June 2012

International Financial Reporting Standards

Taking Stock: Progress towards an IFRS on Insurance Contracts

Insurance working group, 25-26 June 2012

IWG Agenda ref 9

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Overview: Project progress

Key decisions reached

- Definition, scope and unbundling
- Measurement of insurance contract liability
- Special applications: participating contracts, reinsurance, short duration contracts
- Presentation

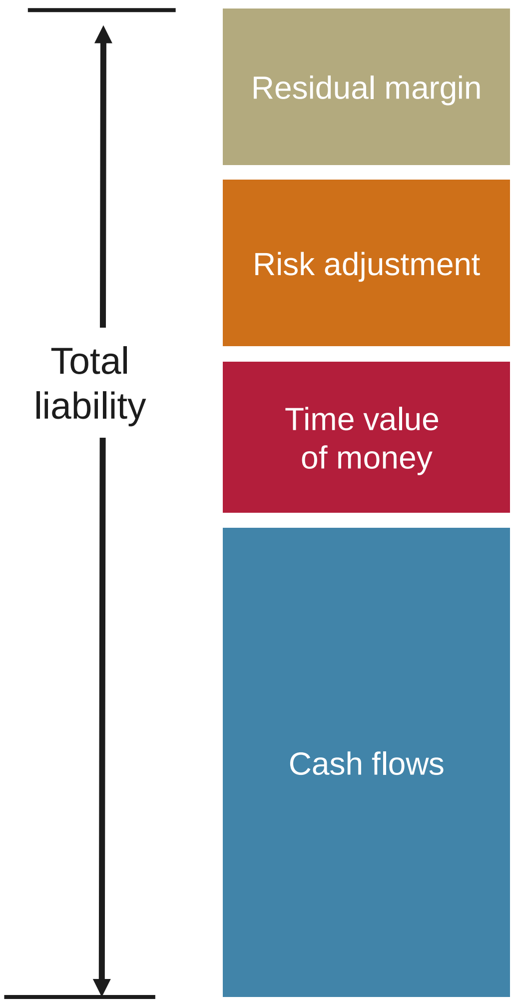
Complete remaining topics

- Volume information
- Residual margin
- Disclosure
- Remaining details

Review draft or re-expose

- Expected in H2 2012
- Final standard not effective before 1 January 2015

Measurement of insurance contracts liability



Quantifies the unearned profit the insurer expects to earn as it fulfils the contract

Quantifies the difference between the certain and uncertain liability

An adjustment that reflects the time value of money

The amounts the insurer expects to collect from premiums and pay out as it acquires, services and settles the contract, estimated using up-to-date information

What's changed since the ED (1)

Exposure draft	Decisions so far
Definition and scope	No significant change from ED except financial guarantee contracts
Unbundling	Some changes from ED; on-going discussions
Which cash flows, including acquisition costs	Minor changes in response to comment letters • Acquisition costs • Recognition point • Contract boundary
Discount rate	No change in principle, change in application
Risk adjustment	Minor changes from ED in response to comment letters
Residual margin	Unlocking is a significant change from ED in response to comment letters; on-going discussions

What's changed since the ED (2)

Exposure draft	Decisions so far
Participating features	Minor change from ED
Reinsurance	Minor changes from ED in response to comment letters
Premium allocation approach	Minor changes from ED in response to comment letters
Presentation	Presentation of discount rate changes in OCI is a significant change from ED in response to comment letters; on-going discussions
Disclosures	To be discussed
Transition and effective date	To be discussed

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The Board's tentative decisions

A closer look

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Overview of topics

Scope

- What does the standard apply to?
  - Scope and scope exceptions
  - Definition of insurance contract and insurance risk

Identify

- What are we measuring?
  - Unbundle non-insurance components
  - Identify recognition point
  - Identify cash flows within the contract boundary

Measure

- How do we measure the contract?
  - Consider eligibility for special applications (eg premium allocation approach, mirroring approach for participating contracts)
  - If applying building block approach: cash flows, discount rate, risk adjustment, residual margin

Present

- How do we communicate?
  - Presentation in statement of comprehensive income and statement of financial position
  - Disclosures

Scope

- No significant changes to scope and definition

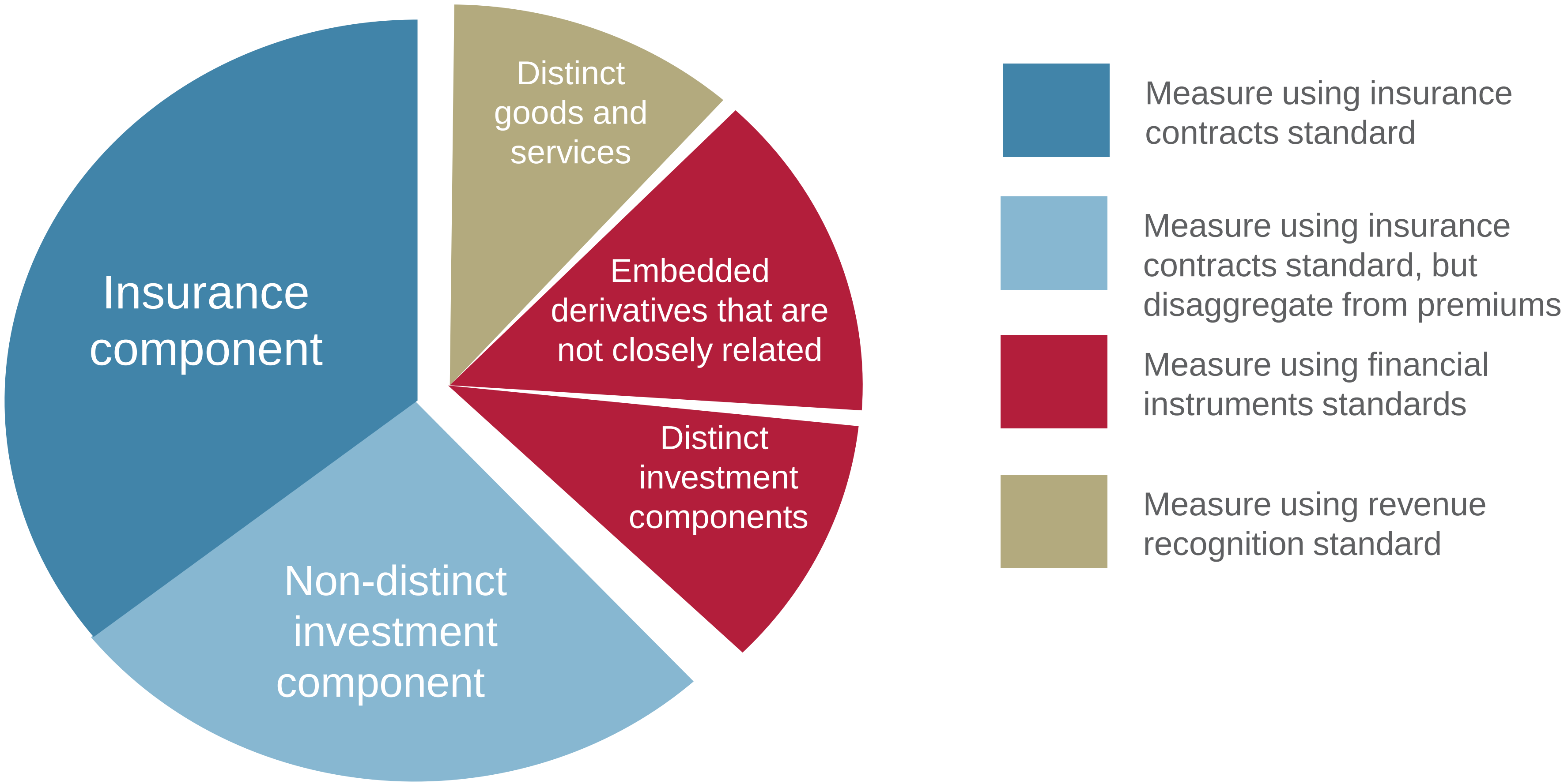
Confirm standard applies to:

- Insurance contracts the insurer issues
- Reinsurance contracts the insurer holds
- Financial instruments with discretionary participation features **issued by insurers**

Some changes to scope exceptions:

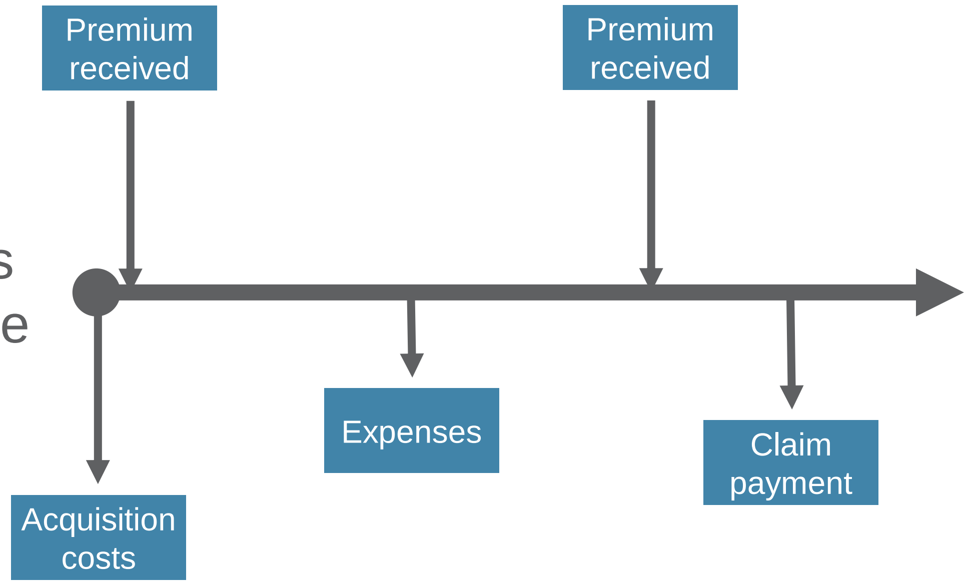
- Exclude financial guarantee contracts unless previously regarded as insurance contracts (status quo)
- Fixed fee service contracts – additional guidance provided

Identify: Unbundle non-insurance components



Identify: Defining the cash flows that arise from the contract

Recognition point:
Contract starts when coverage period begins (may be after insurer is on risk)



Contract boundary:
Ends when:
- Not required to provide coverage
- Can reprice to reflect risks of policyholder
- In some cases, when insurer can reprice to reflect risk of portfolio
- On substantial modification

Included in cash flows:
All direct costs of *originating* and all directly attributable costs incurred in *fulfilling* a portfolio of insurance contracts

Measure: Which cash flows?

Residual margin

Risk adjustment

Time value of money

Cash flows

An explicit, unbiased and probability-weighted estimate of the future cash outflows (less the future cash inflows) that will arise as the insurer fulfils the insurance contract

✓ Confirm use of expected value of cash flows incurred in fulfilling the contract, considering all relevant information

\+ Add guidance:

- \+ not all possible scenarios need to be identified and quantified
- \+ do not adjust measurement to reflect subsequent outcome of an insured event that was impending at the end of reporting period

Measure: Time value of money

Residual margin

Risk adjustment

Time value of money

Cash flows

A discount rate that adjusts cash flows for the time value of money

✓ Confirm discount rate:
- Reflects only the characteristics of the insurance contract liability
- Current and updated each reporting period

\+ Guidance on determining the discount rate
- Do not prescribe method – ‘top-down’ and ‘bottom-up’ both acceptable
- Remove any factors that influence observable rates not relevant to the liability

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Measure: Risk adjustment

Residual margin

Risk adjustment

Time value
of money

Cash flows

An explicit estimate of the effects of uncertainty about the amount and timing of future cash flows

- Different IASB and FASB conclusions:
  - ✓ IASB confirm measurement of liability should include explicit risk adjustment
  - ✓ FASB confirm risk should be reflected implicitly in the measurement of the liability
- No restriction on permitted techniques

✓ Disclose confidence level equivalent

Measure: Residual margin

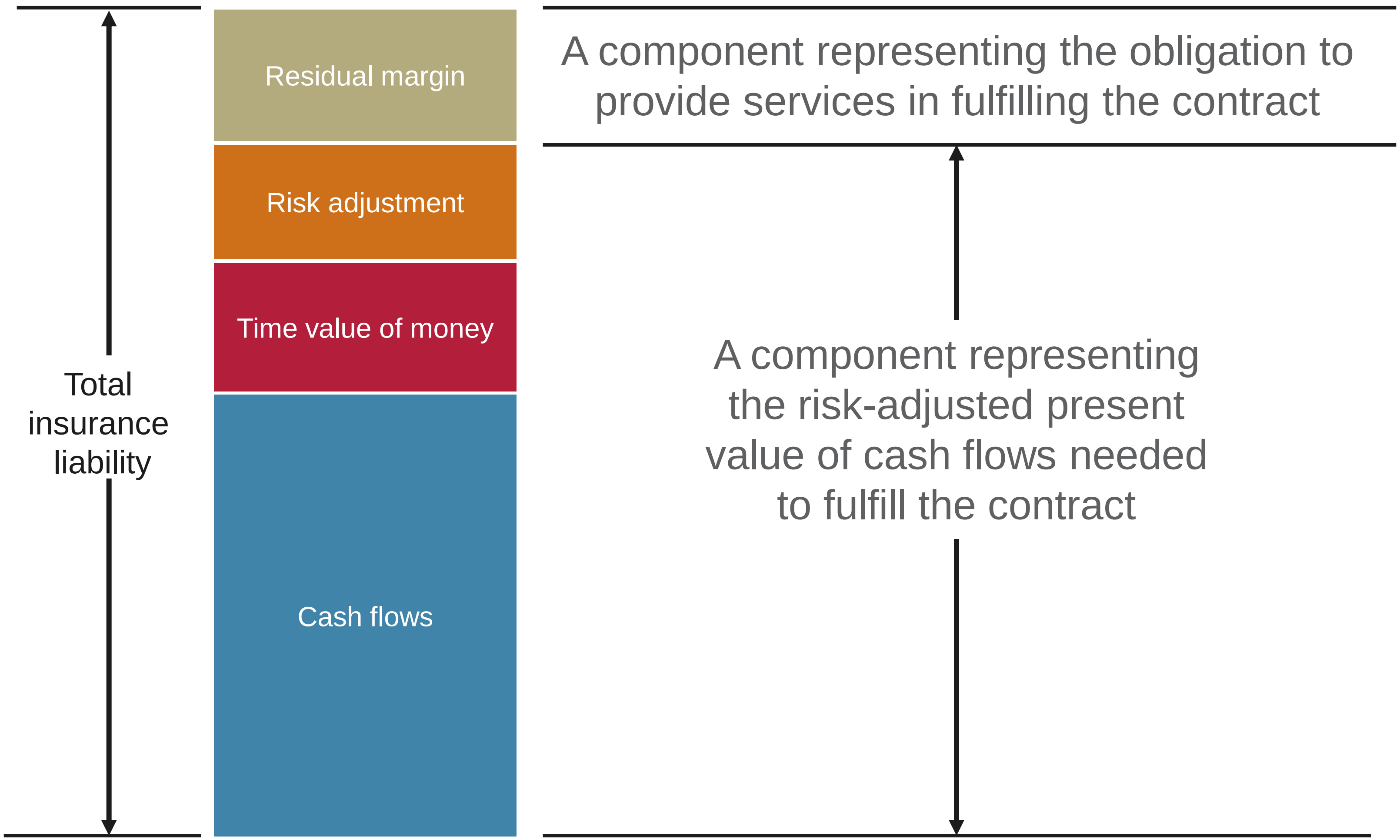
Residual margin
Risk adjustment
Time value of money
Cash flows

A residual margin that quantifies the uneared profit the insurer expects to earn as it fulfils the contract

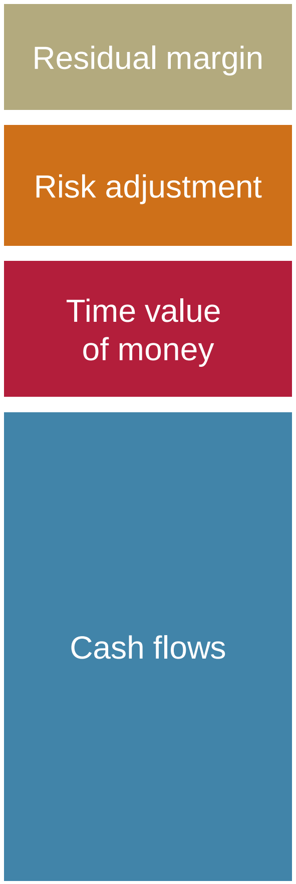
✓ Confirm no gain at inception

- Portfolio unit of account
- Adjust for changes in estimates of cash flows
- Adjustments made prospectively
- To be determined
  - ? Allocation of residual margin after change in estimates
  - ? Accretion of interest

Measure: Summary of decisions

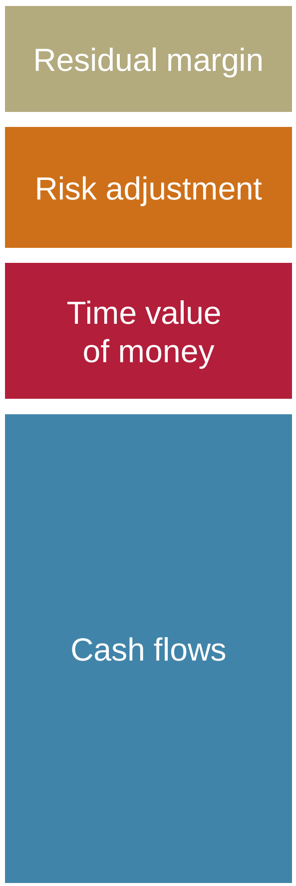


Special applications: Participating contracts



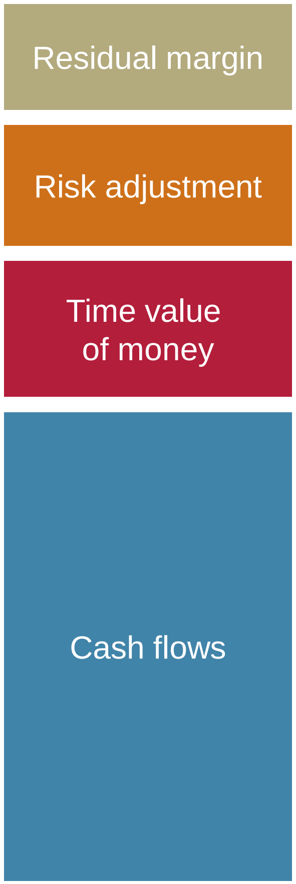
- When liability contractually based on performance of underlying assets or groups of assets:
  - Discount rate reflects dependence of cash flows on specific assets
  - Adjust cash flows to reflect the measurement basis of the items underlying participation
  - Present changes in estimates consistently with equivalent changes in underlying item

Special applications: Reinsurance assets



- ED: symmetry with underlying liability
  - Losses at inception recognised over contract term
  - Gains at inception recognised immediately
- Tentative decisions:
  - Use same estimates for reinsurance asset and underlying direct insurance liability
  - Gains recognised over coverage period
  - Losses recognised immediately if for past events, otherwise recognised over coverage period

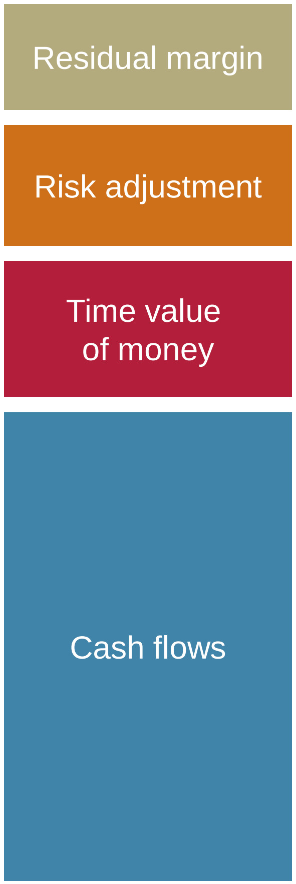
Special applications:
Premium allocation approach– Eligibility (1/2)



- IASB: permitted if reasonable approximation to the building block approach, ie if:
  - coverage period is 12 months or less
  - both following apply:
    - no significant changes in estimate are likely to occur before the claims incur
    - no significant judgement needed to allocate the premium
- FASB: For reinsurer, required if both criteria are met:
    - no significant changes in estimate are likely to occur before the claims incur
    - no significant judgement needed to allocate the premium

    For cedant:
    - Same approach used for underlying direct contract
  - practical expedient: apply to contracts if coverage period is 12 months or less

Special applications: Premium allocation approach – Measurement (2/2)



- Liability for remaining coverage (pre-claims liability)
  - Simpler accounting with limited remeasurement unless contract is onerous
  - Reflect time value of money if financing element significant
  - No need to reflect time value of money if period between payment and satisfying obligation less than 12 months
  - Onerous contract test when facts and circumstances indicate contract might be onerous
- Liability for incurred claims
  - Measured consistently with the liability for building block approach (with no residual margin)
  - Discounted if material. Discounting deemed not material if claims to be settled within 12 months.

Present: Statement of comprehensive income

ED proposals

- All premiums treated as deposits, all payments as return of deposits
- All changes in estimate presented in profit and loss

Statement of comprehensive income

	20XX
Risk adjustment	X
Residual margin	X
Experience adjustments and changes in estimates	X
Underwriting result	X
Investment income	X
Interest on insurance liability	X
Net interest and investment	X
Profit or loss	X

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Present: Statement of comprehensive income

Tentative decisions

- Volume information on face of statement of comprehensive income
- Exclude investment components from premiums presented on face of statement of comprehensive income
- Present in OCI changes in the insurance liability arising from changes in the discount rate

Statement of comprehensive income

	20XX
Premiums*	x
Changes in insurance liability	x
Claims and expenses	(x)
Underwriting result	**X**
Investment income	x
Interest on insurance liability, based on locked in discount rate	x
Net interest and investment	**X**
Profit or loss	**x**
Effect of discount rate changes in insurance contract liability	x
Total comprehensive income	**x**

*The boards have yet to determine the amount of premiums presented in each accounting period

Present: statement of financial position

Line items to be presented

- Building block approach contracts: Insurance contract assets
- Building block approach: Insurance contract liabilities
- Building block approach contracts: Unconditional rights to premiums
- Premium allocation approach contracts: Liability for remaining coverage
- Premium allocation approach contracts: Liability for incurred claims
- Reinsurance assets

Disclosures

- Confirmed approach and most of disclosures in ED
  - Methods and inputs used to derive estimated values
  - Effect of changes in estimates
  - The effects of risks arising from insurance contracts, including sensitivity analysis
  - IASB: maturity analysis of cash flows / FASB liquidity risk analysis
- Still to discuss:
  - Level of aggregation in the reconciliation of changes in insurance liability
  - Disclosures relating to unlocked residual margin, participating contracts and use of OCI
  - Interim disclosures

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What’s next?

IASB / FASB: Key decisions in common

- Measurement of insurance contract using all cash flows expected to fulfil contract
- Measurement and presentation of a performance linked participation feature should be consistent with the measurement of the underlying item (the 'mirroring approach')
- Cash flows discounted using a rate that reflects only the characteristics of the liability
- No gain at inception
- Presentation that shows information about key drivers of profitability
- Effects of changes in discount rates presented in OCI

IASB / FASB: Differences in view

Topic	IASB view	FASB view
Risk adjustment	Risk: •explicitly determined •remeasured each period through P&L	Risk: •included implicitly in single margin •not remeasured over the contract term
Residual/single margin	•Released over the coverage period based on pattern of service •Changes in estimates of future cash flows offset in the measurement of the residual margin	•For BBA: released over the coverage and settlement period based on the release from risk •For PAA: released over the coverage period only, based on release from risk •All changes in cash flow estimates recognised in P&L

IASB / FASB: Differences in view

Topic	IASB view	FASB view
Acquisition costs (new difference since ED/DP)	Residual margin shows expected profit after deducting all costs of acquiring and fulfilling the insurance contract liability	Residual margin shows expected profit after deducting all costs of acquiring and fulfilling the insurance contract liability excluding the portion deemed to not result in the issuance of particular contracts
Premium allocation approach	***Permit*** premium allocation approach for contracts when it produces similar measurements to building block approach	***Require*** premium allocation approach for all contracts meeting specified criteria

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What next?

Complete remaining topics

- Volume information
- Residual margin
- Other comprehensive income
- Other matters

Review

- Review changes since the ED
- Review differences between IASB and FASB
- Review due process completed

Publish

- Determine whether to publish a review draft or second exposure draft
- Expected in H2 2012

Complete remaining topics

Volume information

- How to define the volume information presented in the statement of comprehensive income

Residual margin

- Allocation of residual margin after change in estimates
- Whether to accrete interest on residual margin

(Important) details in other areas

- Transition
- Disclosures
- Remaining details

Review draft or re-expose: Re-exposure criteria

In considering the need for re-exposure, the IASB will:

- identify substantial issues that emerged during the comment period on the exposure draft that it had not previously considered
- assess the evidence that it has considered
- evaluate whether it has sufficiently understood the issues and actively sought the views of constituents
- consider whether the various viewpoints were aired in the exposure draft and adequately discussed and reviewed in the basis for conclusions in the exposure draft

For more information

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