Insurance

# Seeing risk from the inside:

## The impact of IFRS 7 and revised IFRS 4 on insurers' financial reporting*

IFRS – Global Reporting Revolution

May 2007

*connectedthinking

PRICEWATERHOUSECOOPERS

# The IFRS Revolution

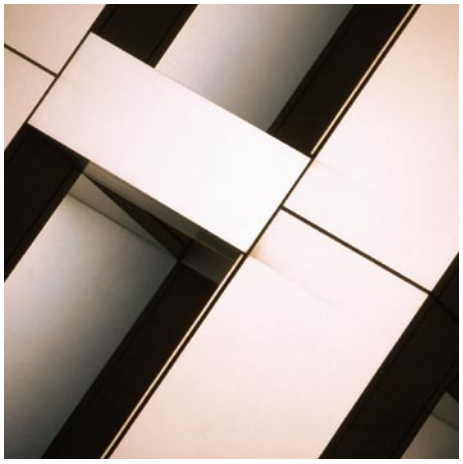
**Welcome to the 20th in a series of papers dedicated to discussing International Financial Reporting Standards (IFRS) and their impact on insurers and the users of their accounts.**

It is clear that the new regime is changing the way companies conduct business and how the market judges corporate performance and prospects. Recognising this, the Global Insurance Leadership Team is sponsoring a series of briefing papers focusing on the key commercial and technical challenges, aimed at delivering the information the industry needs to respond to the IFRS revolution.

This paper examines key changes to IFRS risk reporting, under which insurers will be required to set out how management itself perceives, measures and manages risk. The changes offer well-run insurers an opportunity to demonstrate the strengths of their risk management more forcibly at a time when analysts and investors are taking an ever-keener interest in the impact of risk on financial performance. To realise this opportunity, however, companies will need to address potentially complex and arduous implementation and communication challenges.

I hope that you find this paper thought-provoking and insightful. If you would like to discuss any of the issues addressed in more detail, please speak with your usual contact at PricewaterhouseCoopers or those listed at the end of this paper. We would also appreciate your feedback on this paper, as this helps us to ensure that we are addressing the issues that you are most focused on.

**Ian Dilks**
Global Insurance Leader



## Introduction:
## Through the eyes of management

*Under the latest IFRS developments, insurers must convey management's own objectives and perspectives about the risks arising from their financial investments and insurance contracts.*

Insurers' reporting of risk continues to evolve, presenting implementation and communication challenges that could have important implications for the way companies are valued in the market.

IFRS 7 'Financial Instruments: Disclosures', the new financial risk reporting standard, and the associated amendments to the disclosure requirements in IFRS 4 'Insurance Contracts', aim to make it easier for analysts and investors to gauge the impact of risk on a company's financial health and position.

Critically, the enhanced disclosure should reflect the way senior management itself perceives, measures and manages the company's risks. The trend within IFRS towards the closer alignment of internal and external reporting is also evident in the new requirements for segment reporting under IFRS 8 'Operating Segments', which will come into force in 2009.

Companies must now explain their objectives, policies and processes for managing capital, under a modification to IAS 1. This could be especially pertinent for the insurance industry, due to its extensive capital regulations.

IFRS 7 and the related amendments to IFRS 4, along with the updated IAS 1, are obligatory for reporting periods beginning 1 January 2007. Comparative information for 2006 will also be required.

**Strategic implications**

Seeing risk 'through the eyes of management' is a welcome opportunity to bring financial reporting more closely into line with the way insurers run their businesses. It allows management to disclose internal measures not previously recognised under IFRS or local accounting principles, such as embedded value. This could enhance a company's ability to demonstrate the strengths of its control environment, but it could also expose any flaws in the risk assumptions underlying key accounting judgements and estimates. The closely-related approach to the risk disclosure of financial instruments and insurance contracts could, in particular, bring the consistency and effectiveness of asset-liability management (ALM) strategies into the spotlight.

Meeting these requirements is likely to be a two-stage process. In stage one, management should consider the key strategic messages that it wishes to present to the market, and how to make the most of the options available under IFRS 4, IFRS 7 and IAS 1. In stage two, management should prepare a detailed implementation plan that identifies data gaps and the work which will be required to update and optimise existing reporting capabilities in order to deliver the chosen communication strategy.

This paper looks in detail at the implications of IFRS 7 and the associated amendments to IAS 1 and IFRS 4 for insurance companies. It also looks at how a holistic approach to financial risk, insurance risk and capital management disclosure could enhance insurers' ability to convey the strength and coherence of their ALM frameworks, including some of the key features of their business models.

‘Companies must provide information about the extent to which they are exposed to financial risks, based on information provided internally to the entity’s key management personnel’

From IFRS 7 ‘Financial Instruments: Disclosures’

## Section 1
## Overhaul of risk reporting

*The new approach to risk reporting could improve insurers’ ability to convey the strength and potential of their business.*

IFRS 7 replaces and updates the disclosure requirements of IAS 32 ‘Financial Instruments: Presentation’ and supersedes IAS 30 ‘Disclosures in the Financial Statements of Banks and Similar Financial Institutions’. IFRS 7 also extends the scope of many of the disclosure requirements within IAS 30 from banks to all financial institutions. Companies must ‘provide information about the extent to which they are exposed to financial risks, based on information provided internally to the entity’s key management personnel’ – in other words, through the eyes of management. Financial risk disclosures include credit risk, liquidity risk and market risk (see Figure 1 for risk definitions).

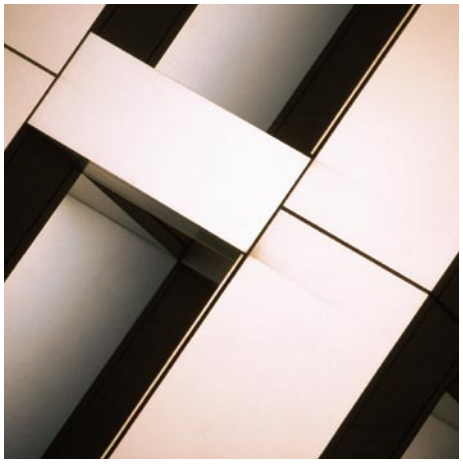
IFRS 4 and its implementation guidance have been revised to bring insurance contract disclosures into line with IFRS 7. This includes quantitative disclosure about liquidity risk, extending the focus of sensitivity analysis to market risk, and imposing enhanced data requirements for credit risk. Information about financial and insurance risks arising from insurance contracts must reflect the perspectives of management, in keeping with IFRS 7.

In a related move, IAS 1, the standard covering the presentation of financial statements as a whole, has been expanded to cover disclosures about what a company perceives and manages as capital. This includes ‘the entity’s objectives, policies and processes for managing capital’ and compliance with regulatory capital requirements.

Figure 1 IFRS 7 key definitions:

| | |
|---|---|
| **Credit risk** | The risk that one party to a financial instrument will cause a financial loss for the other party by failing to discharge an obligation. |
| **Liquidity risk** | The risk that an entity will encounter difficulty in meeting obligations associated with financial liabilities. |
| **Market risk** | The risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices. Market risk comprises three types of risk: **currency risk, interest rate risk** and **other price risk**. |
| **Currency risk** | The risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in foreign exchange rates. |
| **Interest rate risk** | The risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market interest rates. |
| **Other price risk** | The risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices (other than those arising from **interest rate risk** or **currency risk**), whether those changes are caused by factors specific to the individual financial instrument or its issuer, or factors affecting all similar financial instruments traded in the market. |

Source: International Accounting Standards Board, IFRS 7 ‘Financial Instruments: Disclosures’



**Opening the window**

For the first time, insurers can use their own internal measures in their external financial statements, as well as IFRS and GAAP (generally accepted accounting principles) information, to convey critical aspects of the strengths and potential of their business. This is a valuable opportunity for an industry whose external reporting principles have often been viewed by the financial market as opaque. Much of the problem stems from the fact that GAAP reporting is so often out of step with the way insurers actually manage their businesses.

However, how to summarise and communicate internal data to an external audience in a clear and concise way is a challenge that will need to be addressed as part of the implementation process. Insurers using sophisticated modelling and reporting systems may need to look at how to bring this complex analysis up to auditable, understandable and presentable standards. Risk data capture and analysis also needs to be integrated across the organisation and embedded into financial reporting systems, much as a general ledger would be. This is likely to require input from finance, actuarial, reinsurance and risk management teams, underpinned by active board-level direction. Ensuring that metrics and assumptions are consistent across different territories and business lines could be a particular challenge. Preparation of the half-year reports could offer a valuable opportunity for an internal dry run.

Considering the key messages to be conveyed in the financial statements is a strategic matter that needs to be addressed proactively by the board.

Internal information can provide valuable insights, but only if it is succinctly presented, clearly flagged and provides an appropriate balance between numbers and narrative explanation. There is no point in deluging analysts with excessive or potentially unintelligible data. As our survey of IFRS financial reports also highlighted, companies need to look carefully at how to ensure that data and analysis are comparable with those of their peers, especially as IFRS disclosure is still a largely unfamiliar concept for many analysts.[1] Those companies that move quickly to establish a clear and effective format for risk disclosure will be able to set a competitive lead for others to follow.

1 'Reporting Under the new regime: A survey of IFRS insurance annual reports 2005' (available for download from www.pwc.com/insurance)

The discretion available under IFRS 4 and IFRS 7 allows insurers to present this interaction and the objectives and effectiveness of its management within a coherent and comparable set of ALM disclosures.

## Section 2
## Relating assets, liabilities and capital

*Disclosing the risks relating to insurance contracts and financial instruments could focus particular market attention on the interaction between an insurer's contractual liabilities and the associated assets held to fund such exposures.*

For example, a Lloyd's insurer that conducts much of its business in US dollars, but sets provisioning levels and buys reinsurance in sterling, faces potentially significant foreign exchange risk. Similarly, a life insurer offering certain options and guarantees may face potential equity price and interest rate risk in relation to its assets and liabilities. There is also potential liquidity risk in ensuring that investment maturities and contract obligations match or, if not, that alternative funds are available, for example.

Under the latest IFRS developments, sensitivity to foreign exchange and equity prices movements is included within the market risk disclosure relating to assets and liabilities, along with interest rate risk. In relation to interest rate risk, companies currently have to produce exposure analysis of assets and liabilities under IAS 32. IFRS 7 goes further by requiring disclosure that seeks to meet analysts' consistent focus on the importance of sensitivity analysis. Liquidity risk has also been incorporated into IFRS 4 and IFRS 7 (see Section 3 for details).

Many insurers naturally seek to match the asset and liability risks through hedging strategies or by managing the balance between floating and fixed-income instruments, for example. The discretion available under IFRS 4 and IFRS 7 allows insurers to present this interaction and the objectives and effectiveness of its management within a coherent and comparable set of ALM disclosures. The reported capital management objectives can include an outline of how compliance with solvency regulations is embedded into the ALM framework.

### Illustrative approach

A possible approach to ALM disclosure is set out in PricewaterhouseCoopers' recently updated 'Illustrative consolidated financial statements 2006 – Insurance'.[2] For example, in relation to its short-term insurance liabilities, the fictional company states that it seeks to fund its liabilities with a portfolio of equities and debt securities exposed to market risk (see Figure 2 on pages 6, 7 and 8). The movements in assets and liabilities are presented in a single comparable table. The subsequent tables set out the changes in the expected timing of cash coming in and out (addressing liquidity risk). Finally, there is a narrative explanation of how management controls equity price, currency and interest rate risks, along with the required disclosure of quantitative sensitivity analysis for each significant risk.

The key message of this 'holistic' approach is that these risks are actively and interactively managed to ensure that the company meets its payment obligations over time. In the year in question, this included reducing equity holdings and increasing debt securities to mitigate the impact of stock market volatility.

2 'Illustrative consolidated financial statements 2006 – Insurance' (available for download from www.pwc.com/insurance)

Figure 2 Illustrative consolidated financial statements 2006 – Insurance (March 2007) – 4.2.4 Short-term insurance contracts

**4.2.4 Short-term insurance contracts**

(a) Short-term insurance contracts

For short-term insurance contracts, the Group funds the insurance liabilities with a portfolio of equity and debt securities exposed to market risk.

During the current year, the Group has increased the portion of financial assets invested in debt securities to mitigate the impact of the volatility of equity prices experienced in recent periods.

**Financial assets**

| | 2006 | 2005 |
|---|---|---|
| Debt securities: | | |
| At fair value through profit or loss: | | |
| – Listed securities – fixed rate | 11,493 | 2,345 |
| – Unlisted securities – fixed rate | 1,839 | 4,766 |
| – Government bonds – fixed rate | 12,500 | 3,998 |
| Available for sale: | | |
| Listed securities: | | |
| – Fixed rate | 32,467 | 35,430 |
| – Floating rate | 31,697 | 12,300 |
| Equity securities: | | |
| Available for sale: | | |
| – Listed securities | 50,416 | 56,253 |
| – Unlisted securities | 10,681 | 8,115 |
| Loans and receivables from insurance and reinsurance contracts | 6,080 | 12,660 |
| Derivative financial instruments | (2,053) | (2,032) |
| Cash and cash equivalents | 9,966 | 22,412 |
| **Total** | 165,086 | 156,247 |
| | | |
| Short-term insurance liabilities: | | |
| Insurance contracts – short term | 213,294 | 185,459 |
| Less assets arising from reinsurance contracts held short term | (60,688) | (49,919) |
| **Total** | 152,606 | 135,540 |

Short-term insurance liabilities are not directly sensitive to the level of market interest rates, as they are undiscounted and contractually non-interest bearing. However, due to the time value of money and the impact of interest rates on the level of bodily injury and asbestos-related claims incurred by the Group's insurance contract holders (where a reduction of interest rates would normally produce a higher insurance liability), the Group matches the cash flows of assets and liabilities in this portfolio by estimating their mean duration.

The mean duration of liabilities is calculated using historical claims data to determine the expected settlement pattern for claims arising from insurance contracts in force at the balance sheet date (both incurred claims and future claims arising from the unexpired risks at the balance sheet date). The mean durations are:

| | 2006 | 2005 |
|---|---|---|
| Net short-term insurance liabilities – life risk | 0.2 years | 0.2 years |
| Net short-term insurance liabilities – property risk | 2.7 years | 2.8 years |
| Net short-term insurance liabilities – casualty risk | 8.2 years | 7.8 years |
| Financial assets (excluding equity securities) | 3.1 years | 3.6 years |

Source: Adapted from PricewaterhouseCoopers 'Illustrative consolidated financial statements 2006 – Insurance'

The following tables indicate the contractual timing of cash flows arising from assets and liabilities included in the Group's ALM framework for management of short-term insurance contracts as of 31 December 2006:[1]

| **Financial assets** | **Carrying amount 31 Dec 2006** | **No stated maturity** | **Contractual cash flows (undiscounted)** | | | | |
|---|---|---|---|---|---|---|---|
| | | | 0-1 yr | 1-2 yrs | 2-3 yrs | 3-4 yrs | > 5 yrs |
| Debt securities: | | | | | | | |
| At fair value through profit or loss: | | | | | | | |
| – Listed securities – fixed rate | 11,493 | – | 3,220 | 5,576 | 4,872 | 3,818 | – |
| – Unlisted securities – fixed rate | 1,839 | – | 844 | 615 | 660 | 321 | – |
| – Government bonds – fixed rate | 12,500 | – | 8,223 | 4,161 | 1,502 | 2,121 | – |
| Available for sale: | | | | | | | |
| Listed securities: | | | | | | | |
| – Fixed rate | 32,467 | – | 21,975 | 8,951 | 3,942 | – | – |
| – Floating rate | 31,697 | – | 11,443 | 13,077 | 12,174 | – | – |
| Equity securities: | | | | | | | |
| Available for sale: | | | | | | | |
| – Listed securities | 50,416 | 50,416 | – | – | – | – | – |
| – Unlisted securities | 10,681 | 10,681 | – | – | – | – | – |
| Loans and receivables, at amortised cost | 6,080 | – | 5,382 | 998 | – | – | – |
| Derivative financial instruments, net | (2,053) | – | (125) | (799) | (965) | (732) | – |
| Cash and cash equivalents | 9,966 | – | 9,966 | – | – | – | |
| **Total** | 165,086 | 61,097 | 60,928 | 32,579 | 22,185 | 5,528 | – |

| **Short-term insurance liabilities** | | **Contractual cash flows (undiscounted)** | | | | |
|---|---|---|---|---|---|---|
| Insurance contracts – short-term | 213,294 | – | 86,234 | 47,756 | 37,898 | 33,838 | 7,568 |
| Less assets arising from reinsurance contracts held short-term | (60,688) | – | (27,310) | (16,993) | (9,103) | (9,495) | (2,976) |
| **Total** | 152,606 | – | 58,924 | 30,763 | 28,795 | 24,343 | 4,592 |
| **Difference in contractual cash flows** | | 61,097 | 2,004 | 1,816 | (6,610) | (18,815) | (4,592) |

The sensitivity analyses below are based on a change in one assumption while holding all other assumptions constant. In practice this is unlikely to occur, and changes in some of the assumptions may be correlated – for example, change in interest rate and change in market values.

*(a) Sensitivity analysis – interest-rate risk*

The sensitivity analysis for interest rate risk illustrates how changes in the fair value or future cash flows of a financial instrument will fluctuate because of changes in market interest rates at the reporting date. For financial instruments and insurance contracts described in this note, the sensitivity is solely associated with the former, as the carrying amounts of the latter are not directly affected by changes in market risks.

The Group's management monitors the sensitivity of reported interest rate movements on a monthly basis by assessing the expected changes in the different portfolios due to a parallel movement of plus 100 basis points in all yield curves of financial assets and financial liabilities. These particular exposures illustrate the Group's overall exposure to interest rate sensitivities included in the Group's ALM framework and its impact on the Group's profit or loss by business.

An increase of 100 basis points in interest yields would result in a loss for the period of €479 in 2006. Out of the total loss €288 would have been recognised in equity (2005: total loss of €396, of which €311 would have been recognised in equity).

A decrease of 100 basis points in interest yields would result in a gain for the period of €465 in 2006. Out of the total gain €279 would have been recognised in equity (2005: total gain of €388, of which €298 would have been recognised in equity).

1 The comparative table for the year ended 31 December 2005 has been intentionally omitted from this figure.

*Continued overleaf*

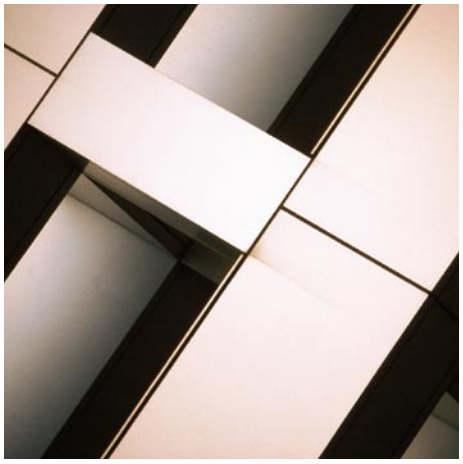


Figure 2 Illustrative consolidated financial statements 2006 – Insurance – 4.2.4 Short-term insurance contracts *continued*

*(b) Sensitivity analysis – equity risk*

The sensitivity analysis for equity risk illustrates how changes in the fair value of equity securities will fluctuate because of changes in market prices, whether those changes are caused by factors specific to the individual equity issuer, or factors affecting all similar equity securities traded in the market.

Management monitors movements of financial assets and equity price risk movements on a monthly basis by assessing the expected changes in the different portfolios due to parallel movements of a 15% increase or decrease in the various stock exchange indexes (for example, Eurostoxx, FTSE-100, and other) with all other variables held constant and all the Group's equity instruments in that particular index moving proportionally.

The equity securities described in this note are classified as available for sale and are invested only in Euravia[1] and UK operations. All the financial assets backing the US run-off casualty liabilities are floating-rate listed debt securities.

An increase and a decrease in 15% in the Eurostoxx and in the FTSE-100 indexes would result in an impact on available-for-sale reserve in equity of €5,193 and €917 respectively in 2006 (2005: €7,172 and €1,266 respectively).

*(c) Sensitivity analysis – currency risk*

The Group underwrites short-term insurance contracts through operations in Euravia, the US and the UK. The Group's US and UK short-term insurance portfolios invest in assets denominated in the same currencies as their insurance liabilities, which eliminates the foreign currency exchange rate risk for these operations. Foreign exchange risk arises from recognised assets and liabilities held in the Euravian portfolios that are denominated in currencies other than the euro and from net investments in foreign operations.

The Group exposure to foreign currency risk within the portfolio supporting the Group's eurozone short-term insurance liabilities arises primarily from purchased investments that are denominated or payable in UK pounds and US dollars. The Group hedges in euros all foreign-currency-denominated available-for-sale debt securities supporting the eurozone operations, using exchange traded future contracts, in order to mitigate the risk that the fair value of these investments fluctuates as a result of changes in foreign exchange rates. The Group's hedging strategy is fully effective, and movement in foreign exchange rates would have no impact on the Group's net current year result.

1 Fictional country with Euro currency where the illustrative company is based.

Source: Adapted from PricewaterhouseCoopers 'Illustrative consolidated financial statements 2006 – Insurance'

These disclosures are designed to help investors gauge the potential impact of changes in key risk variables on profit and equity.

## Section 3
## Gauging risk sensitivities

*Under the updated IFRS 4, insurers are able to choose 'alternative' methods in use within the company to develop their sensitivity disclosures for insurance risk and market risk. An example cited is embedded value.*

This discretion may help to bring financial reporting closer to the advanced techniques now increasingly used in risk management. Insurers are also free to base their disclosures on more than one analytical technique if this is how sensitivity to market conditions is managed within the business. For example, embedded value may be used for risks within life business; more traditional sensitivities ('as-if analyses') may be disclosed for non-life business. Any alternative disclosure based on methods such as embedded value must be in keeping with the risk management techniques used to monitor and control risk sensitivities within the company, rather than being a set of numbers created solely for public consumption.

**Specific requirements**

*Market risk*

Insurance companies already had to explain sensitivity analysis for insurance risk. With the adoption of IFRS 7 and revised IFRS 4, this requirement will include all market risk factors including changes in interest rates, foreign exchange rates, equity prices and other indices. These disclosures are designed to help investors gauge the potential impact of changes in key risk variables on profit and equity.

IFRS 7 and the revised IFRS 4 break new ground by allowing the disclosures to be based on data from alternative methods used to manage sensitivity. For example, insurers that decide to use embedded value for this purpose could integrate both insurance and market risk disclosures. In deploying techniques such as embedded value, the insurer must explain the main parameters and assumptions used and their limitations.

In preparing the required quantitative sensitivity analysis using traditional IFRS or GAAP approaches, IFRS 7 requires companies to select hypothetical movements in the underlying variables that reflect a 'reasonably possible change in the relevant risk variable'. This needs to be based on the economic environment in which the insurer operates and the timeframe over which it is making the assessment (usually the next annual reporting period).

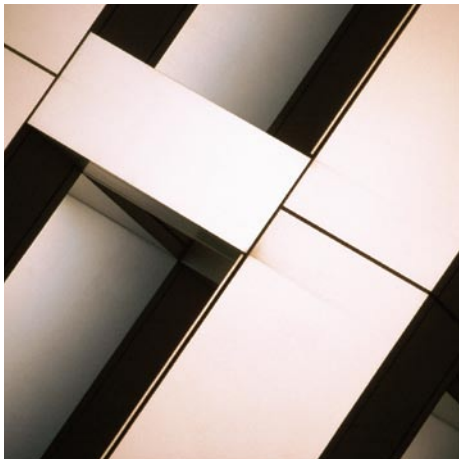


Figure 3 Illustrative consolidated financial statements 2006 – Insurance

| As at 31 December 2006[1] | Carrying amount | Contractual cash flows (undiscounted) | | | | |
|---|---|---|---|---|---|---|
| **Carrying value and cash flows arising from:** | | **0-5 yrs** | **5-10 yrs** | **10-15 yrs** | **15-20 yrs** | **> 20 yrs** |
| Assets backing liabilities – guaranteed component | | | | | | |
| Available for sale: | | | | | | |
| Listed debt securities: | | | | | | |
| – Fixed rate | 380,435 | 55,771 | 112,570 | 208,072 | 164,942 | 72,910 |
| – Floating rate | 111,002 | 39,645 | 46,531 | 50,862 | - | - |
| Unlisted debt securities fixed rate | 17,464 | 1,345 | 2,345 | 5,678 | 9,234 | 3,256 |
| Held to maturity: | | | | | | |
| – Listed debt securities fixed rate | 80,342 | 10,345 | 44,367 | 39,657 | 31,345 | - |
| – Unlisted debt securities fixed rate | 1,242 | 1,409 | - | - | - | - |
| Derivative financial instruments, net | 5,884 | (1,383) | (5,984) | 1,595 | 9,065 | 13,699 |
| Cash and cash equivalents | 6,142 | 6,142 | | | | |
| **Total** | 602,511 | 113,274 | 199,829 | 305,864 | 214,586 | 89,865 |

| **Liabilities** | **Carrying amount** | **Expected cash flows (undiscounted)** | | | | |
|---|---|---|---|---|---|---|
| Long-term insurance contracts | 347,624 | 30,042 | 71,100 | 198,280 | 201,341 | 160,226 |
| Long-term investment contracts | 147,420 | 51,045 | 65,687 | 51,747 | 30,998 | 15,945 |
| **Total** | 495,044 | 81,087 | 136,787 | 250,027 | 232,339 | 176,171 |
| **Difference in expected cash flows** | | 32,187 | 63,042 | 55,837 | (17,753) | (86,306) |

| | |
|---|---|
| Mean duration of assets | 12.0 years |
| Mean duration of liabilities | 12.6 years |

All the long-term insurance and investment contracts with fixed and guaranteed terms can be surrendered before maturity for a cash surrender value specified in the contractual terms and conditions. For insurance contracts, the Group is not required to measure this embedded derivative at fair value. This surrender value is always lower than the carrying amount of the insurance liabilities as a result of the application of surrender penalties set out in the contracts. The range of such penalties is between 2% and 3% of the carrying amount of investment contracts and between 7% and 20% of the carrying amount of insurance contracts. For insurance contracts, these penalties mitigate the expense incurred from derecognising the associated DAC assets when the insurance contracts are surrendered. For investment contracts, there are no DAC assets, and all surrender options are related to the host contract.

The impact on the Group's current year results if all the contracts with this option were surrendered at the financial year-end, net of surrender penalty charges and DAC recognition, would have been a loss of €233 (prior year: €316).

A maturity analysis based on the earliest contractual repayment date would present all the liabilities as due on the earliest period of the table (between 0 and 5 years) because these options can be exercised immediately by all policyholders.

1 The comparative table for the year ended 31 December 2005 has been intentionally omitted from this figure.

Source: Adapted from PricewaterhouseCoopers 'Illustrative consolidated financial statements 2006 – Insurance'

The different bases of presentation could create a mismatch between the disclosure of settlement obligations from investment contracts (captured under IFRS 7) and insurance contracts (IFRS 4).

*Liquidity risk*

Companies must set out their policies for managing liquidity risk, including the time bands in which they may be required to settle their obligations and how they ensure that sufficient funds are available at the appropriate times (the asset implications).

As a concession to insurers that reflects the interim accounting regime currently in place, IFRS 4 is less restrictive. In particular, it offers an option that appears to be closer to how insurance liabilities are managed. Insurers only need to disclose their settlement projections for each time band based on the accounted amounts and the time when they estimate they would reasonably expect to pay. In contrast, under the time bands for IFRS 7, companies must set out a table that includes the undiscounted cash outflows at the earliest contractual payment date.

The different bases of presentation could create a mismatch between the disclosure of settlement obligations from investment contracts (captured under IFRS 7) and insurance contracts (IFRS 4). A possible approach, as set out in Figure 3, is to provide disclosures on the settlement of investment contract liabilities on the IFRS 4 basis, in keeping with existing management projections. To comply with IFRS 7, the notes explain that the earliest contractual repayment date for these investment contract liabilities would fall in the earliest time band set out in the table (0-5 years). This reflects the surrender option that makes each contract payable on demand.

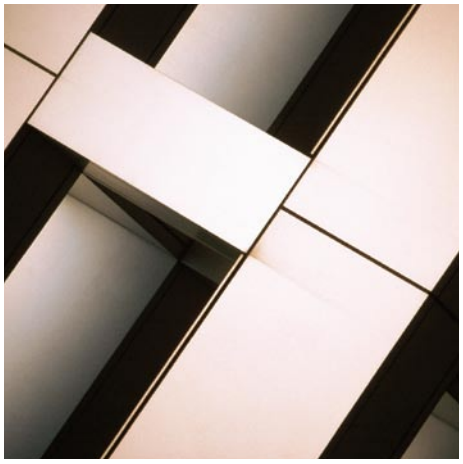


Figure 4 Illustrative consolidated financial statements 2006 – Insurance

| | 2006 | 2005 |
|---|---|---|
| Debt securities: | | |
| At fair value through profit or loss: | | |
| – Listed securities | 77,335 | 48,755 |
| – Unlisted securities | 1,839 | 9,326 |
| Available for sale: | | |
| – Listed securities | 699,296 | 625,707 |
| – Unlisted securities | 17,464 | 15,152 |
| Held to maturity: | | |
| – Listed securities | 80,342 | 71,994 |
| – Unlisted securities | 1,242 | 3,477 |
| Loans and receivables, at amortised cost: | | |
| – Insurance receivables | 6,080 | 12,660 |
| – Other | 671 | 1,014 |
| Derivative financial instruments, at fair value | | |
| – Hedges | 1,681 | 1,962 |
| – At fair value through profit or loss | 9,783 | 9,234 |
| Reinsurance contracts | 60,688 | 49,919 |
| Cash and cash equivalents | 28,993 | 39,806 |
| **Total assets bearing credit risk** | 985,414 | 889,006 |

The assets above are analysed in the table below using Standard & Poors (S&P) rating (or equivalent when not available from S&P). The concentration of credit risk is substantially unchanged compared to the prior year.

| | 2006 | 2005 |
|---|---|---|
| AAA | 698,157 | 590,581 |
| AA | 154,813 | 115,261 |
| A | 75,213 | 118,967 |
| BBB | 44,591 | 46,221 |
| Below BBB or not rated | 12,640 | 17,976 |
| **Total assets bearing credit risk** | 985,414 | 889,006 |

The assets reported above include €48,196 (2005: €59,897) related to the assets held in funds linked to insurance and investment contracts without fixed terms. The holders of these contracts bear the credit risk (as well as all other financial risks) arising from these assets. The assets above include the entire Discretionary Participation Feature (DPF) funds where the Group is able to transfer part of the credit risk arising from these assets to holders of investment and insurance contracts with DPF to the extent that future level of discretionary bonuses can be reduced to absorb any associated credit losses (as well as losses arising from all other financial risks).

Source: Adapted from PricewaterhouseCoopers 'Illustrative consolidated financial statements 2006 – Insurance'

## Insurers are already required to disclose information about their sensitivity to insurance risk.

*Credit risk*

Credit risk analysis has been extended and enhanced. This includes more details about maximum possible losses and the impact of any credit impairment, including disputes with brokers and reinsurers.

IFRS 7 introduces a new requirement to disclose the credit quality of financial assets that are neither impaired nor past due (ie fully performing assets). This is likely to provide a fresh insight into how management monitors the credit quality of the company's significant investments in the bond market and the quality of their reinsurance protection. An approach to the credit quality analysis is set out in Figure 4. This includes a box that apportions assets bearing credit risk to their credit rating.

Companies must also explain the credit risk from financial guarantees under IFRS 7 if they use IAS 39 to measure these contracts. Insurers have generally taken advantage of the IAS 39 exemption to continue to account for these contracts under IFRS 4, in which case the disclosures fall under the insurance risk requirements (for example, IFRS 4 requires details about claims development).

*Insurance risk*

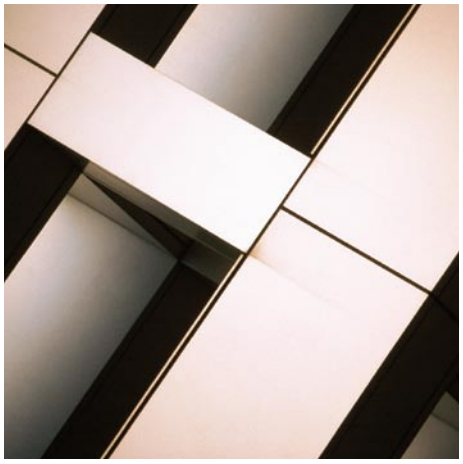
Insurers are already required to disclose information about their sensitivity to insurance risk. This information could either be qualitative or, preferably, quantitative, though the original IFRS 4 did not explain in detail how to meet this requirement.

The amended IFRS 4 both specifies and supplements these requirements. Insurers can choose from three different approaches to this disclosure. The first two options are comparable to market risk. The third alternative, qualitative (narrative) disclosure, is available only for insurance risk sensitivity analysis:

a. 'Traditional' sensitivity disclosures ('as-if analyses') – impact on variables of reasonably possible changes.

b. Alternative sensitivity measures, such as embedded value sensitivities (for example, impact of a change of mortality on embedded value).

c. Qualitative disclosures (narrative explanation) – disclosure of all terms and conditions of insurance contracts issued and reinsurance contracts held that have a material effect on the amount, timing and uncertainty of future cash flows.



## Conclusion:
## How effective is your risk management strategy?

*The changes in risk reporting are as much a competitive as a compliance issue at a time of ever more probing market scrutiny.*

IFRS 4 and IFRS 7 offer well-run insurers an opportunity to demonstrate the strengths of their risk management more forcibly at a time when analysts and investors are taking an ever-keener interest in the impact of risk on financial performance. This includes being able to present the company's risk appetite in a more discernible and quantifiable way. Through a well-thought-out, strategic approach to disclosure, insurers can also present the management of their assets, liabilities and capital in a more coherent and intelligible fashion.

The key question that needs to be addressed is: will your company's risk management come up to scratch under this enhanced disclosure? An acid test opened up by these changes is susceptibility to market risk, including the vulnerability of earnings and the level of retained risk. Any flaws in the risk management need to be addressed.

Even if risk management appears robust, how can this be demonstrated under the IFRS 4 and IFRS 7 disclosure parameters? Is the necessary data available? If not, how can you bridge the gaps?

The substantial alignment of IFRS 7 and the modified IFRS 4 insurance risk and financial risk disclosures provides an important stepping stone towards a finalised IFRS for insurance contracts that would seek to provide greater comparability between insurance and other financial sectors. By seeking to bring risk reporting into line with the way businesses are managed, these developments also look forward to Solvency II. Ensuring a consistent approach to financial and prudential risk reporting is likely to be a key challenge in the years ahead.

Insurers that can respond to these strategic challenges will be able to set a competitive benchmark for open and informative risk reporting against which companies whose disclosure is opaque or poorly presented are likely to be judged.

## Contacts

If you would like to discuss any of the issues raised in this paper, please speak to your usual contact at PricewaterhouseCoopers. This paper was prepared by:


**Francesco Nagari**
Director, Global Accounting Consulting Services
PricewaterhouseCoopers LLP
44 20 7804 2036
francesco.nagari@uk.pwc.com

**David F. Bacher**
Senior Associate,
Financial Services Insurance
PricewaterhouseCoopers AG
49 89 5790 50
david.f.bacher@de.pwc.com

**Alexander Dieter-Hofmann**
Partner, Financial Services Insurance
PricewaterhouseCoopers AG
49 211 981 7492
alexander.dieter.hofmann@de.pwc.com


## Global Insurance Leadership Team


**Ian Dilks**
Global Insurance Leader
44 20 7212 4658
ian.e.dilks@uk.pwc.com

**David Campbell**
86 21 6123 3228
david.campbell@cn.pwc.com

**Joseph J. Foy**
1 646 471 8628
joseph.foy@us.pwc.com

**Werner Hölzl**
49 89 5790 5248
werner.hoelzl@de.pwc.com

**Paul L. Horgan**
1 646 471 8880
paul.l.horgan@us.pwc.com

**Ray Kunz**
1 312 298 2728
ray.kunz@us.pwc.com

**David Parmee**
44 20 7213 3954
david.parmee@uk.pwc.com

**Richard Patching**
1 441 299 7131
richard.patching@bm.pwc.com

**James Scanlan**
1 267 330 2110
james.j.scanlan@us.pwc.com

**John S. Scheid**
1 646 471 5350
john.scheid@us.pwc.com

**Kim Smith**
61 28 266 1100
kim.smith@au.pwc.com

**Clare Thompson**
44 20 7212 5302
clare.e.thompson@uk.pwc.com


For further information on PricewaterhouseCoopers IFRS briefing papers, please contact Áine Bryn, Marketing Director, Global Financial Services, PricewaterhouseCoopers LLP, on 44 20 7212 8839 or e-mail at aine.bryn@uk.pwc.com.
If you would like additional copies of this paper, please contact Alpa Patel via e-mail at alpa.patel@uk.pwc.com.
Copies of all 19 previous briefing papers are available free of charge from www.pwc.com/insurance.

The firms of the PricewaterhouseCoopers global network (www.pwc.com) provide industry-focused assurance, tax and advisory services to build public trust and enhance value for clients and their stakeholders. More than 140,000 people in 149 countries across our network share their thinking, experience and solutions to develop fresh perspectives and practical advice.



For further information please contact Áine Bryn, Marketing Director, Global Financial Services, PricewaterhouseCoopers LLP, London on 44 20 7212 8839 or at aine.bryn@uk.pwc.com

For additional copies please contact Alpa Patel at PricewaterhouseCoopers LLP, London at alpa.patel@uk.pwc.com


Designed by studio ec4 18630 (04/07)

www.pwc.com