Deloitte.

Conflicting comments
IFRS 4 Phase II Update

IASB and FASB joint meeting – January 2011

Francesco Nagari

24 January 2011

Agenda

- Highlights of the 18 and 19 January joint meeting
- Discounting – Respondent proposed models
- Summary of comments received
- Timetable and next steps

Highlights of joint IASB / FASB meeting – 18 January 2011

Response summary

- 253 letters from 247 respondents
  - Majority of stakeholders and geographical regions represented
  - Conflicting views as to whether a single standard can effectively address both life and non-life contracts
  - Conflicting comments over the cost-benefit of an insurance standard issued as drafted
  - Demand for a sufficient period to adopt the final standard
  - General support for building block model (for life), but concerns raised over its comparability
  - Many non-life insurers believe this model is overly complex for their business

Key issues for redeliberation

- Volatility in profit and loss and discount rates
- Residual vs. composite margin and remeasurement of the residual/composite margin
- Unbundling
- Presentation
- Short-duration contracts

Highlights of joint IASB / FASB meeting – 19 January 2011

Educational session on discount rates

- The ED approach to select the discount rate is a “bottom up” construction that starts from a risk free market interest rate and adds to it a premium for the illiquidity of the insurance cash flows
- Staff selected three proposed discount rate measurement alternatives all based on a “top down” approach removing certain characteristics from identified interest rates
- The approaches illustrated were discussed with the Boards in an educational session by the following presenters:
  - Rob Esson (NAIC)
  - Francesco Nagari and Andrew Smith (Deloitte)
  - Nick Bauer (Eckler)

Discounting – Respondent proposed models

Rob Esson – NAIC

- Discount rate based on the Economic Default Adjusted Rate ("EDAR") approach currently exposed as a proposal within NAIC Principle Based Reserving for the US insurance market

Why EDAR?

- Aligned with business models and insurer management processes
- Principles based (although there is significant guidance for implementation)
- Supports a fulfilment objective for insurance accounting

EDAR's key features

- Top-down approach which starts from actual or estimated asset earnings and eliminates risk factors that are irrelevant to the underlying insurance liability
- Reflective of those assets that the insurer actually holds
- Excludes investment expenses, credit default spreads and investment mismatch risks from the discount rate

EDAR objectives

- Similar default costs for similar assets used across companies
- Companies cannot lower reserves through investment in risky assets
- Short term volatility should be offset by long-term trends
- Methodology should be simple

Discounting – Respondent proposed models (cont.)

Rob Esson – NAIC (cont.)

Issues raised by Board members

- Asset based rates use inverse adjustments for uncertainty and default
  - Agreed, but practicality and observability were considered adequate trade-offs
- How are credit default rates determined? Management or market? Time horizon? Pure default or total loss?
  - Start with historic rates (e.g. Moody's), and use a current treasury spread. Changes smoothed over a 4 year period to highlight trends and eliminate short-term volatility. Similar to the "credibility test" required in the ED for mortality and other non-financial variables
- Subsequent measurement?
  - Floating rate, adjusted every period

Discounting – Respondent proposed models (cont.)

Francesco Nagari and Andrew Smith – Deloitte

- Proposal focuses on the implementation of a discount rate calculated from a reference portfolio
- Returns on assets = risk-free return rate + premiums for bearing risks
- Bottom-up approaches are impractical because there is no generally accepted basis for estimating many of the build up factors
- Top-down approach, based off reference asset rates, is in line with overall principles of the ED and it offers a more practical adoption

Approach overview

- The difference between risk-free rate and expected rate is comprised primarily of seven elements:
  - Expected default losses (and reward for default risk)
  - Illiquidity losses (and reward for illiquidity risk)
  - Management expenses (and reward for expense risk)
  - Unexplained residuals
- From an illiquid liability perspective asset illiquidity premium is negligible because the creditor cannot demand its payment and thus the debtor does not incur these losses
- This leaves a large unexplained residual
- Pragmatic approach eliminates the IFRS 9 expected default losses in the calculation of the discount rate

Discounting – Respondent proposed models (cont.)

Francesco Nagari and Andrew Smith – Deloitte (cont.)

IASB criteria met by this model

- It measures the time-value of money of the insurance cash flows on a current basis
- Uses observable rates for a portfolio that matches the characteristics of the cash flows
- Removes the identifiable attributes of market rates which are not relevant to the liability

Advantages of this model

- Eliminates the problem of estimating the illiquidity premium
- Aligns with other IFRS concepts (e.g. impairment in IFRS 9)
- Liability are responsive to market fluctuations in a way similar to backing assets' fair values
- Decision neutral towards asset allocation for matching contract cash flows

Potential problems

- Identifying candidate assets for the replicating portfolio
- Identifying expected losses where sufficient observable data is unavailable
- Detailed knowledge of the individual cash flows is required

Discounting – Respondent proposed models (cont.)

Francesco Nagari and Andrew Smith – Deloitte (cont.)

Issues raised by Board members

- How can this be implemented in developing countries where high-grade bonds are unavailable?
  - Reference portfolio should be based on “good quality” assets that are available to the insurer in the market where contracts are issued
- Why is your portfolio based on “good quality instruments” rather than “high quality bonds”?
  - Different countries have different asset availabilities. “Good instruments” is aimed at producing a reference asset portfolio that is reflective of the insurers market conditions
- How can you match a 30-year liability if available assets are limited to 10-year instruments?
  - Use of extrapolation, in the same way as would be done for the cash flows

- Also noted the general point that this exercise is already performed by many insurers as part of their pricing decisions, and so will require more manageable changes compared to a brand new – untested – method

Discounting – Respondent proposed models (cont.)

Nick Bauer – Eckler

- Asset-linked discount rate focused on life business
- Considered needlessly elaborate for non-life
- Based on Canadian market practices, but can be applied in many jurisdictions

Approach overview

- Forecast net insurance contract cash flows (best estimate adjusted for uncertainty)
- Forecast net backing asset cash flows (expected return, historical limits, reduced for expected credit losses or impairments)
- Forecast net cash flows (does not account for mismatch risk)
- Economic scenarios are built to consider risks from assets and liabilities and the possible mismatch risk
- The end result is a liability whose value is equivalent to the assets required to fulfil the liability
- The discount rate is derived from this result for disclosure purposes

Discounting – Respondent proposed models (cont.)

Nick Bauer – Eckler (cont.)

IASB criteria met by this model

- Consistent with the fulfilment notion, and provides for all sources of uncertainty
- Top-down approach, uses replicating portfolio and measures time-value of money

Advantages of this model

- Faithfully represents the interaction of assets and liabilities on the balance sheet
- Reflects the real economic mismatches that may exist
- Minimises accounting mismatches
- Can be readily applied in any jurisdiction and is based on generally accepted theories
- Independent of balance sheet value of assets because the assets' measure drives the liability's value

Potential problems

- Considered by many to be complex
- Riskier investments decrease liability (but limits on asset risk can be set separately)
- Limited comparability (based on insurers actual assets rather than market references)
- More volatile than an amortised cost approach

Discounting – Respondent proposed models (cont.)

Nick Bauer – Eckler (cont.)

Issues raised by Board members

- Why does this model work regardless of the asset valuation method?
  - Model is based on providing enough assets (whatever the valuation method) to generate cash flows to meet the liability payments. Their accounting value is used to measure the liability if cash flows match
- How will non-insurance companies apply this model as the statement will also apply to them?
  - If they aren't using designated asset portfolios the way an insurer does, they will need to develop their asset cash flow projections from whatever assets support their business (e.g. their ongoing profitable trading). The use of traditional financial instruments is not required.

Discounting – Respondent proposed models (cont.)

All respondents

Issues raised by Board members

- Should the Boards open the discount rate to any defensible method?
  - Nick Bauer: Accounting standards don't currently tell oil companies how to value their oil reserves, they just specify the appointment of an appropriate expert. Shouldn't the insurance standard do the same?
  - Deloitte: No objection to proposal, but the IASB should still specify what factors should be in/excluded from a discount rate. The exact methodology is not necessarily required to be specified but well articulated principles are necessary in the final IFRS
  - Rob Esson: Three presentations are extremely similar. If a specific method is adopted, the similarities should be strongly considered by the Boards for inclusion in the principles

- Presenters agreed to work with the Staff to use a common fact pattern and determine the resulting discount rate using their own method.

- One Board member asked the Staff to analyse, in parallel with the leasing project, a method based on a rate implicit in the insurance contract to measure time value of money

Summary of comments received

General comments

- Support for a new insurance standard as current IFRS 4 is too permissive. A new, imperfect standard would be better than the current position (almost no standard at all)
- US comments that potentially two standards are needed as life and non-life are significantly different types of business
- Most respondents (barring regulators) believe the cost-benefit supports a new standard, but comment that this can only be confirmed after field testing and refinements are complete
- Concern that the proposals are not fully developed, with insufficient detail on implementation, so a standard based on the ED will leave many questions unanswered
- Comment period was insufficient, additional concerns are likely to arise with time
- The June 2011 deadline for finalisation is artificial (linked to IASB membership rotation), and may compromise the quality of the standard
- Some believe that a converged standard with FASB is more important than finalisation in June

Overall comments on model

- General support for building block model for life business, but concern over the current implementation of the blocks and the interactions between them
- General consensus that the building block approach is overly complicated for non-life business pre-claim liability

Summary of comments received (cont.)

Critical issues for redeliberation

Volatility in profit or loss and discount rate

- Current model would have significant volatility affecting profit and loss as well as equity
- Hindering faithful representation of the economic reality with reduced relevance, reliability and comparability
- Sources of volatility: “current-current” and “cost-current”
- Proposals include:
  - different approach to discount rates,
  - presentation of economic mismatches in OCI,
  - offset volatility against residual margin. or
  - extended unbundling of components

Deloitte position

- In general, we agree with the concerns above
- Potential solutions include recalibration of the residual margin or changes in the proposed discount rate model
- In addition, potential links to IFRS 9 hedge accounting should be considered

Summary of comments received (cont.)

Critical issues for redeliberation (cont.)

Volatility in profit or loss and discount rate

- Although there is some support for the discount rate "bottom up" concept, the implementation is extremely difficult and there is no sufficient guidance in the ED
- Disagreement among commentators that risk-free rate plus liquidity adjustments captures all the characteristics of the liability
- Judgments required to estimate the Illiquidity adjustment likely to reduce comparability and objectivity
- Large numbers of suggested alternatives discount rate solutions for the final IFRS
- Boards to redeliberate in February

Deloitte position

- In general, we agree with the concerns and have concerns that a bottom-up approach may not be observable and comparable
- As noted earlier, we propose a reference asset portfolio approach for the selection of a discount rate

Summary of comments received (cont.)

Critical issues for redeliberation (cont.)

Residual vs. composite margin and remeasurement of residual/composite margin

- Responses vary greatly dependant on geographical location and type of respondent
- Composite margin was generally supported by the US and Japan and by non-life insurers. Arguments noted include:
  - Risk adjustment constitutes deferred profit, risk adjustment is not decision-useful as it may conceal risk aversion, introduces bias and therefore reduces comparability
- Explicit risk margin was generally supported in Europe, Canada and Asia-Pacific and by auditors and life insurers
  - Provides a current measure of insurance risk, composite margin may conceal decision-useful information and significant uncertainty between pre- and post-claims liabilities

Deloitte position

- In general, we support an explicit risk margin approach
- This is conditional on the final standard providing clarification on the definition of the risk adjustment margin to promote comparability

Summary of comments received (cont.)

Critical issues for redeliberation (cont.)

Residual vs. composite margin and remeasurement of residual/composite margin

- Conflicting views regarding the size of residual margin
- Significant opposition to locked-in residual/composite margins for numerous different reasons
- Proposed improvements include
  - adjusting the residual/composite margin for prospective changes in non-financial inputs and estimates,
  - use of residual/composite margin as a shock absorber, and
  - redetermination of residual/composite margin at each reporting period
- Board to redeliberate this issue in March

Deloitte position

- We support the recalibration of the residual margin at each reporting date in order to reduce volatility and better reflect the economic realities
- In addition, we recommend adjustments to the recalibration where the insurer measures related financial assets at fair value

Summary of comments received (cont.)

Critical issues for redeliberation (cont.)

Unbundling

- General support for unbundling in limited circumstances, but motivations for support varied
- Many respondents felt that the proposals were unclear and could result in multiple interpretations, with some respondents stating that even the objective of unbundling was unclear
- To be discussed by the Boards in February, but final decision will be linked to other decisions to be taken by the Boards

Deloitte position

- We do not support the extent of unbundling proposed by the Board and believe that unbundling should only occur when the components :
  i. are not interdependent with the insurance coverage *and*
  ii. have been included with the insurance contract for reasons that lack commercial substance

Summary of comments received (cont.)

Critical issues for redeliberation (cont.)

Presentation and short duration contracts

- Many found the information provided by a margin-based presentation approach useful, but there was limited support for the proposed summarised margin approach as drafted
- Most users want to see information about premiums, claims and claims expenses in the primary statements

- Support for short-duration contract proposals, but with a recommendation to further simplify the calculation
- Concerns that the eligibility for the modified approach (12 months coverage bright line) is overly restrictive, leaving out contracts that should be included
- Most believe that the modified approach for short duration contracts should be permitted rather than required

Deloitte position

- We recommend changes to the summarised margin approach to include volume information
- We have proposed an alternative model to the Boards which we believe meets their requirements while satisfying this information need

Summary of comments received (cont.)

Responses to other proposals in the ED

- General support for use of **probability-weighted expected cash flows**, but some concerns about the extent of the probabilities to be considered
- Definition of **acquisition costs** is considered to be too narrow because of the exclusion of non-incremental costs which are still necessary for obtaining and underwriting new business with differences arising based on the distribution system used by each insurer
- General support for including **payments arising on participation features** as part of the contractual cash flows
- Most supported the **contract boundary** principle, but there is concern around the restrictions on re-pricing arising from regulations
- Widespread **misunderstanding of discount rates for participating contracts**
- Non-life respondents do not agree with applying a **discount rate to non-life contracts**
- Most agree that there should be **no day-one profit**, but concerned that some **day-one losses** would be caused by inappropriately lower discount rates
- Limited support for Boards' **risk adjustment restricted techniques**, with majority of respondents favouring a principles based approach

Summary of comments received (cont.)

Responses to other proposals in the ED (cont.)

- Most respondents disagreed with the proposals to **disclose an implied confidence level** where the risk adjustment is calculated using CTE or cost of capital
- Similar outcome on the issue of **aggregating risk at the portfolio level** where several favoured the **aggregation of portfolios** for diversification benefits emerged
- Concern that "**portfolio**" is inadequately defined
- Some believe that also **residual margins should be assessed over portfolios** rather than cohorts
- Mixed responses to the proposals to have **interest accretion on the residual margin**, with arguments made for and against
- Significant levels of concern over the treatment of **financial guarantee contracts**, with respondents arguing for inclusion of such contracts within their own native standard (insurance, financial instruments etc.)
- Most agree that insurance contracts with DPF should be included in the standard, but the majority disagree with a similar inclusion for **investment contracts with DPF**
- Much disagreement with the **proposed changes to the definition of insurance contracts**, with many noting the significant expense of re-reviewing all extant contracts

Summary of comments received (cont.)

Responses to other proposals in the ED (cont.)

- Most insurers disagree with the proposed **recognition criteria** due to cost of system changes and several alternatives have been put forward
- Support the **expected loss model for reinsuran**ce emerged, but with some disagreement on the recognition of **day-one gains on reinsurance purchased**
- Significant concern about the **volume and complexity of proposed disclosures**, with insurers proposing reductions and refocusing of requirements, and regulators proposing instead additional requirements
- General agreement with the proposals for **unit-linked contracts**
- Vast majority of respondents disagree with proposed **transitional provisions** with a number of alternatives being presented
- Requests for a longer, 3-5 year **implementation period**

Timetable

- Board still committed to releasing the final standard in June 2011
- Indications that the effective date may be pushed out, perhaps to 2014 or 2015
- The Boards will be holding several meetings over the next few months to attempt meeting their ambitious target date
- Next meeting on Wednesday 2 February 2011

Contact details

Francesco Nagari

Deloitte Global IFRS Insurance Leader

+44 20 7303 8375

fnagari@deloitte.co.uk

Link to **Deloitte Insurance Accounting Newsletter:**

http://www.deloitte.com/view/en_GB/uk/industries/financial-services/sector-focus/insurance/article/ac9955baf1001210VgnVCM100000ba42f00aRCRD.htm

Insurance Centre of Excellence:

insurancecentreofexc@deloitte.co.uk