



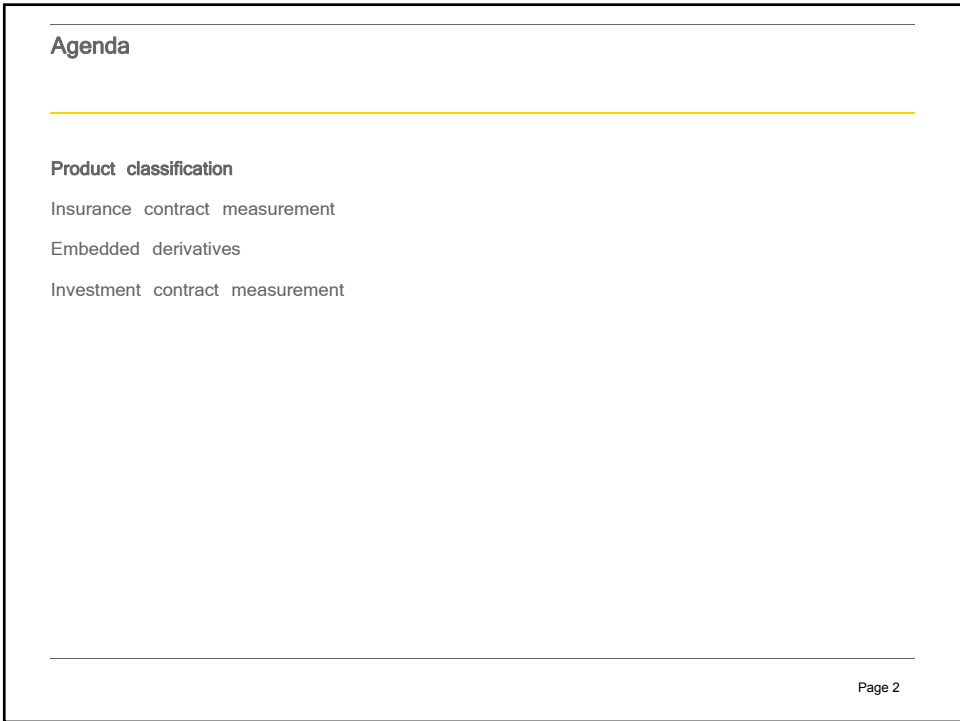
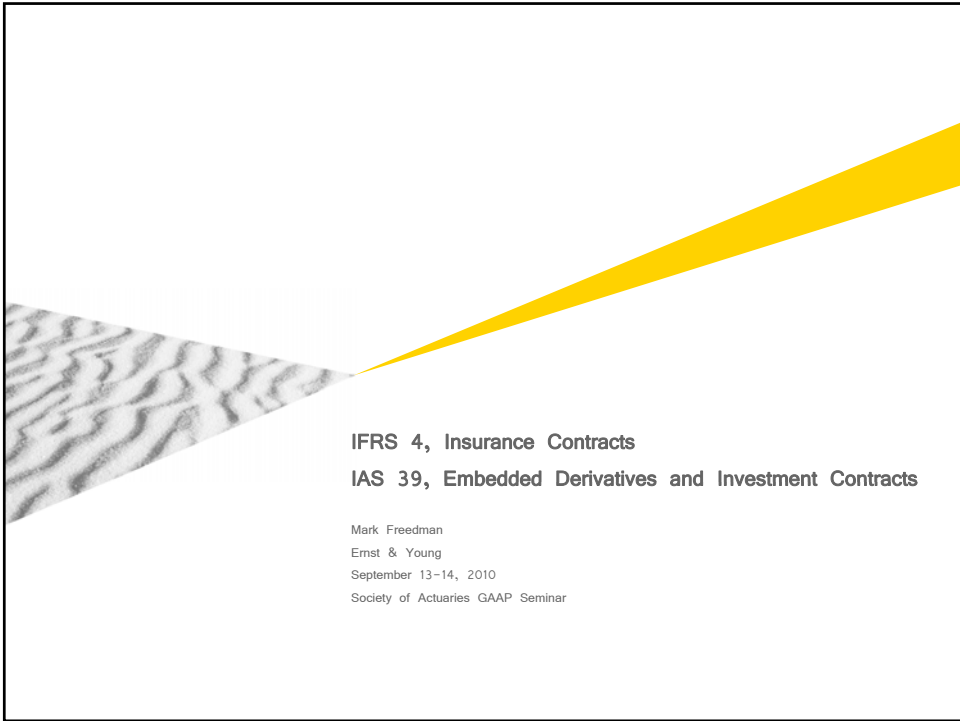
SOCIETY OF ACTUARIES

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IAS 4 and 39

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Significant insurance risk

- ▶ ‘Significant if, and only if, an insured event could cause an insurer to pay significant additional benefits in any scenario, excluding scenarios that lack commercial substance.’

IFRS 4, Appendix B22 - B28

Examples of insurance and financial risks

Insurance - significant insurance risk

- ▶ Most property/casualty insurance contracts
- ▶ Term assurance and pure endowment assurance
- ▶ Life contingent annuities
- ▶ Whole life contracts
- ▶ Variable annuities with significant death benefit
- ▶ Fixed or variable (unit-linked) with significant life contingent annuity guarantee
- ▶ Most reinsurance contracts
- ▶ Financial guarantees of specific third party debts

Examples of insurance and financial risks

Investment - insignificant insurance risk

- ▶ Reinsurance contracts that do not transfer any significant reinsurance risks
- ▶ Short-term endowment contracts
- ▶ Variable or unit-linked without significant death benefit (e.g. 101% value of units)
- ▶ Pension accumulation contracts without significant death benefits
- ▶ Contract exposed to lapse or expense risk only
- ▶ Financial derivatives
- ▶ Deferred annuity with no life contingency or insurance guarantee
- ▶ Guaranteed investment contract or bond
- ▶ Product warranties issued directly by manufacturer
- ▶ Reinsurance catastrophe bonds with triggers not directly related to the issuer's losses
- ▶ Financial guarantees linked to credit index

Definition of discretionary participating features

- ▶ Contractual right to additional payments as a supplement to guaranteed minimum payments
 - ▶ Likely to be a significant portion of the total contractual payments.
 - ▶ Amount or timing is contractually at the discretion of the issuer
 - ▶ Contractually based on
 - ▶ Performance of a specified pool of contracts or a specified type of contract
 - ▶ Realised and / or unrealised investment returns on a specified pool of assets held by the issuer
 - ▶ Profit or loss of the company, fund or other entity that issues the contract

IFRS 4. Appendix A

Agenda

Product classification

Insurance contract measurement

Embedded derivatives

Investment contract measurement

Insurance contract measurement

During Phase I, existing accounting policies apply with certain modifications

- ▶ **Prohibited** – certain accounting policies are prohibited as they do not meet the IFRS framework
- ▶ **Mandated** – certain accounting policies must be implemented if they are not already in the existing accounting policies
- ▶ **Allowed to continue, but not start** – certain accounting policies that do not meet the IFRS framework can continue, but cannot be implemented.
- ▶ **Can be started** – certain accounting policies can be introduced.

Prohibited policies

- ▶ The following accounting policies are **prohibited**
 - ▶ Amounts for catastrophe provisions for potential claims beyond the term of existing contracts
 - ▶ Amounts for claims equalisation provisions
 - ▶ Offsetting of reinsurance assets and direct liabilities

IFRS 4.14

This is no different from US GAAP.

Mandated policies

- ▶ The following accounting policies are **mandated** if they are not already present
 - ▶ Liability adequacy testing
 - ▶ Impairment of reinsurance assets

IFRS 4.14

Mandated policies

Liability adequacy test

- ▶ Current liability adequacy test applies if
 - ▶ Test at each reporting date using current estimates of future cash flows (including guarantees and options)
 - ▶ If these are greater than current liability, liability is increased and deficiency flows through profit and loss
- ▶ Otherwise → Liability Adequacy Test under IAS 37 *Provisions, Contingent Assets and Contingent Liabilities*
 - ▶ Fair value like calculations

IFRS 4.15-19

US companies may have to change loss recognition policies for deferred annuities that are insurance contracts under IFRS but investment contracts under US GAAP to avoid having them fall under IAS 37.

Policies that may continue

- ▶ The following accounting policies **may continue** but companies may not switch to these where they are not already applied
 - ▶ Using an undiscounted liability basis
 - ▶ Measuring future investment management fees at a value greater than the acquisition costs
 - ▶ Using non-uniform accounting policies for subsidiaries
 - ▶ Using excessive prudence in the valuation of liabilities

IFRS 4.25

Policies that may be started

- ▶ The following accounting policies **can be started** subject to certain restrictions
 - ▶ Use of current market discount rates and use of other current variables for selected liabilities
 - ▶ Use of shadow accounting
 - ▶ Use of asset based discount rates
 - ▶ Only if part of a comprehensive accounting policy which makes financial statements more relevant and reliable

Measurement of discretionary participation features

- ▶ Investment contracts with discretionary participation features are measured under IFRS 4
- ▶ Investment contracts without discretionary participation features are measured under IAS 39
 - ▶ Investment management services separated and measured under IAS 18

IFRS 4.2

Insurance contracts with discretionary participating features

- ▶ Distributable surplus must be classified as liability or equity
 - ▶ Disclosure of movement in statement of equity if any distributable surplus classified as equity
 - ▶ Distributable surplus classified as liability taken into account in liability adequacy test

IFRS 4.34

This means, for example, that a PDO associated with a closed block of contracts from a demutualized company could be reported as a component of equity rather than as a liability. Few insurers in Europe took the alternative to classify distributable surplus as equity and it is doubtful that US insurers will find this attractive.

Changes in IFRS 4 accounting policies

An insurer may change its accounting policies for insurance contracts if, and only if, the change makes the financial statements:

- ▶ more relevant and no less reliable, or
- ▶ more reliable and no less relevant

An insurer shall judge relevance and reliability by the criteria in IAS 8.

- ▶ Relevance – economic decision-making needs of users
- ▶ Reliability
 - ▶ represent faithfully the financial positions, financial performance and cash flows of the entity
 - ▶ reflect the economic substance of transactions, other events and conditions, and not merely the legal form
 - ▶ are neutral, ie free from bias
 - ▶ are prudent; and
 - ▶ are complete in all material respect

Agenda

Product classification

Insurance contract measurement

Embedded derivatives

Investment contract measurement

Measurement of embedded derivatives

- ▶ Certain embedded derivatives have to be separated from insurance contracts, investment contracts with DPF and investment contracts without DPF measured at amortised cost
- ▶ If separated, measured under IAS 39:
 - ▶ Fair value
 - ▶ Changes in fair value through profit and loss

IFRS 4.7-9

Note that fair value is measured according to IAS 39, not FAS 157.

Meets definition of insurance contract

If a derivative meets the IFRS 4 definition of an insurance contract, then it does not need to be separated. Examples include:

- Guaranteed minimum death benefit
- Guaranteed annuity option

This exemption also applies if the derivative meets the definition of DPF.

A guaranteed minimum maturity benefit may be an insurance feature. It is insurance if it is a significant benefit on surviving the contract that is not provided if the contractholder dies before the contract matures.

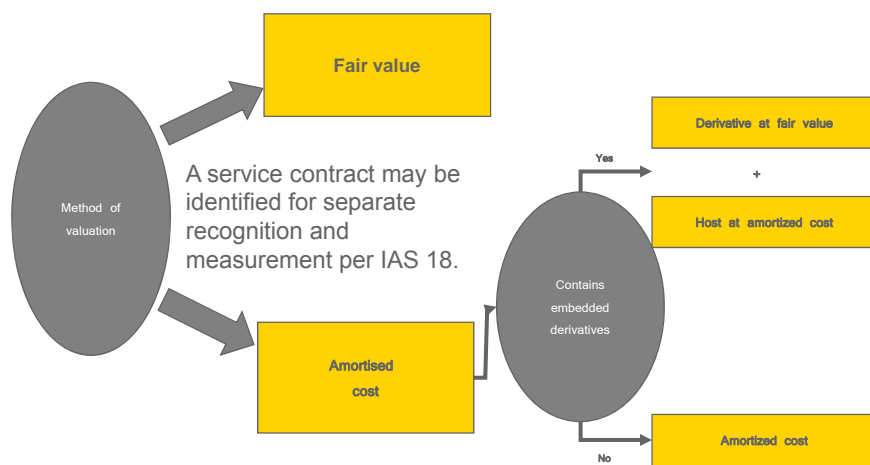
Embedded derivatives –other considerations

- ▶ Note that the definition of a derivative in IAS 39 does not require that they can be net settled.
- ▶ SFAS 133 allows grandfathering, while IAS 39 does not
- ▶ The host contract is measured by the insurer's existing accounting policy. This may be difficult to do if the existing accounting policy does not require separation of embedded derivatives. For example, if an equity indexed feature is separated from a universal life product, what is the host and how is it measured?

Agenda

Product classification
Insurance contract measurement
Embedded derivatives
Investment contract measurement

Measurement options under IAS 39



Transaction costs

Transaction costs become important because they affect the starting point for determining the amortised costs basis of contracts and because they can be deferred when separating the servicing component from investment contracts. They are costs that are

- ▶ **“Incremental”**: excludes allocated costs or overhead
- ▶ **“Directly Attributable”**: must be acquisition related

IAS 18A14(c) iii , which is consistent with IAS 39

The definition is more restrictive than US GAAP for deferrable expenses.

Amortised cost definition

“... the amount at which the financial liability is measured at initial recognition minus principal repayments, plus or minus the cumulative amortisation using the **effective interest method** of any difference between that **initial amount** and the **maturity amount**”

IAS 39.9 paraphrased

As compared to US GAAP, which requires catch-up approach, retrospective method or prospective method of calculating the interest for amortized cost-based assets, depending on the type of instrument.

Effective interest method

- ▶ The effective interest method gives a liability where the initial amount is grown by the effective interest rate to the maturity period.
- ▶ The effective interest rate exactly discounts the **estimated** future cash payments or receipts through maturity to the initial amount.
 - ▶ If cash flows cannot be reliably measured – contractual cash flows are used

Initial amount

- ▶ The initial amount is made up of:
 - ▶ Fair value at issue of initial premium
 - Minus
 - ▶ Transaction costs
- ▶ Implicitly creates deferred acquisition cost

Fair value constraints

- ▶ Demand deposit floor (DDF)
 - ▶ The minimum fair value liability is the amount payable on demand – surrender value
 - ▶ Limits liability to a minimum of zero

- ▶ Calibration at issue – when inputs are not market based
 - ▶ Best evidence of fair value at inception is the premium paid
 - ▶ Calibration required – ongoing calibration is unclear
 - ▶ No gain or loss at issue – except for initial expenses due to DDF

Example of use of fair value – variable annuity

- ▶ Fair value has its greatest use for investment contracts that are variable or unit linked. These are contracts without guaranteed annuity options, GMDBs or other features that would cause them to be classified as insurance. Such contracts are common in Europe, but less common in North America.
- ▶ Premiums are used to purchase units in funds, generally with a high proportion being equity funds. The value of the contract is the value of the units, which are linked to the fair value of the assets in the funds.
- ▶ Fees are charged by deduction from the contracts value and there may be surrender charges.
- ▶ The IFRS accounting treats these as a financial instrument and a separable service contract for the investment management.
- ▶ The service contract comprises the fees (less the imputed fee related to separated guarantees and options, if any) and surrender charges and all transaction costs are assumed to relate to this.

Service contract

Separate servicing elements from financial liability

Financial liability	Servicing elements
Premium invested	Fees (b/o spread, IMF etc.)
	Transaction costs
	Maintenance Fees and Expenses
Unit-fund paid out	Surrender penalties

Service contract – revenue recognition

Revenue is recognized in relation to services provided

- ▶ The pattern of services is determined
- ▶ Front end fees are deferred and earned over the life of the contracts in relation to the pattern of services unless it can be established that significant services are provided at inception of the contracts
- ▶ “For practical purposes, when services are performed by an indeterminate number of acts over a specified period of time, revenue is recognized on a straight-line basis over the specified period unless there is evidence that some other method better represents the stage of completion.” (IAS 18.25)
- ▶ The pattern is influenced by asset growth, lapses and the nature of fees; i.e., policy related or fund based.
- ▶ Changes are reflected prospectively; i.e., without cumulative catch up
- ▶ Time value of money is not considered; i.e., there is no discounting
- ▶ Recurring fees and surrender charges are generally recognized as revenue in the period received unless this distorts the revenue recognition as compared to the pattern of services.

Service contract – transaction costs

▶ Transaction costs are deferred and amortised in relation to revenue. Consistent with the approach for front-end fees,

- ▶ Amortization is without discounting
- ▶ There is no DAC-style unlocking effect, changes in expected revenues result in prospective changes in amortization

As compared to US GAAP, the deferrals are less but the amortization may be slower.

Financial liability

- ▶ Fair value of units plus the fair value of any options and guarantees, e.g., guaranteed accumulation values. The presumption is that the fair value of units is the market consistent measure of the future cash flows
- ▶ The unit value are based on the fair value of underlying assets
- ▶ The fair value of guarantees and options is a part of the liability
 - ▶ Market consistent valuation required
 - ▶ Calibration at issue to imputed fees charged