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FASB / IASB Insurance Contracts Project

CAMAR Meeting
December 2, 2010

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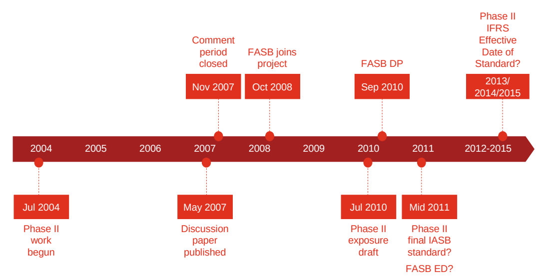
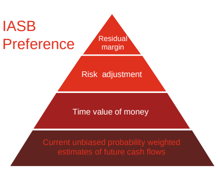
Background and timetable



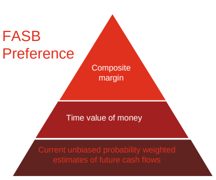
Measurement Model - overview

IASB Preference



Fulfillment rather than an exit value objective

FASB Preference



- One model for all insurance contracts
- Remeasured each period using current estimates
- Combination of rights and obligations (inflows and outflows)
- Day 1 loss in income statement, no day 1 gain
- Adjustments/margins are part of liability
- Discount rate is risk free plus liquidity adjustment

Legend

Description	Bullet
Significant issues	🔴
Some or modest issues	🟡
Minimal issues	🟢

Issues relate to 1) implementation or 2) meaningfulness

Summary of the key issues by topic

Topic	US Industry reaction – P&C	Analyst reaction*	Implementation for P&C	Academy Response*
Definition & scope	🟢	🟢	🟢	🟢
Expected value cash flows	🔴	🟢	🟡	🟡
Contract boundaries	🟢	🟢	🟡	🟡
Discount rate	🟢	🟡	🟡	🟡
Risk adjustment	🔴	🟡	🔴	🟡
Residual margin	🟡	🔴	🟡	🔴
Composite margin	🟡	🟡	🟡	🟡
Short duration contracts	🟡	🟢	🟡	🟡

* Life & P&C

Summary of the key issues by topic (cont'd)

Topic	US Industry reaction – P&C	Analyst reaction*	Implementation for P&C	Academy Response*
Unbundling	🟢	🟡	🟢	🟡
Acquisition (and other) costs	🟡	🟢	🟢	🟡
Recognition	🟢	🟢	🟡	🟢
Reinsurance	🟡	🟡	🔴	🔴
Presentation	🔴	🔴	🔴	🟡
Disclosure	🔴	🟢	🔴	🟢
Transition	🟡	🔴	🟡	🔴
Timetable / field testing	🔴	🟢	🟡	🟡

* Life & P&C

Definition and scope

US Industry – P&C	Analysts	Implementation – P&C	Academy Response

- Retain IFRS 4 definition
  'A contract under which one party (the insurer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder'
- Significance measured using present values
- Underwriting or timing risk but additional guidance that timing delays may reduce uncertainty
- Requires a scenario in which present value of cash outflows exceeds present value of premiums

Definition and scope (cont'd)

US Industry – P&C	Analysts	Implementation – P&C	Academy Response

Excluded

- Manufacturer / dealer / retailer warranties
- Fixed fee service contracts
- Policyholder accounting
- Residual value guarantees in leases

cluded

- Financial guarantees
- Certain DPF contracts

Boundary of contract

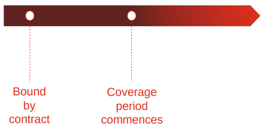
US Industry – P&C	Analysts	Implementation – P&C	Academy Response

- Contract boundary is where insurer
  - is no longer required to provide cover or
  - has right or practical ability to reassess risk of particular policyholder and can reprice
- Options and guarantees included on look through basis of expected future cash flows with no "deposit floor"

Recognition

US Industry – P&C | *Analysts* | *Implementation – P&C* | *Academy Response*

Earlier of:



- Systems implications
- Premium estimation complexities
- Changes in risk assumptions between signing and inception?

Unbundling

US Industry – P&C | *Analysts* | *Implementation – P&C* | *Academy Response*

'Closely related'

- Account balances
- Embedded derivatives
- Goods and services combined with no commercial substance

- Industry seeking further clarification
- Principle versus series of rules
- Potentially significant system and data implications

Short duration model

US Industry – P&C | *Analysts* | *Implementation – P&C* | *Academy Response*

- IASB ED – mandatory. FASB undecided.
- Unearned premium method required for pre-claims liabilities of short-duration contracts
- Applies when:
  - Coverage period approximately 12 months or less
  - No embedded options or other derivatives that would significantly affect the variability of cash flows
- Onerous contract test (includes risk adjustment)
- Pre-claims liability is premiums received less incremental acquisition costs
- Claims liabilities measured at present value of fulfilment cash flows (including risk adjustment)

Expected value cash flows

US Industry – P&C	Analysts	Implementation – P&C	Academy Response

An explicit, unbiased and probability-weighted estimate (i.e., expected value) of future cash outflows less future cash inflows that will arise as the insurer fulfills the insurance contract

Key points:

•Expected value, not 'best estimate'

•All probabilities, including remote ones considered

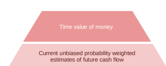
Not all cases require development of explicit scenarios

Not expected that every possible scenario will be identified and its expected cash flows quantified

Discounting and the interest rate

US Industry – P&C	Analysts	Implementation – P&C	Academy Response

- Reflects characteristics of the liability
  - If liability independent of supporting asset, discount rate is risk free with adjustment for illiquidity
  - If liability linked to supporting assets then discount rate reflects that linkage
- No adjustment for non-performance risk

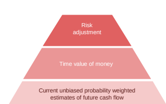


Risk adjustment

US Industry – P&C	Analysts	Implementation – P&C	Academy Response

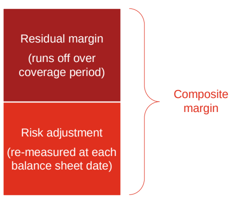
- Objective of risk margin to reflect the maximum amount that an insurer would rationally pay to be relieved of the risk that the ultimate fulfilment cash flows exceed those expected.
- Limited range of permitted techniques
  - Confidence level, conditional tail expectation (or tail VAR) or cost of capital.
  - Confidence level disclosures are required irrespective of technique used
- Diversification at portfolio level

'Subject to broadly similar risks and managed together as a single pool'



Risk adjustment (cont'd)

US Industry – P&C | Analysts | Implementation – P&C | Academy Response



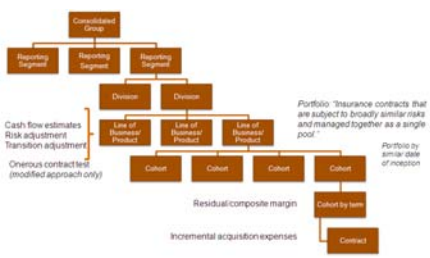
- 3 methods allowed… only!
- Confidence level disclosure needed
- Diversification
  - Entity vs. portfolio
  - Nature of 'portfolio'?
- Consistency of approach?
- How meaningful a split from residual?

What is a portfolio? One possible interpretation . . .

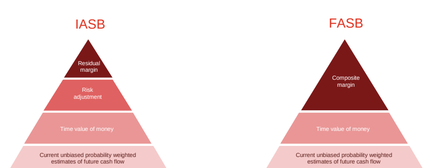
Level of Measurement

(P/C Company example)

At what level are components measured?



Measurement Model - comparison



FASB differences

- No explicit risk adjustment
- No accretion of interest on residual/composite margin
- All investment contracts with DPF in financial instrument standard
- Not yet concluded on simplified UPR approach

Composite margin model

US Industry – P&C	Analysts	Implementation – P&C	Academy Response
●	●	●	●

- Release over coverage and claims handing period
- Amortised using FASB formula:

$$\frac{\text{Premium allocated to date} + \text{Claims and benefits paid to date}}{\text{Total expected premium} + \text{Total expected claims and benefits}}$$

- Composite margin not re-measured but amortization pattern could change based on cash flow changes and changes in premium and loss estimates

Basic Measurement Model
Should there be an explicit risk adjustment?

Advantages

- An explicit measurement for uncertainty is useful information
- Explicit risk adjustment could be remeasured to reflect changes in price and quantity of risk
- Reflects risk in skewed tail distributions
- Lessens amount of residual margin subject to the complexities of amortising/remeasuring the residual margin
- Consistent with some regulatory regimes

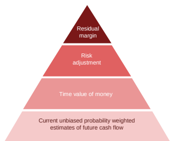
Disadvantages

- Little chance of comparability and consistency without rules
- Market may not trust explicit risk calculations
- Not sure objective of risk adjustment can be consistent with fulfilment objective
- Cost/benefit for all sized companies uncertain
- Can it be done quickly enough for quarterly reporting?
- Difficult to audit

Residual margin

US Industry – P&C	Analysts	Implementation – P&C	Academy Response
●	●	●	●

- Residual margin amortised in systematic way over coverage period
  - Passage of time; or
  - Expected timing of claims and benefits if different
- Interest accreted at locked in rate
- Residual margin cannot be negative



Acquisition (and other) costs

US Industry – P&C	Analysts	Implementation – P&C	Academy Response

Include in the cash flows only those that are incremental at the following levels:

Portfolio level	Contract level
Claims handling costs Policy and maintenance costs	Acquisition costs

Excluded:
General Overheads Investment returns
Underwriting department Taxes

- Some current acquisitions costs will be disallowed
  - Comparability of different distribution models?
- Capturing data at the right levels?
- More restrictive than recent FASB Accounting Standards Update (ASU 2010-26)

Reinsurance

US Industry – P&C	Analysts	Implementation – P&C	Academy Response

Assumed Reinsurance:

- Same building block approach – present value of fulfilment cash flows

Ceded Reinsurance:

- Reinsurance asset uses same approach calibrated to reinsurance premium
- Gain if expected cash inflows plus risk adjustment > expected cash outflows
- Non performance risk of reinsurer is included in expected cash flows
- Ceding commissions recognised as a reduction of premium ceded to reinsurer
- Reinsurance balances not offset against direct insurance balances

Presentation

US Industry – P&C	Analysts	Implementation – P&C	Academy Response

Margin approach	Inception 1 Jan	Six months to 30 June	Six months to 31 Dec
Change in risk margin		21	26
Residual margin		13	13
Underwriting margin		34	39
Acquisition costs (non-incremental)	10	–	–
Experience adjustments		(10)	(10)
Changes in estimates		(20)	0
Net gain/(loss) at inception		0	0
Investment income		40	38
Interest on insurance liability		(25)	(23)
Profit/(loss)	(10)	19	44

- Application of presentation proposals to short duration contracts
- Concern re loss of volume data
- Concern that too little time devoted to presentation

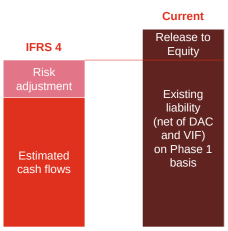
Disclosure

US Industry – P&C | Analysts | Implementation – P&C | Academy Response

- Retains IFRS 4 and IFRS 7 requirements
  - Appropriateness of prescriptive disclosure requirements
  - Implementation challenges re extensive disclosure requirements
- Additional reconciliations
- Methods and inputs used in estimates

Transition

US Industry – P&C | Analysts | Implementation – P&C | Academy Response



- Loss of currently deferred profits
- Alternatives?
  - Full restatement?
  - Grandfathering?
- Significant restatement challenge?

American Academy of Actuaries Comment Letter Key Points

- Overall, generally favorable but with important comments
- P&C insurance – focus of comments
  - Short duration model and its complexity
  - Ceded reinsurance
  - Expected value cash flows
  - Explicit risk adjustment – objective and methods
- Life insurance – focus of comments
  - Interest rate used to discount cash flows
  - Residual margin amortization
  - Unbundling
  - Transition

QUESTIONS ?