

Practical Implications of Implementing IAS in a Life Insurance Company

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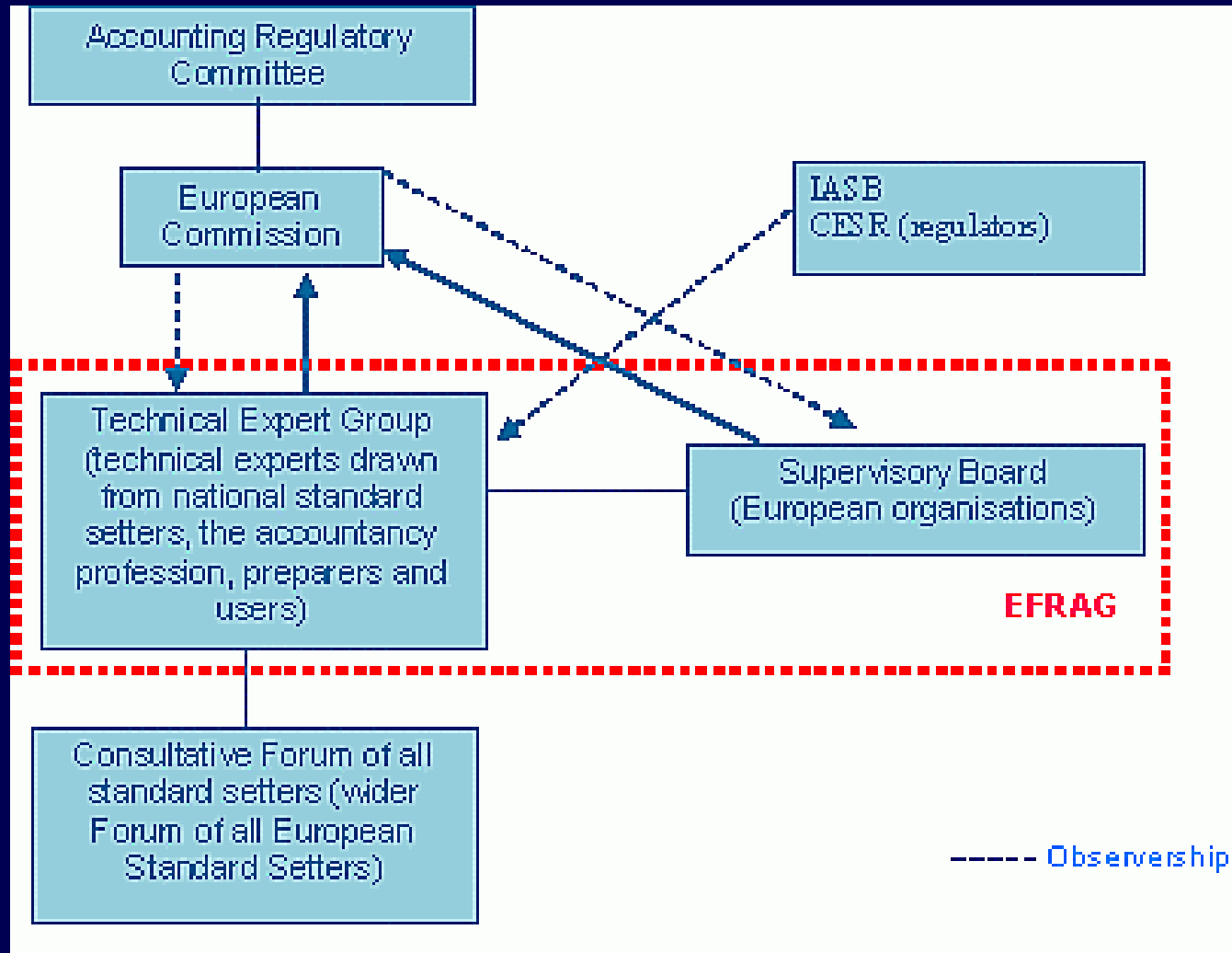
1.	Background on IAS Reporting Requirements	GH
2.	Product Classification	GH/NMR
3.	Embedded Derivatives	GH
4.	Valuation of Non Participating Investment Contracts	GH/NMR
5.	Valuation of Insurance and Participating Contracts	NMR
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TLAs, FLAs, etc

- EFRAG
- CESR
- EU ARC
- IFRIC
- TEG

- IASC
- IASB IAS
- IFRS
- ED
- FSAP
- DSOP

EC Decision Making – EFRAG and ARC



Some (Ancient) History



1997 - IASC
Insurance
Accounting
Project

Issues
paper

Draft
DSOP

EC Reg
1606/2002

**WE ARE
HERE!**

ED for
Phase 1

IFRS for
Phase 1

PSB for
life
assurers

1st IAS
Annual Reports
(Phase 1)

ED for
Phase 2?

1999

2000

2001

2002

2003

2004

2005

2006

2007

IASB
replaces
IASC

IASB –
2-phase
insurance
project

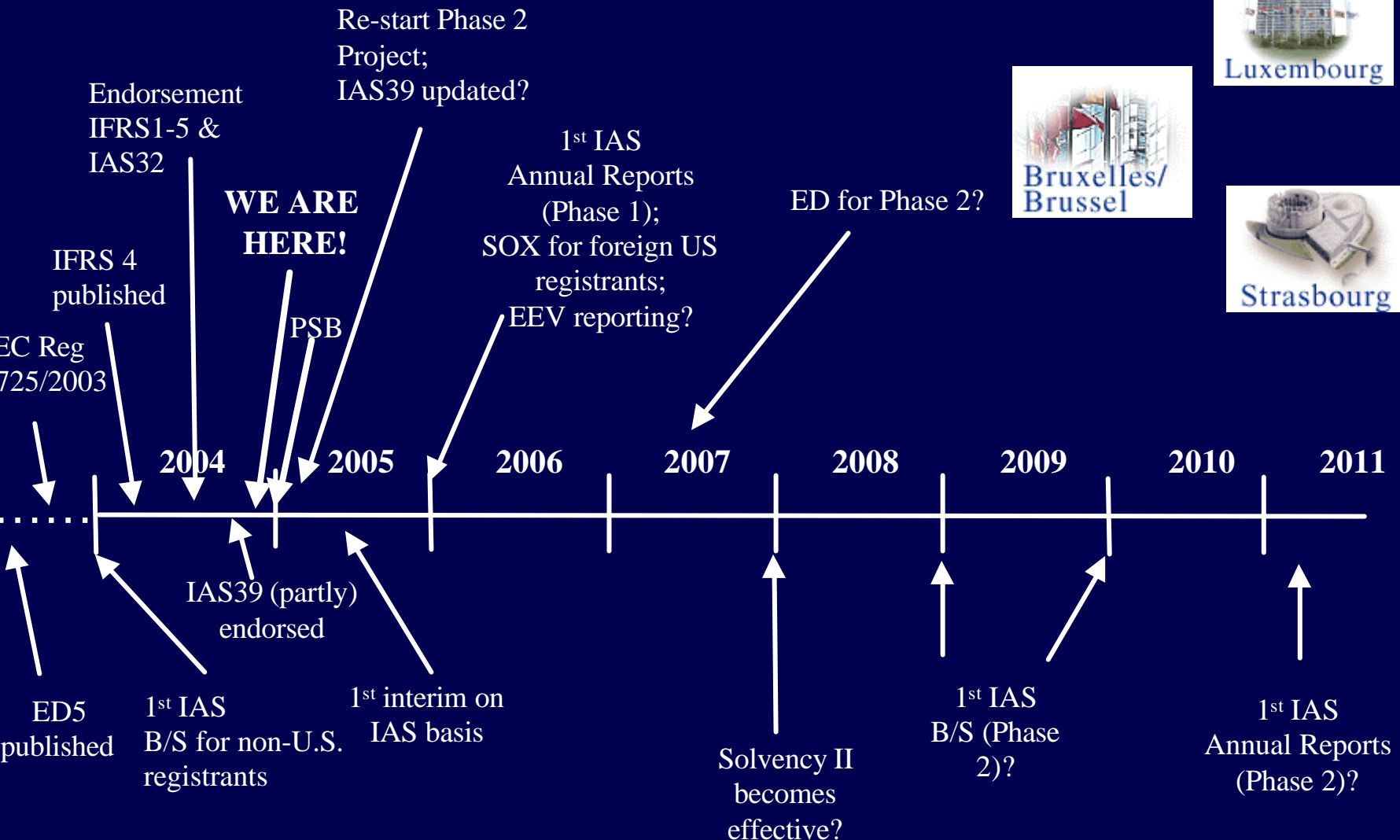
1st IAS
B/S for U.S.
Registrants

1st IAS
B/S for non-U.S.
registrants

1st Quarterly
interim on IAS
basis

Solvency II
becomes
effective?

Recent Past, Present and Future



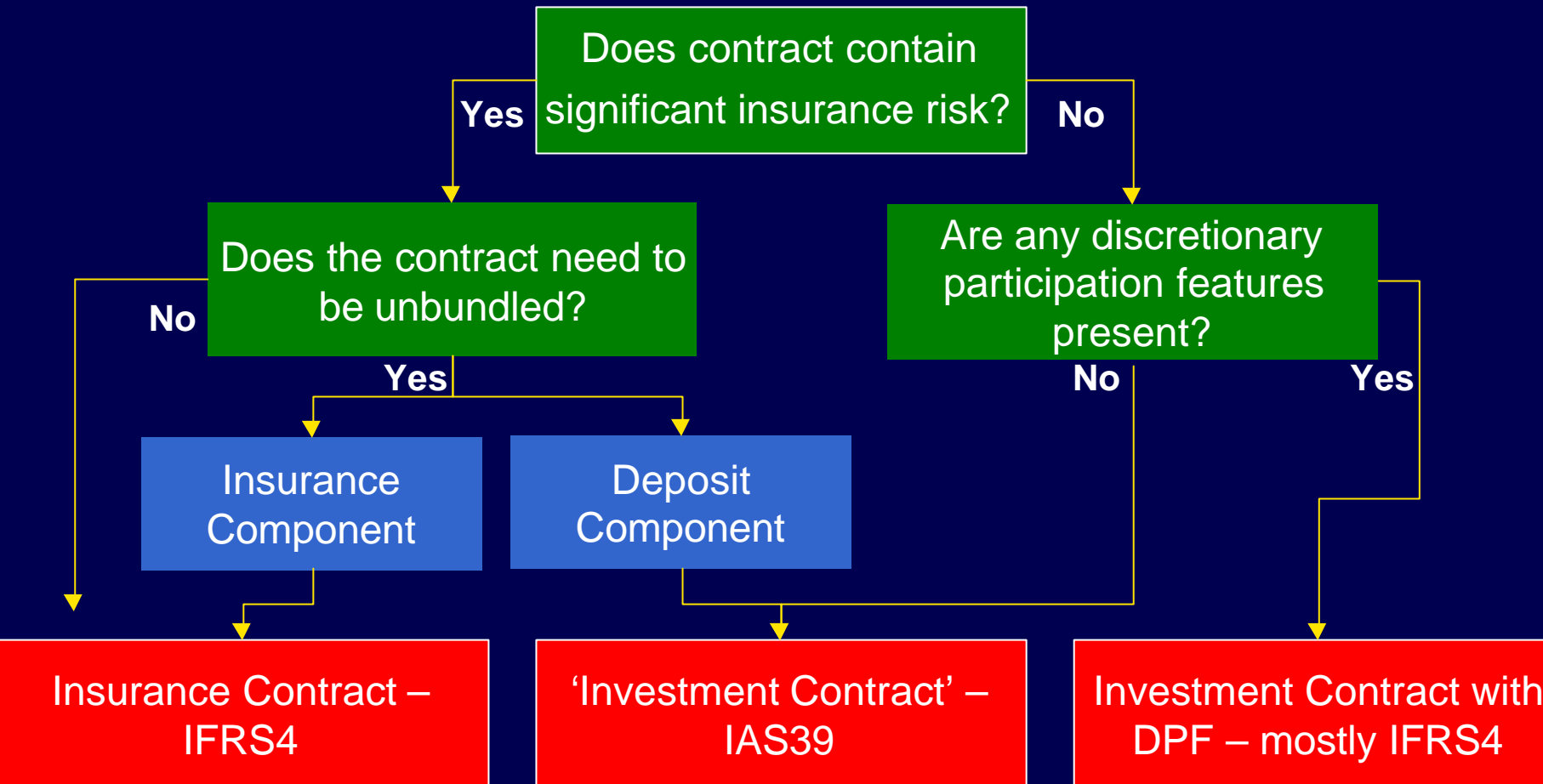
Practical Implications of IAS Reporting

- *Actuarial Systems:* DAC calculations, fair value calculations, disclosures, analysis of results
- *Data Requirements:* Hybrid products, historical information
- *Accounting Systems:* Deposit accounting, IAS accounts, disclosures
- *Asset Data:* IAS valuations, amortised cost disclosures
- Multi-GAAP reporting burden
- Lack of clarity on reporting requirements and divergence of industry practice

Practical Implications of Implementing IAS in a Life Insurance Company

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Product Classification



Definition of Insurance Contract

IFRS 4 defines an insurance contract as *‘contract under which one party (the **insurer**) accepts significant insurance risk from another party (the **policyholder**) by agreeing to compensate the policyholder if a specified uncertain future event (the **insured event**) adversely affects the policyholder.’*

- Minor change from exposure draft (other beneficiary omitted).

Product Classification – Why Does it Matter?

Its not just IFRS4!

Insurance contract liabilities - IFRS4

- broadly, continue with local GAAP
- very broadly, includes contracts with 'discretionary participation features'

'Investment contract' liabilities – IAS39

- very very broadly, akin to USGAAP
- 'fair value' or amortised cost

Most financial assets - IAS39

- classification decisions to make – various valuation bases



Beware scope for asset-liability mismatching



Product Classification - What is Significant Insurance Risk?

- [illegible]

Significant Insurance Risk – Surrender Penalties and MVAs

- Large product groups can be borderline
 - UL Bonds & UL Pensions
- Was risk pre-existing?
 - Redemptions charges (e.g. to recoup initial expenses) waived on death do not transfer insurance risk from the policyholder, so do not form part of the significance test.
- Impact of MVAs:

MVA on surrender	MVA on death	MVA on maturity	Classification
v	v	v	Insurance
v	X	v	Insurance
v	X	X	Investment

Examples of Insurance Contracts/Features

- Conventional with profit
- Conventional non profit
- Protection Contracts
- Annuities (deferred and in payment)
- Unitised with profit bonds (no fixed maturity date), including any unit-linked component
- Unit-Linked and guaranteed equity contracts with guaranteed minimum death benefits
- Savings contracts with additional death benefits

Participating Investment Contracts

Even if a contract is not classified as insurance, it could still be exempt from IAS 39 under Phase 1 if it is participating, e.g.

- Unitised with profit pensions (no MVR on death or maturity)
- Hybrid unit-linked/unitised with profit investment contracts.

Note : The existence of an option to switch from an investment benefit into an insurance/participating benefit does not enable the contract to be classified as insurance/participating until the option has been exercised.

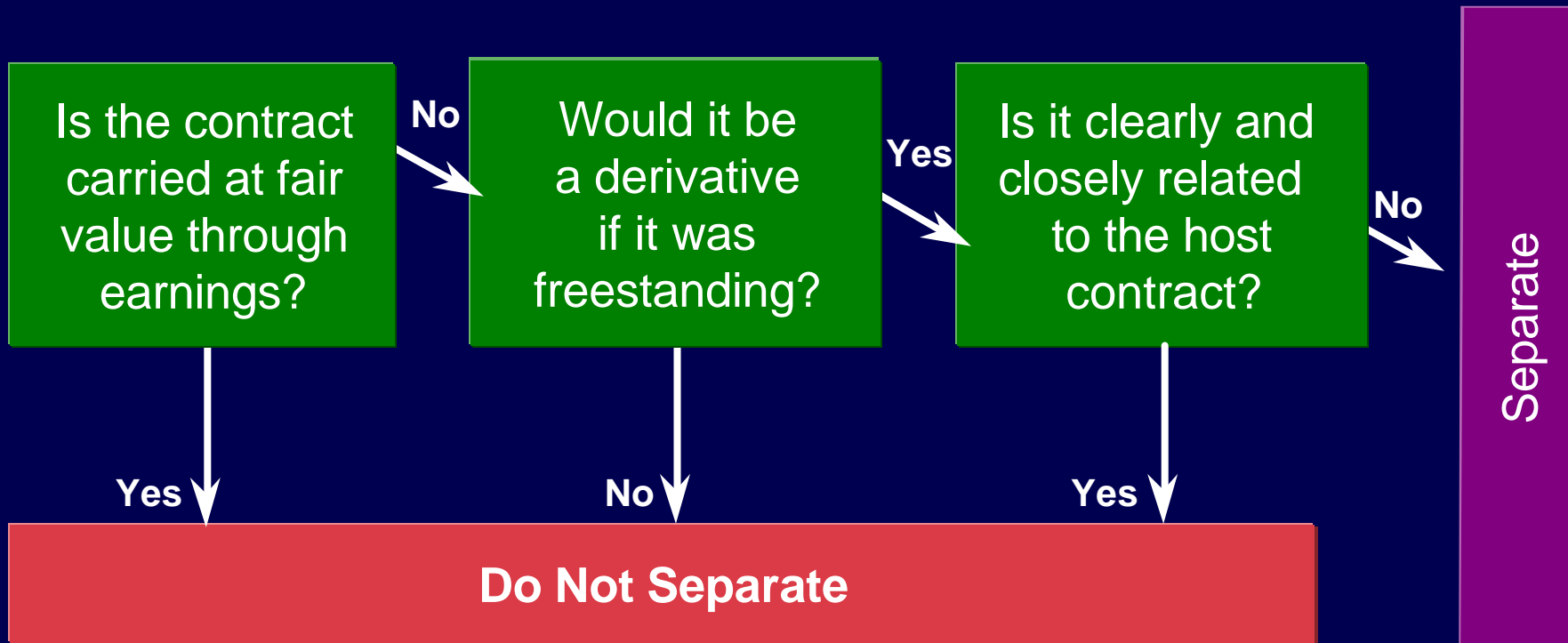
Implementation of Production Classification

- In most cases, entire blocks of business can be classified as either insurance, participating or investment, but there are two main exceptions.
- Hybrid Unitised Policies : Need to separately identify unit-linked component of hybrid policies from unit-linked only policies.
 - Need to create separate data files for unit-linked
 - Could use policy count variable if using individual policy data
 - Need to be sure that insurance/participating benefit is significant
 - Ideally, need to identify unit-linked only policies which used to have an insurance/participating component.
- Savings Policies with Additional Death Benefit Option : Need to consider the proportion of contracts with additional death benefits and, if acceptable, treat the block as wholly insurance or wholly investment.

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Overview of Embedded Derivatives – Identification Under IAS39



Embedded Derivatives – Definitions and Exemptions

■ A derivative is a financial instrument with:

- value changing in response to the change in a specified.....
'underlying'
- no / little initial net investments, and
- settlement at a future date

■ Under IAS39 (and IFRS4) - separate from host contract and hold at fair value with changes through P&L

■ Do not need to separate:

- Derivatives that are insurance contracts (e.g. GAOs, GMDB)
- Surrender of participating contracts
- Derivatives closely related to host (e.g. surrender options paying close to book value, out of the money, not leveraged at issue,...)

Embedded Derivatives - What is Caught?

- Options 'in the money' or leveraged at outset
 - Most non-WP surrender options are at or near book value, not leveraged / in the money at issue

- In practice, little, but needed to consider them all
 - Guarantees on Unit Linked – Fair Value calculation
 - GEB-type (insurance) contracts - Market value of matching asset under UKGAAP

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Valuation of Non-Participating Investment Contracts

■ In practice, primarily:

- UL pensions
- UL investment bonds

■ Apply IAS39

- Written for banking products by banking professionals
- Used USGAAP as a starting point

■ Amortised cost or 'fair value'?

- Assets mostly at 'fair value' under IAS39 (and UKGAAP)
- Apply fair value to unit liability

Valuation of Non-Participating Investment Contract Liabilities – Its Fair Value, But Not As We Know It

- DSOP 'fair value' recommended asset-liability (not deferral & matching) - prospective cash flows + MVMs
- IAS39 – Fair value
 - Apply measurement 'hierarchy'
 - Initial recognition at (retail) transaction price => beware recognising profit at issue
 - 'Demand deposit floor' => fair value > surrender value
 - Use deposit accounting
- Apply IAS18 (Revenue) to recognise a DAC for 'investment management fees'
- What if unit liability is insufficient to meet future liabilities?
 - fair value underpin / liability adequacy test / 'IAS £reserve' / DAC recoverability

Deferrable Acquisition Costs

IAS 39 Definitions

“Transaction costs are incremental costs that are directly attributable to the acquisition, issue or disposal of a financial asset or liability. An incremental cost is one that would not have been incurred if the entity had not been acquired, issued or disposed of the financial instrument.”

IAS 39 Application Guidance 13

“Transaction costs include fees and commissions paid to agents (including employees acting as agents), advisers, brokers and dealers.....

Transaction costs do not include ... discounts ... or internal administrative or holding costs.”

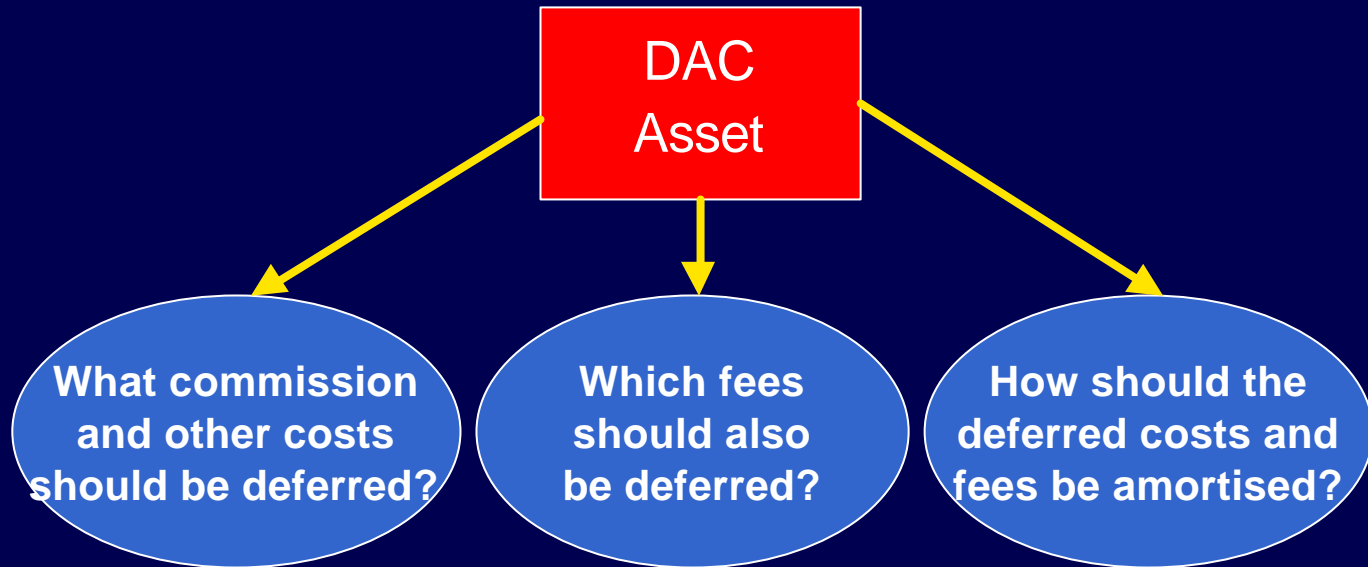
DAC Assets Under IAS 18

IAS 18 Appendix Paragraph 14(B)

“Fees charged for managing investments are recognised as revenue as the services are provided.

Incremental costs that are directly attributable to securing an investment management contract are recognised as an asset if they can be identified separately and measured reliably and it is probable that they will be recovered... The asset represents the entity's contractual right to benefit from providing investment management services, and it is amortised as the entity recognises the related revenue. If the entity has a portfolio of investment management contracts, it may assess their recoverability on a portfolio basis.”

Determining the DAC Asset Under IAS 18



The establishment and amortisation of the DAC asset will have a significant impact on the profit (or loss) at point of sale and the emergence of profit over the policy lifetime.

What Costs Should be Deferred?

Deferrable costs are likely to be limited to commission and sales bonuses.

- Is all initial commission deferrable or just the excess over renewal commission?
- How should level commission be treated? What if the level commission is indemnified?
- How should commission claw-back be treated?
- Need to allow for commission on increments and additions as well.

What Fees Should be Deferred?

Need to identify and defer up front fees either to amortise DAC (net DAC approach) or to defer recognition until services are provided (gross DAC and deferred income approach).

- How should any bid/offer spread be treated?
- Allocation rates can give rise to deferrable fees, but what about rates in excess of 100%?
- Are limited period additional charges deferrable? Need to be consistent with treatment of allocation rates.
- What about loyalty bonuses?

Need to develop practical rules which can be implemented.

The purpose of the DAC asset and deferred income reserve is not necessarily to smooth out all uneven incidence of costs and revenue.

How Should DAC and Deferred Fees be Amortised?

- What period should be used for amortisation?
 - Policy/portfolio lifetime?
 - Limit to 10 or 20 years?
 - Indemnification period?
- What profile should be used for amortisation?
 - Straight-line?
 - Present value of fees?
 - Effective interest rate method (amortised cost)?
- Should DAC be regarded as a portfolio cost as opposed to an individual policy cost? This would mean that DAC derived from an individual policy need not be written off on discontinuance of that policy.
- If using individual policy projection, would need to “gross up” DAC.
- Need to ensure (net) DAC is recoverable - compare with value of future fees less expenses, but what valuation basis?

Practical Issues Associated with DAC and DIR Calculations

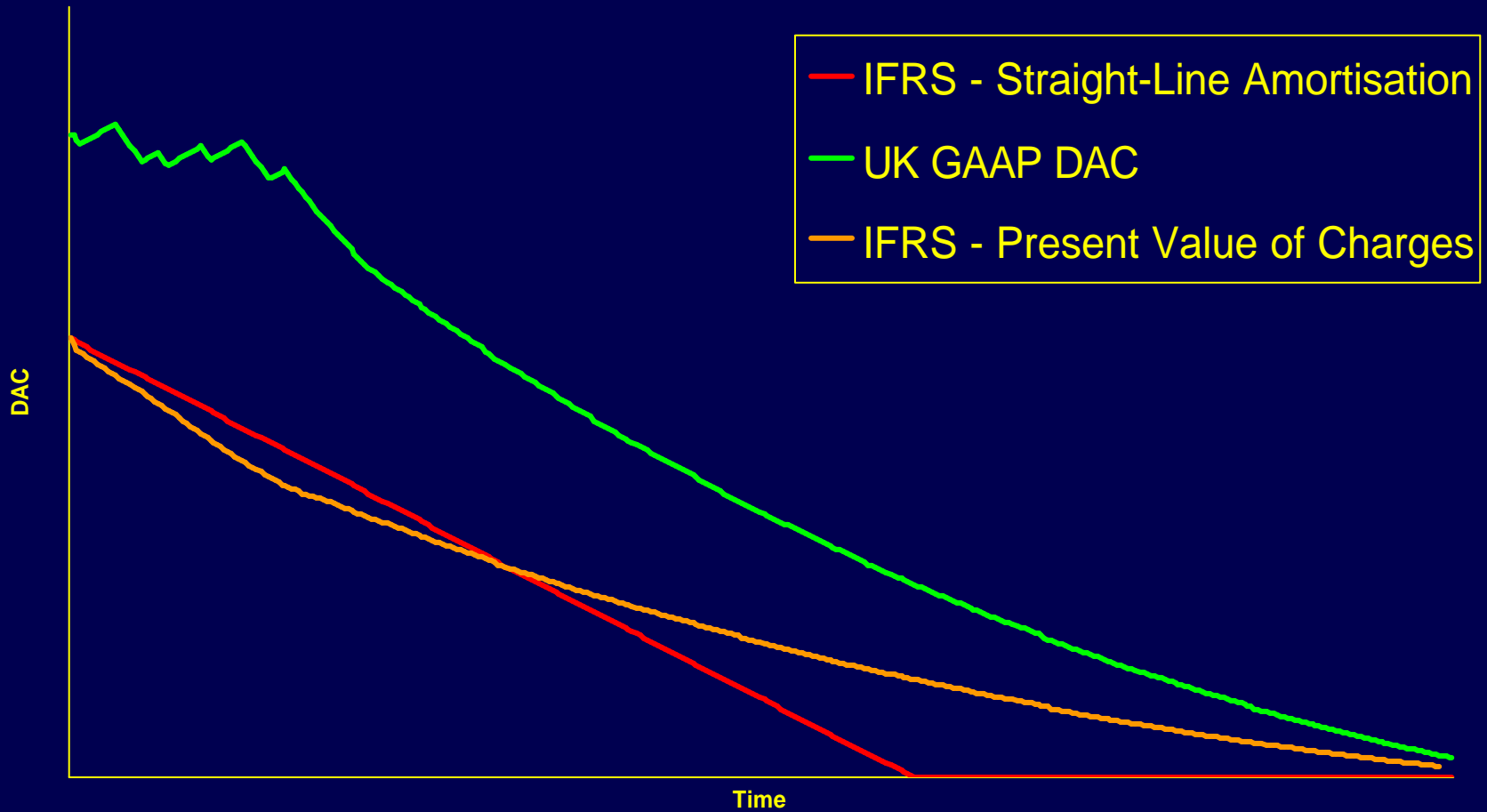
- Collation and subdivision of the required accounting data, particularly commission data.
 - Analysis by commission type
 - Subdivision between investment and insurance/participating contracts.

- Collation of historic policy data
 - Premium and commission history
 - Historic discontinuance rates for “gross up” purposes.

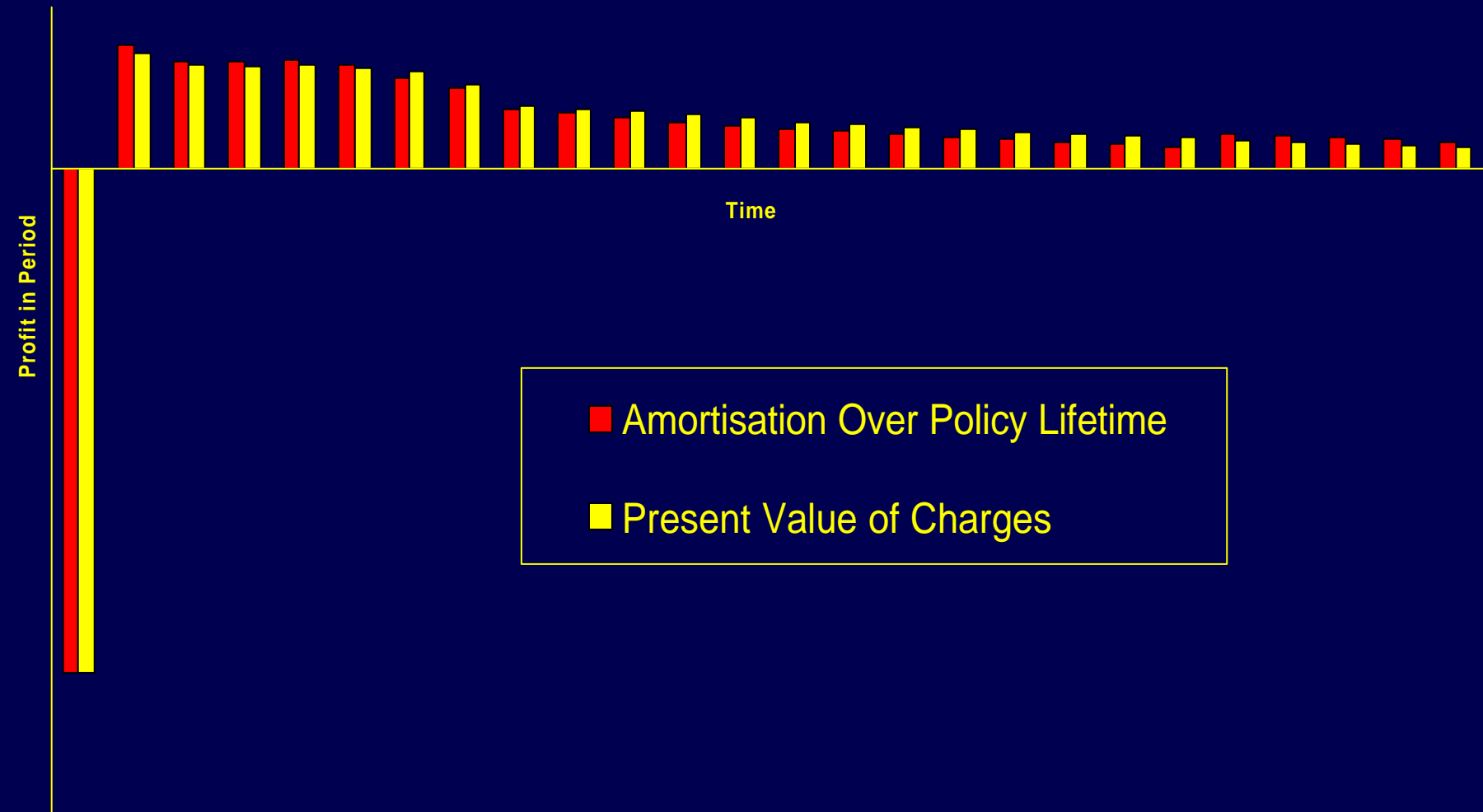
Example - Unit Linked Bond

Premium	£25,000
Allocation Rate	102%
Annual Charge	1.5%
Surrender Charge	8% (reducing to zero over 5 years)
Commission	5%
Non Deferrable Acquisition Expenses	£250
Maintenance Expenses	£20 per annum
Investment Expenses	0.12% per annum

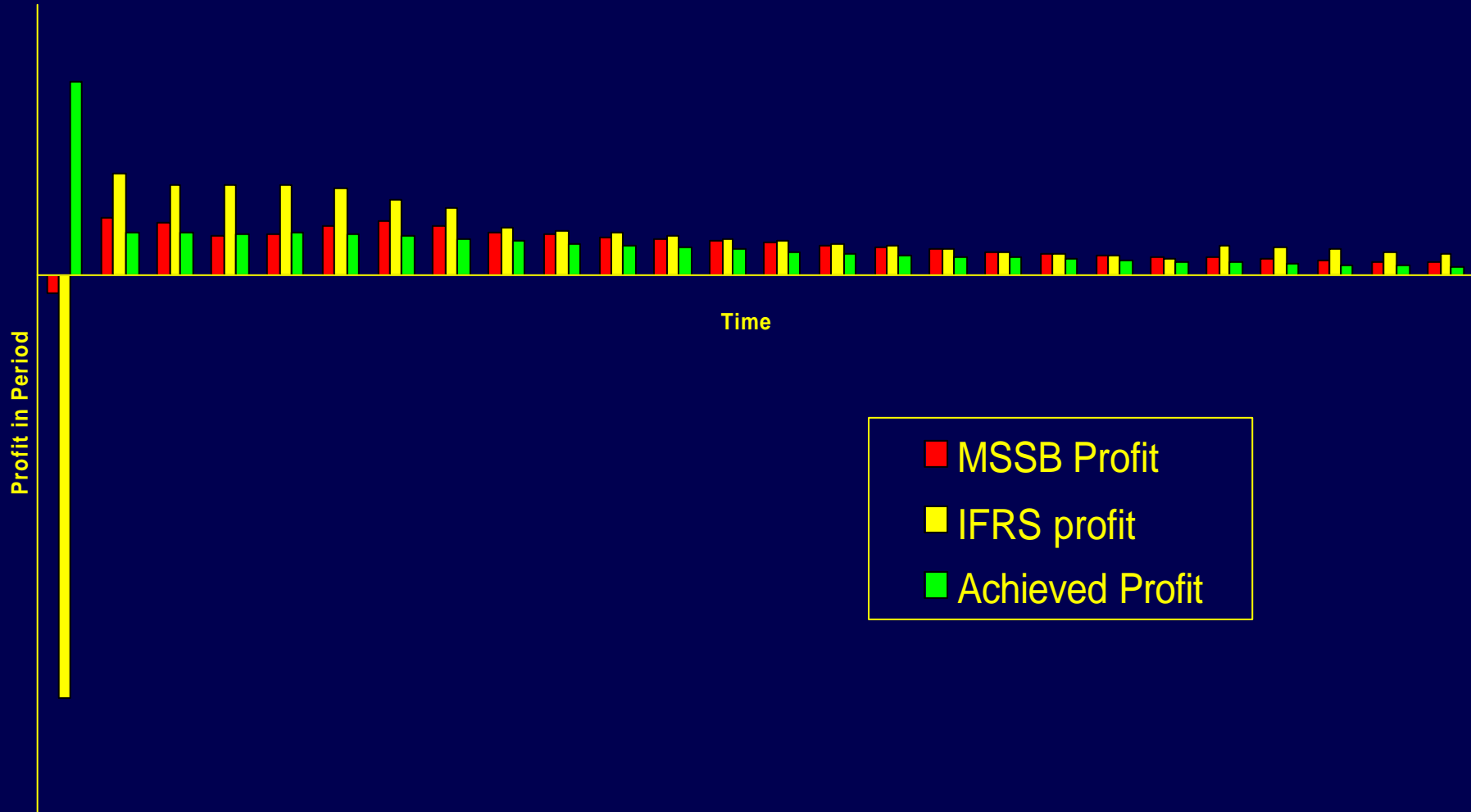
Unit Linked Bond - DAC Profiles



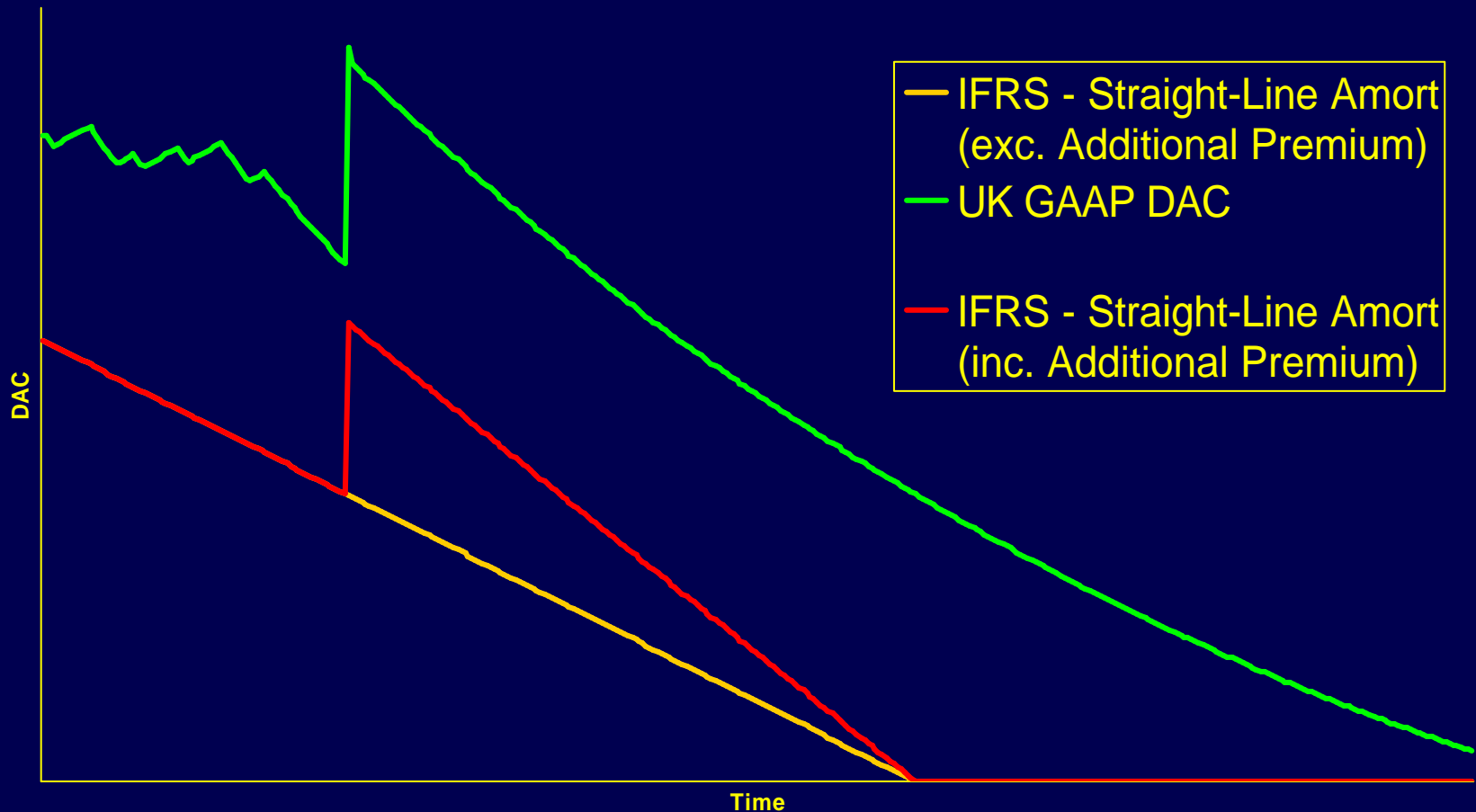
Unit Linked Bond - IFRS Profit Profile



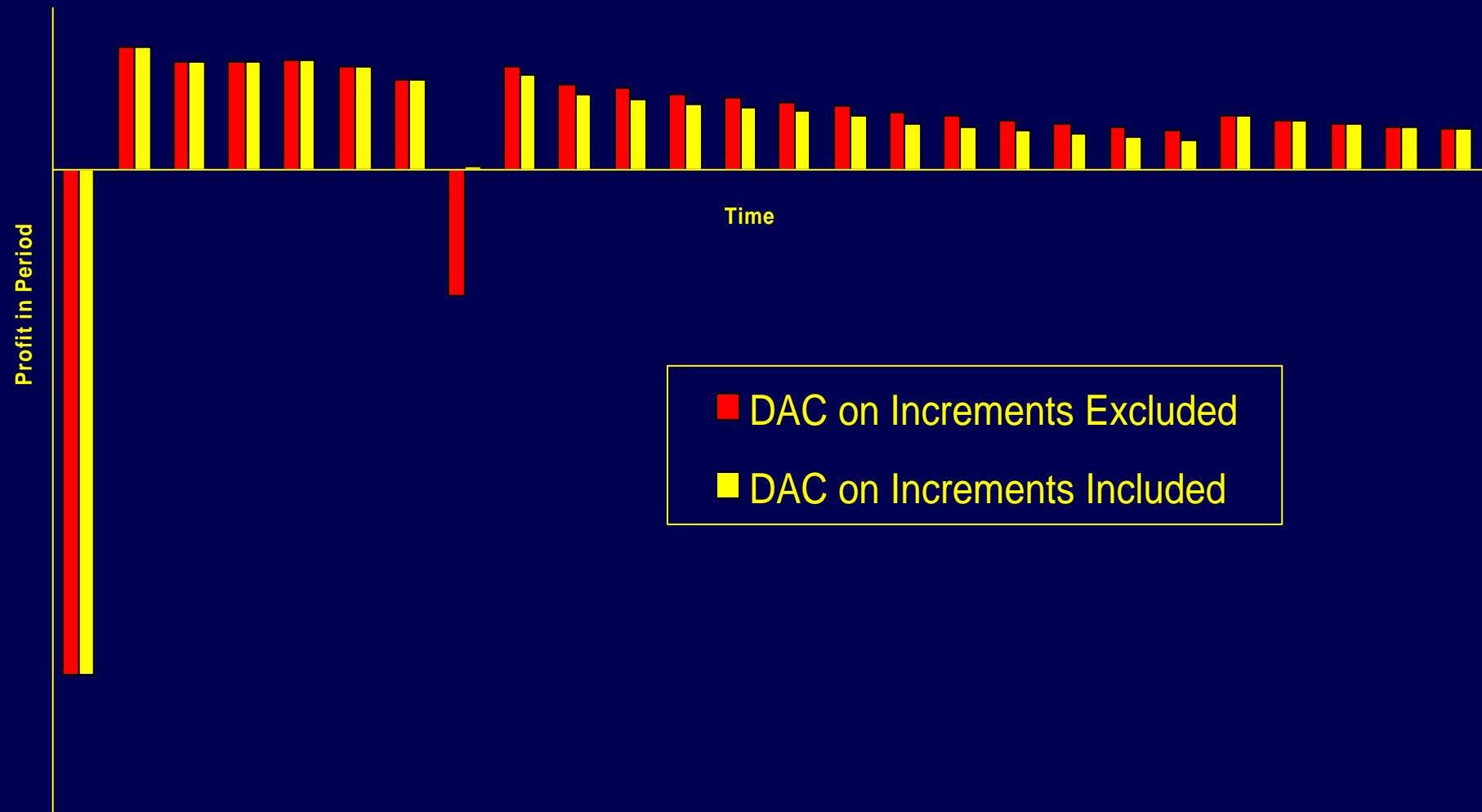
Unit Linked Bond - Comparison of Profit Profiles



Unit Linked Bond - Impact of Additional Premium on DAC Profile



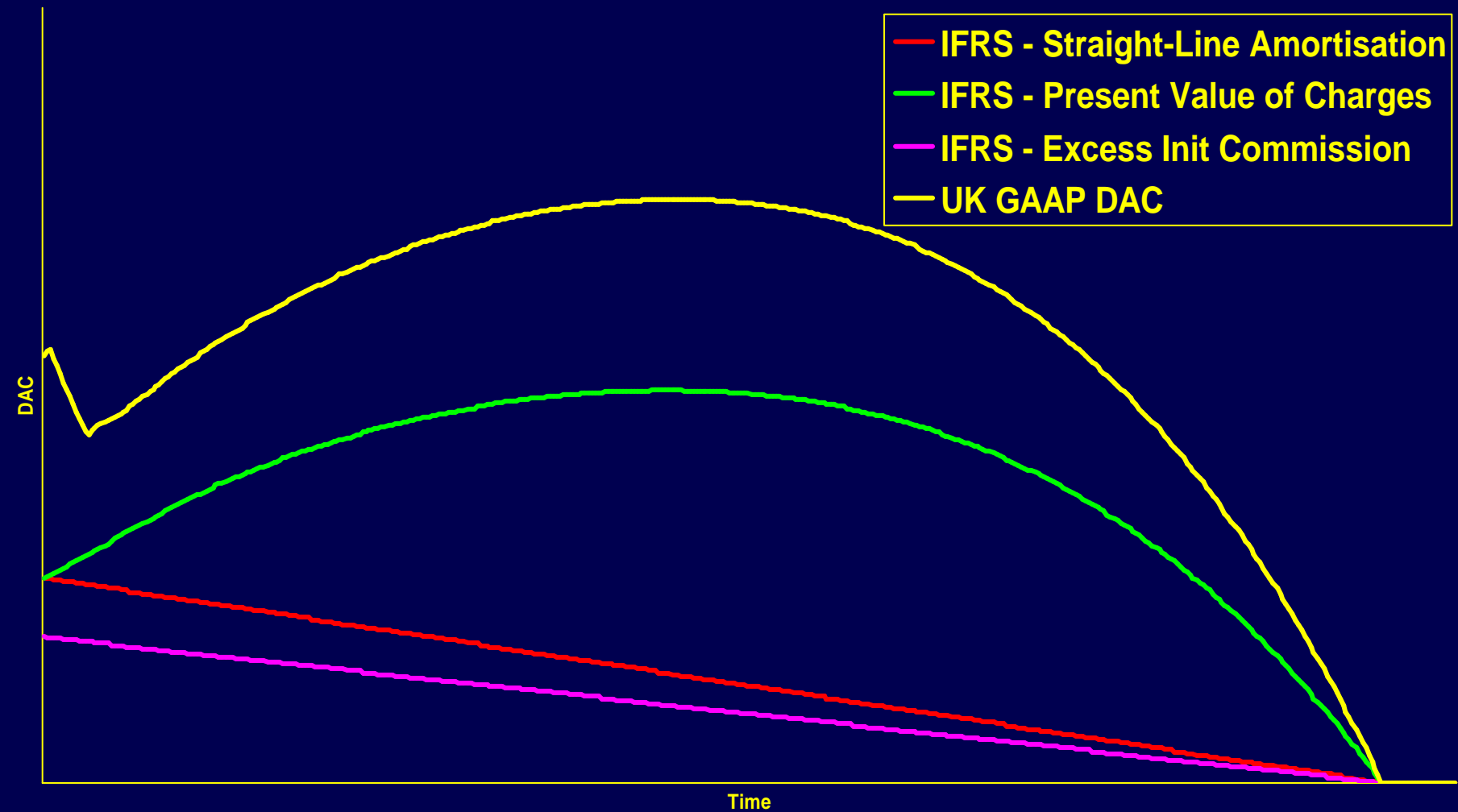
Unit Linked Bond - Impact of DAC on IFRS Profit Profile



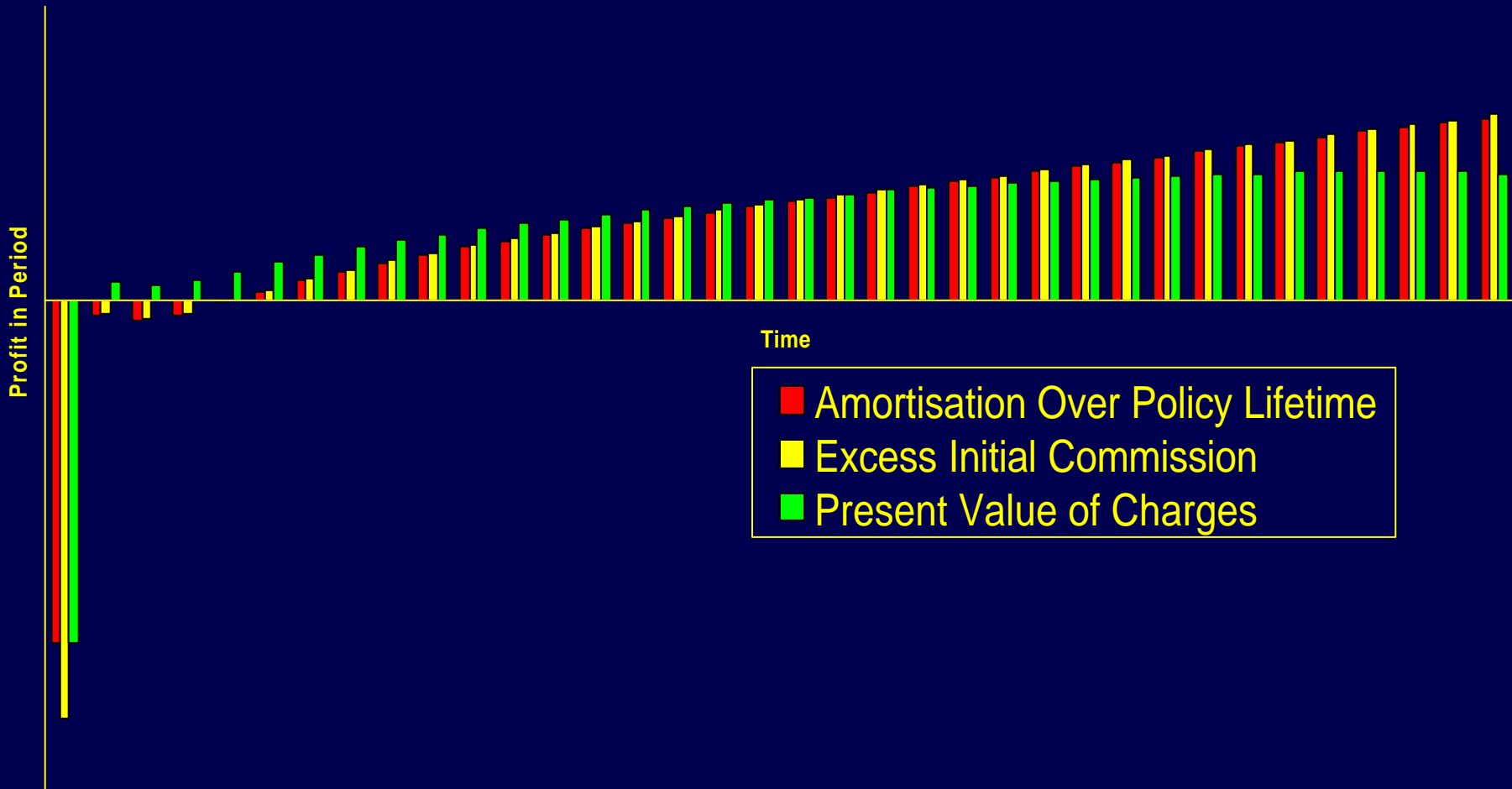
Example - Stakeholder Pension

Premium	£3,000 per annum
Allocation Rate	100%
Annual Charge	1%
Initial Commission	8% for 27 months
Renewal Commission	2.5%
Non Deferrable Acquisition Expenses	£250
Maintenance Expenses	£25 per annum
Investment Expenses	0.1% per annum

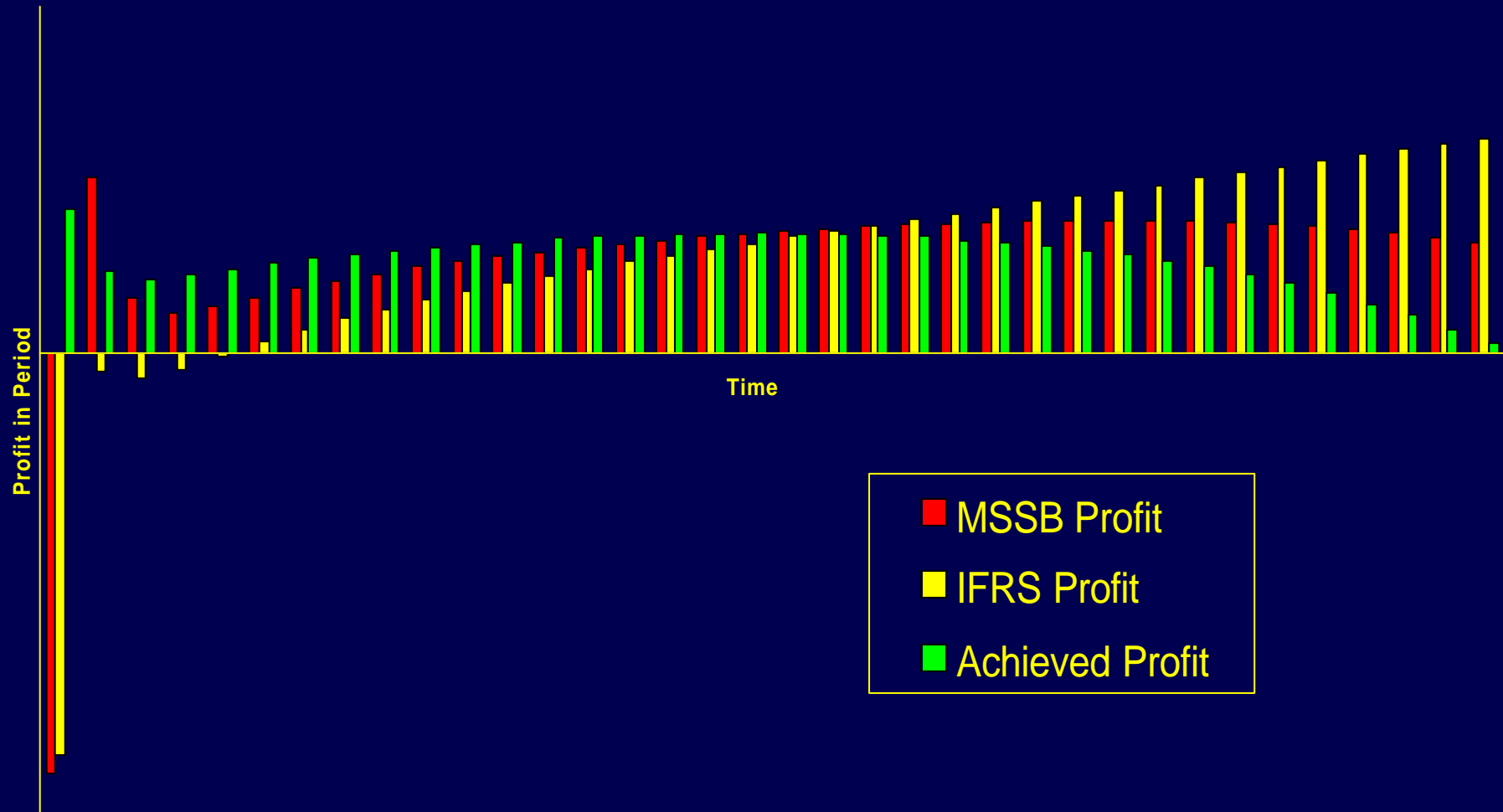
Stakeholder Pension - DAC Profiles



Stakeholder Pension - IFRS Profit Profile



Stakeholder Pension - Comparison of Profit Profiles



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Accounting Policy for Insurance and Participating Contracts

IFRS 4 Paragraph 13

“... this IFRS exempts an insurer from applying those criteria [of IAS 8] to its accounting policies for ... insurance contracts.”

IFRS 4 Paragraph 22

“An insurer may change to accounting policies for insurance contracts if, and only if, the change makes the financial statements more relevant ... and no less reliable, or more reliable and no less relevant ...”

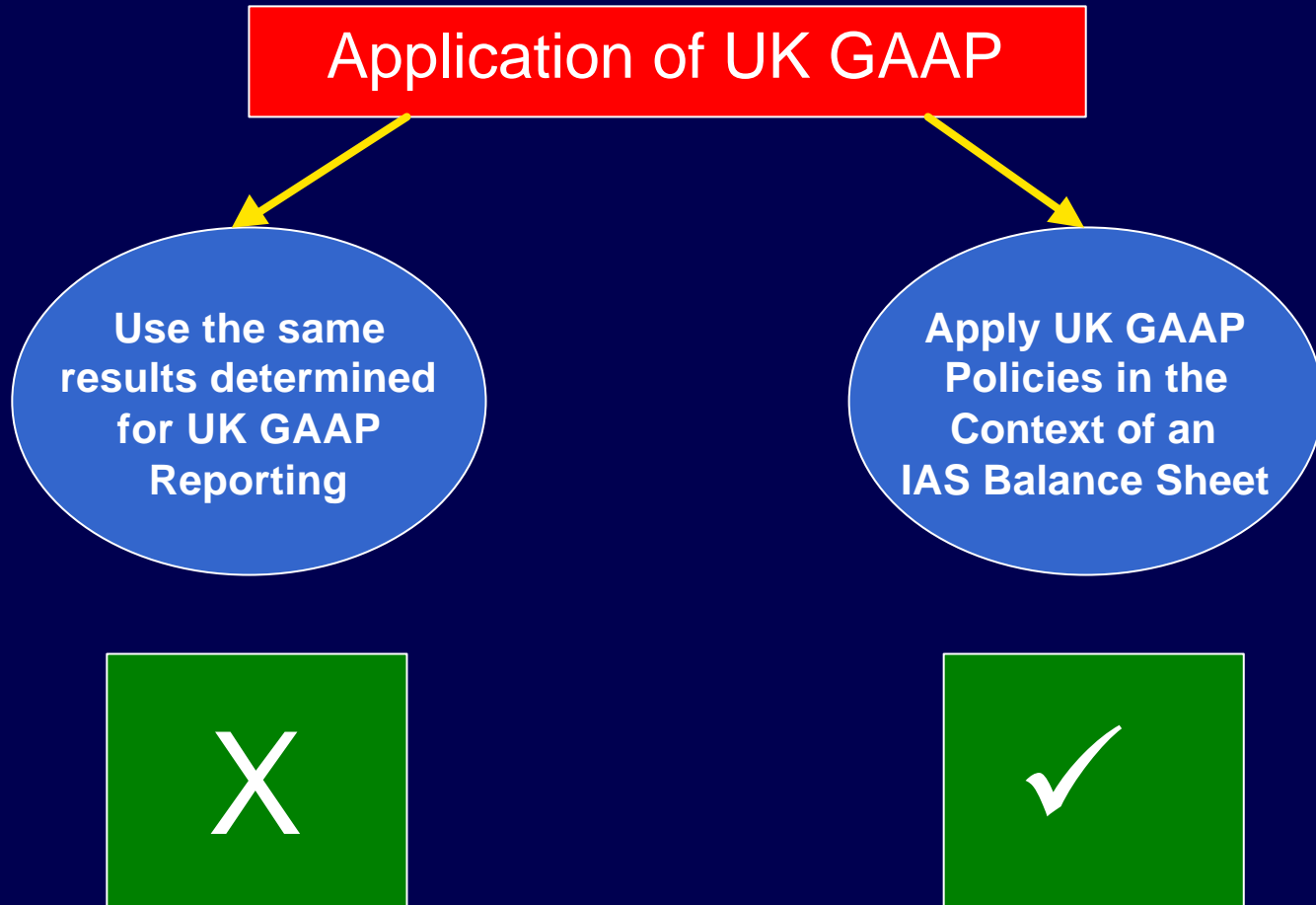
IFRS 4 Paragraph 34

“The issuer of such a [participating] contract ... shall ... continue its existing accounting policies ...”

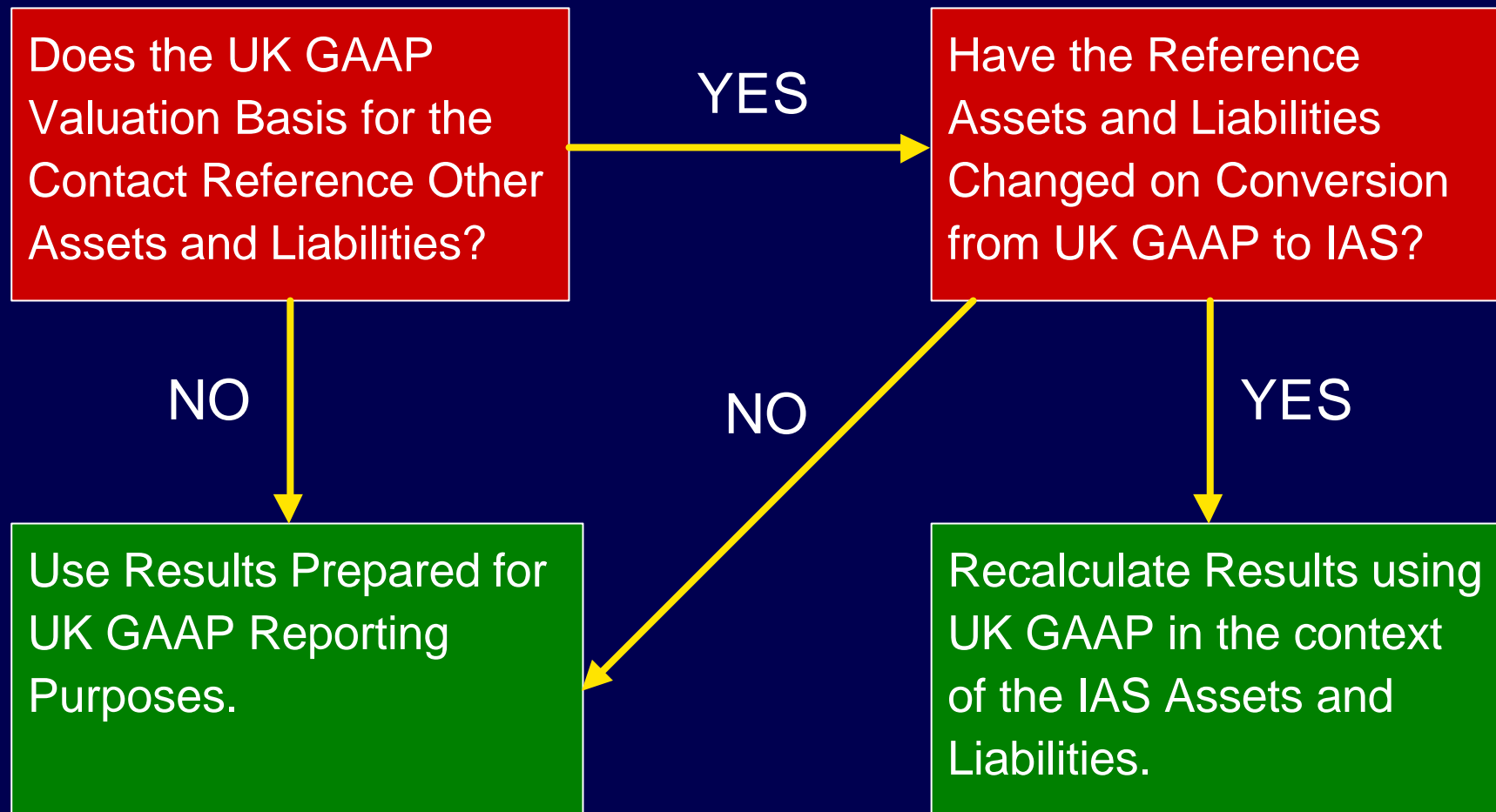
Insurance and Participating Contracts

- Conventional non-profit business, including protection etc.
- Deferred and Immediate Annuities
- Conventional with profits
- Unitised with profits (UWP)
- Unit-linked contracts with insurance features
- Unit-linked contracts with UWP component.

UK GAAP for Insurance and Participating Contracts



UK GAAP for Insurance and Participating Contracts



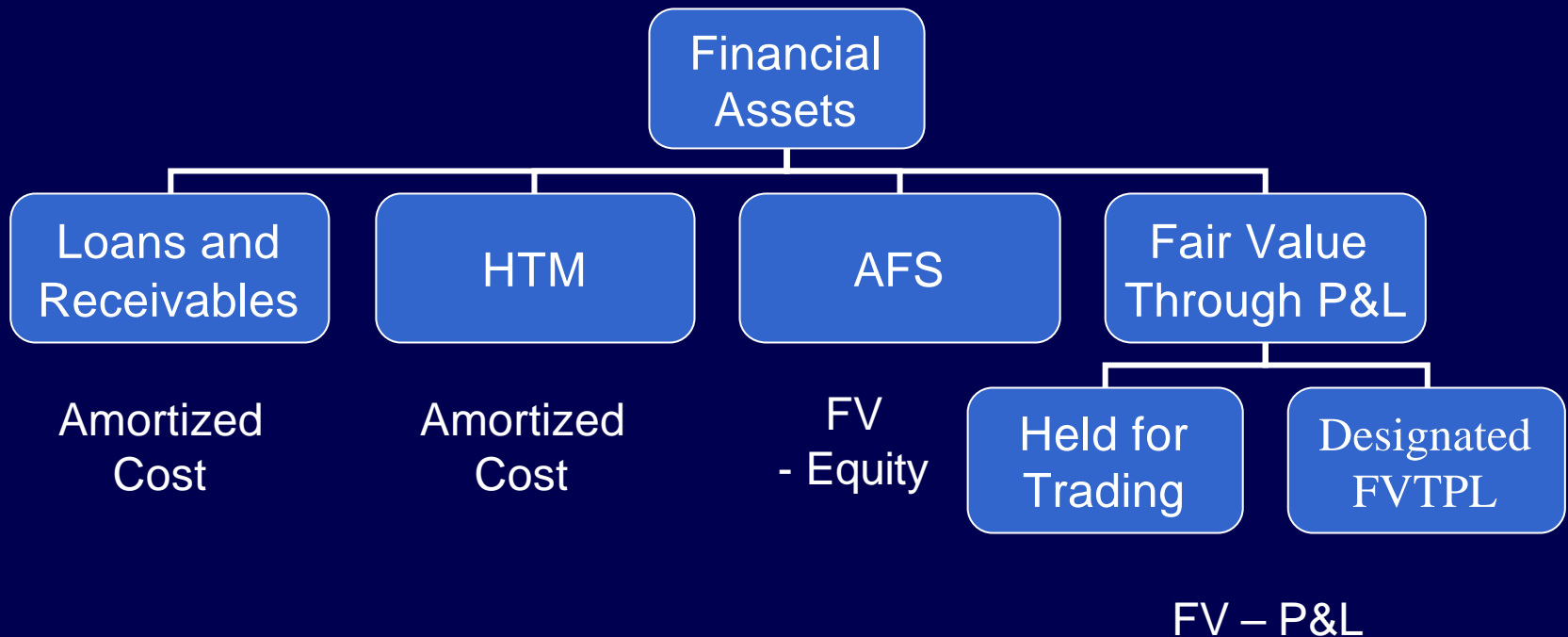
Application of UK GAAP in IAS Context

<u>Product</u>	<u>Accounting Policy</u>	<u>Potential Changes</u>
Annuities	Value liabilities using yield derived from supporting assets (adjusted for defaults).	Fair valuation of assets, available for sale valuation, amortised cost for loans, bid valuation of assets
Unit-Linked	Adjust unit liabilities to eliminate any mismatches in asset values or deferred tax assets/liabilities.	Bid valuation of assets, undiscounted deferred tax.
With Profits	Fund for Future Appropriations determined as excess of assets over liabilities.	Valuation of non profit liabilities, bid valuation of assets, financial reinsurance, etc.
Unitised	DAC recoverability/amortisation performed for block of business as a whole.	Separation of investment contracts from insurance/ participating contracts.

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Classification of Financial Assets Under IAS39 (Dec 03 Version)



“An entity may designate any financial instrument within the scope of IAS39 irrevocably on initial recognition as fair value through P&L”

Financial Asset Valuation

Classification determines the measurement and valuation rules.

IAS39 discourages / outlaws reclassification

Loans & Receivables, HTM and HFT – requirements are restrictive => main options are AFS and FVTPL

Question:

Of all these categories, what is best match for Insurance & DPF contract liabilities valued using UKGAAP (MSSB)?

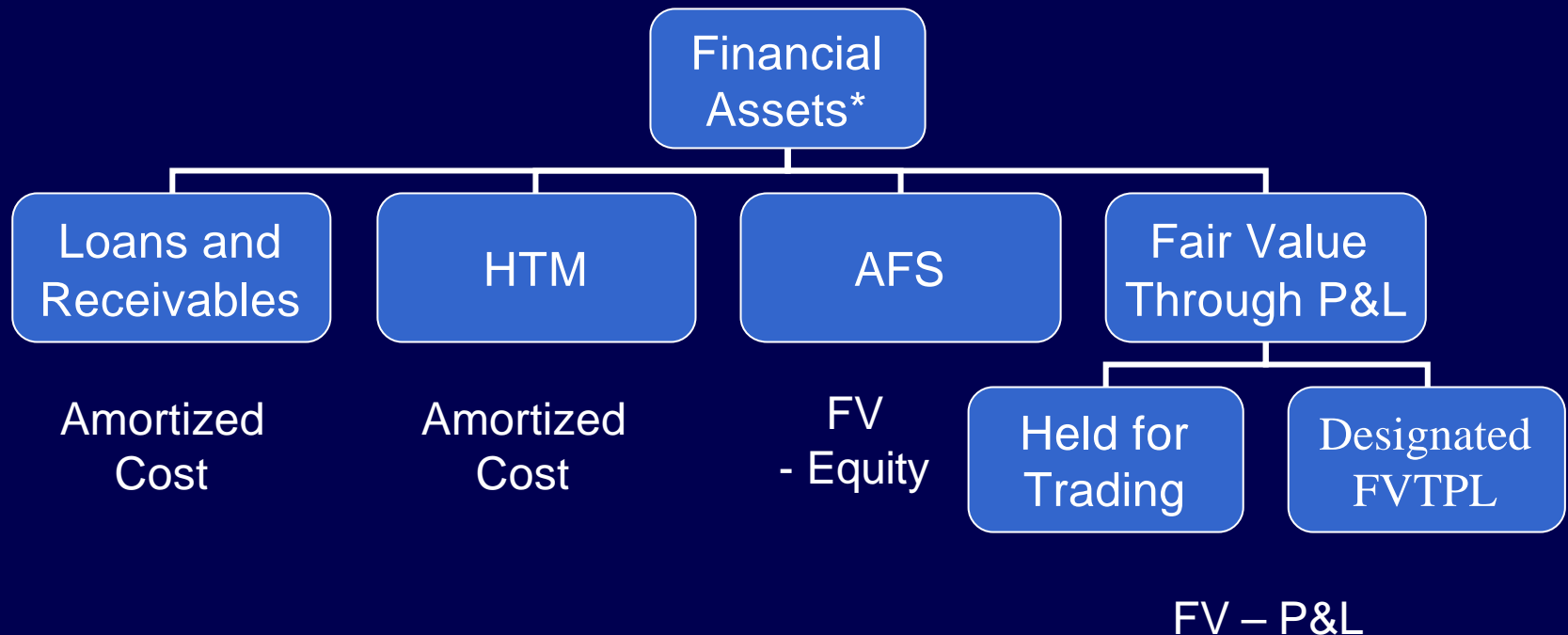
Answer:

Fair **V**alue **T**hrough **P**rofit & **L**oss

The IAS39 FVTPL Saga



Classification of Financial Assets Under IAS39 (March 04 Version)



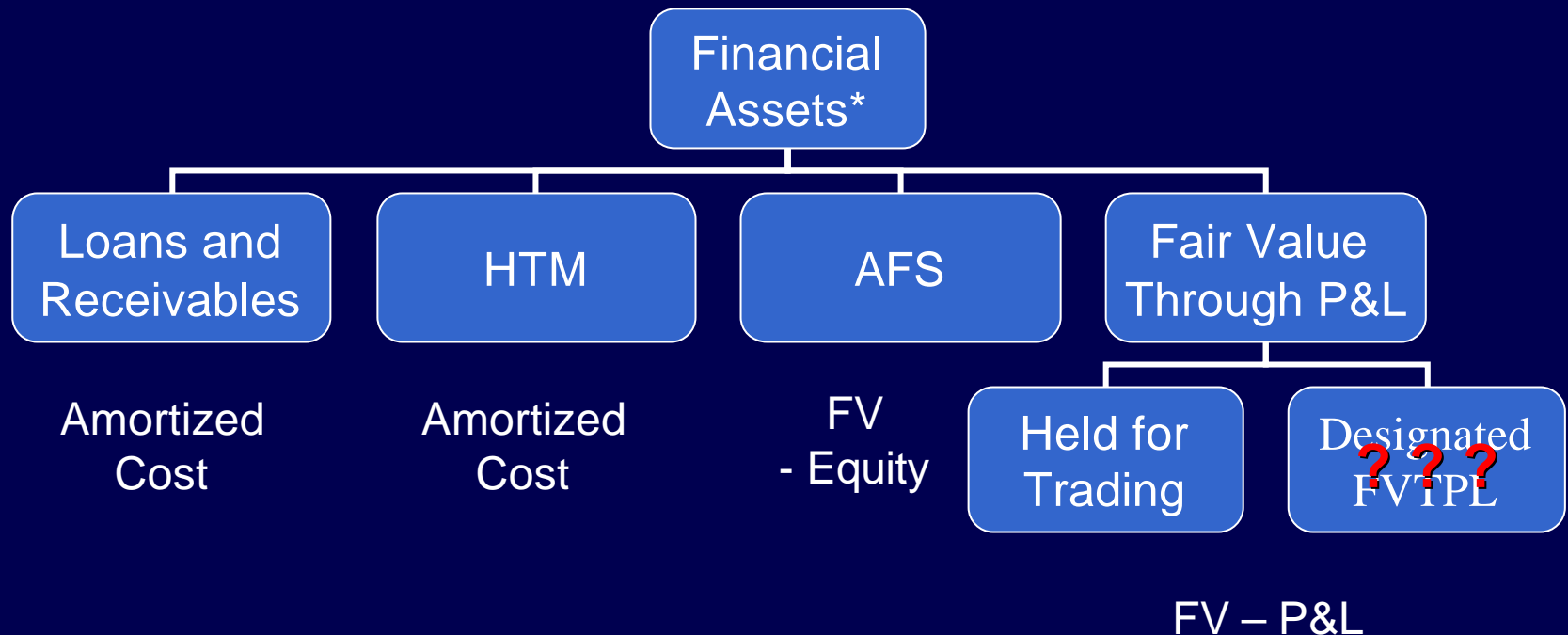
Restrictions placed on FVTPL option – questionable whether some assets would fit

*see IAS40 for Investment Property

Valuation and Full Fair Value Option – Commercial Mortgages

- Significant portfolio
- Held to back annuities valued at portfolio GRY adjusted for defaults
- FVTPL provides substantial offset for liabilities
 - Not traded – consider current rates for similar loans
- If no FVTPL, likely to be Loans & Receivables at amortised cost => major mismatch
- If restricted FVTPL, would the portfolio meet the restrictions?

Classification of Financial Assets Under IAS39 (After ARC Sept 04 Restrictions)



The classification determines the measurement and valuation rules

*see IAS40 for Investment Property

Asset Valuation

Working expectation all along has been to use market value with changes through P&L to match:

- Insurance contract liabilities at UKGAAP
- Investment contract liabilities at fair value

Practical implications when chasing a moving target:

- Go with what you want / expect / can do
- Follow the debate & have contingency plans
- Lobby hard!

‘The Commission hopes these fair value provisions will be revised by the IASB no later than December 2004’

Asset-Liability Issue: Unit Valuations

- UK practice – use mid-market prices for both asset and unit liability valuation
- IAS39 interpretation - bid value for assets
- Problem – ‘lose’ bid-mid difference from net assets
- Solution – apply same measurement basis for both
- This is permitted under UK GAAP and is supported by Paragraph AG72 of the Application Guidance for IAS39

“When an entity has assets and liabilities with offsetting market risks, it may use mid-market prices as a basis for establishing fair values for the offsetting risk positions

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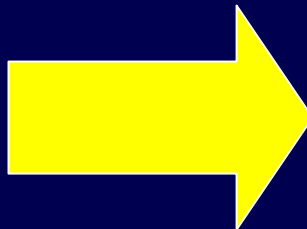
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Deposit Accounting for Investment Contracts

IFRS 4 Appendix B Paragraph B20

“..... this means that the parties to the [investment] contract use what is sometimes called deposit accounting, which involves ... [the recognition of any] consideration received as a financial liability, rather than as revenue ... [and the recognition of any] consideration paid as a financial asset, rather than as an expense.”

Traditional
Revenue
Accounting



Deposit
Accounting

Deposit Accounting for Investment Contracts

Traditional Revenue Accounting

Premiums

+ Investment Income

- Claims

- Expenses

- Change in DAC/DIR

- Change in Liabilities

= Profit

Deposit Accounting

Fees

- Expenses

+ Investment Income

- Change in DAC/DIR

- Income Attributed to Policyholders

- Excess Claims

- Change in Excess Liabilities

= Profit

Deposit Accounting for Investment Contracts

Traditional Revenue Accounting

Premiums

Includes initial charges, policy administration charges, annual management charges, surrender charges etc

- Change in DAC/DIR
- Change in Liabilities
- = Profit

Deposit Accounting

Fees

- Expenses
- + Investment Income
- Change in DAC/DIR
- Income Attributed to Policyholders
- Excess Claims
- Change in Excess Liabilities
- = Profit

Deposit Accounting for Investment Contracts

Traditional Revenue Accounting

Premiums

- Growth in unit fund before deduction of annual management charges but after allowance for tax charged to policyholders
- Change in Liabilities
- = Profit

Deposit Accounting

Fees

- Expenses
- + Investment Income
- Change in DAC/DIR
- Income Attributed to Policyholders
- Excess Claims
- Change in Excess Liabilities
- = Profit

Deposit Accounting for Investment Contracts

Traditional Revenue Accounting

Premiums

+ Investment Income

- Claims

- Expenses

- Claims in excess of account balance (if any)

- Change in Liabilities

= Profit

Deposit Accounting

Fees

- Expenses

+ Investment Income

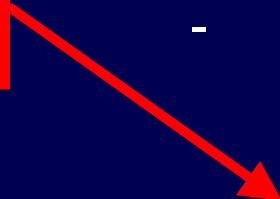
- Change in DAC/DIR

- Income Attributed to Policyholders

- Excess Claims

- Change in Excess Liabilities

= Profit



Deposit Accounting for Investment Contracts

Traditional Revenue Accounting

Deposit Accounting

Premiums

Fees

+ Investment Income

- Expenses

- Claims

+ Investment Income

- Expenses

- Change in DAC/DIR

- Change in DAC/DIR

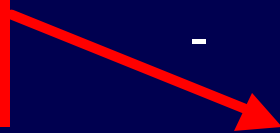
- Income Attributed to Policyholders

- Change in liabilities in excess of account balance (if any)

- Excess Claims

- Change in Excess Liabilities

= Profit



Deposit Accounting Example

Single Premium Bond with Two Year Term

Premium	£1,000
Investment Return	£70 per annum
Acquisition Expenses	£50
Deferrable Expenses	£40
Maintenance Expenses	£10 per annum
Up Front Fee	£30
Annual Charge	£25 per annum
No Tax	

Deposit Accounting Example - Year 1					
	Revenue Accounting	Premiums	Fees	Income Attributed	Deposit Accounting
Premiums	1,000	(1,000)			0
Fees	0		55		55
Change in DIR	(15)				(15)
Investment Income	70				70
Claims	0				0
Acquisition Expenses	(50)				(50)
Maintenance Expenses	(10)				(10)
Change in DAC	20				20
Income Attributed	0			(70)	(70)
Change in Liabilities	(1,015)	1,000	(55)	70	0
Profit	0	0	0	0	0

Deposit Accounting Example - Year 2					
	Revenue Accounting	Claims	Fees	Income Attributed	Deposit Accounting
Premiums	0				0
Fees	0		25		25
Change in DIR	15				15
Investment Income	70				70
Claims	(1,060)	1,060			0
Acquisition Expenses	0				0
Maintenance Expenses	(10)				(10)
Change in DAC	(20)				(20)
Income Attributed	0			(70)	(70)
Change in Liabilities	1,015	(1,060)	(25)	70	0
Profit	10	0	0	0	10

Practical Issues Associated with Deposit Accounting

- Need to identify premiums and claims for non-participating investment contracts
 - Actuarial and accounting product sub-division may not be aligned
 - Need to map actuarial product classification to accounting product codes
 - May need to determine factors to apportion premiums, claims and fees within product codes
- Need to identify fees
 - Not just AMCs
 - Need to include surrender charges etc
- Income attributed to policyholders is a subset of investment income
 - In theory, need to identify investment income for non-par investment contracts only
 - Could treat as balancing item after eliminating change in account balance
 - Would need to allow for reclassification of contracts and check reasonableness of income attributed

Treatment of Policyholder Tax Charges Under Deposit Accounting

- IAS profit is shown before tax, including any tax attributable (and charged to) policyholders
- This means gross profit will be “boosted” by any charge levied on policyholders for tax, although in such cases, the effective tax rate will also be artificially high
- Need to include the policyholder tax charge in the (before tax) income statement
 - Could classify as an additional fee
 - Could offset against income attributed to policyholders

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8.	Tax Treatment Under IAS	NMR
9.	Practical and Business Implications of IAS	NMR

Tax Treatment Under IAS

IAS 12 Paragraph 46

“Current tax liabilities (assets) for the current and prior periods should be measured at the amount expected to be paid to (recovered from) the taxation authorities, using the tax rates (and tax laws) that have been enacted by the balance sheet date.”

IAS 12 Paragraph 47

“Deferred tax assets and liabilities should be measured at the tax rates that are expected to apply to the period when the asset is realised or the liability settled, based on tax rates (and tax laws) that have been enacted by the balance sheet date.”

IAS 12 Paragraph 53

“Deferred tax assets and liabilities should not be discounted.”

Tax Treatment Under IAS

- Need to determine tax liabilities and assets using undiscounted tax rates
- Need to tax effect UK GAAP to IAS conversion items (DAC, liabilities, asset values etc) using relevant tax rates
 - Policyholder tax rate for BLAGAB component of with profit funds
 - Policyholder tax rate for BLAGAB component of I - E only changes in non profit funds
 - Corporate tax rate for I - E and NC1 changes in non profit funds
 - Marginal corporate rate for NC1 only changes in non profit funds
- If unit prices are determined after allowing for discounted deferred tax assets/liabilities, then use of undiscounted tax rates will generate a balance sheet mismatch and serve to increase the volatility of profits

Single Premium Bond Example

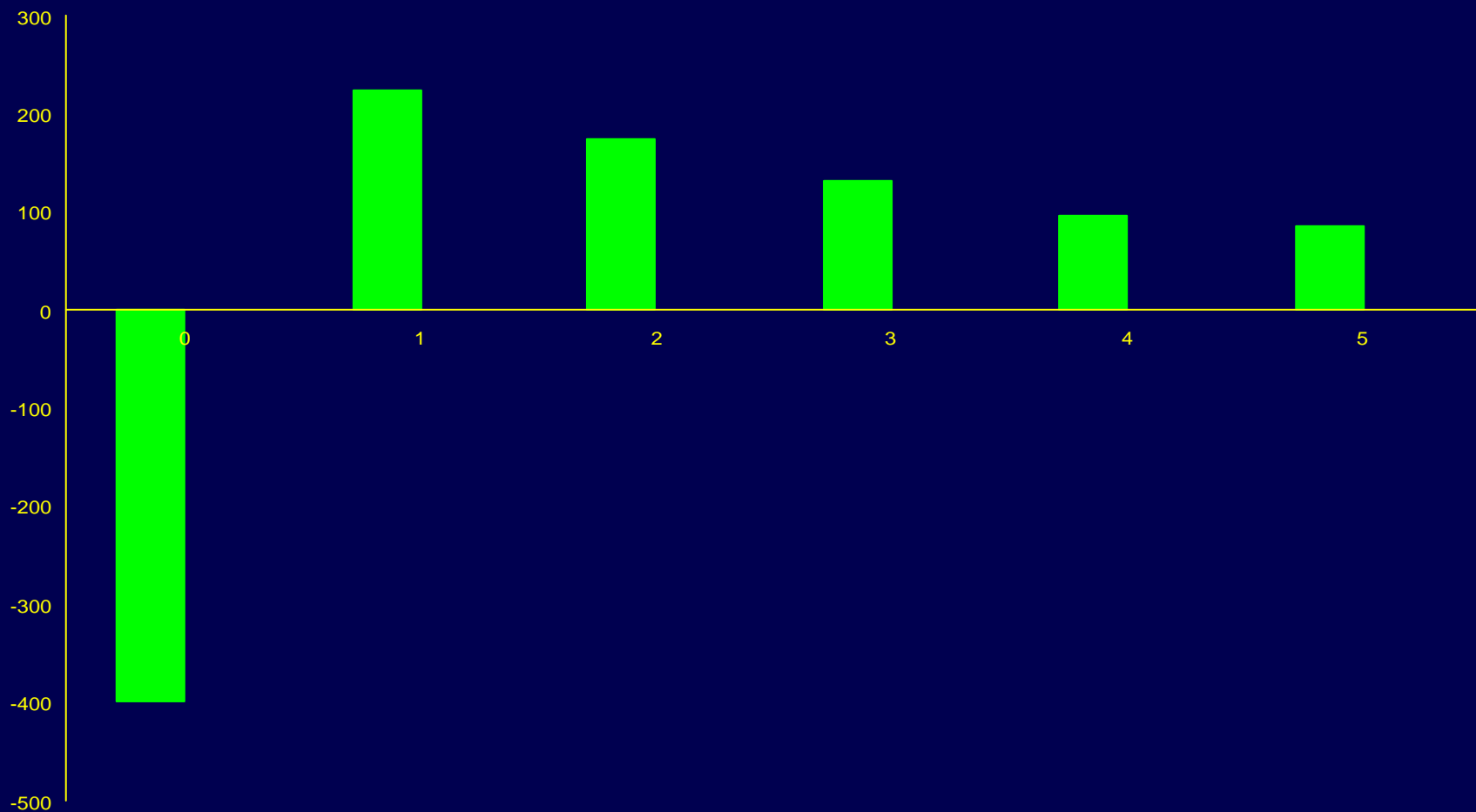
New Business Case

Premium	£20,000
Term	5 years
Annual Charge	1.5%
Initial Charge	2%
Surrender Charge	5%
(reducing to zero over 5 years)	
Undiscounted Tax	20%
Discounted Tax	15%

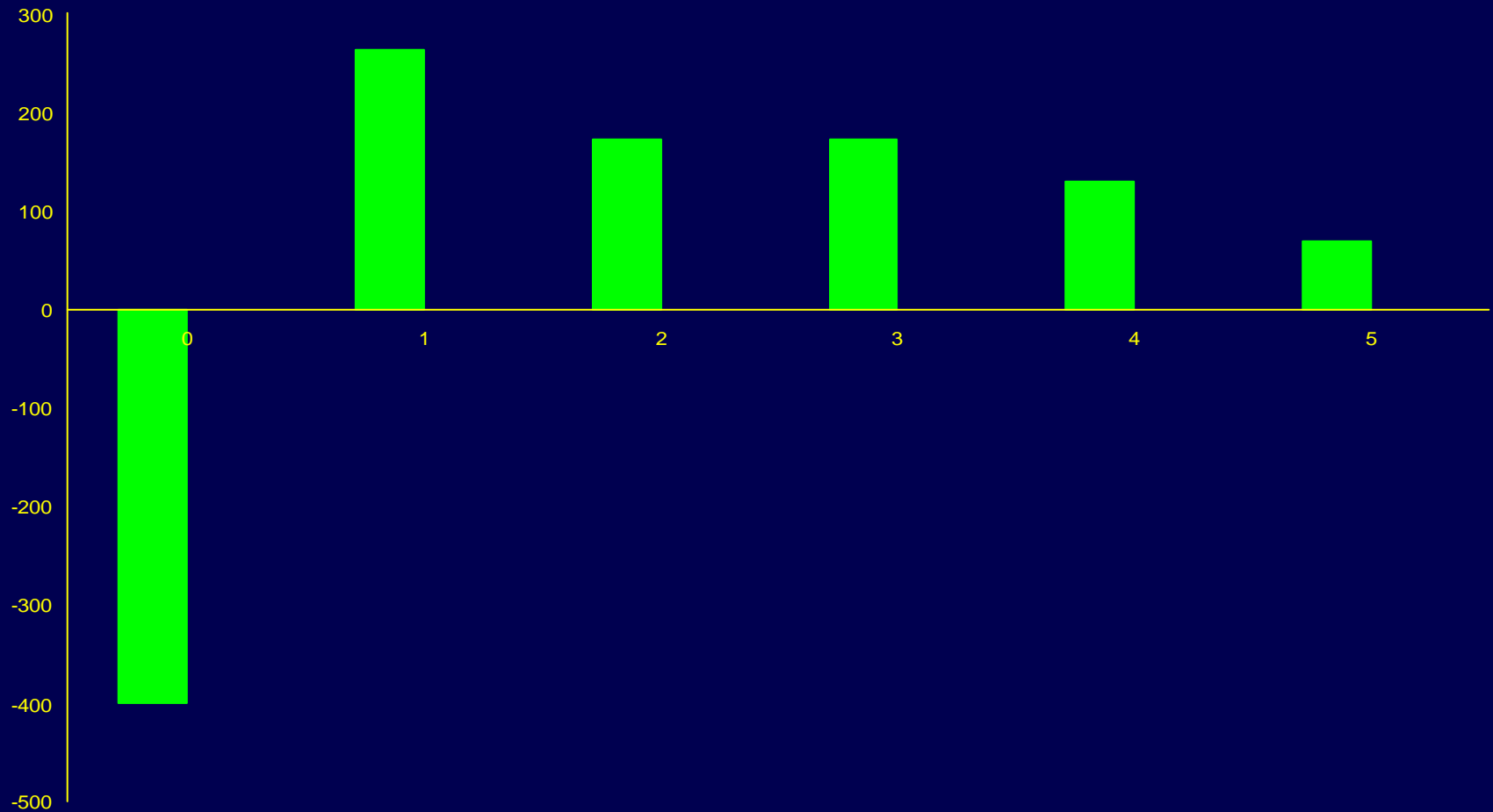
Existing Business Case

Fund	£20,000
Outstanding Term	5 years
Annual Charge	1.5%
Surrender Charge	zero
Undiscounted Tax	20%
Discounted Tax	15%
Deferred Tax	5%
Provision as a proportion of gross assets	

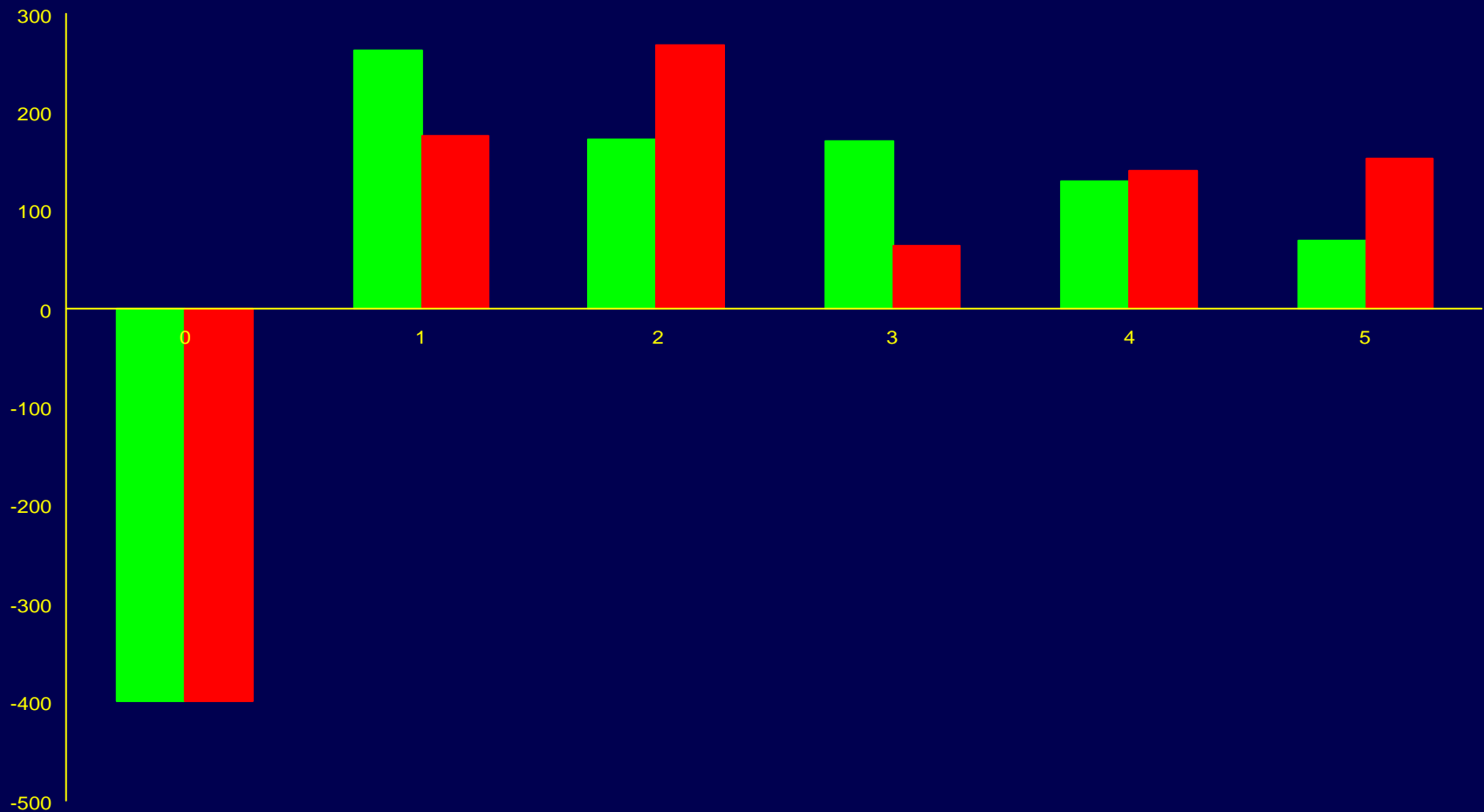
New Business Case - Profit Profile



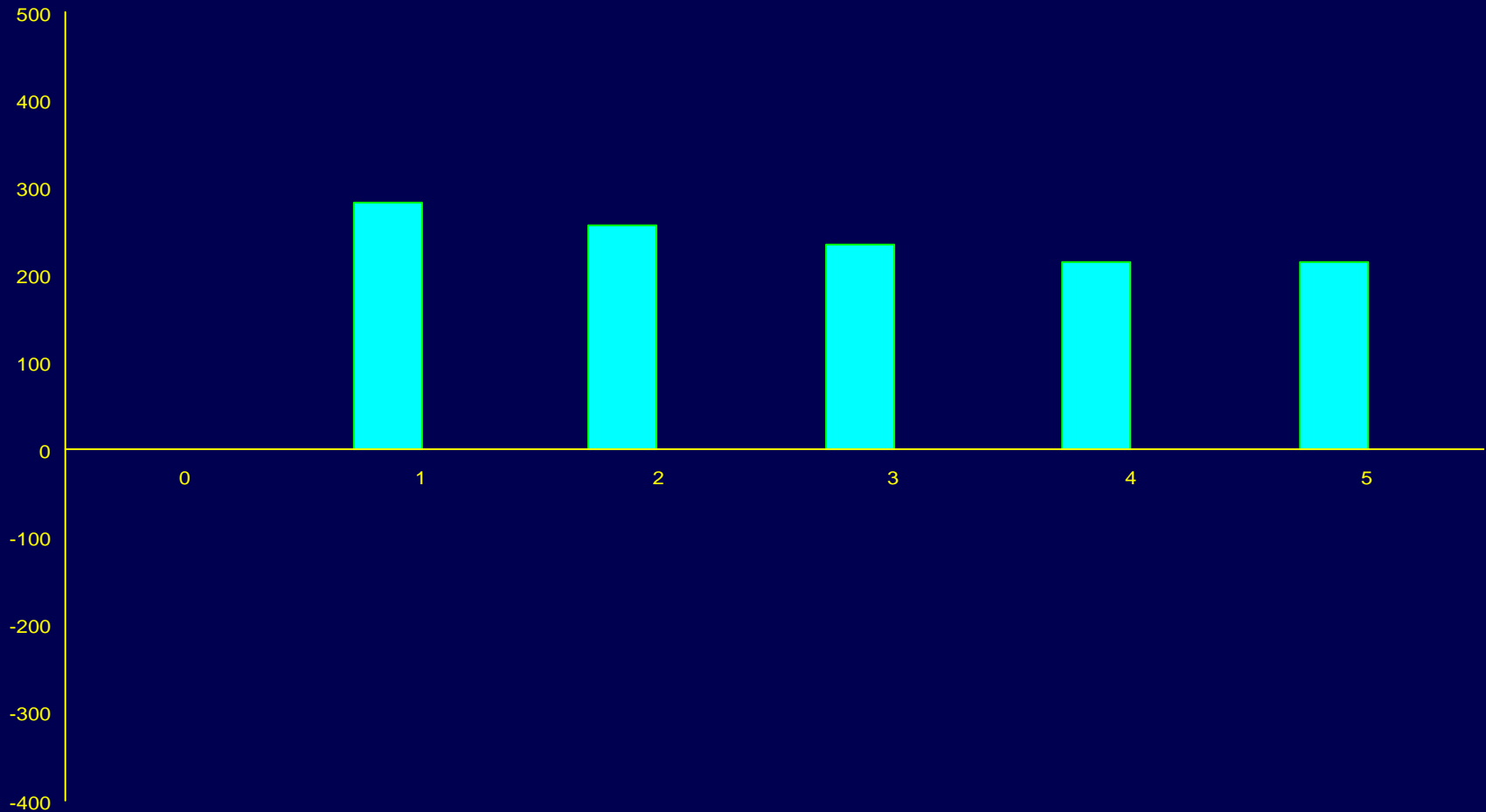
New Business Case - Volatile Returns



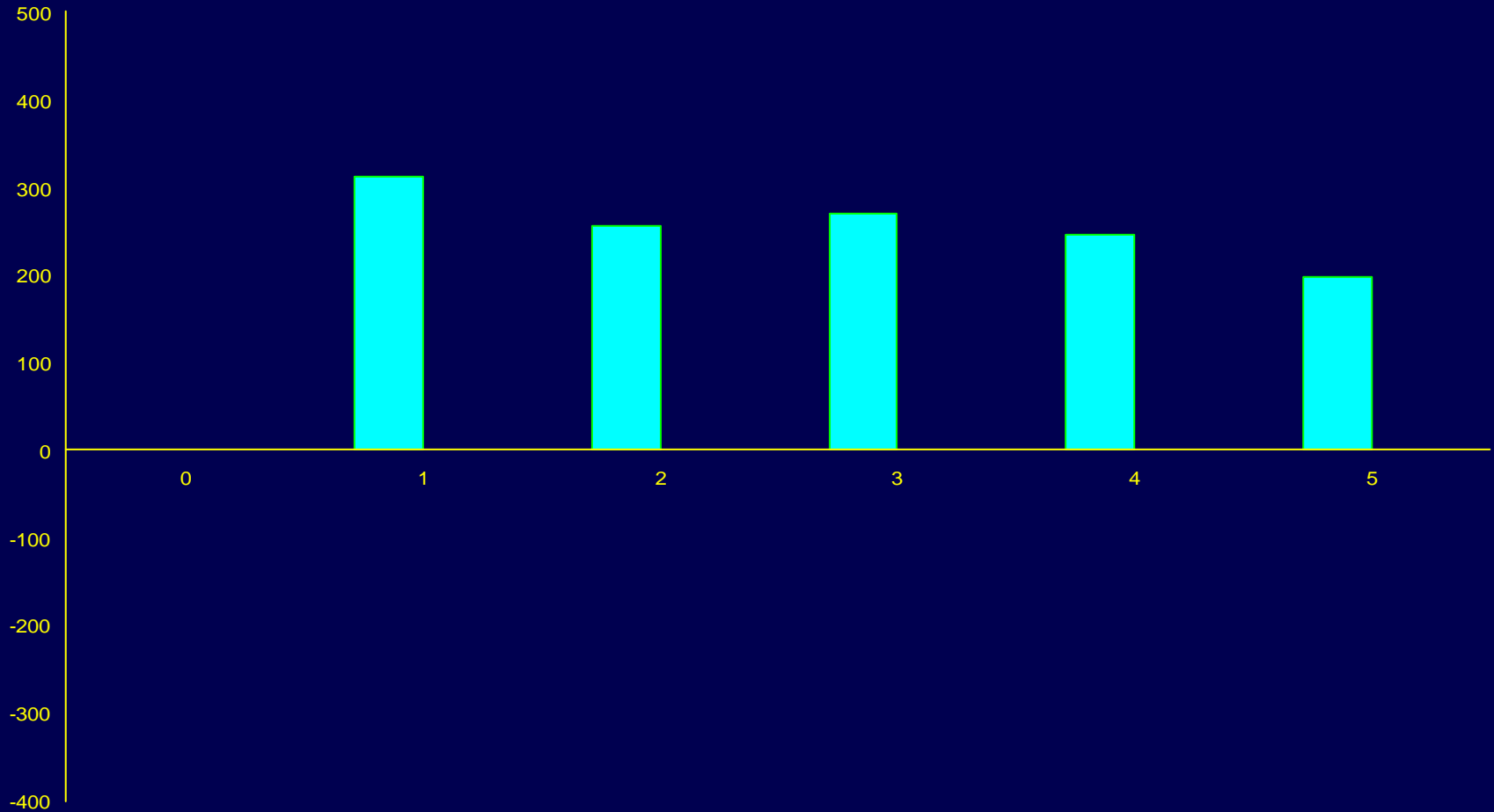
New Business Case - Volatile Returns and Undiscounted Tax



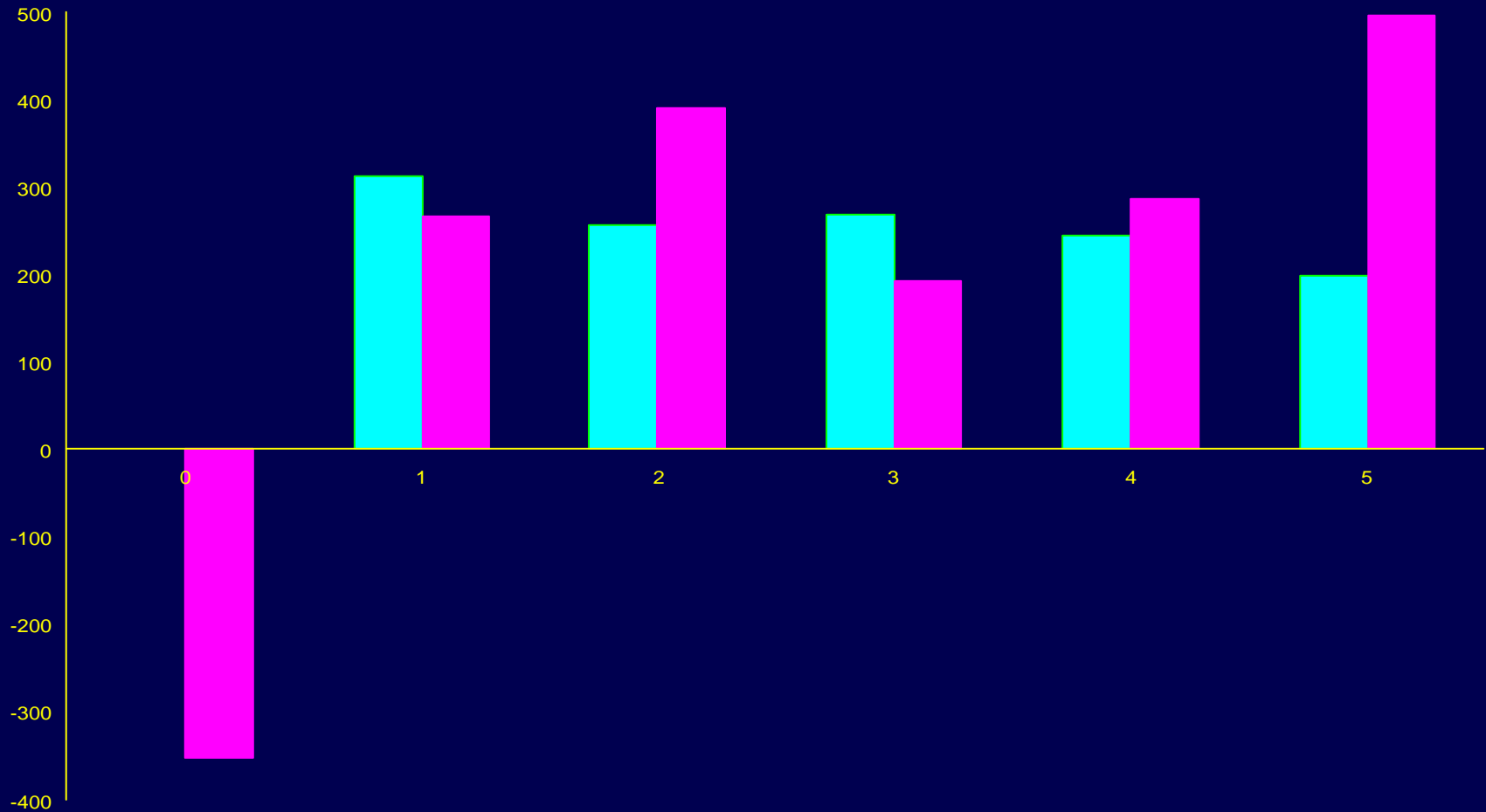
Existing Business Case - Profit Profile



Existing Business Case - Volatile Returns



Existing Business Case - Volatile Returns with Undiscounted Tax



Practical Implications of Implementing IAS in a Life Insurance Company

1.	Background on IAS Reporting Requirements	GH
2.	Product Classification	GH/NMR
3.	Embedded Derivatives	GH
4.	Valuation of Non Participating Investment Contracts	GH/NMR
5.	Valuation of Insurance and Participating Contracts	NMR
6.	Financial Asset Valuation	GH
7.	Deposit Accounting	NMR
8.	Tax Treatment Under IAS	NMR
9.	Practical and Business Implications of IAS	NMR

Practical Implications of IAS Reporting

- *Actuarial Systems:* DAC calculations, fair value calculations, disclosures, analysis of results
- *Data Requirements:* Hybrid products, historical information
- *Accounting Systems:* Deposit accounting, IAS accounts, disclosures
- *Asset Data:* IAS valuations, amortised cost disclosures
- Multi-GAAP reporting burden
- Lack of clarity on reporting requirements and divergence of industry practice

Business Implications of IAS Reporting

- Potential switch from UK GAAP to IAS for subsidiaries - implications for tax computations?
- Need to manage IAS profits?
 - Introduce insurance features
 - Service company charge structure
 - Commission structure
 - Investment strategy
 - Hedging strategy
- Stakeholder management and market communications

Other IAS Issues and Hot Topics

...or what we have not covered – didn't take up our time in this project, but might do for others:

- Reinsurance, including disclosure of impact, gross reporting & asset impairment
- Unbundling & FinRe
- Disclosures – IAS32 / ED7
- Liability Adequacy Test

Other things to watch out for from the IASB:

- Financial Guarantees & Credit Insurance
- Revenue Recognition (biz-2-biz or retail?)
- IAS39 (again!)
- Phase 2!!!