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With You Today

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Agenda

- History and Scope of Insurance Contracts Project
- Why Should You Care
- Overview of IASB Insurance Contracts Exposure Draft
- Modified Approach Measurement
  (For Pre-Claim liabilities on certain Short-Duration Contracts)
- Measurement
- An Example
- Risk Margins
  Permitted Approaches and Portfolio Aggregation
- Reinsurance

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Insurance Project History

Insurance Contracts Project

- Joint project between IASB and FASB
- **Project phases**
- IASB Discussion Paper – Preliminary Views on Insurance Contracts (May 2007) – Current Exit Value Approach
- FASB Invitation to Comment wrapping IASB paper (August 2007)
- FASB joins IASB project (October 2008)
- IASB Exposure Draft (July 2010)
- FASB Discussion Paper (Aug/Sept 2010)
- Final IASB standard expected by **June 2011;** Final FASB standard expected in **2012**
- First time application to be established (Boards' intent is to align effective date with IFRS 9 *Financial Instruments- 2013?*)

Comment deadline on ED ends 30 November 2010

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Insurance Project Scope

- Insurance and reinsurance contracts (not insurance enterprises)
- Investment contracts containing a discretionary participation feature (DPF) provided that there also exist insurance contracts that provide similar contractual rights to participate in the performance of the same pool or entity.
- Financial guarantee contracts *issued* by an entity (and financial guarantee reinsurance contracts held) that meet the definition of an insurance contract. Definition does not capture some types of credit-related contracts.

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Scope Exemptions

- Product warranties issued directly by a manufacturer, dealer or retailer;
- Residual value guarantees embedded in a finance lease and residual value guarantees provided by a manufacturer, dealer or retailer;
- Employers' assets and liabilities under employee benefit plans and retirement benefit obligations reported by defined benefit retirement plans;
- Contractual rights or contractual obligations that are contingent on future use, or right to use, a non-financial item;
- Contingent consideration payable or receivable in a business combination;
- Fixed fee service contracts that have as their primary purpose the provision of services, but that expose the service provider to risk because the level of service depends on an uncertain event; and
- Policyholder accounting (other than reinsurance).

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Why Should You Care?

- **SEC remains committed to convergence**
  - G20 Toronto Summit: "We re-emphasize the importance of achieving a single set of high-quality improved global accounting standards. We urge the IASB and FASB to increase their efforts to complete their convergence project by the end of 2011."
  - Insurance Contracts standard identified as a priority project
- **NAIC uses issuance of new FASB standards as a "trigger" for consideration of new statutory accounting guidance**
- **Fundamental changes in actuarial processes supporting financial reporting will be required for implementation**

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Definition of an Insurance Contract

"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."

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Significant insurance risk

Insurance risk is significant if, and only if, an insured event could cause an insurer to:

- pay significant additional benefits
- in any scenario
- excluding scenarios that lack commercial substance (i.e. have no discernable effect on the economics of the transaction)

This condition may be met even if the insured event is extremely unlikely or even if the expected (i.e. probability weighted) present value of contingent cash flows is a small portion of the expected present value of contractual cash flows.

A contract does not transfer insurance risk if there is no scenario that has commercial substance in which the present value of the net cash outflows paid by the insurer can exceed the present value of the premiums.

Incorporates an amendment to the guidance in IFRS 4 to explain that contractual terms that delay timely reimbursement to the policyholder can significantly reduce insurance risk, so that some contracts containing such terms might not meet the definition of an insurance contract.

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Key Features
IASB Insurance Contracts Exposure Draft

Feature	IASB Exposure Draft
Model	A single model – Life, non-life, direct, reinsurance
Recognition	Consistent with financial instruments – when the insurer is bound by the terms of the contract or first exposed to risk
Unearned Premium	Premium Allocation Model applies for certain short-duration contracts
Unit of account	Portfolio with broadly similar risks and managed together as a single pool
Measurement	Fulfilment value -- Four building blocks
Initial measurement	Day one profit prohibited

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Key Features
IASB Insurance Contracts Exposure Draft

Feature	IASB Exposure Draft
Acquisition Costs	*Incremental* acquisition costs recognized in the future cash flows; non-incremental acquisition costs recognized as expense when incurred
Credit characteristics	Credit standing NOT considered in measurement of insurance liability
Participating contracts	Future policyholder dividends are liabilities where a legal or constructive obligation exists
Unbundling	Investment and service components of an insurance contract should be unbundled and accounted for separately if the components are *not closely related* to the insurance coverage

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Recognition and Derecognition

An entity should recognize an insurance contract liability or asset at the earlier of:

(1) the date when the insurer is bound by the terms of the contract; and

(2) the date when the insurer is first exposed to risk under the contract. This is when the insurer can no longer withdraw from its obligation to provide coverage and no longer has the right to reassess the risk of the policyholder and as a result can no longer change the price to fully reflect that risk.

An insurance contract liability (or a part thereof) is derecognised from the statement of financial position when, and only when, it is extinguished, i.e. when the obligation specified in the insurance contract is discharged or cancelled or expires. At that point, the insurer is no longer at risk and is therefore no longer required to transfer economic resources to satisfy the insurance obligation.

The purchase of reinsurance does not trigger derecognition of an insurance liability unless it is extinguished.

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Contract Boundary

Boundary of the contract is defined the point at which the insurer either:

- is no longer required to provide coverage;
- has the right to reassess the risk of the particular policyholder and, as a result, can set a price that fully reflects that risk.

Options, forwards and guarantees that do not relate to the coverage under the existing insurance contract are not included within the boundary of that contract. Instead those features should be recognised and measured as new insurance contracts or other stand-alone instruments according to their nature.

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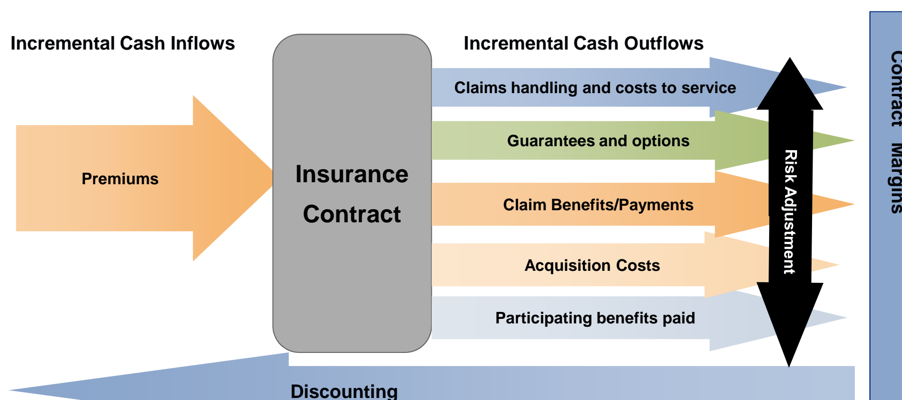
The Measurement Model

Measurement model is based on a principle that insurance contracts create a bundle of rights and obligations that work together to create a package of cash inflows (premiums) and outflows (benefits, claims and costs). The model uses certain "building blocks" in measuring that package of cash flows.



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Modified Approach or "Premium Allocation Model"

The modified approach is required for pre-claim liabilities for contracts that meet both of the following definitions:

- The coverage period is approximately 12 months or less
- The contract does not contain embedded options or other derivatives that significantly affect the variability of cash flows

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Modified approach measurement

PRE CLAIM OBLIGATION

Premiums received
Present value of future premiums in boundary of contract **less** **incremental acquisition costs**

- Pre-claims obligation is reduced over the coverage period in a systematic way that best reflects the exposure from providing insurance coverage either
  - on the basis of the passage of time; or
  - the expected timing of incurred claims and benefits if this pattern differs significantly from the passage of time.
- The pre-claims liability is the pre-claims obligation less the present value of future premiums within the boundary of the contract.
- Discounting is required.
- Interest should be accreted on the carrying amount of the pre-claims liability using a current discount rate.

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Modified approach measurement

- If a contract is onerous based on a comparison of the expected present value of the fulfilment cash flows for future claims and the pre-claim obligations for contracts in a portfolio with similar inception dates, the excess of the present value of the fulfilment cash flows over the carrying amount of the pre-claims obligation is recognised as an additional liability and expense.
- Liabilities for claims incurred are measured at the present value of fulfilment cash flows (including risk adjustment) in accordance with the general measurement model.
- Consistent with the general measurement model, a current market discount rate would be used in discounting the pre-claims obligation and claims liability.

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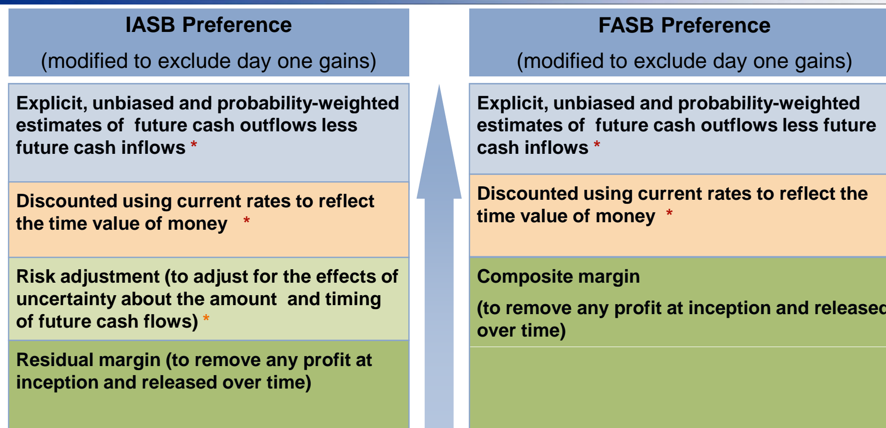
Proposed Measurement Models
The three (or four) 'building blocks'



Contract liability measurement

** Re-measured subsequent to inception through profit or loss*

The sum of the first three building blocks in the IASB model (discounted cash flows with risk adjustment) is referred to as the present value of fulfilment cash flows

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Level of measurement

- An insurer would measure the present value of the fulfilment cash flows (includes risk adjustment) at a portfolio level of aggregation for insurance contracts.
- A *portfolio of contracts* are contracts that are subject to broadly similar risks and managed together as a single pool. The definition is consistent with IFRS 4.
- The residual margin should be determined by grouping insurance contracts by portfolio and, within the same portfolio, by similar date of inception of the contract and by similar coverage period.

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General Liability – Assumptions

Assumptions:

	Large Company	Small Company
Written Premium	5,000,000	500,000
Contract Duration		12 Months
Policy Acq. Rate		15%
Estd. Ultimate Loss Ratio:		75%
Estd. Ultimate Losses		375,000
Investment Yield		4.0% for 2010
		4.0% + Risk Free Rate for 2011 & 2012
		5.0% + Risk Free Rate for 2013 & After
IFRS		
Risk Free Interest Rate		U.S. Treasury yield curve @ 6/30/2010
Target Return on Capital		10.0% + Risk Free Rate
Payout Pattern		100% Paid in Ten Years

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General Liability
US GAAP Basis – Sample Large Company

Traditional Basis:

	1-Jul-10	31-Dec-10	31-Dec-11	31-Dec-12	31-Dec-13	31-Dec-14	31-Dec-15	31-Dec-16	31-Dec-17	31-Dec-18	31-Dec-19
Balance Sheet:											
Cash and Investments	4,250,000	4,295,106	4,387,123	3,911,178	3,308,865	2,762,488	2,351,657	2,199,593	2,123,441	2,125,319	2,211,023
Deferred Acquisition Costs:	750,000	375,000	0	0	0	0	0	0	0	0	0
UPR:	(5,000,000)	(2,500,000)	0	0	0	0	0	0	0	0	0
Claim Provision:	0	(1,835,106)	(3,630,319)	(2,952,128)	(2,154,255)	(1,396,277)	(797,872)	(478,723)	(239,362)	(79,787)	0
Equity / Deficit:	0	335,000	756,804	959,051	1,154,610	1,366,211	1,553,784	1,720,870	1,884,079	2,045,532	2,211,023
Income Statement:											
Earned Premium:		2,500,000	2,500,000	0	0	0	0	0	0	0	0
Investment Income:		85,000	171,804	202,246	195,559	211,602	187,573	167,085	163,210	161,452	165,492
Acquisition Cost Expense:		(375,000)	(375,000)	0	0	0	0	0	0	0	0
Claim Expense:		(1,875,000)	(1,875,000)	0	0	0	0	0	0	0	0
Net Income / (Loss):		335,000	421,804	202,246	195,559	211,602	187,573	167,085	163,210	161,452	165,492
Total Profit (Cumulative):		335,000	756,804	959,051	1,154,610	1,366,211	1,553,784	1,720,870	1,884,079	2,045,532	2,211,023

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General Liability
ED Basis – Sample Large Company

IFRS Basis

	1-Jul-10	31-Dec-10	31-Dec-11	31-Dec-12	31-Dec-13	31-Dec-14	31-Dec-15	31-Dec-16	31-Dec-17
Balance Sheet:									
Cash and Investments	4,250,000	4,295,106	4,387,123	3,911,178	3,308,865	2,762,488	2,351,657	2,199,593	2,123,441
Unpaid Claims Liability									
Pre-claim Obligation	(4,250,000)	(2,125,000)							
Expected Value (Post Claim)		(1,875,000)	(3,630,319)	(2,952,128)	(2,154,255)	(1,396,277)	(797,872)	(478,723)	(239,362)
Discount		94,528	137,767	116,462	88,106	59,283	35,351	19,300	8,182
Risk Margin		(461,533)	(372,267)	(215,757)	(103,092)	(41,580)	(15,071)	(7,591)	(3,068)
Residual Margin		0	0	0	0	0	0	0	0
Equity / Deficit:	0	(71,899)	522,304	859,756	1,139,623	1,383,914	1,574,064	1,732,578	1,889,193
Income Statement:									
Premium Revenue	0	2,125,000	2,125,000						
Claims Incurred Expense	0	(1,914,894)	(1,835,106)	0	0	0	0	0	0
Unwind of Discount		94,528	43,239	(21,305)	(28,357)	(28,823)	(23,932)	(16,051)	(11,118)
Release of Risk Margin		(461,533)	89,266	156,510	112,665	61,512	26,509	7,480	4,523
Release of Residual Margin		0	0	0	0	0	0	0	0
Investment Income		85,000	171,804	202,246	195,559	211,602	187,573	167,085	163,210
Net Income / (Loss)	0	(71,899)	594,203	337,451	279,867	244,291	190,149	158,514	156,615
Total Profit (Cumulative):	0	(71,899)	522,304	859,756	1,139,623	1,383,914	1,574,064	1,732,578	1,889,193

The aggregate net income under IFRS is identical to the aggregate income under the traditional basis. However, the timing of recognition may be different. In the early periods, it may result in a net loss.

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Level of Aggregation

- Each of the permitted techniques for measuring risk adjustments builds on a probability distribution of the underlying cash flows.
- The shape of that distribution depends on the level at which the insurer determines the risk adjustments (e.g. for a contract, for a portfolio, for a legal entity or for the reporting entity as a whole.
- The Board has proposed that, for the purpose of measuring risk adjustments, an insurer shall aggregate insurance contracts into a portfolio of insurance contracts that are subject to broadly similar risks and managed together as a single pool.
- The benefit of diversification can be considered WITHIN a portfolio, but diversification benefits across portfolios cannot.
- All other things being equal, for similar portfolios, the risk margin will generally decrease as the size of the portfolio increases.

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Questions to Consider:

- Can Reporting Segment be used to define portfolio aggregation?
- How does the way you manage your business impact aggregation?
  - Company A writes workers compensation through three business units: National Accounts, Standard Commercial and Specialty Markets? Separate management would lead to separate portfolios.
- How does the level at which the Company evaluates liabilities influence the portfolio measurement?
  - Company B evaluates workers compensation for California and for All Other States, and separately for Indemnity and Medical. Must each of the four reserve segments be considered a portfolio?

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Comparison of Risk Margin – Confidence Level Approach (Based on 95% confidence)

Line of Business	Industry (Ex. Reins.)	Sample Small Company	Sample Large Company	Reinsurance (Industry)
Gen. Liab. - Occ	7%	15%	16%	-----
Gen. Liab. – CM	10%	30%	16%	-----
Workers Comp	4%	33%	15%	-----
Comm. Auto Liab.	3%	17%	19%	-----
CMP	5%	43%	18%	-----
Pers. Auto Liab.	2%	8%	12%	-----
Homeowners	10%	103%	25%	-----
Reins. Liab	-----	-----	-----	15%
Reins. Property	-----	-----	-----	39%
Total	5%	36%	17%	30%

Note – Estimates presented in these exhibits were derived using 2009 Schedule P data by line of business

Mix of business matters; risks vary significantly by line of business; size of portfolio also matters; generally speaking, larger portfolios will have lower risk margins than smaller portfolios.

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Comparison of Risk Margin By Approach
Based on 95% Confidence Level

Approach	Industry (Ex. Reins.)	Sample Small Company	Sample Large Company	Reinsurance
Conditional Tail Expectation (CTE)	7%	50%	22%	40%
Confidence Level	5%	36%	17%	30%
Cost of Capital	5%	37%	20%	38%

Note – Estimates presented in these exhibits were derived using 2009 Schedule P data by line of business

Generally speaking, the Conditional Tail Expectation (CTE) approach will result in a higher risk margin than the Confidence Level approach at comparable levels. The Cost of Capital approach depends on several consideration, including underlying capital requirements, interest yield rates and desired ROE.

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Comparison of Risk Margin By Approach
Based on Industry Experience

Approach	Confidence Interval				
	75%	85%	90%	95%	99.5%
CTE	4%	5%	6%	7%	10%
Confidence Level	2%	3%	4%	5%	8%
Cost of Capital	2%	3%	4%	5%	9%

Note – Estimates presented in these exhibits were derived using 2009 Schedule P data by line of business

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Comparison of Risk Margin By Approach
Based on Experience from a Sample Large Company

Approach	Confidence Interval				
	75%	85%	90%	95%	99.5%
CTE	13%	16%	18%	22%	33%
Confidence Level	7%	10%	13%	17%	27%
Cost of Capital	7%	10%	14%	20%	34%

Note – Estimates presented in these exhibits were derived using 2009 Schedule P data by line of business

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Comparison of Risk Margin By Approach
Based on Experience from a Sample Small Company

Approach	Confidence Interval				
	75%	85%	90%	95%	99.5%
CTE	27%	35%	40%	50%	88%
Confidence Interval	13%	20%	26%	36%	66%
Cost of Capital	13%	19%	26%	37%	63%

Note – Estimates presented in these exhibits were derived using 2009 Schedule P data by line of business

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Let's Return to our General Liability Example
ED Basis – Sample Small Company

IFRS Basis

	1-Jul-10	31-Dec-10	31-Dec-11	31-Dec-12	31-Dec-13	31-Dec-14	31-Dec-15	31-Dec-16	31-Dec-17	31-Dec-18	31-Dec-19
Balance Sheet:											
Cash and Investments	425,000	429,511	438,712	391,118	330,886	276,249	235,166	219,959	212,344	212,532	221,102
Unpaid Claims Liability											
Pre-claim Obligation	(425,000)	(212,500)									
Expected Value (Post Claim)		(187,500)	(363,032)	(295,213)	(215,426)	(139,628)	(79,787)	(47,872)	(23,936)	(7,979)	0
Discount		9,453	13,777	11,646	8,811	5,928	3,535	1,930	818	216	0
Risk Margin		(143,115)	(172,180)	(119,933)	(77,880)	(47,433)	(21,041)	(5,908)	(1,345)	(194)	0
Residual Margin		0	0	0	0	0	0	0	0	0	0
Equity / Deficit:	0	(104,152)	(82,723)	(12,382)	46,392	95,116	137,873	168,109	187,881	204,575	221,102
Income Statement:											
Premium Revenue	0	212,500	212,500								
Claims Incurred Expense	0	(191,489)	(183,511)	0	0	0	0	0	0	0	0
Unwind of Discount		9,453	4,324	(2,130)	(2,836)	(2,882)	(2,393)	(1,605)	(1,112)	(602)	(216)
Release of Risk Margin		(143,115)	(29,065)	52,248	42,053	30,447	26,392	15,133	4,563	1,151	194
Release of Residual Margin		0	0	0	0	0	0	0	0	0	0
Investment Income		8,500	17,180	20,225	19,556	21,160	18,757	16,709	16,321	16,145	16,549
Net Income / (Loss)	0	(104,152)	21,429	70,342	58,773	48,725	42,756	30,237	19,772	16,694	16,527
Total Profit (Cumulative):	0	(104,152)	(82,723)	(12,382)	46,392	95,116	137,873	168,109	187,881	204,575	221,102

While the overall profit recorded by the smaller company will be identical, on a percentage basis, to that of the larger company, the timing of profit recognition likely will be quite different. All other things being equal, smaller portfolios will have higher risk margins in the claims liabilities, changing the timing of profit recognition, and the potential for losses being reported initially under IFRS.

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Reinsurance

- Reinsurer should use the same recognition and measurement approach for reinsurance contracts it issues as all other insurers use for the insurance contracts they have issued.
- A cedant shall measure a reinsurance contract it holds as the sum of the expected present value of the cedant's future cash inflows plus the risk adjustment less the expected present value of the cedant's future cash outflows and a residual margin that eliminates any loss at inception of the contract.
- The residual margin cannot be negative. If the present value of fulfilment cash flows (expected present value of the cedant's future cash inflows plus the risk adjustment less the expected present value of the cedant's future cash outflows) for the reinsurance contract is less than zero, the cedant establishes a residual margin. If the fulfilment cash flows for the reinsurance contract is greater than zero, the cedant recognises that amount in profit or loss.

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Reinsurance

- The cedant estimates the present value of fulfilment cash flows in the same manner as the corresponding part of the present value of fulfilment cash flows for the underlying insurance contract, after remeasuring the underlying insurance contract on initial recognition of the reinsurance contract.
- The cedant considers the risk of non-performance by the reinsurer on an expected value basis when estimating the present value of fulfilment cash flows and also updates for any change in the risk of non-performance by the reinsurer in subsequent measurement.
- Any ceding commissions a cedant receives should be recognised as a reduction of the premium ceded to the reinsurer.

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Recognition of Reinsurance Contracts

- An insurer may become party to a reinsurance contract before the coverage period starts.
- The residual margin is established at the inception of the contract and is not recognized in profit or loss until the coverage period begins.
- The ED suggests that the measurement of insurance contracts may not change materially between initial recognition and the start of the coverage period.
- The residual margin shall be adjusted if fewer than expected contracts are in force at the end of a period but no adjustment is made if more contracts than expected are in force.

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Reinsurance Considerations

- The cedant shall estimate the present value of the fulfillment cash flows for the reinsurance contract in the same manner as the corresponding part of the underlying insurance contract or contracts, after remeasuring the underlying insurance contract(s) on initial recognition of the reinsurance contract.
- Even when estimated in the same manner and remeasured on the same date:
  - Differences in cash flows may exist due to additional cash flows related to the reinsurance contract (e.g., the risk of non-performance by the reinsurer, ceding commissions, etc.).
  - Different risk adjustments may emerge as the risk profile of the ceded cash flows does not necessarily match the risk profile of the direct cash flows.
- The way companies evaluate reinsurance products may change under the proposed ED.

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Are You Prepared for the Changes?

- What is the portfolio aggregation that makes sense for your company? How would you support that decision?
- What additional data will be needed to support your company's financial reporting process?
- Does "management's best estimate" comply with the requirements of the first building block?
- Will your current actuarial processes support the evaluation (and reevaluation) of discount and risk margin at each reporting period?
- What training is needed to prepare for these changes?

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Questions/Comments

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