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IFRS Phase II and Solvency II

Paul Appleton

IFRS PHASE II – WHERE ARE WE?

What is IFRS Phase II?

- Review of accounting for Insurance Contracts (IFRS4)
- Why?
 - Perception of inconsistencies in accounting for insurance
 - Accounting for insurance often differs from other sectors
 - Phase I only addressed this to a limited extent

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The timeline

IASC starts work	1997
IASB issues IFRS 4 Phase I	2004
IASB DP – 'Preliminary views on insurance contracts'	May 2007
• 162 responses	End 2007
Insurance working group – updated timetable published	Nov 2008
Exposure draft	Oct 2009
Final standard	May 2011
Implementation	End 2012?

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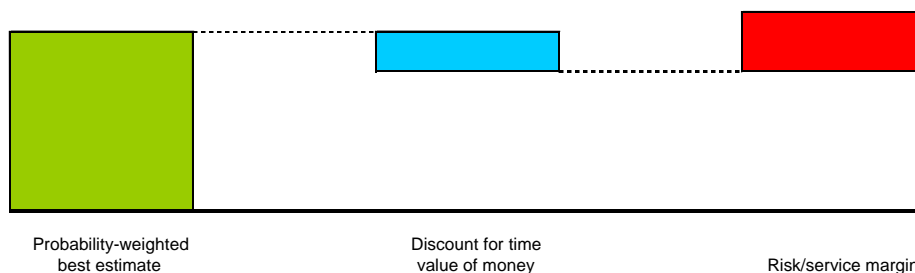
ISSUES

Life and non-life fundamentally different

- Non-life contracts have wider variety of risk exposures, durations and volatile results than life business
- Hence a wider range of outcomes in absolute terms, let alone cash flows
- The three part model adds assumptions on assumptions!
 - It's not easy to establish a best estimate – factoring in cash flows and a risk margin makes it much more difficult and uncertain
- Therefore:
 - model needs to be sufficiently flexible to meet requirements for both life and non-life, or
 - Two separate models are needed

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Valuing insurance liabilities: IFRS Phase II model



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Valuing insurance liabilities - issues

- Unbiased best estimate
 - Probability weighted
 - Method of measuring
- Discounting
 - Market based or entity based?
- Risk margin
 - How is it calculated
 - Prudence?

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Profit on inception?

- Risk margin:
 - Calibrate to premium thus no profit on inception?
 - Profit earned as risk expires (UPR)
 - Or recognise that profit may be earned on Day 1?
 - This is a contentious area!

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Recognition

- Date of inception v date of contract
- Subscription market:
 - Underwriters write risks at different times
 - Need for consistency
 - Retain recognition at inception
- Need to properly match reinsurance contacts
 - Account for substance over form for RI contracts acquired after year end

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Reporting issues

- No DAC – how do we account for acquisition costs?
- Premiums – income or deposit?
 - Revenue or margin
- Balance sheet disclosure
- Current presentation works well – improve disclosure
- Unbundling of insurance and financial elements?
- Important that the financial statements are of use to the users
- Does it add any clarity to facilitate comparison between insurers?

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THE INTERPLAY WITH SOLVENCY II

The biggest change in insurance regulation for a generation

- Affects every insurer in the EU
- A principles based capital setting and supervision regime based on economic values
- Will encourage insurers to improve measurement and monitoring of risks
- Due to start in 2012

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Solvency II covers both capital assessment and supervision

Pillar 1:

Solvency

Balance sheet valuation & capital requirements

Harmonised standards for the valuation of assets and liabilities, and the calculation of capital requirements

Pillar 2:

Regulatory

Supervisory review process

To help ensure insurers have good monitoring and management of risks, and adequate capital

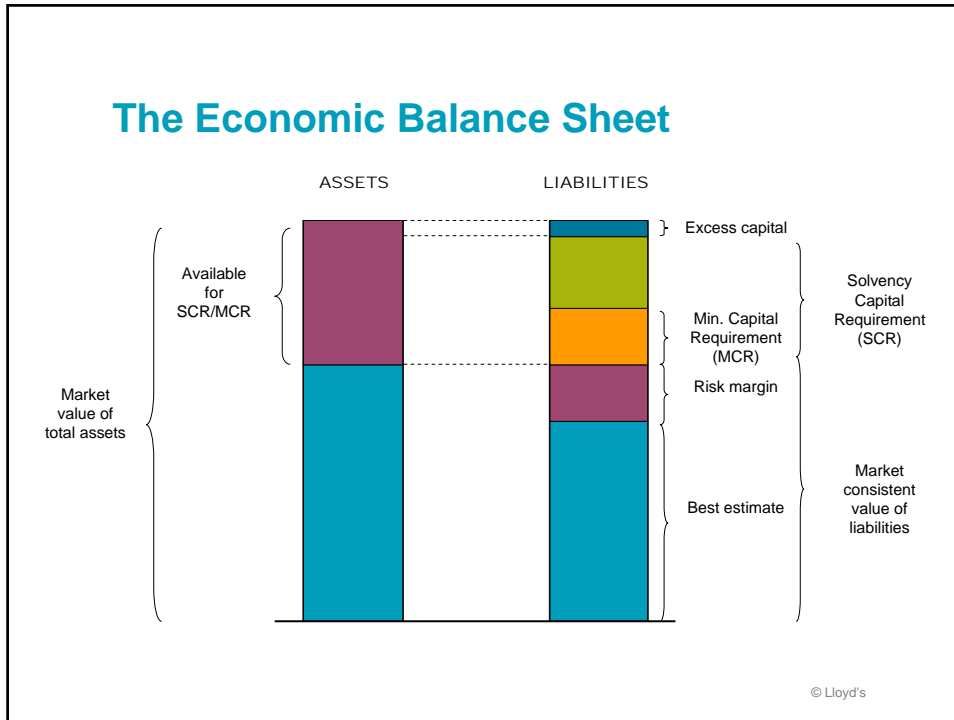
Pillar 3:

Disclosure

Market discipline and disclosure

Harmonisation of supervisory reporting requirements that allow capital adequacy to be compared across institutions

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On the face of it, similar...

- Market consistent values
- Three part approach to valuing insurance liabilities
- Timing for both end 2012?

...but not the same

- Discounting – basis of rate expected to be prescribed in Solvency II
- Risk margin:
 - Cost of capital prescribed for Solvency II
 - No service margin in Solvency II
 - No diversification in Solvency II
- Hence IFRS and Solvency II technical provisions may be different

- Financial accounting is not the same as regulatory accounting!

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