



Casualty Loss Reserve Seminar: FASB/IASB Insurance Contracts Project Update

Bob Miccolis, FCAS, MAAA

Deloitte Consulting LLP

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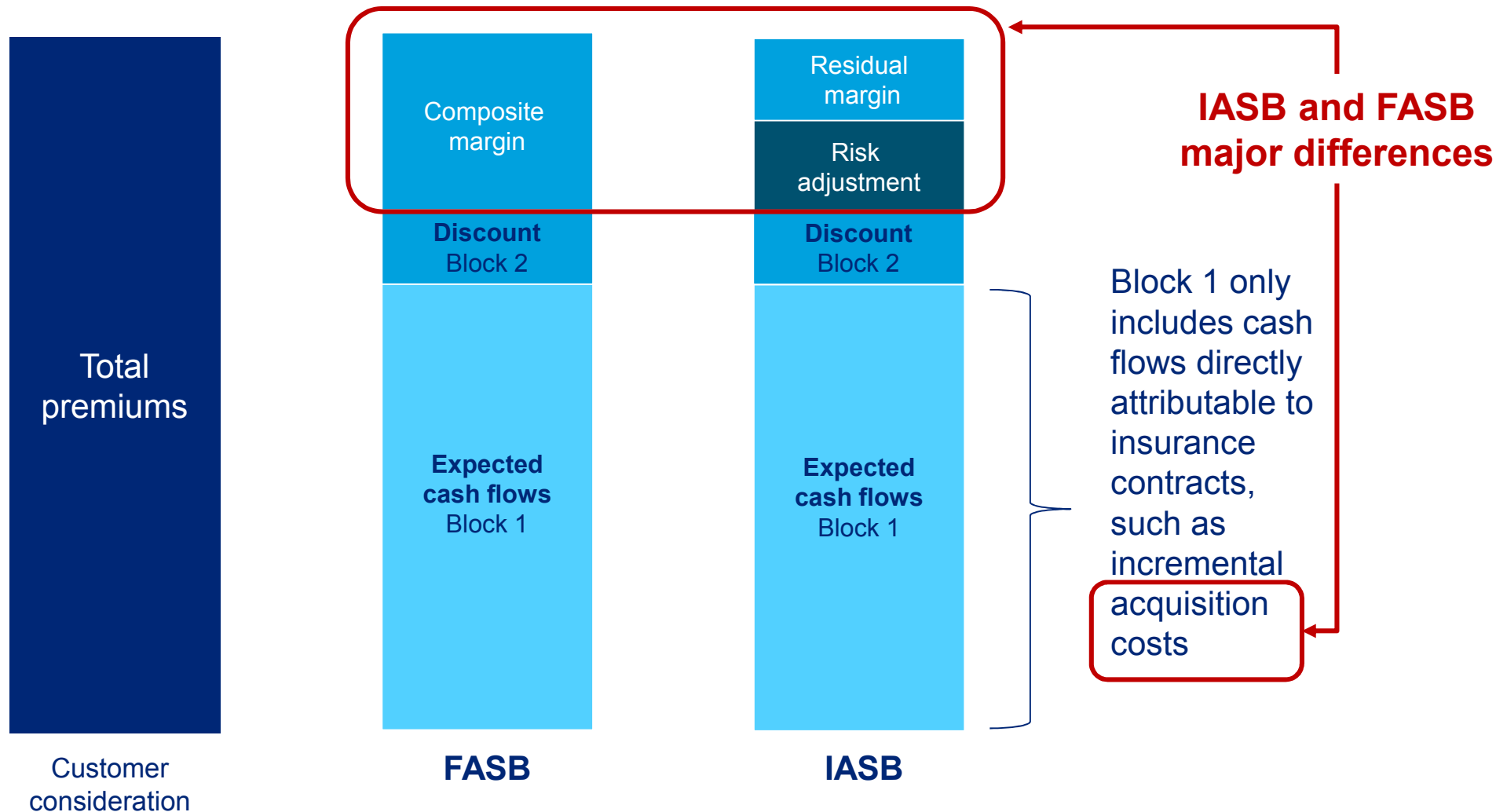


IASB Exposure Draft and FASB Discussion Paper

Summary of Key Issues

IFRS insurance contract – Measurement models

Building Blocks to account for “current fulfillment value”



- FASB margins are intended to only defer profit recognition
- IASB margins are intended to defer profit recognition AND to account for risk

Measurement model — IASB & FASB

Building block 1: Cash flow estimates

A current, unbiased and probability-weighted estimates of contractual cash flows

- Current estimates — updated at each reporting period
- Incorporate, in an unbiased way, all available information about the amount and timing of all contractual cash flows
- Probability weighted cash flows — Stochastic modeling might be needed for complex contracts
- If observable market data exists, incorporated in the model to the extent possible
- For non-market variables, entity-specific cash flows should be used

Observations

- **The primary notion behind a probability-weighted estimate is expected value rather than the most likely value or the median value**
- **There has been concern that the proposed accounting model would require explicit probability weights which are generally not used to estimate mean values for P&C**
- **An unbiased estimate would exclude any implicit conservatism in selecting a point estimate and may be different than “Management’s Best Estimate” as currently used**

Measurement model — IASB & FASB

Building block 1: Cash flow estimates

A current, unbiased and probability-weighted estimate of contractual cash flows

- Includes all incremental cash flows that arise as the insurer fulfils the insurance contract:
 - Premiums and other cash flows that arise within the “**contract boundary**”
 - Claims and benefits paid to policyholders, plus associated costs such as LAE
 - Cash flows resulting from any policy options and guarantees
 - Incremental costs of selling, underwriting and initiating - only written contracts
 - Taxes and levies on policies written
 - Policy administration and policy maintenance costs
- Excludes any costs considered general overhead or not incremental to a written policy (does not allow allocation of G&A expenses – G&A expenses would be booked as incurred)
- Produces cash flow estimates of income and expense (including losses) only from business written – the cash flow amounts at each point in time

Observations

- **There would be a mismatch of when acquisition costs are expensed vs. when premiums are recognized as income (similar to STAT accounting for P&C)**
- **There could be a difference between the discount rate used to price the contract and the risk-free discount rate for accounting possibly causing a booked loss at inception**

Measurement model — IASB & FASB

Building block 2: Discount rate

Adjusts Building Block estimates for for time value of money

- Discount rate based on **characteristics of the insurance liability cash flows**:
 - Currency
 - Duration
 - Liquidity
- Use an **asset based discount rate ONLY** if the amount, timing or uncertainty of the cash flows depend on performance of assets, e.g. **participating contracts** (primarily life insurance)
- Discount rate is a market consistent interest rate based on a “**risk free rate**” **plus an illiquidity premium** based on the characteristics of liability cash flows, e.g., how illiquid are the cash flows
- No further guidance on how to calculate the illiquidity premium (more liquid = lower discount rate)
- Disclosures required on the discount rate, impact of illiquidity and sensitivities

Observations

- **Discount rate would not be set at an asset earning rate for P&C**
- **Insurers will determine the discount rate applicable to their portfolios based on the risk free rate adjusted for illiquidity, their cash flow characteristics and market rates**
- **There is a need to develop a measure of the illiquidity of cash flows and to determine the relationship between the illiquidity measure and the discount rate adjustment**

Measurement model — IASB & FASB

Building block 3: Margins — Risk margin (IASB)

A margin to reflect uncertainty in the estimate of fulfillment cash flows

- Explicitly reported as a component of the insurance contract liability, defined as:
 - *“the maximum amount an insurer would rationally pay to be relieved of the risk that the ultimate fulfillment cash flows exceed those expected”*
- Updated risk margins for at each reporting period
- Estimated at the **level of each portfolio** of insurance contracts
- The measure of risk can consider risk diversification within each portfolio of insurance contracts, but not across portfolios
- Limited to three **permitted techniques** for estimating the risk margin:
 - Confidence Interval (VaR)
 - Conditional Tail Expectation (CTE or TVaR)
 - Cost of Capital

Observations

- **An explicit risk adjustment may be the most substantive change from most current accounting models for insurance contracts where margins are more typically implicit**
- **How an insurer defines its insurance portfolios will become an important element of accounting practice and potentially impacting the level and volatility of profits**

Measurement model — IASB & FASB

Building block 3: Risk margin (IASB) — limited to 3 permitted techniques

- **Confidence Interval (VaR):**
 - Likelihood that the actual outcome will be within a selected percent confidence (probability)
 - May not be as useful for extreme probability distributions that are far from statistically normal
- **Conditional Tail Expectation (CTE or tail VaR):**
 - Generally a better reflection of the potential for extreme losses – focus in on the tail
 - Judgement required to determine where the “tail” begins and may change in future periods
- **Cost of Capital:**
 - Applied concept used in pricing, valuations and for regulatory reporting, etc.
 - Reflects estimated cost of holding capital to meet obligations with a high level of confidence
 - Requires the selection of a capital rate that reflects the relevant risk from the liability
 - Similar to the approach used in Solvency II for risk margin

Guidance for which technique to use is based on characteristics of probability distribution in order to best represent “the maximum amount the insurer would rationally pay to be relieved. . . “

Observations

- **Several challenges arise when selecting the appropriate risk adjustment technique from the three permitted, defining the appropriate level of aggregation, and calibrating the technique to each portfolio in a way that a company can implement and maintain**
- **High sensitivity of risk adjustments to the selection of a tail probability value (confidence level) to use in each technique – no obvious benchmark or performance criteria for a probability value**

Measurement model — IASB & FASB

Building block 3: Margins — Residual margin (IASB)

A margin to eliminate any gain at inception of the contract

- A residual margin arises when:
 - PV of future cash inflows > PV of future cash outflows + risk adjustment
- Estimated at level of portfolio of insurance contracts, with same inception date and similar coverage duration (cohort)
- Calculated at initial recognition and released over coverage period
- Cannot be negative, as a loss must be recognized immediately through income
- Interest expense accretion (unwinding of discount) required using the discount rate locked-in at inception

Observations

- Information captured with the residual margin might offer some insight into the profitability of the business beyond the risk adjustment
- Questions of how to judge the adequacy or redundancy of risk adjustments and whether residual margins are just a plug to defer profit recognition and smooth out reported earnings

Measurement model — IASB & FASB

Building block 3: Composite margin (FASB)

A margin to eliminate any gain at inception of the contract

- A composite margin arises when:
PV of future cash inflows > PV of future cash outflows
- Estimated at a level within a portfolio of insurance contracts, i.e., with same inception date and similar coverage duration (cohort)
- Measured at inception and released over coverage and claim payment period as risk exposure unwinds based on the following specified formula:

$$\frac{\text{Premium allocated to current period} + \text{Current period claims and benefits}}{\text{Total contract premium} + \text{Total claims and benefits}}$$

- No interest accretion (unwinding of discount) on the composite margin

Observations

- **Composite Margin avoids the explicit measurement of risk/uncertainty**
→ defers profits in a way that recognizes declining risk exposure in runoff
- **Lower likelihood that a loss is reported on day one versus IASB model**
- **Concerns that formula does not release margins in a way that is always meaningful**