



SOCIETY OF ACTUARIES

**International Financial Reporting for Insurers:  
IFRS and U.S. GAAP Seminar  
September 2009**

**Session 18: IFRS – Phase II Current Status  
Insurance Contracts**

[Thomas Herget](#)

# IFRS Phase 2 Insurance Contracts

R. Thomas Herget  
Hong Kong, September 2009



## Overview

- Timeline
- 2009 Accomplishments
- 2009 Yet To Go
- 2010 and Later



# Timeline

**Actuaries**  
Risk is Opportunity.\*

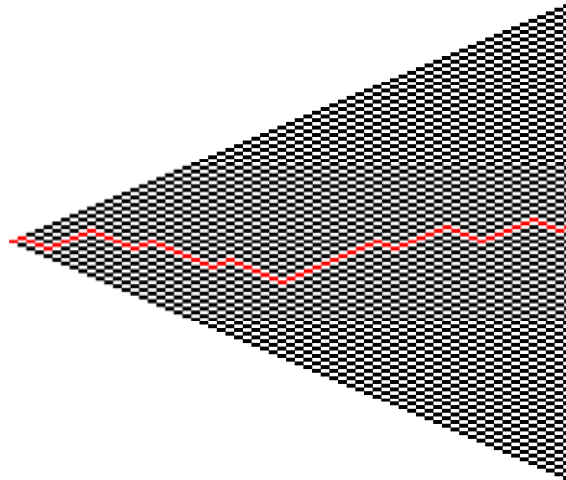
We are here



SOCIETY OF ACTUARIES

# Original Vision

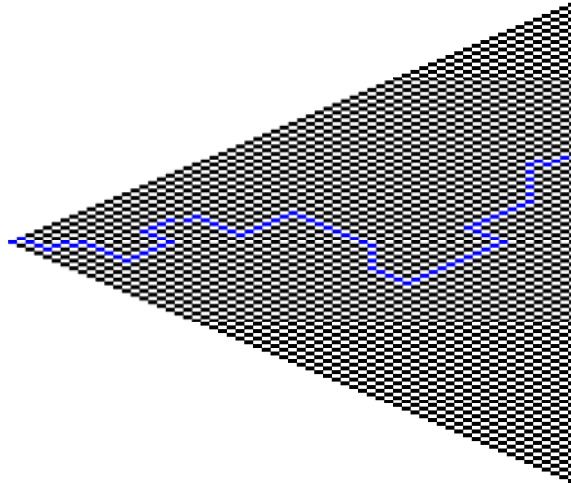
**Actuaries**  
Risk is Opportunity.\*



SOCIETY OF ACTUARIES

## Actual Trail

Actuaries  
Risk is Opportunity.®



SOCIETY OF ACTUARIES

## Timeline

Actuaries  
Risk is Opportunity.®

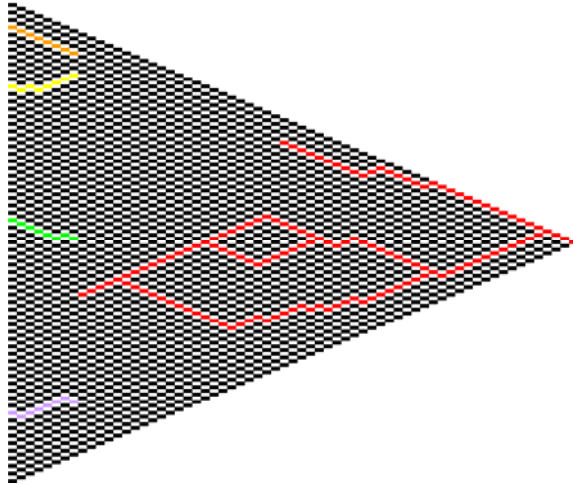
- Now through November:
  - ◆ Deliberations
  - ◆ Targeted field testing
- December:
  - ◆ Exposure Draft issued
- May 2010:
  - ◆ Comments due
- June 2011:
  - ◆ Standard issued
- 2013(?):
  - ◆ Implementation



SOCIETY OF ACTUARIES

## What's ahead

**Actuaries**  
Risk is Opportunity.®



SOCIETY OF ACTUARIES

## Other Influences

**Actuaries**  
Risk is Opportunity.®

Within IASB (and major)

- Revenue Recognition
- Revised Financial Instruments (IAS 39)
- Revised Contingent Liabilities (IAS 37)



SOCIETY OF ACTUARIES

## Other Influences

### Within IASB (and minor)

- Conceptual Framework
- Fair Value Measurements
- Financial Statement Presentation



## Other Influences

### Outside IASB

- FASB – a joint project as of October 2008



## Revenue Recognition DP

**Actuaries**  
Risk is Opportunity.®

### Ideas that fit well for insurance

- Contract as whole
- Profit when insurance protection provided
- Calibrating considerations to zero at issue (no gain at issue)



SOCIETY OF ACTUARIES

## Revenue Recognition DP (cont.)

**Actuaries**  
Risk is Opportunity.®

### Concerns for insurance:

- No mention of recurring premiums
- Do not subsequently unlock
- Do not consider acquisition costs when calibrating (loss at issue)



SOCIETY OF ACTUARIES

## Revenue Recognition IASB subsequent discussion

**Actuaries**  
Risk is Opportunity.®

- Time value of money
- Uncertain considerations



SOCIETY OF ACTUARIES

## Update of IAS 39 (Financial Instruments)

**Actuaries**  
Risk is Opportunity.®

- FASB, IASB at different speeds
- IASB 2009 ED's:
  - July – Classification and Measurement
  - October – Impairment Testing
  - December – Hedging
- Assets – either
  - Amortized Cost (AC) or
  - Fair Value (FV)



SOCIETY OF ACTUARIES

## Update of IAS 39 (Financial Instruments) (cont.)

To be AC, an asset must

- Have “loan features” – pays principal and interest
- Managed on a contractual yield basis

AC assets:

- Measured at AC in Income Statement
- Measured at FV on Balance Sheet
- Changes in FV or AC run through OCI



## Update of IAS 39 (Financial Instruments) (cont.)

- There is a Fair Value Option (FVO) that can be applied in order to avoid an accounting mismatch
- No more bifurcation and separate valuation of embedded derivatives
- Insurance products that are Financial Instruments:
  - GIC's
  - Fixed period immediate annuities
  - Funding Agreements
  - Perhaps some deferred annuities



## Revision of IAS 37 (Contingent Liabilities)

**Actuaries**  
Risk is Opportunity.®

- Work already in progress
- Covers non-contractual liabilities, such as litigation and self-insurance
- Measurement objective – what an entity would rationally pay to be relieved of the present obligation
- Does contemplate a market transaction, but from seller's, not buyer's, perspective



SOCIETY OF ACTUARIES

## 2009 Accomplishments

**Actuaries**  
Risk is Opportunity.®

- Board Meetings
- IWG Meetings



SOCIETY OF ACTUARIES

## Surviving Principles

**Actuaries**  
Risk is Opportunity.®

- 3 building blocks
- Use all available information
- No gain at issue



SOCIETY OF ACTUARIES

## Other Major 2009 Accomplishments

**Actuaries**  
Risk is Opportunity.®

- Narrowed down Measurement Method
- Time value of money –should be reflected wherever material



SOCIETY OF ACTUARIES

## Other Major 2009 Accomplishments

### Deliberation over measurement method

- Exit Value
- Modified Exit Value
- Fulfillment Value
- Modified IAS 37 Value

Note – exit value relies on market participants



## Distinctions Between Methods

- Fulfillment Value  
Expected Present Value of the future cash flows that will occur when the entity fulfills the insurance obligation with the policyholder over time. Excludes concept of own credit risk.
- Modified IAS 37 Value  
The amount an entity would rationally pay to be relieved of the present obligation at the reporting date
  - ◆ Presumably the largest amount
  - ◆ A work in progress



## Distinctions Between Methods (cont.) – Fulfillment Value



## Distinctions Between Methods (cont.)

	Measurement approach based on updated IAS 37 model (new candidate 2)	Current fulfillment value (previously candidate 4)
<b>Definition</b>	The amount the entity would rationally pay at the end of the reporting period to be relieved of the present obligation  Plus a "residual margin", based on the day one difference.	The expected present value of the cost of fulfilling the obligation to the policyholder over time, <b>excluding</b> the cost of bearing risk.  Plus a "composite margin", based on the day one difference.
<b>Scope</b>	All insurance liabilities.	Same
<b>Building blocks for the measurement approach</b>	<ul style="list-style-type: none"> <li>▪ Current estimate of the expected (i.e. probability weighted) present value of future cash flows</li> <li>▪ Time value of money</li> <li>▪ An explicit margin</li> </ul>	Same



## Distinctions Between Methods (cont.)

	Measurement approach based on updated IAS 37 model (new candidate 2)	Current fulfillment value (previously candidate 4)
Inputs for which observable market information is available (financial market variables)	Consistent with observed market prices.	Same.
Other inputs	The entity's estimate of the cash flows it would incur in fulfilling the liability.	Same.
Cash flows that arise from the characteristics of the portfolio (portfolio-specific)	Included.	Included.
Cash flows that arise from the characteristics of the entity (entity-specific)	Included.	Included.
Subsequent measurement of cash flows	Current estimates for all variables.	Same.
Changes in estimates of cash flows	Effect included in profit or loss.	Same.



## Distinctions Between Methods (cont.)

	Measurement approach based on updated IAS 37 model (new candidate 2)	Current fulfillment value (previously candidate 4)
Time value of money	Consistent with observable current market prices, capturing the characteristics of the liability.	Same.
Components of the margin	<ul style="list-style-type: none"> <li>• Risk margin</li> <li>• Service margin</li> <li>• Residual margin (calibrated to premium)</li> </ul>	<ul style="list-style-type: none"> <li>• Composite margin</li> </ul>
Risk margin	The amount the entity would pay to be relieved of risk.	No explicit risk margin. Implicit in the "composite margin".
Risk margin – initial measurement	Estimates the amount the entity would pay to be relieved of risk.	Uses premium as basis for determining the initial composite margin.
Risk margin – subsequent measurement	Remeasured at each reporting date.	Not applicable. (Implicit release as the composite margin runs off)
Service margin	The amount required by the contractor for other services. [Often to be estimated by the amount the entity requires for other services].	No explicit service margin. Implicit in the "composite margin".
Service margin – subsequent measurement	Remeasured at each reporting dates.	Not applicable. (Implicit release as the composite margin runs off)



## Distinctions Between Methods (cont.)

	Measurement approach based on updated IAS 37 model (new candidate 2)	Current fulfillment value (previously candidate 4)
<b>Day one difference (the difference between the actual margin and the required margin)</b>	No profit at inception; "residual margin" recognized as a separate item (presumably within the insurance liabilities).	No profit at inception; "composite margin" recognized as a separate item (presumably within the insurance liabilities).
<b>Liability adequacy test</b>	Not applicable.	Not applicable.
<b>Acquisition costs</b>	Expensed when incurred.	Same.
<b>Part of the premium expected to recover incremental acquisition costs</b>	IASB: Recognized as revenue on day one. FASB: Included in the residual margin	IASB: Recognized as revenue on day one. FASB: Included in the composite margin
<b>Own credit risk</b>	To be discussed (arguably implicit in residual margin at inception).	To be discussed (arguably implicit in composite margin at inception).



## And the winner...



## Measurement Model

- Revenue Recognition has been elevated to be a method to be considered



## Other Items needed before Exposure Draft

- Risk Margins
- Discount Rate
- Acquisition Expenses
- Other



## Risk Margins

- Quantile
  - Percentile
  - Confidence levels
  - CTE
  - Tail VAR
- Cost of Capital
- Explicit Assumptions
- Discount-rate related



## Risk Margins (cont.)

### Variability in Size between Methods

Risk margin approach	Product A Simple Life	Product B Motor	Product C Risky Liability
Confidence level			
65%	1.1%	4.4%	7.1%
75%	2.0	8.5	15.7
90%	3.9	17.6	35.7
40% CTE	1.9	8.4	16.2
Cost of Capital (99.5% VaR)	4.1	4.5	36.8
Implicit (0% discount)	44.6	7.7	23.4
Discount 2% discount rate (4% risk free – 2 % risk adjust)	19.0	3.7	10.7

Risk margin expressed as % of underlying liability



## Discount Rate

- New for non-life
- Independent of assets held, unless the obligation is a direct function of a set of assets
- Generally, a risk-free rate (government bond or swap rates)
- May include a liquidity adjustment to avoid initial loss on heavy savings contracts



## Acquisition Costs

- IASB (Insurance Contracts) – acknowledge incremental acquisition costs
- IASB (Revenue Recognition) – expense them all
- FASB – expense them all

Therefore, losses at issue



## Other Issues to be Addressed

- Policyholder dividends
- Universal Life
- Renewal premium
- Unit of Account
- Disclosures
- Need for liability adequacy test
- Use of OCI
- Use of own credit risk
- Unit-linked (Are separate funds part of the reporting entity?)
- Definition of insurance
- Presentation (unbundling)



## Definition of Insurance

- from IFRS 4
- a contract under which one party accepts significant insurance risk from another party by agreeing to compensate the policyholder if a specified uncertain future event adversely affects the policyholder.
- an investment contract is not directly defined in IFRS 4
- the term "investment contract" refers to a financial instrument that does not meet the definition of an insurance contract



## Unbundling

Unbundling means the insurer would:

- treat the insurance component as an insurance contract
- treat the deposit component as a financial liability or financial asset (under IAS 39)



## 2009 Yet To Go

- Field Testing
- Board Meetings
- Issuance of Exposure Draft



## IASB Field Testing

**Actuaries**  
Risk is Opportunity.®

- Run by IASB staff
- Targeted on certain issues
- Recruited volunteer companies around the world
- August through November 2009
- Needs definition, scope, education, instructions, vetting



SOCIETY OF ACTUARIES

## Board Meetings

**Actuaries**  
Risk is Opportunity.®

- Each month September  
October  
November  
December
- Vote on and issue ED in December 2009



SOCIETY OF ACTUARIES

## 2010 and later

**Actuaries**  
Risk is Opportunity.®



SOCIETY OF ACTUARIES

## January through May 2010

**Actuaries**  
Risk is Opportunity.®

- Users evaluate ED
- Prepare and submit comments



SOCIETY OF ACTUARIES

## Society of Actuaries Research Project

**Actuaries**  
Risk is Opportunity.®

- A repeat of 2008 report
- Already underway
- Actuarial Task Forces, Project Manager, Project Oversight Group
- Purpose
  - To educate interested parties
  - To help members formulate their own opinions



SOCIETY OF ACTUARIES

## Society of Actuaries Research Project (cont.)

**Actuaries**  
Risk is Opportunity.®

- New business only
- Many lines of business
- Today's products
- April 2009



SOCIETY OF ACTUARIES

## May 2010 through June 2011

**Actuaries**  
Risk is Opportunity.®

- Staff and Board evaluate comments
- Continue Field Tests
- Deliberate and Draft
- Issue Standard (June 2011)



SOCIETY OF ACTUARIES

## Implementation

**Actuaries**  
Risk is Opportunity.®

- Usually 2-3 years allowed
- Preparers submit parallel presentations
- Financials usually show 2 prior years of earnings
- Implies you need 3 prior balance sheets
- SEC roadmap – convert from US GAAP to IFRS by December 31, 2015



SOCIETY OF ACTUARIES

So where will we end up?



This Path?



## Maybe this path?

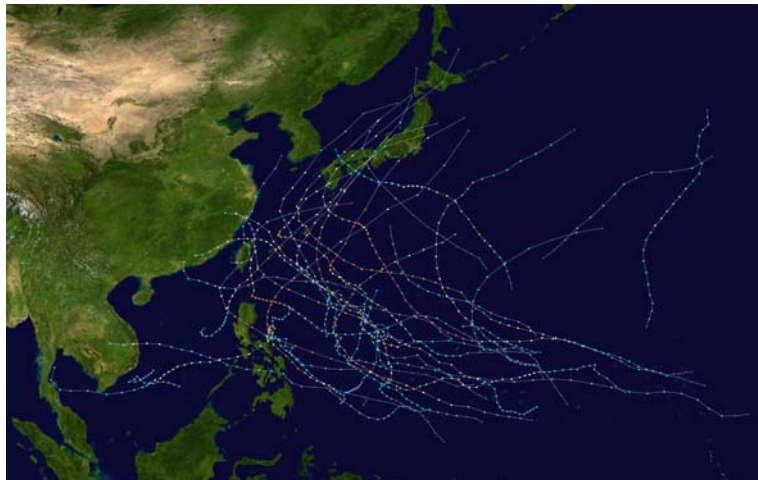
**Actuaries**  
Risk is Opportunity.®



SOCIETY OF ACTUARIES

## Range of possibilities

**Actuaries**  
Risk is Opportunity.®



SOCIETY OF ACTUARIES

# Questions & Answers

Tom Herget  
herg411@aol.com

