IFRS Preliminary Views

Where are we now?
Where are we going?

By Tom Herget, FSA, MAAA

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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

IASB

- 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

IASB Insurance Project

- 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

IFRS Insurance Project – Phase I

- 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*

IFRS Insurance Project – Phase II Recent Timeline

- 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

“Preliminary Views” Document

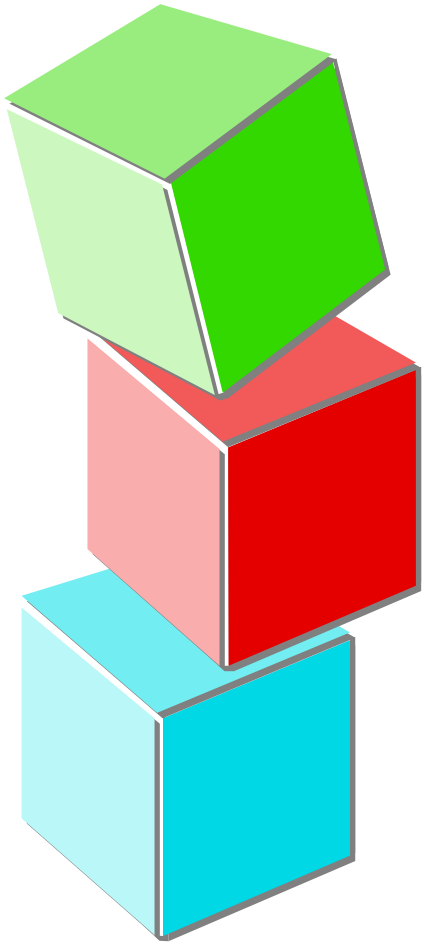
- Main text – 150 pages
- Appendices – 80 pages
- Search for fundamental principles underlying the accounting basis

Identify the Measurement Attribute

- 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

Cash Flows (Paragraph 34)

(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

Cash Flows (Paragraph 34)

(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”

Time Value of Money (Paragraph 63)

- Use “current market discount rates that adjust the estimated future cash flows for the time value of money.”

Time Value of Money (Paragraph 63)

- 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.”

Risk Margins (Paragraph 71)

"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 Purpose

- Risk margins provide for:
  - "An explicit and unbiased measurement of the compensation that entities demand for bearing risk."
- Not for conservatism

Risk Margins

- Estimating risk margins
- Typically, cannot be observed
- Assess how market participants would measure

Risk Margins

- Suggested Suitable Methods (Appendix F)
- Confidence levels
- Conditional Tail Expectation (CTE)
- Explicit margin within a specified range
- Cost of capital
- and others

Risk Margins

- 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

Risk Margins

- 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

Risk Margins

- 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

Risk Margins Calibration

- 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

Constructive Obligation

- 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.

from Appendix/Glossary

Policyholder Participation

- 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.”

Universal Life

- 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.”

Concerns

- The Board was very split on whether or not these items should be considered a liability.

Universal Life

- 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

Things I Like

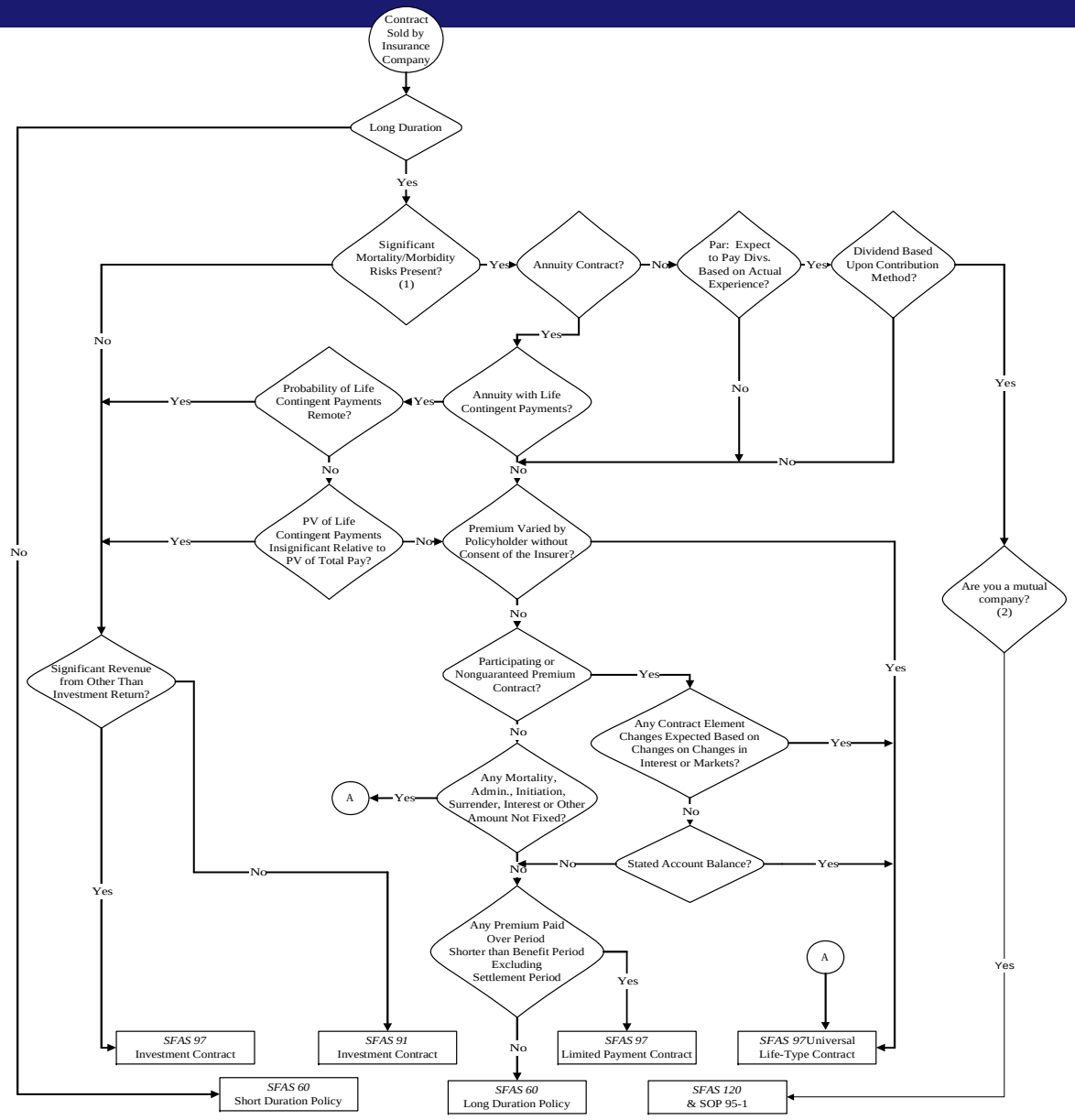
- 1 – a single standard of investor accounting for insurers around the world to prepare

Things I Like

- 2 – No contract classification; same guidance for life, health and most annuities
- This means,

Things I Like

No More Flow Chart



Things I Like

- 3 – Always current estimates

Things I Like

- 4 – Explicit loss recognition and recoverability studies not needed

Things I Like

- 5 – No SOP's, No FAS133, No DAC

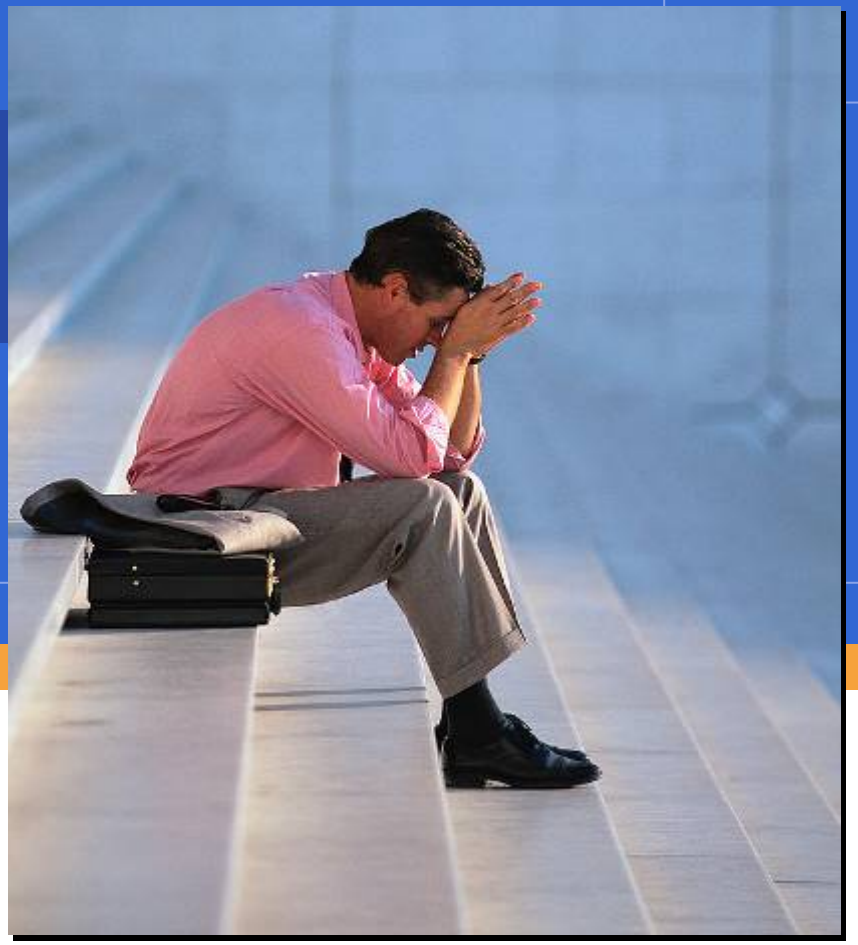
Things I Like

- 6 – Closer economic match of assets and liabilities

Things I Like

- 7 – we need more actuaries
  - Brother
  - Sister
  - Son
  - Daughter

4. Things I Don't Like



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

Things I Don't Like

- 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?

Things I Don't Like

- 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

YEAR	BUYER	BOUGHT	P/E	P/B
1998	Fortis	John Alden	27	1.6
1998	Swiss Re	Life Re	38	2.6
1998	AIG	Sun America	36	5.4
1999	Allstate	Am. Heritage	24	3.3
1999	Aegon	Transamerica	14	1.7
2000	ING	Reliastar	19	2.4

Things I Don't Like

- 2 – But prices fall

YEAR	BUYER	BOUGHT	P/E	P/B
2001	Old Mutual	FVG	11	1.1
2001	Nationwide	Prov. Mutual	15	1.5
2001	Sun Life	Clarica	20	2.4
2002	Manulife	Canada	17	1.7
2003	Prudential	Cigna	11	1.9
2003	Manulife	John Hancock	12	1.3

Things I Don't Like

- 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?

Things I Don't Like

- 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?

Things I Don't Like

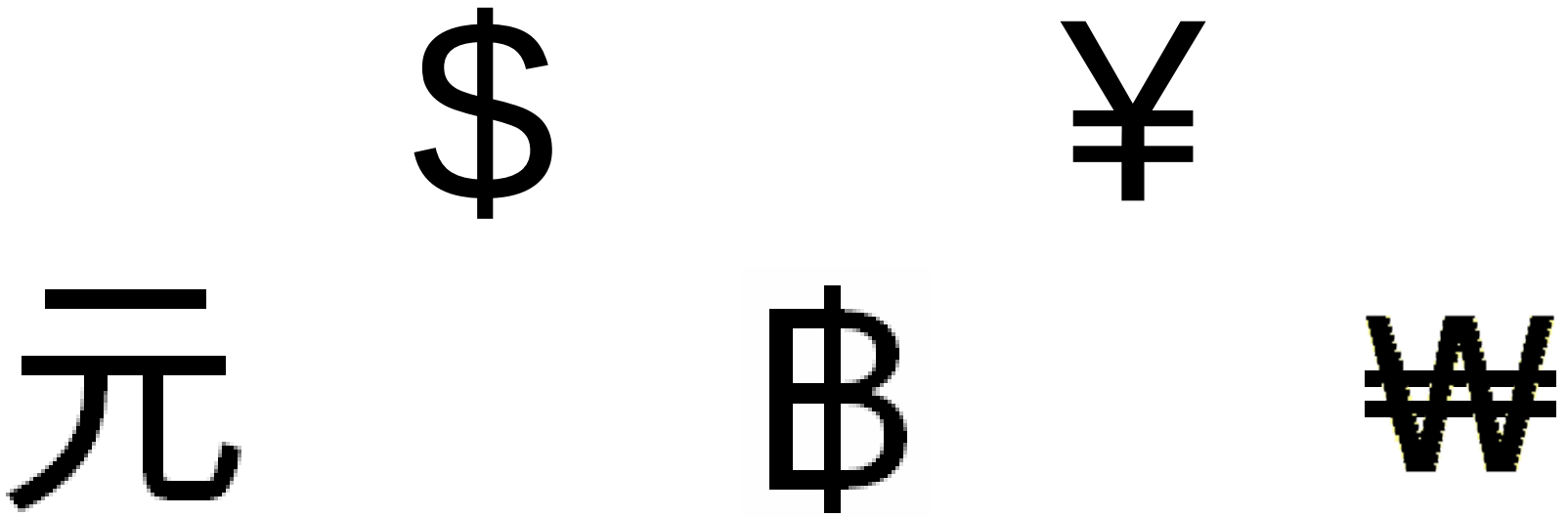
- 3 – Calibration Example 2
  - Two years later
  - Significant reserve strengthening
  - Scottish Re stock plummets 75% in single day
  - Comments on other bids
  - Another observable value
  - Calibrate?

Things I Don't Like

- 3 – Calibration
  - Value of transactions
    - Overpaid
    - About right
    - Underpaid

Things I Don’t Like

- 4 – Earnings at issue



Things I Don't Like

- 5 – Daunting to calculate and check

Things I Don't Like

- 6 – More susceptible to unwarranted pressures

Things I Don't Like

- 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**

Solvency

- 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 GAAP

- 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

Embedded Value

- Needed to analyze results
- Likely will provide more insights than IFRS
- May be more suitable for incentive compensation

Perspective

- Statutory – what the regulators think
- US GAAP – primarily what you think
- IFRS – what you think someone else thinks

6. Society of Actuaries

Numerical Examples

SOA 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

Take a Look

- 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

Risk Margins – Liability

- The liability for risk margins
  = Present Value of
  Cost of Capital rate
  × capital in year *t*

where

Present Value uses discount rate from the scenario,

Cost of Capital rate is 12%, and

Capital in year *t* comes from capital factors on next slide

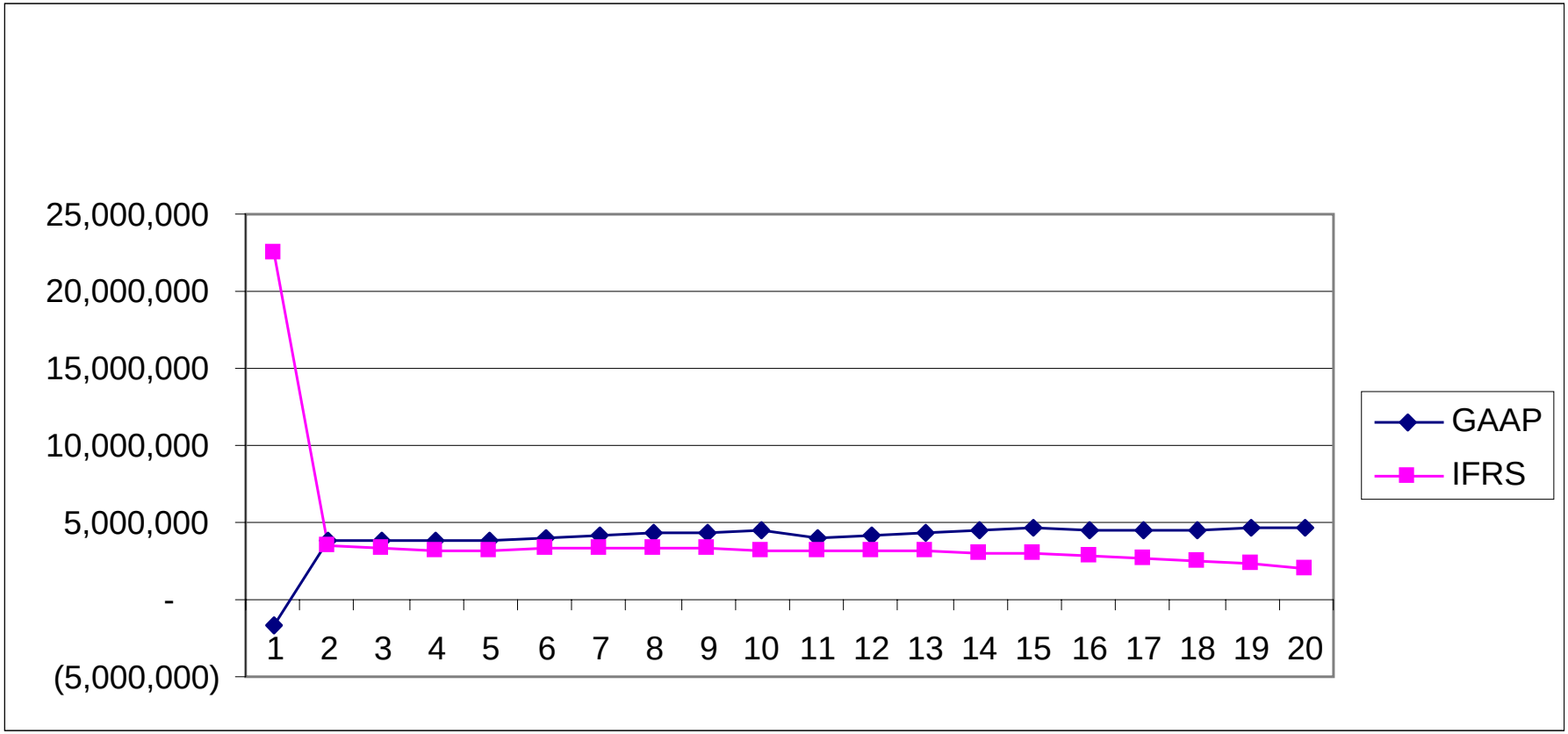
Risk Margins – Capital Factors

Sample Capital Factors	AV/Claim	Face	Premium
Fixed Annuity	1.15%		3.08%
Immediate Annuity	1.15%		3.08%
Participating WL	1.15%	0.9%	3.08%
Supplemental Health	5.00%		4.27%
Term Life		0.9%	3.08%

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

Term – GAAP and IFRS – Income

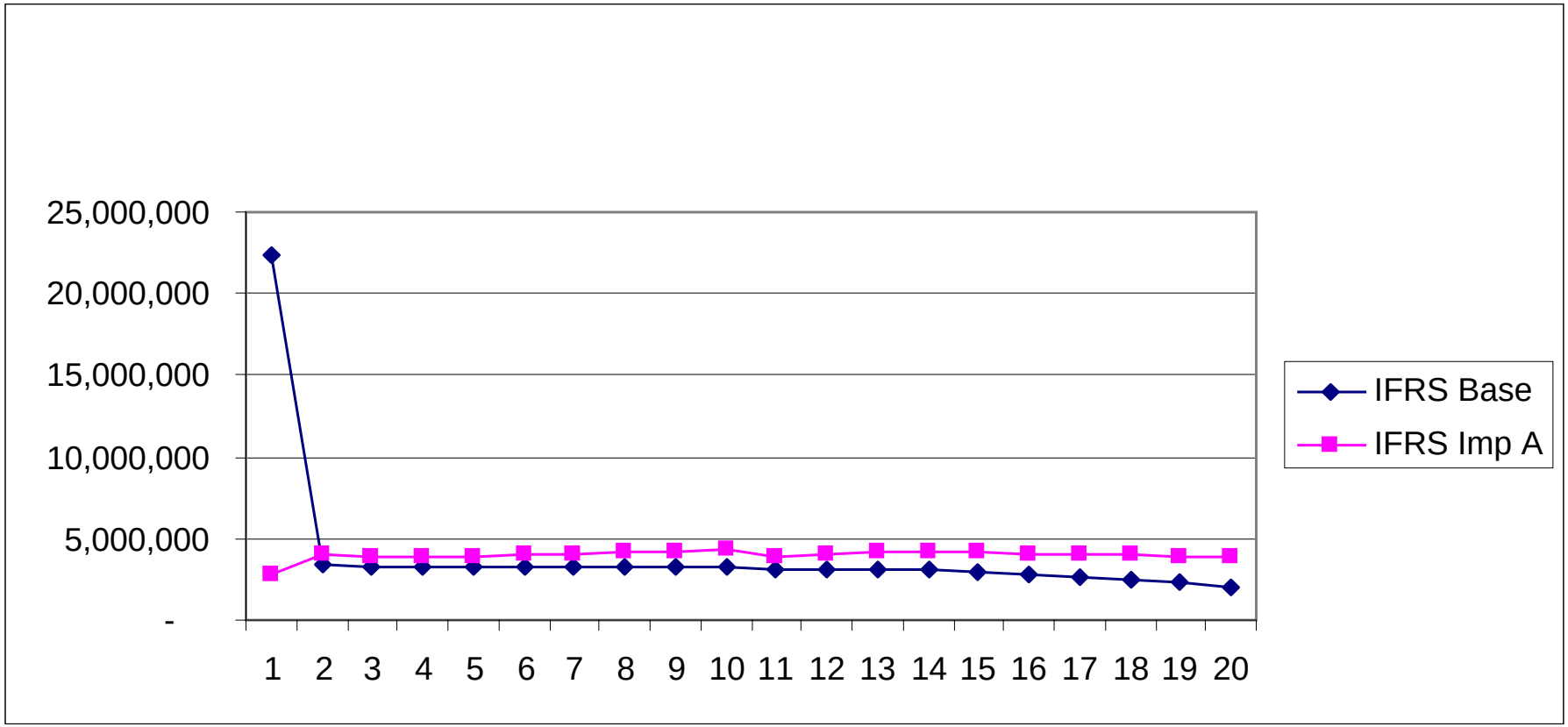


First year premium = $28,000,000

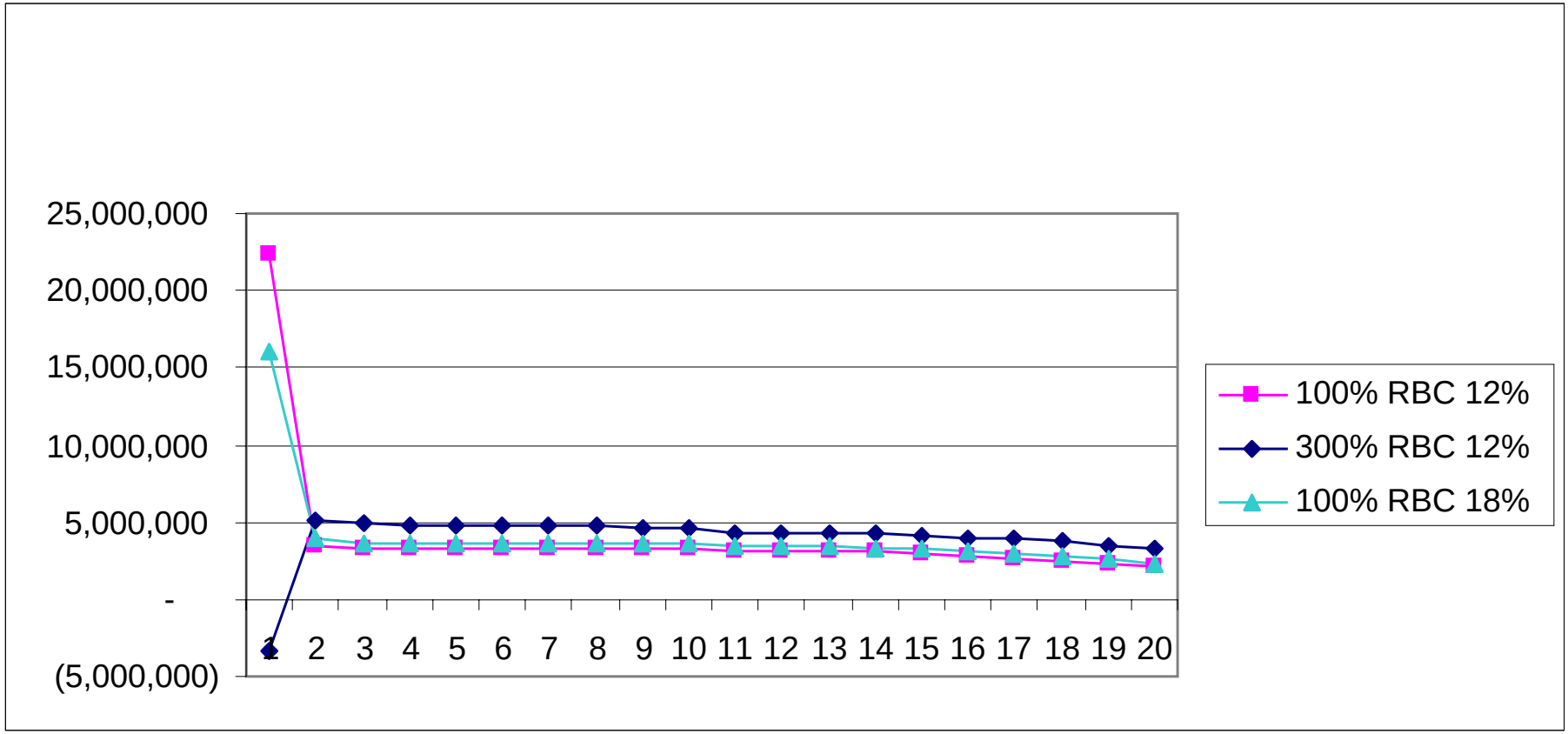
Term – Comment on First Year Earnings

- 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

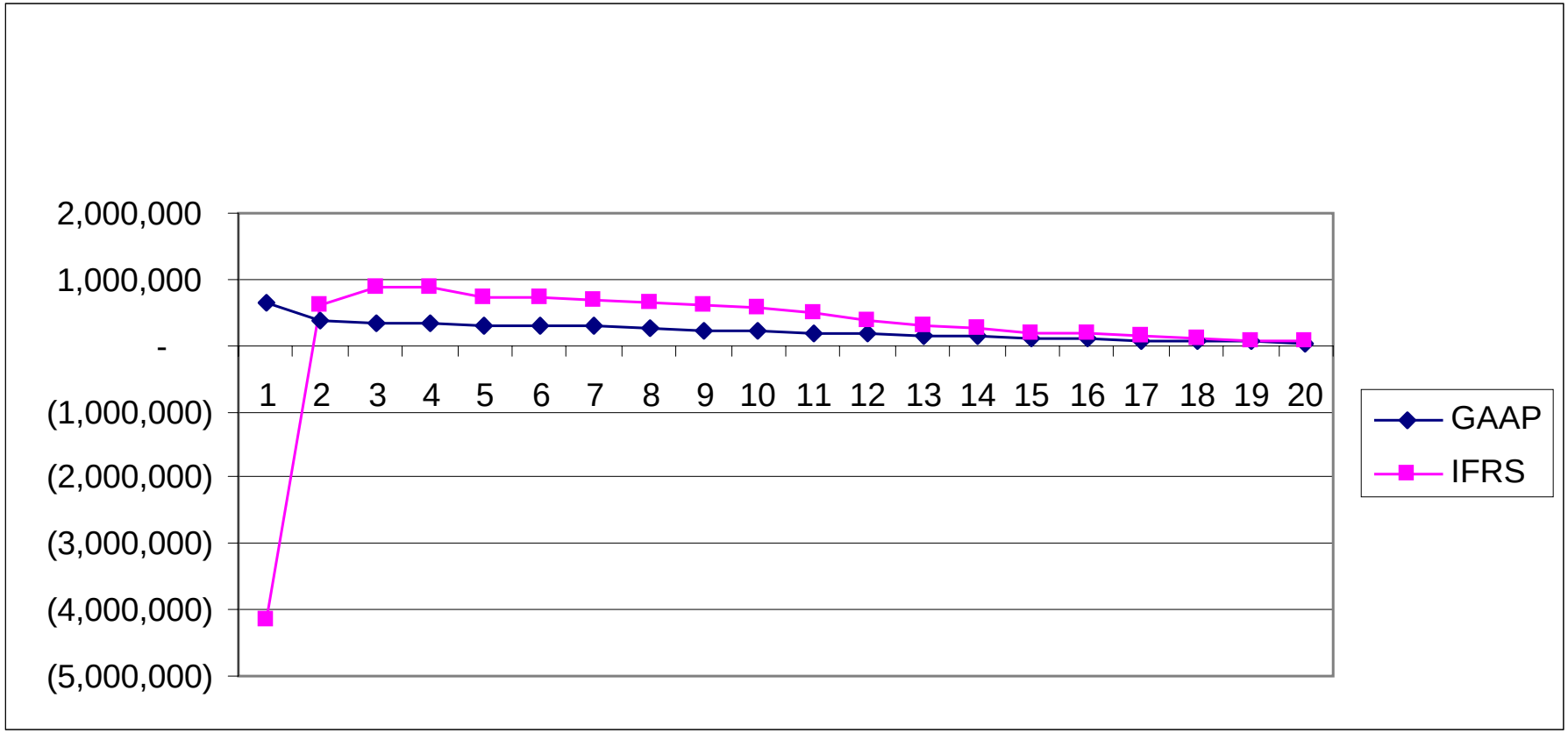
Term – IFRS “B” and “A” – Income



Term – Risk Margin Sensitivity – Income

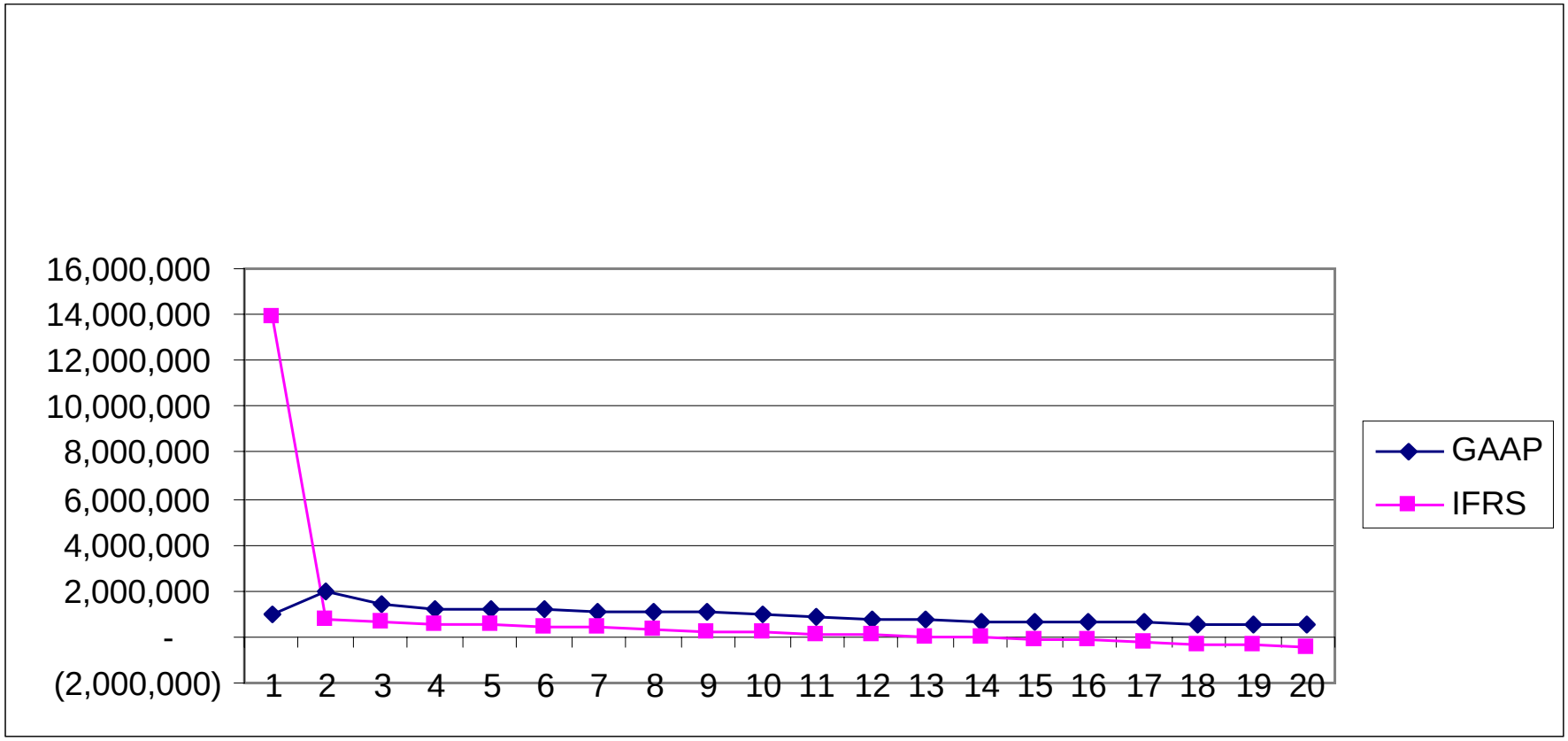


SPIA – GAAP and IFRS – Income



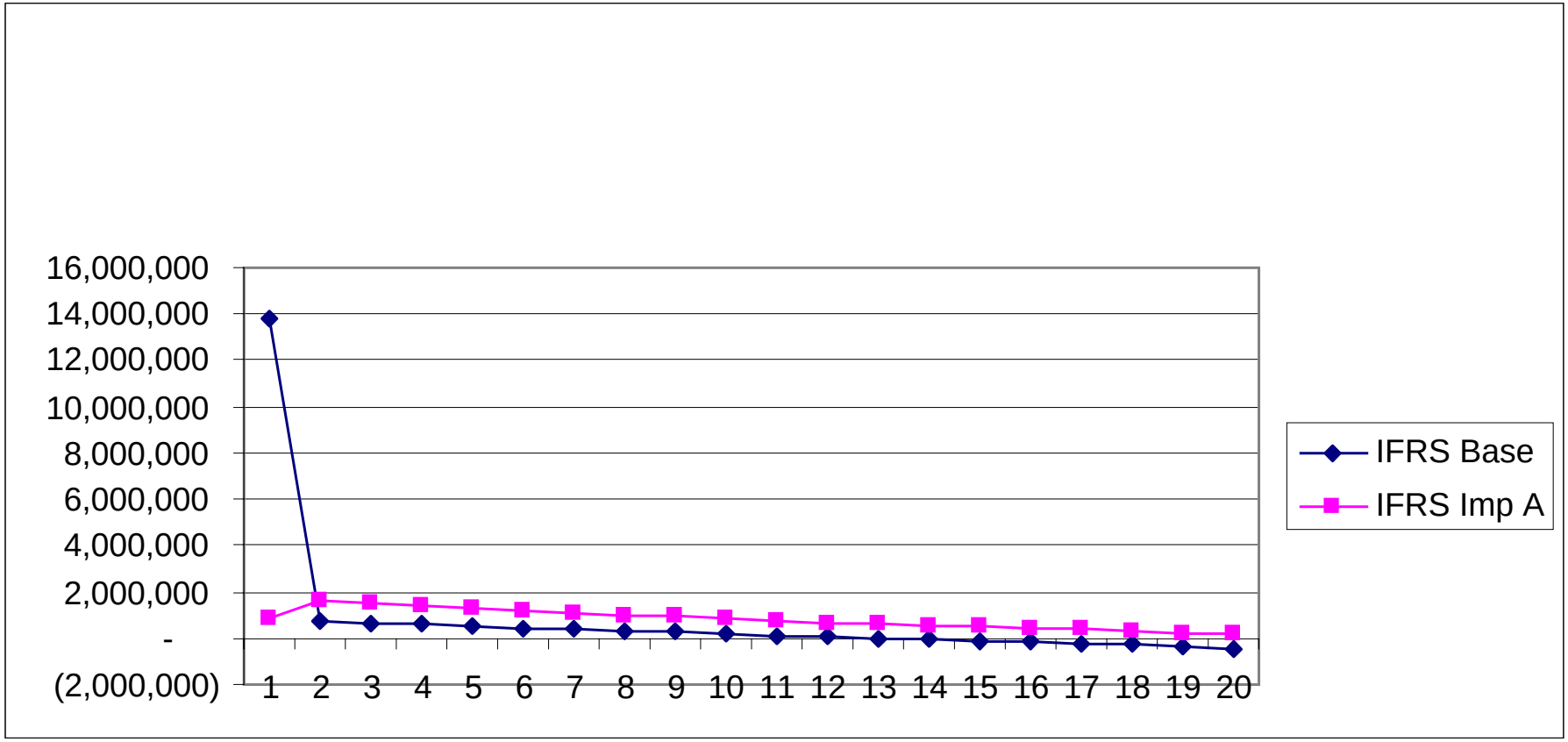
Premium = $117 million

Health GAAP and IFRS – Income

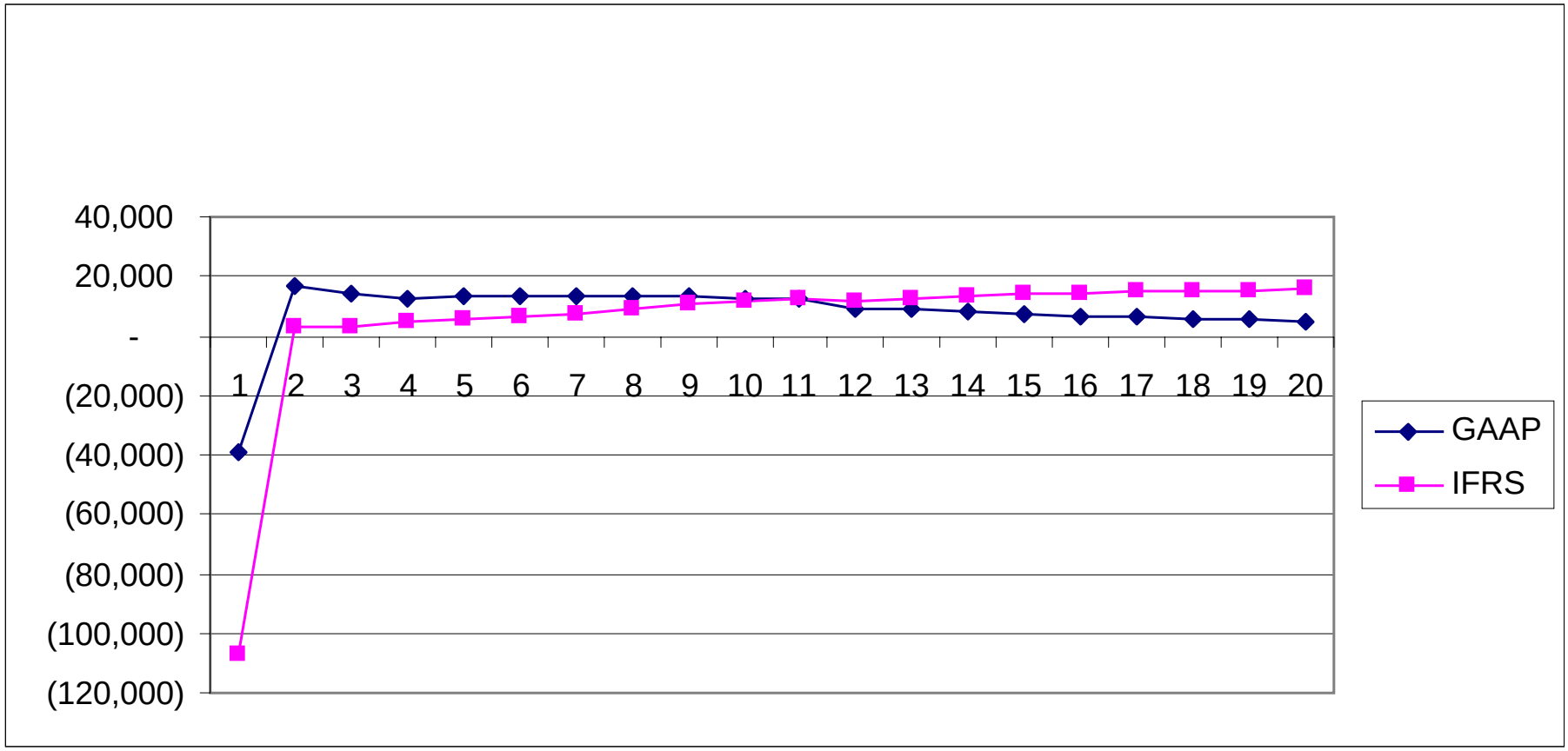


First year premium = $3.2 million

Health IFRS “B” and “A” – Income

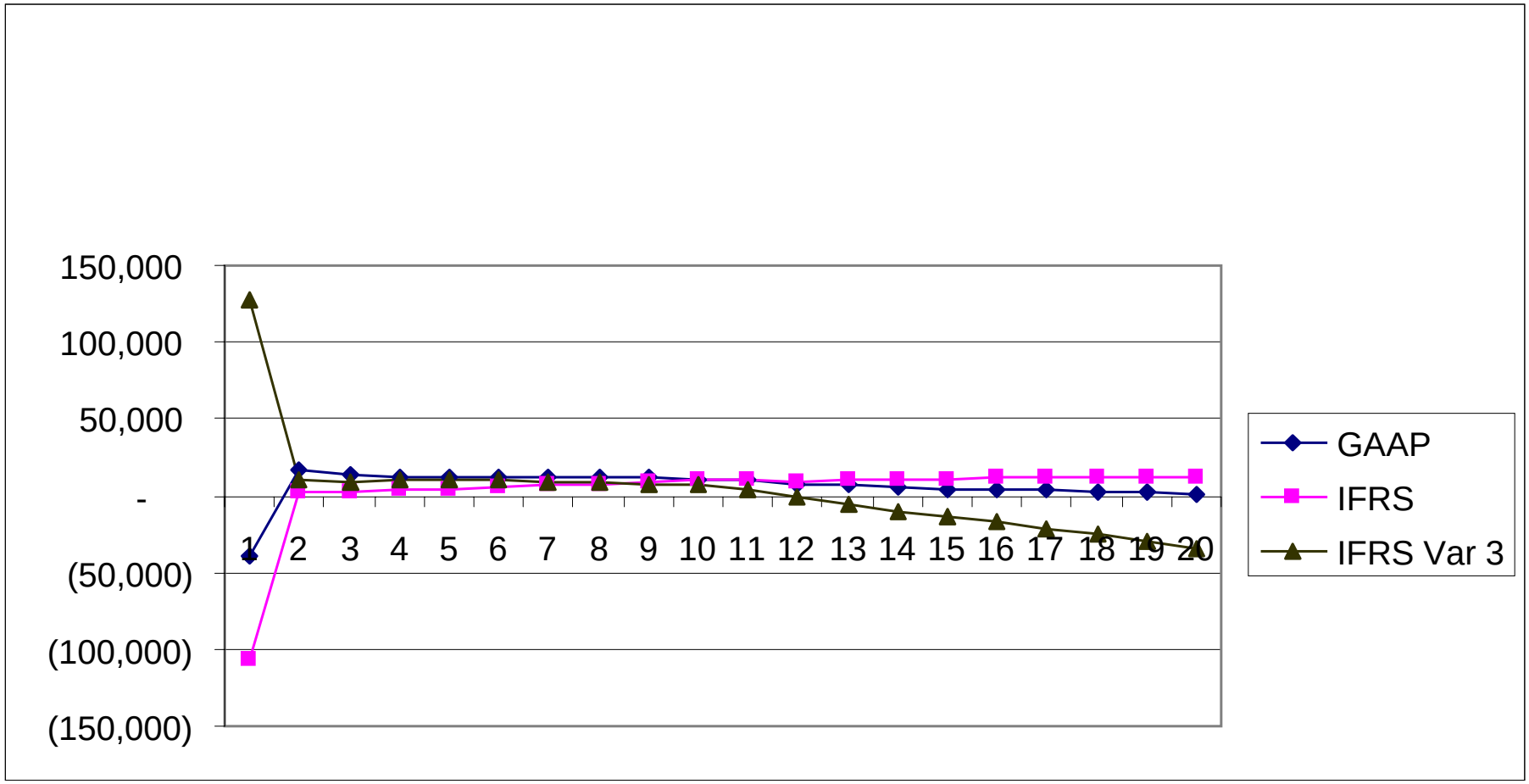


Par Whole Life GAAP & IFRS – Income

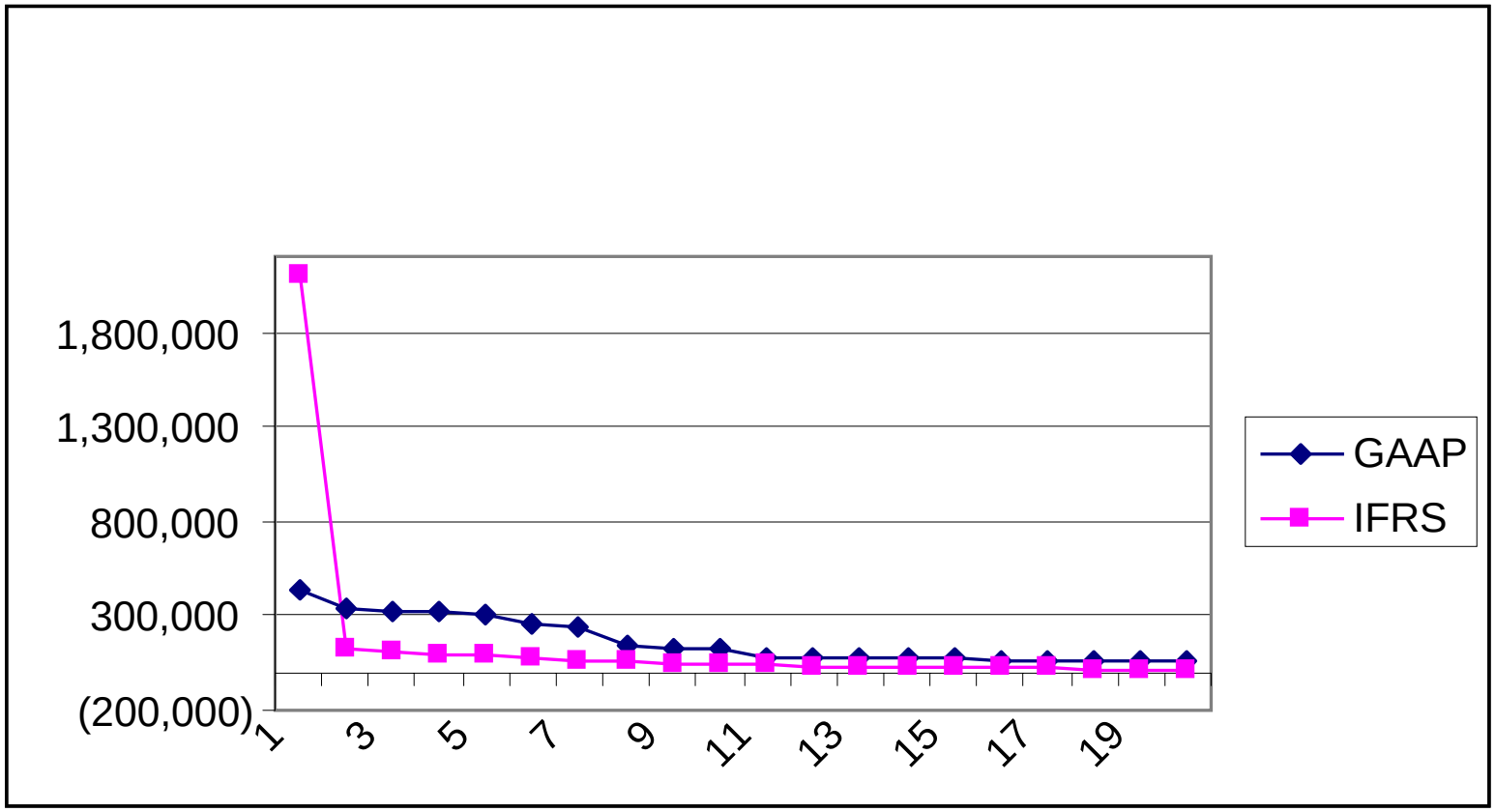


First year premium = $133,000

Par Whole Life – Exclude Dividend – Income

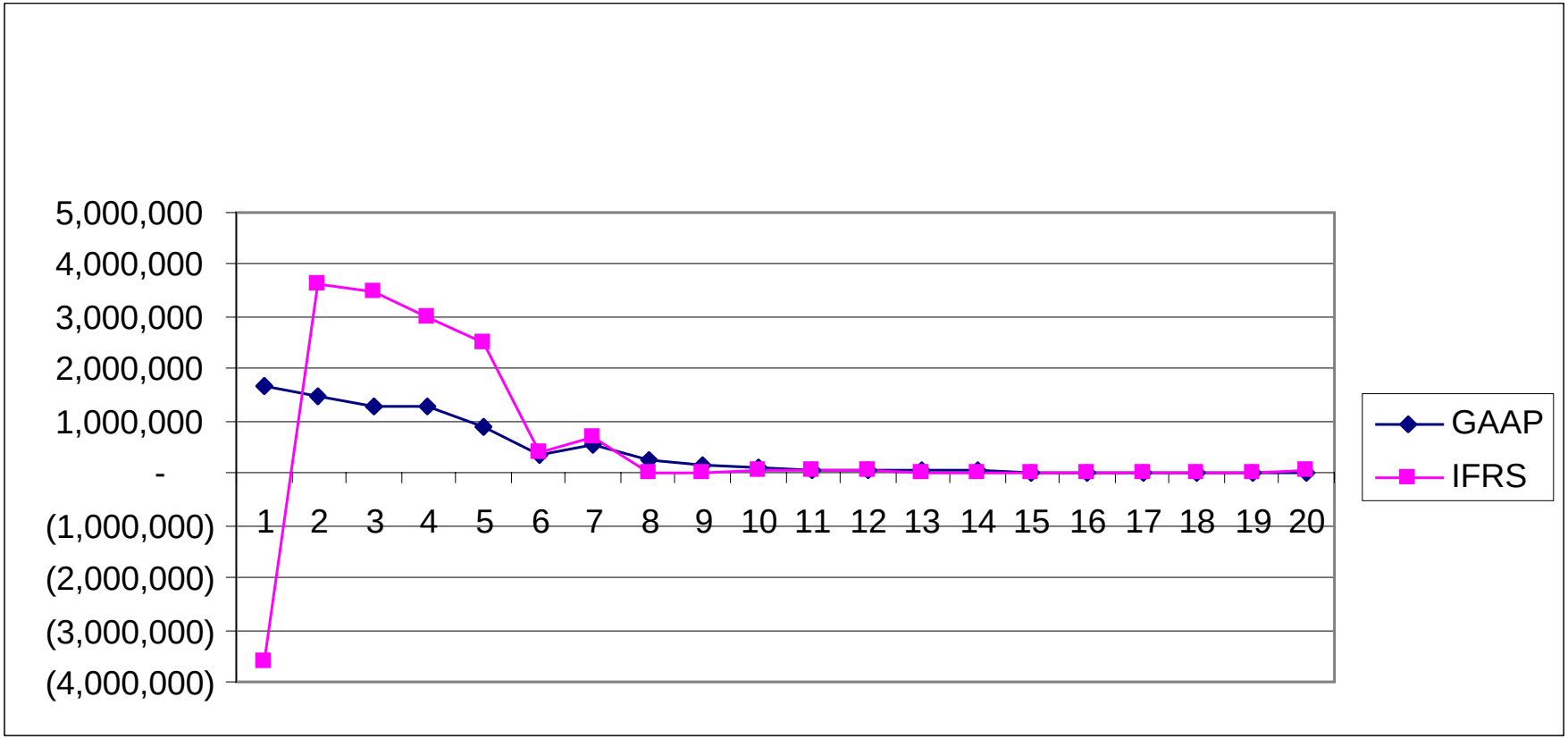


Variable UL GAAP and IFRS – Income



First year premium = $3.2 million

SPDA GAAP and IFRS – Income



Premium = $3.2 million

Relative Size (1 of 2) of Cash Flows and Risk Margins ($000)

		Year 1	Year 5
PAR WL	PV Cash Flows	<$497>	$2,916
	PV Margins	232	215
		<262>	3,131
UL	PV Cash Flows	68	1,326
	PV Margins	53	42
		121	1,369
SPIA	PV Cash Flows	919	722
	PV Margins	9	6
		928	727
TERM	PV Cash Flows	<1,766>	<875>
	PV Margins	461	344
		<1,305>	<531>

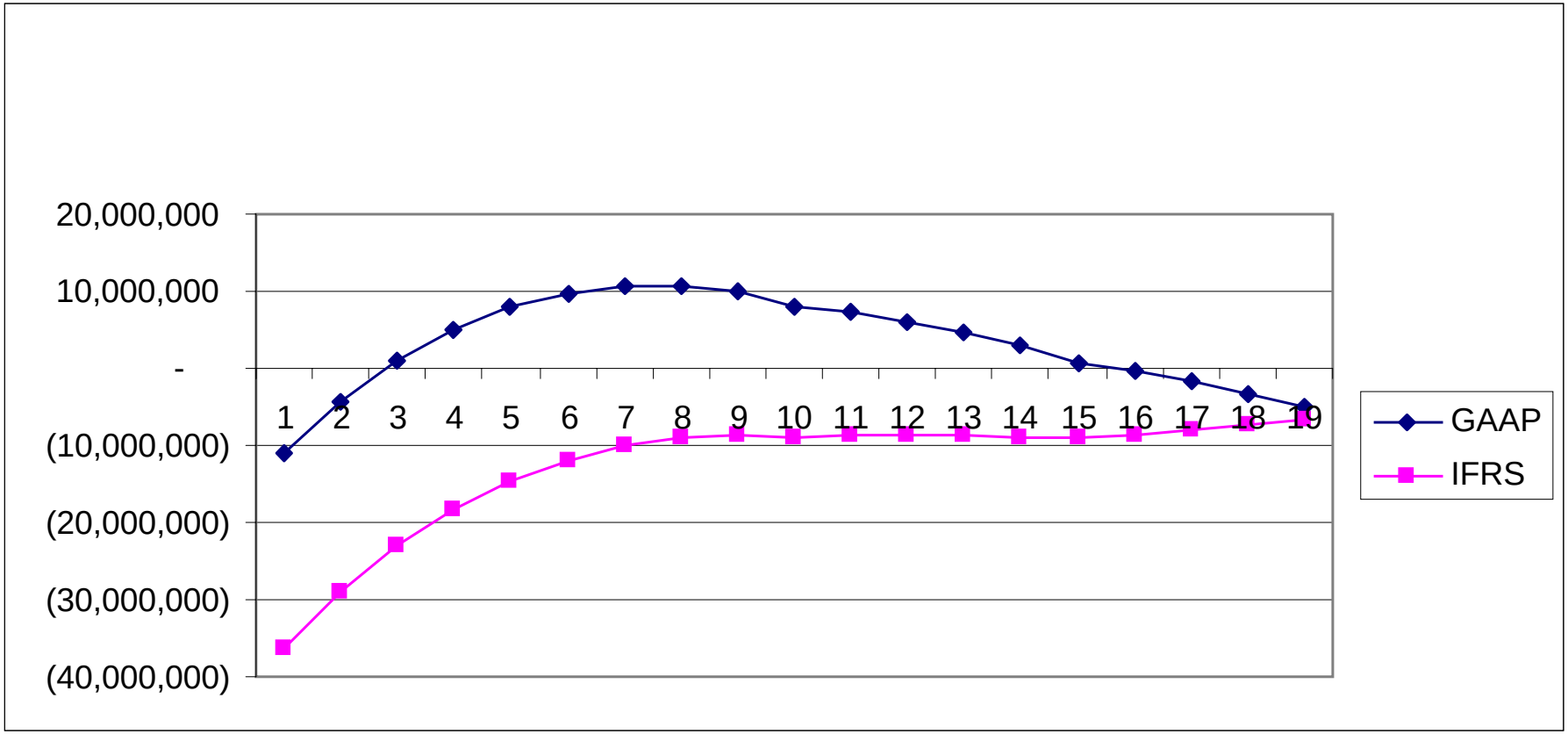
PV = Present Value

Relative Size (2 of 2) of Cash Flows and Risk Margins ($000)

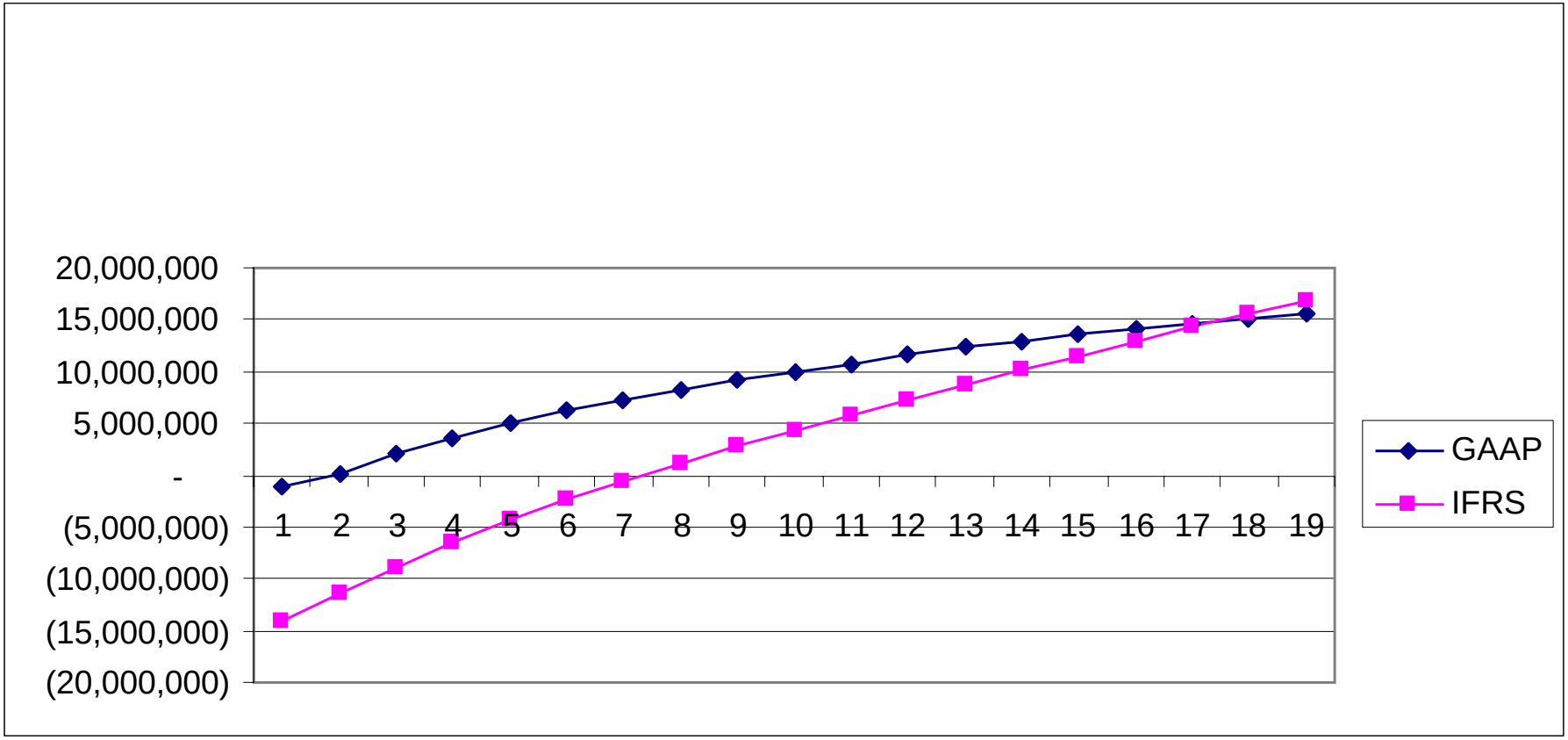
		1	5
VUL	PV Cash Flows	<$2,330>	<$1,573>
	PV Margins	142	129
		<2,187>	<1,444>
SPDA	PV Cash Flows	940	892
	PV Margins	2	1
		942	893
HEALTH	PV Cash Flows	<4,526>	<1,507>
	PV Margins	87	65
		<4,439>	<1,442>
LTC	PV Cash Flows	<21>	3,137
	PV Margins	366	270
		346	3,407

PV = Present Value

Balance Sheet, Term



Balance Sheet, Health



Summary 1 of 2

- 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.

Summary 2 of 2

- 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

Responses to IASB (as of January 2008)

- 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)

AIG – U.S.-based; in 130 countries

- 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

ManuLife – Canadian-based; in 19 Countries

- 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

International Actuarial Association (IAA) – 57 Members; 95% of Actuaries

- 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

United Kingdom Actuarial Profession (Institute, Faculty, 17,000 Members)

- 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

Institute of Actuaries of Japan (3,500 Members)

- 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

Institute of Actuaries of Korea (800 Members)

- Agrees with using a transfer to another party as the source for calibration
- Should define Fair Value first
- Should provide some practical examples

International Association of Insurance Supervisors (IAIS) [1 of 2]

- Its members supervise 140 countries, 97% of world's insurance
- Would like to use IFRS accounting for solvency (statutory) purposes

International Association of Insurance Supervisors (IAIS) [2 of 2]

- 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

International Organization of Securities Commissioners (IOSCO)

- 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

Ernst & Young (Worldwide Audit Firm)

- 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

PricewaterhouseCoopers 1 of 2 (Worldwide Audit Firm)

- 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?

PricewaterhouseCoopers 2 of 2 (Worldwide Audit Firm)

- 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?

KPMG (Worldwide Audit Firm)

- 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

Deloitte (Worldwide Audit Firm)

- 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

Merrill Lynch (Buys/Sells Securities)

- 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

Standard & Poor's (Rating Agency)

- Wants more disclosures
- Use all cash flows
- Gains at issue are acceptable

GNAIE – 16 gigantic Life and P&C Insurers
Group of North American Insurance Enterprises

- 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

CFO Forum (2 of 2)

- 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

Umbrella – CFO Forum, GNAIE and Four Large Japanese Insurers

- 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

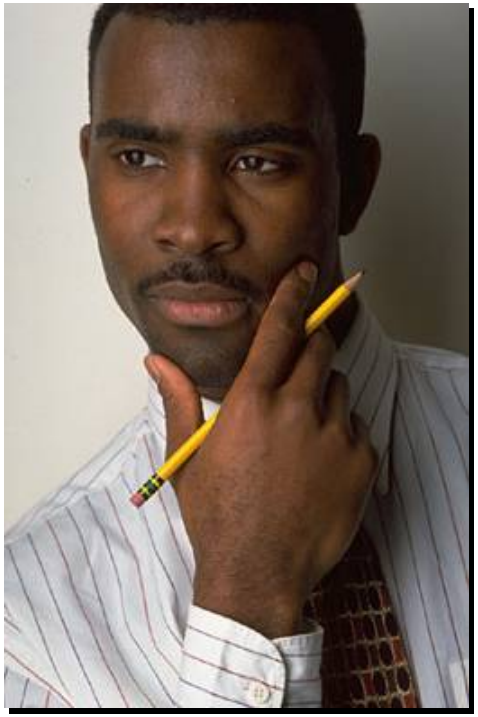
- 44 in total; 500 pages
- 29 clearly answered questions 1 and 2

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

IASB 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

FASB Next Steps

- 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

SEC Next Steps (2 of 3)

- 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

therget@polysystems.com