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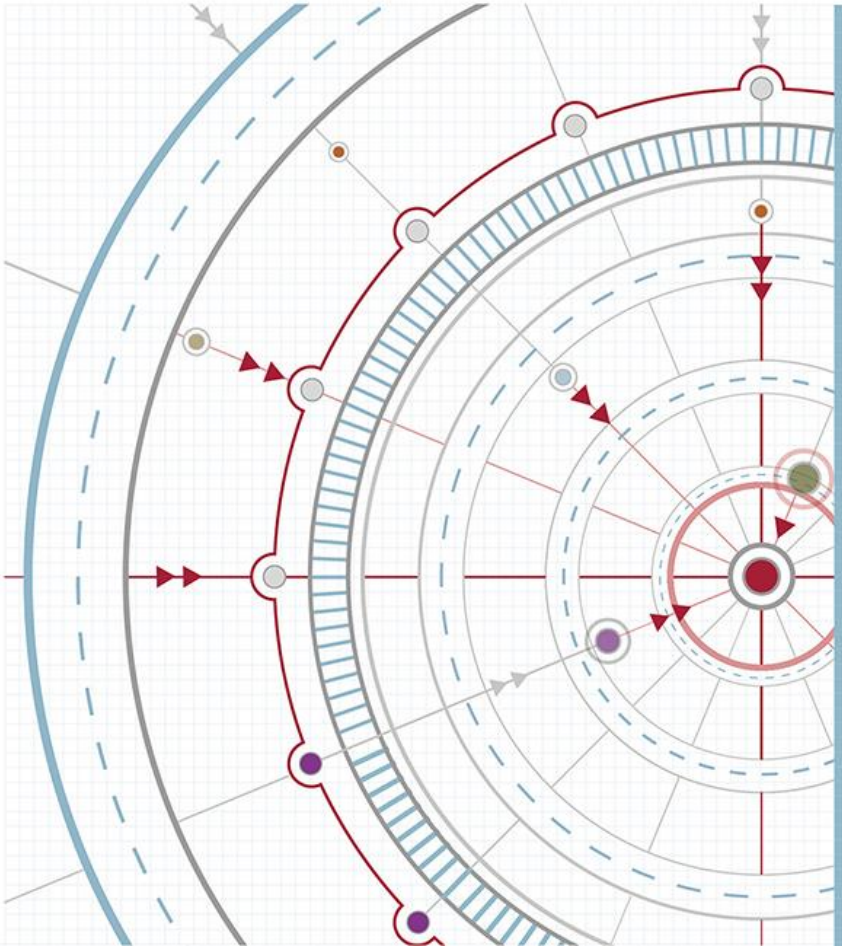

Beyond IFRS 4
Insurance Contracts Project

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The views expressed in this presentation are those of the presenter,
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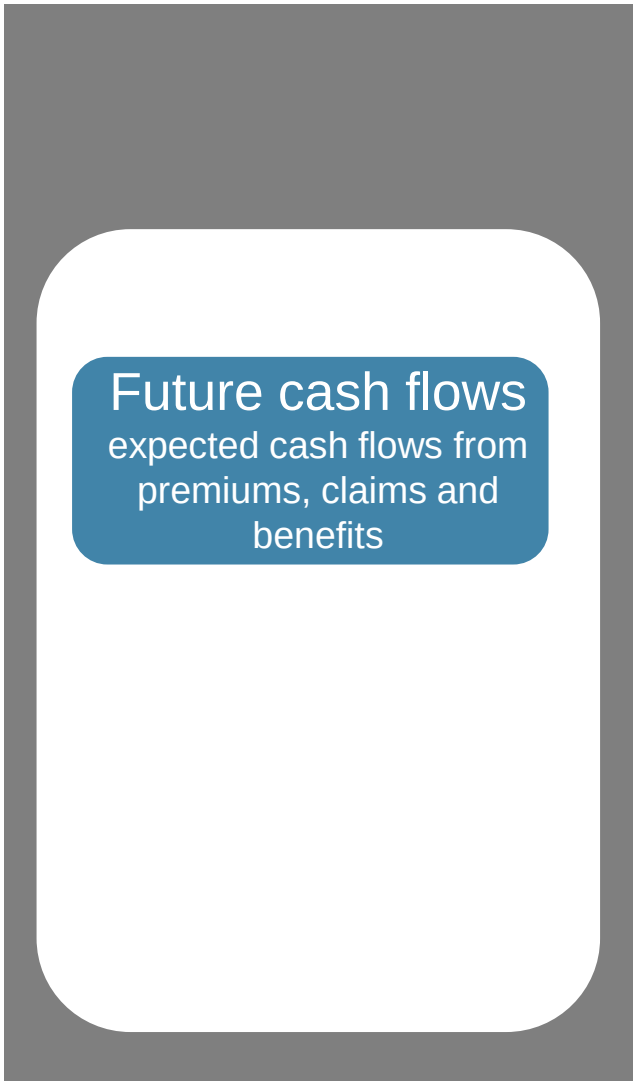
Mutualisation

Measure contract at initial recognition
Future cash flows

Measurement of an insurance contract incorporates all available information, in a way consistent with observable market information.



An explicit, unbiased and probability-weighted estimate of future cash flows that will arise as the insurer fulfils the insurance contract

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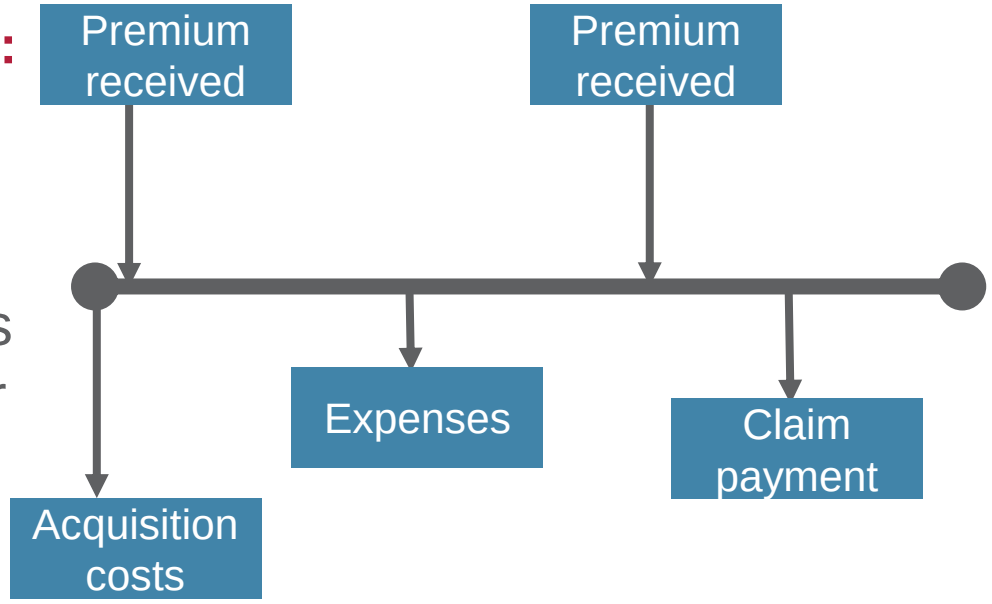
Measure contract at initial recognition
Future cash flows

Recognition:
Contract starts when coverage period begins (may be after insurer is on risk) unless contract is onerous



Included in cash flows:
All direct costs of *originating* and all directly attributable costs incurred in *fulfilling* insurance contracts

Contract boundary:
Contract ends when:

- Not required to provide coverage
- Can reprice to reflect risks of policyholder
- Or, In some cases, to reflect risk of portfolio
- On substantial modification

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Measure contract at initial recognition
Fulfilment cash flows: mutualisation

In some contracts or contract types, other policyholders form first layer of risk absorption. In such cases:

- Expected cash flows from/to participating policyholders are part of the fulfilment cash flows of the primary policyholders: A group of policies is not considered to be onerous if another set of policyholders bears those losses
- Losses are only recognised in profit or loss from onerous contracts when the underlying items in the fund as a whole are insufficient to bear those losses, ie when no other policyholder has the capacity to absorb those losses

Mutualisation
Guidance

- No specific guidance for mutualisation
- Mutualisation is inherent in the cash flows guidance, and consequently is subject to that guidance
- Thus, included in cash flow of individual policyholder are:
  - Expected future cash flows to any other policyholder, or
  - Expected future cash flows from any other policyholder
- But mutualisation is not:
  - diversification of risk or cross subsidisation or discretion
- Requires explicit right of the insurer to act:
  - To the detriment of one policyholder;
  - To fund loss of another policyholder (or visa versa)

Mutualisation
Level of determination

- Expected cash flows from/to participating policyholders are part of the fulfilment cash flows
  - In determining present value of future cash flows, it is irrelevant whether determined at individual or group level
  - Entity includes cash flows which come from or go to other policyholders as part of present value determination
  - Cash flows are cash flows (doesn't matter where from, so across portfolios is acceptable)
- Level of aggregation important for CSM determination only, but is determined after determination of cash flows, thus:
  - Level of aggregation does not affect mutualisation
  - Mutualisation may affect level of aggregation

Mutualisation
Level of determination

- Thus first determine expected cash flows, including cash flows to other policyholders, and cash flows from other policyholders (level of aggregation not relevant),

Then

- Determine level of aggregation, and
- Determine at inception CSM,

Thereafter

- Maintain the level of aggregation (no reassessment) and
- Remeasurements of cash flows include cash flows to and from other policyholders, and if they relate to future services, adjust CSM

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Mutualisation
Examples

- Most obvious mutualisation between policyholders sharing same pool of assets, and same generation, for example:
  - Two policyholders (A & B) share in same underlying items, but A has higher guarantee
  - B shares in residual of underlying after A's guarantee settled
  - B is subsidising A – there is mutualisation
- Can also occur across generations, for example:
  - Returns on underlying assets accumulate, but are not paid out to current generation of policyholder (generation C)
  - Instead accumulated as obligation to future generation (D)
  - There is consequently mutualisation between C and D

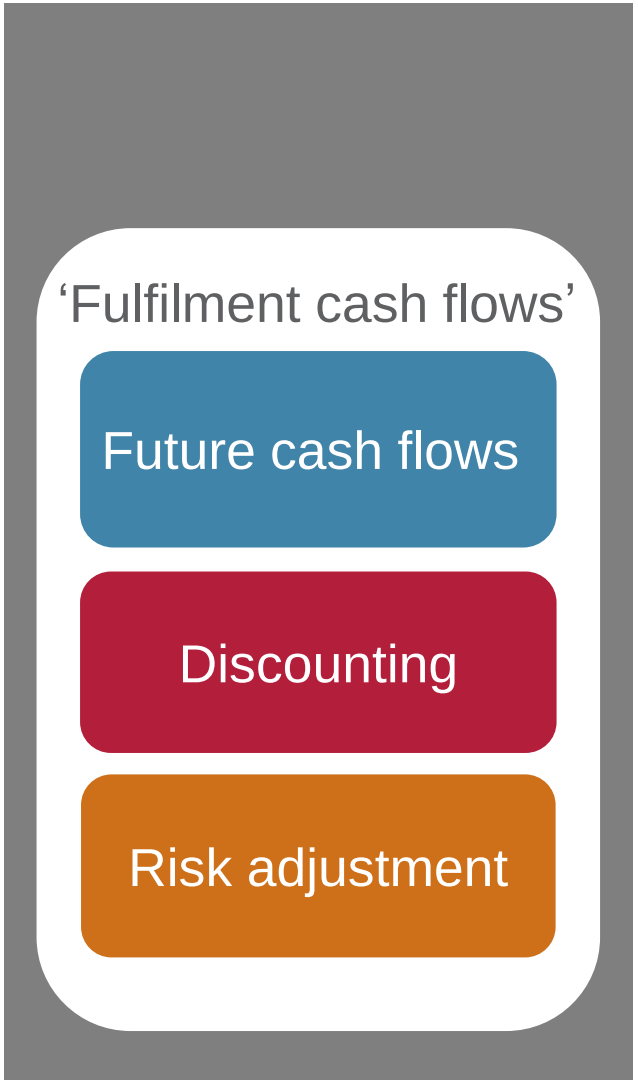
Mutualisation
Examples

- Mutualisation can also occur across product lines, for example:
  - Product E participates in the return on an underlying product line, product F
  - In determining the expected cash flows of E, entity must consider cash flows to and from F
  - In determining the expected cash flows of F, entity must consider cash flows to and from E

Level of aggregation

Measure contract at initial recognition
Fulfilment cash flows

Measurement of an insurance contract incorporates all available information, in a way consistent with observable market information.



Fulfilment cash flows is a probability-weighted, risk adjusted, estimate of the present value of cash inflows and outflows that will arise as the entity fulfils the contract.

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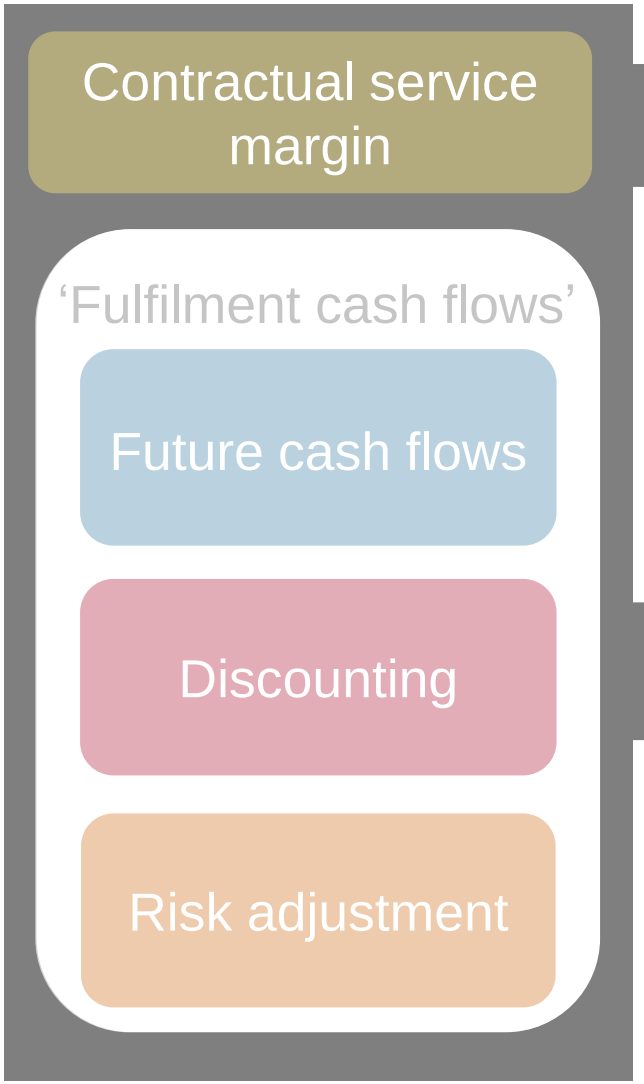
Measure contract at initial recognition
Fulfilment cash flows: Level of aggregation

Level of aggregation is **not** relevant for:

- Determination of fulfilment cash flows
  - Present value is consistently applied irrespective of level of application
- Determination and allocation of directly attributable expenses
  - Allocation based on nature and ‘attribute-ability’ of costs
- Determination and allocation of risk margin
  - Based on entity approach to determining compensation for risk

Measure contract at initial recognition
Contractual Service Margin (CSM)

Measurement of an insurance contract incorporates all available information, in a way consistent with observable market information.



Contractual service margin is measured as the **positive** (net inflow) difference between the risk-adjusted present value of expected inflows and outflows at inception.

Fulfilment cash flows is a probability-weighted estimate of cash inflows and outflows that will arise as the entity fulfils the contract.

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Measure contract at initial recognition
CSM

- CSM is determined as the risk adjusted present value of **all** the cash inflows and outflows (including mutualised cash flows)
- As such, at inception it captures the expected profitability of the contract over its entire expected life
  - If contract expected to be loss making, CSM is 'negative' and recognised in profit or loss (onerous contract)
  - If contract expected to be profit making, CSM is 'positive' and recognised as a liability (unearned profit)
- At inception, CSM is not a cash flow, instead it is the inverse of other cash flows

Measure contract at initial recognition
CSM: Onerous contracts

- Loss for onerous contracts should be recognised only when the contractual service margin is negative for a group of contracts, and that group should comprise contracts that at inception have:
  - Cash flows entity expects will respond in similar ways to key drivers of risk in terms of amount and timing AND
  - Similar expected profitability (ie similar contractual service margin as a percentage of the premium)
- Within group, net off the negative and positive CSM
- Model is asymmetric
- Group not reassessed after inception

Subsequent remeasurement
CSM: Onerous contracts

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Subsequent remeasurement
CSM: Allocation

- Objective for adjustment and allocation of CSM is that CSM at end of reporting period represents profit for future services for a group of contracts
- The group is the same as that for deciding when contracts are onerous
- Allocation should reflect expected duration and size of contracts remaining in the group

Importance of aggregation
Why aggregate

- Model is asymmetric
  - This causes different outcomes for grouped and individual contracts
  - For example,
    - entity has 2 contracts, based on data at inception are identical
    - after inception, Contract A becomes onerous (CSM = -CU10), while the contract B remains as expected (CSM = +CU20).
    - If accounted individually level, loss on A recognised immediately, profit on B spread over its life,
    - if grouped, A set off against B, smaller profit spread over life
- Nature of insurance is to aggregate risks
- Operationally, insurers use a myriad of different levels of aggregation

Importance of aggregation
Why limit aggregation

- Loss of transparency of information
  - Insight into loss making activities, cohorts, or products
  - Timing of loss recognition shielded by profitable business
  - Timing of profits over contract life (allocation)
  - At extreme, no losses until entire entity loss making
- Current inconsistency of application
  - Not generally defined in National GAAPs, or regulatory frameworks
- Consistency within IFRS
  - Revenue, leases and impairment all allow grouping, but only in very limited circumstances

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Importance of aggregation
Why more generous for Insurance

- Level of aggregation guidance allows considerably fewer groups then would be the case for equivalent guidance for Impairment/revenue/leases
- Those standards prohibit the setting off of onerous contracts against profitable contracts in the absence of contractual link

BUT in balancing reasons for and against

- Board maintains importance of transparency, but
- Board accepts that insurance is different
  - Risk Aggregation
  - Longer term contracts

Measure contract at initial recognition
CSM: Effect of regulation

- No exception to the level of aggregation for determining onerous contracts or the allocation of the contractual service margin when regulation affects the pricing of contracts
  - Contracts that do not have similar profitability, even if as a consequence of regulation, may not be aggregated for determining onerous contracts
  - Normal test applies
  - Regulation does not change the economics of the contracts, aggregation based on economics of the contracts

Questions or comments?