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Aktuarielles Controlling I

Exposure Draft IFRS 2010 *First Draft*

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1. Foreword

- The **Exposure Draft International Financial Standard *Insurance Contracts* (ED IFRS)** is set out in paragraphs 1 – 102 and Appendices A – C. All the paragraphs have equal authority. Paragraphs in **bold type** state the main principles
- In addition, the **International Accounting Standard Board (IASB)** published the **Basis for Conclusions (BC)** which contains comments on the standard
- The following presentation contains the most relevant paragraphs from the ED IFRS, some comments from the BC, some comments from other publications and some definitions from the Appendices A and B

1. Foreword

- In 2002 the IASB decided to address accounting for insurance contracts in a **two-phase project**
- In **2004** the IASB completed the **first phase** of this project by issuing **IFRS 4 *Insurance Contracts***
- Although **IFRS 4** addressed some of the more urgent issues in insurance contract accounting, it was **only a temporary solution**
- **It permits a wide variety of existing accounting practices to continue, hindering comparability for users**
 - Especially concerning the valuation of insurance contract liabilities (technical reserves) there is no uniform methodology determined in IFRS 4

1. Foreword

- In **July 2010** the IASB published the **ED IFRS** containing proposals on the
 - **recognition**
 - **measurement insurance contract liabilities**
 - **presentation**
 - **disclosure**of insurance contracts
- The **ED IFRS** is part of the **second phase** of the IASB's project on insurance contracts
- The deadline for public comments on the ED IFRS is 30. November

1. Foreword

- The **IASB aims to improve financial reporting** by issuing a high quality standard **for insurance contracts** that provides a **consistent basis for accounting for such contracts**
- The IASB expects the implementation of these improvements **to make it easier** for users of financial statements **to understand how insurance contracts affect an insurer's financial position, financial performance and cash flows**
- The proposals would also **enhance comparability across entities, jurisdictions and capital markets**

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2. Objectives, Scope and Recognition

§ 1: Objective

- The **objective of this ED IFRS** is to **establish the principles** that an entity should apply to report **useful information** to users of its financial statements **about the amount, timing and uncertainty of cash flows** from:
 - (a) insurance contracts that it issues,
 - (b) reinsurance contracts that it holds, and
 - (c) financial instruments containing discretionary participation features that it issues

2. Objectives, Scope and Recognition

§ 2: Scope

- An entity shall apply this ED IFRS to:
 - (a) **insurance contracts** (including reinsurance contracts) that it issues and reinsurance contracts that it holds
 - (b) **financial instruments** that it issues containing a **discretionary participation feature**
- Comment: § 6 states that **a reinsurance contract is a type of insurance contract**

2. Objectives, Scope and Recognition

§ 3: Scope

- **This ED IFRS does not address** other aspects of accounting by insurers, such as **accounting for their financial assets** and financial liabilities, other than those mentioned in paragraph 2(b) (see **IFRS 9 Financial Instruments**, IFRS 7 Financial Instruments: Disclosures, IAS 32 Financial Instruments: Presentation and IAS 39 Financial Instruments: Recognition and Measurement), except in the transition requirements in paragraph 102

Comments:

- The principles to value the **financial assets of an insurance company** are addressed in **IFRS 9**.
- It is planned that the definitive version of this ED IFRS and IFRS 9 become effective at the same time

2. Objectives, Scope and Recognition

Comment: § 4 contains a list of products for which this ED IFRS is not relevant

§ 5: Scope

- For ease of reference, this ED IFRS describes **any entity that issues an insurance contract as an insurer, whether or not the issuer is regarded as an insurer for legal or supervisory purposes**

Comment:

- This can imply special issues for financial institutions
 - which are no insurance companies
 - but issue insurance contracts in the sense of this ED IFRS

2. Objectives, Scope and Recognition

§ 8: Unbundling

- Some **insurance contracts contain one or more components** that would be within the scope of another IFRS ... If a component is **not closely related** to the insurance coverage specified in a contract, an insurer shall apply that other IFRS to account for that component as if it were a separate contract (i.e. shall **unbundle that component**)

§ 10: Unbundling

- An insurer shall **not unbundle** components of a contract that are **closely related to the insurance coverage** specified in the insurance contract

2. Objectives, Scope and Recognition

Comment:

- The **purpose of unbundling** is to make possible or **improve comparability** between insurers and other financial institutions which offer similar components
- The ED IFRS does not define the term “**closely related**” and so there are different interpretations possible

2. Objectives, Scope and Recognition

§ 13: Recognition

- **An insurer shall recognize an insurance contract liability or an insurance contract asset when the insurer becomes a party to the insurance contract**

§ 14: Recognition

- An insurer becomes a party to an insurance contract on the earlier of the following two dates:
 - (a) when the insurer is bound by the terms of the insurance contract, and
 - (b) when the insurer is first exposed to risk under the contract, which is when the insurer can no longer withdraw from its obligation to provide insurance coverage to the policyholder for insured events and no longer has the right to reassess the risk of the particular policyholder and, as a result, cannot set a price that fully reflects that risk

2. Objectives, Scope and Recognition

§ 15: Recognition

- **An insurer shall not recognize as a liability** or an asset any amounts relating to possible claims under future insurance contracts (such as the amounts described in some jurisdictions as **catastrophe provisions or equalization provisions**).
- **This ED IFRS does not prohibit** an entity from presenting **such amounts by appropriating retained earnings to reserves within equity**.
 - *IAS 1 Presentation of Financial Statements* requires an entity to describe the nature and purpose of each **reserve within equity**

2. Objectives, Scope and Recognition

Comment:

- This ED IFRS applies to
 - **insurance contracts and**
 - **financial instruments with discretionary participation feature (DPF)**
- The relevant definitions of insurance contract, DPF etc. are same as in IFRS 4 (see Appendix A)
- 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 if a specified uncertain future event (the **insured event**) adversely affects the policyholder

2. Objectives, Scope and Recognition

- **Insurance risk** is a risk, other than **financial risk**, transferred from the holder of a contract to the issuer
- **Financial risk** is the risk of a possible future change in one or more of a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract

2. Objectives, Scope and Recognition

- A **discretionary participation feature (DPF)** is a contractual right to receive, as a supplement to guaranteed benefits, additional benefits:
 - (a) that are likely to be a significant portion of the total contractual benefits and
 - (b) whose amount or timing is contractually at the discretion of the issuer and
 - (c) that are contractually based on:

2. Objectives, Scope and Recognition

- (c) that are contractually based on:
 - (i) the performance of a specified pool of insurance contracts or a specified type of insurance contract or
 - (ii) realized and/or unrealized investment returns on a specified pool of assets held by the issuer or
 - (iii) the profit or loss of the company, fund or other entity that issues the contract,
 - provided that there also exist insurance contracts that provide similar contractual rights to participate in the performance of the same insurance contracts, the same pool of assets or the profit or loss of the same company, fund or other entity

2. Objectives, Scope and Recognition

- An **insurance contract asset** is an insurer's net remaining contractual rights less obligations under an insurance contract, if the rights exceed the obligations
- An **insurance contract liability** is an insurer's net remaining contractual obligations less rights under an insurance contract, if the obligations exceed the rights

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3. Measurement

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3.1. Initial Measurement

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3.1.5. Time Value of Money

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3.1.7. Acquisition Costs

3.1. Initial Measurement

3.1.1. Concept

§ 17:

- **An insurer shall measure an insurance contract initially at the sum of:**
 - **(a) the expected present value of the future cash outflows less future cash inflows that will arise as the insurer fulfils the insurance contract,**
 - **adjusted for the effects of uncertainty about the amount and timing of those future cash flows (present value of the fulfillment cash flows, see paragraph 22); and**
 - **(b) a residual margin that eliminates any gain at inception of the contract**
 - **A residual margin arises when the amount in (a) is less than zero (i.e. when the expected present value of the future cash outflows plus the risk adjustment is less than the expected present value of the future cash inflows)**

3.1. Initial Measurement

3.1.1. Concept

In the Appendix A are the following definitions:

- The **present value of the fulfillment cash flows** is the expected present value of the future cash outflows less future cash inflows that will arise as the **insurer fulfils the insurance contract**, adjusted for the effects of uncertainty about the amount and timing of those future cash flows
- A **risk adjustment** is an adjustment to the expected present value of future cash flows, to capture the effect of uncertainty about the amount and timing of those cash flows

3.1. Initial Measurement

3.1.1. Concept

§ 18:

- If the **present value of the fulfillment cash flows** specified in paragraph 17(a) **is greater than zero** (i.e. the expected present value of the future cash outflows plus the risk adjustment exceeds the expected present value of the future cash inflows), **the insurer shall immediately recognize that amount in profit or loss as an expense**

3.1. Initial Measurement

3.1.1. Concept

§ 19:

- It follows from paragraphs 17 and 18 that the **measurement of an insurance contract at initial recognition** is:
 - (a) **zero, if the present value of the fulfillment cash flows is zero or less**
 - Comment: i.e. if there is a **day one profit**
 - (b) **the present value of the fulfillment cash flows, if that present value is greater than zero**
 - Comment: i.e. if there is a **day one loss**; this loss is immediately recognized as an expense in the P&L

3.1. Initial Measurement

3.1.1. Concept

§ 20:

- An insurer shall **determine the residual margin** in paragraph 17(b) at a level that **aggregates insurance contracts into a portfolio** of insurance contracts and, within a portfolio, **by similar date of inception of the contract and by similar coverage period**

3.1. Initial Measurement

3.1.1. Concept

Comment:

- According to **the ED IFRS, the liabilities of an insurance contract** are measured as the **amount required to fulfill the contractual obligations** over the lifetime of the contract **adjusted by a risk margin** to reflect the uncertainty of the cash flow projections
 - The “fulfillment amount” mentioned above is the present value of all

3.1. Initial Measurement

3.1.1. Concept

Comment:

- This present value of the cash flows plus the risk margin is called **fulfillment value**
- At the **initial measurement**
 - **day one profits** are eliminated by setting up a residual margin as an additional part of the contract liability
 - **day one losses** are immediately recognized as an expense in the P&L

3.1. Initial Measurement

3.1.1. Concept

Comment:

- Main components of contract liabilities according to **IFRS 4 Phase I** with different structures for Life and Non-Life
 - **Life:**
 - Provisions for policyholders' benefits
 - Claim reserves
 - Provisions for policyholders' participation
 - Deferred bonus reserve (Legal Quote)
 - Shadow liabilities
 - **Non-Life:**
 - Loss reserves
 - Unearned premium reserves

3.1. Initial Measurement

3.1.1. Concept

Comment:

- Main components of contract liabilities according to the ED IFRS Phase II with same structure for Life and Non-Life:
 - **Life and Non-Life:**
 - **Best estimates of future contractual cash flows**
 - Expected premiums, claims, benefits, expenses
 - **Discount rate**
 - Time value of money
 - **Risk adjustment**
 - Uncertainty concerning the amount and timing of future cash flows
 - **Residual margin**
 - Day one profit of the contract

3.1. Initial Measurement

3.1.2. Present Value of Fulfillment Cash Flows

§ 22:

- The following **building blocks** constitute the **present value of the fulfillment cash flows**:
 - (a) an **explicit, unbiased and probability-weighted estimate (i.e. expected value) of the future cash outflows less the future cash inflows** that will arise as the insurer fulfils the insurance contract (paragraphs 23–25)
 - (b) a **discount rate** that adjusts those cash flows for the time value of money (paragraphs 30–34) and
 - (c) an **explicit estimate of the effects of uncertainty** about the amount and timing of those future cash flows (risk adjustment-paragraphs 35–37)

3.1. Initial Measurement

3.1.3. Future Cash Flows

§ 23:

- Estimates of cash flows for a portfolio of insurance contracts shall include **all incremental cash inflows and cash outflows arising from that portfolio**, and shall:
 - (a) be **explicit** i.e. **separate from estimates of**
 - **discount rates** that adjust those cash flows for the time value of money and
 - **the risk adjustment** that adjusts those cash flows for the effects of uncertainty about the amount and timing of those future cash flows
 - (b) reflect the **perspective of the entity** but, for **market variables**, be consistent with observable **market prices**

3.1. Initial Measurement

3.1.3. Future Cash Flows

§ 23 (cont.):

- (c) incorporate, in an unbiased way, **all available information** about the amount, timing and uncertainty of all cash flows that will arise as the insurer fulfils the insurance contract
- (d) **be current**
 - i.e. the estimates shall reflect all available information at the measurement date
- (e) include **only those cash flows** that arise from **existing contracts**
 - i.e. cash inflows and cash outflows that arise within the boundary of those contracts - see paragraphs 26 and 27

3.1. Initial Measurement

3.1.3. Future Cash Flows

Comment:

- The term “**incremental cash flows arising from a portfolio**” is not explicitly defined in the Appendix A
- But the term “incremental acquisition costs” is defined in the Appendix A as follows:
 - **Incremental acquisition costs** are the costs of selling, underwriting and initiating an insurance contract that would not have been incurred if the insurer had not issued that particular contract, but no other direct and indirect costs
 - I.e. “**incremental acquisition costs**” are comparable with “**deferrable acquisition costs**” according to US GAAP but the definition according to the ED IFRS is more restrictive

3.1. Initial Measurement

3.1.3. Future Cash Flows

Comment:

- That is why incremental cash flows arising from a portfolio are interpreted as cash flows that would not have flowed if the insurer had not the contracts of that particular portfolio on his book
 - **I.e. incremental cash flows arising from a portfolio are induced by this particular portfolio**
- The incremental cash flows arising from a portfolio should be calculated
 - using updated **best estimate assumptions** and
 - independently from the time value of money and the risk adjustment
 - These two elements are determined on their own

3.1. Initial Measurement

3.1.3. Future Cash Flows

Comment:

- The wording “probability-weighted estimate (i.e. expected value)” can be interpreted that the cash flows should be calculated using **stochastic simulations** comparable to the calculations in Solvency II according QIS 5 and MCEV
- This implies that
 - **dynamical management rules** and
 - **reasonable policyholders’ behavior**should be implemented in the stochastic simulation so that all **options and guarantees** of the products can be modeled in a realistic manner

3.1. Initial Measurement

3.1.3. Future Cash Flows

Comment:

- **“Incremental expenses”** can be interpreted as **“policy maintenance expenses”** according to US GAAP
 - Compare the terms “incremental acquisition costs” and “other acquisition costs”
- The **“other administration expenses”** (e.g. overhead expenses) are excluded from the future cash flows and it seems that they are – analogue to the other acquisition costs - **recognized in the P&L as an expense when they incur**

3.1. Initial Measurement

3.1.3. Future Cash Flows

Comment:

- The methodology to determine the present value of the contractual cash outflows less the contractual cash inflows can be compared with the **prospective method to determine the provision for policyholders' benefits** for traditional life products:
 - **provision for policyholders' benefits =
present value of expected future benefits –
present value of expected future premiums**
- This provision can be interpreted as **that part of the present value of the benefits** (cash outflow) **which is not financed by the premiums of the insured** (cash inflow)
- This amount is a claim of the insured against the insurance company, thus it is a liability of the insurance company

3.1. Initial Measurement

3.1.4. Contract Boundary

§ 27:

- The boundary of an insurance contract distinguishes the future cash flows that relate to the existing insurance contract from those that relate to future insurance contracts
- The **boundary of an insurance contract** is the point at which an insurer either:
 - (a) **is no longer required to provide coverage**, or
 - (b) **has the right or the practical ability to reassess the risk** of the particular policyholder and, as a result, **can set a price that fully reflects that risk**
 - In assessing whether it can set a price that fully reflects the risk, an insurer shall ignore restrictions that have no commercial substance (i.e. no discernible effect on the economics of the contract)

3.1. Initial Measurement

3.1.4. Contract Boundary

BC 55:

- Clearly, the point at which the insurer is no longer required to provide coverage and the policyholder has no right of renewal is one point on the boundary of the existing contract. Beyond that point, neither party is bound

BC 56:

- Similarly, at the point at which the insurer has the right (conferred by the contract) or the practical ability (e.g. through access to claims information) to reassess the risk presented by a policyholder and, as a result, can set a price that fully reflects that risk, the insurer is no longer bound by the existing contract
- Thus, any cash flows arising beyond that point occur beyond the boundaries of the existing contract and should be related to a future contract, not to the existing contract

3.1. Initial Measurement

3.1.5. Time Value of Money

§ 30:

- An insurer shall adjust the future cash flows for the **time value of money, using discount rates** that:
 - (a) are **consistent with observable current market prices** for instruments with cash flows whose characteristics reflect those of the insurance contract liability, in terms of, for example, timing, currency and liquidity.
 - (b) exclude any factors that influence the observed rates but are not relevant to the insurance contract liability (e.g. risks not present in the liability but present in the instrument for which the market prices are observed)

3.1. Initial Measurement

3.1.5. Time Value of Money

§ 31:

- As a result of the principle in paragraph 30, **if the cash flows** of an insurance contract **do not depend on the performance of specific assets, the discount rate shall reflect the yield curve** in the appropriate currency for instruments that expose the holder to **no or negligible credit risk, with an adjustment for illiquidity** (see paragraph 34)

3.1. Initial Measurement

3.1.5. Time Value of Money

Comment:

- Paragraph 31 can be interpreted that
 - for **non-participating liabilities** the discount rate curve should be the **risk free curve plus a possible illiquidity premium**
 - for **liabilities linked to specific assets** the discount rate curve should **reflect that dependence**

3.1. Initial Measurement

3.1.5. Time Value of Money

§ 34:

- Many insurance liabilities do not have the same liquidity characteristics as assets traded in financial markets
 - **For example, some government bonds are traded in deep and liquid markets ...**
- In contrast, **policyholders cannot liquidate their investment in some insurance contract liabilities without incurring significant costs, and in some cases they have no contractual right to liquidate their holding at all (e.g. annuities in payment)**
- Thus, in estimating discount rates for an insurance contract, an **insurer shall take account of any differences between the liquidity characteristics** of the instruments underlying the rates observed in the market and the liquidity characteristics of the insurance contract

3.1. Initial Measurement

3.1.5. Time Value of Money

Comment:

- Example of
 - a **liquid insurance liability**: endowment with surrender option
 - an **illiquid insurance liability**: annuity in payment

3.1. Initial Measurement

3.1.5. Time Value of Money

Comment according to a paper of the SAV on the liquidity premium:

- **Illiquid financial instruments**, e.g. certain corporate bonds, have a **lower value than identical but liquid instruments**
- This is expressed in a **higher spread for illiquid instruments**
- The **return of an illiquid instrument** is the sum the following components:
 - **risk free return**
 - **spread** as compensation for
 - **credit risk**
 - **illiquidity**
 - **remainder**

3.1. Initial Measurement

3.1.5. Time Value of Money

Comment according to a paper of the SAV on the liquidity premium (cont.):

- For **illiquid insurance liabilities** (products without surrender option) the **liability cash flows are highly predictable**
- If these liabilities are backed by illiquid long-dated corporate bonds **the cash flows of the insurance liabilities can very well replicated by these illiquid bonds**, since it is not necessary to sell the bonds due to a surrender
- Hence **for discounting the risk free rate and in addition the illiquidity premium** can be used
- Conclusion:
 - **The illiquidity premium approach relies on held to maturity arguments that are inconsistent with a market consistent valuation standard**

3.1. Initial Measurement

3.1.5. Time Value of Money

Comment

- An illiquidity premium is allowed in Solvency II QIS 5
- An illiquidity premium is not allowed in Swiss solvency Test

3.1. Initial Measurement

3.1.6. Risk Adjustment

§ 35:

- The risk adjustment shall be the maximum amount the insurer would rationally pay to be relieved of the risk that the ultimate fulfillment cash flows exceed those expected

§ 36:

- An insurer shall estimate the risk adjustment at the level of a portfolio of insurance contracts. Therefore, the risk adjustment shall reflect the effects of diversification that arise within a portfolio of insurance contracts, but not the effects of diversification between that portfolio and other portfolios of insurance contracts

3.1. Initial Measurement

3.1.6. Risk Adjustment

§ 37:

- Appendix B provides guidance for estimating the risk adjustment (see paragraphs B67–B103).

§ B73:

- An insurer shall use **only the following techniques for estimating risk adjustments**:
 - (a) **confidence level** (paragraphs B75–B79)
 - (b) **conditional tail expectation** (paragraphs B80–B83)
 - (c) **cost of capital** (paragraphs B84–B90)

3.1. Initial Measurement

3.1.6. Risk Adjustment

§ B84: Cost of Capital

- **Cost of capital** techniques are applied for a number of purposes, for example
 - pricing insurance contracts
 - valuations in business combinations
 - regulatory reporting
 - internal capital management and
 - supplementary reporting.
- For general purpose financial reporting, a **cost of capital technique can be used to estimate a risk adjustment that reflects the uncertainty about the amount and timing of the future cash flows that will arise as an insurer fulfils its existing insurance contracts**

3.1. Initial Measurement

3.1.6. Risk Adjustment

§ B85: Cost of Capital

- **In order to fulfill an insurance contract, an insurer needs to hold and maintain a sufficient amount of capital**
- If an insurer does not have sufficient capital, it might be unable to fulfill its obligations and the policyholders would be likely to surrender their insurance contracts

3.1. Initial Measurement

3.1.7. Acquisition Costs

§ 39:

- **At initial recognition**, an insurer shall:
 - (a) **include incremental acquisition costs** in the present value of the fulfillment cash flows (see also paragraph B61(f))
 - (b) recognize **all acquisition costs other** than those identified in (a) as an **expense when incurred**

3.1. Initial Measurement

3.1.7. Acquisition Costs

§ B61 (f):

- The incremental costs of selling, underwriting and initiating an insurance contract for those contracts that have been issued and that the insurer has incurred because it has issued that particular contract (i.e. the incremental acquisition costs)
- Thus, **these costs are identified at the level of an individual insurance contract rather than at the level of a portfolio of insurance contracts**

3.1. Initial Measurement

3.1.7. Acquisition Costs

Repetition of the definition in the appendix A of the term
“incremental acquisition costs”

- **Incremental acquisition costs** are the costs of selling, underwriting and initiating an insurance contract that would not have been incurred if the insurer had not issued that particular contract, but no other direct and indirect costs
 - I.e. incremental acquisition costs are comparable with deferrable acquisition costs according to US GAAP but the definition according to the ED IFRS is more restrictive

3.1. Initial Measurement

3.1.7. Acquisition Costs

Comment:

- The **incremental acquisition costs** are according to the ED IFRS integrated into the fulfillment cash flows
 - These costs are no more shown separately as an intangible asset (“Deferred Acquisition Costs” (DAC))
 - These costs are according to the ED IFRS **part of the liabilities in reducing the residual margin**
- Activating and amortizing of these “deferrable acquisition expenses” is no more done
 - I.e. a DAC roll-forward including true up and dynamical unlocking effects does not longer exist
- The **other acquisition costs** are treated as an expense in the P&L when they incur

3.1. Initial Measurement

3.1.7. Acquisition Costs

Comment:

- The treatment of the acquisition costs according to the ED IFRS implies impacts that differ with the way the distribution channels are paid
 - Commissions to **external distribution** channels as e.g. brokers or independent agents are **incremental acquisition costs** that **influence the contract liabilities** and at the end **reduce the residual margin**
 - **Internal distribution channels** as e.g. direct marketing or salaried in-house sales force imply **other acquisition costs** that are expensed immediately when they incur
 - There is **no impact** on the **contract liabilities** and on the **residual margin**

3. Measurement

Content

3.1. Initial Measurement

3.2. Subsequent Measurement

3.3. Pre-Claims Liabilities for Short-Duration Contracts

3.4. Financial Instruments that contain Discretionary Participation Features

3.2. Subsequent Measurement

§ 47:

- The **carrying amount of an insurance contract** at the end of each reporting period shall be the **sum of**:
 - (a) **the present value of the fulfillment cash flows** at that date, and
 - (b) **the remaining amount of the residual margin**

3.2. Subsequent Measurement

§ 48:

- The **present value of the fulfillment cash flows** shall reflect **all available information** at the end of the reporting period
 - I.e. it shall reflect **current estimates** of the amount, timing and uncertainty **of the remaining future cash flows**, **current discount rates** and a **current risk adjustment**
- An insurer shall **review its estimates at that date and update** them if evidence indicates that previous estimates are no longer valid. In doing so, an insurer shall consider both of the following:
 - (a) whether the updated estimates represent faithfully the conditions at the end of the reporting period, and
 - (b) whether changes in estimates represent faithfully changes in conditions during the period

3.2. Subsequent Measurement

§ 50:

- An insurer shall **recognize the residual margin determined at initial recognition as income in profit or loss** over the coverage period in a systematic way that best reflects the exposure from providing insurance coverage, **as follows**:
 - (a) **on the basis of the passage of time**, but
 - (b) **on the basis of the expected timing of incurred claims and benefits**, if that pattern differs **significantly from the passage of time**

3.2. Subsequent Measurement

§ 51:

- An insurer shall accrete **interest on the carrying amount of the residual margin, using the discount rate specified in paragraph 30 as determined at initial recognition**

§ 52:

- **The residual margin shall not be negative**
- **Once the coverage period has ended, the residual margin is zero**
 - Hence, after that point the contract shall be measured as the present value of the fulfillment cash flows

3.2. Subsequent Measurement

§ 53:

- If **fewer contracts are in force** at the end of a period **than was expected** at the beginning of the period, the amount of the **residual margin** recognized in profit or loss during the period shall include an **adjustment to eliminate from the residual margin** at the end of the reporting period **the portion relating to contracts** that are no longer in force
- If **more contracts are in force** at the end of a period than was expected at the beginning of the period, the insurer **shall not increase the residual margin**

3.2. Subsequent Measurement

Comment:

- **At inception, the residual margin**
 - **offsets day one profits**
 - **is set to zero** if there is a day one loss

3.2. Subsequent Measurement

Comment:

- **At subsequent closings, the residual margin**
 - **is not re-measured** in an analogue way as at inception but
 - **is released over the coverage period**
 - **pro rata temporis or**
 - **based on expected claims pattern**, if this implies a different pattern
 - **bears interest** using the discount rate determined at inception
 - i.e. the interest rate is locked in at inception
 - **is proportionally reduced** if fewer contracts are in force at the end of the period as expected at the beginning

3.2. Subsequent Measurement

Comment:

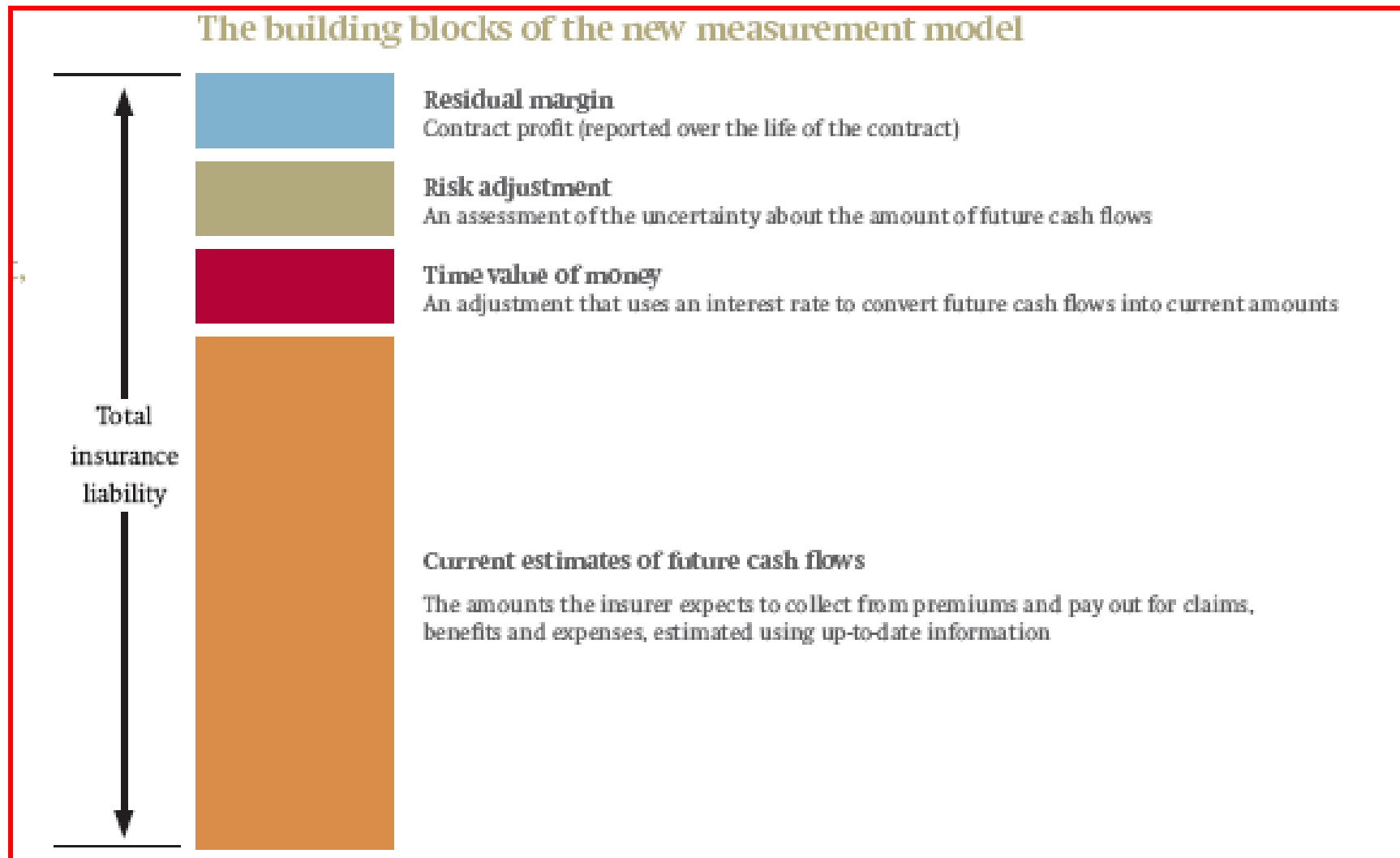
- **The release of the residual margin is recognized in the P&L**
- The residual margin does not offset changes in the expected cash flows or the risk adjustment

3.2. Subsequent Measurement

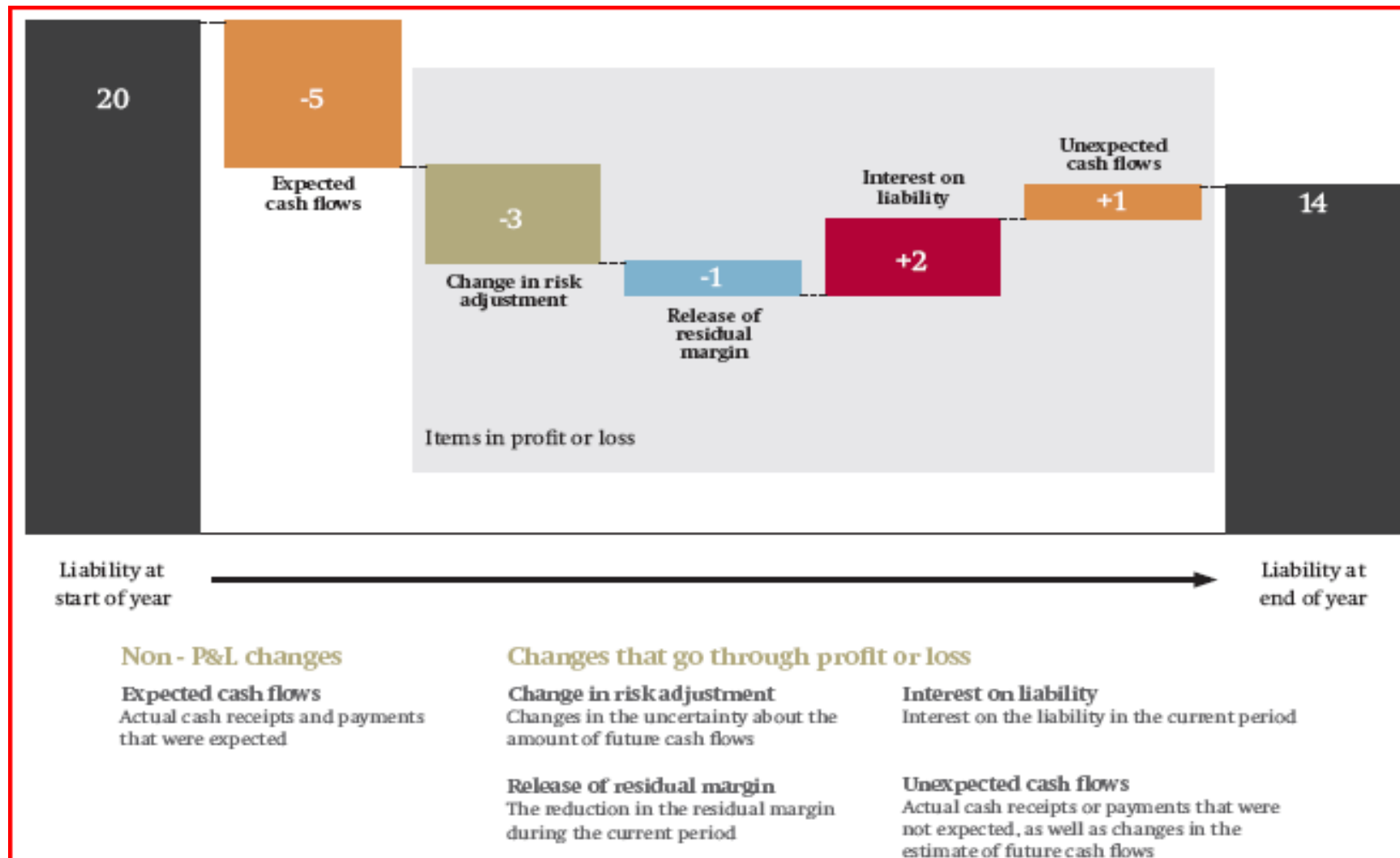
Comment:

- In general, the **change of a contract liability** during a reporting period consists of the following items
 - expected change of the cash flows
 - unexpected change the of cash flows
 - change of the risk adjustment
 - release of the risk margin
 - interest on the liability in this period
- **All these changes – except the first one, i.e. the expected changes in cash flows – are recognized in the P&L**
- The following two graphs are from the snapshot insurance contracts of the IASB

3.2. Subsequent Measurement



3.2. Subsequent Measurement



3. Measurement

Content

- 3.1. Initial Measurement
- 3.2. Subsequent Measurement
- 3.3. Pre-Claims Liabilities for Short-Duration Contracts**
- 3.4. Financial Instruments that contain Discretionary Participation Features

3.3. Short-Duration Contracts

§ 54:

- Paragraphs 55–60 apply to insurance contracts that meet both of the following conditions:
 - (a) **The coverage period of the insurance contract is approximately one year or less**
 - (b) **The contract does not contain embedded options or other derivatives** that significantly affect the variability of cash flows, after unbundling any embedded derivatives in accordance with paragraph 12
- **Comment: Both conditions are fulfilled for the majority of non-life contracts**

3.3. Short-Duration Contracts

§ 55:

- For those contracts, an insurer shall:
 - (a) measure its **pre-claims liability** by allocating premiums over the coverage period as described in **paragraphs 56–60**
 - (b) measure its **claims liability** at the **present value of the fulfillment cash flows**, in accordance with **paragraphs 22–46**

- Comment: (b) implies that the **claims liability for non-life contracts** is determined according to the **same methodology as the liability for life contracts without the residual margin**

3.3. Short-Duration Contracts

§ 56:

- The **pre-claims liability is the pre-claims obligation** (as described in **paragraphs 57 and 58**), **less the expected present value of future premiums**, if any, that are within the boundary of the existing contract

§ 57:

- For insurance contracts specified in paragraph 54, an insurer shall measure its **pre-claims obligation at initial recognition** as
 - (a) **the premium, if any, received at initial recognition, plus the expected present value of future premiums**, if any, that are within the boundary of the existing contract
 - (b) **less the incremental acquisition costs**

3.3. Short-Duration Contracts

§ 58:

- **Subsequently**, the insurer shall **reduce the measurement of the pre-claims obligation** over the coverage period in a systematic way that best reflects the exposure from providing insurance coverage, as follows:
 - (a) **on the basis of the passage of time**, but
 - (b) **on the basis of the expected timing of incurred claims and benefits**, if that pattern differs significantly from the passage of time

§ 59:

- An insurer shall **accrete interest on the carrying amount of the pre-claims liability**, using the discount rate specified in paragraph 30 (observable market rates), updated in each reporting period

3.3. Short-Duration Contracts

Comment:

- The **pre-claims obligation** is
 - **released over the coverage period**
 - **comparable with an Unearned Premium Reserve (UPR)**

3.3. Short-Duration Contracts

§ 60:

- **An insurance contract is onerous** if, at initial recognition or subsequently,
 - **the present value of the fulfillment cash flows** relating to future insured claims that are within the boundary of an existing contract **exceeds the carrying amount of the pre-claims obligation**
- **If a contract is onerous,**
 - the insurer shall **recognize an additional liability and a corresponding expense**, measured as the difference between the carrying amount of the pre-claims obligation and the present value of the fulfillment cash flows

3.3. Short-Duration Contracts

§ 60 (cont.):

- **To determine whether insurance contracts are onerous and, if applicable, to measure the amount of the additional liability**, the insurer shall **aggregate the insurance contracts into portfolio** and, within a portfolio, by **similar date of inception**
- An insurer shall **update the measurement of that additional liability** at the end of **each reporting period** and **reverse it to the extent** that the insurance contract is **no longer onerous**

3.3. Short-Duration Contracts

Comment:

- The **test for onerous contracts**
 - **is comparable with a premium deficiency test**
 - is done for portfolios of contracts with similar date of inception
 - i.e. there is no subsidizing between different “generations” of contracts
- An additional liability is updated at every closing so that the contracts are no longer onerous

3. Measurement

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- 3.1. Initial Measurement
- 3.2. Subsequent Measurement
- 3.3. Pre-Claims Liabilities for Short-Duration Contracts
- 3.4. Financial Instruments that contain Discretionary Participation Features**

3.4. Financial Instruments with DPF

§ 62:

- As specified in paragraph 2(b), **this ED IFRS applies to financial instruments that contain a discretionary participation feature**

§ 63:

- **Such financial instruments do not transfer significant insurance risk.** Therefore, some of the requirements in this ED IFRS are modified as described in **paragraphs 64 and 65** when applied to those financial instruments

3.4. Financial Instruments with DPF

§ 64:

- Paragraph 27 defines the boundary of an insurance contract
- Instead, the **boundary of a financial instrument with a discretionary participation feature** is the point at which the contract holder no longer has a contractual right to receive benefits arising from the discretionary participating feature in that contract

3.4. Financial Instruments with DPF

§ 65:

- Paragraph 50 describes the basis for the release of the residual margin
- Instead, the **residual margin for an financial instrument with a discretionary participation feature** shall be **recognized as income in profit or loss** over the life of the contract in a systematic way that best reflects the asset management services, as follows:
 - (a) on the basis of the passage of time, but
 - (b) on the basis of the fair value of assets under management, if that pattern differs significantly from the passage of time

3.4. Financial Instruments with DPF

§ 66:

- **Other requirements of this ED IFRS apply equally to a financial instrument with a discretionary participation feature**, even though those contracts do not transfer significant insurance risk
- For example, the cash flows arising from those financial instruments may be subject to uncertainty as a result of risks other than insurance risk (e.g. lapse risk and expense risk)
- If those risks are material, the present value of the fulfillment cash flows shall include a risk adjustment to reflect the risk that the ultimate cash flows may exceed those expected

3.4. Financial Instruments with DPF

§ 66 (cont.):

- But because financial instruments with discretionary participation features contracts do not transfer significant insurance risk, the application of some of the requirements in this ED IFRS may not be relevant or may not have a material effect

3.4. Financial Instruments with DPF

Comment:

- The treatment of financial instruments with DPF is according to ED IFRS differs only in the following two items from the treatment of insurance contracts:
 - Boundary of contracts (see § 64)
 - Release of the residual margin (see § 65)

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4. De-Recognition

§ 67: De-Recognition

- An insurer shall **remove an insurance contract liability** (or a part of an insurance contract liability) from its statement of financial position **when, and only when, it is extinguished**
 - i.e. **when the obligation** specified in the insurance contract **is discharged or cancelled or expires**
- At that point, the insurer is no longer at risk and is therefore no longer required to transfer any economic resources to satisfy the insurance obligation

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5. Presentation

Content

5.1. Statement of Financial Position

5.2. Statement of Comprehensive Income

5. Presentation

Comment:

- A **statement of financial position** typically include the following four basic financial statements
 - Balance Sheet
 - Income Statement (Profit and Loss Statement)
 - Statement of Retained Earnings
 - Statement of Cash Flows

5. Presentation

Comment:

- **Comprehensive income** is defined by the Financial Accounting Standards Board, or FASB, as “the change in equity [net assets] of a business enterprise during a period from transactions and other events and circumstances from non-owner sources. It includes all changes in equity during a period except those resulting from investments by owners and distributions to owners.”

Source: Wikipedia

5.1. Statement of Financial Position

§ 69:

- **An insurer shall present each portfolio of insurance contracts as a single item within insurance contract assets or insurance contract liabilities**

§ 70:

- **An insurer shall not offset reinsurance assets against insurance contract liabilities**

Comment:

- The presentation should be done gross regarding reinsurance
- Same procedure as in US GAAP and IFRS 4, i.e. no change

5.1. Statement of Financial Position

§ 71:

- **An insurer shall present:**
 - **(a) the pool of assets underlying unit-linked contracts as a single line item, and not commingle it with the insurer's other assets**
 - **(b) the portion of the liabilities from unit-linked contracts linked to the pool of assets in (a) as a single line item and not commingle it with the insurer's other insurance contract liabilities**

Comment:

- The assets and liabilities of traditional contracts and unit-linked contracts should be presented separately

5. Presentation

Content

5.1. Statement of Financial Position

5.2. Statement of Comprehensive Income

5.2. Statement of Comprehensive Income

§ 72:

- At a minimum, an insurer shall include for insurance contract line items in its statement of comprehensive income that present the following amounts for the period:
 - (a) **underwriting margin**, disaggregated either in the statement of comprehensive income or in the notes into:
 - **(i) the change in risk adjustment**
 - **(ii) the release of residual margin**

5.2. Statement of Comprehensive Income

§ 72 (cont.):

- (b) **gains and losses at initial recognition**, disaggregated either in the statement of comprehensive income or in the notes into:
 - (i) **losses on insurance contracts acquired in a portfolio transfer** (see paragraph 40(b)).
 - (ii) **gains on reinsurance contracts bought** by a cedant (see paragraph 45(b)).
 - (iii) **losses at initial recognition of an insurance contract** (see paragraph 18).
- (c) **acquisition costs that are not incremental** at the level of an individual contract (see paragraph 39(b)).

5.2. Statement of Comprehensive Income

§ 72 (cont.):

- (d) **experience adjustments and changes in estimates**, disaggregated either in the statement of comprehensive income or in the notes into:
 - (i) **differences between actual cash flows and previous estimates of those cash flows** (i.e. experience adjustments)
 - (ii) **changes in estimates of cash flows and changes in discount rates**
 - (iii) **impairment losses on reinsurance assets**
- (e) **interest on insurance contract liabilities**

5.2. Statement of Comprehensive Income

§ 73:

- The changes in estimates of discount rates and the interest on insurance liabilities shall be presented or disclosed in a way that highlights their relationship with the investment return on the assets backing those liabilities

5.2. Statement of Comprehensive Income

§ 74:

- An insurer **shall not present in the statement of comprehensive income, except as noted in paragraph 75(a):**
 - (a) **premiums**
 - which instead are treated in the same way as deposit receipts; and
 - (b) **claims expenses**
claims handling expenses
incremental acquisition costs and
other expenses included in the measurement of the insurance contract,
 - which instead are treated in the same way as repayments of deposits

5.2. Statement of Comprehensive Income

§ 75:

- For some **short-duration contracts**, the **pre-claims liability** is measured in accordance with paragraphs 56–60.
- For those contracts, an insurer shall, in addition to the applicable line items in paragraph 72, include in its statement of comprehensive income line items that present the following amounts from insurance contracts for the period:

5.2. Statement of Comprehensive Income

§ 75 (cont.):

- (a) the **underwriting margin**, disaggregated either in the statement of comprehensive income or in the notes into:
 - (i) **premium revenue**, determined as the gross release of the pre-claims obligation
 - i.e. grossed-up for the amortization of incremental acquisition costs, see paragraph 57(a)
 - (ii) **claims incurred**
 - (iii) **expenses incurred**
 - (iv) **amortization of incremental acquisition costs** included in the pre-claims obligation (see paragraph 57(b))
- (b) **changes in additional liabilities for onerous contracts** (see paragraph 60)

5.2. Statement of Comprehensive Income

§ 76:

- **An entity shall present all income and expense from insurance contracts in profit or loss**

§ 77:

- **An insurer shall not offset income or expense from reinsurance contracts against the expense or income from insurance contracts**

Comment:

- The presentation should be done gross regarding reinsurance
- Same procedure as in US GAAP and IFRS 4, i.e. no change

5.2. Statement of Comprehensive Income

§ 78:

- **An insurer shall present income and expense from:**
 - **(a) unit-linked contracts as a single line item, and not commingle them with income and expense from the insurer's other insurance contract liabilities**
 - **(b) the pool of assets underlying unit-linked contracts as a single line item, and not commingle them with income or expense from the insurer's other assets**

Comment:

- The income and expense of traditional contracts and unit-linked contracts should be presented separately

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6. Disclosure

§ 79:

- **To help users of financial statements understand the amount, timing and uncertainty of future cash flows arising from insurance contracts, an insurer shall disclose qualitative and quantitative information about:**
 - **(a) the amounts recognized in its financial statements arising from insurance contracts (see paragraphs 85–90); and**
 - **(b) the nature and extent of risks arising from insurance contracts (see paragraphs 91–97)**

§ 80:

- If the disclosures required by this ED IFRS and other IFRSs do not meet that objective in a particular situation, an insurer shall disclose whatever additional information is necessary to meet that objective
-

6. Disclosure

§ 82:

- An insurer shall provide sufficient information to permit reconciliation to the line items presented in the statement of financial position

§ 85:

- **An insurer shall disclose information about the amounts recognized in its financial statements in sufficient detail to help users of its financial statements evaluate the timing, amount and uncertainty of future cash flows arising from insurance contracts, including:**
 - (a) reconciliation from the opening to the closing aggregate contract balances (see paragraphs 86–89)
 - (b) the methods and inputs used to develop the measurements (see paragraph 90)

6. Disclosure

§ 86:

- To comply with paragraph 85(a), an insurer shall disclose a reconciliation from the opening to the closing balance of each of the following, if applicable:
 - (a) insurance contract liabilities and, separately, insurance contract assets
 - (b) risk adjustments included in (a)
 - (c) residual margins included in (a)
 - (d) reinsurance assets arising from reinsurance contracts held by the insurer as cedant
 - (e) risk adjustments included in (d)
 - (f) residual margins included in (d)
 - (g) impairment losses on reinsurance assets

6. Disclosure

§ 87:

- For each reconciliation required by paragraph 86, an insurer shall show, at a minimum, each of the following, if applicable:
 - (a) the carrying amounts at the beginning and end of the period
 - (b) new contracts recognized during the period
 - (c) premiums received
 - (d) payments, with separate disclosure of:
 - (i) claims and benefits
 - (ii) expenses
 - (iii) incremental acquisition costs

6. Disclosure

§ 87 (cont.):

- (e) other cash paid and, separately, other cash received
- (f) income and expense, reconciled to the amounts disclosed to comply with paragraphs 72 and 75
- (g) amounts relating to contracts acquired from, or transferred to, other insurers in portfolio transfers or business combinations
- (h) net exchange differences arising on the translation of foreign currency amounts into the presentation currency

6. Disclosure

§ 88:

- For short-duration contracts measured using the measurement described in paragraphs 54–60, an insurer shall disclose the reconciliation required by paragraph 86 separately for:
 - (a) pre-claims liabilities
 - (b) additional liabilities for onerous insurance contracts
 - (c) claims liabilities

§ 89:

- For those contracts for which uncertainty about the amount and timing of claims payments is not typically resolved fully within one year, an insurer shall disclose the claims and expenses incurred during the period
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7. Effective Date and Transition

§ 98:

- The transition requirements in paragraphs 99–102 apply both to an insurer that applies IFRSs when it first applies this ED IFRS and to an insurer that applies IFRSs for the first time (a first-time adopter)

§ 99:

- An insurer shall apply this ED IFRS for annual periods beginning on or after [date to be inserted after exposure]
- If an insurer applies this ED IFRS for an earlier period, it shall disclose that fact

7. Effective Date and Transition

Comment:

- It is planned to finalize IFRS *Insurance Contracts* in 2011
- It is planned to introduce IFRS *Insurance Contracts* in 2013

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8. Example

Example 1 – Initial measurement of insurance contracts

- An insurer issues an insurance contract, receives CU50 as the first premium payment and incurs acquisition costs of CU70, of which incremental acquisition costs are CU40
- The insurer estimates an expected present value (EPV) of subsequent premiums of CU950 and a risk adjustment of CU50
- In example 1A, the insurer estimates that the EPV of future claims is CU900
- In Example 1B, the insurer estimates that the EPV of claims is CU920

8. Example

- The present value of the fulfillment cash flows is the difference between the EPV of cash inflows (CU1,000) and the EPV of fulfillment cash outflows (CU940 in Example 1A and CU960 in Example 1B), less the risk adjustment (CU50)
- At initial recognition, the insurer would measure the insurance contract as follows:

8. Example

	Example 1A	Example 1B
	CU	CU
EPV of cash outflows	940	960
Risk adjustment	50	50
EPV of cash inflows	<u>(1,000)</u>	<u>(1,000)</u>
Present value of the fulfilment cash flows	(10)	10
Residual margin	<u>10</u>	<u>0</u>
Liability at initial recognition	<u><u>0</u></u>	<u><u>10</u></u>

8. Example

The effect on profit or loss will be the following:

Loss at initial recognition	0	10
Non-Incremental acquisition costs (CU70–CU40)	30	30
Loss	<u>30</u>	<u>40</u>

8. Example

- Immediately after initial recognition, the carrying amount of the insurance contract liability changes as follows because of the cash flows (first premium and incremental acquisition costs) arising on the day of initial recognition (see paragraph 24):

8. Example

EPV of cash outflows	900	920
Risk adjustment	50	50
Residual margin	10	0
EPV of cash inflows	(950)	(950)
	<hr/>	<hr/>
Liability immediately after initial recognition	10	20
	<hr/> <hr/>	<hr/> <hr/>