IFRS Preliminary Views
Where are we now?
Where are we going?

By Tom Herget, FSA, MAAA

February, 2008
Who is Tom Herget?

- Executive Vice President, PolySystems, Inc.
- Practicing actuary for more than 35 years
- Former Governor, Society of Actuaries
- Current Director, American Academy of Actuaries
- Chief Editor, *US GAAP for Life Insurers*
- Co-Editor, *Insurance Industry Mergers & Acquisitions*
- Involved with SoA and AAA response to “Preliminary Views”
Outline of Speech

1) Insurance IFRS 1990–2007 (5 minutes)
2) Preliminary Views and Exit Value basics (10 minutes)
3) Things I like (5 minutes)
4) Things I don’t like (10 minutes)
5) Impacts on insurers (5 minutes)
6) SoA Numerical Examples (20 minutes)
7) Responses to IASB (20 minutes)
8) Responses to FASB (5 minutes)
9) Next steps (5 minutes)
1. Insurance
IFRS 1990–2007
International Accounting Standards Board
- London-based, 14 members from 9 countries, staff
- Insurance Working Group (IWG)
- Works with FASB (U.S. Financial Accounting Standards Board)
- Publishes
  - IAS (International Accounting Standards)
  - IFRS (International Financial Reporting Standards)
    - These are identical – IAS was published before IFRS
Those providing significant input:
- CFO Forum (European insurers)
- GNAIE (plus 4 companies from Japan)
- IAA (International Actuarial Association)
- IAIS (International Association of Insurance Supervisors)

Others with influence:
- IOSCO (International Securities Commissioners)
- Banks (they sell annuities)
- EU (European governments)
- SEC (Security & Exchange Commission)
IFRS Insurance Project Objectives

- Reduce diversity of accounting practices that currently exist for insurance contracts
- Where possible, bring the accounting more in line with other business sectors
- Increase users’ understanding of insurance financial statements
- Help investors make decisions
Phase I started in 1997
2001 Draft Statement of Principles
Phase I ended with IFRS4 in March 2004
- Defined insurance
- Revised IAS 39, guidance for investment products
- Existing GAAP with additional disclosure and loss recognition was permitted
- Still allowed diverse practices

Applies to insurance contracts, not insurance companies
Phase II started mid-2004

- IASB, IASB staff and IWG worked on a discussion paper called “Preliminary Views”, released in May 2007
- Comments due November 16, 2007
- About 150 replies
- Board and staff to read all submissions
2. Preliminary Views and Exit Value Basics
Main text – 150 pages
Appendices – 80 pages
Search for fundamental principles underlying the accounting basis
Paragraph 93 “Exit Value”:
- The amount the insurer would expect to pay to transfer its remaining contractual rights and obligations to another carrier.
- Similar to Fair Value
What is Exit Value?

- Measure insurance liabilities using three building blocks:
  1. Cash flows
  2. Time value of money
  3. Risk margins
Cash Flows (Paragraph 34)

(a) are explicit
(b) are as consistent as possible with observable market prices
(c) incorporate, in an unbiased way, all available information about the amount, timing and uncertainty of all cash flows arising from the contractual obligations.

(d) are current, in other words they correspond to conditions at the end of the reporting period... use all available information.
(e) Exclude entity-specific cash flows. Cash flows are entity-specific if they would not arise for other entities holding an identical obligation.

(f) In addition, paragraph IN18 says they are “probability-weighted”
Use “current market discount rates that adjust the estimated future cash flows for the time value of money.”
Don’t use existing portfolio of assets

Paragraph 69: “the discount rate should be consistent with observable current market prices for cash flows where characteristics match those of the insurance liability, in terms of timing, currency and liquidity.”
“an explicit and unbiased estimate of the margin that market participants require for bearing risk (a risk margin) and for providing other services, if any (a service margin).”

- Explicit
- Unbiased
Risk margins provide for:

“An explicit and unbiased measurement of the compensation that entities demand for bearing risk.”

Not for conservatism
- Estimating risk margins
- Typically, cannot be observed
- Assess how market participants would measure
Suggested Suitable Methods (Appendix F)
Confidence levels
Conditional Tail Expectation (CTE)
Explicit margin within a specified range
Cost of capital
and others
Estimate Risk Margins using appropriate combination of:

- Observed market prices for similar contracts
- Pricing models

Other inputs if available:
- Prices for similar new contracts
- Reinsurance prices
- Prices for insurance – linked securities
- Prices for business combinations or portfolio transfers
Approach to estimate risk margins
- Should be explicit, not implicit
- Should reflect all risks associated with the liability
- Should not reflect risks that do not arise from the liability, such as investment risk
- Should be as consistent as possible with observable market price
Cost of capital approach

- Determine the amount of capital backing the liabilities
  - Regulatory capital
  - Economic capital

- Determine the cost of holding that capital
  - Cost of capital as required by the market
  - Cost of capital = % CoC × capital required

- Margins = PV of Cost of capital
The insurer needs to estimate the price that market participants require both at inception and subsequently.

“The margin should be as consistent as possible with observable market prices.”
Risk Margins – Implementations B and A

- Implementation B – exit value
  - But please comment on

- Implementation A – entry value
  - No gain at issue
Service Margins

- Per IASB staff, “service margins” would normally be included in cash flows and risk margins.
- It was given its own paragraphs to ensure it wasn’t overlooked.
Non-guaranteed Elements

- Participating policies
- Universal life
- Deferred annuities
A present obligation that arises from an entity’s past actions when:

(a) By an established pattern of past practice, published policies or a sufficiently specific current statement, the entity has indicated to other parties that it will accept particular responsibilities; and

(b) As a result, the entity has created a valid expectation in those parties that they can reasonably rely on it to discharge those responsibilities.
Paragraph 254: “…the cash flows used in measuring a participating insurance liability should incorporate for each scenario an unbiased estimate of the policyholder dividends payable in that scenario to satisfy a legal or constructive obligation that exists at the reporting date.”
Paragraph 267: “…estimates of crediting rates in each scenario should reflect the estimated rate payable in that scenario to satisfy a legal or constructive obligation that exists at the reporting date.”
The Board was very split on whether or not these items should be considered a liability.
Paragraph 154: “…future premiums should be included…if and only if… (a) the policyholder must pay the premiums to retain guaranteed insurability.”

Conflicts with concept of exit value, what an acquirer would pay
3. Things I Like
1 – a single standard of investor accounting for insurers around the world to prepare
2 – No contract classification; same guidance for life, health and most annuities

This means,
3 – Always current estimates
4 – Explicit loss recognition and recoverability studies not needed
5 – No SOP’s, No FAS133, No DAC
6 – Closer economic match of assets and liabilities
7 – we need more actuaries

- Brother
- Sister
- Son
- Daughter
4. Things I Don’t Like
1 – “Exit Value” not what party would pay for existing block
- Future Universal Life premiums
- Single discount rate used for all scenarios
- Entity-specific values may not be useable, for example, expenses
- Risk margins
- Agency force
- Taxes
- Acquisition cost recoveries
- Profits
2 – Very thin market; when to calibrate

- Preliminary Views calls for “consistency with observed prices to the extent they are available.” [paragraph IN20g]
  - Always calibrate?
  - Never calibrate?
2 – How to know what to calibrate to,
Example one:

- Multi-line parent sees attractive prices and decides to divest life operations in 2000.

Attribute: Bob Shapiro
# Things I Don’t Like

## 2 – Sample prices

<table>
<thead>
<tr>
<th>YEAR</th>
<th>BUYER</th>
<th>BOUGHT</th>
<th>P/E</th>
<th>P/B</th>
</tr>
</thead>
<tbody>
<tr>
<td>1998</td>
<td>Fortis</td>
<td>John Alden</td>
<td>27</td>
<td>1.6</td>
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<tr>
<td>1998</td>
<td>Swiss Re</td>
<td>Life Re</td>
<td>38</td>
<td>2.6</td>
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<tr>
<td>1998</td>
<td>AIG</td>
<td>Sun America</td>
<td>36</td>
<td>5.4</td>
</tr>
<tr>
<td>1999</td>
<td>Allstate</td>
<td>Am. Heritage</td>
<td>24</td>
<td>3.3</td>
</tr>
<tr>
<td>1999</td>
<td>Aegon</td>
<td>Transamerica</td>
<td>14</td>
<td>1.7</td>
</tr>
<tr>
<td>2000</td>
<td>ING</td>
<td>Reliastar</td>
<td>19</td>
<td>2.4</td>
</tr>
</tbody>
</table>
## Things I Don’t Like

2 – But prices fall

<table>
<thead>
<tr>
<th>YEAR</th>
<th>BUYER</th>
<th>BOUGHT</th>
<th>P/E</th>
<th>P/B</th>
</tr>
</thead>
<tbody>
<tr>
<td>2001</td>
<td>Old Mutual</td>
<td>FVG</td>
<td>11</td>
<td>1.1</td>
</tr>
<tr>
<td>2001</td>
<td>Nationwide</td>
<td>Prov. Mutual</td>
<td>15</td>
<td>1.5</td>
</tr>
<tr>
<td>2001</td>
<td>Sun Life</td>
<td>Clarica</td>
<td>20</td>
<td>2.4</td>
</tr>
<tr>
<td>2002</td>
<td>Manulife</td>
<td>Canada</td>
<td>17</td>
<td>1.7</td>
</tr>
<tr>
<td>2003</td>
<td>Prudential</td>
<td>Cigna</td>
<td>11</td>
<td>1.9</td>
</tr>
<tr>
<td>2003</td>
<td>Manulife</td>
<td>John Hancock</td>
<td>12</td>
<td>1.3</td>
</tr>
</tbody>
</table>
2 – Over 40 potential buyers view company

- Many bids are submitted, but none high enough for management
- So, management decided not to sell the block
  - If you were the valuation actuary, how would you be calibrating?
3 – Calibration Example 2

- Scottish Re acquires ING individual reinsurance operations at 12/31/2004
- Assets = reserves = $800 million
- ING pays to Scottish Re ceding commission of $560 million
- Other bidders needed $1 billion
- Now you have an observable price; calibrate?
3 – Calibration Example 2

- Two years later
- Significant reserve strengthening
- Scottish Re stock plummets 75% in single day
- Comments on other bids
- Another observable value
- Calibrate?
Things I Don’t Like

3 – Calibration

- Value of transactions
  - Overpaid
  - About right
  - Underpaid
4 – Earnings at issue
Things I Don’t Like

- 5 – Daunting to calculate and check
6 – More susceptible to unwarranted pressures
7 – Income statement may be unsuitable for a measure of performance
Things I Don’t Like

- 8 – Difficult to predict
5. Impacts on Insurers

- Solvency
- US GAAP
- Embedded value
- Perspective of the presentation
International Association of Insurance Supervisors (IAIS)

- This body of regulators would like to adopt IFRS as statutory
- So all countries around the world would be regulated using same set of books and similar rules for total capital
US, SEC, FASB, Wall Street realize they need to be competitive

SEC has said they will accept IFRS statements without reconciliation to US GAAP

FASB – will consider replacing US GAAP with IFRS
- Needed to analyze results
- Likely will provide more insights than IFRS
- May be more suitable for incentive compensation
- Statutory – what the regulators think
- US GAAP – primarily what you think
- IFRS – what you think someone else thinks
6. Society of Actuaries

Numerical Examples
Society of Actuaries Study
- Completed February, 2008
- Commissioned by American Academy of Actuaries
- 15 companies
- 20 Submissions
- 80 pages
- Available on SoA website
  - www.soa.org/research/research-life.aspx
Products Covered

- Traditional life (Term)
- Universal life (UL)
- Variable universal life (VUL)
- Single premium fixed deferred annuity (SPDA)
- Variable deferred annuity
- Single Premium Immediate Annuity (SPIA)
- Long-term care
- Supplemental health (medical)
Deliverables

- Existing business and new business
- US GAAP – balance sheet and income statement
- IFRS – balance sheet and income statement
- Alternate scenarios
- Observations
Let’s look at six products
- New business income statements
- IFRS basis is “Implementation B”
- Liability basis is sum of
  - PV of cash flows and
  - PV of margins,
  - Both discounted at risk-free rate
- Margins use Cost of Capital method
The liability for risk margins

\[ = \text{Present Value of Cost of Capital rate} \times \text{capital in year } t \]

where

\[ \text{Present Value uses discount rate from the scenario,} \]
\[ \text{Cost of Capital rate is 12\%, and} \]
\[ \text{Capital in year } t \text{ comes from capital factors on next slide} \]
<table>
<thead>
<tr>
<th>Sample Capital Factors</th>
<th>AV/Claim</th>
<th>Face</th>
<th>Premium</th>
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</thead>
<tbody>
<tr>
<td>Fixed Annuity</td>
<td>1.15%</td>
<td></td>
<td>3.08%</td>
</tr>
<tr>
<td>Immediate Annuity</td>
<td>1.15%</td>
<td></td>
<td>3.08%</td>
</tr>
<tr>
<td>Participating WL</td>
<td>1.15%</td>
<td>0.9%</td>
<td>3.08%</td>
</tr>
<tr>
<td>Supplemental Health</td>
<td>5.00%</td>
<td></td>
<td>4.27%</td>
</tr>
<tr>
<td>Term Life</td>
<td></td>
<td>0.9%</td>
<td>3.08%</td>
</tr>
</tbody>
</table>
Risk Margins – Calibration

- Base line – used 100% United States Risk Based Capital, an estimate of economic capital
- For perspective:
  - 300–750% – most companies
  - 300% – an A company
  - 100% – company action
First year premium = $28,000,000
GAAP – first year non-deferrable costs of $5.5 million cause a loss

IFRS – day one gains are $19 million; days 2–365 gains are $4 million
Term – IFRS “B” and “A” – Income
Term – Risk Margin Sensitivity – Income

![Graph showing risk margin sensitivity over time for different scenarios: 100% RBC 12%, 300% RBC 12%, and 100% RBC 18%.

The graph illustrates the change in income over a period of 20 years for each scenario, with the y-axis representing income in millions and the x-axis representing years from 1 to 20.

Key observations:
- The 100% RBC 12% scenario shows a steady increase in income throughout the years.
- The 300% RBC 12% scenario starts with a significant drop and then stabilizes.
- The 100% RBC 18% scenario exhibits a moderate decline in the first few years before leveling off.

Overall, the graph demonstrates the impact of different risk margin sensitivities on income over time.
Premium = $117 million
Health GAAP and IFRS – Income

First year premium = $3.2 million
First year premium = $133,000
Variable UL GAAP and IFRS – Income

First year premium = $3.2 million
Premium = $3.2 million
## Relative Size (1 of 2) of Cash Flows and Risk Margins ($000)

<table>
<thead>
<tr>
<th></th>
<th>PV Cash Flows</th>
<th>PV Margins</th>
<th>Year 1</th>
<th>Year 5</th>
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</thead>
<tbody>
<tr>
<td>PAR WL</td>
<td></td>
<td></td>
<td>&lt;$497&gt;</td>
<td>$2,916</td>
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<td></td>
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<td></td>
<td>&lt;$262&gt;</td>
<td>3,131</td>
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<tr>
<td>UL</td>
<td></td>
<td></td>
<td>68</td>
<td>1,326</td>
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<td>121</td>
<td>1,369</td>
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<tr>
<td>SPIA</td>
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<td>919</td>
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<td>&lt;$1,305&gt;</td>
<td>&lt;$531&gt;</td>
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</table>

PV = Present Value
## Relative Size (2 of 2) of Cash Flows and Risk Margins ($000)

<table>
<thead>
<tr>
<th></th>
<th>PV Cash Flows</th>
<th>PV Margins</th>
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<th>5</th>
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<tr>
<td>VUL</td>
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<td>893</td>
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<td>HEALTH</td>
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<td>&lt;4,208&gt;</td>
<td>142</td>
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<td>366</td>
<td>346</td>
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<td>LTC</td>
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<td>&lt;21&gt;</td>
<td></td>
</tr>
</tbody>
</table>

PV = Present Value
Balance Sheet, Term

GAAP

IFRS
Income varies dramatically by product.

Products that derive a significant portion of their profits from investment income will show lower profits, or losses, in year one.
Products with significant sources of profits other than investment income portray a larger year one income.

Initial and subsequent profitability is extremely impacted by choice of methods and assumptions to determine risk margins.
7. Responses to the IASB
Go to www.IASB.org
- Click on (left-hand column):
  - IASB projects and work plan, then
  - Insurance contracts, then
  - Discussion paper, then
  - Comment letters
- 151 responses, 2,000 pages
Profiles of Responders

- 47 insurers (2)
- 28 professional societies (4)
- 23 regulators (2)
- 6 auditors (4)
- 32 industry associations (3)
- 15 others (2)
Generally supportive

Leave general (property & casualty) insurance alone (have 2 models)

Questions relevance of exit value
- Hypothetical
- Not observable
- Pricing details unavailable
- No profit charge
- Market data inferior to entity-specific

Unwarranted profit at inception
Very supportive; is similar to Canadian GAAP

Some refining is needed – use discount rates an insurer would expect to earn

Needs more specific guidance, especially in margins
- Constraints on cash flows should be removed
- Use own (not market) servicing (expense) costs
- Eliminate service margins
- Don’t unbundle
- Reflect diversification effects in margins
- Don’t overlook the income statement
Comments only where they differ from IAA

Some views too complex and demanding for all preparers

Measurement – value should reflect own costs to settle, not to transfer to a buyer

Cash flow assumptions – should be from the viewpoint of the insurer, not the market

Risk margins – should be based on insurer’s cost for risk where there is no market
American Academy of Actuaries (AAA) (USA – 15,000 Members)

- Has concerns
  - Gains at issue
  - Too much actuarial guidance (should do by nation)
  - Impractical issues (each possible scenario)
  - Limitations on cash flows
Should reflect policyholder dividends in the liabilities
Discount rate – need rates for very long term
Difficult to calibrate insurance products to market
Expenses – use entity-specific
Need consistent measurement and reporting of changes in assets and liabilities
Agrees with using a transfer to another party as the source for calibration
Should define Fair Value first
Should provide some practical examples
Its members supervise 140 countries, 97% of world’s insurance

Would like to use IFRS accounting for solvency (statutory) purposes
- Endorses principles-based
- Supports some form of exit value
- Suggests a “reference entity” (large, efficient, well-diversified) with equal or higher rating
- Reflect all expected cash flows
- Its member organizations regulate 90% of the world’s securities markets
- Generally supportive, but
  - Difficult to determine market participant assumptions
  - Solvency – increasing a discount rate (own credit standing) lowers a liability
  - Include all cash flows relevant to the contract
Why not these principles for all industries?

Not supportive of Exit Value
- Hypothetical
- Doesn’t reflect actual cash flows

Can’t assess quality of earnings
- Source of earnings
- Identify impacts of judgment

Focus on entity’s own value and entity’s principal market – the customer
- Affirm consistency with other IASB initiatives
- Consult more widely with affected parties and field test
- Reliability of data is dependent on an assessment of a transaction in a hypothetical market
- Hypothetical basis – does not meet the needs of users for transparency
- Is exit value relevant?
- Changes to building blocks
  - Cash flows
    - Include all cash flows
    - Consider market value only when directly observable
  - Discount rates – drop liquidity adjustment
  - Margins – needs more work
    - How to select? Not observable
    - Portfolio vs. entity
    - Why service margin?
Generally supportive

- Less emphasis on market participants’ views and more on internal information
- Risk margins – little or no consensus, so use entity-specific
- “Exit Value” as defined wouldn’t produce a transaction price – so don’t call it exit value
- Market data must be available and relevant; use entity-specific
- Margins need further elaboration and should address explicit profits
- Use all relevant cash flows
- Gains/losses at issue is acceptable
Too theoretical

Reduces comparability within the industry

All you need to do is align liability discounting with rates used for assets to help identify asset/liability mismatch
- Wants more disclosures
- Use all cash flows
- Gains at issue are acceptable
- Doesn’t support Exit Value
- "Market consistent" is a problem because there are no regularly observable transfer markets
- Wants extensive field testing
- Recognize profit over coverage period
- Develop separate models for life and P&C
- No restrictions on building block cash flows
- Discount rate – reflect actual return
CFO Forum (1 of 2)

- Represents Europe’s 20 largest insurers, 94% of the market
- Discussion Paper is good starting point
- As is, it is not relevant to users, preparers or regulators
- Keep working; maintain dialogue and due process
- Field test before a final exposure draft is issued
- Tie in with regulatory developments, such as solvency II
Issues with three building blocks

- Level of day one profit
- Use discretionary benefit payments
- Consider all expected cash flows
- Use run-off, not transfer or exit values
- Hold back initial profits at issue and recognize in line with release from risk over the lifetime of the contract
Areas of consensus:

- Recognize all future premium
- Recognize all future expected payments to par-policy holders
- Don’t use market assumptions for expenses
- Unit of account – redefine portfolio solely on the “managed together” criteria

- Do not unbundle
- Do not reflect “own credit standing” in valuing liabilities
- Going forward, engage in robust and transparent process for engaging with preparers and users prior to issue of both the exposure draft and final standard
8. Responses to FASB Invitation to Comment
Profiles of Responders

- 13 insurers
- 6 professional societies
- 2 regulators
- 4 auditors
- 8 industry associations
- 11 others
Respondents

- 44 in total; 500 pages
- 29 clearly answered questions 1 and 2
FASB Question 1

- Is there a need for a comprehensive project to redo U.S. GAAP for insurance?
  - Yes – 25
  - No – 4
FASB Question 2

- Is the Discussion Paper a suitable starting point?
  - All 25 who said yes to question 1:
    - Yes – 10; No – 15
  - Americans only
    - Yes – 4; No – 13
9. Next Steps
From summer 2007:
- Exposure draft, November 2008
- Final standard, November 2009
- Effective Date, around 2011
- Now moved back
- Coordination with other projects could slow down the timeline
  - Conceptual framework
  - Other IFRS standards on revenue recognition and fair value measurement
  - Coordination with FASB
Will likely participate directly with IASB
Maybe spring 2008 decision on how to go forward
SEC Next Steps (1 of 3)

- Recent steps
  - Allowed foreigners to file IFRS financials without reconciliation
  - Asked if U.S. registrants should be able to do the same
  - Issued statement saying it’s aware there are no IFRS standards for insurance
Concerns to be addressed

- Ceding control of U.S. standard
  - U.S. is ⅓ of world’s GDP
  - ⅓ of market capitalization
- Will IASB be able to keep up with the world’s emerging issues?
- What if national interpretations or recommendations develop?
SEC Next Steps (3 of 3)

- What if judgment is boundless? (no comparability)
- What if enforcement is too diverse?
- IASB must be properly funded
- Concern over IFRS “as adopted” by different countries
Questions & Answers

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