International Accounting and Progress on a New Insurance Accounting Standard

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Outline of Speech

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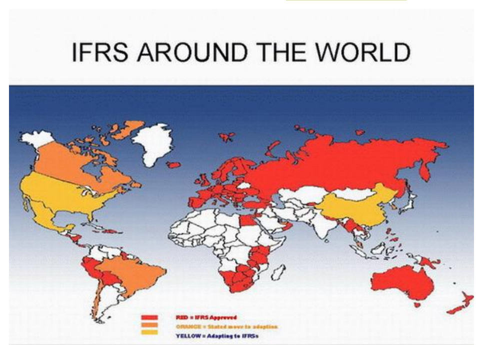
IASB

- Formed April 1, 2001, assuming standards setting from IASC
- 15 international members (4 from USA)
- Actions taken at monthly meetings
- Staff is located in London and most meeting take place in London
- www.IASB.org



IFRS in the US

- SEC has already decided that foreign companies no longer need to reconcile IFRS based financial statements to US GAAP
- SEC has published a roadmap that could lead to a decision to require US companies to report under IFRS
- FASB and IASB have a Memorandum of Understanding to converge IFRS and US GAAP
- FASB is working with IASB on new Insurance Standard

FASB

- Formed 1973
- 7 members (3 are new)
- Actions taken at weekly meetings
- Staff is located in Connecticut and most meeting take place in Connecticut (or London)
- SEC delegates standard setting to FASB
- www.FASB.org

Timeline

- IASB
  - Spring 2007 – Phase II Discussion Paper
  - July 2010 – Insurance Standard Exposure Draft
  - June 2011 – IASB Insurance Standard
  - 2014 or 2015 – Insurance Standard Effective
- FASB
  - September 2010 – Insurance Discussion Paper
  - June 2011 – FASB Exposure Draft
  - ? – FASB insurance Standard
  - 2014 or 2015 – Insurance Standard Effective

IFRS Insurance Project Objectives

- Reduce diversity of accounting practices that currently exist for insurance contracts
- Align insurance accounting with other business sectors, where possible
- Increase users' understanding of insurance financial statements
- Help investors make decisions

IASB Exposure Draft

Overview of Exposure Draft

- Principles-based approach with additional guidance
- Reflects the economics of insurance contracts
- Based on insurance contracts, not insurance companies

Goals of Exposure Draft

- A measurement model that focuses on the drivers of profitability and uses current estimates of cash flows
- Presentation of information about insurance contracts that reflects the changes in those drivers
- Consistent accounting for embedded options and guarantees in insurance contracts
- Consistency with market inputs, such as interest rates
- A coherent framework for dealing with complex and future insurance contracts

Measurement: Four Building Blocks

- Current estimate of future cash flows
- Time value of money
- Risk adjustment
- Residual margin
- For short-term contracts, required to use unearned premium liability as alternative model
  - The current P&C pre-claims model seen as working fairly well

Current Estimate of Future Cash Flows

- Current
- Unbiased
- Explicit
- Probability weighted
  - Expected value (mean), not "best estimate"
  - Number of scenarios depend on product

Acquisition Costs

- The ED limits acquisition costs to incremental at a policy level and only for successful sales
- This is more restrictive than other cash flows whicha are to be based on a portfolio of similar contracts

Time Value of Money

- Consistent with current observable market prices
- Exclude factors not present in the insurance liability
  - Independent of assets held unless obligation is a direct function of a set of assets
- Guidance in ED is risk free plus adjustment for illiquidity
- Any discounting would be a change for P&C

Risk Adjustment

- The maximum that the insurer would rationally pay to be relived of the risk that the ultimate fulfillment cash flow exceed those expected
- Designed to take into account that insurers/investors have a preference for an expected cash flow of 10 with a standard deviation of 1 versus an expected cash flow of 10 with an expected deviation of 12
- Remeasured at each period
- Not a PAD

Measuring Risk Adjustment

- ED limits methods allowed to calculate Risk adjustment to:
  - Confidence interval
  - CTE
  - Cost of Capital

Residual Margin

- Residual Margin is the plug so that there is no profit at issue
- The IASB Discussion Paper allowed a profit at issue, but insurance industry generally supported not allowing profits at issue
- Residual Margin is locked in at issue and is amortized over the coverage period of the insurance contract.

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Presentation of Income Stmt

- Summarized Margin
- Expected cash flows are not part of income statement
- Release of Risk Adjustment and Residual Margin equals Underwriting Margin
- Add experience adjustment for current period plus changes in estimates for future periods to get Underwriting Results
- Add investment income minus interest on insurance liability to get to Profit

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FASB Discussion Paper

- IASB and predecessor organization has been working on an insurance standard since 1997. FASB started in 2008
- FASB wanted to get users opinion on whether the proposal was an improvement on current GAAP
- FASB had certain areas where they disagreed with the IASB

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Differences from IASB

- Composite Margin instead of Risk Adjustment plus Residual Margin
  - Concerned about reliably measuring the Risk Adjustment
- Amortization of Composite Margin would take into account that risk adjustment is part of CM and the CM would need to also cover the claims period

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Comment Letters

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General comments

- Support for building block approach
- Most believe ED is a significant improvement over the IASB 2007 Discussion Paper
- The are specific issues with each of the building blocks
- There is general, but not unanimous, support for a current measurement model

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Issues for Redeliberation

- Volatility in profit and loss
- Discount rate
- Residual vs Composite Margin
- Remeasurement of Residual Margin
- Unbundling
- Presentation
- Short duration contracts
- Probablity weighted cash flows
- Transition rules

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Comments specifically to FASB

- Produce a converged standard
- Resolve any differences between IASB and FASB
- Problems with the discount rate
- Many supported the Composite Margin but did not like the proposed amortization
- Didn't like the summarized margin presentation

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SOA Research Project

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SOA Research Project

- Financial Reporting for Insurance Contracts Under Possible Future International Accounting Standards November 24, 2010
- 2011 Extension – Discount Rates, Subsequent Measurement of Margins, and Expenses March 16, 2011

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High Level Observations

- The relative size of the Risk Adjustment is small
  - Only liability risks, not asset risks
- The relative size of the Residual Margin is large
  - Overhead expenses
  - Other acquisition expenses
  - Asset risks
  - Taxes
- Assumptions affect amortization of Residual Margin
  - Benefit pattern vs coverage pattern
  - Interest

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Recent Progress

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Pursue New Standard

- On February 9, 2011, FASB voted to pursue a new insurance standard based on a converged view with IASB
- Decision was unanimous

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Expenses

- Increased the amount of maintenance expenses that would be part of the model and decreased overhead
- Increased the amount of acquisition costs that would be part of the model by basing them on a portfolio of policies. The IASB voted to include expenses for both successful and unsuccessful sales. The FASB stuck with only successful sales

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Discount Rate

- Confirmed that discount rate should reflect the characteristics of the liability
- Final Standard will not prescribe method for determining discount rate
  - Consistent with observable rates but excluding insurer's own credit risk
  - Reflect only risks and uncertainties not reflected elsewhere in the measurement of liabilities
- Top-down can be used as well as bottom up

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Risk Adjustment

- Both IASB and FASB agreed the inclusion of a Risk Adjustment would be relevant
- This is a change for FASB
- Caveat that there must be techniques that could faithfully represent the risk inherent in the insurance liability

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Discounting Insurance Liabilities

- Don't need to discount if effect is immaterial
  - P&C pre-claims UEP
  - Short duration claim reserves
- Long term P&C claims should be discounted for time value of money

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Implementation

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Probability Weighted Cash Flows (Mean)

- Must capture option costs
  - Term, SPIA – single scenario
  - UL, SPDA – must capture floor on crediting rates
  - Variable products – stochastic to capture cost of guarantees
- Current assumptions
  - Experience studies
  - Expense studies
  - Ability to update model assumptions at each valuation date and describe the financial impact of individual changes

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Discount with Current Interest

- Bottom up – risk free rate plus illiquidity spread where the illiquidity spread may vary by liability portfolio
- Top down – model asset portfolio (not same as cash flow testing)
  - Make deduction for credit spread and other deductions
  - Goal is a yield curve for each major currency you do business in
  - Deductions, and therefore yield curve, may vary by liability portfolio
- Reference rate

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Residual Margin

- Residual Margin is only assumption that is locked in (although re-measuring is being discussed)
- Allocate down to policy level?
- Run off over life of the contract
- If Composite Margin, then need to take release from risk into account with run off

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Presentation

- Will be a significant change from current practice if the Boards stay with Summarized Margin

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Disclosures / Explanations

- Possible use of a database
- New canned reports

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Questions?