International Financial Reporting Standards

Exposure Draft
Insurance Contracts

The views expressed in this presentation are those of the presenter, not necessarily those of the IASB or IFRS Foundation

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Agenda

IASB project on Insurance Contracts

- Project basics
- Proposals in the Exposure Draft
  – Measurement model
  – Presentation and disclosures
  – Recognition
  – Transition
- What are the next steps? How can you get involved?

Project basics

Project history

- IFRS 4 *Insurance Contracts*
  - started in 1997
  - standard issued in 2004 (‘Phase I’)
    - aimed at making only limited improvements
- Discussion Paper *Preliminary Views on Insurance Contracts* (‘Phase II’)
  - issued in 2007
  - further discussed since early 2008
  - 162 comment letters received

Project basics continued

- FASB
  - joint project since 2008
  - issues a Discussion Paper to further solicit input from constituents
- Due process documents
  - Exposure Draft: published 30th July 2010
  - Standard: expected for Q2 2011

Why are we doing this project? Accounting for insurance contracts TODAY

- IFRS 4 (Phase I) temporary solution
- Wide variety of
  - accounting practices for different contract types and jurisdictions
  - measurement models

→ lack of comparability and transparency

→ current insurance accounting does not provide users with relevant information

Insurance accounting TODAY is a black box

What did respondents tell us about the Discussion Paper?

- Measurement model: current exit value ☒ ED
  - Typically no transfer, but fulfilment
- Non-performance risk ☒ ED
  - Should not be reflected
- Building block approach to measurement ☑ ED
  - Supported, but some concerns

What did respondents tell us about the Discussion Paper? continued

- Current estimates based on observable market prices for interest rates and equity prices ☑ ED
  - Generally supported
  - Market consistent where available, if not, entity's own inputs
- Explicit risk margin ☑ ED
  - Generally supported
  - For comparability reasons, limited number of techniques

Advantages of the proposed model

- Principles - not detailed guidance
- Comparability – global standard, consistent accounting
- Coherent framework to deal with:
  - – more complex contracts
  - – emerging issues (no need for ‘add – on’ rules)

continued…

Advantages of the proposed model

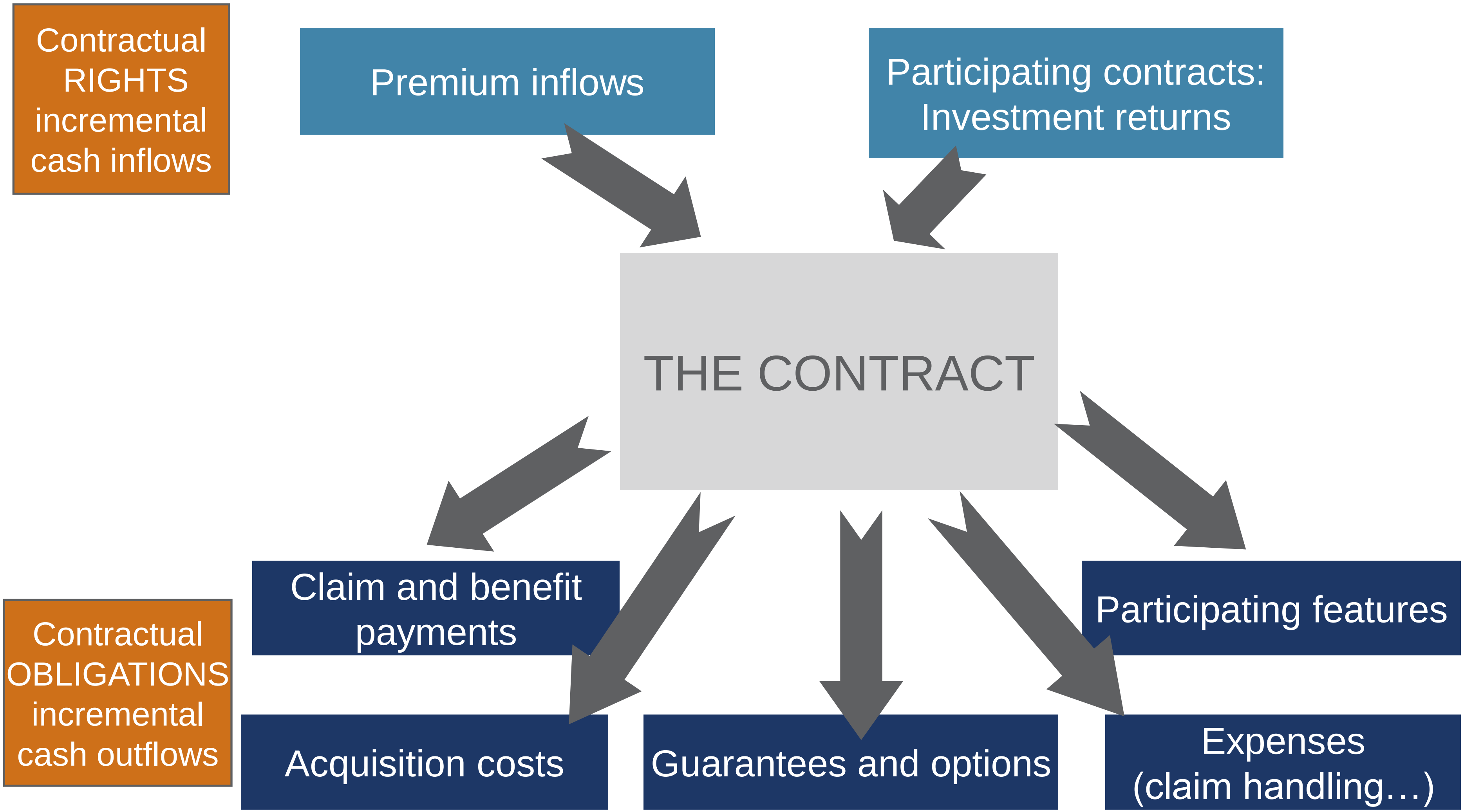
continued

- Relevant information for users:
  - focus on drivers of profitability of insurance contracts
  - amount, timing and uncertainty of future cash flows
  - current estimates
  - income recognised in line with release from risk
  - eliminate accounting mismatches
  - consistent accounting for embedded options and guarantees

Scope of the project

- Accounting for insurance contracts
  - The contract
    - Combination of rights and obligations
    - Presented on a net basis
  - One model for all insurance types
  - Not about the insurer's other assets or liabilities
  - For the time being: not policyholder accounting
  - Definition
  - Investment contracts with discretionary participating feature

What does “accounting for the contract” mean?



Related projects

Eliminate accounting mismatches

Use of OCI

Aligning of effective dates

- Financial Instruments
  - Classification and measurement
- Revenue Recognition
  - Contracts with customers
- Liabilities (Amendments to IAS 37 *Provisions, Contingent Liabilities and Contingent Assets)*
  - Measurement of uncertain liabilities

Proposals in the Exposure Draft

overview

- Measurement model
  - inputs and estimates
  - building blocks
- Presentation and disclosures
- Recognition
  - contract boundaries
  - unbundling
  - reinsurance
- Transition

Measurement model

- Current measurement of an insurance contract
  - remeasured each reporting period
  - not locked-in
  - not updated for own credit risk
- Reflect insurer’s perspective of the contract
- Building block approach
  - Four (or three) building blocks
- No deposit floor

Inputs and changes in estimates

- Inputs
  - Financial market variables: consistent with observable market prices
  - Other variables: use all available information
  - unbiased
- Changes in insurance liabilities
  - profit or loss

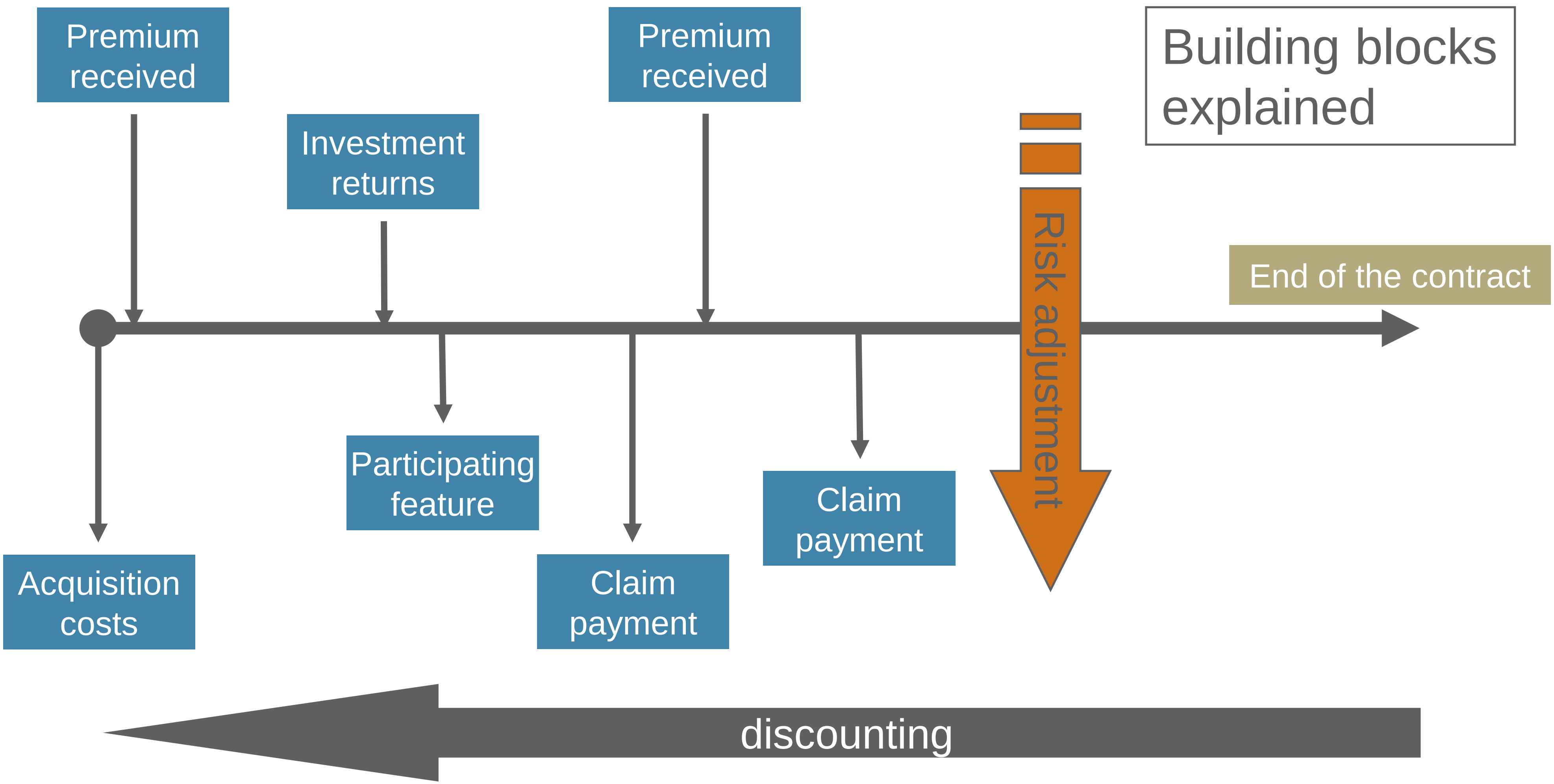
Measurement model continued

- Building blocks
  - Expected (probability-weighted) future incremental cash flows (that arise from the contract)
  - Time value of money
  - Risk adjustment

Cash flows	Discounting	Risk adjustment	Margin

- No day one gains: residual margin
- Day one losses recognised in profit or loss

Measurement model continued



Measurement model continued

Cash flows	Discounting	Risk adjustment	Margin

Expected (probability-weighted) future incremental cash flows

- current estimates
- on a portfolio level
- expected to arise from the contract, including
  - incremental acquisition costs
  - cash flows arising from participating features

Cash flows	Discounting	Risk adjustment	Margin

Acquisition costs

- Costs of selling, underwriting and initiating an insurance contract
- Some insurers currently defer all acquisition costs
- Proposal in the ED:
  - – incremental acquisition costs (on a contract level) are included in the cash flows
  - – non-incremental acquisition costs are expensed

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Measurement model continued

Cash flows	Discounting	Risk adjustment	Margin

Participating contracts

- Cash flows from participating features
  - (incremental) Participating benefits an insurer expects to pay arising from participating insurance contracts

  → Contract cash flows like any other

- Mutual insurers?

Measurement model continued

Cash flows	Discounting	Risk adjustment	Margin

Time value of money

- Discount rate:
  Reflecting characteristics of the insurance contract
  - Non-participating: risk-free plus adjustment for illiquidity
  - Participating: consider performance of assets
- Excluded: non-performance risk

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Measurement model continued

Cash flows	Discounting	Risk adjustment	Margin

Risk adjustment

- Explicitly measures the effects of uncertainty associated with future cash flows
  - insurer's view of uncertainty
- Remeasured each reporting period
- Measured at portfolio level
- Permitted measurement techniques

Confidence interval/ Conditional Tail Expectation/ Cost of Capital

Measurement model continued

Cash flows	Discounting	Risk adjustment	Margin

Residual margin

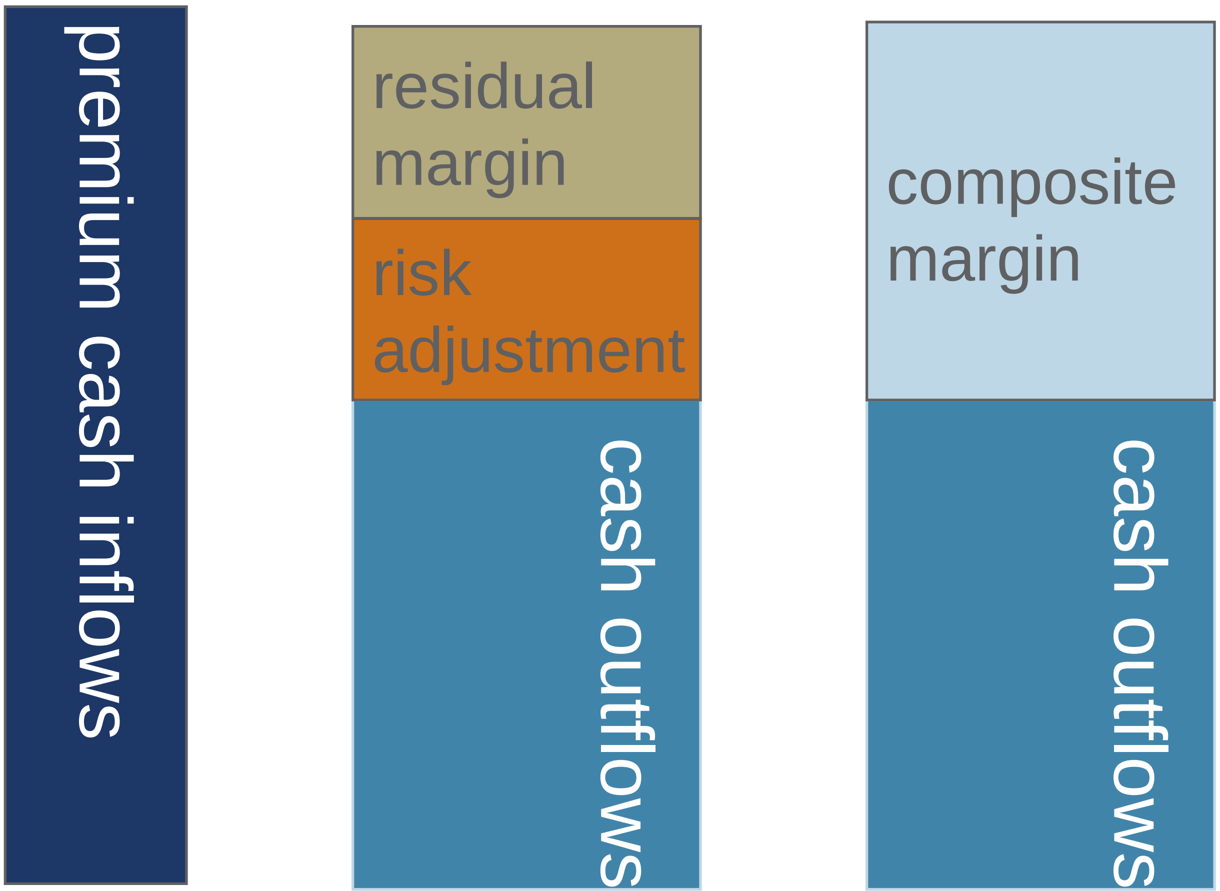
- Allocation of 'day-one gain' - releasing it to profit or loss over the coverage period in a systemic way
  - passage of time, or
  - pattern that better reflects the occurrence of benefits and claims
- 'Day-one loss' exists when:
  cash inflows < cash outflows + risk adjustment

Premium received 12	<	Expected claim payments 10
		Risk adjustment 3

- Accretion of interest (locked-in)

Measurement model continued

Cash flows | Discounting | Risk adjustment | Margin



Margins

Two approaches considered

Measurement model continued

Cash flows	Discounting	Risk adjustment	Margin

The Board also considered as an alternative: Composite margin (not part of the proposal!)

- Allocation of 'day-one gain' - subsequent release to profit or loss
  - over coverage period plus claims handling period
  - amortisation according to the exposure from
    - providing insurance coverage
    - uncertainties related to future cash flows
- 'Day-one loss' exists when: cash inflows < cash outflows

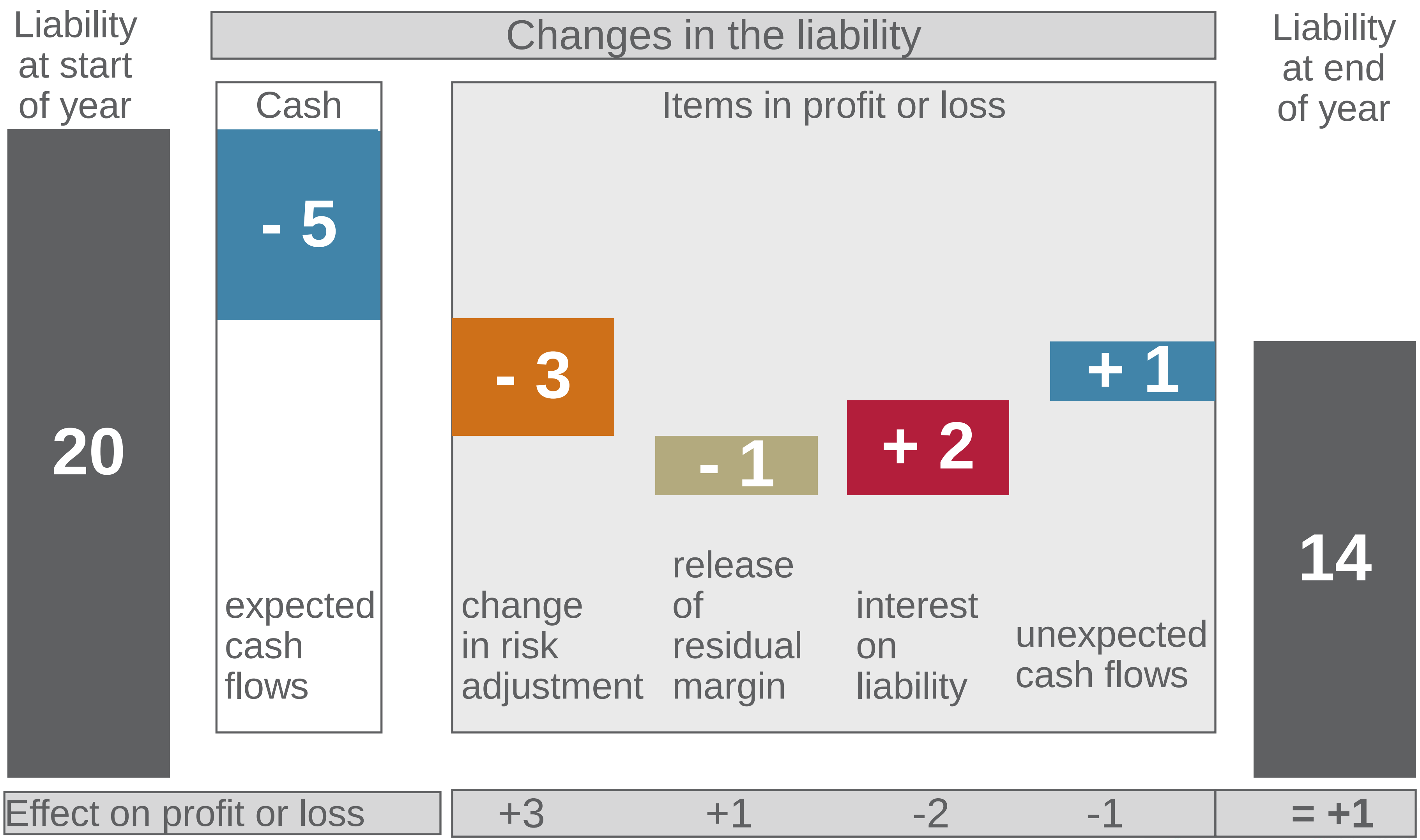
Premium received 12 < Expected claim payments 13

Measurement model continued

Modified approach

- Premium allocation model (‘unearned premium’)
- Required for pre-claim liability of most short-duration contracts
- General measurement model for claim liability (risk adjustment, discounting…)

Measurement model continued
Performance reporting



Presentation and disclosures

Presentation of income statement

- Margin-based approach
  - **follows the direct measurement model**
  - what insurers expect to earn from providing insurance services and investment return
  - treating insurance premiums as deposits
  - broadly showing:
    - change in the risk adjustment and the release of the residual margin
    - gross inflows and outflows in the disclosures

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Presentation and disclosures continued

Income statement	Year X	Year X-1
Risk adjustment	3	2
Residual margin	1	1
Underwriting margin	4	3
Experience adjustment	(0.5)	1
Changes in estimates	(0.5)	0
Underwriting result	3	4
Investment income	5	3
Interest on insurance liability	(2)	(1.5)
Net interest and investment	3	1.5
Profit	**6**	**5.5**

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Presentation and disclosures continued

Disclosures

- Disclosure principle aims at
  - explaining **the amounts** recognised in the financial statements arising from insurance contracts; **and**
  - **the nature and extent of risks** arising from those contracts.
- Auditable information about effectiveness in risk management practices (vs. non-audited MD&A info)
- Risk disclosures similar to IFRS 7
  - Sensitivity analyses

Recognition

Recognition

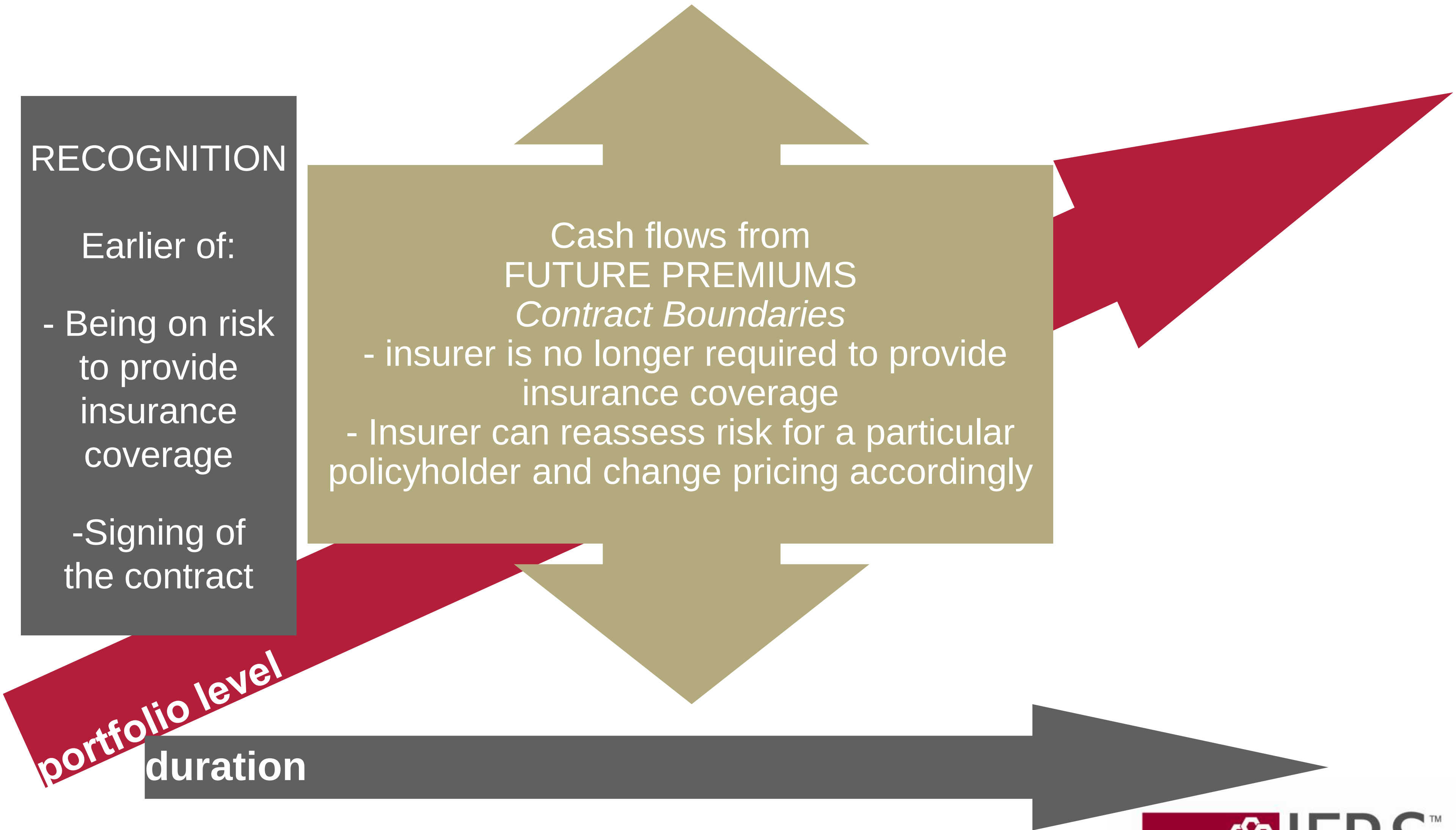
- At the earlier of
  - the insurer being on risk to provide insurance coverage
  - the signing of the contract

Recognition continued

Contract boundaries

- Where does an ‘existing contract’ end?
- Existing contract ends if insurer
  - is no longer required to provide coverage, or
  - can reassess the risk for a particular policyholder and change the pricing accordingly

Which future cash flows are included?



What is ‘insurance’ in a contract?

Definition of an insurance contract

A contract under which:

one party (the insurer) accepts

significant insurance risk (other than financial 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.

Unbundling

- Account for components of a contract as if they were separate contracts
- Unbundle components of an insurance contract that are **not closely related** to the insurance coverage
- Most common examples:
  - Policyholder account balances
  - Embedded derivatives
  - Goods and services that are not closely related to insurance
- Not permitted otherwise

Recognition continued

Reinsurance

- One model for all insurance and reinsurance contracts
  - No anti-abuse rules necessary
- Cedant: same measurement as used for underlying direct insurance contracts
  - Initial measurement: residual margin
  - Ceding commission reduces premium
- No offsetting
  - unless requirements for offsetting are met
- No derecognition of ceded contracts
  - unless obligation is discharged, cancelled or expired

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Recognition continued

Derecognition

- When the insurance liability no longer qualifies as a liability
  - When it is extinguished, ie when the obligation is discharged or cancelled or expires
  - Clarification in guidance:
    at that point where the insurer is
    - no longer at risk and
    - no longer required to transfer any economic resources for the insurance obligation

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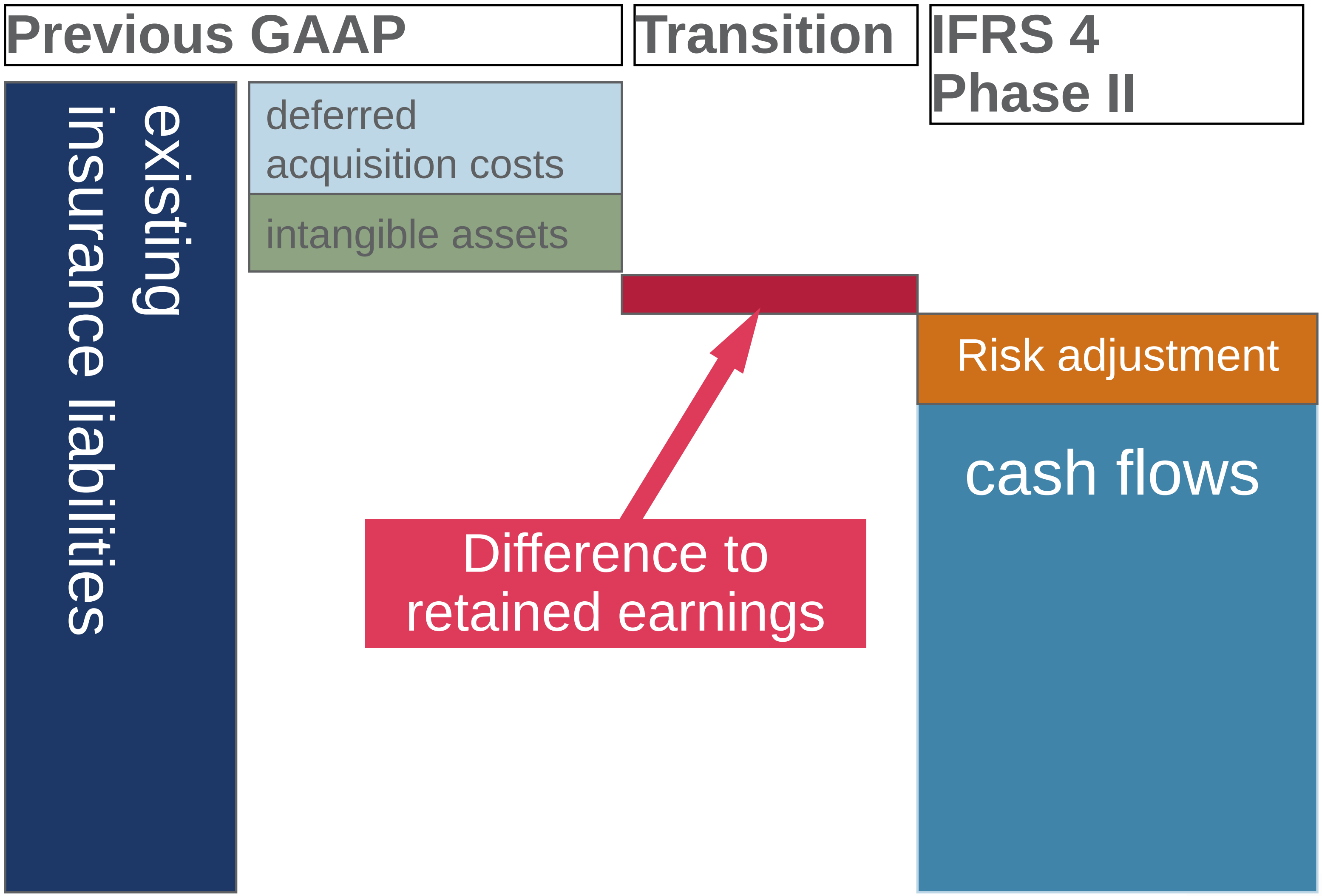
What happens on transition?



Transition continued

- Redesignation of financial assets
  - permitted
  - measured at fair value through profit or loss
  - to reduce inconsistency in measurement or recognition
  - adjustment to retained earnings
- Disclosure exemption
  - previously undisclosed claim development information
  - > 5 years

What are the next steps?

- ED published: 30th July 2010
- FASB: issues a Discussion Paper
- Outreach: Working Group, field tests…
- Comment period ends: 30th November 2010
- Final standard by mid-2011

How can you get involved?

Staying up to date

- www.ifrs.org
- go.ifrs.org/
insurance_contracts
- IASB Update
- Board meeting webcasts
- Project webcasts and podcasts

Contacts

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Questions or comments?

Expressions of individual views by members of the IASB and its staff are encouraged. The views expressed in this presentation are those of the presenter. Official positions of the IASB on accounting matters are determined only after extensive due process and deliberation.

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