Deloitte.

The future of insurance accounting
IFRS 4 Phase II Exposure Draft

Francesco Nagari

6 August 2010

Agenda

- Background to the insurance project
- Summary of the exposure draft
- Next steps

Background

Insurance project

- The IASB has been working on improving insurance accounting for over 10 years now.
- After a preliminary intention in 2007 to create a fair value approach, the direction is now focused on an entity specific model.
- The FASB joined the insurance accounting project in 2008 to achieve convergence.
- The Current Exit Value Model (fair value/transfer notion) was abandoned, and the Current Fulfillment Model was settled upon.
- Some areas of disagreement remain, and resulted in the IASB publishing its exposure draft without the FASB.
- The FASB expects to publish a consultation paper in August.

Improvements to insurance accounting

- Outline a comprehensive framework that will require insurers to provide information relevant to users of financial statements for economic decision-making.
- Eliminate inconsistencies and weaknesses in existing practices and IFRS 4 Phase I.
- Provide comparability across entities, jurisdictions and capital markets.

Summary of the ED proposals

- Current IFRS 4 definition of “insurance” carried forward.
- Single prospective measurement model for:
  - life and non-life businesses; and
  - insurance and reinsurance contracts.
- Measurement model uses a “building block” approach:
  1. Expected present value of future cash flows; and
  2. Risk adjustment.
- Measurement is current, i.e. no locking-in of assumptions.
- Measurement objective based on a “fulfillment of obligations” notion.
- No profit recognition allowed at inception of the contract – a residual margin liability is added to the building blocks amount.
- Day-one losses recognised in P&L immediately.
- Acquisition costs are expensed.

Measurement model

Measurement objective and approach

- Current assessment of insurer's rights and obligations under contract – single amount on financial statements representing the net contract fulfilment value.

- Use of a transparent "building block" approach, with a simplified approach required only for short-duration contracts:
  - Present value of fulfilment cash flows;
  - Risk adjustment; and
  - Residual margin.

Measurement model (cont.)

Block 1: Fulfilment cash flows

- Explicit, unbiased and probability-weighted estimate of future cash flows.
- Includes all incremental cash flows that will arise as the insurer fulfils the insurance contract:
  - Premiums and cash flows that arise from those premiums;
  - Claims and benefits paid to policyholders, plus associated costs;
  - Cash flows resulting from options and guarantees;
  - Incremental costs of selling, underwriting and initiating the contract; and
  - Policy administration and maintenance costs.
- Cash flows included if arise within the “contract boundary”:
  - Boundary is point at which insurer can terminate or re-underwrite a contract; and
  - Future premiums and claims/expenses related to those premiums.
- Cash flows re-assessed at each reporting period.
- Stochastic modelling may be required.
- Estimates of market variables to be consistent with observable market prices.

Measurement model (cont.)

Block 2: Time value of money

- Adjusts first building block for time value of money.
- Discount rate based on characteristics of the insurance liability:
  - Currency
  - Duration
  - Liquidity
- Measurement reflects characteristics of the assets backing insurance liability only if:
  - Amount, timing or uncertainty of contract cash flows depend on performance of assets;
  - e.g. Participating contracts;
  - Linkage may be reflected using a replicating portfolio.
- Discount rate is a market consistent “risk free rate”, adjusted for illiquidity characteristics of liability cash flows.
- No further guidance on what is “risk free” or how to calculate the illiquidity premium.
- Disclosures on discount rate, impact of illiquidity and sensitivities.

Measurement model (cont.)

Block 3 – Margins: Risk adjustment

- A margin to reflect uncertainty in the estimate of fulfilment cash flows.
- Included in the measurement explicitly.
- Defined as:

"the maximum amount an insurer would rationally pay to be relieved of the risk that the ultimate fulfilment cash flows exceed those expected"

- Re-measured at each reporting period.
- Estimated at level of portfolio of insurance contracts.
- Effects of diversification between portfolios of insurance is not allowed.
- Techniques for estimating the risk adjustment:
  - Confidence Interval;
  - Conditional Tail Expectation (CTE); and
  - Cost of Capital.

Measurement model (cont.)

Risk adjustment – permitted techniques

- Confidence Interval:
  - Likelihood that the actual outcome will be within specified interval.
  - Sometimes referred to as Value at Risk (VaR).
  - Easy to communicate and calculate.
  - Not as useful for distribution that are not statistically normal.
- Conditional Tail Expectation (CTE or tail VaR):
  - Better reflection of extreme losses.
  - Focuses on the tail of the probability distribution → reflects aspects of insurance.
  - Judgement required to determine band and may need to change in future periods.
- Cost of Capital:
  - Applied in pricing, valuations and regulatory reporting, etc.
  - Reflects estimated cost of holding required capital to meet obligations with high confidence.
  - Need to determine capital rate that reflects risk relevant to liability.
  - Approach used in SII for risk margin.
- Some guidance provided for when to use which technique.

Measurement model (cont.)

Block 3 – Margins: Residual margin

- Eliminates any gain at inception of the contract.
- A residual margin arises when:

  PV of future cash inflows > PV of future cash outflows + risk adjustment
- Estimated at level of portfolio of insurance contracts, with same inception date and similar coverage duration (cohort).
- Measured at initial recognition and amortised over coverage period.
- Cannot be negative as a loss must be recognised immediately.
- Interest accrete using discount rate locked-in at inception.

Measurement model (cont.)

Block 3 – Alternative: Composite margin

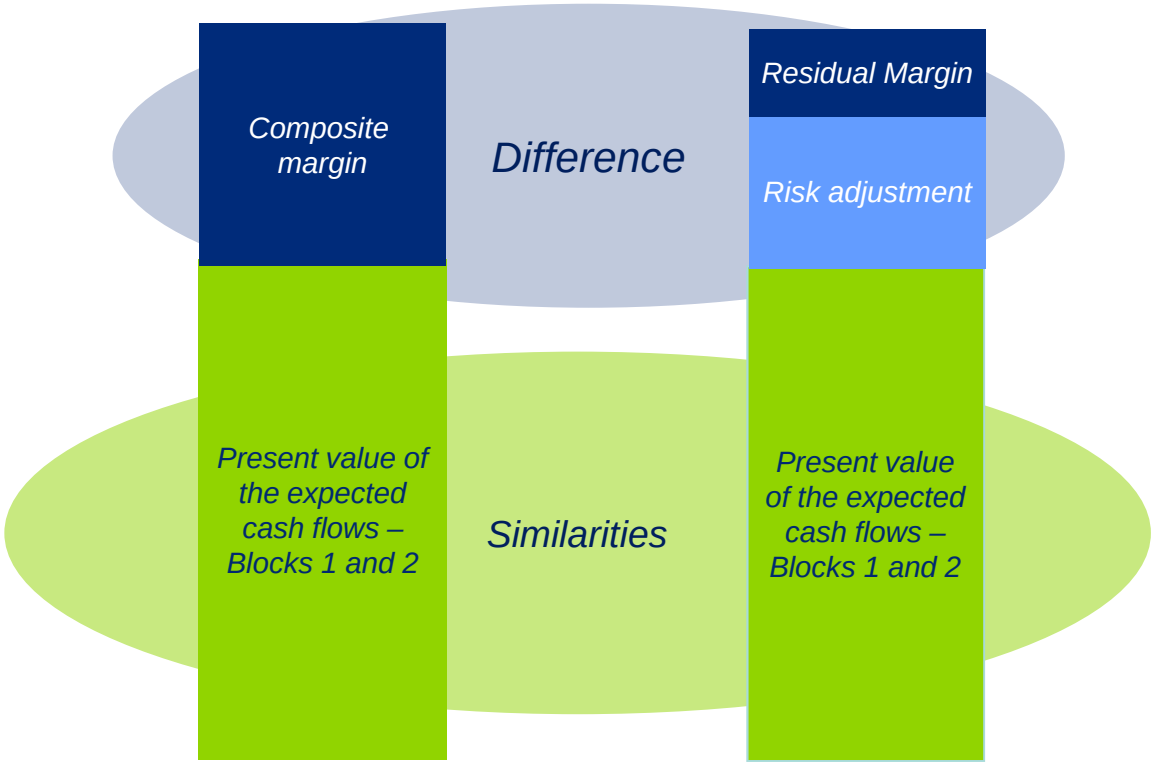
- Preferred by FASB.
- Avoid explicit measurement of uncertainty → capture risk together with future profit.
- Measured at inception and released as risk exposure unwinds based on a specified formula.
- No interest accretion.

Measurement model (cont.)

Comparison	Risk adjustment and residual margin	Composite margin
Margin components	Explicit risk adjustment liability + residual margin to eliminate day 1 gain.	Single margin to eliminate gain at inception and charge the policyholder for risk assumed by insurer.
Calibration	Against expected PV of contract CFs, including risk adjustment. Accounting loss recognised immediately.	Against expected PV of contract CFs. Accounting loss recognised immediately.
Interest accretion	At same rate used to discount the expected CFs at inception.	No accretion.
Techniques available	Confidence level Conditional tail expectation Cost of capital	n/a
Level of aggregation	At portfolio level, i.e. “group of contracts that are subject to broadly similar risks and managed together as a single portfolio”.	At cohort level. A cohort is a group of contracts within the same portfolio that have the same duration coverage and have been issued in the same period.
Subsequent measurement	Risk adjustment is re-measured at each reporting date. Residual margin is no re-measured but released to income over the coverage period..	Not re-measured but released using: (premium allocated to current period + current period claims and benefits) (total contract premium + total claims and benefits)

Measurement model (cont.)

Proposed model – alternatives:



Block 1 includes directly attributable incremental acquisition costs

FASB	IASB
Current Fulfilment Value with composite margin	*Current Fulfilment Value with risk adjustment*

Measurement model (cont.)

Short-duration contracts

- Pre-claims liability for all contracts that:
  - Have a coverage period of approximately one year or less; and
  - Do not contain embedded options or derivatives that significantly affect the variability of CFs.
- Measure pre-claims liability by allocating premiums over coverage:

  At initial recognition = premium received + expected PV of future premiums less incremental acquisition costs

- Full amount will be earned over the coverage period.
- The post-claims liability will be recognised as claims incurred measured using three building blocks.
- After the coverage period accounting models align with a post-claim liability based on building blocks.
- This results in simpler measurement for the pre-claim liability (first 12 months or less).

Contract boundary

- New concept, crucial to the proposed measurement model.
- Insurance contract is measured and presented as one balance to represent the bundle of rights and obligations.
- The measurement of insurance contract includes all rights and obligations, including policyholder options, if they fall within the contract boundary.
- The boundary of an insurance contract has been based on two key principles:
  - The ability of the insurer to unilaterally cancel the contract; and
  - The ability of the insurer to re-price the contract to reflect the current assessment of insurance risks applicable to the specific policyholder.

Contract boundary (cont.)

- The inclusion of ‘specific policyholder’ in the principle is important, as it allows insurers to re-price portfolios of policies without breaking the contract boundary.

- If insurance policy includes options, forwards or guarantees not falling within the existing contract boundary, they are accounted as new insurance contract or under other applicable standards.

- Inclusion of contingent cash flows from policyholder options would require assessment of policyholder behaviour on expected value basis.

- Actuarial models need to be reviewed to ensure they capture expected value of premiums of those options that fall within the contract boundary.

Contracts with participating features

Discretionary Participation Feature (DPF)

Definition brought forward from IFRS 4 Phase I virtually unchanged.

Insurance contracts with DPF

- Insurance contracts with DPF should not be unbundled.
- Expected future discretionary policyholder bonuses/dividends must be included in the first building block.
- The discount rate is based on the assets within the participating fund.

Investment contracts with DPF

- **IASB:** Contracts that participates in the same pool of assets as participating insurance contracts are included in the insurance standard. All other contracts are excluded.
- Policyholder losing his right to discretionary benefits sets the contract boundary.
- Asset under management determine the pattern for the residual margin to be earned.
- **FASB:** All contracts are scoped into the financial instruments standards.

Unbundling

- Unbundling will be required for all components that are not closely related to the insurance coverage.
- Three examples of this principle where unbundling will be mandatory are set out in the ED:
  1. Account balances – a deposit component with certain characteristics;
  2. Embedded derivatives – based on the current IAS 39 rules also from a “closely related” test angle; and
  3. Service components – all non-contingent obligations that are not closely related to the insurance coverage but have been combined with the contract for reasons that have no commercial substance.
- Any unbundled component is separated alone without any of the related fees, charges etc. which continue to be accounted for with the insurance contract.

Unbundling (cont.)

- The more serious implication of this set of requirements is likely to be the separation of account balances.
- The characteristics that need to be met to be caught by the requirement are:
  - The deposit must be an explicit account balance with the policyholder. Implicit account balances derived from discounting maturity values are not account balances.
  - The account balance must receive interest based on a crediting rate that is “based on the investment performance of the underlying investments”.
  - The crediting rate is not capped.

Other measurement characteristics

The ED introduces other requirements:

Foreign currency translation – The ED clarified that all accounting amounts associated with insurance contracts are monetary items that should be revalued at the FX rate in force at the reporting date.

This approach improves on the current practice of treating only certain amounts as monetary and eliminates the associated accounting inconsistency with investments.

Business combinations and portfolio transfers – The accounting for insurance contracts in these cases is identical to normal reporting.

Any difference with the fair value will respectively go to goodwill or as a loss in case it is negative. In the event it is positive it will be captured in a residual margin liability in both cases.

Insurer's non-performance risk – The ED requires ignoring the risk that the insurer does not perform under the contract (own credit risk being the most commonly known).

Accounting for this risk would have resulted in a scenario where claims and benefits are not paid and the expected value of the liability would have been lower in proportion to the associated probability of non-performance.

Definitions

Insurance contract: An insurance contract is a contract under which one party (the insurer) accepts **significant** insurance risk from another party (the policyholder) by agreeing to compensate the policyholder if a specific uncertain future event (the insured event) adversely affects the policyholder.

Insurance risk: Insurance risk is risk, other than financial risk, transferred from the holder of a contract to the insurer. Financial risk is the risk of a possible future change in one or more of a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract.

- Clarification of the meaning of significant insurance risk
- Significance is assessed on a present value basis and contract by contract
- Significant if there are scenarios where as a result of an insured event the insurer could make payments in present value significantly exceeding the present value of the premiums received
- Lack of timing risk is a disqualifying, rather than a qualifying factor

Scope of IFRS 4

IFRS 4 applies to:

- All insurance / reinsurance contracts issued and reinsurance contracts held.

- Certain financial instruments with discretionary participation features:
  - If they participate in the performance of the same assets/contracts/entities as insurance contracts do.
  - This is a point of difference with FASB.

- All financial guarantee contracts meeting the definition of an insurance contract:
  - These will no longer be in the scope of financial instruments standards IAS 32, IAS 39, IFRS 7 and IFRS 9.

Scope of IFRS 4 (cont.)

Scope exclusions

Main change from IFRS 4 Phase I:

- Fixed fee service contracts if the primary purpose of is provision of services, regardless of whether they meet the definition of insurance.

Other retained scope exclusions:

- Warranties issued directly by a manufacturer, dealer or retailer;
- Lessee's residual value guarantees embedded in a finance lease or provided by a manufacturer, dealer or retailer ;
- Employers' assets and liabilities under employee benefit plans and retirement benefit obligations reported by defined benefit retirement plans;
- Contingent consideration payable or receivable in a business combination; and
- Insurance contracts held.

Recognition and derecognition

- Rights and obligations are recognised when the insurer becomes a party to the contract.
- At the earlier of the insurer being “on risk” or the signing of the insurance contract.
- If the insurer can reassess the risk, and either cancel the contract or change the contract terms, the insurer is not likely to be considered “on risk”.

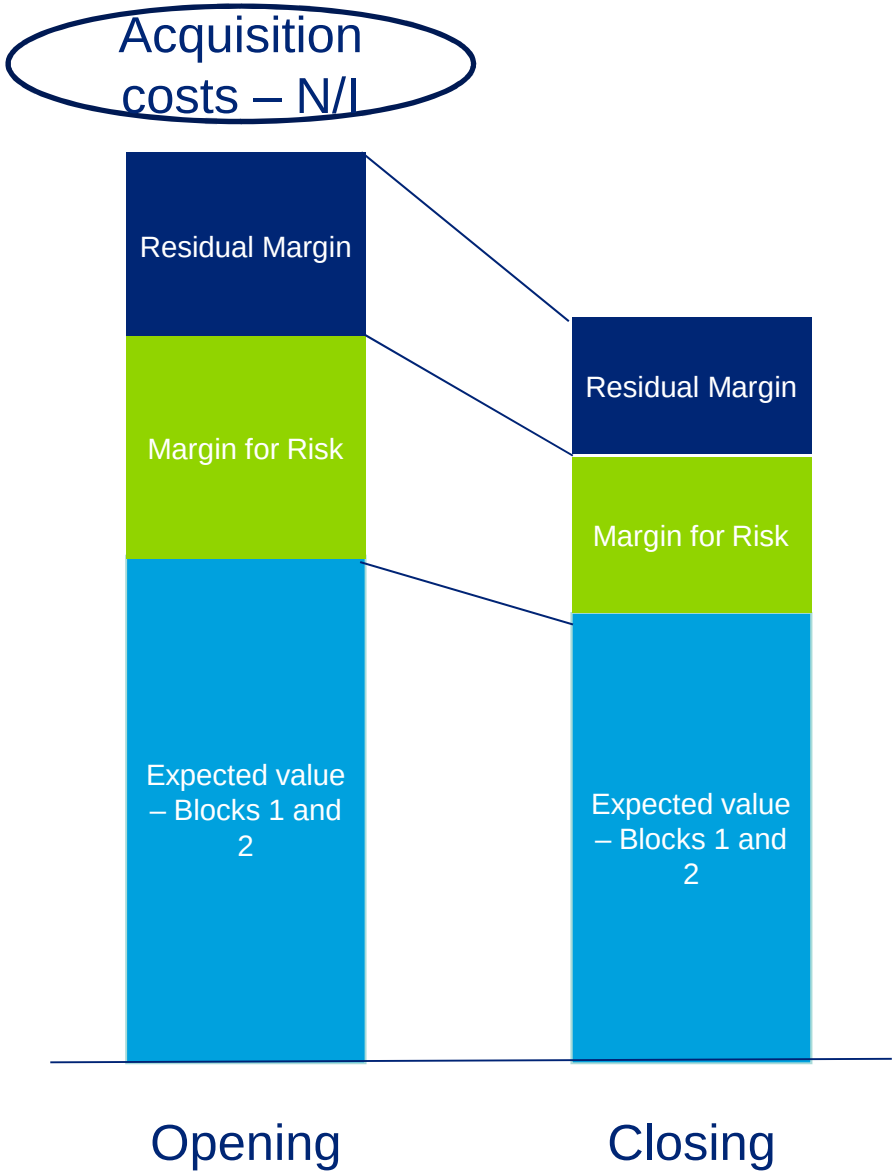
- Derecognition takes place, similar to IAS39 for financial liability, at the point where the insurer is no longer “on risk”.

Presentation

Three building blocks

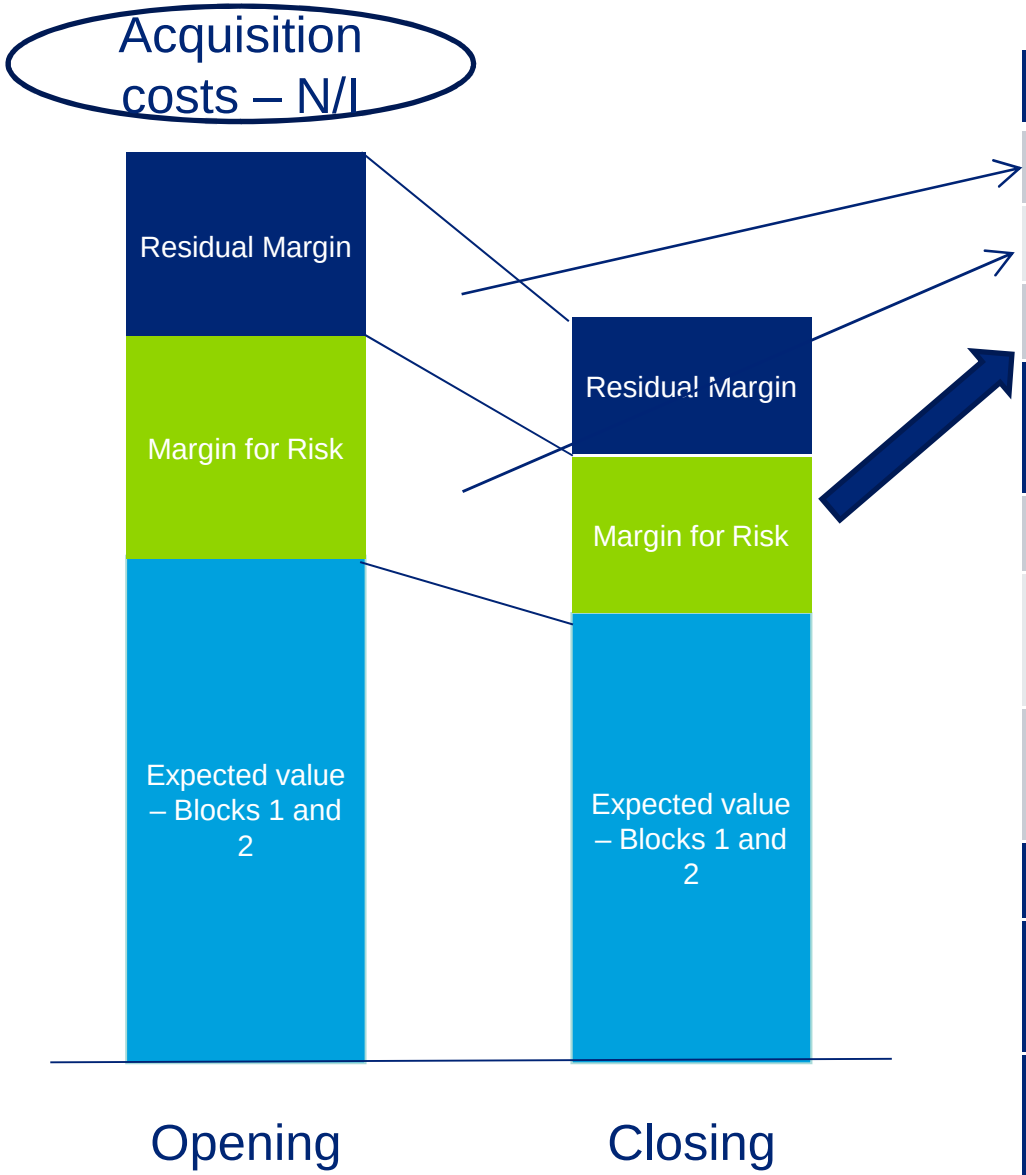
- The new presentation model in the ED has been developed from two key conclusions:
  1. Presentation of an insurer's profit or loss is better expressed from the building-blocks model; and
  2. A margin approach is the most suited presentation to display the sources of profit from the building-blocks model.
- To ensure consistency in the application and greater comparability there are five minimum line items to be put on the face of the income statement:
  i. Underwriting margin;
  ii. Experience variances and changes in assumptions;
  iii. Day one losses on insurance sold and day one gain on reinsurance bought;
  iv. Acquisition expenses (non incremental); and
  v. Interest expense from discount unwinding (ideally paired with an asset investment income line to display an investment margin).
- All these lines have a link to the building blocks.
- Special lines will be added for the unearned premium method.

Presentation (cont.)



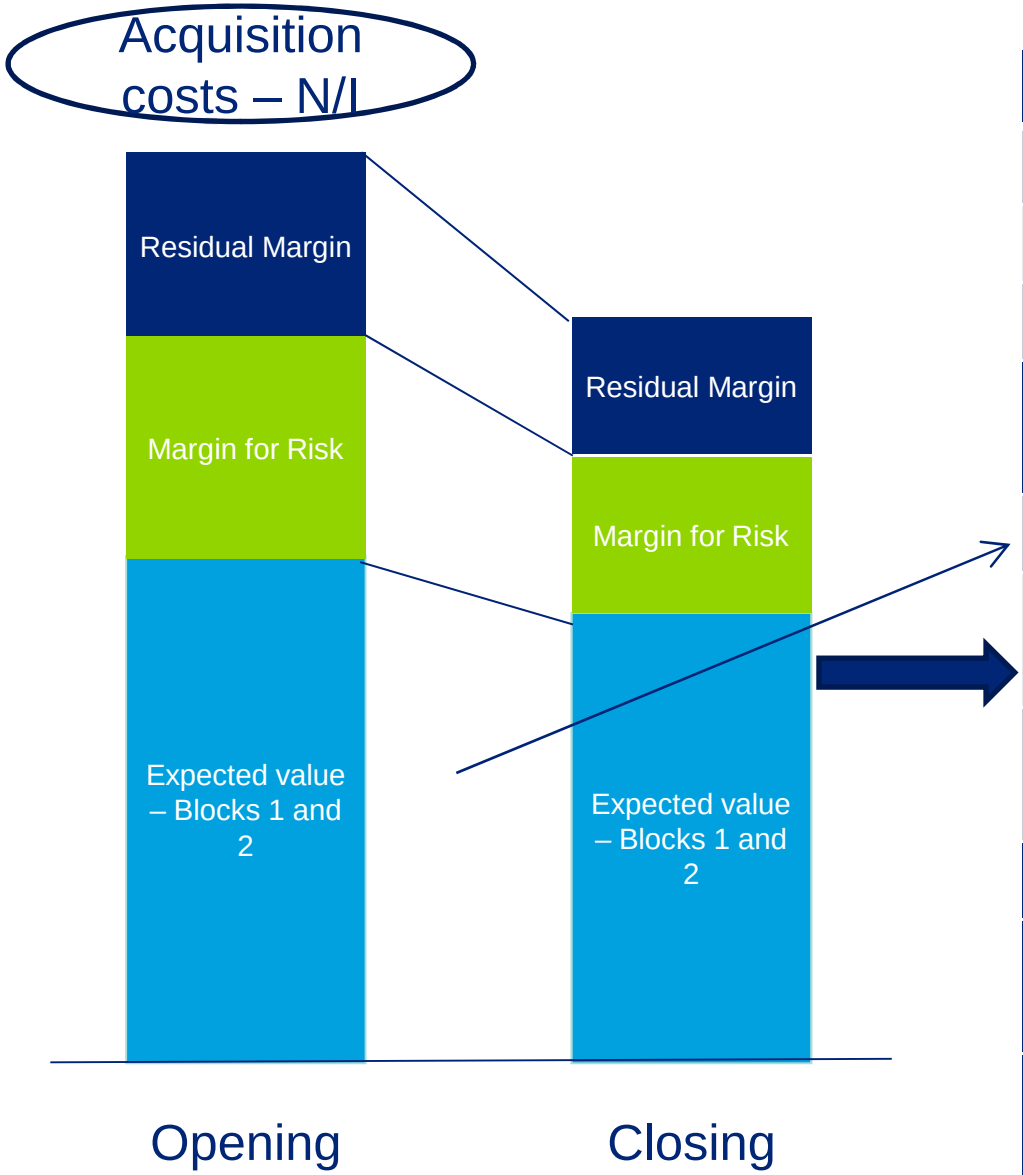
i. Underwriting margin	
a. Income from residual margin	+
b. Income from opening risk adj.	+
c. Changes in closing risk adj.	±
ii. Experience variances and changes in assumptions	
d. Experience variances	±
e. Changes in closing cash flow estimate	±
f. Changes from closing discount rate	±
iii. Day 1 R/I gains/ Ins. losses	**±**
iv. Non-incremental acquisition costs	**-**
v. Interest expense from discounting unwind	**-**

Presentation (cont.)



i. Underwriting margin	
a. Income from residual margin	+
b. Income from opening risk adj.	+
c. Changes in closing risk adj.	±
ii. Experience variances and changes in assumptions	
d. Experience variances	±
e. Changes in closing cash flow estimate	±
f. Changes from closing discount rate	±
iii. Day 1 R/I gains/ Ins. losses	**±**
iv. Non-incremental acquisition costs	**-**
v. Interest expense from discounting unwind	**-**

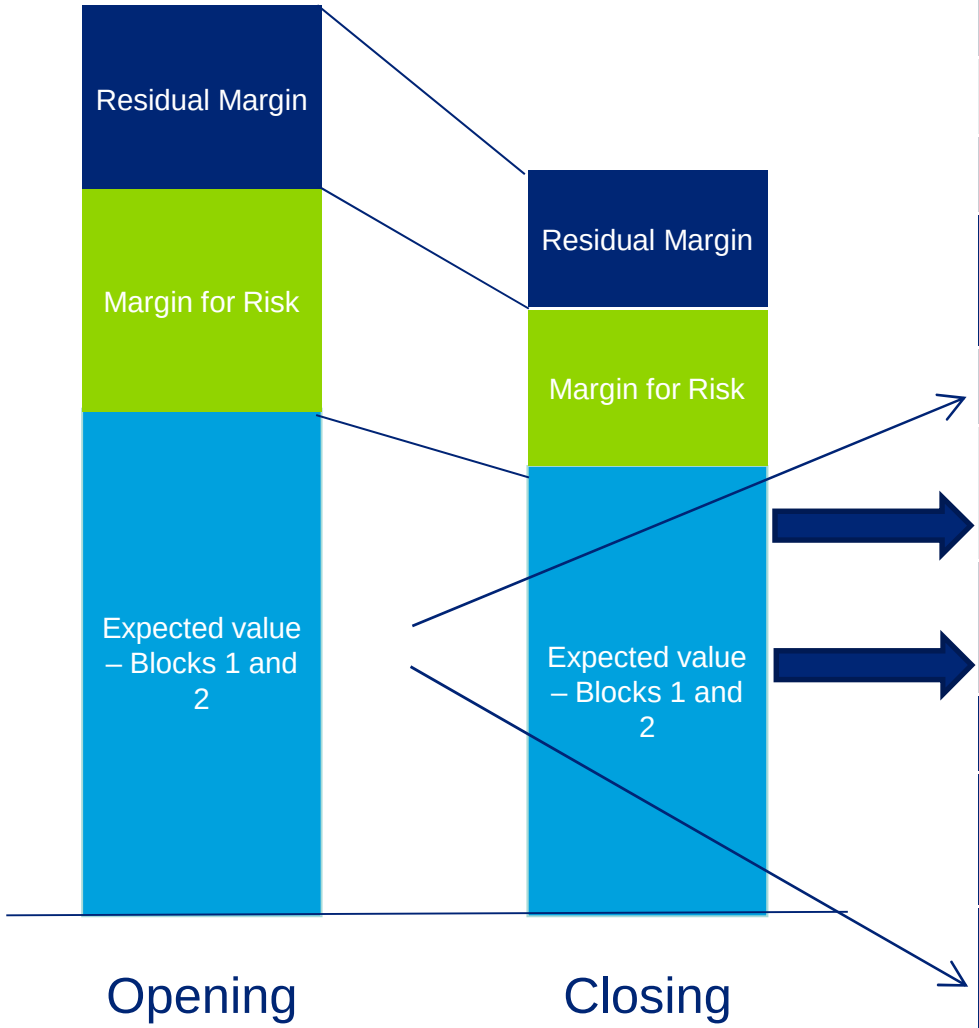
Presentation (cont.)



i. Underwriting margin	
a. Income from residual margin	+
b. Income from opening risk adj.	+
c. Changes in closing risk adj.	±
ii. Experience variances and changes in assumptions	
d. Experience variances	±
e. Changes in closing cash flow estimate	±
f. Changes from closing discount rate	±
iii. Day 1 R/I gains/ Ins. losses	**±**
iv. Non-incremental acquisition costs	**-**
v. Interest expense from discounting unwind	**-**

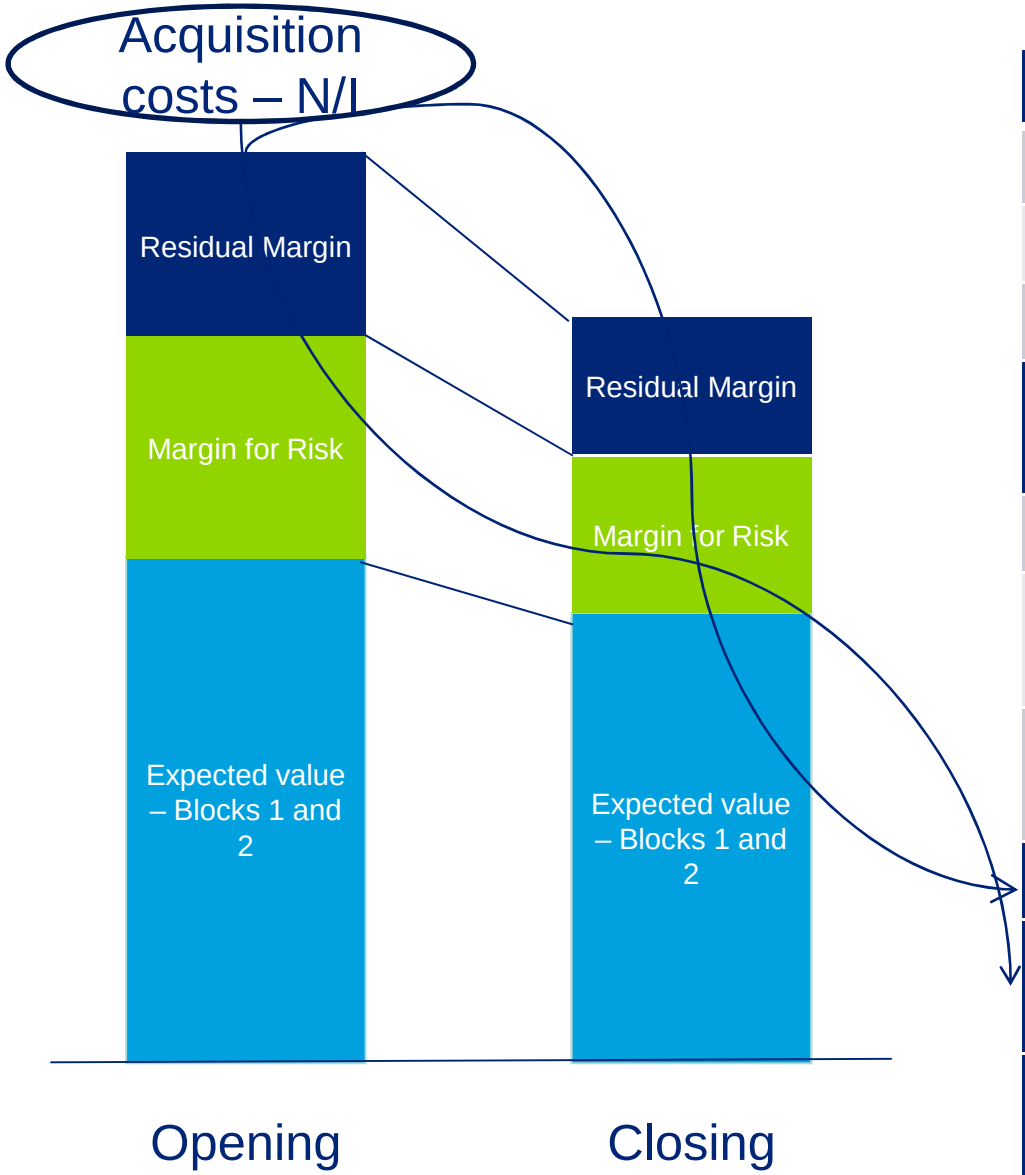
Presentation (cont.)

Acquisition costs – N/I



i. Underwriting margin	
a. Income from residual margin	+
b. Income from opening risk adj.	+
c. Changes in closing risk adj.	±
ii. Experience variances and changes in assumptions	
d. Experience variances	±
e. Changes in closing cash flow estimate	±
f. Changes from closing discount rate	±
iii. Day 1 R/I gains/ Ins. losses	**±**
iv. Non-incremental acquisition costs	**-**
v. Interest expense from discounting unwind	**-**

Presentation (cont.)



i. Underwriting margin	
a. Income from residual margin	+
b. Income from opening risk adj.	+
c. Changes in closing risk adj.	±
ii. Experience variances and changes in assumptions	
d. Experience variances	±
e. Changes in closing cash flow estimate	±
f. Changes from closing discount rate	±
iii. Day 1 R/I gains/ Ins. losses	**±**
iv. Non-incremental acquisition costs	**-**
v. Interest expense from discounting unwind	**-**

Disclosure

- The ED has adopted the current IFRS disclosure principles for insurance and added more stringent requirements to ensure alignment with the building blocks model and consistency of minimal content in the notes.
- Aggregation is prohibited at a level greater than operating segment.
- There is great focus on two particular areas which have been expanded:
  - Assumptions and their changes:
    - Focus on the block estimation;
    - Assessment of the impact on profit and equity; and
    - Disclosure of changes from prior period.
  - Reconciliation of movements to balance sheet and income statement lines:
    - Specific minimum reconciling items set out;
    - Tailored requirements for the simplified method;
    - All amounts before and after reinsurance; and
    - Focussed on the cash flows exchanged and their comparison with estimates.

Unit-linked contracts

- These provisions apply to both insurance and financial instruments with unit-linked features.

Measurement

- Certain current 'accounting mismatches' will be eliminated through requirement to fair value through profit and loss:
  - Insurer's own issued shares if they are held in a pool of assets underlying unit-linked contracts (amending IAS 32 and IFRS 9 financial instruments standards).
  - Owner-occupied properties that form part of a pool of assets underlying unit-linked contracts (amending IAS 16 Property, Plant and Equipment).

Presentation

- Single line item for assets backing unit-linked contracts.
- Single line item for their income/expense.

Reinsurance

- Reinsurance contracts are measured using the building-blocks as insurance contracts.
- Reinsurance assets held by cedants should be measured with reference to the reinsured liability.
- Offsetting reinsurance assets and reinsured liabilities is prohibited unless the appropriate legal requirements are met.
- Ceding commissions should be treated as a reduction in the reinsurance premium paid
- Entity specific approach to the recognition of the building-blocks could create an asset that is larger than the premium paid (e.g. due to portfolio diversification).
- This case results in an immediate gain through income.
- In the event of a negative figure it would be capitalised as a ceded residual margin to be amortised over the reinsurance coverage.
- In addition to the building-block estimate the cedant must apply an expected credit loss adjustment to reflect present and future impairment on a probability weighted basis.
- This is similar to the new IASB proposal for loan impairment.

Transition and effective date

- The new standard is likely to be effective for periods beginning on or after 1 January 2013.
- The effective date will move in parallel with IFRS 9.
- Early adoption will be permitted, but this fact will need to be disclosed.
- Same transitional provisions will apply for early adopters and existing IFRS reporting entities.

On adoption:

- Insurance liabilities will be calculated as the sum of blocks 1 and 2 plus the risk adjustment (even if a composite margin approach is finally selected).
- All insurance intangible balances (e.g. deferred acquisition costs, intangibles arising from existing insurance contracts assumed in a previous business combination) will be written off.
- All these adjustments will be recognised in opening retained earnings.

Transition

- Estimation of 3 building blocks on transition will be important.
- Measurement of risk adjustment on transition will impact future income.
- If composite margin model is selected, the risk adjustment on transition will be treated as opening composite margin.
- For participating insurance and investment contracts there may be significant impact depending on previous accounting model (inherited estate).

Timetable

- There is a 4 month comment period, ending on 30 November 2010.
- Target date for the publication of the final IFRS remains the end of June 2011.
- We expect the FASB to publish a consultation paper rather than an ED.

Contact details

Francesco Nagari

Deloitte Global IFRS Insurance Leader

+44 20 7303 8375

fnagari@deloitte.co.uk

Link to **Deloitte Insurance Accounting Newsletter:**

http://www.deloitte.com/view/en_GB/uk/industries/financial-services/sector-focus/insurance/article/ac9955baf1001210VgnVCM100000ba42f00aRCRD.htm

Insurance Centre of Excellence:

insurancecentreofexc@deloitte.co.uk