IFRS Insurance Project Phase II - Potential Business Impacts

Casualty Loss Reserving Seminar

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Quality In Everything We Do

Discussion topics

As actuaries we often focus on the balance sheet impact of our reserve studies. On the other hand, management and investors are focused on profits from the income statement. This presentation looks at the affect on profit emergence from reserving on a fair value basis and how it is important to understand the underlying dynamics. We conclude with some of the resulting business impacts.

- ►Profit emergence – baseline example
- ►Profit emergence – sensitivity testing
- ►Business impacts of a fair value reserving basis

Profit emergence – baseline example

P&C profit emergence – assumptions

- Applied a basic three building block approach to obtain fair value of the insurance liabilities as outlined in the IASB's Discussion Paper, "Preliminary Views on Insurance Contracts"
- The three explicit building blocks consist of:
  - explicit, unbiased, market-consistent, probability-weighted and current estimates of the contractual cash flows;
  - current market discount rates that adjust the estimated future cash flows for the time value of money; and
  - 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).

P&C profit emergence – assumptions

- $100,000 of premium is written on July 1st for one year of coverage, so that half is earned in year one and the other half in year two
- Acquisition costs are $20,000, losses include ALAE and ULAE, and there are no other expenses
- The risk free rate of return is 5.0%
- There is no tax or reinsurance
- Actual reserve development does not differ from expected

P&C profit emergence – assumptions

- The risk margin is estimated using a "Cost of capital" approach
- The allocated capital is 25% of undiscounted future cash flows associated with loss and LAE
- The required return on capital is 6% above the risk free rate
- Loss ratio is 80%
- Losses are paid out over 10 years

Projected US GAAP income statement

US GAAP

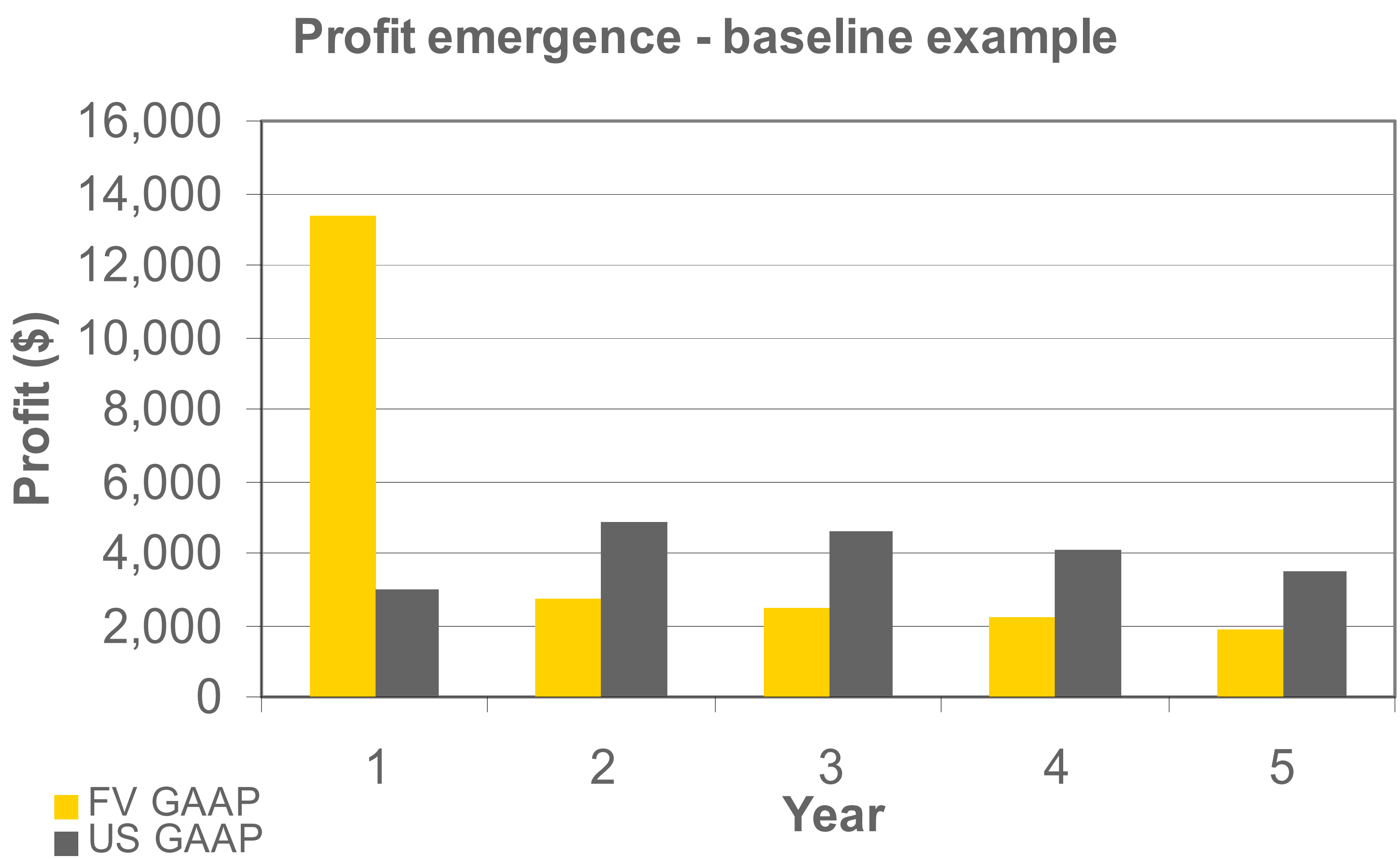
	Year 1	Year 2	Year 3	Year 4	Year 5
Written Premiums	100,000	-	-	-	-
Unearned Premiums	(50,000)	-	-	-	-
Earned Premiums	50,000	50,000	-	-	-
Claims Expense	(40,000)	(40,000)	-	-	-
Discount	-	-	-	-	-
Risk Margin	-	-	-	-	-
Acquisition costs	(10,000)	(10,000)	-	-	-
Underwriting Profit	-	-	-	-	-
Unwind of Discount - Claims Reserve	-	-	-	-	-
Unwind of Discount - Risk Margin	-	-	-	-	-
Profit After Unwind of Discount	-	-	-	-	-
Investment Return	2,976	4,877	4,586	4,125	3,465
Profit	**2,976**	**4,877**	**4,586**	**4,125**	**3,465**

Projected Fair Value GAAP income statement

Fair Value GAAP

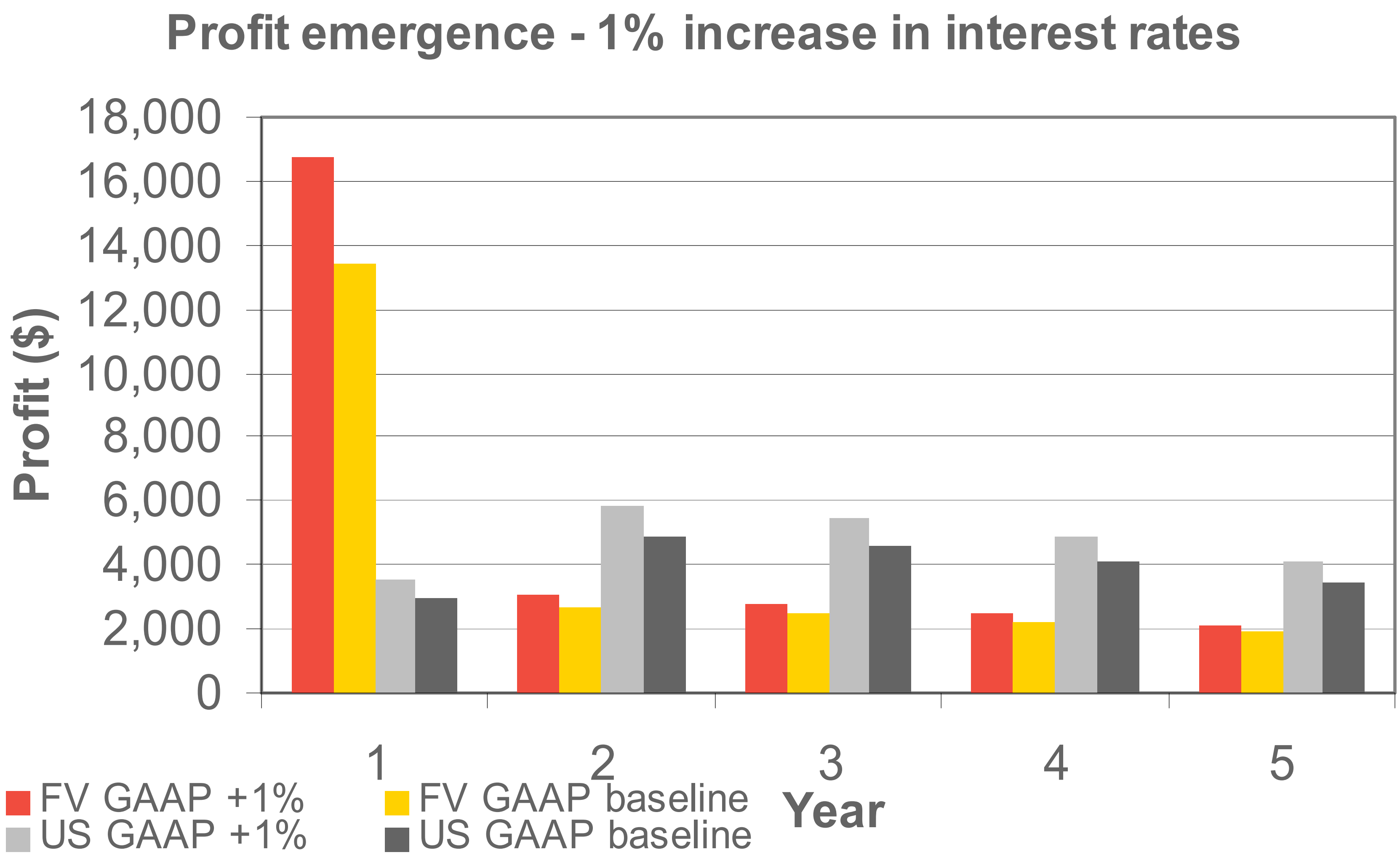
	Year 1	Year 2	Year 3	Year 4	Year 5
Written Premiums	100,000	-	-	-	-
Unearned Premiums	-	-	-	-	-
Earned Premiums	100,000	-	-	-	-
Claims Expense	(80,000)	-	-	-	-
Discount	17,282	-	-	-	-
Risk Margin	(5,170)	1,225	1,182	1,082	938
Acquisition costs	(20,000)				
Underwriting Profit	**12,112**	**1,225**	**1,182**	**1,082**	**938**
Unwind of Discount - Claims Reserve	(1,549)	(3,154)	(3,093)	(2,858)	(2,423)
Unwind of Discount - Risk Margin	(143)	(261)	(207)	(156)	(107)
Profit After Unwind of Discount	**10,421**	**(2,190)**	**(2,118)**	**(1,933)**	**(1,592)**
Investment Return	2,976	4,877	4,586	4,125	3,465
Profit	**13,396**	**2,686**	**2,468**	**2,192**	**1,873**

Comparison of baseline profit emergence

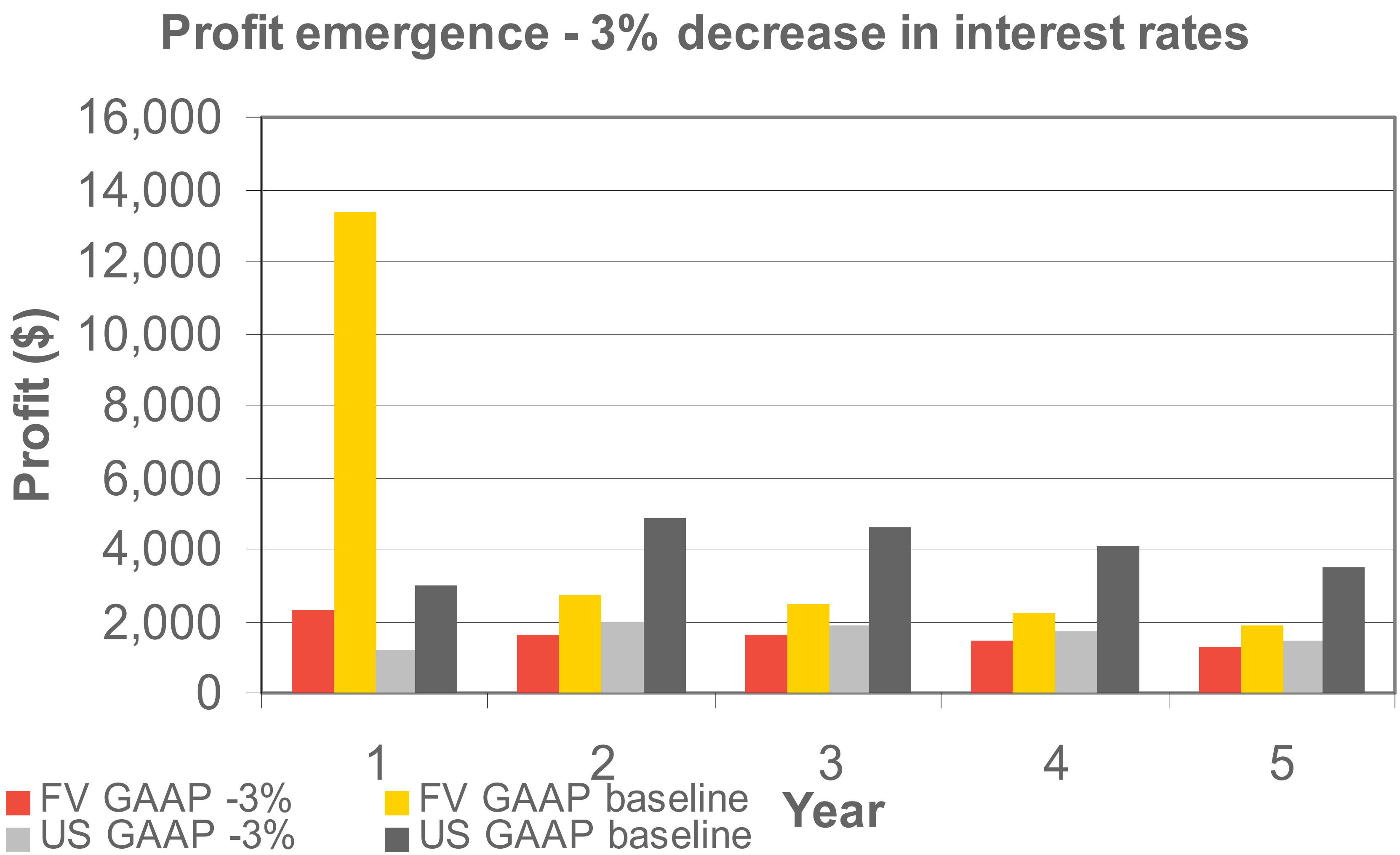


Profit emergence – sensitivity testing

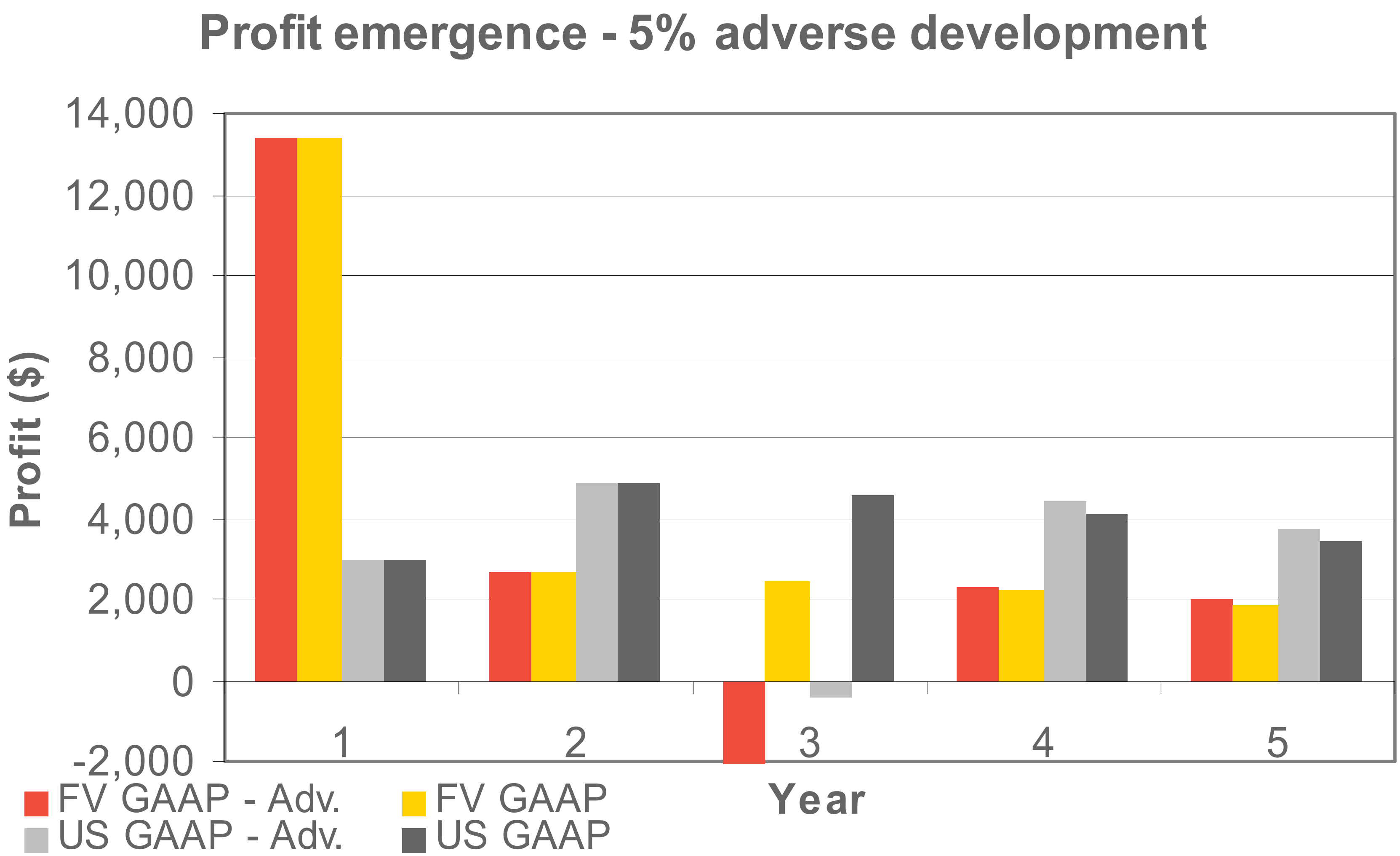
Sensitivity testing – 1% increase in interest rates



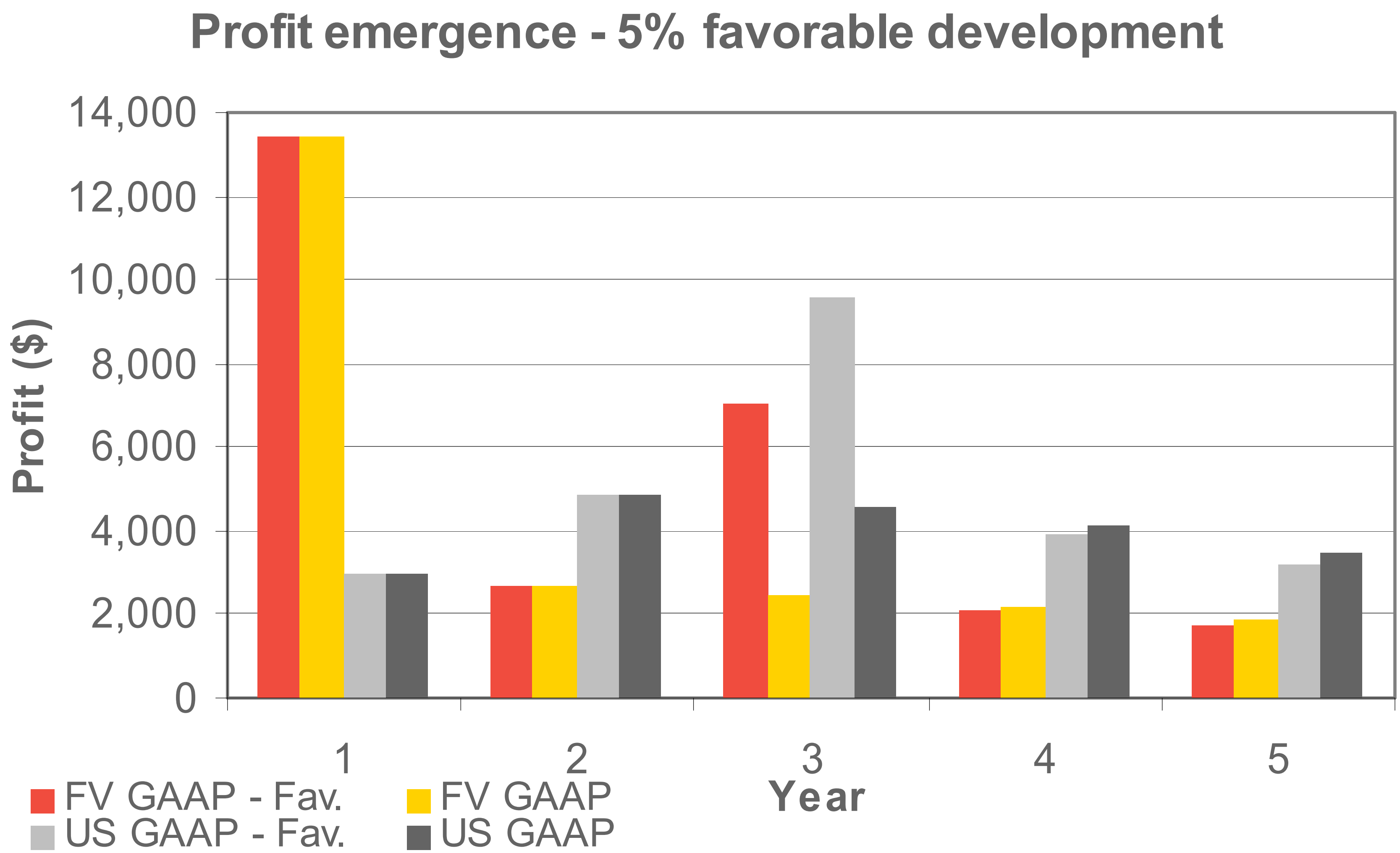
Sensitivity testing – 3% decrease in interest rates



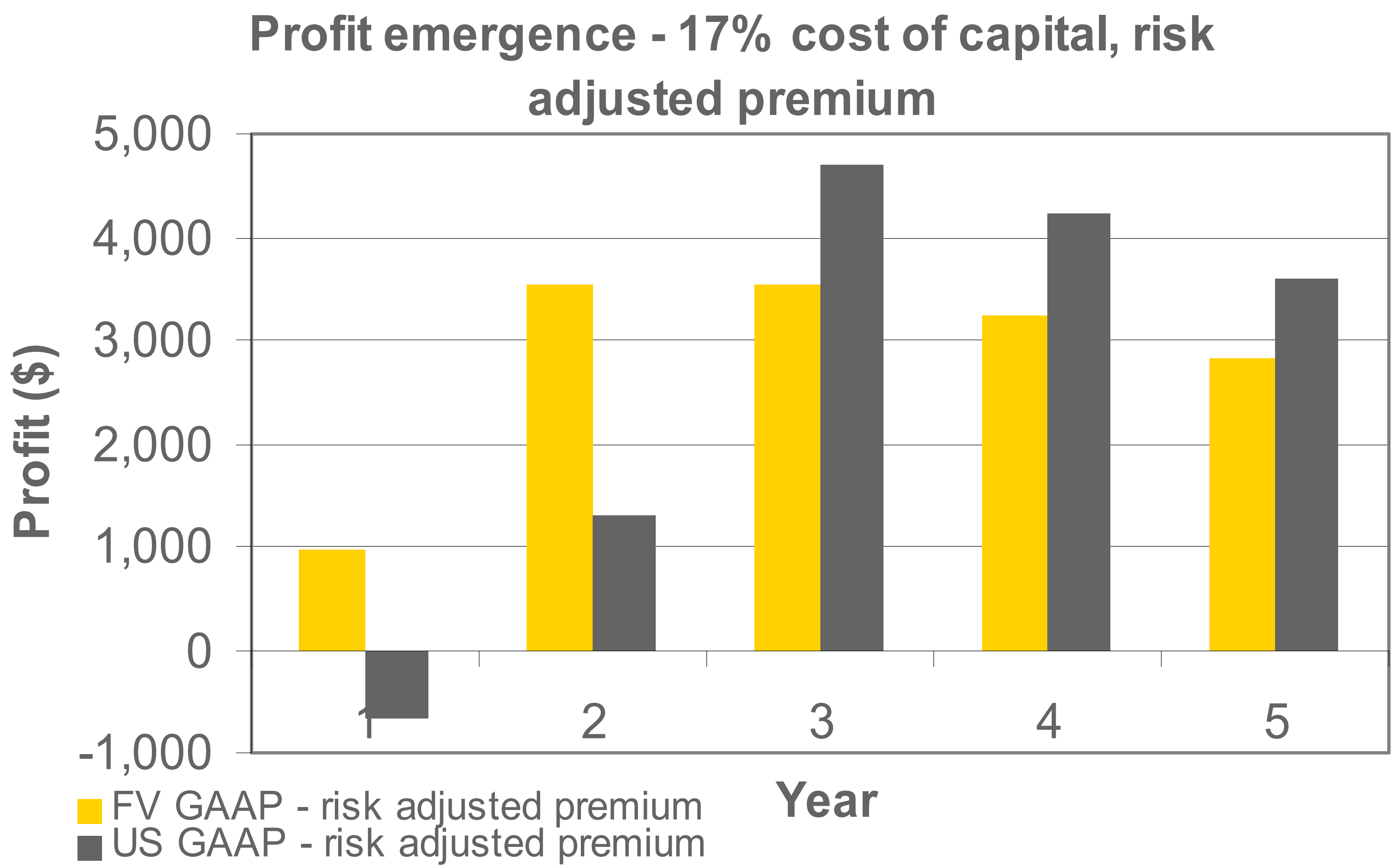
Sensitivity testing – adverse loss ratio development of 5% in year 3



Sensitivity testing – favorable loss ratio development of 5% in year 3



Sensitivity testing – 17% cost of capital, risk adjusted premium



Profit emergence observations

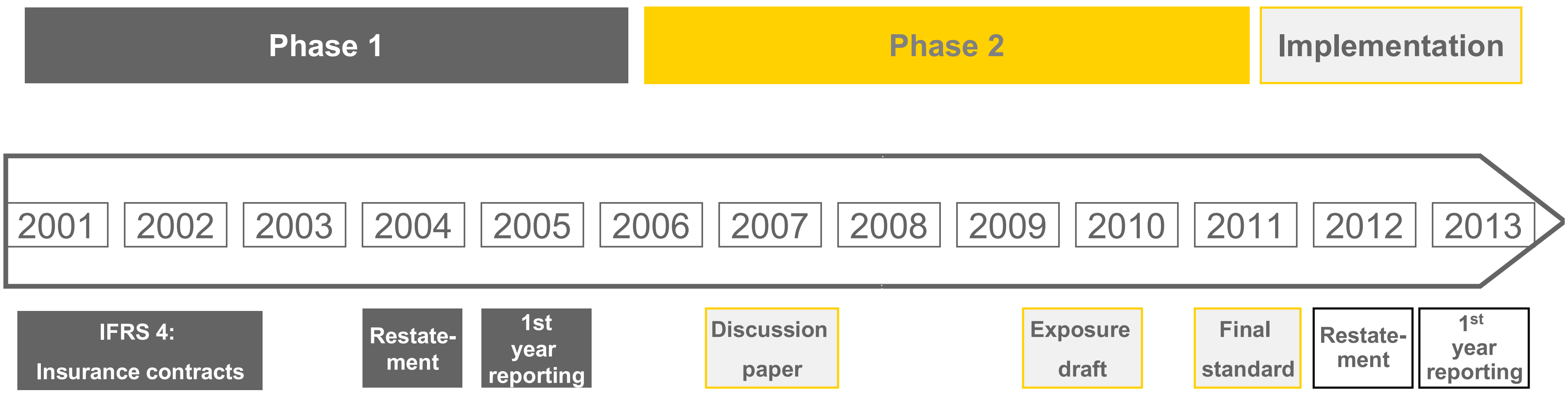
- Nominal profit will be the same under a fair value reporting basis as it is under US GAAP if allocated capital is the same under both bases.
- Under a fair value reporting basis:
  - Gains and losses, in comparison to the expected fair value profit, are recognized at the inception of a contract;
  - The effects of a change in interest rates is recognized immediately in income;
  - Favorable/adverse loss reserve development will have a greater or lesser immediate effect on income than US GAAP depending on the relationship between the nominal reserve and the fair value reserve; and
  - Consistency in reserving and pricing assumptions may eliminate profits and losses at the inception of a contract.
- The dynamics of income under a fair value reporting basis are more complex. Fair valuing reporting requires a greater level of diagnostics to understand the reasons for differences in actual versus expected profit emergence.

Business impacts of a fair value reserving basis

Effects of fair valuing insurance liabilities

- Effects of fair valuing insurance liabilities include:
  - If product development and pricing is carried out on a risk adjusted basis, reserving and pricing actuaries can work together to minimize the effects of profits and losses at inception;
  - Asset/liability strategy will need to be revised to help manage the greater income volatility under a fair value reserving basis;
  - Management will need to develop new performance indicators under a fair value accounting standard;
  - Will greater transparency of the profitability of products on a risk adjusted basis lead to changes in the underwriting cycle?

Current Timeline for IASB insurance contracts project



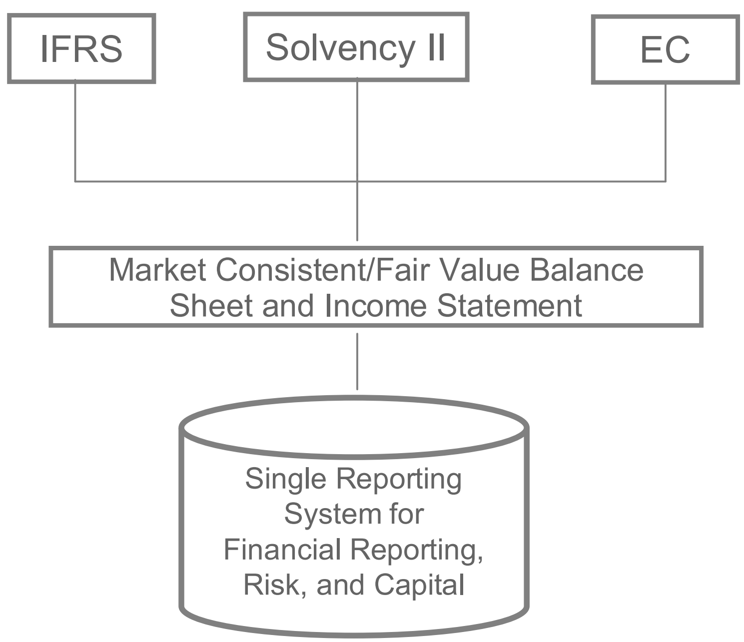
US adoption of IFRS is under a different timetable. The first year of three years of comparable statements for certain US companies may coincide with the restatement year of the new insurance contracts standard.

What needs to be done in the near future

- Need to assess the impact of the potential effect of Phase II of the insurance contracts project on any current IT or transformation project
- Many companies are starting to undergo diagnostic testing to convert from US GAAP to IFRS. Given the timetable for Phase II of the insurance contracts project and its potential impact across business operations it is key that management include the potential impacts from fair valuing insurance contracts in the diagnostic phase

The future state?

The Ultimate Market Consistent Model leads to a single reporting and management model for all aspects of the business



The cornerstone is market consistent or fair value financial statements

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