Update on FASB Insurance Contracts Exposure Draft

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Update on FASB Insurance Contracts Exposure Draft

- Agenda
  - Background and Basics
  - Implementation Challenges

Background And Basics

Two Exposure Drafts

FASB

- Formed 1973
- 7 members
- Actions are taken at weekly meetings in Connecticut or London
- SEC delegates standard setting to FASB

IASB

- Formed April 1, 2001, assuming standards setting from IASC
- 16 international members (3 from USA)
- Actions are taken at monthly meetings, usually in London
- Staff is located in London and most meeting take place in London

Comparison of the Two Timelines

FASB

- Sep 2010 – Discussion Paper
- June 2013 – Exposure Draft included 48 questions covering broad range
- 2014/15? – New Standard
- 2018? – Effective Date

IASB

- Spring 2007 – Discussion Paper v2
- July 2010 – Exposure Draft
- June 2013 – Exposure Draft v2, comments only allowed on:
  - Presentation of premium
  - Unlocking CSM
  - Discount rate changes via OCI
  - Transition requirements
  - Mirroring on participating contracts
- 2014/15? – New Standard
- ? – Effective Date

"Big Bang" implementation affects all your in-force and all of your companies

IFRS Insurance Project Objectives

- Reduce diversity of accounting practices that currently exist for insurance contracts
- Align insurance accounting with other business sectors, where possible
- Increase users' understanding of insurance financial statements
- Help investors make decisions

Overview of Exposure Draft

- Principles-based approach with additional guidance
- Reflects the economics of insurance contracts
- Based on insurance contracts, not insurance companies

Goals of Exposure Draft

- A measurement model that focuses on the drivers of profitability and uses current estimates of cash flows
- Presentation of information about insurance contracts that reflects the changes in those drivers
- Consistent accounting for embedded options and guarantees in insurance contracts
- Consistency with market inputs, such as interest rates
- A coherent framework for dealing with complex and future insurance contracts

Premium Allocation Approach

- Gross Unearned Premium for short-term (one year) contracts
- Keep P&C pre-claims accounting similar to current P&C accounting

Four Building Blocks

- Current estimate of future cash flows
- Time value of money
- IFRS – Risk adjustment
- IFRS – Contractual Service Margin (CSM)
- FASB – Single Margin

Current Estimate of Future Cash Flows

- Current, use all relevant information
- Unbiased
- Explicit
- Probability weighted
  - Expected value, i.e. the mean, not the"best estimate"
  - Number of scenarios depend on product
- Exclude non-performance risk for insurer but may include non-performance risk for ceded reinsurance

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Acquisition Costs

- The 2010 ED limits acquisition costs to incremental at a policy level and only for successful sales
- This is more restrictive than other cash flows which are to be based on a portfolio of similar contracts
- The IASB has changed its mind to be less restrictive than the 2010 ED, but the FASB has not changed its view

Time Value of Money

- Consistent with current observable market prices
- Exclude factors not present in the insurance liability
  - Independent of assets held unless obligation is a direct function of a set of assets
  - Do not consider non-performance risk of insurer
- Guidance in 2010 ED is risk free plus adjustment for illiquidity (bottom up)
- IASB and FASB will now allow top down
- Any discounting would be a change for P&C

IASB – Risk Adjustment

- Compensation the insurer requires for bearing the uncertainty inherent in cash flows that arise as the insurer fulfills the insurance contract
- Designed to take into account that insurers/investors have a preference for an expected cash flow of 10 with a standard deviation of 1 versus an expected cash flow of 10 with an standard deviation of 12
- Re-measured at each period
- Not a PAD

IASB – Contractual Service Margin

- Contractual Service Margin is the plug so that there is no profit at issue
- Contractual Service Margin is re-measured for changes in future assumptions. Current year experience flows through income statement

FASB – Single Margin

- Similar to IASB Contractual Service Margin – it is the plug so that there is no profit at issue
- The FASB is not in favor of running experience changes through the margin

Differences Between FASB & IASB

- Number of margins
  - One or two
- Margin unlocking
- Acquisition costs
- Premium allocation approach
  - Optional or mandatory

Other Comprehensive Income

- Insurers required to present premiums, claims, benefits and the gross underwriting margin in income statement
- Other Comprehensive Income (OCI)
  - Changes in liability due to changes in discount rate will be reflected in OCI
  - Potential FVOCI asset category within IFRS 9

Balance Sheet

Assets	
Reinsurance assets	XXX
Other assets	XXX
Total Assets	**XXX**
Liabilities	
Insurance contract liabilities	XXX
Other liabilities	XXX
Total Liabilities	**XXX**
Total Equity	XXX
Total Liabilities and Equity	**XXX**

Statement of Comprehensive Income

Insurance contracts revenue	XXX
Incurred claims and expenses	(XXX)
Underwriting Result	**XXX**
Investment income	XXX
Interest on insurance liability	XXX
Net Interest and Investment	**XXX**
Profit or Loss	**XXX**
Effect of discount rate changes on insurance liability	(XXX)
Total Comprehensive Income	**XXX**

Revenue Presentation

- Definition of premium is different from what is commonly used today
- Under building block approach earned premium (revenue) should be consistent with Revenue Recognition standard
- Revenue stream will look like YRT premiums
- Cannot be derived from collected and doesn't affect bottom line
- When experience differs from assumed the earned premium is affected

Disclosure Requirements

- Reconciliation of income and expense
- Reconciliation of margin(s)
- Reconciliation of premiums to insurance revenue
- Inputs to determine insurance revenue
  - PV expected cash flows excluding acquisition cost
  - Amortization of acquisition costs
  - Release of margin(s)
- Claims incurred

Transition Rules

- Measure the present value of fulfillment cash flows using current estimates
- Derecognize current DAC balances
- Determine the single or CSM:
  - Through retrospective application of new principles to all prior periods where it is practical to do so
  - For earlier periods where the retrospective application is not practical, estimate the margin
- Determine the discount rate for a minimum of 3 years
  - Use difference from a reference rate for prior periods if necessary

Implementation Challenges

Polling Question #1

What has your company done to prepare for Insurance Contracts?

A. Nothing
B. Read, seminars, webcasts
C. Impact study
D. Begun implementation
E. Other, don't know, N/A (consultants, regulators, etc.)

Top 5 Implementation Challenges

- Assumption management
- Data management and version control
- Resource limitations
- Setting up new calculations and processes
- Getting comfortable with and explaining changes in the numbers

Assumption Management

- Ability to change assumption more frequently and keep track of those changes
  - Universal database vs. internal system tools
- Handling of "last minute" changes
- Knowing when to change assumptions
  - Assumption setting governance
  - Productionable experience studies

Data Management and Version Control

- Multiple new cashflows and rates to keep track of from issue/change
  - Fixed vs. asset dependent; mirrored or not
  - Locked in vs. current
- Policy changes to keep track of
- Managing increased number of portfolios
- Managing multiple projections
  - Stochastic, sensitivities, portfolios
- Need for multiple environments (test, dev, prod) with proper governance

Resource Limitations

- Time
- Dollars
- People
  - Expertise and interpretation, impact studies, transition calculations, implementation, and ultimate workload
- Systems
- Hardware
  - Scalable grid for increased projections due to portfolios, stochastic scenarios, sensitivities

Setting up New Calculations and Processes

- Interpretation
- Initial testing done on spreadsheets and ad-hoc models; moved to more controlled systems over time
  - Margins calculation and amortization
  - Discount rate, interest accretion rate, and OCI
  - Revenue presentation
- Work on your cash flow models
  - Where are deterministic models sufficient?
  - Where do you need to measure embedded guarantees?
  - Reconcile cash flow models from one period to the next
- Projecting liabilities
  - Nested stochastic issue

Polling Question #2

What is most important to you in getting comfortable that financial results are right?

A. Detailed current period reports
B. Period over period attribution analysis
C. Good controls on data and model versions
D. Sensitivity analysis
E. All equally important
F. Other, don't know, N/A

Getting Comfortable With and Explaining Changes in the Numbers

- Increased volatility
- More sensitivities
- Auditability
- Attribution analysis requires proper assumption set management and version control
- Leverage hardware and automation to allow more time for analysis

Other Implementation Concerns

- One time data and calculation exercise related to the transition
- Documentation and reporting