

**Everything You
Need to Know for
Now about the
IASB's Exposure
Draft *Insurance
Contracts*
and related topics**

A Presentation by Jim Milholland to
the

Atlanta Actuarial Club

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AGENDA

- IASB's *Insurance Contracts* (the ED)
 - Status and timing
 - Accounting mismatches
 - Identifying the contract
 - Measurement and presentation
- Related Topics
 - FASB's Discussion Paper (the DP)
 - Actuarial Response
- Topics saved for later

Status and Timing

- IASB – still set for June 2011 adoption
 - Insurance Working Group meets in November
 - Roundtable discussions in December
 - Effective date uncertain
 - Reconciliation to FASB
 - Time required for implementation
- FASB – no date for adoption
- Both – is it worth it?

Accounting Mismatches

..... spurious, non-economic effects on profit or loss resulting from inconsistent approaches to measurement of assets and of liabilities

- For example, assets at amortized cost and liabilities at current value, or the reverse
- IASB believes it has minimized accounting mismatches
- But the measurement model is hybrid

Investment Accounting

- IAS 9 applies to most assets backing insurance
 - Amortized cost for debt instruments that are not traded except for risk management purposes
 - Otherwise fair value through profit or loss (FVTPL)
 - Fair value option for specific reasons; e.g., avoiding mismatches
- This presentation assumes investments are FVTPL
- IAS 9 is effective in 2013 but may be delayed to coincide with the adoption of the insurance standard

Identifying the Contract

- Contractual relationship, substance over form
- Scope and definition of insurance
- Unbundling
- Long duration or short duration

Scope and Definition of Insurance

- Definition of insurance
 - “significant insurance risk” - nearly same as IFRS4
 - Claims and expenses exceed premiums in some scenarios -new
- Specific scope inclusion and exclusions
 - Excluded: manufacturer warranties, roadside assistance, credit guarantees, others
 - Included: financial instruments with discretionary participation features

Unbundling

- Embedded derivatives – as before
- Service and financial components not closely related
 - “Not closely related” in IAS 39 means separately measurable
 - ED refers to variable (unit-linked) and universal-life type contracts are unbundled; nonetheless opinions vary
- Service components are in scope of IAS 18 Revenue Recognition, which is in revision
- Financial components are in scope of standards on financial instruments, namely IFRSs 7& 9/IAS 32&39 , also in revision

Long Duration or Short Durations

Duration - the period until insurer can re-evaluate

- Long - exceeds approximately one year
 - Measurement by building blocks
 - Presentation by summarized margin approach
- Short - less than approximately one year
 - Measured by
 - Premium allocation approach pre claims or coverage period
 - Building blocks for claims
 - Presentation is earned premiums and incurred claims and expenses, including amortization of acquisition costs

Three Building Blocks

- **Current estimates of future cash flows**
The amounts the insurer expects to collect from premiums and pay out for claims, benefits and expenses, estimated using up-to-date information
- **Time value of money**
An adjustment that uses an interest rate to convert future cash flows into current amounts
- **Risk adjustment**
An assessment of the uncertainty about the amount of future cash flows
- **Residual margin**
The remainder, so that value at inception is zero, recognized in profit or loss over the life of the contract

Cash Flows

Current, unbiased estimates

- Future premiums to contract boundary (duration)
- Dividends and interest credits
- Realistic lapse assumptions
- Realistic mortality, morbidity – no implicit PAD
- Direct expenses of for claims and administration
- Acquisition costs incremental to the contract

Acquisition Costs

- No DAC
- Acquisition costs are capitalized by inclusion in cash flows; i.e., initial liability is effectively net of acquisition costs
- But only those incremental to the contracts
 - Less than current US GAAP for most insurers
 - Biggest effect is on direct marketers, unless they outsource on an incremental basis

Time Value of Money

“...discount rates that are consistent with observable current market prices for instruments with cash flows whose characteristics reflect those of the insurance contract liability...”

- **Reflect dependence on specified assets , otherwise**
- **Risk-free with adjustment for liquidity**

Discount rates

Interpretations vary

- Is adjustment for liquidity
 - Everything in spread except expected credit losses, or
 - Specific quantifiable market based parameter for illiquidity (as in Solvency II)?
- Why not
 - Market rates less dividend spread for Par contracts?
 - High quality bond rates, as for pensions ?

Adjustment for Risk

“ ...the maximum amount the insurer would rationally pay to be relieved of the risk that the ultimate fulfilment cash flows exceed those expected.”

- Like stop loss at the expected value
- Three acceptable methods - confidence interval, conditional tail expectation, cost of capital
- Determined at portfolio level

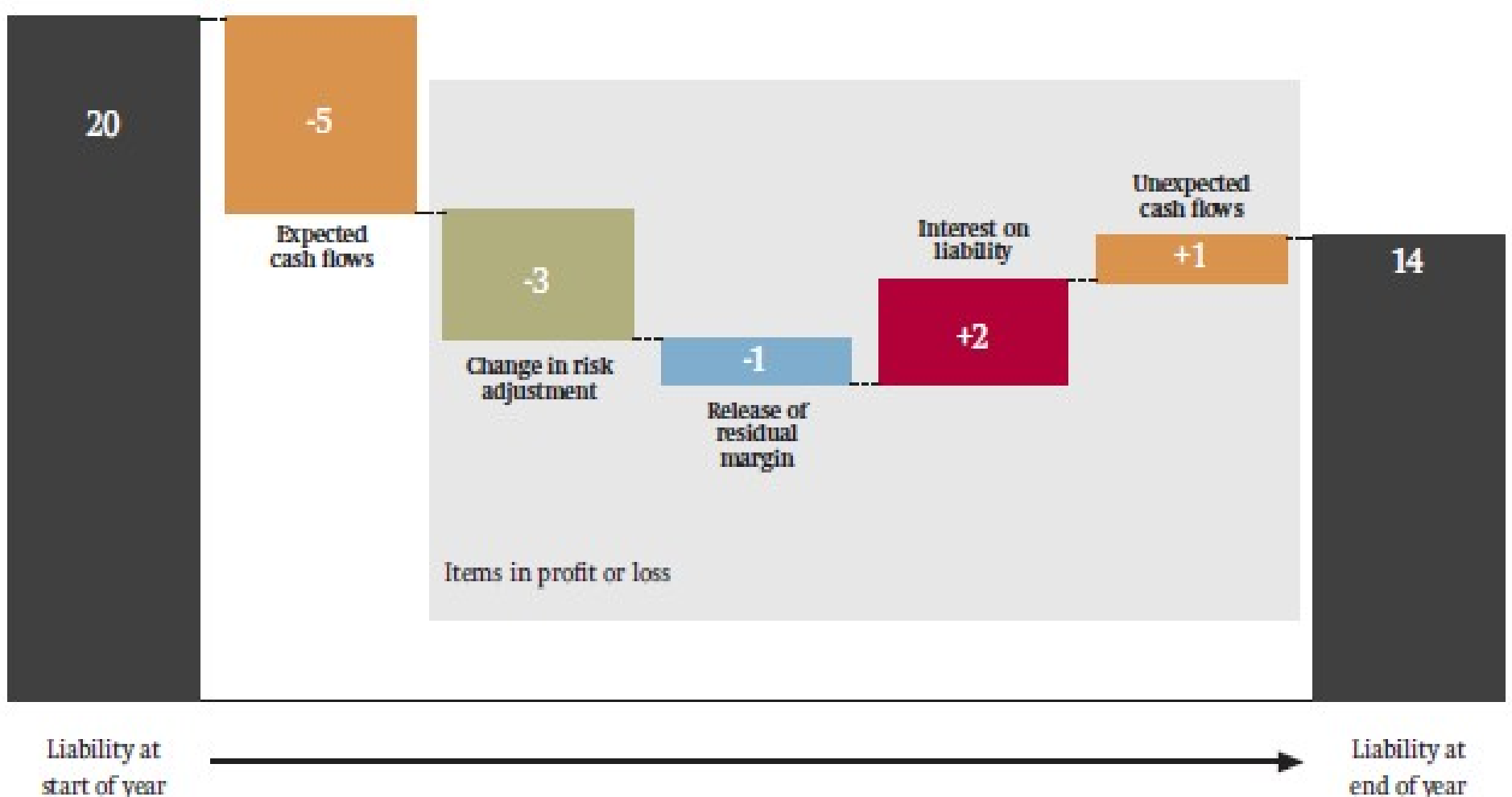
Critiques of Risk Adjustment

- Objective is unclear, inappropriate; uncertainty is not one-sided
- Actuaries should not be constrained to specified methods
- Methods are not linked to the objective

Residual Margin

- Purposes
 - To avoid gain at issue
 - To provide for those items not considered in cash flows; e.g., indirect costs, overheads
 - To be more consistent with principles for revenue recognition
- Residual margin is not re-measured, hence model is hybrid of current fixed values

Movement in the Liability



Profit or Loss - Summarized Margins

+ Investment income	3
+ Change in risk margin	3
+ Change in residual margin	1
- interest on liabilities	2
- deviations in cash flow	1
- change in estimates	2
- cash flows not provided for*	<u>1</u>
Profit or loss	1

*non-incremental acquisition costs, overheads, etc

Short Duration - Allocated Premiums

For pre-claims obligations

- Initial liability
 - Premium received plus present value of future premiums, less
 - Acquisition costs
- Subsequent liability - premium allocated to reporting periods
 - **on the basis of the passage of time, but**
 - **on the basis of the expected timing of incurred claims and benefits, if that pattern differs significantly**
- **Interest accretion is an expense**

Short Duration - Presentation in P/L

Investment income	XX
Premium revenue	XX
Claims incurred	XX
Expenses	XX
Amortization of incremental acquisition costs	XX
Interest on liability	<u>XX</u>
Profit or loss	XX

FASB DP

- Major differences
 - Uncertain about modified model, one may suffice
 - Composite margin amortized over coverage and claims-handling periods
 - Scope excludes investment contracts with discretionary participation features
- Summary comparison of current US GAAP, IASB and FASB views in the DP

Actuarial Response

“Really?”

“Come on,
man.”

“Are you kidding
me?”



AAA Comment Letter

... is a work in progress, will say improvement needed to avoid misrepresenting economics of insurance

- Mixed model can lead to accounting mismatches
- Unbundling should be rare
- All cash flows should be considered
- Risk margin should reflect uncertainty in the amount and timing of the cash flows **without restrictions**
- Simplify the modified approach
- Many others

Topics for later

- Recognition and derecognition
- Reinsurance
- Disclosures
- Business combinations and portfolio transfers
- Transition
- Onerous contracts
- Details
- Details

Summary Comments

- Much to be resolved
- Watch responses on cost/benefit and timing
 - Solvency II has been very expensive
 - Early estimates of time required are ~ 3 years
- Systems and resources demands
 - Timely measurement on current basis
 - Timely analysis of movement in liability
 - Step-up in on-going resources needed

Q & A



Bonus Slide

Ellen's Sweet Potato Pie - Side Dish or Dessert

Ingredients

Servings: 10

4 sweet potatoes (or yams)

1/4 cup butter (4 tablespoons), melted

1 1/2 cups milk or cream (may substitute orange juice for a lighter dish)

1/2 cup sugar (may use brown sugar) plus up to 1 cup sugar

2 eggs, lightly beaten

1 tablespoon vanilla

2 tablespoons orange zest

Directions

Preheat oven to 400°F.

Roast sweet potatoes for about one hour or until soft enough to mash. Allow sweet potatoes to cool then peel and cut into chunks and place in a large mixer bowl.

Preheat oven to 350°F.

Beat yams at medium speed and gradually add melted butter.

Gradually add 1/2 cup sugar (add up to an additional one cup of sugar or to taste, if making a pie). Gradually add milk (or cream if making pie, or orange juice for a healthful dish). Finish by adding vanilla and orange zest.

Pour mixture into a 2 1/2 quart buttered casserole dish (may use a non-stick cooking spray such as Pam).

If making a pie, pour mixture into a pastry pie crust.

Bake for about 40 minutes until filling is just set.

Serve warm or at room temperature.