



## Main features of ED 5

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Luxembourg, 3 December 2003

# The insurance discussion of today

**“Europe should not accept IAS since this will have negative effects for companies and the European economy”**

**“Fair value accounting will increase volatility and, therefore, cost of capital and premium rates”**

**“IAS is about the unknowledgeable forcing the unwilling to do the unnecessary”**

**“IFRS not yet required for banks and insurers”**

**“Insurers should be exempted from IAS 39”**



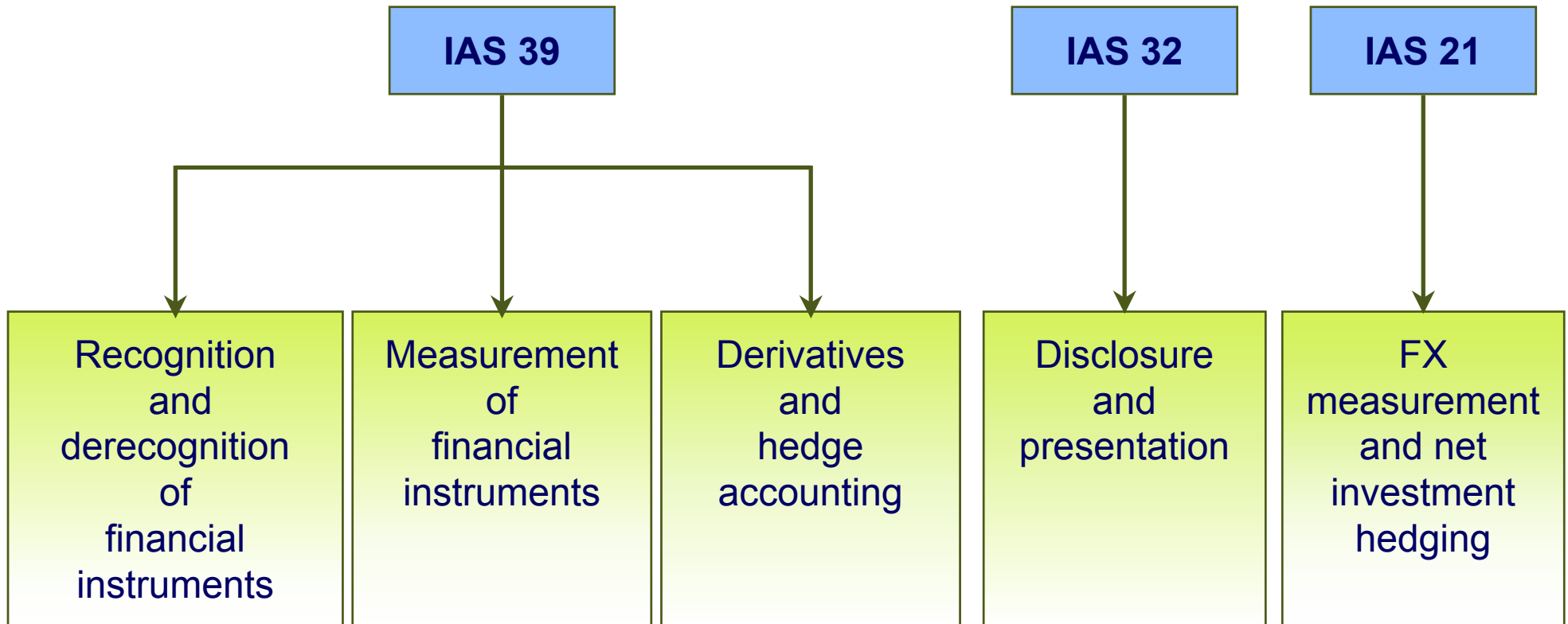
# IAS concerns all aspects of the financial statements of an insurance company

|                                   | IAS      |                       | IAS       |
|-----------------------------------|----------|-----------------------|-----------|
| Intangible assets                 | 38       | Net equity            | 32        |
| Investments                       |          | Insurance liabilities | Fase I/39 |
| - Property                        | 16/36/40 | Provisions            | 37        |
| - Subsidiaries and participations | 27/28/31 | Deferred tax          | 12        |
| - Financial investments           | 32/39    | Pension liabilities   | 19        |
| Tangible assets                   | 16/17/36 | Payables              | 23/32/39  |
| Receivables                       | 32/39    |                       |           |
|                                   |          |                       |           |

|                        |        |                          |        |
|------------------------|--------|--------------------------|--------|
| Presentation - general | IAS 1  | Foreign currencies       | IAS 21 |
| Cash flow statements   | IAS 7  | Related parties          | IAS 24 |
| Accounting changes     | IAS 8  | Financial institutions   | IAS 30 |
| Subsequent events      | IAS 10 | Earnings per share       | IAS 33 |
| Segment information    | IAS 14 | Discontinuing operations | IAS 35 |

# IAS for financial instruments

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# Future measurement and income recognition financial assets & liabilities

| Financial Instrument                               | Measurement                                   | Value changes                     |
|--|---|-----------------------------------|
| Earmarked assets and liabilities                   | Fair Value                                    | P/L                               |
| Held to maturity asset                             | (Amortised) Cost<br>(effective interest rate) | not relevant<br>(unless impaired) |
| Loans and receivables originated by the enterprise | (Amortised) Cost                              | not relevant<br>(unless impaired) |
| Available for sale                                 | Fair Value                                    | Equity<br>(unless impaired)       |
| Assets held for trading                            | Fair Value                                    | P/L                               |
| Derivatives  | Fair Value                                    | P/L                               |
| Liabilities held for trading                       | Fair Value                                    | P/L                               |
| Other liabilities                                  | (Amortised) Cost                              | not relevant                      |

# Held to maturity instruments *definition*

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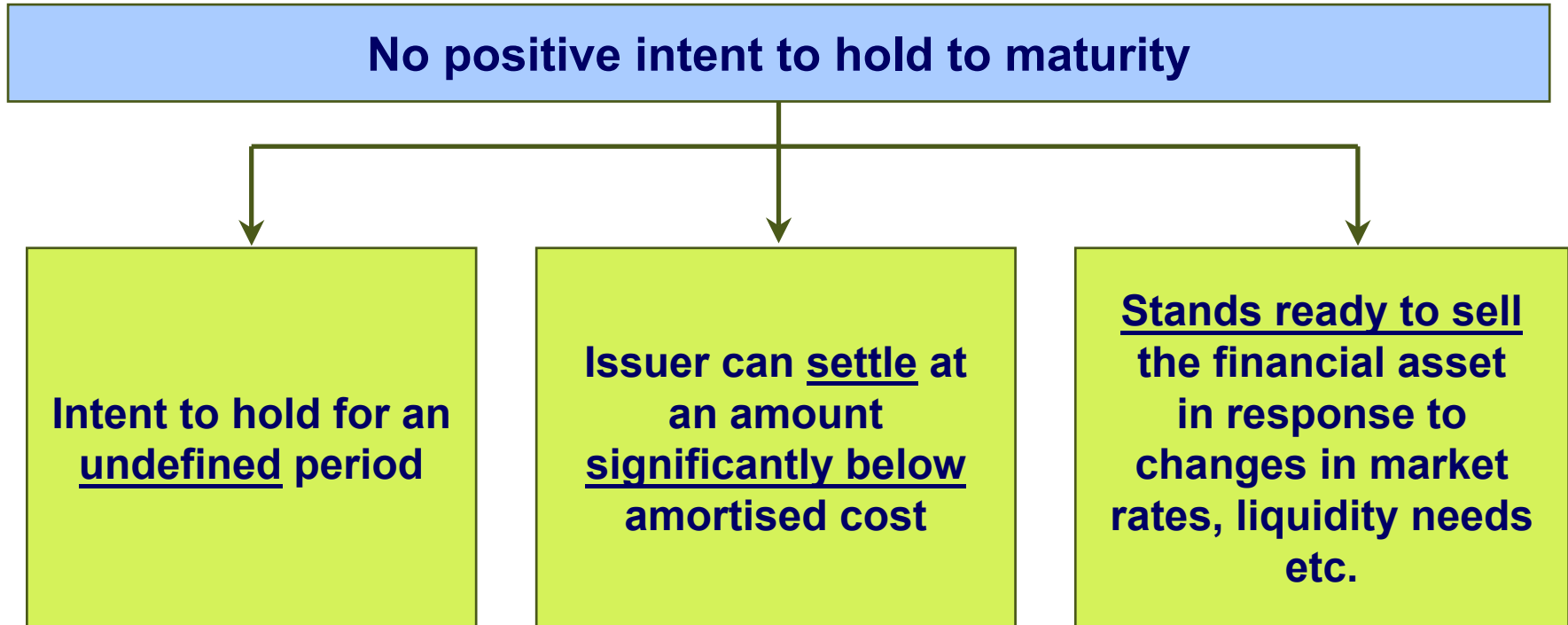
## **Financial assets with:**

- Fixed or determinable payments
- Fixed maturity
- Enterprise has the positive intent and ability to hold to maturity

**Intent and ability must be assessed at each reporting date**

# Intent to hold to maturity?

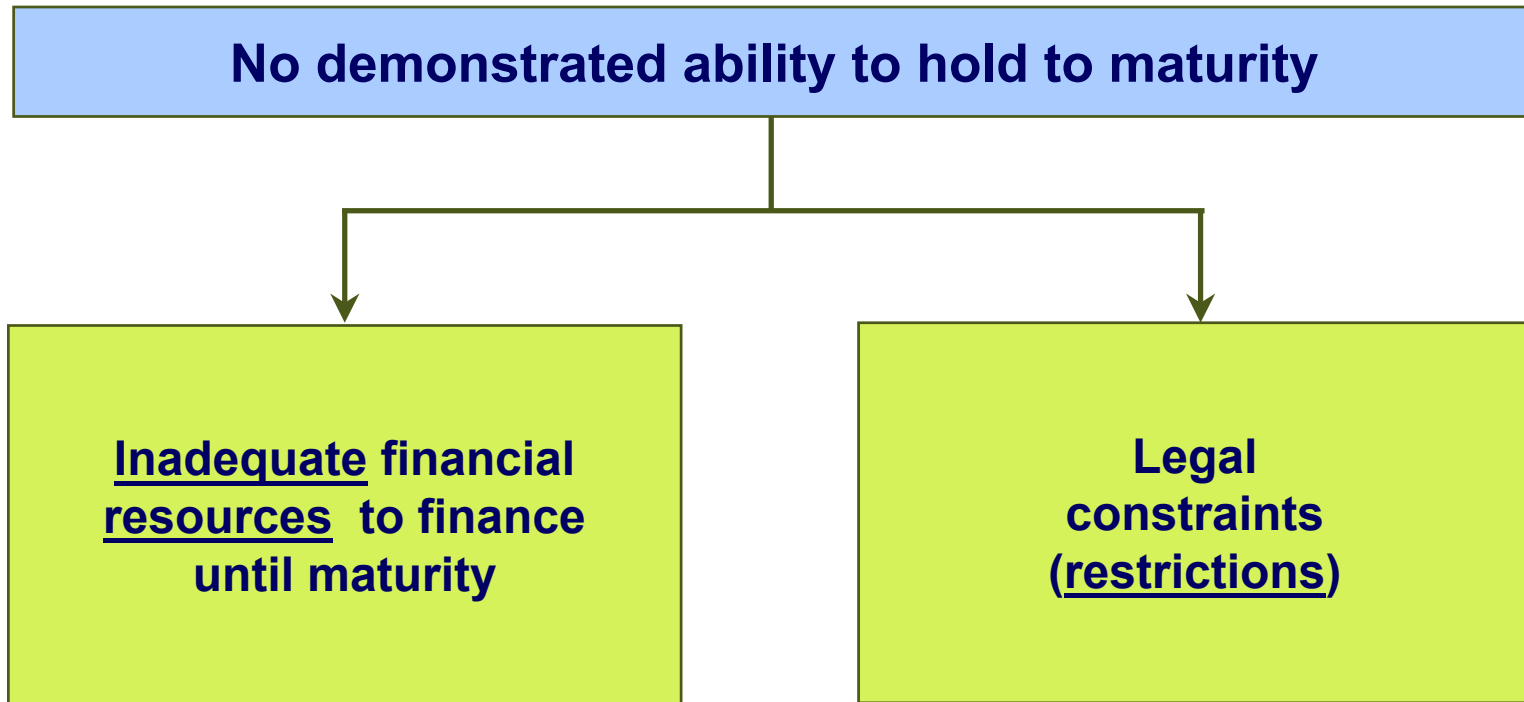
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**When there is a track record of breaking with intention, financial assets should not be classified as held-to-maturity**

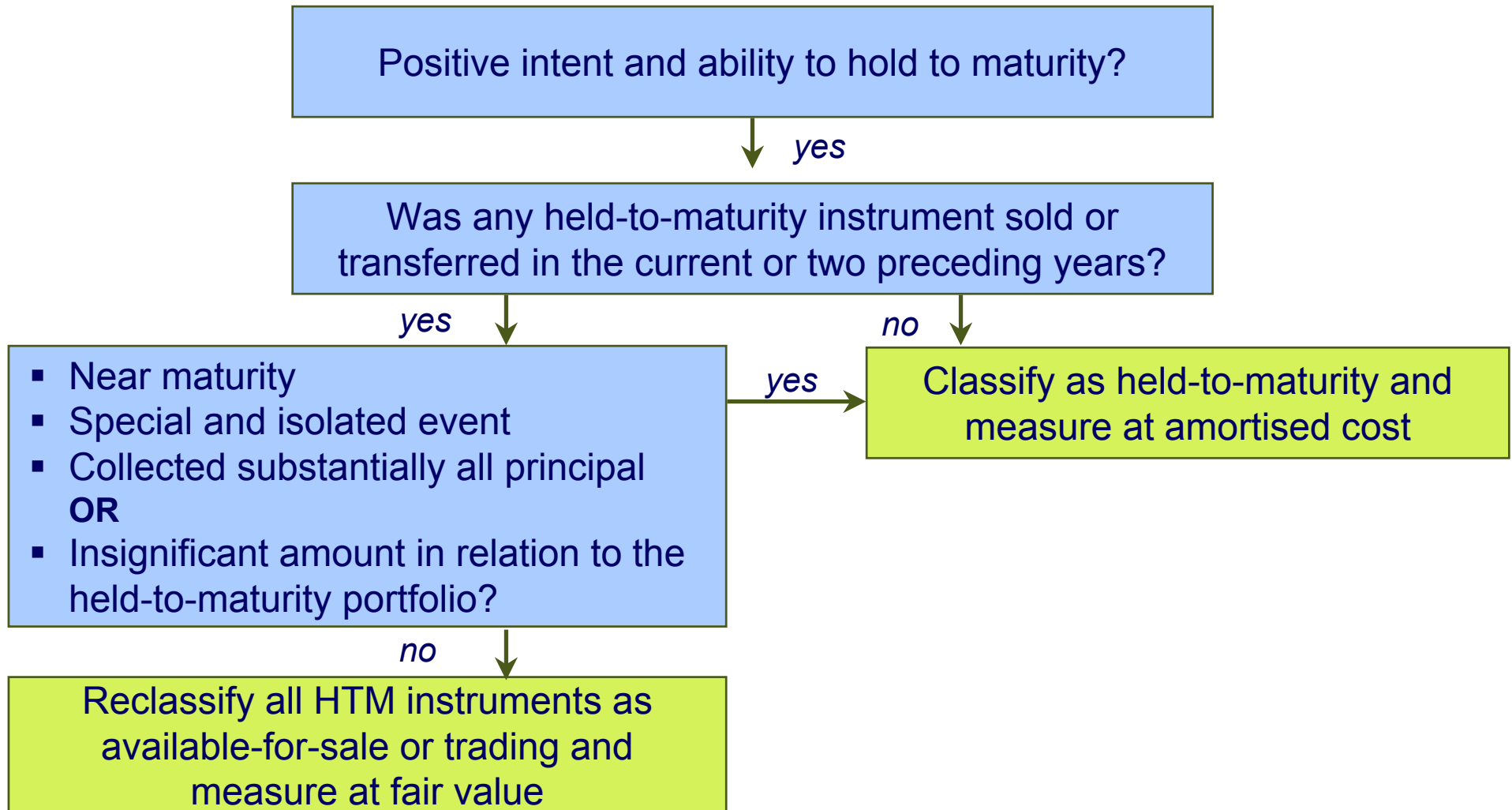
# Ability to hold to maturity?

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# Decision tree

## Held-to-maturity assets

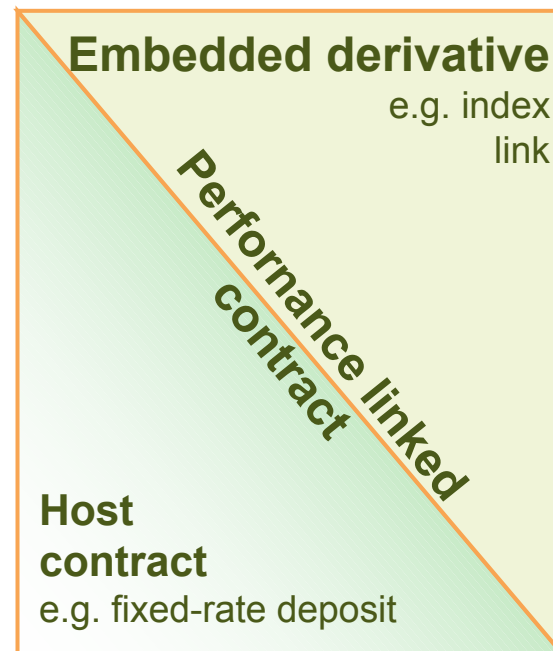


# Derivatives, including embedded derivatives, are to be separately measured at fair value

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A derivative has three characteristics:

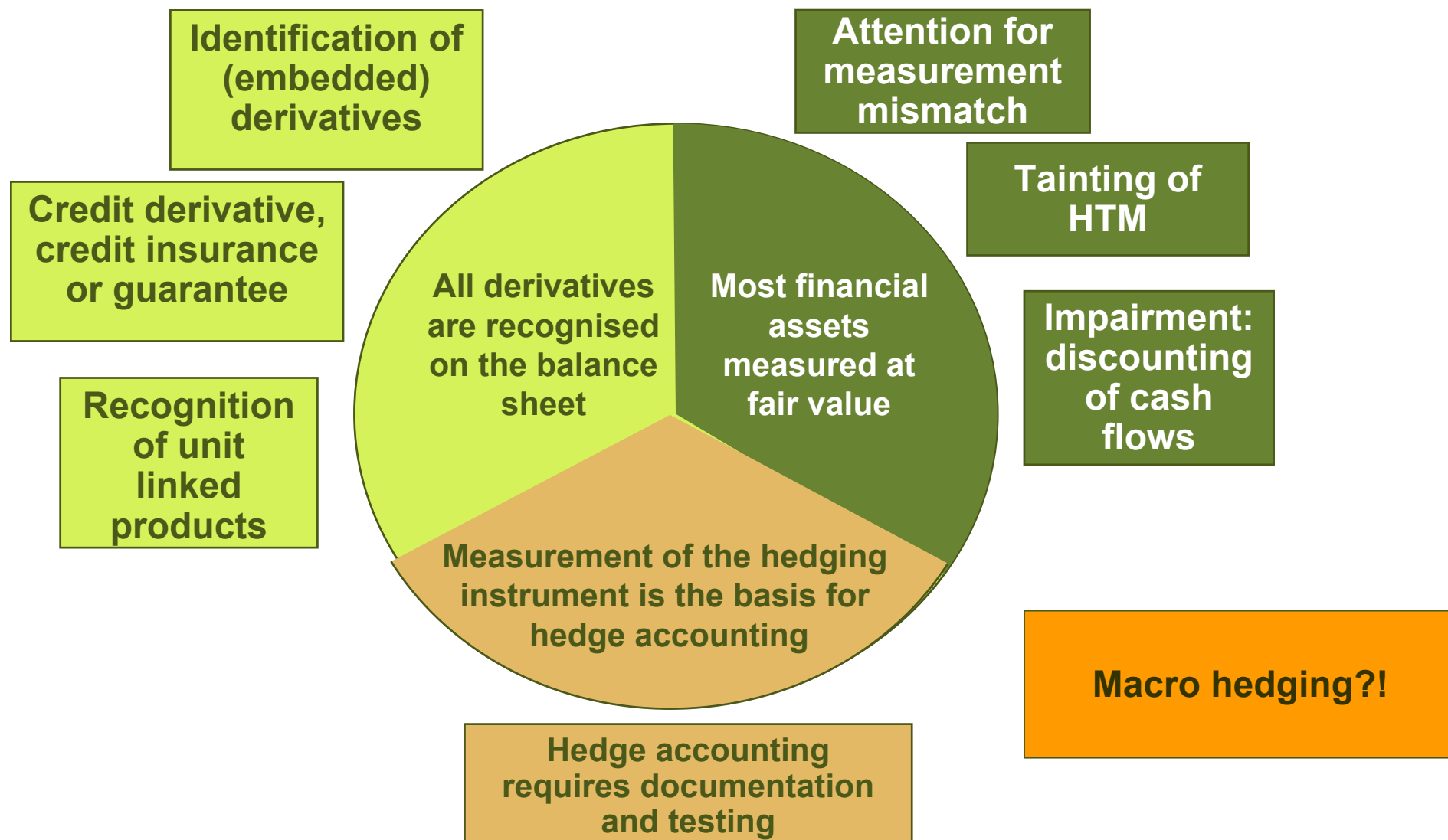
- Fair value changes in response to the change in underlying
- No or little initial net investment
- Settled at a future date



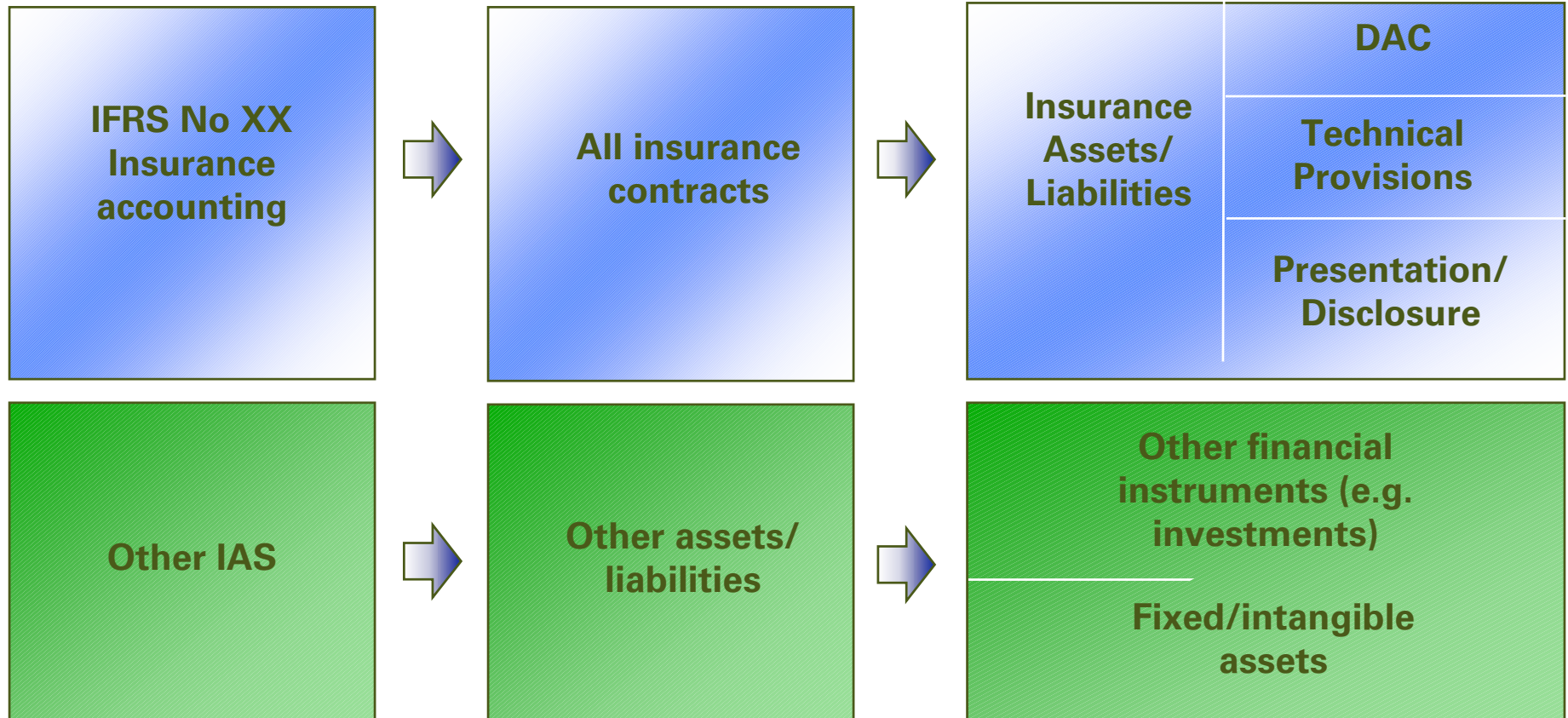
Separate out when (a) not measured at fair value with adjustments in P/L and (b) not closely related

Host contract can be an insurance contract!

# Financial instruments accounting will have a major impact

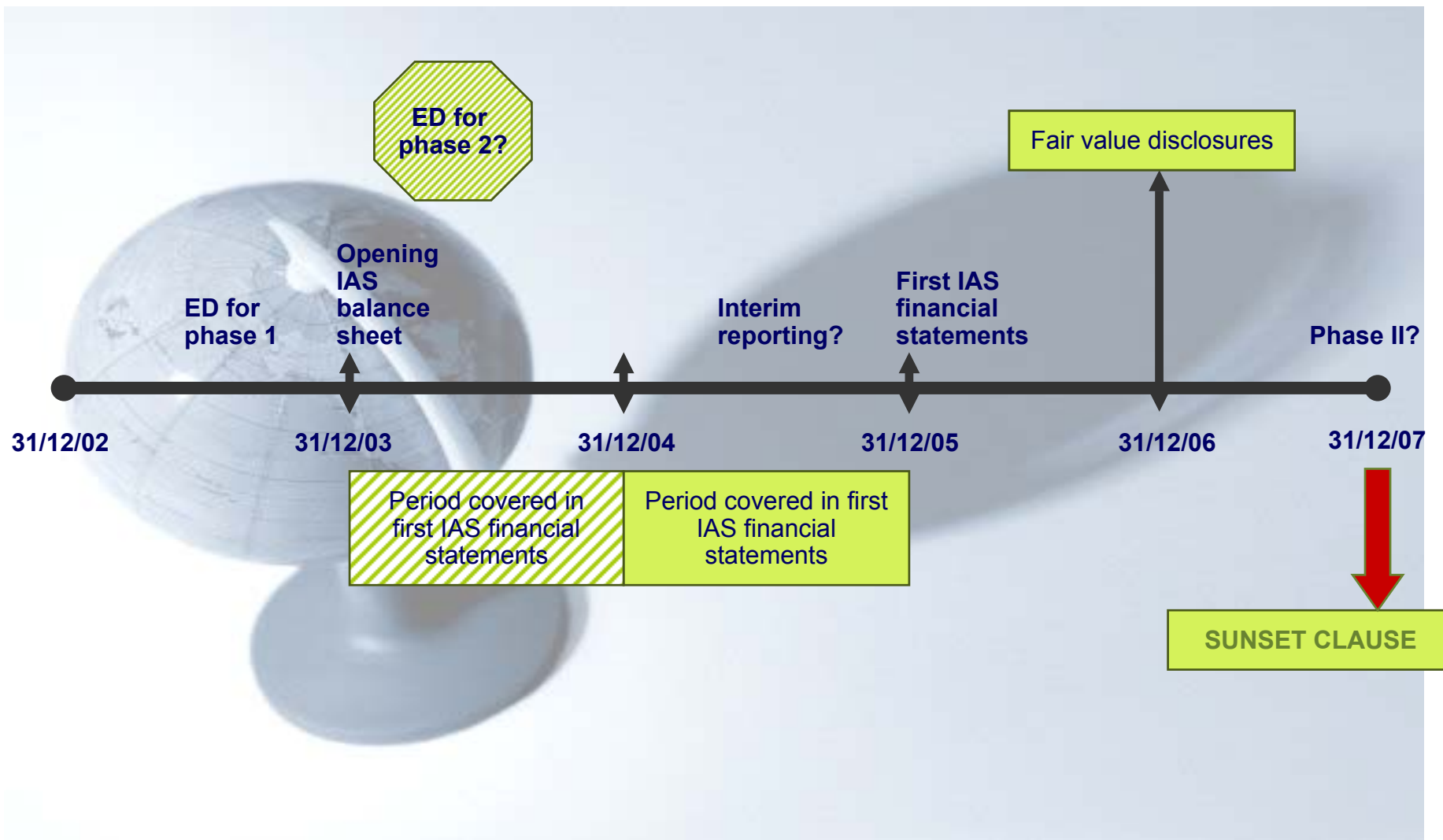


# Scope of insurance standard



**Applicable to all entities**

# Timetable of the standard on Insurance Contracts



# Temporary exemption from the IAS 8 hierarchy

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IAS 8 specifies criteria companies should use when developing accounting policies where no IFRS exists

- Apply IAS standard
- Apply IAS framework
- Apply local or other relevant standards to the extent these are consistent with the Framework

(paras 5 and 6 of May 2002 Exposure Draft of improvements to IAS 8)

*Sunset Clause 2007*



# Definition of an insurance contract

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## ED 5:

*“An insurance contract is a contract under which one party (the insurer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder or other beneficiary if a specified uncertain future event (the insured event) adversely affects the policyholder or other beneficiary.”*

## Board also agreed:

- To use this definition throughout IFRSs
- To change all scope exclusions that refer to ‘insurance entities’ to ‘insurance contracts’
- To define reinsurance contract as contract between two insurers

## Definition of insurance risk

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- **Insurance risk is risk, other than financial risk, transferred from the holder of a contract to the issuer**
- **Insurance risk is significant if, and only if, it is plausible that an insured event will cause a significant adverse change in the present value of insurer's net cash flows arising from that contract. This condition is met even if the insured event is extremely unlikely or if the present value of contingent cash flows is a small proportion of the expected (ie probability-weighted) present value of all the contractual cash flows.**
- **Insurance risk is not significant if the occurrence of the insured event would cause a trivial change in the present value of the insurer's contractual cash flows in all plausible scenarios.**

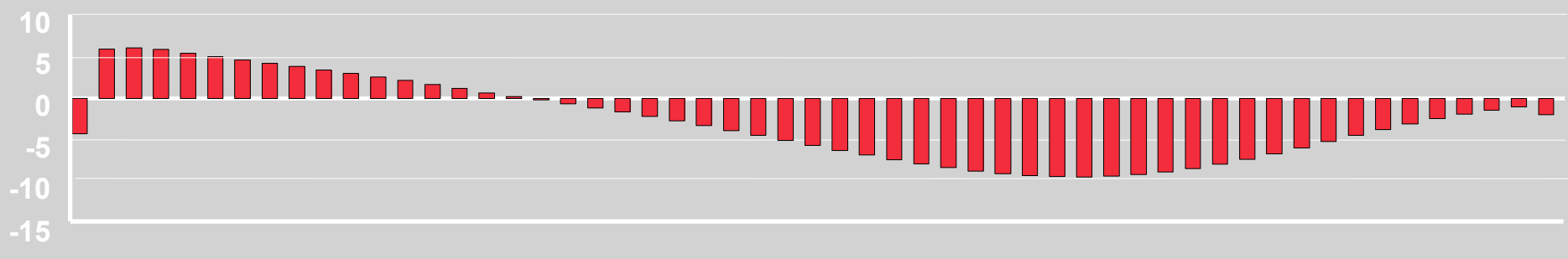
# Cash flow profile insurance contract

## Premiums

- Gross premiums
- Retrospective premium adjustments
- Premium tax

## Claims

- Gross payments to policyholders
- Salvage & subrogation
- New legislation
- Profit sharing



## Options given to policyholders

- Valuable renewals
- Loans to policyholders
- Surrenders & lapses

## Expenses

- Acquisition costs
- Policy admin. maintenance
- Direct overheads
- Claims handling expenses

## Draft guidance to the definition (1)

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- At least one of the following is uncertain at inception of the contract:
  - Whether the future event will occur;
  - When the future event will occur; or
  - How much the insurer will need to pay if the future event occurs
- Insurance risk is other than financial risk: without insurance risk, the contract is not an insurance contract
- A significant proportion of contracts that have the legal form of insurance contracts do not meet the definition of an insurance contract; if so, they should not be accounted for as if they were insurance contracts

# What is financial risk?

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## Enterprise assumes or transfers to another party

- Currency risk
- Interest rate risk
- Market risk
- Credit risk
- Liquidity risk
- Cash flow risk

} **Price risk**

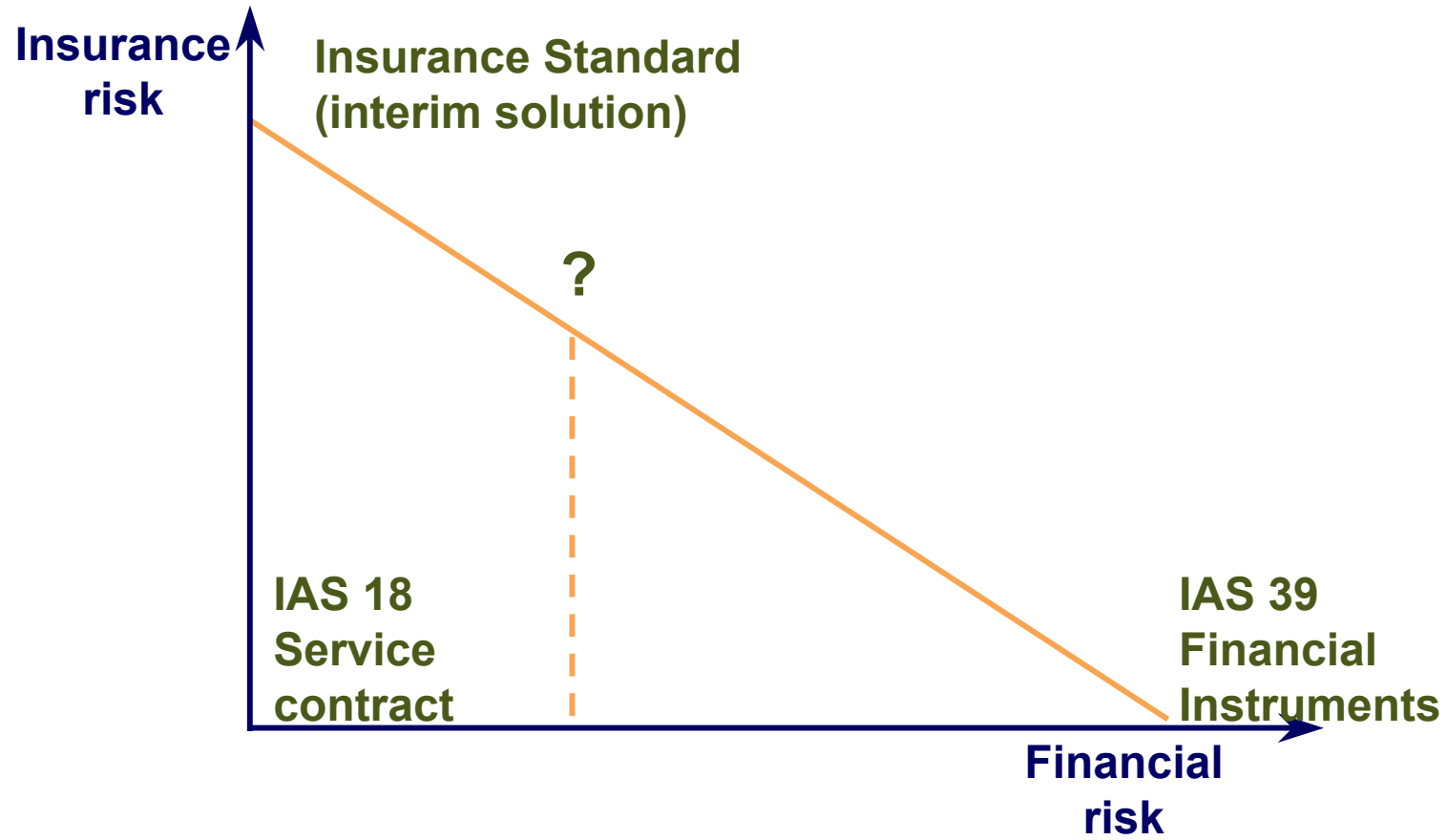
How many contracts, not transferring significant insurance risk, will be classified as a financial instrument or as a service contract?

## Draft guidance to the definition (2)

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- If a 'non-insurance' contract creates financial assets or financial liabilities, IAS 39 is applicable
- If a 'non-insurance' contract does not create financial assets or financial liabilities, IAS 18 is applicable
- Lapse risk and persistency risk are not insurance risk because the payment is not contingent on a future event that adversely affects the counterparty
- Expense risk is not insurance risk because an unexpected increase in expenses does not adversely affects the counterparty

# How much risk transfer?

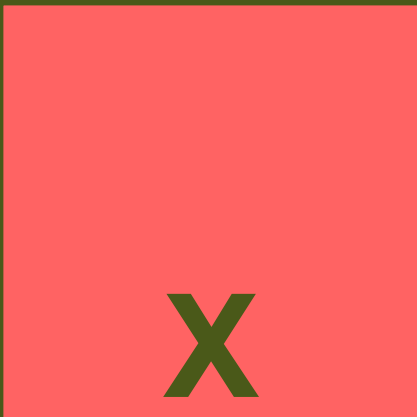
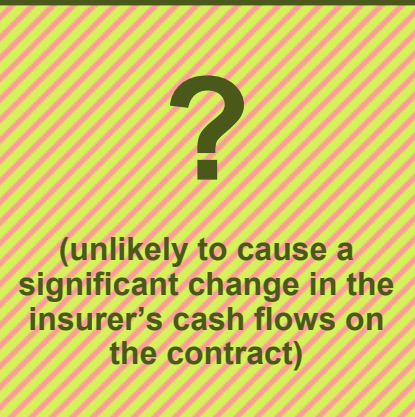
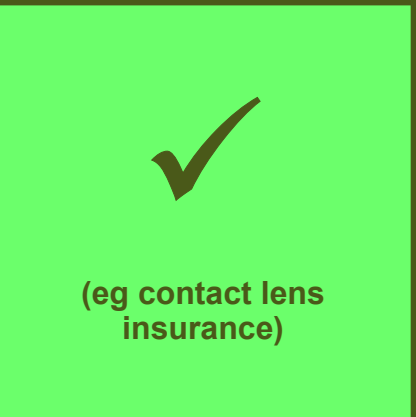




# Insurance risk assessment

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- Test to assess significant insurance risk:
  - Not a percentage test, professional judgement required
  - Test on a contract-by-contract basis
  - Need to satisfy test at inception of contract only
  - Insurance risk is other than financial risk
  - Where a contract exposes the issuer to lapse or expense risk, that contract is not an insurance contract unless it also exposes the issuer to insurance risk

# Significance

|           |      | Probability   |   |  |
|-----------|------|---|---|--|
|           |      | Unfeasible  | Low   | High   |
| Magnitude | Low  | <br>(eg all members of parliament die the same day) | <br>(unlikely to cause a significant change in the insurer's cash flows on the contract) | <br>(eg contact lens insurance) |
|           | High |   | <br>(eg earthquake insurance in a geographically stable area)                           |                                |

## Key implications of the definition

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- Financial reinsurance contracts will be accounted for as loans under principles of deposit accounting
  - i.e. prepayment made by reinsurer (often commission) treated as deposit (not as premium income)
- Range of contracts may be treated as “Other financial liabilities” under IAS 39:
  - Accounted for at amortised cost;
  - IAS 39 does not provide for proper measurement of “mixed” contracts (what is amortised cost for an insurance contract?) but
  - IAS39 improvement project may solve this issue
- IAS 32 requires extensive disclosures that are much broader than present insurance accounting
- IAS 32 requires “unbundling” of embedded derivatives
- IAS 32/39 already in existence TODAY!

# Proposed recognition and measurement changes for phase I

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- An insurer should not recognise catastrophe provisions or equalisation provisions
- Phase I should include a loss recognition test if not required by local GAAP. If not required, the liability should be increased to the amount required by IAS 37 ( best estimate plus provision for prudence)
- Offsetting reinsurance assets against related liabilities would be prohibited
- An insurer should not change the measurement basis for its liabilities when it buys insurance

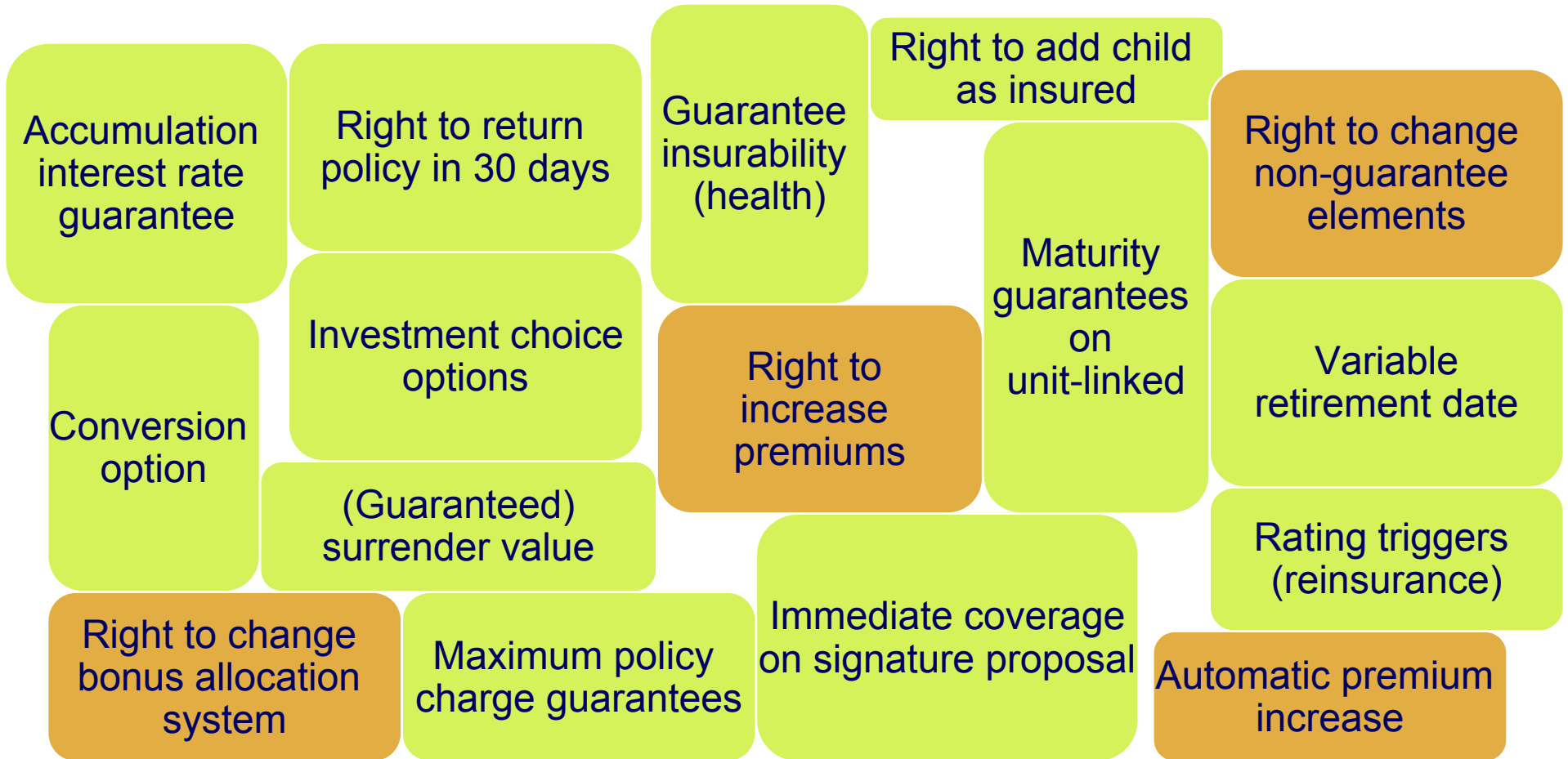
# Continuation of some existing practices for phase I

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## Phase I should not:

- Require discounting
- Try to define or eliminate excessive prudence
- Preclude an insurer from continuing to use embedded value in its financial statements
- Require an insurer to use uniform accounting policies for the insurance liabilities of all its subsidiaries (disclosure needed?)
- However, phase I will prohibit:
  - Switching from discounting to non-discounting
  - Creation or increase of excessive prudence
  - Inclusion of future investment margins
  - Switching from uniform to non-uniform accounting policies for the insurance liabilities of its subsidiaries

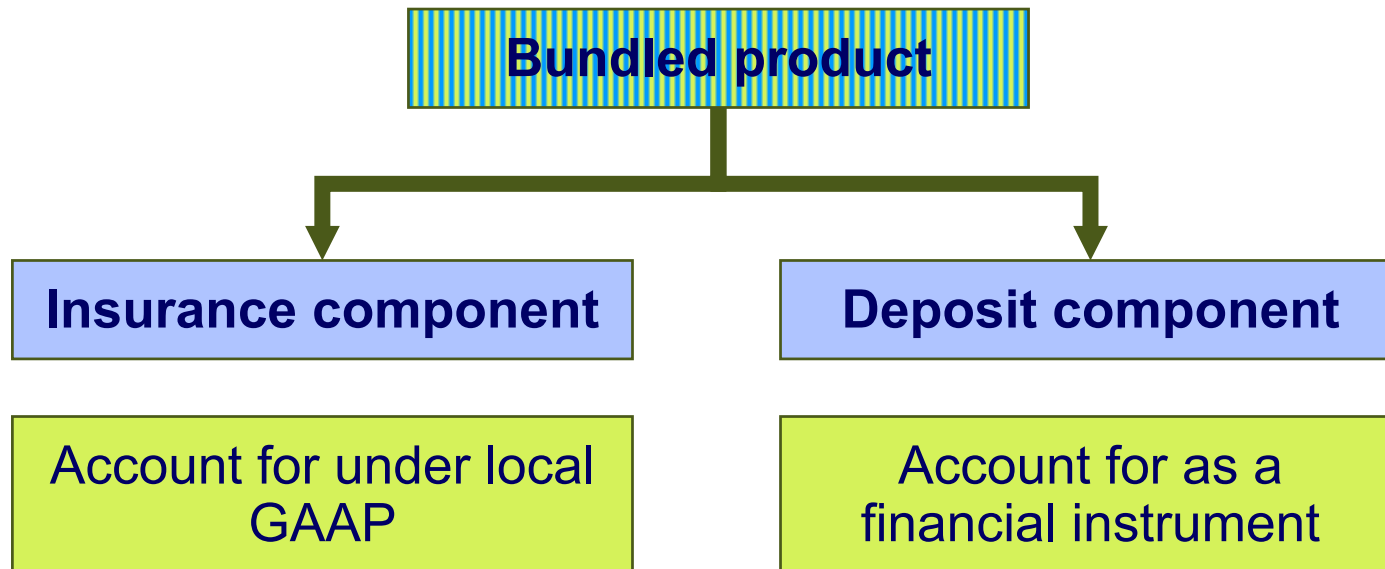
# What exactly are embedded options and guarantees?



**The building blocks of today's insurance contracts**

# Unbundling

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ED 5 requires unbundling only in rare cases like financial reinsurance

# Areas not addressed in phase I

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## **Phase I should not:**

- Prohibit or require DAC including contents, amortisation and presentation
- Require specific methods for dealing with embedded insurance options that do not contain financial components such as interest rate guarantees
- Prohibit or introduce “shadow accounting” adjustments
- Address SPEs used by insurers
- Address salvage and subrogation
- Specify presentation of policy loans

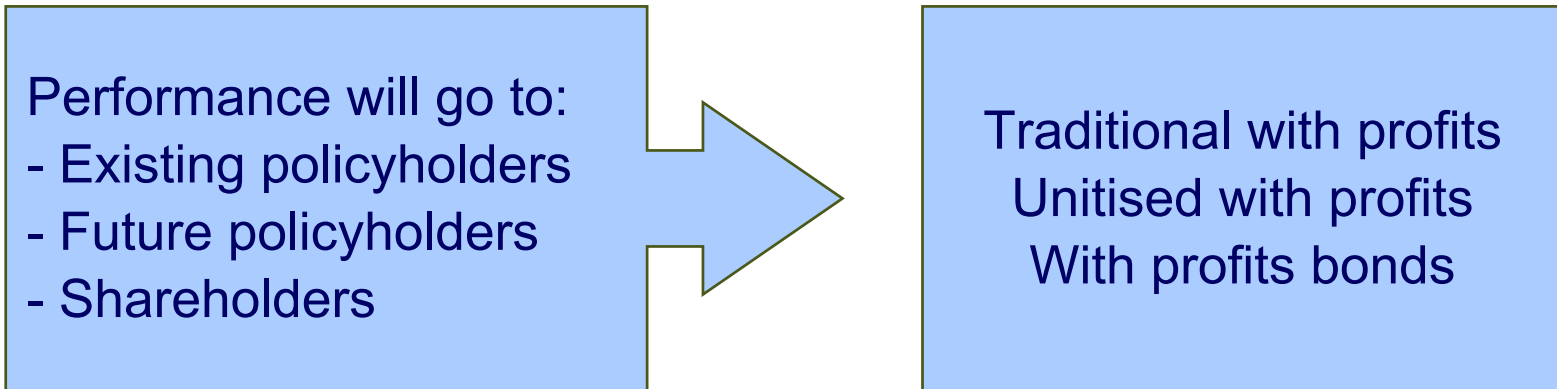
# Accounting treatment investment contracts: IAS 39

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- Measurement: **Fair value or amortised cost**
- Recognition: **Premiums are not recognised in P&L**
- Other specific issues
  - **Transaction Cost**
  - **Maintenance Cost**
  - **Investment management fees**
  - **(Discretionary) participation features**
  - **Significant 'up front' costs and front-end fees**
  - **Renewal options**
  - **Surrender penalties**
- There is no specific guidance in the ED but many of these features are likely to be embedded or something IAS 39 related

# Exemption for IAS 39 - performance linked contracts

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- Distinction between contracts where benefit linked to:
  - Performance of the specified type of contract or a specified pool of contracts
  - Performance of the company, fund or other entity that issues performance linked contracts
  - Asset return
- First two categories will be exempt from IAS 39, but the third will not

# Insurance risk disclosures

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## Disclosures

- Requirements are extensive
- It is probable that systems/ reports will need amendments in order to provide the appropriate information
- Fair value disclosures require fair value modelling prior to Phase II

# 1 - Insurance contract related amounts

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To satisfy this requirement, the company would need to disclose:

- its accounting policies
- material amounts of assets, liabilities, income and expense (on primary statements)
  - premiums, claims incurred, acquisition costs, reinsurance held
- process used to determine significant assumptions
- effects of changes in assumptions (next slide)
- changes in insurance liabilities, reinsurance assets and DAC/ VOBA
  - IAS 14 segment reporting

# 1 - Insurance contract related amounts (cont.)

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## Changes in assumptions

- Consistent with IAS 8 – disclosure of nature and effect of change in an accounting estimate that has a material effect in the current period or is expected to have a material effect in subsequent periods.  
Examples:
  - **Discount rate**
  - **Investment return assumptions**
  - **Expense assumptions**
- Analysis may be arbitrary. If possible, the company should disclose separately the impact of changes in different assumptions especially if some have an adverse impact and the others a beneficial impact. In addition, interdependencies between assumptions should be explained.

# 1 - Insurance contract related amounts (cont.)

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## Other information

- Average effective interest rate implicit in the measurement of insurance liabilities for each period described
- Amount of insurance liabilities or insurance liabilities denominated in foreign currencies
- Sensitivity of reported profit and equity to changes in key assumptions
- Terms of coverage by state or other guarantee funds that aim to protect policyholders, and the terms of any obligation or contingent obligation for the company to contribute to those funds
- Segregation requirements that are intended to protect policyholders by restricting the use of some of the assets

## 2 - Amount, timing and uncertainty of future cash flows

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To satisfy this requirement, the company would need to disclose:

- its objectives in managing risks and its policies to mitigate risk
- terms and conditions of insurance contracts which have a significant impact on cash flows
  - gross and net of reinsurance
- information about insurance risk including sensitivity to key variables, concentrations of insurance risk, details of actual claims compared with previous estimates
  - determine risk, sensitivities and concentrations
  - format for loss development table?
- information about interest risk and credit risk
- the sensitivity of embedded derivatives to interest risk and credit risk

## **3 - Fair values of insurance liabilities and insurance assets**

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**Fair value disclosures:  
Not required for dates before 31 December 2006**

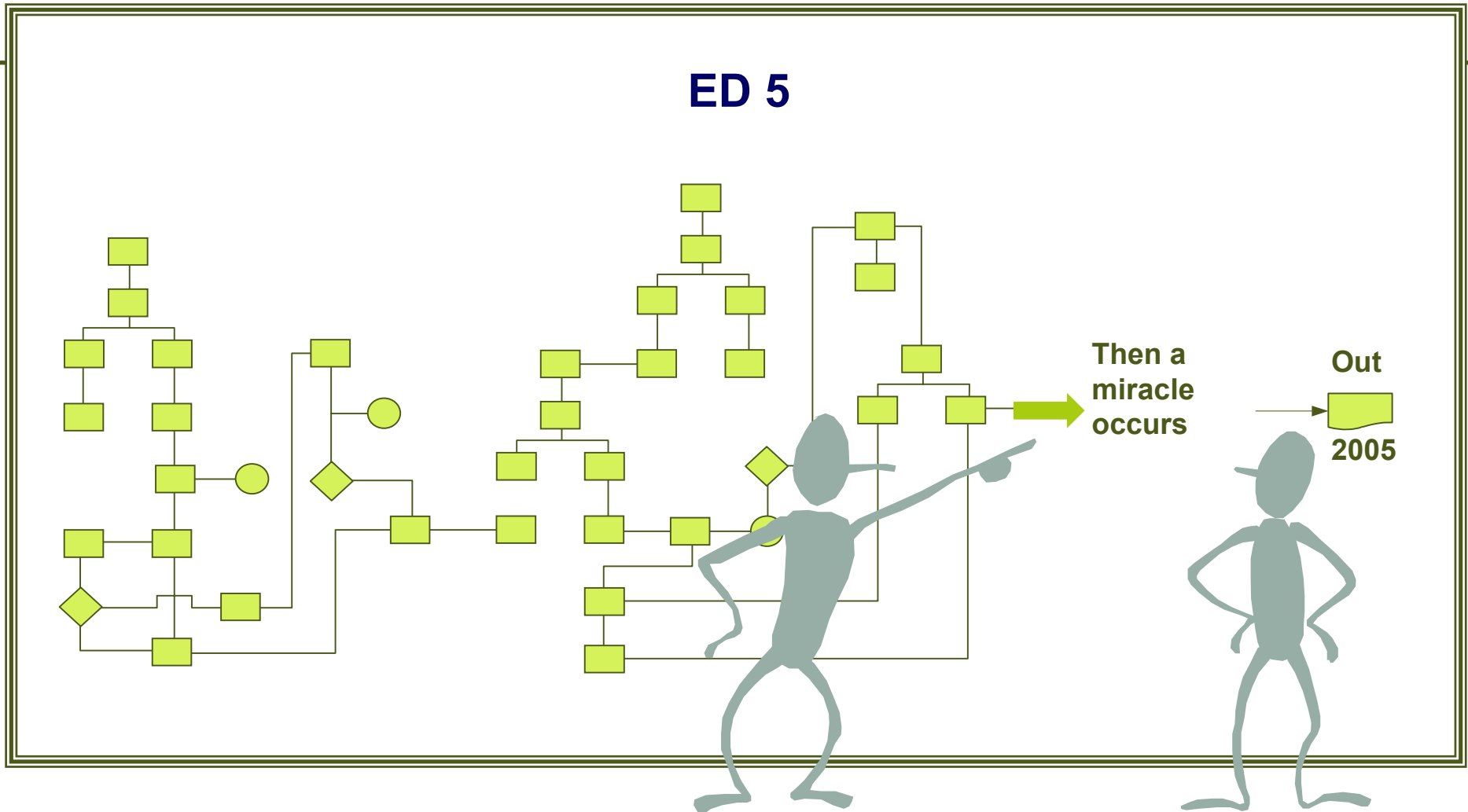
## Other decisions for Phase I

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- **No separate category of financial assets ‘held to cover insurance liabilities’ will be introduced**
- **No relaxation of the held-to-maturity or tainting requirements to allow the company to classify as H-T-M assets that it might sell in order to meet insurance liabilities**
- **On transition to ‘Phase I’, an entity already applying IAS will be permitted to reclassify a financial asset into the ‘fair value through income’ category**
- **If the company decides to implement a permitted improvement in its accounting for insurance contracts (towards fair value) is also permitted to reclassify any financial asset into the ‘fair value through income’ category**

**Asset-liability measurement mismatch and volatility will be the result  
(unless the IASB changes its mind)**

## ED 5



*“Good work . . . But can we agree on the major issues?”*

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# Thank You