

Phase 2 IFRS for Insurance Contracts

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Recent History
of Accounting

Early Insurance and Financial
Instruments Papers by the IASC

IFRS 4 (Phase 1)

IASC - International Accounting Standards Committee

- founded 1973 by national professional accounting associations (US, UK, AU, CA, FRA, GER, NL, J, MX)
- based in London
- initial form of first and only organisation devoted to setting international accounting standards
 - IFAC (1977, International Federation of Accountants)
 - IOSCO (1983, International Organisation of Securities Commissions)
- issued the IAS-series of accounting standards
International Accounting Standards: IAS 1,..,IAS 41
 - IAS 1 „Presentation of Financial Statements“
 - IAS 19 „Employee Benefits“
 - IAS 37 „Provisions, Contingent Liabilities and Contingent Assets“
 - IAS 39 „Financial Instruments: Recognition and Measurement“

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IASB – International Accounting Standards Board

- the IASB is the outcome of restructuring the IASC
 - in operation since April 2001
 - new governance structure
 - strengthened independence to warrant reliance on IASB as an extra-jurisdictional authority
 - full-time board members
 - board of trustees for oversight, also procurs financing
 - G20-Recommendations have resulted in additional oversight structure
- maintains the IASs
- issues the IFRS-series of accounting standards
International Financial Reporting Standards: IFRS 1,...,IFRS 9,..
 - IFRS 4 „Insurance Contracts“
 - IFRS 7 „Financial Instruments: Disclosures“
 - IFRS 9 „Financial Instruments“

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IFRS 4 (Phase 1)

Accounting in the European Union – up to 2000

- directive-based harmonisation
 - member states must implement the directives in national law
 - the main accounting directives:
 - 78/660/EEC (4. Council Directive, annual accounts, adopts the British „true and fair view“ concept)
 - 83/349/EEC (7. Council Directive, consolidated accounts)
 - 91/674/EEC (Insurance Accounts Directive)
- by the mid 90’s it was becoming evident that this system was failing to achieve the desired harmonisation of accounting practice in the EU
- EU blue chips were converting to US GAAP for NYSE listing

Recent History
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IFRS 4 (Phase 1)

Accounting in the European Union – Move to IFRS

- European Committee decided to move to IAS in 2000
 - Regulation 1606/2002
 - implementation by 1.1.2005
 - mandatory only for consolidated accounts
- EFRAG (European Financial Reporting Advisory Group)
 - governance similar to IASB, i.e., private sector body,...
 - assists Commission in technical issues re adoption of IFRSs
 - comments IASB due-process documents (DPs, EDs)
- ARC (Accounting Regulatory Committee)
 - stipulated in Regulation 1606/2002
 - member states advise on adoption of IFRSs through ARC

Recent History
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Early Insurance and Financial
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IFRS 4 (Phase 1)

FASB – Financial Accounting Standards Board

- in operation since 1973
 - succeeded the AICPA's Accounting Principles Board (APB) as the accounting standard setter in the U.S.
 - SEC has ultimate authority over U.S. accounting standards
- issued SFASs (Statements of Financial Accounting Standards), i.e., SFAS 1,...,SFAS 168
 - since completion of codification project, i.e., 1.7.2009, issues ASUs (Accounting Statement Updates), e.g., ASU 2009-05 „Faire Value Measurements and Disclosures“

Recent History
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Early Insurance and Financial
Instruments Papers by the IASC

IFRS 4 (Phase 1)

FASB – Accounting Standards Codification Project

- the „accounting standards codification“ (ASC) project restructured US GAAP pronouncements into a single user-friendly online source organized as about 90 topics which are in line with the IASB’s standards
 - Citation format: ASC xxx-yy-zz-pp (xxx Topic, yyy Subtopic, zz Section, pp Paragraph)
 - „Financial Services – Insurance“ is ASC Topic 944
 - „Fair Value Measurements and Disclosures“ is ASC Topic 820
 - Definition of Fair Value is ASC 820-10-35-2
 - Subtopic 10 „General“, Section 35 „Subsequent Measurement“
 - „[.] the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date“
 - FAS 60.42 (policyholders’ surplus funds) is ASC 944-50-25.2

Recent History
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IFRS 4 (Phase 1)

Convergence between IFRS and US GAAP

- considered by FASB since the late 80's
- 2002 FASB and IASB agree to collaborate (Norwalk)
- 2005 SEC roadmap to eliminate 20-F reconciliation
- 2006 FASB and IASB issue MoU re progress by 2008
- 2007 SEC eliminates 20-F reconciliation requirement
- 2007 SEC „Concept Release“ re optional use of IFRS by US issuers (turned down due to complexity)
- 2008 SEC roadmap for adoption of IFRS in US by 2014, with go/no-go decision in 2011

Recent History
of Accounting

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IFRS 4 (Phase 1)

Accounting in Switzerland

- standard setting for auditing under the commercial code by the „Treuhandkammer“ since 1971 (Revisionshandbuch)
 - hidden reserves
 - LOCOM (lower of cost and market, „Niederstwert-Prinzip“, „principe de la valeur minimale“)
- FER (Fachempfehlung für Rechnungslegung) established 1984 as the formal accounting standard setting body of Switzerland
 - advocated „true and fair view“
 - re-named to „Swiss GAAP FER“ in 2001
 - technically, FER standards are devised for compliance with the accounting provisions of the Swiss stock corporation law (Aktienrecht, droit de la société anonyme)
 - many Swiss multinationals started publishing consolidated IAS-accounts in the mid-90s
 - since 2007, focuses on the needs of Swiss SMEs
 - FER 14 for Insurance Groups

Early Insurance and Financial Instruments Papers by the IASC

IFRS 4 (Phase 1)

Phase 2 Discussion Paper

IASC Insurance Issues Paper (1999)

- addresses insurance *contracts*, not insurance companies
- asset-liability measurement, not deferral-and-matching
- catastrophe and contingency reserves are not liabilities
 - only items from *existing contracts* are recognised on the balance sheet
- no deferral of acquisition costs
 - definition of an asset
- participating features classified as liabilities unless insurer controls allocation of the surplus
- for investment-linked contracts, risk- and investment-components may need to be split (unbundling)
- proposals apply also to re-insurers' accounting for reinsurance contract
- no netting of reinsurance receivables against insurance liabilities

Early Insurance and Financial
Instruments Papers by the IASC

IFRS 4 (Phase 1)

Phase 2
Discussion Paper

IASC Insurance Issues Paper – Measurement

- discounting of insurance liabilities (life, and non-life)
- current estimates of future cash flows
- renewals included if insurer can't reprice
- measurement of insurance liabilities should reflect risk
 - reference to an arms-length transaction (exit value)
 - long-term insurance contract may lead to profit at inception
- overstatement of liabilities not to represent an implicit solvency/capital element
- all changes in the carrying amount of insurance liabilities to be recognized as they arise (current assumptions)
- intended to be consistent with essentially a full fair value regime for financial assets and liabilities
 - therefore insurance liabilities to be fair valued
 - however, role of future investment margins therein unsettled
 - replicating portfolio / valuation portfolio

Early Insurance and Financial Instruments Papers by the IASC

IFRS 4 (Phase 1)

Phase 2 Discussion Paper

Financial Instruments „Draft Standard“ (2000)

- measure almost all financial instruments at fair value
- recognize virtually all gains and losses from fair value changes in income
- no special hedge accounting for instruments used in hedging relationships
- components approach to transfers of financial instruments
- expansion of disclosures about financial instruments, financial risk positions, and income statement effects

Early Insurance and Financial Instruments Papers by the IASC

IFRS 4 (Phase 1)

Phase 2 Discussion Paper

Fair Value Measurement

- **Motivation for FV in the US:**
 - Amortized Cost and „Cherry Picking“ in the US S&L crisis
 - SFAS 115/ASC 320 „Accounting for Certain Investments in Debt and Equity Securities“ (1993)
 - CON 7 „Using Cash Flow Information and Present Value in Accounting Measurements“ (2000)
 - SFAS 157/ASC 820 „Fair Value Measurements“ (2006)
- **IASB ED on FVM (May 2009), IFRS (Q3 2010)**
- **Specifies *what* Fair Value is, not where it is applied**

Early Insurance and Financial Instruments Papers by the IASC

IFRS 4 (Phase 1)

Phase 2 Discussion Paper

Fair Value Measurement - Definition

- Objective of FV measurement: exit price
 - transfer of the balance sheet item in a market transaction
 - either in a real or hypothetical transaction
- **as in the JWG's DS on Financial Instruments (2000):**

Fair Value is an estimate of the price an enterprise would have received if it had sold an asset or paid if it had been relieved of a liability on the measurement date in an arm's length exchange motivated by normal business considerations

- **current definition of Fair Value (IASB, FASB):**

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

Early Insurance and Financial
Instruments Papers by the IASC

IFRS 4 (Phase 1)

Phase 2
Discussion Paper

Fair Value Measurement

- Fair Value-Hierarchy of inputs to the valuation :
 - Level 1 inputs: unadjusted quoted prices from active markets
 - Level 2 inputs: observable input other than Level 1 (market prices for similar instruments, inputs such as interest rates)
 - Level 3 inputs: not observable in a market, assumptions reflect assumptions that market participants „would use“ in pricing

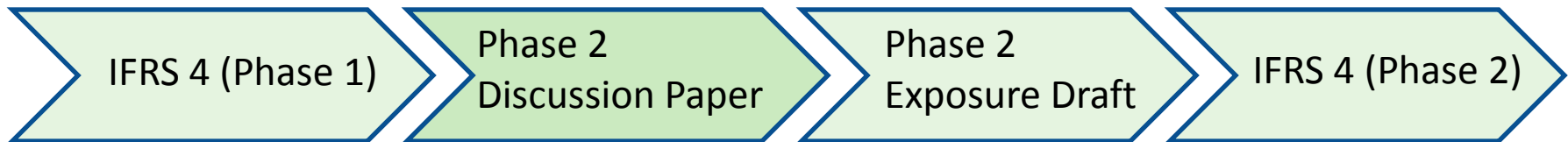
Early Insurance and Financial Instruments Papers by the IASC

IFRS 4 (Phase 1)

Phase 2 Discussion Paper

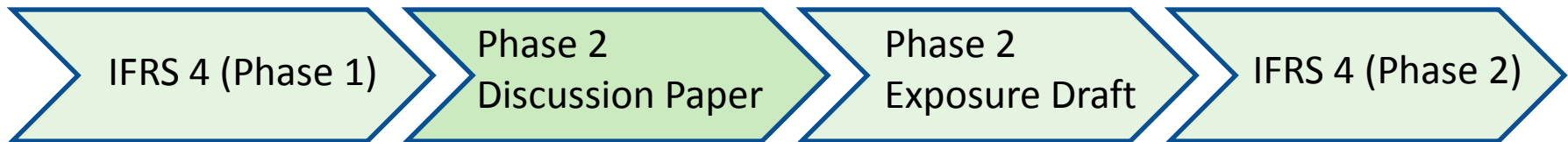
IFRS 4 „Insurance Contracts“ (2004)

- applies to all insurance and reinsurance contracts
- prohibits catastrophe and equalisation reserves
- requires liability adequacy testing and impairment testing for reinsurance assets
- prohibits offsetting of insurance liabilities with reinsurance assets
- certain accounting policies may be continued but not newly introduced
 - non-discounting claim reserves
 - non-uniform accounting policies on subsidiaries' portfolios
 - measure investment management fees above current market rates
- new accounting policies permitted if they make financial statements „more relevant and no less reliable“ or vice-versa



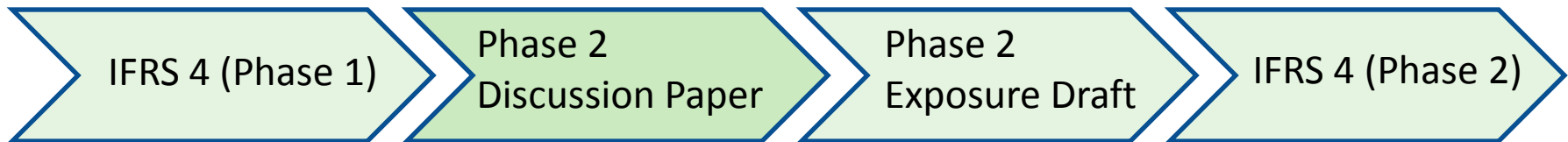
DP „Preliminary Views on Insurance Contracts“ (2007)

- Measurement Objective (Current Exit Value)
 - 3 building blocks:
 - a) explicit, unbiased, market-consistent, probability-weighted and current estimates of the contractual cash flows
 - b) current market discount rates that adjust the estimated future cash flows for the time value of money
 - c) an explicit and unbiased estimate of the margin that market participants require for bearing risk (a risk margin) and for providing other services, if any (a service margin)
 - DP advocates this approach as leading to a coherent framework that will allow handling emerging issues in a principled fashion, i.e., without resorting to new rules and exceptions.
 - credit standing is incorporated in the measurement



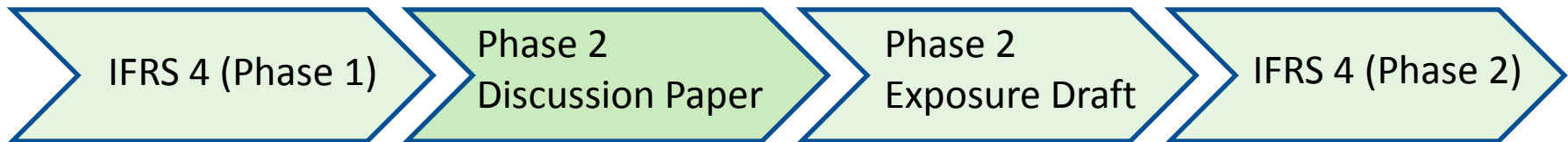
Role of the IAA in developing the DP

- IAA and GNAIE (Group of North American Insurers) advocated consistent measurement of assets and liabilities on the balance sheet
 - needed under an asset-liability measurement paradigm
 - extensive case studies
- IAA promoted „behavioural economics“ in the measurement of insurance liabilities
 - renewal premiums (now boundary of insurance contracts)
 - minimum deposit floor



DP „Preliminary Views [..]“ – Comments received

- the framing of measurement as „3 building blocks“ was basically accepted by respondents to the DP
- however, the concept of „current exit value“ was not
- moreover, respondents wished to permit entity-specific assumptions in deriving current estimates of future contractual cash flows
 - the DP’s proposal of market-consistent admin expenses was widely opposed
- the DP’s proposal to reflect the liability’s credit standing was vigorously opposed by most respondents

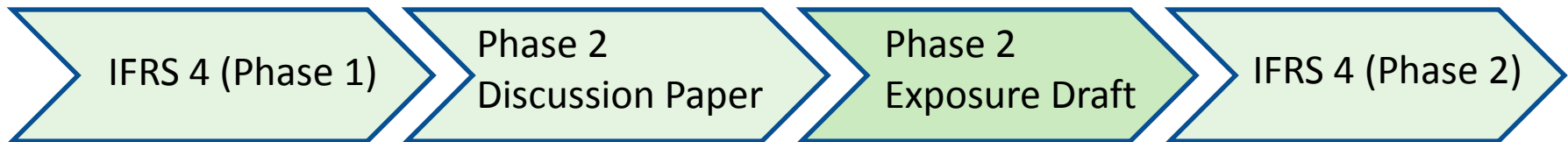


„Current Exit Value“ or „Fulfilment Value“ ?

- insurance portfolios are typically „held to maturity“, not „held for trading“
- therefore, respondents suggested a „settlement value“, later renamed by the IASB-staff to „**fulfilment value**“

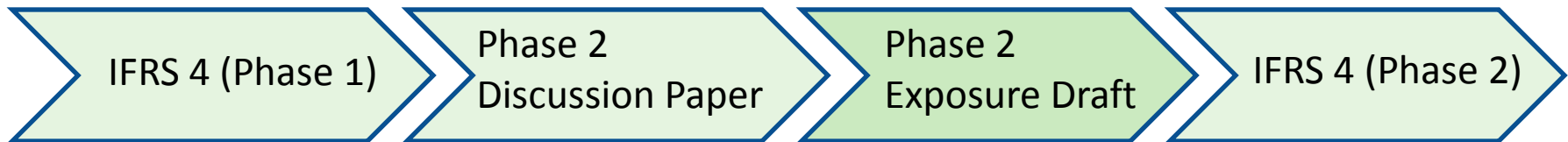
- the **EFRAG comment letter - CL 161** – noted

that the IASB’s proposal was to determine the conceptually correct approach in perfect markets and then to apply that approach in *all* circumstances, on grounds that market imperfections [only] raised practicality issues but no conceptual issues. This was unacceptable for EFRAG, since „**Imperfect markets are not some sort of exception, they are the norm[..]**“.



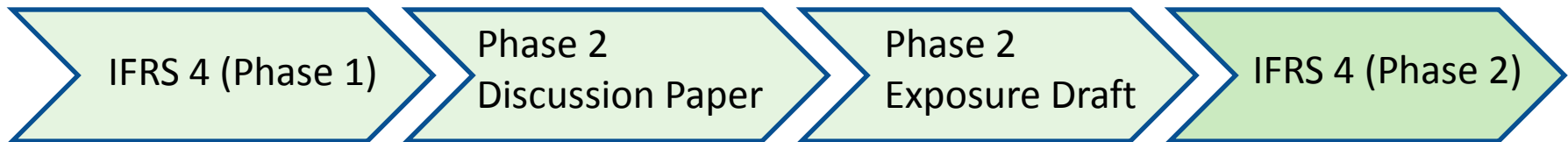
Towards the Phase 2 Exposure Draft - Measurement

- Objective based on the following *four* building blocks
 - the unbiased, probability-weighted average of future cash flows expected to arise as the insurer fulfils the contract
 - the time value of money
 - a risk adjustment for the effects of uncertainty about the amount and timing of future cash flows
 - risk adjustment is that which the *insurer* requires for bearing the uncertainty
 - risk adjustment is remeasured in each reporting period
 - an amount (residual margin) that eliminates any gain at inception of the contract
 - day-1 losses recognized at inception, however
 - guidance on how to release residual margin into P&L to be developed
 - residual margin is *not* adjustable for changes in net cash flow estimates
- Policyholder behaviour: no deposit floor (!)
 - policyholder options and financial options are modeled in cash flows *if* related to current coverage ..
- Measurement of insurance liabilities not to be updated for changes in insurers non-performance risk (own credit standing)
- Initial acquisition costs must be expensed
 - consistency with revenue recognition project



Towards the Phase 2 Exposure Draft – Other issues

- Unearned premium for short-duration contracts
- Discount rates
- Policyholder participation: undecided
 - IASB favors all cash flows from participating feature to be included in expected cash flows
 - FASB favors that only required (non-discretionary) participation cash flows be included in expected cash flows
- Presentation
 - 4 models remaining after written-premium model has been rejected
- Disclosure
- Reinsurance
- Unbundling for recognition and measurement (i.e. not presentation!)
 - removed choice / option to insurer, i.e.,
 - unbundle insurance component if not interdependent with rest of contract
 - don't unbundle otherwise
- Embedded Derivatives: undecided
 - either use existing bifurcation and measure at fair value
 - or measure consistently with host contract



Conceivable Outcomes of Phase 2

- **Scenario 1:** IFRS 4 remains in force „as is“
 - insurers will continue publishing the Embedded Value of their life business
- **Scenario 2:** the Phase 2 IFRS fails to report the value of insurers' life business in a way satisfactory to the market
 - insurers will continue publishing Embedded Value of their life business
- **Scenario 3:** the Phase 2 IFRS conveys the value of life business in a way satisfactory to the industry
 - Embedded Value reporting would become redundant