of IAS 21: *The Effects of Changes in Foreign Exchange Rates*

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Short duration contracts: modified approach

Under discussion (or to be discussed):

- A more flexible principle for the eligibility criteria (and its interaction with contract boundary proposals)
- Whether the modified approach should be permitted but not required
- Under what circumstances should interest be accreted and future premiums discounted
- If the onerous contracts test should include a risk adjustment
- Whether incremental acquisition costs should be recognised as an asset (or expensed)

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Post claims liability
The three 'building blocks'

Proposed IASB model	Proposed FASB model
Unbiased **probability-weighted current estimates of future cash flows**	
Discounted using current rates to reflect the time value of money	
Risk adjustment *To adjust for the effects of uncertainty about the amount and timing of future cash flows*	

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Building Block 1
Which cash flows?

Incremental cash flows within boundary of a contract that are incremental at portfolio level

Post claims liability

Claims payable (notified claims + IBNR)	**+**
Claims handling costs	**+**
Other costs of servicing the contract (policy administration/maintenance)	**+**
Salvage and subrogation	**-**

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Building Block 2
Time value of money

Discount rate:

To adjust the future cash flows for the time value of money and to reflect the characteristics of the insurance contract liability

Own credit risk:

Not reflected in present value of fulfilment cash flows either at initial recognition or subsequently

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Volatility: Discount rates

Bottom-up approach

Liquidity premium

Risk-free reference rate

Top-down approach

Asset yield

Expected defaults

Market premium for unexpected defaults

Cash flow mismatches

Note: the risk composition of the reference asset portfolio should not impact the discount rates

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Building block three
Risk adjustment

- **Objective**

The compensation the insurer requires for bearing the uncertainty inherent in the cash flows that arise as the insurer fulfils the insurance contract

- **Permitted techniques**
  - No limit to the range of techniques to estimate the risk adjustment
  - The examples in the ED together with the application guidance of desirable characteristics for a technique will be retained

Confidence level | **Conditional Tail Expectation (CTE)** | **Cost of Capital (CoC)**

  - Disclose the equivalent confidence level if confidence level approach not used

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Building block three
Residual margin (general model only)

- Objective

To eliminate any gain at inception and release it over time

  - The residual margin should be unlocked (prospectively) for favourable and unfavourable changes in estimates of future cash flows
  - Experience adjustments and changes in the risk adjustment are recognised immediately in profit and loss
  - The residual margin cannot be negative
  - The residual margin should not be unlocked for changes in the risk adjustment
  - The residual margin should be allocated *over the coverage period* in a systematic basis that is consistent with the pattern of transfer of services

The IASB will consider whether to unlock the residual margin for changes in discount rate and the level of aggregation for determining the residual margin at a future meeting

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Post claims liabilities

Will post-claims liabilities carried on the balance sheet be higher or lower under IFRS phase II versus current levels?

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Direct reinsurance

A reinsurer would account for reinsurance contracts it issues using the recognition and measurement approach for insurance contracts

- Although the reinsurer and cedant both use the same ‘building block’ model to measure their rights and obligations they would not necessarily arrive at the same amounts. In particular, they might arrive at different risk adjustments
- It is not yet clear in what circumstances a reinsurer might be permitted or required to use the modified approach where it reinsures short-duration contracts
- Concerns had been expressed regarding the recognition proposals included in the ED but the Boards tentative decision to change the trigger for recognition to the beginning of the coverage period has alleviated these concerns

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Reinsurance ceded
current status

Expected cash inflows and risk adjustment

- Use same measurement for expected present value of future cash inflows and the risk adjustment as for the underlying direct insurance contracts

Deduct: Allowance for credit losses on expected value basis

At initial recognition

- If this measurement exceeds the net consideration (i.e. premiums less commission) paid by the cedant, the difference **(a liability)** is the residual margin **(i.e. deferred income)** at initial measurement
- If the net consideration paid by the cedant exceeds this measurement the difference **(an asset)** is treated as **a prepaid reinsurance premium** at initial measurement

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Transition

Exposure draft

– Building block approach but with no residual margin
– Adjustment to opening reserves at transition date

Life insurers

- Significant reduction in reported profits:
  – Release of risk adjustment only
  – No 'day one' profits on new business

Revised proposal

?

Non- life insurers

- Applying either the approach in the ED or a retrospective approach is unlikely to be a problem for the non-life sector

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Presentation: Summarised Margin Illustration

Short-duration contracts – modified approach

Statement of comprehensive income	Pre-claims	Post-claims	Other
Premium revenue *(release of pre-claims obligation plus interest)*	x		
Incurred claims *(amount initially recognised)*	(x)		
Expenses incurred *(relating to contract activity in coverage period)*	(x)		
Amortisation of incremental acquisition costs	(x) -------		
Underwriting margin on pre-claims liability	x		
Change in additional liability for onerous contracts	x		
Change in risk adjustments		x	
Gains and losses at initial recognition	x	x	
Experience adjustments and changes in estimates		x	
Unallocated overheads			(x)
Investment return on assets			x
Interest on Insurance liabilities	(x)	(x)	

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Disclosures

- Disclosure requirements in IFRS 4 and IFRS 7 are the starting point

Aggregation/disaggregation principle:
Useful information should not be obscured by either the inclusion of a large amount of insignificant details or the aggregation of items that have different characteristics

Additional disclosures include:

- A more detailed reconciliation of changes in contract balances including disclosures about changes in risk adjustments and residual margins
- Information about the effect of the regulatory frameworks in which the insurer operates (eg minimum capital requirements)
- A translation of risk adjustments into a confidence level for disclosure (if CTE and/or CoC is used)

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Disclosures: Reconciliations

- Reconciliations from the opening to the closing aggregate contract balances including:
  - Total contract liabilities (or assets) and reinsurance ceded
  - Risk adjustments (included in the above)
  - Residual margins (included in the above)
  - Impairment losses on reinsurance assets
- For short-duration contracts reconciliations should also be presented for:
  - Pre-claims liabilities
  - Additional liabilities for onerous insurance contracts
- **IFRS 4 contains a similar requirement to provide reconciliations but the requirements relate to the total amounts presented on the statement of financial position only**

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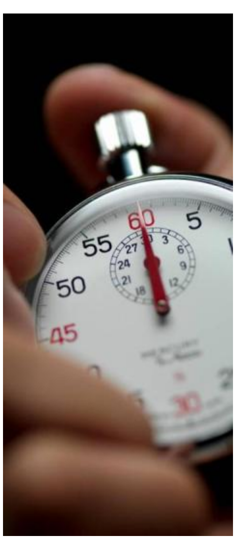
Current status



- The IASB had been working towards issuing a final standard by June 2011
- Re-exposure or review draft of the proposed standard now expected to be available during H1 2012
- Final standard to be issued? (end 2012 might not be achievable)
- Effective date? – TBC but not likely to be earlier than 1 January 2015

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Other factors that may influence timeline

FASB

- Alternative measurement model
  - 'Locked-in' single margin approach for general model
  - No margin for non-life post claims
- Acquisition costs limited to those related to successful sales
- Participating contracts measurement – contractual basis
- Disclosures – measurement uncertainty analysis
- Presentation – more prescribed information on face of primary statements?

EU endorsement

- IFRS wave 2

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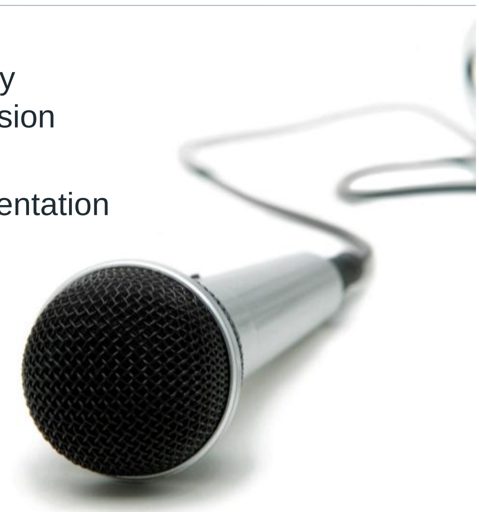
Questions or comments?

Expressions of individual views by members of The Actuarial Profession and its staff are encouraged.

The views expressed in this presentation are those of the presenter.



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