

IFRS news supplement

IFRS by industry – insurance

IFRS news supplement
IFRS by industry – insurance

November 2010

Hot topics in insurance

PwC's 'IFRS news' industry supplements are looking at issues affecting the financial services industry over the next three issues (see banking, October 2010 and asset management in January 2011). This month, Elizabeth Lynn of PwC's Global Accounting Consulting Services central team, looks at developments in accounting that will have significant implications for the insurance industry.

The IASB has a full agenda and hopes to complete some key projects by June 2011. One of these projects is insurance contracts. The board has been working on Phase II of insurance since the publication of IFRS 4 in 2004. IFRS 4 allowed insurers to continue to use a variety of accounting practices

subject to some minimum criteria. The phase II ED proposes a comprehensive accounting model for the recognition, measurement, presentation and disclosure of insurance contracts. The new standard will have a significant impact on most insurers; the nature and amount of that impact will vary depending on the extent of the difference between the proposals and the insurers' current practice.

The insurance ED may be the main hot topic for insurers, but it is not the only driver of change. Several other proposals are expected to be completed by June 2011 and may also have a significant impact. The table below outlines the expected timelines for the various projects, and this article considers each in turn.

Table 1

Topic	Exposure draft	Target date for IFRS	Effective date
Insurance contracts	July 2010	Expected Q2 2011 1 January 2013*	No earlier than
Classification and measurement of financial assets	July 2009	IFRS 9 published November 2009	1 January 2013
Classification and measurement of financial liabilities	May 2010	Published October 2010	1 January 2013
Impairment and amortised cost	October 2009	Expected Q4 2010 1 January 2013*	No earlier than
Hedge accounting	Expected Q4 2010	Expected Q2 2011 1 January 2013*	No earlier than
Fair value measurement disclosures	June 2010	Expected Q1 2011	TBC
Consolidations	December 2008	Expected Q4 2010	TBC
Revenue recognition	June 2010	Expected Q2 2011	TBC

* The IASB has not specified any dates in these EDs but has indicated that these standards will not be applicable before the application date of IFRS 9.

Insurance contracts

ED issued July 2010 Q2	Final IFRS expected 2011	Effective no earlier than 1 January 2013
------------------------------	--------------------------------	--

The IASB issued an ED in July 2010 of a comprehensive standard that will fundamentally change the accounting by insurers and other entities that issue contracts with insurance risk. The FASB has been deliberating this project with the IASB; it issued a discussion paper in September 2010 that is broadly consistent the IASB's ED but has some key differences.

Scope and definition

The ED retains the IFRS 4 definition of an insurance contract as 'a contract under which one party accepts significant insurance risk from another party by agreeing to compensate the policyholder if a specified uncertain future event adversely affects the policyholder'.

The scope of the ED is largely unchanged for insurers. However, financial guarantee contracts that meet the definition of an insurance contract are within the scope; fixed fee service contracts (for example, fixed-fee maintenance contracts or road side assistance) are excluded. Most insurers already account for financial guarantees as insurance contracts, so this would not be a significant change for them. Certain financial instruments containing discretionary participation features continue to be included in the scope of the insurance standard. These are addressed in more detail below.

Measurement

The proposals require all insurance contracts to use a current measurement model of the present value of expected cash flows to fulfil the obligation, where estimates are re-measured at each reporting period.

This measurement model is based on the building blocks of discounted probability-weighted cash flows, a risk adjustment and a residual margin to eliminate any initial profit. The residual margin is not subsequently re-measured but is recognised in a systematic way over the coverage period. Any initial loss on a contract is recognised immediately in profit or loss. See diagram below.

Cash flows

The cash flows are explicit, unbiased and probability-weighted estimates of future cash outflows less future cash inflows that will arise as the insurer fulfils the insurance contract. This expected value is determined by considering the full range of scenarios that could result from the contract. However, stochastic modelling* may be needed where there are complex underlying factors. This may require a change to some valuation models.

The cash flows include all incremental inflow and outflows arising from a portfolio of insurance contracts. This includes direct costs and an allocation of costs that relate directly to the contract (for example, policy administration and maintenance costs) but excludes general overheads. Cash flows are current and reflect the perspective of the insurer (for example, the entity's own estimate of policy claim expenses). However, any

market variables should be as consistent as possible with observable market prices.

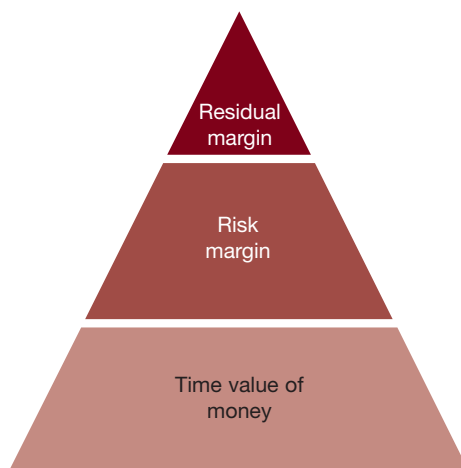
Acquisition costs are included in the cash flows of the contract where they are incremental at the contract level; otherwise, they are expensed immediately.

Insurers that pay independent intermediaries are likely to incur incremental commission at the contract level that will be treated as part of the contract cash flows, with no initial impact on the income statement. Insurers that have a salaried in-house sales force are likely to have fewer acquisition costs that are incremental at the contract level and therefore are likely to expense more of their acquisition costs immediately.

Insurance contracts often include embedded options and guarantees such as surrender options. The expected cash flows should reflect expected policyholder behaviour where policyholders' actions change the amount, timing or nature of the benefits they will receive.

Discount rate

The discount rate should reflect the characteristics of the liability, which for most contracts will be the risk-free yield curve with an appropriate adjustment for illiquidity. Where the



Remeasurement

X amount initially recognised is unwound but not remeasured

✓ updated for current estimates

✓ updated for market rates

✓ updated for current estimates

* A tool for estimating probability distributions of potential outcomes by allowing for random variation in one or more inputs over time.

cash flows depend on the performance of specific assets (for example, insurance contracts with a unit-linking feature), the discount rate should reflect the dependence on those assets. The recent credit crisis has highlighted the difficulty in measuring illiquidity, so this may prove challenging for insurers to determine.

Risk adjustment

One of the most controversial issues in the insurance contract project was whether or not an explicit risk adjustment should be included in measuring the contract liability. The IASB decided that an explicit risk adjustment should be part of the building-block measurement; the FASB decided that it should not. The IASB addresses concerns over comparability by limiting the range of permitted techniques for calculating the risk adjustment to the 'confidence level' technique (value at risk), the 'conditional tail expectation' technique (tail value at risk) or the 'cost of capital' technique. The proposals require the risk adjustment to be measured at a portfolio level. This will allow for risk diversification within that portfolio but not between different portfolios.

Having an explicit risk margin is consistent with the pricing of financial instruments and written options as well as the proposals in the IAS 37 ED. It also reduces the amount of the residual margin to be amortised. The challenge for insurers to reliably and consistently measure the risk adjustment will vary from territory to territory, depending on whether similar risk adjustment techniques are used for capital management or solvency requirements.

Residual margin

The residual margin is a derived amount that eliminates any initial profit, determined within a portfolio by date of inception and by length of the contract. It is recognised over the coverage period in a systematic way that reflects the exposure from providing insurance coverage (for

example, on the basis of time or expected claims and benefits). Unlike the other components of the insurance liability measurement, the residual margin is not remeasured.

The FASB's alternative model has a single composite margin on inception of the contract that is also derived to eliminate any initial profit. The insurance liability at each reporting date would be the sum of the present value of probability weighted cash flows (with no risk adjustment) and the remaining composite margin. The composite margin would be amortised over both the coverage and claims-handling period according to a prescribed formula.

Short-duration contracts

The proposals require short-duration contracts of approximately 12 months or less that do not contain any embedded derivatives or options to be initially measured as premiums less any incremental acquisition costs. This pre-claim liability is reduced in a systematic way over the coverage period; any claims that occur are measured using the building-block approach described above. Property and casualty insurers may therefore have to apply the two different measurement models where only the contract term is different.

Reinsurance

Reinsurance contracts assumed are measured using the same building-block measurement approach as for other insurance contracts. For the ceding insurer, an immediate gain can be recognised if the reinsurance premium is less than the expected recovery based on the building block model. An insurer does not offset reinsurance assets against reinsurance liabilities, or reinsurance income against reinsurance expense, as currently.

Unbundling

An insurer unbundles components of a contract that are not closely related to the insurance coverage. The ED specifies examples of such components

(for example, account balances that meet certain criteria). It cannot voluntarily unbundle closely related components within an insurance contract. Unbundling is important, as the insurance model differs from measurement models that may be applied to the unbundled components.

Discretionary participation features

The ED includes insurance contracts that include both guaranteed benefits (for example, a death benefit) and a discretionary right to participate in the performance of a class of asset or of the entity. It also includes investment contracts (that is, financial instruments with no insurance risk) that have discretionary participation features as long there are also insurance contracts that share in performance of the same pool of assets or of the entity. The FASB proposals exclude all investment contracts with discretionary participation features from the insurance standard and treat them as financial instruments.

Presentation and disclosure

The income statement is driven by the measurement model. Issuers will not recognise premiums as revenue; they will separately show an underwriting margin (comprising changes in the risk adjustment and residual margin) and changes in estimates and experience variances. However, insurers issuing short-duration contracts may expand the underwriting margin in the income statement to show premiums and claims. There are additional disclosures beyond the current IFRS 4 requirements, including detailed reconciliations of the components of the building block model.

Transition arrangements

The ED includes transition provisions that require insurance contracts in force at the transition date to be measured at the present value of the expected cash flows and risk adjustment as described above without any residual margin (after writing off any deferred acquisition costs). The only profit that will be recognised in

future profit or loss for contracts in existence at transition will come from the release of the risk adjustment, experience variances and any subsequent changes in estimates. This is likely to be a significant change for most life insurers.

The proposals are likely to result in increased volatility and significant changes in the presentation of the income statement. Insurers should begin to assess the implications of the new model on their existing contracts. They should also consider commenting on the ED to ensure their views are considered. This is likely to be a significant change for most life insurers.

Classification and measurement of financial assets (IFRS 9)

ED published July 2009	IFRS 9 issued November 2009	Effective 1 January 2013
------------------------	-----------------------------	--------------------------

The IASB has accelerated its project to replace IAS 39, 'Financial instruments: Recognition and measurement', and subdivided it into three main phases. The IASB completed part of the first phase of this project on the classification and measurement of financial assets when it issued IFRS 9, 'Financial instruments', in November 2009. Financial assets typically form the majority of an insurer's assets. The extent of IFRS 9's impact will vary depending on the nature of the financial assets an insurer holds and the existing accounting that it has adopted for its financial assets. Some insurers measure financial assets at fair value through profit and loss. IFRS 9 will not affect these assets. However, IFRS 9 may affect the accounting treatment of investments that are currently held as available for sale and assets held at amortised cost.

IFRS 9 replaces the multiple classification and measurement models for financial assets in IAS 39 with a model that has only two balance sheet classification categories: amortised

cost and fair value. Classification under IFRS 9 is driven by the entity's business model for managing the financial assets and the contractual cash flow characteristics of the financial assets.

A financial asset is measured at amortised cost if two criteria are met:

- the objective of the business model is to hold the financial asset for the collection of the contractual cash flows; and
- the contractual asset's cash flows solely represent payments of principal and interest.

IFRS 9 removes existing IAS 39 categories, notably the held-to-maturity and available-for-sale categories. It also removes the requirement to separate embedded derivatives from financial asset hosts; a hybrid contract is classified in its entirety at either amortised cost or fair value.

One of the fair value option conditions in IAS 39 is carried forward to the standard – that is, if designation at fair value through profit or loss (FVTPL) significantly reduces an accounting

mismatch. The designation at fair value through profit or loss continues to be irrevocable.

IFRS 9's classification principles require all equity investments to be measured at fair value. However, management has an irrevocable option to present in other comprehensive income fair value gains and losses on equity investments that are not held for trading. The election is available at initial recognition on an instrument-by-instrument basis, with no recycling to profit or loss. Dividends continue to be recognised in the income statement. Table 2 summarises typical financial assets and the implications of IFRS 9 on their accounting.

Financial liabilities

ED published May 2010	Final IFRS expected Q4 2010	Effective 1 January 2013
-----------------------	-----------------------------	--------------------------

The IASB a new standard in Oct 2010 addressing the classification and measurement of financial liabilities under IFRS. The accounting for financial liabilities in general remains the same as in IAS 39 except where

Table 2

Type of instrument/
categorisation of
instrument

Type of instrument/ categorisation of instrument	Accounting under IAS 39	Accounting under IFRS 9
Investments in equity instruments that are not held for trading purposes	Often classified as 'available for sale', with gains/losses deferred in other comprehensive income (but may be measured at FVTPL depending on the instrument).	Measured at fair value, with gains/losses recognised in the income statement or through other comprehensive income if elected.
Convertible instruments	Embedded conversion option split out and separately recognised at fair value. The underlying debt instrument is usually measured at amortised cost.	The entire instrument is measured at fair value with gains/losses recognised in the income statement.
Complex debt obligations (CDOs)	Embedded derivative is split out and measured at fair value through profit or loss; the remainder of the instrument is measured at amortised cost or FVTPL.	Measure entire asset at FVTPL (do not split out embedded derivative).
Debt security (for example, government or corporate bonds)	Measured at 'available for sale', with gains/losses deferred in other comprehensive income or measured at amortised cost unless fair value option elected.	Measured at amortised cost where certain criteria are met. Where criteria are not met, measured at FVTPL.
Held-to-maturity investments	Measured at amortised cost.	Measured at amortised cost where certain criteria are met. Where criteria are not met, measured at FVTPL.

the financial liabilities are designated at FVTPL. In addition to insurance contracts, many insurers issue investment contracts (that is, financial instruments that do not have significant insurance risk). Often insurers choose to designate some or all of their investment contracts at FVTPL. This is discussed in detail in the main edition of this month's *IFRS news*, p2.

Impairment

ED published October 2009	Final IFRS expected Q4 2010	Effective no earlier than 1 January 2013
---------------------------	-----------------------------	--

The IASB proposed fundamental changes to the impairment guidance for financial assets accounted for at amortised cost in October 2009. This is the second phase of the replacement of IAS 39. The extent to which insurers hold financial assets at amortised cost varies widely from jurisdiction to jurisdiction. The assets that insurers hold at amortised cost tend to be medium- to longer term, high-quality government or corporate bonds backing insurance liabilities. Such assets often have a lower risk of default than loan portfolios held by banks. The changes to the impairment guidance, although significant, are therefore likely to be less fundamental to insurers than to banks and other financial institutions.

The proposed approach is built on the premise that interest charged on financial instruments includes a premium for expected losses, which should not be included as part of interest revenue/income, and results in an allocation of the initial estimate of expected credit losses over the expected life of the financial asset. This expected cash flow (ECF) approach and the operational challenges in implementing and applying this approach are discussed in detail in the banking update in the October 2010 supplement to *IFRS news*.

Hedge accounting

ED expected Q4 2010	Final IFRS expected Q2 2011	Effective no earlier than 1 January 2013
---------------------	-----------------------------	--

Hedge accounting is the third phase of the project to replace IAS 39. The objective of this phase is to improve the decision-usefulness of financial statements for users by fundamentally reconsidering the current hedge accounting requirements for financial and non-financial items.

The IASB has started making some tentative decisions regarding hedge accounting and expects to issue an ED in Q4 2010. One of its objectives is to reduce the complexity of hedge accounting documentation and effectiveness testing.

Insurers may hold derivatives (or other hedging instruments) to manage risk, but the extent to which they use hedge accounting varies widely. Insurers often hold financial assets and investment contracts at FVTPL, this can result in a 'natural offset' in the profit or loss without the need for hedge accounting. However, the changes to hedge accounting may have a greater impact where insurers hold financial assets or liabilities at amortised cost or where insurers wish to hedge future cash flows.

The potential changes in hedge accounting may offer different and/or new opportunities utilise hedge accounting, together with the changes in accounting that result from adopting IFRS 9 and the insurance standard when issued.

Offsetting

ED expected Q4 2010	Final IFRS expected Q2 2011	Effective date TBC
---------------------	-----------------------------	--------------------

The IASB is planning on issuing an ED in Q4 2010 in response to stakeholders' concerns. The ED is

expected to propose changes to address differences between IFRS and US GAAP on balance sheet netting of derivative contracts and other financial instruments.

Under IFRS and US GAAP, an entity can generally only net a recognised financial asset and financial liability if the entity has a legally enforceable (unconditional) right to offset and intends to offset those positions. However, US GAAP has an exception that permits the netting of derivative balances if they are transacted with the same counterparty under a master netting agreement. Any insurers that have derivatives held under master netting agreements should continue to monitor this project. No decisions have been made to date.

This project will not impact reinsurance assets and liabilities. These are within the scope of the insurance ED, which continues to prohibit offsetting of reinsurance assets against reinsurance liabilities, or reinsurance income against reinsurance expense.

FV measurement

ED issued May 2009, and June 2010	Final IFRS expected Q1 2011	Effective date TBC
-----------------------------------	-----------------------------	--------------------

The IASB has been working with the FASB to produce a converged standard on fair value measurement. Many insurers measure financial assets at fair value and they also may measure investment contract liabilities at fair value. We do not expect the final fair value measurement standard itself to require significant changes in how insurers determine the fair value of their financial instruments, with a couple of exceptions.

Insurers would no longer need to determine the fair value of their assets and liabilities using bid or ask prices in specific circumstances. Judgement could be used to determine the price within the bid-ask spread that best

represents the fair value of the asset or liability. Insurers may wish to use the mid price to establish the value of their assets or liabilities (that is, the mid point between the bid and offer price quote in the market).

In addition, the IASB has re-exposed its proposals for fair value measurement disclosures, which if retained would require significant additional effort to prepare. The ED puts forward an additional requirement for the entity to consider the expected effect of correlation between inputs when performing the uncertainty analysis. In other words, it would no longer be possible to ignore the interdependencies between input variables for assets and liabilities measured at fair value and categorised in Level 3 of the fair value hierarchy.

It is not yet clear what the effective date of these requirements will be; however, insurers should continue to monitor the progress of this project.

Consolidations

ED issued	Final IFRS expected	Effective date TBC
December 2008	Q4 2010	

The consolidation standard will replace IAS 27, 'Consolidated and separate financial statements', and SIC-12, 'Consolidation – special purpose entities' (SPEs). The IASB has published a staff draft that includes their decisions following comment letters and the redeliberations of ED 10, 'Consolidated financial statements', which was published in December 2008 (see the main edition of *IFRS news*, October 2010, p1).

The IASB's staff draft of the proposed new consolidation standard changes the definition of control so that the same criteria are applied to all entities (both operating and SPEs) to determine control. The definition will be supported by application guidance that addresses the ways in which a reporting entity (investor) might

control another entity (investee). The fact that control is intended to be temporary does not obviate the requirement to consolidate any investee under the control of the investor. These definitions and guidance will be relevant for insurers in determining whether to consolidate investments in vehicles such as unit trusts, funds or other collective investment schemes.

The IASB plans to issue its final standard in the fourth quarter of 2010. Insurers may need to reconsider some of their consolidation decisions once the final requirements are known.

Separately, the IASB plans to add guidance to the consolidation standard on investment entities. It is likely to propose that investment entities should not consolidate entities that they control but should measure them as single assets at FVTPL. This may have limited impact on insurance entities that own funds because the proposals will require a wide range of investors for qualification as an investment entity. An ED is expected in the fourth quarter of 2010.

Revenue recognition

ED issued	Final IFRS expected	Effective date TBC
June 2010	Q2 2011	

The revenue recognition ED does not apply to insurance contracts but will apply to non-insurance activities the insurer undertakes – for example, asset management services. Details of the revenue recognition ED are in *IFRS news*, July/August 2010, p1. A key impact of the ED for insurers is a potential change to the accounting for the costs of acquiring investment contracts. Insurers can currently defer certain costs incurred to acquire investment contracts – for example, direct incremental broker commissions. However, the revenue ED would require all costs to obtain a contract (for example selling, marketing and advertising costs) to be expensed as

incurred. This would result in insurers having different treatment of acquisition costs for insurance contracts (treated as a contractual cash flow and therefore reducing the residual margin) and investment contracts (expensed to profit and loss immediately).

Effective dates and transition methods

The IASB issued a request for views on effective dates and transition methods in October 2010. It recognises the potential challenges for entities in implementing the large number of substantial new standards that are due to be finalised and applicable over the next few years.

The IASB is seeking views on issues including: how long is needed to prepare for the new standards, whether application should be retrospective and whether entities prefer a single 'big bang' date of application for all new standards or a phased approach over a number of years. The following standards are included in the request for views: fair value measurement, financial instruments (IFRS 9), revenue, insurance contracts, leases, amendments to IAS 19, 'Post-employment benefits', and to IAS 1, 'Presentation', regarding the presentation of items in other comprehensive income.

The comment letter period closes 31 January 2011. The views expressed will influence the Board's decision on the application date of the insurance contract and financial instruments standards among others; we therefore encourage insurers to respond.

Other developments

If the above is not enough, there are a few other projects on the IASB's agenda due to be completed by June 2011 on leasing, pensions and non-financial liabilities that may also impact insurers' financial reporting.