

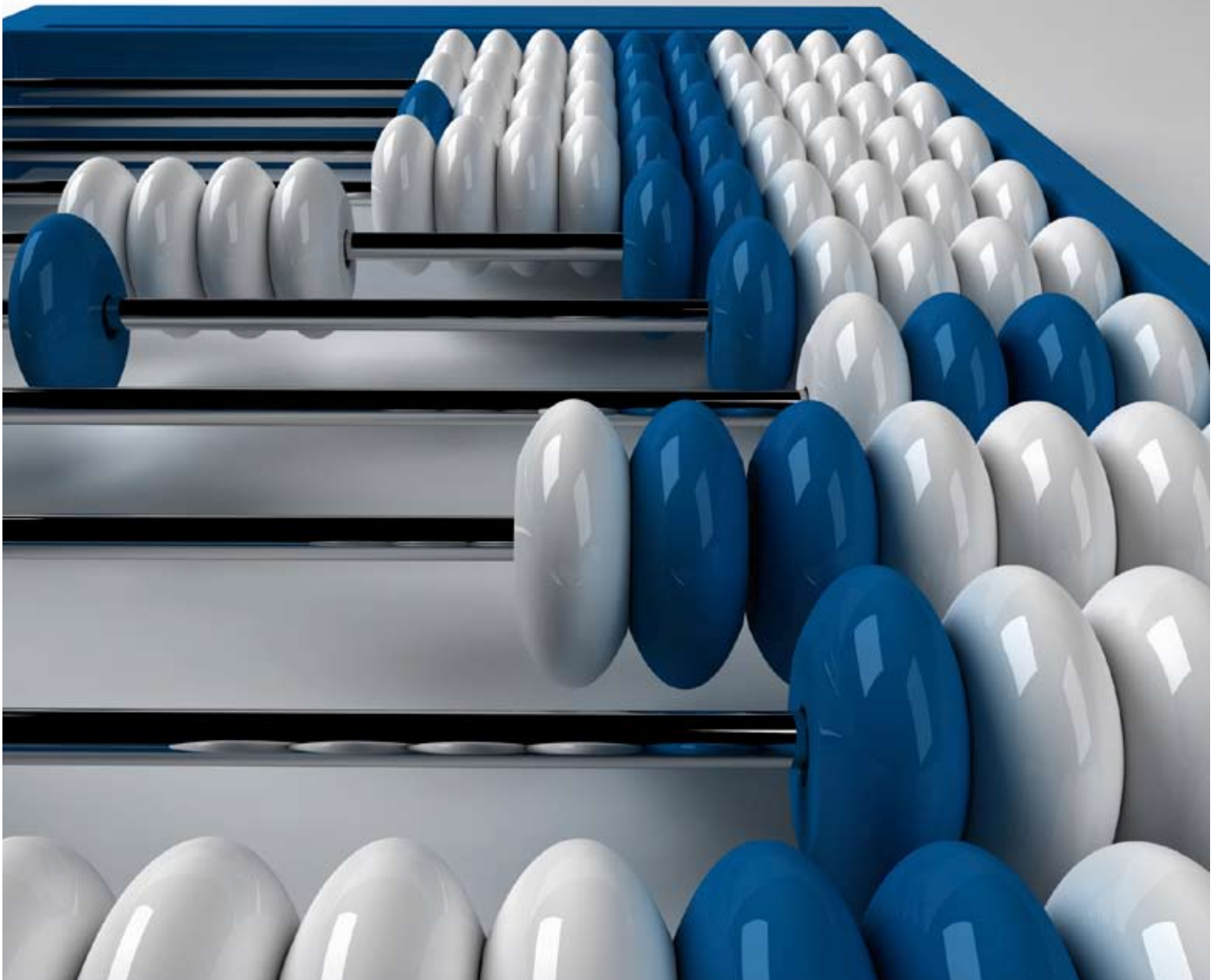
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Discussion of the IFRS Exposure Draft for Insurance Contracts





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A. OVERVIEW

On 30 July 2010, the International Accounting Standards Board (IASB) published its long-awaited exposure draft *Insurance Contracts*. The exposure draft contains proposals on the recognition, measurement, presentation, and disclosure of insurance contracts. The publication of the exposure draft is a key milestone in Phase II of the IASB's insurance project.

In 2004, the publication of IFRS 4 *Insurance Contracts*, represented the completion of Phase I of the insurance project, addressing what the IASB felt were the more urgent issues in insurance contract accounting. However, comparability across entities and jurisdictions remained difficult because of the continuation of varied practices in insurance accounting. Therefore, in 2004 the IASB embarked on Phase II of the project and established the Insurance Working Group to provide feedback on issues specific to insurance contracts. The IASB's discussion paper 'Preliminary Views on Insurance Contracts,' published in May 2007, laid much of the foundation for the current exposure draft proposals.

In 2008, the US Financial Accounting Standards Board (FASB) joined the IASB's project in order to develop a common standard. Many of the decisions relating to the exposure draft were, therefore, made jointly with the FASB.

In 2008, the US Financial Accounting Standards Board (FASB) joined the IASB's project in order to develop a common standard. Many of the decisions relating to the exposure draft were, therefore, made jointly with the FASB. Later in this paper, we briefly discuss some key points of difference that remain between the IASB and FASB.

The exposure draft is open for public comment until the end of November 2010. The IASB then plans to finalise the new standard by mid-2011. The FASB has decided to issue a discussion paper (DP) instead of an exposure draft, and this is expected to be released in 3rd quarter of 2010. At the time of writing, the FASB DP has not yet been issued.

In this paper, we explore the key aspects relating to the exposure draft and some key implications of the proposals.

B. SCOPE OF EXPOSURE DRAFT

The exposure draft applies to three types of contracts:

- Insurance contracts issued by the insurer
- Reinsurance contracts held by the insurer
- Financial instruments containing a discretionary participation feature (DPF)

An insurance (or reinsurance) contract continues to be defined as per IFRS 4 *Insurance*, namely:

'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.'

Under the exposure draft proposals, the valuation of 'investment contracts' would not change (i.e., they would continue to be valued under IAS 39 or IFRS 9). Thus the definition of significant insurance risk remains key to accounting treatment. Insurance risk is risk, other than financial risk, that is transferred from a contract holder to the insurer. This risk must be a preexisting risk to the contract holder and not one created by the contract. An uncertain future event is an event with uncertainty at inception of the contract about either when the event will occur or the amount an insurer will need to pay when it occurs.

The exposure draft defines this insurance risk to be significant if, and only if, an insured event could cause an insurer to pay significant additional benefits in any scenario with commercial substance. These additional benefits are to be evaluated on an expected present value basis and thus an insurance event causing a given loss in 50 years' time may not be an insurance contract, whereas a contract causing the same loss with the same probability but where the payment was in five years' time could well be. Once classified as an insurance contract, a contract remains so classified until all rights and obligations are extinguished.

Classification of contracts is to be performed on a contract-by-contract basis. Although a group of contracts may not be exposed to a significant insurance risk collectively, each contract considered independently could transfer significant insurance risk and such contracts would be classified as insurance. A contract does not transfer significant insurance risk if there is no scenario under which the insurer would make a loss on a present value basis.

Financial instruments with a discretionary participating feature are also within the scope of the exposure draft (although FASB adopted a different view—see Section E). A financial instrument containing a discretionary participating feature is one with a contractual right to receive, as a supplement to guaranteed benefits, additional benefits:

- That are likely to be a significant portion of the total contractual benefits.
- Whose amount of timing is at the discretion of the insurer.
- That are contractually based on either the performance of a specific pool or type of insurance contract or investment returns on a specified pool of assets or the profit of a specific fund, entity or company. Additionally there must 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.

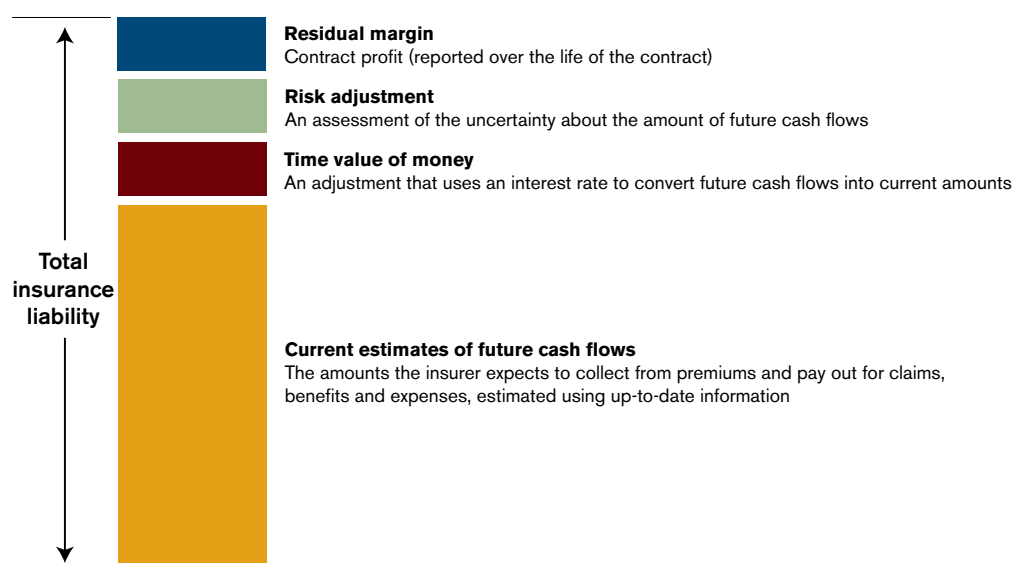
C. KEY FEATURES OF THE IASB PROPOSALS

With the exposure draft proposals, the IASB aims to introduce a principles-based accounting standard that reflects the economics of insurance contracts.

With the exposure draft proposals, the IASB aims to introduce a principles-based accounting standard that reflects the economics of insurance contracts. There are two models used in the exposure draft: a new measurement model based on a risk-adjusted current fulfilment value; and a simplified model for the pre-claim liabilities of short-term contracts. First we focus on the main proposed measurement model, which consists of the following four key 'building blocks' (also see Figure 1):

1. Current estimates of future cash flows
2. Time value of money
3. Risk adjustment
4. Residual margin

**FIGURE 1:
THE BUILDING BLOCKS OF THE PROPOSED MEASUREMENT MODEL FOR INSURANCE CONTRACTS**



Source: Snapshot: Insurance Contracts, IASB, July 2010

The proposed measurement model requires that the first three building blocks be re-measured at each valuation date. The residual margin will not be re-measured, but will instead be amortized over the coverage period.

FUTURE CASH FLOWS

The proposed measurement of the insurance contract is based on the 'current fulfilment value,' which encompasses the future probability-weighted cash flows that arise as the insurer fulfils the insurance contract. This basis of measurement, as opposed to say 'current exit value,' has some interesting implications. For example:

- Indirect costs, such as general overheads, are specifically excluded from the liability under the current fulfilment value. The measurement will include only costs which relate directly to the insurance contracts measured.

-
- Investment return on assets, payment to and from reinsurers, cash flows from future contracts, non-incremental acquisition costs, income tax payments, and general overheads would not be included. See later sections of the report for more details on some of these items.

As mentioned, current fulfilment value is based on the cash flows that the insurer needs to make to fulfil its current obligations. Previously the concept of current exit value had been considered, which is based on the amount an insurer would need to pay to transfer its liabilities. The change in measurement was based on feedback that exit value would be an inappropriate way to measure liabilities that would rarely be transferred. Further, current exit value would require estimation of the cash flows arising for market participants rather than for the insurer itself and could produce less relevant information.

Cash flows that are dependent on market variables should be valued consistently with observable market prices. The exposure draft specifically mentions the use of replicating portfolio techniques as a way of achieving this consistency.

Cash flow estimates used must reflect all cash flows, be explicit, and reflect the perspective of the entity (i.e., be entity-specific). They must also be probability-weighted. To reflect the correct market-consistent probabilities, options and guarantees, along with other non-symmetric features, should be valued using stochastic scenarios.

For participating contracts, the exposure draft proposes that payments arising from the participating feature should be included in the measurement of insurance contracts in the same way as any other contractual cash outflows.

The risk of non-performance of the insurer is not reflected in either the expected cash flows or the liability value.

CONTRACT BOUNDARIES

A key area of debate, and one which can significantly impact the balance sheet, relates to contract boundaries of multi-period, regular premium insurance contracts. The exposure draft proposes that the boundary of an insurance contract would be the point at which an insurer either:

- Is no longer required to provide coverage
- Has the right or the practical ability to reassess the risk of the policyholder and, as a result, can set a price that fully reflects that risk

No examples of the effect this definition will have on different types of contracts are given. However, we believe casualty contracts will be one-year contracts. Additionally, many unit-linked contracts contain reassessment features that would render them shorter-term contracts and mean that future premiums would not be within the contract boundary.

The contract boundary for an investment contract with discretionary participation features is the point at which the contract holder no longer has a contractual right to receive benefits arising from the participation feature.

For certain types of contract, the above definition of contract boundary potentially conflicts with the current definition proposed by Solvency II (as specified in the QIS 5 technical specifications), which could in turn lead to significant differences in best estimate liabilities between IFRS and Solvency II.

A key area of debate, and one which can significantly impact the balance sheet, relates to contract boundaries of multi-period, regular premium insurance contracts.

DISCOUNT RATES

The exposure draft proposes current risk-free discount rates, adjusted for the liquidity characteristics of the liability. These discount rates should not reflect investment risk (except where this affects payments to policyholders), asset liability mismatch risk, or general operational risk. This is consistent with the overall measurement of fulfilling only obligations to policyholders.

As indicated above, if cash flows depend on the performance of the underlying assets, then the measurement of the insurance liabilities should reflect this. Contracts that do not depend on assets are those with cash flows not dependent on asset performance.

The exposure draft gives little guidance on the use and calibration of economic scenarios within a stochastic model. However, the modelling method should be appropriate to the complexity of the liabilities. For instance, the exposure draft states that some liabilities could be modelled relatively simply without the need for a larger number of detailed scenarios, whereas others with complex underlying factors and non-linear dependence on economic conditions would require a sophisticated stochastic approach. Where necessary, risk-neutral valuation would be appropriate to ensure market consistency.

For many non-life insurers, the introduction alone of discounting represents a major step in insurance liability measurement. More generally though, the choice of (a) an appropriate risk-free rate (e.g., government bonds or swaps), or (b) an appropriate illiquidity premium, raises two significant issues that continue to be debated vigorously across the industry. It is worth noting, however, that the IASB has linked the choice of illiquidity premium to the liquidity characteristics of the liability. This potentially differs from the current approach adopted for Solvency II QIS 5, where prescribed illiquidity premiums of various levels are applied to cash flows of different types of liability.

More generally, it is worth highlighting that this is an area that continues to cause significant confusion for Solvency II across the industry, in particular the application of the QIS 5 illiquidity premium in a market-consistent valuation framework. Any decisions by the IASB in this area will require careful consideration in order to maintain a robust economic valuation framework for the new standard.

The method of extrapolation of the observable yield curve to longer durations and within observable time periods can be material to the measurement of the present value of cash flows. The exposure draft provides no instruction or additional information on this aspect.

RISK ADJUSTMENT

The risk adjustment represents the allowance for risk of the ultimate fulfilment cash flows exceeding those expected. It is analogous to the risk margin under Solvency II. Similar to Solvency II, the risk adjustment does not apply to liability values based on market prices (so as not to double-count the implicit risk allowance inherent in the market price). This risk adjustment is one-sided and only accounts for adverse development as opposed to a risk adjustment for volatility, which would include allowance for fulfilment cash flows being lower than expected.

The exposure draft proposes that the risk adjustment should be measured at portfolio level, which potentially restricts any allowance for diversification benefits across different lines of business.

Proposed techniques in the exposure draft for measuring the risk adjustment are limited to one of the following:

- 1. Confidence level (also known as Value at Risk)**

The exposure draft states that this should not be used for skewed distributions.

- 2. Tail Value at Risk (also known as conditional tail expectation)**

This technique focuses on the tail of the distribution, which correctly reflects the area of most risk in an insurance contract. The exposure draft states that significant judgment is needed to set the conditional tail expectation band but doesn't provide help in this respect.

The exposure draft proposes that the risk adjustment should be measured at portfolio level, which potentially restricts any allowance for diversification benefits across different lines of business.

3. Cost of capital

The exposure draft states that the capital used in this calculation must be calibrated to a sufficiently high level that it calibrates almost the entire tail of the distribution. This capital should be that needed to cover only liability risks. Similarly, the cost of capital rate should exclude all risk premia for risks other than liability risks. This technique allows for the specific runoff of the risks of a contract over time, which the other techniques do not explicitly.

Despite these prescribed techniques, significant judgment remains in the measurement of the risk adjustment. For example, neither the target level of confidence nor level of capital are specified in the exposure draft. This is clearly one area that carries significant potential for lack of comparability between companies, although the level of confidence used in any of the above techniques must be disclosed.

RESIDUAL MARGIN AND TREATMENT OF DAY 1 PROFITS AND LOSSES

The residual margin is the key mechanism for ensuring an appropriate emergence of profit over the duration of the contract. It is calibrated at contract inception such that the insurer recognises no gain on entering into an insurance contract. Furthermore, incremental acquisition expenses are included as cash outflows in the initial liability measurement, which correspondingly reduces the residual margin and offsets the impact of those expenses in the profit and loss account (P&L) as they are incurred. All other acquisition costs are recognised as an expense when incurred. This approach is essentially equivalent to setting up an asset for deferred acquisition costs (relating to incremental acquisition costs only).

The residual margin is subject to a zero floor; hence any loss at initial recognition is recognised immediately in the P&L.

The above can be summarised in the following formulaic definition of residual margin:

Residual Margin at Inception = Max (0, expected present value of future inflows less benefits outflows after risk adjustment less incremental acquisition costs)

The residual margin is released over the contract duration in line with an appropriate amortisation schedule. The amortisation should be in line with the passage of time unless this is expected to be significantly different from the pattern of future claims, in which case the amortisation schedule should reflect the future claims pattern. The amortisation of the residual margin should not be adjusted at each valuation date, even if future cash flow estimates change, except in respect of:

- Interest earned on the residual margin
- An adjustment for lapses—that part of the residual margin relating to lapsed contracts in the reporting period should be eliminated

For investment contracts with participation features, the amortisation of the residual margin should best reflect the asset management services provided and thus the amortisation is to be based on the fair value of assets under management if that significantly differs from the passage of time.

On adoption of the new IFRS standard, the residual margin will not apply to in-force business as at the date of transition (see the section on 'Transitional Measurement' later in this paper). This has the benefit of reducing significantly the amount of data needed to determine the re-measured liability at the implementation date.

MEASUREMENT (PREMIUM RESERVE) FOR SHORT-TERM CONTRACTS

The proposal specifies a simplified measurement approach for short-duration contracts in the pre-claim stage. This applies to contracts with durations of one year or less, as long as there are no embedded options or guarantees that would significantly affect the variability of the cash flows.

On adoption of the new IFRS standard, the residual margin will not apply to in-force business as at the date of transition.

For these contracts, the pre-claim obligation is defined as the initial premium plus the expected future premium less incremental acquisition costs. The obligation is amortised over the coverage period in a way that recognizes the insurance exposure. This is based on the passage of time (i.e., straight-line amortisation) or based on the expected timing of claims and benefits if this is significantly different. Additionally, the pre-claim liability earns interest.

For the other associated cash flows (i.e., the claim liability), no simplification is possible and it is to be measured as the present value of fulfilment cash flows.

The modified approach is subject to a liability adequacy test and thus at each reporting date an insurer must determine if the contract is 'onerous.' An onerous insurance contract is one where the pre-claim obligation is less than present value of fulfilment cash flows. If the contract is onerous, an additional liability for the difference between the pre-claim obligation and the present value of fulfilment cash flows must be recognized. This corresponding loss flows through the profit and loss account.

UNBUNDLING

An insurance contract may contain several different elements, in addition to the basic insurance coverage (which defines the contract as insurance). These commonly include investment components and service components. If the contract was not defined as insurance, these other components would be accounted for under other IFRS standards. Under the exposure draft proposals, a company must unbundle these various components and account for them separately if, and only if, the other components are not 'closely related' to the key insurance component. The exact meaning of closely related, however, is not defined in the exposure draft. Three key types of components that should be unbundled are specifically mentioned in the exposure draft:

1. Investment components reflecting an account balance that is credited with an explicit return and where that crediting rate is based on an underlying pool of assets. The whole investment performance must be credited to the policyholder.
2. Embedded derivatives that are separated from the host contract.
3. Goods and services not related to the insurance coverage.

REINSURANCE

Reinsurance contracts are within the scope of the exposure draft and treated in a similar manner as direct insurance contracts. The present value of fulfilment cash flows under the reinsurance contract should be estimated in the same way as the corresponding fulfilment cash flows for the underlying contract, after re-measuring the underlying contract on initial recognition of the reinsurance contract. For the cedent's balance sheet measurement, an adjustment is required for non-performance of the reinsurer.

Ceding commissions are to be treated as a reduction in premium ceded to the reinsurer.

Reinsurance assets are presented separately on the asset side of the balance sheet and not offset against gross insurance liabilities.

INSURANCE CONTRACTS ACQUIRED IN A PORTFOLIO TRANSFER OR BUSINESS COMBINATION

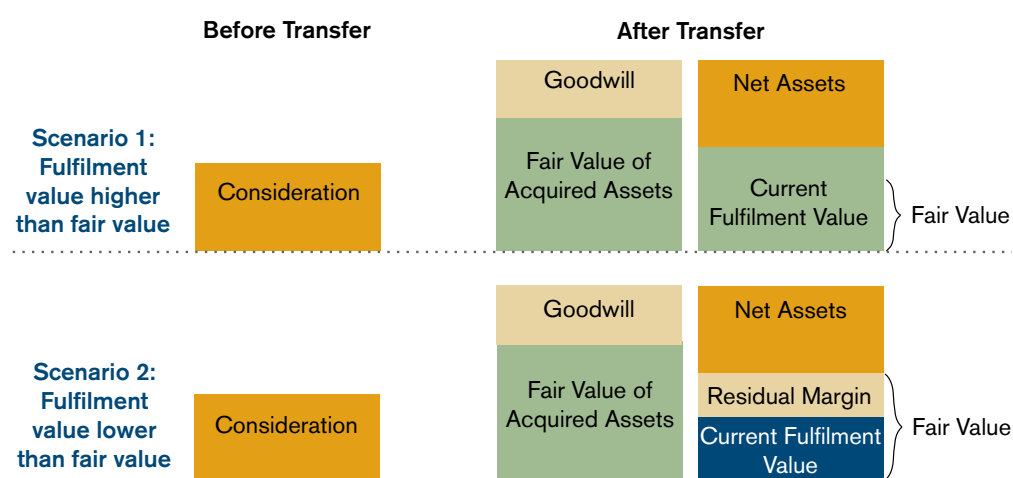
The proposed treatment of acquired contracts in a business combination departs from the current IFRS 3 *Business Combinations*. The approach in IFRS 3 is to measure acquired assets and liabilities at fair value. In contrast, the proposed approach in the exposure draft is to measure the insurance liabilities at the higher of the present value of fulfilment cash flows and fair value. If the fair value is higher, then a residual margin is set up equal to the difference between fair value and present value of fulfilment cash flows. However, if fair value is lower then the difference is recognized as goodwill.

Similarly, for contracts acquired through a portfolio transfer, the contracts should be measured at the higher of present value of fulfilment cash flows and the consideration received for the insurance

Under the exposure draft proposals, a company must unbundle these various components and account for them separately if, and only if, the other components are not 'closely related' to the key insurance component.

liabilities. If the fair value is higher, a residual margin will be established for the difference. If, however, the fair value is lower, the difference would be recognised immediately in the profit and loss, as shown in Figure 2. Under the proposals, therefore, acquired contracts are treated in a similar fashion to contracts written by the company measured at inception.

**FIGURE 2:
PORTFOLIO TRANSFER SCENARIOS**



D. PRESENTATION AND DISCLOSURE OF FINANCIAL RESULTS

STATEMENT OF FINANCIAL POSITION

The following key requirements are proposed for the statement of financial position (balance sheet):

- Unit-linked assets and liabilities must be shown distinct from other assets and insurance liabilities
- Reinsurance assets and gross insurance liabilities must be presented separately and not netted against each other

STATEMENT OF COMPREHENSIVE INCOME

The following key requirements are proposed for the statement of comprehensive income (income statement):

- All income and expense relating to insurance contracts must be shown
- Reinsurance cash flows must not be offset against gross insurance flows
- Items relating to unit-linked business must be shown distinct from other business

While the proposed approach to liability measurement will remove much of the accounting mismatch with assets measured at fair value, it is worth noting that IFRS 9 *Financial Instruments* allows insurers to measure certain assets at amortised cost. This inconsistency with the proposed measurement of insurance liability could lead to accounting mismatches. Therefore, on transition to the new insurance accounting standard, insurers will be permitted to reclassify assets from amortised cost to fair value through P&L in order to avoid such issues.

As a minimum, the income statement requires the following line items to be presented:

Change in risk adjustment
Release in residual margin

Underwriting margin

Losses on contracts acquired in a portfolio transfer
Gains on reinsurance contracts
Losses at initial recognition of an insurance contract

Gains and losses at initial recognition

Non-incremental acquisition costs

Differences between actual and expected cash flows
Changes in estimates of cash flows and changes in discount rate
Impairment losses on reinsurance assets

Experience adjustments and change in estimates

Interest on insurance liabilities

On transition to the new insurance accounting standard, insurers will be permitted to reclassify assets from amortised cost to fair value through P&L.

This 'margins-based' approach means that premiums and claims paid are accounted for as deposits received and repaid respectively, and thus go straight to the statement of financial position. However, for contracts treated under the simplified measurement model, a more traditional presentation is needed. The following entries in the statement of comprehensive income are the minimum required:

Premium revenue, i.e., the release in the pre-claim liability
Claims incurred
Expenses incurred
Amortisation of incremental acquisition costs
Underwriting margin

Changes in additional liabilities for onerous contracts

OTHER DISCLOSURES

In addition to the financial statements, the exposure draft requires disclosures about the amount recognized in the statements and the nature and extent of risks from the insurance contracts.

Specifically, the following disclosures are required about amounts recognized in the statements:

- Reconciliation of opening to closing account balance of items such as assets, liabilities, risk adjustments, residual margins, and reinsurance assets
- The methods and inputs used to develop the measurements

The minimum disclosures for risks related to insurance contracts include:

- Exposure to risks and how they arise and changes in the reporting period
- Risk management objectives, policies, and processes and changes in the reporting period
- Information about the regulatory framework the insurer operates under and the effect of this
- A sensitivity analysis of insurance risk factors
- Information about exposure and credit-worthiness of reinsurers
- Description of how liquidity risk is managed, along with a maturity analysis
- Sensitivity analysis of market risk factors

In addition to the financial statements, the exposure draft requires disclosures about the amount recognized in the statements and the nature and extent of risks from the insurance contracts.

E. KEY DIFFERENCES BETWEEN IASB AND FASB

There are several key areas where the FASB proposals differ from the IASB. Most notably, a single composite margin is proposed by the FASB, rather than a separate risk adjustment and residual margin (see below). Based on the joint IASB/FASB board meeting in June 2010, there are several key areas where the FASB proposals differ from the IASB. We eagerly await the publication of the FASB discussion paper for more clarity on the current FASB position on these points. However, the IASB exposure draft contains an appendix on the differences between the IASB and FASB proposals. The key differences relate to scope and measurement and are as follows.

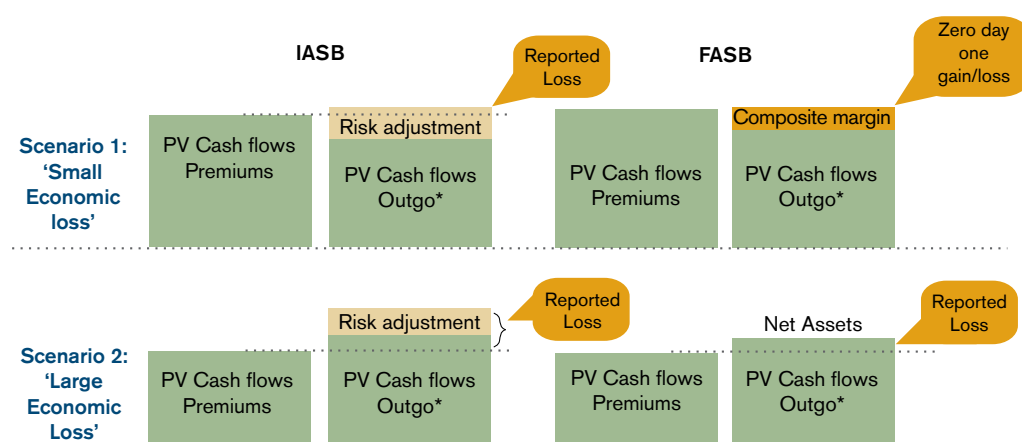
A single composite margin is proposed by the FASB, rather than a separate risk adjustment and residual margin. The FASB proposes that the composite margin is released over both the coverage period and the claim-handling period.

COMPOSITE MARGIN

A single composite margin is proposed by the FASB, rather than a separate risk adjustment and residual margin. The FASB proposes that the composite margin is released over both the coverage period and the claim-handling period. At outset, margin(s) under both the IASB and FASB proposals are calibrated to the consideration receivable from the policyholder. However, the implication is a different expected emergence of profit over the duration of the contract, as compared to the IASB's proposal, for the following reasons:

- The composite margin would not be re-measured at each reporting date to reflect the changes in the price of risk and uncertainty, as is the case for the risk adjustment
- The composite margin would not earn interest on the grounds of simplicity and because FASB regards the margin as a deferred credit rather than a component of an obligation
- The composite margin would be amortised over the coverage and claim-handling period using an approximation for the pattern of declining risk
- Because of the existence of the risk adjustment, Day 1 losses are potentially treated differently under the two proposals; in particular, the IASB's measurement model leads to a higher likelihood of Day 1 losses

**FIGURE 3:
POTENTIAL DIFFERENCES IN DAY 1 PROFITS AND LOSSES BETWEEN IASB AND FASB PROPOSALS**



SCOPE

The IASB's scope in its exposure draft includes participating investment contracts. The basis for conclusions gives the following reasons for this:

- Participating insurance and participating investment contracts are often linked to the same underlying asset pool and thus accounting for both contracts in the same way will simplify the accounting and produce more relevant information for uses of the accounts
- Participating investment contracts have similar features as other insurance contracts such as long maturities, regular premiums, and high acquisition costs
- Splitting contracts that often have complex and interdependent options and guarantees would not faithfully represent the contract as a whole and could reduce the usefulness of the accounts and increase the cost and time associated with preparing them

However, FASB doesn't believe these arguments are sufficient for it to make an exception from the scope of its financial instrument standard and thus the scope of its proposed insurance standard would not include financial instruments with discretionary participation features.

The IASB's scope in its exposure draft includes participating investment contracts. However, FASB doesn't believe these arguments are sufficient for it to make an exception from the scope of its financial instrument standard.

F. TRANSITIONAL MEASUREMENT

On the date of transition to the new standard, it is proposed that the insurance contract liability specifically excludes a residual margin.

On the date of transition to the new standard, it is proposed that the insurance contract liability specifically excludes a residual margin. Additionally, any existing balances of deferred acquisition costs should be de-recognised. The difference between the existing and new liability will represent an adjustment to retained earnings, but will not be recognised in the P&L.

As mentioned earlier, companies that currently classify certain financial assets as amortised cost will be permitted to reclassify those assets as fair value through P&L in order to avoid accounting mismatches that could result from the new proposed measurement of insurance liabilities.

G. BUSINESS IMPACT

Implementing the new standards will be a challenge for companies. The implications of the exposure draft proposals are much broader than purely a compliance exercise. The introduction of realistic reporting (i.e., based on best estimate operational assumptions and market-consistent economic assumptions as opposed to subjective prudent regulatory reporting) and risk-based capital measures represents a significant change in mindset for the insurance industry in many countries. The combined impact of IFRS Phase II and Solvency II will have far-reaching implications for the way insurers manage their businesses in future. Life companies who have adopted market-consistent embedded value have benefited already from some of this change in mindset. But the new requirements mean that all companies now face significant business implications under the new reporting and solvency regime. Companies that are well prepared will be well positioned to capitalize on the significant business opportunities that are presented. In this section, we explore some of these key business areas.

The combined impact of IFRS Phase II and Solvency II will have far-reaching implications for the way insurers manage their businesses in future.

VOLATILITY OF EARNINGS AND SOLVENCY

The new proposals for IFRS will likely introduce increased volatility into insurers' financial statements, the extent of which will depend heavily on the exact risk profile of an individual company. Furthermore, Solvency II will introduce additional volatility into the solvency position of the company.

It is worth highlighting, however, that while some volatility will be driven by accounting (assets values reacting to changes in asset yields whereas liabilities react to changes in risk-free yields), most volatility will be driven by economics rather than accounting as we believe most companies will choose to measure their assets at fair value in order to better match the accounting for liabilities under the new proposals. Therefore, volatility will reflect the risks inherent in the business. Good risk management will be an important consideration in managing such reporting volatility. We discuss some key aspects of risk management below.

Additionally, there is likely to be more volatility in the P&L that is due to variances between the best estimate assumptions used to value the liabilities and the reality that occurs. Previously under many accounting standards, insurance liabilities were valued on a prudent basis so there was a release of this prudence over time. With best estimate valuation, reality could be either worse or better than the best estimate. Similarly, changes in operational assumptions will introduce volatility into the P&L, as an assumption change could significantly change the liability valuation without a corresponding change in asset value.

ASSET LIABILITY MANAGEMENT

A key driver of a company's risk profile and, therefore, its earnings and solvency volatility under the new regime relates to the asset-liability management (ALM) practices of the company, particularly for life insurers that are typically highly exposed to market risks. ALM risks relate to the extent to which asset and liability values respond differently to changes in economic conditions. Reducing ALM mismatch risk is key to reducing the overall risk profile. However, it should be noted that companies still have a focus on shareholder return and thus maximising their returns for a given risk. This risk optimisation often leads to a risk-budgeting exercise, where available capital is effectively allocated to covering different types of risk.

We view the development of more sophisticated ALM techniques and management as an important area for the industry in the coming years. Through the financial crisis, it was apparent from industry studies that companies that adopted appropriate ALM hedging strategies withstood the market turmoil significantly better than companies with less sophisticated ALM strategies. On this evidence, then, improved practices in this area can lead to more robust balance sheets, particularly with long-term liabilities such as life companies.

PRODUCT DESIGN AND PRICING

Under the new regime, there is a clear incentive to reduce, or at least manage, the level of risk associated with new products. It is also important to price for those risks appropriately. Companies will therefore have to ensure a strong understanding of the product features and their risks in order to optimise product performance. For example, thorough understanding and management through robust product design and pricing of the following areas will be important:

- Financial options and guarantees
- Dynamic policyholder behaviour (i.e., the extent to which policyholders react to changes in external conditions, such as increased lapses during times of financial crisis)
- Dynamic management actions (e.g., reduced bonus rates on life products during times of crisis) and the interaction with dynamic policyholder behaviour
- Risk-mitigating impact of future discretionary benefits and how it can be utilized to improve capital efficiency and loss-absorbing capacity of products

New generation insurance products that better cope with the pressures of the new reporting regime are increasingly being designed and launched. Such new launches represent an opportunity for companies to gain an early competitive edge in their product offerings.

Despite the new products being introduced, it is worth highlighting the continued importance to the industry of the more traditional insurance products. In particular, we believe that life-participating business will continue to be a major line of business for the life industry. However, we anticipate some gradual phase of evolution in order to mitigate the economic risks inherent in such products and, at the same time, to increase their capital efficiency.

Notwithstanding these considerations from an economic and risk perspective, it is worth bearing in mind that commercial attractiveness and legislative requirements will be fundamental to successful product design.

SYSTEMS, DATA, AND PROCESSES

The introduction of the new reporting requirements potentially raises significant system and data issues for companies. Development of sophisticated valuation, forecasting, and reporting tools will be required by many companies.

Data issues relating to setting best estimate assumptions will be important to resolve prior to producing financial statements.

Efficient information flows using automated processes are also becoming increasingly important, in order to have the ability to report under tight time frames on an increasingly frequent basis using current information and data. However, for most companies, premium income is a key performance indicator that will not be reflected in the margins-based P&L. This will require organisation change to adjust to the new P&L and associated metrics. Additionally, several IFRS-specific changes will need to be made to underlying data sources. For instance, there will be a mixture of contracts with and without residual margin and that will require earmarking contracts and components of the income statement.

Technical provisions will likely be calculated using tools like MG-ALFA[®]. It will require stringent procedures for the design, build, test, and operations of the tools. The aforementioned also applies to the determination of non-economic and economic assumptions. Staff and management will need to be educated to understand the mechanisms of these new measures and decide upon the best way is to manage the business, given the new information and reporting.

We believe that life-participating business will continue to be a major line of business for the life industry. However, we anticipate some gradual phase of evolution in order to mitigate the economic risks inherent in such products and, at the same time, to increase their capital efficiency.

There are differences between the requirements and measures of IFRS under this exposure draft, FASB's standards, Solvency II, and other accounting standards. For most companies where IFRS Phase II will apply, dual accounting will be applicable. The consequences of this for system and processes will include:

- More complex processes for financial and risk reporting
- Conflicting or sub-optimal decision-making processes
- Companies may decide to develop their own views on the value of the company and the performance. It is likely, thus, that companies will maintain embedded value reporting for the time being.

INVESTOR COMMUNICATION

The new proposals represent a significant shift in mindset for insurance industry reporting. It will therefore be important for the industry to communicate appropriately, and perhaps educate, the investor community on the new reporting framework. Clearly a high level of internal company knowledge and understanding is a prerequisite to such investor communication; hence knowledge sharing across actuarial, finance, and risk management teams will be vital to successful acceptance by the capital markets.

The new proposals represent a significant shift in mindset for insurance industry reporting. It will therefore be important for the industry to communicate appropriately, and perhaps educate, the investor community on the new reporting framework.

H. CONCLUSION

The release of the exposure draft is a major step towards the new accounting standard for insurance contracts. It is clear, however, that additional work remains in certain key areas in order to refine the proposals into a full standard that meets the goals of both the IASB and the FASB.

Successful implementation of the proposals, including ensuring a favourable acceptance by the investor community, will be a challenge for insurers.

Successful implementation of the proposals, including ensuring a favourable acceptance by the investor community, will be a challenge for insurers. Additionally, the business implications are wide-ranging, although these represent an opportunity for companies to gain a competitive advantage through improvements in areas such as ALM strategy and product design and pricing.

APPENDIX

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