IFRS and General Purpose Insurance Contract Accounting

Presenters

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General Purpose
Insurance Contract Accounting

- IASB and IFRS
- Insurance Contract Project
- Measurement Overview
- Other Tentative Decisions for the Exposure Draft
- Topics the Boards Continue to Discuss
- Question and Answer

Overview IFRS

- What is IFRS?
  - International GAAP
    - Single set of global accounting standards developed by the International Accounting Standards Board (IASB)
    - To provide the world’s integrating capital markets with a common language for financial reporting
    - Bring about convergence of national accounting standards and IFRS (especially US GAAP)

Overview IFRS

- Why IFRS?
  - Globalization
  - Cross-border capital flows and listings
  - Concern about quality of standards in certain markets
  - Comparability between industries

International Accounting Standards Board

- Currently 15 full time members.
  - Significant board turnover July 2011
- Members are geographically diverse
- 4 members have previously worked in the US
- Meet monthly
- www.IASB.org

Relevance of IASB to the World

- Over 100 countries require or permit the use of IFRS for domestic entities
- European Union requires the use of IFRS
- Canada switching to IFRS in 2011

Relevance of IASB to US

- FASB and IASB have a Memorandum of Understanding to converge IFRS and US GAAP
- SEC has already decided that foreign companies no longer need to reconcile IFRS based financial statements to US GAAP
- SEC has published a roadmap that could lead to a decision to require US companies to report under IFRS.

What Does IFRS Say About Insurance?

- Before 2004, nothing
- A stop-gap Phase I (IFRS 4) adopted in 2004
- The IASB started with Phase II in mid-2004
- The Phase II is a comprehensive rethinking of insurance accounting from the ground up

AMERICAN ACADEMY *of* ACTUARIES

IFRS Insurance Contracts
Project Objectives

- Reduce diversity of accounting practices that currently exist for insurance contracts
- Align insurance accounting with other business sectors, where possible
- Increase users' understanding of insurance financial statements
- Help investors make decisions

Insurance Working Group

- The insurance working group is a group of approximately 40 people that met on a regular basis with the IASB and the IASB staff to discuss insurance accounting.
- The IWG has representatives of industry, auditor, investors, and professional organizations.
- Rob Esson, a member of the NAIC staff, represents the IAIS on this group.

IASB Insurance Project

- Those providing significant input:
  - CFO Forum (European insurers)
  - GNAIE (North America plus 4 companies from Japan)
  - IAA (International Actuarial Association)
  - IAIS (International Association of Insurance Supervisors)
  - FASB
- Others with influence:
  - IOSCO (International Securities Commissioners)
  - Banks (they sell annuities)
  - EU (European governments)
  - SEC (Security & Exchange Commission)

Other IASB Projects

- Revenue Recognition
- Financial Instruments
- Fair value
- Contingent Liabilities

IFRS Insurance Project – Phase I

- Phase I started in 1997
- 2001 Draft Statement of Principles
- Phase I ended with IFRS4 in March 2004
  - Defined insurance
  - Revised *IAS 39*, guidance for investment products
  - Existing local GAAP with additional disclosure and loss recognition was permitted
  - Still allowed diverse practices
- Applies to insurance *contracts*, not insurance *companies*

IFRS Insurance Project – Phase II Recent Timeline

- Phase II started mid-2004
  - IASB, IASB staff and IWG worked on a discussion paper called "Preliminary Views", released in May 2007
  - Main text – 150 pages
  - Appendices – 80 pages
  - 150 comment letters submitted November, 2007
  - Board and staff evaluated all submissions
  - Using feedback to craft Exposure Draft

FASB Question 1

- Is there a need for a comprehensive project to redo U.S. GAAP for insurance?
  - Yes – 25
  - No – 4

FASB Question 2

- Is the Discussion Paper a suitable starting point?
  - All 25 who said yes to question 1:
    - Yes – 10; No – 15
  - Americans only
    - Yes – 4; No – 13

IFRS Insurance Project – Phase II Recent Timeline

- In the fall of 2008 FASB joined as a joint project
  - The Boards meet both separately and jointly
  - Even at the joint meetings the votes are separate
  - They try to reconcile any differences
- Projected Exposure Draft May 2010
- Comments due Sept 2010
- Final standard June 2011
- Effective date of final standard projected to be 2013

Measurement Overview

Goals Remain Similar to Preliminary Views

- Principles-based approach with additional guidance
- Based on insurance contracts, not insurance companies
- Current measurement

Insurance Liability Measurement

Measurement of the insurer's assessment of its contract obligations using:

- 4 building blocks
  - Estimate of Future Cash Flows
  - Time Value of Money (discounting)
  - Risk adjustment (also known as risk margin)
  - Amount to eliminate day one gain (residual margin)

Current Estimate of Future Cash Flows

- Current
- Market variables: consistent with observable market prices (e.g., traded securities prices, interest rates)
- Non-Market variables: incorporate, in an unbiased way, all available evidence about the amount, timing and probability of relevant cash flows
- Probability weighted (i.e., expected value)
- Expected cash flows to fulfill contract obligations
- Net policyholder inflows and outflows

Time Value of Money

- Discounting no big deal for life insurance, but a change for non-life in the U.S.
- Independent of assets held, unless obligation is a direct function of a set of assets
- Reflect the characteristics of liabilities
- Current market assessment of the time value of money
- Potentially discount would be based on risk-free rates

Risk Adjustment

- The maximum amount the insurer would rationally pay to be relieved of the uncertain outflows of resources required for that insurer to fulfill the remaining contract obligations
- Explicit
- Not for conservatism (not an unspecified confidence level, sufficiency, adverse deviation, prudence, etc.)
- Reflects the effects of uncertainty about the amount and timing of future cash flows
- Insurer's view of its own cost to fulfill the contract

Residual Margin

- The goal of the Residual Margin is to avoid "Day one" profits
- The first three building blocks are calculated from first principles, and the residual margin on day one is the plug
- How the residual margin is amortized is still under discussion

Views of Some Commentators

- Changed in new model:
  - Use all premium {and dividend} cash flows
  - Use company specific expense assumptions
  - Don't use company specific credit standing
- Not changed in new model:
  - Use discount rates that reflect the type of assets insurance companies invest in.

Financial Instruments

- Some types of regulated insurance contracts that don't meet the definition of insurance and most will be treated as financial instruments
  - Current IFRS is less restrictive than U.S. GAAP
- Consistency of measurement between liabilities and assets

Financial Instruments (cont'd)

- Assets – either
  - Amortized Cost (most fixed financial instruments) or
  - Fair Value
  - No more Available for Sale category

Financial Instruments (cont.)

- There is a Fair Value Option that can be applied in order to avoid an accounting mismatch
- Insurance products that may be Financial Instruments:
  - GICs
  - Fixed period immediate annuities
  - Funding Agreements
  - Perhaps some deferred annuities

Other Tentative Decisions for the Exposure Draft

Unearned Premium

- The IASB decided that:
  - An unearned premium approach would be useful for pre-claims liabilities of short duration contracts
  - To require rather than permit the use of an unearned premium approach for those liabilities

Discounting Claim Liabilities

- The IASB would require claim liabilities to be discounted for the time value of money and to have an explicit risk adjustment
- Field testing results indicate companies are concerned about the impact of the discount rate causing day one losses

Acquisition Costs

- Expense all acquisition costs when incurred
- No recognition of any revenue (or income) to offset those costs when incurred.

Recognition and Derecognition

- Recognize an insurance obligation at earlier of:
  - Being on risk to provide coverage to the policyholder for insured events
  - The signing of the insurance contract
- Insurers should derecognize an insurance liability when it no longer qualifies as a liability of the insurer

Reinsurance

- Reinsurers should use the same recognition and measurement approach
- Cedants should recognize and measure their reinsurance assets using the same recognition and measurement approach that they use for the reinsured portion of the underlying insurance contracts that it has issued
- Ceding commissions for proportional contracts should be treated like acquisition expenses

Policyholder behavior and contract boundaries

- Policyholder options, forwards and guarantees related to existing coverage should be included in the measurement on a look-through basis using expected cash flows
- Consequently, no deposit floor will apply
- Staff is still developing material on contract boundaries to be discussed in the Boards March meetings

Unbundling

- IASB tentatively decided that for recognition and measurement an insurer should:
  - Unbundle a component of an insurance contract if it is not interdependent with other components of that contract
  - Not unbundle a component that is interdependent
- FASB tentatively decided that if unbundling is not required then

Topics the Boards Continue to Discuss

Presentation (income statement)

- Staff have recommended three models to the Boards:
  - A summarized margin approach
  - An expanded margin approach
  - ‘Traditional’ premium allocation – Unearned premium
- Staff have indicated they believe the income statement, at a minimum, would separately include:
  - Release of the risk adjustment and the residual margin
  - Difference from actual versus expected cash flows
  - Changes in estimate from remeasurement
  - Investment results separately for interest income and interest on the insurance liability

Miscellaneous items

- Follow up discussions of measurement model including risk adjustments and the treatment of residual margins
- Policyholder participation
- Treatment of participating, UL and variable contracts

Miscellaneous items (cont'd)

- Level of aggregation for the measurement of insurance contracts
- Disclosures
- Business combinations
- Transitions
- Policyholder accounting

Q & A