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Emerging Risks... Daring Solutions

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SECTION SANTÉ DE L'AAI
IAA HEALTH SECTION
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IFRS Project – Non-life

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Outline

- Non-life versus Short Duration
- Pre-claims
  - Recognition
  - Measurement
- Post claims
- Reinsurance
- Presentation & Disclosure
- Summary of non-life issues

(Appendix on Fulfillment Value)

Non-life versus Short Duration

Life vs. non-life concept is not in the IFRS proposal, instead, it refers to short duration vs. long duration, with same rules for direct and assumed.

Short Duration Definition

- Contract coverage period – approx. 1 yr or less

Short Duration contacts treated differently for:

- Pre-claims liability (*today's Unearned Premium*)
  Residual margin approach not used for short duration!
- Income statement

Pre-claims - Recognition

Recognize contract liability at earlier of

- Date bound
- Date first exposed to risk under the contract

(Current practice - recognize at effective date.)

Onerous contract test applied, even if policy is not yet effective.

Feedback to IASB – expensive to implement, not worth the effort.

Pre-claims – Measurement – part 1

Pre-claims ***obligation***

Initially

Premium received,

\+ Expected ***present value*** of future premiums

\- Incremental acquisition costs

Subsequently

- Reduce over coverage period "in a systematic way that best reflects exposure … "

  allow for seasonality (e.g. monsoons)?

- ***Accrete interest*** on pre-claims liability balance

Today's Unearned Premium, but made complicated?

Pre-claims – Measurement – part 2

Pre-claims ***liability*** =

Pre-claims obligation

MINUS

Expected ***present value*** of future premiums

Similar to netting Unearned Premium Liability and Agents Balances Asset into single liability item

NOTE: Current wording has omissions, confusions (not operational). ***THE WORDING WILL CHANGE !***

Pre-claims – Measurement – part 3

<u>Onerous Contract test</u>

Based on fulfillment value (building blocks)

- Probability-weighted (i.e., expected value) of future ***<u>incremental</u>*** cash flows (in and out)
- Discounted
- Risk adjustment

Unit of account – by portfolio (and by similar inception date)

Cushion exists to the extent that incremental cash flows leave out certain costs (e.g., overhead)

Same as Premium Deficiency Test with risk margin?

Post Claims Liability – Measurement

Fulfillment value - i.e., Three Building Blocks

- Expected Cash Flows
- Time Value of Money
- Risk “Adjustment”

Discounted claim liability with risk adjustment

Ceded Reinsurance

Ceded premiums shown net of commissions

Confusion as to whether to apply long duration or short duration model.
Intent supposedly was to follow the underlying

Problem of “policies attaching” reinsurance

1. All the underlying policies may be short duration, but resulting reinsurance policy may be “long duration”
2. Risk adjustment may span multiple underlying direct insurance “portfolios”

Calculate gross and ceded margin, or gross and net?

Short Duration - Presentation

Very similar to status quo for underwriting income – for current year policies

- Premiums (gross of incremental acquisition)
- Incurred Claims
- Expenses Incurred
- Amortization of incremental acquisition in “pre-claims liability”

Changes in prior yr estimates not in “incurred claims”

- Shown separately?

Balance sheet

- Ceded reinsurance is an asset, not a contra liability
- Break out balances by portfolio (reporting segment?)

Disclosures

Extensive disclosures required, but

"An insurer shall consider the level of detail necessary to satisfy the disclosure requirements and how much emphasis to place on each of the various requirements. ***<u>An insurer shall aggregate or disaggregate information so that useful information is not obscured by either the inclusion of a large amount of insignificant detail or the aggregation of items that have difference characteristics</u>****."*

In the end, it's not clear as to how much is required

Issues (Non-Life perspective)

- Definition of short duration
- Complicated approach for short duration pre-claims
- “probability-weighted cash flows”
- Restrictions on risk adjustment techniques
- Ceded reinsurance not following same model as underlying?
- Are risk adjustment complications worth it?
- Portfolio definition uncertainty

Is this an improvement over current short duration accounting (which is generally consistent throughout the world)?

QUESTIONS?

APPENDIX - Fulfillment Value

Three Building Blocks

- Expected future cashflows
- Time value of money discount
- Risk adjustment

Appendix (cont.) - Building Block 1 – expected future cash flows

"unbiased … probability-weighted estimate (i.e. expected value)"

- Reportedly, intent was not to require stochastic, but words may imply otherwise – differing views
- Reflect full range of ***all possible outcomes*** – impossible standard

"future cash flows"

- Incremental flows (to the portfolio) – including L&LAE, commissions, etc.
- Don't include overhead
- Net of inflows and outflows *within contract boundary*

Unit of account – portfolio of insurance ***contracts***

- "Insurance contracts that are subject to broadly similar risks and managed together as a single pool"

Appendix (cont.) - Building Block 2 – time value of money

What discount rate should be used?

- Yield curve with no or negligible credit risk, adjusted for differences in liquidity.
- Don't reflect own credit risk
- Don't base the rate on actual asset portfolio
- Approach consistent with a "benchmark portfolio" approach – i.e., based on hypothetical portfolio that matches expected payouts.

(based partly on KPMG presentation material)

Appendix (cont.) - Building Block 3 – risk adjustment

“The maximum amount that the insurer would rationally pay to be relieved of the risk that the ultimate fulfillment cash flows may exceed those expected."

- Must use one of the following techniques:
  - Confidence level
  - Conditional Tail Expectation (CTE = TVaR)
  - Cost of Capital (CoC)
- Does not specify the confidence level, TVaR or CoC to use.
- Requires Capital in CoC to be based on VaR.
- Estimated at a portfolio basis - reflect diversification within a portfolio but not between different portfolios
- Re-measured each reporting period