

# *How to make the proposed new insurance standard more useful*

*US perspectives on PwC's response to the latest proposals for the future of insurance accounting from the IASB and FASB*

*December 2010*

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# Executive summary

## Introduction

The development of the planned new IFRS for insurance contracts is an opportunity to create a reporting framework capable of conveying to investors the true value being created within insurance businesses. A consistent measurement of insurance contracts will allow for comparison of insurers' performance across different groups and territories.

While some of the points in question might seem arcane, the final outcome of the debate could have a crucial impact on the level and trajectory of insurers' earnings and how performance and prospects are judged by analysts and investors.

This paper summarizes the PwC global network of firms' comment letter on the latest proposals for the future of insurance reporting published by the International Accounting Standards Board (IASB) in July 2010. We also outline PwC US's additional comments on the discussion paper (DP) the Financial Accounting Standards Board (FASB) published in September 2010, which seeks views on the IASB exposure draft (ED) and input on the differences in views between the IASB and FASB in the insurance contract project.

In developing our response, we have taken account of the increasing use of IFRS around the world and the resulting need to ensure that the proposals are relevant to a wide range of contracts and companies in very diverse economies. Our responses drew on in-depth surveys of practitioners specializing in the industry, along with discussions with users and our clients from around the world. Although the opinions of different preparers and users of accounts can vary quite markedly, their perspectives have provided valuable insights that have

helped us to formulate our view, which we believe represents a balanced and coherent approach to financial reporting for insurance contracts.

## Overview of our response

We appreciate the contribution that the IASB and FASB have made towards developing a comprehensive model of accounting for insurance contracts. A comprehensive new standard is essential as the transitional arrangements established in IFRS 4 ('Phase 1') do not provide the level of transparency and comparability that users of financial statements need to make a fully informed evaluation of the business. We believe the IASB's proposal is a significant improvement, which addresses many of the concerns over corporate reporting by insurers and is an improvement from the current exit value notion in the previous IASB DP.

We recognize that the proposed standard will bring about pervasive changes to the way insurers measure and present the results from issuing insurance contracts and we encourage the boards to work closely with the insurance industry to comprehensively test the proposals with real data before finalizing the standards.

Overall, we support the use of a measurement model for all insurance contracts that portrays a current assessment of the amount, timing and uncertainty of the future cash flows that the insurer expects its existing insurance contracts to generate.

However, modification in a number of key areas would help to make the model more relevant, reliable and workable for both users and preparers of insurance accounts as summarized below and set out in more detail in the following sections.



“...recommend the Board work closely with the insurance industry to comprehensively test the proposals...”

*From PwC's response to IASB exposure draft*

*We do not agree with not recognizing any residual margin on transition and instead would support full retrospective application unless impracticable.*

## **Key points**

### **Discount rate**

While we support the use of a discount rate that reflects the characteristics of the insurance contract liability, we realize that the use of a discount rate that excludes credit risk may result in the recognition of a day one accounting loss. In addition, we would support the option to lock in the discount rate as it could alleviate the potential mismatch between insurance liabilities and assets held to back them that are measured at amortized cost.

### **Risk adjustment**

We conceptually agree with the need for a risk adjustment, but we believe the IASB should work with users and preparers to ensure that the recognition of an explicit risk adjustment will provide decision-useful information.

### **Residual margin**

We support the use of a residual margin to avoid an initial profit. However, we have concerns as to whether the amortization method and recognition of changes in estimates will recognise the income on a contract in an appropriate manner.

### **Short duration contracts**

The modified measurement approach for short duration contracts should be permitted but not mandated and available for contracts of more than twelve months duration.

## **Unbundling**

We would prefer unbundling to only be required when the economic characteristics and risks of the component aren't significantly interdependent with those of the host insurance contract but would support the optional unbundling of interdependent account balances.

## **Transition**

We do not agree with not recognizing any residual margin on transition and instead would support full retrospective application unless impracticable.

## **Presentation**

We support the summarized margin approach but recommend specific volume disclosures.

## **FASB involvement and convergence with US GAAP**

We agree with preparers and users that existing US Standards on accounting for insurance contracts are well understood and produce relevant information. We do not believe that any targeted improvements would significantly improve current US GAAP and believe it would be more efficient for FASB to work with the IASB towards converged financial instrument and insurance contracts standards to warrant its adoption in the US.

# Summary of our comments on the proposed measurement model

## Introduction

The IASB outlined its proposals for the measurement of insurance contracts in its July 30, 2010 ED. We summarized the main proposals in PwC's "Practical Guide to IFRS," which the firm issued on August 23, 2010. We also summarized the FASB's views in its September 17, 2010 discussion paper in our DateLine 2010 - 39, issued September 24, 2010.

In the three years since the publication of the IASB's original discussion paper (IASBDP), both boards, the industry and PwC have continued to discuss the accounting for insurance contracts. As a result of our discussions, some of our views have changed; we are pleased to note that the ED reflects many of our comments on the IASBDP proposals. In our response to the IASB on the ED, we support the use of a fulfillment objective of a current value measurement that assumes performance according to the terms of the contract rather than an exit model. However, while we support the IASB proposal overall, we also have some concerns about certain aspects of the proposed measurement model.

*"...allow insurers an option to apply a locked-in discount rate ..."*

*From PwC's response to IASB exposure draft*

## Discount rate

We agree that the discount rate an insurer uses should reflect the characteristics of the insurance contract liability. We believe that, in a measurement model with a fulfillment objective, the discount rate should not reflect the issuer's own credit risk. The exclusion from profit and loss of the changes in the measurement of a liability due to changes in an entity's own credit risk in circumstances where they are not expected to be realized by transfer to a third party is also consistent with the conclusions reached by the IASB in their recent project on financial liabilities. While we support the use of the risk free

rate with an adjustment for illiquidity, we note that in some instances the exclusion of the issuer's own credit risk from the discount rate may result in the recognition of a day one accounting loss.

In the PwC US response to the FASB, we noted that a day one accounting loss could occur where, for example, the insurer priced the insurance contract with an expected rate of return to the policyholder that is greater than the risk free discount rate. We believe the boards should assess the prevalence and significance of such apparently uneconomic outcomes in conjunction with its field testing to determine whether an exception to the overall model is warranted or whether some additional disclosure should be given in such circumstances. We believe an avenue of exploration could include deferring any day one loss resulting solely from the difference in the risk free rate and the rate of return to the policyholder, and amortizing it over the life of the contract.

In the PwC US response to the FASB, we also observed that the Boards have proposed new guidance involving measurement of fulfillment obligations for insurance, leasing, and revenue recognition, each of which requires different discount rates and measurement approaches. In addition, there is a current debate in practice as to the discount rate to be used for provisions. We find these proposals difficult to bridge in a conceptually consistent manner and suggest the boards reconcile or conform, if at all possible.

We agree with the adjustment of the discount rate to reflect the liquidity characteristics of the insurance contract. The holder of a government bond effectively acquires a non-tradable investment and an embedded option to sell the instrument (for which the holder pays a premium through a reduction in the return). For

insurance contracts that cannot be put back to the insurer, the discount rate should equal the higher return on a non-tradeable investment.

At the time the DP was issued and during the IASB's deliberations on the discount rate, there was general consensus that accounting for financial instruments would predominantly follow a fair value measurement model. However, in the development of IFRS 9, 'Financial Instruments', the IASB has concluded that amortized cost is a valid measurement approach for certain financial assets if the aim of the holder is to collect the contractual cash flows under the contract. The use of a current discount rate to measure insurance contracts will introduce an accounting mismatch in the income statement if insurers use amortized cost for many of the assets backing the insurance liability. To alleviate this potential concern, we believe insurers should be allowed an option to apply a locked-in discount rate as established at the inception of the contract. This option, applied at a portfolio level, should be available if it eliminates or reduces an accounting mismatch and is consistent with the insurer's business model of fulfilling the contracts.

### **Risk adjustment**

Whether or not to include an explicit risk adjustment in the measurement of insurance contracts is a very difficult issue. Some of the advantages that we considered when we debated the merits of including an explicit risk adjustment are that it provides decision useful information about the uncertainty included in the subjective cash flow estimates and the fact that the risk adjustment will be updated for changes in the price and quantity of risk included in those estimates. Not only does an explicit risk adjustment better reflect skewed tail distributions, its inclusion

in the measurement of the liability also lessens the amount of residual margin which is subject to the complexities of amortizing and potentially re-measurement. An added benefit for insurers in some jurisdictions is the consistency with the regulatory regimes which also require the calculation of explicit risk adjustments.

However, these benefits are offset by the potential lack of comparability and consistency for the calculation of the risk adjustment and this may lead the users of the financial statements to not trust the explicit risk adjustment calculations. We also debated whether the objective of the risk adjustment can be consistent with the overall fulfillment objective of the measurement model. We considered whether the inclusion of a risk adjustment would be cost beneficial for all sized companies and also considered whether it could be implemented given the time constraints imposed by reporting timelines.

The two boards also struggled with this aspect of the measurement model and came to different conclusions. On balance, we concluded that we would conceptually support the inclusion of an explicit risk adjustment in the measurement of an insurance contract at the portfolio level. However, we are concerned that the proposed model may not produce comparable results among insurers and that the proposed amortization methods for both the residual margin (in the risk adjustment model) and the composite margin (in the alternative model proposed by FASB) may not recognize the income on a contract in an appropriate manner. We believe the IASB should work with users to ensure that the recognition of an explicit risk adjustment will provide sufficient decision-useful information to make this approach cost beneficial to adopt.

*"...work closely with the insurance industry to understand the practical implications and operationality of both the explicit risk adjustment and the alternative composite margin"*

*From PwC's response to IASB exposure draft*

We also note that the standard should provide the principle for the risk adjustment and allow for the use of any risk adjustment technique that complies with the objective. This will allow the use of more appropriate and reliable methods to calculate the risk adjustment that may be developed over time. However, we believe that insurers should use a consistent methodology within group financial statements to calculate the risk adjustment for all similar contracts. We also do not support the disclosure of confidence level information as a 'comparable benchmark' as this could be misleading when the pattern of claims is not a normal distribution.

### ***Residual margin and reporting changes in circumstances***

We agree that no gain should be recognized at the initial recognition of an insurance contract. This is consistent with our support for the proposals in the revenue recognition ED and IAS 39 for financial instruments that are valued using non-market observable inputs. We also took into consideration the findings in our 2009 survey of insurance analysts where three-quarters of participants were opposed to the recognition of profit at the inception of the contract.

When the measurement model proposed by the IASB is applied, the residual margin will reflect items such as non-incremental acquisition costs, general overheads and profit margins which are included in pricing the contract but which are not reflected in any of the other building blocks in the measurement model. Given the myriad of items that end up being reflected in the residual margin, we do not agree with the principle that the residual margin should be



*“...The pattern for the release of the residual margin will significantly impact the earnings pattern of some insurers...”*

*From PwC’s response to IASB exposure draft*

recognized in a manner that reflects the probability of incurring a claim, as this is incorporated in the explicit risk adjustment. Without the benefit of field testing, we are unable to propose a specific amortization pattern, but would support the recognition of the residual margin in the income statement over the coverage period in a pattern that is reflective of the time value of money, without the accretion of interest.

We have concerns with the immediate recognition of all changes in estimates in the income statement and the impact it may have on the perception of performance as a result of this volatility. We would support recalibrating the residual margin at each reporting period using updated cash flow estimates with all current information (including the actual cash flow experience to date) discounted at the original discount rate. The residual margin would be recalibrated (re-measured) as at inception of the contract and amortized over the coverage period using updated information and assumptions of future cash flows. This treatment would allow the remaining residual margin and its release to represent the current expected future profit on the contract at the reporting date. If a contract becomes onerous subsequent to issuance, we do not believe that recognizing the entire change in estimates in the current period income statement followed by

the continued amortization of profits from the release of the locked in residual margin in subsequent periods provides useful information. However, we acknowledge that insurers may find the subsequent recalibration of the residual margin operationally challenging and therefore the IASB should work closely with the industry to ensure such an approach can be practically applied.

### ***Short duration contracts***

We believe the modified measurement approach for short duration contracts should be permitted but not mandated as some insurers may find it operationally easier to apply the full model to all of their contracts rather than to have two different accounting methodologies. We do not believe the criteria for the use of the simplified measurement should be limited to a coverage period of approximately 12 months or less. For example, if an insurer issues a 24 month contract and does not expect the distribution of expected cash flows of future claims to change because new information will not become available or the distribution rarely changes, it should be permitted to apply the simplified measurement model. However, we would support all twelve-month contracts being permitted to use the modified measurement approach as a practical expedient.

# Our comments on other areas of the exposure draft proposals

*“...an insurance contract is difficult or sometimes impossible to analyze and separate into its individual parts...”*

*From PwC’s response to IASB exposure draft*

## **Unbundling**

We believe it is appropriate that insurers unbundle some components included in an insurance contract in limited circumstances. Having worked through the proposals in the ED, we are unclear on what the IASB meant by ‘closely related’ as this term is not defined. We also believe the interplay between the principle and the examples in analyzing product features should be clarified. For example, it is unclear whether insurers will be required to unbundle an account balance that does not meet any of the specified unbundling criteria but is considered not to be closely related to the host insurance contract.

Given that most components in insurance contracts are interdependent, we would prefer if unbundling were only required when the economic characteristics and risks of the component aren’t significantly interdependent with those of the host insurance contract. This is likely to mean that most insurance contracts would not be unbundled. We believe this would eliminate the potential “bundling” of two non-interdependent contracts with the same customer if they are closely related activities, for example, where claims administration services and stop loss insurance coverage are combined in a single contract. We would support the optional unbundling of interdependent account balances in insurance contracts to enable, for example, loans that are waived on death to be unbundled.

## **Investment contracts with discretionary participating features**

Consistent with our views on the IASBDP, we do not believe that investment contracts with discretionary participation features should be in the scope of the insurance contracts standard in the longer term as they do not transfer significant insurance risk. However, while we believe these should be accounted for as financial instruments, we realize that insurers would be faced with significant complexity and operational challenges in applying the current financial instrument accounting to these contracts, particularly in relation to debt versus equity. We drew the IASB’s attention to the fact that these contracts comprise a significant proportion of life insurers’ business in some countries and that they should therefore consider the treatment of investment contracts with discretionary participation features within the financial instruments with characteristics of equity project. However, due to the IASB’s and FASB’s decision not to issue an ED on that project in the near future, we recommend that all of these contracts be included within the scope of the insurance contracts standard as an interim measure.

## **Financial guarantee contracts**

In our discussions with insurers that write credit insurance business, it is clear they do not believe these contracts should be outside the scope of the insurance standard. However, talking to their banking counterparts that issue credit derivatives, financial guarantee contracts, and loans, they perceive the risk arising from all of these contracts

*“Such an approach would distort an insurer’s reported income for years into the future.”*

*From PwC’s response to IASB exposure draft*

as credit risk, which in their view is a form of financial risk, not insurance risk.

On balance and after much debate we concluded that we do not believe that contracts that are currently defined as financial guarantee contracts should be within the scope of the insurance standard. Conceptually, we believe credit risk arising from a failure to pay is a type of financial risk and so should be addressed using an expected loss accounting model as part of the IASB’s and FASB’s financial assets impairment project. However, we recognize that this solution will be a concern for credit insurers and suggest that the IASB and FASB consult further with them to identify whether these products can be distinguished in some way from those more commonly issued by banks or other entities.

### **Transition**

Although we support the IASB’s proposal that the standard should be applied retrospectively, we do not support their proposal not to recognize any residual margin for contracts in existence on transition to the new standard. For those insurers that issue long duration contracts, sometimes in excess of 30 years, the proposals will result in no profit being recognized in the income statement other than the release of the risk adjustment and we do not believe this will faithfully present the performance of the business in future years. Therefore, we support full retrospective application of the proposed model with the IAS 8 impracticability exemption. Although this proposal may be challenging we didn’t identify any other proposal that was conceptually sound and which would result in consistency and comparability between different insurers. If however full retrospective application is impracticable, we agree

with excluding any residual margin on contracts in existence on transition.

### **Boundary of the contracts**

We agree with the contract boundary principle proposed by the boards. In most circumstances insurers will be able to consistently apply the proposed principle because it relies on the rights and obligations contained in the contract and it should result in a sensible contract term.

However, we believe the boards should clarify how the proposed boundary of the contract principle should be applied when the insurer’s ability to underwrite individual policyholders and/or to set premium rates are subject to external regulatory constraints. For example, for certain types of healthcare contracts, insurers may not have a legal right to underwrite a policyholder based on his/her individual health risk. Applying the contract boundary proposals, these contracts would not be short duration contracts. We also note that the inclusion of payments to future participating policyholders contradicts the boundary of the contract principle.

### **Reinsurance**

We support the proposed use of an expected loss model for reinsurance assets as it is consistent with the insurance contract expected cash flow model. However, we do not support the recognition of an initial gain by a cedant on entering into a reinsurance contract. In keeping with the proposals for underlying insurance contracts and other standards, we would defer the recognition of any day one gain except when the gain offsets a loss recognized at inception on an underlying onerous contract. We are concerned that this proposal could encourage the structuring of reinsurance transactions

*“...this could encourage the structuring of reinsurance transactions...”*

*From PwC’s response to IASB exposure draft*

to allow cedants to recognize immediate gains on entering into a reinsurance contract.

### ***Presentation and disclosure***

We continue to believe that the summarized margin approach will be useful to users as it reflects the building blocks measurement model. However, further consideration should be given to presentation when a business issues insurance contracts while also undertaking significant non-insurance activities. Corporate reporting by insurers today includes a number of different performance measures. However, the lack of consistency of this information among competitors significantly reduces the comparability and therefore, to an extent, the usefulness of this information. Therefore, we recommend that the IASB specify the disclosure of volume measures, such as annualized premium equivalent or gross written premium, to improve the consistency of performance measures presented to users.

While we believe it is useful to allow an expanded presentation of the underwriting margin for short duration contracts in the income statement, the standard should state whether differences in the initial estimate of claims incurred are presented in the claims incurred line within the underwriting margin or in the experience adjustment line.

### ***Acquisition costs***

We believe that a mismatch between acquisition costs incurred and premiums charged to reimburse these costs should be avoided where possible. We believe insurers should not recognize a loss at inception of the contract due to the treatment of acquisition costs unless the contract is onerous. We therefore support the ED proposals to treat incremental acquisition costs as a contractual cash flow. We considered whether the proposals could be broadened to include non-incremental acquisition costs but, like the IASB, struggled to determine a principle that could be applied consistently in practice. We are also mindful of the fact that the restriction to acquisition costs incremental at the contract level is consistent with accounting for financial instruments.



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## ***FASB involvement and convergence with US GAAP***

*“We believe that convergence to a single set of high quality accounting standards will benefit the global capital markets...”*

*From PwC’s response to IASB exposure draft*

We agree with preparers and users that existing US Standards on accounting for insurance contracts are well understood and produce relevant information in the markets that use US GAAP. Thus, we believe the boards need to resolve their remaining differences on this project and finalize one converged financial instrument standard, in order for a proposed insurance contracts accounting standard to be sufficiently beneficial to warrant its adoption in the US. We do not believe any targeted improvements would significantly improve current US GAAP and believe it would be more efficient for FASB to work with the IASB as it field tests and re-deliberates the proposals.

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

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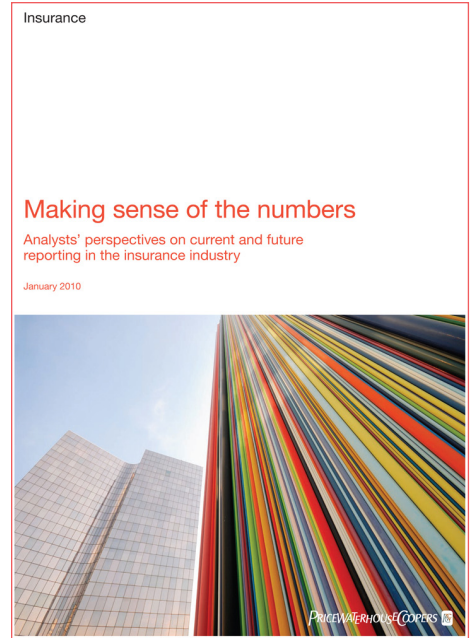
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## ***Making Sense of the Numbers***

PwC interviewed more than 40 investment professionals to understand their thoughts on the current state of insurance reporting and its future direction. Findings revealed widespread dissatisfaction with the current state of financial reporting.



## ***Getting to grips with the shake-up, October 2010***

PwC Solvency II and IFRS specialists have come together to review the first steps and challenges in implementing Solvency II and IFRS in parallel. This new thought leadership examines the key similarities and differences between IFRS and Solvency II in the areas of measurement of contract liabilities, measurement of assets and other liabilities, disclosures and group consolidation and provides a technical comparison.



***[pwc.com/us/insurance](http://pwc.com/us/insurance)***