September 2012

International Financial Reporting Standards

Insurance Contracts

SAICA Seminar

Insurance

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Board Member

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

- Insurance entity orientation
- A huge variety of accounting models for different types of contract
- Estimates for traditional long duration contracts locked in at inception
- Little information about economic value of embedded options and guarantees
- Discount rate typically based on estimates of investment returns determined at inception
- Lack of discounting for non-life liabilities

Complex to understand
Project objectives

Improve comparability
One accounting model that provides a coherent, principles-based framework for all types of insurance contracts

Increase transparency
Provide information about how much risk and uncertainty there is
Highlight information about what drives performance
Explain what an insurer expects to pay to fulfil its insurance contracts
Expose the hidden value of embedded options and guarantees

Increase convergence with US GAAP
Key features of the model

- Relevant, complete information about changes in estimates
- Transparent reporting of the economic value of embedded options and guarantees
- An uncertain liability is a greater burden to the insurer than a certain liability
- Updated estimates and assumptions
- Current measurement of risk
- Market consistent estimates
- Reflect time value of money
- Liabilities have different values depending on expected due dates
- When available, market information is more objective
Benefits of a coherent framework

• Reflect the many different ways in which insurers make money
  – asset management services
  – spread business
  – protection business.

• Accommodates insurance contracts that blend different activities
  – eg some contracts that combine underwriting risk (ie whether the insured event will occur) and investment risk (irrespective of whether the insured event occurs)
  – One model for underwriting and investment reflects both elements with no ‘cliff effects’
Overview: Project progress

Key decisions reached
- Definition, scope and unbundling
- Measurement of insurance contract liability
- Special applications: participating contracts, reinsurance, short duration contracts
- Presentation

Complete remaining topics
- Volume information
- Residual margin
- Disclosure
- Sweep issues

Review draft or re-expose
- Expected in H2 2012
- Final standard not effective before 1 January 2015
Measurement of insurance liability

- **Residual margin**: Quantifies the unearned profit the insurer expects to earn as it fulfills the contract.

- **Risk adjustment**: Quantifies the difference between the certain and uncertain liability.

- **Time value of money**: An adjustment that reflects the time value of money.

- **Cash flows**: The amounts the insurer expects to collect from premiums and pay out as it acquires, services and settles the contract, estimated using up-to-date information.
Main changes since the ED: *Unbundle non-insurance components*

- **Insurance component**
  - Distinct goods and services
  - Embedded derivatives that are not closely related
  - Distinct investment components

- **Non-distinct investment component**

Measure using insurance contracts standard
Measure using insurance contracts standard, but exclude from volume information
Measure using financial instruments standards
Measure using revenue recognition standard
Main changes since the ED: *Time value of money*

✓ Confirm discount rate:
  – Reflects only the characteristics of the insurance contract liability
  – Current and updated each reporting period

+ Guidance on determining the discount rate
  – Do not prescribe method – ‘top-down’ and ‘bottom-up’ both acceptable
  – Remove any factors that influence observable rates not relevant to the liability
Main changes since the ED: Comprehensive income

ED proposals

- All premiums treated as deposits, all payments as return of deposits
- All changes in estimate presented in profit and loss

<table>
<thead>
<tr>
<th>Statement of comprehensive income 20XX</th>
</tr>
</thead>
<tbody>
<tr>
<td>Risk adjustment</td>
</tr>
<tr>
<td>Residual margin</td>
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<tr>
<td>Experience adjustments and changes in estimates</td>
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<tr>
<td>Underwriting result</td>
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<tr>
<td>Investment income</td>
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<tr>
<td>Interest on insurance liability</td>
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<tr>
<td>Net interest and investment</td>
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<tr>
<td>Profit or loss</td>
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</tbody>
</table>
Main changes since the ED: 
*Comprehensive income* continued

**Tentative decisions**

- **Information about premiums, claims and expenses on face**
- **Present in OCI changes in the insurance liability arising from changes in the discount rate**

### Statement of comprehensive income

<table>
<thead>
<tr>
<th>20XX</th>
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<tbody>
<tr>
<td>Premiums</td>
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<tr>
<td>Changes insurance liability</td>
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<tr>
<td>Claims and expenses</td>
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<tr>
<td>Underwriting result</td>
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<tr>
<td>Investment income</td>
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<tr>
<td>Interest on insurance liability, at locked in rate</td>
</tr>
<tr>
<td>Net interest and investment</td>
</tr>
<tr>
<td>Profit or loss</td>
</tr>
<tr>
<td>Effect of discount rate changes on insurance liability</td>
</tr>
<tr>
<td>Total comprehensive income</td>
</tr>
</tbody>
</table>
Some thoughts

Presenting premiums and claims/benefits

- Acknowledges that information about different measures of premium can be useful
- Believes that:
  - Premiums in the income statement should be consistent with the concept of revenue, i.e.,
    - Exclude investment components
    - Reported as earned (not as billed, not as written)
  - Premiums in the income statement should be consistent with the measurement model for insurance contract liabilities
  - Claims/benefits should be reported as incurred
The Board’s proposals

A closer look

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

• No significant changes to scope and definition

Confirm standard applies to:

- Insurance contracts the insurer issues
- Reinsurance contracts the insurer holds
- Financial instruments with discretionary participation features *issued by insurers*

Some changes to scope exceptions:

- Exclude financial guarantee contracts unless previously regarded as insurance contracts (status quo)
- Fixed fee service contracts – additional guidance provided
Recognition

Defining the cash flows

Recognition point:
Contract starts when coverage period begins (may be after insurer is on risk)

Included in cash flows:
All direct costs of originating and all directly attributable costs incurred in fulfilling a portfolio of insurance contracts

Contract boundary:
Ends when:
- Not required to provide coverage
- Can reprice to reflect risks of policyholder
- Or, In some cases, to reflect risk of portfolio
- On substantial modification
Explicit, unbiased probability-weighted estimate of the future cash flows that will arise as the insurer fulfils the insurance contract

- Confirm use of expected value, considering all relevant information

+ Add guidance:
  - not all possible scenarios need to be identified and quantified
  - do not adjust measurement to reflect subsequent outcome of an insured event that was impending at the end of reporting period
A discount rate that adjusts cash flows for the time value of money

✓ Confirm discount rate:
  – Reflects only the characteristics of the insurance contract liability
  – Current and updated each reporting period

+ Guidance on determining the discount rate
  – Do not prescribe method – ‘top-down’ and ‘bottom-up’ both acceptable
  – Remove any factors that influence observable rates not relevant to the liability
An explicit estimate of the effects of uncertainty about the amount and timing of future cash flows

- Different IASB and FASB conclusions:
  - IASB confirm measurement of liability should include explicit risk adjustment
  - FASB confirm risk should be reflected implicitly in the measurement of the liability
- No restriction on permitted techniques
  - Disclose confidence level equivalent
A residual margin that quantifies the unearned profit the insurer expects to earn as it fulfils the contract.

- Confirm no gain at inception
  - Portfolio unit of account
  - Adjust for changes in estimates of cash flows
  - Adjustments made prospectively
  - To be determined
    - Allocation of residual margin after change in estimates
    - Accretion of interest
Special applications

Reinsurance assets

- ED: symmetry with underlying liability
  - Losses at inception recognised over contract term
  - Gains at inception recognised immediately

- Tentative decisions:
  - Use same estimates for reinsurance asset and underlying direct insurance liability
  - Gains recognised over coverage period
  - Losses recognised immediately if for past events, otherwise recognised over coverage period
Permitted if reasonable approximation to the building block approach, ie if:

- coverage period is 12 months or less, or
- both following apply:
  - no significant changes in estimate are likely to occur before the claims incur
  - no significant judgement needed to allocate the premium
- IASN and FASB reached different conclusions
Premium allocation approach

**Measurement**

- **Residual margin**
- **Risk adjustment**
- **Time value of money**
- **Cash flows**

### Residual margin
- On initial recognition
  - Record a liability at the PV of premiums received/receivable, less acquisition costs
  - Record an asset as the PV of premiums receivable

### Risk adjustment

### Time value of money
- Reduce the liability for passage of time
- Reduce asset for receipt of premiums
- Recognise an additional liability if contract is onerous

### Cash flows
- Recognise a liability for incurred claims (using building block approach)
**Premium allocation approach**

*Measurement* continued

**Time value of money**
- Remaining coverage
  - Discounting required only if significant financing component
  - Practical expedient 12 months
- Liability for incurred claims
  - Practical expedient 12 months

**Onerous contract test**
- Only when facts and circumstances indicate
- Includes a risk adjustment
• Liability for remaining coverage (pre-claims)
  – Simpler accounting with limited remeasurement
  – Reflect time value of money if financing significant
  – Practical expedient - 12 months
  – Onerous contract test when facts indicate

• Liability for incurred claims
  – Measured consistently with the building block approach (with no residual margin)
  – Discounted if material. Practical expedient 12 months
What next?

Complete remaining topics
- Volume information - How to define the volume information presented in the statement of comprehensive income
- Residual margin - Allocation of residual margin after change in estimates, accretion of interest
- Other matters – transition, disclosure, review participating disclosures

Review
- Review changes since the ED
- Review differences between IASB and FASB
- Review due process completed

Publish
- Determine whether to publish a review draft or second exposure draft
When will the changes become effective?

**Jul 2010**
IASB Exposure Draft
*Insurance contracts*

**Sep 2010**
FASB Discussion Paper
*Preliminary views on Insurance contracts*

**Now**
Joint deliberations

**Not before Jan 2015 (TBC)**
Effective date of new standard

IASB Revised Exposure Draft or Review Draft / FASB Exposure Draft
Thank you
Stay up to date

Where to find out more

• Visit our website:
  – www.ifrs.org
  – go.ifrs.org/insurance_contracts

• Sign up for our email alert

• Email us: insurancecontracts@ifrs.org

Resources

• IASB Update
• Meeting webcasts
• Project podcasts
• Investor resources
• High level summary of progress on the project
• Detailed summary of boards’ tentative decisions
• Topics reports on IASB’s tentative decisions and working drafts
## Response to feedback

<table>
<thead>
<tr>
<th>Exposure draft</th>
<th>Decisions so far</th>
</tr>
</thead>
<tbody>
<tr>
<td>Definition and scope</td>
<td>No significant change from ED except partial scope exclusion for financial guarantee contracts</td>
</tr>
<tr>
<td>Unbundling</td>
<td>Some changes from ED including introduction of approach that excludes from premiums amounts that would be repaid to the policyholder regardless of whether an insured event occurs (as a consequence of decision to include volume information, see presentation)</td>
</tr>
</tbody>
</table>
| Which cash flows, including acquisition costs | Minor changes in response to comment letters  
• Acquisition costs  
• Recognition point  
• Contract boundary |
| Discount rate | No change in principle, change in application guidance |
| Risk adjustment | Minor changes from ED in response to comment letters |
### Response to feedback continued

<table>
<thead>
<tr>
<th>Exposure draft</th>
<th>Decisions so far</th>
</tr>
</thead>
<tbody>
<tr>
<td>Residual margin</td>
<td>Unlocking is a significant change from ED in response to comment letters; on-going discussions</td>
</tr>
<tr>
<td>Participating features</td>
<td>• Change from ED in response to comment letters&lt;br&gt;• Introduction of mirroring approach</td>
</tr>
<tr>
<td>Reinsurance</td>
<td>Minor changes from ED in response to comment letters</td>
</tr>
<tr>
<td>Premium allocation approach</td>
<td>Minor changes from ED in response to comment letters</td>
</tr>
<tr>
<td>Presentation</td>
<td>Significant changes form ED in response to comment letters; on-going discussion&lt;br&gt;• Inclusion of volume information&lt;br&gt;• Presentation of discount rate changes in OCI</td>
</tr>
<tr>
<td>Disclosures</td>
<td>To be discussed</td>
</tr>
<tr>
<td>Transition and effective date</td>
<td>To be discussed</td>
</tr>
</tbody>
</table>
Comparison to FASB
tentative decisions

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IASB / FASB: Key differences

- Measurement of insurance contract using all cash flows expected to fulfil contract
- Measurement and presentation of a performance linked participation feature should be consistent with the measurement of the underlying item (the ‘mirroring approach’)
- Cash flows discounted using a rate that reflects only the characteristics of the liability
- No gain at inception
- Presentation that shows information about key drivers of profitability
- Effects of changes in discount rates presented in OCI
## IASB / FASB: Differences in view

<table>
<thead>
<tr>
<th>Topic</th>
<th>IASB view</th>
<th>FASB view</th>
</tr>
</thead>
<tbody>
<tr>
<td>Risk adjustment</td>
<td>Risk:</td>
<td>Risk:</td>
</tr>
<tr>
<td></td>
<td>• explicitly determined</td>
<td>• included implicitly in single margin</td>
</tr>
<tr>
<td></td>
<td>• remeasured each period through P&amp;L</td>
<td>• not remeasured over the contract term</td>
</tr>
<tr>
<td>Residual/single margin</td>
<td>• Released over the coverage period based on pattern of service</td>
<td>• For BBA: released over the coverage and settlement period based on the release from risk</td>
</tr>
<tr>
<td></td>
<td>• Changes in estimates of future cash flows offset in the measurement of the residual margin</td>
<td>• For PAA: released over the coverage period only, based on release from risk</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• All changes in cash flow estimates recognised in P&amp;L</td>
</tr>
<tr>
<td>Topic</td>
<td>IASB view</td>
<td>FASB view</td>
</tr>
<tr>
<td>------------------------------------------</td>
<td>---------------------------------------------------------------------------</td>
<td>---------------------------------------------------------------------------</td>
</tr>
<tr>
<td>Acquisition costs (new difference since ED/DP)</td>
<td>Residual margin shows expected profit after deducting all costs of acquiring and fulfilling the insurance contract liability</td>
<td>Residual margin shows expected profit after deducting all costs of acquiring and fulfilling the insurance contract liability excluding the portion deemed to not result in the issuance of particular contracts</td>
</tr>
<tr>
<td>Premium allocation approach</td>
<td>Permit premium allocation approach for contracts when it produces similar measurements to building block approach</td>
<td>Require premium allocation approach for all contracts meeting specified criteria</td>
</tr>
</tbody>
</table>
What will really change?
What will really change for non-life?

For some jurisdictions, introduction of discounting and risk adjustment in measuring the liability for incurred claims.

More information in the audited financial statements about claims liabilities, changes in risk and effects of discounting.
What will really change for life?

A single accounting model for all life insurance contracts, rather than different accounting models based on product type. That model gives:

- Updated, rather than locked-in, assumptions
- Current value measurement of guarantees and options previously not recognised
- More information about the effects of risk, time value of money and other estimates
- Discount rate reflects insurance contract liability, not reduced by expected investment spreads
- No need for complex and hard-to-understand mechanisms for dealing with deferred acquisition costs
## No loss of KPIs: Non-life

<table>
<thead>
<tr>
<th>KPI</th>
<th>Available from new standard?</th>
<th>Our proposals</th>
</tr>
</thead>
<tbody>
<tr>
<td>Premiums written/premiums earned</td>
<td>✓</td>
<td>Underwriting margin, including disaggregation of claims, expenses and premiums on the face of the profit or loss (for short duration contracts) or in the notes</td>
</tr>
<tr>
<td>Combined ratio</td>
<td>✓</td>
<td></td>
</tr>
<tr>
<td>Cost ratio</td>
<td>✓</td>
<td></td>
</tr>
<tr>
<td>Claims ratio</td>
<td>✓</td>
<td></td>
</tr>
<tr>
<td>Loss development tables</td>
<td>✓</td>
<td>Disclosed in the notes, not in MD&amp;A</td>
</tr>
</tbody>
</table>
## No loss of KPIs: Life

<table>
<thead>
<tr>
<th>KPI</th>
<th>Available from new standard?</th>
<th>Our proposals</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment returns</td>
<td>✓</td>
<td>Investment results highlighted separately from underwriting results on the face of the profit or loss</td>
</tr>
<tr>
<td>Expense ratio</td>
<td>✓</td>
<td></td>
</tr>
<tr>
<td>Actual to expected experience measures for mortality, morbidity</td>
<td>✓</td>
<td>Disaggregation of information about the effect of experience adjustments and changes in estimates required in the notes</td>
</tr>
<tr>
<td>Value of new business</td>
<td>✓</td>
<td>Information about the residual margin and how it changes each period required in the notes</td>
</tr>
<tr>
<td>Value of existing book</td>
<td>✓</td>
<td></td>
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</tbody>
</table>