New rules for insurance contracts – a significant issue for all insurers

Application date: An exposure draft was issued in July 2010; a re-exposure or review draft is expected in Q4 2011 with a final standard expected H1 2012. The application date is not confirmed but is expected to be no earlier than 1 January 2015. If endorsed, the new standard will fundamentally change the accounting for all insurers across the globe.

What is the issue?

After more than 13 years in the making the International Accounting Standards Board (IASB) released its Exposure Draft (ED) on insurance contracts in July 2010. The proposals are the result of prolonged debate between the IASB and the Financial Accounting Standards Board (FASB) and will, for the first time, culminate in a single standard for all insurance contracts. The new guidance will replace the current insurance guidance in IFRS 4, which permits a variety of local GAAP practices in accounting for insurance contracts.

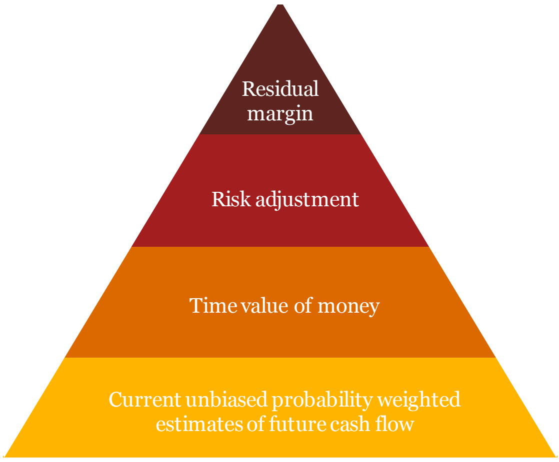
Why is this issue significant for insurers?

The proposals will fundamentally change the accounting for all insurers that apply IFRS. Below is a summary of the most significant proposals in the ED and their likely impact on current accounting practice.

What are the overarching proposals?

At the core of the proposed new accounting standard is the measurement model. Under this model, the liability for all insurance contracts (except for certain short duration contacts of 12 months or less) is determined by reference to the present value of the expected cash flows required to fulfil the insurance obligation.

The present value of expected cash flows is measured using the following building blocks.



The explicit, unbiased, probability-weighted cash flows that the insurer expects to incur in fulfilling the contract. This includes all related cash flows within the existing contract that are incremental at the level of a portfolio of insurance contracts. It includes cash flows related to insurance premiums, payments to policyholders, claims handling costs, direct policy administration and maintenance costs, acquisition costs and any potential recoveries such as salvage or subrogation.

A discount rate which reflects the time value of money. In most circumstances this is based on the risk-free rate of cash flows, which is adjusted for the characteristics of the liability, such as illiquidity. For contracts where the cash flows depend wholly or partly on the performance of specific assets, the discount rate should reflect that dependence.

An explicit risk adjustment. This adjustment reflects the uncertainty about the timing and amount of future cash flows. This adjustment is the maximum amount the issuer would pay to be relieved of the risk when the ultimate cash flows exceed those expected.

A residual margin. This is an amount that eliminates any gain at the inception of the contract and is amortised over the coverage period.

Note. Other than the residual margin, all "building" blocks are remeasured at each reporting period.

Risk adjustment

The concept of an explicit risk adjustment has been one of the most controversial aspects of the proposals. The Boards are yet to agree on a common approach. The IASB proposes an explicit risk adjustment to cash flows and a residual margin to eliminate any initial gain on the contract. In contrast, the FASB prefers a single composite margin, which is determined at the inception of the contract and amortised over the coverage and claims handling period.

Both models recognise changes in expected present value cash flows (both positive and negative), either resulting from financial variables (such as the discount rate) or other estimates (such as expenses, claims experience, lapses) immediately in profit or loss. Additionally, the IASB model would recognise changes in the risk adjustment immediately in profit or loss. The IASB requested comments from the business community about which method they prefer and why. This is a key component of the IASB's consultation with stakeholders and redeliberations as they finalise the standard.

Insight

Based on the conversations we have had to date, many insurers seem to support estimating cash flows at their present value and including a risk adjustment and residual margin. They feel that the risk adjustment provides useful information about the uncertainty inherent in insurance contracts and for some jurisdictions would align accounting with regulatory requirements.

However, there has been strong opposition from some in relation to the explicit risk adjustment. Principally, concerns seem to centre on the concept that a risk adjustment is inconsistent with the overall framework of a fulfilment model; it is hard to measure reliably; and it will reduce consistency and comparability of financial statements. Concerns about the cost of compliance compared to the perceived benefit have also been raised.

Presentation

Under the proposals, the income statement presentation is driven by the previously mentioned "building blocks". Issuers of most insurance contracts would not recognise premiums as revenue; instead they would separately show an underwriting margin (comprising changes in the risk adjustment and residual margin) and changes in estimates and experience variances. Supplementary disclosures would provide premium and claim information.

Insight

Although the proposals are consistent with the 'building blocks' model, many commentators requested the IASB to develop a presentation model that is more consistent with other industries and includes premium and claim information in the income statement. In addition, many commentators indicated that short term volatility in the income statement arising from movements in market-based variables such as the discount rate does not reflect the long term nature of many insurance contracts. This has become a key issue for the Boards' re-deliberations and they are considering different presentation approaches that may mitigate volatility in the income statement.

Acquisition costs

The ED proposed that contract cashflows should include incremental acquisition costs relating to an insurance contract. These are costs of selling, underwriting and initiating insurance contracts. Any more general acquisition costs at the portfolio level are expensed directly to the profit and loss. However, this definition of acquisition costs may be narrower than the criteria used under local GAAPs currently permitted by IFRS 4.

Insight

Since the costs had to be incremental at the contract level, different business models for acquiring contracts would have an impact on the measurement of the contract liability.

Example

Under the proposed standard, an insurer would be unlikely to classify the general costs of an in-house sales force as acquisition costs (except for any employee bonuses directly incremental to an individual contract) and these would be expensed directly in the income statement. However, costs that an insurer pays as directly incremental commission to external sales advisors would be acquisition costs and therefore included as part of the insurance contract fulfilment cash flows. This topic is part of the IASB's redeliberations as commentators requested greater consistency between business models and the treatment of costs to acquire contracts in the Board's revenue and leasing projects.

Contract boundary

The proposals define the boundary for the relevant cash flows as the point at which an insurer:

- is no longer required to provide insurance coverage; or
- has the right or practical ability to reassess the risk of a particular policyholder and can set a price that fully reflects that risk.

This boundary has been a key topic discussed by the standard-setters; they have attempted to find the balance between the legal form and substance of many insurance contracts. The definition is important in determining the duration of the contract. This has an impact as the simplified model for insurance contracts is only available for contract with a duration of 12 months or less.

Insight

This new definition has gone some way to finding a solution that works for short and longer term duration contracts, but challenges remain.

Example

Health insurers will need to look at the wording of the definition carefully and consider how it would apply to their business. Most local GAAPs currently treat health insurance contracts as annual renewable contracts, but this was likely to change under the proposals for those insurers that are constrained (for example by law) in their ability to refuse to renew cover for existing policy holders or to raise the premiums they charge on renewal. This would have required insurers to consider all future cash flows from a policyholder over their expected lifetime and treat the contracts as long duration. Many health insurers requested the Boards' to revisit this definition so that such contracts may continue to be regarded as short term. The Boards' are seeking ways of addressing these concerns in their redeliberations.

Scope

The definition of an insurance contract and the scope of the insurance proposals have not changed significantly from current IFRS 4. However the ED recommends financial guarantee contracts to be within the scope of the insurance project. Currently financial guarantee contracts are accounted for under IAS 39 as financial instruments unless the issuer of the financial guarantee meets the criteria to account for them under IFRS 4. In addition, investment contacts (that is financial instruments rather than insurance contracts) that have a discretionary participating feature (DPF) continue to be in the scope of the insurance ED.

Insight

Although the proposal for financial guarantees was well received by insurers, banks and other financial institutions also issue financial guarantee contracts. These institutions commented that they wanted to continue to account for financial guarantees as financial instruments. This is because they manage financial guarantee contracts and other credit related instruments (such as credit default swaps) together. This issue forms part of the Boards' re-deliberations.

Although the IASB proposed that investment contracts with DPF should continue to be in the scope of the insurance proposals, this is another area where the FASB reached a different conclusion. The FASB proposed that such contracts be accounted for as financial instruments since they don't have any insurance risk. Although some respondents agreed in principle that investment contracts with DPF do not have insurance risk, several pointed out that there are substantial practical difficulties in applying financial instrument accounting to such contracts. This will be a key topic for the Boards' to work toward a converged approach.

Unbundling

The proposals require non-insurance elements of an insurance contract to be separated (unbundled) and measured separately where they are not closely related to the insurance element. Often insurance contracts have a combination of features (eg, life insurance cover with a savings element). This proposal would result in insurers having to determine which elements of a contract were non-insurance in nature, and whether they are closely related or not and create separate models to measure the two components.

Insight

Under the proposals, it was not clear how the 'closely related' test would operate in practice and how entities would allocate different cashflows such as fees and expenses to the separate parts of the contract. This is important as the method of allocating cashflows to the insurance and non-insurance element could substantially impact the timing of profit in the income statement and also the amount of the liability recorded in the balance sheet. In addition, splitting insurance contracts into different elements would involve systems changes and data collection issues. This is an area that the IASB is revisiting in its deliberations when finalising the standard.

Where to from here?

The Boards have been re-deliberating these issues as well as others when finalising the insurance project. The timetable to complete a final standard has been affected by the extent of the re-deliberations required to address respondents concerns and to achieve consensus between the two Boards. The Boards' have also indicated that they will consider cross cutting issues that are relevant to the revenue recognition, leasing, financial instruments and insurance project which could also affect the timetable and the extent of re-deliberations. The transition arrangements will have key significance given the profound impact of the proposals and the decisions the Boards' make in this area, together with the timing of the proposed standards likely to be impacted by further comments from the business community. Management should begin to assess the implications on their existing contracts and current business practices to identify some of the implementation challenges that will inevitably emerge, Management should also follow the re-deliberations and comment on the re-exposure or review draft to make their views known.