

IASB's *Insurance Contracts* Project

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SOCIETY OF ACTUARIES

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- Brief History of the Insurance Contracts Project
- Exposure Draft (ED) Highlights
- Earnings patterns from the Society of Actuaries study for life, annuity and health products
- What others think
- Action during 2011
- Next steps



Brief History

Actuaries
Risk is Opportunity.™



SOCIETY OF ACTUARIES

History of Project - IASB

- International Accounting Standards Board
 - London-based, 14 members from 9 countries
 - Dedicated staff
 - Insurance Working Group (IWG)
 - Worked with FASB (U.S. Financial Accounting Standards Board) (2008-2010) (resumed in 2011)
 - Pronouncements:
 - ◆ IAS (International Accounting Standards)
 - ◆ IFRS (International Financial Reporting Standards)
 - These are identical – IAS was published before IFRS



History of Project - Influencers

- Those providing significant input:
 - ◆ CFO Forum (European insurers)
 - ◆ GNAIE – Group of North American Insurance Enterprises
 - ◆ Insurers from Japan
 - ◆ IAA (International Actuarial Association)
 - ◆ IAIS (International Association of Insurance Supervisors)
 - ◆ European Union (EU) – they mandate the IASB make the standards, but each country must adopt



History of Project - Objectives

- To provide information to users of financial statements that is relevant for economic decision-making
- To eliminate inconsistencies and weaknesses in existing practices
- To provide comparability across entities, jurisdictions and capital markets



History of Project – Phase 1

- Phase 1 started in 1997
- 2001 Draft Statement of Principles
- 2004 - Phase 1 ended with IFRS4
 - Defined insurance
 - Revised *IAS 39*, guidance for investment products
 - Existing local GAAP with additional disclosure and loss recognition was permitted
 - Still allowed diverse practices
- Applies to insurance *contracts*, not insurance *companies*



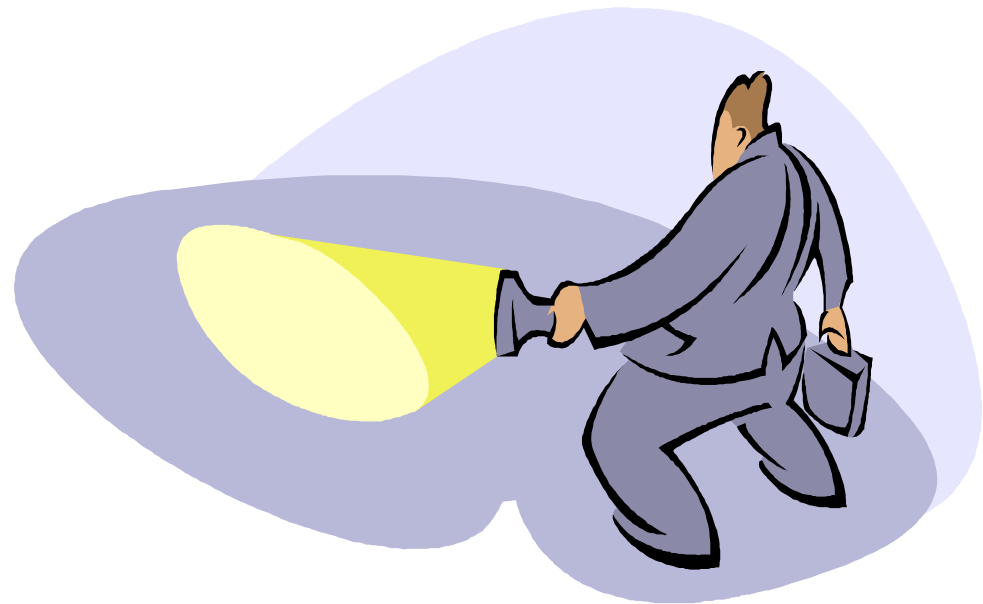
History of Project – Phase 2

- Phase 2 started mid-2004
 - IASB, IASB staff and IWG worked on a discussion paper called “Preliminary Views” or “Discussion Paper,” released in May 2007
 - Main text – 150 pages; Appendices – 80 pages
 - Over 160 Comments letters
 - Had something appealing and something offending to everybody



Exposure Draft Highlights

(as they relate to this presentation)



Exposure Draft

- Board worked on for 2 years
- Issued ED (Exposure Draft) July 2010
 - ED 87 pages
 - Basis for Conclusions 95 pages
 - Plus appendices with numerical examples



ED Highlights

- Four Building Blocks
 - Current Estimates of Future Cash Flows
 - Time Value of Money
 - Risk Adjustment
 - Residual Margin
- Contract Classification
- Unbundling
- Other



Current Estimates of Future Cash Flows 1 of 2

- Explicit, unbiased and probability-weighted estimate of future cash flows
- Includes all incremental cash flows that will arise as the insurer fulfills the insurance contract
 - Premiums and cash flows that arise from those premiums,
 - Claims and benefits paid to policyholders, plus associated costs,
 - Cash flows resulting from options and guarantees,
 - Incremental costs of selling underwriting and initiating the contract, and
 - Policy administration and maintenance costs.



Current Estimates of Future Cash Flows 2 of 2

- Cash flows included if they arise within the contract boundary
 - Boundary is a point at which insurer can terminate or re-underwrite a contract, and
 - Future premiums, claims and expenses are related to those premiums.
- Cash flows are re-assessed at each reporting period
- Stochastic modeling may be required
- Estimates of market variables are to be consistent with observable market prices



Time Value of Money

- Adjusts first building block for time value of money
- The discount rate is based on the characteristics of the insurance liability: currency, duration and liquidity
- Measurement reflects characteristics of the assets backing the insurance liability only if the amount, timing or uncertainty of contract cash flows depend on performance of assets
- Discount rate is a market consistent “risk free rate” adjusted for illiquidity characteristics of liability cash flows
- No further guidance on what is a “risk free rate” or how to calculate the illiquidity premium



Risk Adjustment (RA) 1 of 4

- A liability to reflect uncertainty in the estimate of future cash flows
- Included in the measurement explicitly
- Defined as “*the maximum amount an insurer would rationally pay to be relieved of the risk that the ultimate fulfillment cash flows exceed those expected.*”
- Re-measured at each reporting period
- Estimated at level of portfolio of insurance contracts
- Effects of diversification between portfolios of insurance is not allowed
- Allow one of three techniques
 - Confidence Interval (CI)
 - Conditional Tail Expectation (CTE)
 - Cost of Capital



Risk Adjustment (RA) 2 of 4

- Confidence Interval
 - Likelihood that the actual outcome will be within a specified interval
 - Sometimes called Value at Risk (VaR)
 - Easy to communicate and calculate
 - Not as useful for distributions that are not statistically normal



Risk Adjustment (RA) 3 of 4

- Conditional Tail Expectation
 - Better reflection of extreme losses
 - Focuses on the tail of the probability distribution
 - Judgment needed to determine band and may need to change in the future
 - Tail VaR is similar



Risk Adjustment (RA) 4 of 4

- Cost of Capital
 - Often used in pricing, valuations and regulatory reporting (such as Solvency II)
 - Estimates cost of holding required capital to meet obligations with high confidence
 - Need to determine capital rate that reflects risk relevant to liability



Residual Margin (RM)

- Eliminates any gain at inception of contract
- May not be negative; arises when Present Value (PV) of future cash inflows exceeds sum of PV of future cash outflows plus the Risk Adjustment
- Estimated at portfolio level, split by cohort (contracts with same inception date and similar coverage duration)
- Measured at initial recognition only
- Amortized over coverage period based on expected claims, with interest
- Cannot be negative as a loss must be recognized immediately
- Interest accretes using the discount rate locked-in at inception



Contract Classification (simplified)

- Does contract have significant insurance risk?
 - No – measure as investment contract (IAS 39)
 - Yes – does contract need to be unbundled?
 - ◆ If yes, value deposit component under IAS39
 - ◆ If no, value insurance component under Insurance Contracts



Unbundling

- Unbundling is required for all components that are not “closely related” to the insurance coverage
- The ED provides 3 examples of this principle:
 - Account balances – a deposit component with certain characteristics
 - Embedded derivatives
 - Service components
- Any unbundled component is separated without any of the related fees or charges, which are accounted for with the insurance contract



Significant ED items outside of study scope

- Presentation
- Disclosures
- Portfolio / unit of account
- Short term contracts
- Contract boundaries
- Transition
- Implementation issues
- Conflict between RA objective and RA options
- IAS39/IFRS9 Financial Instruments



Society of Actuaries Study

Actuaries
Risk is Opportunity.™



SOCIETY OF ACTUARIES

SOA Study – Overview

- Requested by American Academy of Actuaries for their response to IASB
- Sponsored by Financial Reporting Section to provide valuable research to its members
- Completed November 2010
- 8 companies
- 15 submissions
- 100 page report
- Available on SOA website: www.soa.org/research/research-projects/life-insurance/research-fr-insurance-contracts.aspx
-



Participating ATFs

- Deloitte
- Manulife
- AFLAC
- Ernst & Young
- PolySystems
- New York Life
- Jackson National
- AIG
- Great American
- Lincoln National
- And others



SOA Study – Products

- Traditional Life (Term)
- Traditional Life (Participating)
- Universal Life (UL), with and w/o Guarantees
- Single Premium Fixed Deferred Annuity (SPDA)
- Variable Deferred Annuity with and w/o Guar's
- Single Premium Immediate Annuity (SPIA)
- Long-term Care (LTC)
- Supplemental Health (Medical)
- Equity Indexed Annuity



SOA Study – Deliverables

- New Business Only (one year's issues)
- US GAAP – Balance Sheet and Income Statement
- IFRS – Balance Sheet and Income Statement
- Alternative Scenarios
- Observations – why results are what they are
- Observations – areas where new or more research is needed



Variations Requested

- Include/exclude acquisition costs
- Composite margin
- Investment / Discount rate
- Change in estimate after issue
- Change in experience after issue
- Alternative levels of RA (200% of CofC)
- Alternative RA methods

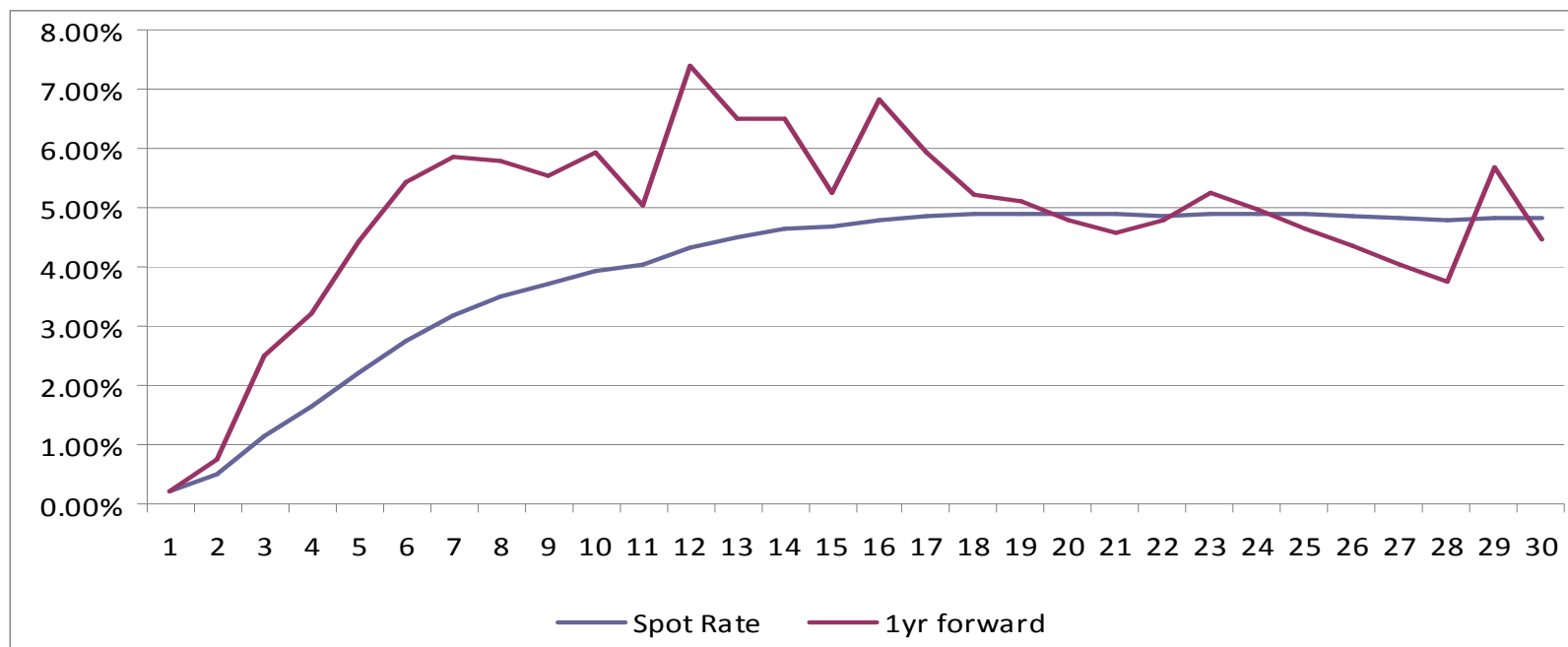


Discount Rates

- Risk-Free Rates
- Illiquidity Premium
- Par WL, variable annuity use investment earned rate
- No adjustment for own credit risk



Risk-Free Discount Rates



June 30 2009 one year forward rates were smoothed to remove anomalous pattern



Illiquidity Adjustment to Discount Rates

- .73 basis points for SPIA
- .37 basis points for all other products
- Based on May 2010 study by Groupe Consultatif in Europe
- Not an adjustment for “own credit risk” or “non-performance”



Risk Adjustment Choices

- Confidence Interval (CI)
 - Conditional Tail Expectation (CTE)
 - Cost of Capital (C of C)
-
- We used C of C



Risk Adjustment – Cost of Capital Calculation

Risk Adjustment liability equals

Present Value of

Cost of Capital rate $\times$ capital needed in year t

Where

PV uses discount rate from the scenario,

Cost of capital rate is 6%, and

Capital need in year t comes from factors on next slide



Risk Adjustment Capital Factors

Fixed Annuity and Immediate Annuity: 2.3% of Account Value plus 6.16% of premium

Par WL and UL: 2.3% of claims plus 1.8% of face amount plus 6.16% of premium

Term life: 1.8% of face plus 6.16% of premium

Supplemental Health: 10% of claims plus 8.54% of premium

Long Term Care: 15.4% of Claims plus 47.74% of premiums



Risk Adjustment Calibration

- The Base Line used 200% of CAL (Company Action Level) of U.S. RBC which represents an estimate of a component of economic capital
- For perspective,
 - Most companies are at 300 to 750%
 - An A company is 300%
 - Company Action is required at 100%
- But remember, we don't incorporate economic cost of investments and financial risk (credit risk and ALM), which regulatory capital does include
- Remeasured each period



Residual Margin

- Amount needed to avoid profit at issue
- Is a “plug” based on level of Current Estimate plus Risk Adjustment
- Cannot be negative
- Amortized by ratio of PV expected benefits at time t divided by PV expected benefits at issue
- Accretes with interest, using the discount rates in effect at issue



Composite Margin

- Not for IASB but for FASB
- Equates to Risk Adjustment plus Residual Margin
- Amortization without interest accretion
- Amortization based on premiums and claims



Other Basic Assumptions

- Investment Income – Based on GAAP Net Assets
- No reflection of volatility due to asset fair value valuation
- Investment Earned Rate – based on ATF pricing assumptions
- Pre-tax
- Earnings paid out as Shareholder Dividend Annually
- Base studies – actual experience equals expected

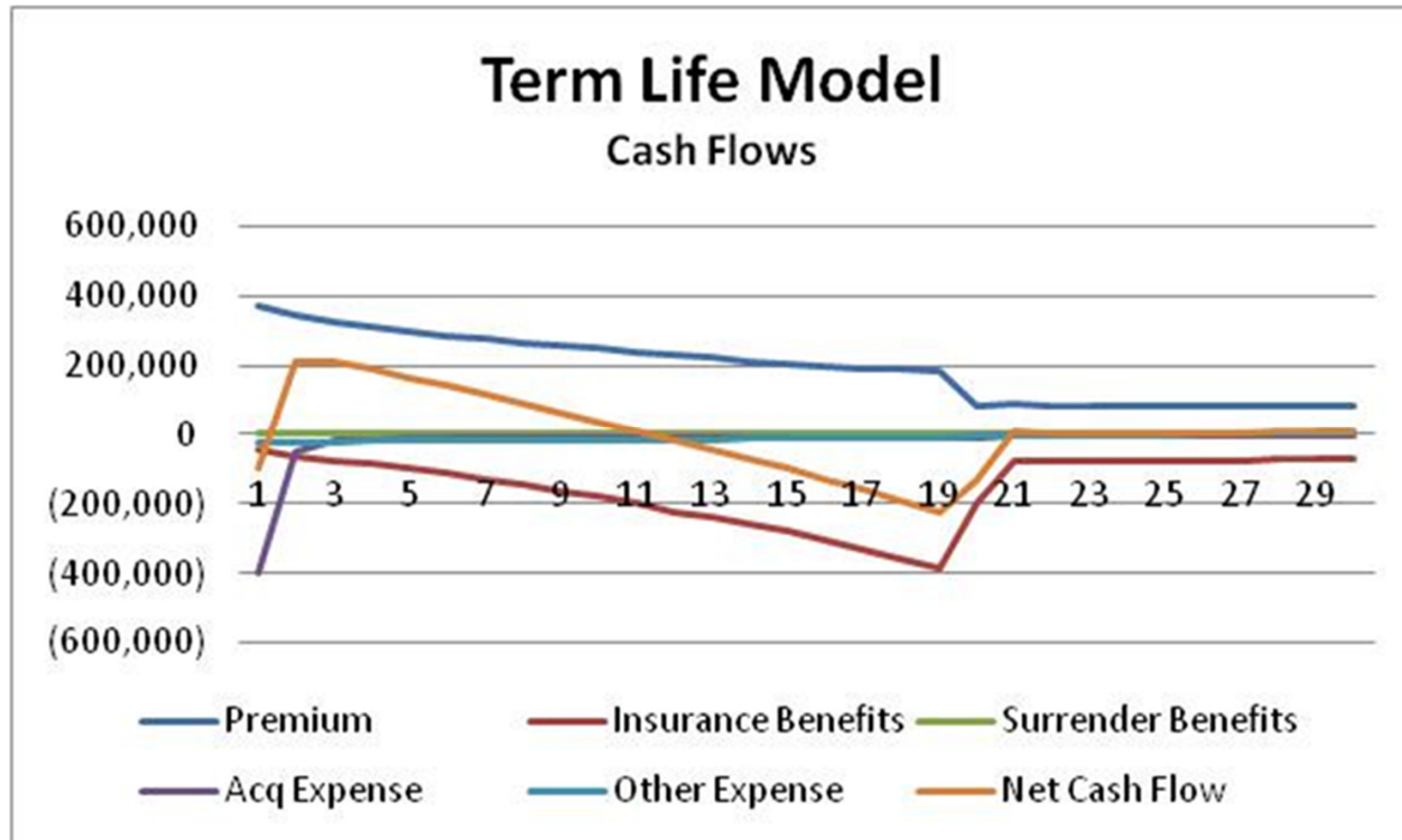


Term Life Product

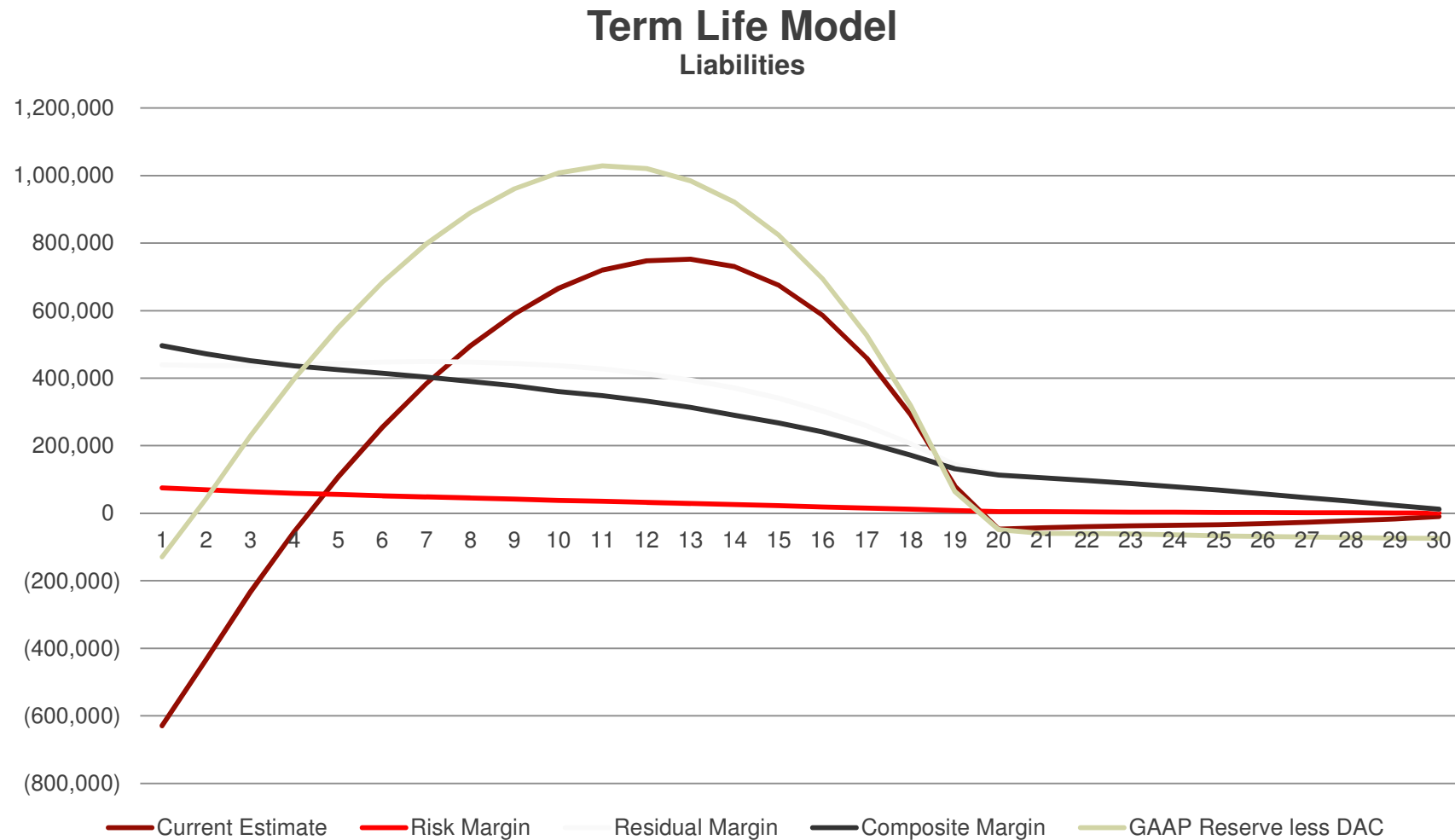
- 20 Year Level Term with ART Rates Starting Year 21
- One year's issues
- No reinsurance



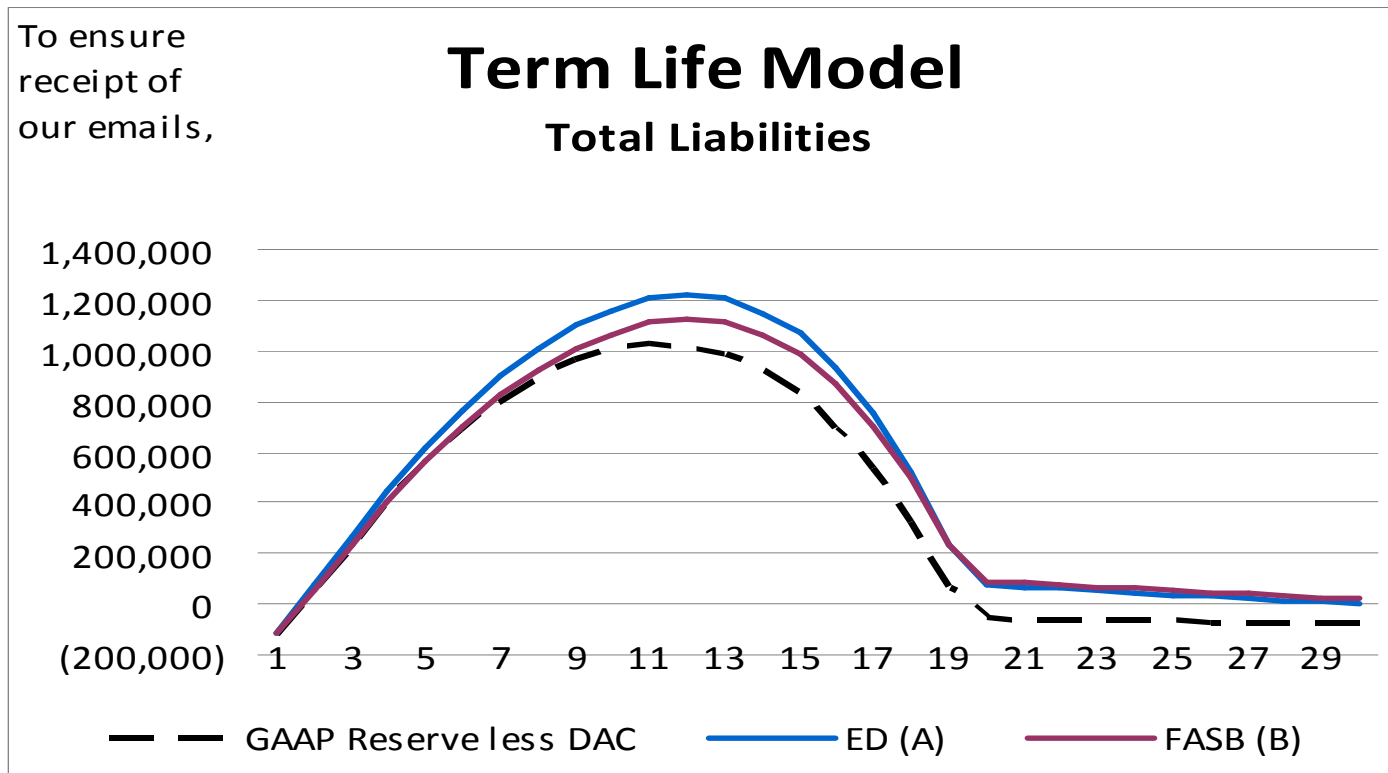
Term Life – Cash Flows



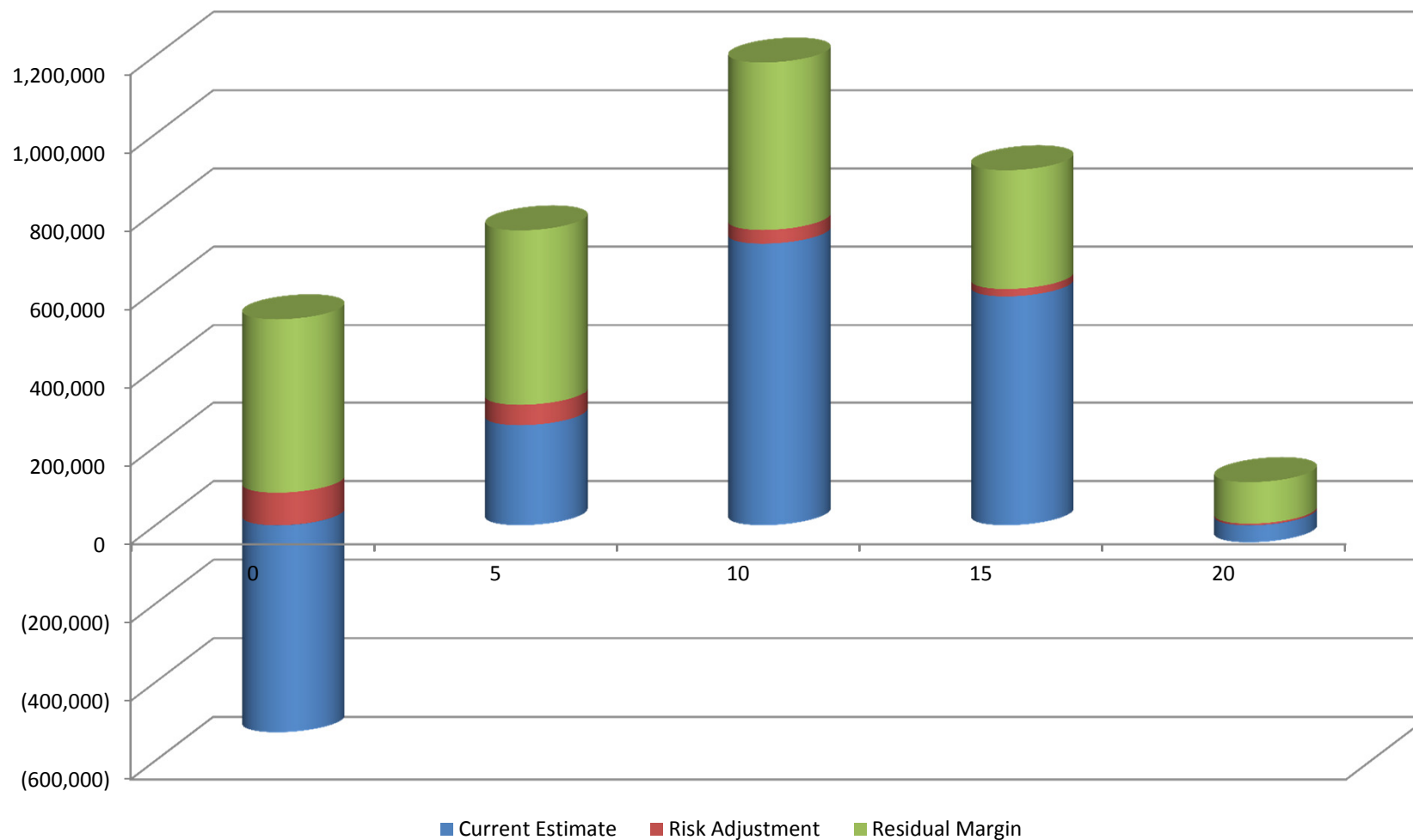
Term Life – Liability Components



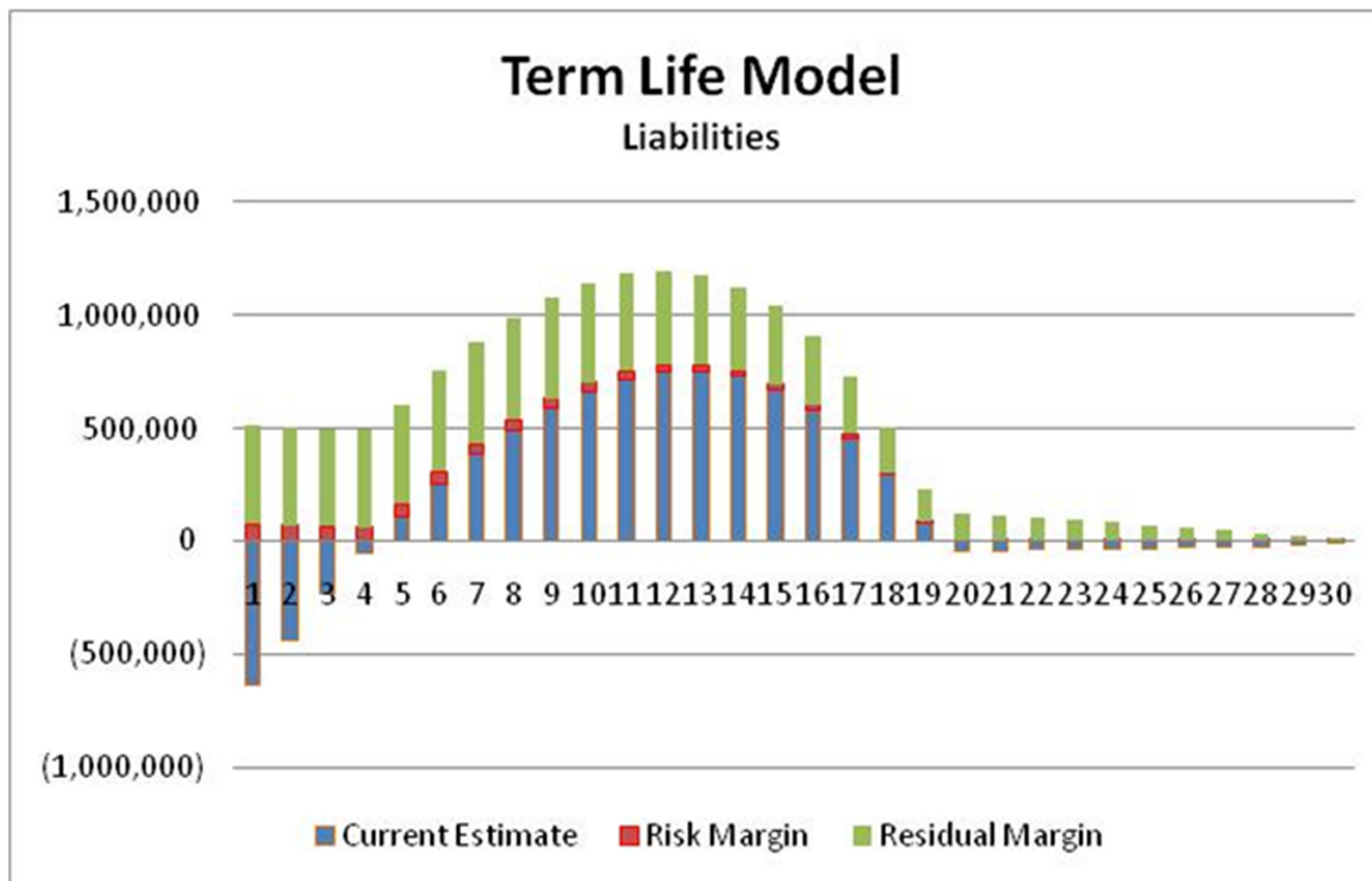
Term Life Liabilities – 3 Models



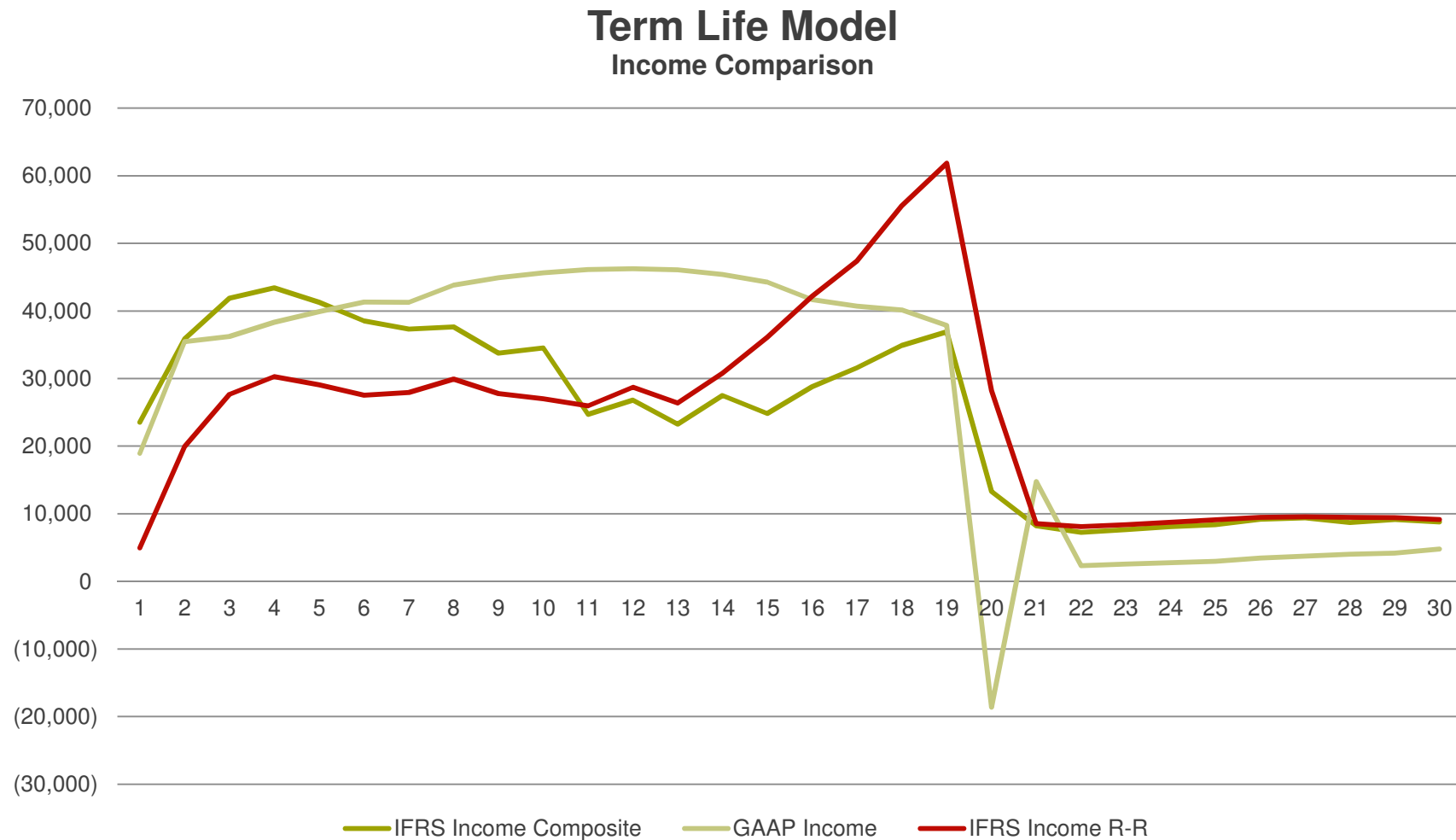
Term Life Liability Components



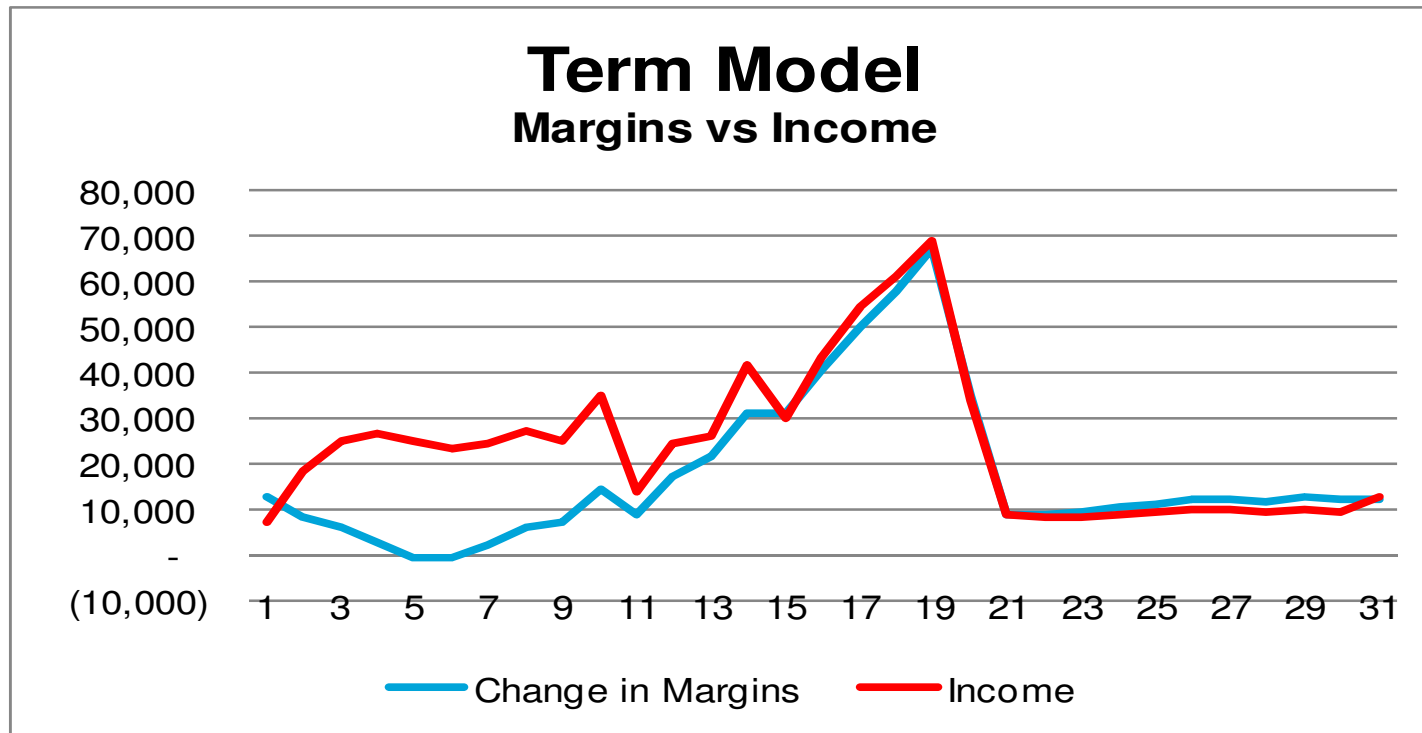
Term Life Liability Components



Term Life Income Comparison



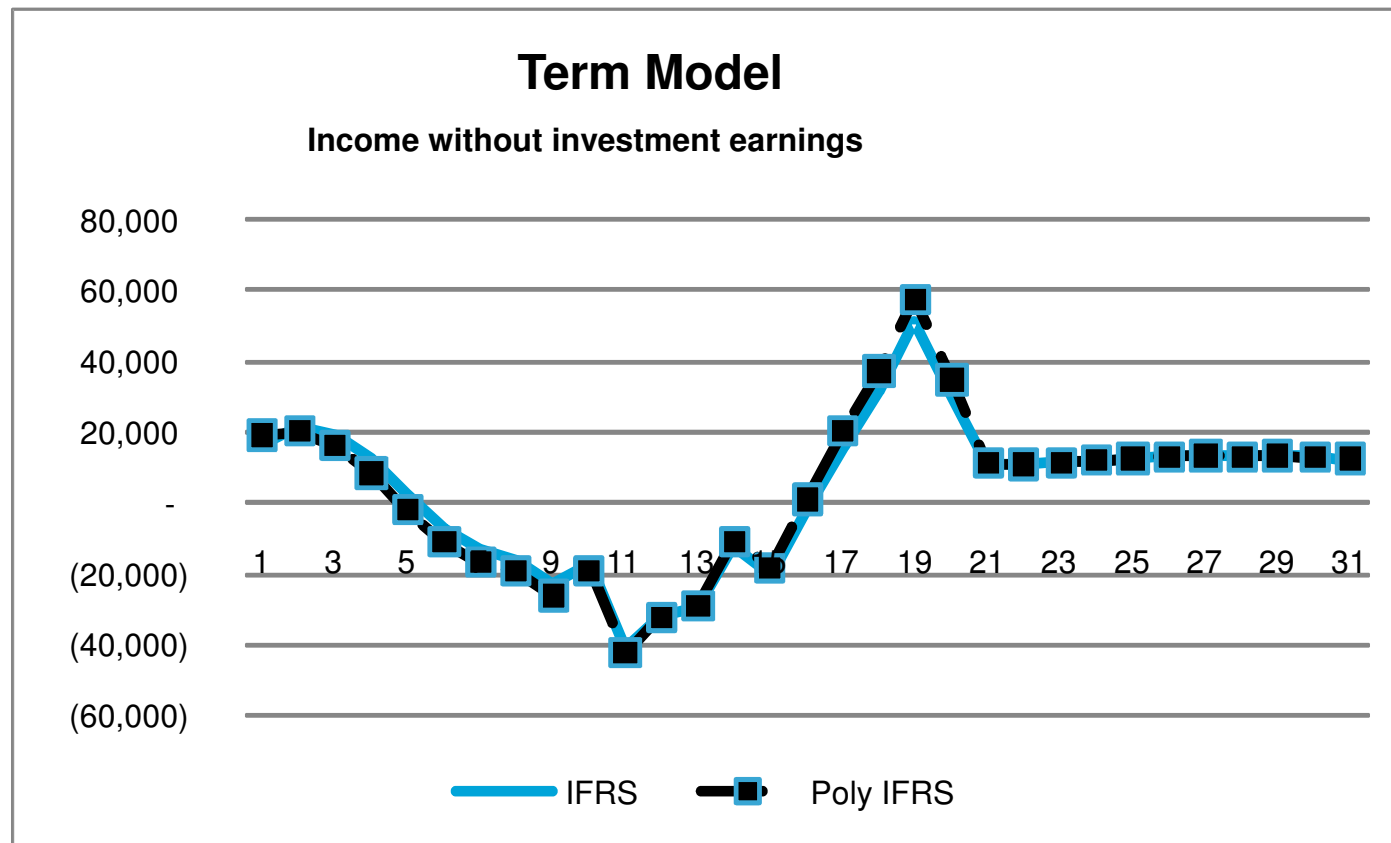
Term Life IFRS Margins vs. Income



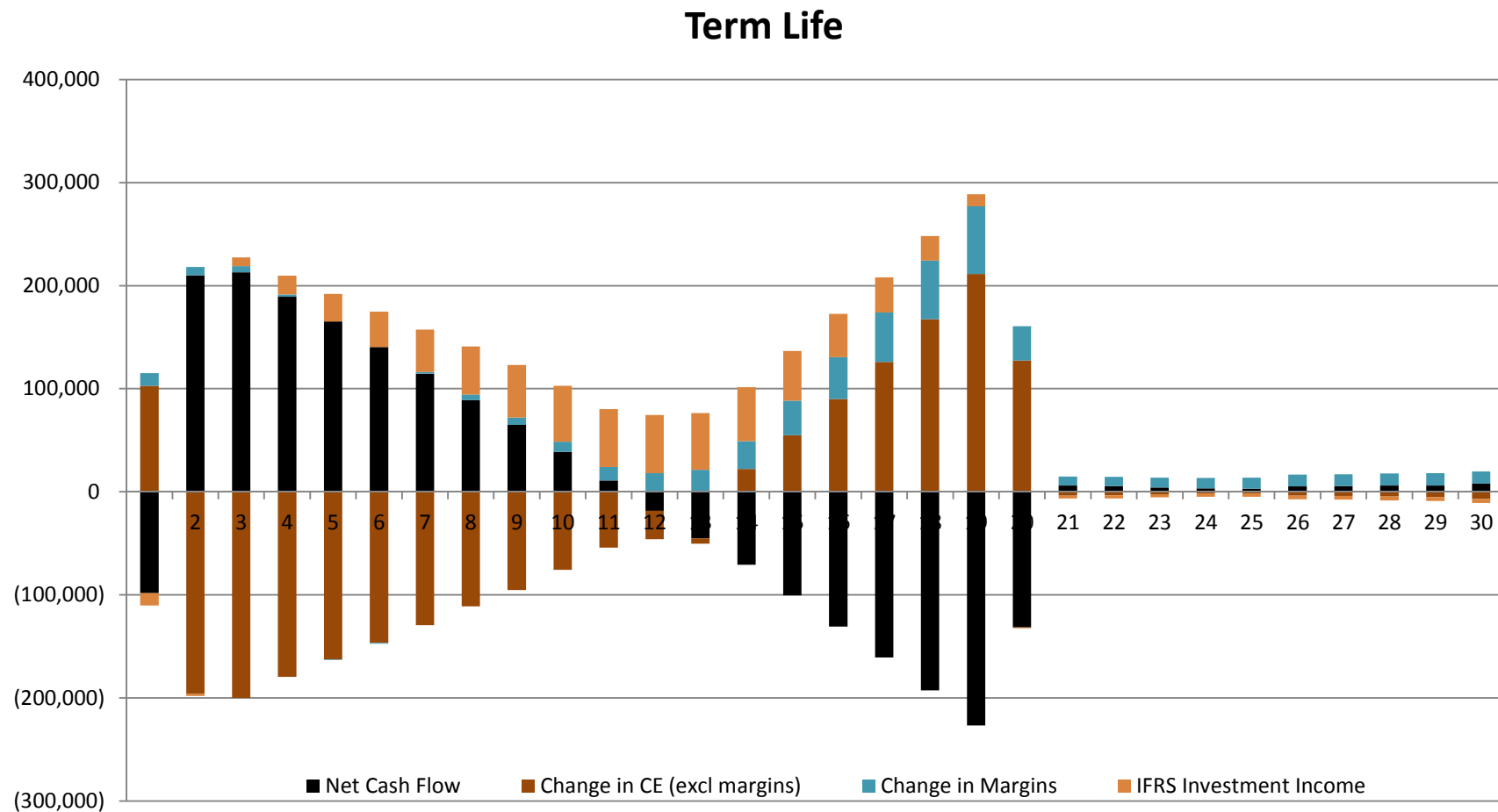
Term Life – Results Verification

Solid – Margin change only;

Box – earned rate is discount rate; assets equal IFRS liability



Term Life IFRS income components

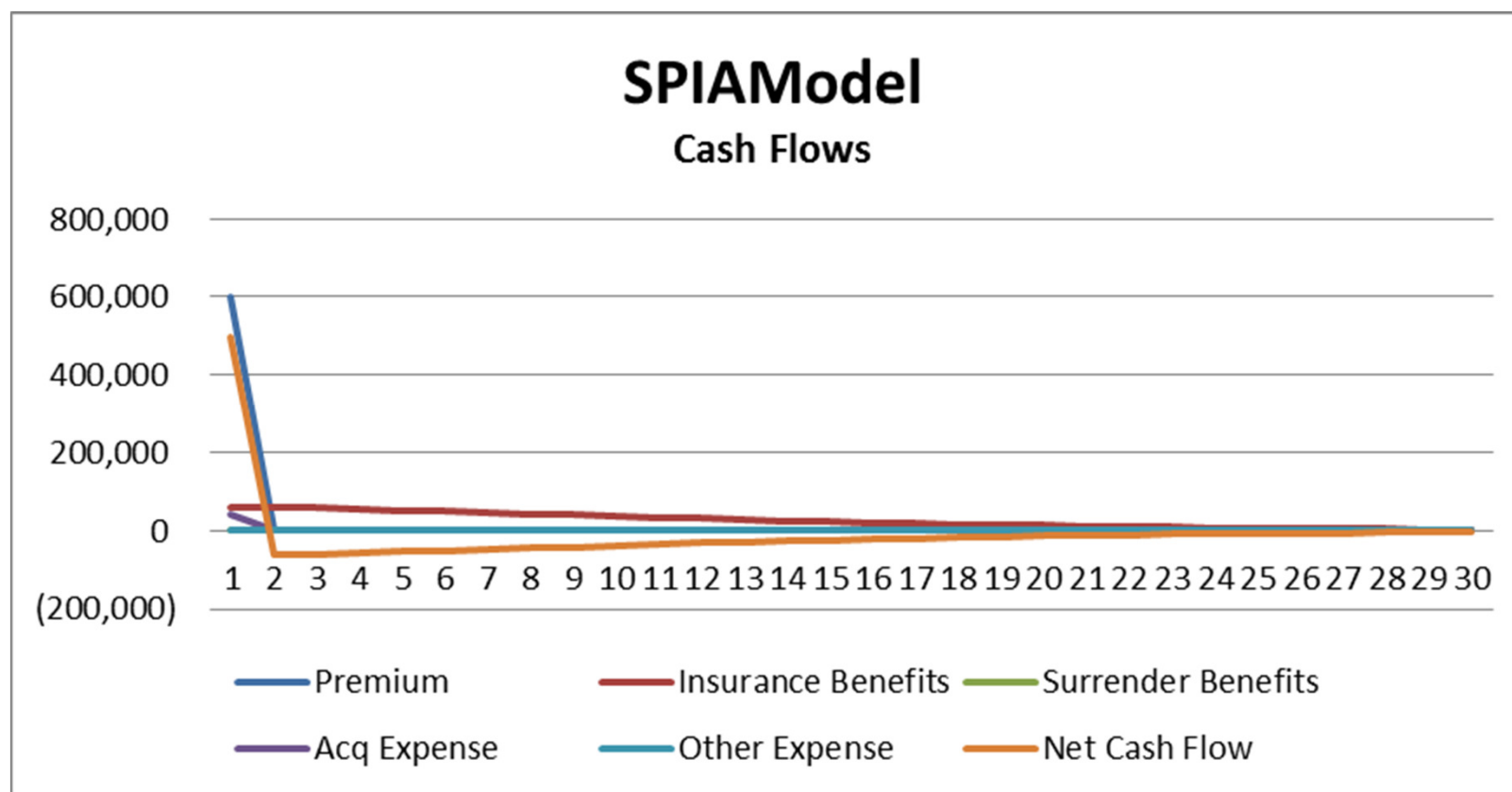


Single Premium Income Annuity

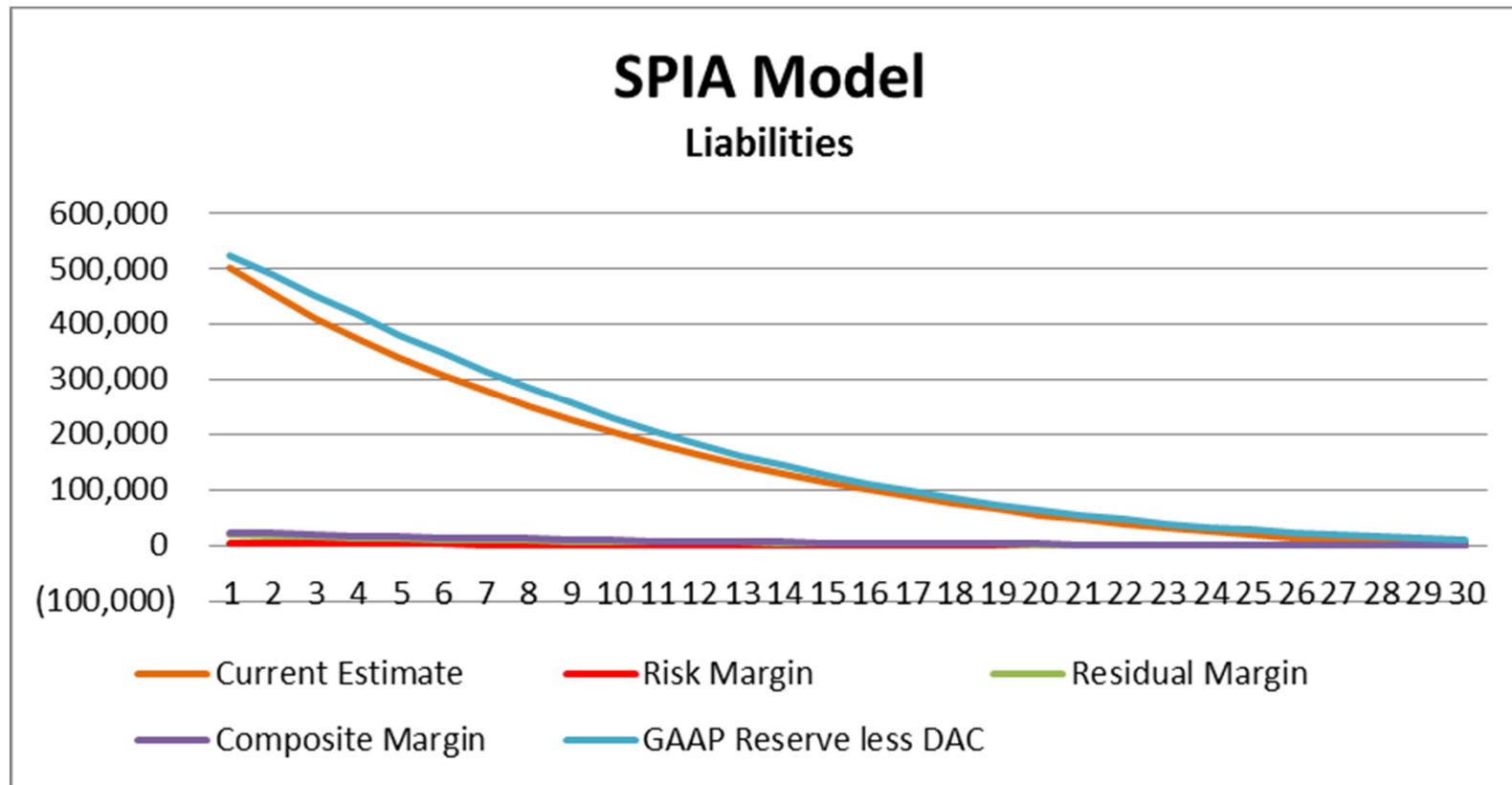
- Six cells: male, female; 65, 75 & 85
- All life only



SPIA Cash Flows

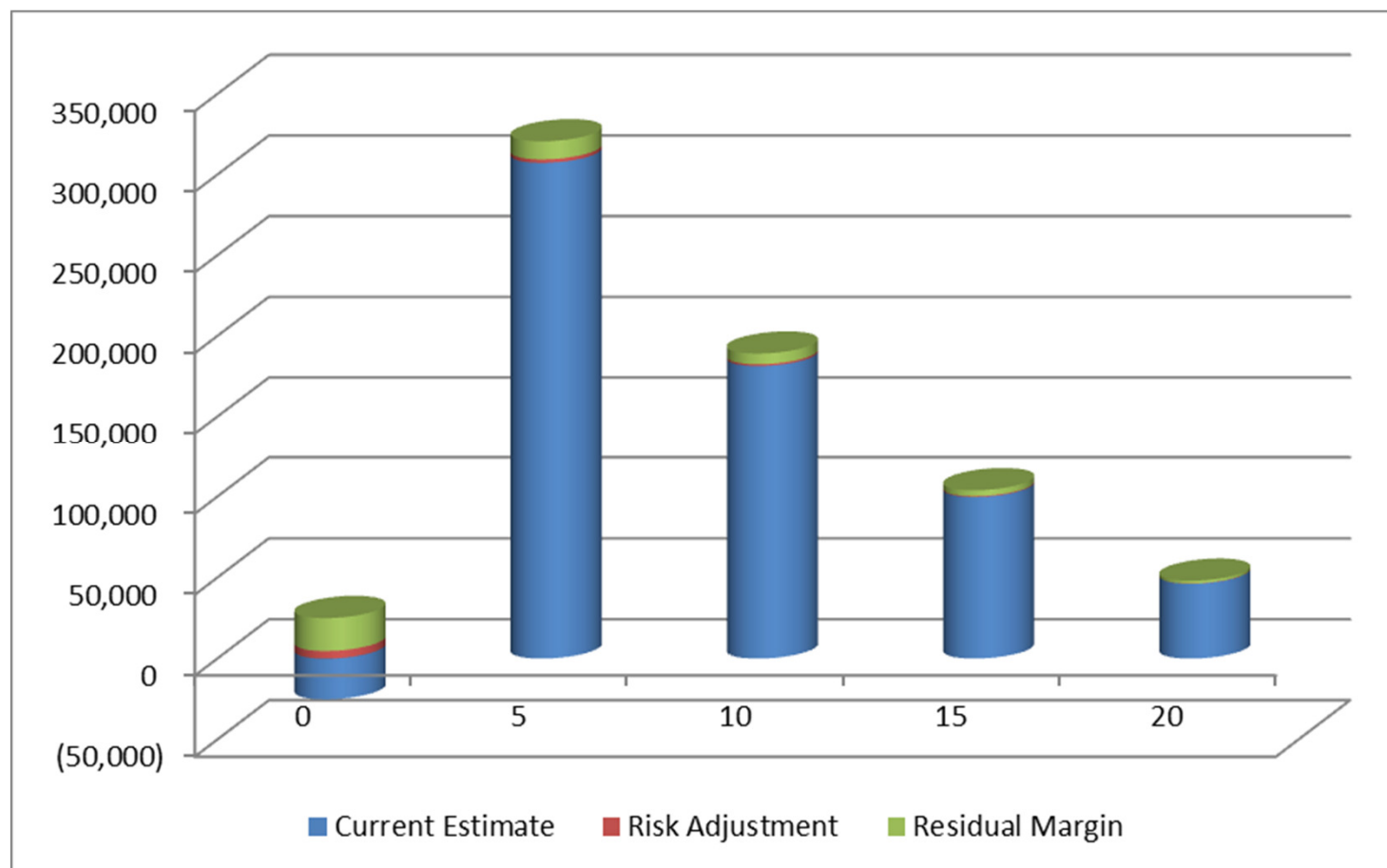


SPIA Liability Comparison



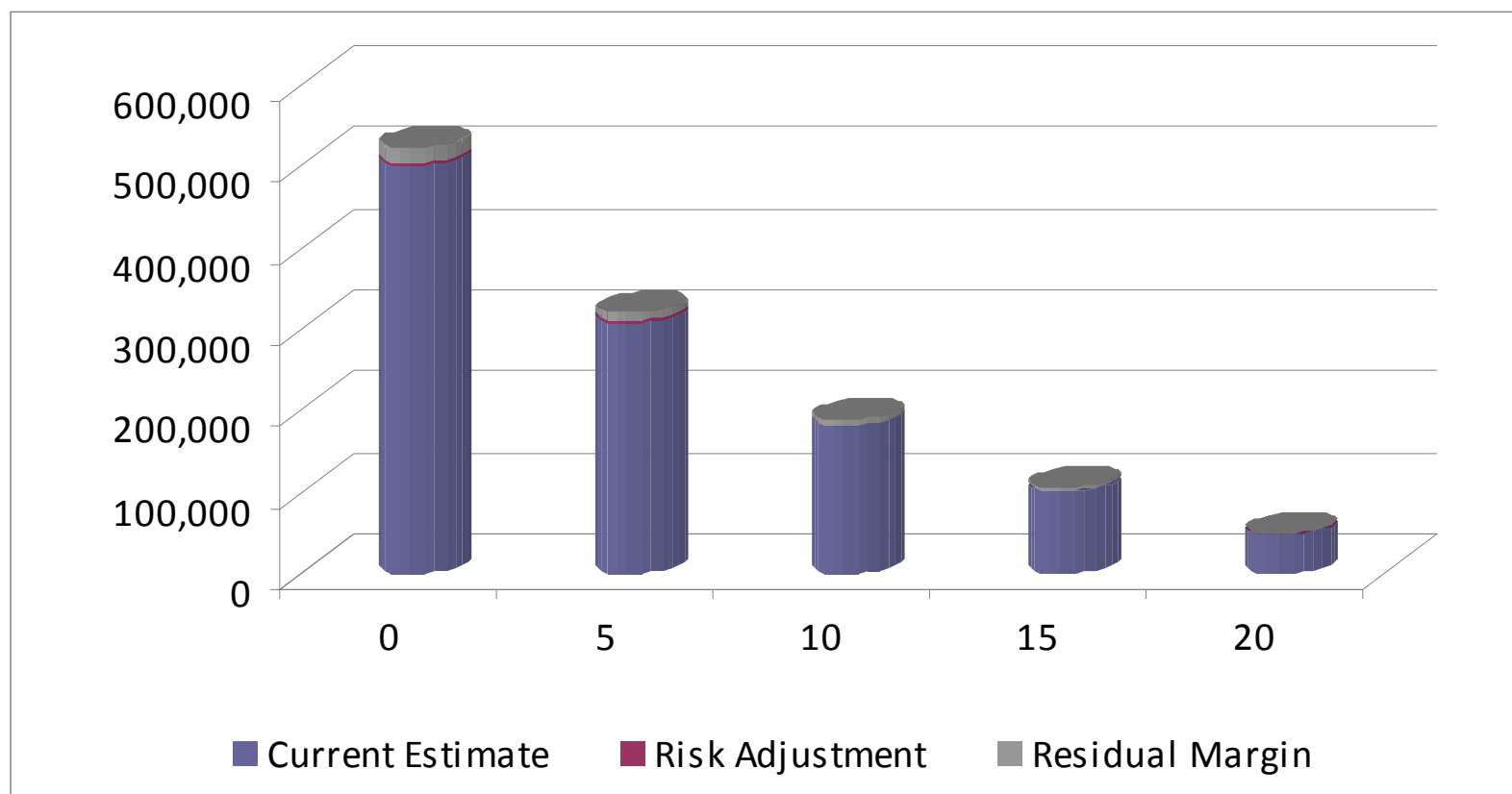
SPIA Liability Components

time zero is one second before issue

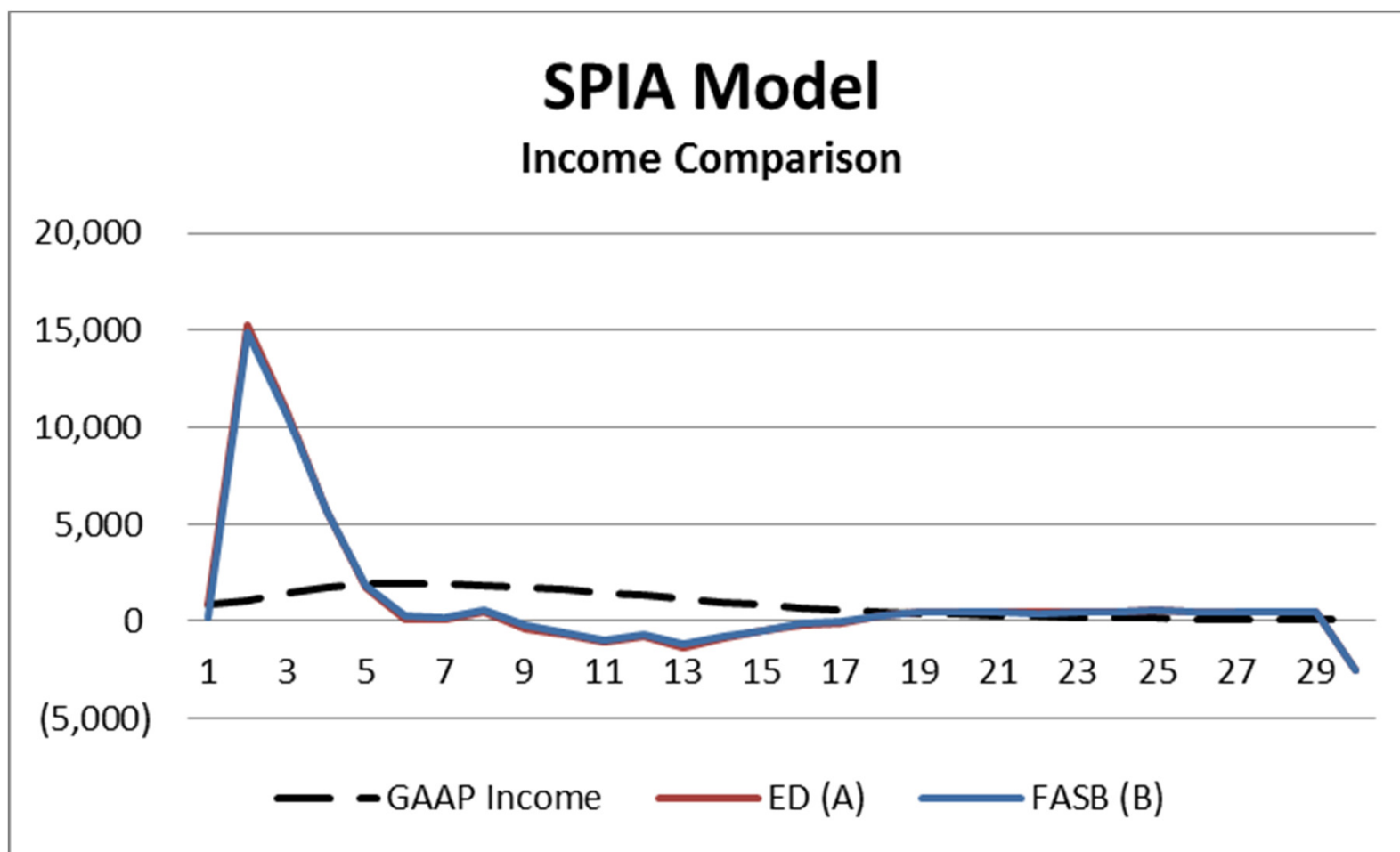


SPIA Liability Components

time zero is one second after issue



SPIA Income Comparison

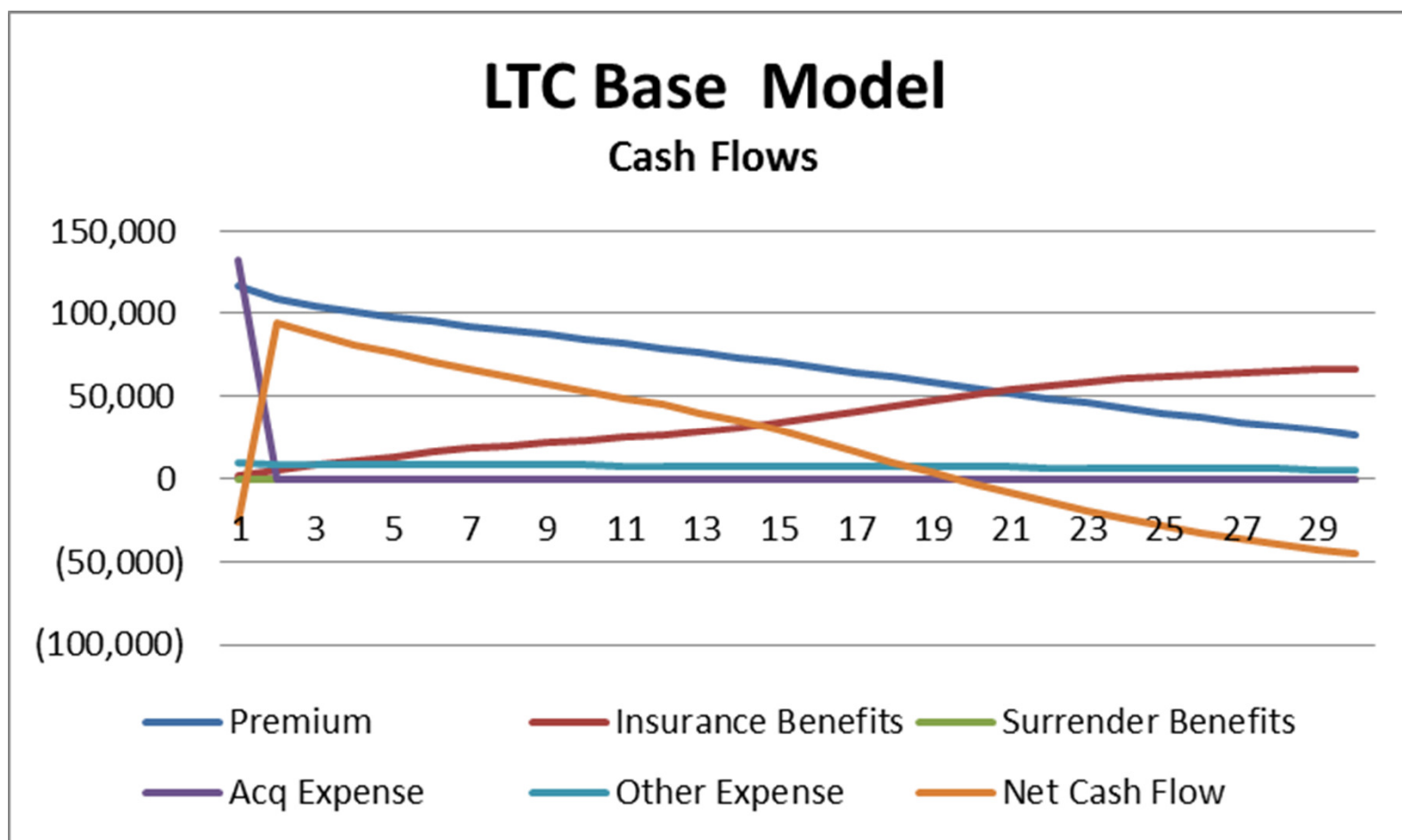


Long Term Care (LTC) Product Features

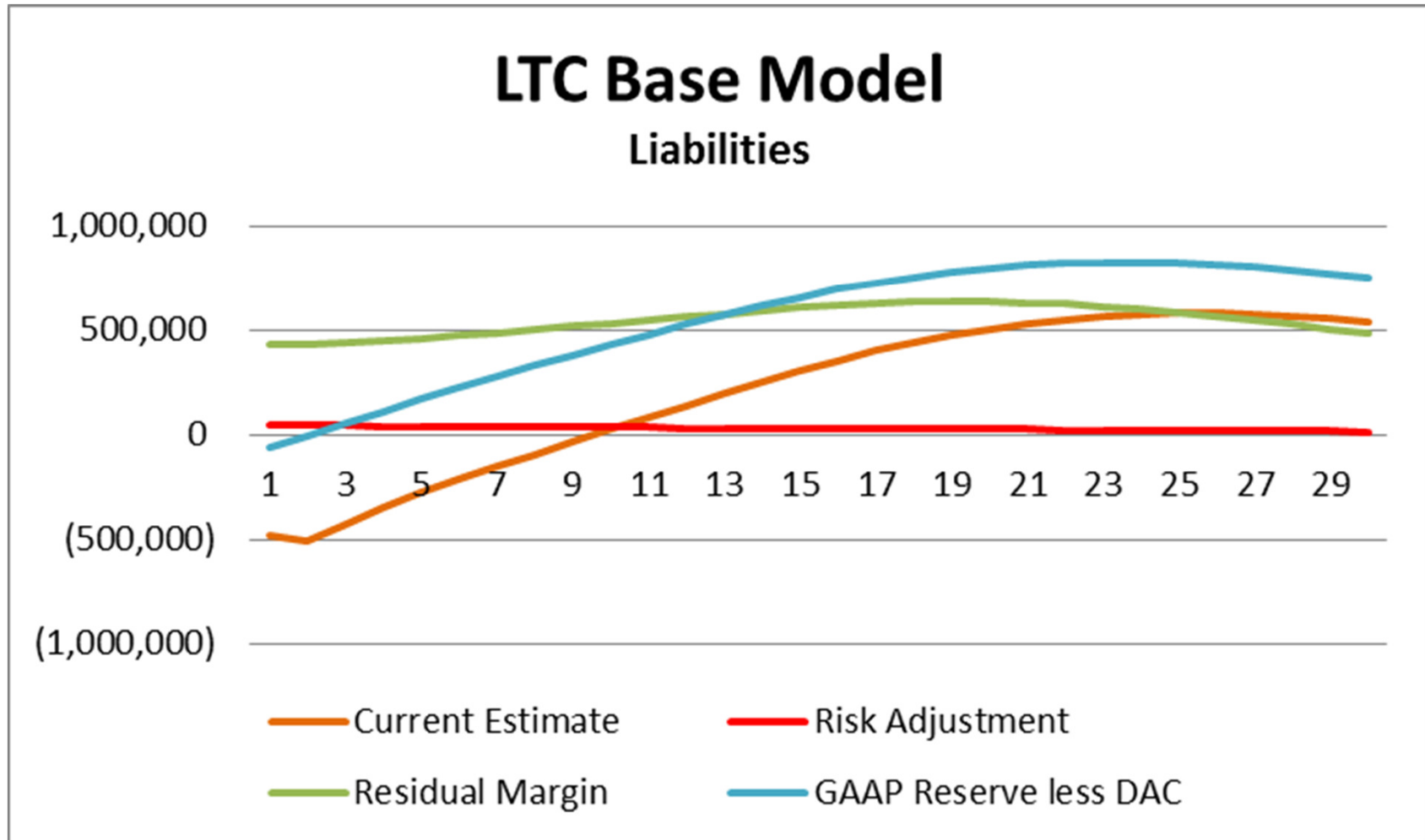
- A health type policy, paying an annuity-type benefit based on poor health
- Premiums to age 100
- Benefits to age 115
- Issue ages 45, 55 and 65



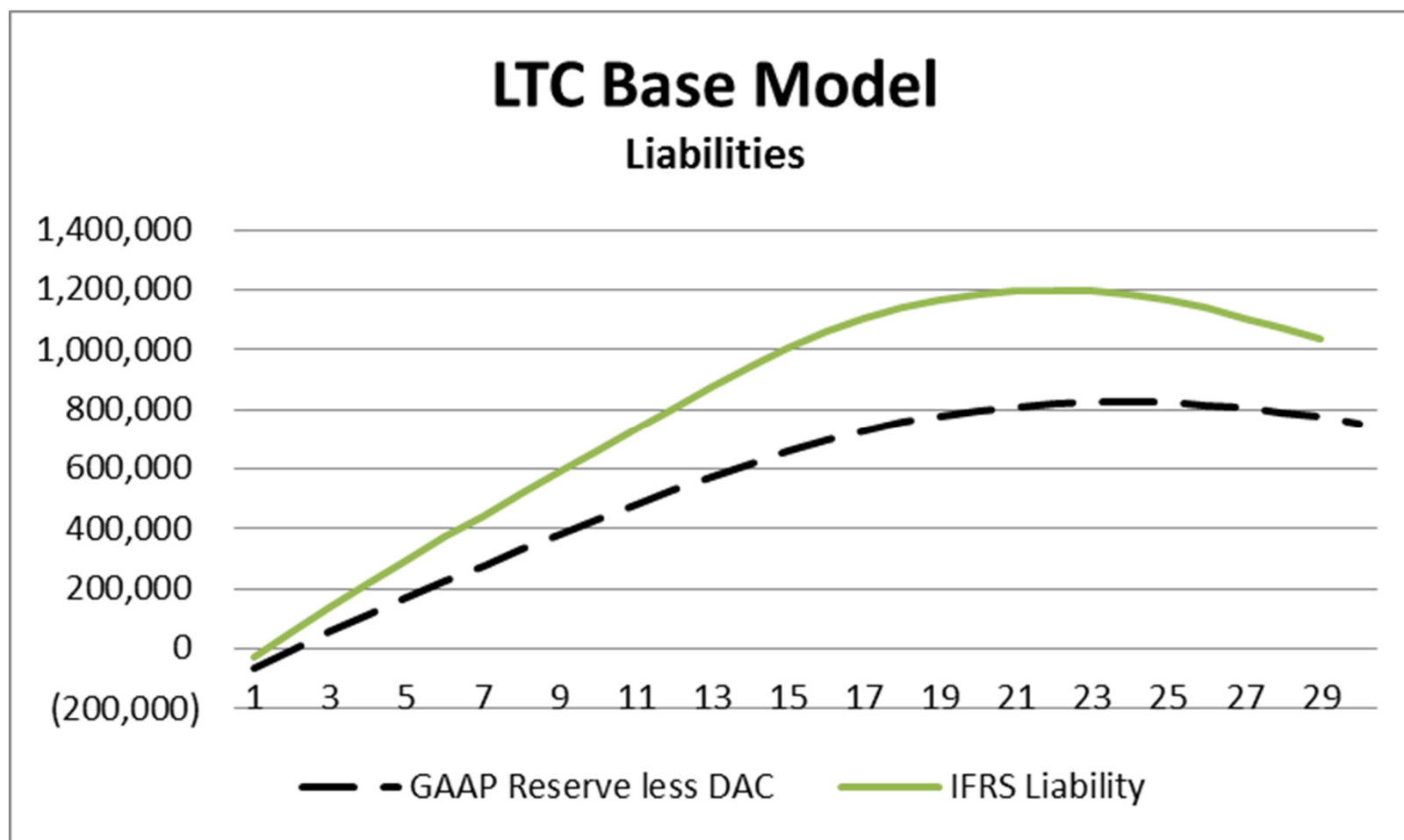
LTC Contract Cash Flows



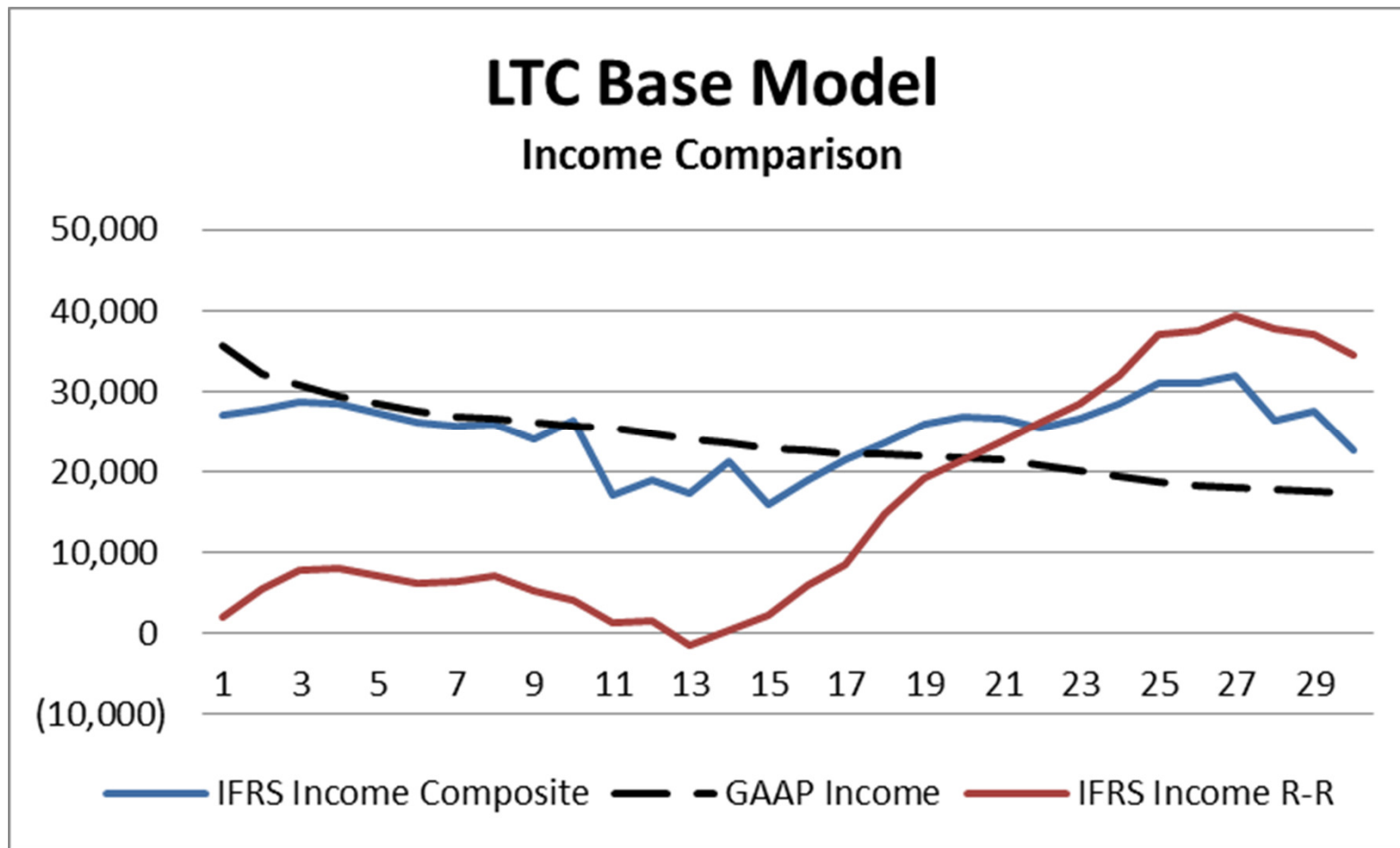
LTC Comparative Liability Levels



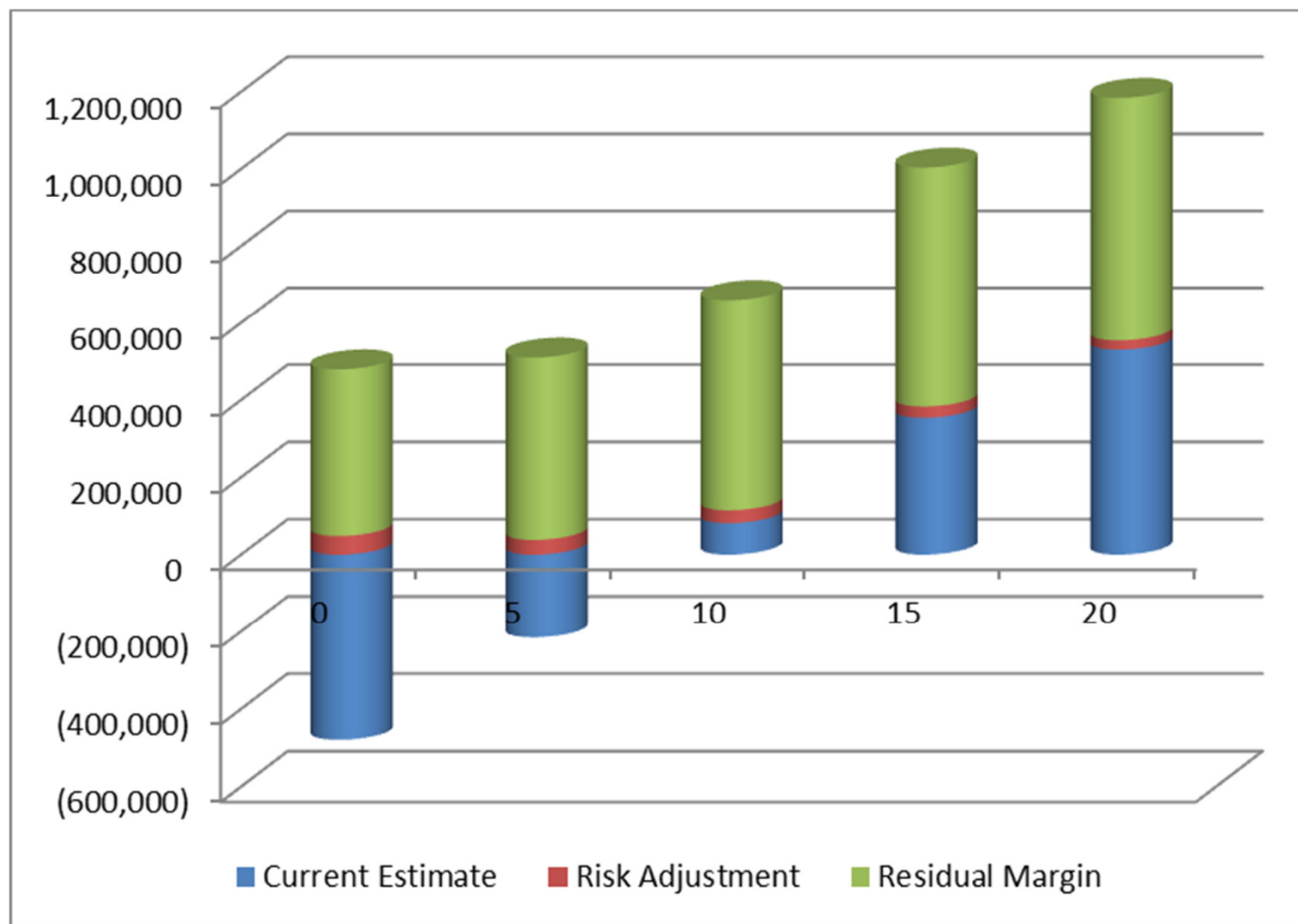
LTC Total Liabilities



LTC Income Comparison



LTC components of IFRS liability



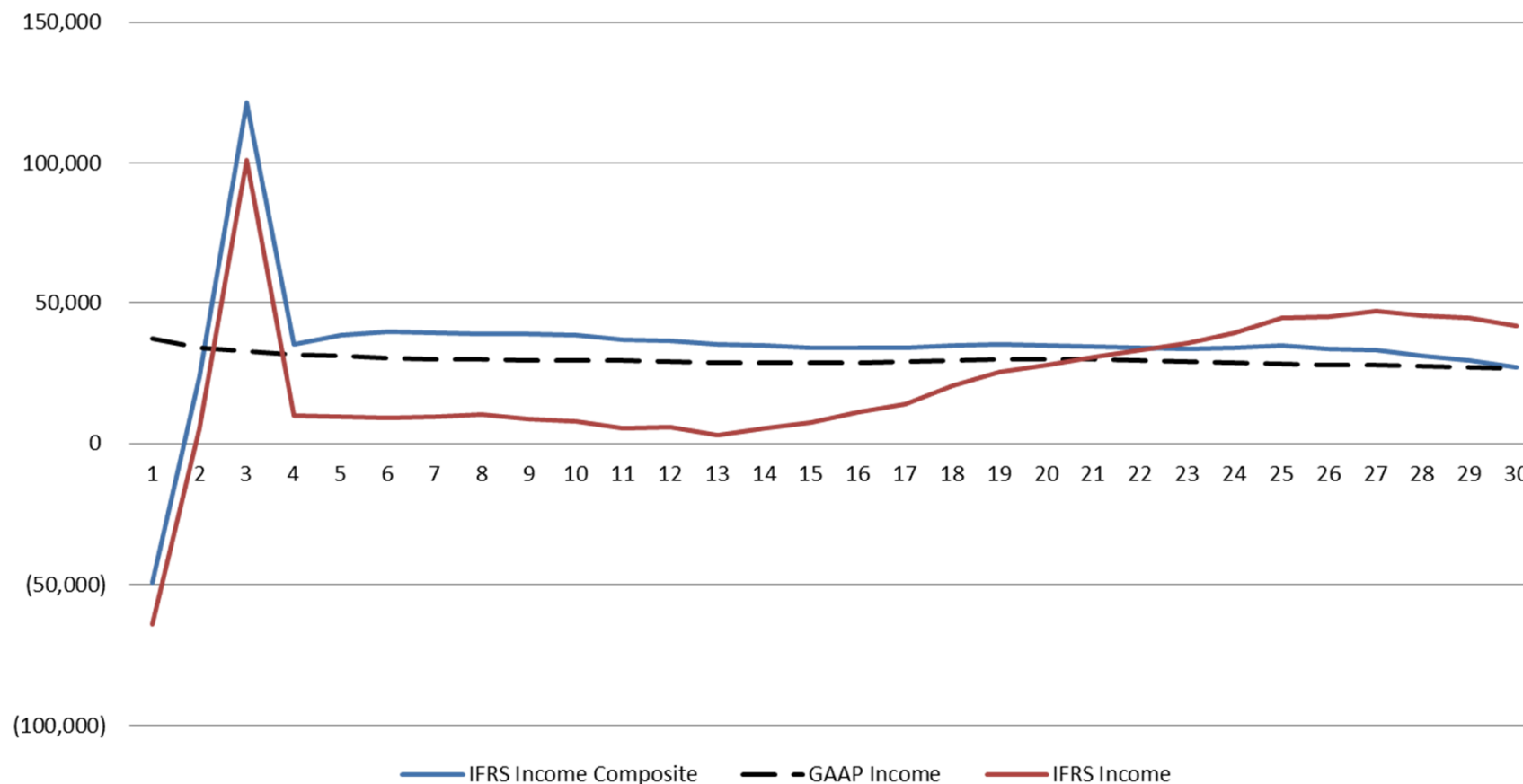
LTC Sensitivity Test 1 of 2

- Experience is positive; morbidity is 85% of expected, starting day one
- This observation is reflected in Current Estimate in year 3



LTC Sensitivity Test 2 of 2

LTC 85pct Morb Model
Income Comparison

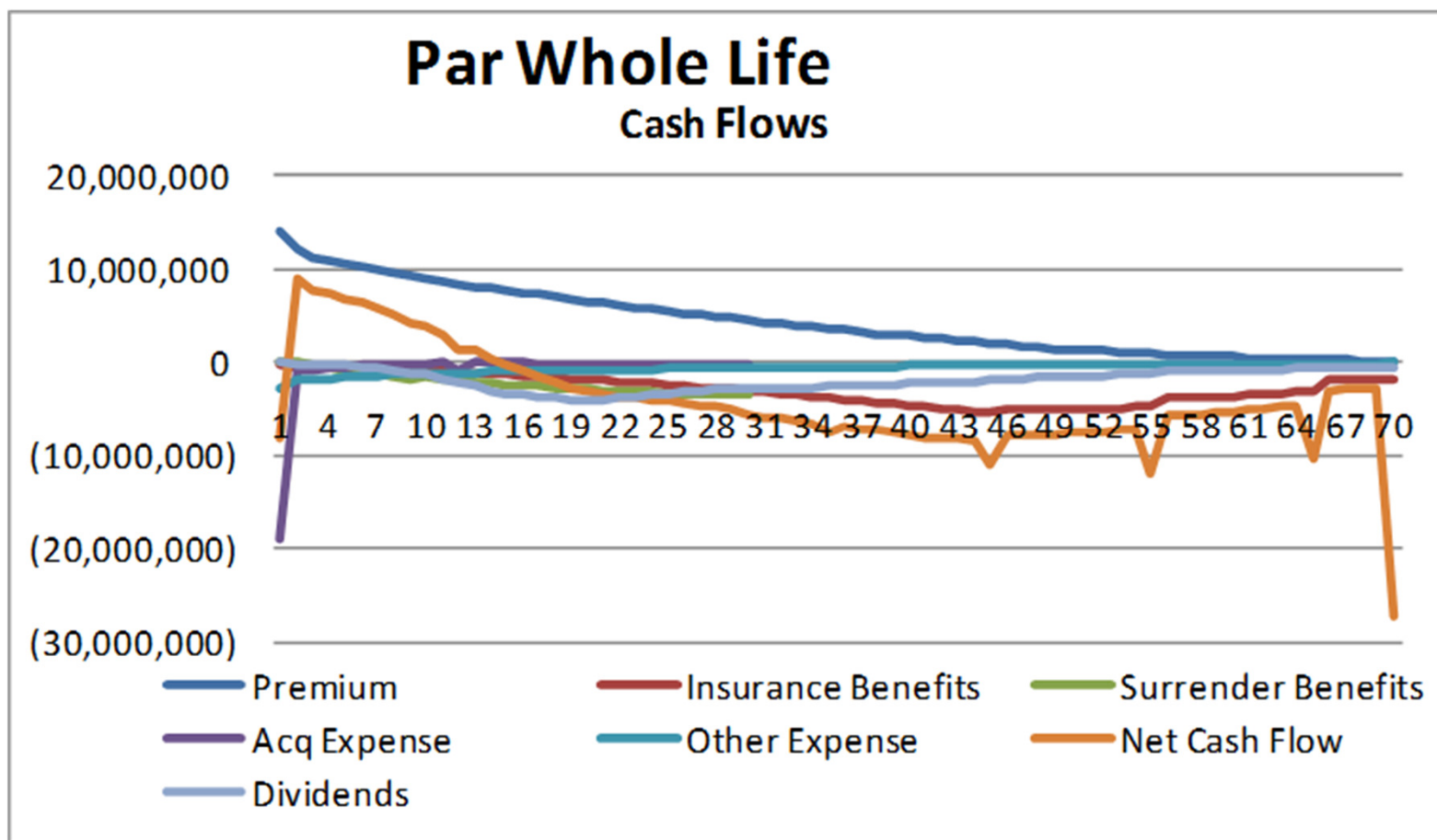


Participating Whole Life – Product Features

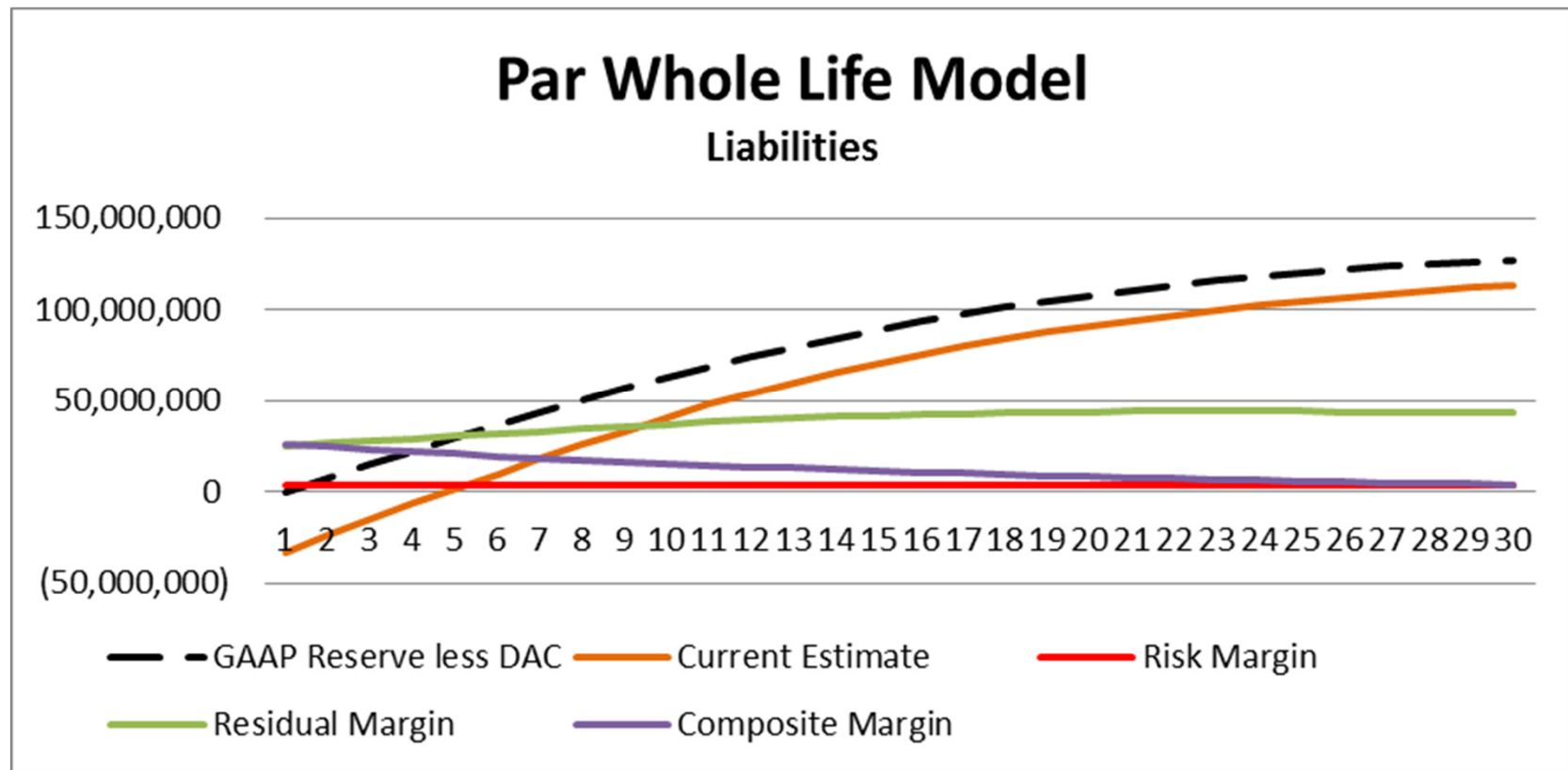
- Whole Life – to age 100
- Policyholder dividends every year
- Interest element of dividend is based on actual investment returns
- No earning restrictions to shareholders
- Discounted at asset earned rate



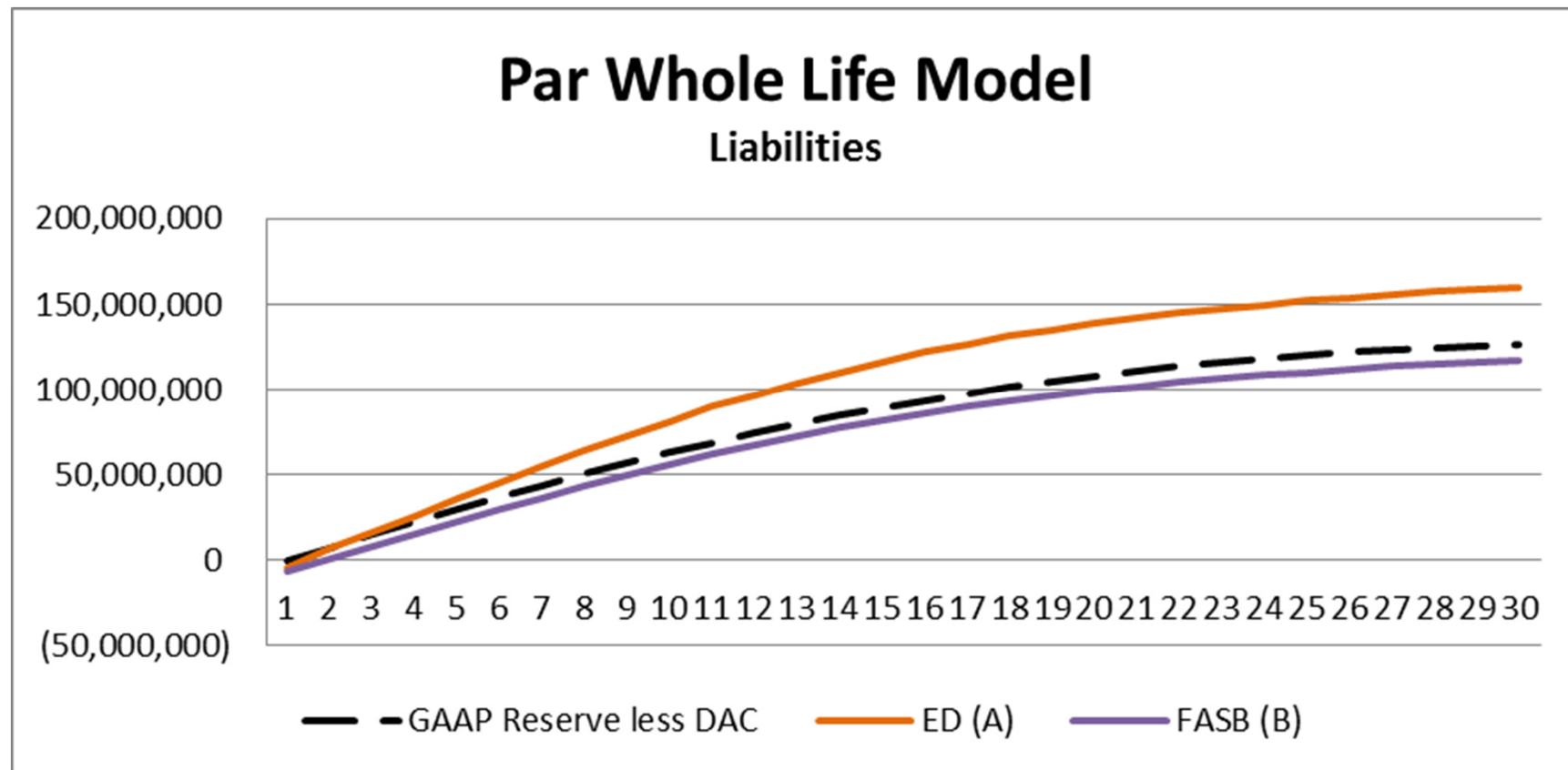
Participating Whole Life – Cash Flows



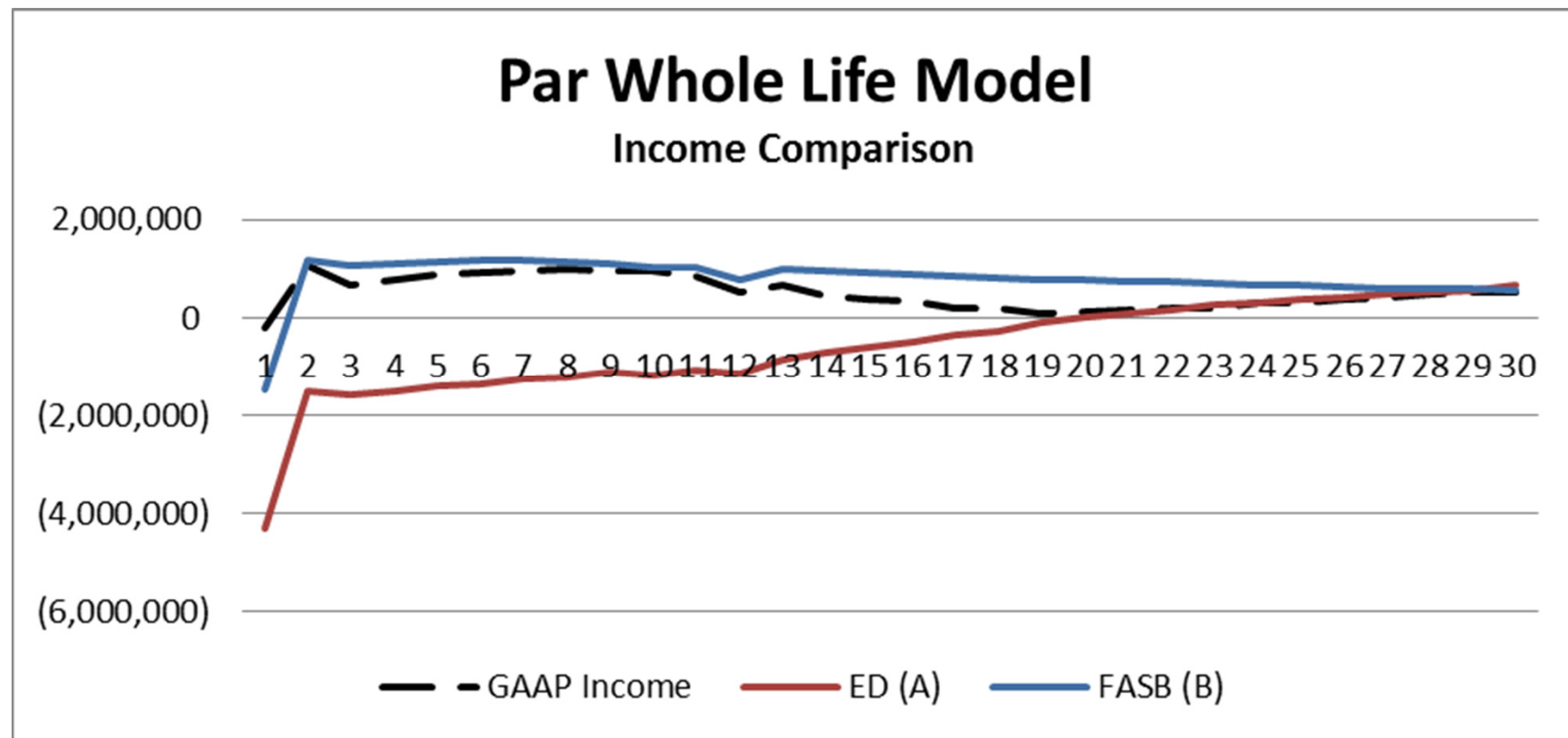
Par WL – Liability elements 1 of 2



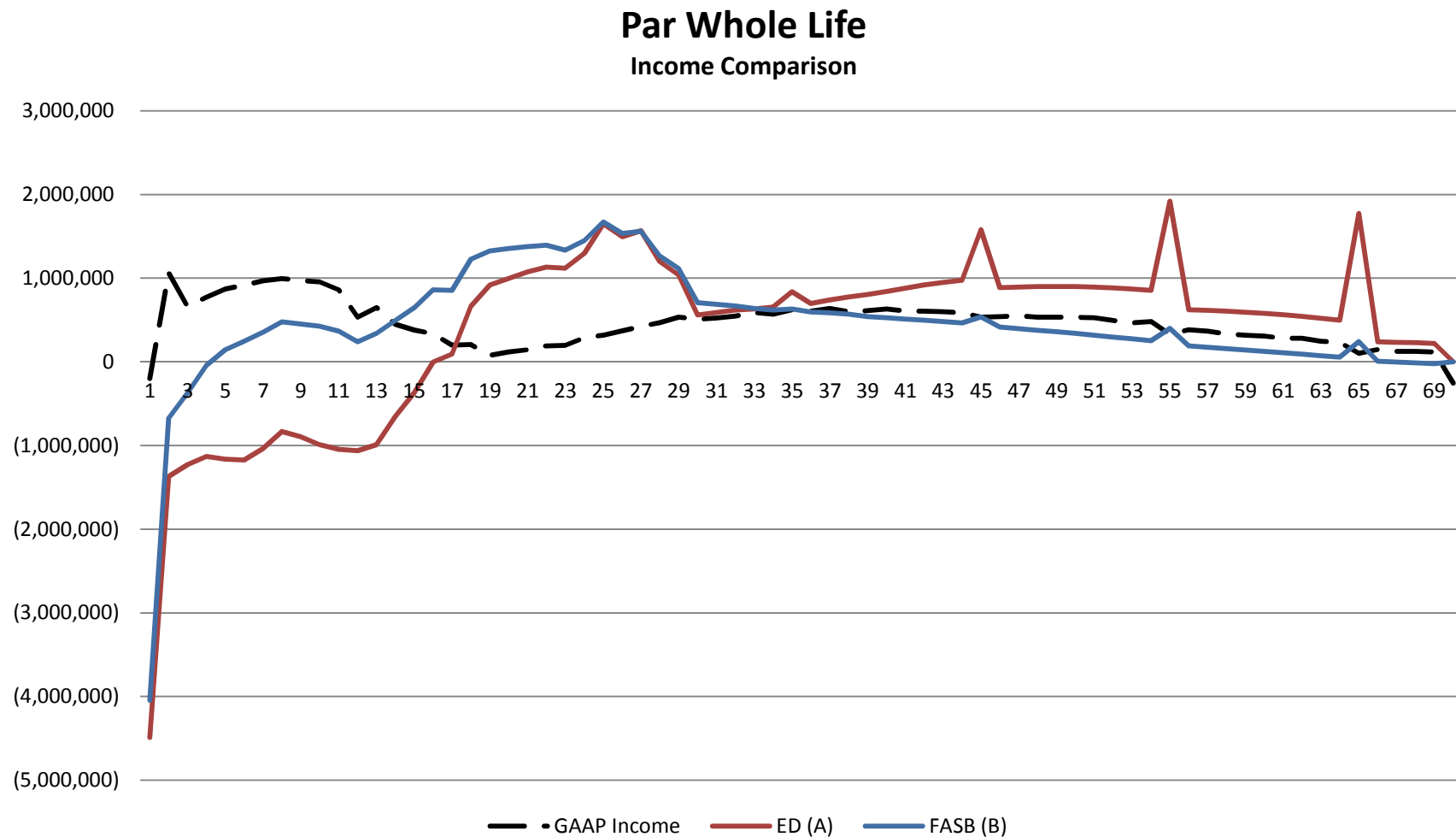
Par WL – Liability elements 2 of 2



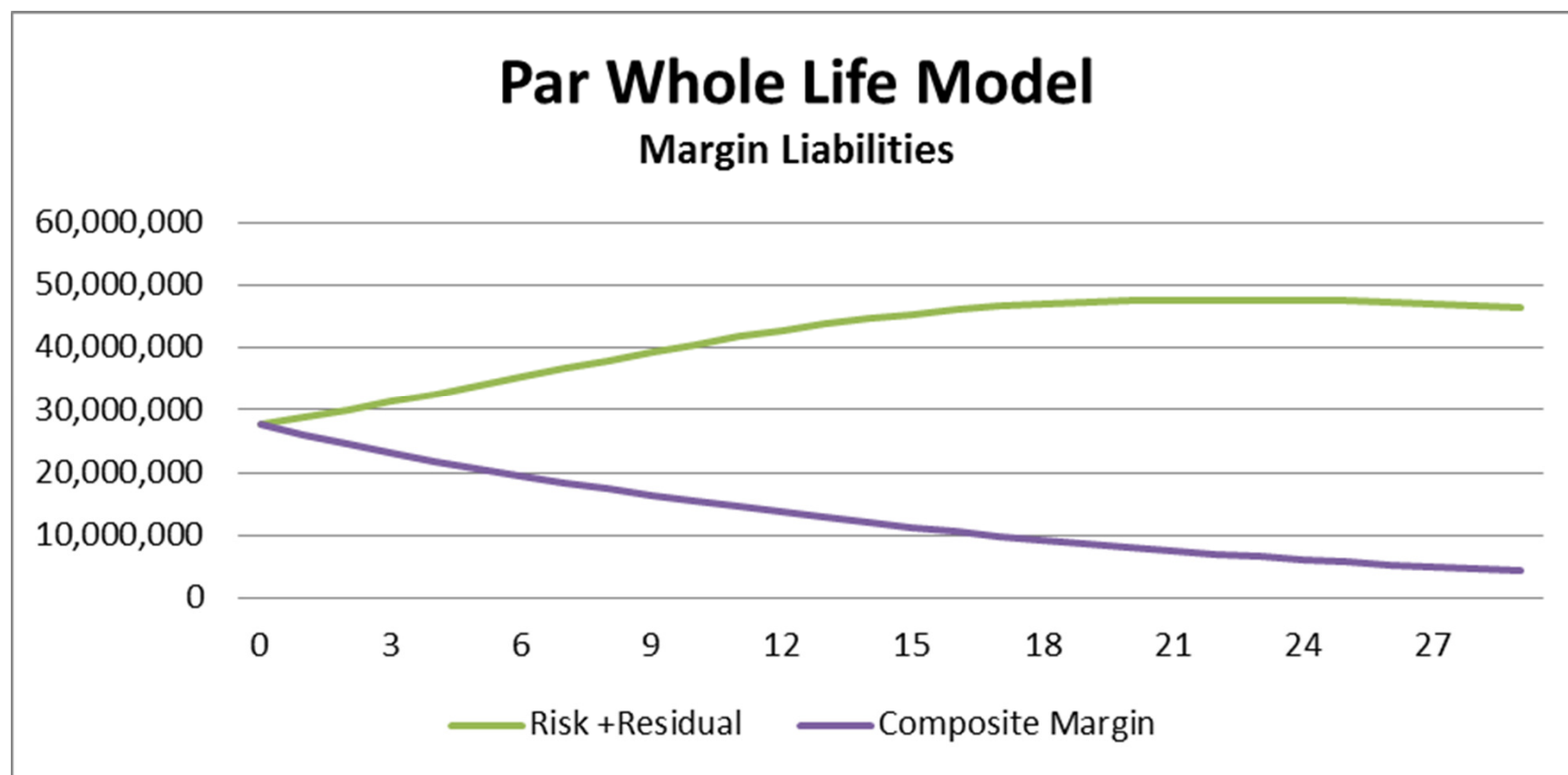
Par WL – Income Comparison



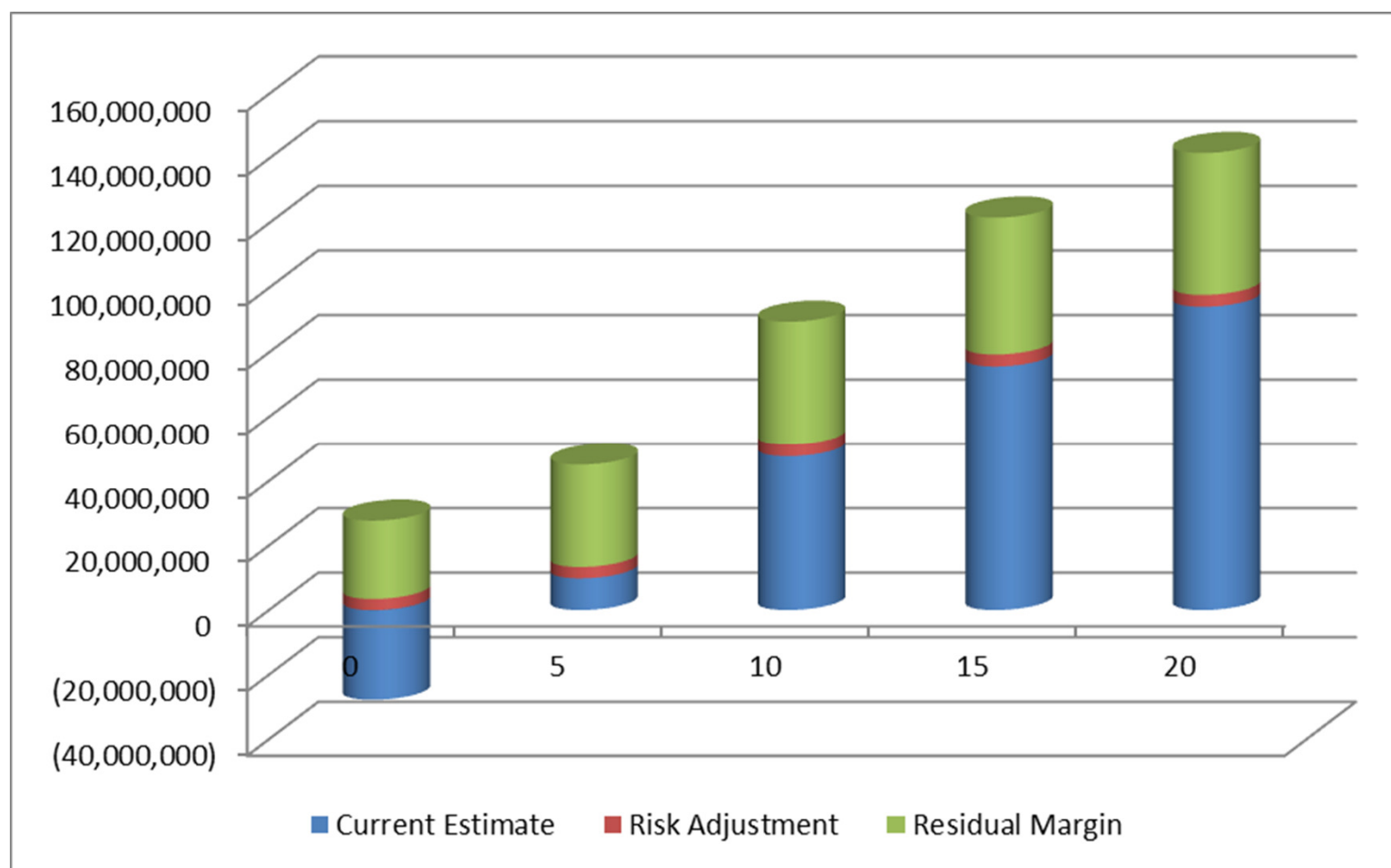
Par WL – longer income comparison



Par WL – Size of Margins



Par WL - Components of IFRS liabilities



What Others Think



Comment Letters to IASB

- 234 comment letters
- Selected from the most recognizable and most active names
- The letters themselves are 20 to 30 pages long; what follows are highlights from executive summaries
- The concerns identified are not all issues listed in each letter; I have attempted to extract the concerns that are identified by many parties



Deloitte

- Coordinate with IFRS 9 (assets at either AC or FV)
- Whatever is used to value assets won't align with rates used to discount liabilities
- RM – unlock
- Discount rate – used asset-based, allowing for defaults
- Unbundling – modify, clarify
- RA – restate its objective
- RA – allow calculation at portfolio level to accommodate diversification
- Do more field testing



Ernst & Young

- Be sure to converge with FASB
- Discount at high-quality corporate bond rate rather than risk-free rate
- Allow option to use volume-based items (premiums, claims) in income
- Simplify onerous contract test if short-term modified measurement model is used
- RM – unlock
- Transition – future profitability will not be fairly represented



- Volatility – unlocking assumptions for CE and RA without unlocking for RM
- Volatility – discounting at rates less than those used for pricing
- Volatility – discounting at fluctuating current rates
- Transition – no RM
- Presentation – is summarized margin really relevant?
- RA – don't limit (to three) the techniques
- Timing – OK to delay introduction of final standard
- Conduct further field testing



PWC

- Artificial day one losses caused where insurer priced products using rate of return greater than risk-free rate
- Allow option for locked-in liability discount rate (to align with AC feature of IFRS 9)
- RM – amortization
- RA methodology freedom causes incomparability between companies
- RM – not remeasured
- Unbundling – needs clarification
- Transition – need RM on existing business
- Field testing – do more; OK to push back timeline



- IASB and FASB should work together to issue identical standards
- Discount rates within IASB initiatives are inconsistent
 - Insurance – risk free plus illiquidity
 - Pensions – high-quality corporate bonds
 - Leasing – incremental borrowing rate
- RA definition is unclear which will result in inconsistent presentation and lack of comparability
- Unbundling definition is unclear
- Need volume indicators (premiums, claims) in the presentation statement, not as footnote
- Transition: allow future profits on existing business



RGGA

- Discount rate – using (lower) rates not linked to policyholder pricing will lead to product withdrawal
- Discount rate – use of current curves with amortized cost assets will lead to volatility in earnings
- Discount rate – too much inconsistency in selection of illiquidity adjustment. 2008 MCEV disclosures showed companies varied illiquidity premiums from 0 to 300 basis points
- RA definition - The “maximum amount an insurer would pay to be relieved of risk” is somewhat nebulous
- Unbundling – not well-defined; costly to account; little value to users
- Presentation – wants premiums, claims
- Disclosures – complexity and extensiveness reduces usefulness. Readers will be overwhelmed with these disclosures. Disclosures will be expensive to prepare. Should pare back.
- Transition - need RM on all business. Otherwise inconsistent results will appear for many years



GNAIE

- Need separate models for long-term (life) and short-term (P&C) business
 - Long-term – long duration, asset/liability relationship, known payment, single loss, reliance on investment income
 - Short-term – short duration, payment not known, multiple chances for loss, investment income not as relevant
 - Different capital requirements, RBC and regulatory reporting forms
- Modified approach for short term products isn't materially simpler, distracts from key measurement of claim rates and shouldn't use interest discounting
- Coordinate financial instruments (IFRS 9) and this project.
- Use a risk-adjusted asset portfolio rate for discounting since performance of life and annuity contracts are inextricably linked to earnings on assets; ignoring asset returns will cause distorted earnings and potentially cause withdrawal of products
- Prefer CM, not the RA plus RM
- If RA is used, allow more than three methods
- At transition, do allow RMs on existing business
- Retain key indicators (premium, claims) in income statement
- No unbundling except for derivatives and other items not closely related to the insurance policy



- Discount rate – generates false positives and false negatives
- Discount rate – use of risk-free rate plus illiquidity won't let users judge if company can fulfill its obligations
- Discount rate – investment portfolios will gravitate to mirror assets used for discount rate, significantly narrowing the diversity of the portfolio and creating unnatural demand
- Unbundling - limit to separate account products
- Expenses – expand includable acquisition and maintenance costs
- Presentation – let margins be an analytic; replace with premiums and claims
- RM – eliminate; OK for day one gain
- Transition – include RM for existing business



UK Actuarial Profession

- Institute and Faculty of Actuaries
- Add liability for undistributed par earnings (90/10)
- RA – why advocate method such as CoC if you have to do a CI (which may be unrealistic) anyway?
- Undesirable to exclude general overhead from CE – will exacerbate future losses for companies closed to new business
- Transition – require RM for existing business



CEIOPS

- Unbundling – do only if it produces more relevant information
- Illiquidity premium – not needed, as illiquidity has already been baked in by use of all possible scenarios
- Make clear under which circumstances (e.g., exact matching in all scenarios) replicating portfolio techniques may be used
- Incremental costs – make them at the portfolio, not contract, level
- Presentation – will need explanation; any way to include volume indicators (premium, claims)?
- Transitional provision – don't set RM to zero on existing business
- Income statement volatility – needs both assets and liabilities discounted on a market consistent basis



CFO Forum

- Need another ED; June 2011 is too soon to address all issues
- Need field testing
- Need to reflect insurer's business models; IFRS 9 did this for banks (e.g., if assets are at AC, then liability discount rate should be locked in)
- Unbundling – needs clarification
- Transition – lack of profits on in-force portrays insurance as a start-up business
- Presentation – not suitable for short-term contracts



International Actuarial Association

- Doesn't produce transparency
- Magnifies accounting mismatches
- RA – provide an explicit objective
- Acquisition costs – include all
- RM – please revisit for dynamic and better amortization
- Unbundling - tighten definition
- Transition – lack of RM misrepresents economic reality



International Association of Insurance Supervisors (IAIS)

- Three-fold interest:
 - Methodologies for calculating items in general purpose financial reports can be used for, or are substantially consistent with, the methodologies used for supervisory reporting purposes
 - Accounting results drive management behavior and supervisors would be concerned about any accounting requirements that may potentially incent management not to act in the interests of policyholders
 - Accounting requirements which might lead to outcomes in general purpose financial reporting of insurers that could pose a threat to global financial stability
- Discount rate will cause constant, unwarranted gains/losses when not much has changed in the long-term perspective; non-economic volatility
- Need field testing



IASB Outreach

- Needs: Most recognized need to reduce diversity allowed by IFRS4; US GAAP for life insurers can be confusing; US GAAP for P&C insurers continues to work
- Timetable: many say June 2011 is too soon and artificial; some say more field testing is needed, more deliberation and clarity needed
- Items for Redeliberation: on following slides



- Volatility caused by:
 - Most report assets at FV; all its volatility goes through profit/loss, not OCI
 - Fluctuation in credit spreads on assets not matched with corresponding changes in insurance liability
 - Use of current risk-free plus illiquidity rates
 - If you use AC for assets as permitted by IFRS9, still get volatility



- Risk Margin, Risk Adjustment, Composite Margin
 - Many want a CM
 - RA implies undue precision
 - RA definition implies an exit value but we are doing fulfillment value
- Presentation
 - Most are uncomfortable about eliminating premiums, claims and expenses
 - Few insurers would be in Fortune 500
 - Some users want more information about “free cash flow”



- Non-life
 - Needs work
 - Most believe the non-life modified approach has been over-engineered
 - Many believe onerous test should be at higher level of aggregation
 - One-year cutoff for contracts is too short



IASB outreach – Items for Redeliberation 4 of 4

- This outreach summary document states participating business should not use investment portfolio rate
- RA methods – some say principles only so that new methods can be used; others say the wide variety will eliminate the ability to compare companies
- Unbundling: unclear; “closely related” needs to be better understood; it will be costly
- RM – amortization method and unlocking needs to be revisited
- Acquisition costs have been too narrowly defined
- Many concerns about volume and complexity of disclosures
- *No one* agreed with lack of RM for existing business at point of transition



Action during 2011

- Recent Board Activity
- HUB
- SOA research extension



Recent Board Activity

- Don't have to identify *all* possible scenarios
- Will *not* prescribe a method for determining the discount rate
- Discount rate *will* be a current rate and not be locked in
- They *will* discuss the precise wording of the objective for an explicit Risk Adjustment (see next slide)
- *Do* include in contract cash flows acquisition costs relating to a portfolio of insurance contracts
 - IASB – make no distinction between successful and unsuccessful efforts
 - FASB – limit these expenses to costs related to successful acquisition efforts
- Eliminate the term “incremental” from the discussion of fulfillment cash flows



Objective of the Risk Adjustment

- The boards tentatively decided:
 - to remove references in the objective of the risk adjustment proposed in paragraph 35 of the ED to 'the amount the insurer would rationally pay to be relieved of the risk' and to a 'maximum amount'. As a result, the objective of the risk adjustment would be as follows: 'The risk adjustment shall be the compensation the insurer requires to bear the risk that the ultimate cash flows could exceed those expected.'
 - to provide application guidance that this amount would reflect both favorable and unfavorable changes in the amount and timing of fulfillment cash flows.
- The staff will consider how to capture in the application guidance the notion that the risk adjustment *reflects the point at which the insurer is indifferent between holding the insurance liability and a similar liability that is not subject to uncertainty.*



HUB

- European, US, Canadian and Asian companies
- Concerned about loss of confidence in insurance sector due to inadequate accounting framework
- Wants adherence to six principles



HUB principles

1 of 2

- Accurate picture of *performance*
- Level playing field with competing financial networks – banks don't show artificial volatility
- Accounting rules should reflect the underlying business model – life (ALM) and non-life (underwriting)



HUB principles

2 of 2

- No artificial volatility (maybe run through OCI)
- No new model needed for short-term business
- Use top-down discount rate
 - Portfolio gross yield
 - Less expected defaults
 - Less expenses
 - Less expected liquidity losses on force sales
 - Less a risk margin

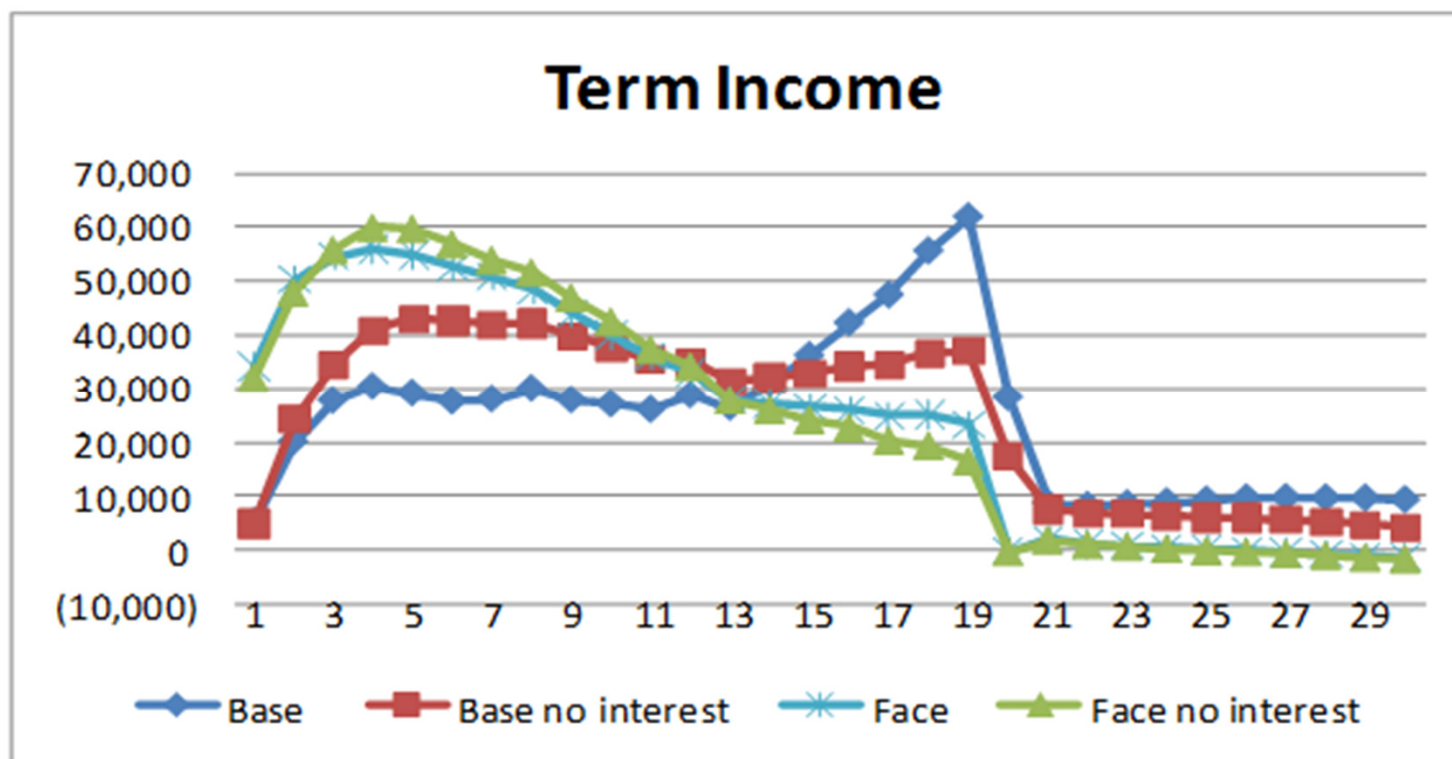


Society of Actuaries

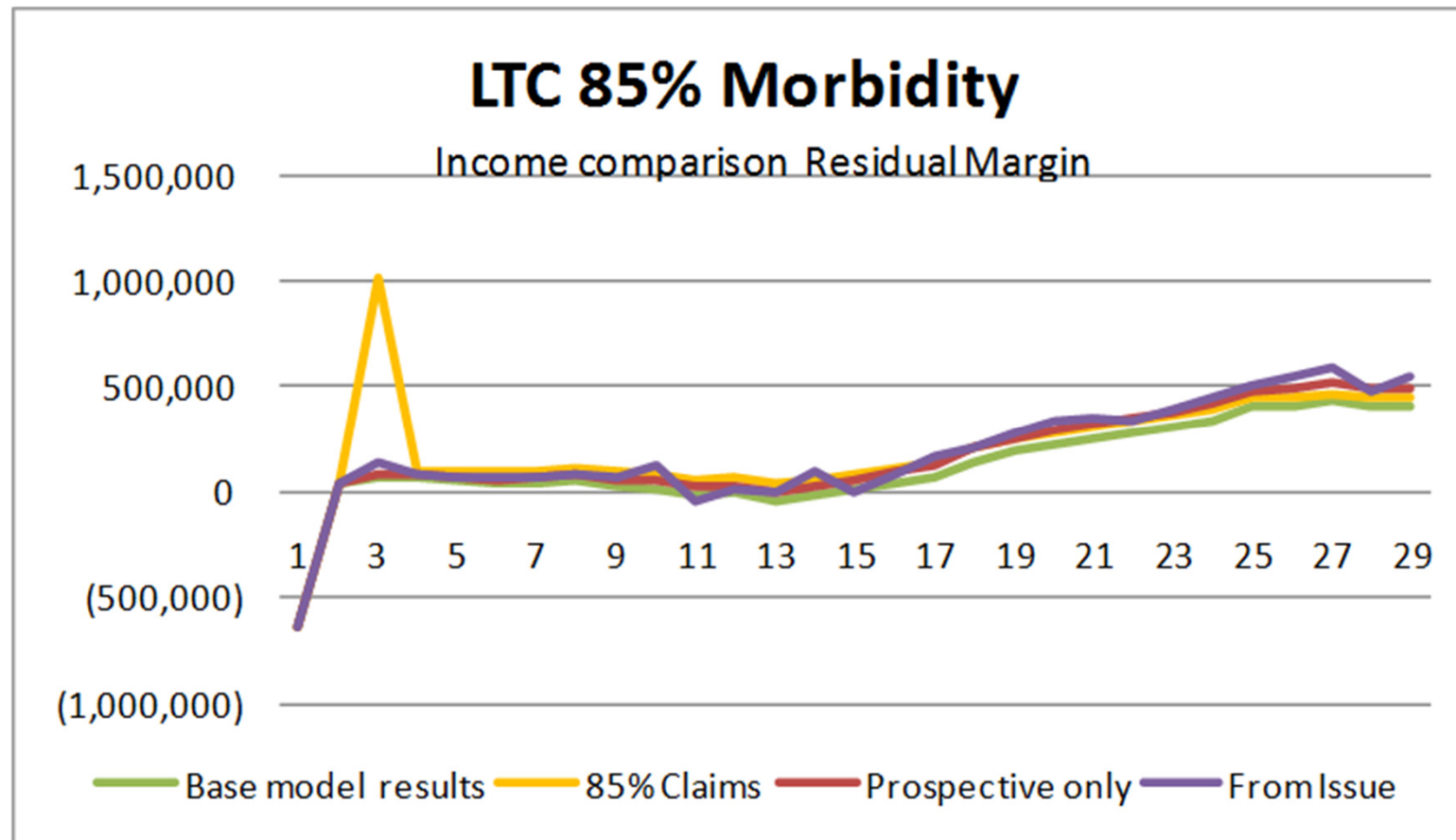
- Good news – more studies
 - Expenses
 - Margin amortization alternatives
 - Discount rates – display volatility using 1993-1999 as basis
- Available on SOA website:
 - www.soa.org/research/research-projects/life-insurance/research-fr-insurance-contracts-extension.aspx



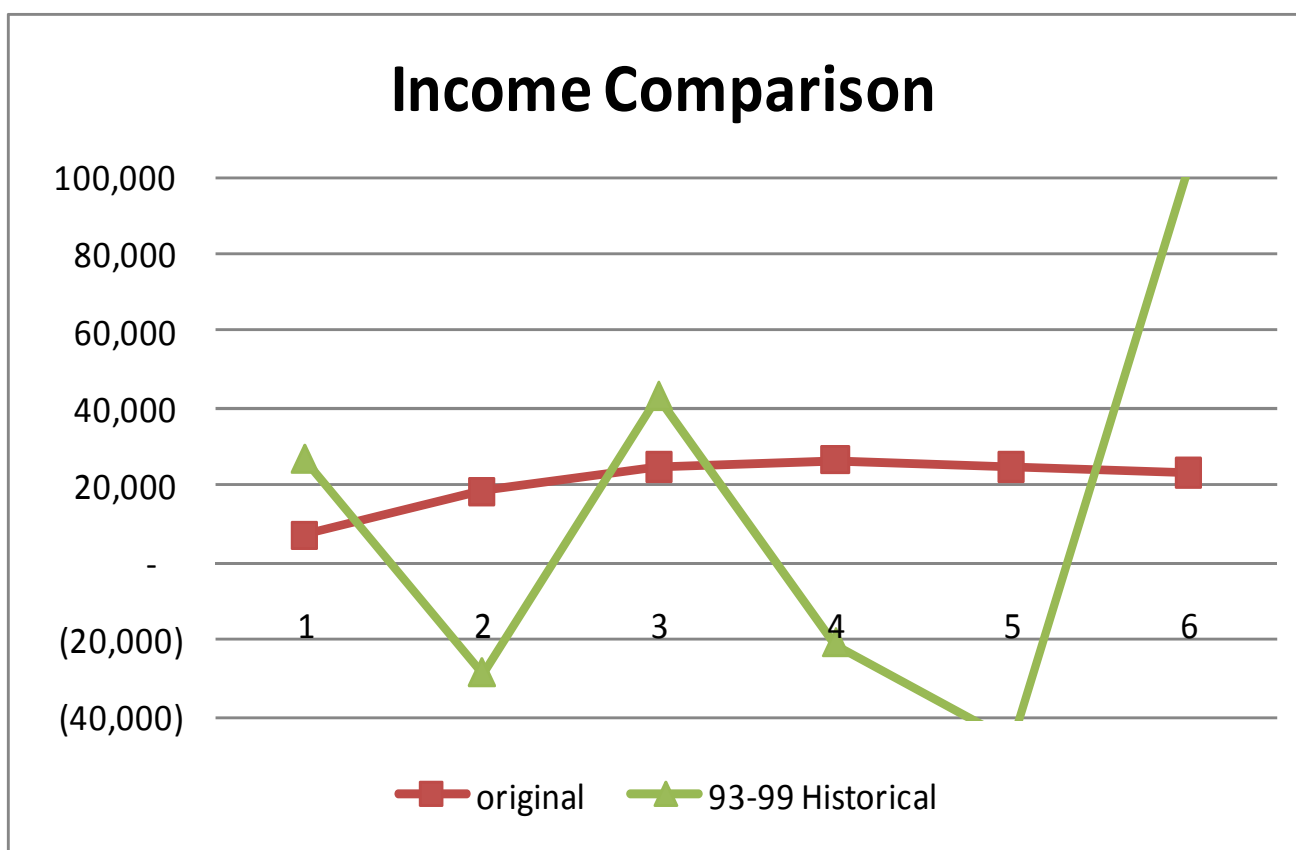
Residual Margin – different amortization bases – not remeasured



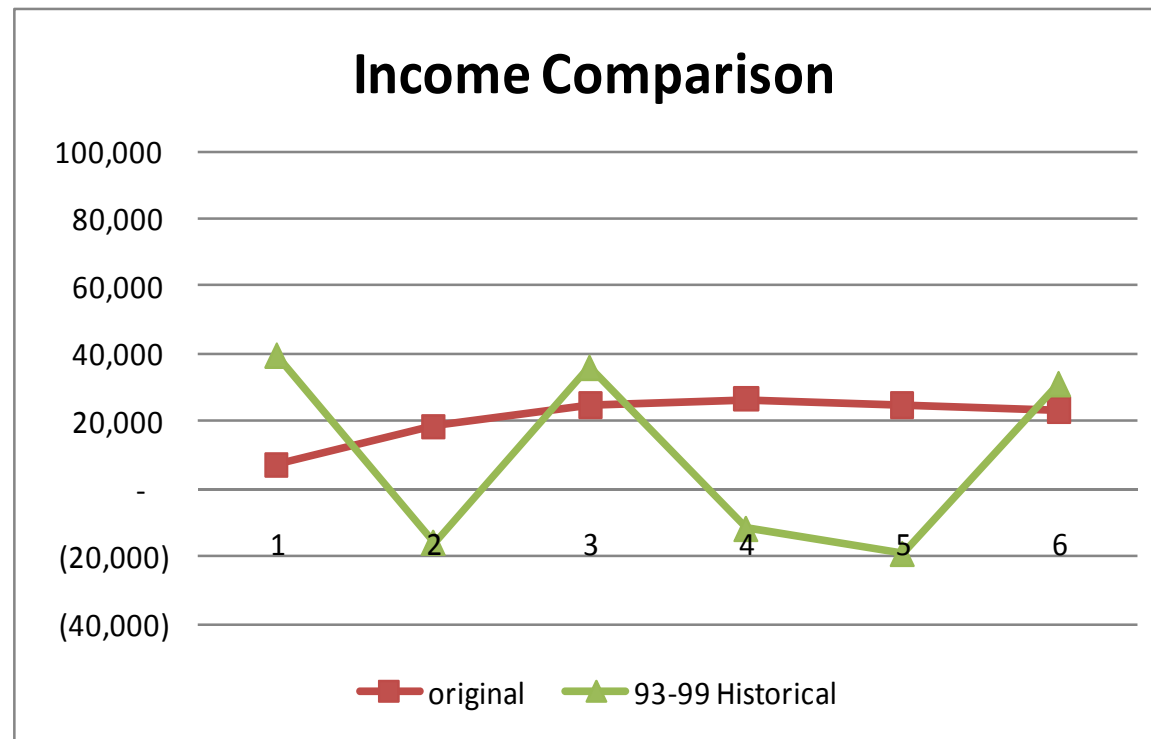
Residual Margin - Remeasured



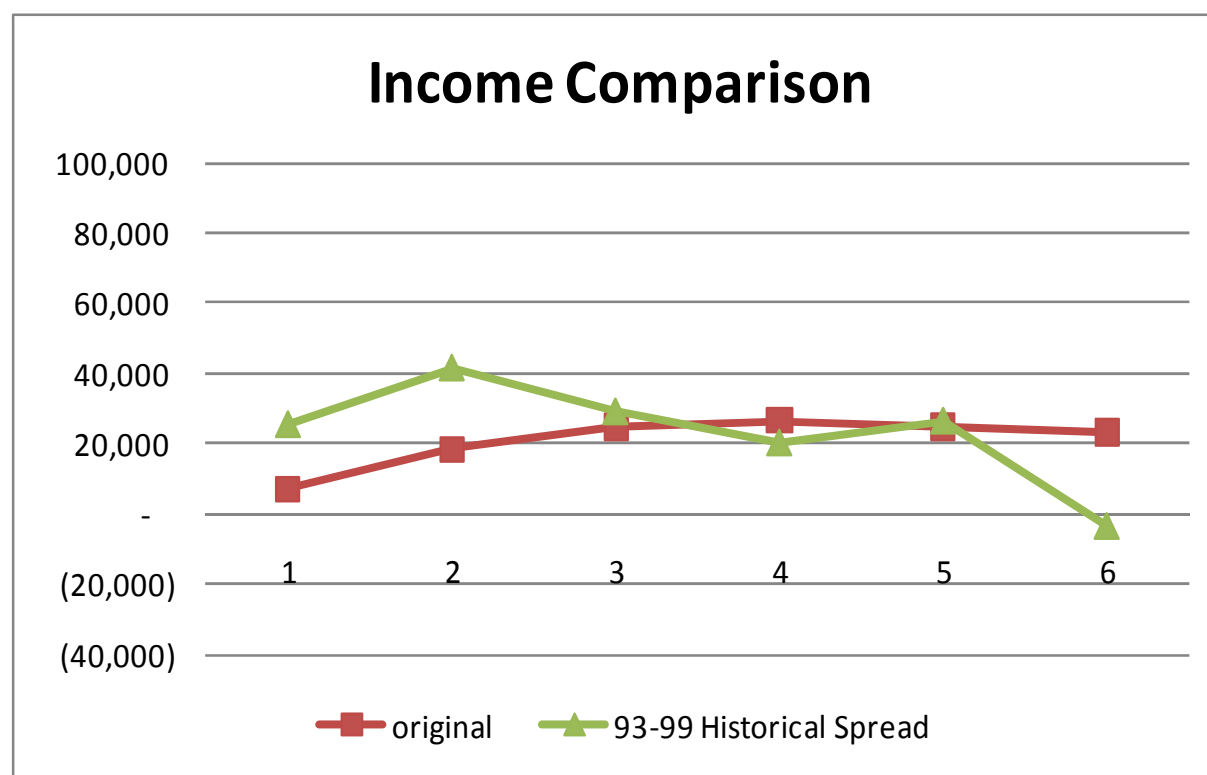
Discount rates – liability discounting only



Discount Rates – hypothetical bond portfolio reported at Fair Value



Discount Rate – New, perfectly matched investment portfolio



Next Steps



Next Steps

- Board receiving tailored presentations and education sessions
- IWG meeting
- Board deliberates through mid-May
- Standard to be issued end of June 2011
- Implementation...2 – 3 Years Later
- SEC decision on convergence – late 2011
 - But FASB has already said IFRS will replace US GAAP for insurance companies



Questions & Answers

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