



SOCIETY OF ACTUARIES

**SOA 09 Annual Meeting & Exhibit
October 25-28, 2009**

**Session 57 PD, The Convergence of Accounting
Standards for Insurance**

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Session 57:

The Convergence of Accounting Standards for Insurance

October 27, 2009

Convergence of Accounting Standards for Insurance

Agenda – Mode I Overview of standards

- I. Brief Overview of IFRS Initiatives
- II. Insurance Contracts Project
- III. Financial Instruments

Agenda - Mode II Deep Dive

- I. What do we mean by conversion
- II. Reporting bases going through changes
- III. Conversion implications
- IV. Responding to the change

What is IFRS?

- IFRS is a "principle-based" approach versus U.S. GAAP being a more "rules" based approach.
- IFRS places greater emphasis on interpretation and judgment and less reliance on "bright-line rules"
- There is no industry specific guidance under IFRS
- Determining the appropriate accounting treatment under IFRS will be based on professional judgment
- IFRS is appears less comprehensive than U.S. GAAP and focuses on assessing the "substance" of transactions and evaluating whether the accounting presentation reflects the "economic reality"

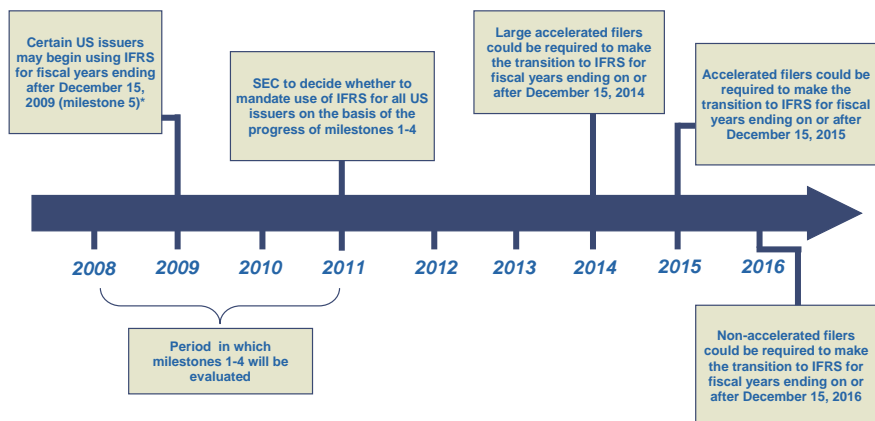
	U.S. GAAP	IFRS
Pronouncements	164	49
Interpretations	>500	33
Pages of guidance	25,000	2,500

- IFRS also places a greater emphasis on disclosure of transactions that do not have clearly defined accounting in the limited IFRS literature. IFRS is expected to lead to a new perspective on financial reporting with a focus on "transparency" of financial information versus uniformity of practices.
- IFRS in many instances increases the focus on fair value concepts for valuing assets and liabilities

The principles-based nature of IFRS, a focus on the substance and economic reality of transactions, the reduced focus of industry guidance and the increased use of fair value is expected to cause significant changes under IFRS

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IFRS Overview: SEC Roadmap for IFRS



This is a pretty diagram and may be interesting for a manufacturing company with inventory and fixed assets, but it DOES NOT MATTER FOR AN INSURANCE COMPANY!!!

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Convergence of IFRS and US GAAP

- In 2006, the IASB and FASB agreed to work together on key projects in order to improve and to bring about convergence of their respective Conceptual Frameworks;

Area of Convergence	2009 Q3	2009 Q4	2010 Q1	2010 Q2	2010 Second Half	2011 Q1 or Q2	2011 or later
Earnings Per Share							
Taxes	These Projects are already completed						
Business Combinations							
Consolidation		IFRS					
Derecognition					IFRS		
Fair value measurement guidance [Comment period ended September 2009]				IFRS			
Financial instruments (IAS 39 replacement)							
Classification and measurement [ED, comments due by 14 September 2009]		IFRS					
Impairment		ED		IFRS			
Hedging		ED		IFRS			
Financial statement presentation				ED		IFRS	
FI with characteristics of equity			ED			IFRS	
Income taxes					IFRS		
Joint ventures		IFRS					
Leases					ED	IFRS	
Post-employment benefits (incl. pensions)							
Revenue recognition				ED		IFRS	
Discontinued operations (IFRS 5)		IFRS					
Insurance contracts		ED				IFRS	

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Insurance Contracts Project

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Highlights of IASB September meeting

“Updated” IAS 37 or Current Fulfilment Value (CFV) models

- 8 v. 7 majority in favor of IAS 37 (9 votes needed to publish the Exposure Draft - ED)
- CFV supported by FASB may be included in the exposure draft

Accounting for margins under the IAS37 model

- Risk margin MUST be remeasured at each balance sheet date
- Residual margin to be earned over coverage period
- Residual margin is released to income independently of adverse or favourable experience
- No agreement on drivers to earn residual margin

Discount rate

- Principles based approach – based on liability characteristics – currency, duration and liquidity

Policyholder accounting

- Exclude from the ED but to be included in the final IFRS (no exposure will take place)

Updated IAS 37 versus CFV – summary comparison

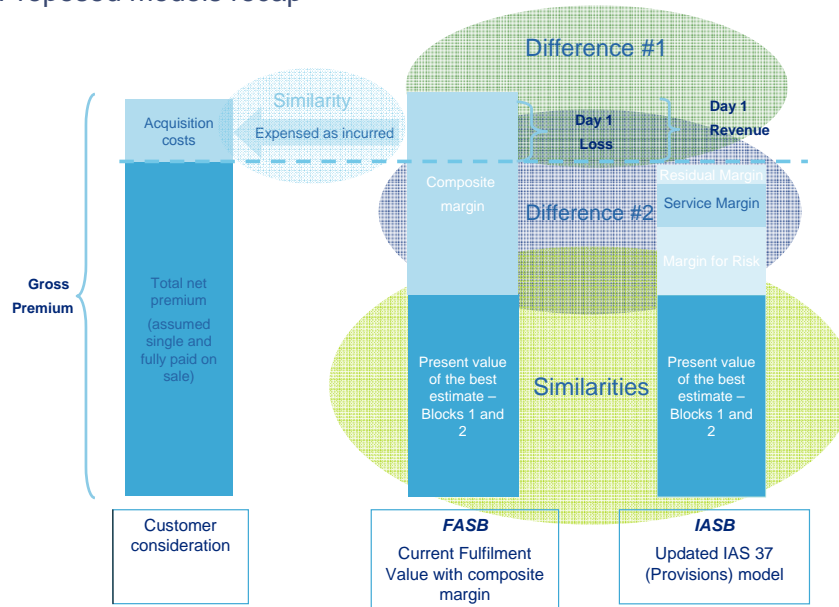
Similarities

- Measure from perspective of insurer and include insurer's specific cash flows when no directly observable market price is available to estimate variables
- Estimates of financial market variables as consistent as possible with observable market prices
- Use of 3 building blocks, first two blocks are identical
- Prohibition of day 1 accounting profit => residual / composite margins
- Requirement of day 1 accounting loss

Differences

- Measurement objective
 - Updated IAS 37: amount insurer would pay to be relieved of the obligation
 - CFV: measure expected probability-weighted present value of the cost of fulfilling the obligation over time
- Service and risk margins – explicit in IAS 37 to account for expected profit required for other services and uncertainty. Implicit components of the composite margin in CFV

Proposed models recap



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Accounting for residual margin

IASB's staff proposals

- Drivers for release of margins developed with two distinct views (no staff consensus) for the release to income:
 - Consistent with insurer's performance of the contractual obligations
 - Based on the release from risk, a function of the margin for risk
- Period over which to release the margins:
 - Coverage period (staff recommendation)
 - Claims handling period – staff recommendation only for composite model – NOT RELEVANT FOR THE IAS 37 MODEL
- Interaction of margin release and change in estimates (e.g. due to adverse or favourable experience) (no staff consensus)
 - Independent release of margin irrespective of the sign in the revised estimates
 - Changes in estimates from financial variables taken to income as incurred with recalibration of the residual margin for all other changes in estimates.

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Selecting the discount rate

Should liquidity of the liability be taken into account?

- Unanimous agreement that the discount rate should not reflect the characteristics of assets held to match the liabilities unless the assets determine the liabilities
- The insurer's own credit risk is NOT reflected in the discount rate
- Agreed the principle that liquidity of the liability is a characteristic that should be taken into account in determining the discount rate
- Concern noted that, to date, there is no widely accepted basis of determining the liquidity component of the discount rate applicable to risk free government bonds
- Disclosure and sensitivity will be important
- Field testing will attempt to address the effects of using a risk free rate for illiquid liabilities and seek to identify alternative bases for identifying the illiquidity adjustment
- IASB will consider the need for further guidance on illiquidity premium and discount rates when discussing the results of the targeted field testing

Recap on previous decisions

IASB /FASB agreement on several principles

- The new model will be based on a "three-building-blocks" approach
- Block 1: the undiscounted probability weighted estimate of future cash flows
- Block 2: a market consistent discount rate
- Blocks 1 and 2 must be updated at each balance sheet date – no locked-in assumptions
- Immediate loss through income at point of sale if premium insufficient – "onerous contract test"

IASB/FASB disagreement in two key areas affecting the accounting profit pattern

1. Objective of the initial measurement of an insurance contracts – the role of acquisition costs
2. Nature and purpose of Block 3 (margins)

Timetable

Commitment to a December 09 exposure draft

- Exposure draft issue date remains in December 2009
- Comment period ends May 2010
- Standard due in June 2011

Policyholder accounting

- IASB rejected exclusion of policyholder accounting from Phase II
- However it agreed to exclude from the December 09 exposure draft and to work on this in the exposure period in 2010
- No exposure of policyholder accounting provisions is likely

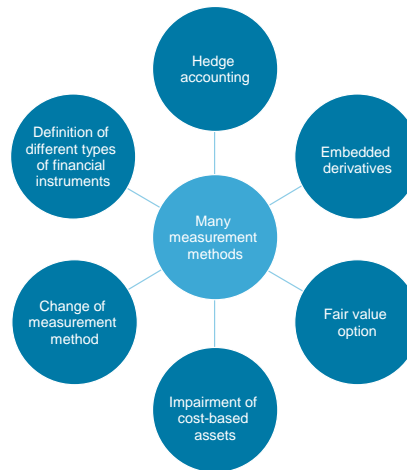
Field testing

- 15 companies involved
- Questionnaire sent out on acquisition costs
- Further questionnaire on release of margins following this meeting
- Will continue before and after exposure draft

Financial Instruments

Financial instrument accounting: a significant source of complexity

- The IASB is addressing complexity using a phased approach, focusing first on how various types of financial instruments should be classified and measured
- The FASB is addressing complexity using a holistic approach that will consider together how financial instruments should be classified and measured, how they should be evaluated for impairment, and how hedge accounting should be applied



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Project timeline

	IASB	FASB
Q3 2009	July 14, 2009: IASB publishes ED on classification and measurement of financial instruments (with 60 days comment period)	July/August 2009: FASB agrees to propose a model to improve financial reporting for financial instruments and issues detailed project plan
	September 2009: Joint roundtables in Tokyo, London and Norwalk	September 2009: Joint roundtables in Tokyo, London and Norwalk
Q4 2009	October 2009: IASB to publish ED on impairment of financial assets	Q4 2009: FASB continues to develop a comprehensive model for the recognition and measurement of financial instruments, including hedge accounting and deliberate on various issues, including the scope, effective date, and transition requirements
	Q4 2009: IASB to issue final IFRS on classification and measurement of financial instruments (early adoption permitted as of 2009)	
	IASB to publish ED on hedge accounting (December)	
H1 2010	H1 2010: IASB to complete replacement of IAS 39 by issuing final guidance on: <ul style="list-style-type: none"> • Impairment • Hedge accounting 	December 2009 / January 2010: FASB expected to issue ED covering classification and measurement, impairment, and hedging (with 90 days comment period)
		June 2010: FASB roundtables
2012		H2 2010: FASB to publish final Accounting Standards Update
	January 1, 2012: Expected mandatory effective date of successor standard to IAS 39	January 1, 2012: Expected mandatory effective date of financial instruments standard

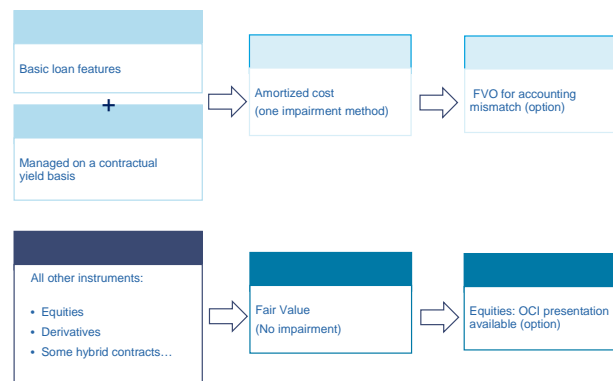
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Overview of FVM Guidance

Subject	ED	Statement 157
Scope	Applies to leasing arrangements.	Does not apply to leasing arrangements.
Reference market	Assumes that the transaction takes place in the most advantageous market for the asset or liability. The market in which the reporting entity would normally enter into a transaction for the asset or liability is presumed to be the most advantageous market.	Assumes that the transaction to sell the asset or transfer the liability occurs in the principal market or, in the absence of a principal market, in the most advantageous market for the asset or liability.
Highest and best use	Includes presentation requirements for circumstances in which an entity uses an asset with other assets in a way that differs from the asset's highest and best use.	No similar presentation requirement.
Fair value at initial recognition	Day one differences are recognized in accordance with existing criteria in other IFRSs.	Implicitly requires the recognition of day one profits or losses in some circumstances even if the fair value measurement inputs are unobservable.
Valuation premise	Explicitly states that the in-use valuation premise is not relevant to financial assets.	Not explicitly addressed.
Measurement of liabilities	Proposes a framework in which an entity would use the same method to measure the fair value of a liability as a counterparty uses to measure the fair value of a corresponding asset.	Includes limited guidance on the measurement of liabilities. The FASB has issued a proposed Staff Position (FSP) to clarify the measurement of liabilities at fair value (proposed FSP FAS 157-F); the proposed FSP is largely consistent with the proposals in the ED.
Measurement of equity instruments	Includes a separate discussion for equity instruments measured at fair value. Indicates that fair value is measured from the perspective of a market participant who holds the instrument as an asset.	No separate discussion for equity instruments. Footnote 4 of Statement 157 indicates that the definition of fair value should be applied to equity instruments measured at fair value.
Market participant	Is defined as "knowledgeable, i.e. they are sufficiently informed to make an investment decision and are presumed to be as knowledgeable as the reporting entity about the asset or liability."	Is defined as "knowledgeable, having a reasonable understanding about the asset or liability and the transaction based on all available information, including information that might be obtained through due diligence efforts that are usual and customary."

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Overview of IASB Project Classification & measurement – overview

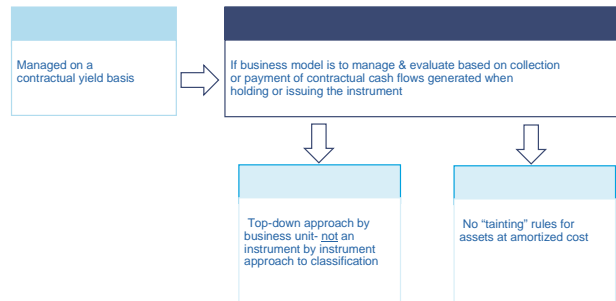


- No reclassifications
- No cost exemption for unquoted equities

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Overview of IASB Project

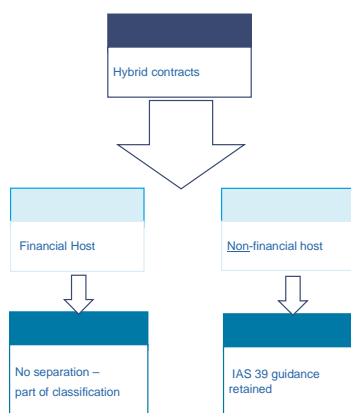
Classification & measurement – managed on contractual yield basis



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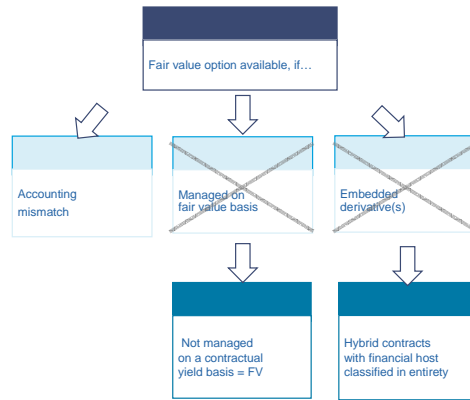
Overview of IASB Project

Classification & measurement – hybrid contracts



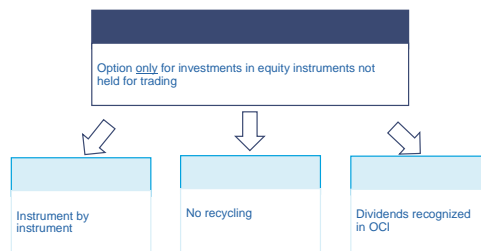
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Overview of IASB Project Classification & measurement – Fair value option



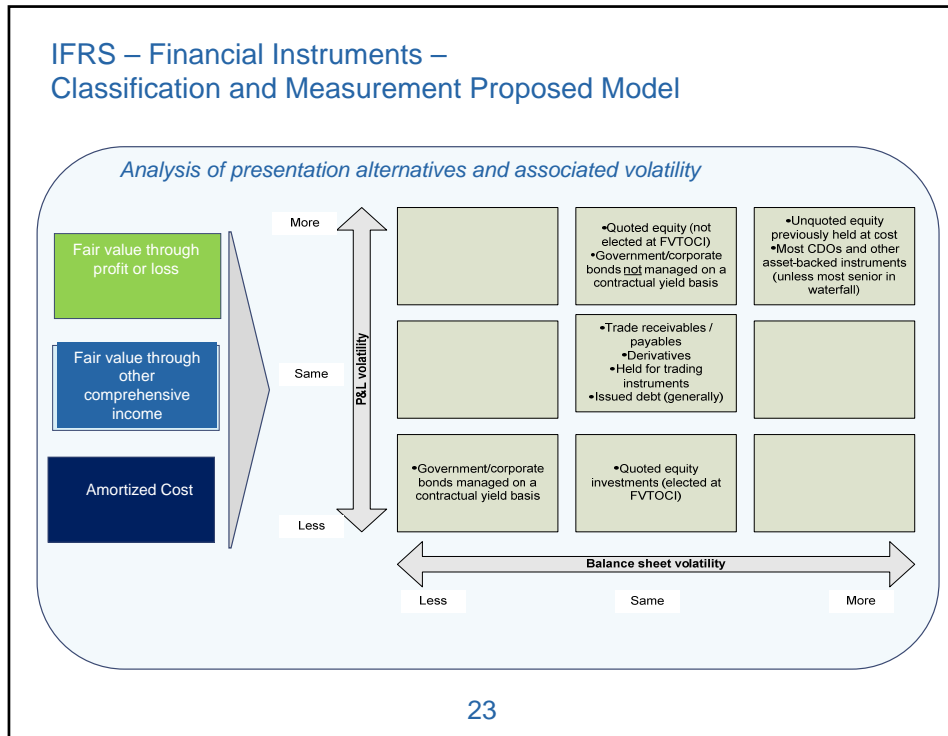
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Overview of IASB Project Classification & measurement – OCI alternative



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IFRS – Financial Instruments – Classification and Measurement Proposed Model



Overview of IASB Project Impairment of financial assets

- Request for Information (RI) on expected loss model published in June 2009
- Current state of impairment under IAS 39: Losses expected as a result of future events are not recognized
- Possible alternative approach for the impairment of financial assets measured at amortized cost
 - An expected loss impairment model as part of expected cash flow measurement. Main features:
- Interest revenue recognized on the basis of expected cash flows (including expected credit losses)
- Impairment results from an *adverse change in credit loss expectations*
- Reversal of impairment loss when *favorable change*
- Subsequent or additional impairment is recognized through continuous re-estimation of credit losses
- Exposure draft is expected to be issued in fourth quarter 2009

Overview of IASB Project Hedge accounting

Two general approaches to changing hedge accounting requirements:

- **Eliminate (and possibly replace hedge accounting) existing hedge accounting requirements. Three potential ways to replace fair value hedge accounting:**
 - A fair value option
 - Recognition outside earnings of gains and losses on hedging instruments (similar to cash flow hedge accounting)
 - Recognition outside earnings of gains and losses on hedged items

- **Maintain and simplify the existing hedge accounting requirements.**
 - Prohibit hedge accounting for partial hedges
 - Require irrevocable designations
 - Eliminate portfolio hedges
 - Eliminate basis adjustments

- **Exposure Draft is expected to be issued in Q4 2009**

Summary of Classification and Measurement

Instrument	IASB's ED	FASB's Tentative Decision
Derivatives not in a qualifying hedge accounting relationship and derivatives in a qualifying fair value hedge accounting relationship	FVTPL	FVTPL
Derivatives in a qualifying cash flow or net investment hedging relationship (effective portion)	FVTOCI with reclassification to income (hedge accounting to be discussed in a later phase of the project)	FVTOCI with reclassification to income (hedge accounting to be discussed in a later phase of the project)
Financial instruments held for trading	FVTPL	FVTPL
Marketable equity securities not held for trading	FVTPL (default category) or FVTOCI (option) without reclassification to income	FVTPL
Nonmarketable equity securities not held for trading	FVTPL (default category) or FVTOCI (option) without reclassification to income	FVTPL
Loan receivables (not held for sale, not subject to fair value option)	Amortized cost	FVTPL or FVTOCI (option) with reclassification to income
Debt instruments managed on a fair value basis	FVTPL	FVTPL
Investments in debt securities (not structured, not held for trading, not held for sale, not subject to fair value option)	Amortized cost	FVTPL or FVTOCI (option) with reclassification to income
Issued debt instruments (not structured, not subject to fair value option)	Amortized cost	FVTPL, FVTOCI (option) with reclassification to income or amortized cost (option)
Structured notes	FVTPL	FVTPL
Investments in convertible debt	FVTPL	FVTPL

Overview of FASB Project

Overview – decisions to-date

Comprehensive project intended to:

- Reconsider the recognition and measurement of financial instruments
- Address issues related to impairment of financial instruments
- Simplify and resolve practice issues in accounting for hedging activities
-

Due Process Documents:

- Joint Discussion Paper, *Reducing Complexity in Reporting Financial Instruments* issued in March 2008
- FASB's Exposure Draft, *Accounting for Hedging Activities* issued in June 2008
- FASB expects to issue one Exposure Draft that addresses the recognition and measurement, impairment of financial instruments, and hedge accounting, by the end of 2009 or early 2010
- Decisions reached to date on recognition and measurement posted on FASB website (addressed in following slides)

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Overview of FASB Project

Hedge accounting

FASB's Exposure Draft, *Accounting for Hedging Activities*, issued in June

2008 Topic	Proposed Statement
Hedgeable risks	Eliminates hedging by bifurcated risk. Generally, can only designate the risk of changes in overall fair value or cash flows. Two exceptions are permitted: an entity may designate (1) only foreign exchange risk or (2) only certain risks at initial recognition of the entity's own debt
Determination of amounts recorded in OCI for cash flow hedges	Recorded at the amount necessary to offset the present value of the cumulative change in expected future cash flows on the hedged transaction from hedge inception
Assumption that a hedge is perfectly effective	Neither the shortcut method nor critical terms matching is permitted
Frequency of hedge effectiveness assessments	Inception only, unless a change in circumstances warrants reassessment
Threshold for hedge accounting	Reasonably effective
Means of assessing effectiveness	Qualitative assessment is required at the inception of the hedging relationship; however, a quantitative assessment may be necessary in certain situations
Dedesignating a hedging relationship	Entity cannot remove hedge designation after it has been established; however, entity may enter into an offsetting derivative to effectively terminate the hedge

The FASB is planning to redeliberate hedging during November 2009

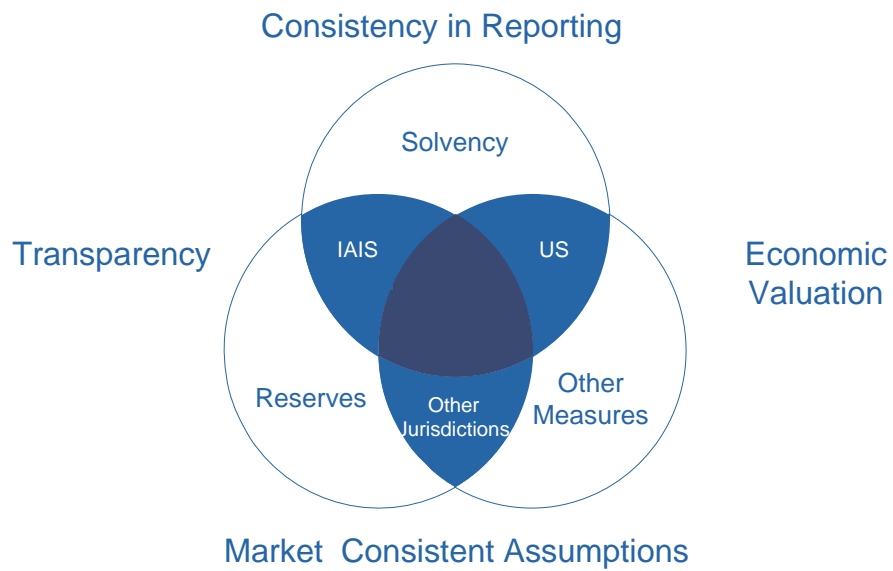
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Agenda

- What do we mean by conversion
- Reporting bases going through changes
- Conversion implications
- Responding to the change

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What do we mean by convergence?

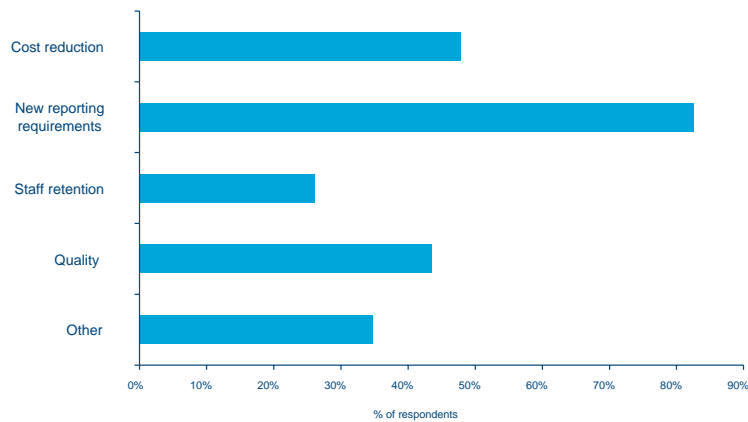


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An example – Most Pressing Issues Finance Functions Will Face

The majority of respondents to PwC's Financial Reporting survey indicated that new reporting requirements are at the top of their list of issues to be faced within the next two years.

Most pressing issues finance function will face in the next 2 years



Source: PricewaterhouseCoopers North American Financial Reporting Survey

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Reporting Bases Going Through Changes

General Purpose Reporting

- IFRS
- GAAP – Fair value and new standard

Regulatory Reporting

- Solvency II
- RBC – C3 Phase 2 and Phase 3
- STAT – AG 43 and Principle based reserves

Management Reporting

- EEV / MCEV

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Reporting Bases Going Through Changes

Similarities - They all require relatively complicated models

- Projected cash flows
- Path dependency
- Market inputs or influence

Differences are in the details

- Basis for assumptions
- Credit risk and other factors for discount rates
- Nature of initial calibration and subsequent updates
- Perspective on risk margins
- Liability only or asset/liability model

Reporting Bases Going Through Changes

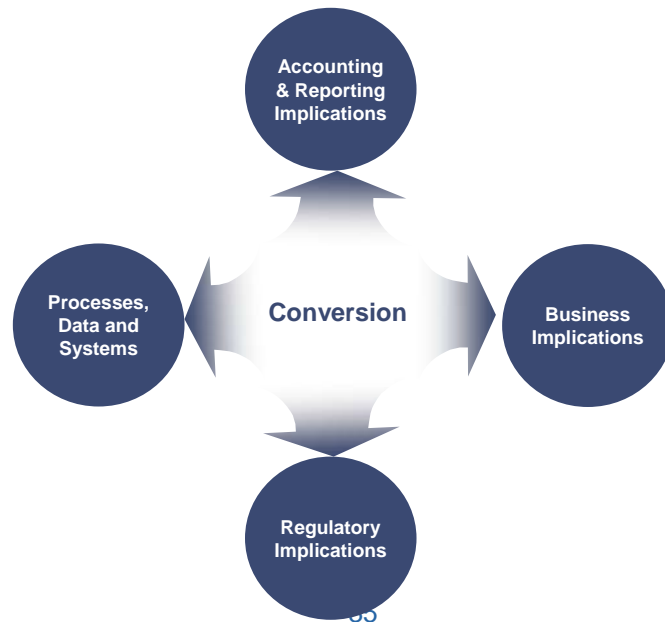
Opportunity to view these all together

- Develop a framework to meet multiple needs
- Despite differences, the various underlying models share much complexity
- Several of these bases require significant, enhanced disclosures

New risks are also introduced

- Increased reliance on models
- New investments in software and hardware
- Model validation will be key

Conversion Implications



Conversion Implications

Regulatory implications

- Issues with projection of capital and capital planning
- "Use test" of Solvency II
- Rating agency EC requirements

Accounting and reporting

- Disclosures
- Restatements
- Development of new expectations of earnings

Conversion Implications

Business implications

- Changes in competitive landscape due to jurisdictions
- Change due to products within framework
- Changes to incentive comp measures

Processes, data and systems

- New models may be required
- New historical and current information may be required
- New processing capability will likely be required

Conversion Implications

A Possible Scenario for Insurance Contracts

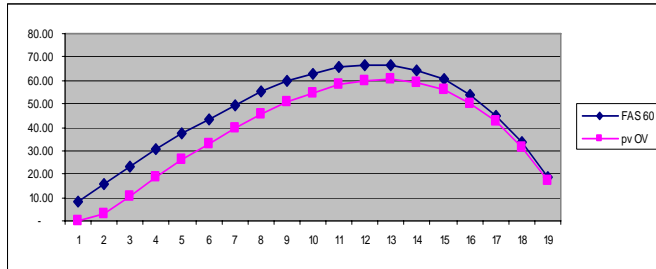
One insurance contract model that has been discussed by the boards:

- View the contract as a current obligation and a series of options
- Acquisition costs is not associated with the contract

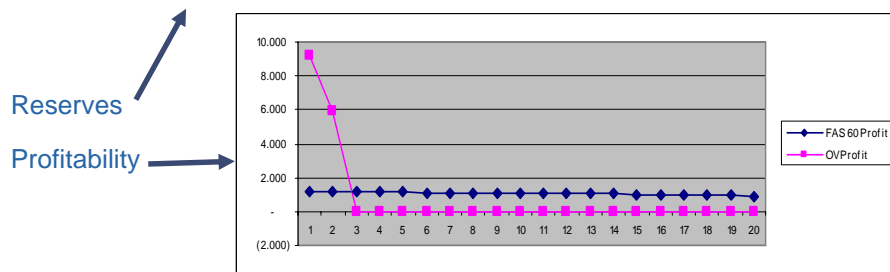
Following examples are based on a 20 year level term product issued to a 60 y.o male

- 5% pricing discount rate
- 2% annual lapse
- 10% mortality PAD
- Acquisition costs are not considered

Conversion Implications A Possible Scenario for Insurance Contracts



Discount with pricing
No lapses
No PADs

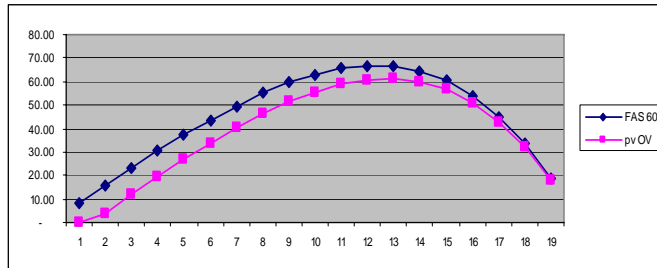


Reserves

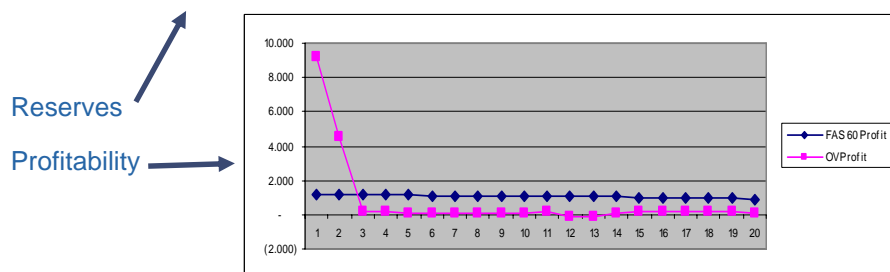
Profitability

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Conversion Implications A Possible Scenario for Insurance Contracts



Discount with swap rate
No lapses
No PADs

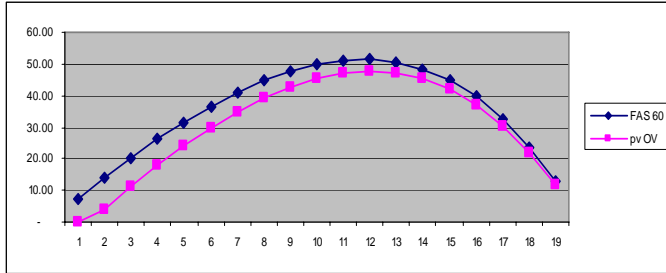


Reserves

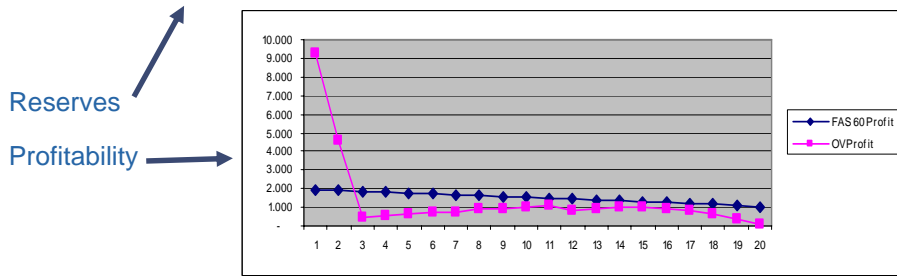
Profitability

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Conversion Implications A Possible Scenario for Insurance Contracts



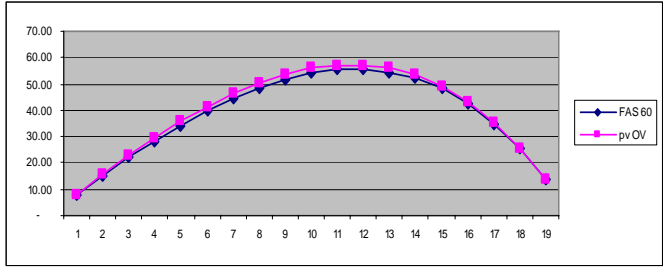
Discount with swap rate
Include lapses
No PADs



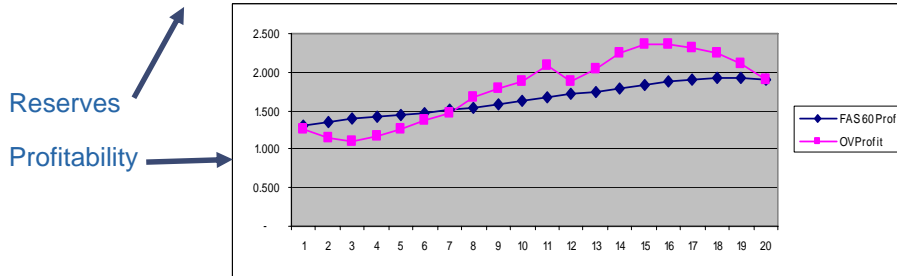
Reserves ↗
Profitability →

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Conversion Implications A Possible Scenario for Insurance Contracts



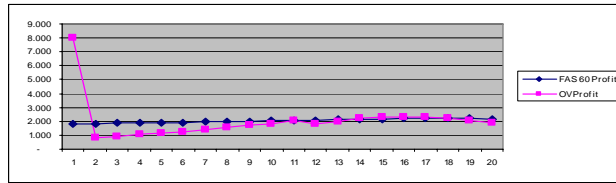
Discount with swap rate
Include lapses
Include PADs



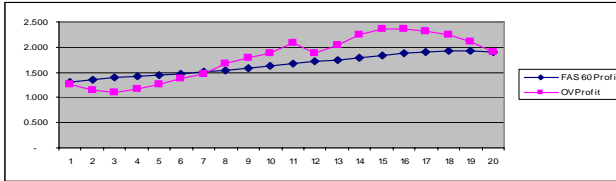
Reserves ↗
Profitability →

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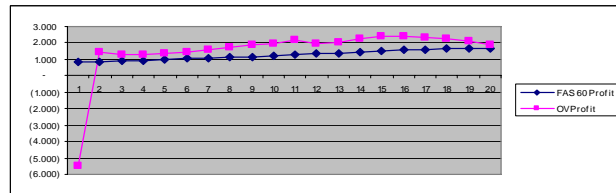
Conversion Implications A Possible Scenario for Insurance Contracts



5% Increase in Premiums



Base case



5% Decrease in Premiums

Conversion Implications A Possible Scenario for Insurance Contracts

Implications

- Regardless of the model, the income statement approach is likely dead
- Emergence of profitability can be very sensitive to assumptions
- Solutions to potential acquisition cost strains need to be considered

Question

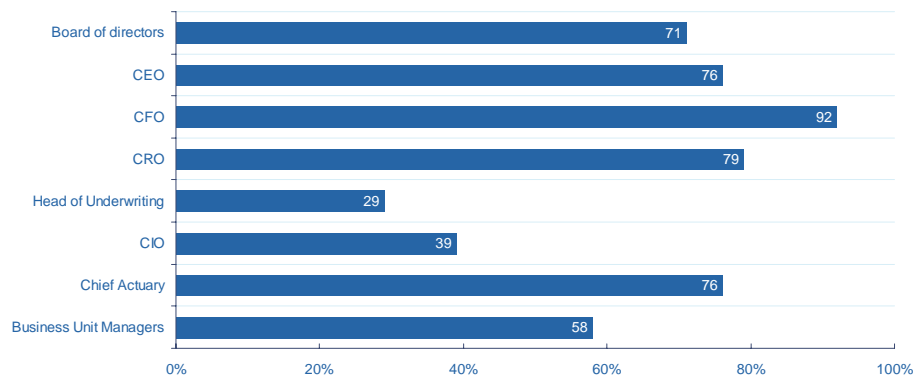
Regulatory and external disclosures within my company are:

1. Seriously considered, addressed in any process development, and well controlled.
2. Recognized as significant and important but there are occasional issues with data quality.
3. More often than we like an afterthought where broad estimates are required for completion.

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An example – Reliance on economic capital models

A high proportion of respondents to PwC's ERM survey indicated that their Board, CEO, CFO, CRO and Chief Actuary are the key users of the results of economic capital models. However, 30% of respondents indicated their Boards cannot clearly articulate the purpose or use of these models.



Source: PricewaterhouseCoopers Global ERM Survey

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Responding to the Change

Modeling and Disclosure Implications

Start early

- If not already, get involved in the process
- Identify your software and hardware needs
- Identify disclosure needs
 - Decide how to address various requirements
 - Identify data requirements and determine how to collect
- How many models will be necessary
 - One model may not satisfy all your needs
 - Different run-time constraints
 - Differences in flexibility required
- Build or enhance internal competencies
- Establishing a robust model control framework is key

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Objectives of model validation

- In any situation, it is important that management take responsibility for their models and do not treat them as fail-safe “black-boxes”.
- Model validation involves developing a deep understanding of both the strengths and limitations of a model and testing to ensure the model is operating as intended.
- A robust model validation framework, including independent validation of high risk model components, can help mitigate the increasing levels of model risk introduced within an economic capital environment.

Specifically, the aims of model validation are to determine whether a model:

- Has a clear purpose
- Uses appropriate methodology which is “fit-for-purpose”
- Reflects relevant regulation and industry practice
- Is adapted over time in response to the experience of actual outcomes
- Employs reliable data and appropriate assumptions
- Produces results that have been tested for reasonableness
- Provides relevant information in an effective way
- Has well articulated and understood limitations
- Has appropriate governance and controls

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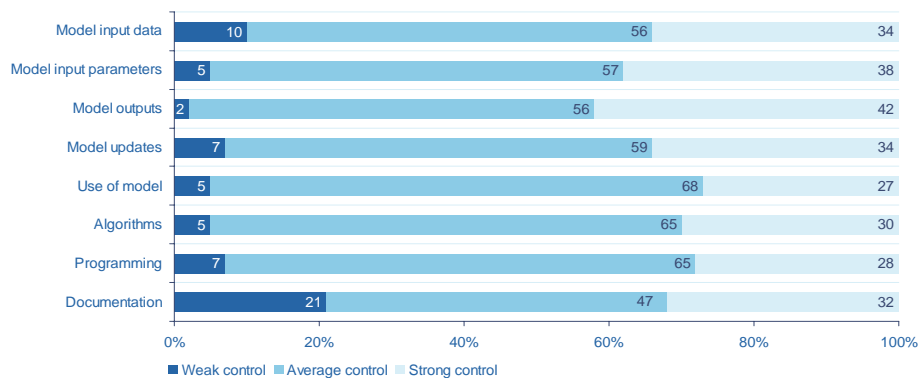
Key elements of a model validation framework

Model risk management requires the design and implementation of a robust model validation framework. Such a framework should incorporate several key elements, including:

- Establishment of a descriptive model validation policy (approved by the Board and/or senior management) requiring periodic validation of key models
- Defined roles and responsibilities around model ownership and validation
- Development of a comprehensive enterprise wide model inventory
- Independent risk assessment to identify “high risk” models (i.e. those with the greatest potential impact from an error or misinterpretation of results)
- Testing to help ensure the high-risk models are functioning as intended
- Use of independent reviewers (including external specialists where appropriate) to validate high risk models at appropriate intervals
- Documentation of a governance framework summarizing ownership of the model register and model validation program (e.g. risk or internal audit) and guidance around the model validation process (selection of models, frequency of reviews, validation approach)

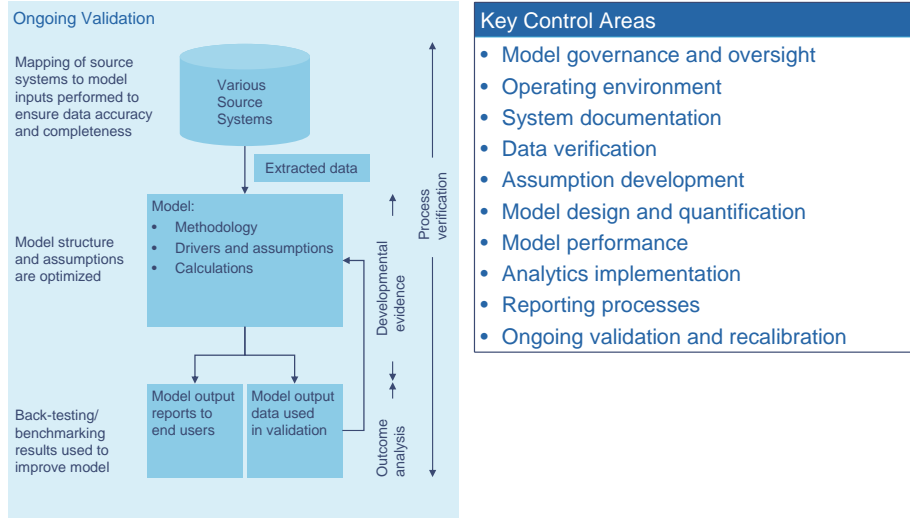
An example – ECM control environment

More than half of the participants in the most recent PwC ERM survey indicated that the overall control environment around their economic capital model was ‘weak’ or ‘average’. In particular, more than 20% of respondents felt that their model documentation was weak, and only 34% of respondents felt that the controls around the model input data were strong.



Source: PricewaterhouseCoopers Global ERM Survey

A model control framework needs to cover end-to-end activities



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Questions

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