FASB/IASB Insurance Contracts Project – Financial statement impact and business implications

June 6, 2011

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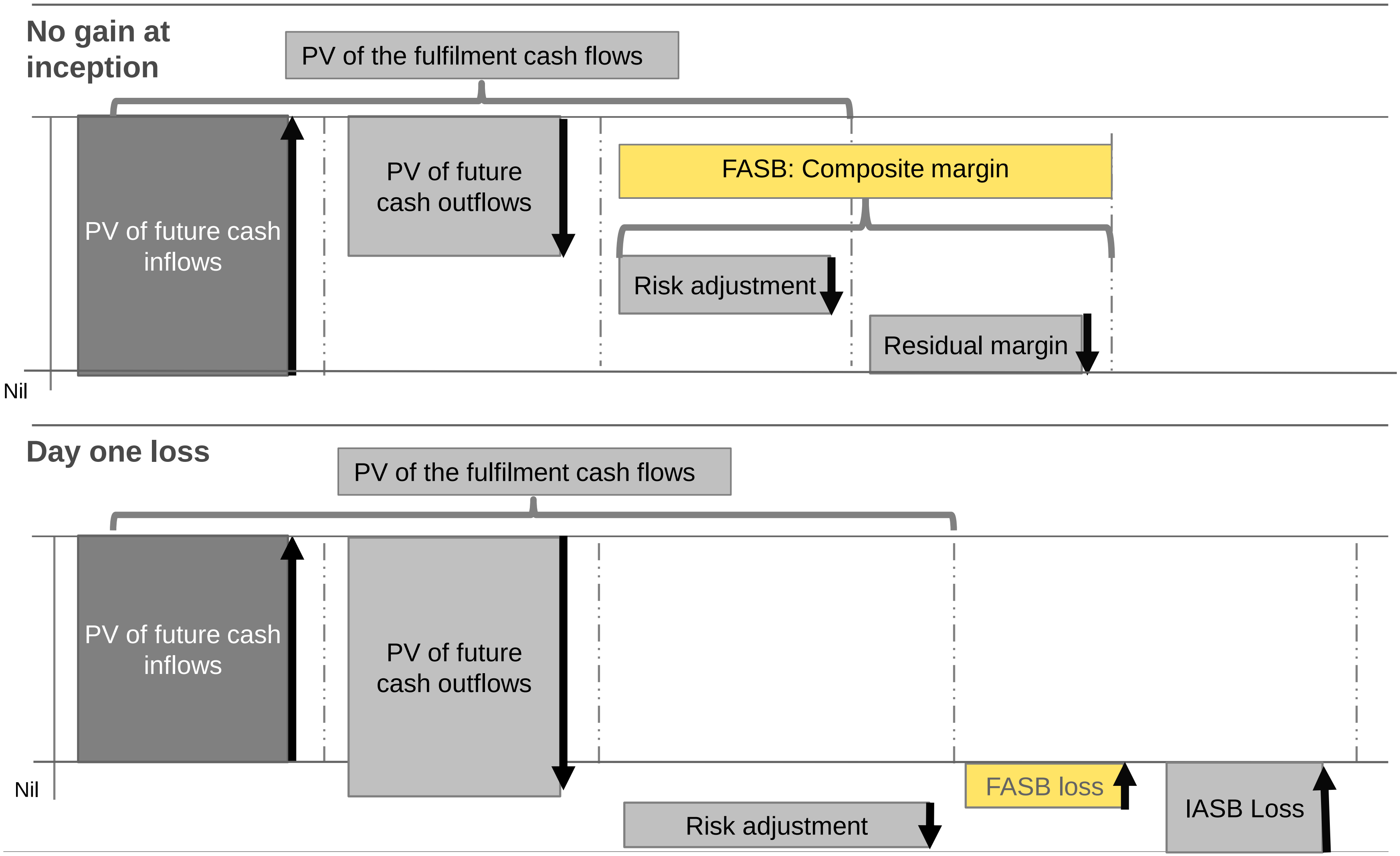
Agenda

- IASB/FASB proposals
- Business implications
- Summary of comment letters
- IASB/FASB recent progress
- Model office

Measurement model



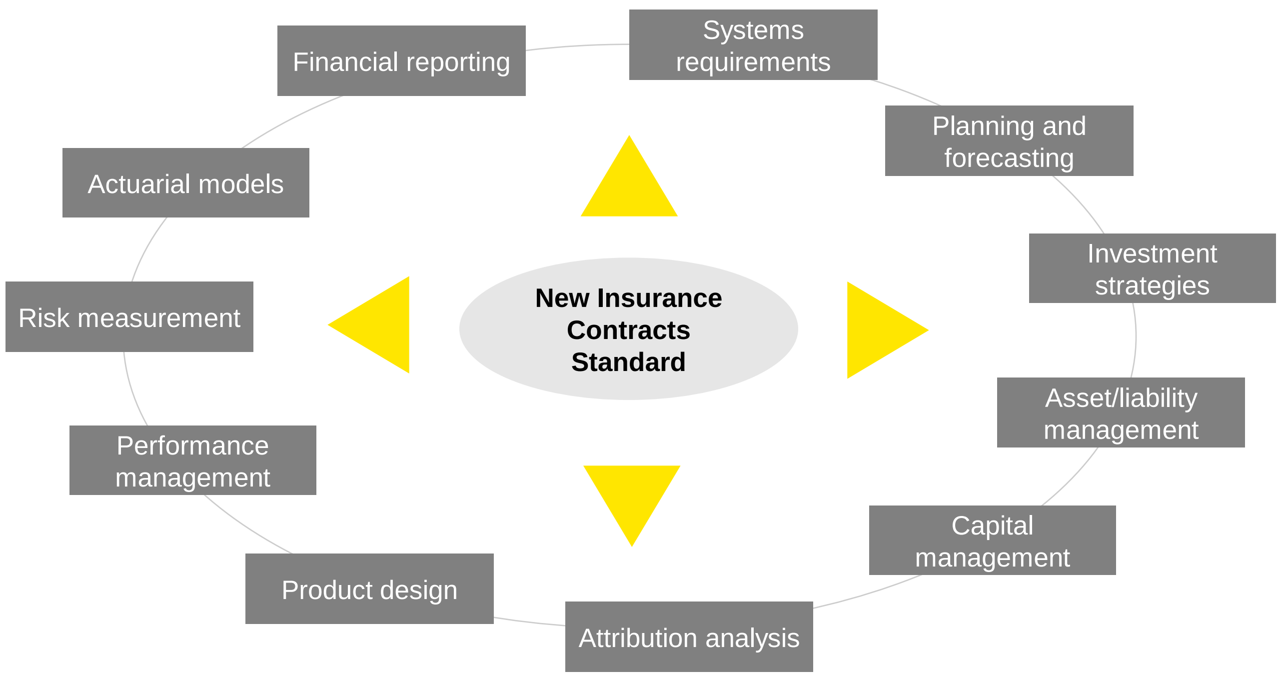
Modified model

- IASB's ED proposed a modified measurement model for certain contracts in the pre-claim period.
- An insurer would use the modified model if the contract meets both of the following criteria:
  - Coverage period is approximately one year or less.
  - Does not contain embedded options or other derivatives that significantly affect the variability of cash flows.
- Pre-claim liability equals the pre-claim obligation less the expected present value of future premiums.
- The pre-claim liability is released over the coverage period based on:
  - The passage of time, or
  - The timing of expected claims and benefits incurred if the insurer expects to incur claims and benefits in a pattern that is significantly different than the passage of time.
- Onerous contract test at inception and subsequently at each reporting period.

> The FASB did not determined the extent to, or the conditions under which, a modified approach would apply in their discussion paper.

Business implications

The new standard for insurance contracts is based on a framework with significant market consistent components which will impact profit emergence and create earnings volatility. This standard will significantly affect…



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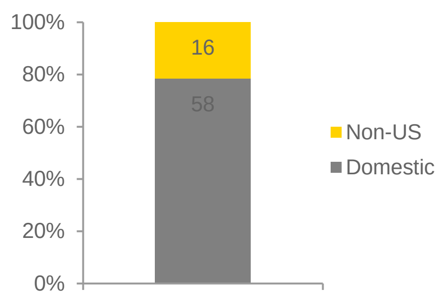
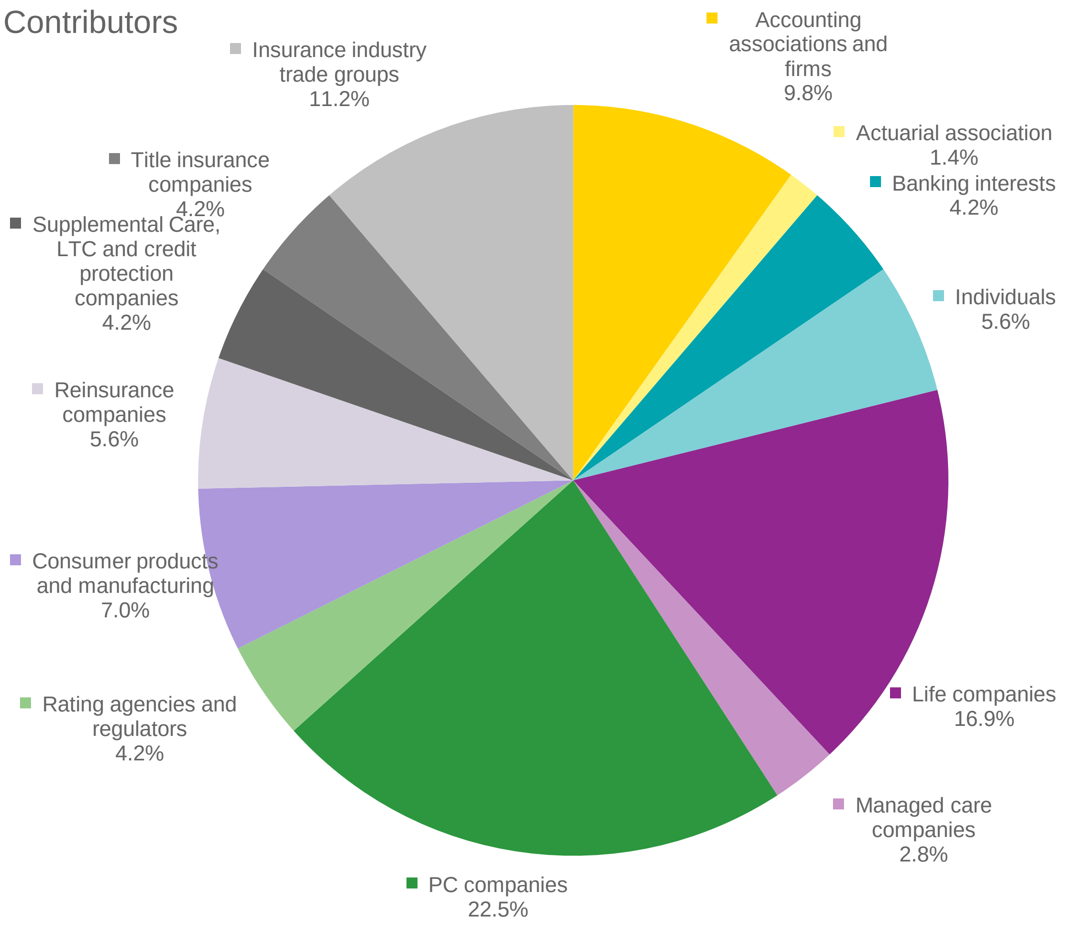
The respondents

- Seventy-four Constituents contributed letters to the FASB, far fewer than the 254 letters submitted to the IASB project
- The letters were from a wide range of interests, with a noticeable gap in respondents representing the user community
- As expected, respondents were generally US domiciled; however, there was material contribution from non-domestic constituents as shown below

Respondent geography

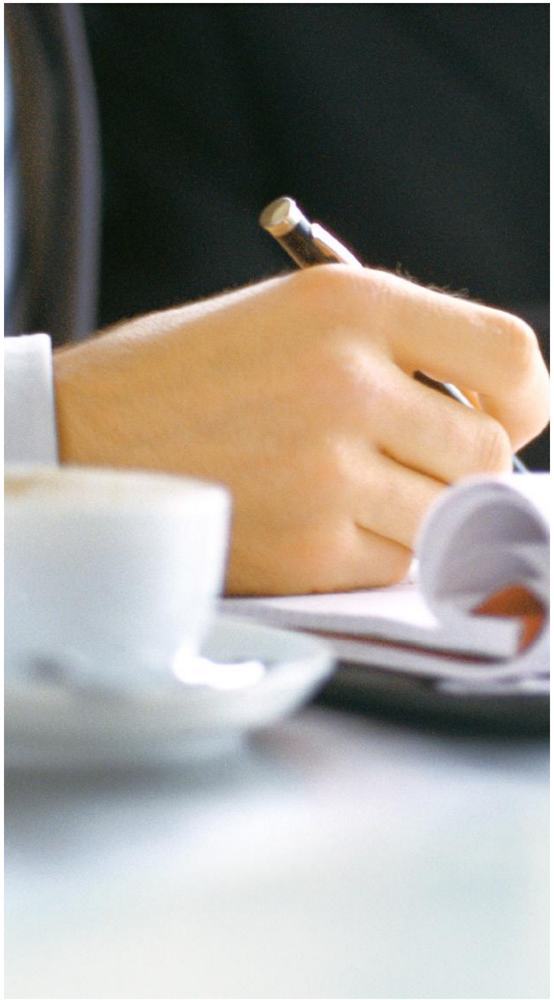


Contributors



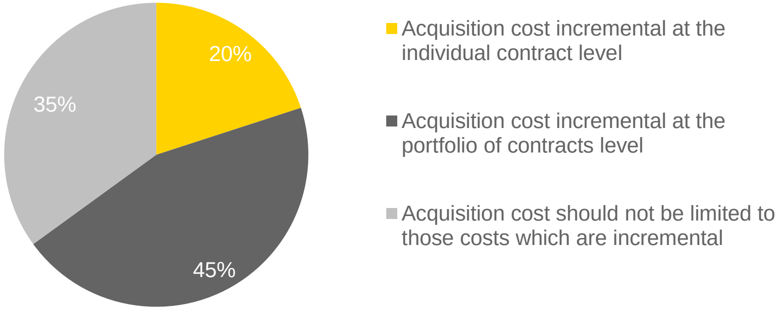
Thematic measurement concerns

Cash flows



- Within our sample, we noted 45% of respondents support the use of probability-weighted estimate of net cash flows to measure insurance contracts
- The remainder of respondents generally cited concern with the perceived necessity of a full stochastic approach in all circumstances, stating that often an actuarially determined mean can be resolved in more simple and efficient fashions
- It was also suggested by a limited number of respondents within our sample that the use of a best estimate has been historically sufficient for non-life insurance entities and should not be summarily abandoned
- Most of our sample respondents were pleased with the inclusion of acquisition costs in the measurement of an insurance contract, but many expressed concerns with which acquisition costs warrant inclusion
- Many respondents stated concerns with the requirement to evaluate acquisition costs at the individual contract level

Which acquisition costs would you include in the measurement of an insurance contract?



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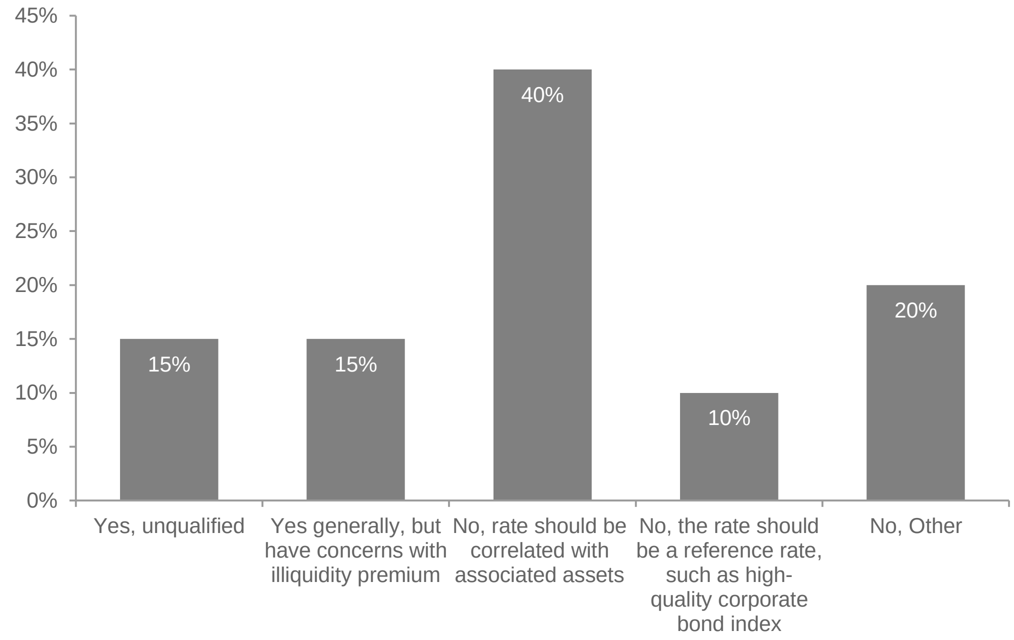
Thematic measurement concerns

Discount rate

- The selection of a circumstance- appropriate discount rate was, as no surprise, the matter discussed with the most frequency and in the greatest depth throughout our sample
- Concerns with the discount rate were generally voiced in the context of concerns with matching the accounting for insurance contracts with the economics of the business and the generation of non-economic volatility
- Proposed solutions were primarily centered around changes in the proposed rate such as the use of an asset earned rate, a uniform reference rate, or a rate commensurate with current pricing
- Other solutions noted within our sample were focused on alternative approaches to application of the rate in lieu of changes to the rate itself, such as the use of locked-in rates or the use of other comprehensive income to capture changes and mitigate volatility. One respondent we reviewed even suggested that the Board consider not prescribing a rate but instead dictate a principal and allow users to choose an appropriate rate and locking mechanisms
- Frequently, within discussions regarding discount rate, concerns with the coupling of the insurance contracts project with the pending financial instruments guidance were voiced

Do you agree with the proposed guidance on the discount rate? If not, which discount rate should be used?



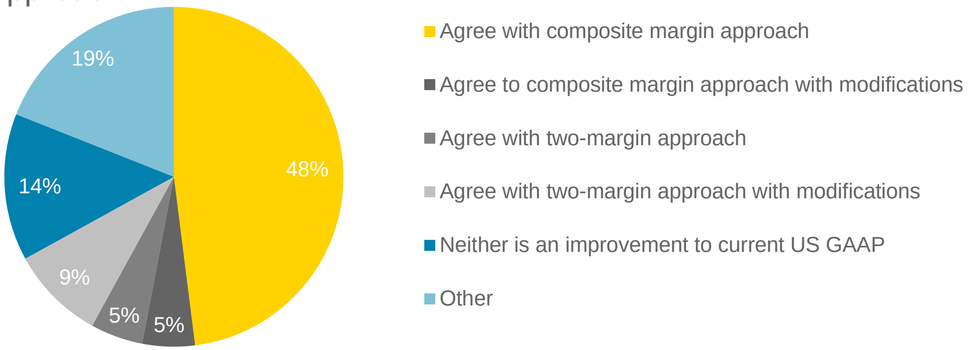
"In our view, the discount rate should not be delinked from the assets backing the liability. Ignoring the assets that back the liability is a flawed approach that will result in inaccurate measurement of the entity, noneconomic earnings and surplus volatility" - GNAIE

Thematic measurement concerns

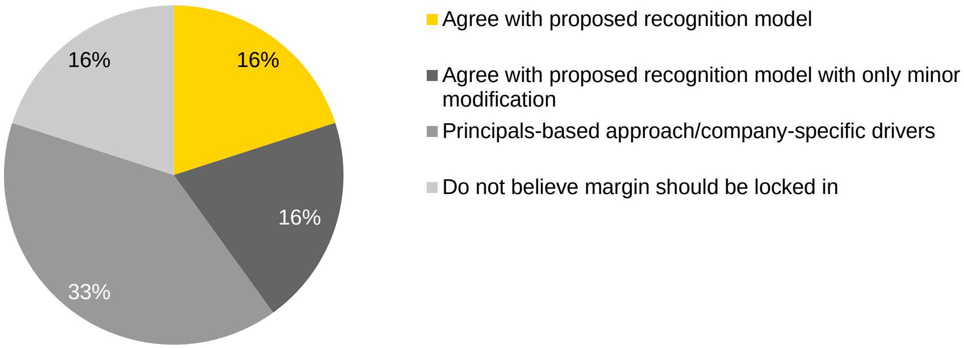
Margin

- Only one of our surveyed respondents took exception with the Board's intent to disallow profit at issue
- Of the respondents in our review, 68% support the use of a single composite margin, with comments from those in support mostly centering around their belief that it is a misperception that risk can be quantified with a single number and that the objective of the explicit risk margin lacks clarity
- A commonly expressed opinion was that should a two-margin approach be required, the calculation of an explicit risk margin would be difficult and costly and those costs would likely outweigh potential user benefits
- Though there was wide support for the use of a single composite margin, there was wide diversity in opinion regarding how the margin should be recognized in earnings, noting a fair number of respondents support a composite margin model, which includes periodic re-measurement

Do you agree with the composite or two-margin approach?



How do you believe the composite margin should be recognized in earnings?



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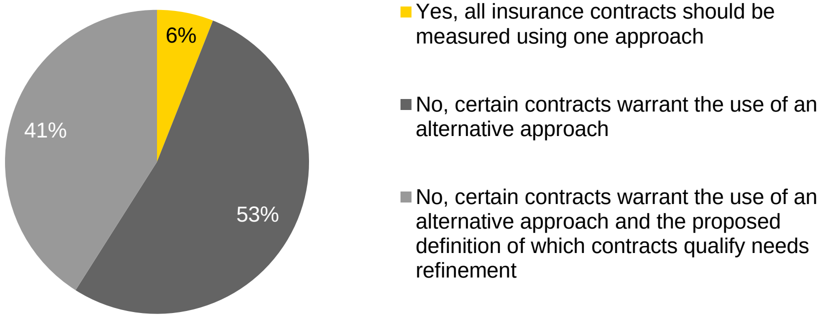
Thematic measurement concerns

Modified approach

- Most respondents we surveyed were supportive of the necessity of an alternative measurement approach for certain short-duration contracts
- Many respondents suggested that the determination of which contracts qualify should be changed with frequent references to defining the cutoff only conceptually in lieu of defining bright-line tests
- We also observed that approximately half of the respondents in our sample suggested that the use of a modified approach should be on an optional basis
- Finally, we noted that a number of the respondents in our survey who support the use of a modified approach do not see any value in first discounting and then accreting interest to uncollected premiums and benefits

Do you think that all insurance contracts should be recognized and measured using one approach?



"... the determination of short- versus long-duration contracts should take into consideration the coverage duration as well as other characteristics such as guaranteed renewability of the contracts as is currently the guidance under US GAAP. In our opinion, this current approach to classification of short- versus long-duration of insurance contracts works very well and has not been abused or caused any issues in application." – MetLife

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Boards re-deliberations

Key topics discussed	Key topics to be discussed
• Scope • Fulfillment cash flows • Discount rate • Risk adjustment/Composite margin* • Recognition • Contract boundary • Acquisition costs	• Risk adjustment/Composite margin* • Modified approach • Reinsurance • Presentation • Disclosures

Key changes to measurement inputs

Measurement input	IASB ED/FASB DP	Result of re-deliberations
Current estimate of future cash flows	Current, explicit and unbiased expected value estimate of future cash flows.	The measurement objective of expected value refers to the mean that considers all relevant information. The Boards noted that not all possible scenarios need to be identified and quantified, provided that the estimate is consistent with the measurement objective of determining the mean.
Discount rate	Discount rate should reflect the characteristics of the liabilities. Derived as the risk free rate plus a premium for illiquidity.	The Boards recognize that an illiquidity premium may be difficult to calculate. Therefore they will allow a top down approach from taking the expected return of a portfolio of assets that have similar characteristics to the insurance contracts minus the spread for credit risk.
Risk adjustment (IASB ONLY)	The risk adjustment should be the amount the insurer would rationally pay to be relieved of the risk and should be updated (remeasured) each reporting period	Objective has been change to, "'The risk adjustment shall be the compensation the insurer requires to bear the risk that the ultimate cash flows could exceed those expected". The IASB tentatively decided that the measurement of an insurance contract should contain an explicit adjustment for risk. The adjustment would be determined independently from the premium and would be re-measured in each reporting period.

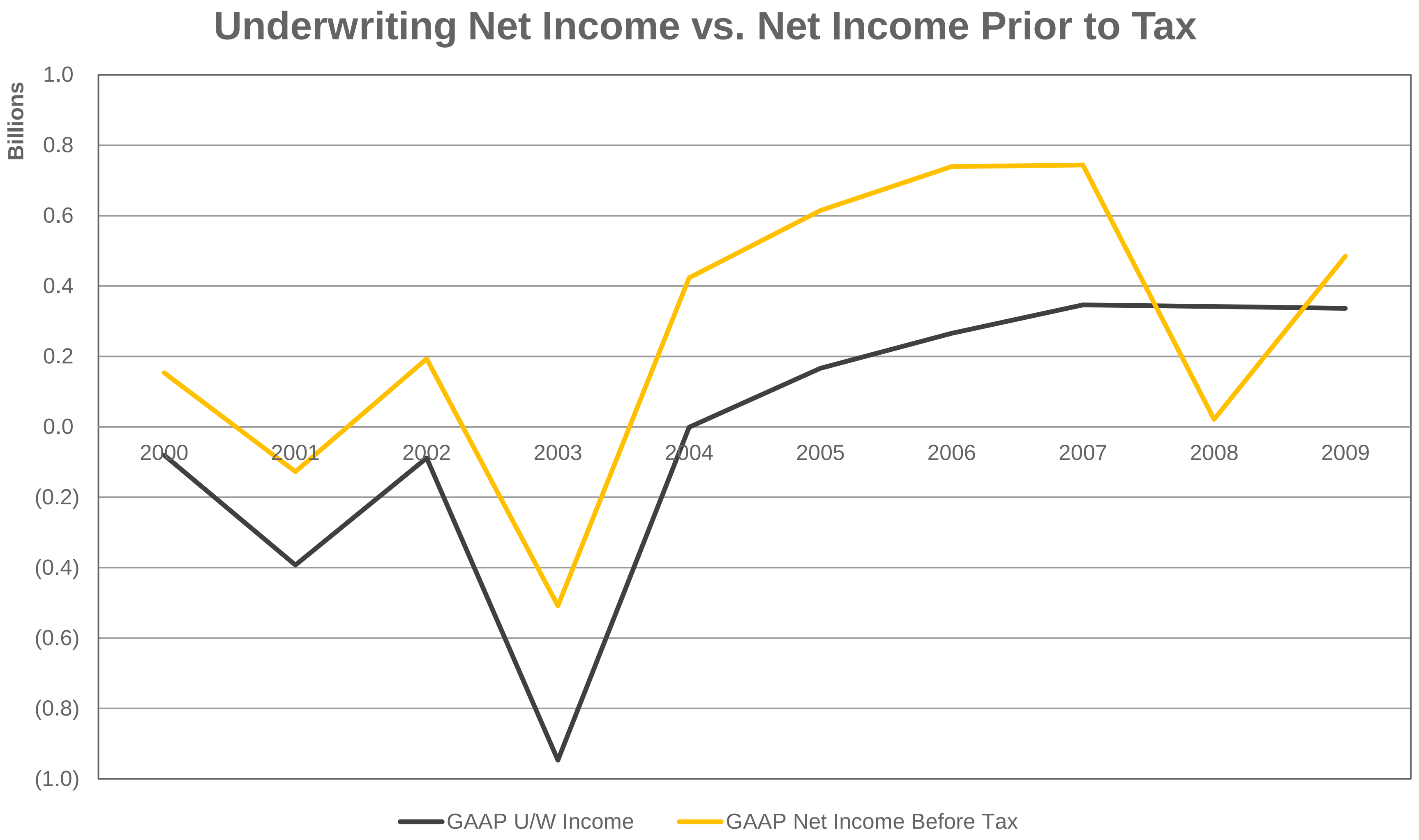
Key changes to measurement inputs

Measurement input	IASB ED/FASB DP	Result of re-deliberations
Composite Margin (FASB ONLY)	Difference between premium and current estimate of cash flows discounted for the time value of money	The FASB has tentatively decided that the measurement model should use a single margin approach that recognizes profit as the insurer satisfies its performance obligation . An insurer satisfies its performance obligation as it is released from exposure to risk as evidenced by a reduction in the variability of cash outflows. An insurer should not remeasure or recalibrate the single margin to recapture previously recognized margin.
Acquisition costs	Expenses that were incremental to writing a contract could be reflected in the measurement of the cash flows of the contract.	The IASB has decided to allow all the costs that the insurer will incur in acquiring the portfolio, including costs that relate directly to the acquisition of the portfolio to be included in the measurement of the cash flows. The FASB that the acquisition costs included in the cash flows of insurance contracts would be limited to those costs related to successful acquisition efforts and direct costs that are related to the acquisition of a portfolio of contracts.

Model office background

- The EY model office is designed to show a retrospective view over the last ten years of financial statements under four accounting standards: statutory, current US GAAP, IFRS as proposed by the IASB insurance contract exposure draft, and proposed US GAAP as presented in the FASB insurance contract discussion paper
- Data is obtained from 10-K and statutory annual statement filings over the period 1999 through 2009
- Throughout the presentation current US GAAP is labeled “GAAP, the IASB proposal is labeled “IFRS” and the FASB proposal is labeled “FASB”.

Key events from 2000-2009



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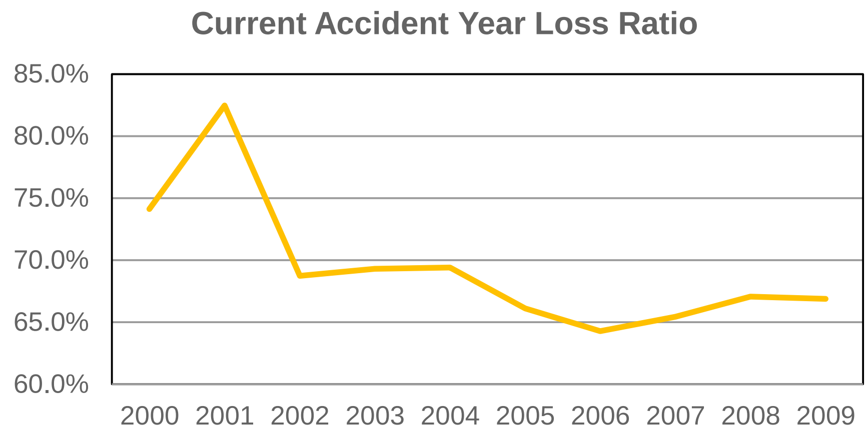
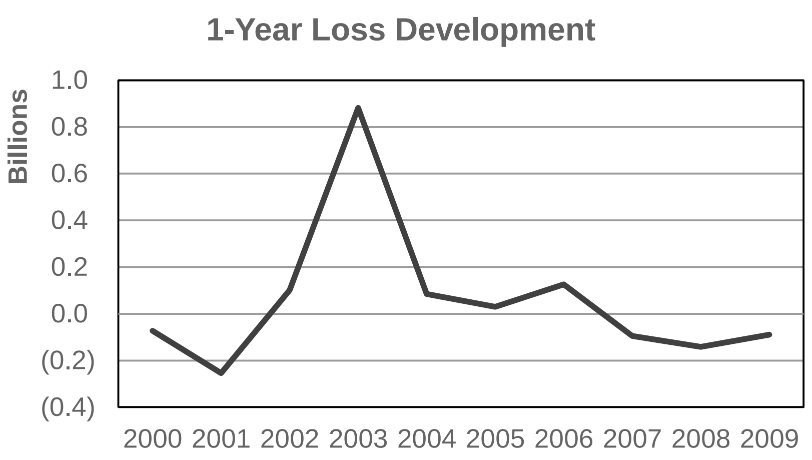
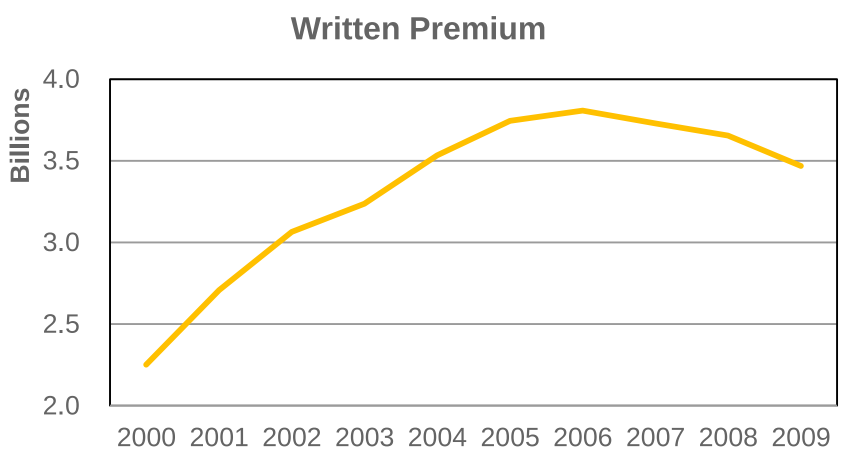
10-Year History of Key Income Drivers







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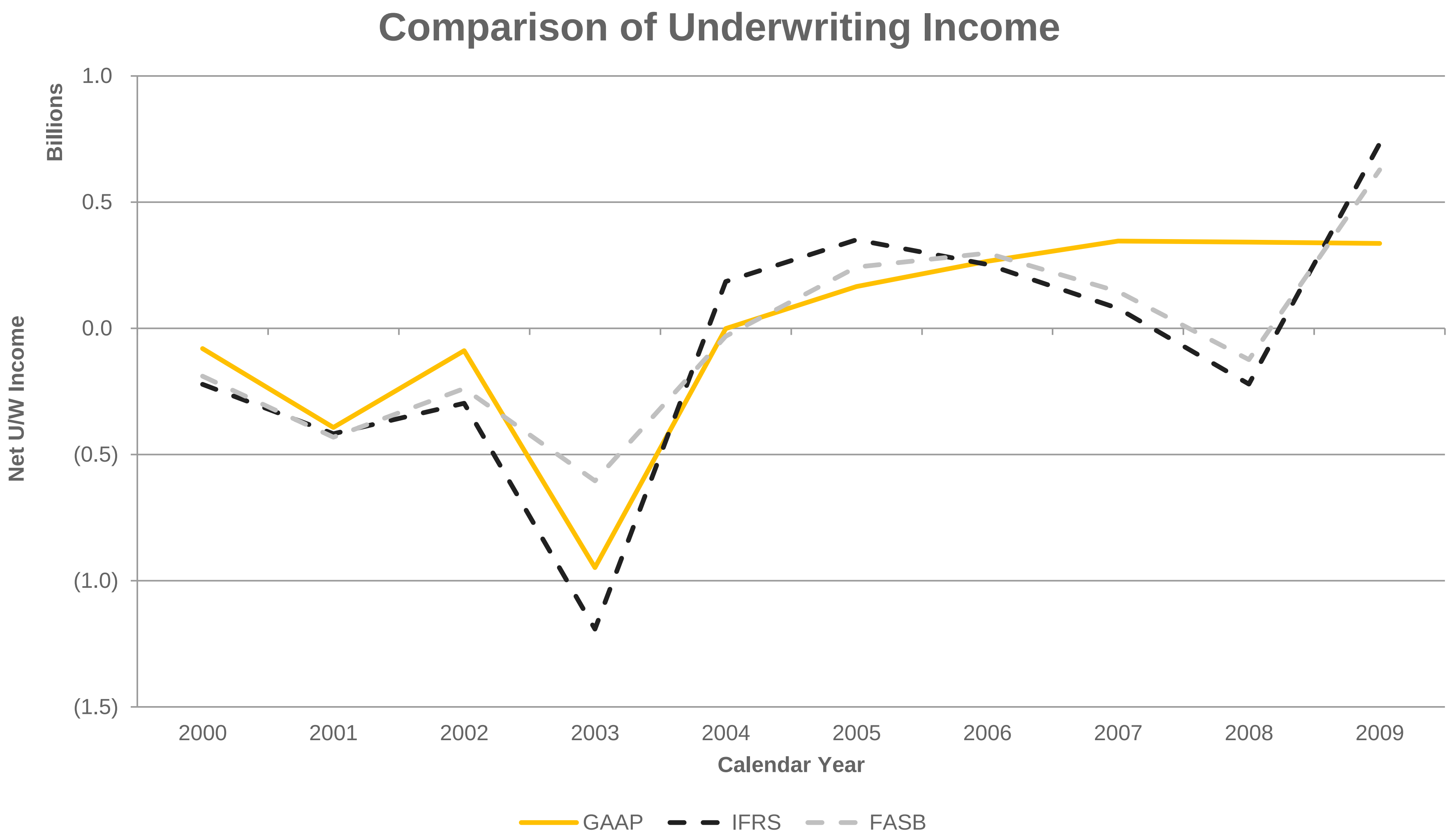
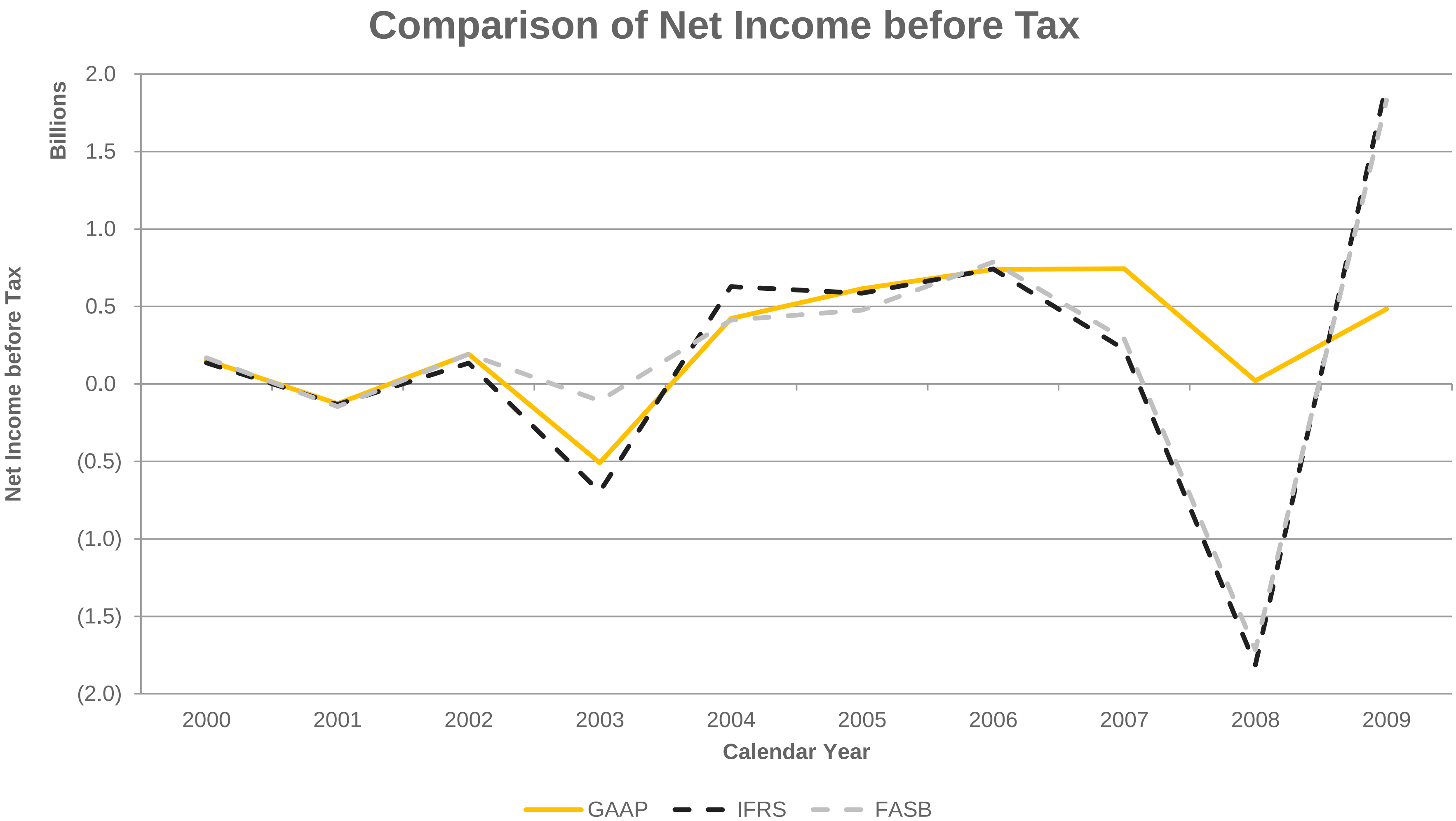
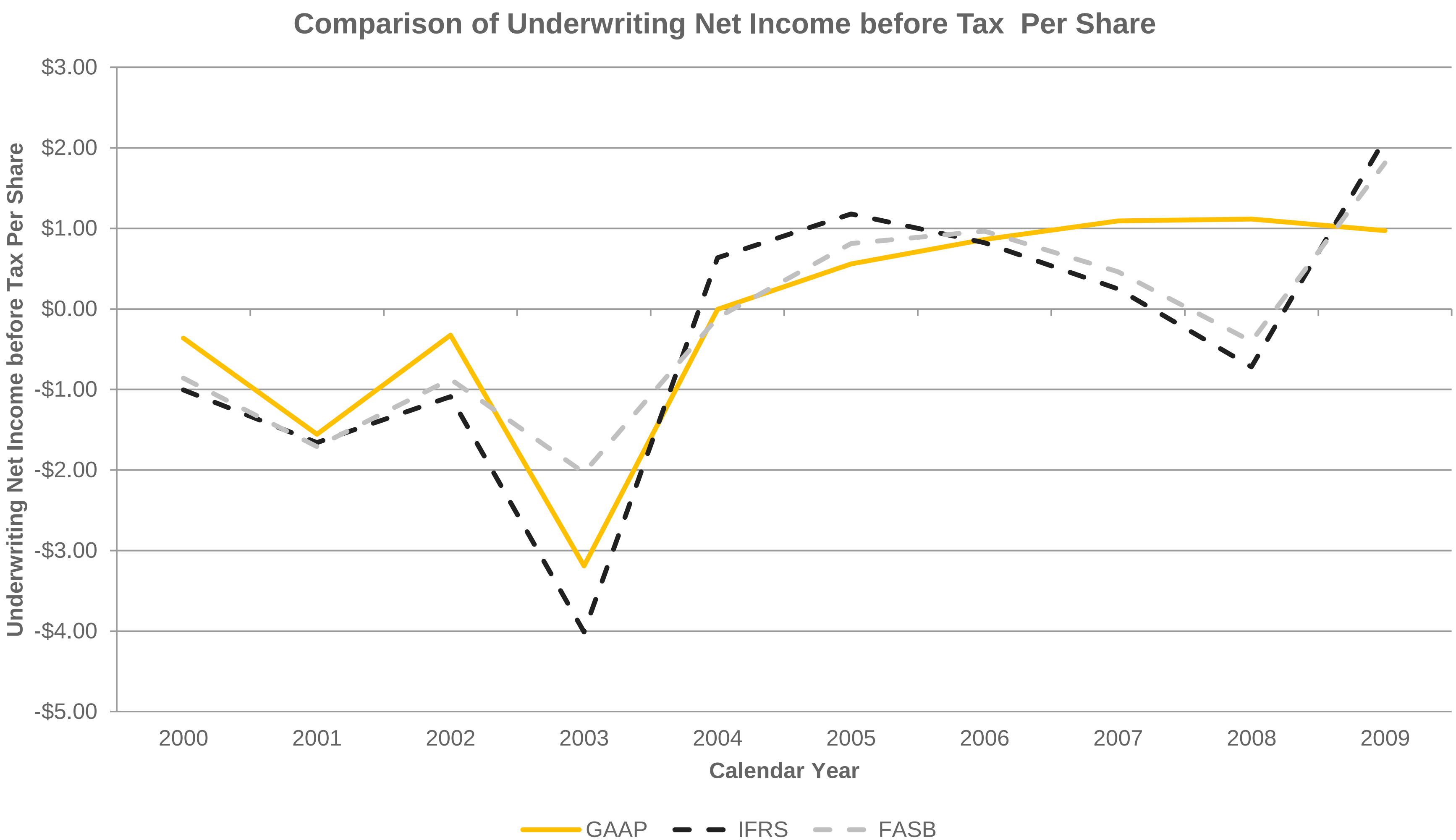
GAAP v IFRS v FASB underwriting income



GAAP v IFRS v FASB total net income



GAAP v IFRS v FASB underwriting income per share



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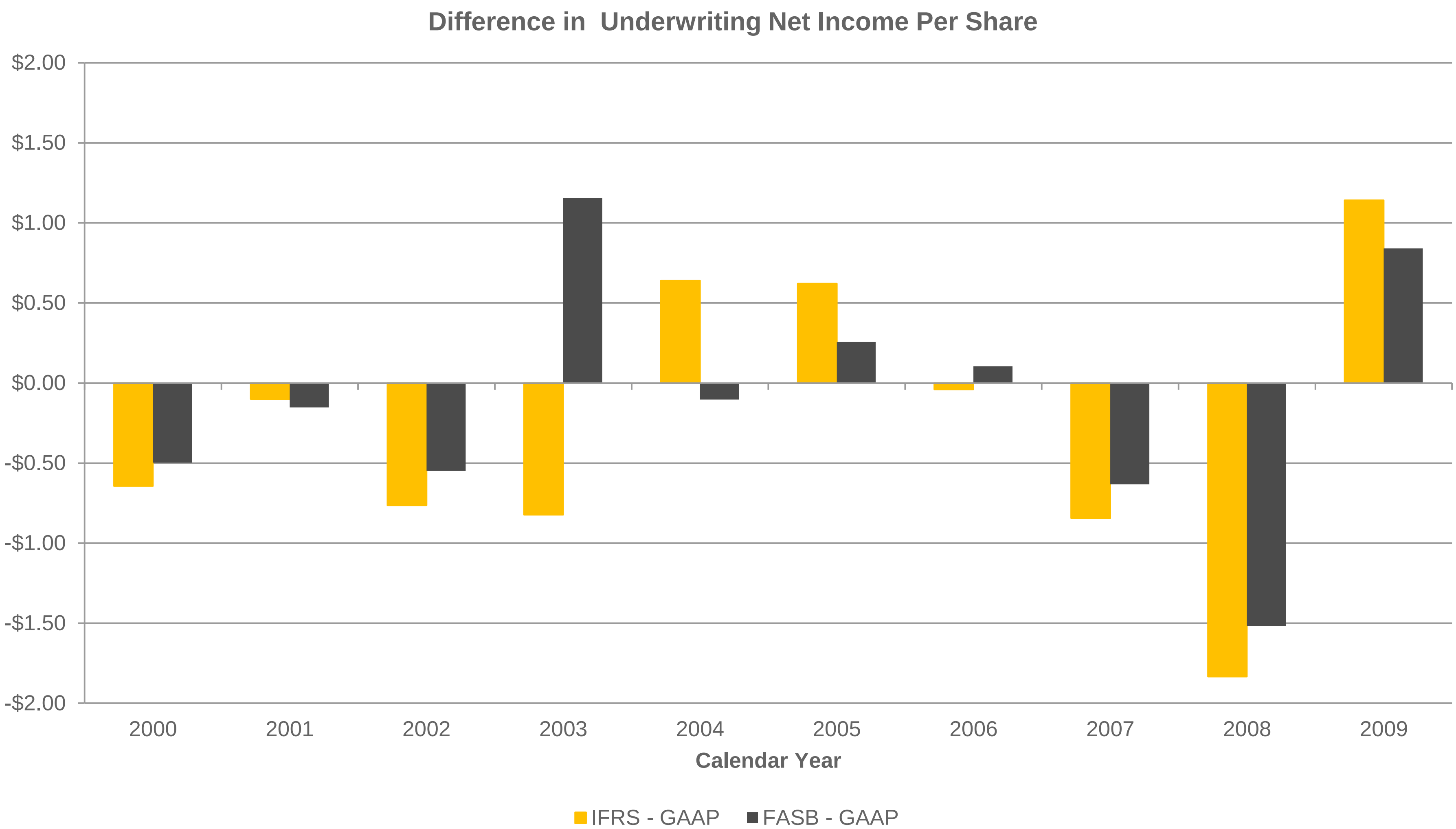
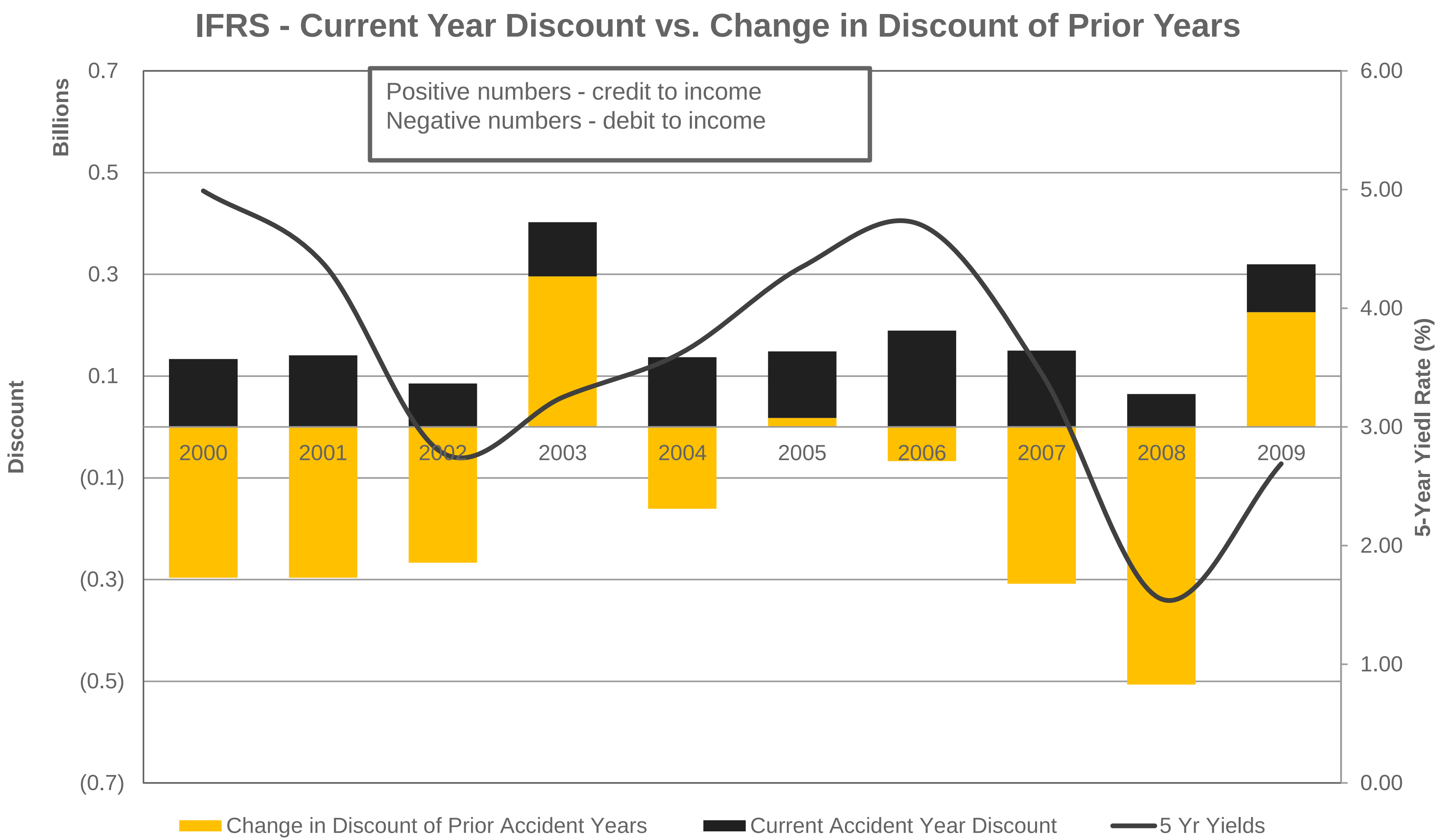
Impact on underwriting net income per share



Income effects of loss reserve discount – IFRS Basis



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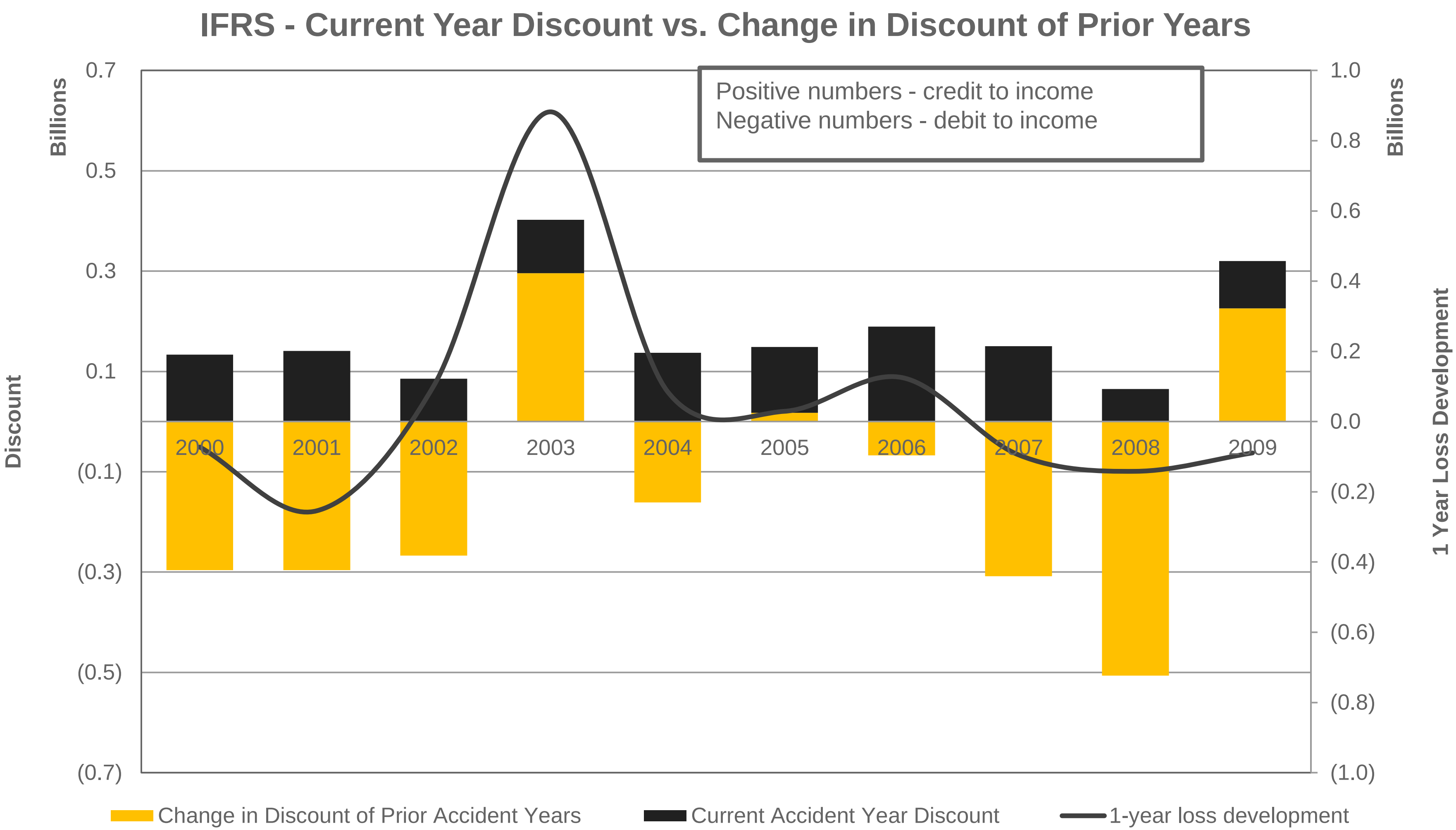
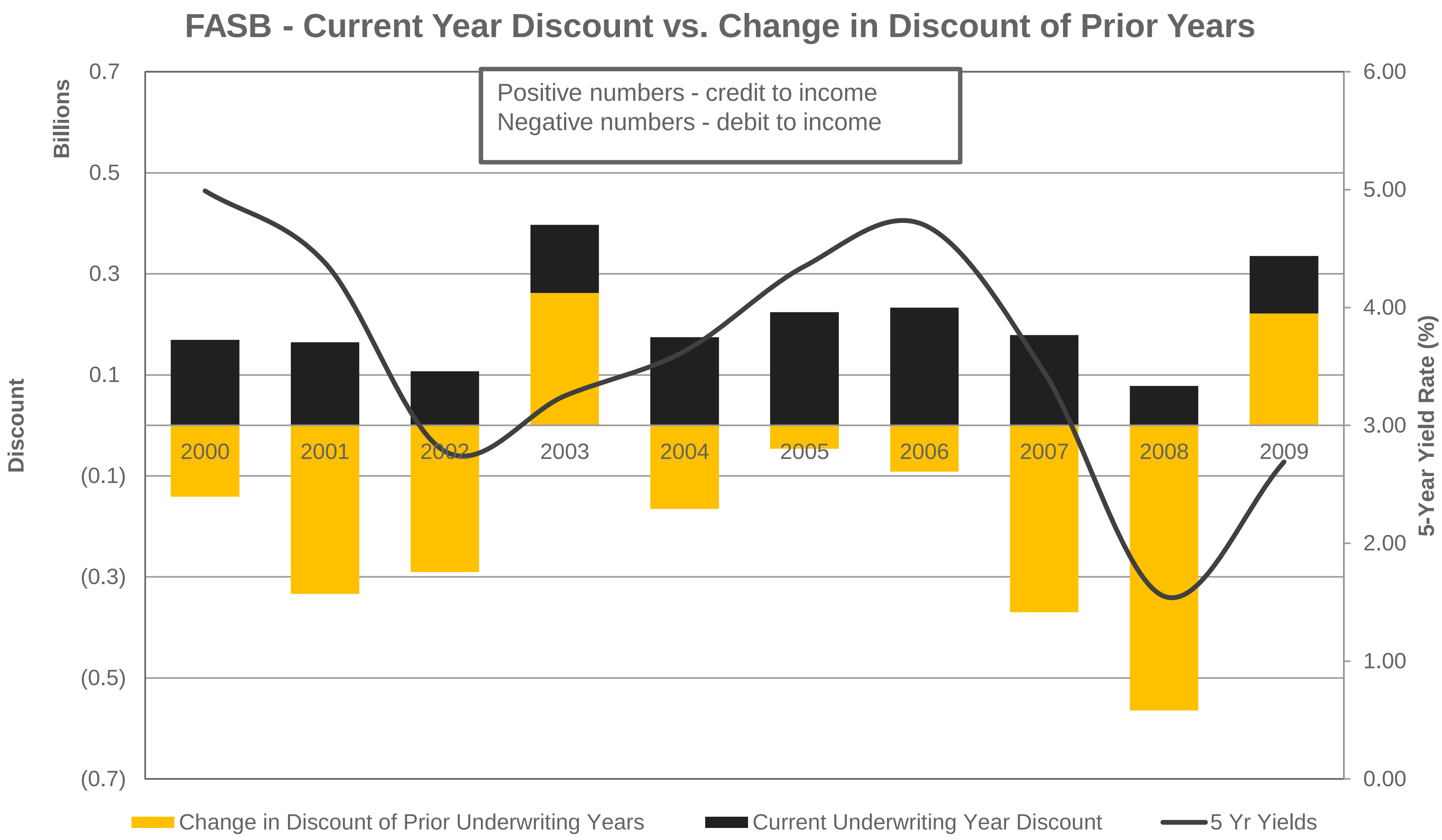
Loss development effects of loss reserve discount – IFRS Basis



Income effects of loss reserve discount – FASB Basis



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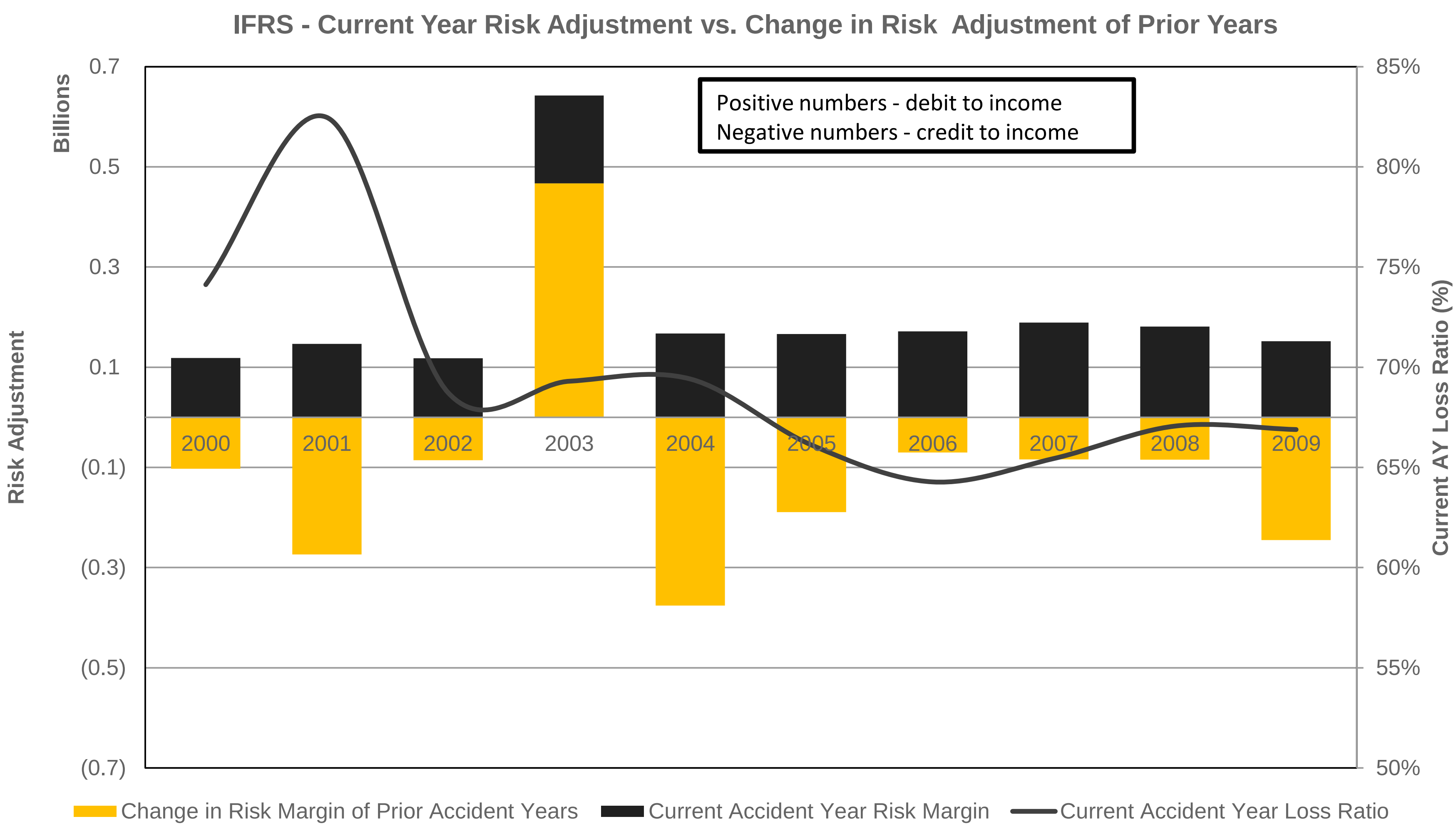
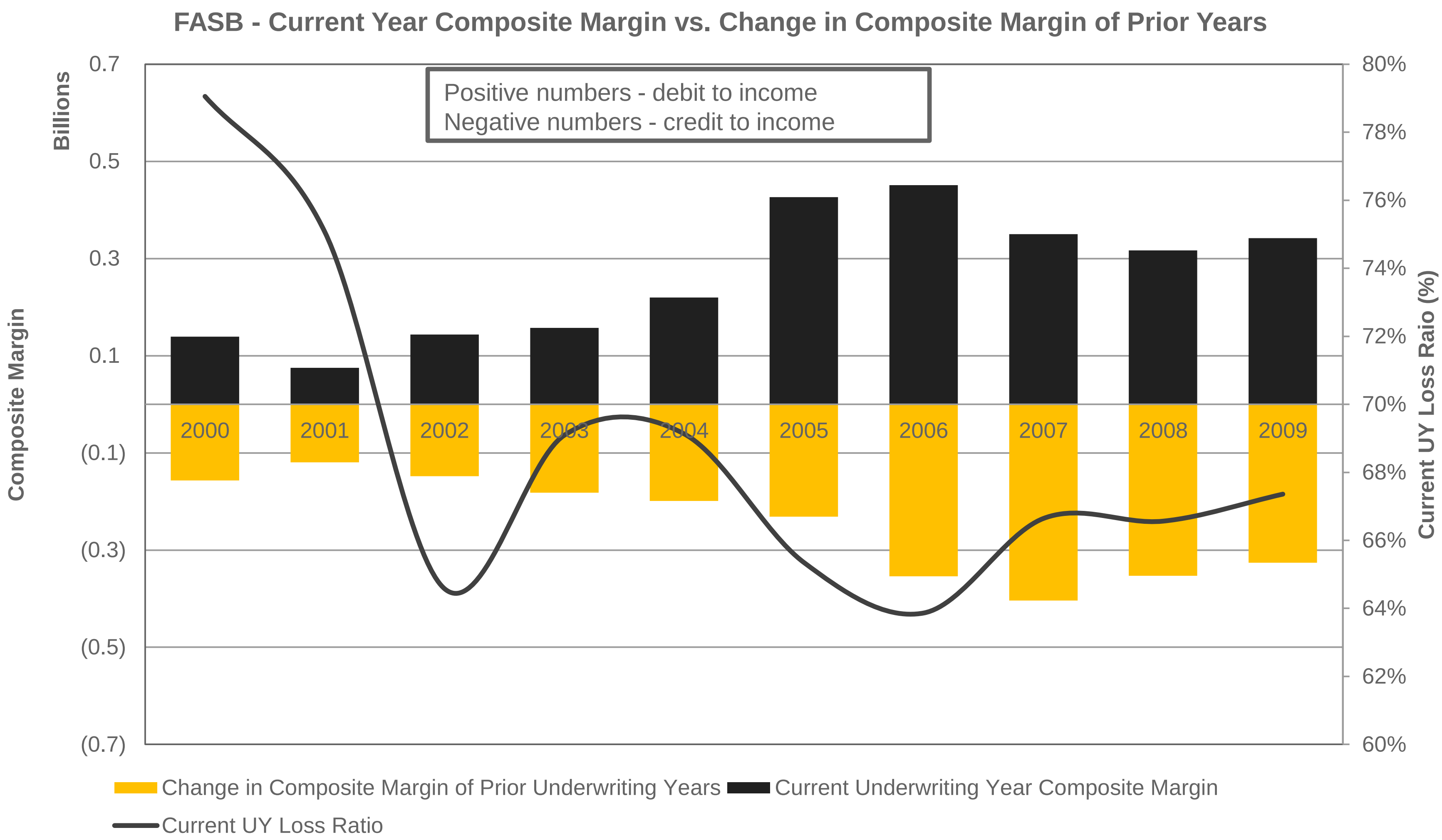
Risk adjustment – effects of changing loss ratios



Composite margin – effects of changing loss ratios



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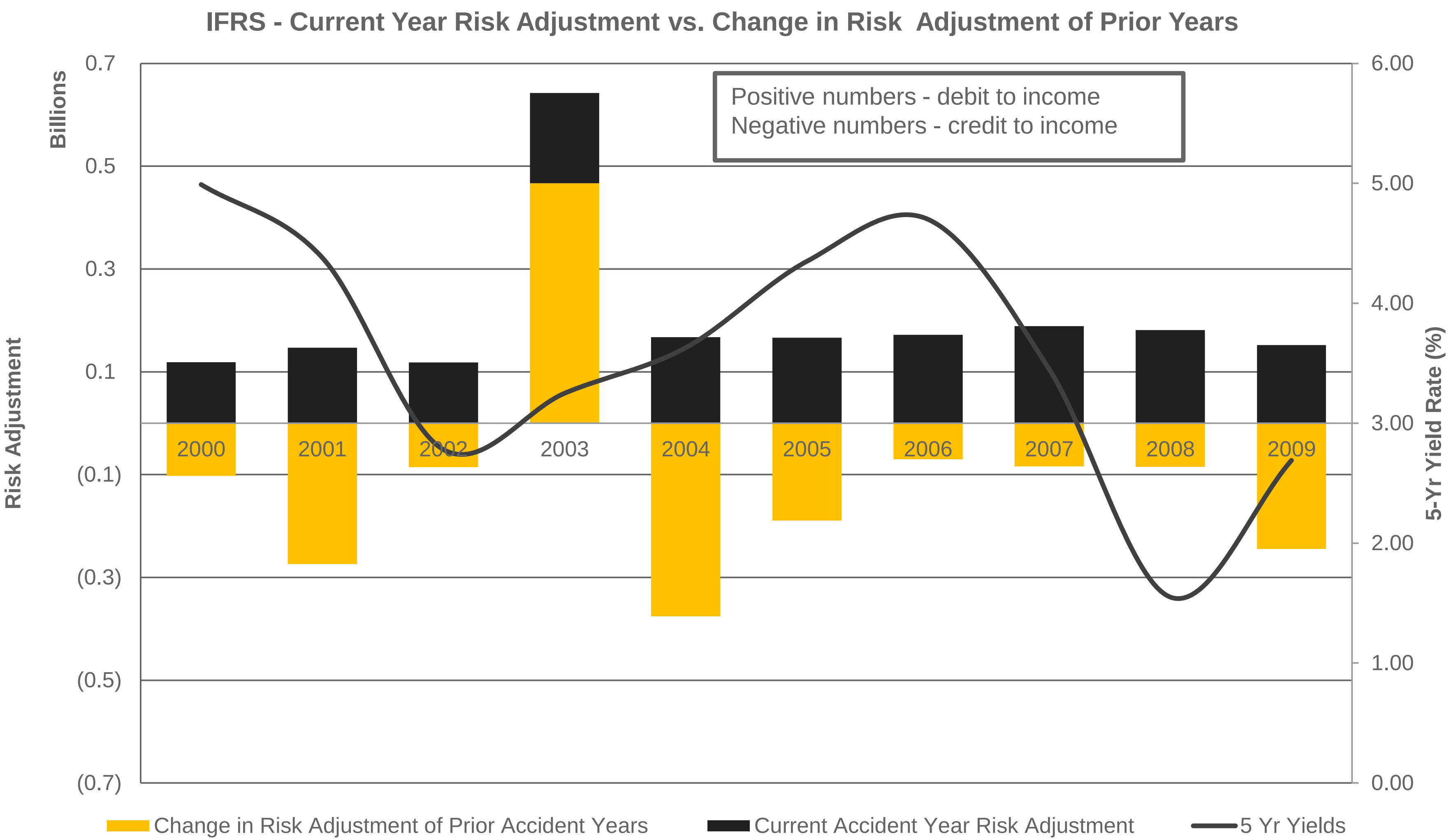
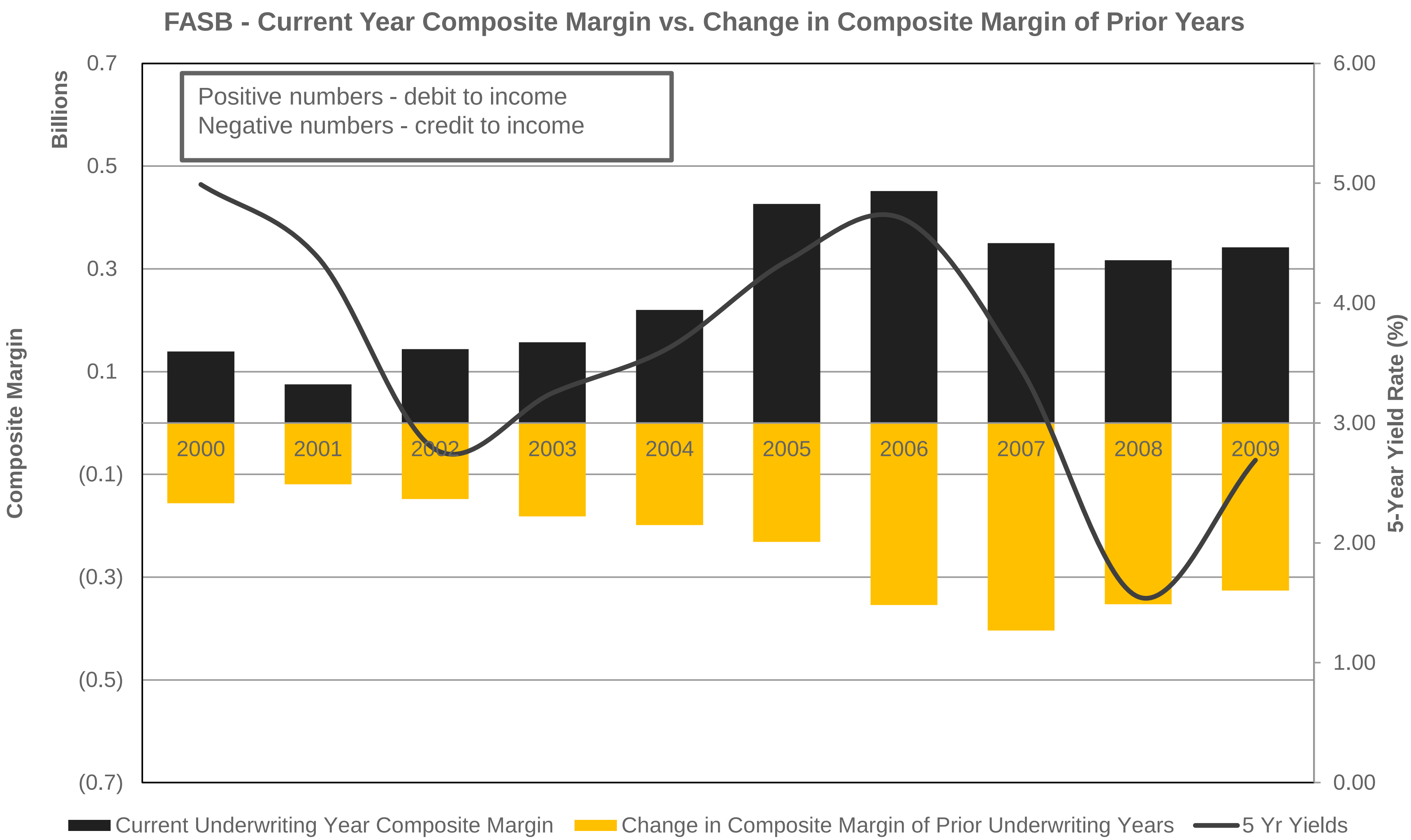
Risk adjustment – effects of changing discount rate



Composite margin – effects of changing discount rate



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