1st IAIS South American Regional Information Session

Accounting and Valuation Observations and Developments

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Outline of presentation

- Background to APRA
- Impacts of the global financial crisis (GFC)
- Lessons learned from the GFC
- Accounting Developments (mostly unrelated to the GFC)
- IAIS Valuation Standard

Background to APRA – an integrated regulator

- APRA is an integrated regulator (non-life insurance; life insurance; banking; pensions)
  - Separate frameworks for each industry but long-term aim is further harmonisation and treatment of like risks in like ways across industries.
  - Consistency with overseas regulatory frameworks is always considered.

- Group supervision/solvency requirements by industry sector (Level 2):
  - fully implemented in banking
  - supervision of NOHCs in non-life insurance; new group solvency and reporting requirements effective March 2009
  - "work in progress" in life insurance

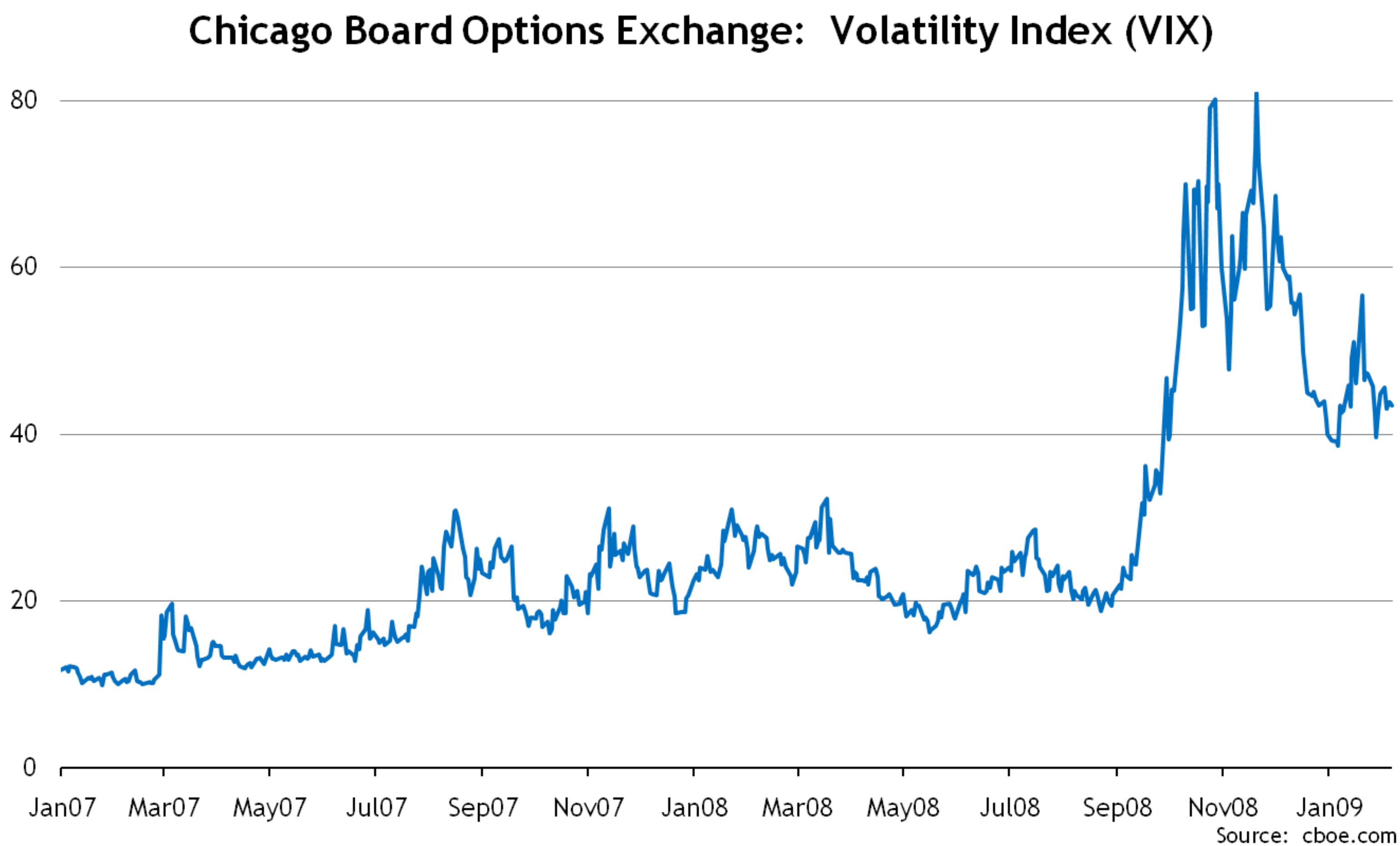
- Conglomerate (multi-sector) group supervision proposals (Level 3):
  - currently being developed – release of proposals in 2009

Background to APRA – Supervisory approach

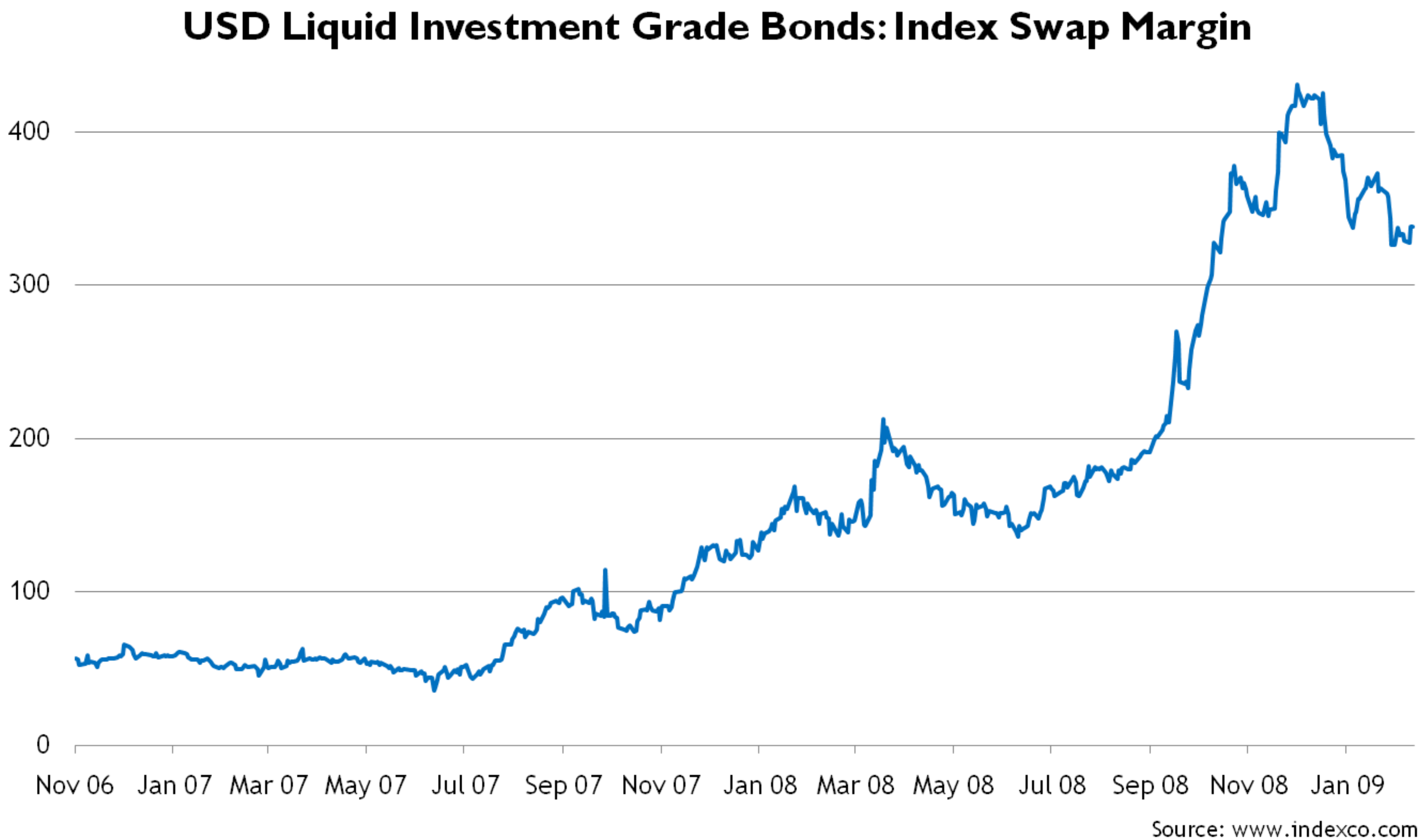
- Group supervision supplements solo supervision rather than replaces it
  - Legislative remit focuses on solo entities
  - Strength of solo entities considered in context of strength of group
  - Acknowledge risk and operational management often at group level

- Risk management – same requirements as for solo entities applied at group level

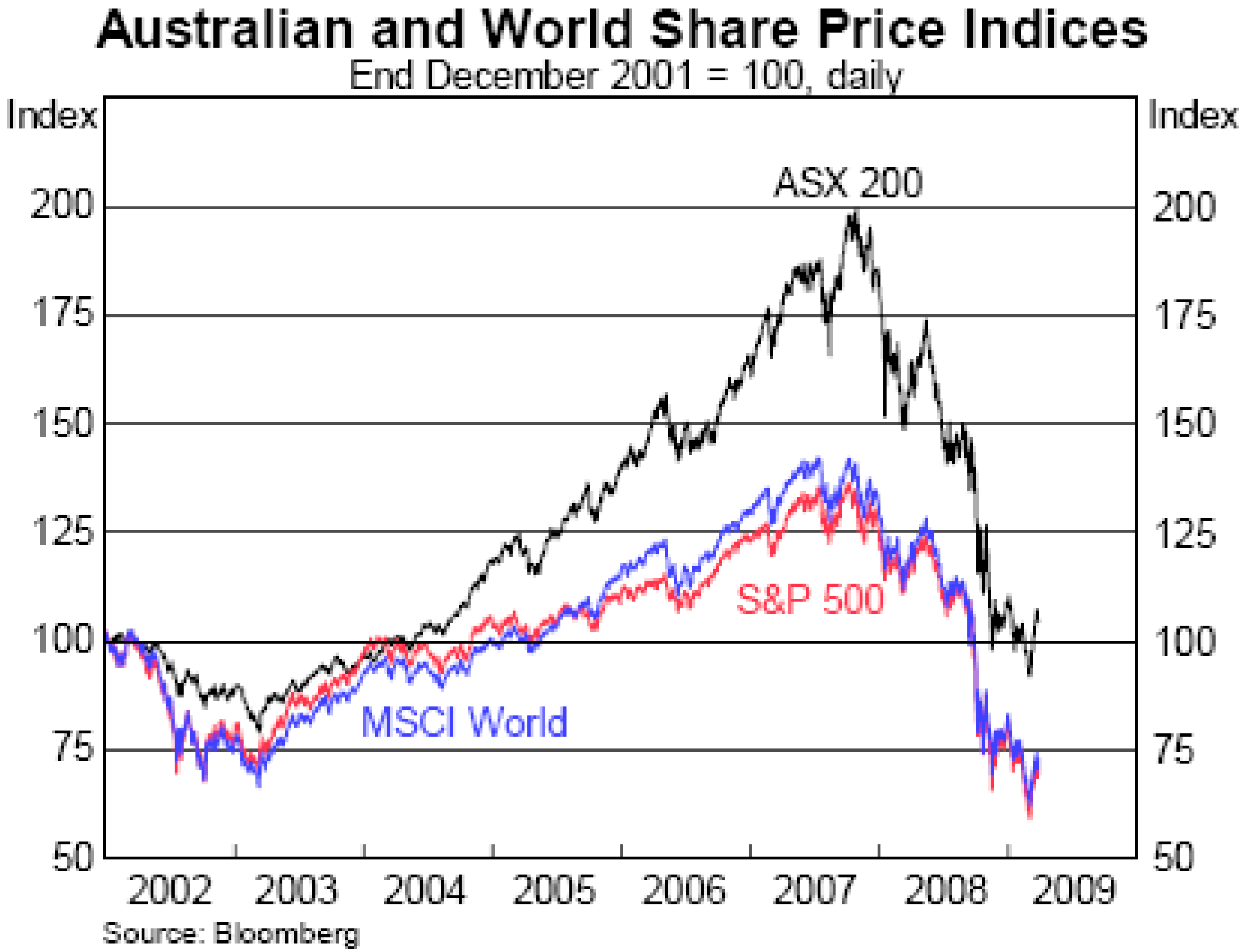
GFC Background - Increased Market Uncertainty



GFC Background - “Exploding” Credit Spreads



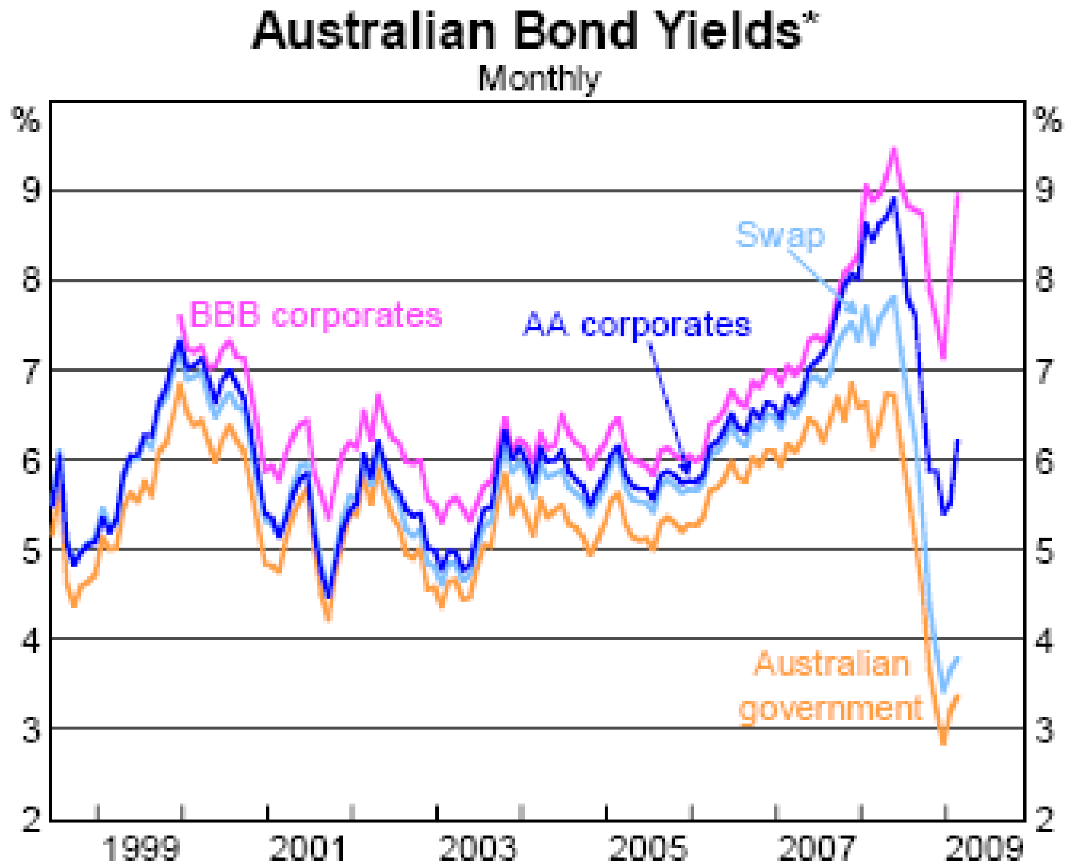
GFC Impacts – Falling Equity Markets



GFC Impacts – Commercial Property Markets

- The amount of transactions is greatly reduced. Nationally by value, sales were down 60% in 2008 over 2007.
- Asset values started to fall in 2008 and still have some way to go. A peak-to-trough reduction of 20%-30% is likely before values stabilise in 2009.
- In 2009, the income from commercial property may also be impacted by increasing vacancy and lower consumer spending.

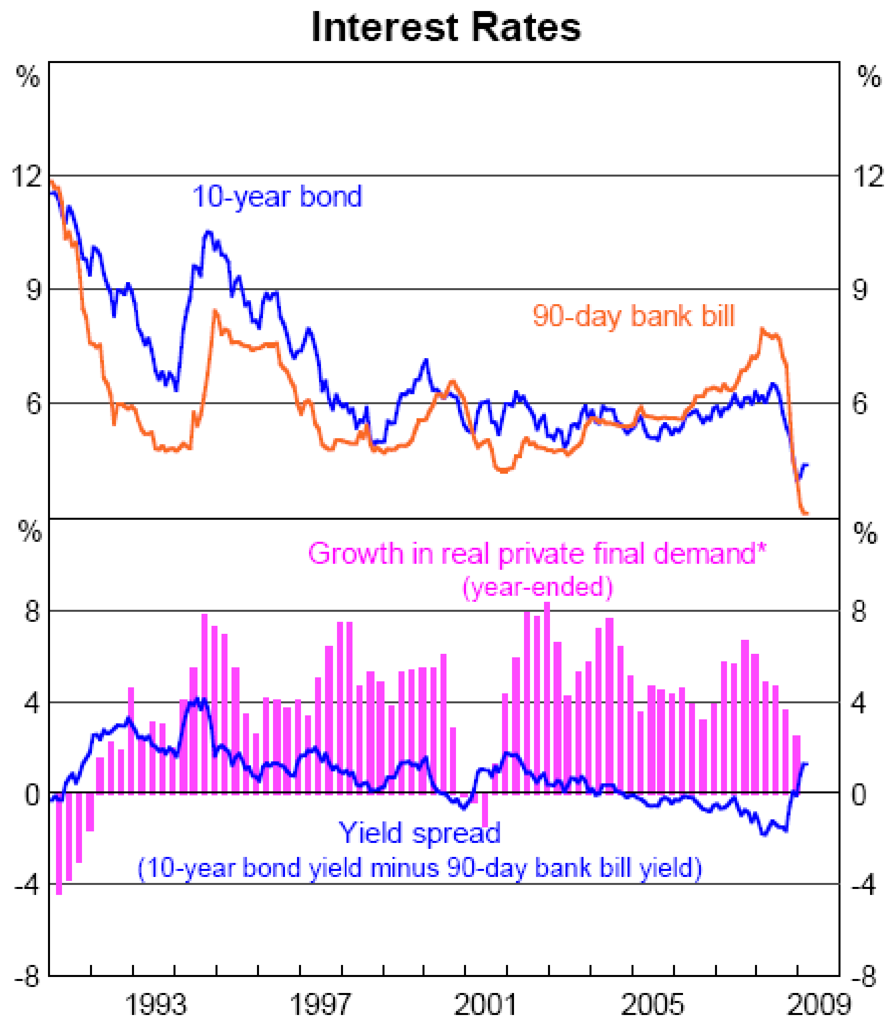
GFC Impacts – Falling Interest Rates (Note flight to quality)



* Yields on bonds issued by the Australian government and swap rates are 3-year maturities. Corporate bond yields are a weighted average of bonds with remaining maturities of 1 to 5 years; they include financial and non-financial corporates.

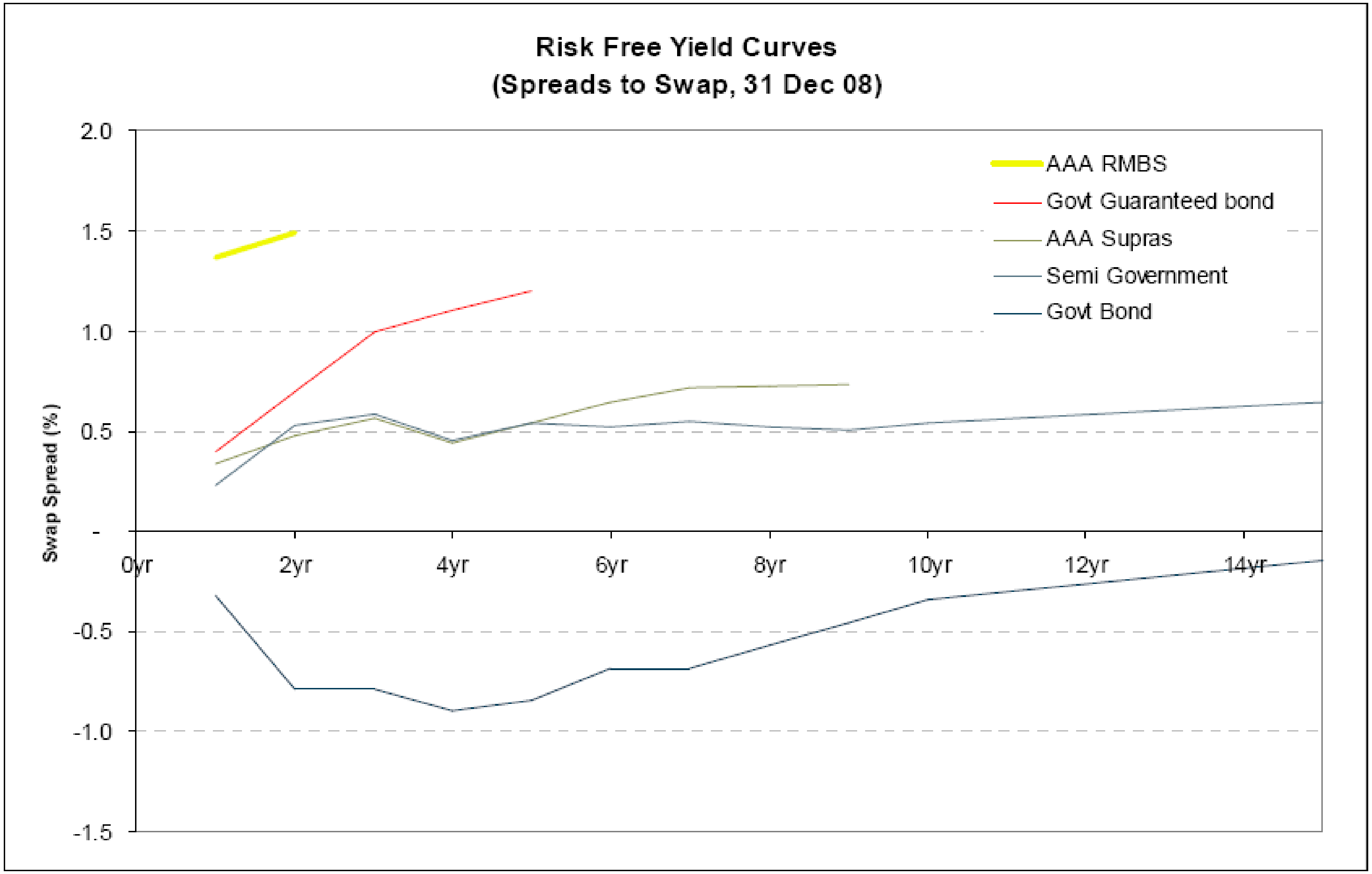
Sources: Bloomberg; RBA; UBS AG, Australia Branch

GFC Impacts – Yield Curve Inverted



* Excludes the effect of transfers between the private and other sectors
Sources: ABS; RBA

GFC Impacts – What is Risk Free?



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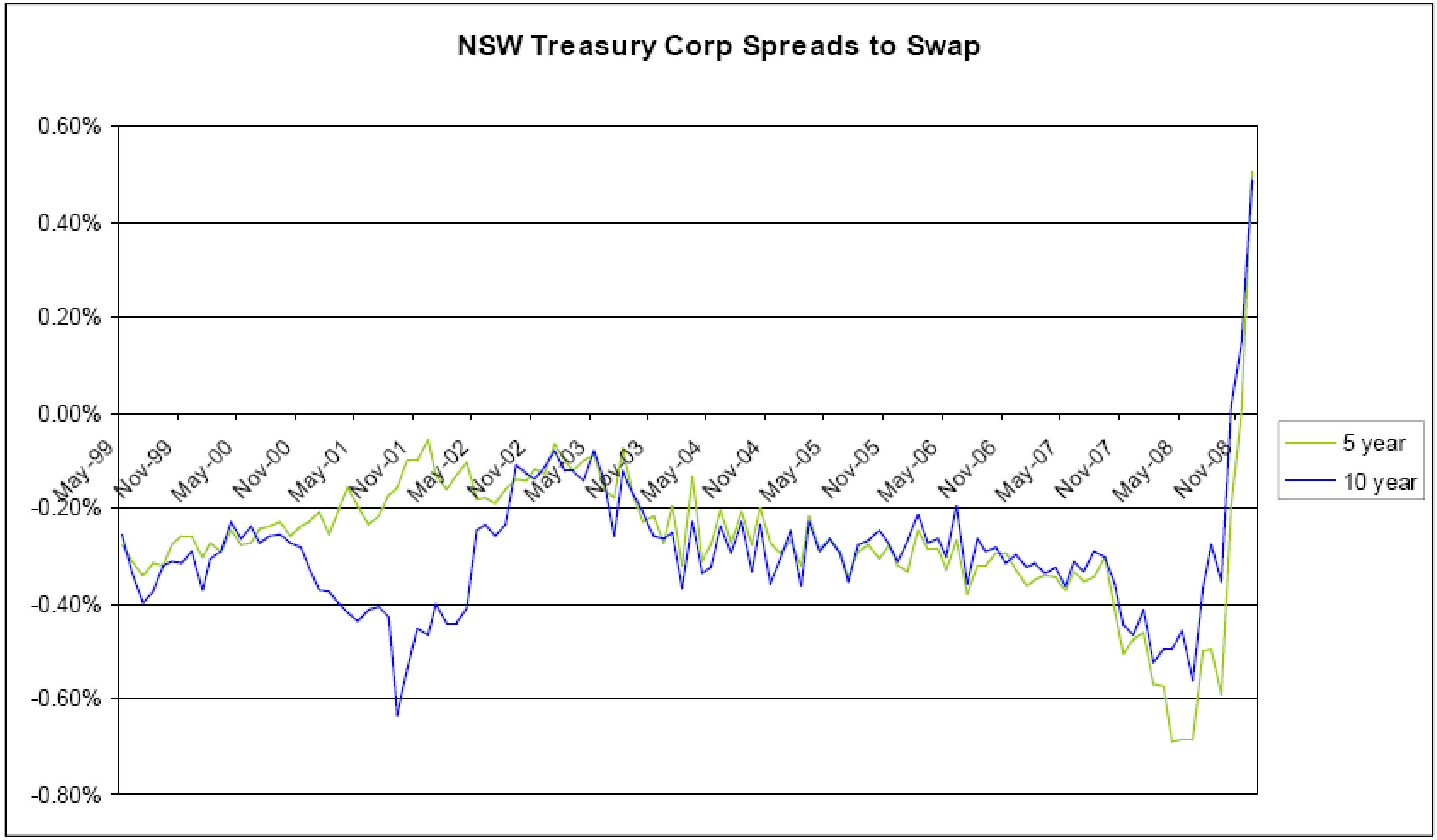

General issues for APRA have included:

- Volatile/deteriorating solvency positions – life more than GI
- Funding & liquidity constraints – primarily banking & wealth management (pensions)
- Contagion risks – particularly impact of unregulated entities
- Balancing capital and funding/liquidity needs of all group members given constraints on access to additional capital
- Ensuring access to liquidity & capital from group for branches and subs
- Concern over impact of recession on claims experience
- For non-life, compounded by concerns over mid-sized claims

GFC – Key lessons learned

- Speed with which issues develop/change requires
  - timely access to information to assess position
  - efficient process for determining action required
  - prompt response from group to requests for action/information
- Management/Board awareness/responsiveness to issues across groups varies considerably
- Past stress testing has not been “stressful” enough – entities need more robust capital management plans
- Regular and effective communication with the group (at a range of levels) and with other regulators is critical
- Proactive paranoia is helpful in reducing surprises – frequent detailed monitoring!

Lessons Learned – The Actuarial Perspective

1. Need for a dynamic risk sensitive framework to avoid under-pricing of risk
2. Risk modelling that addresses inadequate risk measures
3. Risk Culture and Remuneration Incentives
4. Valuation of Illiquid liabilities and the use of Risk Margins in accounting
5. Recognising that the objectives of risk (or prudential) reporting and general purpose financial reporting are different
6. Need for a "Control Cycle" approach such as used by the actuarial profession
7. Independence and role of the Risk Function in prudentially regulated entities
8. International prudential regulation needs to be less "silo" driven

Lessons Learned - Prevention of Future Financial Crises

The G 20's common principles for reform:

- Strengthen transparency and accountability
- Enhance sound regulation
- Promote integrity in financial markets
- Reinforce international co-operation
- Reform international financial institutions

Actuaries believe additional measures are needed:

- Introduction of more counter-cyclical regulatory arrangements
- Creation of Country Chief Risk Supervisor role
- Wider use of comprehensive risk management concepts in banks and non-regulated sector
- Improved use of ERM & risk governance

Lessons Learned – APRA’s Policy Response

- In most cases developments were already in train – but now incorporate lessons learned:
  - Executive Remuneration
  - Bank Liquidity management and reporting
  - Financial Claims Scheme implementation
  - Failure management – including trans-Tasman
  - Conglomerate Supervision Framework (including capital)
  - Life NOHCs
  - Life and General Insurance Capital Review
  - LMI capital changes
  - General Insurance Consolidated Supervision
  - Non-Authorised Reinsurance Recoverables
  - Definition of Insurance
  - Implementing latest Basel changes

Meanwhile … Accounting Developments

- Insurance Contracts
- Revenue – Customer Contracts
- Other IFRS Developments

- Key milestones
- February 09 board discussion
- Candidate Liability Measures

Insurance Contracts Key Milestones

- May 2007 : Discussion paper issued
- Nov 2007 : Comments received
- 2008 : Responses considered and ways forward developed
- *Nov 2008 – Sept 2009 : Board discussions, including:*
  - *Measurement approach, boundaries of contract, discount rates, policyholder participation - classification and measurement, IFRS mismatches (IAS 39 & 18), policyholder accounting, recognition and derecognition, insurance contract definition and scope exclusions*
- Dec 2009 : Exposure Draft due
- April 2010 : Comments due to the IASB on ED
- May 2011 : Final Standard due to be issued

Also – IAA just released "Measurement of Liabilities for Insurance Contracts: Current Estimates and Risk Margins"

February 2009 Board Discussions

- Measurement approach conceptually unchanged, use
  - Estimates that are as consistent as possible with observable market prices
  - Explicit current estimates of expected cash flows, discounted, explicit margin

- Measurement objectives (tentative, change from Discussion Paper)
  - No profit at inception; and
  - Margin at inception determined with reference to premium; but
  - Treatment of acquisition costs and premium relating to those costs deferred for later meeting

- Candidate measurement approaches
  - Considered and rejected an undiscounted, no margin, no discounting approach for non-life claims
  - Views diverged on Exit Value vs Fulfilment Value, no consensus
  - Asked staff to analyse further applicability of approaches from other existing and future standards, particularly revenue, financial instruments, and non-financial liabilities

Candidate Liability Measures

Current exit value	Current fulfilment value	Entry value	Unearned premium
Candidate 1	Candidate 2 and 3	Candidate 4	Candidate 5
The **expected payment** required **to transfer** the remaining contractual rights and obligations immediately to another entity	The **expected** present value of the **cost of fulfilling the obligation** to the policyholder over time	Same as #3.	**Unexpired** part of the **premium**, subject to liability adequacy test. *Only for short term, pre-claim insurance*
Margins: •Risk Margin •Service Margin	**Margins:** •Risk margin •No Service Margin • #3 Extra Margin set at inception to premium	**Margins:** One composite margin set at inception to premium	**No explicit margin**

Candidate Liability Measures

Current exit value (1)	Current fulfilment value (2) and (3)	Entry value (4)	Unearned premium (5)
Exit value	#2 Exit version #3 Entry version	Customer consideration	
Current estimate of future cash flows	Same	Same	N/A
Market's time value of money	Same	Same	N/A
Risk margin - market cost for bearing risk & remeasured	Risk margin - entity cost for bearing risk & remeasured Extra Margin under #3 locked in	In combined margin based on price at entry & locked in	N/A
No Liability Adequacy Test (LAT)	No LAT	LAT required at inception only	LAT required at inception and ongoing

Candidate Liability Measures

Current exit value (1)	Current fulfilment value (2) and (3)	Entry value (4)	Unearned premium (5)
Uses observable market inputs	Same	Same	N/A
For non market inputs - can only use portfolio specific estimates, not entity specific	Entity specific estimates if no market observable information	Entity specific estimates if no market observable information	N/A
Portfolio specific cash flows	Entity specific cash flows	Entity specific cash flows	N/A
Profit or loss at inception	#2 Profit or loss at inception #3 No profit at inception, loss possible	No profit at inception, loss possible	No profit at inception, loss possible
Own Credit Risk -yes	Own Credit Risk -no	Own Credit Risk -no	N/A

Revenue - Customer Contracts

- Dec 08 Discussion Paper Issued – "Preliminary Views on Revenue Recognition in Contracts with Customers"
- Joint Project with FASB, DP comments due by 19 Jun 09. Exposure Draft 1H10, final standard 2011, Effective 2012
- Will replace IAS11 Construction Contracts and IAS 18 Revenue
- Clearly impacts service related revenue for Investment Contracts and will impact insurance contracts unbundled into a deposit component and an insurance component
- May also influence the development of the Insurance Standard for bundled contracts
  - Alignment is a consideration in setting the approach for Insurance
  - Board have asked staff to analyse further if Revenue Standard can be used for Insurance

Revenue - Customer Contracts

- IASB aim is for clearer guidance and consistency in treatment of similar contracts regardless of Industry.
- Current Exit Value was considered but Boards preferred a model based on the contract with the customer and consideration received.
- A contract creates payment rights from the customer and obligations to provide goods and services to the customer – ‘performance obligations’
- The net contract position can be an asset or a liability.
- Revenue arises from changes in that net position.
- Revenue is recognised when the performance obligation is satisfied, not on activity, ie when customer has physical possession or has received the promised service

Revenue - Customer Contracts

- Changes in cash, inventory, expenditure or activity do not give rise to revenue
- Acquisition costs are expensed as incurred (unless able to be capitalised under another standard) giving rise to a loss unless a performance obligation is also satisfied at inception, releasing an amount of offsetting revenue.
- Not clear how it handles contracts with multi-period consideration and performance obligations.
- Some thought that it may not be appropriate for insurance contracts and these would be excluded from scope.
- But seen as potentially applying to simpler insurance cases, eg fits with un-expired premium reserve

Revenue - Customer Contracts General Issues

- An Investment Contract may be thought of as a combination of a Financial Instrument and a Management Services Element.
- The Management Services Element will come under the new Revenue standard.
- Currently can defer direct origination costs (eg fees and commission paid to agents & brokers). Under new standard would have to expense as incurred.
- No fee revenue at inception unless can identify a performance obligation that is satisfied at inception. (Even if client is charged a directly linked origination fee.)
- Advice could be an origination service, but problem of determining standard price, especially if only charged to those who take other services?
- If investment management is the only performance obligation, will need to allocate any upfront and ongoing fees in proportion to standard price for each period.
- How do you determine your standard price, if you charge a combination of upfront and ongoing fees, and a combination of fixed $ fees, % of AUM fees and rebates?

Potential Issues if Applied to Insurance

- Insurance probably out of scope, but not certain.
- Revenue recognised over the life of contract, but initial commission and acquisition expenses up-front
- Potentially no recognition of revenue from future premiums
- Locked in assumptions and hence locked in ‘expected’ revenue.
- Different discount rates.
- Insurance is different from goods and services; ie revenue and expense recognition only makes sense on a portfolio level, allowing for best estimate assumptions for discontinuance, mortality etc
- Problem that revenue and costs not treated consistently – revenue is aligned with service delivery while costs are expenses when incurred. Alternative would be to align profit (revenue less costs) with service delivery.

Other IFRS Developments

The IASB has proposals for change in a number of other areas.

These include:

- Consolidation and Derecognition
- Revenue recognition
- Financial Instruments and Fair Value Measurements

Changes to Accounting rules

Consolidation, Derecognition, and Revenue Recognition

- All rely on the notion of “control” which has been redefined
- No emphasis on risk and reward

Main Issues for Banks and Insurance companies

- Banks and insurance companies measure and manage risk and rewards
- In the absence of incorporating risk and reward into the accounting framework, the transactions of the entity might be misrepresented.

Financial Instruments & Fair Value Measurements

- Simplification of Asset categories in IAS 39.
  - The proposed model is a mixed attribute model
  - Fair Value would be the default
  - Other Assets would be measured at Amortised cost

- Further guidance and disclosure on Fair Value is likely to be introduced
  - This includes treatment of realised and unrealised gains
  - Whether markets are active
  - How are fair values determined from the nature of inputs?
  - Fair values continue to be controversial (the US has allowed flexibility with illiquid instruments initially measured at fair value)

- Provisioning
  - The IASB has informally proposed adding two items after the bottom line of the income statement to calculate the distributable profit:
  - Item 1: counter-cyclical reserve requirement
  - Item 2: accounting reserve due to valuation uncertainty

IAIS Valuation Standard

- Market Consistent Economic Valuation for Technical Provisions
- Balanced against consistency with General Purpose Financial Statements

AND

- Consistency between measurement of assets and of liabilities
- Use of models for determining market consistent economic value
- Characteristics of technical provisions – similar to those being considered by IASB:
  - Current Estimate
  - Margin (primarily for risk – will need to consider treatment of residual margins)
  - Discount rates
  - Boundaries of cashflows
  - Diversification
  - Participation
  - Acquisition costs
  - Etc.
- Transparency and Disclosure
- Will need to align with ICP criteria

Summary

The GFC emphasises more than ever the need for:

- Robust supervision frameworks at solo and group level
- Reliable, realistic asset and liability valuations
- Effective, risk based capital regimes

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