

Setting the standard How to make the proposed new insurance accounting standard more useful

*Exploring our response to
the latest proposals for
the future of insurance
reporting from the IASB
and FASB*

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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 summarises our comment letter on the latest proposals for the future of insurance reporting published by the International Accounting Standards Board (IASB) in July 2010. We've also outlined our additional comments on the discussion paper (DP) published by the US Financial Accounting Standards Board (FASB) in September 2010, which seeks views on the IASB exposure draft (ED), as well as 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 specialising in the industry, along with discussions with users, clients and insurers 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 has 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') don't 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 concept in the previous IASB DP.

We recognise 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 finalising the standard.

'...we recommend the Board work closely with the insurance industry to comprehensively test the proposals...'

From PwC's response to IASB exposure draft

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 summarised below and set out in more detail in the subsequent sections.

Key points

Discount rate

While we support the use of a discount rate that reflects the characteristics of the insurance contract liability, we realise that the use of a discount rate that excludes credit risk may result in the recognition of a day one accounting loss. We also support an option to lock in the discount rate which could alleviate the potential mismatch between insurance liabilities and assets held to back them that are measured at amortised 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 amortisation method and recognition of changes in estimates will recognise the profit 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 12 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 significant interdependent account balances.

Transition

We disagree with not recognising any residual margin on transition and would support full retrospective application unless impracticable.

Presentation

We support the summarised margin approach, but recommend the disclosure of 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 in the markets that use US GAAP. We don't believe the 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 contract standards to warrant its adoption in the US.

Summary of our comments on the proposed measurement model

Introduction

The IASB's proposals for the measurement of insurance contracts were outlined in the ED that was issued on 30 July 2010. We summarised the main proposals in our Practical Guide to IFRS, issued on 23 August 2010.

In the three years since the publication of the IASB's DP, both boards, the industry and ourselves have been continuing to discuss the accounting for insurance contracts. As a result of these discussions some of our views have changed and we're also pleased to note that a lot of our comments on the IASB's DP proposals have been reflected in the ED. In our response to the IASB on the ED we support the use of a fulfilment 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.

Discount rate

We agree that the discount rate used by the insurer should reflect the characteristics of the insurance contract liability. We believe that in a measurement model with a fulfilment 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're not expected to be realised 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. However it's unclear to us whether this will occur often enough to cause concern. We believe the boards should assess the prevalence and significance of such apparently uneconomic outcomes to determine whether an exception to the overall model is warranted. Alternatively, the IASB may find that the concerns can be addressed through additional disclosure.

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

From PwC's response to IASB exposure draft

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-tradeable 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 IASB's 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 amortised 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 amortised 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 judgemental cash flow estimates and the fact that 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 amortisation and potentially remeasurement. An added benefit for insurers in some jurisdictions is the closer alignment with the regulatory regimes that also require the calculation of explicit risk adjustments.

'...work closely with the insurance industry to understand the practical implications and operability of both the explicit risk adjustment and the alternative composite margin model...'

From PwC's response to IASB exposure draft

However, these benefits are offset by the potential lack of comparability and consistency without introducing rules 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 fulfilment 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 IASB and FASB 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're concerned that the proposed model may not produce comparable results among insurers and that the proposed amortisation methods for both the residual margin (in the risk adjustment model) and the composite margin (in the alternative model proposed by FASB) may not recognise 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.

We believe 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 don't support the disclosure of confidence level information as a 'comparable benchmark' as this could be misleading when the pattern of your claims is not a normal distribution.

Residual margin and reporting changes in circumstances

We supported the recognition of a net day one gain at the IASB's DP stage because the gain results from agreeing the contractual terms and conditions and is independent of any release from risk. Although that is still a valid argument, we now agree that no gain should be recognised 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 don't agree with the principle that the residual margin should be recognised 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're unable to propose a specific amortisation 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.

'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

Taking changes in estimates immediately to the income statement will increase volatility which may raise concern from users about an entity's performance over both the short and long term. 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 (remeasured) as at inception of the contract and amortised 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 recognising the entire change in estimates in the current period income statement followed by the continued amortisation 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 a recalibration 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 also don't 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 permitting the use of the modified measurement approach for all 12 month contracts as a practical expedient.

Our comments on other areas of the exposure draft proposals

Unbundling

We believe it's 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

analysing 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.

'...an insurance contract is difficult or sometimes impossible to analyse and separate into its individual parts...'

From PwC's response to IASB exposure draft

Investment contracts with discretionary participating features

Consistent with our views on the IASB's DP, we don't believe that investment contracts with discretionary participation features should be in the scope of the insurance contracts standard in the longer term as they don't transfer significant insurance risk. However, while we believe these should be accounted for as financial instruments, we realise 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 IAS 32. 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 decision not to issue an ED on that project in the near future, we recommend that these contracts are all included within the scope of the insurance contracts standard as an interim measure.

Financial guarantee contracts

It all depends on who you talk to... In our discussions with insurers that write credit insurance business, it's clear they don't for a minute believe these contracts should be outside the scope of the insurance standard. However, talking to their banking counterparts that issue both credit derivatives and financial guarantee contracts, they don't distinguish between the two types of contracts in any way. They perceive the risk arising on the two contracts in the same way.

On balance and after much debate we concluded that we don't 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 financial assets impairment project. However, we recognise that this solution will be a concern for credit insurers and suggest that the IASB consults further with them to identify whether these products can be distinguished in some way from those more commonly issued by banks or other entities. An advantage of including these contracts in the financial asset impairment project is that group companies that enter into intra-group financial guarantees will not be required to use the insurance contract measurement model.

Transition

Although we support the IASB's proposal that the standard should be applied retrospectively, we don't support its proposal not to recognise 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 recognised 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. We therefore 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.

'Such an approach would distort an insurer's reported income for years into the future.'

From PwC's response to IASB exposure draft

Boundary of the contract

We agree with the contract boundary principle proposed by the IASB. 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. At the IASB's DP stage we supported a principle that includes all estimated future contractual cash flows that have commercial substance (those that the insurer can expect to receive or pay during the period of the contract when it is in the policyholder's interests to continue to make payments). However, we recognise that the insurance industry has worked with the IASB to determine the current definition of the contract boundary that reflects the substance of its contracts.

However, we believe the IASB 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 and 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.

Presentation and disclosure

We continue to believe that the summarised 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. We therefore recommend that the IASB specify the disclosure of volume measures, such as annualised 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.

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 don't 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 recognised at inception of an onerous contract. We are concerned that this proposal could encourage the structuring of reinsurance transactions to allow cedants to recognise immediate gains on entering into a reinsurance contract.

'...this could encourage the structuring of reinsurance transactions...'

From PwC's response to IASB exposure draft

Acquisition costs

We believe that a mismatch between acquisition costs incurred and premiums charged to reimburse these costs should be avoided where possible. In a model that recognises day one gains, as previously proposed in the DP, we supported the recognition of acquisition costs in the income statement when incurred due to the inherent reimbursement of these costs that are included in future premiums that would implicitly be recognised as part of that day one gain. Given the explanation above as to why we no longer support the recognition of day one gains, we believe insurers should not recognise 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.

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 in the markets that use US GAAP. Thus we believe the boards need to resolve their remaining differences on this project and finalise 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 don't believe the 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.

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

From PwC's response to FASB discussion paper

Contact us

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 PwC.

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Recent insurance-related publications



Practical guide to IFRS – Insurance contracts August 2010

This publication explores the proposed standard and the implications following the release of the

IASB's exposure draft on insurance contracts on 30 July 2010.



First steps and challenges in implementing Solvency II and IFRS in parallel 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.

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