INSURANCE

International Accounting Standards
Where are we?

Southeastern Actuaries Conference
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ADVISORY

AUDIT ▪ TAX ▪ ADVISORY

- Where are we now?
- Where are we going?

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The IASB's Insurance Project

- The IASB began considering accounting for insurance contracts in 1997
- Adoption of IAS by the European Union accelerated the need for an insurance standard
- The Board decided to split project into two phases as there was insufficient time to complete the project by 2005
- Phase I deals with disclosures and addresses the perceived "worst practices" to that point in time
- Phase I standard was issued March 31, 2004
- Phase II, TBD

The Importance of Contract Definition

- Insurance Contracts use existing or "improved" accounting policies
- Other contracts – Apply relevant IAS
- Therefore, Product Classification is a Key Item

- **IAS 4 – Insurance Contracts**
- **IAS 39 – Investment Contracts**

- **IAS Definition:**
  - *“a contract under which one party (the <u>insurer)</u> accepts significant insurance risk from another party (the <u>policyholder</u>) by agreeing to compensate the policyholder if a specified uncertain future event (the <u>insured event</u>) adversely affects the policyholder”*

- Contracts that do not qualify as insurance contracts will be accounted for as financial instruments under IAS 39 – although there is a partial exemption from this requirement for with profits contracts (in phase I)

- *‘Insurance risk is significant if, and only if, an insured event could cause an insurer to pay significant additional benefits in any scenario, excluding scenarios that lack commercial substance’.*
- The reference to the scenario lacking in commercial substance replaces the previous reference to a plausible scenario which was intended to exclude artificial conditions
- The level of additional benefits that are required before these benefits are deemed significant remains open to interpretation

The level of insurance risk may vary throughout a contract.

For example:

- <u>Term insurance:</u> The risk level remains constant throughout the contract lifetime
- <u>Endowment insurance:</u> The risk level reduces as the value of investment component increases
- <u>Deferred annuities:</u> No insurance risk exists during the savings phase, but insurance risk exists in the payout phase.

What qualifies as insurance?

Product	Why
Annuities in payout	Longevity Risk
Term assurances, including critical illness	Mortality / morbidity risk is significant
Permanent Life insurances	Mortality risk is significant
Permanent Health insurances	Morbidity risk is significant
Unit linked mortgage endowments	Mortality risk is significant
Waiver of premium riders	Morbidity risk is significant
Deferred annuities written to provide a pre-determined pension at retirement	Longevity Risk will become significant

What doesn't qualify:

- Unit linked products with trivial insurance risk
- Deferred annuities without payout guarantees
- Term certain payout annuities

Account for these under IAS 39

IAS 39 – Embedded Derivatives

What are they?

- An implicit or explicit term or terms in a contract that makes it behave like a derivative
- Separation from the host contract may be required
- A separated derivative is recorded at fair value

IAS 39 – Embedded Derivatives

When are they separated?

- Embedded derivative would be a derivative if freestanding; or
- The host contract is not carried at fair value through P/L; or
- The embedded derivative is not closely related to the economic characteristics and risks of the host

Accounting Treatment for Embedded Derivatives

- Host contract and embedded derivatives: Apply rules of IAS 39 (or other applicable IAS if host is not a financial instrument)
- If the embedded derivative cannot be reliably identified and measured: Measure the entire combined contract at fair value as a financial instrument held for trading

Examples of Embedded Derivatives

- Guaranteed bond benefits linked to performance of indices
- Guaranteed minimum maturity benefits on unit-linked products
- Some guaranteed minimum surrender benefits
- Persistency bonuses and units
- Future guaranteed annual bonus

Embedded Derivatives – IFRS 4 Exemptions

- Need not separate and embedded derivative included in an insurance contract that itself meets the definition of a contract within the scope of IFRS 4 (embedded derivative is contingent on an insured event)
  - e.g. a life contingent annuity linked to a price index payment for changes in the index depends on the survival of the policyholder
- Need not separate an option to surrender an insurance contract for a fixed amount (or for an amount based on a fixed amount and an interest rate) – IFRS 4
- Unit linking features if the unit denominated payments are measured at current unit values that reflect the fair values of the assets of the fund

Examples of IFRS 4 Exemptions

Feature	Reason
Guaranteed Annuity Options	Insurance Contract
Guaranteed minimum death benefits on investment contracts	Insurance Contract
Index/equity linked annuities in payment	Insurance Contract
No MVA payable on death on UWP contract	Insurance Contract
Guaranteed sum assured at maturity on non profit policy (ex endowment non-profit)	Integral part of host contract (i.e. closely related)
Guaranteed interest payment on (vanilla) guaranteed income bond	Integral part of host contract (i.e. closely related)

Liability Adequacy Test (LAT)

- The company must assess at each reporting date whether recognized insurance liabilities are adequate based on current estimates of future cash flows under insurance contracts.
- The test must use current estimates and consider all contractual cash flows including:
  - Claims handling costs; and
  - Cash flows from embedded options and guarantees
- If those estimates show that the liabilities (less DAC and intangible assets) are insufficient, a loss should be recognized.

- If existing accounting policies include a test that meets the minimum requirements, no further action is required. (LAT would be carried out at a level of aggregation consistent with the existing test)

Reinsurance

- Offsetting reinsurance assets and liabilities is prohibited. The balance sheet is presented on a gross basis.
- Gains and losses recognized on buying reinsurance should be disclosed.
- Financial reinsurance must be unbundled and the deposit component recognized on the balance sheet as a liability

Unbundling

- Unbundling is required where:
  - The insurer can measure the deposit component (including any embedded surrender options) separately (i.e. without considering the insurance component); and
  - The insurer's accounting policies do not otherwise require it to recognize all obligations and rights arising from the deposit component
- IAS permits but does not require insurers to unbundle contracts into a deposit component and insurance component where:
  - The insurer can measure the deposit component (including any embedded surrender options) separately (i.e. without considering the insurance component); and
  - The insurer's accounting policies require it to recognize all obligations and rights arising from the deposit component
- Where the deposit component cannot be measured separately unbundling is prohibited

Unbundling

- The unbundling requirement is intended to catch arrangements where a payment by one party leads to automatic repayment by the other party in future periods
- Arrangements of this kind are common to financial reinsurance

- Contracts issued by an insurer that do not meet the definition of an insurance contract (i.e. investment contracts) will be accounted for under IAS 39 and IAS 18 (Asset management)
- Investment contracts will include but are not limited to:
  - Unit linked products with trivial insurance risk
  - Deferred annuities without payout guarantees
  - Term certain payout annuities

- IAS39 allows any financial instrument to be designated as “held at fair value the profit and loss” when originally recognized. Insurers have the option to designate the investment contracts either as “fair value through profit and loss” or as other liabilities.
- The decision to designate as “held at fair value through profit and loss” is irrevocable
- Additionally, this is only allowed if fair value can be measured reliably

Income statement impact of IAS 39

- Premiums received and claims paid are not recognized as revenue but as balance sheet movements (like a deposit received)
- All subsequent revenue movements in respect of financial liabilities (e.g. amortization, impairment write downs, fair value adjustment) are included in the income statement

Measurement of financial liabilities under IAS 39

Initial measurement

- All financial liabilities measured at ‘cost’
- ‘Cost’ is the fair value of the consideration received
- Transaction costs that are directly attributable to the acquisition or issue are included in (netted against) the initial measurement if the instrument is measured at amortized cost

Subsequent measurement

- After initial recognition, financial liabilities are measured either:
  - At fair value: if designated as ‘held at fair value’
  - At amortized cost: if not designated as ‘held at fair value’

Amortized Cost of Financial Assets/Liabilities =

- Cost
- \- Principal Payments
- +/- Cumulative Amortization
- \- Write down for impairment or collectability

Investment Contract Value

- Host contract (cost = premium + front end fees - transaction costs)
- Property-linked derivative at fair value
- Surrender option at fair value

Fair value key principles

- Per IAS 39 the fair value of the consideration received for a financial liability is normally determinable by reference to the transaction price (or other market prices)
- In the absence of market evidence to the contrary, the estimated fair value of an insurance liability shall not be less, but may be more than the entity would charge to accept new contracts with identical terms and remaining term from new policyholders. It follows that a policy issuer would not recognize a net gain at inception of an insurance contract unless such market evidence is available.

What is fair value?

The hierarchy for determining the fair value of a financial instrument is:

- The price in an active market
- By reference to recent market transactions between knowledgeable, willing parties in an arms length transaction
- By a valuation technique:
  - Current market value of another instrument, e.g. replicating portfolio
  - Discounted cash flow analysis
  - Option pricing model

What does all this mean for an actual IFRS valuation?

Once products are appropriately classified, specific valuation rules default to local GAAP accounting. In the United States, US GAAP rules are applicable:

- FAS60
- FAS97
- FAS91 methods are applicable to payout annuities valued at amortized cost
- Methods for capitalizing and amortizing deferred acquisition costs are similar
- Current techniques for performing Loss recognition and Recoverability analyses can be extrapolated to be appropriate proxies for Liability Adequacy Testing

Disclosure – Insurance Contract Recognized Amounts

- Accounting policies
- Recognized assets, liabilities, income, expense and cash flows arising from insurance contracts, and how significant measurement assumptions are determined (and if practicable quantified disclosures of assumptions used should be given);
- Gains and losses recognized, or deferred, on buying reinsurance;
- The effect of each change in assumption that has a material effect on the financial statements; and
- Reconciliations of opening to closing balances of insurance contract assets, liabilities and deferred acquisition costs

Disclosure – Amount, timing and uncertainty of cash flows

- Objectives and policies for managing insurance risk
- Information about insurance risk (before and after mitigation by reinsurance)
  - Sensitivity of income and equity to changes in insurance risk
  - Concentrations of insurance risk
  - Actual claims compared to previous estimates, for each period in which uncertain claims remain outstanding, up to 10 years
- Information about interest rate and credit risk in insurance contracts, and financial risk in embedded derivatives that are not separated

In addition, an insurer should make the disclosures required by IAS 32 with respect of its financial assets and financial liabilities (this includes investment contracts with discretionary participation features)

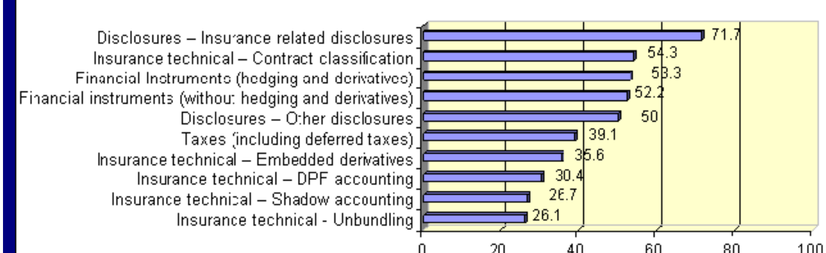
Disclosure – Insurance Contract Related Amounts: Assumptions

Disclose the process used to determine assumptions that have a significant effect on recognized amounts and where practical, make quantified disclosures of those assumptions. The process used to determine assumptions might include:

- Objective (e.g. level of assurance)
- Source of data
- Consistency with the market
- Past experience
- Future trends assumptions
- Identifying correlations
- Allocations or distributions
- Significant uncertainties

Disclosure – Provisions on First Time Adoption

- Need not apply the disclosure requirements in IFRS 4 to comparative information related to annual periods beginning before January 1, 2005 expect for the disclosure on accounting policies and recognized balances under insurance contracts
- For claims development disclosures, need to disclose information about claims development that occurred earlier than five years before the end of the first financial year IFRS applied. Further, if impractical, on first time application, to prepare information about claims development that occurred before the beginning of the earliest period for which an entity presents full comparative information under IFRS 4, this fact should be disclosed.



- Insurers are hesitating to provide adequate disclosures
- Certain disclosures concern financial risks
- Significant lack of information provided regarding insurance risks

- Some regulators are reported to provide their own interpretations of IFRS 4

Result = Change in the disclosure requirements:

- An insurer shall disclose information that (helps) enables users of its financial statements to (understand) evaluate the (amount, timing and uncertainty of future cash flows) nature and extent of risks arising from insurance contracts
- This creates a more demanding requirement on companies

GMDB:

If the GMDB < sum of the premiums paid plus interest, the existence of insurance risk can be questioned.

The solution of the IFRS Insurance Topic Team:

If it is reasonably possible that the contract value falls significantly below the GMDB, the contract transfers significant insurance risk.

This creates a stricter standard for determining risk than “existence of commercial substance”

Note: IFRS Panel approval is still pending

IASB has made significant progress in defining a recognition and measurement model for insurance

- Prospective, discounted cash flows
- Market-consistent allowance for risk

Still a long way to go

- The Board is divided on some key issues
- There are many interested parties in the debate
  - Insurance companies
  - EU
  - Regulators
  - FASB

FASB – Invitation to Comment

Bifurcation of Insurance and Reinsurance Contracts for Financial Reporting

- Bifurcation – Divide same or all insurance and reinsurance contracts into the following components:
  - Transfer of significant insurance risk – accounted for as insurance
  - Financing components – accounted for as deposits
- Affects non-insurance companies that buy insurance contracts
- Concerns about the depiction in the policyholder's financial statements of contracts that transfer only limited insurance risk (finite risk contracts)

Measurement model – tentative decisions

<u>Current exit value</u> – at inception and subsequently

- "Amount insurer would expect to pay to another entity if it transferred all its remaining contractual rights and obligations immediately"
- Current unbiased probability-weighted estimates of future cash flows
- Current market discount rates that adjust the estimated future cash flows for the time value of money
  - Discount rate should be consistent with observable market prices for cash flows whose characteristics match those of the insurance liability
- An unbiased estimate of the margin that market participants require for
  - Bearing risk (a risk margin); and
  - Providing other services (a profit margin)

Measurement model – tentative decisions

- Not prohibited from recognizing a net gain or net loss at the inception of an insurance contract
- Recognise a customer relationship asset that relates to future payments that the policyholder must make to retain a right to guaranteed insurability
  - Present it as part of the related liability, not as a separate asset
- Not require insurers to unbundle deposit and service components
- Acquisition costs should be recognised as an expense when incurred
- Policyholder participation rights create a liability when the insurer has an unconditional obligation that compels the insurer to transfer economic benefits to policyholders, current or future

	Current entry value	Current Exit Value
Market participants margins	The per-unit price (for risk and profit) is locked-in at inception	The per-unit price (for risk and profit) may vary over time
Net gain/loss on inception	No gain can be recognised on inception, although a loss could be recognised (see LAT)	A net gain or loss could be recognised on inception
Acquisition Costs	Need to define acquisition costs since margin is calibrated by reference to premium less acquisition costs	No need to define acquisition costs although costs (including non-incremental costs) may help an insurer estimate market participant margins
Liability Adequacy Test	Required at inception, but not subsequently	Not required

Current exit value model

Advantages

- Generally agreed to be the better model – conceptually
- Consistent with IAS 37 (and closely aligned with IAS 39)
- No need to define acquisition costs, or undertake a Liability Adequacy Test

Disadvantages

- Recognition of gain on inception would be inconsistent with allocated customer consideration approach under development in the revenue recognition project
- The allocated customer consideration approach would not permit the recognition of 'selling' profit at the inception of a contract because it is not verifiable

Risk margins should be consistent with the margin that the insurer would expect to pay were it to transfer all its contractual rights and obligations to another party

- Explicit, not implicit
- Should reflect all risks associated with the liability
- Should not reflect risks that do not arise from the liability
- Should be as consistent as possible with observable market prices
- Should not ignore the tail risk in contracts with very skewed pay-offs
  - Contracts that contain embedded options
  - Low-frequency high-severity risks
  - Portfolios that contain significant concentrations of risk

Risk margins

Benefits

- Should make it easy to provide concise and informative disclosure
- Comparison between insurers

Other issues

- Preferable to builds on models that insurers currently use to run their business
- Should not overlook model risk
- Should be implemented at a reasonable cost and in a reasonable time, and be auditable

Insurance Working Group meeting	29-30 June 2006
Discussion draft	
• First pre-ballot draft	July 2006
• Second pre-ballot draft	September 2006
• Ballot draft	November 2006
• Publication	December 2006
Exposure Draft	+ 18 months (2008?)
Final Standard	+ 12 months (2010?)