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OCI – a transparent and feasible solution for insurance accounting

Burkhard Keese
Executive Vice President, Allianz SE
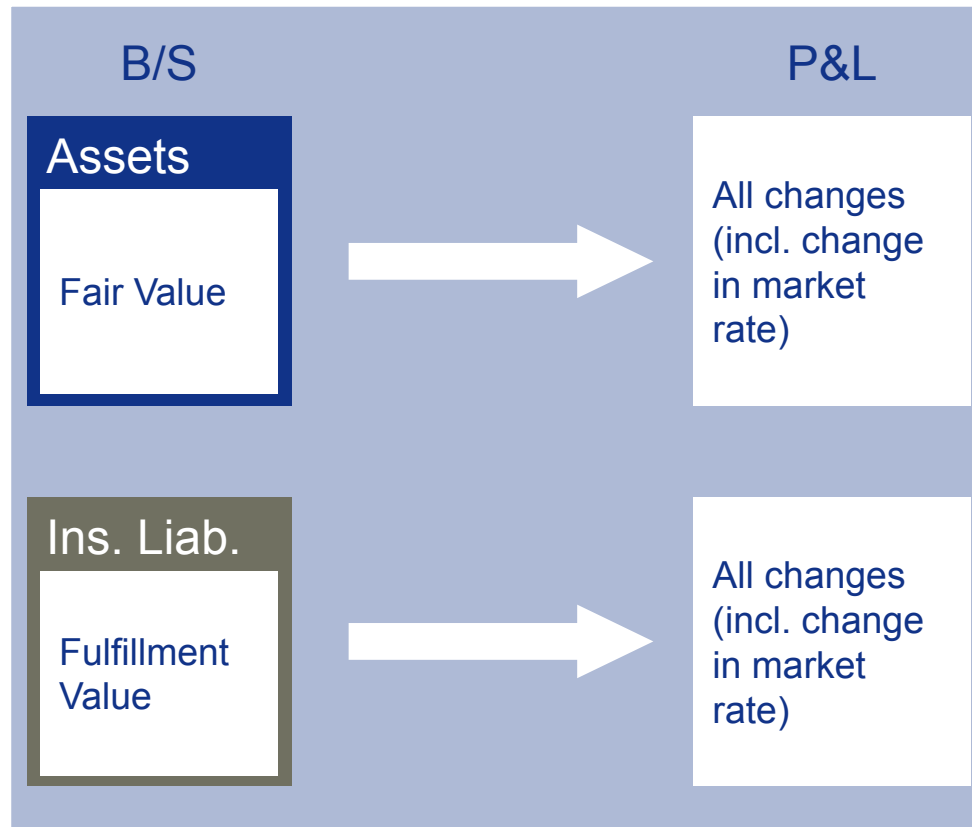*October 24, 2011*

Agenda

1 The issue and alternative solutions

2 Key considerations

3 Insurance liability adequacy

4 Backup

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Objectives of the HUB global insurance group

- Recommend a technical solution which can be supported by the overwhelming majority of the international insurance industry

- Meet the criteria of the Conceptual Framework that information should be relevant, reliable and decision useful as well as being transparent, understandable and comparable supporting the needs of investors, regulators and other stakeholders

- Support standard-setters in developing a single, robust high-quality global standard
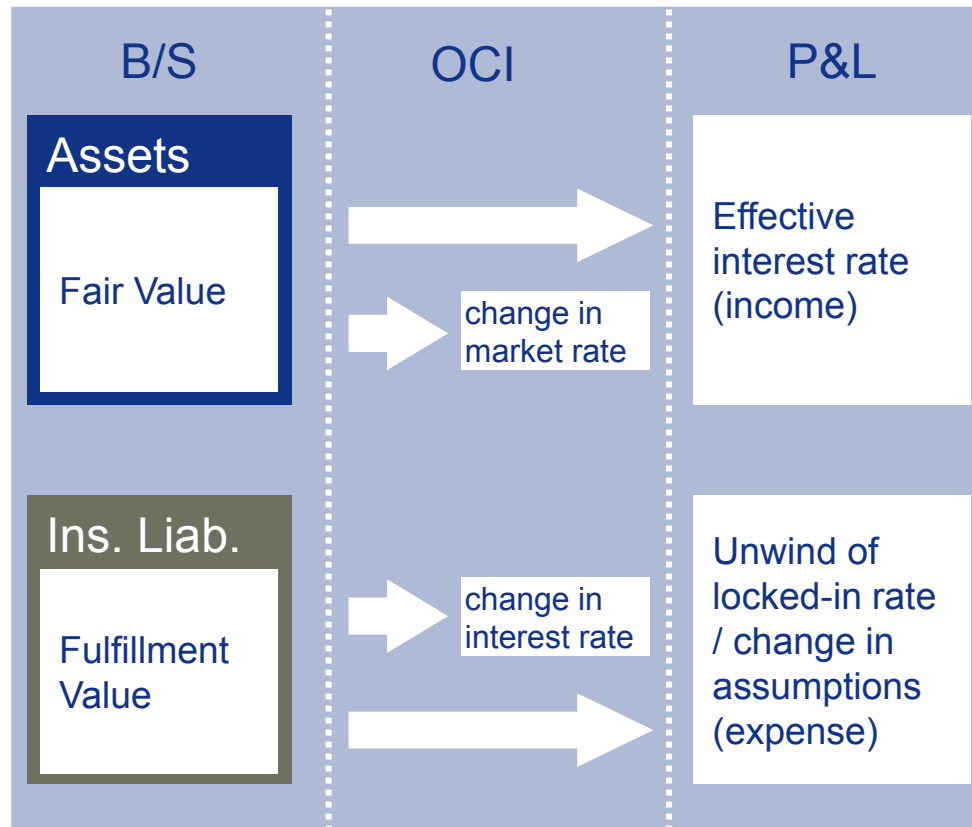
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Limited use of current-current through P&L measurement model

B/S		P&L
Assets Fair Value	→	All changes (incl. change in market rate)
Ins. Liab. Fulfillment Value	→	All changes (incl. change in market rate)

- No differentiation between unrealized and realized losses (e.g. credit spread widening vs. default)

- Short term market movements should be excluded from P&L as they do not reflect long term business model

- Current-current measurement model works for contracts where policyholders participate in unrealized market movements and should therefore be optional (Fair Value Option)

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Solution: 'current-current through OCI approach'

Today's focus

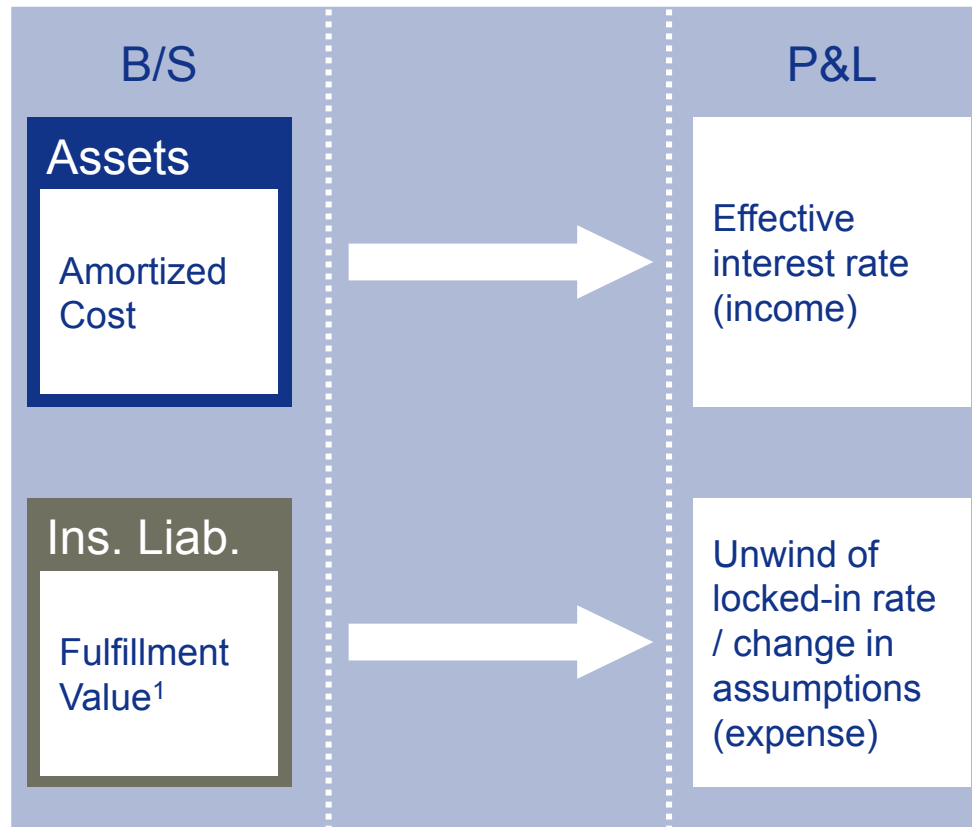| B/S	OCI	P&L
Assets / Fair Value	→ / change in market rate	Effective interest rate (income)
Ins. Liab. / Fulfillment Value	→ / change in interest rate	Unwind of locked-in rate / change in assumptions (expense)

- Meets P&L objective to present business performance without impact from non-relevant market movements

- Provides better information than current-current through P&L

- Transparent balance sheet

- Consensus of industry, users and regulators as demonstrated in the IWG meeting on 16 May 2011

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Alternative: 'locked-in approach'

B/S		P&L
Assets Amortized Cost	→	Effective interest rate (income)
Ins. Liab. Fulfillment Value[1]	→	Unwind of locked-in rate / change in assumptions (expense)

- Meets P&L objective to present business performance without impact from non-relevant market movements

- Provides level playing field with banks

- Enables insurers to use amortized cost category in IFRS 9

- Current values disclosed in notes

- This approach is an alternative to the 'current-current through OCI approach'

1) All assumptions current; discount rate locked-in

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Assets backing insurance liabilities should fall under OCI category

Question 1: Which assets should be eligible for the OCI category?

Issue	- Assets backing insurance business can be financial instruments, real estate and other asset classes - In most G20 jurisdictions, policyholders participate in a pool of all types of assets; no one-to-one assignment of specific assets to policyholders
Solution	- All assets associated with the insurance business should be eligible under the OCI category - The current definition of "Available-for-Sale" assets of IAS 39 could serve as a second best solution (potentially not all assets backing insurance liabilities could be considered) - Exception: Unit-Linked and Variable Contracts

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Straight forward impairment rules for assets backing insurance liabilities

Question 2: What are the appropriate impairment rules for assets backing insurance liabilities?

Issue	▪ The impairment rules of IAS 39 were challenged because they are/were interpreted inconsistently
Solution	▪ Current rules for bonds are acceptable and we appreciate the opportunity to support the ongoing IASB project on impairment ▪ We would also like to support you in the development of impairment rules for equities

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The consequence of the OCI solution is asset recycling

Question 3: Why should recycling be permitted?

Issue	▪ Users of financial statements do not see the so-called "recycling" as an issue since it is transparently presented ▪ Recycling exists for all assets, like real estate, inventory, etc.

Solution	▪ Can be made even further transparent with enhancement of disclosures:
	  - Roll forward table of the OCI component within the equity
	  - Clear disclosure and analysis of realized gains and losses

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OCI for liabilities – Mechanics

Question 4: How does the OCI proposal work mechanically?

Solution	
	▪ While the ED requires the P&L include all changes in insurance liabilities, under the current-current through OCI approach an insurer would record changes in the market value of assets and changes in the liability due to interest rate movements in OCI
	▪ The discount rate would be locked at inception and the difference between the locked discount rate and the current interest rate would be recorded in OCI

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OCI is only used as temporary storage

Question 5: How does recycling work for liabilities?

Issue	▪ It must be ensured that all positions are only temporarily recognized in OCI
Solution	▪ After fulfillment or portfolio transfer of a liability the OCI position disappears since there is by definition no difference between the liability with the locked-in rate and the liability discounted by current rates ▪ In case of loss recognition, unrealized losses are transferred from OCI to the P&L immediately (details see slide 16)
Conclusion	▪ No recycling mechanism needed

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Options and guarantees measured consistently with insurance liabilities
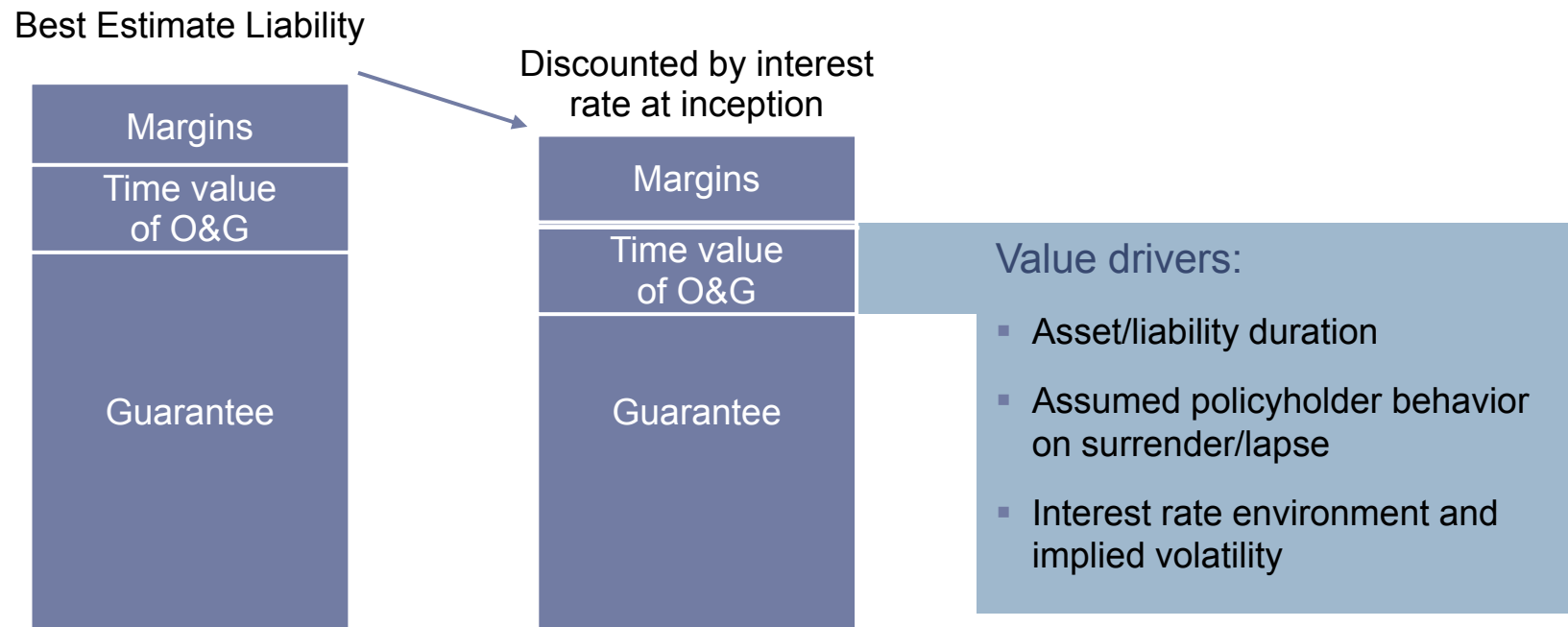
Question 6: What are options and guarantees (O&G)?

Issue	- O&G are clearly and closely related to the insurance contract and are not bifurcated and accounted for separately under IAS 39 and IFRS 9, respectively. - Most O&G included within the cash flows of insurance liabilities materially consist of one or more of the following features: **guaranteed interest rates** and **minimum maturity values, guaranteed minimum surrender values**, annuity **conversion options**, and **extension options**

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Options and guarantees are heavily impacted by market interest rate movements

Best Estimate Liability

Discounted by interest rate at inception

Margins
Time value of O&G
Guarantee

Margins
Time value of O&G
Guarantee

Value drivers:

- Asset/liability duration

- Assumed policyholder behavior on surrender/lapse

- Interest rate environment and implied volatility

Consequence: All changes of options and guarantees due to change in interest rate movements should go through OCI

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Real life example of how 'current-current through OCI' approach works

Liability assumptions*:

► 20 year insurance contract

► 2% minimum guarantee

► 3% interest rate at t=0

► 2.75% interest rate at t=1

Asset assumptions:

► 100% fixed income assets (zero coupon bonds) with a 3% interest rate at inception

► 10 year duration (fixed income assets)

► 2.75% interest rate at t=1

► Duration mismatch	20 year insurance contract backed by only 10 year fixed income assets

* Flat yield curve assumed.

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Result provides transparency and reflects product reality

Balance Sheet at t=0

Assets		Liabilities	
Fixed Income	10000	Best Estimate Liability (BEL)	8227
Thereof recorded in OCI = 0		*Thereof recorded in OCI = 0*	*0*
		O&G	134
		Thereof recorded in OCI = 0	*0*
		Residual Margin (RM)	1639
		S/H Equity	0
	10000		10000

Balance Sheet at t=1

Assets		Liabilities	
Fixed Income	10528	Best Estimate Liability (BEL)	8874
Thereof recorded in OCI = 228		*Thereof recorded in OCI = 400*	
		O&G	195
		Thereof recorded in OCI = 57	
		Residual Margin (RM)	1596
		S/H Equity	-137
	10528		10528

Current-Current through OCI	
Investment income FI	300
Delta P/H Liabilities BEL	-247
O&G [*]	-4
RM	43
Net income	92
Delta OCI	
Assets	228
Liabilities - BEL	-400
Liabilities - O&G	-57
Total OCI	-229
Total Delta S/H Equity	-137

[*] One year less of discounting of future O&G

Current-Current	
Investment income FI	528
Delta P/H Liabilities BEL	-647
O&G	-61
RM	43
Net income	-137

Change in S/H equity is the same in both approaches

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Insurance liability loss recognition

Question 7: How does the insurance liability adequacy test work?

Issue	- It must be ensured that the OCI is a temporary storage for temporary differences in current values only which reduces to zero until de-recognition of the liability - No permanent losses can be stored in the OCI
Solution	Fluctuation of the time value of O&G are stored in OCI, however whenever O&G are "in the money" trigger is breeched and the amount is taken into P&L, i.e. $$\text{If Liability}_{CurrentRate} \quad < \quad \text{Liability}_{GuaranteedRate} \quad \rho \quad \text{Difference recorded in P\&L}$$

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Backup: Members of the HUB Global Insurance Group

HUB global insurance group:

Asian, European and North & South American

insurance companies and trade associations

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Backup: Members of the HUB Global Insurance Group

Backup: 'current-current through OCI' example for participating contracts

Liability assumptions*:

► 20 year insurance contract

► 2% minimum guarantee

► 4% interest rate at t=0

► 3.5% interest rate at t=1

► **90% policyholder participation in asset returns**

Asset assumptions:

► 100% fixed income assets (zero coupon bonds) with a 4% interest rate at inception

► 10 year duration (fixed income assets)

► 3.5% interest rate at t=1

► Duration mismatch	20 year insurance contract backed by only 10 year fixed income assets

* Flat yield curve assumed.

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Backup: Result provides transparency and reflects product reality

Balance Sheet at t=0				
Assets			**Liabilities**	
Fixed Income	10000	Best Estimate Liability (BEL)		9456
Thereof recorded in OCI = 0	*0*	*Thereof recorded in OCI = 0*		*0*
		O&G		40
		Thereof recorded in OCI = 0		*0*
		Residual Margin (RM)		504
		S/H Equity		0
	10000			10000

Returns over minimum guarantee are considered in BEL ρ BEL is higher as the BEL without policyholder participation in asset returns

Balance Sheet at t=1				
Assets			**Liabilities**	
Fixed Income	10861	Best Estimate Liability (BEL)		10296
Thereof recorded in OCI = 461		*Thereof recorded in OCI = 461*		
		O&G		84
		Thereof recorded in OCI = 42		
		Residual Margin (RM)		486
		S/H Equity		-5
	10861			10861

Current-Current through OCI	
Investment income FI	400
Delta P/H Liabilities BEL	-379
O&G [a]	-2
RM	18
Net income	**37**
Delta OCI	
Assets	461
Liabilities - BEL	-461
Liabilities - O&G	-42
Total OCI	**-42**
Total Delta S/H Equity	**-5**

[a] One year less of discounting of future O&G

Current-Current	
Investment income FI	861
Delta P/H Liabilities BEL	-840
O&G	-44
RM	18
Net income	**-5**

Change in S/H equity is the same in both approaches

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Backup: OCI for liabilities – use of a top-down discount rate

Question: What is the right discount rate?

Issue	- The bottom-up computation of the right discount rate is technically difficult - Risk free rates are difficult to determine - One rate for one currency is not acceptable because of - Different liquidity characteristics of different insurance contracts - Different risk profiles in Euro zone
Solution	We appreciate the progress made in this area by the IASB but we would like to highlight the remaining concerns: - The discount rate should be set using the same conceptual components as the building blocks model: - Expected investment performance - Based on carrying value of the asset (i.e., cost vs. fair value) - Less a risk margin related to investment risks retained by the insurer - The graphic on the following slide describes how the liability discount rate is derived from the gross yield of the assets backing the contracts - This is in addition to the OCI solution and not a substitute for it

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Backup: OCI for liabilities – determining the discount rate

Bottom-up approach

Top-down approach

HUB Group proposal

Risk-free Rate

Illiquidity Premium

Market yield (w/ matched CFs)

Market risk premium*

Portfolio Gross Yield

Less expected default losses
Less expected liquidity losses on forced sales
Less expected management expenses
= Expected Portfolio Yield
Less risk margin for investments

Liability discount rate

*Market risk premium for risks not inherent in the insurance liability

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