Canadian Institute of Actuaries
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Canadian Methods for the Valuation of Insurance Contracts (Life and P&C) to Satisfy the Requirements of IFRS 4.14

IFRS

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INTRODUCTION

International Financial Reporting Standard 4 (IFRS 4) deals with the measurement of liabilities for insurance contracts. It is still a preliminary standard (often called "Phase 1"), but will apply in Canada when we move to IFRS in 2011. IFRS 4 allows company management to continue to use their current accounting policy for the measurement of insurance contract liabilities, provided certain criteria are met. The criteria are described in paragraph 14 of IFRS 4.

SUMMARY OF THE PRACTICE COUNCIL'S POSITION

In Canada, current accounting policies for the measurement of insurance contract liabilities follow the Canadian Generally Accepted Accounting Principles (GAAP) methods of valuation described in sections 2100 to 2300 of the Standards of Practice that govern actuarial practice in Canada. The Practice Council of the Canadian Institute of Actuaries (CIA) believes that current Canadian GAAP methods of valuation satisfy the requirements of paragraph 14 of IFRS 4, and hence companies may continue to use current methods for the measurement of life and Property and Casualty (P&C) insurance contract liabilities in Canada after IFRS is adopted. However, one change in presentation of the liability amount will be required for life insurance contracts in order to display results gross of reinsurance.

BASIS FOR CONCLUSIONS

Paragraph 14 of IFRS 4 contains five criteria that must be satisfied by the accounting policy for insurance contracts. It states:

"An insurer:

(a) shall not recognise as a liability any provisions for possible future claims, if those claims arise under insurance contracts that are not in existence at the end of the reporting period (such as catastrophe provisions and equalisation provisions).

(b) shall carry out the *liability adequacy test* described in paragraphs 15-19.

(c) shall remove an insurance liability (or part of an insurance liability) from its statement of financial position when, and only when, it is extinguished–ie when the obligation specified in the contract is discharged or cancelled or expires.

(d) shall not offset:

  i. *reinsurance assets* against the related insurance liabilities; or

  ii. income or expense from reinsurance contracts against the expense or income from the related insurance contracts.

(e) shall consider whether its reinsurance assets are impaired (see paragraph 20)."

A discussion of how Canadian GAAP methods of valuation meet each of these criteria follows.

(a) No catastrophe or equalization provisions

Paragraphs BC87-BC93 of IFRS 4 provide further information about the intent of paragraph 14(a), and imply that the focus is on catastrophe provisions and equalization provisions, neither of which are held as liabilities under Canadian GAAP.

Furthermore, paragraph 2130.03 of the Standards of Practice makes it clear that, under Canadian GAAP, liabilities are only recognized for contracts that are in existence at the reporting date. This complies with IFRS 4, paragraph 14(a).

One possible question is whether a commitment to issue a contract is considered an insurance contract in existence at the reporting date. It is the Practice Council's view that, if the nature of the commitment is such that current Canadian GAAP would require recognition of a liability, then a liability would also be recognized under IFRS.

(b) Liability adequacy test

Paragraph 16 of IFRS 4 says:

> "If an insurer applies a liability adequacy test that meets specified minimum requirements, this IFRS imposes no further requirements. The minimum requirements are the following:
>
> (a) The test considers current estimates of all contractual cash flows, and of related cash flows such as claims handling costs, as well as cash flows resulting from embedded options and guarantees.
>
> (b) If the test shows that the liability is inadequate, the entire deficiency is recognised in profit or loss."

The relevant policies for the valuation are those that are in force, including those whose issue is then committed, at the balance sheet date, or that were in force earlier and that will generate cash flow after the balance sheet date.

According to paragraphs 2130.04 to 2130.05 of the Standards of Practice, current Canadian valuation methods clearly make provision for all contractual cash flows and related cash flows, including those from embedded options and guarantees. Further, the entire change in liability is recognized in profit or loss at each reporting date in Canadian GAAP reporting. Hence, Canadian GAAP includes a 'built-in' liability adequacy test that meets the minimum requirements of IFRS 4 paragraph 16.

Though the term 'current estimate' is not defined in IFRS 4 (and does not appear in the IFRS glossary), International Actuarial Standards of Practice (IASP) 5 of the International Actuarial Association (IAA) defines it as "the estimation of the expected value based on current knowledge". Further, section 4.1.5 of IASP 6 indicates that a current estimate would be based on continuously updated assumptions, and that both estimates with and without adjustments for risk and uncertainty would be acceptable for a test to meet the minimum requirements. Subsection

1730 of the Standards of Practice indicates that the assumptions used in the Canadian GAAP valuation are acceptable in this context.

It is worth noting that paragraph 16 of IFRS 4 does not specify any basis for choosing the discount rate that would be used in the liability adequacy test, as reinforced by IFRS 4 BC101. Thus, we are free to assume that the discount rate implicit in the Canadian Asset Liability Method (CALM) for life policy liabilities and the discount rate established in accordance with subsection 2240 of the Standards of Practice for P&C policy liabilities are both acceptable.

Though not expressly stated in IFRS 4, it is generally believed that the liability adequacy test would be performed without regard to cash flows expected to be received under reinsurance agreements (e.g., see IASP 6, section 4.1.9). Current practice for the P&C policy liabilities reflects this requirement. Although this would not be true for CALM as it is currently presented on the balance sheet, it will be true once the presentation adjustment discussed in (d) below is made.

One final point to consider is the 'term of the liability' concept under CALM, whereby only cash flows incurred during the term of the liability are considered in the CALM valuation. However, as paragraphs 2320.16 through 2320.27 of the Standards of Practice explain, the term of the liability restriction would almost always act to increase the amount of the liability, by preventing the insurer from recognizing profits on renewals of contracts where the insurer has the unconstrained right to adjust premiums or coverage for the renewed term.

In essence, such a renewal is considered a future contract because, in substance, the existence of a right to renew at whatever terms the insurer chooses to set places no current obligation on the insurer. This is consistent with the concept of 'recognition' of a liability under IFRS, and thus we can conclude that the term of the liability restriction does not violate the minimum requirements of the liability adequacy test under IFRS 4.

(c) Derecognition

Taking into account the 'term of the liability' discussion in (b) above for life insurance contracts, paragraphs 2130.03 through 2130.05 of the Standards of Practice indicate that policy liabilities continue to be recognized until the obligation is discharged, cancelled, or expires. Hence, we conclude that Canadian GAAP valuation complies with paragraph 14(c) of IFRS 4.

(d) Separate presentation of reinsurance ceded assets

This is current practice for the presentation of P&C policy liabilities in Canada; however, it is not current practice for Life contracts. The balance sheet presentation of CALM liabilities currently offsets reinsurance assets against the related reinsurance liabilities, because all policy-related cash flows, including reinsurance cash flows, are considered in the valuation of liabilities, as stated in paragraph 2130.05 of the Standards of Practice.

However, this balance sheet presentation will be changed to comply with the requirement in paragraph 14(d) of IFRS 4 by separately reporting the liability before reinsurance ceded and a separate asset for anticipated recovery under reinsurance ceded agreements. The net amount of the direct liability together with the reinsurance asset would equal the original net CALM liability.

The allocation of the net liability into a direct liability and a reinsurance asset would be based on the underlying cash flows, together with a reasonable assumption about the nature of the related assets.

(e) Impairment of reinsurance assets

Paragraph 2130.30 of the Standards of Practice states that “The recovery on account of reinsurance ceded would take account of the financial condition of the reinsurer.” Thus, it is clear that Canadian GAAP valuation of life and P&C contracts considers whether reinsurance assets are impaired, as required by paragraph 14(e) of IFRS 4.