13th Global Conference of Actuaries 2011

Emerging Risks… Daring Solutions

IFRS: Insurance Contracts
Life Insurance: The Indian Context

Sanket Kawatkar

Samreen Asif

February 20 – 22, 2011

Disclaimer

The views and opinions expressed in this presentation are those of the authors and not necessarily of the employer that they represent

Definition (1)

- Insurance contract
  - is 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.
- Key aspects
  - Uncertain future event
  - 'Significant' insurance risk

Not insurance contracts?

- ULIPs with 'low' death benefits
- Non-participating / unit-linked 'pension' endowments with no death benefits
- Participating 'pension' endowments with zero death benefits → these can be argued to be financial instruments with discretionary participation feature

Definition (2)

- Discretionary participation feature
  - Contractual rights to receive additional benefits on top of the guaranteed benefits, that are:
    - Likely to be significant portion of the total contractual benefits
    - Timing and amount at the discretion of the insurer
    - Based on performance of specified pool of insurance contracts, realised / unrealised gains on assets; profit / loss of the entity / fund….. Provided there are other insurance contract which provide similar contractual right to participate in the performance of the same insurance contracts

Response from IRDA

- Where there are regulatory requirements to separate the business with discretionary participation feature into two different funds (life – with significant insurance cover and pension – without significant insurance cover), the definition would preclude the pensions business being treated under IFRS4. IRDA does not agree with this.

Are 'par pension endowments with no life cover' covered under the ED?

- Covered as financial instruments with discretionary participating feature, as there are likely to be 'insurance' contracts providing similar participation feature of the same company (even though through a separate fund)

Recognition

- Recognise an insurance asset / liability on the earlier of:
  - when bound by the contract or
  - exposed to risks
- No recognition of assets / liabilities for amounts relating to possible future claims under future insurance contracts (e.g. catastrophe reserves or equalisation provisions)
  - No prohibition to presenting such amounts by appropriating retained earnings to reserves within equity

Reserves currently held under Indian GAAP that may be affected

- Reserves for lapsed non-linked policies that may be revived in the future (given that insurers typically decide on the revival terms)
- Reserves for additional expenses under a new business discontinuance scenario. This is an additional provision, for expenses that may be incurred if the company stops writing new business in one year and therefore can be argued to be a risk arising due to 'future' insurance business.

Un-bundling (1)

- Un-bundle the other components in an ‘insurance’ contract if, and only if, the other components are not closely related to the insurance coverage:
  - What is ‘closely related’ is not defined
- Other components:
  - Investment component
  - Embedded derivative that are separated from the host contract
  - Goods and services that are not related to insurance coverage

Response from IoAI and IRDA

- These should be treated as one contract. If required to unbundle, ‘closely related’ should be defined.

Un-bundling (2)

Implications for India

ULIPs

- Not to unbundle the investment component from ULIPs if it can be argued to be ‘closely related’
- Not to unbundle the embedded surrender option in a ULIP, if it can be argued to be ‘closely related’ and can’t be measured separately without considering the host contract
- Unbundle the option to pay future top-up premiums in a ULIP?

Child Education Endowments

- Should we unbundle the ‘certain’ payments (not dependent on the survival status of the life insured) in contracts that are currently marketed as ‘child education’ plans on conventional par / non-par platforms?
  - These contracts can be seen to be a term insurance contract plus an investment component towards the ‘certain’ payments
  - But, these contracts can also be seen as a conventional endowment / anticipated endowment contract, with an additional death benefit (equal to the amounts that would be paid after the death of the insured on the pre-specified dates)

Un-bundling (3)

Implications for India

Group Gratuity / Superannuation / Leave Encashment

- Unbundle the ‘services’ related to actuarial valuation services, if offered?
- Unbundle the scheme administration / record keeping / initial administration services (trust deed / rule amendments etc.) in a group gratuity / superannuation contract?
- In the Group Leave Encashment Plans issued along with One Year Group Term Cover (through separate contracts) – should the Group Leave Encashment contract be unbundled (as it is not ‘closely related’)?

Measurement (1):
Current estimates of future cash-flows

- "Current fulfilment value" as opposed to "current exit value"
- Incremental acquisition costs to be included

Response from IoAI

- Welcome inclusion of incremental acquisition costs. But definition needs to be reworded. For example, the current definition would exclude incremental acquisition costs that were incurred for contracts that could not be issued.

- Excluded:
  - indirect costs, investment returns on assets backing policyholder liabilities, income tax, reinsurance cash-flows (to be measured separately), non-incremental acquisition costs (to be expensed off at the time of initial measurement).

Cash-flows currently included under Indian GAAP reserves that may be excluded in IFRS

- Shareholders' transfers linked to bonus declared and taxes thereon, with respect to the participating business

Measurement (2):
Current estimates of future cash-flows

- Entity specific and probability weighted – i.e. options, guarantees required to be valued using stochastic techniques
- Risk of non-performance by the insurer is not reflected
- Contract boundaries
  - Beyond which no coverage, OR
  - Practical ability to re-assess the risks and reflect fully in pricing

Response from IRDA
- More guidance required – e.g. what about voluntary contributions in the future?

Response from IoAI
- More guidance required in applying the principles for young companies (e.g. expenses)
- All expenses should be included, not just direct expenses

Examples from Indian practices
- Charges in UL contracts are typically variable and can be reflected upon reassessment of risks. But is it practical to vary these?
- Assumption of 'nil' policy discontinuance rates in reserves calculations - This may need to change under IFRS, where the expected behaviour of the policyholders may need to be reflected (with an adjustment under 'risk adjustment' that the actual behaviour may differ from that expected)

Measurement (3):
Time value for money

- Non-participating contracts (where future cash-flows are not dependent on performance of underlying assets):
  - Risk free rates with liquidity premium
- Others (where the cash-flows depend on performance of underlying assets):
  - Reflecting this dependence, for example, using replicating portfolio techniques
  - IASB Staff Paper November 2010 proposes that different discount rates can be used for different components of a contract e.g. option pricing techniques for participating features and the non-participating contract rate for other cash flows of the same contract
- No allowance for investment risks, ALM risks or other operational risks

Responses from IoAI and IRDA

- More guidance on development of risk free yield curves is required
- IASB should not re-consider the current exclusion from the discount rate of the insurer's non-performance risk

Measurement (4):
Risk adjustment

- Maximum amount an insurer would rationally pay to be relieved of the risk that the ultimate fulfilment of cash-flows exceed those expected

Response from IoAI

- Prefer reference to an economic way to measure the risks involved, rather than the market price that would be charged (e.g. "an amount that would provide high degree of certainty that the insurer would fulfil the contract" as opposed to "the maximum amount payable…")

Response from IRDA

- Impossible to calibrate in the Indian context as liabilities are not traded

Implications for India

- Who would set the tolerance limits? Board? Appointed Actuary?
- Currently, in a joint venture context, the promoters (who are the 'shareholders'), may have different views about what they would rationally pay to be relieved of the risk that the ultimate cash-flows may be higher than expected

Measurement (5):
Risk adjustment

- Should not apply to liability values based on market prices
  - so as not to double count the implicit allowance inherent in market prices
- Risk adjustment 'one sided'
  - only allows for the risk that the fulfilment cash-flows are higher than expected
- Measured at portfolio level
  - restricts potential allowance for diversification of risks across product segments
- Measured based on either of VaR or TVaR or Cost of Capital approaches

Responses from IoAI and IRDA
- Shouldn't restrict to only these three techniques

- What target level of confidence / capital? - Required to be disclosed

Responses from IoAI and IRDA
- No point in disclosing only the target level of confidence, unless full disclosure of the method used, sensitivities are also disclosed.
- May run the risk of convergence to 'a' confidence level as opposed to application of the principle to quantify risk adjustment useful for economic decision making

Measurement (6):
Residual margin

- No gain on entering into an insurance contract
  - Incremental acquisition expenses included as liability cash out-flows and thus lowers the residual margin. All other acquisition costs are charged to P&L as incurred.
  - This is similar to setting up DAC (but only for incremental acquisition expenses)

Implications for India

- DAC is currently not allowed. But a prospective gross premium reserves calculation can be argued to defer all the 'acquisition costs' (although the negative non-unit reserves is subject to a minimum floor of zero in India).
- Under IFRS:
  - Any artificial 'floors' such as the setting up of negative non-unit reserves to zero, may need to be removed
  - An explicit adjustment is required in the fulfilment cash-flows for the incremental acquisition costs

Measurement (7):
Residual margin

- Residual margin is released over the contract duration based on time passage (unless this is different as compared to the pattern of future claims expected)

Response from IoAI

- May consider alternative approaches to release (e.g. based on selected 'profit drivers' at a product level)

Response from IRDA

- Should not be released until contracts go off the books to avoid booking 'paper profits'.

Implications for India

- For lapsed policies under ULIPs (or indeed those policies that have matured and have left the maturity proceeds under the "settlement option" offered), the residual margins may be assumed to be released immediately upon lapse / maturity.
- The risk for any strain upon revival (in case of lapsed ULIPs reviving) may need to be reflected in the risk adjustment.

Measurement (8):
Residual margin

- Not re-calculated every year based on revised estimates of fulfilment cash-flows and risk margins
- Interest accretion to residual margin
  - Rate determined at outset for each contract and locked-in
  - May vary by product based on the discount rates used in the measurement of present value of fulfilment cash-flows
- On first adoption of IFRS, residual margins will not apply to in-force business

Response from IoAI

- Support separation of risk and residual margin

Response from IRDA

- Support a composite margin

Measurement (9):
Short duration contracts

- Simplified approach
- Applies to short-term contracts during pre-claim period
- Subject to liability adequacy test
  - To check if contract is 'onerous' and reserve for the shortfall

Responses from IoAI and IRDA

- Would support such an approach as a 'permit but not require' basis

Implications for India

- Several companies currently use UPR method to reserve for riders such as ADB, ADD etc.
- Apart from group term contracts (or YRT type contracts) which are 'short duration' contracts, an explicit measurement as in the case of long term contracts may be required for such riders under the IFRS, as these riders may not be classified as 'short duration' contracts.

Reinsurance

- Measured separately and not by netting off against insurance cash-flows
- Similar to 'insurance' contract
  - But to reflect an adjustment for non-performance by the reinsurer in a cedent's balance sheet

Response from IoAI and IRDA

- Inconsistent treatment – to recognise profit on cedant's reinsurance contract at inception, but eliminate the losses on insurance contracts upon initial recognition
- Also, what happens when the profit on cedant's reinsurance is more than loss on insurance contracts?

Presentation and disclosures (1)

- Statement of Financial Position (i.e. Balance Sheet)
  - UL assets / liabilities to be shown separately from other assets and insurance liabilities
  - Reinsurance assets to be shown separately from gross insurance liabilities
- Statement of Comprehensive Income (i.e. P&L Statement)
  - All income and expenses related to insurance contracts
  - Reinsurance cash-flows to be shown separately
  - Items related to UL business to be shown separately
  - A ‘margins’ approach as opposed to showing all cash-flows such as premiums, expenses, claims etc.
    - Underwriting margins
    - Gains / losses at initial recognition
    - Non-incremental acquisition costs
    - Experience adjustments and changes in estimates
    - Interest on insurance liabilities

Presentation and disclosures (2)

- Other comprehensive disclosure
  - Reconciliation of opening / closing balances
  - Method and approach used
  - Sensitivity analysis
  - Etc.

Response from IoAI and IRDA

- Information would be illuminating for experts, but difficult to be understood by most users and supplementary information (premiums, claims, expenses etc.) need to be disclosed.
- Also, outputs would typically come out of actuarial (as opposed to accounting) models. For these to be primary reporting, would require significant re-engineering of actuarial and accounting processes and software

Transitional measurement

- Through an adjustment in retained earnings:
  - Exclude residual margins

Response from IoAI

- This would mean a significant reduction in the post-transitional earnings from the in-force business

Response from IRDA

- This would accelerate the emergence of future surplus

  - De-recognise any DAC
- Permitted to, but not required to re-classify assets to avoid accounting mis-matches
- Timelines for implementation to be notified

Response from IRDA

- Expected timelines to adopt (after ED is notified) – a minimum of 2 years

Status for Indian Accounting Standards

- *"Let me make it very clear that India is a signatory to accept IFRS. By accept, I mean convergence to IFRS by April 2011 and not adoption. We stand by that. There is no reason to change that date or extend the time"* – Mr. R. Bandyopadhyay, Ministry of Corporate Affairs, at "IFRS Summit 2009" organised by the CII
- Slow progress so far on issuance of Indian Accounting Standards
- IndAS 104 (Insurance Contracts):
  - Equivalent to IFRS 4 (Insurance Contracts)
- No IFRS / exposure draft equivalent to the ED (Insurance Contracts) issued by IABS. Timelines not clear.
- Likely delay?

Acknowledgements

- Exposure Draft (ED/2010/8) – Insurance Contracts – July 2010
- Basis for Conclusion (Exposure Draft 2010/8) – Insurance Contracts – July 2010
- Snapshot: Insurance Contracts – July 2010
- Milliman Research Reports
  - "Discussion of the IFRS Exposure Draft for Insurance Contracts" (September 2010) by William Hines, Nick Kinrade, Scott Mitchell, Henny Verheugen
  - "IFRS Statement of Comprehensive Income – A Practical Implementation" (December 2010) by Lotte van Delft, Henny Verheugen
- Comments of IRDA on Exposure Draft on Insurance Contract – 27 Nov 2010
- Comments from IoAI on Exposure Draft of Insurance Contract – 30 Nov 2010
- IASB Staff Paper – Discount Rate on Participating Contract – 8 Nov 2010