

Insurance


# Getting closer to the finish line?\*

## Insurance Contracts accounting under IFRS

March 2008



\*connectedthinking

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## Foreword

This paper provides a status update on the IASB's insurance contracts project. The project has been a focus of attention and discussion for several years. 2007 was a particularly busy year with the publication of a Discussion Paper in May which elicited a high level of response. Now, a few months after the closure of the comment period for the Discussion Paper, and after the IASB staff have considered those responses in some detail, we can draw breath and consider the nature of the responses, along with reflecting on some other developments affecting the project. Accordingly, we hope that this paper will put readers in a better position to look forward and assess what the future holds in the area of insurance accounting.

A handwritten signature in white ink on a blue background. The signature is written in a cursive style and appears to read "Ian D. Little".

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# Introduction

The IASB's insurance contracts project has been something of an arduous journey, and it is a matter of some conjecture as to how far along the road to completion it currently stands

The issue of the Discussion Paper: Preliminary views on insurance contracts (The Discussion Paper) in May 2007 was clearly a major step forward. Consideration of the responses to that Discussion Paper will help take the project forward to its next stage, the issuance of an exposure draft, currently expected in late 2009 (although this may slip).

Four months after the deadline for comments, this paper considers the responses received by the IASB to the Discussion Paper. It notes the key themes and issues emerging and reflects on proposed next steps from the IASB. It also considers some 'external' influences around the IASB's project, such as the development of the Solvency II regulatory regime in Europe and the FASB's expected decision over whether to participate with the IASB in a joint project. As many people will be aware, Peter Clark and other IASB staff prepared a 16-page summary of the responses received that was presented to the IASB at its February 2008 meeting ('the IASB summary'). Based on our own review of responses received, we consider this document to represent a balanced summary of respondents' views and hence an appropriate starting point for ongoing IASB discussions leading towards the development of an exposure draft.

# Summary of Discussion Paper responses

The comment period for the Discussion Paper closed on 16 November 2007, and Peter Clark's summary prepared for the February IASB meeting is based on 158 responses received. However, responses continue to trickle in with 161 on the IASB website as at 7 March. Respondents range from individuals to life and non-life companies and wide-ranging industry groups, in addition to accounting and actuarial firms, analysts, regulators and other professional bodies. The truly global nature of the debate is reflected by the fact that responses came from all parts of the world, including significant numbers from the US, Australasia and Canada as well as Europe.

The Appendix to this paper provides a longer synopsis of the key points raised in the IASB summary, but the main themes were:

- The three building block approach (best estimate of future cash flows, discounted to reflect the time value of money with margins for bearing risk and providing other services) is considered a useful framework, but 'virtually all' respondents had 'significant' concerns about important aspects of the building blocks.
- These concerns with the three building blocks include:
  - issues around the recognition of, and the amount of, profit at inception;
  - the need for clarity around the nature of, and basis of calculation of, risk margins;
  - the rationale for the service margin;
  - use of estimates of expenses that market participants would incur rather than entity-specific expenses;
  - use of discounting and risk margins for non-life insurance contracts;
  - reflection of a liability's credit characteristics in its carrying value;
  - use of a discount rate reflecting the characteristics of the liability rather than an asset-based rate; and
- artificial constraints on cash flows resulting from future premiums and expected payments to participating policyholders (see below).
- The suggested measurement attribute, 'current exit value', based around a transfer concept, was supported by some respondents but many suggested further consideration of a settlement basis was needed reflecting the anticipated means of 'exit' from the obligation for insurers.
- Many respondents suggested that measurement should focus on the contract as a whole rather than on those individual rights and obligations underlying a contract that meet the definitions of assets and liabilities.
- Many respondents opposed the guaranteed insurability test for future cash inflows (notably future premiums).
- Concerns were expressed that the current IAS 37 Liabilities project may narrow the definition of a constructive obligation and therefore limit the ability to recognise all expected cash flows associated with payments to participating contract policyholders.
- In relation to performance reporting most respondents viewed all premiums as revenue, especially for non-life contracts, although some saw merit in a margin approach, notably for life contracts.
- Views were mixed on allowing for diversification benefits beyond the portfolio level.
- Respondents generally agreed that acquisition costs should be expensed when incurred but noted that this was on the proviso that the measurement model allows all future cash flows from which acquisition costs would be expected to be recovered.
- Many respondents did not agree with the unbundling proposals in the Discussion Paper.
- Various concerns were expressed around timetable and process with particular reference to the interaction with other ongoing IASB projects, particularly revenue recognition, the implications of the FASB joining the project, and the need for field testing to be carried out.

# International Accounting Standards Board (IASB)

## next steps

In addition to the summary responses, Peter Clark and the IASB staff produced three other papers for the February Board meeting.<sup>1</sup> One of these presented a project plan which set out the issues that must be addressed in the form of a series of questions that the IASB must answer over forthcoming meetings. No timetable was imposed, although the subjects were divided into eight separate Board meetings with an acknowledgement that these were highly unlikely to be eight consecutive meetings. On the basis that the first in-depth discussions are unlikely to take place until the May or even June IASB meeting, it appears that an exposure draft before the end of 2009 will represent a challenging objective.

The other papers produced for the February meeting dealt with two particular issues that featured heavily amongst the responses received, notably 'Accounting for the whole contract' and 'Settlement value as a candidate measurement attribute'.

The former seeks to consider whether there is a difference between accounting for a contract as a whole and accounting separately for the rights and obligations created by a contract. The 'whole contract' approach was supported by a number of respondents and suggests that recognition criteria should be applied to a contract rather than to the underlying component rights and obligations. This approach was seen by some respondents as an opportunity to remove constraints placed on expected cash flows by IASB asset and liability definitions being applied to individual rights and obligations, notably in relation to future premiums and participating contract payments.

The production of the settlement value paper reflects the number of respondents who expressed 'significant opposition' to the current exit value transfer concept, and is therefore the first step in the IASB's consideration of a potential alternative. Opposition to current exit value focused around three factors:

- Lack of relevance of current exit value if an entity cannot actually transfer the liability.
- Current exit value excludes entity-specific cash flows.
- Current exit value of a liability reflects its credit characteristics.

The paper makes it clear that it is considered important that a measurement attribute is defined to provide a single all-encompassing summary description of the measurement model rather than merely listing the building blocks to be used. Settlement value is identified as a serious candidate for selection as the measurement attribute, but the IASB paper makes it clear that none of the responses received 'defines that notion clearly enough for it to be desirable as a measurement attribute'. It appears that this presents an opportunity to those in favour of such an alternative measurement attribute to have an input into the development of a concrete proposal for the Board.

It is apparent from the content of the project plan and the production of these specific papers that there are many questions, including some extremely fundamental ones, that are still to be answered before this project can be taken to the next stage.

In order to take matters forward as effectively as possible the IASB has made a decision to reconstitute the Insurance Working Group ('IWG') that provided significant input to the development of the Discussion Paper. The group met on 1 and 2 April 2008 and discussed some of the key contentious issues set out above prior to recommendations being made to the Board itself. The membership of the IWG has been reassessed with a wider reflection of views sought through increased user participation with the appointment of more analysts to the group, including Andrew Crean (Citigroup) from the UK and William Wilt (Morgan Stanley) from the US.

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<sup>1</sup> The IASB Board papers for 19/02/08 can be found at: [www.iasb.org/Meetings/IASB+Board+Meeting+19+February+2008.htm](http://www.iasb.org/Meetings/IASB+Board+Meeting+19+February+2008.htm)

# Solvency II

In Europe, it is not only financial reporting for insurers that is undergoing a period of change; the same is true of regulatory reporting with the development of Solvency II. Solvency II is likely to require full adoption around the same time, if not before, IFRS Phase II and incorporates its own requirements for measuring insurance liabilities. These requirements, as set out in the draft Framework Directive issued by the European Commission<sup>2</sup> are based around similar concepts to the IASB's proposals, including a 'current exit value' basis of valuation and conceptually similar building blocks. Whilst Solvency II is a European initiative, it is apparent that regulators across the globe are monitoring developments, and it is likely that solvency regimes of varying degrees of similarity to Solvency II will be developed in many other territories in due course.

Given these apparent parallels in timing and requirements for measuring liabilities, there is an understandable desire for some level of consistency between Solvency II and IFRS Phase II amongst European insurers and this aspect was apparent in some of the responses to the Discussion Paper. The European Insurance CFO Forum and Comité Européen des Assurances responded jointly and refer to the need for the IASB to 'monitor Solvency II developments and, if appropriate, liaise with regulators to ensure a broadly consistent regime where appropriate.'

Solvency II is currently undergoing field testing in the form of Quantitative Impact Studies and the latest of these, QIS 4, is due to take place in the coming months. It is apparent that a number of concepts taken from the IASB's accounting proposals have been taken on board by the European regulators (CEIOPS) in developing QIS 4 requirements around valuation of technical provisions, in addition to the 'current exit value' label in the draft Framework Directive. Thus, for example, the draft QIS 4 technical specifications have adopted the 'guaranteed insurability' criteria from the IASB Discussion Paper as a basis for determining which future premiums to include in cash-flow estimates. Furthermore, the Discussion Paper's proposed requirement to restrict any allowance for diversification benefits to those within a portfolio is addressed in QIS 4 by a background document issued by CEIOPS on 31 January 2008 (Guidance on the definition of the reference entity for the calculation of the Cost of Capital).<sup>3</sup>

This document suggests that a market participant to whom the hypothetical transfer of a portfolio takes place is an 'empty undertaking'. Accordingly, there is assumed to be no other business within the transferee from which diversification credit can be taken beyond that within the portfolio itself.

These instances of Solvency II apparently adopting elements of the IASB Discussion Paper, together with the current exit value 'transfer' concept included in the draft Framework directive, do not take into account the level of opposition expressed to these aspects of the IASB's proposals in many of the response letters as indicated above. There is a danger that apparent convergence between accounting and regulatory frameworks, reflecting the desire for consistency, will see accounting proposals that are unpopular with some groups of respondents finding their way into regulatory requirements.

<sup>2</sup> To review the draft Framework Directive go to: [www.ec.europa.eu/internal\\_market/insurance/docs/solvency/proposal\\_en.pdf](http://www.ec.europa.eu/internal_market/insurance/docs/solvency/proposal_en.pdf)

<sup>3</sup> For more information see: [www.ceiops.eu/media/docman/public\\_files/publications/submissionstotheec/QIS4-Background-document-on-Cost-of-Capital.pdf](http://www.ceiops.eu/media/docman/public_files/publications/submissionstotheec/QIS4-Background-document-on-Cost-of-Capital.pdf)

# Financial Accounting Standards Board (FASB)

In August 2007, the FASB issued an Invitation to Comment that incorporated the IASB's Discussion Paper in order to gather views as to whether it should add to the FASB's agenda a joint project with the IASB on insurance contracts. Views were sought by November 2007, the same timetable as the IASB was operating to in requesting responses to its Discussion Paper. The FASB Invitation to Comment highlighted the increasingly international scope of the insurance industry, including the cross-border activity of many insurers. Accordingly, the need for international comparability between insurers competing on global capital markets is made apparent. The FASB paper also sets out some perceived benefits of the IASB's preliminary views in the Discussion Paper compared to current US GAAP, and concludes that the great majority of proposals will result in improvements or simplifications over current US accounting.

The FASB has indicated that it will make a final decision as to whether to join the project in quarter three of 2008 and, to assist in its deliberations on this subject, it will discuss the responses received in its Insurance Forum on 6 May 2008.

As indicated previously, many Discussion Paper respondents commented on the timing of the Insurance Contracts project, and whilst some indicated their support for a joint project with the FASB, others expressed concerns that FASB involvement might slow the project down.

If the FASB does join the project, as appears likely, it will present a further challenge in terms of maintaining momentum and meeting the objectives around timing expressed by many respondents. However, such concerns should be balanced by the fact that the active participation of the FASB will clearly enhance the global reach of the ultimate standard and provide increased comparability in reporting for insurers across global capital markets.

# Conclusion

The Discussion Paper has clearly elicited a wide range of strong views from industry, users, accountants, regulators and others. In many areas, there is a clear convergence of views either for or against the IASB's proposals. For example, many support the building blocks concept and the constituent parts thereof, whereas many oppose the use of guaranteed insurability, inclusion of own credit characteristics and unbundling. In other areas, there is a divergence of views from respondents, reflecting in many cases industry (life versus non-life) or geographical factors.

The challenge for the IASB is to keep the momentum going on this important project, especially with the FASB likely to join the project in the third quarter of this year. So, is it any closer to the finish line now? If you are prone to standing on the finish line and looking back to the runners and riders then you might conclude that this IASB horse has made little progress. However, if you choose to stand on the starting line and look down the race course it is clear that substantial progress has been made and the finishing line is at least now in sight. What do you think?

# Appendix – IASB staff paper: Overview of comments

The following is a synopsis of the 16 page summary paper prepared by Peter Clark of the IASB staff for the February IASB meeting. In our view the paper is a reasonably balanced reflection of the comment letters received. The full paper is available on the IASB website.<sup>4</sup>

## Three building blocks

There was general agreement that the building blocks provide a useful framework for considering the measurement of insurance liabilities, though virtually all respondents had significant concerns about important aspects of the building blocks.

Aspects of the building blocks that were largely supported included:

- Use of current estimates of cash flows.
- Consistency with observable market prices for factors, such as interest rates and equity prices.
- Using 'expected value', i.e. probability-weighted average (subject to some concerns around practicalities).
- Reflecting time value of money (subject to some significant disagreement from some non-life insurers).
- Including a risk margin and recognising income in line with release from risk.

Concerns expressed around aspects of the three building blocks included:

- Divided views expressed over whether it would be acceptable to recognise a net profit (i.e. after

acquisition costs) at inception, with some suggested alternatives to immediate recognition.

- Some respondents believed that net profits at inception would be common and significant.
  - Many respondents queried the relationship between the proposals in the Discussion Paper and those in the Board's Revenue Recognition project.
  - Most respondents wanted more information on how to estimate risk margins. Many were concerned about the lack of observable benchmarks for risk margins and there were mixed views on the level of guidance required, and the range of options available, to calculate risk margins.
  - Some respondents argued that the risk margin should be limited to the cost of bearing risk (for example, the cost of holding the necessary capital) and should not include any profit that the insurer, or another entity, would require for bearing risk beyond this cost.
  - Most respondents did not understand the rationale for the service margin and commented that users would not benefit from a separation of risk margin from service margin.
  - Respondents generally supported use of market participant cash flows in cases where they are determined by observable financial market prices, such as interest rates or equity prices.
- However, many respondents objected to the use of estimates of expenses that market participants would incur rather than entity-specific expenses. Reasons of relevance, reliability, practicality and basis of pricing were put forward.
  - Some respondents opposed the requirement for discounting and risk margins for non-life insurance contracts and suggested retention of the existing unearned premiums and undiscounted liabilities approach in these cases. As such, these respondents support the use of separate models for life and non-life insurance. Other respondents generally favoured the Discussion Paper's proposed approach for non-life contracts and hence supported a single measurement model.
  - Most respondents vigorously opposed the proposals to reflect a liability's own credit characteristics in its carrying value.
  - Most respondents supported a discount rate for non-participating liabilities that reflects the characteristics of the liability, although a few argued for asset-based rates.
  - Many respondents argued against the artificial constraints on cash flows imposed by the Discussion Paper proposals in the areas of future premiums and other aspects of policyholder behaviour and expected payments to participating policyholders (see overleaf).

<sup>4</sup> The full paper is available on the IASB website at: [www.iasb.org/NR/rdonlyres/C825EFD5-6D1A-494B-A5CA-5D3B7F9082B2/0/IC0802b02aobs.pdf](http://www.iasb.org/NR/rdonlyres/C825EFD5-6D1A-494B-A5CA-5D3B7F9082B2/0/IC0802b02aobs.pdf)

## Measurement attribute

Whilst some respondents supported current exit value, many suggested that the Board explore a notion tied more directly to the fact that insurers generally expect to settle their liabilities over time by paying benefits to policyholders as they fall due, rather than transfer their liabilities to a third party. Support for a settlement value was based around the preference for entity-specific cash flows, the opposition to reflection of own credit characteristics and conceptual concerns, given that such liabilities will not, and often cannot, be transferred. However, respondents did not generally suggest precise definitions of a measurement attribute that correspond exactly to the notion of settlement over time.

Many respondents suggested that measurement should focus on the contract as a whole rather than on individual elements of contracts that meet the definitions of assets and liabilities. Respondents indicated that this approach would resolve issues relating to future premiums and policyholder participation discussed below.

## Policyholder behaviour and future premiums

Many respondents opposed the guaranteed insurability test with arguments around:

- The preference for a whole contract approach (see above).
- Market participants would include all expected cash flows and hence the resulting value

under the guaranteed insurability criteria would not constitute a current exit value.

- The test would be difficult and burdensome and the distinction between cash flows that pass the test and those that do not would have no internal use.
- A few respondents were concerned that too many cash inflows would be included, notably health insurers and non-insurers.

Respondents were unable to suggest how to distinguish existing contracts from possible future contracts and it was acknowledged that further work may be required in this area.

## Participating contracts

Most respondents indicated that measurement of a participating contract should include all cash flows from the contract. In this regard, some respondents supported the legal or constructive obligation test for recognition of participating policyholder dividends, whilst expressing concerns that the ongoing IAS 37 Liabilities project may narrow the definition of a constructive obligation.

Many respondents suggested that investment contracts with discretionary participation features should be in scope for the Phase II standard.

## Performance reporting

Most respondents viewed all premiums as revenue, especially for non-life contracts, although some

saw merit in a margin approach, notably for life contracts

Most agreed that all changes in insurance liabilities should be reported in profit or loss although some proposed use of other comprehensive income to avoid mismatches where the AFS asset classification is used.

Many indicated that they found it difficult to comment on measurement without a clearer understanding as to how performance reporting would work.

## Recognition

Concerns were expressed over the 'party to the contract' recognition criteria in the Discussion Paper. Some view insurance contracts as service contracts rather than financial instruments and hence would rather not recognise the contract until the coverage period begins. Others were concerned with the Discussion Paper proposals on grounds of practicality.

## Unit of account

Views differed on the definition of a portfolio, although most agreed that diversification within a portfolio should be reflected. Views were mixed on allowing for diversification benefits between portfolios.

## Assets backing insurance contracts

There was general agreement that it would be desirable to eliminate accounting mismatches that arise if assets of a unit-linked fund are not recognised or are not carried at fair value through profit or loss.

Some respondents indicated that similar mismatches could arise for participating contracts or contracts that allow switching between funds. Differing solutions were suggested, including a requirement to fair value assets backing insurance contracts and the removal of constraints around the use of the fair value option.

### Acquisition costs

Respondents generally agreed that acquisition costs should be expensed when incurred, provided that the measurement model includes all future cash flows from which acquisition costs would be expected to be recovered.

### Unbundling

Many respondents did not agree with unbundling proposals in the Discussion Paper. Conceptual and practical objections were noted, including lack of usefulness, cost and lack of clarity around the terms 'interdependent' and 'arbitrary'.

### Tax

Several respondents suggested that careful consideration should be given to the tax effects of the proposals in order to avoid anomalies.

### Inconsistencies with IAS 39/ IAS 18

Suggested amendments to IAS 39 included the elimination of the deposit floor although others felt that any changes to that standard should

be considered in a wider context rather than as part of this project.

### Reinsurance assets

Some respondents agreed with the proposed expected loss approach for defaults and disputes whilst others preferred an incurred loss model on grounds of practicality.

### Business combinations and portfolio transfers

There was general agreement that the need for the expanded presentation of insurance contracts acquired in a business combination, as permitted by IFRS 4, would disappear if current exit value is retained and deemed to be the same as fair value under IFRS 3.

### Timetable and process

Some respondents were concerned with the use of this project as a testing ground for wider concepts, whilst others felt that the adoption of particular ideas in the Insurance Contracts project might prejudice conclusions in other projects.

Whilst some respondents supported the project becoming a joint project with the FASB, others expressed concerns over implications for timing of the standard of such a development.

Many respondents supported field tests being carried out. European respondents requested consistency with the Solvency II project and urged timely completion of the project to allow consistent timing of adoption with Solvency II.

Many respondents argued that a standard is needed urgently, whilst recognising the complexity of the issues and the need for the Board to take enough time to reach the right answers.

Some respondents suggested that policyholder accounting is not a priority and should not be the reason for a delay in the production of a standard for insurers.

A few respondents asked the Board to hold roundtables at this stage.

### Interaction with other projects

Many respondents stressed the need to ensure coordination with other ongoing projects, particularly revenue recognition but also the revision of IAS 37, liabilities and equity, the conceptual framework, presentation of financial statements, fair value measurements, financial instruments and pensions. There was a suggestion that certain issues should be dealt with as 'cross-cutting issues' affecting several projects, rather than dealing with them separately under individual projects.

# Contacts and related publications

If you would like to discuss any of the issues raised in this paper, please call one of the following or speak with your usual contact at PricewaterhouseCoopers.

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To find out more about IFRS Phase II and to download these publications, please go to: [www.pwc.com/ifrs](http://www.pwc.com/ifrs)

## Recent financial services related publications:

- The future of insurance reporting: PricewaterhouseCoopers' view on the latest IASB and FASB proposals, December 2007
- Insurance reporting at the crossroads: What do the analysts think?, November 2007
- European Insurance Digest – includes 'Measuring Up: Fair Value and IFRS for Insurers', September 2007
- Get set for IFRS Insurance Phase II, August 2007
- IFRS Insurance Alert, May 2007



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