IFRS Foundation Special Interest Sessions:
IFRS for Insurance Contracts
Actuarial perspective

Hideyuki Yoshida
Tokyo July 28, 2010
Disclaimer

The content and opinions expressed in this presentation do not necessarily reflect those of the Professional Associations (IAA, IAJ, etc) and Firms (PwC, etc) associated with the Author.
As of this writing (July 14, 2010), the Exposure Draft has not been published and the contents in this presentation are based upon published documents by IASB/FASB up to this time.

It is expected that actuarial associations around the world (including IAA and IAJ) will prepare their own comment letters in due course after the Exposure Draft is published.

To gain local actuaries’ opinions on this subject at this timing, the author conducted a survey on various issues regarding the IFRS Insurance contracts project in early June this year.

Nine senior actuaries from nine life insurance companies contributed to this survey.

The following slides refer to actuarial observation for each issue based upon the survey on top of the author’s own views. In addition, IAA documents are frequently referred to.

There are five topics in the main presentation which the author believes require mathematical skills and actuarial knowledge most.
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(1) **Explicit risk adjustment approach:**

This approach includes two margins:

1) An explicit risk adjustment for the effects of uncertainty about the amount and timing of future cash flows from the perspective of insurer rather than from the perspective of a market participant.

2) An amount that eliminates any gain at inception of the contract (residual margin).

- Explicit risk adjustment is the maximum amount insurer would rationally pay to be relieved of the risk that the ultimate fulfilment cash flows may exceed those expected. **(Objective)**

- Explicit risk adjustment would be updated (re-measured) each reporting period.

- Under the explicit risk adjustment approach, the guidance would limit the range of permitted techniques by specifying the available techniques, (See slide 1.1).

- Although the risk adjustment is included in the measurement as conceptually separate from other building blocks (cash flows and discount rate), this is not intended to preclude “replicating portfolio approaches”. To avoid double counting, the risk adjustment does not include any risk captured in the replicating portfolio.
## 1. Risk adjustment (continued)

### (2) Composite margin approach:

- This approach includes a single margin that eliminates any gain at inception of the contract (composite margin).
- Under composite margin approach, no explicit risk adjustment, is made, as objective may not sufficiently robust to promote rigorous application.

### (3) Should there be an explicit risk margin?

<table>
<thead>
<tr>
<th>Advantages</th>
<th>Disadvantages</th>
</tr>
</thead>
<tbody>
<tr>
<td>• An explicit measurement of uncertainty is useful information</td>
<td>• Little chance of comparability and consistency without rules</td>
</tr>
<tr>
<td>• Explicit risk margin could be remeasured to reflect changes in price and quantity of risk</td>
<td>• Market may not trust explicit margin calculations</td>
</tr>
<tr>
<td>• Reflects risk in skewed tail distributions</td>
<td>• Not sure objective of risk margin can be consistent with fulfilment objective</td>
</tr>
<tr>
<td>• Lessens amount of residual margin subject to the complexities of amortising/remeasuring the residual margin</td>
<td>• Cost/benefit for all sized companies uncertain</td>
</tr>
<tr>
<td>• Consistent with some regulatory regimes</td>
<td>• Can it be done quickly enough for quarterly reporting?</td>
</tr>
<tr>
<td>• Explicit risk adjustment currently required under transition rules for inforce business at transition</td>
<td>• Difficult to audit</td>
</tr>
</tbody>
</table>
IASB permits the following techniques for determining risk adjustments and no others:

1. **confidence interval**; Also known as value-at-risk (VaR), in which the risk margin is the difference between a specified quantile (percentile) of the distribution and the expected value.

\[
\text{CTE}(p) = E\{x \mid x > z(p)\} = \frac{\int_{z(p)}^{\infty} xf(x)dx}{\int_{z(p)}^{\infty} f(x)dx}
\]

where \( f(x) \) is the probability density function, \( p \) is the selected quantile and \( z(p) \) is chosen so that

\[
\int_{z(p)}^{\infty} f(x)dx = 1 - p
\]

2. **conditional tail expectation (CTE)**;

3. **cost of capital**

\[
\text{Risk Adjustment} = (r - i) \sum_{t=0}^{\infty} \frac{C_t}{(1+i)^{t+1}}
\]

\( i \) = Risk-free rate of return on investments
\( f \) = Total rate of return demanded by investors for taking on insurance risk
\( C_t \) = Amount of capital required (or allocated) to support an insurance portfolio at time \( t \).
Desirable risk margin characteristics (IAIS, IAA, and Draft application guidance except e.)

a. The less that is known about the current estimate and its trend; the higher the risk margins should be.

b. Risks with low frequency and high severity will have higher risk margins than risks with high frequency and low severity.

c. For similar risks, contracts that persist over a longer timeframe will have higher risk margins than those of shorter duration.

d. Risks with a wide probability distribution will have higher risk margins than those risks with a narrower distribution.

e. To the extent that emerging experience reduces uncertainty, risk margins will decrease, and vice versa.

Reference Materials for Risk Adjustment


3. The CRO Forum Market Value of Liabilities paper  
The way to develop Cost of Capital rate (CoC) seems very subjective. The IASB staff paper, shows the following example:

- CoC=8% = 18% (investor’s required rate) - 2% (asset risk) - 1% (ALM risk) - 3% (Operational risk etc.) - 4% (Risk free rate).
- Determination of those subtracting components, other than risk free rate seems challenging for actuaries.
- Common challenge for all techniques is how to develop the “right” risk distribution for each portfolio. (transparency and full disclosure should be required.)
- The capital will be economic capital not regulatory capital.

1.3 Risk adjustment techniques – Actuarial Perspective

(CFO FORUM MCEV PRINCIPLE 9; COST OF RESIDUAL NON HEDGEABLE RISKS seems to have a similar issue.)

Principle 9: An allowance should be made for the cost of non hedgeable risks not already allowed for in the time value of options and guarantees or the PVFP. This allowance should include the impact of non hedgeable non financial risks and non hedgeable financial risks. An appropriate method of determining the allowance for the cost of residual non hedgeable risks should be applied and sufficient disclosures provided to enable a comparison to a cost of capital methodology.
Imagine there are two companies, A and B which have totally identical liability portfolios. The auditor is the same for both companies.

Both companies came up with current estimates of liability, say US$100 billion.

Company A used CoC approach assuming 99.5% confidence level of Economic Capital and 6% CoC rate and calculated risk adjustment as US$8 billion. At the same time, Company A disclosed Quantile approach based risk adjustment using 75% confidence level which resulted in US$2 billion. Company A had difficulty reconciling those two numbers; they adjusted the various parameters and took the average of two approaches; **US$5 billion** was the final statement number.

Company B (which has a more conservative management view) also used CoC approach assuming 99.95% confidence level of Economic Capital and 6% CoC rate and calculated risk adjustment as US$11 billion. At the same time, Company B disclosed Quantile approach based risk adjustment using 90% confidence level which resulted in US$4 billion. Company B had difficulty reconciling those two numbers and decided to use the larger of the two numbers which is **US$11 billion** as the final statement number.

The liabilities are identical for both companies, only judgments of management are different. Assume those companies are listed on a major Stock Exchange.

**The difference of the total liability (excluding residual margin) is US$6 billion** which could prove to be important to the users of the financial statements.
2. Level of measurement

- If the measurement approach includes an explicit risk adjustment, the adjustment should be determined for a portfolio of insurance contracts rather than individually.

- The current definition of a portfolio of insurance contracts in IFRS 4 will be retained (“contracts that are subject to broadly similar risks and managed together as a single portfolio”).

- The explicit risk adjustment would not reflect the effects of diversification or negative correlation between portfolios.

- Residual and composite margins would be determined initially and subsequently at a cohort level that groups insurance contracts (a) by portfolio, (b) within the same portfolio by date of inception of the contract, and (c) by length (life) of the contract.

Discussion Comments

- There will be practical implementation challenges when measuring the residual and composite margin at such a granular level (portfolio, inception year, life of contract).
(IAA Discussion regarding Level of measurement)

✓ Margins will be determined initially and subsequently at a cohort level. Does this mean that we know insurance liability only on a cohort basis not on a policy by policy basis? Or will the liability for a cohort be allocated to individual policies by some formula?

✓ For current Boards’ decisions, the margins could be allocated to the individual policies but because they specify the risk and the risk of one policy is not the risk of the portfolio divided by the number of the policies, I don’t see very much sense in allocating the margins to the individual policies. As I said above, I would keep the risk margin as a non-allocable item. (Opinion of an IAA insurance accounting committee member)

✓ Additive calculation of each portfolio’s risk adjustment is not mentioned, but it seems clear from the previous page saying “Not reflect the effects of diversification or negative correlation between portfolios”.
3. Discount rates

- The discount rate for insurance liabilities should conceptually adjust estimated future cash flows for the time value of money in a way that captures the characteristics of that liability.

- Those characteristics are not best reflected using a discount rate based on expected returns on actual assets backing those liabilities (unless those asset returns affect cash flows to policyholders).

- Liquidity is one of the relevant characteristics that should theoretically be reflected in the discount rate.

- Exposure draft will not propose to include an adjustment for nonperformance risk (including credit spreads), but will solicit views on this from constituents.

Reference Materials for Discount rate

Calculation of the illiquidity premium applied will be particular challenging. See the work of the European Insurance Industry for Solvency II where this is also an issue.

1. QIS 5 Technical Specification Risk-free interest rates by CFO FORUM and CRO FORUM

2. Application of the illiquidity premium to liabilities by CRO FORUM and CFO FORUM
3. 1 Discount rates - Actuarial Perspective

(IAA’s reference materials)

- “Summary of Liquidity Premium Estimation Methods” by Barrie & Hibbert (October 2009).
- IAA Educational Monograph on the Topic of Issues Associated with the Determination of Discount Rates for Financial Reporting Purposes to be prepared.
### 4. Participating features in insurance contracts

<table>
<thead>
<tr>
<th>IASB</th>
<th>FASB</th>
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<tbody>
<tr>
<td>• Include all cash flows that arise from a participating feature in the measurement of the insurance liability on an expected present value basis.</td>
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**Discussion Comments**

- Potential conflict exists between the proposed insurance model (reflecting all *expected* cash flows, including those that are discretionary) and the definition of a liability.

- But limiting liability to amounts that meet legal or constructive obligation definition seen by some as not useful for users as it represents minimum rather than expected payments.

- Staff noted potential practical difficulty in determining which part of participation feature meets the definition of a legal or constructive obligation.

- FASB changed its position after reconsideration of measurement objective to include a **broader notion of cash flows.**
Japanese life insurance companies’ par contracts have many features such as following:

- **Netting of three sources of gains** (Mortality, Interest, Expenses) in one contract. Normally interest component is negative and this is offset by other sources of positive gains. (mortality and expense gains.)

- **Netting effect between base policy and riders.** (Example: Whole life with term rider, normally whole life dividend is likely to be negative and this is offset by term rider’s mortality gain.)

- **Computation has to be done on a contract by contract basis.** So, Model-pointing approach is not easily acceptable by auditor when projecting future dividend cash flows using stochastic model for future interest element projection (there are many interest rate projection models.) This is more a calibration issue.

- **Five year interest only dividend** (Special Par contracts started by non-mutual companies): Interest component is only one source of gain. There will be positive years and negative years, we accumulate those positives and negatives until end of 5th year. And only when the total is positive, is a dividend paid. How shall we measure dividend liability?
5. The challenge for the finance function

- **The roles** that are undertaken by a high performing finance and actuarial function are changing.

- Previously **finance function was seen purely as the accounting and reporting function**, producing financial and management accounts.

- Now world class finance and actuarial teams are re-shaping themselves to take on a **much more prominent and value adding role alongside the business**.

- Questions finance functions are asking themselves:
  - **What role** does Finance function **aspire to**?
  - **Where does the business currently see the role**?
  - **What will be required to enable a change** in emphasis in these roles?
5.1 The challenge for the finance function - Roles in the finance & actuarial function

**Commentator**
- Finance as ‘commentator’ explaining the business story in numbers
- Business recognises value of interpretation of the numbers
- Increasingly has to translate the differences between account bases

**Score keeper**
- Actuarial and Accounting skills sets
- Role focused on bookkeeping and reserving
- Inward looking culture
- Slow and averse to change
- Efforts focused on transaction processing and period end figures

**Business partner**
- Using finance skills to help the business realise and operationalise its strategy
- Acts as business advisor and integrator
- Providing insight and advice on competitive issues/strategy (e.g. business forecasting, input to product development)
- Single unified Finance and Actuarial function

**Diligent caretaker**
- Role focused on governance
- Works with business to ensure compliance and effective controls
- Efficient processes benchmarked and managed for continuous improvement

---

**Business skills**

**Technical skills**

**Reactive**

**Proactive**
6. Concluding remark

For more than a half century, we have had a system of accrual accounting that will be moved towards the new measurement approach consisting of building blocks concept.

1. From technical perspective

following will be of particular importance.

➢ The financial and administration system transformation---- process and data flow will increase, massive computations will be involved with stochastic modeling.

➢ There will be many technical challenges for actuaries to compute risk adjustment using three proposed approaches.

➢ Auditors will need to be prepared for model validation of more complicated techniques utilized by their clients.

➢ On a positive note, there are many similarities between IFRS Phase II, Solvency II, ERM, and MCEV, so synergy effect should be realized. For example, financial modelling computation engine can be shared among those financials with minor modification.

2. From Company (management's) perspective

➢ How may products change?

➢ How may capital raising change?

➢ How might key performance indicators change?

➢ How will economic mismatches be reduced?
Q & A
Appendix A
- Other Issues Update
A-1 Measurement approach

- Measurement approach should portray a current assessment of the contract, using the following building blocks:
  - unbiased, probability-weighted average of future cash flows expected to arise as insurer fulfils the obligation
  - incorporation of time value of money
  - a margin* (see next page)

- These building blocks should be used to measure the combination of rights and obligations arising from an insurance contract rather than to measure the rights separately from the obligations.

- That combination of rights and obligations should be presented on a net basis.

- Objective for measuring an insurance contract should refer to a value rather than cost.

- Cash flows under the building block approach would include cash flows that arise as the insurer fulfils the contract rather than the narrower objective of including those cash flows needed to fulfil the contract.
Two different margin approaches proposed are **explicit risk adjustment approach** and **composite margin approach**. Both approaches eliminate any gain at inception. The Boards are split between the two approaches with FASB favoring the composite margin approach, and with IASB favoring the explicit margin approach.
• In principle the initial recognition of an insurance contract should not result in the recognition of an accounting profit.

• A loss arises at inception if the expected present value of cash outflows, plus explicit risk adjustment exceeds the expected present value of cash inflows.

• An entity should recognize that loss in profit or loss at inception.
A-3 Measurement of margins at inception - composite margin approach

- In principle the initial recognition of an insurance contract should not result in the recognition of an accounting profit.

- Composite margin is the difference between the expected value of cash inflows and the expected cash outflows.

- In composite margin approach, a loss arises at inception if the expected present value of cash outflows exceeds the expected present value of cash inflows, i.e., any Day 1 loss would not include a risk adjustment.

- An entity should recognize that loss in profit or loss at inception.
### A-4 Unearned premium

<table>
<thead>
<tr>
<th>IASB</th>
<th>FASB</th>
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</thead>
<tbody>
<tr>
<td>• An unearned premium measurement approach (simplified measurement</td>
<td>• An unearned premium approach for pre-claim liabilities for certain</td>
</tr>
<tr>
<td>approach) for pre-claim liabilities for certain short-duration contracts would be required rather than permitted.</td>
<td>short-duration contracts meeting specified criteria would be required rather than permitted.</td>
</tr>
<tr>
<td>• Building block approach for claim liabilities, including an explicit risk adjustment, but excluding a residual margin.</td>
<td>• Scope potentially limited to those short-duration contracts with a short-term coverage period and perhaps a relatively short “tail” (claim payout period).</td>
</tr>
<tr>
<td></td>
<td>• Claim liabilities would be discounted unless the effect is not material.</td>
</tr>
<tr>
<td></td>
<td>• No margin allocated to claim liability under the unearned premium approach.</td>
</tr>
</tbody>
</table>
A-5 Subsequent treatment of residual margins under explicit risk adjustment approach

- Insurer should not adjust the residual margin in subsequent reporting periods for changes in estimates.

- Insurer should release residual margin over coverage period in a systematic way that best reflects exposure from providing insurance coverage on the basis of passage of time; but if the insurer expects to incur benefits and claims in a pattern that differs significantly from passage of time, the residual margin should be released on the basis of the initial expected value of benefits and claims to be incurred over the coverage period.

- Residual margin would be included as part of insurance liability.
• Composite margin is “released” or “allocated” over both the coverage and claims handling periods (relates to building block measurement).

• Amortise composite margin based on a combination of two drivers, the provision of insurance coverage and the uncertainty in future cash flows.

• Approach specifies using a formula that calculates a ratio of current period allocated premiums plus claims and benefits cash flows to the expected value of total premiums plus claims and benefits and then applies this ratio to the composite margin. (see slide A-6.1)

• Composite margin would not be “re-measured” (no change to initial inception amount).

• Composite margin would not be adjusted for changes in cash flow estimates, i.e., not a “shock absorber”.

• Allocation pattern/term could change based on cash flow changes.

• Composite margin would be included as part of the insurance liability.
A-6.1 Subsequent treatment of composite margin under composite margin approach

Amortised using formula:

\[
\frac{\text{Premium allocated to current period} + \text{Current period claims and benefits}}{\text{Total contract premium} + \text{Total claims and benefits}}
\]

It would be better if time and shape of the distribution of the risk be considered in the formula.

“time”: the rate at which risk is released over time; and

“shape”: the risk distribution of possible outcomes around the mean value, at the reporting date, over a specified time horizon.
**A-7 Acquisition costs**

<table>
<thead>
<tr>
<th>IASB</th>
<th>FASB</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Acquisition costs that are “incremental at the contract level,” such as initial and recurring commissions, would be included as cash flows in the building block approach.</td>
<td>• “Incremental at the contract level” means those acquisition costs that would not have been incurred absent the contract sale.</td>
</tr>
</tbody>
</table>

**Discussion Comments**

- Immediate expense with no income offset or no capitalization viewed by industry as inconsistent with economics of contract pricing and major change from current practice.
- FASB changed its position after reconsideration of measurement objective to include a broader notion of cash flows.
- “Incremental” is more restrictive than current GAAP in many territories.
A-7.1 No Day 1 Gain, but Day 1 loss may occur

- Present value of expected cash flows including recurring commissions
- Paid Incremental Acquisition Costs

IASB
- Residual Margin
- Risk Adjustment
- Recurring commissions
- Policyholder Dividends
- Other Cash Flows

FASB
- Composite Margin
- Recurring commissions
- Policyholder Dividends
- Other Cash Flows
### Other Issues Update

**A-8 Participating features in insurance contracts - Investment Contracts with DPF**

<table>
<thead>
<tr>
<th>IASB</th>
<th>FASB</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Included in scope of insurance contracts standard if they participate in the same pool of assets as insurance contracts.</td>
<td>• Included in scope of financial instruments standard.</td>
</tr>
<tr>
<td>• Other participating investment contracts included in scope of financial instruments standard.</td>
<td></td>
</tr>
</tbody>
</table>

**Discussion Comments**

- IASB chair made decision to include participating investment contracts in insurance contracts exposure draft after a split vote by IASB.

- Several IASB members as well as FASB members concerned with lack of conceptual basis for including financial instruments in an insurance standard and potential arbitrage, arguing that all financial instruments should be measured consistently.

- Unclear how unbundling of account balance decision will impact participating investment contracts.
A-9 Unbundling

• Issue is whether and how to unbundle the components of an insurance contract (e.g., insurance, deposit, service, embedded derivative components) for recognition and measurement purposes.
• Staff proposal built around notion of lack of significant interdependence potentially being replaced.
• Possible alternative proposal is that if the policyholder could redeem or withdraw his/her investment without the occurrence of an insurable event, or if the amount varies primarily based on a financial variable, insurer must unbundle.
• Factors to consider in unbundling include whether the component exposes the insurer only to financial risk, whether there is a separate observable market for the component, whether the component alters cash flows in a manner not linked to or directionally of insurance protection, or whether the component represents an account balance.
• “Account balance” definition would be based on the characteristics described in existing US GAAP guidance for universal life insurance contracts.
• Embedded derivatives in insurance contracts should be unbundled using the unbundling principle being developed for insurance contracts.
• Where unbundling is not required it should be prohibited.
• The key challenge is the allocation of such factors as par dividends, and experience elements between the unbundled components.

Possible measurement models:
• Fair value
• Amortised cost
• Fulfilment model
• Through other comprehensive income
A-10 Presentation of performance statement

The staff paper (June 23) provided examples of the four potential presentation approaches for insurance contracts that had been discussed at previous meetings:

1. Written premium approach
2. Allocated premium approach
3. Summarised margin approach
4. Expanded margin approach

Summarized margin approach now preferred over an expanded margin approach as it is most consistent with the liability measurement model. Both approaches show the following information on the face of statement:
- Release of expected margin during the period
- Difference between expected and actual cash flows
- Changes in estimate (re-measurement)
- Results from investments (with interest income separate from interest on insurance liability)

Summarized margin approach would be supplemented by additional information including a reconciliation of changes in the liability and volume of business written.

Unclear how presentation for short-duration contracts subject to practical expedient/uneared premium measurement approach is impacted by the Boards’ latest decision to adopt summarized margin presentation.
### Summarised Margin

<table>
<thead>
<tr>
<th></th>
<th>Inception 1 January</th>
<th>Six month to 30 June</th>
<th>Six months to 31 December</th>
</tr>
</thead>
<tbody>
<tr>
<td>Risk adjustment</td>
<td></td>
<td>21</td>
<td>26</td>
</tr>
<tr>
<td>Residual margin</td>
<td></td>
<td>2</td>
<td>2</td>
</tr>
<tr>
<td>Insurance margin</td>
<td>0</td>
<td>23</td>
<td>29</td>
</tr>
<tr>
<td>Experience adjustments</td>
<td>(10)</td>
<td>(10)</td>
<td></td>
</tr>
<tr>
<td>Changes in estimates</td>
<td>(20)</td>
<td>0</td>
<td></td>
</tr>
<tr>
<td>Acquisition costs</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Net gain at inception</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Investment income</td>
<td>39</td>
<td>37</td>
<td></td>
</tr>
<tr>
<td>Interest on insurance liability</td>
<td>(25)</td>
<td>(23)</td>
<td></td>
</tr>
<tr>
<td>Net interest and investment</td>
<td>0</td>
<td>15</td>
<td>14</td>
</tr>
<tr>
<td>Profit</td>
<td>0</td>
<td>8</td>
<td>33</td>
</tr>
</tbody>
</table>

### Expanded Margin

<table>
<thead>
<tr>
<th></th>
<th>Inception 1 January</th>
<th>Six month to 30 June</th>
<th>Six months to 31 December</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue</td>
<td>20</td>
<td>113</td>
<td>114</td>
</tr>
<tr>
<td>Policyholder benefit</td>
<td>(50)</td>
<td>(65)</td>
<td></td>
</tr>
<tr>
<td>Expenses</td>
<td>(40)</td>
<td>(40)</td>
<td></td>
</tr>
<tr>
<td>Acquisition Costs</td>
<td>(20)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Release of benefits and expenses accrued in previous periods</td>
<td>0</td>
<td>20</td>
<td></td>
</tr>
<tr>
<td>Insurance margin</td>
<td>23</td>
<td>29</td>
<td></td>
</tr>
<tr>
<td>Experience adjustments</td>
<td>(10)</td>
<td>(10)</td>
<td></td>
</tr>
<tr>
<td>Changes in estimates</td>
<td>(20)</td>
<td>0</td>
<td></td>
</tr>
<tr>
<td>Net gain at inception</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Investment income</td>
<td>39</td>
<td>37</td>
<td></td>
</tr>
<tr>
<td>Interest on insurance liability</td>
<td>(25)</td>
<td>(23)</td>
<td></td>
</tr>
<tr>
<td>Net interest and investment</td>
<td>0</td>
<td>15</td>
<td>14</td>
</tr>
<tr>
<td>Profit</td>
<td>0</td>
<td>8</td>
<td>33</td>
</tr>
</tbody>
</table>
**Other Issues Update**

**A-11 Transition and effective date**

- **IASB/FASB decision**
  Difference from current carrying value in *equity* on transition

- **Staff proposal**
  Residual or composite *margin calibrated* to current carrying value on transition

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“Portfolio of contracts subject to broadly similar risks and managed together”
Theoretically, some actuaries would prefer the ‘full retrospective application’ as compared to the ‘pure prospective application’ because it would be more accurate and fair and equitable to existing policyholders.

However, it may be impracticable to apply because, for example, undue costs and efforts due to calculation of residual/composite margin.

Regarding participating business, we need to consider, that IFRS is not the legal basis of determining policyholders’ actual rights under that feature.

However, legal implication of policyholder equity change at transition needs careful consideration beyond IFRS accounting framework. (eg, demutualization)
Appendix B
- Result of Industry Actuaries Survey
Some of the comments from local actuaries are as follows:

✓ Majority of local actuaries who participated in the survey preferred explicit risk adjustment approach.

✓ A few indicated from practical viewpoints that it is desirable that measurement approach of regulatory accounting and general purpose accounting would be better if consistent.

✓ Some indicated that by having explicit risk margin, a sensitivity test will become more feasible.

✓ Some commented that they have no preference. Since both IASB/FASB use a hybrid method, measurement for renewal years do not have rational meanings.
Some of the comments from local actuaries are as follows:

- Within the Boards’ discussions, there seems to be **no logical reasoning about No gain at Issue**. This leads to the current situation of not being able to describe the measurement approach for the following years. Some have no preference as to choice of “Cost of Capital” or “Quantile” methods. Please let them know if there are any differences from the auditability perspective.

- Some prefer “Cost of Capital” approach. The Quantile approach has modelling difficulties. Although “Cost of Capital” approach has similar modelling problems, it is used in regulatory requirements like Solvency II and connected to the recognition of “Economic Capital” which considers market needs.

- If Risk Adjustment is used, reliability of measurement needs to be considered. It is difficult to decide one single method of calculation of RA when considering a variety of products in the international market and future development of technology.

- Some agree not to recognize “Initial Gains”. **If Japanese pricing practices are considered, there should be normally no initial “Loss”**.

- Some believe that “Cost of Capital” approach is desirable when Some consider future Solvency II.

- Theoretically, Some believe that “Cost of Capital” approach is desirable, but others do not understand the calculation.

- At inception, insurer should recognize initial loss is supported by some.
Some of the comments from local actuaries are as follows:

- If Composite margin approach is used, considering allowance for future risks, there is a possibility that the total liability is not sufficient. Therefore, Liability adequacy test is a **must**.

- No gain at issue is supported. However, after year 1, by updating assumptions, immediate recognition of gains/losses is not desirable and margin should be defined as such. Whether initial loss should go to P/L or not will require consideration of consistency with subsequent years’ treatment (P/L or OCI).
Some of the comments from local actuaries are as follows:

- It would be important to define “what short duration exactly means”. Life insurance companies should not be affected.

- Unearned premium method may not be suitable for Long term home owners’ fire insurance (Japanese specific product).
B-5 Subsequent treatment of residual margins under explicit risk adjustment approach

Some of the comments from local actuaries are as follows:

- Some basically agree with the Boards’ approach. However, regarding method of releasing residual margin, for comparability purpose, **certain guidance or disclosure will be necessary.**

- Some do not believe that the proposed approach is rational. Unless the meaning of measurement is well defined, Some have a great concern that the standards will not be practical on a principle basis. Detailed rules may be necessary if auditability is to be secured. Consistency between 1st year and subsequent years must be maintained. For example, for the subsequent years, the total amount of liability is locked in and residual margin is calculated as difference. Then it will function as a shock absorber and becomes rational and consistent.

- Some object to the idea of having residual margin. Deferral of profit recognition is against asset/liability method and will not support the **objectives of ALM risk management.**

- If the changes in estimates will not be reflected in the residual margin, all changes will go to net gains or OCI and Some have a **concern about instability of the results.**

- Some think that **further discussion** is necessary on this topic.

- Some support the Boards’ approach.

- Some support the release on the basis of passage of time. If there are no changes in assumptions, no **distorted emergence of profit** in a particular year is desirable.
Some of the comments from local actuaries are as follows:

- If Composite margin is not adjusted by changes in estimates (considering allowance for future risks), there is a possibility that the total liability is not sufficient. Therefore, a Liability Adequacy Test is a must.

- Some believe that consistency with release of risk is necessary, but under the composite margin approach, to do it properly is not realistically achievable.

- Composite margin will make a sensitivity test difficult.

- Release should be for the entire contract period rather than over contract and claim period.
Some of the comments from local actuaries are as follows:

✓ Some basically support the Boards’ approach. However, as to liquidity premium, for the purpose of comparability, guidance or disclosure will be necessary.

✓ Some believe that consistency with other standards (IAS 19, IAS37, etc.) is needed.

✓ Own credit risk should not be included.

✓ If expected return is considered to be an approximation of replicating portfolio of liability, use of expected return on assets may have certain supporting grounds. Further discussion is appreciated.

✓ Some agree to include liquidity premium and not to include own credit risk.

✓ Some support including liquidity premium as characteristics of liability. However, what kind of premium is to be included needs further consideration.
Some of the comments from local actuaries are as follows:

- In Japan, by enforcing net level premium statutory reserving methods, abuse of new business acquisition costs were controlled by regulation. Therefore, from the perspective of policyholder protection, certain measures to control abuse of new business acquisition costs will be necessary.

- There should be no reason to differentiate acquisition costs from other expenses. A consistent approach is desired.

- Clarification of incremental acquisition costs is needed.

- To achieve consistency with pricing, immediate expensing of acquisition costs does not seem rational.
Some of the comments from local actuaries are as follows:

- Regarding unbundling, Some think that only complex financial instruments which manipulate insurance contract standards should be unbundled.
- Interdependency based judgment is appropriate. However, in practice, strict application of the rule will be difficult and it should be a matter to be decided by each local jurisdiction.
Some of the comments from local actuaries are as follows:

- Due to consistency with measurement approach (building block approach), summarized margin is easy and useful.

- Premiums and claim payments are core parts of the business activities of insurance companies and useful information for the user of statements and those items should be included in the performance statement.

- As consideration of accepting risks, premium collected as an index of performance should be recognized as income.
Contact Information

Hideyuki E. Yoshida  
FIAJ, FSA, MAAA, FCA  

PricewaterhouseCoopers Aarata  
Director Chief Actuary  
Assurance - Financial Services

Sumitomo Fudosan Shiodome Hamarikyu Bldg.  
8-21 Ginza, 1-chome  
Chuo-ku, Tokyo (104-0061)  
Japan

Mobile: +81-90-6514-4650  
Facsimile: +81-3-3546-8451  
Email: hideyuki.yoshida@jp.pwc.com