

Insurance Accounting Newsletter Insurance Working Group meeting



The Insurance Working Group (IWG) of the International Accounting Standards Board (IASB) met for two days in London on the 29 and 30 June 2009. This special issue of our Insurance Accounting Newsletter reports on the salient issues discussed. We have highlighted our own understanding of the areas where IWG members expressed their support for the decisions reached so far and the issues that continue to present a more problematic solution ahead of the crucial Board meeting week of late July 2009.

Introduction and background

The IWG was established in September 2004 and it has provided the IASB with the views of the top CFOs from the insurance industry, key representatives of the investor community, the actuarial profession, regulators and audit firms (see full membership list in the appendix). The IWG meetings are always chaired by the IASB Chairman or one of his fellow board members (Warren McGregor chaired this meeting) and their comments have constituted a very important source of input for discussion at the IASB meetings over the last five years.

The June IWG meeting was held at a crucial junction of the IASB process to deliver the new IFRS for insurance contracts and the agenda was particularly full. In this newsletter we cover most of the agenda items:

- Insurance contracts project timetable, update on other IASB and FASB projects relevant to insurers and field testing programmes.
- Financial instruments accounting.
- Investors' views on the future insurance accounting standard.
- Measurement models for insurance contracts.
- Acquisition costs and new business revenue.
- Presentation and disclosure issues.

In addition the IAA gave an update on its work on the valuation of risk margins.

Project timetable

The final standard should not be delayed beyond mid 2011. There are still many issues for the IASB and FASB to resolve. Therefore publication of the ED in February 2010 with a comment deadline of June 2010 was suggested.

The IWG was presented with the IASB decision to reject the staff proposal for a delayed publication of the Exposure Draft (ED). The consensus that seemed to have emerged among the IWG members was that the publication of the final standard should not be delayed beyond mid 2011. Therefore the IASB proposal to issue the ED in December 2009 rather than April 2010 (as per timetable presented by the Staff in June) was generally welcomed. However, it was noted that there are still many issues for the IASB and the FASB to resolve before the ED can be issued. Furthermore, several commented that given the insurance companies would need to give their attention to finalising the publication of their year end results in January and February, a small delay on the publication of the ED to the end of February with a comment deadline of 30 June 2010 could be the optimal compromise allowing the discussion to finalise the ED to be more comprehensive.

IWG members also suggested the IASB may wish to consider longer sessions to cover more insurance issues together.

During the session on the other IASB projects IWG members paid particular attention to the IASB debate on the measurement of liabilities under IAS 37 and the progress on a new revenue accounting standard.

With respect to the IAS 37 project some IWG members expressed the view that the IASB should re-expose the amendments to IAS 37 Liabilities because of the significant changes approved compared to the text published in 2005.

The majority of IWG members commented that the proposed Revenue Recognition model locks the measurement into the customer consideration received and does not include any reassessment of future cash flows as revenue is earned unless the contract becomes onerous. For this reason most IWG members considered the proposed Revenue Recognition model unsuitable for insurance contracts as insurance cash flows are highly variable and any locked in approach would produce representationally unfaithful financial information.

The IASB has yet to decide whether insurance contracts will be outside the scope of the new Revenue Recognition standard.

There was general support for the IASB's proposal for targeted field testing to commence before the ED is issued. The view was also that more detailed field testing should be carried out after the ED is issued but before the publication of the IFRS.

Financial instruments

Insurers need the two new standards on financial instruments and insurance contracts to dovetail to minimise accounting mismatch between them.

IASB staff presented an update on the Exposure Draft that will change classification and measurement for financial instruments¹.

The key concern raised is that the proposals to simplify the classification and measurement of debt instruments to permit only amortised cost (AC) or Fair Value through Profit & Loss (FVTPL), and eliminating the current Available for Sale (AFS) classification, could lead to new accounting mismatch issues.

In summary the major concerns raised were:

- the proposed new AC category for basic fixed interest rate bonds will produce a bigger accounting mismatch as the IFRS 4 Phase II will require insurance liabilities to be constantly revalued in line to current market interest rates. Insurers at the IWG indicated that the current AFS category would have allowed them to mitigate better this situation via the recycling of gains to income statement, an option that will no longer exist under the proposed new IAS 39;
- the elimination of AFS for debt instruments would increase accounting volatility since it may force insurers to designate their debt portfolios to the FVTPL category bringing through income all fair value changes on these assets, even those that would not be reflected in the liability measurement (e.g. the impact on debt illiquidity spreads that would not necessarily be reflected in the liability discount rates); and
- the new category for equity securities, Fair Value Through Other Comprehensive Income, where all fair value changes and dividends will never be recycled through income, would require the reconsideration of the IFRS 4 Phase II principle that all changes in the carrying amount of insurance liabilities must be accounted for through the income statement.

¹ The Exposure Draft was issued on 14 July 2009. See IASPlus link [<http://www.iasplus.com/pressrel/0907financialinstrumentsed.pdf>]

Insurers at the IWG warned the IASB that it is conceivable these accounting changes could produce economic decisions motivated purely to avoid accounting consequences. For example, it was noted that participating contract liabilities in Europe are currently not fair valued and therefore eliminating AFS for debt investments will mean significant income statement mismatch compared to what can be achieved with the AFS category.

As a general comment on the due process to change IAS 39, insurers at the IWG noted that their industry is one of the largest purchasers of financial instruments and that they felt to have been underrepresented in the IAS 39 debate to date.

From a general view point, IWG members welcomed the proposal for a less restrictive set of conditions around the use of AC than the current "Held-To-Maturity" tainting provisions. The new condition for the investor to manage the debt investment "on a contractual yield basis" is likely to be satisfied by most assets held to match annuities. However some questions were raised as to how this condition could be satisfied where there are sales of investments not directly linked to changes in the liability profile.

IWG members also questioned the proposal that only the most senior layer of a structured bond waterfall would be eligible for the AC category as all other layers provide some form of credit protection to more senior layers and would need to be accounted at FVTPL. It was suggested that the distinction should take into account bond rating as "investment grade" or similar characteristics to lead to that classification.

Finally, Australian IWG members observed that a move away from FVTPL for investments accounting would be seen as a backward step in Australia where insurers are already extensively using the FVTPL basis across all asset classes.

Investors' views

In deciding on the features of the new accounting model for insurance contracts there is an important trade off between simplicity, transparency and understandability on one side, and a model that is theoretically correct but complex and with subjective application in practice on the other.

There was general consensus that the current complexity of insurance reporting (particularly life insurance) detracts from the perceived value of insurance companies by investors.

Some of the points discussed at the meeting were:

- Co-mingling of policyholder and shareholder cash flows, income/expense and the different characteristics of various life insurance products reduce transparency of life insurer performance statements.
- The proposed accounting model must produce more readily understandable financial statements that support the measurement and presentation of the drivers of insurers' profitability.
- There is a perception that the model eventually selected for insurance accounting will be overly complex. In deciding on the features of the new accounting model for insurance contracts the IASB should consider the trade off between simplicity, transparency and understandability and a model that is theoretically correct but complex and with subjective application in practice.

Measurement of insurance contracts

IFRS 4 Phase II based on the IAS37 measurement attribute

There was general support for using the IAS37 measurement attribute to finalise the IFRS 4 Phase II project although it was noted that its application to insurance has to be outlined more fully and considered by the IASB and FASB.

There was general support for the rejection of the Current Exit Price measurement attribute and for the decision to use the IAS 37 measurement attribute proposed by the IASB although it was noted that its application to insurance has to be outlined more fully and considered by the IASB and FASB. Because of this lack of detailed understanding, IWG members suggested that it may be premature to reject the Current Fulfilment Value "candidate 3" (that with a separate risk margin), until the IAS 37 measurement basis applicable to insurance contracts is developed further.

IWG members suggested to the IASB that it should conduct urgent work on the application of the IAS 37 measurement attribute to insurance in the following areas:

- own credit risk – suggesting that this should not be taken into account as the measurement attribute is not a fair value basis;

- risk margin – clarifying whether the principle to be applied is the cost or compensation for bearing risk and whether, if compensation is selected, it should essentially measure the profit the insurer would require for accepting risk;
- cancellation and renewal options – clarifying that the IAS37 attribute is compatible with the decision on cancellation and renewal options and the recognition of an insurance contract asset in certain situations (e.g. long term regular premium contracts at initial recognition); and
- participating and universal life contracts – testing that the application of the IAS37 attribute to these transactions does not create representationally unfaithful accounting results.

Margins

Most favoured a remeasured risk margin calculated on a cost of capital basis with a residual margin recognised to eliminate any day 1 profit and earned through income subsequently.

Many IWG members supported a model inclusive of an actively measured risk margin to capture the different uncertainty of different insurance liabilities. Cost of capital appeared to be the favourite choice of those IWG members in this particular camp.

Some IWG members noted that a measurement model such as the proposed IAS 37 with three margins (risk, service and residual) may be overly complex and would have favoured the simplicity offered under the Current Fulfilment Value with a composite margin (known as “candidate 4”). However, others noted that the components of any composite margin are so diverse that merging them into one margin liability would make any subsequent earning pattern potentially arbitrary.

There was no consensus on the earning pattern other than it would need to consider the timing of risk release.

Effect of subsequent changes in cash flow estimates on the earning of the residual margin

Adjusting residual margins for subsequent changes in estimates is one of the unresolved issues to complete the work on IFRS 4 Phase II. The practical application issues could weigh in favour of a simpler alternative of not adjusting residual margin earning patterns for subsequent changes in estimates.

Most IWG members noted that the residual margin should not be accounted for as a shock absorber. According to those individuals the effect of changes in all estimates should be recognised as they arise rather than offset against a residual margin. However the discussion did not produce a favoured approach and the issue remains the last major issue on the path to completing the development of the new IFRS 4 Phase II.

Acquisition costs

While the majority of IWG members concurred with the IASB tentative decision to recognise new business revenue, there was a recommendation from several IWG members to consider a definition of the acquisition costs considered in the initial calibration that effectively deliver the fundamental principle of an IFRS that produces similar contract liabilities irrespectively of the distribution channel chosen.

IWG members expressed their preference for the IASB approach rather than for the FASB decision not to recognise revenue to match the acquisition costs expensed and thus producing different insurance contract liabilities purely because of the different distribution channel chosen.

Some IWG members wary of the possibility of the reversal of the IASB decision at the future joint meeting with FASB suggested that, in that case, acquisition costs could be considered as part of the same unit of account as the insurance contract cash flows with a corresponding adjustment to reduce the residual margin.

IWG members offered to the IASB their advice on the effectiveness of the narrow definition of acquisition costs adopted last April. They explained that to achieve the fundamental principle of equal measurement at the point of sale for equal contractual rights and obligation, a definition aligned with the FAS 91 approach would be more effective than the current tentative basis that considers only incremental costs. The FAS 91 basis includes all costs directly attributable to the issuance of an insurance contract without imposing an test on their incremental nature.

Presentation and disclosure

There was general support for retaining premiums and claims presentation as revenues and expenses for property and casualty business and life protection business. However there was an acknowledgement that this approach presents clear shortcoming when applied to life products with significant deposit components.

Investors at the IWG recommended addressing the current disclosure problems with the requirement of:

- enhanced segmental reporting where different bases more appropriate to each segment should be permitted;
- consistent disclosure of the amount and basis of risk margins; and
- information on the earning patterns of risk and residual margins.

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The discussion seemed to suggest that the income statement of an insurer with all these different types of product may not provide meaningful presentation if the preferred basis was adopted as the single approach. Some suggested that an IFRS with more focus on segmental reporting by category of business that could be provided on different bases would offer a more appropriate presentation basis at each segment. Another suggestion on presentation was the consideration of separate presentation of policyholder and shareholder income, expense and cash flows to make it easier to use life insurers' financial statements.

We note that IWG members did not support any requirement to unbundle insurance products due to a number of practical problems that would make the costs outweigh the benefits of a more precise financial presentation in the income statement.

On the subject of disclosure, IWG members from the investors' community demanded clear disclosure of the amount and basis of risk margins as well as information on the earning patterns of both risk and residual margins.

The Australian non life run off triangles disclosed both before and after the application of risk margins were noted as another example of appropriate disclosure in the context of a three-building-blocks accounting model.

It was noted that the next IWG meeting may not be held until after the Exposure Draft is issued but the IASB may wish to consult with IWG members on specific issues before the Exposure Draft is issued.

Appendix – IWG membership

Name	Title	Company
Norbert Barth	Senior Analyst – Equity Research	DZ Bank AG – Germany
Albert Benchimol	Chief Financial Officer	PartnerRe Ltd – Bermuda
Tony Coleman	Director	Lonergan Edwards & Associates – Australia
Andrew Crean	Managing Director	Autonomous Research LLP
Jerry de St Paer	Executive Chairman	Group of North American Insurance Enterprises – United States
Denis Duverne	Chief Financial Officer	Axa – France
Frank Ellenbuenger	Global Head of Insurance	KPMG – Germany
Sam Gutterman	Chair of Insurance Accounting Committee	International Actuarial Association – International (United States)
Toshiyuki Hanazawa	General Manager – Accounting Department	Sompo Japan Insurance – Japan
Bradley Hunkler	Vice President and Controller	Western and Southern Financial Group – United States
Rob Jones	Managing Director	Standard & Poors – United Kingdom
Tom Kornya	Partner	Ernst & Young – Canada
Maurizio Lualdi	Senior Associate – Insurance Sector	Capital Research Global Investors – United Kingdom
Martin Müller	Chief Accounting Officer – Managing Director	Swiss Re – Switzerland
Jan Nooitgedagt	Chief Financial Officer	Aegon – The Netherlands
Andrew Palmer	Group Director (Finance)	Legal & General – United Kingdom
Hitesh Patel	Finance Director	Lucida Plc – United Kingdom
Helmut Perlet	Chief Financial Officer	Allianz – Germany
Peter Rubenovitch	Chief Financial Officer	Manulife Financial – Canada
Jörg Schneider	Chief Financial Officer	Munich Re – Germany
Brian Shea	Managing Director	Merrill Lynch – United Kingdom
Yasunori Tanimoto	General Manager Planning & Research Department	Nippon Life Insurance – Japan
David A. Wheat	Executive Vice President & Chief Financial Officer	ING Americas – United States
Alan Zimmerman	US Director of Research	Fox-Pitt Kelton – United States

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