Insurance contracts

Overview of the IASB revised exposure draft and comparison to SAM

QUANTIFYING RISK, ENABLING OPPORTUNITY

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Measurement model
Building block approach

- One model for all insurance contracts.
- Explicit margins as part of liability. Day 1 loss in income statement, no day 1 gain.
- Combination of rights and obligations (considers cash inflows and outflows).

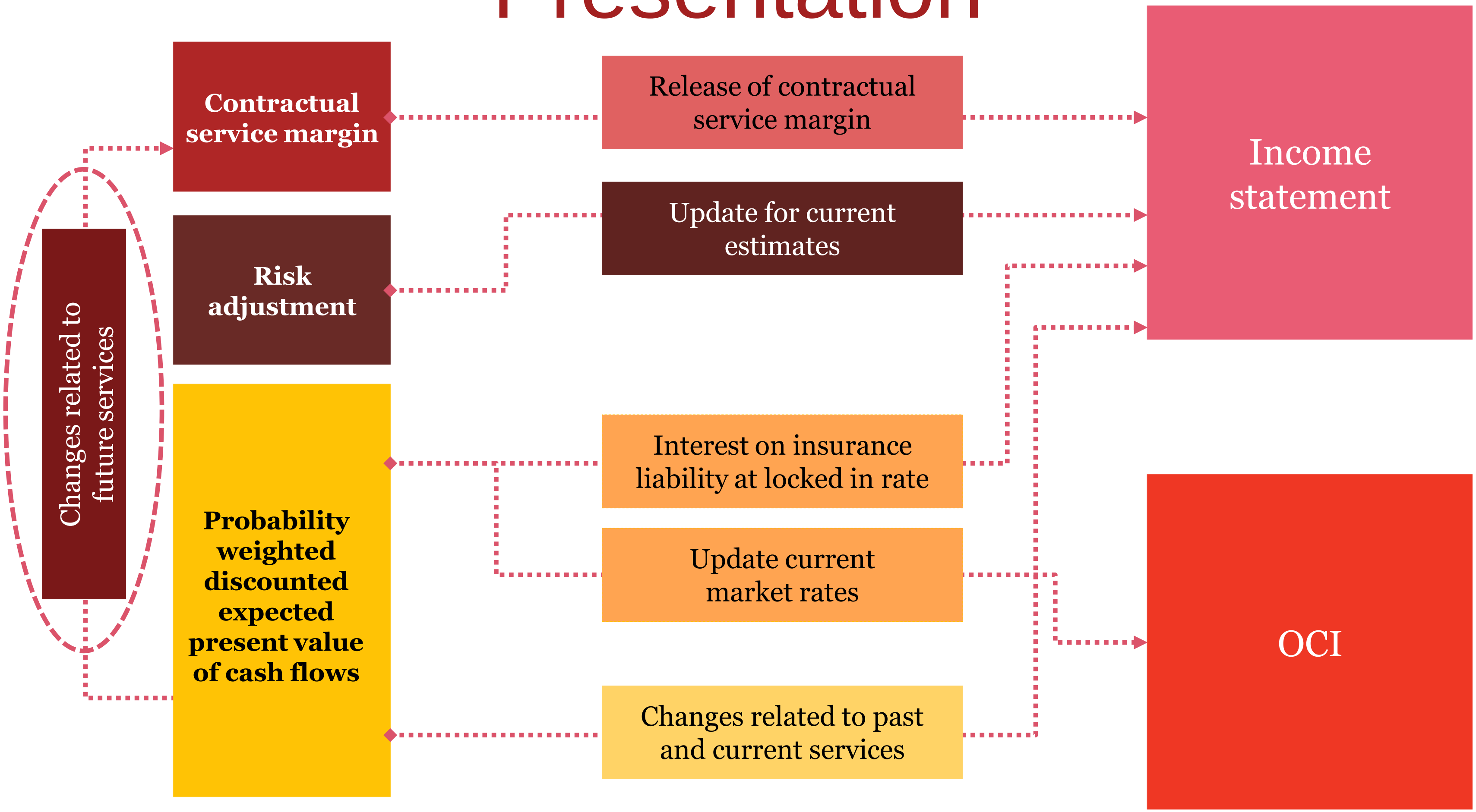
	Contractual service margin	Unearned profits recognised over life of contract
Present value of the fulfilment cash flows	**Risk adjustment**	Reflect compensation for uncertainty. Quantifies the value difference between certain and uncertain liability. No prescribed methodology given.
	Discounting	Discounting future cash flows using "top-down" or "bottom-up" approach to reflect characteristics of the liabilities
	Best estimate of fulfilment cash flows	Best estimate cash flows – explicit, unbiased and probability weighted estimate of fulfilment cash flows

- Optional simplified model for pre-claim liabilities based on the unearned premium. Applies to short duration contracts (period cover <1 year) or where the approach is a reasonable approximation.

Measurement model
Premium allocation approach

- Simplification for liability for remaining coverage
- Liability for incurred claims according to BBA
- Premium allocation approach is optional
- Applies when:
  - Reasonable approximation of the building block model; or
  - Coverage period 12 months or less
- Reasonable approximation when entity expects no significant variability in cash flows

Measurement model Presentation



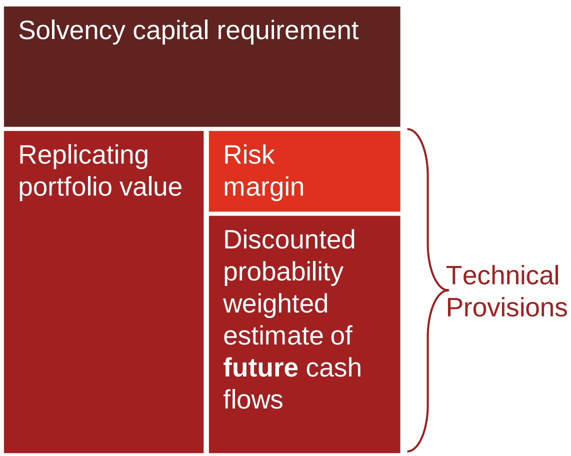
Overview of the ED proposals
Targeted re-exposure

1	***Transition***	• Retrospective application with new practical expedients
2	***Participating / unit linked contracts***	• Splitting cash flows into those that vary directly with cash flows on underlying assets and those that do not. Measure and present directly varying cash flows in line with the underlying assets ('mirroring')
3	***Contractual service margin unlocking***	• Re-measured prospectively for changes in future cash flow estimates • Amendments to amortisation pattern to reflect change in pattern of transfer of services
4	***OCI***	• Changes in discount rates for liability recognised in OCI rather than P&L (where mirroring does not apply and no options and guarantees)
5	***Income statement presentation***	• Premiums and claims in the income statement • Earned premium model
6	***Unbundling***	• Unbundling for measurement based on 'distinct' investment components and goods and services • Non-distinct investment components disaggregated for premium presentation

Many issues identified with the 2010 Exposure Draft have developed significantly.
Changes 1 to 5 are the target areas for the 2013 Exposure Draft

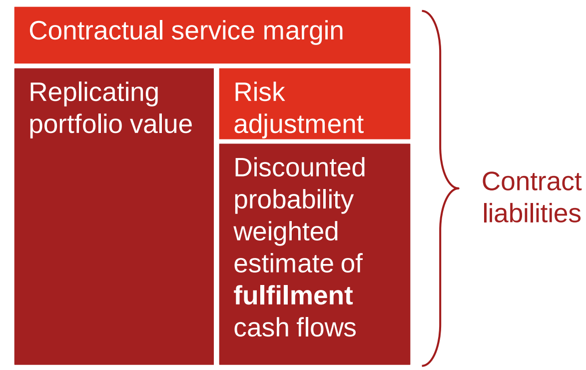
SAM versus IFRS for insurance contracts - Contract liabilities

SAM



- Risk margin = Sets the technical provisions as the expected amount required to take over and meet the obligations.
- As a regulatory regime, there is a capital requirement– the Solvency Capital Requirement (SCR).

IFRS – Insurance Contracts as defined



- Risk adjustment = Compensation the entity requires for bearing the uncertainty about the amount and timing of the cash flows that arise as the entity fulfils the contract.
- Contractual service margin represents unearned profit in contract.
- Certain acquisition costs are included in the fulfilment cash flows resulting in implicit deferral of these costs.

SAM versus IFRS for insurance contracts

Topic	IFRS	SAM	Significance	Observations
Definition and scope	Insurance and participating investment	All contracts		• The measurement of investment contracts in IFRS may be significantly different to SAM. • Certain fixed-fee contracts scoped out.
Recognition	Date coverage begins (plus onerous contact test for earlier)	Date party to contract		• Significance of any difference will depend on the onerous contract test in IFRS. For many short term contracts the recognition will be the same.
Separating components from an insurance contract	Distinct investment components, embedded derivatives and certain goods and services (e.g. asset management services)	No		• Potential requirement to separate asset management and other service components in IFRS could be a difference to SAM. • Revenue items are not presented on the IFRS income statement for non-distinct investment components.

SAM versus IFRS for insurance contracts

Topic	IFRS	SAM	Significance	Observations
Contract boundary	No longer required to provide coverage or contract does not confer any substantive rights to policyholder	Amend terms to 'fully reflect risk' No projection of premiums for savings contracts		• In SAM (unlike IFRS), there is a requirement to separate contracts into components, where the contract boundary differs between components. • Devil will be in the detail as the distinct definitions for SAM and IFRS are considered in view of contract terms.
Cash flows (excluding acquisition)	Incurred directly to fulfil portfolio of contracts	Prescribed		• Potential risk of differences in certain cash flows, for example, certain overheads expenses and tax.
Acquisition costs	Directly attributable at portfolio level	Expensed as incurred		• In IFRS, there is "implicit" deferral of acquisition costs. There is no equivalent concept in SAM.

SAM versus IFRS for insurance contracts

Topic	IFRS	SAM	Significance	Observations
Discount rate	Top down or bottom up (current and locked-in for OCI purposes)	Prescribed risk-free		• The discount rate remains one of the most significant areas of uncertainty in SAM. It is unclear how the prescribed SAM discount rate will compare to the principle-based approach in IFRS. • No concept of locking-in/OCI in SAM.
Risk adjustment	No prescribed method (fulfilment value)	Prescribed cost of capital (transfer value)		• The SAM risk margin is prescribed, while the IFRS risk adjustment is principle-based. It is likely that there will be differences in the two approaches.

SAM versus IFRS for insurance contracts

Topic	IFRS	SAM	Significance	Observations
Contractual service margin	Eliminate day-one gain (update for certain subsequent changes)	No		• No equivalent concept of deferral-and-matching (through the contractual service margin) in SAM.
Short duration contracts	Unearned premium model for pre-claims liability while cash flow projection for claims liability	As for other contracts		• In IFRS, the unearned premium model is optional. A cash flow approach can be adopted as in SAM.

Questions

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