IAIS presentation to joint IASB/FASB meeting

London, 18 February 2010

Rob Esson, Chair, Insurance Contracts Subcommittee

Agenda

Topics we will address today

- Comprehensive approach reflective of the business of insurance
- Key issues with approach so far
  - Remeasurement of residual margins
  - Acquisition costs and residual/composite margin
  - Contract boundaries (reminder from last presentation)
  - Discretionary participation features

Comprehensive approach

- A core concern lies with the Boards' approach to considering issues on theoretical grounds on an individual basis. While this is a necessary step, we believe that the Boards should also consider the impact of the tentative decisions made on the totality of financial reporting by insurers.

Comprehensive approach

- The Boards should consider the business structure for insurers and determine whether, in totality, the tentative decisions made so far would lead to useful information for users of the financial reports of insurers.

Comprehensive approach

- Where accounting is not reflective of the business of insurance, it creates inappropriate incentives for management
- Asset/Liability matching is key part of the business model of an insurer
- Where volatility on one side of the balance sheet occurs and economically that volatility should be reflected on the other side – the accounting should reflect this
- If the accounting creates a <u>mismatch</u> where volatility on one side of an insurer's balance sheet is reflected in the performance results – this is probably not useful to users of financial statements

Comprehensive approach: a key principle

<u>UNBIASED</u>, PROBABILITY-WEIGHTED CASH FLOWS ANSWER MANY PROBLEMS IN INSURANCE CONTRACTS PROJECT

- Cash flows include immediate and future cash flows, both negative and positive, within the boundaries of the contract.

Boards' Current Tentative Approach – residual margin remeasurement

- Day one – the approach calibrates margins to premium & creates a residual margin (= deferred profit)
- Day 2 or day 200 – assume new estimates of expected cash flows or the risk margin increase
- With no residual margin remeasurement – a loss would be recorded
- At the same time – the residual margin remains a deferred profit: the IAIS believes this is not appropriate, certainly for non-financial changes in estimates e.g. mortality
- Financial changes (e.g. interest/discount rates) may need to be reflected in profit and loss for asset/liability matching and to reflect the business model

Acquisition costs and margins

- Key principle is no profit on inception – much IAIS support
- Acquisition costs to be expensed – IAIS supports no deferred acquisition cost
- If no allowance for the acquisition cost cash flow is recognised in the insurance obligations and in the income statement, there will always be a loss on inception relating to acquisition costs
- Residual margin or composite margin is to be calibrated to premium – element of deferred profit
- Problematic recording of a loss on profitable business when a deferred profit is locked away in the margin

Contract Boundaries
Issues for long-term policies (reminder)

- Cash outflows for death or maturity do not occur absent prior premium cash flows
- Cannot evaluate one without the other
- This is not the same as netting – simple corollary of decision to use expected cash flow model
- Continuation of long-term contract <u>not</u> a renewal option – cancellation option
- Difference in value between run-off portfolio and continuing business portfolio – possible renewal business but this is akin to goodwill
- Cash flow scenarios – lapses/surrenders, maturity, death

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Contract boundaries: IAIS principles (reminder)

- The relevant cash flows are bounded by the earlier of the following, if they exist:
  - the contractual termination date as extended by any unilateral option available to the policyholder, or
  - the insurer having a unilateral right to cancel or freely re-underwrite the policy, or
  - both the insurer and policyholder being jointly involved in making a bilateral decision regarding continuation of the policy.
- Measurement of cash flows – use probability weighting

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Discretionary participation features

- Policies are priced in the expectation of payment of policyholder dividends
- IAIS believes a more sensible and economic result arises if the probability weighted cash flows are not constrained (or biased) to only those cash flows scenarios that can be compelled
- Include the expected cash flows in the probability weighting (and therefore scenarios)
- Area of difference between Boards

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International Association of Insurance Supervisors (IAIS)

Questions and Answers

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