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The Institute of Actuaries of Japan

Developments in International Accounting Standards for Insurance Companies

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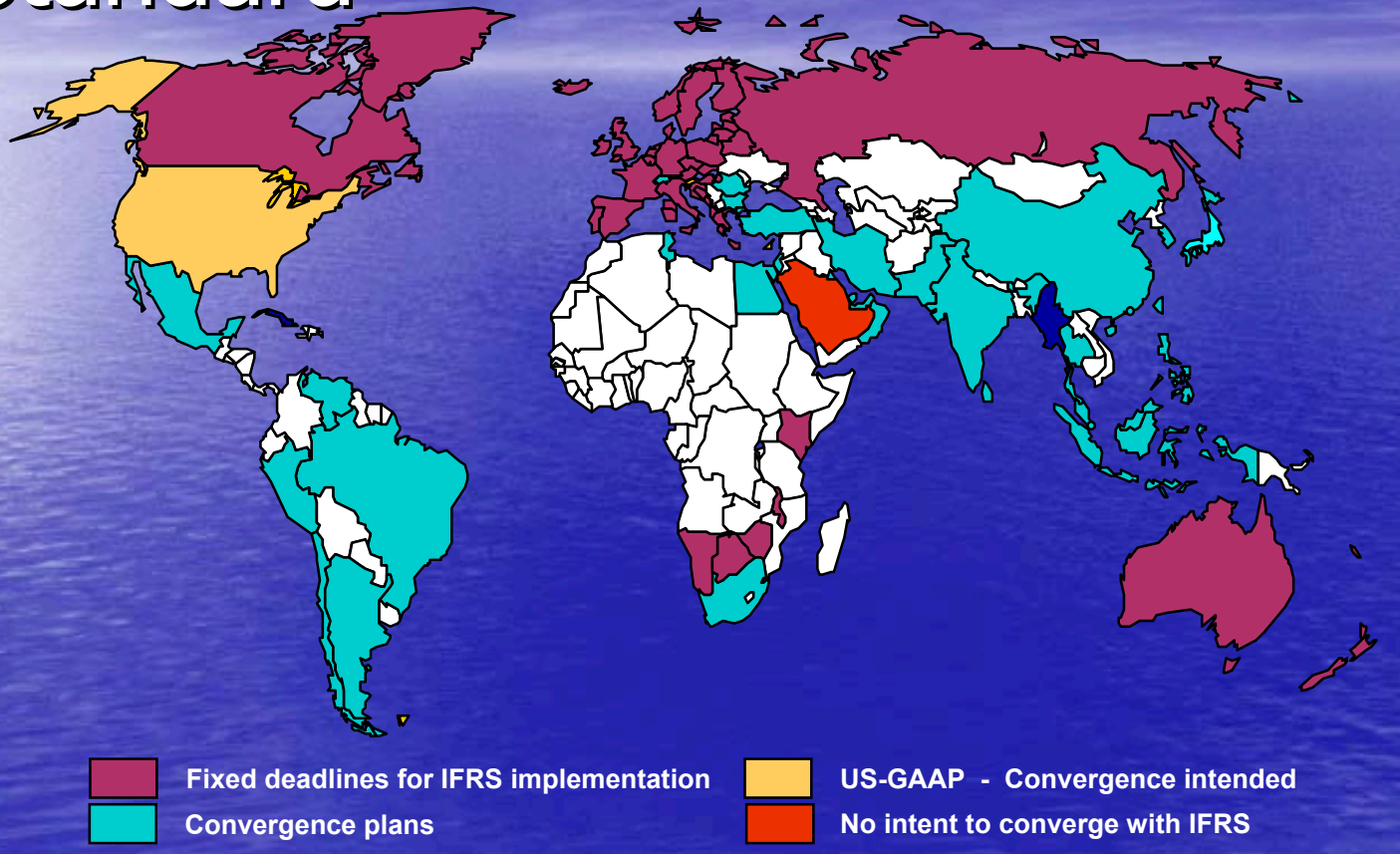
Agenda

- Background and Timetable
- IASB and FASB – Discussion Paper - SFAS 157 Fair Value Measurements
- IASB – Discussion Paper – Preliminary views on Insurance Contracts
  - Phase 1
  - Phase 2
  - IAA Risk Margins Paper
- IAA – Future Activity

Why International Financial Reporting Standards?

- IFRS is becoming the basis of GAAP in most major jurisdictions outside North America
- IFRS are principles-based standards, as opposed to rules-based standards (e.g.. US GAAP)
- Many companies, including insurers, already report upstream on this basis

IFRS – Moving Towards a Global Standard



Source KPMG

International Convergence Project – US SEC

SEC Chairman Christopher Cox –July 25 2007

"Having a set of globally accepted accounting standards is critical to the rapidly accelerating global integration of the world capital markets"

- Concept Release for public comment
- Allowing US Issuers prepare on IFRS for SEC purposes

This follows the June 2007 proposal

- Proposal to eliminate the requirement on foreign private issuers using IFRS to reconcile to US GAAP

What is Fair Value - 157?

- How should it be Measured?
  - US GAAP
  - Current IASB Standards
- When does it apply?
- When is it coming?

What is Fair Value?

- US GAAP

  "The price that would be received for an asset or paid to transfer a liability in a transaction between marketplace participants at the measurement date" (SFAS 157.5)
- IFRS

  "The amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction." (IAS 39.11)

How to measure

- Key Points
  - Exit price basis.
  - In the principal market.
  - From perspective of market participant.
  - Focus economic value.
- Relevant to insurance and investment contracts, even with no relevant and reliable exit market.
- Insurance contracts would be primarily a marked-to-model basis.

Market

- Two types of Market
  - Wholesale – Business to Business (Exit)
  - Retail – Business to Consumer (Entry)
- Use assumptions a market participant would use in pricing, including risk.
- Entity Specific inputs are alright if not inconsistent with what market participants would use.

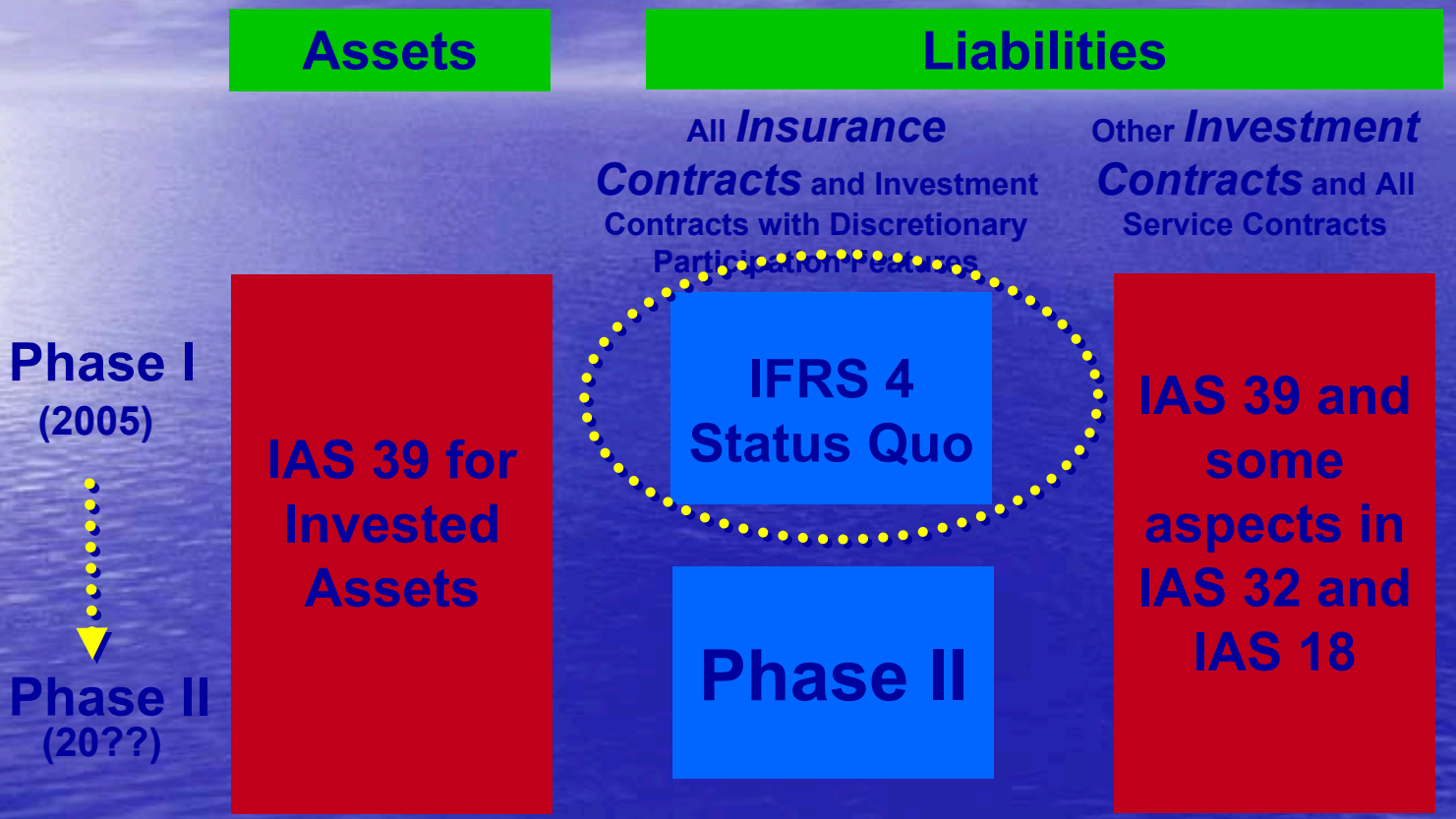
Market Participant

- Independent of the reporting entity
- Knowledgeable
- Able and willing to transact
- For a liability would assume a transfer to participants of comparable non performance risk

Valuation approach

- May be consistent with market, income or cost/replacement approach and multiple methods may be used.
- Appropriate for the circumstances
- Inputs
  - Level 1 – quoted prices
  - Level 2 – other market observable
  - Level 3 – based on best available information
- Lowest Input determines the category and disclosure
- Recognition issues

IFRS Phase I --> Phase II



Source E&Y

IAA Insurance Actuarial Practice Guidelines

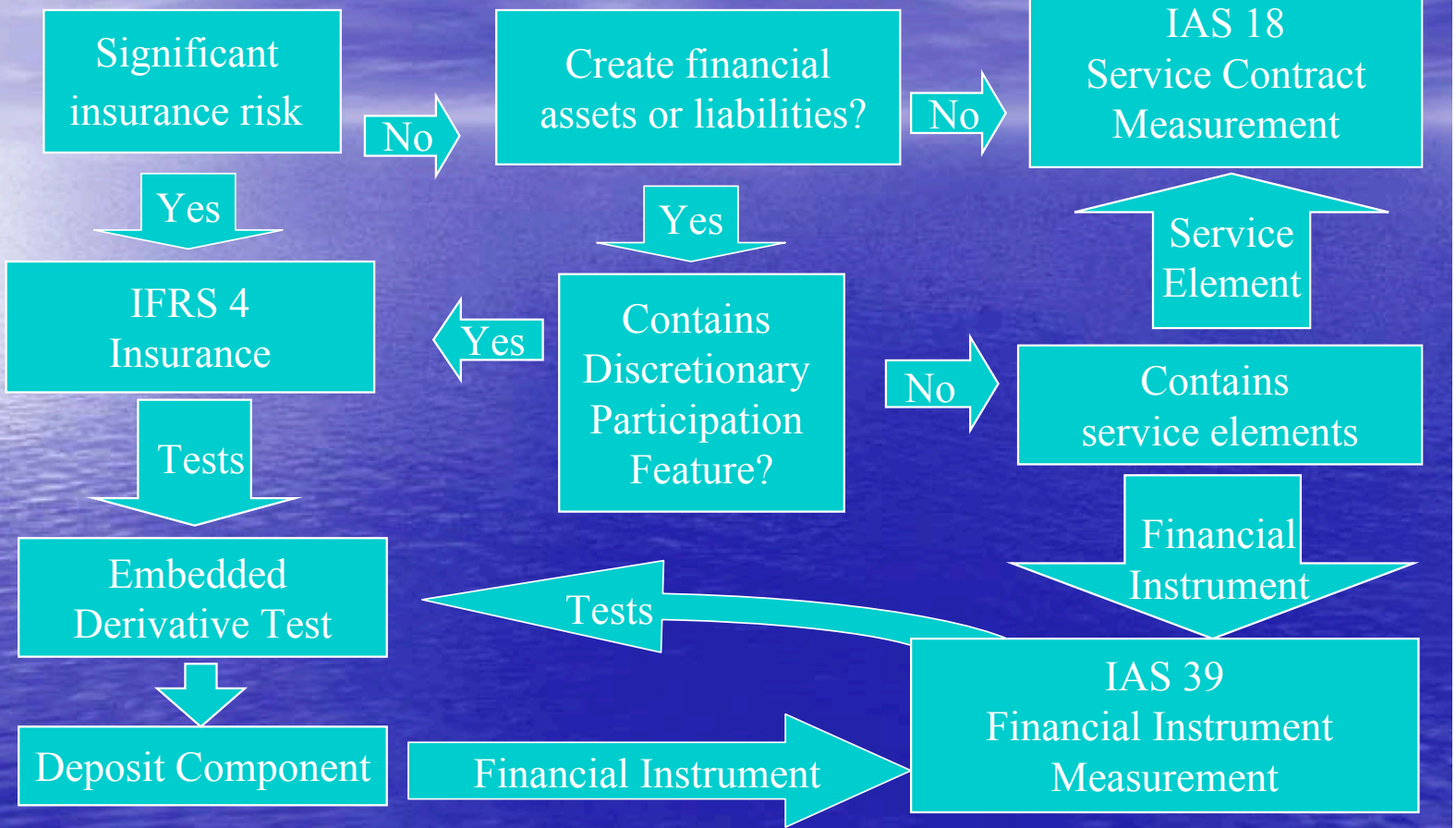
- IASP 2 Actuarial Practice
- IASP 3 Classification of Contracts
- IASP 4 Measurement
- IASP 5 Current Estimates
- IASP 6 Liability Adequacy Testing
- IASP 7 Discretionary Participation Features
- IASP 8 Changes in Accounting Policies

Introduced July 25, 2005

- IASP 9 Accounting for Reinsurance Contracts
- IASP 10 Embedded Derivatives and Derivatives

Introduced June 11, 2007

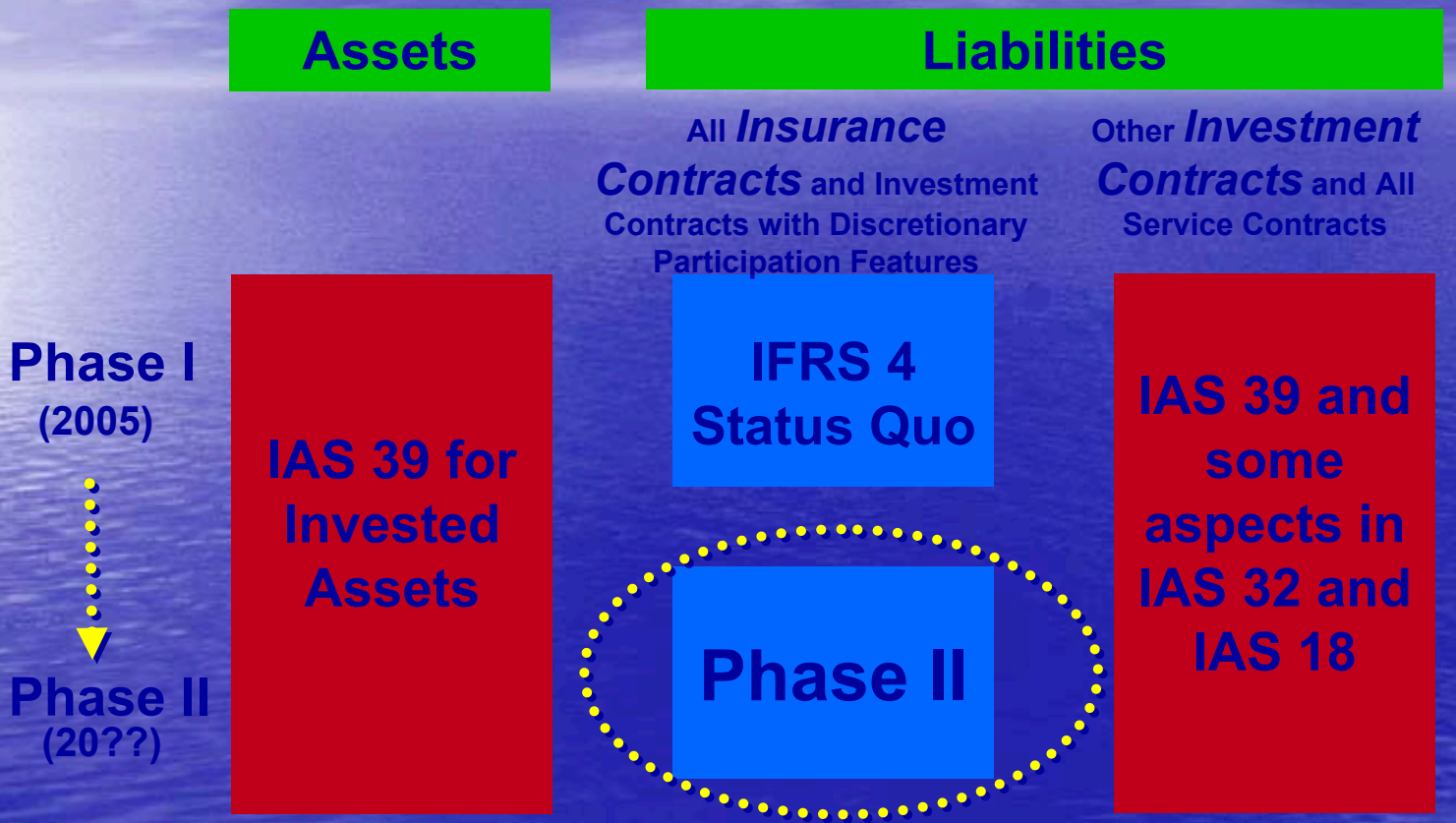
Review IAA Exposure Drafts Classification Paper



Review IAA Exposure Drafts Measurement

- Measurement approaches addressed
  - Amortised Cost model
  - Fair Value model
  - Stage of completion
- Structure
  - Approach
  - Models and assumptions
  - Updating
  - Accounting Constraints

IFRS Phase I --> Phase II



Source E&Y

Phase II Discussion Paper - Objectives

- Insurance to be subject to the same general principles as other financial services firms
- Principles-based approach with additional guidance
- Consistency of treatment between insurance, investment management and banking products

Features of IASB's proposed measurement model

- *Single measurement model*:

Life insurance and non-life insurance

- *Prospective valuation:*

Value of insurance contract = PV (all future cash flows)

- *Current exit value*:

The amount the insurer would expect to pay to another entity if it transferred all its remaining contractual rights and obligations immediately

Preliminary views of the IASB expressed in the discussion paper

Issue	IASB preliminary view
Measurement attribute	Current exit value - single approach for all insurance
Discount rate	Observable market rates for similar cash flows
Unit of account	Risk margins determined on portfolio basis
Initial measurement	Day one profits may be recognised
Subsequent measurement	All changes in estimates recognised immediately
Policyholder behaviour	Recognise future premiums only if certain tests are met
Acquisition costs	Acquisition costs are expensed as incurred
Unbundling	Unbundle deposit and service components unless interdependent
Participating contracts	Par component is a liability if a legal or constructive obligation exists
Own credit risk	Included in the liability measurement

Features of IASB's proposed measurement model

An insurer should use the following inputs to measure its insurance liabilities

- Current **unbiased** probability-weighted estimates of future cash flows (ie an expected value approach)
- Current market **discount** rates that adjust the estimated future cash flows for the time value of money
- An **explicit** unbiased estimate of the margin that market participants require for
  - Bearing risk (a risk margin); and
  - Providing other services (a service margin)

Comparison of Measurement Attributes

Criteria	Current Exit B	Current Exit A	Value in Settlement	Fair Value	Embedded Value
Relevance	Market prices	Pricing	Run Off	Market Prices	Management
Comparability					
Reference Entity	Market Parcicipant	Mixed	Reporting Entity	Market Parcicipant	Reporting Entity
Assumptions	Market Parcicipant	Mixed	Entity Specific	Market Parcicipant	Entity Specific
Reliability					
Adequacy Test	No - implicit	Required	Required	No - implicit	Required
Profit at Issue	Potentially	No	Potentially	Potentially	Potentially
Embedded derivatives	Not expected	Expected	Expected	Not expected	Expected
Earnings Emergence					
Changes in estimates	Market Changes	Partial Market Changes	Entity Specific Changes	Market Changes	Management Changes

Estimates of Future Cash Flows

- These should:
  - Be explicit
  - Be consistent with observed market prices
  - Be current

  - Exclude
    - entity-specific cash flows
    - Non – enforceable premiums
    - Income Tax
    - Transaction costs
    - Investment revenues

Discount Rate

- All insurance assets and liabilities to be discounted including claims liabilities
- Discounting exclusively for consideration of "time value of money"
  - ➡ discount rate should be consistent with observable current market prices for cash flows whose characteristics match those of the insurance liability, in terms of, for example, timing, currency and liquidity

↩ Discounting based on all possible due dates, weighted with the probability of the due date

Risk Margin

- Convey uncertainty associated with cash flows
- Should be market consistent
- IASB has given high level guidance, leaving details to industry
- Acceptable approaches include:
  - Cost of capital
  - Percentile
  - A multiple of standard deviation
  - Confidence level
  - Tail Value at Risk
  - Explicit margin within a specified range
  - Methods based on CAPM or other asset-pricing models
  - Adjusted discount rates (only if it can be shown the risk is proportional to cash flows and duration)

Service Margin

- Service margin = Unbiased estimate of the margin, if any, that market participants would require for rendering other services (in addition to cost included in the current estimate)
- Measurement of insurance liabilities should include an explicit service margin, if other services than insurance converage are provided, e.g. administrative or investment management services

Future Premiums and policyholder behaviour

- Future premiums are included in the projected cash flows to the extent that either:
  - The insurer has an unconditional contractual obligation to accept premiums whose value is less than the value of the resulting additional benefit payments
  - They are required for the policyholder to continue to receive guaranteed insurability at a price that is contractually constrained

Issue:

Should gains from future beneficial policyholders‘ behavior (especially payment of future profitable premiums) be anticipated or not?

Discretionary Participating Features and Universal Life Contracts

- Liability or equity?
  - Policyholder participation rights create a liability only when the insurer has a legal or constructive obligation to pay dividends to policyholders
  - In assessing whether an insurer has a constructive obligation the Board will rely on definitions in its current literature

IAA – Risk Margins paper

- Generally consistent with IASB Discussion Paper
- More restricted Risk Margin approaches
- Focus on Reference Entity
- Excellent feedback

IAA Risk Margin Approaches

- Cost of capital
  - Apparent preferred approach
- Statistical Methods
  - Quantile
  - Conditional tail expectation
- Explicit assumption approaches
  - May produce inconsistency between
    - Assets and liabilities
    - Insurance and other industries

IAA Reference Entity

- To be consistent with an exit value approach, it is reasonable to construct a reference entity to which the portfolio would be transferred
- The use of a reference entity would promote increased comparability between preparers' financial statements

IAA – Future Activity

- Response to the IASB Discussion Draft Exposure Draft
- Measurement of Liabilities for Insurance Contracts: Current estimates and risk margins.
- IASP's
  - Business Combinations
  - Disclosure
- Stochastic Modelling
- Identification of where new IASP's needed for Phase 2
- Responses to other Exposure Drafts

To Learn More

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