CFO FORUM

Day one profit quantification

Introduction

This paper has been prepared by the CFO Forum to assist the IASB staff in its development of the Insurance Contracts Standard.

The IASB assert that the profit arising at inception (the difference between the premium income and the liability measured using the three building blocks and based on the current exit value) will be small. Such profits will relate to a portfolio assembly or will occur due to niche markets or other advantageous market position for participants.

As indicated in the joint CFO Forum/CEA response letter, the CFO Forum believes that this initial profit is more significant than that envisaged by the IASB. The size of the initial profit margin is demonstrable in market transactions and in published market consistent embedded value figures. Our views on accounting for the initial profit margin are set out in the CFO Forum/CEA joint response letter and have not been repeated here.

It is believed that the size of these profits can be further demonstrated by the level of new business contribution reported under Market Consistent Embedded Value (MCEV) principles. This paper compares the recently issued CFO Forum MCEV Principles to those under the proposed insurance contract standard (Phase II) with a view to demonstrating that MCEV new business contribution is a suitable proxy for the day one profit emerging.

For the purposes of the quantitative analysis provided in this paper the MCEV figures used represent those published under existing MCEV bases for 2007 as opposed to being under the newly published MCEV Principles. The new Principles introduce a number of improvements to existing MCEV reporting. In the absence of published numbers under the new Principles, it is felt that the figures provided below are consistent enough with the principles described for the purposes of this paper.

Quantification

Quantitative data to illustrate the potential day one profits has been prepared based on MCEV new business contribution. This information has been gathered in respect of the eight CFO Forum member companies who have published 2007 new business contribution on a direct MCEV basis. As indicated above, the results are included based on companies existing direct MCEV methodologies and therefore are not in full compliance with the recently published CFO Forum MCEV Principles.

The new business value (NBV) figures for the eight companies include insurance contracts and investment contracts, with and without discretionary participating features, and regular and single premium business. The figures are net of taxation.

The aggregate NBV figure of **€4.91 billion** (out of total MCEV post tax earnings of €14.2 billion) can be put into context by reference to aggregate IFRS post-tax profit figures for life insurance businesses in the relevant companies of €11.91 billion. For the same companies MCEV at 31 December 2007 was €115 billion compared to life business IFRS net assets of €89 billion.

Similarities between MCEV Principles and proposed IFRS accounting model

Both models are based on the best estimate of the present value of future cash flows.
Although the MCEV methodology articulates this as the present value of future shareholder cash flows rather than the cash flows of policy liabilities that Phase II is based on, these

shareholder cash flows will be derived from the same building blocks and so this is not expected to give rise to any differences in practice.

In both models economic assumptions, including the discount rate, are based on market observable data. MCEV explicitly requires the discount rate to be the swap yield curve appropriate to the currency of the cash flows with no adjustment for liquidity or credit risk premiums. This is broadly consistent with the more general Phase II guidance, which simply requires a discount rate which is consistent with observable market prices for cash flows whose characteristics match those of the insurance liability. This would include liquidity factors, but the use of the swap curve is seen as a proxy for a risk free rate plus an allowance for liquidity.

Both models allow a margin for risk and uncertainty. MCEV expresses this in a different way to the Phase II model, which requires an explicit and unbiased estimate of the margin that market participants require for bearing risk and for providing other services. The cost of capital approach is listed as one of the methodologies that may meet this requirement. MCEV allows for the cost of risk and uncertainty by requiring provision for the frictional costs (i.e. tax and investment fees) of holding capital assets to support the business and by the inclusion of the residual cost of non-hedgeable risks. This must be benchmarked to the cost of capital methodology and is intended to replicate how the market will value risk and uncertainty, to the extent that cost has not been included elsewhere. Therefore, although there may not be an explicit total risk margin in the same way as the Phase II model, suitable allowance should be included in the model for the cost of risk and uncertainty. In terms of hedgeable risks, as these have already been valued at market prices, no separate allowance for risk is required. Whilst the approach to risk margin represents an apparent similarity between the models it may also constitute a significant difference depending upon the interpretation placed on the risk margin under IFRS (see below).

The Phase II and MCEV models are therefore underpinned by similar principles and rationale and theoretically the two would be anticipated to give similar results at point of sale.

Differences between the two models

A number of detailed differences do exist between the two models however. These include:

- The scope of contracts
- The contract boundary
- Taxation
- Non-economic assumptions
- Own credit standing
- Diversification
- Margins

Each of these differences is considered in turn below, however it is not felt that these in themselves are drivers of the day one profit, albeit that they clearly influence it, and many of these factors the CFO Forum has opposed in its response to the Discussion Paper (i.e. MCEV is felt to be more reflective of the economic position of the insurance contract which the CFO Forum supports for insurance contracts).

The scope of contracts

IFRS Phase II will apply to insurance contracts, both life and non-life, and, it is anticipated, investment contracts with discretionary participating features. MCEV applies to all “covered” contracts, both insurance and investment contracts, but is predominantly applied to life contracts. Although this will influence the magnitude of the day one profit as a whole and it is the case that different products will have a different level of day one profit, it is thought that the significance of day one profits can adequately be demonstrated by the life business and that there is no automatic skew between investment and insurance contracts. This means that MCEV is still a suitable model for illustrating the size of day one profit.

The contract boundary

In the Discussion Paper, IFRS Phase II does place some restrictions on which cash flows can be used in the present value calculation, namely around guaranteed insurability and participating contracts. The CFO Forum opposes these restrictions and for MCEV includes the expected cash flows from existing contracts to provide an economic value of contracts.

Taxation

MCEV is calculated net of taxation. Some countries, principally the UK, gross up amounts using the shareholder rate of return purely for presentational purposes. Under Phase II, cash flows should be stated gross of income tax amounts (although allowance is made for transaction based taxes).Theoretically this could lead to different results, especially as IAS 12 does not allow discounting of deferred tax. The use of discounting in particular is yet to be considered by the Board. However, MCEV should still be a suitable proxy of a post tax return, albeit that detailed differences may arise after further consideration of this topic by the IASB Board.

Non-economic assumptions

The IASB Discussion Paper states that the inputs used to develop estimates of future cash flows should, as far as possible, be consistent with observed market prices. This contradicts with the MCEV guidance where it is explicitly stated that such assumptions should be best estimate and entity specific rather than being based on the assumption a market participant would use.

The majority of respondents to the Discussion Paper supported the use of entity specific assumptions in the absence of a market. Given that this is still an area of debate this difference does not therefore invalidate using MCEV to give indication of the size of day one profits.

Own credit standing

No allowance under MCEV is made for own credit characteristics, unlike the requirement under Phase II. However, this is not expected to materially influence the level of day one profit.

Diversification

Under the IASB's Phase II discussion paper, risk margins would be calculated at the unit of account (portfolio level) and no further allowance for diversification would be made. The MCEV principles will make additional allowance for diversification when determining the cost of residual non-hedgeable risks, but only to the extent that it relates to diversification benefits within non-hedgeable risks within the covered business (i.e. diversification benefits between non-hedgeable and hedgeable risks should not be allowed for and no allowance should be taken for diversification benefits between covered and non-covered business.)

Margins

The Phase II model includes a service margin. There is no such concept under MCEV where the costs of providing services are included in the best estimate cash flows. The CFO Forum has proposed the same treatment under IFRS.

Whilst the risk margin concepts in the two models can be considered similar, as noted above, there is also a possibility of a significant difference depending on the interpretation applied to the risk margin in IFRS. The CFO Forum believes that this margin should represent the cost of risk and uncertainty, which is broadly consistent with the MCEV principles as indicated above. If the IFRS risk margin is interpreted as including a significant element of future profit in the form of compensation for bearing risk then this would represent a further difference.

Conclusion

On the basis of the analysis above MCEV new business contribution is a reasonable proxy for the purpose of giving an indication of the size of the day one profit under the Phase II insurance contracts model. Although detailed differences exist particularly around diversification and contract definition, these differences are not expected to be the key driver of the day one profit, albeit they will influence it. This paper assumes that the purpose and basis of determination of the risk margin as articulated in the CFO Forum/CEA response letter, and further discussed in our letter on the measurement attribute dated 25 July 2008, will be acceptable under the final standard. Any change to this assumption would introduce a significant difference between the two bases which could materially impact the size of the day one profit.

As previously highlighted the existence of significant profits is supported by real life market transactions where sales of business are based on embedded values before allowance for customer relationships, goodwill and other intangibles.

In conclusion, if MCEV new business contribution is accepted as a reasonable proxy for profit arising on inception of insurance contracts under a new IFRS measurement model, then the initial profit generated can be illustrated as representing a significant amount in relation to currently reported IFRS profits.