Fair Value for Insurance
A Canadian Perspective

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Ernst & Young
Quality In Everything We Do

Canadian GAAP for P&C Insurance

Current Canadian Accounting Model

- Unearned premium approach effectively limits impact of discounting and PfAD to claim liabilities
- Unearned premium approach spreads profit recognition over life of policy
- Impact of present values and margins on premium liabilities limited to use in premium deficiency test

Typical Canadian P&C actuarial approach

- Based on company specific claim experience and investment yield
  - Establish traditional ultimate undiscounted estimates for gross and ceded claim liabilities (“square the triangles”)
  - Estimate payment patterns applicable
  - Apply discount rate based on current (and anticipated) portfolio market yield
  - Determine claim development PfAD
  - Determine interest rate PfAD
  - Determine reinsurance PfAD to reduce ceded claim liabilities

Margin for Adverse Deviation

- Actuarial standards describe low and high margin situations
- Margin limited to between 2.5% to 15% of discounted estimate. Standards constrain when low margin can be selected
- Actuary determines where in continuum a particular insurer and its products fall.
- Margin typically separately determined for each subdivision of data

IFRS 4 – Insurance Contracts

Phase I --> Phase II

	Assets	Liabilities	
		All Insurance Contracts and Investment Contracts with Discretionary Participation Features	Other Investment Contracts and All Service Contracts
Phase I (2011)	IAS 39 for Invested Assets	IFRS 4 Phase 1 Status Quo	IAS 39 and some aspects in IAS 32 and IAS 18
Phase II		IFRS 4 Phase 2	

IFRS 4 – Insurance Contracts Phase 1

Definition of Insurance Contract

- One standard
  - For Life and Non-Life
  - For Direct Written and Reinsurance

- A contract under which the insurer accepts *significant insurance risk* by agreeing to compensate the beneficiary if the insured event adversely affects the policyholder

  (Insurance Contracts (Phase I) paraphrased with emphasis added)

- Significant means at least one scenario with payment of commercial substance with an amount that is not trivial

Insurance Versus Financial Risk

- *Financial risk* is risk of possible future change in specified interest rate, security price, commodity price, foreign exchange rate, index of prices or rates, a credit rating or credit index or similar variable

- *Insurance risk* is risk from contingent events other than financial risk

- If both financial risk and significant insurance risk are present, the contract is classified as insurance

Insurance Contract Accounting

- During Phase I, existing accounting policies apply with certain modifications
  - **Prohibited** – certain accounting policies are prohibited as they do not meet the IFRS framework
  - **Mandated** – certain accounting policies must be implemented, if they are not already in the existing accounting policies
  - **Allowed to continue, but not start** – certain accounting policies that do not meet the IFRS framework can continue, but cannot be implemented.
  - **Can be started** – certain accounting policies can be introduced.
- Existing accounting policies are those in the primary financial statements

Prohibited Policies

- The following accounting policies are **prohibited**
  - Catastrophe provisions
  - Claims equalisation provisions
  - Offsetting of reinsurance assets and direct liabilities

Mandated Policies

- The following accounting policies are **mandated** if they are not already present
  - Liability adequacy testing
  - Impairment of reinsurance assets

Liability Adequacy Testing

- Current liability adequacy test applies if
  - Test at each reporting date using current estimates of future cash flows
  - If these are greater than current liability, liability is increased and deficiency flows through profit and loss

- This is current Canadian P&C actuarial practice
  - Known as equity in unearned premium or premium deficiency reserve

Impairment of Reinsurance Assets

- Reinsurance asset is reduced and reduction flows through income statement if it is impaired
- Reinsurance asset is impaired if:
  - Objective evidence of an event after initial inception that the cedant may not receive all amounts due to it
  - The impact of the event can be reliably measured
- Impairment may be reversed

IFRS 4 – Insurance Contracts Phase 2

Phase I --> Phase II

	Assets	Liabilities	
		All Insurance Contracts and Investment Contracts with Discretionary Participation Features	Other Investment Contracts and All Service Contracts
Phase I (2011)	IAS 39 for Invested Assets	IFRS 4 Phase 1 Status Quo	IAS 39 and some aspects in IAS 32 and IAS 18
Phase II (???)		IFRS 4 Phase 2	

Phase 2 Discussion Paper

- Principles-based approach with additional guidance
- Insurance to be subject to the same general principles as other financial services firms
- Consistency of treatment between insurance, investment management and banking products

IFRS 4 (Phase 2) Timetable

IASB – Discussion paper issued	May 2007
FASB – Invitation to Comment	August 2007
End of comment periods (IASB & FASB)	16 November 2007
Exposure draft	October 2009
Final standard	May 2011
Implementation date	January 2013? (originally 2011)

Related IASB Projects

- Conceptual Framework
- Revenue Recognition
- Fair Value Measurements (FAS 157)
- Revisions to “Provisions, Contingent Liabilities and Contingent Assets” (IAS 37)
- Financial Statement Presentation
- Financial Instruments

Issues Not Addressed in Discussion Paper

- Issues already settled
  - Definition of insurance contract
  - Catastrophe/equalization reserves
  - Timing of recognition of assets
- Issues being considered in other projects
  - Separate accounts
  - Securitizations and other ART transactions
  - Deferred taxes
  - Interim reporting
- Issues to be resolved in the future
  - Presentation and disclosure
  - Measurement by policyholders
  - Transition/effective date

Measurement Attribute – Current Exit Value

- Current exit value: The amount an insurer would expect to pay at a reporting date to transfer its remaining contractual rights and obligations immediately to a market participant

- Insurance liabilities measured at current exit value, with single model used for:
  - Life and non-life insurance
  - Insurance and reinsurance contracts
  - Claims period and pre-claims period

- Difficult to estimate, due to lack of secondary marketplace
- No requirement for break-even at issue
- May be equivalent to fair value, as defined in FAS 157

Current Exit Value

- Relevant and reliable information to help users with economic decisions
- Does not imply that an insurer can, will, or should actually transfer the liability to a third party
- In most cases, insurers cannot transfer the liabilities and do not want to do so

Three Building Blocks

- Reserve is a present value calculation using:
  - Estimates of future cash flows
  - Time value of money (Discounting)
  - Margins

Future Cash Flows

- Current estimates
- Unbiased
- Probability-weighted (expected value)
- Use observable market inputs, where they exist
- Principles, not detailed guidance

P&C Actuarial Liabilities

- Reported claims
  - Case reserves
  - IBNR
- Pre-claim liabilities
  - Stand ready obligation

P&C Actuarial Liabilities Discounting

- Discounting of liabilities will become mandatory
- Expected returns of invested assets no longer relevant
- Discounting at “risk free” rate, plus spread for credit and MVM

P&C Actuarial Liabilities
Market Value Margins

- Margin required by market participants, for
  - bearing risk (risk margin)
  - other services (service margin)
- Not intended as a shock absorber
- How calibrated?
- Gain or loss at inception?

P&C Actuarial Liabilities
Setting Margins

- IASB has given high level guidance, leaving detail to be determined

- IABS approaches to determining risk margins
  - Confidence levels
  - Conditional tail expectations
  - Explicit margin within a specified range
  - Cost of capital approach
  - Others

- IASB will look to IAA to provide guidance to actuaries

P&C Actuarial Liabilities
Unearned Premium Reserve

- For contracts in which claims have yet to be incurred, liabilities will have to be determined by projecting future cash flows
- Eliminates UPR and DAC
- Many existing accounting systems use UPR (less acquisition costs) as a proxy for this item
- IASB notes the unearned premium “may sometimes provide an approximation”
- Requires recognition of liabilities from date of substantive commitment, not necessarily policy effective date

Unresolved Issues

- P&C and Life:
  - Gain on issue
  - Setting risk margins
  - Discount rate
- Life:
  - Term of the Liability/renewal premiums
  - Participating Business

Summary of responses to IASB DP

- As of January 24, 2008, 158 letters had been posted to the IASB's website.
- Responses reflect consideration of the issues presented by the IASB, typically running from five to 50 pages.
- The summary of responses considered the respondents' home country/region and the type of respondent, e.g., insurers, accounting firms, industry groups, accounting associations, professional associations, country-based accounting standards boards, analysts, and individuals.

Survey objectives

- The purpose of the review was to:
  - Summarize respondents' answers to the DP's questions
  - Summarize respondents' views on certain questions from the DP and other issues not directly asked about in the DP, e.g., "How should the IASB proceed with the insurance project given its dependency on other IASB projects?"
  - Attempt to gain an understanding of the various rationales for differing responses
  - Gauge the level of acceptance of the IASB's preliminary views

Measurement approach

- The respondents broadly agree with an approach to measurement for all insurance with three components, similar to the building blocks:
  - A current measurement of future, unbiased estimates of cash flows
  - Discounting for the time value of money
  - A margin

- Many respondents favor a single model for all insurance products, but there was also a significant number of non-life focused respondents who support a separate model for non-life insurance.

Building blocks

- Respondents:
  - Generally favor use of entity-specific cash flows
  - Do not all agree with a requirement for using probability-weighted cash flows, except as needed to recognize optionality in contracts
  - Strongly disagree with constraints on cash flows or on reflecting policyholder behavior
  - Have differing views on calibrating margins to premiums and request clarification on the objectives and intent of margins
  - Generally do not want to recognize profit immediately
  - Have differing views on discount rates, generally supporting either market rates or earned rates

Further summary points

- Respondents generally:
  - Do not agree with unbundling
  - Do not agree with reflecting credit characteristics of liabilities
  - Want to avoid accounting mismatches
  - Want consistent accounting treatment for investment contracts
  - Consider the topics of presentation and disclosure and of measurement as critical to each other

General observations

- Respondents believe accounting for insurance should reflect the economics of the business.
- The comment letters show there is little support for Current Exit Value (CEV) without potentially substantial modification.
- Many respondents do not agree that the transfer value concept is appropriate for valuing insurance liabilities.

Recent Developments

- Per Warren McGregor, IASB board member
  - comments August 2008
  - IASB is considering fulfillment value rather than current exit value
  - Possibility than there will be separate approaches for short term (P&C) and long term (Life) contracts
  - Will leave quantification of market value margins to actuaries

Questions

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