

IFRS for Insurance Contracts Phase II
Exposure Draft

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13 October 2010



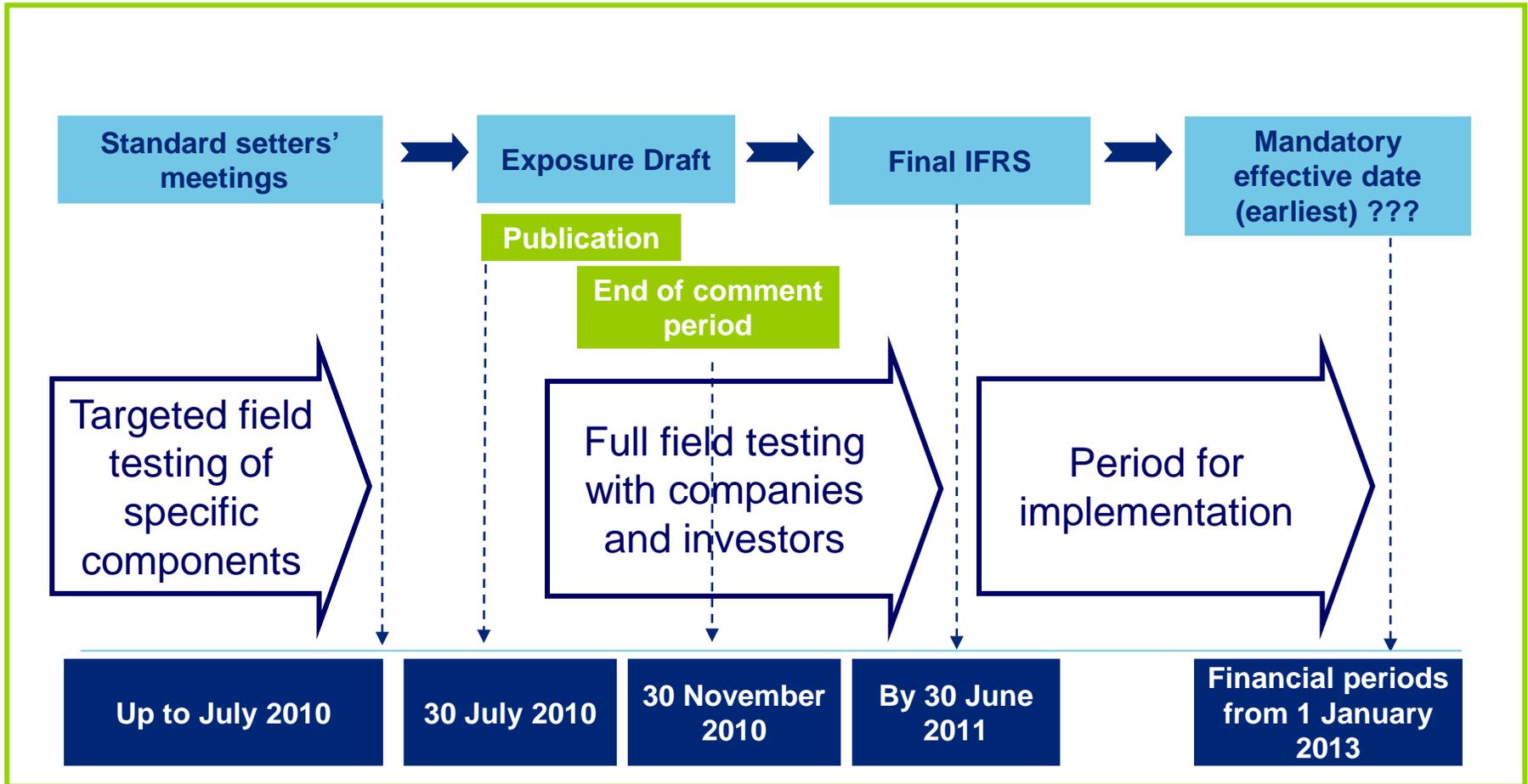
Background

Insurance Accounting Project - Objectives

Insurance project

- The key objectives of the Phase II of the IASB's insurance project are:
 - Introduce for the first time a single IFRS accounting model for all types of insurance contracts;
 - Make the new accounting model highly transparent and;
 - Align as much as possible insurance accounting with the general IFRS accounting of other industries.
- After preliminary views published in 2007 based on an exit value approach, the Exposure Draft of the new IFRS delivered an entity specific current measurement model.
- The US FASB joined the insurance accounting project in late 2008 aiming at a potential replacement of the existing US GAAP for insurance with an identical or very similar standard to the one under IFRS.
- Some areas of disagreement remain, and resulted in the IASB publishing its exposure draft without the FASB.
- On 17 September 2010, the FASB issued a Discussion Paper called “Preliminary Views on Insurance Contracts”.

Insurance Accounting Project - Detailed timeline



Royal Decree dated 27 September 2009 - As from 2012, Belgian insurance companies shall prepare their consolidated financial statements in accordance with IFRS as endorsed in the EU.

First IFRS consolidated financial statements - Reporting date: 31 December 2012 Date and Opening IFRS Balance sheet 1 January 2011 (comparative figures to be presented).

IFRS for Insurance Contracts Phase II Exposure Draft – Key Concepts

Step 1 – Scoping

General



The ED applies to:

- All insurance / reinsurance contracts issued and reinsurance contracts held.
- All financial instruments with discretionary participation features if they participate in the performance of the same assets/contracts/entities as insurance contracts do.
- All financial guarantee contracts meeting the definition of an insurance contract. They will no longer be in the scope of financial instruments standards IAS 32, IAS 39, IFRS 7 and IFRS 9.

Examples: Financial guarantee insurance, mortgage guarantee insurance, trade credit insurance and some letters of credit. Contracts that pay out regardless of whether the counterparty holds the underlying debt instrument or on a change of credit rating or credit index will continue to be accounted for as financial instruments.

Scope exclusions

Main change from IFRS 4 Phase I:

- Fixed fee service contracts if the primary purpose of is provision of services.

Other retained scope exclusions:

- Warranties issued directly by a manufacturer, dealer or retailer;
- Lessee's residual value guarantees embedded in a finance lease or provided by a manufacturer, dealer or retailer;
- Employers' assets and liabilities under employee benefit plans and retirement benefit obligations reported by defined benefit retirement plans;
- Contingent consideration payable or receivable in a business combination; and
- Insurance contracts held.

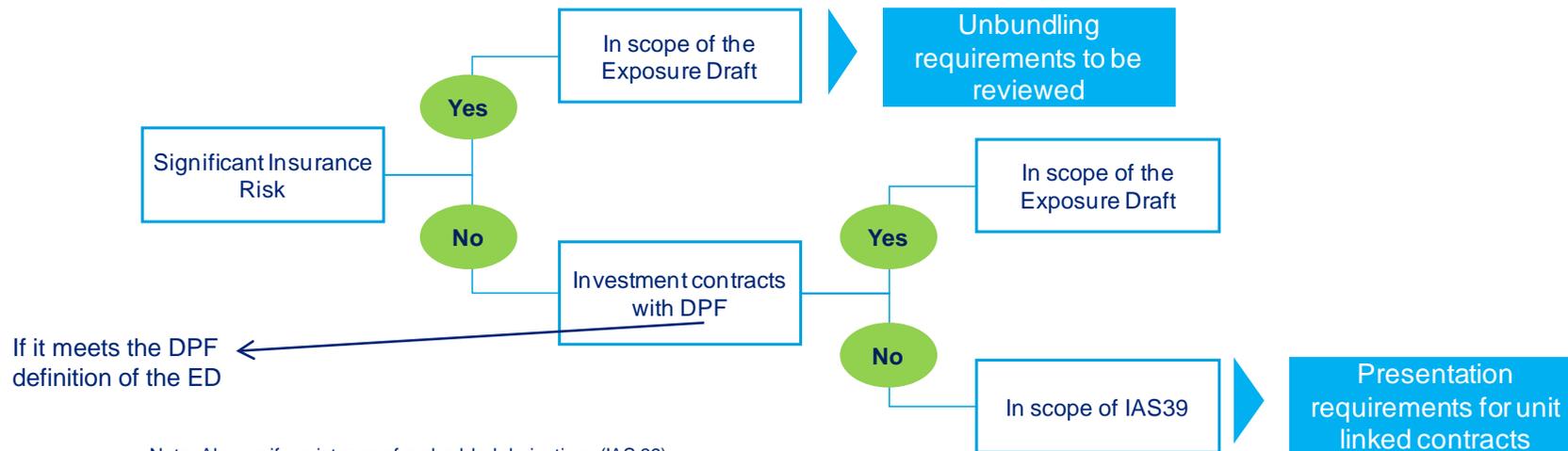
Step 1 – Scoping General



- Definitions brought forward from IFRS 4 Phase I virtually unchanged:

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

- An insurance risk is a risk different than a financial risk transferred from the holder of a contract the issuer.
- Notion of **timing risk** or notion of **a loss** included in the definition.
- Decision tree.



Step 1 – Scoping Questions



Question 1

Are contracts without significant insurance risk always excluded from the scope of the exposure draft (“ED”)?

No.

As stated under § 2 of the ED an entity shall apply this IFRS to:

- insurance contracts (including reinsurance contracts) that it issues and reinsurance contracts that it holds.
- AND financial instruments that it issues containing a discretionary participation feature.

Question 2

The measurement of pure unit linked contracts (‘Branche 23’ type contracts without any guarantee) is not within the scope of the ED?

Yes.

Due to the fact that a pure unit linked insurance contract does not transfers significant insurance risk, IAS 39 currently applies. Nevertheless details are included in the ED with respect to the presentation of these contracts.

Step 1 – Scoping

Unit linked contracts



These provisions apply to both insurance and financial instruments with unit-linked features.

Measurement

- Certain current ‘accounting mismatches’ will be eliminated through requirement to fair value through profit and loss:
 - Insurer’s own issued shares if they are held in a pool of assets underlying unit-linked contracts (amending IAS 32 and IFRS 9 financial instruments standards).
 - Owner-occupied properties that form part of a pool of assets underlying unit-linked contracts (amending IAS 16 Property, Plant and Equipment).

Presentation

- Single line item for assets backing unit-linked contracts in the balance sheet and for their income/expense in the income statement.

Step 1 – Scoping

Unbundling



- Unbundling will be required for all components that are not closely related to the insurance coverage.
- Three examples of this principle where unbundling will be mandatory are set out in the ED:
 1. Account balances – a deposit component with certain characteristics;
 2. Embedded derivatives – based on the current IAS 39 rules also from a “closely related” test angle; and
 3. Service components – all non-contingent obligations that are not closely related to the insurance coverage but have been combined with the contract for reasons that have no commercial substance.
- Any unbundled component is separated alone without any of the related fees, charges etc. which continue to be accounted for with the insurance contract.
- The more serious implication of this set of requirements is likely to be the separation of account balances.
- The characteristics that need to be met to be caught by the requirement are:
 - The deposit must be an explicit account balance with the policyholder. Implicit account balances derived from discounting maturity values are not account balances.
 - The account balance must receive interest based on a crediting rate that is “based on the investment performance of the underlying investments”.
 - The crediting rate is not capped.

Step 1 – Scoping Questions



Question 3

Is unbundling applicable for

- (a) Investment contracts with DPF?
- (b) Pure unit linked contracts ('Branche 23' type contracts)?

(a) Yes.

Although the contract does not meet the definition of an insurance contract under the ED, this type of contracts are specifically scoped into the exposure draft. It is stated in the ED that 'other' requirements equally apply to a financial instrument with DPF (although some of the requirements may not be relevant or may not have a material effect).

(b) No.

As the contract is an investment contract. Only if the contract includes significant insurance risk, the contract would qualify as an insurance contract and unbundling has to be analysed under the ED. The unbundling can result into deposit accounting (IAS 39) for the financial component of the contract.

Step 2 – Recognition

General



Presentation & Disclosure

Recognition

Rights and obligations are recognised when the insurer becomes a party to the contract, which means at the earlier of the two following dates:

- The insurer being “on risk”;
- The insurer can NO LONGER reassess the risk or either cancel the contract or change the contract terms.

Accounting for insurance contracts on this basis will require changes in all those cases where the insurer had used the “risk inception date” to recognise insurance contracts. This approach is particularly common among general insurers that underwrite property and casualty risks.

Step 2 – Recognition Questions



Presentation & Disclosure

Question 4

Will an insurer always start to recognize an insurance contract at the date when the premium is paid by the policyholder?

No.

An insurer shall recognise an insurance contract liability or an insurance contract asset when the insurer becomes a party to the insurance contract (paragraph 13 of the ED).

Paragraph 14 of the ED states that an insurer becomes party to an insurance contract on **the earlier of the following 2 dates:**

- The date he becomes bound by the terms of the contract;
- The date he is exposed to risks and cannot longer withdraw from its obligations.

? Payment dates, signature dates by policyholders, cancellation / renewal clauses,...

? Systems and operational procedures within the insurance company....

Step 3 – Measurement

Measurement model decision tree

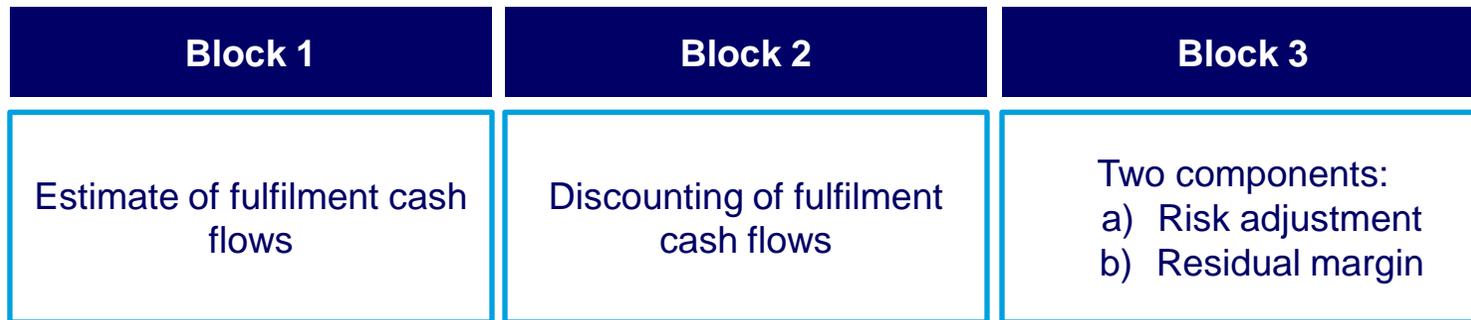
	Insurance contracts / Investment contracts with DPF	Investment contracts	Short duration contracts
<u>Pre claims Liability</u>	3 building blocks	IAS 39	Unearned premium allocation: <ul style="list-style-type: none"> • Passage of time, • <u>Or</u> claims / benefits time patterns
Claims Liability	3 building blocks	IAS 39	3 building blocks (no residual margin)

Step 3 – Measurement

Three building blocks

Measurement objective and approach

- Current assessment of insurer's rights and obligations under contract – single amount on financial statements representing the net contract fulfilment value.
- Use of a transparent “building block” approach.
- There are three building blocks to the measurement approach:



FASB / IASB Difference

- Alternative model for block 3 is a single composite margin.
- No explicit measurement of uncertainty → capture risk together with future profit at inception based on policy price.

Building Block 1: Cash Flows Estimate

A current, unbiased and probability weighted estimates of the contractual cash flows.

- An insurer should develop estimates of cash flows that:
 - are **current**, in other words, they correspond to conditions at the end of the reporting period;
 - incorporate, in an **unbiased** way, all available information about the amount, timing and uncertainty of all cash flows arising from the contractual obligations **as well as directly attributable and incremental acquisition costs (identified at the individual contract level and NOT on portfolio level)**;
 - are as consistent as possible with observable **market** prices; and
 - include **entity-specific** cash flows (e.g. expenses).
- Acquisition costs that are not incremental and directly attributable to the sale of an individual policy cannot be treated as a component of the cash flows and would result in an expense as incurred.
- The ED requires all of the sales costs that are not incremental to be presented as a separate line on the face of the income statement representing the IFRS new business strain.

- The requirement to consider a range of outcomes and use all available information to arrive at the probability-weighted estimates is generally not used in current accounting models and will require model and system adjustments to produce timely financial information.
- The narrow definition of acquisition costs and the role that directly attributable and incremental costs will play in the new model may require adjustments in some insurer's expense allocation systems.
- Distribution models that are funded by directly attributable incremental expenses will receive a more favourable accounting treatment (no new business strain).

Building Block 1: Cash Flows Estimate

A current, unbiased and probability weighted estimates of the contractual cash flows.

- Cash flows should be included if they arise within the “contract boundary”:
 - The contract boundary is the point in time in the future when an insurer can terminate or re-underwrite a contract; and
 - Future premiums and claims/expenses related to those premiums that fall beyond the contract boundary are not included in the cash flows estimate.
- Cash flows re-assessed at each reporting period.
- Stochastic modelling may be required.

Step 3 – Measurement model

Questions

Question 5

Can acquisition costs still be deferred and presented as a separate asset on the balance sheet?

No.

Acquisition costs are included in the first building block of the estimate of fulfilment cash flows. Consequently no separate asset recognition is allowed.

ONLY incremental costs at the contract level can be included within the present value of the fulfilment cash flows.

Step 3 – Measurement model

Contract boundary

- New concept, crucial to the proposed measurement model.
- Insurance contract is measured and presented as one balance to represent the bundle of rights and obligations.
- The measurement of insurance **contract includes all rights and obligations, including policyholder options, if they fall within the contract boundary.**
- The boundary of an insurance contract refers to a future point in time where one of these conditions is true:
 - **The insurer is able to unilaterally cancel the contract;** or
 - **The insurer is able to re-price the contract** to reflect the current assessment of insurance risks applicable to the specific policyholder.
- The inclusion of ‘specific policyholder’ allows insurers to re-price groups of policies without shortening the contract boundary.
- If insurance policy includes options, forwards or guarantees not falling within the existing contract boundary, they are accounted as new insurance contract or under other applicable standards.

Actuarial models will need to be reviewed to ensure that the full benefit of future premiums is only counted to the extent that they fall within the contract boundary.

Building Block 2: Discount rate

The time value of money is taken into account by explicitly discounting all cash flows.

- Adjusts first building block for time value of money.
- Discount rate based on characteristics of the insurance liability:
 - Currency;
 - Duration;
 - Liquidity.
- Measurement reflects characteristics of the assets backing insurance liability only if the amount, timing or uncertainty of contract cash flows depend on performance of assets, e.g. participating contracts;
 - Linkage may be reflected using a replicating portfolio.
- Discount rate is a market consistent interest rate based on a “risk free rate” plus an illiquidity premium based on the characteristics of liability cash flows.
- No further guidance on how to calculate the illiquidity premium.
- Disclosures on discount rate, impact of illiquidity and sensitivities.

- Insurers will need to develop their approach to determining the risk free rate and methodologies to determine the illiquidity premium.
- Systems and processes will need to be re-configured to discount insurance contracts based on liability characteristics.

Step 3 – Measurement model

Questions

Question 6

Are all cash flows discounted by applying a risk free rate and is the same rate applied for all cash flows?

No.

Only cash flows which are included within the contract boundaries are taken into account with the present value of fulfilment cash flows as part of the measurement block 1.

Such cash flows are discounted using discount rates which are consistent with observable market rates for instruments which cash flows characteristics reflect those of the insurance contract liabilities (timing, currency, liquidity).

Building Block 3: Margins - Risk Adjustment

A margin to reflect uncertainty in the estimate of fulfilment cash flows.

- Explicitly reported in the financial statements as a component of the insurance contract liability
- Defined as:
 - “the maximum amount an insurer would rationally pay to be relieved of the risk that the ultimate fulfilment cash flows exceed those expected”.
- Re-measured at each reporting period.
- Estimated at level of portfolio of insurance contracts – benefit of risk pooling allowed.
- Effects of diversification across different portfolios of insurance contracts is not allowed.
- Three permitted techniques for estimating the risk adjustment:
 - Confidence Interval;
 - Conditional Tail Expectation (CTE); and
 - Cost of Capital.

Building Block 3: Margins - Risk Adjustment (permitted techniques)

- Confidence Interval:
 - Likelihood that the actual outcome will be within specified interval;
 - Sometimes referred to as Value at Risk (VaR);
 - Easier to communicate and calculate compared to other techniques;
 - Not as useful for probability distributions that are not statistically normal.
- Conditional Tail Expectation (CTE or tail VaR):
 - Better reflection of extreme losses;
 - Focuses on the tail of the probability distribution → reflects aspects of insurance;
 - Judgement required to determine band and may need to change in future periods.
- Cost of Capital:
 - Applied in pricing, valuations and regulatory reporting, etc;
 - Reflects estimated cost of holding required capital to meet obligations with high confidence;
 - Need to determine capital rate that reflects risk relevant to liability;
 - Approach used in SII for risk margin.
- Guidance provided for when to use which technique based on the characteristics of the probability distribution.

Selecting the appropriate valuation technique from the three permitted, defining the correct level of aggregation and calibrating the technique to the portfolios could be a challenge for companies to implement and maintain.

Building Block 3: Margins - Residual Margin

A margin to eliminate any gain at inception of the contract.

- A residual margin arises when:
 - PV of future cash inflows $>$ PV of future cash outflows + risk adjustment.
- Estimated at level of portfolio of insurance contracts, with same inception date and similar coverage duration (cohort).
- Calculated at initial recognition and earned over coverage period. It is also explicitly reported in the financial statements.
- Cannot be negative. In the event of a negative value a loss must be recognised immediately through profit and loss.
- Interest expense accretion required using discount rate locked-in at inception.

- Information captured with the residual margin offers an insight in the product profitability beyond the risk adjustment.
- The requirement to aggregate residual margins by cohorts transparently reports “vintages” of product profitability.

Step 3 – Measurement model

Questions

Question 7

Will day one gains and day one losses of insurance contracts be included directly into the income statement?

No.

Day one gains of insurance contracts are eliminated by the residual margin which is calibrated at inception to an amount that precludes the recognition of any gain.

The residual margin will be released through the statement of income on a systematic way **over the coverage period** (passage of time or risks pattern).

Attention: Level of aggregation = contracts with similar coverage period.

Day one losses are to be recognised into the income statement at inception.

Step 3 – Measurement model

Example for a regular premium policy

An insurer issues an insurance contract and receives 50 EUR as the first premium and incurs acquisition costs of 70 EUR, of which incremental acquisition costs are 40 EUR. The insurer estimates an expected present value (EPV) of subsequent premiums of 950 EUR and a risk adjustment of 50 EUR.

In Case A, the insurer estimates that the EPV of future claims is 900 EUR.

In Case B, the insurer estimates that the EPV of future claims is 920 EUR.

		Case A	Case B
First Premium (Cash Inflow)	RP	50	50
Expected Present Value of Premiums (Cash Inflow)	EPV(Pr)	950	950
Total Acquisition Cost (Cash Outflow)	AC	-70	-70
Incremental Acquisition Cost (Cash Outflow)	IAC	-40	-40
Expected Present Value of Benefits (Cash Outflow)	EPV(Bens)	-900	-920
Risk Adjustment	RA	-50	-50

If $EPV (\text{Inflows} - \text{Outflows}) + \text{Risk Margin} \geq 0$, than Recognise Residual Margin

If $EPV (\text{Inflows} - \text{Outflows}) + \text{Risk Margin} < 0$, than Recognise Day One Loss in P&L

Step 3 – Measurement model

Example for a regular premium policy

At initial recognition of the contract t(0)

		Case A t(0)	Case B t(0)
First Premium (Inflow)	RP	50	50
Expected Present Value of Premiums (Inflow)	PV(Pr)	950	950
Expected Present Value of Cash Inflows		1.000	1.000
Incremental Acquisition Cost (Outflow)	IAC	-40	-40
Expected Present Value of Benefits (Outflow)	PV(Bens)	-900	-920
Expected Present Value of Cash Outflows		-940	-960
Risk Adjustment	RA	-50	-50
Present Value of Fulfilment Cash Flows		10	-10
Residual Margin		-10	0
Insurance Liability (Ct)		0	-10
Non Incremental Acquisition Costs Liability (Ct)		-30	-30
Day One Loss - Profit and Loss (Dt)		0	10
Non Incremental Acquisition Costs - Profit and Loss (Dt)		30	30
Total at Initial Recognition - Profit and Loss (Dt = loss)		30	40



Step 3 – Measurement model

Example for a regular premium policy

Immediately after inception of the contract t(1) Situation: first premium of 50 EUR has received and acquisition costs are due 70 EUR, of which 40 EUR incremental acquisition costs. No change of residual margin, estimates and interest.

		Case A t(0)	Case A t(1)	Case B t(0)	Case B t(1)
First Premium (Inflow)	RP	50	0	50	0
Expected Present Value of Premiums (Inflow)	PV(Pr)	950	950	950	950
<i>Expected Present Value of Cash Inflows</i>		1.000	950	1.000	950
Incremental Acquisition Cost (Outflow)	IAC	-40	0	-40	0
Expected Present Value of Benefits (Outflow)	PV(Bens)	-900	-900	-920	-920
<i>Expected Present Value of Cash Outflows</i>		-940	-900	-960	-920
<i>Risk Adjustment</i>	RA	-50	-50	-50	-50
Present Value of Fulfilment Cash Flows		10	0	-10	-20
Residual Margin		-10	-10	0	0
Insurance Liability (Ct)		0	-10	-10	-20

Change of insurance liability in comparison to t(0) = -10 EUR (increase of insurance liability) and equals the cash inflow of 50 EUR minus the cash outflow of 40 EUR.

Step 3 – Simplified Measurement model

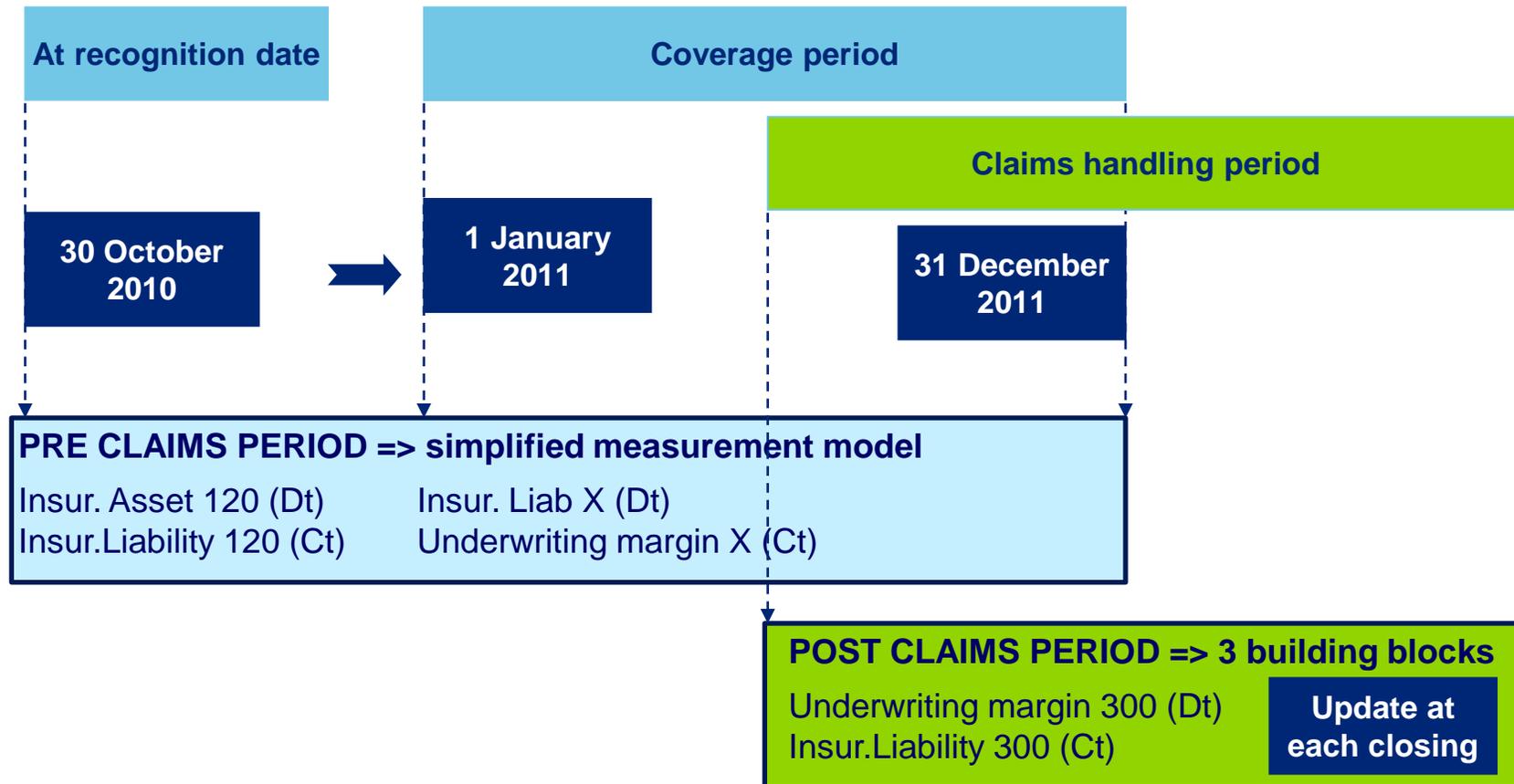
Simplified method for short-duration contracts

- Pre-claims liability for all contracts that:
 - Have a coverage period of approximately one year or less; and
 - Do not contain embedded options or derivatives that significantly affect the variability of CFs.
- Measure pre-claims liability by allocating premiums over coverage:
 - At initial recognition = premium received + expected PV of future premiums
 - incremental acquisition costs
- Full amount will be earned over the coverage period.
- The post-claims liability will be recognised as claims incurred measured using three building blocks.
- After the coverage period accounting models align with a post-claim liability based on building blocks.
- This results in simpler measurement for the pre-claim liability (first 12 months or less).

- The requirement to release revenue from the pre-claims liability in a manner that reflects the seasonality of expected claims is a revenue recognition approach which will be familiar to many insurers (particularly catastrophe reinsurers) but may be new to others.

Step 3 – Simplified Measurement model

An property & casualty insurer concludes a car insurance contract at 30 October 2010. Coverage period for the insurance contract = 1 January 2011 until 31 December 2011. The annual premium to be received amounts to 120 EUR. At 30 June 2011 a claims occur whereby the present value of the fulfilment cash flows amount to 300 EUR.



Step 3 – Measurement Questions

Question 8

Is there a different measurement approach for Life and Non-Life contracts?

Yes.

For Non-Life insurance contracts with a short duration of 12 months or less:

- The pre-claims liability shall be measured by allocating premiums over the coverage period (passage of time rule or risk pattern),
- The claims liability shall be measured using the three building blocks approach.

This proxy (or simplified measurement model) is also required for short duration Life contracts.

Step 3 – Contracts with participating features

Discretionary Participation Feature (DPF)

- Definition brought forward from IFRS 4 Phase I virtually unchanged.

Insurance contracts with DPF

- Expected future discretionary policyholder bonuses/dividends must be included in the first building block.
- The discount rate and cash flows are based on the assets within the participating fund.

- The inclusion of discretionary payments to policyholders will require insurers to estimate the future performance of the underlying variables which drive the discretionary payments.
- Insurers will also need to estimate the extent of the award that they would reasonably expect to add to the guaranteed benefits under the contract.
- Insurers will have to analyse the surplus arising from participating funds held on their balance sheet in terms of the expected distribution to policyholders and shareholders. The allocation of the surplus to the former will be part of the insurance contract liability, whilst allocating to the latter will flow to the insurer's equity. Considering the large surplus that certain participating funds carry due to their long history, insurers need to start this analysis early to understand the implications of this potential change.

Step 3 – Contracts with participating features

Investment contracts with DPF

- Contracts that participates in the same pool of assets as participating insurance contracts are included in the insurance standard. All other contracts are excluded.
- The contract boundary is set at the time when the policyholder is no longer able to receive the discretionary benefits sets the out at the inception of the contract.
- Asset under management determine the pattern for the residual margin to be earned.

Step 3 – Other measurement characteristics

The ED introduces other requirements:

Foreign currency translation – The ED clarified that all accounting amounts associated with insurance contracts are monetary items that should be revalued at the FX rate in force at the reporting date.

This approach improves on the current practice of treating only certain amounts as monetary and eliminates the associated accounting inconsistency with investments.

Business combinations and portfolio transfers – The accounting for insurance contracts in these cases is identical to normal reporting.

Any difference with the fair value will respectively go to goodwill or as a loss in case it is negative. In the event it is positive it will be captured in a residual margin liability in both cases.

Insurer's non-performance risk – The ED requires ignoring the risk that the insurer does not perform under the contract (own credit risk being the most commonly known).

Accounting for this risk would have resulted in a scenario where claims and benefits are not paid and the expected value of the liability would have been lower in proportion to the associated probability of non-performance.

Step 3 – Reinsurance

- Reinsurance contracts are measured using the building-blocks as insurance contracts.
- Reinsurance assets held by cedants should be measured with reference to the reinsured liability.
- Offsetting reinsurance assets and reinsured liabilities is prohibited unless the appropriate legal requirements are met.
- Ceding commissions should be treated as a reduction in the reinsurance premium paid.
- Entity specific approach to the recognition of the building-blocks could create an asset that is larger than the premium paid (e.g. due to portfolio diversification).
- This case results in an immediate gain through income.
- In the event of a negative figure it would be capitalised as a ceded residual margin to be amortised over the reinsurance coverage.

Step 4 – Derecognition



Derecognition

- Takes place, similar to IAS 39 for financial liability, at the point where the insurer is no longer “on risk”. Not a new concept or requirement compared to most existing practices.

Three building blocks

- The new presentation model in the ED has been developed from two key conclusions:
 1. Presentation of an insurer's profit or loss is better expressed from the building-blocks model; and
 2. A margin approach is the most suited presentation to display the sources of profit from the building-blocks model.
- To ensure consistency in the application and greater comparability there are five minimum line items to be put on the face of the income statement:
 - i. Underwriting margin;
 - ii. Experience variances and changes in assumptions;
 - iii. Day one losses on insurance sold and day one gain on reinsurance bought;
 - iv. Acquisition expenses (non incremental); and
 - v. Interest expense from discount unwinding (ideally paired with an asset investment income line to display an investment margin).
- Currently the ED proposes a summarised margin presentation.
- All these lines have a link to the building blocks.
- Special lines will be added for the unearned premium method.

- Changes to general ledgers and underlying accounting systems will be needed to accommodate the new requirements.

Presentation Questions

Question 9

Will premiums and claims for life insurers be included in the statement of comprehensive income?

No.

Life Insurers are required to use a presentation model for reporting the income and charges related to insurance contracts and investment contracts with DPF which is consistent with the building blocks measurement approach.

→ Margin approach for presentation - no premiums and claims presented in PL (but disclosed in the notes).

Exception: For short term duration contracts the underwriting margin needs to be further detailed in the statement of comprehensive income or the notes (1) premium revenue, (2) claims incurred, (3) expenses incurred.

Stat. of financial posit. & comprehens. income

Example non-short term insurance contracts

Presentation & Disclosure

<u>Statement of financial position</u>		<u>Statement of comprehensive income</u>	
<i>Insurance contract liabilities</i>		<i>Underwriting margin</i>	
Portfolio A	X	Change in risk adjustment	X
		Release of residual margin	X
<i>Insurance contract assets</i>		<i>Gains / losses at initial recognition</i>	
Portfolio B	X	Losses on insurance contracts acquired in a portfolio transfer	X
<i>Residual margin liability</i>		Gains on reinsurance contracts bought by the a cedant	X
Portfolio B	X	Losses at initial recognition of an insurance contract	X
Unit linked contract liability	X	Non-incremental acquisition costs	X
Assets underlying unit-linked contracts	X	<i>Experience variances and changes in assumptions</i>	
		Experience adjustments	X
		Changes in estimates of cash flows	X
		Changes in discount rates	X
		Impairment losses on reinsurance assets	X
		Interest on insurance contract liabilities	X
		Income / expense from unit-linked contracts	X
		Gain / loss from assets underlying unit-linked contracts	X

Observation

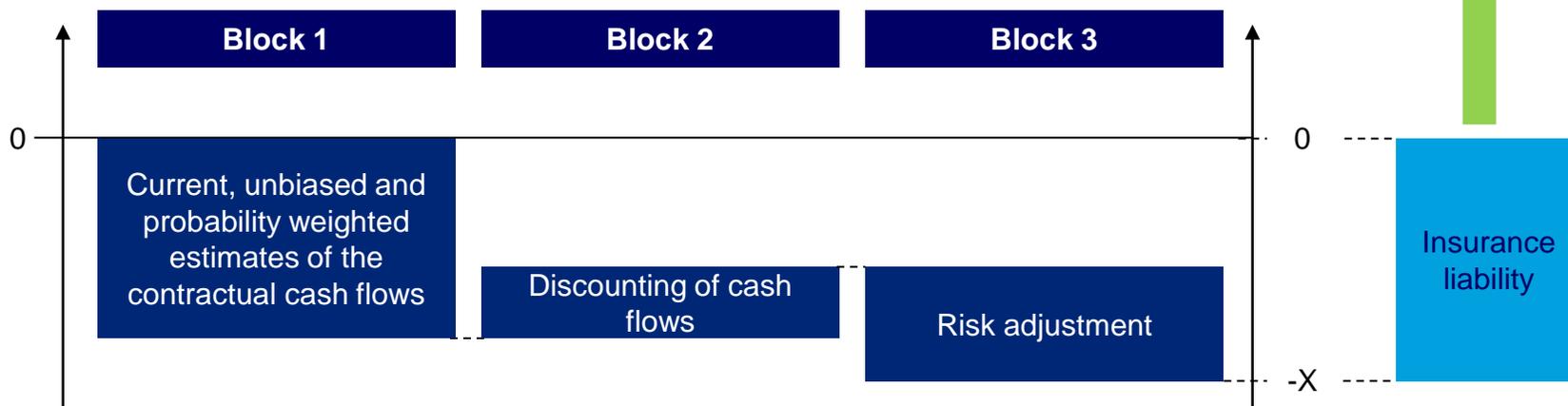
An insurance contract asset cannot arise on the inception of a contract but could arise at a later date depending on changes to the best estimate contractual cashflows, the discount rate and risk adjustment.

Source of balances in stat. of finan. position

On inception of non-short term insurance contract

Statement of financial position	
<i>Insurance contract liabilities</i>	
Portfolio A	X
<i>Insurance contract assets</i>	
Portfolio B	X
Residual margin liability	X
Unit linked contract liability	X
Assets underlying unit-linked contracts	X

As the expected present value of the future cash outflows plus the risk adjustment exceeds the expected present value of the future cash inflows the insurer will immediately recognise an expense equal to X.



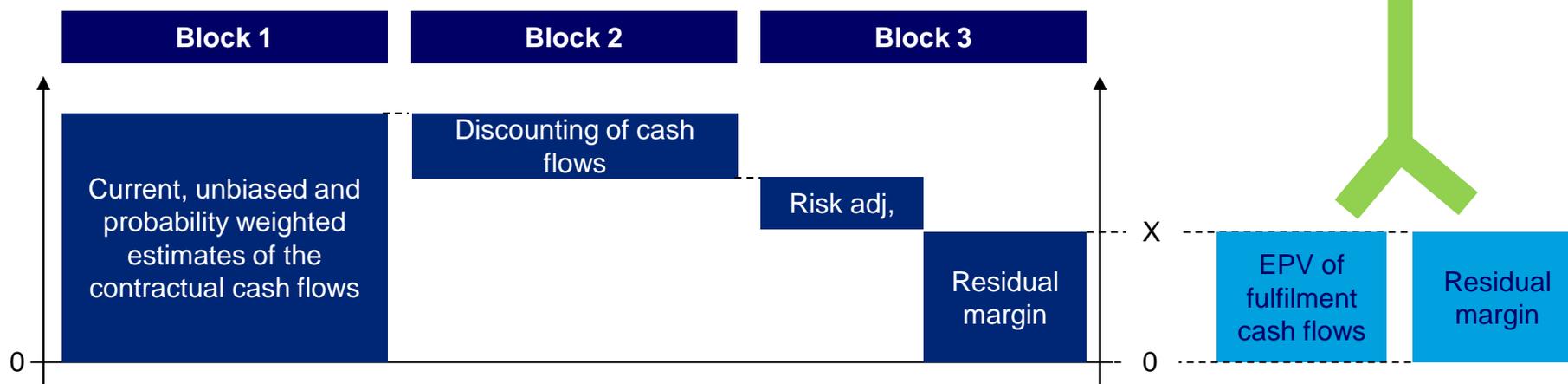
Source of balances in stat. of finan. position

On inception of non-short term insurance contract

Presentation & Disclosure

Statement of financial position	
<i>Insurance contract liabilities</i>	
Portfolio A	X
<i>Insurance contract assets</i>	
Portfolio B	X
Residual margin liability	X
Unit linked contract liability	X
Assets underlying unit-linked contracts	X

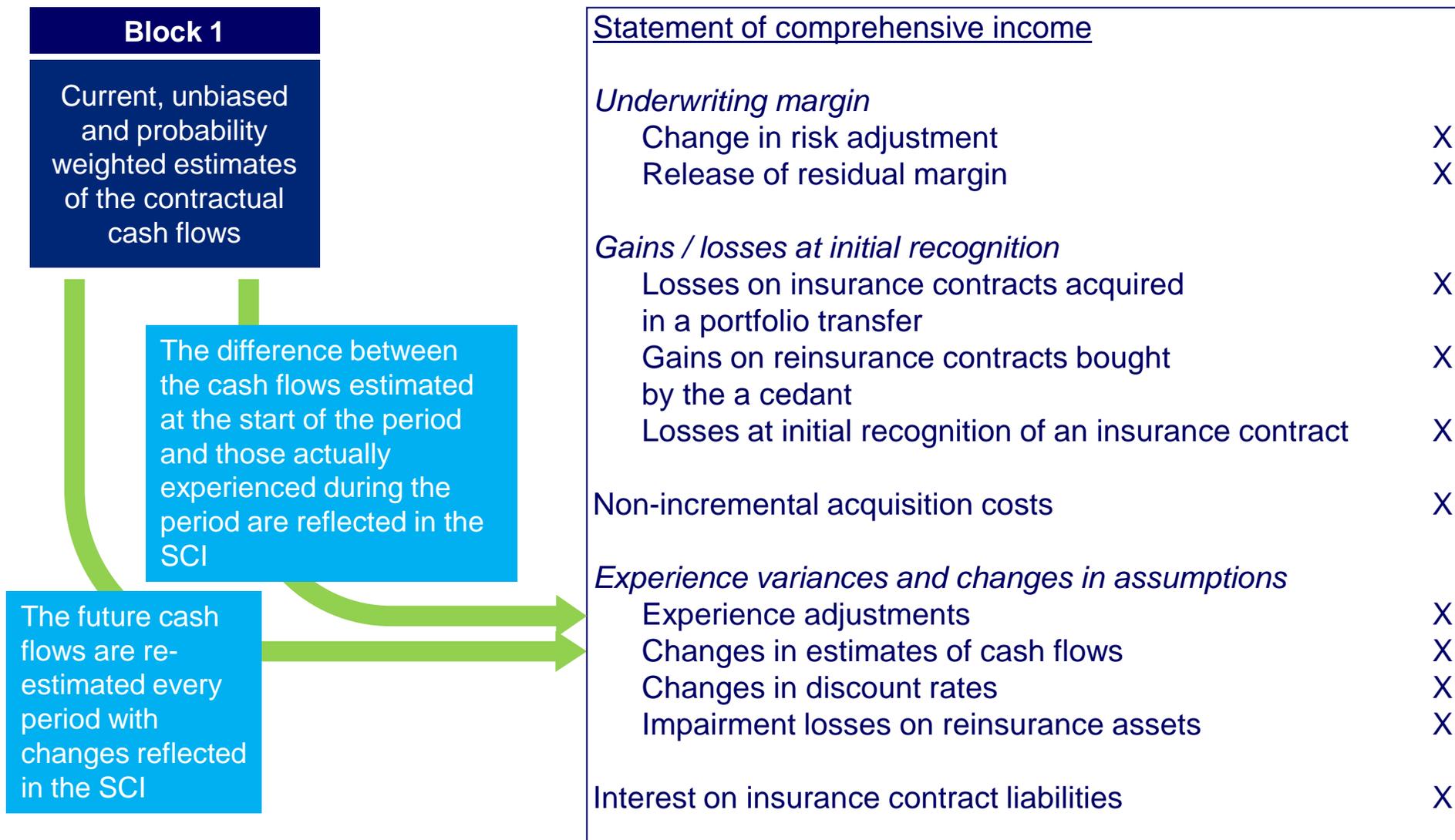
As the expected present value of the future cash inflows exceeds the expected present value of the future cash outflows plus the risk adjustment insurer will recognise a residual margin liability of X. The residual margin will at inception be counterbalanced with the Expected Present Value of the fulfilment cash flows => Liability at $t(0) = 0$.



Source of balances in stat. of compr. income

Non-short term insurance contract over future periods

Presentation & Disclosure



Source of balances in stat. of compr. income

Non-short term insurance contract over future periods

Presentation & Disclosure

Block 2

Discounting of cash flows

The discount rates are re-estimated every period with changes recognised in the SCI

The interest expense from the discount unwinding is recognised in the SCI

Statement of comprehensive income

Underwriting margin

Change in risk adjustment	X
Release of residual margin	X

Gains / losses at initial recognition

Losses on insurance contracts acquired in a portfolio transfer	X
Gains on reinsurance contracts bought by the a cedant	X
Losses at initial recognition of an insurance contract	X

Non-incremental acquisition costs	X
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Experience variances and changes in assumptions

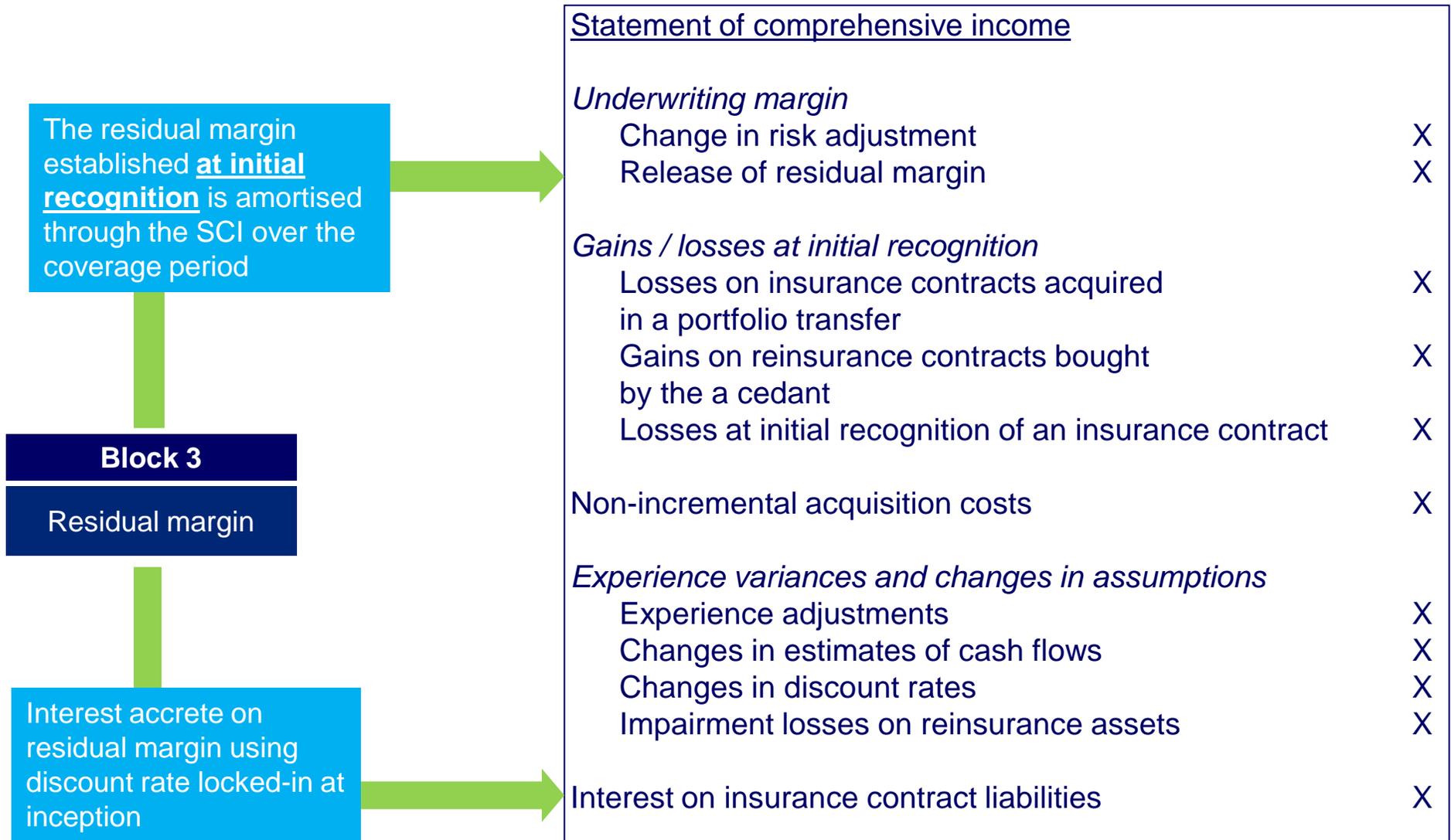
Experience adjustments	X
Changes in estimates of cash flows	X
Changes in discount rates	X
Impairment losses on reinsurance assets	X

Interest on insurance contract liabilities	X
--------------------------------------------	---

Source of balances in stat. of compr. income

Non-short term insurance contract over future periods

Presentation & Disclosure



Source of balances in stat. of compr. income

Non-short term insurance contract over future periods

Presentation & Disclosure

The risk adjustment is re-measured at each reporting period and the movement is recognised in the SCI

Block 3

Risk adjustment

Statement of comprehensive income

Underwriting margin

Change in risk adjustment	X
Release of residual margin	X

Gains / losses at initial recognition

Losses on insurance contracts acquired in a portfolio transfer	X
Gains on reinsurance contracts bought by the a cedant	X
Losses at initial recognition of an insurance contract	X

Non-incremental acquisition costs	X
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Experience variances and changes in assumptions

Experience adjustments	X
Changes in estimates of cash flows	X
Changes in discount rates	X
Impairment losses on reinsurance assets	X

Interest on insurance contract liabilities	X
--------------------------------------------	---

- The ED has adopted the current IFRS disclosure principles for insurance and added more stringent requirements to ensure alignment with the building blocks model and consistency of minimal content in the notes.
 - Aggregation is prohibited at a level greater than operating segment.
 - There is great focus on two particular areas which have been expanded:
 1. Assumptions and their changes:
 - Focus on the block estimation;
 - Assessment of the impact on profit and equity; and
 - Disclosure of changes from prior period.
 2. Reconciliation of movements to balance sheet and income statement lines:
 - Specific minimum reconciling items set out (see next slide);
 - Tailored requirements for the simplified method;
 - All amounts before and after reinsurance; and
 - Focused on the cash flows exchanged and their comparison with estimates.
- The added level of disclosure will require insurers to reassess the way that they capture and manage data as well as assessing their current systems capabilities.

Disclosure – required reconciliations

Reconciliations are required from the opening to closing balances for each of the following, if applicable:

1. Insurance contract liabilities and, separately, insurance contract assets.
2. Risk adjustments included in 1.
3. Residual margin included in 1.
4. Reinsurance assets arising from reinsurance contracts held by the insurer as cedant.
5. Risk adjustments included in 4.
6. Residual margin included in 4.
7. Impairment losses on reinsurance assets.

For each reconciliation the following should be shown, at a minimum, of applicable:

- Carrying amount brought forward.
- New contracts recognised during the period.
- Premiums received.
- Payments split into: claims and benefits; expenses; and, incremental acquisition costs.
- Other cash paid and, separately, other cash received.
- income and expenses.
- Amounts relating to contracts acquired from, or transferred to, other insurers in portfolio transfers or business combinations.
- Net exchange differences on the translation of foreign currency amounts.

Transition and effective date

- The new standard is likely to be effective for periods beginning on or after 1 January 2013.
- The effective date will move in parallel with that of IFRS 9 “Financial Instruments”.
- Early adoption will be permitted, but this fact will need to be disclosed.
- Same transitional provisions will apply for IFRS “first time” adopters and existing IFRS reporting entities.

On adoption

- Insurance liabilities will be calculated as the sum of blocks 1 and 2 plus the risk adjustment (even if a composite margin approach is finally selected). No recognition of residual margin.
- All insurance intangible balances (e.g. deferred acquisition costs, intangibles arising from existing insurance contracts assumed in a previous business combination) will be written off.
- All these adjustments will be recognised in opening retained earnings.
- Redesignation of financial assets ONLY into fair value through P&L is permitted (not required) .

- The estimation of a proper risk adjustment on transition is crucial as it will determine the primary source of future accounting profits from the contracts in-force at the transition date.
- The existence of large, historic surpluses in participating funds held on balance sheets will further complicate the restatement of participating insurance and investment contracts.

Transition Questions

Question 10

If a prudence reserving margin is currently included in the technical provisions under local GAAP, will the release of this margin impact P&L upon transition date?

No.

Any adjustments between local GAAP accounting and the present value of the fulfilment cash flows of a portfolio of insurance contracts re-measured at transition date are recognized within retained earnings (of the earliest period presented).

Today's speakers

Any further questions? Don't hesitate to contact us...

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Appendix IFRS Phase II versus Solvency II

IFRS Phase II versus Solvency II

	IFRS Phase II Exposure Draft	Solvency II	Practical considerations
Timeline	Earliest effective date may be for annual periods ending on or after 1 January 2013. The final date will be decided after the comment period closes on 30 November 2010.	Implementation date of 31 October 2012, which may be extended to 31 December 2012.	<ul style="list-style-type: none"> • Opportunities for synergies in modelling solution and processes. • Joint implementation projects. • Significant resource challenges.
Objective / purpose	Provides a consistent basis for accounting for insurance contracts to enhance comparability across entities, jurisdictions and capital markets.	EU solvency regime to protect policyholders / beneficiaries using a principle based regulation that relies on management's good risk management practices and a regime of transparent disclosure to markets and regulators.	<ul style="list-style-type: none"> • For an EU group, both SII and IFRS may apply. Where a regime is deemed equivalent, this may lead to reconciliation challenges between the existing regulatory regime and IFRS. • Where there is an EU subgroup, IFRS may apply globally but SII will only apply to the EU subgroup, which could limit the scope of synergies and could necessitate separate programmes.
Scope	Insurance contracts as defined in IFRS and investment contracts with DPF issued from the same participating funds as insurance contracts.	Function of the entity's regulatory status as an authorised (re)insurer rather than the transfer of significant insurance risk.	<ul style="list-style-type: none"> • Reconciliation between IFRS and SII technical provisions is required under the SII disclosure provisions. • The difference in scope is likely to result in significant valuation differences for unit-linked investment contracts (i.e. without insurance risk) which will be accounted for as banking deposits in IFRS with no credit for future fees.

IFRS Phase II versus Solvency II

	IFRS Phase II Exposure Draft	Solvency II	Practical considerations
Measurement approach	Three building blocks with a calibration to add a residual margin liability if there is an accounting profit at the point of sale.	Three building blocks.	<ul style="list-style-type: none"> • SII and IFRS likely to run off the same models but with different assumptions. • Need to consider the process and timelines for the model runs given these will be generated by the same systems. • Clear reconciliation and explanation needed for Board review and approval and external disclosure.
Expenses	Include only incremental acquisition costs in the fulfilment cash flows.	All costs which will be incurred in servicing all obligations related to existing contracts (including commissions) need to be included in technical provisions best estimate cash flows.	<ul style="list-style-type: none"> • Adjustments to expense allocation systems. • Implementation challenge to identify the incremental acquisition costs.
Contract boundary	The point at which the insurer has the right to re-assess the risk and re-price.	Similar definition included in QIS5 but not supported by CEIOPS Technical Advice where the proposal is that the best estimate cannot be an asset.	<ul style="list-style-type: none"> • A point of significant controversy in the SII negotiations which increases the SII liability compared to that under IFRS – all other factors being equal.

IFRS Phase II versus Solvency II

	IFRS Phase II Exposure Draft	Solvency II	Practical considerations
Time value of money	Discounting reflects the characteristics of the liability cash flows (duration, currency and liquidity).	Discounting is required using the risk free rate adjusted for illiquidity based on prescribed rules for a transitional period. Post transitional period the discount rate is a risk free rate without any illiquidity premium.	<ul style="list-style-type: none"> • The SII liabilities will be higher than IFRS – all other factors being equal. • The assumptions for discounting are likely to be different, hence requiring separate modelling runs on a different assumption set. • Developing the approach to determining the discount rate, particularly the illiquidity premium, will involve significant financial / actuarial expertise and time. • Clarity in the disclosures around the discount rate is important, given its significance and the likelihood of varying practices in the market for IFRS. • Delinking the discount rate from the asset return may lead to more earnings volatility which will need to be explained carefully to the Board, analysts and investors.
Unbundling	Components of the insurance contract must be unbundled e.g. to measure separately certain account balances, embedded derivatives and contractual terms and conditions not closely related to the insurance contract.	Contract covering risks across different lines of business need to be unbundled into the appropriate lines of business. Unbundling may not be required where only one of the risks is material.	<ul style="list-style-type: none"> • Significant implications for the life insurance industry primarily in the implementation phase. • Challenges are more likely to exist in the reporting and reconciling technical provisions rather than in modelling / valuation.
Participating contracts	Discretionary benefits must be included in the best estimate cash flows.	Similar treatment as IFRS.	<ul style="list-style-type: none"> • Both IFRS and SII have a significant challenge of identifying the expected distribution to policyholders and shareholders.

IFRS Phase II versus Solvency II

	IFRS Phase II Exposure Draft	Solvency II	Practical considerations
Risk Margin	<p>An entity specific measure of insurance uncertainty.</p> <p>One of three methods must be used to calculate the risk margin to capture the maximum value the insurer would pay to be relieved from the future uncertainty (VaR, CTE and CoC).</p> <p>Remeasured at each reporting date from portfolios that share the same risk characteristics and are managed as one portfolio.</p>	<p>An alleged market consistent measure of insurance uncertainty.</p> <p>The margin tries to capture the amount that a (re)insurer would be expected to pay to transfer the (re)insurance obligations.</p> <p>Only one method must be used: cost of capital based on the future SCR levels. In addition the cost of capital rate is fixed at 6%.</p> <p>Remeasured at each reporting date based on regulatory defined portfolios that represent the maximum aggregation permitted.</p>	<ul style="list-style-type: none"> • The SII liability is likely to be higher than IFRS due to the imposed CoC rate and maximum aggregation of portfolios (lower diversification benefits) – all other factors being equal. • Identification of the most appropriate method to calculate the risk margin which may differ depending on the nature of the insurance contract. • Complexity in defining the portfolios to maximise diversification benefit. • Different profit recognition patterns to communicate to Board and externally to analysts and investors. • Still need to calculate a VaR for IFRS disclosure even where CTE or CoC method is used. • VaR method requires additional modelling capabilities. Whilst there are not necessarily any synergies, it may help to address significant model changes at the same time as SII.
Residual margin	<p>Designed to eliminate any gains on inception. It is calculated separately for each portfolio of insurance contracts with similar inception date and coverage period.</p>	<p>No residual margin liability.</p>	<ul style="list-style-type: none"> • Need to define the level of aggregation for the most efficient calculation of the residual margin.

IFRS Phase II versus Solvency II

	IFRS 4 Phase II Exposure Draft	Solvency II	Practical considerations
Presentation of performance statement	The income statement will be fundamentally different using a margin based approach rather than the traditional premiums and claims analysis, similar to EV reporting.	Performance disclosed in Section A of the SFCR and RTS and limited disclosure in the QRTs. SII is a balance sheet, solvency focussed regulatory regime.	<ul style="list-style-type: none"> • Changes to the general ledger and underlying accounting systems required for IFRS reporting including interfaces with policy administration systems. • Processes will need to be updated to capture the more granular margin movements. • More detailed movement data will need to be organised to construct the income statement e.g. data on policies which have terminated during the year.
Short duration insurance contracts	For contracts with a duration of no more than one year, an unearned premium less deferred acquisition costs must be applied if certain criteria are met.	No such simplification provided in SII.	<ul style="list-style-type: none"> • An analysis is necessary to identify the areas where this simplification is required to limit the differences between SII and IFRS measurement approaches. • This approach is likely to be similar to current practices for IFRS but only relates to the pre claim liability. • An onerous contracts test must be developed based on the three building blocks (expected present value of cash flows plus risk adjustment).

Information links



Link to **Deloitte Insurance Accounting Newsletter:**

http://www.deloitte.com/view/en_GB/uk/industries/financial-services/sector-focus/insurance/article/ac9955baf1001210VgnVCM100000ba42f00aRCRD.htm

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