Accounting for insurance contracts: History in the making

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Agenda

- Introduction and project background
- Discussion paper
- Recent events
- Other key projects
- Profit emergence
- Project timetable

Introduction and project background

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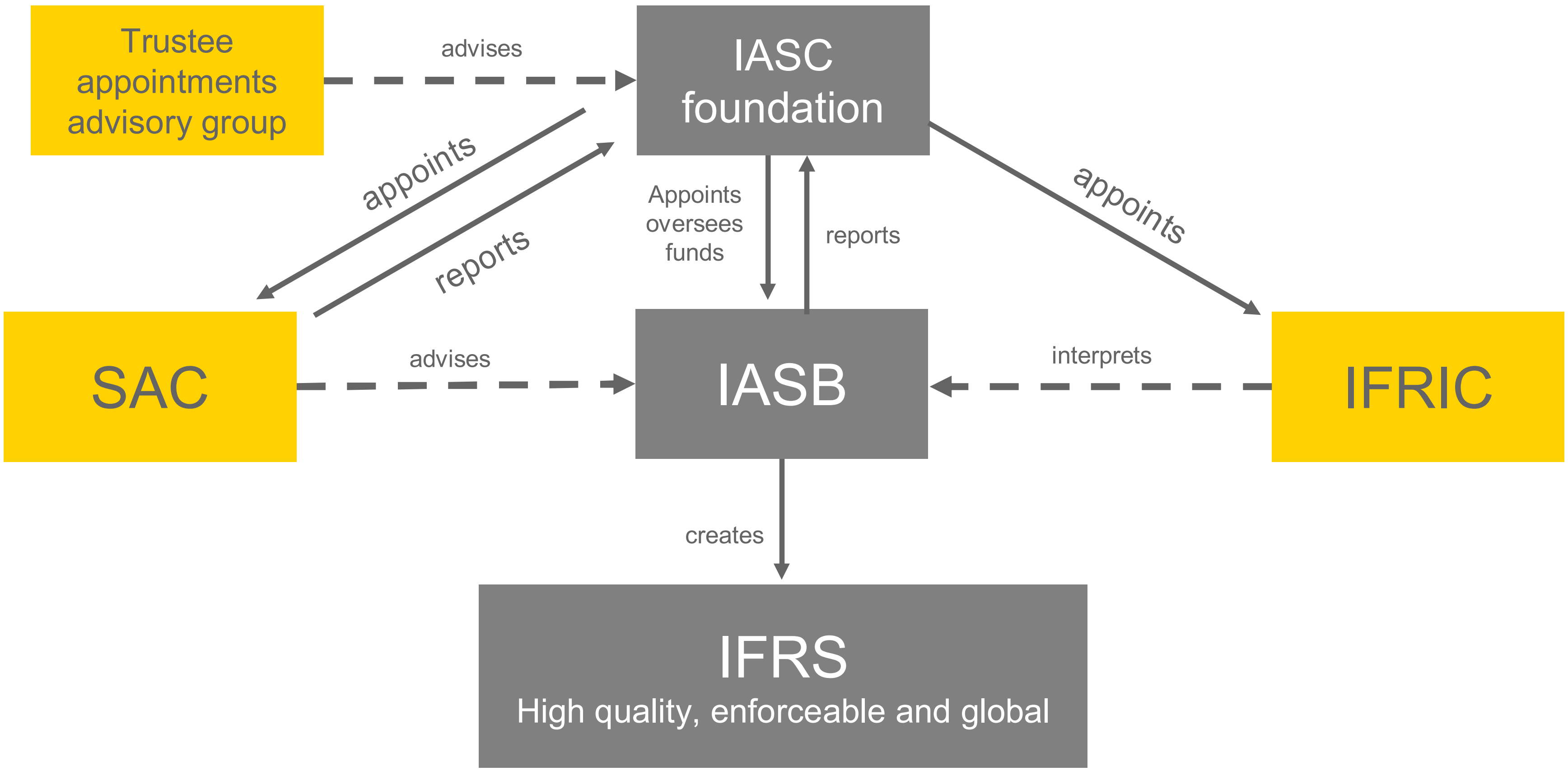
International Financial Reporting Standards

- What are International Financial Reporting Standards (IFRS)?
  - International GAAP
    - Single set of global accounting standards developed by the international accounting standards board (IASB)
    - To provide the world's integrating capital markets with a common language for financial reporting
    - Bring about convergence of national accounting standards and IFRS (especially US GAAP)
- Why IFRS?
  - Globalisation
  - Cross-border capital flows and listings
  - Concern about quality of standards in certain markets
  - Comparability of risk and reward across industries

International Accounting Standards Board



SAC: Standards Advisory Council

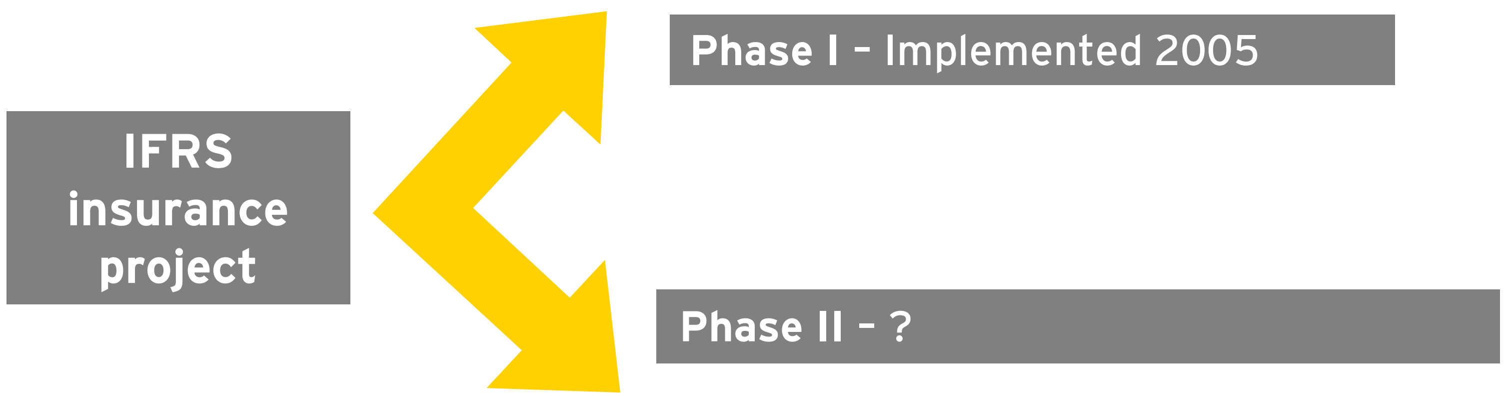
IFRIC: International Financial Reporting Interpretations Committee

Insurance contracts project

- Insurance has always been a problem area
  - Diversity of practices around the world
  - Overly influenced by regulatory prudence – not accurate picture
  - Some 'insurance contracts' really financial instruments
  - Investors don't currently use accounting info (esp. for Life Insurance) – alternative measures life embedded value
  - Inconsistency with other industries accounting

Phased approach for insurance

- There is a phased approach to insurance contracts.



- Phase I implemented some components of the insurance project in 2005
- Phase II will be a uniform, likely new, insurance measurement standard

Why is this important to me?

- SEC Roadmap
  - Plan to move SEC filers form reporting under US GAAP to international GAAP
- FASB joined the insurance project in October, 2008
  - Project will now impact US GAAP even if SEC doesn't require International GAAP
  - Mutual's reporting under US GAAP
- NAIC International Solvency and Accounting Working Group
  - Monitoring developments from the IASB and Solvency II

Discussion paper

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Measurement attribute

- The IASB reached a preliminary view that the measurement attribute for insurance contracts should be Current Exit Value (CEV)
- CEV can be defined as the amount the insurer would expect to pay at the reporting date to transfer its remaining contractual rights and obligations immediately to another entity.
- CEV is not observable so mark-to-model

Three building block model

Current estimate of future cash flows - Time Value + Risk and service margin = Insurance Contract Liability

Three building block model (continued)

- Explicit, unbiased, market-consistent, probability-weighted and current estimates of future cash flows
- Discount rates should be consistent with prices observable in the market place for instruments whose characteristics reflect those of the insurance liability, and be adjusted for the company's own credit standing
- Explicit and unbiased estimate of margin that market participants require for bearing risk ("risk margin") and for providing other services, if any ("service margin")

Comment letters on the discussion paper

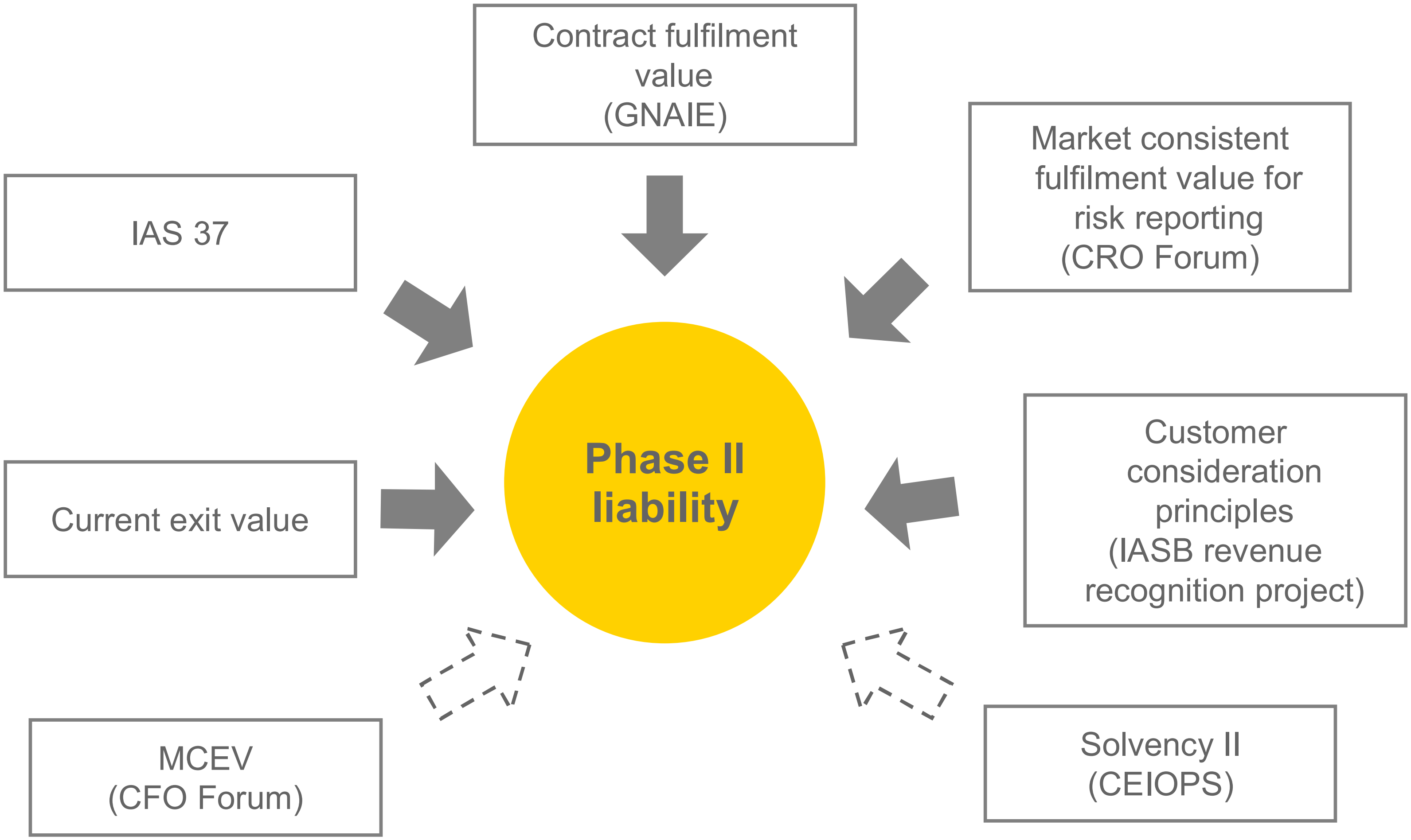
- Respondents:
  - Generally favor use of entity-specific cash flows
  - Do not all agree with a requirement for using probability-weighted cash flows, except as needed to recognize optionality in contracts
  - Generally do not want to recognize profit immediately, have differing views on calibrating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

Comment letters on the discussion paper (continued)

- Accounting for insurance should reflect the economics of the business. Many respondents do not agree that the transfer value concept is appropriate for valuing insurance liabilities. Preference for the concept of a fulfillment value which the IASB is now exploring.
- Virtually all respondents called for field testing prior to issuance of a final standard.

Recent events

Candidates for phase II – measurement of insurance liability



FASB and IASB update

Topic	IASB	FASB
Measurement Objective	The IASB discussed whether a measurement approach for insurance contracts should be based on an exit notion or a fulfillment notion. Views diverged and no clear consensus emerged.	The FASB agreed to explore current fulfillment value rather than fair value as defined in FASB Statement No. 157, Fair Value Measurements (an exit value).
Features of the measurement approach	The IASB tentatively decided that a measurement approach for insurance contracts conceptually should: a) use estimates of financial market variables that are as consistent as possible with observable market prices b) use explicit current estimates of the expected cash flows c) reflect the time value of money d) include an explicit margin	The FASB discussed the potential components of a fulfillment value but did not come to any conclusions.

FASB and IASB update (continued)

Topic	IASB	FASB
Measurement of the margin at inception	The IASB tentatively decided that the margin at inception should be measured by reference to the premium and that therefore no day one gains should be recognized in profit or loss. The IASB will discuss at a future meeting how to treat acquisition costs and the part of the premium that recovers those costs.	The FASB agreed that in principle the initial recognition of an insurance contract should not result in the recognition of an accounting profit. However, some FASB members acknowledged that future deliberations and decisions (such as the accounting for acquisition costs) may necessitate revisiting this issue.
Candidate measurement approaches	The IASB voted against considering an approach that uses an estimate of future cash flows with no margins and no discounting for non-life claims Liabilities. Although, candidates to be considered at a future meeting include an unearned premium approach for short duration pre-claims liabilities.	The FASB will consider at a future meeting whether an approach for measuring insurance contracts would include using future cash flows with no margins and no discounting in certain instances.

Other key projects

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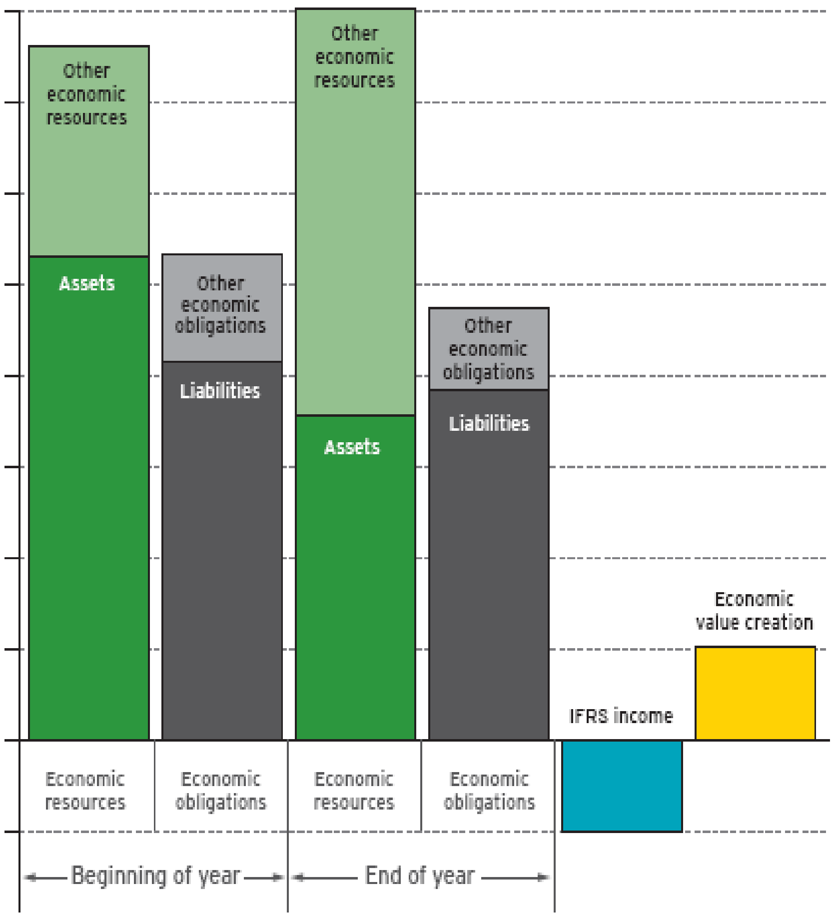
Framework discussions: Economic resources and obligations



In the current framework deliberations:

- ► An economic resource is something that is scarce and capable of producing positive incremental net cash flows.
- ► An economic obligation is something that is capable of resulting in negative incremental net cash flows.
- ► Under the present and presumably the future framework, not all economic resources are assets and not all economic obligations are liabilities.
- ► This creates accounting mismatches, which may cause the size or even the direction of IFRS comprehensive income to be different from economic value creation.

Framework discussions (continued)

- While the development in all economic resources and economic obligations will be the most relevant to the user, some of them cannot be represented faithfully.

- Relevance and faithful representation are the fundamental qualitative characteristics of financial reporting mentioned in the exposure draft of an improved conceptual framework (chapter 1 and 2).

- Opinions on faithful representation may change in time due to market developments (new markets may come into existence or may become deep and liquid) or due to technical developments in a certain industry. An example is the development of embedded value during the last decade.

Framework discussions (continued)

► Information can be directly verified if a market quotation is available. However, in many instances this is not the case. Insurance contracts is an example of lack of available market prices.

► Without the possibility of direct verification, information may be indirectly verified by reviewing the inputs, the estimation model or comparing experience to earlier assumptions.

► Alternatively, information may be verified by reflection to other information used in the decision process within the enterprise, that has been prepared under segregation of functions and that is "through the eyes of management" (e.g. product costing).

Revenue recognition – discussion paper

- **What is Revenue Recognition about?**
  - About how revenue is earned and disclosed
  - Asset and liability approach means that it is all about liability measurement for ordinary business transactions
- **Discussion paper issued 19 Dec 2008 – joint FASB and IASB. Standard by June 2011**
- **New standard may apply to some or all insurance contracts**

Key Concept	Implication
Performance obligation	► the promise in a contract to transfer economic resources to a customer
Satisfaction of performance obligation	► Goods – when enforceable rights or access to goods transfer to customer ► Services – when a service or access to a service is provided
Revenue recognition	► Revenue is recognised when contract asset increases or contract liability decreases. Revenue can be recognised at two occasions: ► when the contract is obtained (if a contract asset is recognised) ► when a performance obligation is satisfied

Revenue recognition - challenges for insurance

"*In the boards' view, the proposed revenue recognition model might provide decision-useful information for some contracts that the insurance project is considering, but not all of them*" DP para S11(b)

Possible issues:

- ► No credit for amounts charged to cover acquisition costs
- ► Lock-in at inception for long term contracts
- ► Insurers earn revenue not by providing goods or services, but by standing ready to provide indemnity or financial compensation
- ► Insurance is based on a portfolio perspective (do we need recognition of this in measuring liabilities?)
- ► What is 'delivery' for an insurance contract?

Profit emergence

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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

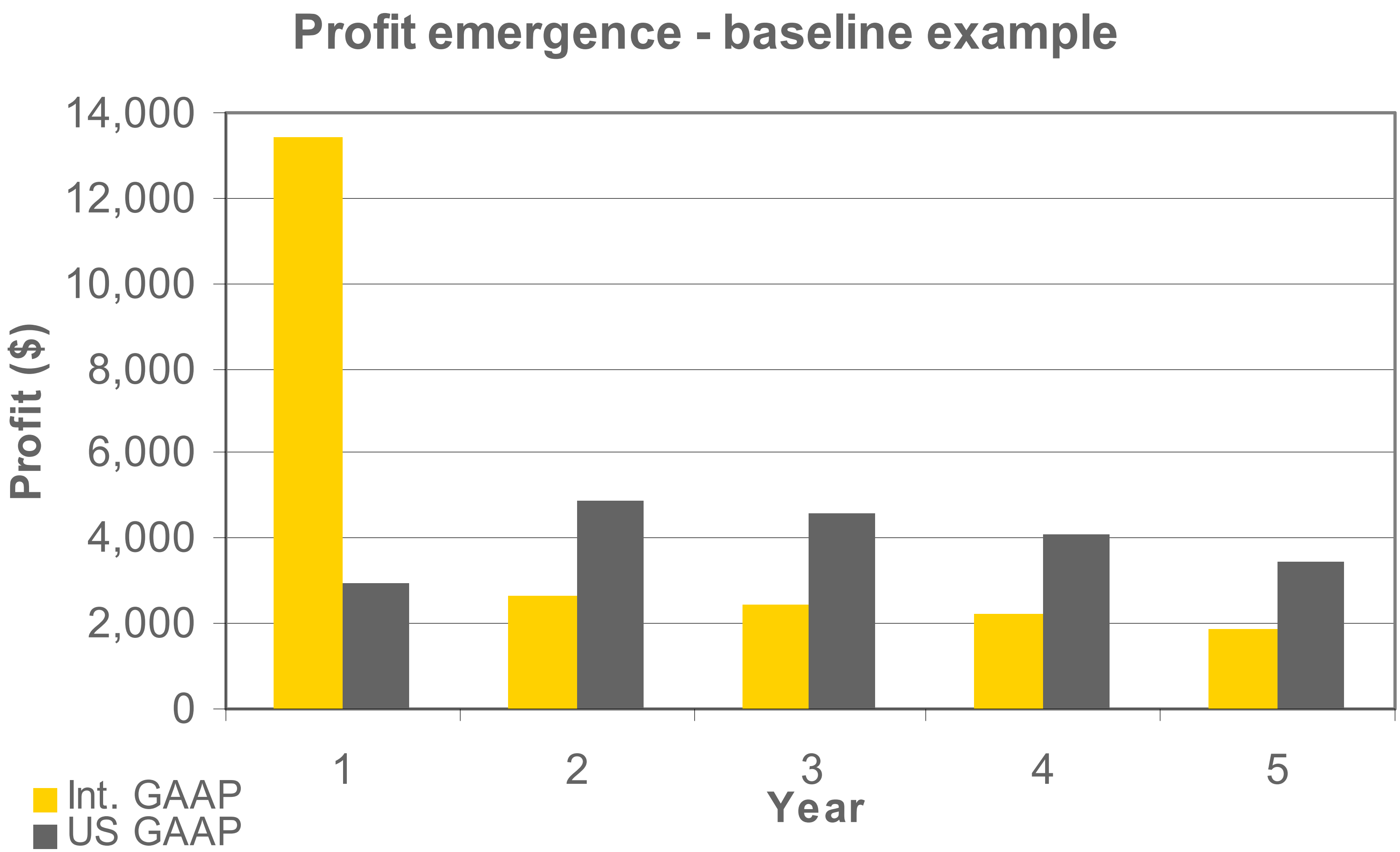
	Year 1	Year 2	Year 3	Year 4	Year 5
Written Premiums	100,000	-	-	-	-
Unearned Premiums	(50,000)	-	-	-	-
Earned Premiums	50,000	50,000	-	-	-
Claims Expense	(40,000)	(40,000)	-	-	-
Discount	-	-	-	-	-
Risk Margin	-	-	-	-	-
Acquisition costs	(10,000)	(10,000)	-	-	-
Underwriting Profit	-	-	-	-	-
Unwind of 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 International GAAP income statement

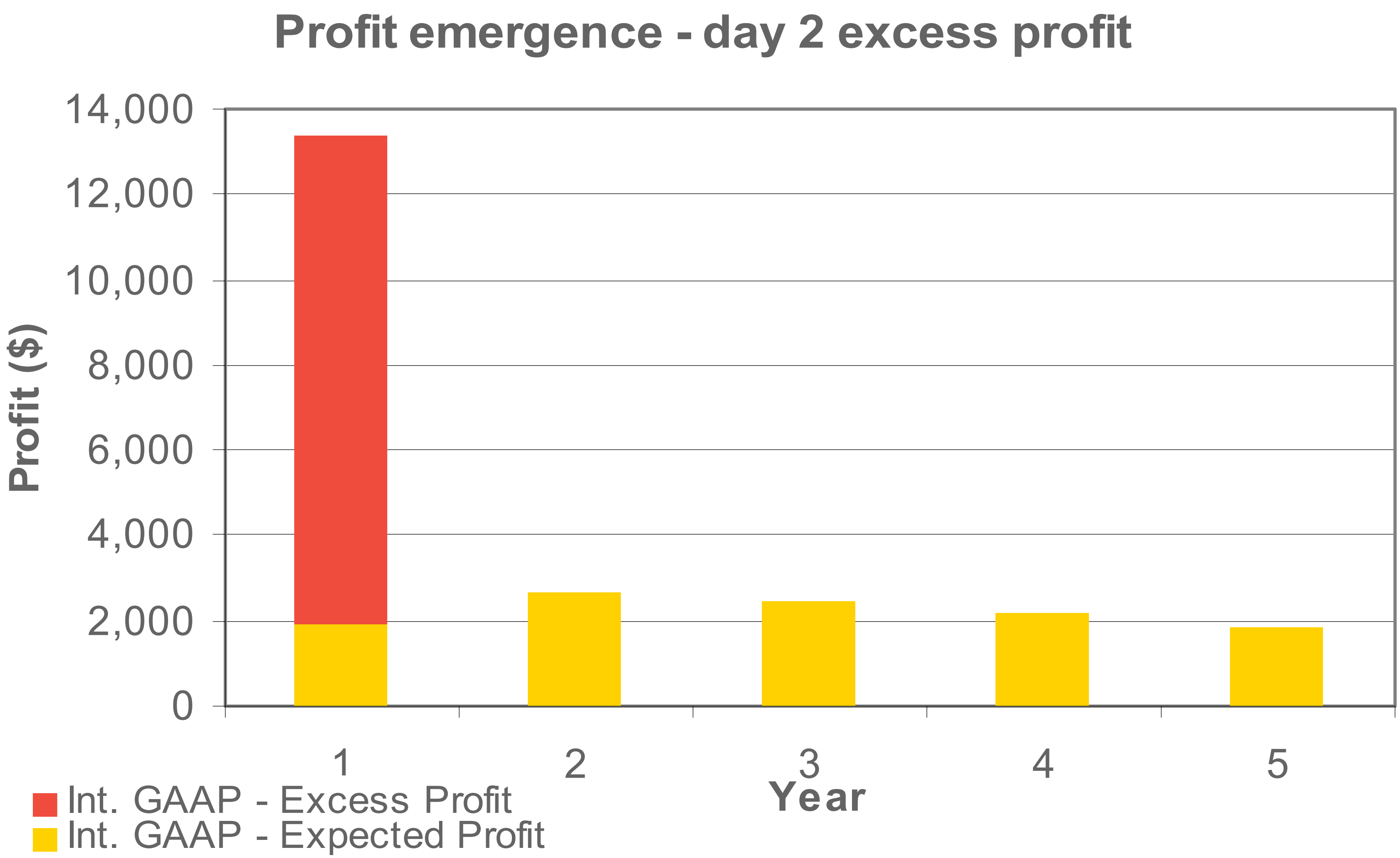
International GAAP

	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**

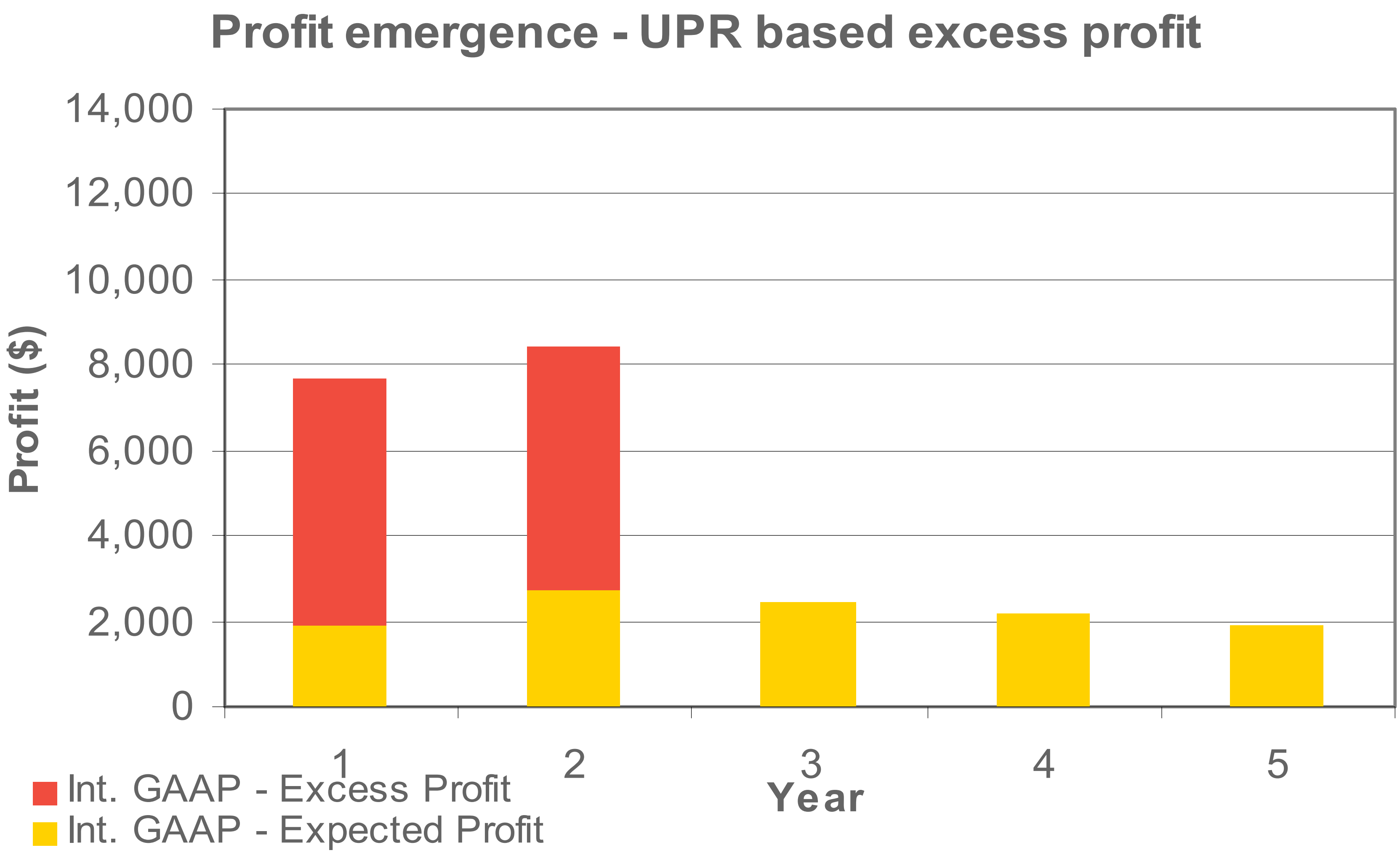
Comparison of baseline profit emergence



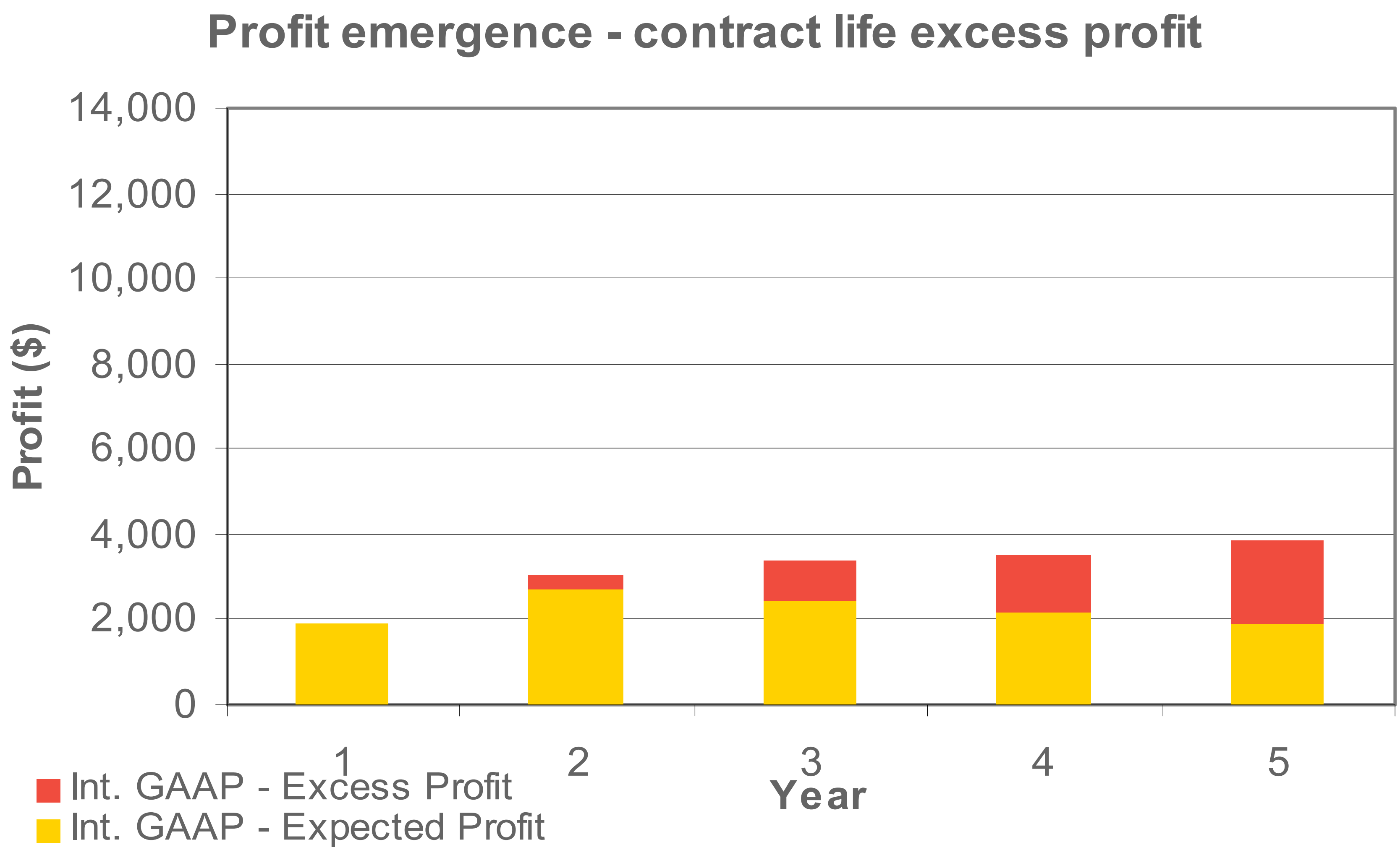
Excess profit in baseline profit emergence



Excess profit emergence based on UPR



Excess profit emergence based on contract lifetime payments



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Project timetable

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Current project timetable

IASB – discussion paper issued	► May 2007
FASB – invitation to comment	► August 2007
End of comment periods (IASB and FASB)	► 16 November 2007
Exposure draft	► December 2009
Comments due	► April 2010
Final standard	► May 2011
Implementation date	► 2012 or 2013?