Application of business model to insurance contracts
Technical position of the HUB Group on Insurance Contracts

The following report on applying the "Application of the business model" framework to the accounting and reporting of insurance contracts reflects a proposal by the HUB global insurance group. This technical paper is being provided to members and staff of the IASB and FASB to assist them in understanding the proposal prior to the Insurance Working Group meeting on 24 March 2011.

This paper provides additional detail on applying the business model construct inherent in IFRS No. 9, *Financial Instruments* ("IFRS 9"), to the development of a measurement framework for insurance contracts as outlined in the HUB Group's Insurance Industry Proposal Discussion Paper dated 22 March 2011.

As with all our documents, comments from the public are welcome.

I. Objective

Develop a measurement and presentation framework for insurance contracts consistent with the Conceptual Framework for Financial Reporting ("CFFR"). The goal of the CFFR is to provide useful information to existing and potential investors about the amount, timing, and uncertainty of future cash flows which we believe is enhanced when the measurement and presentation of financial liabilities (including insurance contracts) faithfully represents[1] a reporting entity's business model[2].

The importance of adopting a business model approach for the measurement and classification of insurance contracts is not only that it will provide measurements that most faithfully represent how the business is managed, but also that it is consistent with the guidance in IFRS recently adopted in IFRS 9.

II. Relevant Excerpts from IFRS 9 Re: Business Model

Appendix B of IFRS 9 (paragraph B4.1)…….requires an entity to classify financial assets…..on the basis of the entity's business model for managing the financial assets. An entity assesses whether its financial assets meet this condition on the basis of the objective of the business model as determined by the entity's key management personnel.

---

1 Conceptual Framework QC4: If financial information is to be useful, it must be relevant and faithfully represent what it purports to represent. The usefulness of financial information is enhanced if it is comparable, verifiable, timely and understandable.

2 Conceptual Framework OB2: The objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity.

BC4.1 In IFRS 9…….the Board aimed to help users to understand the financial reporting of financial assets by…..(c) aligning the measurement attribute of financial assets with the way the entity manages its financial assets ('business model') and their contractual cash flow characteristics, thus providing relevant and useful information to users for their assessment of the amounts, timing and uncertainty of the entity's future cash flows.

BC4.2 Board believes that IFRS 9 both helps users to understand and use the financial reporting of financial assets and eliminates much of the complexity in IAS 39…..IFRS 9 aligns the measurement attribute of financial assets with the way the entity manages its financial assets ('business model') and their contractual cash flow characteristics.

BC4.15 The Board concluded that an entity's business model affects the predictive quality of contractual cash flows—i.e., whether the likely actual cash flows will result primarily from the collection of contractual cash flows.

BC4.20 The Board noted that an entity's business model does not relate to a choice (i.e., it is not a voluntary designation) but rather it is a matter of fact that can be observed by the way an entity is managed and information is provided to its management.

III. Measurement and presentation of insurance contracts shall be based on the business model the insurer follows for managing its portfolios of insurance liabilities

The business model is typically developed around key profit drivers that provide investors and other stakeholders the most representationally faithful information about periodic business performance. Insurers' business models typically follow one of two basic approaches for managing insurance liabilities.

1. Integrated Insurance Business Model ("II-BM")
2. Continuous Risk Reunderwriting Business Model ("CRR-BM")

The determination of which basic business model an insurer follows should be based in part upon the following factors and characteristics:

The characteristics of the insurance contracts underwritten

1. II-BM
   - Typically more granular asset-liability matching;
   - Typically associated with long-duration[3] contracts;
   - Investment results a primary consideration;
   - Primary risk – investment, mortality and morbidity experience;
   - Primary performance analysis tools - margin analysis for investments, mortality, and morbidity and actual to expected experience measures;
   - Discretionary premiums may continue over coverage period;
   - Dollar amount of insurance coverage specified in contract;

[3] Insurance contracts classified as long-duration if expected to remain in force for extended period. Factors:
- Contract generally not subject to unilateral changes, such as a non-cancellable or guaranteed renewable contract;
- Contract requires performance of various functions and services (including insurance protection) for extended period.

- Ø Risks not re-underwritten or re-priced annually or more frequently

2. CRR-BM
   - Ø Typically only high level matching of asset and liability cash flows;
   - Ø Typically associated with short-duration[4] contracts;
   - Ø Investment results a secondary consideration;
   - Ø Primary risk exposure to frequency and severity of claims (P&C and health);
   - Ø Primary performance analytical tool – experienced-based claims development ;
   - Ø Premiums typically single and fixed;
   - Ø Insurance risks re-underwritten and re-priced annually or more frequently;
   - Ø Claims typically emerge quickly for personal lines products and less so for business lines such as medical malpractice;
   - Ø Latent exposures not reliably estimable;
   - Ø Dollar amount of insurance risk variable up to policy limits;
   - Ø Contracts cancellable during coverage period with mandatory pro-rata refunds;
   - Ø Profitability issues typically addressed through pricing of future contracts versus modified investment strategies

All factors and characteristics need not be present; rather the predominate factors and characteristics shall support the designated business model.

- Ø An insurer's business model, once adopted, is a matter of fact and not an arbitrary periodic selection.

  - Whether a life insurer measures and presents its insurance contracts and corresponding financial assets on a fulfillment value/FVNI, fulfillment value/FVOCI or locked-in/amortized cost basis, the business model is a function of how it underwrites, manages, and reports results consistent with its business model

  - Whether a property-casualty insurer measures and presents insurance contracts on an ultimate basis or discounted basis with explicit risk adjustments, the business model is a function of how it underwrites, manages, and reports results consistent with its business model

- Ø An insurer's business model designation would be subject to periodic audit verification.

- Ø Reclassification between business models would be very rare, but allowed (with supporting disclosures regarding rationale) only when an insurer's business model changes.

- Ø The level of aggregation in measurement and presentation shall be consistent with the insurer's business model.

[4] Insurance contracts classified as short-duration if expected to remain in force for short period. Factors:
- – Contract provides insurance protection for a fixed period of short-duration;
- – Contract enables insurer to cancel the contract or to adjust provisions of the contract at the end of any contract period, such as adjusting the amount of premiums charged or coverage provided.

- Diversification benefits (and costs) shall be recognized across portfolios, if based on the insurer's business model, and if the insurer is legally and practically able to realize such benefits (and subject to such costs).

IV. Integrated Insurance Business Model

The II-BM approach (used primarily, but not exclusively, by life insurers) focuses on all cash flows of the business, including investment income on financial assets and the anticipated amount and timing of benefit payments.

- The II-BM is typical for insurers that issue long-duration insurance contracts in which the insurer accumulates over the life of the contracts significant asset portfolios used to meet the payment obligations on underlying portfolios of insurance contracts.

- The II-BM approach is consistent with a building blocks measurement approach (mean of discounted expected cash flows, with explicit risk adjustments); it is based on matching asset cash flows with corresponding liability cash flows over the life of portfolios of insurance contracts.

- Net investment income is a primary consideration in the II-BM. The interaction of the accounting models for insurance liabilities and financial assets (i.e., IFRS 9) should be coordinated to produce a meaningful reflection of the insurer's periodic performance.

- Primary business drivers include investment results, mortality/morbidity experience, and lapse experience. Primary business metrics include net interest margin, mortality margin, morbidity margin and surrender percentages. Primary analytical tools include relevant margin analysis and actual to expected experience ratios.

- The rate(s) used to discount expected future cash flows shall be consistent with the business model and shall be based on how insurance contracts are priced and managed in order to reflect the characteristics of the liabilities and how the liabilities are funded. See HUB group paper on establishing discount rates where discounting is employed.

V. Continuous Risk Reunderwriting Business Model

1. Ultimate Basis CRR-BM focuses on underwriting income (loss)
   Components of underwriting income (loss) which are also primary business drivers include:
   - premiums received from policyholders;
   - claims and related claims expenses;
   - other expenses incurred

   The above components are calculated on an undiscounted (i.e., ultimate basis) without explicit risk adjustments for the Ultimate Basis CRR-BM.

   - Ultimate Basis CRR-BM is consistent with how most property-casualty insurers throughout the world underwrite, manage, and evaluate the performance of most short-duration property-casualty insurance contracts, for which success is heavily dependent on close monitoring of underwriting results. For these insurers, investment income, while important, is a secondary consideration and not a component of underwriting income.

- Ultimate Basis CRR-BM has the benefit of being proven reliable over time throughout a variety of business environments, business cycles, and across diverse geographies.

- Measuring claims and claims expense on an ultimate basis in the CRR-BM allows investors and other financial statement users to evaluate the adequacy of claim and claim expense reserves through reconciliation with paid and incurred regulatory claim development data (currently available in certain geographic jurisdictions and would be a required disclosure under a new standard)

- Primary business metrics include underwriting income (loss), claims ratio, expense ratio, and combined ratio. These ratios can be, and are, applied at a very granular level in managing the business of a property-casualty insurer (the same would not typically be true for discounted information as the discounting would be applied at a more summarized level). Primary analytical tools include appropriately prepared claims development tables and claim, expense, and combined ratios over time.

2. Discounted Basis CRR-BM focuses on underwriting income (loss).
   Components are the same as the Ultimate Basis CRR-BM, but are measured and presented on a discounted basis, typically together with explicit risk adjustments.

   The adequacy of claim and claim expense reserves can be evaluated through application of the discounted basis CRR-BM, the most prominent element of which is claim and claim expense reserves presented on a discounted basis typically together with explicit risk adjustments.

   - Insurers that follow the discounted basis CRR-BM shall provide investors and other financial statement users sufficient disclosure, including historical comparative information where necessary, to support the discounting and explicit risk adjustments included in claim and claim expense reserves;

   - Where discounting is employed in the CRR-BM the impact of discounting shall be deferred and recognized over the combined coverage and settlement period as more fully described in the HUB group paper on the discounting of property-casualty insurance contracts.

3. Under the CRR-BM invested assets are typically managed more around overall entity liquidity needs than a granular matching of financial asset cash flows to liability cash flows.

The selection of the most appropriate measurement alternative for financial assets will depend upon both the extent of matching financial asset and insurance liability cash flows by the insurer, balanced with the needs of investors and other financial statement users.

Most property-casualty insurers do not employ granular asset-liability management programs but rather manage asset portfolios to maintain sufficient liquidity to meet contractual obligations to policyholders as they come due which may require measuring assets under IFRS 9 on a fair value through net income basis. If the IASB follows our suggestions and re-opens IFRS 9 to return the fair value through other comprehensive income category currently residing in IFRS 39 but was eliminated from IFRS 9, we believe many insurers would choose that category to account for financial assets.

VI. Business Model – Permitted Measurement Applications

II-BM – Insurer selects one of the following three applications that is most consistent with its business model and that also reduces accounting mismatches

- Fulfillment Value (Insurance Contracts)/Fair Value Net Income for Assets
  - Impact of changing interest rates on assets reflected in profit and loss ("P&L"). Similarly, changes in top down interest rate and other assumption changes reflected in P&L.

- Fulfillment Value (Insurance Contracts)/Fair Value Other Comprehensive Income (Assets)
  - Impact of changing interest rates on assets reflected in other comprehensive income ("OCI"). Similarly, changes in top down interest rate reflected in OCI and other assumption changes reflected in P&L.

- Locked-in (Insurance Contracts)/Amortized Cost (Assets)
  - As an alternative to fulfillment value/FVOCI, assets measured at amortized cost and insurance contracts at fulfillment value with interest rates locked-in at inception.

CRR- BM – Insurer selects one of the following two applications that is most consistent with its underwriting, management, and performance reporting.

- Ultimate Basis CRR-BM
  - Record premiums, claims and claims expenses, and other expenses on an ultimate basis (i.e., undiscounted), without explicit risk adjustments, consistent with the underwriting, management, and performance reporting of the insurer.
    - No discounting or explicit risk adjustments in pre-claim or post-claim periods
    - All insurance contract revenue earned over the policy coverage period which coincides with the period over which insurance protection is provided. There is no insurance protection risk beyond the coverage provided, only adverse claim development risk.

- Discounted Basis CRR-BM
  - Record premiums, claims and claims expenses, and other expenses on a current fulfillment basis (i.e., discounted and with an explicit risk adjustment) consistent with the underwriting, management, and performance reporting of the insurer.
  - The effect of discounting would be deferred and recognized over the combined coverage and settlement period. See HUB group paper on discounting P&C contracts for a more comprehensive discussion of this topic.

For both "Ultimate Basis" and "Discounted Basis" CRR-BM, there would be (a) continuous remeasurement of claim reserves and (b) accompanying loss development tables prepared on an appropriate basis to allow reconciliations between recorded and paid reserves on a continuous basis.

VII. Presentation

The basis of presentation shall be consistent with the insurer's business model, could be based on premiums or margins, and should be supplemented by disclosure.

Conceptual Framework for Financial Reporting

To Provide Useful Information to Existing and Potential Investors, Measurement and Presentation of Insurance Contracts shall be Consistent with Insurer's Business Model

Two Distinct Business Models (II-BM & CRR-BM") for Insurance Contract Portfolios with Five Permitted Applications

[Three II-BM Applications & Two CRR-BM Applications]

Integrated Insurance BM

Distinguishing Characteristics:

- Typically long-duration
- Mortality/morbidity coverage specified
- Risks not re-underwritten or re-priced
- Investment results, mortality and lapse experience key business metric
- Primary analytical tools – margin analyses for investments, morality and morbidity

Select application consistent with BM that reduces accounting mismatches

Fulfillment Value/FVNI
Changing interest rates reflected in P&L. Change in top down interest rate and other assumptions changes reflected in P&L

Fulfillment Value/FVOCI
Changing interest rates reflected in OCI. Change in top down interest rate reflected in OCI, other assumption changes in P&L

Locked-in/Amortized Cost
As an alternative to fulfillment value/FVOCI; assets at amortized cost and insurance contracts at fulfillment value with locked-in interest rate

Continuous Risk Re-underwriting BM

Distinguishing Characteristics:

- Typically short-duration
- Insurance risk variable up to policy limits
- Risks re-underwritten and re-priced annually
- Primary risk – exposure to claims
- Primary performance analytical tool – claim development table
- Cancellable contracts with pro-rata refunds

Select application consistent with underwriting, management, and performance reporting

Ultimate Basis – CRR-BM
Business managed on an undiscounted basis with no explicit risk adjustments

Discounted Basis – CRR-BM
Business managed on discounted basis with explicit risk adjustments