





IASB Exposure Draft *Insurance Contracts*

Educational session
August 27, 2010
KPMG in The Bahamas

AUDIT ■ TAX ■ ADVISORY


Background



Insurance Contracts Project

- Joint project between IASB and FASB
- **Project phases**
- IASB Discussion Paper – Preliminary Views on Insurance Contracts (May 2007) – Current Exit Value Approach
- FASB Invitation to Comment wrapping IASB paper (August 2007)
- FASB joins IASB project (October 2008)
- IASB Exposure Draft (July 2010)
- FASB Discussion Paper (Aug/Sept 2010)
- Final IASB standard expected by **June 2011**; Final FASB standard expected in **2012**
- First time application to be established (Boards' intent is to align effective date with IFRS 9 *Financial Instruments-2013?*)

Comment deadline on ED ends 30 November 2010



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Insurance Project Scope



- Insurance and reinsurance contracts (not insurance enterprises)
- Investment contracts containing a discretionary participation feature (DPF) provided that **there also exist insurance contracts that provide similar contractual rights to participate in the performance of the same pool or entity.**
- Financial guarantee contracts *issued* by an entity (and financial guarantee reinsurance contracts held) that meet the definition of an insurance contract. Definition does not capture some types of credit-related contracts.



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Scope Exemptions

- product warranties issued directly by a manufacturer, dealer or retailer;
- residual value guarantees embedded in a finance lease and residual value guarantees 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;
- contractual rights or contractual obligations that are contingent on future use, or right to use, a non-financial item;
- contingent consideration payable or receivable in a business combination;
- fixed fee service contracts that have as their primary purpose the provision of services, but that expose the service provider to risk because the level of service depends on an uncertain event; and
- policyholder accounting (other than reinsurance).



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Definition of an 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.”

- Consistent with existing definition and related guidance in Appendix B of IFRS 4 with minor changes to the application guidance to make distinctions between insurance contracts and other types of contracts.
- Proposals do not retain IFRS 4 implementation guidance

Significant insurance risk

Insurance risk is 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 (i.e. have no discernable effect on the economics of the transaction)

This condition may be met even if the insured event is extremely unlikely or even if the expected (i.e. probability weighted) present value of contingent cash flows is a small portion of the expected present value of contractual cash flows.

A contract does not transfer insurance risk if there is no scenario that has commercial substance in which the present value of the net cash outflows paid by the insurer can exceed the present value of the premiums.

Incorporates an amendment to the guidance in IFRS 4 to explain that contractual terms that delay timely reimbursement to the policyholder can significantly reduce insurance risk, so that some contracts containing such terms might not meet the definition of an insurance contract.

Significant insurance risk

Contractual terms that delay timely reimbursement to the policyholder can eliminate significant insurance risk

Example

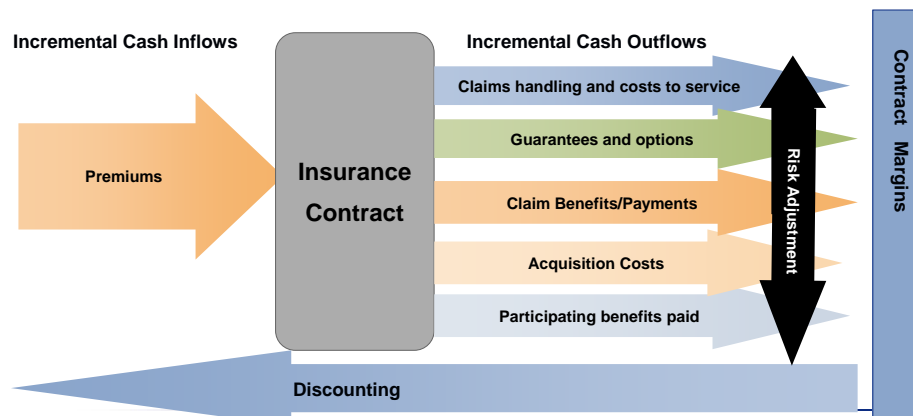
Reinsurance contract

- Cedant enters into a reinsurance contract covering a book of one yr contracts
- Reinsurer’s payments – 10 yrs after the start of the contract
- Beginning of contract – claims will range from \$1,000 to \$1,200
- Discount rate – 5%

Does the reinsurance contract transfer significant insurance risk?

The Measurement Model

Measurement model is based on a principle that insurance contracts create a bundle of rights and obligations that work together to create a package of cash inflows (premiums) and outflows (benefits, claims and costs). The model uses certain “building blocks” in measuring that package of cash flows.



Proposed Measurement Models The three (or four) 'building blocks'

IASB Preference (modified to exclude day one gains)	FASB Preference (modified to exclude day one gains)
Explicit, unbiased and probability-weighted estimates of future cash outflows less future cash inflows *	Explicit, unbiased and probability-weighted estimates of future cash outflows less future cash inflows *
Discounted using current rates to reflect the time value of money *	Discounted using current rates to reflect the time value of money *
Risk adjustment (to adjust for the effects of uncertainty about the amount and timing of future cash flows) *	Composite margin (to remove any profit at inception and released over time)
Residual margin (to remove any profit at inception and released over time)	

Contract liability measurement

* Re-measured subsequent to inception through profit or loss

The sum of the first three building blocks in the IASB model (discounted cash flows with risk adjustment) is referred to as the present value of fulfilment cash flows



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Level of measurement



- An insurer would measure the present value of the fulfilment cash flows (includes risk adjustment) at a portfolio level of aggregation for insurance contracts.
- A *portfolio of contracts* are contracts that are subject to broadly similar risks and managed together as a single pool. The definition is consistent with IFRS 4.
- The residual margin should be determined by grouping insurance contracts by portfolio and, within the same portfolio, by similar date of inception of the contract and by similar coverage period.



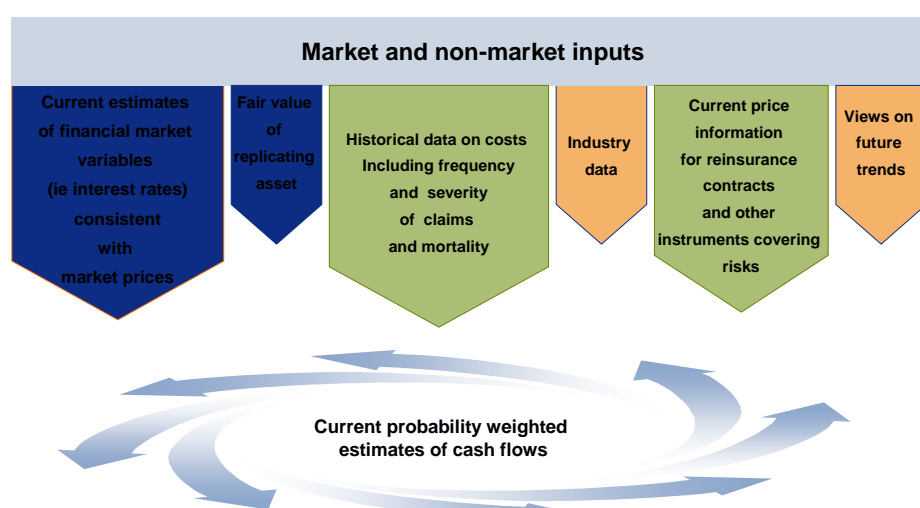
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Building Block 1- cash flows

- *Estimates of cash flows for a portfolio of insurance contracts should include all incremental cash inflows and outflows arising from that portfolio*
- *Cash flow estimates are required to be updated each reporting period and changes are recognised in profit or loss*
- *Estimates of cash flows start with a range of scenarios that reflects a full range of possible outcomes. Each scenario specifies the amount and timing of cash flows for a particular outcome and the estimated probability of that outcome.*

Building Block 1- What inputs are considered?



Building Block 1 – Which contractual cash flows?

Incremental cash flows within boundary of a contract that are incremental at portfolio level ✓

Claims and benefits paid to policyholders (including IBNR)	+	Contractual benefits paid in kind	+
Claims handling costs	+	Payments to current or future policyholders as a result of a contractual participation feature	+
Premiums	-	Incremental* costs of selling, underwriting, and initiating an insurance contract (acquisition costs) but only for contracts issued	+
Salvage and subrogation	-	Options or guarantees	+
Costs of servicing the contract (policy administration and maintenance)	+		
Transaction-based taxes and levies	+		

+ Indicates an obligation/ – Indicates a right

* Incremental at contract rather than portfolio level



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Building Block 1 – cash flows excluded

Cash flows that will arise as the insurer fulfils an existing insurance contract that are **not included**:

(a) investment returns. The investments are recognised, measured and presented separately. However, the measurement of a participating insurance liability is affected by the cash flows, if any, that depend on the investment returns.

(b) payments to and from reinsurers. Reinsurance assets are recognised, measured and presented separately.

(c) cash flows that may arise from future insurance contracts, ie cash flows that are outside the boundary of existing contracts or from options, forwards and guarantees that do not relate to the existing insurance contract.

(d) acquisition costs other than incremental acquisition costs.

(e) cash flows arising from abnormal amounts of wasted labour or abnormal amounts of other resources used to fulfil the contract.

(f) costs that do not relate directly to the contract or contract activities, such as general overheads.

- An insurer should recognise all non-incremental acquisition costs as an expense when incurred.



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Building Block 2- Discounting

What discount rate should be used in measurement?

- ✗ Should not capture **characteristics of assets actually held** to back the insurance liability, unless the contract shares those characteristics
- ✓ Should be consistent with observable current market prices for instruments whose **characteristics reflect the insurance liability** (e.g. timing, currency and liquidity)
- ✓ Discount rate is yield curve with no or negligible credit risk, adjusted for differences in liquidity, if cash flows are not dependent on specific assets
- ✗ Should not include **own credit risk**
- ✗ Should not include factors not relevant (i.e. risks not present in liability but present in the instrument with observable market price)
- ✓ If the amount, timing or uncertainty of cash flows for the insurance contracts depends on the **performance of specific assets** measurement shall reflect that fact
- ✗ Should not include any risk that is included in other parts of measurement

Building Block 3 - Risk Adjustment

Risk Adjustment: *"The maximum amount that the insurer would rationally pay to be relieved of the risk that the ultimate fulfilment cash flows may exceed those expected."*

- An insurer shall use only the following techniques for estimating the risk adjustment:
 - Confidence level
 - Conditional Tail Expectation (CTE)
 - Cost of Capital (CoC)
- The proposals in the ED do not mandate a specific confidence level or CTE band for calibrating the risk adjustment.
- An insurer discloses the confidence level and, if applicable, CTE bands used in estimating the risk adjustment.
- Should be estimated at a portfolio basis to reflect diversification of risks within a portfolio, but not diversification between different portfolios
- Re-measured each reporting period and changes are recognised in profit or loss
- Although the risk adjustment must be explicit, this requirement is not intended to preclude a "replicating portfolio" approach

Building Block 3 or 4- Composite or Residual Margin



Residual Margin

- Arises when the present value of the fulfilment cash flows* is less than zero
- If the present value of fulfilment cash flows is greater than zero, this amount should be recognised in profit or loss at inception (i.e. a day one loss)
- **Systematic release over coverage period based on the passage of time**
- If an insurer expects to incur benefits and claims in a pattern that differs significantly from passage of time the residual margin should be released on the basis of the expected benefits and claims to be incurred
- Classified as part of the insurance liability
- **Interest accretion using “locked in” rate**

Composite Margin

- Arises when the present value of future cash outflows less the present value of future cash inflows is less than zero.
- If the present value of future cash outflows less the present value of future cash inflows is greater than zero, this amount should be recognised in profit or loss at inception (i.e. a day one loss)
- **Release over both the coverage period and the claims handling period (during which the insurer is expected to pay claims)**
- Percentage of completion amortisation reflecting the decline of risk based on actual and expected cash flows
- Classified as part of the insurance liability
- **No interest accretion**

Unit of account at cohort level – grouping insurance contracts by portfolio and within the same portfolio, by similar date of inception of the contract and by similar coverage period.

* defined as the expected present value of the future outflows plus risk adjustment less cash inflows



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Modified Approach or “Premium Allocation Model”



The modified approach is required for pre-claim liabilities for contracts that meet both of the following definitions:

- The coverage period is approximately 12 months or less
- The contract does not contain embedded options or other derivatives that significantly affect the variability of cash flows

The pre-claims liability is the pre-claims obligation less the present value of future premiums within the boundary of the contract.



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Modified approach measurement

PRE CLAIM OBLIGATION

Premiums received

Present value of future premiums in boundary of contract

less

incremental acquisition costs

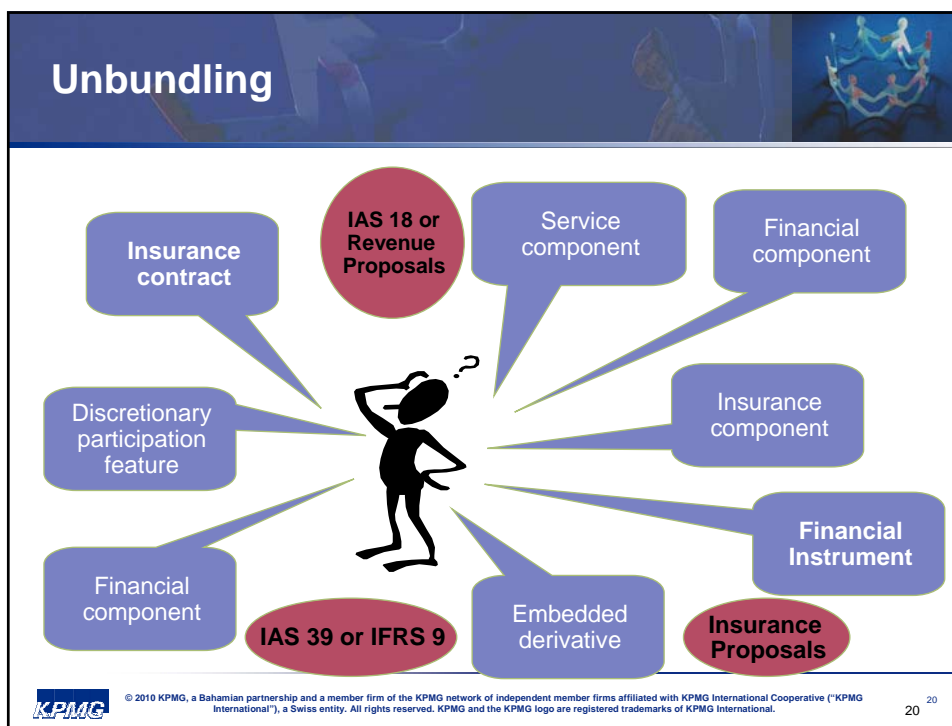
- Pre-claims obligation is reduced over the coverage period in a systematic way that best reflects the exposure from providing insurance coverage either
 - on the basis of the passage of time; or
 - the expected timing of incurred claims and benefits if this pattern differs significantly from the passage of time.
- Discounting is required.
- Interest should be accreted on the carrying amount of the pre-claims liability using a current discount rate.

Reinsurance Ceded

At initial recognition of a reinsurance contract, a cedant remeasures the underlying insurance liability, and applies that measurement in the initial measurement of the reinsurance asset under the building block approach, taking account of the risk of non-performance by the reinsurer.

Negative Difference		Positive Difference	
Input	Measurement	Input	Measurement
Reinsurance premium paid (premium ceded to reinsurer lump sum paid upfront)	(100)	Reinsurance premium paid (premium ceded to reinsurer lump sum paid upfront)	(110)
Reinsurance commission received	7	Reinsurance commission received	10
Expected present value of reinsurance recoverable cash inflows (after allowance for expected credit losses)	80	Expected present value of reinsurance recoverable cash inflows after allowance for expected credit losses)	80
Risk adjustment	15	Risk adjustment	15
Gain at inception	(2)	Residual margin	5

- If the consideration paid by the cedant to the reinsurer exceeds that measurement under the building block approach, the cedant treats that **excess as the residual or [composite] margin** at initial measurement.
- If that measurement under the building block approach exceeds the consideration paid by the cedant to the reinsurer, the cedant recognises that **difference as a gain in profit or loss at initial recognition** of the reinsurance contract.



- ## Statement of financial position
- The ED proposes that an insurer present each portfolio of insurance contracts as a single item within insurance contract assets or insurance contract liabilities.
 - It also proposes that an insurer present a pool of assets underlying unit-linked contracts as a single line item separate from the insurer's other assets and that the portion of the liabilities linked to the pool be presented as a single line item separate from the insurer's other liabilities.
 - Reinsurance assets are not offset against insurance contract liabilities.
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Statement of comprehensive income (SOI)



The ED proposes a summarised margin presentation for the statement of comprehensive income.

This presentation approach treats all **premiums as deposits** and all **claims and benefits as repayments to the policyholder**; those elements are treated as movements in the insurance liability.

This presentation is supplemented by disclosures of premiums and expenses (as part of the reconciliation of opening and closing contract balances).

Exception:

For short-duration contracts that are eligible for the modified measurement approach, the underwriting margin is disaggregated in the statement of comprehensive income into:

- Premium revenue (release of gross pre-claims obligation plus accreted interest)
 - Claims incurred
 - Expenses incurred
 - Amortisation of incremental acquisition costs included in the pre-claims obligation
- plus**
- changes in additional liabilities for onerous contracts



Summarised Margin Presentation



Statement of comprehensive income

Standard model – on face of SOCI

Underwriting margin	yes
• Change in risk adjustments	disaggregation could be included in notes
• Release of residual margins	
Gains and losses at initial recognition	yes
• Losses on insurance contracts acquired in a portfolio transfer	disaggregation could be included in notes
• Gains on reinsurance contracts bought by a cedant	
• Losses at initial recognition of an insurance contract	
Acquisition costs that are not incremental at individual contract level	yes
Experience adjustments and changes in estimates	yes
• Differences between actual cash flows and previous estimates	disaggregation could be included in notes
• Changes in estimates of fulfilment cash flows and discount rates	
• Impairment losses on reinsurance contracts	
Interest on insurance liabilities	yes



Disclosures

Under the proposals, an insurer is required to disclose quantitative and qualitative information in respect of:

- the amounts arising from insurance contracts recognised in the financial statements; and
- the nature and extent of risks arising from insurance contracts.

The IASB used the disclosure requirements in IFRS 4 (including the disclosures about financial risks in insurance contracts incorporated in IFRS 4 by cross reference to IFRS 7) as a basis for its proposals

Aggregation principle

- Useful information should not be obscured by either the inclusion of a large amount of insignificant details or the aggregation of items that have different characteristics

Required disclosures include: reconciliation of contract balances; methods and inputs used to develop the measurements, including a measurement uncertainty analysis; the nature and extent of risks arising from insurance contracts; a risk sensitivity analysis; and claims development information.

Additional disclosure requirements from IFRS 4 were retained

Timeline for Completion

Time line

Third quarter 2010
November 30, 2010

December 2010 – March
2011

April – May 2011

June 2011

Third quarter 2011
2012

Topic for discussion

Publication of FASB discussion paper (end of Aug)
Comments due on the ED & FASB discussion
paper

Summary of comments and discussion of issues
raised in the comment letters

Pre-balloting and sweep issues

Publication of final standard by IASB

Publication of exposure draft by FASB

Publication of final standard by FASB



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