

# Current accounting for insurance contracts

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## AMIS

Mike Lombardi

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# Agenda

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1 Overview of applicable standards

2 Contract classification

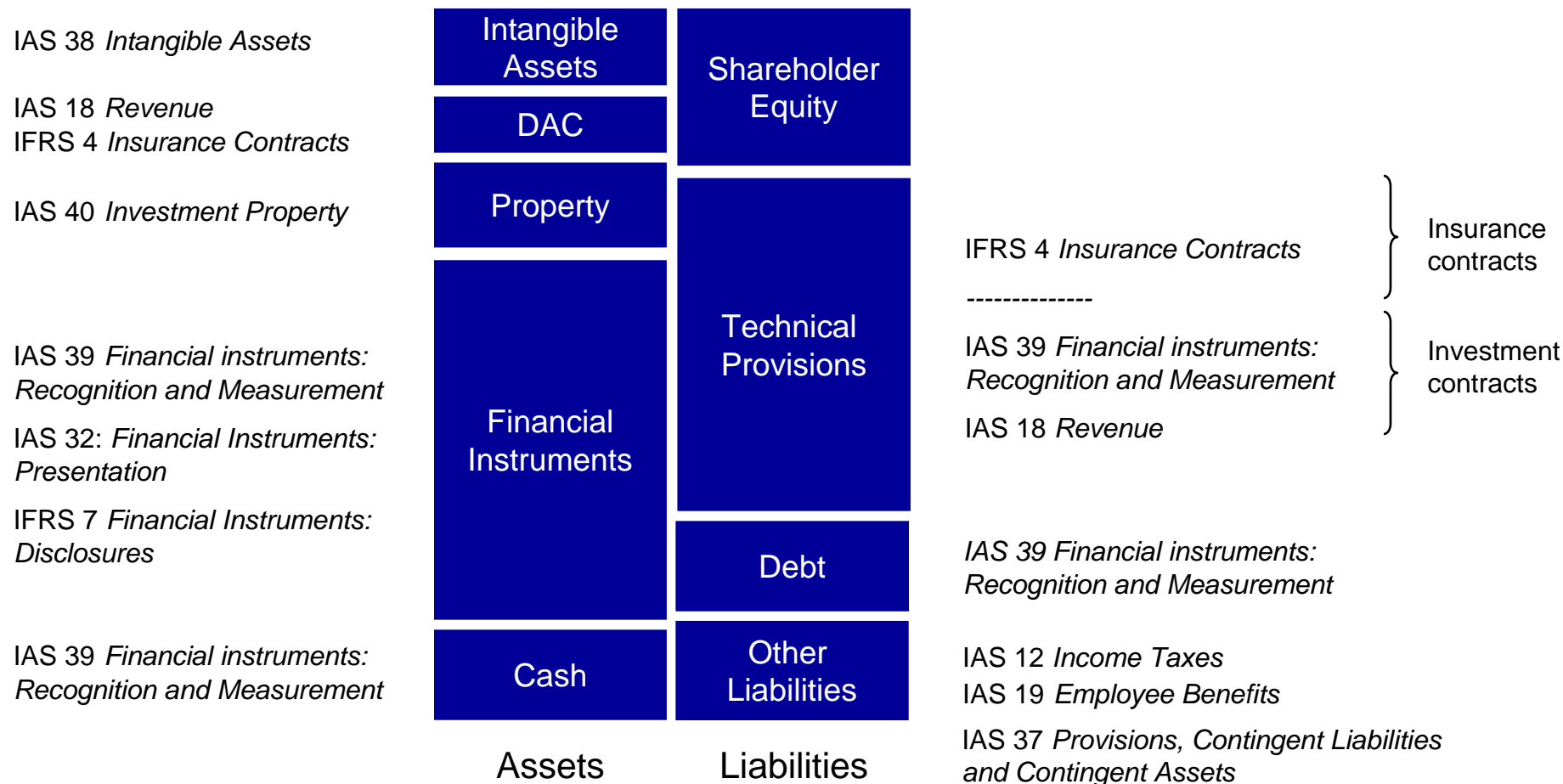
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# IFRS balance sheet overview



# Relevant standards

IFRS	Content	Relevance for insurance companies
IFRS 4 <i>Insurance Contracts</i>	Makes limited improvements to already existing accounting policies in respect of measurement of insurance contracts. Disclosures related to insurance contracts	Significant relevance
IAS 39 <i>Financial Instruments: Recognition and Measurement</i>	Recognition criteria for financial instruments. Classification of financial instruments and assigns them to different valuation models	Significant relevance
IAS 32 <i>Financial Instruments: Presentation</i>	Prescribes principles how to present financial instruments and for offsetting financial assets and financial liabilities	Significant relevance
IFRS 7 <i>Financial Instruments: Disclosures</i>	Requires disclosures on significance of financial instruments on an entity's financial position and nature and extent of risks arising from financial instruments	Significant relevance
IAS 40 <i>Investment Property</i>	Accounting treatment for investment property and related disclosure	Significant relevance
IAS 18 <i>Revenue</i>	Practical guidance on revenue recognition. Identifies circumstances under revenue will be recognised	Significant relevance
IFRS 3 <i>Business combinations</i>	Prescribes the financial reporting by an entity when it undertakes a business combination (bringing together of separate entities or businesses into one reporting entity)	Significant relevance in M&A situations

# Relevant standards

IFRS	Content	Relevance for insurance companies
IFRS 1 <i>First-time Adoption of International Financial Reporting Standards</i>	Applies when an entity adopts IFRSs for the first time by an explicit and unreserved statement of compliance with IFRSs	General relevance for first-time adopters
IAS 1 <i>Presentation of Financial Statements</i>	Prescribes the basis for presentation of general purpose financial statements, to ensure comparability both with the entity's financial statements of previous periods and with the financial statements of other entities	General relevance
IFRS 8 <i>Operating Segments</i>	Requires information about an entity's operating segment	General relevance
IAS 12 <i>Income Taxes</i>	Accounting principles for income taxes and allocation of tax consequences	General relevance
IAS 19 <i>Employee Benefits</i>	Recognition criteria for employee benefit. Classification of employee benefits and assigns them to different valuation models	General relevance
IAS 36 <i>Impairment of Assets</i>	Prescribes procedures that an entity should apply to make sure its assets are carried at no more than their recoverable amount	General relevance
IAS 37 <i>Provisions, Contingent Liabilities and Contingent Assets</i>	Recognition criteria and measurement bases for provision and contingent assets and liabilities and disclosure responsibilities	General relevance
IAS 38 <i>Intangible Assets</i>	Recognition criteria and measurement bases for intangible asset	General relevance

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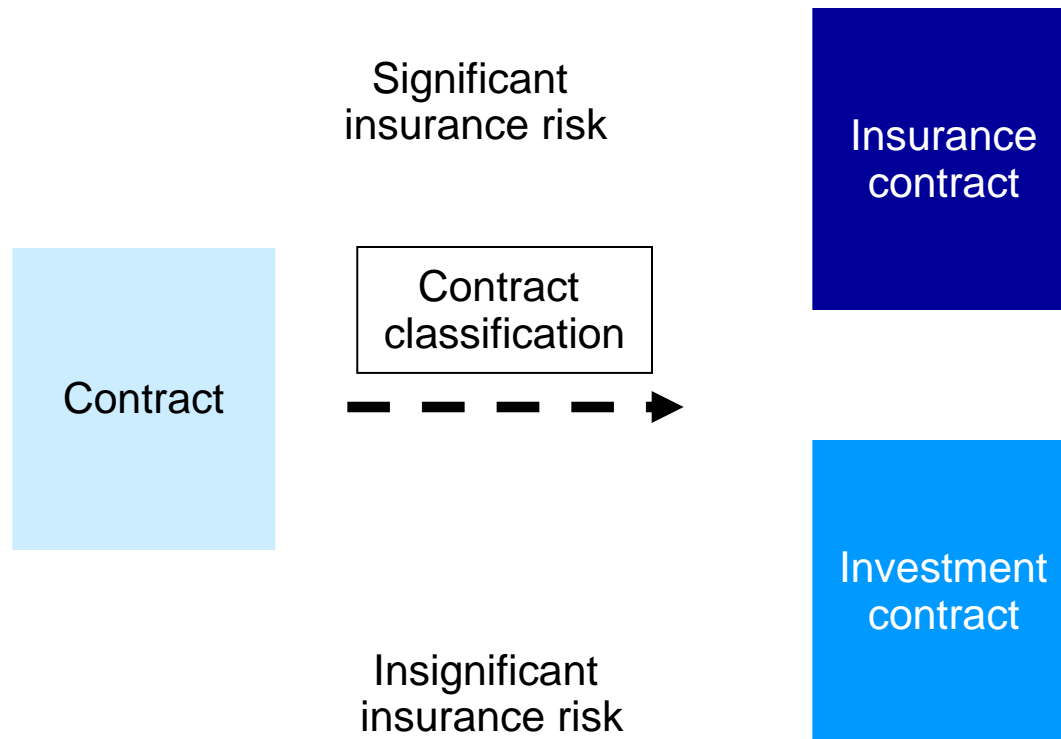
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# Separate treatment

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## Contract classification

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- "An insurance contract is a contract under which the insurer accepts significant insurance risk from the policyholder by agreeing to compensate the policyholder if an insured event adversely affects the policyholder."  
[IFRS 4: Appendix A]
- "Insurance risk is significant if, and only if, an insured event could cause an insurer to pay significant additional benefits in any scenario, excluding scenarios that lacks commercial substance [...]" [IFRS 4: B23]
  - ....even if it is extremely unlikely
  - No quantitative guidance provided

# Insurance Risk

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- Assessment contract by contract  
[IFRS 4: B25]
- Additional benefits include claim handling costs, but exclude the loss of future profits and waived surrender charges on death  
[IFRS 4: B24]
- Once insurance, always insurance  
[IFRS 4: B30]

# IFRS 4 – Insurance Contracts

Examples of contracts covered under IFRS 4:

Life and health	Property casualty
Whole Life	Automobile policy
Term insurance	Theft or damage to property
Pure endowment	Product liability
Life contingent annuities	Professional liability
Disability policies	Structured settlement
	Professional liability

# IAS 39 – Financial Instruments

Examples of contracts covered under IAS 39:

Life and health	Property casualty
Guaranteed Investment Contracts (GICs)	Catastrophe bonds
Deposit components of insurance contracts	Weather derivatives
Immediate annuity certain	Financial reinsurance
Unit Linked contracts with death benefit = 101%	

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# IFRS/IAS for Insurance

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- IFRS 4 applies to “insurance contracts” not insurance companies
  - The same contract, whether issued by bank, mutual fund, or insurance company will be treated the same
  - Special definition of insurance contract
  - Not all contracts written by insurers are “insurance contracts”
- Contracts written by insurers will be covered under:
  - IFRS 4 – Insurance Contracts
  - IAS 39 – Financial Instruments
  - IAS 18 – Service Contracts
- Some contracts could be unbundled into several components which are covered by more than one of the above standards

# Measurement of insurance contracts

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- Companies will be allowed to carry on using their existing accounting basis for insurance contracts  
[IFRS 4: 13, 14, 7]
  - “Grandfathering”
  - Applies also to any DAC asset under existing accounting basis
- Nevertheless, an insurer shall [IFRS 4: 14, 7]
  - Carry out a liability adequacy test
  - Separate certain embedded derivatives and measure them at fair value under IAS 39
  - Not offset reinsurance assets against related insurance liabilities
  - Consider whether its reinsurance assets are impaired
  - Remove any catastrophe/equalisation provisions
  - And others

# Changing current accounting policies

- An insurer may change its current accounting policies for insurance contracts if, and only if, the change makes the financial statements
  - More relevant to the economic decision-making needs of users and no less reliable, or
  - More reliable and no less relevant to those needs.  
[IFRS 4: 22]
- An insurer shall judge relevance and reliability by the criteria in IAS 8  
[IFRS 4: 22]
- Possible changes
  - Introduce current market interest rates [IFRS 4: 24]
  - Eliminate excessive prudence [IFRS 4: 26]
  - Eliminate future investment margins [IFRS 4: 27-29]
  - Shadow accounting [IFRS 4: 30]
  - Any other more relevant or reliable measure

## Liability adequacy test

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- Many existing accounting policies have tests to confirm that
  - Insurance liabilities are not understated, and
  - Related amounts such as DAC are not overstated
- No guarantee that these tests exist everywhere
- Thus, IFRS requires a liability adequacy test

# Liability adequacy test

- Minimum requirement for an existing test
  - Considers current estimates of all contractual cash flows, and of related cash flows
  - If the test shows that the liability is inadequate, the entire deficiency is recognised in profit or loss. [IFRS 4: 16]
- It is not specified
  - whether or how the cash flows should be discounted
  - how the cash flows or discount rate should be adjusted for risk and uncertainty [IFRS 4: BC101]
- Cash flows should include
  - all contractual cash flows [IFRS 4: BC101]
  - effects from options and guarantees, but their intrinsic value is sufficient [IFRS 4: BC101]
- Shall be applied at the level of aggregation specified in the test. [IFRS 4: 19 and BC100]

## Liability adequacy test

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- In case the existing test is not sufficient, an insurer needs to introduce a new test that complies with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*
- Stricter requirements are generally read as imposing a market consistent approach
  - Reflect best estimate of expenditure to settle the present obligation at the balance sheet date
  - Risks and uncertainties shall be taken into account
  - Consider time value of money
- Test shall be applied at the level of reasonably homogeneous risks that are managed together

# Embedded derivatives

- Embedded derivatives should be separated and IAS 39 applied to them
  - An embedded derivative is a any derivative feature attached to the host contract
  - Examples
    - benefits that behave similar to derivatives such as puts, calls, forwards, swaps
    - Some US products such as equity-indexed annuities or minimum interest rate guarantees
    - Some Canadian products such as Guaranteed Minimum Accumulation Benefits (GMAB)
- No separation is required for the following
  - The embedded derivative has the features of an insurance contract itself
  - The option to surrender for a fixed amount (“surrender value guarantee”)
  - Equity-linked derivatives
- In practice, few derivatives have to be separated

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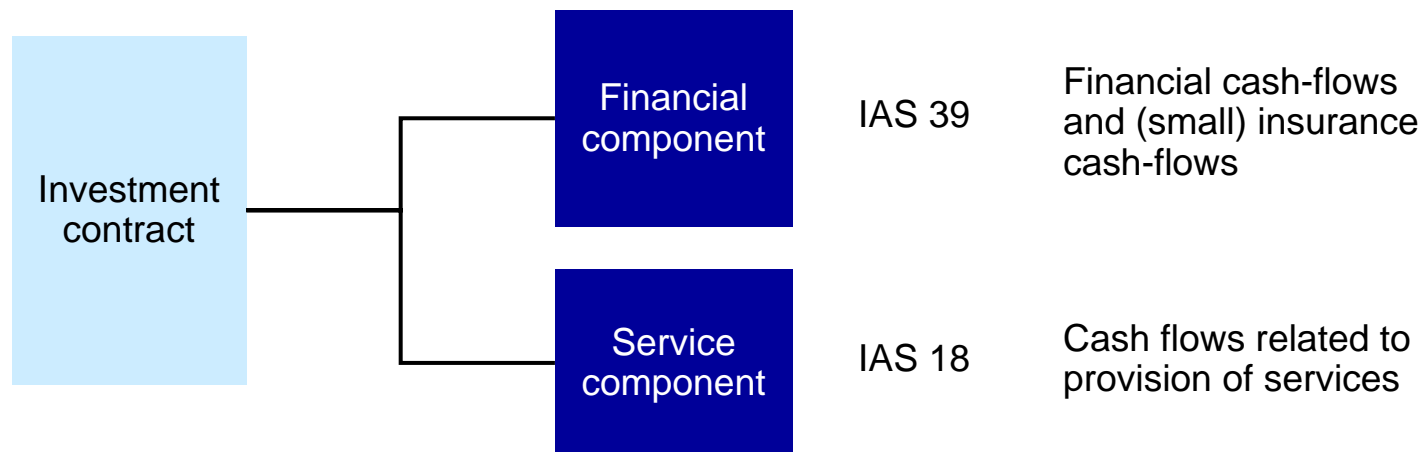
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# Measurement of investment contracts

- Investment contracts are generally within the scope of IAS 39 and IAS 18 *Revenue*
  - IAS 18 requires the separation of fees and costs
    - Relating to the financial instrument
    - Relating to the provision of services
- [IAS 18: A14]
- Based on this, an investment contract is separated into a financial component and a service component



# Financial component

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- Measurement under IAS 39 can be
  - Fair value or
  - Amortised cost
    - Includes deferral of origination costs
    - Calculate discount rate (internal rate of return, IRR) for cash flows, so that  $PV(\text{future cash flows})$  is equal to carrying amount at inception (premium minus initial costs)
- Deposit floor applies to the financial component if measured under fair value
  - The fair value can not be less than the amount payable on demand (surrender) [IAS 39: 49, BC93 and BC94]
  - The DAC asset under IAS 18 is unaffected

# Service component

- IAS 18 prescribes how revenue should be recognised
- Fees charged for managing investments are recognised as revenue as the services are provided  
[IAS 18: A14(b)(iii)]
- Revenue of a transaction involving the rendering of services should be recognised by reference to the stage of completion of the transaction [IAS 18: 20]
- The stage of completion may be determined by a variety of methods
  - Surveys of work performed
  - Percentage of services performed to date
  - Proportion of costs incurred to date compared to the estimated total costs. Only costs that reflect services performed to date are included. [IAS 18: 24]
- Front-ended fees are thus deferred through a Deferred Fee Income (DFI) liability

## Service component: DAC asset

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- IAS 18 allows for a Deferred Acquisition Cost (DAC) asset for investment contracts
  - Incremental costs that are directly attributable to securing an investment management contract are recognised as an asset  
[IAS 18: 14(b)(iii)]
  - The asset represents the entity's contractual right to benefit from providing investment services, and is amortised as the entity recognises the related revenue  
[IAS 18: 14(b)(iii)]
  - If the entity has a portfolio of investment management contracts, it may assess their recoverability on a portfolio basis  
[IAS 18: 14(b)(iii)]

# Service component: DAC asset

- Deferrable costs
  - The costs need to be incremental. As in IAS 39, an incremental cost is one that would not have been incurred if the entity had not secured the investment contract. [IFRS 4: C9 amending IAS 18: 14(b)(iii)]
  - The costs need to be incremental by contract
    - Basic principle: costs that are incurred directly as a result of issuing an additional individual contract ('linear' variability). Not costs that are incremental to new business in general.
    - For 'step' variability, each company must use their judgment. Normally, since the latter commission would not have been incurred unless the extra contracts were not sold, it can be regarded as incremental. Incremental cost must have been incurred to secure the right to charge future investment management fees. That means that other incremental costs such as outsourcing costs are not deferrable.
  - Incremental costs can be both internal or external.
  - Incremental costs can arise up-front or during the term of the contract.

## Service component: DAC asset

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- The DAC asset is subject to IAS 36 *Impairment of Assets* and (unclear) IAS 38 *Intangible Assets*:
  - Recovery test (impairment test) according to IAS 36  
[IAS 36: 9 and 59]
  - Amortisation method according to IAS 38  
[IAS 38: 97]
  - Review for adjustments of
    - Remaining useful life
    - Amortisation method
    - Residual valueaccording to IAS 36 or IAS 38  
[IAS 36: 17] [IAS 38: 104]

# IAS 18 – Service Contracts

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- Applies to service contracts and service components of other contracts, such as:
  - Administrative Services Only (ASO) contracts
  - Investment management
- Traditional “matching” of revenue and expenses
  - Revenue recognized as services completed
- DAC allowed on asset side of balance sheet
  - Deferrable costs (transaction costs) are very limited (same as IAS 39)

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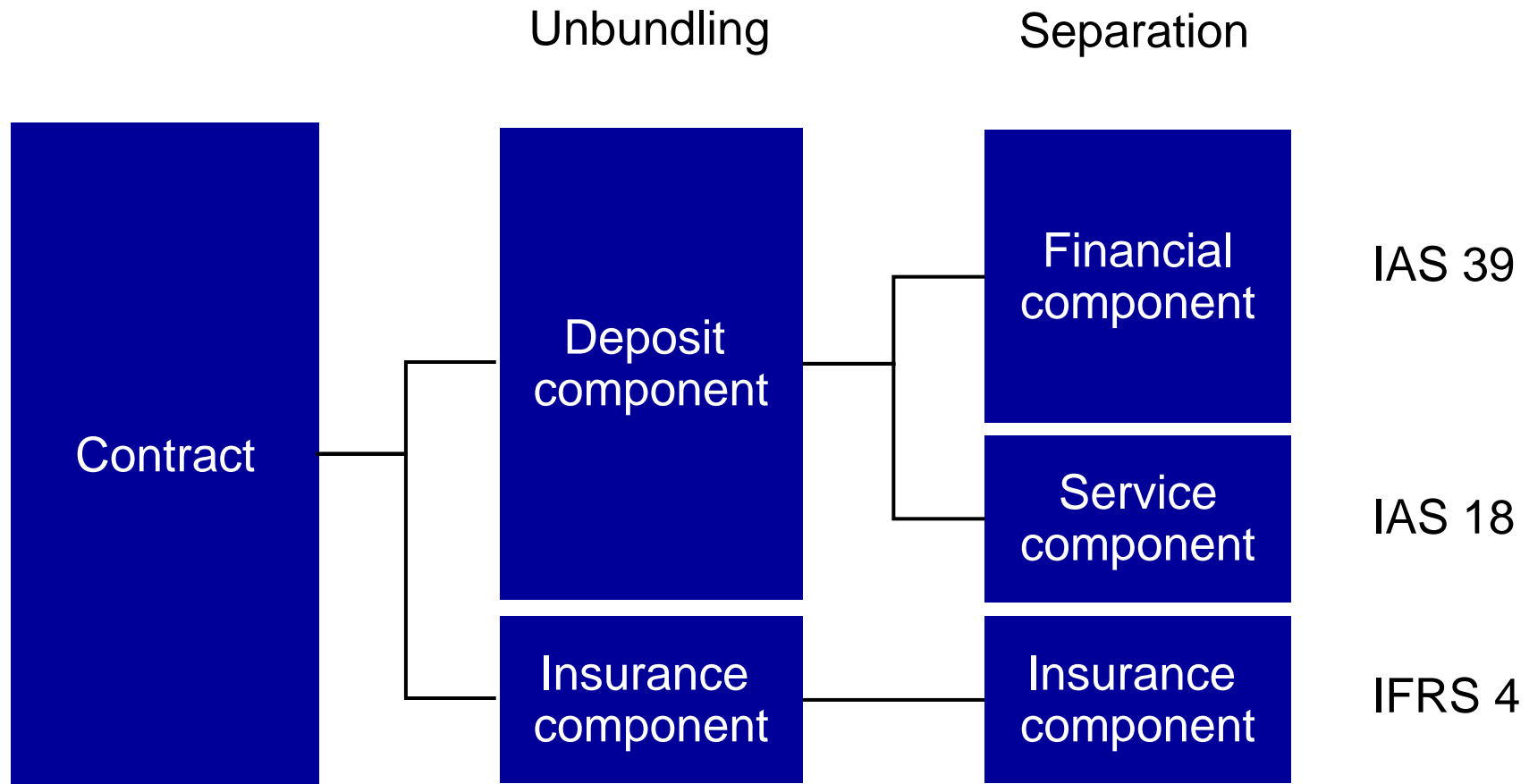
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# Unbundling



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## Key differences to Mexican GAAP

	IFRS	Mexico
<b>Contract Classification</b>	Required	Not required
<b>Reinsurance</b>	Gross, no offset	Gross, no offset
<b>Liability adequacy test</b>	Required	Required, life does not allow lapses
<b>Catastrophe or equalization reserve</b>	Not allowed	Required (earthquake and wind & flood risks)
<b>Financial instruments</b>	Unbundling deposit and service	Not required
<b>Embedded derivatives</b>	Market value	N/A
<b>Public disclosure</b>	Expanded	Limited