Current Issues in Life Assurance
Anthony Coughlan, Kamran Foroughi and Raymond Bennett

Insurance accounting:
– a new era?
16 May 2012


• 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:

<table>
<thead>
<tr>
<th>Anthony Coughlan</th>
<th>Gary Hibbard</th>
<th>Raymond Bennett</th>
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<tbody>
<tr>
<td>Darren Clay</td>
<td>Kamran Foroughi (Chair)</td>
<td>Richard McPherson</td>
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<tr>
<td>Derek Wright</td>
<td>Martin Lowes</td>
<td>Richard Pereira</td>
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<tr>
<td>Erica Nicholson</td>
<td>Martin White</td>
<td>Tony Silverman</td>
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<tr>
<td>Francesco Nagari</td>
<td>Nigel Masters</td>
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**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

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**Existing IFRS**

<table>
<thead>
<tr>
<th>IAS 18: Revenue</th>
<th>IFRS 4: Insurance Contracts</th>
<th>IFRS 7: Financial Instruments Disclosures</th>
</tr>
</thead>
<tbody>
<tr>
<td>IAS 40: Investment property</td>
<td>IAS 39: Financial Instruments Recognition and measurement</td>
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<td>IAS 39: Financial Instruments Recognition and measurement</td>
<td></td>
<td></td>
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<tr>
<td>IAS 32: Financial Instruments Presentation</td>
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</tbody>
</table>

- **Intangibles / DAC**
- **Property**
- **Financial Instruments**
- **Equity**
- **Other Liabilities**
- **Debt**
- **Contract Liabilities**

- **Assets**
- **Liabilities**

= 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

<table>
<thead>
<tr>
<th>2012</th>
<th>2013</th>
<th>2014</th>
<th>2015 onwards</th>
</tr>
</thead>
<tbody>
<tr>
<td>FRS 1</td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>Insurance contracts</td>
<td>Review draft or revised ED</td>
<td>Final standard?</td>
<td>Effective date no earlier than 1 Jan 15</td>
</tr>
<tr>
<td>Financial instruments</td>
<td>Partially complete – various EDs to come</td>
<td>Final standard?</td>
<td>Effective date of 1 Jan 15 or 16?</td>
</tr>
<tr>
<td>Fair value measurement</td>
<td></td>
<td>Issued and effective 1 Jan 13 (relevant when other standards refer)</td>
<td></td>
</tr>
<tr>
<td>Revenue Recognition</td>
<td>Revised ED</td>
<td>Final standard?</td>
<td>Expected effective date no earlier than 1 Jan 15</td>
</tr>
</tbody>
</table>

Solvency II

<table>
<thead>
<tr>
<th>Level 1</th>
<th>Level 2</th>
<th>Level 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Trialogue and final legal process</td>
<td>Finalisation by EC / EIOPA</td>
<td>Ongoing pre-consultation</td>
</tr>
<tr>
<td>Consult &amp; publish</td>
<td>Consult &amp; publish</td>
<td></td>
</tr>
<tr>
<td>Effective date of 1 Jan 14</td>
<td></td>
<td></td>
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</tbody>
</table>

UK GAAP

<table>
<thead>
<tr>
<th>Comprehensive standard</th>
<th>Insurance Contracts</th>
</tr>
</thead>
<tbody>
<tr>
<td>Exposure drafts</td>
<td>Exposure draft (insurance contracts) and single comprehensive standard</td>
</tr>
<tr>
<td>Effective date of 1 Jan 15? (Potential for early adoption)</td>
<td></td>
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Insurance contracts: The building block approach

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

<table>
<thead>
<tr>
<th>Topic</th>
<th>Tentative decision</th>
<th>Observations</th>
</tr>
</thead>
<tbody>
<tr>
<td>Initial recognition</td>
<td>Start of coverage period or in pre-coverage period if onerous</td>
<td>• Application guidance on onerous contract test will be important</td>
</tr>
</tbody>
</table>
| 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

Expected reference portfolio rate

- Expected defaults
- Unexpected defaults
- Illiquidity premium
- Risk free rate
- Bottom up
- Top down

Insurance contracts: Participating contracts

<table>
<thead>
<tr>
<th>Tentative IASB decisions</th>
<th>Observations</th>
</tr>
</thead>
<tbody>
<tr>
<td>Participating investment contracts in scope of the insurance standard if issued by insurers</td>
<td>• Welcome change to ED where certain participating investment contracts would be under financial instruments standards</td>
</tr>
</tbody>
</table>
| 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)

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

(Our understanding as at end April 2012)

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

- 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](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

FRG responded to consultation with views on questions asked by the ASB (see http://www.frc.org.uk/documents/pagmanager/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:

  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.