

Practical Implications of IFRS Phase II

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Celtic Manor

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Agenda

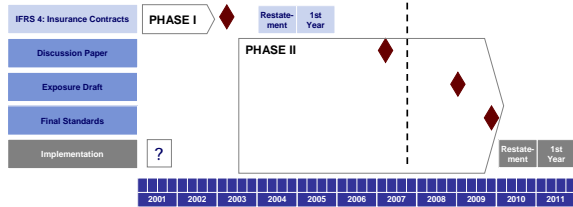
- Technical Issues from IASB Discussion Paper
- Impact on Balance Sheet and Revenue Account
- Implications for Finance and Actuarial Functions

Agenda

- Key Non-Life Insurance Issues

The Timeline

Accounting Standard for Insurance



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Objectives

- Principles-based approach with additional guidance
- Insurance to be subject to the same general principles as other financial services firms
- Consistency of treatment between insurance, investment management and banking products
- Should lead to
 - increased comparability
 - better identification of key value drivers
 - enhanced share values due to improved transparency

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Scope

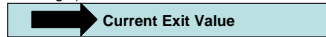
- Considers measurement and recognition issues for insurance liabilities
- Only deals with insurance contracts – does not deal with the treatment of other assets and liabilities of insurers
- Same model for both Life and Non-Life insurance
- Same model will cover both the period before and after a claim is incurred
- Model will apply to both insurance and reinsurance contracts

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Measurement Model

Insurance liability measurement made up of three building blocks:

- Explicit, unbiased, market-consistent, probability-weighted and current estimates of **future cash flows**
- **Discounted** at current market discount rates for cash flows whose characteristics match the insurance liability in terms of timing, currency and liquidity
- Explicit and unbiased estimate of the **margin** that market participants require for bearing risk (a risk margin) and for providing other services, if any (a profit margin)



- The amount an insurer would expect to pay today if it transferred all contractual rights and obligations immediately to a third party

Reinsurance assets will be measured in the same way

- i.e. risk margin will increase the value of this asset

Estimates of Future Cash Flows

These should:

- Be explicit
- Be consistent with observed market prices
- Include all available information
- Be current i.e. should correspond to conditions at the end of the reporting period and hence will affect profit immediately
- Exclude entity-specific cash flows

Discounting

Board's view is that discounting should be used for all liabilities as

- it represents faithfully the insurer's financial position and the economic fact that money has a time value

Some argue that discounting:

- introduces further subjectivity
- may worsen underestimation
- is not necessary as some liabilities are subject to inflation
- and risk margins tend to offset each other

Inappropriate to use discount rates on assets held

Risk Margins

- Convey uncertainty associated with future cash flows
- Margins should be consistent with margins that would be expected if the insurer were to transfer its contractual obligations to another party
- IASB has given high level guidance on calculation of margins, leaving industry to develop details
- Acceptable approaches for estimating risk margins may include:
 - Cost of Capital
 - Percentiles
 - Tail VaR
 - A multiple of standard deviation or variance

Comment

- Calibration the same as Solvency II?
- Tension between pragmatism and simplicity of calculation versus risk sensitivity and accuracy
- Practical implementation will have a knock on impact for actuaries

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Current Exit Value

The amount an insurer would expect to pay today if it transferred all contractual rights and obligations immediately to a third party

Comment

- Difficult to estimate due to lack of a secondary market – hence can it be relevant or reliable?
- Would require cash flows and margins to be re-measured at each reporting date
- May not equal premium at issue leading to the recognition of 'gains/losses' at inception
- Would exclude the use of entity specific cash flows
- Appears to be equivalent to fair value, but will that be true in all cases?
- A final decision on measurement should not be made before presentation and disclosure have been fully considered
- Valuation can be different for different purposes, but an insurers' financial statements must reflect economic reality

All the above suggests there is still debate and, possibly, delay

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Other Issues

Unit of Account

- Is a portfolio of insurance contracts that are subject to broadly similar risks and managed together as a single portfolio
- Liability valuation (including the setting of risk margins) should be determined on a portfolio basis
- Valuation should not reflect diversification between portfolios

Comment

- This is contrary to how insurers set their prices
- Solvency II measurement allows for diversification in the calculation of the SCR. Hence valuation could be more prudent than Solvency II

DAC

- There is to be no separate asset (DAC) to account for the investment the insurer makes in the customer relationship – acquisition costs are to be expensed when incurred

Comment

- Consider the impact on product pricing and design

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Other Issues (2)

UPR

- For contracts under which claims have yet to be incurred, liabilities will have to be determined by projecting expected future cash flows
- Existing models use UPR (less acquisition costs) as a proxy for this liability.

Comment

- IASB state: "The unearned premium may sometimes provide a reasonable approximation to current value if contract is not likely to be highly profitable/unprofitable and circumstances have not changed since inception"

Recognition

- Rights and obligations are recognised when insurer becomes party to the contract

Comment

- Not the inception date of the contract
- This, together with the removal of DAC, will lead to valuing on an underwriting year basis or even to the "old" year of account (YOA) basis
- How should reinsurance which has not been purchased at the valuation date be treated?

Other Issues (3)

Credit Characteristics

- Measurement of liabilities should include the effects of the credit characteristics of the liability

Comment

- Strange that a reduction in the credit standing of an insurer can lead to a decrease in its liabilities
- However, likely to be of limited impact as a policyholder is unlikely to buy insurance if he thinks the insurer may not satisfy its obligations in full
- Quantifying its effects is likely to be impractical

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- Impact on Balance Sheet and Revenue Account

Approach

- Simplified example to show differences in the Income Statement and Balance Sheet between UK GAAP and IFRS Phase II.
- It considers one year of new business, rather than an existing entity
- Simplifying assumptions
- A discounted estimate of claims is calculated using the risk free rate of return (5% p.a.)
- The risk margin is estimated on a Cost of Capital approach
- For UK GAAP, liabilities are assumed to be equal to best estimate (in practice many companies' liabilities include a margin)

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Income Statement for Short Tailed Class

INCOME STATEMENT	UK GAAP						IFRS					
	Year 1	Year 2	Year 3	Year 4	Year 5	Total	Year 1	Year 2	Year 3	Year 4	Year 5	Total
Written Premiums	100.0	-	-	-	-	100.0	100.0	-	-	-	-	100.0
Unearned Premiums	(50.0)	-	-	-	-	(50.0)	-	-	-	-	-	-
Earned Premiums	50.0	50.0	-	-	-	100.0	100.0	-	-	-	-	100.0
Claims Expense	(37.5)	(37.5)	-	-	-	(75.0)	(75.0)	-	-	-	-	(75.0)
Discount	-	-	-	-	-	-	5.7	-	-	-	-	5.7
Risk Margin	-	-	-	-	-	-	(2.8)	1.4	1.2	0.4	0.1	0.5
Acquisition costs	(10.0)	(10.0)	-	-	-	(20.0)	(20.0)	-	-	-	-	(20.0)
Underwriting Profit	2.5	2.5	-	-	-	5.0	8.1	1.4	1.2	0.4	0.1	11.2
Unwind of Discount - Claim Reserve	-	-	-	-	-	-	(3.3)	(1.9)	(0.5)	(0.1)	-	(5.7)
Unwind of Discount - Risk Margin	-	-	-	-	-	-	(0.1)	(0.2)	(0.1)	(0.0)	-	(0.5)
Profit After Unwind of Discount	2.5	2.5	-	-	-	5.0	4.7	(0.7)	0.6	0.3	0.1	5.0
Investment return	3.5	2.2	0.7	0.1	-	6.4	3.5	2.2	0.7	0.1	-	6.4
Profit	6.0	4.7	0.7	0.1	-	11.4	8.2	1.5	1.2	0.4	0.1	11.4

Short-tail Payment Pattern				
Year	1	2	3	4
Percentage paid	15%	55%	25%	5%

Assumptions	
Length of tail	Short
Gross Ultimate Loss Ratio	75%
Cost of capital (above risk free rate)	6%
Capital requirement (% reserves)	25%

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Balance Sheet for Short Tailed Class

BALANCE SHEET	UK GAAP						IFRS					
	Year 1	Year 2	Year 3	Year 4	Year 5		Year 1	Year 2	Year 3	Year 4	Year 5	
Cash and Investments	72.2	33.1	15.0	11.4	11.4		72.2	33.1	15.0	11.4	11.4	
Deferred Acquisition Costs	10.0	-	-	-	-		-	-	-	-	-	
Total Assets	82.2	33.1	15.0	11.4	11.4		72.2	33.1	15.0	11.4	11.4	
Unearned Premiums	50.0	-	-	-	-		-	-	-	-	-	
Undiscounted Best Estimate	25.3	22.5	3.8	-	-		63.8	22.5	3.8	-	-	
Discount Benefit	-	-	-	-	-		(2.8)	(0.9)	(0.1)	-	-	
Risk Margin	-	-	-	-	-		2.7	1.5	0.5	0.1	(0.0)	
Claims Reserves	25.3	22.5	3.8	-	-		64.0	23.5	4.1	0.1	(0.0)	
Retained Earnings	6.0	10.6	11.3	11.4	11.4		8.2	9.7	10.9	11.3	11.4	
Total Liabilities	82.2	33.1	15.0	11.4	11.4		72.2	33.1	15.0	11.4	11.4	

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Key Findings

- Although the total profit over all years is unchanged under IFRS Phase II, the timing of profit recognition can be significantly affected as a result of the move to the IFRS proposals
 - Premiums must be reported in the year that the policy is inception under IFRS Phase II, resulting in profits (or losses) usually being higher than under existing GAAP reporting rules in Year 1, but lower in Year 2
 - The addition of a risk margin under IFRS Phase II has the effect of smoothing the profitability, reducing profit in early years and increasing profit in later years as the risk margin is released
- In our model the balance sheet changes only in Year 1 as acquisition costs cannot be deferred under IFRS Phase II. This is a result of all earnings being retained and would not necessarily be the case if a dividend was paid or tax and reinsurance were considered
- Setting higher risk margins (through higher capital cost or requirements) does not change the total profit. They lead to reduced profits in earlier years balanced by higher profits in later years

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- Implications for Finance and Actuarial Functions

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Business Implications

Earnings volatility

- Due to changes in estimates and assumptions
- Understand and explain to management and investors
- Impact on disclosures
- Increased demand for risk transfer that mitigates volatility

Systems and staffing

- New IT requirements, new techniques
- Upgrade actuarial models
- Tighter timescales
- Resource constraints
- Greater co-operation between accountants and actuaries
- Revision of roles and responsibilities
- Education required at all levels

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Business Implications (2)

Pricing and product design

- Closer alignment of pricing and reporting?
- Will show management where products are priced at profit margin in excess of risk margin
- Changes to product features and their impact on risk profile

Alignment of reporting bases

- Regulatory, accounting and economic becoming market consistent
- Convergence will remove duplication

Improved controls

- Introduction of new reporting systems provides opportunity to redesign and improve controls
- Information can be produced in a more robust and timely manner

Capital management and allocation

- Having a better picture of margins can improve capital management and allocation
- Improved transparency and consistency may lower cost of capital
