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Insurance Contracts Update

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Objective

To provide an update on the accounting standard(s) for insurance contracts, and provide greater awareness of the responsibility of management when using an “expert”.

Insurance Contracts Update

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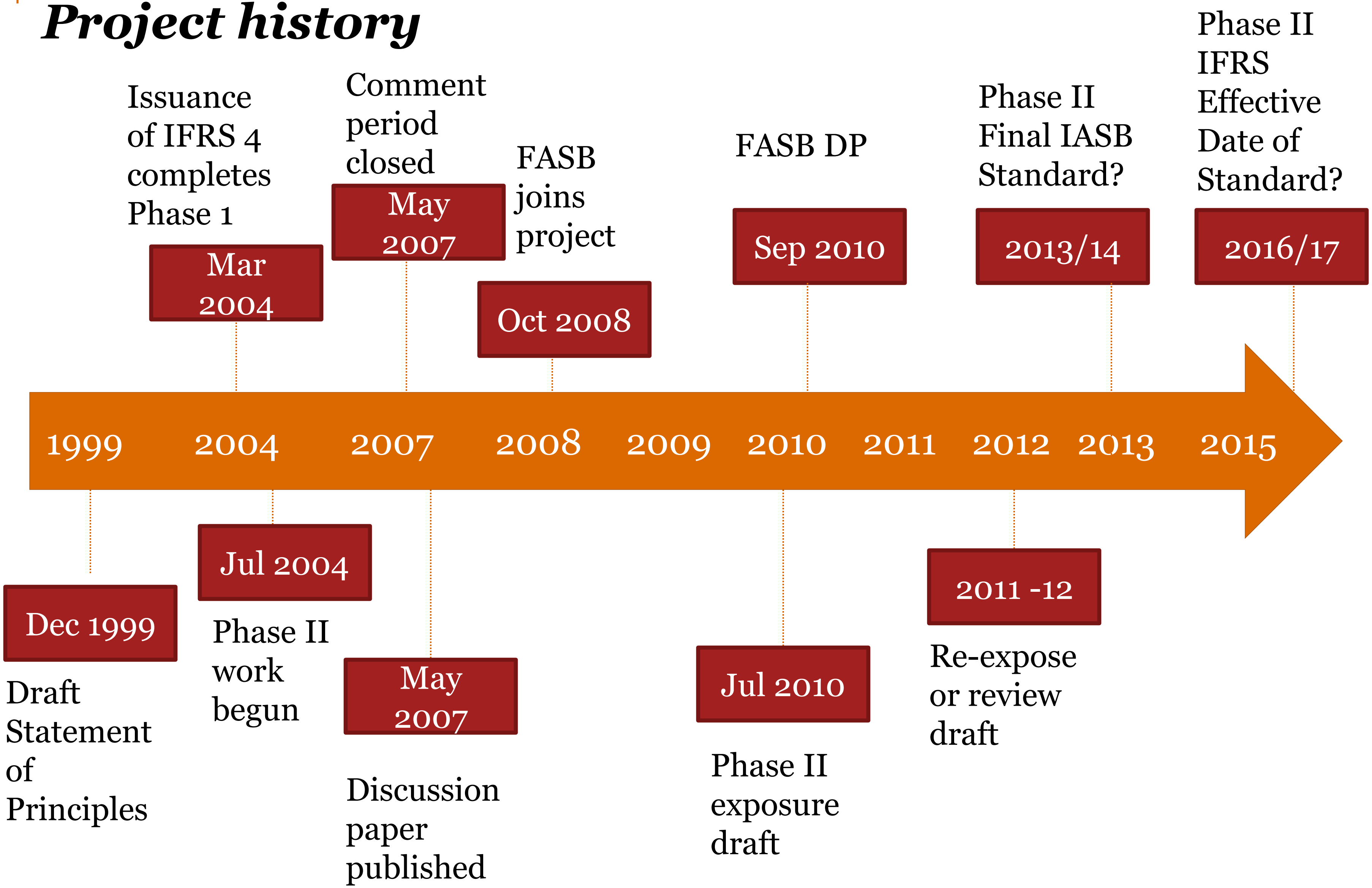
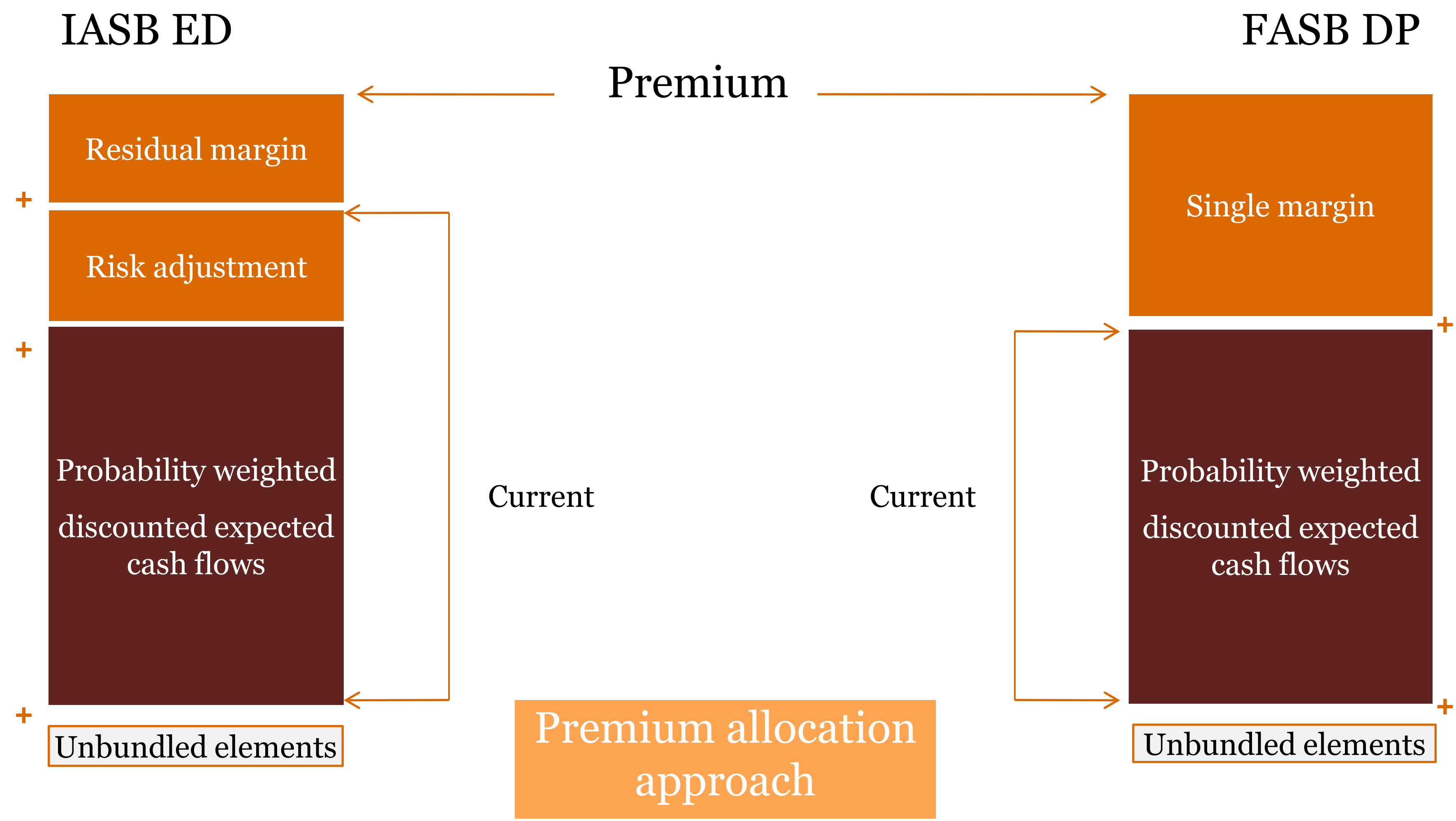
Project history



Exposure draft proposals



Exposure draft proposals
Fulfillment cash flows

Current unbiased probability weighted estimate of future cash flows

- Market variables consistent with market prices
- Entity perspective for other cash flows

- Contract boundary is where insurer:
  - Is no longer required to provide cover; or
  - Has right or practical ability to reassess risk of particular policy holder and can reprice.
- Acquisition costs
  - Incremental at contract level included in contract cash flows
  - Other acquisition costs expensed

Exposure draft proposals
Discount rate

Reflects characteristics of liability:

- If liability independent of supporting asset, discount rate is risk free with adjustment for illiquidity
- If liability linked to supporting assets then discount rate reflects that linkage.

Exposure draft proposals
Risk adjustment

- Objective 'to reflect the maximum amount that an insurer would rationally pay to be relieved of the risk that the ultimate cash flows exceed those expected'

- Limited range of permitted techniques
    - Confidence level
    - Conditional tail expectation
    - Cost of capital

- Diversification at portfolio level

Exposure draft proposals
Premium allocation model

Required for pre-claims liabilities of short duration contracts

- Coverage period approximately one year or less
- No embedded options or other derivatives

- Reduce initial liability in systematic way
  - Passage of time; or
  - Expected timing of claims and benefits if different

- Claims liabilities measured at present value of fulfillment cash flows

- Onerous contract test

Exposure draft proposals
Unbundling

- Unbundle where components are not closely related to insurance

- Three specific examples
  - Account balance
  - Embedded derivatives
  - Unrelated goods and services

- Unbundling prohibited for closely related components

Exposure draft proposals Presentation

	Inception 1 January	Six months to 30 June	Six months to 31 December
Change in risk margin		21	26
Residual margin		13	13
Underwriting margin	**-**	***34***	***39***
Non-incremental acquisition costs	10	-	-
Experience adjustments		(10)	(10)
Changes in estimates		(20)	-
Gains/losses at inception	-	-	-
Investment income		40	38
Interest on insurance liability	-	(25)	(23)
Profit/(loss)	***(10)***	***19***	***44***

Responses to ED

General

- Building blocks generally supported but concerns over several issues
- Lack of global consensus – geographic split

Main concerns

- Volatility in income statement
- Discount rate
- Explicit risk adjustment
- Re-measurement of residual/composite margin
- Unbundling
- Presentation
- Premium allocation approach

Re-deliberations on exposure draft proposals Fulfilment cash flows

- Clarified that expected value refers to the mean
- Recognition at start of coverage period or earlier if onerous

- Contract boundary amended to:
  - *insurer no longer required to provide coverage or*
  - *existing contract does not confer any **substantive rights** to the policyholder.*

  This is where the insurer has the right or practical ability to reassess the risk of:

  - *the particular policyholder and can re-price to fully reflect that risk*
  - *the portfolio and can re-price to fully reflect that risk*

Re-deliberations on exposure draft proposals Discount rate

- Rate should:
  - reflect ‘characteristics of the liability’
  - be consistent with observable current market for instruments with same characteristics as insurance liability
  - exclude risk of non-performance by insurer
  - exclude factors not relevant to liability
  - no locked in discount rate
  - not expected return on assets

Re-deliberations on exposure draft proposals Discount rate (cont)

Boards agreed that a method or rate should not be prescribed:

Top-down versus bottom-up example

Expected reference portfolio rate	7.0%
Market risk premium for expected losses	0.8%
Market risk premium for unexpected losses	0.7%
Insurance contract discount rate	**5.5%**
Liquidity premium	1.5%
Risk free rate of return	4.0%

Re-deliberations on exposure draft proposals Residual margin

- Amortise over coverage period on a systematic basis consistent with the pattern of transfer of services under the contract
- Adjust residual margin prospectively for both favourable and unfavourable changes in cash flow estimates
- The unit of account used to ***determine*** the residual/single margin is the portfolio defined as contracts that are:

- subject to similar risks
- managed together as a single pool
- priced similarly relative to the risk taken on

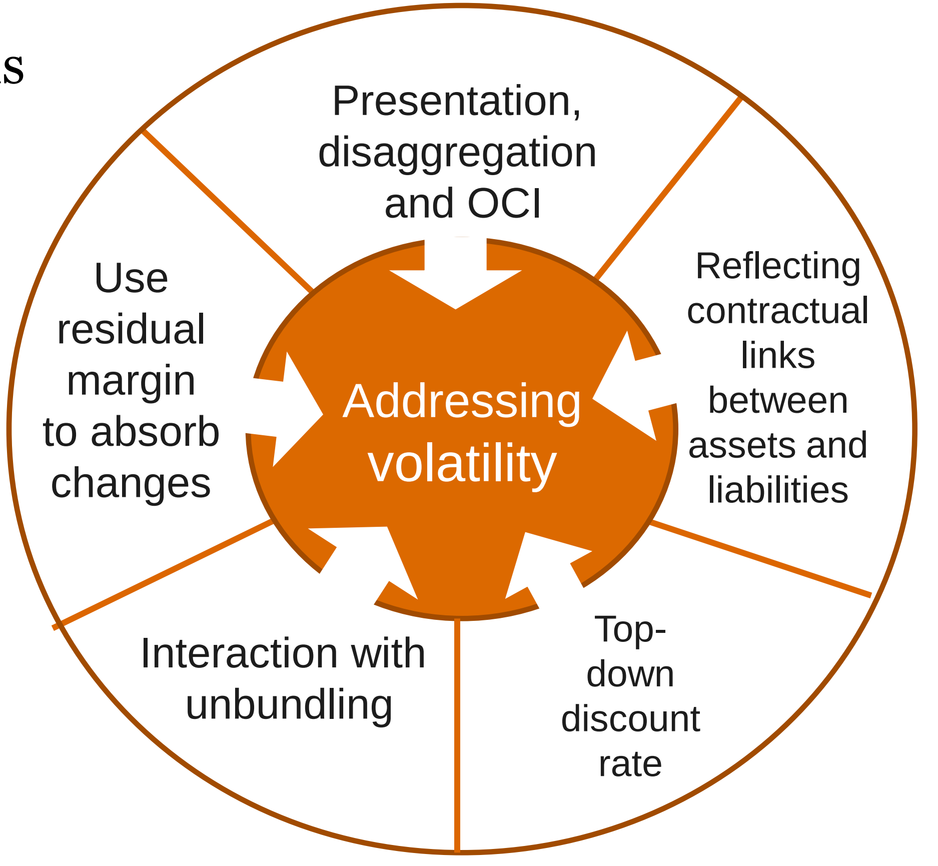
- The unit of account used for ***release*** of residual/single margin is not prescribed, as yet.

Re-deliberations on exposure draft proposals Financial Statement Presentation

- Many disagreed with summarised margin approach
- Boards considering an approach similar to expanded margin approach with volume information
- Gross premium and claims are important as key indicators to understand business
- Separate presentation of balances relating to PAA and BBA
- Non-life insurers want premium receivable, unearned premium reserve and claim liability on balance sheet
- Integration of insurance and non-insurance results difficult
- Possible OCI solutions proposed by industry for income statement volatility:
  - Two discount rates
  - IFRS 9: 'Financial Instruments'

Resulting Volatility

- Critical issue in all jurisdictions for all respondent types
- Is reported volatility faithful representation of the underlying economic phenomena?
- Interaction with IFRS 9 which is being reconsidered



Insurance project – still some way to go

Exposure draft	Re-deliberations
Definition and scope	No significant change from ED - except financial guarantees and investment contracts with DPF
Fulfilment cash flows, including acquisition costs	Some change from ED
Discount rate	Some change from ED
Risk adjustment	Some change from ED
Residual margin	Significant change
Participating contracts	Some change from ED
Modified/UPR approach	Some change from ED
Unbundling	Some change from ED; re-deliberations on-going
Reinsurance	Some change from ED; re-deliberations on-going
Performance statement	Re-deliberations ongoing
Transition/disclosure	Transition not yet re-deliberated / some changes on disclosures

Where to find more information

Insurance alert

IASB/FASB Board meetings - Insurance Contracts 15 - 23 March 2012

PwC Summary of Meetings

15 – 23 March 2012

- Educational session on Separation of Investment Components from Insurance Contracts (IASB only)
- Educational session on recognising changes in the insurance liability in OCI (IASB only)
- Portfolio definition of unit of account
- Disaggregation of investment components

Since a variety of viewpoints are discussed at FASB and IASB meetings, and it is often difficult to characterise the FASB and IASB's tentative conclusions, these minutes may differ in some respects from the actions published in the FASB's Action Alert and IASB Observer notes. In addition, tentative conclusions may be changed or modified at future FASB and IASB meetings. Decisions of the FASB and IASB become final only after completion of a formal ballot to issue a final standard.

Highlights

There were two IASB only educational session focused on the separation of investment components from insurance contracts and possible solutions for recognising changes in the insurance liability in OCI. No decisions were made.

At the joint board meeting, on the disaggregation of investment components from insurance contracts, the boards voted to separate as an investment component the amount that the insurer is obligated to pay to the policyholder regardless of the insured event. The staff was asked to bring back proposals to unbundle distinct balances to a future meeting.

In addition, the IASB voted in favour of insurers excluding from premium presented in the income statement, the present value of the amounts to be paid to policyholders or their beneficiaries, regardless of whether an insured event occurs, measured consistently with the measurement of the overall insurance liability. While the FASB agreed with this concept, they delayed a vote on this matter to a future meeting related to the details of performing the present value calculation of the amount to be paid.

The IASB voted by a large majority, and the FASB by a small majority, in favour of not presenting disaggregated amounts for the investment component in the balance sheet, but disclosing this information within the notes.

The boards also discussed the definition of a portfolio and the unit of account. The FASB voted in favour of their definition of portfolio as the unit of account for both the determination and release of the residual/single margin. The IASB voted in favour of their slightly different definition of portfolio as the unit of account only for the determination of the residual margin and voted that no unit of account would be prescribed for the release of the residual margin.

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IASB/FASB Insurance Contracts Project

PwC Summary as of March 21, 2012

Note: The following summary was developed using the IASB Exposure Draft, *Insurance Contracts*, issued in July 2010, FASB Discussion Paper, *Preliminary Views on Insurance Contracts*, issued in September 2010 as well as PwC knowledge gained from attendance at IASB and FASB meetings through March 21, 2012. *(Note: Changes from prior version appear in italics)*

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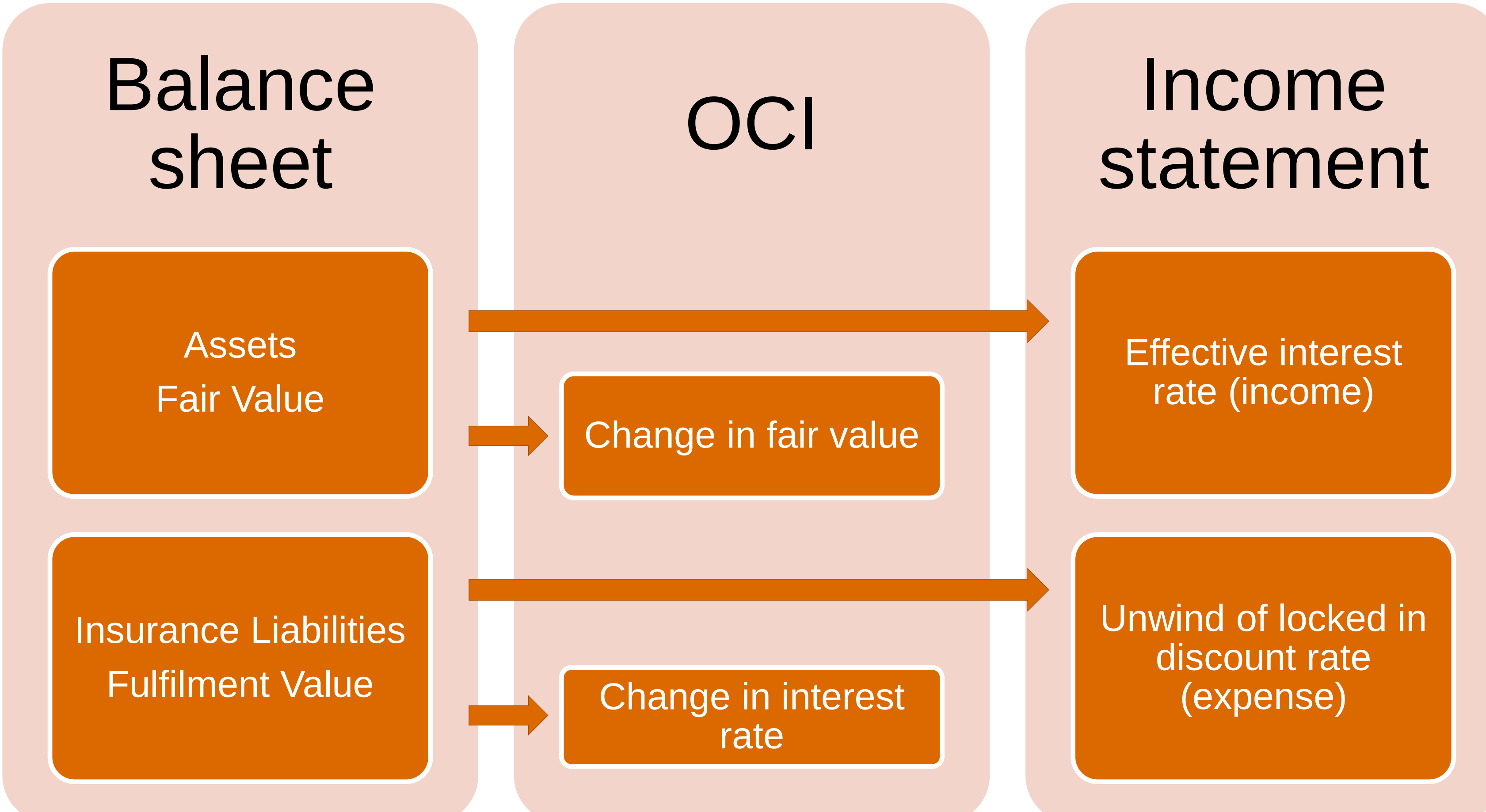
Component	IASB Exposure draft (ED) and FASB Discussion paper (DP) views		Boards' redeliberation status
	IASB	*FASB*	
Status	• Exposure draft (ED) issued July 2010. • Joint redeliberations began January 2011. • Boards plan to complete redeliberations by mid-2012. • Revised exposure draft or final review draft targeted for second half 2012.	• Discussion paper (DP) issued September 2010. • FASB exposure draft targeted for second half 2012.	• Boards will evaluate and attempt reconciliation of key differences at end of redeliberations.
Definition of insurance contract	• Retain IFRS 4 definition of insurance contract: "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."		• Reaffirmed ED/DP position.
Significant insurance risk	• Retains IFRS 4 requirements with additional clarification that evaluation of insurance risk should be done using present values rather than absolute amounts. As a result, contractual provisions that delay timely reimbursement to policyholder can eliminate significant insurance risk. • Risk transfer analysis should focus on the variability of outcomes (i.e., is the range of outcomes significant to the mean?), consistent with IFRS 4, but amended to require that there be at least one possible outcome with commercial substance in which the present value of net cash outflows paid by insurer can exceed the present value of premiums.		• Some constituents (principally IFRS) commented that present value clarification and requirement for at least one possible loss outcome not necessary. • Reaffirmed ED/DP position.
Scope	• Financial guarantee contracts meeting the definition of an insurance contract are included in the scope of the insurance contracts standard. • Exclusions from Insurance Contracts scope include: – Residual value contracts offered by a manufacturer, dealer, or retailer and lessee guarantees of residual value (but stand-alone residual value guarantees not addressed by other projects are in Insurance Contracts scope). – Manufacturer, dealer, and retailer warranty contracts (but unrelated third party warranties are in Insurance Contracts scope). – Fixed-fee service contracts that have as their primary purpose the provision of services, for example maintenance contracts in which the service provider agrees to repair specified equipment after a malfunction. – Contingent consideration payable or receivable in a business combination. – Employer's assets and liabilities under employee benefit plans and retirement benefit obligations reported by defined benefit plans. – License fees, royalties, contingent lease payments and similar items. – Direct insurance contracts an entity holds as policyholder (except for cedant accounting).		• IASB changed position from ED for financial guarantee contracts; will retain existing IFRS 4/IAS 39 scope guidance in the short term. • FASB will deliberate whether financial guarantee contracts (including mortgage guarantee) should be included in scope in conjunction with financial instruments project. • Both Boards reaffirmed scope exclusions. • Boards' reaffirmation of scope exclusions includes FASB decision that employers account for employer-provided healthcare benefits to their employees under employee compensation guidance rather than impute a premium and account for them as issued insurance contracts. • To clarify fixed-fee service contract exclusion, added 3 required qualifying criteria: (a) not priced based on an assessment of the risk associated with an individual customer; (b) contracts compensate customers by providing a service, rather than cash payment; and

http://www.pwc.com/gx/en/insurance/IFRS/progress.jhtml

What should you do next?

- Monitor board's decision and comment on next stage
- Focus on identifying technical impact areas, direction of financial impact and operational challenges
- Cash flow projections and risk adjustment systems
- Slicing and dicing of data – e.g. expense allocation models
- Building block approach on post claims liability for short duration contracts
- Resourcing
- Cultural challenge as more numbers owned by actuaries, challenges of understanding sources of profit

Measurement and classification
Interaction with insurance project – OCI approach



Accounting Estimates, including Fair Value Estimates and Related Disclosures: ISA 540

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Examples of common estimates

- Warranty obligations
- Outcome of long-term contracts
- Cost arising from litigation settlements
- Claim accruals
- Valuation of securities and properties

Management Requirements

- Compliance with applicable financial reporting frameworks
- Develop a process for identifying the need for accounting estimates to be recognised or disclosed.
- Communicate basis for developing management estimates including underlying data used.
- Review the outcome of accounting estimates included in the prior period financial statements, or, as applicable, their subsequent re-estimation in the current period.
  - nature and extent of review takes account of the nature of estimate and whether information to be obtained is likely relevant to identifying and assessing risks.
  - not intended to revisit prior judgments

Nature of Estimation Uncertainty

The susceptibility of an accounting estimate to an inherent lack of precision in its measurement.

The degree of estimation uncertainty affects the risk that the financial statements are materially misstated and whether an estimate is particularly susceptible to management bias.

Disclosures

Disclosures related to accounting estimates should be in accordance with the applicable financial reporting framework.

For estimates giving rise to significant risks, a disclosure of estimation uncertainty in the context of the applicable financial reporting framework should be made.

Use of Specialists and Experts

If management uses specialists in developing estimates, management should take steps to ensure the:

- Competence of the specialist/expert
- Appropriateness of inputs used
- Evaluation of the appropriateness of the method used is done each reporting period

Written Representations

Provide written representations regarding the reasonableness of significant assumptions used in making accounting estimates.

Effective Corporate Governance: (And Its Role In the Insurance Industry)

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Risk Management and Internal Controls

"47% of audit committee chairs consider the company's enterprise risk management system to be very effective."

Internal control is a component of enterprise risk management.

It is the process that provides reasonable assurance that the company will be able to achieve its objectives of:

- Effectiveness and efficiency of operations
- Reliability of financial reporting
- Compliance with applicable laws and regulations

Questions

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Thank you!

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