NZ SOCIETY OF ACTUARIES – LIFE COMMITTEE NOTE

VALUATION OF POLICY LIABILITIES (PS3) AND TRANSITION TO IFRS

1 STATUS OF THIS NOTE

This note was prepared by the Life Insurance Committee in December 2006. It has been prepared for the purposes of assisting members in making the transition to the calculation of Policy Liabilities under IFRS, by describing our understanding of the approach that has been taken by life insurance companies that have early adopted. It is not a professional standard or a guidance note.

The Life Committee is grateful to the 5 companies that have provided the information used as the basis for this note. Companies were not asked specific questions. We simply asked them to provide general notes on the approach they had taken.

Any further information on the approach members have already taken in practice in the areas discussed below, or comment on these matters, is particularly welcomed. Feedback should be forwarded to the Life Committee, care of Linda Caradus.

2 BACKGROUND

2.1 In October 2006, the NZSA issued a new version of PS3, resulting from the implementation of International Financial Reporting Standards (IFRS). New Zealand entities are required to adopt the NZ equivalents of IFRS for the financial year that ends after 1 January 2007.

2.2 A number of entities have elected to report under IFRS from an earlier date, particularly companies with Australian parents that were required to adopt earlier.

2.3 This note covers 5 areas:

- Comparative information
- Classification of business
- Risk free rate
- Other assumptions
- Changes to policy liabilities

2.4 This note discusses only the calculation of Policy Liabilities. A number of changes to other aspects of financial statements are likely to arise as a result of adopting IFRS. The approach that any entity takes in all aspects of making the transition to IFRS should be discussed with its auditors.

2.5 This note relates only to entities that were previously reporting under FRS-34 (Margin on Services). Entities that were reporting under other standards (e.g. friendly societies) are likely to have more extensive revisions to their practices than are indicated here.

2.6 Section 12 of PS3 indicates that the impact on profit margins of buying reinsurance needs to be identified and that the principles of PS3 apply to both the Gross Policy Liability and any Reinsured Policy Liability. This concept was not in the previous standard. A separate note will be issued on this matter.

3 COMPARATIVE INFORMATION

3.1 Entities are required to publish restated prior year comparatives on an IFRS basis. While there was an exemption from this requirement for "early adopters" (before 1 January 2006), this exemption is no longer applicable.

3.2 For example, an entity that has a financial year ending 31 December will be required to publish IFRS-compliant financial statements for the year ending 31 December 2007 which include information on an IFRS basis for the year ended 31 December 2006. Thus, the opening Policy Liabilities for the comparative year (liabilities as at 31 December 2005) need to be calculated.

3.3 A comparative statement of financial position at the start of the prior comparative year is required, with a reconciliation of shareholder equity at that date (31 December 2005 in the above example).

4 CLASSIFICATION OF BUSINESS

4.1 Business is required to be classified as "insurance" or "investment", according to the definitions in the accounting standards IFRS-4 and IAS-39.

4.2 Entities have classified the savings element of unit-linked business as "investment".

4.3 Entities have classified the following types of product as "insurance":

- Risk
- Traditional non-profit
- Annuities
- Participating

4.4 One entity has unbundled and valued its unit-linked business in three parts: the savings component under IAS-39, the insurance component under IFRS-4 and the management services component under IAS-18.

4.5 One entity has classified Investment Account business as "investment". Others have classified this type of product as "insurance". One entity noted that the latter classification followed from the product having a discretionary participating feature: with regard to the crediting rate. Thus, even though some contracts had no significant insurance risk, the product fell within the "insurance" classification.

4.6 Members are warned that there may be particular features of their own companies' products that mean it is not appropriate for them to take the same approach as other entities. It is important to determine each product's classification from first principles.

5 RISK FREE RATE

5.1 IFRS-4 requires the use of a risk-free discount rate in the calculation of Policy Liabilities for contracts that are classified as insurance but where benefits are not contractually linked to the performance of the assets.

5.2 Entities have taken various approaches to determining a risk-free rate:

- 10-year government bonds for all products except annuities, for which a swap curve has been used,
- 5-year or 10-year government bonds, depending on the duration of the liabilities,
- 10-year swap rate, adjusted for credit spread and liquidity premium, and
- 10-year swap rate.

5.3 Entities have allowed for the actual investment expenses expected to be incurred on the backing assets. One has made this allowance explicitly, others have reduced the risk-free rates determined in 5.2.

5.4 NZ swap rates can be found on the NZX website www.nzx.com, by searching Swap Rates. Various durations are available. Members should note that NZX is not planning to keep historical information past 4 weeks on its website, therefore screen captures should be used for audit trail purposes. As alternatives, it is anticipated that Reuters/Bloomberg will keep a longer history, and NZX may oblige with replies to ad hoc requests for information.

6 OTHER ASSUMPTIONS

6.1 Entities have generally made no changes to other assumptions.

6.2 In particular, the methodology for determining the discount rate for books of business where performance is contractually linked to asset values has not been changed.

6.3 One entity noted that deferred tax assumptions have been changed in line with IFRS requirements.

7 CHANGES TO POLICY LIABILITIES

7.1 Four of the entities introduced any necessary changes to their Policy Liabilities with effect from the opening date of the comparative year. Thus, the operating profit for the comparative year was restated. One entity took advantage of the exemption available to early adopters (refer 3.1 above) and changes were applied with effect from the opening date of the actual reporting year.

7.2 Entities reported having made an adjustment to allow for changes in the valuations of assets supporting participating business. One entity reported making an allowance for the cost of capital guarantees (an embedded option) on investment account business, which it classified as insurance.

7.3 Otherwise, no change was made to the Policy Liabilities for business classified as insurance, unless it was in loss recognition. In other words, any change in the discount rate as a result of moving to a risk-free rate was treated as an assumption change with the effect spread over the remaining terms of the contracts where possible.

7.4 Entities have made various changes to the Policy Liabilities for investment contracts, as follows.

- An allowance to bring the Policy Liability up to the surrender value.
- DAC has been written off as a result of the narrower definition of acquisition costs for investment contracts, increasing the Policy Liability. One entity noted that only pure initial commission is now being deferred.
- DAC has been removed from the Policy Liability and recorded separately.
- A Deferred Income Reserve was established, being initial entry fee income on products sold through a third party. As no service was deemed to have been provided by the entity, such income is deferred and run off as services are provided.
- The financial instrument liability under NZ IAS 39 was taken to be the funded value of units for products with capital units, and the surrender value for other products.
- The Fair Value of unit-linked and investment account business was taken to be the account balance, including investment fluctuation reserves.

7.5 One entity noted that, where allowed under policy terms and conditions, unit pricing was changed to use asset values based on bid prices, in order to bring to asset values in the financial statements and the asset values in the unit prices back into line. The amount of the adjustment was immaterial.