# IFRS Presentation

Actuaries’ Club of the Southwest

# IFRS Presentation Outline

- IFRS Timeline
- “Preliminary Views” Overview and Basics
- SOA Study and sample results
- Responses to IASB
- Food for Thought
- Questions

Given that IFRS is the financial reporting standard that has been or will soon be adopted by virtually all countries excluding the US, the transition to IFRS in the US appears inevitable, the question being "when" vs. "if". Consider the following:

Globalization of business and finance is leading to calls for a common set of high-quality, global accounting standards.

IFRS offers a solution to the complexity of the current US GAAP model

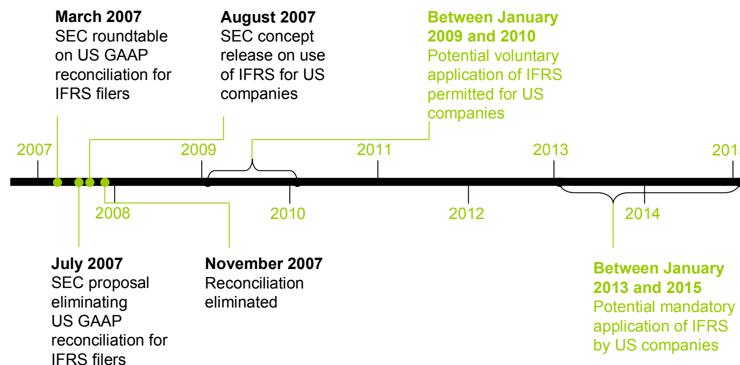
Companies are achieving cost efficiencies by adopting IFRS, implementing a single financial reporting framework across all jurisdictions for external, statutory and tax reporting

The US Congress, the SEC and the various US exchanges are seeking to increase the competitiveness of the US capital markets

Principles based reporting, without the burden of rules and interpretative baggage, encourages more focus on underlying economics

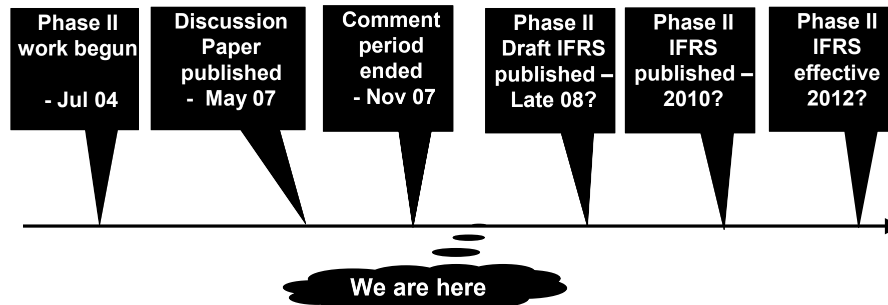


# When might the US transition to IFRS ?



# IFRS Insurance Contracts Phase II
## Status Update

- Current situation for accounting for insurance contracts is a mixed model (IFRS 4 defers to Local standards)
- Resulted in too much diversity, less relevance and reliability, and inconsistency
- The IASB started with a clean slate to develop Phase II
- Modified joint project with FASB (US GAAP convergence)






# 2. Preliminary Views and Exit Value Basics

## Insurance Liability Measurement

- "Preliminary Views on Insurance Contracts" was released by the IFRS in May 2007.
- Search for fundamental principles underlying the accounting basis
- Paragraph 93 of the paper defines "Exit Value":
  - The amount the insurer would expect to pay to transfer its remaining contractual rights and obligations to another party.
  - Similar to Fair Value



## What is Exit Value?

- Exit Value is determined by measuring insurance liabilities using three building blocks:
  1. Cash flows
  2. Time value of money
  3. Margins

## Cash Flows (Paragraph 34)

(a) are explicit
(b) are as consistent as possible with observable market prices
(c) incorporate, in an unbiased way, all available information about the amount, timing and uncertainty of all cash flows arising from the contractual obligations



## Cash Flows (Paragraph 34)

(d) are current, in other words they correspond to conditions at the end of the reporting period …use all available information
(e) exclude entity-specific cash flows. Cash flows are entity-specific if they would not arise for other entities holding an identical obligation
(f) are “probability-weighted” (Par. IN18)

## Time Value of Money (Paragraph 63/69)

- Use “current market discount rates that adjust the estimated future cash flows for the time value of money.”
- **Don’t** use existing portfolio of assets
- “the discount rate should be consistent with observable current market prices for cash flows where characteristics match those of the insurance liability, in terms of timing, currency and liquidity.”
- Readers believe this to be a risk-free rate



## Margins (Paragraph 71)

“an explicit and unbiased estimate of the margin that market participants require for bearing risk (a risk margin) and for providing other services, if any (a service margin).”

KEY WORDS

- Explicit
- Unbiased

## Risk Margins Purpose

- Risk margins provide for:

  "An explicit and unbiased measurement of the compensation that entities demand for bearing risk."
- Must be estimated since, typically, they cannot be observed
- Assess how market participants would measure risk
- Not for conservatism



## Risk Margins

- Approach to estimate risk margins
  - Should be explicit, not implicit
  - Should reflect all risks associated with the liability
  - Should not reflect risks that do not arise from the liability, such as investment risk
  - Should be as consistent as possible with observable market price

## Risk Margins

- Estimate Risk Margins using appropriate combination of:
  - Observed market prices for similar contracts
  - Pricing models
  - Other inputs if available:
    - Prices for similar new contracts
    - Reinsurance prices
    - Prices for insurance – linked securities
    - Prices for business combinations or portfolio transfers



## Risk Margins

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

## Risk Margins

- Cost of capital approach
  - Determine the amount of capital backing the liabilities; could use
    - Regulatory capital, or
    - Economic capital
  - Determine the cost of holding that capital
    - Cost of capital as required by the market
    - Cost of capital = % CoC × capital required
  - Risk Margin = PV of Cost of capital



## Risk Margins – Implementations B and A

- Implementation B – exit value
  - Slightly preferred by IASB
- Implementation A – entry value
  - Risk margins are recalibrated so there is no gain at issue

## Service Margins

- Per IASB staff, “service margins” would normally be included in cash flows and margins
- It was given its own paragraphs to ensure it wasn’t overlooked
- Again this is an explicit, unbiased estimate



## Key open issues

| Issue | Discussion Paper | Alternative View |
|---|---|---|
| Day 1 gain | • Exit value model<br>• Calibrate risk margins to hypothetical market<br>• Day 1 gain may be appropriate in certain markets | • Entry value model<br>• Calibrate risk margins to premiums charged to policyholder<br>• Liability adequacy test required |
| Premium recognition | • Only premiums required to “guarantee insurability” should be recognized in liability<br>• “Beneficial policyholder behaviour” should not be anticipated | • Liability should consider all expected cash flows<br>• History provides that premiums in excess of minimum are paid |
| Discount rate | • Current market risk-free rates from replicating portfolio<br>• Independent of returns based on investment strategy | • Discount rates should reflect the returns expected by market participant |

## 3. SOA Research Report

## SOA Numerical Examples

- Society of Actuaries Study
  - Completed February, 2008
  - Commissioned by American Academy of Actuaries for their response to IASB
  - 15 companies
  - 20 Submissions
  - 80 pages
  - Available on SoA website
    - www.soa.org/research/research-life.aspx

## Products Covered

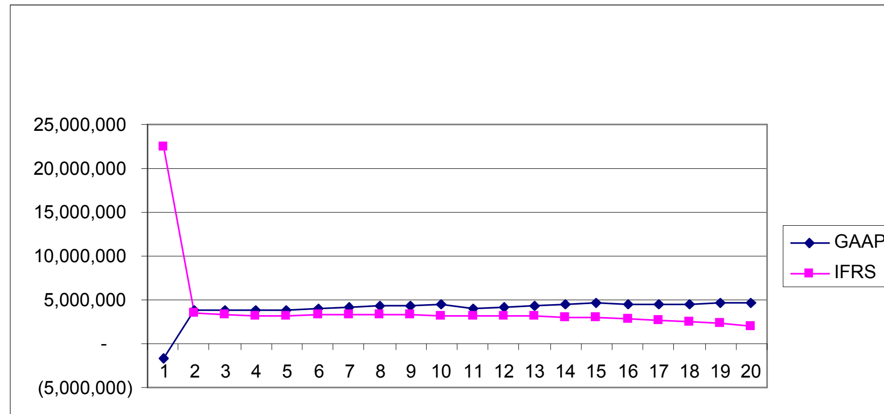
- Traditional life (Term)
- Universal life (UL)
- Variable universal life (VUL)
- Single premium fixed deferred annuity (SPDA)
- Variable deferred annuity
- Single Premium Immediate Annuity (SPIA)
- Long-term care
- Supplemental health (medical)



## Deliverables

- Existing business and new business
- US GAAP – balance sheet and income statement
- IFRS – balance sheet and income statement
- Alternative scenarios
- Observations

# Term – GAAP and IFRS – Income



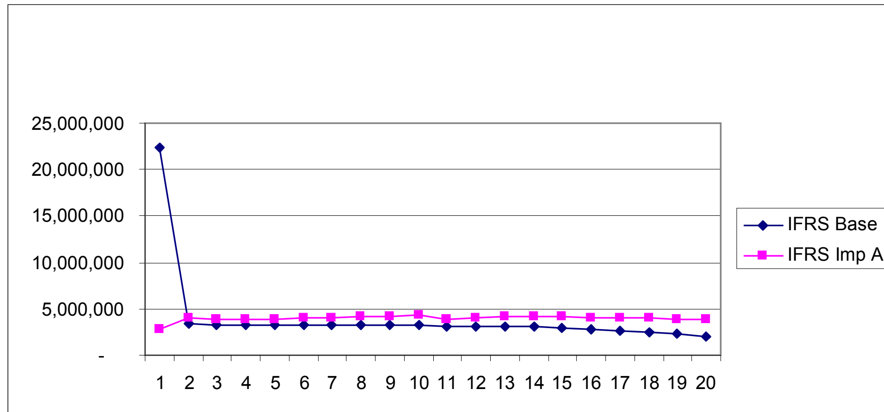

First year premium = $28,000,000



# Term – Comment on First Year Earnings

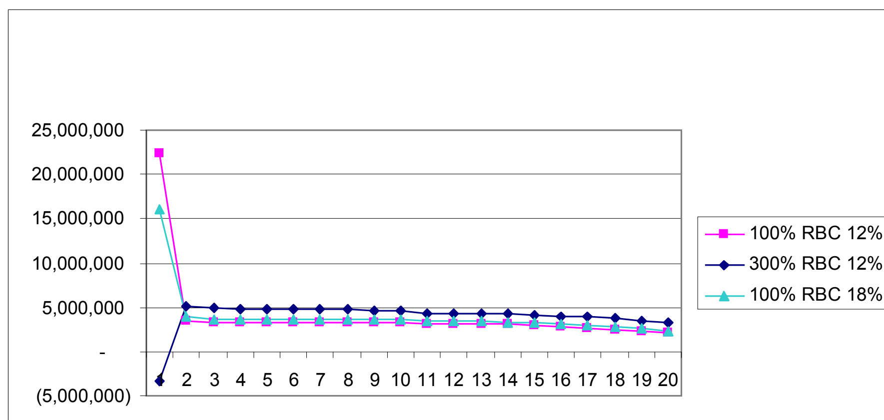
- GAAP – first year non-deferrable costs of $5.5 million cause a loss
- IFRS – day one gains are $21 million; days 2–365 gains are $2 million

# Term – IFRS “B” and “A” – Income

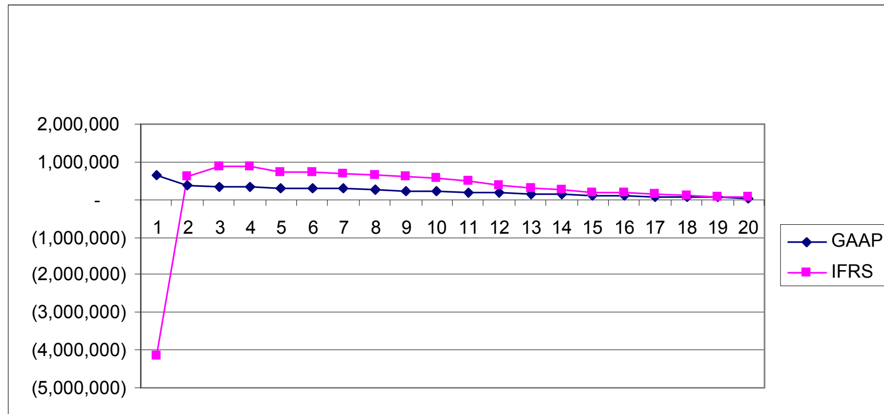





# Term – Risk Margin Sensitivity – Income



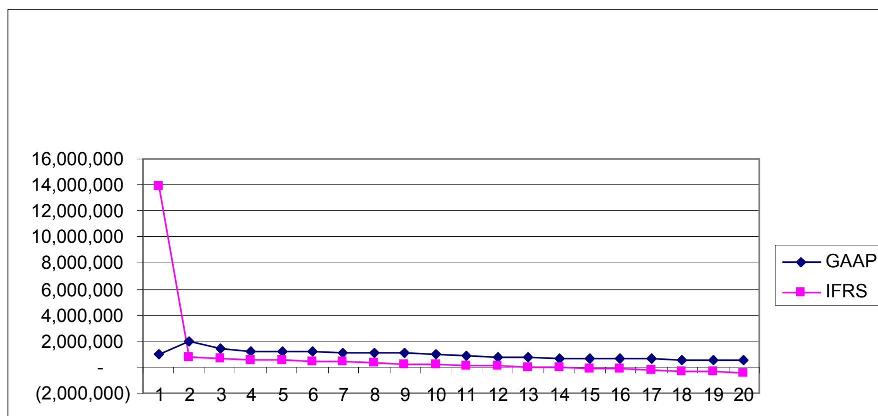
# SPIA – GAAP and IFRS – Income




Premium = $117 million

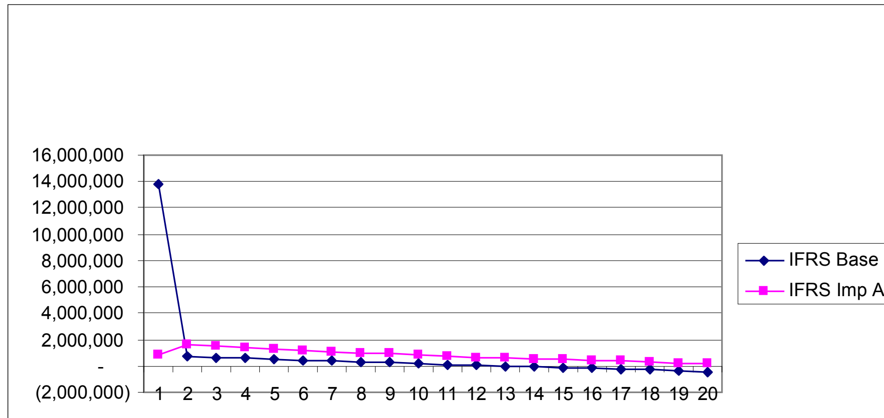


# Health GAAP and IFRS – Income



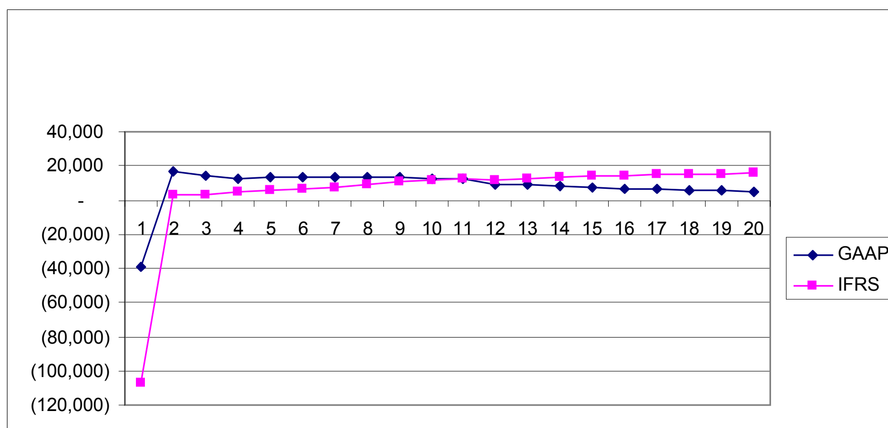

First year premium = $3.2 million

# Health IFRS "B" and "A" – Income



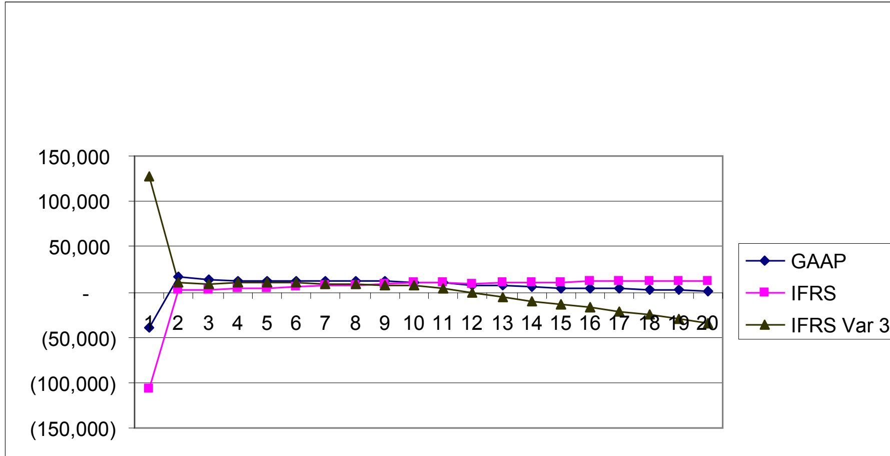



# Par Whole Life GAAP & IFRS – Income



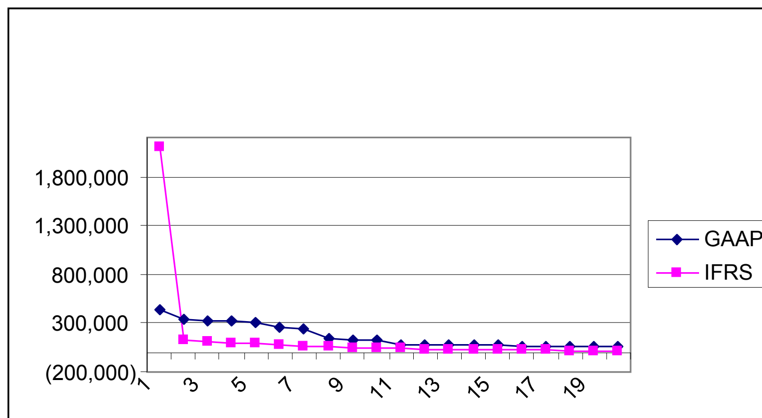

First year premium = $133,000

# Par Whole Life – Exclude Dividend – Income



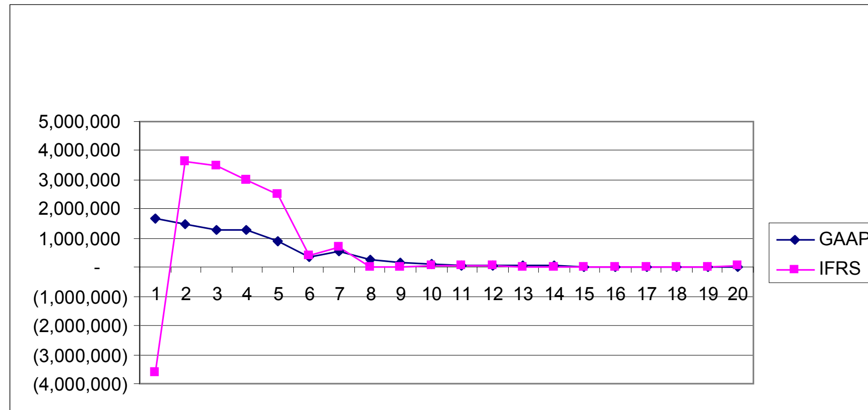



# Variable UL GAAP and IFRS – Income




First year premium = $3.2 million

## SPDA GAAP and IFRS – Income




Premium = $3.2 million



## Summary

- Income varies dramatically by product
- Products that derive a significant portion of their profits from investment income will show lower profits, or losses, in year one
- Products with significant sources of profits other than investment income portray a larger year one income
- Initial and subsequent profitability is extremely impacted by choice of methods and assumptions to determine risk margins

# 4. Responses to IASB

## Responses as of January 2008

- Available at www.IASB.org
  - Click on (left-hand column):
    - IASB projects and work plan, then
    - Insurance contracts, then
    - Discussion paper, then
    - Comment letters
  - 151 responses, 2,000 pages

## Deloitte (Worldwide Audit Firm)

- Market data must be available and relevant; use entity-specific
- Margins need further elaboration and should address explicit profits
- Use all relevant cash flows
- Gains/losses at issue is acceptable



## Ernst & Young (Worldwide Audit Firm)

- Why not these principles for *all* industries?
- Not supportive of Exit Value
  - Hypothetical
  - Doesn't reflect actual cash flows
- Can't assess quality of earnings
  - Source of earnings
  - Identify impacts of judgment
- Focus on entity's own value and entity's principal market – the customer

## KPMG (Worldwide Audit Firm)

- Generally supportive
- Less emphasis on market participants' views and more on internal information
- Risk margins – little or no consensus, so use entity-specific
- "Exit Value" as defined wouldn't produce a transaction price – so don't call it exit value



## PricewaterhouseCoopers 1 of 2 (Worldwide Audit Firm)

- Affirm consistency with other IASB initiatives
- Consult more widely with affected parties and field test
- Reliability of data is dependent on an assessment of a transaction in a hypothetical market
- Hypothetical basis – does not meet the needs of users for transparency
- Is exit value relevant?

## PricewaterhouseCoopers 2 of 2 (Worldwide Audit Firm)

Changes to building blocks

- Cash flows
  - Include all cash flows
  - Consider market value only when directly observable
- Discount rates – drop liquidity adjustment
- Margins – needs more work
  - How to select? Not observable
  - Portfolio vs. entity
  - Why service margin?



## 5. Food for Thought

# IFRS Business implications

- **Competitiveness**
- Product pricing is influenced by return on equity considerations
- In the US, capital is currently independent of the conservatism in policyholder liabilities (VA CARVM is upcoming exception)
- Solvency II (linked to IFRS) will link product economics, liabilities and capital
- Opportunities to "arbitrage" alternative capital requirements available globally may exist
- In the past (as with offshore reinsurance) these arbitrage opportunities have been limited to territories with limited capital investors, meaning earnings needed to be repatriated for distribution
- Solvency II may allow EU-based companies the opportunity to arbitrage capital without repatriation leading to a change in the competitive landscape.



# IFRS Business implications

- **Increased reliance on models**
- Trend toward fair value accounting models increases the importance of liability models
- Liability models that are sufficiently robust for stochastic analysis can be unwieldy
- Economic capital models are now being developed on desk tops. These models will not be able to support future needs
- Governance structures over liability models need to be evaluated based on anticipated future demands from changes in accounting and solvency regulations
- UK and Canadian companies have begun to house liability models centrally to increase processing speeds and tighten controls

Questions