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CONFÉRENCE / RÉASSURANCE

Convergence in Financial Reporting



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Discussion Topics

- Convergence in financial reporting:
 - Update on insurance contracts project
 - Issues from a life reinsurer perspective
 - IASB proposals from an analysts perspective
 - Regulatory implications
- Questions for the panel



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Update on IASB Insurance Contracts Stage II

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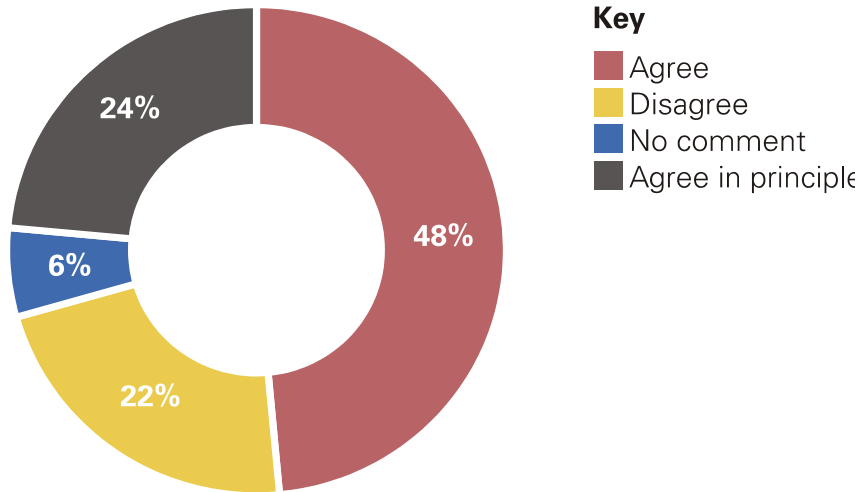


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IASB Stage II Insurance Contracts update

Discount rate

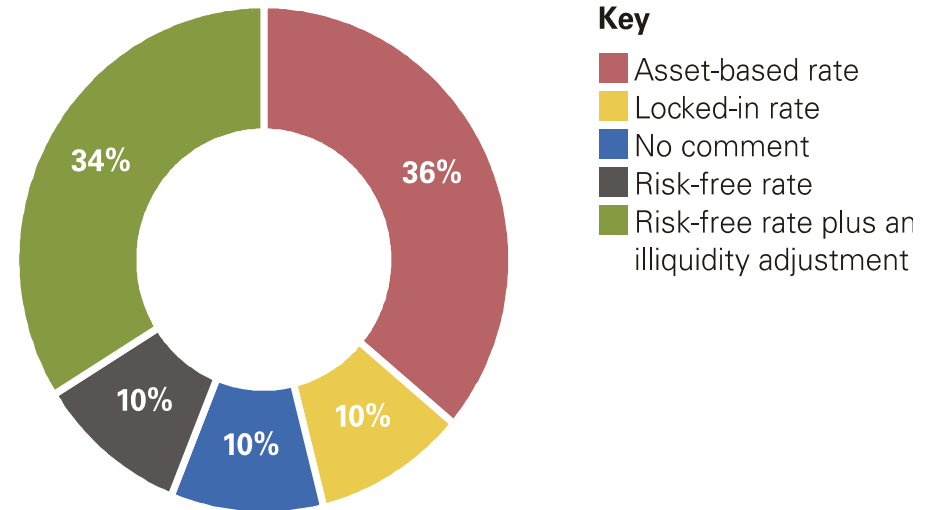
Comment letters: Should a liability based discount rate be used?



Real message is that discount rate will not be based on assets held

- Major change for Canadian (and US) lifecosts
- Potential for substantial mismatches and earnings volatility

Comment letters: What method for the rate?



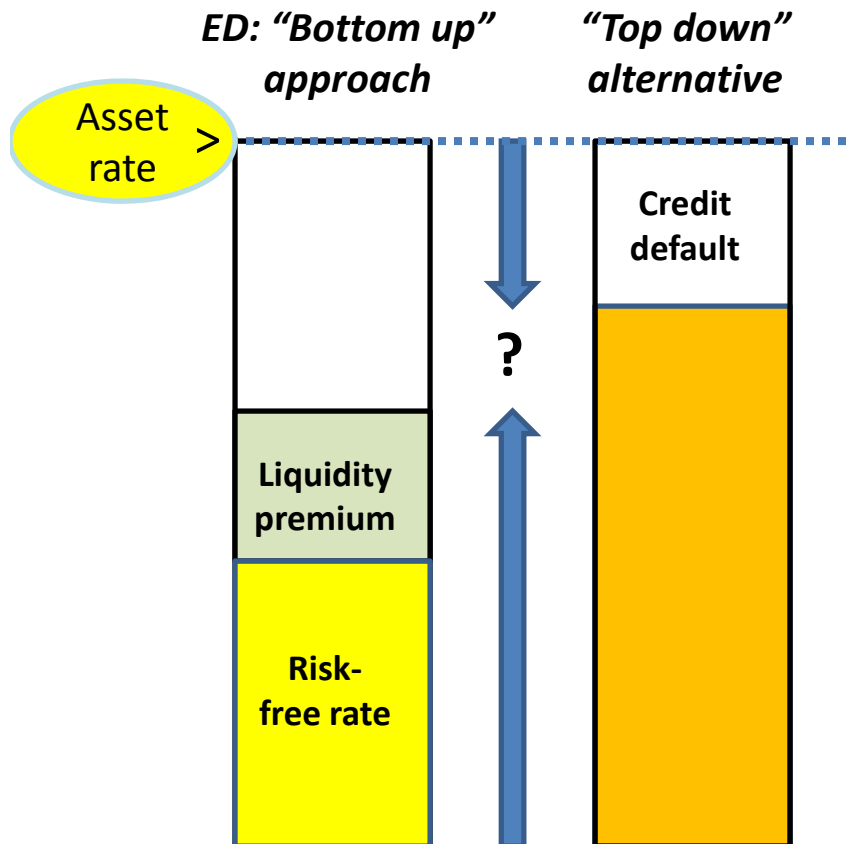
More controversy than consensus

- Those with long duration liabilities advocate for asset-based rates, locked-in rates or some combination
- Many alternatives presented to IASB



IASB Stage II Insurance Contracts update

Discount rate



- Tentative decisions:
 - Reflect the characteristics of the liability; no linkage to assets
 - No “locking in” of the rate
 - Allow a “top down” approach
- Applying the “top down” alternative
 - Deduct risks not present in the liability, e.g. investment risks that can’t be passed to the policyholder (expected and unexpected defaults)
 - IASB: bottom up and top down should get to the same place - ?
 - Might reduce but not eliminate problems of volatility and losses at inception

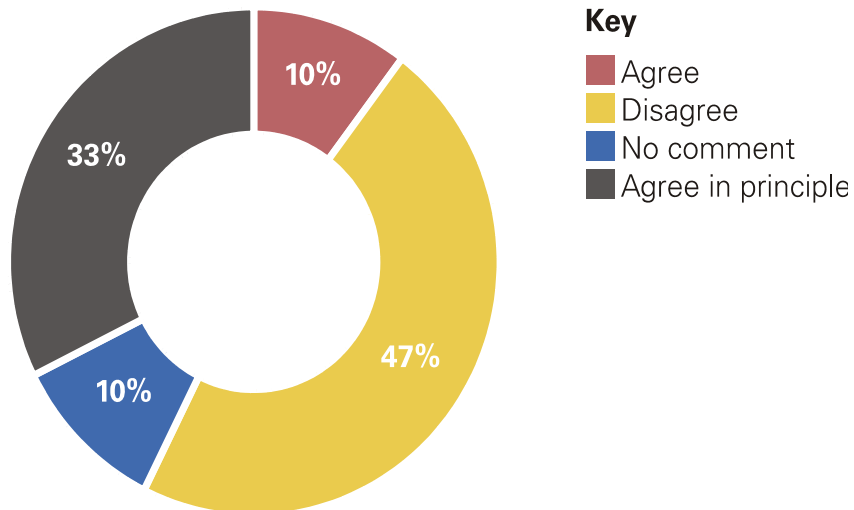


IASB Stage II Insurance Contracts update

Acquisition costs

ED proposed acquisition costs be only direct costs for successful sales.

Comment letters: Do you agree with the proposal for incremental acquisition costs?



- **Change from the ED:** on March 2, IASB reached a tentative decision that acquisition costs should include all costs incurred in acquiring a portfolio, including
 - Direct costs such as commissions, and
 - Costs that are directly attributable to acquisition activity in general and that can be allocated to the portfolio
- Effect is to broaden range of costs and include successful and unsuccessful sales
- FASB disagreed and unanimously agreed to retain its position that acquisition costs would include only direct costs of successful acquisition of insurance contracts



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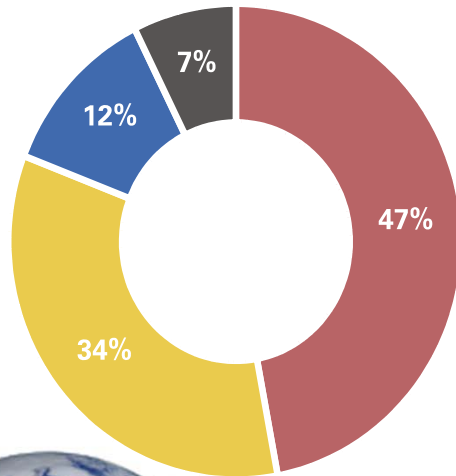


IASB Stage II Insurance Contracts update

Risk + residual margin, or composite margin?

ED called for an explicit risk margin, plus a locked-in residual margin to eliminate day one profits.

Comment letters: Risk adjustment plus residual margin, or composite margin?



Key

- Risk adjustment plus residual margin
- Composite margin
- No comment
- No preference

- Risk adjustment plus residual margin
 - Strong support in Europe as this is consistent with Market Consistent Embedded Value and Solvency II
 - Supported by Australia and Canada as they already have a risk adjustment included in the measurement of insurance liabilities
- Composite margin
 - Supporters concentrated in the United States, Japan and China
 - Supported for the perceived subjectivity involved in determining this risk adjustment
- Current IASB deliberations on allowing re-measurement of residual margin



IASB Stage II Insurance Contracts update

Other issues

Issue	Outlook
<p><u>Insurance contract definition</u></p> <ul style="list-style-type: none"> • ED introduced a quantitative risk transfer test (B25) similar to US GAAP FAS 113, requiring a reasonable scenario where NPV of cash flows would be negative. • Effect could have been to rule out insurance accounting for some quota share and similar reinsurance deals. 	<ul style="list-style-type: none"> • On March 15, the IASB and FASB both agreed to retain the definition of an insurance contract, but with additional guidance for reinsurance risk transfer, likely similar to the US GAAP guidance (see FAS 113.11, or codification paragraph 944-20-15-53)
<p><u>Recognition</u></p> <ul style="list-style-type: none"> • ED discussed recognition of insurance contracts when entered into, rather than at coverage or effective date. 	<ul style="list-style-type: none"> • On March 15, the IASB and FASB agreed to amend the recognition proposals to adopt the more practical approach of recognizing a contract at the effective date or the date coverage begins.



IASB Stage II Insurance Contracts update

Other issues

Issue	Outlook
<p><u>Transition</u></p> <ul style="list-style-type: none">• ED proposed that at transition, the liability for in-force contracts would reflect discounted cash flows plus a risk margin, but not a residual margin.• Effect for profitable business would be to front end expected future profits into retained earnings.	<ul style="list-style-type: none">• Not settled. Comment letters we analyzed were over 90% opposed to the transition approach, arguing for it to be optional and allow a retrospective approach.
<p><u>Modified measurement approach</u></p> <ul style="list-style-type: none">• ED proposed requiring a sort of unearned premium approach for “short term” business”, defined as 12 months or less. UPR method would be net of DAC in effect, and would require accretion of interest.	<ul style="list-style-type: none">• Not settled. Comment letters argued for the modified approach to be optional (over 70%). Comments also opposed accretion of interest as unnecessary, and for a better “short term” definition.



IASB Stage II Insurance Contracts update

Other issues

Issue	Outlook
<p><u>Time line</u></p> <ul style="list-style-type: none"> • ED was silent on effective date. • ED suggested that the IASB would consider deferral of implementation of IFRS 9 (financial instruments) from 2013 if the insurance standard was delayed beyond that year. 	<ul style="list-style-type: none"> • Not settled, but very unlikely the effective date would be before 2015. IASB are sticking to issue of the new standard by June 30 (despite rumours to the contrary). • No discussion of IFRS 9 deferral.
<p><u>Convergence of IASB and FASB</u></p> <ul style="list-style-type: none"> • FASB expected to issue its own ED after IASB issues its standard on June 30. 	<ul style="list-style-type: none"> • Differences are fewer but still exist: <ul style="list-style-type: none"> • FASB has not accepted risk margin concept, but differences are narrowing. • Positions on acquisition costs are diametrically opposed.



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Business Model

- Interaction of assets and liabilities should be fully considered
 - Concern about short-term market movements and artificial volatility - separate from long term performance
 - Allow elements of changes in assets/liabilities through OCI
 - AFS category for assets may need to be reconsidered by the IASB
 - Alternatively, a solution through IFRS 4 will be needed



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Unit of Measurement

- ED proposed that insurers should measure the risk adjustment at portfolio level of aggregation
- Reinsurers position – Further allowance should be made for diversification
 - Current ED would potentially lead to overstatement of realistic liabilities
 - Widespread actuarial techniques used by industry (e.g., capital management and pricing) reflect diversification
 - Diversification between lines of business – e.g., Annuity and Life – up to a group level



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Definition of insurance contract

- ED proposed explicit test based on present values of outflows vs premiums
- Reinsurers position – Boards tentatively agree?
 - Definition in IFRS 4 Phase I worked well
 - Amendment problematic where a single contract covers an entire pool of risks – pooling produces more stable results
 - If retain quantitative test, then include other conceptual guidance from US GAAP
 - Supported alternative – business that meets the definition of an insurance contract in the primary sector should be considered as (re)insurance if reinsured , in whole or in part, and the reinsurer covers the risks relating to the reinsured portion of the portfolio



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Definition of insurance contract (cont.)

- Contractual linkage
 - ED advises that "contracts entered into simultaneously with a single counterparty, or contracts that are otherwise interdependent, form a single contract"
 - Problematic for fronting, retrocession and reinsurance programs
 - Reinsurers have asked IASB to make it clear that the above were not intended to be captured with this wording
- General requirement
 - Reinsurers have asked IASB to clarify that assessment of a contract should only be carried out once, at inception



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Other issues

- Calibration of residual margin to reinsurance premium
 - Misleading – does not take account of differences in risk assessment between primary insurer and reinsurer
 - Residual margin should be based on risk transferred
- How to measure reinsurance asset where modified approach (PAA) is used for liability measurement?
- Coverage period – reinsurance underwritten in advance of underlying primary insurance
 - Tentative Boards decisions – recognize when coverage period begins; set up liability for onerous contracts in pre-coverage period, if mgt aware.



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Discount Rate

- North American impact would broadly be based on underlying business
 - Consider coverage – i.e., types of policies written by primary insurance clients
- Global impact mitigated by mix of business
- Against income volatility due to significant short-term market fluctuations
 - ED does not represent long-term business model of holding assets to satisfy policy



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IASB Proposals From an Analyst Perspective

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What do Investors want from a Financial Reporting Standard?

- Earnings, BV and ROE are the key drivers of valuations so a Financial reporting framework should be
 - Understandable
 - Interpretable
 - Consistent from reporting period to reporting period
 - Sufficiently detailed
- A framework whose earnings are generally smooth and reflect change in revenue
 - Investors don't like volatility



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Key Issue With IFRS Phase II Exposure Draft

- Fundamentally agree with cashflow valuation methodology and ‘source of earnings’ presentation framework. Similar to the current approach in Canada
- Key issue is using a discount rate equal to risk free rate plus a liquidity premium
- Delinking assets from liabilities not only leads to considerable volatility but it does not reflect the risks of the business, particularly the asset/liability mismatch risks
- Will lead to non-GAAP unaudited measures
 - Can be thought of as counter productive and inconsistent with financial reporting principles
 - But “operating earnings” have become the measure in the U.S. and “adjusted earnings from operations” are now used in Canada



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IASB/FASB Convergence is Important

- Need to have U.S. lifecos onboard
- Discussions at recent IASB/FASB joint Board meetings are generally encouraging
 - Essentially ruling out amortized cost (U.S. GAAP) methodology in favour of a more mark-to-market (CGAAP) approach
 - More in depth look at discount rate approach/methodologies
 - Investigating the possibility of presenting some components of economic volatility (possibly related to the discount rate) below the line in OCI



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Regulatory Capital Implication are Equally Important

- Capital is just as important as earnings/ROE/BV, so convergence of global capital requirements is just as important as convergence of accounting standards
- Canada unique in that statutory currently equals CGAAP
- Coordination with IAIS, other regulatory bodies, and Solvency II is vital for competitive reasons (from the standpoint of companies) and comparative reasons (from the standpoint of investors)



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Phase II – Regulatory Implications

Canadian Perspective

- OSFI is actively following Phase II - understanding major policy and business model implications is key to effective change mgmt.
- Phase II implementation is an OSFI priority project:
 - Major links to development of new regulatory capital regime
 - Other OSFI policy considerations and guideline development/revision
 - Significant impacts for OSFI systems, information collection, analysis
- Another major round of IFRS implementation work expected over next 3-4 years, as many convergence projects to be implemented



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Phase II – Regulatory Implications

OSFI's Key Issues/Concerns with IFRS Phase II

- Potential 'inappropriate' volatility from ST rate fluctuations:
 - Earnings should reflect 'fulfillment' nature of business
 - Need to avoid undesirable 'noise' in regulatory capital
 - Understanding that there are no perfect solutions
- Wider range of practice may emerge. OSFI may consider options for narrowing in some areas, especially for reg capital purposes
- Significant changes may have major business model implications



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Phase II – Regulatory Implications

OSFI's Role in Int'l Standard Setting Process

- OSFI looks to influence, both directly and indirectly, the development of standards that may apply to Cdn. Insurers
- For insurance regulators, IAIS is key Int'l group
 - OSFI is a member of Insurance Contracts SC looking at Phase II issues
 - Detailed 'Phase II' ED response letter, extensive previous comments
 - On-going dialogue with IASB and a member of IASB's IWG
- OSFI is also an active member or participant on many other Int'l groups including BCBS, FSB, The Joint Forum and the IAA



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Phase II – Regulatory Implications

International/ IAIS Perspective

- IAIS is supportive of converged insurance acctg std
 - Insurance accounting can be very different across various jurisdictions, even among those jurisdictions that have adopted IFRS
 - Phase II may provide a common language and basis for future international regulatory capital convergence initiatives (ComFrame etc)
- IAIS is generally supportive of Phase II ED, however:
 - Concerns with many aspects of the ED details
 - Jurisdictional differences over how best to resolve key discount rate issues, risk versus composite margins, and approach to residual margins



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