

FRS 104 Insurance Contracts

Singapore Actuarial Society Forum

4 March 2005

Agenda

-  Background
-  Product Classification
-  Insurance Contracts and Contracts with DPF – Accounting Treatment
-  Disclosure Requirements

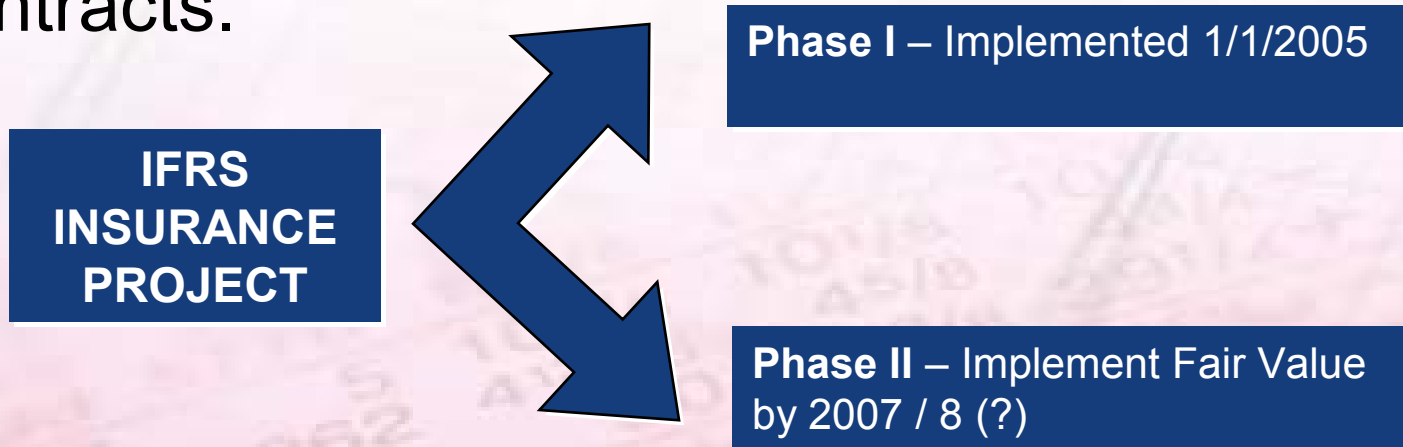
Background on IFRS Insurance Project

Background

- ✎ IASB developing a single set of global accounting standards
- ✎ Many countries committed to the objective of global “harmonisation”
- ✎ Cross-border capital flows highlight the need for consistent, understandable financial information
- ✎ Drivers for fair value
 - ✓ Historical cost accounting models lack relevance
 - ✓ Solvency-based approaches don’t provide an accurate picture

Phased approach for insurance

- ✎ There is now a phased approach to insurance contracts.



- ✎ The Board's objective for Phase I is to implement some components of the insurance project by 2005, without delay to Phase II

2005 requirements

-  All European Listed companies and Australian reporting entities are required to report under International Financial Reporting Standards by 2005
-  Singapore FRS based on IFRS
-  CCDG has adopted FRS 104 for Singapore to be effective 1 Jan 2005

Key standards for insurers

Investments: Equities Fixed Income Mortgages Loans	FRS 39	Equity	Various
Property	FRS 16/25	Insurance Liabilities & Investment contracts with discretionary participation features	FRS 104
Investment Contract DAC	FRS 18		
Insurance DAC	FRS 104	Investment contract liabilities	FRS 39
PVIF	FRS 104	Other liabilities	Various
Other assets	Various		

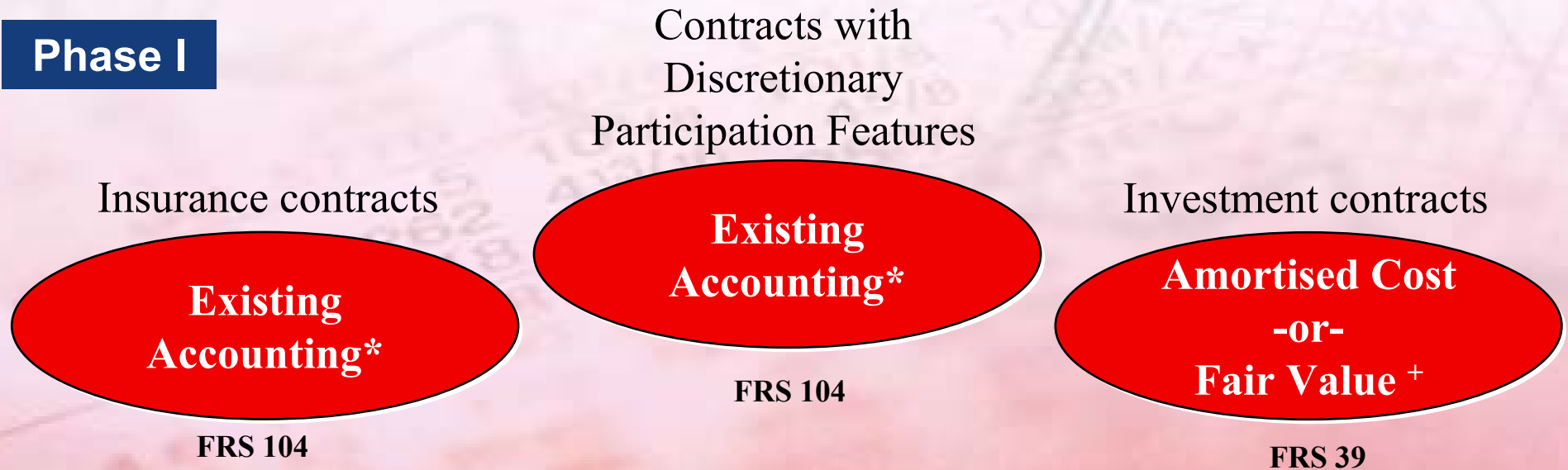
Product Classification

Product classification

- Why is it important?

Product Classification defines accounting treatment

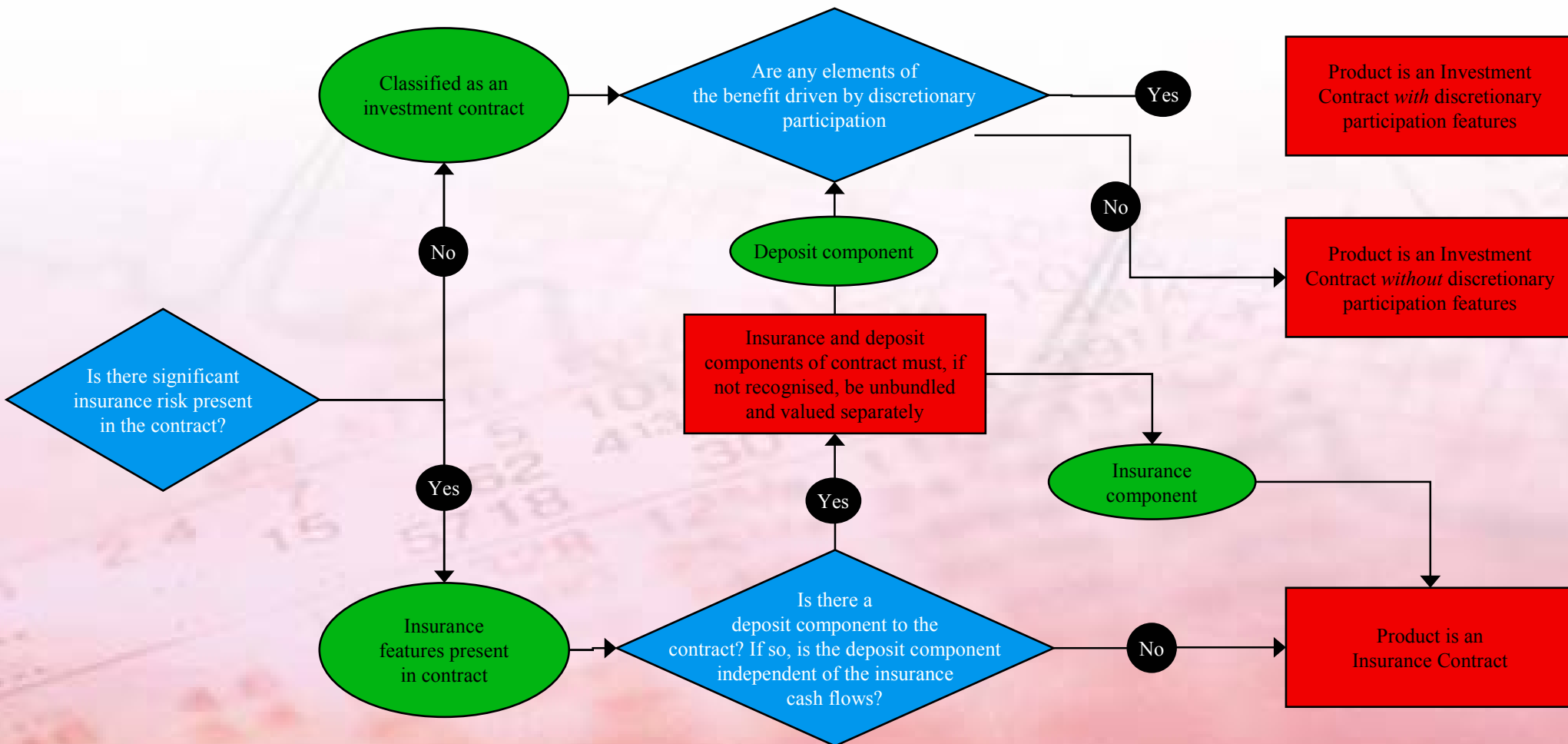
Phase I



**Subject to certain modifications*

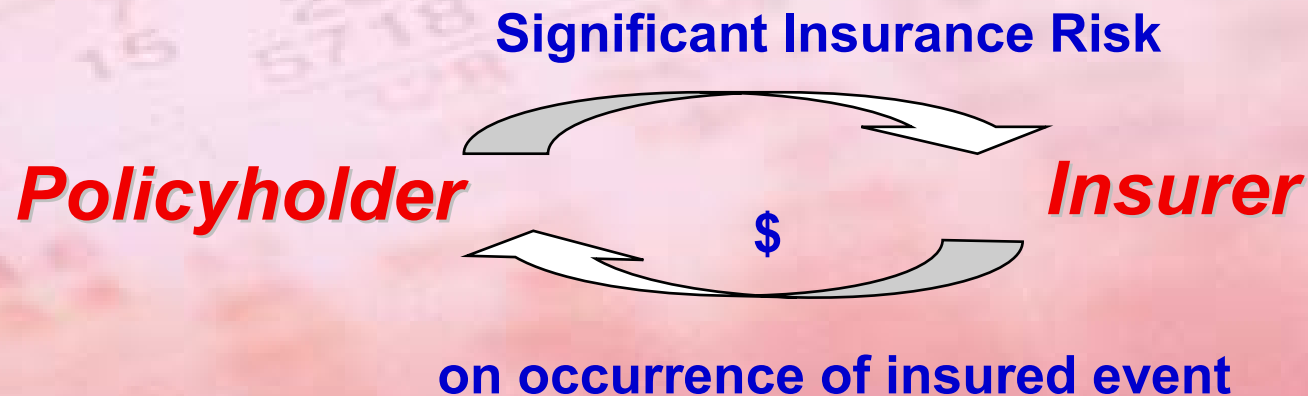
+Subject to exposure draft

Classification flowchart



Definition of insurance

“A contract under which one party (the insurer) accepts **significant insurance risk** from another party (the policyholder) by agreeing to compensate the policyholder if a specified **uncertain future event** (the insured event) adversely affects the policyholder.”

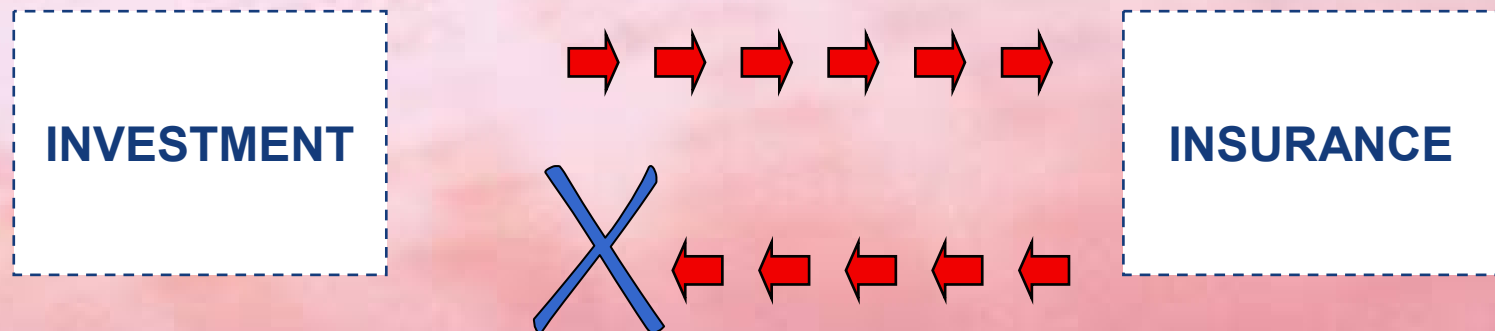


Significant insurance risk

-  ‘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.’
-  Additional benefits must be for pre-existing risk and do not include:
 - ✓ Charges that would be made on cancellation or surrender
 - ✓ Loss of ability to charge policyholder for future services
 - ✓ Possible reinsurance recoveries (these are classified separately)

Change in level of insurance risk

- ✎ Once insurance, always insurance, but can go from investment to insurance
- ✎ Investment may change to insurance through:
 - ✓ Changes in regulation, law
 - ✓ Switch between funds, first fund has no insurance risk – second fund has insurance risk.
 - ✓ Previously underestimated risks in investment contracts



Comparison to US GAAP

US GAAP Classification

FRS Classification

SFAS 60, SFAS 97 Limited
Payment, SFAS 120



Insurance

SFAS 97 Universal Life



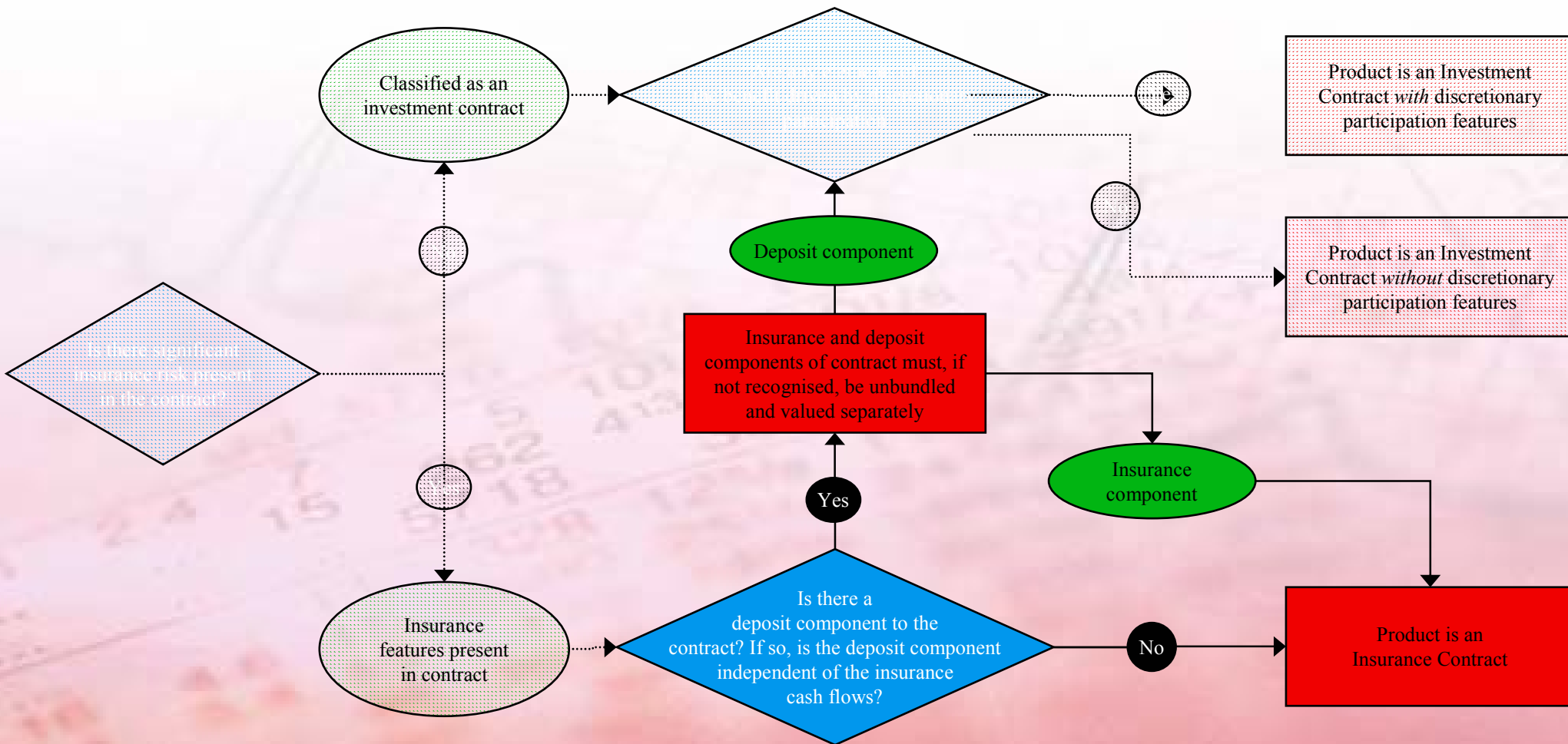
Insurance

SFAS 91, SFAS 97 Investment



Insurance or Investment
(depending on significance of insurance risk)

Unbundling



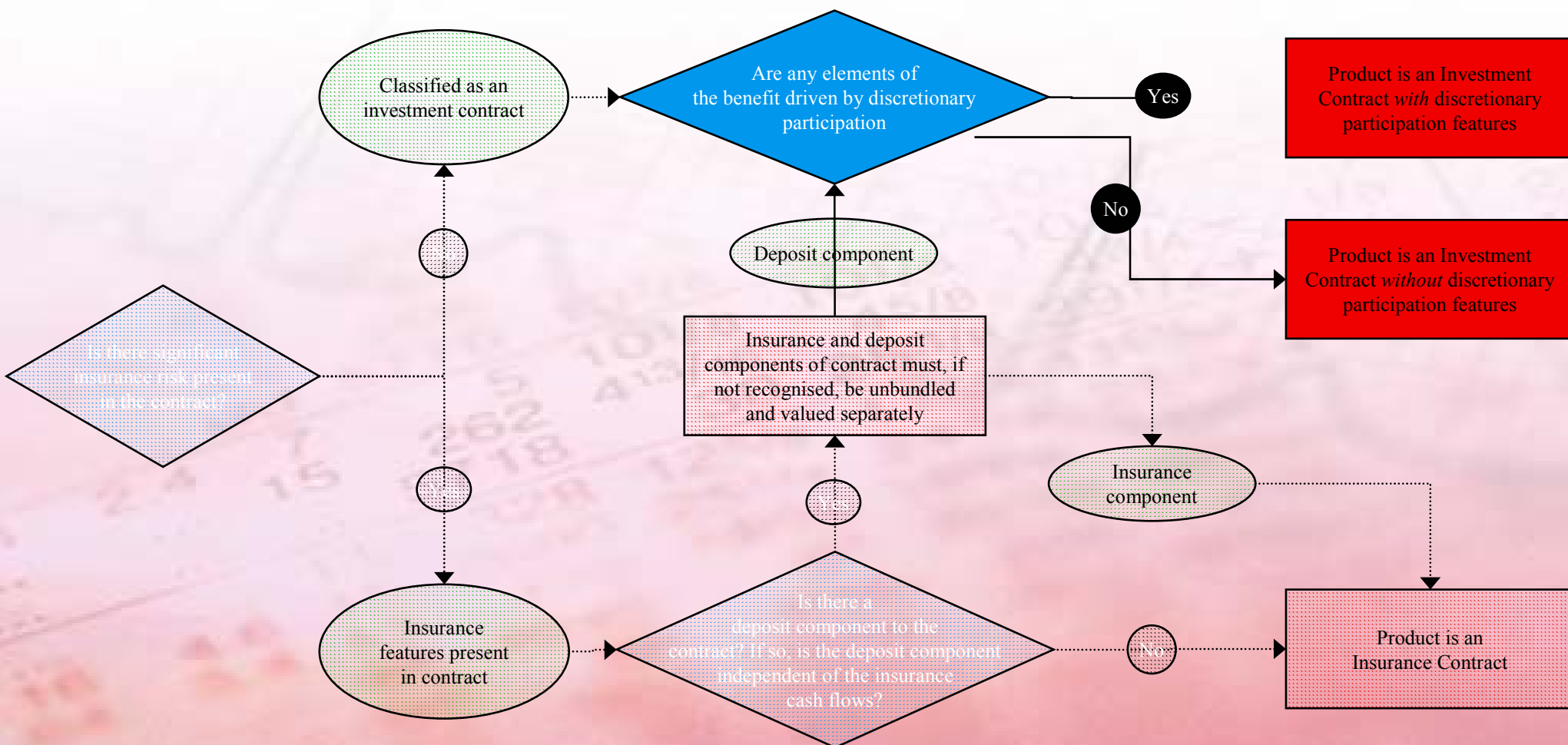
When do you unbundle?

 Unbundling is **required** when:

- ✓ The insurer's existing accounting policies do not require recognition of the deposit component, and
- ✓ The insurer can independently measure the deposit component from the insurance component

 Unbundling is **allowed but not required** when the insurer can independently measure the deposit component from the insurance component

Discretionary participation Features (DPF)



Definition of DPF

- ✎ 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

Insurance Contracts and Contracts with DPF – Accounting Treatment

Insurance Contracts

 During Phase I, existing accounting policies apply with certain modifications

- ✓ **Prohibited** – certain accounting policies are prohibited as they do not meet the FRS 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 FRS framework can continue, but cannot be implemented.
- ✓ **Can be started** – certain accounting policies can be introduced.

 Existing accounting policies are those in the primary financial statements

Prohibited policies

 The following accounting policies are **prohibited**

- ✓ Setting up catastrophe provisions
- ✓ Setting up claims equalisation provisions
- ✓ Offsetting of reinsurance assets and direct liabilities

Mandated policies

 The following accounting policies are **mandated** if they are not already present

- ✓ Liability adequacy testing
- ✓ Impairment of reinsurance assets

Liability adequacy test

 Current liability adequacy test applies if

- ✓ Test at each reporting date using current estimates of future cashflows (including cashflows from embedded guarantees and options)
- ✓ If these are > current liability, liability is increased and deficiency flows through P&L

 Otherwise → Liability Adequacy Test under FRS 37

- ✓ Best-estimate of the payments required to settle the obligations
- ✓ Expected PV of cashflows using realistic assumptions with margins for risk
- ✓ FV like calculations

Impairment of reinsurance assets

-  Reinsurance asset is reduced and reduction flows through income statement if it is impaired
-  Reinsurance asset is impaired if:
 - ✓ Objective evidence of an event after initial recognition that the cedant may not receive all amounts due to it
 - ✓ The impact of the event can be reliably measured
-  Impairment may be reversed

Policies that may continue

-  The following accounting policies **may continue** but companies may not adopt them where they are not already applied
- ✓ Measuring insurance liabilities on an undiscounted basis
 - ✓ Using non-uniform accounting policies for subsidiaries
 - ✓ Using excessive prudence in the valuation of liabilities
 - ✓ Measuring contractual rights to future investment management fees at > their FV as implied by fees charged by others for comparable services

Phase I measurement concerns

- ✎ Liabilities and backing assets may not move together
- ✎ Liabilities are fixed or at amortised cost, but
 - ✓ Assets are classified as AFS, with changes in fair value in equity
 - ✓ Assets are classified as Trading, with changes in fair value in profit and loss account
- ✎ Therefore some policies are allowed to start

Policies that may be started

 The following accounting policies **can be started**

- ✓ Use of current market discount rates
- ✓ Use of shadow accounting
- ✓ Use of asset-based discount rates (subject to certain restrictions)

Current market interest rates

- ✎ Measure designated insurance liabilities using current market interest rates
 - ✓ Current market interest rates
 - Can include investment spreads only if already included
 - Otherwise risk free rates
 - ✓ Can move to using current assumptions at the same time
 - ✓ Can be performed for any designated liabilities
 - ✓ Must be consistently applied to designated liabilities until they are extinguished
 - ✓ All changes in liabilities must flow through income statement

Shadow accounting

Shadow accounting

- ✓ Applicable if the measurement of an insurance liability is driven directly by realised gains & losses on assets held
- ✓ Permits all recognised gains and losses (whether realised or unrealised) on assets to affect the measurement of insurance liabilities in the same way
- ✓ If unrealised gains and losses flow through income statement → resulting change in insurance liabilities recognised in income statement
- ✓ If unrealised gains and losses flow through equity → resulting change in insurance liabilities recognised in equity

Asset-based discount rates

- ✎ Measure liabilities using discount rates based on asset returns
 - ✓ Can continue if already in use
 - ✓ Rebuttable presumption that financial statements will become less relevant and reliable if move towards use of asset-based discount rate
 - ✓ Only as part of move to a new accounting policy system which is more relevant and reliable
 - ✓ Must be applied consistently to all insurance contracts

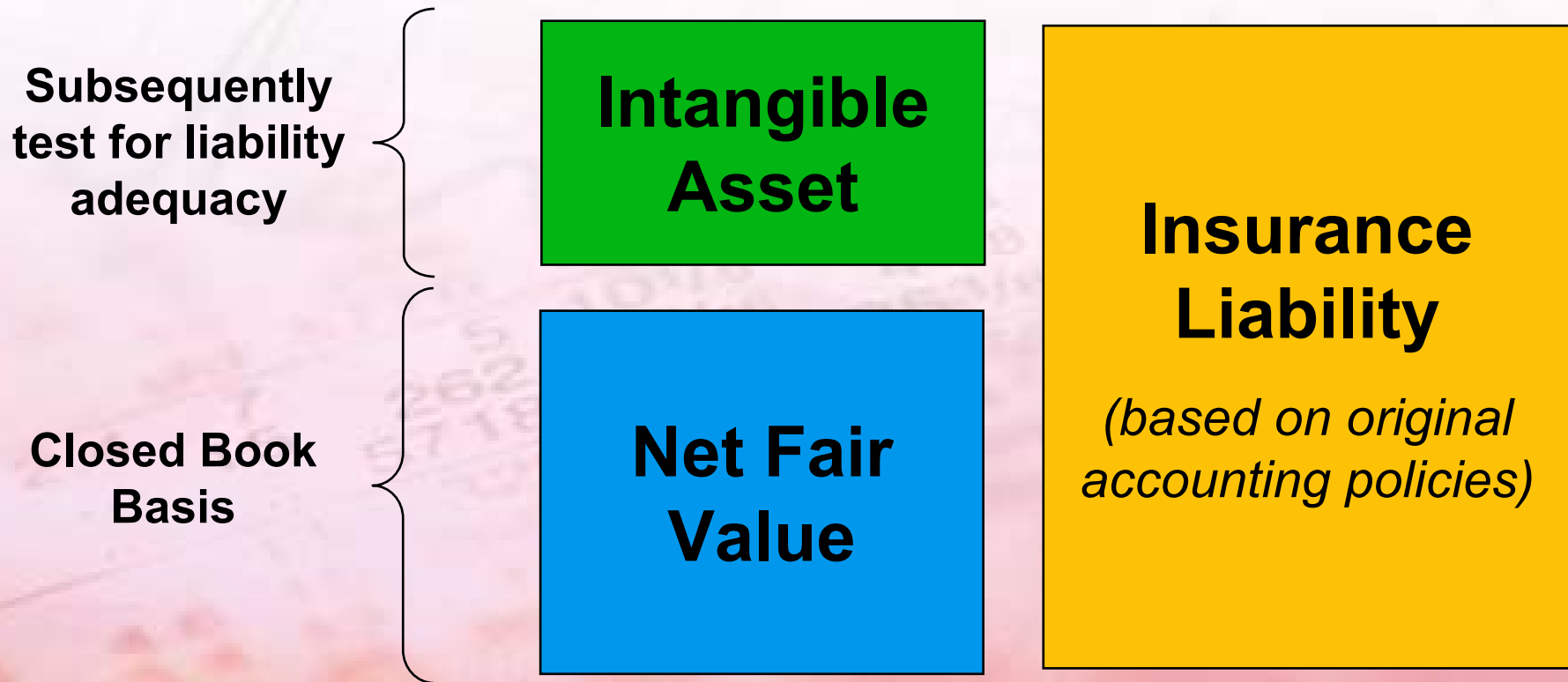
Insurance contracts with DPF

- ✎ 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

Investment contracts with DPF

- ✎ Like insurance contracts, continue existing accounting with additional modifications:
 - ✓ Premiums can still be recognised as revenue
 - ✓ If distributable surplus is classified as equity
 - Minimum liability for investment contracts is IAS 39 liability for guaranteed benefits
 - ✓ If distributable surplus is all classified as liability, need to include this in the liability adequacy testing
- ✎ Fair value disclosure under FRS 32 still applies
 - ✓ If impracticable – disclose this fact, nature of the risks and range in which the fair value is likely to sit

Business combinations - insurance phase I



Business combinations - insurance phase I

 Can be presented as net liabilities

 Intangible asset
= Insurance liabilities (based on existing a/cg policies) – FV of Insurance liabilities (at purchase date)

- ✓ Amortised over the estimated life of the contract
- ✓ Considered a component of insurance liabilities and subject to liability adequacy testing
- ✓ Outside the scope of IAS 36 and IAS 38

 Prior acquisitions – continue existing accounting policies

Key Learning Points

- ✎ Catastrophe and equalisation reserves prohibited
- ✎ Liabilities adequacy testing and impairment of reinsurance assets mandated
- ✎ Gross presentation – reinsurance shown separately
- ✎ Investment contracts with discretionary participation features temporarily under FRS 104 – subject to disclosure requirements of FRS 32
- ✎ Business Combinations allow separate presentation of intangible asset

Phase I – Disclosure Requirements

Insurance disclosure requirements

FRS 104 Two high level principles:

Principle 1 – Explanation of recognised amounts

Principle 2 –Amount, timing and uncertainty of cash flows

Fair Value Disclosure for insurance contract assets and liabilities



- Implementation guidance - runs to 61 paragraphs – but does not create additional requirements!

THANK YOU...