The Actuarial Profession
making financial sense of the future

Current Issues in Life Assurance
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Insurance accounting: – a new era?

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Actuarial Profession: Financial Report Group (FRG)

- Cross practice working group established in June 2011, with remit to:
  - Consider proposed changes to financial reporting standards affecting insurers
  - Support UK FR representation on the International Actuarial Association
- Membership is made up of senior industry practitioners in the area of financial reporting, with a mixture of experience in life / non-life insurance and pensions. Also includes two chartered accountants and one sell-side equity analyst.

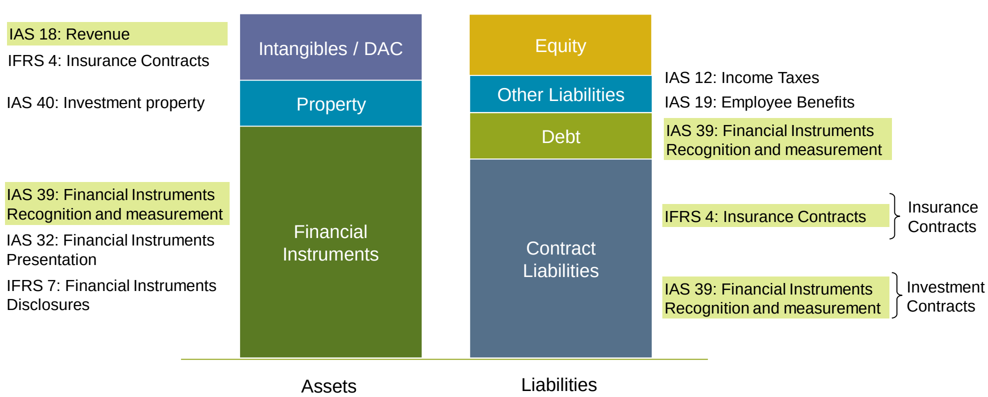
Members:

Anthony Coughlan	Gary Hibbard	Raymond Bennett
Darren Clay	Kamran Foroughi (Chair)	Richard McPherson
Derek Wright	Martin Lowes	Richard Pereira
Erica Nicholson	Martin White	Tony Silverman
Francesco Nagari	Nigel Masters	

Agenda

- Existing and proposed IFRS
- IFRS for Insurance Contracts
- Comparison with Solvency II
- Future of Financial Reporting in the UK (UK GAAP)
- Conclusion and questions

Existing IFRS



= standard undergoing major review with implications for insurers

- Other IASB standards also impact insurers, for example: IFRS 13 – Fair value measurement

Proposed IFRS – key developments

Insurance contracts standard (to replace IFRS 4)

- Ongoing IASB deliberations since H2 2010 Exposure Draft (ED)

IFRS 9: Financial instruments (to replace IAS 39)

- Classification and measurement of financial assets - Fair value (P&L or OCI) or Amortised cost
- Liability deposit floor retained; affects business classified as "investment contracts"

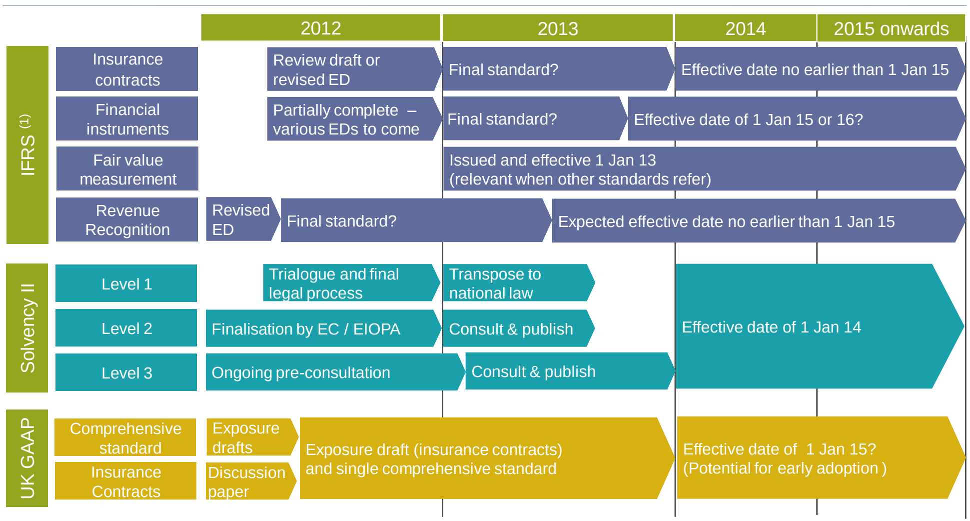
Revenue recognition standard (to replace IAS 18)

- Affects business classified as "investment contracts"
- Retains DAC incremental at contract level (change in second ED)

IFRS 13: Fair value measurement (new standard defining how to fair value)

- *" ... 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"*
- The fair value of a liability should reflect the effect of non-performance risk (i.e. own credit risk)

Timeline – as at end April 2012



(1) The effective date of all IFRS standards is subject to EU endorsement

Insurance contracts: The building block approach

Contract liability

Residual Margin
Risk Adjustment
Discounted probability weighted estimate of fulfilment cash flows

Explicit, unbiased, probability weighted average of fulfilment cash flows
- Current and entity specific assumptions for non-market variables
- No deposit floor

Allowance for time value of money
- Consistent with observable market prices for instruments with cash flows whose characteristics reflect the liability

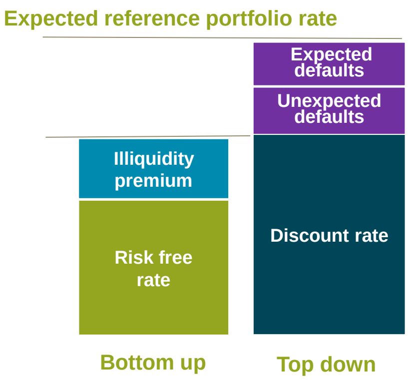
Risk adjustment
- Objective changed from ED to: "*The compensation the insurer requires for bearing the uncertainty inherent in the cash flows that arise as the insurer fulfils the contract*"
- No limitation on techniques or prescribed level of diversification

Residual margin
- Separate risk adjustment and residual margin (no composite margin)
- Set to eliminate gain at inception. Day one loss recognised immediately
- Estimated at portfolio level, earned over coverage period and unlocking permitted in certain circumstances

Insurance contracts: Cash flows

Topic	Tentative decision	Observations
Initial recognition	Start of coverage period or in pre-coverage period if onerous	• Application guidance on onerous contract test will be important
Contract boundaries	Changed from ED to: *"No longer required to provide coverage or contract does not confer any **substantive rights** to policyholder"*	• Change to ED to permit a boundary at portfolio level re-pricing in certain circumstances • IASB to consider potential unintended consequences. • Practical challenges – different to Solvency II and economic reality?
Excluded expense cash flows	Direct attributable overheads included	• Removes ED position whereby a loss would be expected to be recognised in future in respect of these costs
Acquisition costs in PV of cash flows	All direct costs incremental at portfolio level (both successful and unsuccessful)	• Change to ED where at contract level – now similar to existing IFRS • Difference to investment contracts remains

Insurance contracts: Discount rate



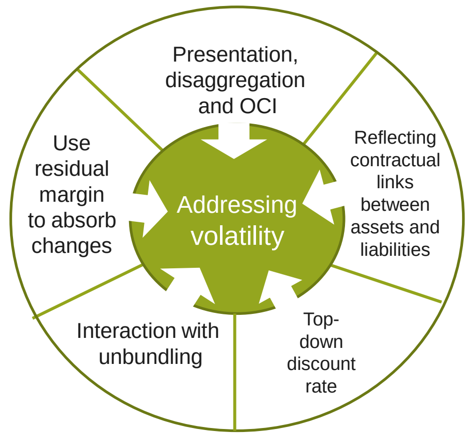
- **No single method** prescribed
- Should be consistent with observable current market prices for instruments with same characteristics as insurance liability
- Exclude own credit risk and factors not relevant to liability
- Rate is not locked in or the expected return on assets
- Clarified ED that a "top down" or "bottom up" rate is permitted
  - Do you get the same answer?
- Level of disclosure will be important for comparability

Insurance contracts: Participating contracts

Tentative IASB decisions	Observations
Participating investment contracts in scope of the insurance standard if issued by insurers	• Welcome change to ED where certain participating investment contracts would be under financial instruments standards
All expected payments to current or future policyholders treated as a liability	• How to split surplus with-profits fund assets between policyholder (current and future) and shareholders? • Impact for a mutual where the estate is the main source of capital?
Cash flows measured on the same basis as the underlying assets	• No significant change to ED for UK with-profits where assets are at fair value typically • Significant change to ED when assets at cost (in Europe), but similar to Existing IFRS
Present changes in liability in P&L consistent with assets presentation (e.g. OCI or P&L).	• In UK, additional investment volatility compared to Existing IFRS where profit is the shareholder share of cost of bonus in year? • May have tax implications?

Insurance contracts: Volatility

- Critical issue in all jurisdictions for all respondent to the ED
- Is income statement volatility a faithful representation of the underlying economic phenomena?
- Interaction with IFRS 9 is being reconsidered by IASB:
  - Certain movements in liabilities and assets presented in "Other Comprehensive Income" (OCI) on balance sheet rather than taken immediately to the P&L.
  - New approach for most UK based insurers



Proposed IFRS versus Solvency II (Our understanding as at end April 2012)

Topic	Proposed IFRS	Solvency II
Purpose and target audience	Measure equity (assets less liabilities) and performance over time	Demonstrate solvency to regulators
Measurement of financial instrument assets	Amortised cost or fair value	Fair value
Measurement of own debt liabilities	Amortised cost or fair value	Entry value with updated risk-free rate
Employee Benefits	IAS 19	Generally IAS 19
Tax assets and liabilities	IAS 12 Income Taxes	IAS 12 Income Taxes
Insurance vs. investment contracts	Distinct treatment	Same for all business
Contract boundary	Repricing – contract or portfolio level (depends)	Repricing - portfolio level? No projection of premiums for savings contracts?

Proposed IFRS versus Solvency II (cont'd) (Our understanding as at end April 2012)

Topic	Proposed IFRS	Solvency II
Financial assumptions	Top-down vs. bottom-up?	Matching Adjustment, CCP?
Non-financial assumptions	Entity-specific best estimates, current as at valuation date (not locked in)	
Overhead expenses	Direct attributable overheads included	Included in liability measurement
Risk adjustment / margin	Fulfilment value from insurer's perspective	Transfer value from third party perspective (cost of capital approach)
Residual margin	Yes	No
Treatment of reinsurance	No offsetting	Gross with separate calculation
Participating business	Expected payments to current or future policyholders is a liability	No shareholder equity can be identified

Proposed IFRS versus Solvency II (cont'd)

- Appendix A of the IFRS working party paper of April 2011 contains further points in this comparison (including MCEV); see: https://www.actuaries.org.uk/sites/all/files/documents/pdf/110411110511combined.pdf
- Clearly the similarities between Proposed IFRS and Solvency II are welcomed…
- … but the remaining differences may introduce practical difficulties e.g.:
  - Contract boundaries: different modelling approach required
  - Potentially different risk margin calculations
  - Challenging timeframes in which to resolve these issues
  - Differences in disclosure requirements

Future of Financial Reporting in the UK

Accounting Standards board published “Insurance Accounting – Mind the UK GAAP” (discussion paper) on 30 January 2012

- Why?
  - Introduction of Solvency II will render existing UK GAAP obsolete
  - Effective date of Solvency II likely to be after effective date of Proposed IFRS – hence a “gap”
  - Statutory accounts to be used for taxation of life insurers
- What? Consultation on four possible approaches:

1. Current IFRS 4	2. Current UK GAAP	3. Solvency II	4. Early Adoption

- Many listed companies already use IFRS for statutory accounting of UK subsidiaries rather than UK GAAP

Future of Financial Reporting in the UK (cont’d)

- FRG responded to consultation with views on questions asked by the ASB (see http://www.frc.org.uk/documents/pagemanager/asb/Responses_to_Revised_FRED/CL47%20-%20The%20Actuarial%20Profession.pdf)
- Long term solution: agreed – IFRS 4 Phase 2 should be incorporated into UK GAAP
- Short term solution – 4 options suggested by ASB:
  - FRG response short term solution should require minimum amount of change:

1. Current IFRS 4	2. Current UK GAAP	~~3. Solvency II~~	~~4. Early Adoption~~

Mixed views in FRG – for many companies either 1 or 2 would amount to the same basis; hence it is the difference between the 2 bases that is important

  - Each has a number of advantages and disadvantages – see FRG’s letter for further details

Conclusion

- Welcome progress by IASB compared to the original insurance contracts ED
- There remain some significant areas to be resolved
- Uncertainty in timetable: what to do when Solvency II is effective before proposed IFRS
- What is the future role of supplementary reporting?
- Upcoming FRG events:
  - Open Forum on future of UK GAAP accounting for insurers (Staple Inn, Thursday 5 July)
  - Sessions at 2012 Life Convention
  - Regular newsletter

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 presenters.