

IMU special edition

Phase II of IFRS for Insurance Contracts – IASB Discussion Paper



Welcome to this special edition of the Insurance Market Update

On 3 May 2007, the International Accounting Standards Board ("the Board") released for comment a Discussion Paper on accounting for insurance and reinsurance contracts entitled 'Preliminary Views on Insurance Contracts' ("the DP"). This is the second phase of the insurance contracts project which in 2005 introduced IFRS 4 – the International Financial Reporting Standard for Insurance Contracts.

The proposals set out in the DP would introduce fundamental changes to insurance accounting and focus on market consistent measurement of insurance liabilities. This will impact the way investors, regulators and other stakeholders assess the insurance industry.

This special edition of the Insurance Market Update, prepared by our Insurance Centre of Excellence, summarises and comments on the measurement issues raised in the DP. Subsequent editions will address the other principal topics covered in the DP. We hope you find it useful and informative and would encourage insurers to provide practical observations and comments to the Board by the 16 November 2007. An Exposure Draft ("ED") is expected to be issued in late 2008 with the final standard on accounting for insurance contracts in place during 2010.

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Overall comment

We welcome progress and are generally supportive of the overall approach of valuing insurance liabilities on a market consistent basis. The current exit value ("CEV") approach proposed in the DP raises many questions the industry will need to consider and it is important that market participants continue to provide input in the development of the principles into a standard across the life and non-life insurance industry. This, along with the emergence of detailed guidance, will no doubt generate much debate as insurers, users of accounts, industry regulators and other accounting standard setters, such as the US Financial Accounting Standards Board, deliberate and comment on the proposals.

Key implications and issues for consideration will be:

- the application of discounting for insurance cash flows (including non-life liabilities) and the selection of the related discount rates;
- the requirement to consider all possible cash flows in deriving probability weighted expected mean average cash flows;
- development of industry market practice for the determination of market consistent risk margins and service margins;
- whether an overall insurer's risk margin should take into account portfolio diversification;
- the risk and service margins established at inception may, in certain circumstances, allow an insurer to report a profit or loss on inception of the insurance business;
- the volatility of insurer liabilities and the resultant profits and losses that will arise as market consistent discount rates and estimates of risk and service margin change after inception;
- the subjectivity of many of the estimates required and the likely range of acceptable estimates will present challenges for directors and auditors in determining the appropriateness of the overall estimates for insurance liabilities;
- detailed disclosure of the assumptions and methodologies used to calculate risk and service margins will be crucial to the effect of market disclosure in promoting the development of established industry practice for the consistent estimation of these margins;
- whether accounting differences between the CEV proposals and the IAS18 requirements for investment contracts should be eliminated and if not, whether the increased cost and complexity of unbundling insurance and investment contracts would be justified;
- whether the CEV should reflect the credit characteristics of the insurer or be estimated on a consistent basis by all insurers;
- convergence of accounting, regulatory, pricing and risk management modelling of insurance liabilities so that the basic modelling techniques can be embedded within the business and deliver consistency of reporting and measurement;
- introducing new accounting systems to determine CEV will be costly but they will be likely to be more cost effective if they can be utilised throughout the business, not just for financial reporting; and
- the need for insurers to educate users of financial statements on the implications of applying this new reporting model to their particular business.

Introduction and background

The IASB insurance project aims to establish a common standard for financial reporting of insurance contracts, based on a form of "fair value". Phase I of the project (IFRS 4) provides a specific definition of an insurance contract, temporary dispensations from certain standards, and guidance on implementing current standards not covered by the dispensations. IFRS 4 was designed to enable insurance companies to report under IFRS by 2005. Phase II of the project is the introduction of a comprehensive IFRS dealing with the recognition and measurement of insurance contracts.

Under Phase I there is currently no globally accepted insurance accounting practice and insurance contracts are not dealt with elsewhere in the body of International Financial Reporting Standards (IFRS). Differences in insurance accounting between some countries are material, making it difficult for users of financial statements to compare and understand results of insurance businesses worldwide. This, together with the complexity of insurance and the current attention focused on corporate accounting integrity, brings a need for a common financial reporting basis for insurance business. Another incentive for change has been the concern raised over the lack of transparency in existing bases of accounting for insurance. Stakeholders are demanding more information as to how insurance business and its inherent risks are managed and mitigated.

Overview of the Discussion Paper

The DP outlines the Board's preliminary views on the main components of the Phase II accounting model for all insurance contracts, including life, non-life, direct insurance and reinsurance. It sets out twenty specific questions and highlights a variety of issues, some controversial; following a six months consultation closing on 16 November 2007, an ED is expected to be issued late in 2008. This ED will expose the comprehensive standard on the recognition and measurement for insurance contracts based on a "current exit value" basis. The final standard, expected to be issued in 2010, will replace the temporary dispensations and interim accounting standard developed in IFRS 4.

The DP focuses on the measurement of insurance liabilities and the need for an approach that will provide more relevant information on the amount, timing and uncertainty of future cashflows, a consistent approach to changes in estimates, consistency of approach to all types of insurance and reinsurance for both life and non-life contracts, and consistency with other IFRS. It does not redefine the definition of insurance as set out in IFRS 4 but adds that the proposed ED will expose the current definition to further comment. The DP also briefly touches on the recognition and derecognition criteria for insurance liabilities i.e. recognition of the rights and obligations when the insurer becomes a party to the contract and derecognition when any specified obligation is discharged, cancelled or expired.

The DP essentially covers four principal topics: measurement – core issues (chapter 3) and other issues (chapter 5), policyholder behaviour, customer relationships and acquisition costs (chapter 4), policyholder participation (chapter 6) and changes in insurance liabilities (chapter 7). In this edition we focus on the measurement issues, and subsequent editions will address the other three principal topics.

Measurement – core issues

The main proposition in the DP is that all insurance liabilities (including life, non-life, direct insurance and reinsurance) should be measured at current exit value ("CEV") using the following three building blocks:

- I. Current estimates:** explicit, unbiased, market-consistent, probability weighted and current estimates of the contractual cash flows;
- II. Time value of money:** current market discount rates that adjust the estimated future cash flows for the time value of money; and
- III. Margins:** an explicit and unbiased estimate of the margin that market participants require for bearing risk (risk margin) and for providing other services, if any (service margin).

CEV is defined as the amount an insurer would expect to pay at the reporting date to transfer its remaining contractual rights and obligations immediately to another entity. Typically, the CEV of an insurance liability is not observable so it must be estimated using the three building blocks described above. The purpose of this measurement attribute is to provide useful information that will help users make economic decisions.

The following sections examine each building block of the CEV model individually.

I. Estimates of future cash flows

The Board's view is that estimates of future cash flows used to measure insurance liabilities should:

- be **explicit**;
- be as consistent as possible with observable **market** prices;
- incorporate all available information about the amount, timing and uncertainty of all cash flows arising from the contractual obligations, in an **unbiased** way;
- be **current**, that is correspond to conditions at the end of the reporting period; and
- exclude **entity-specific** cash flows.

We now look at each component underlying the Board's view on estimates of future cash flows, expand on these by exploring possible consequences on the business and consider some of the practical issues.

Explicit: The use of explicit estimates¹ would provide a more accurate representation of the insurers' obligations to policyholders. The information resulting from using explicit estimates would make it easier for users to understand and compare with other liabilities, such as "provisions" and "employee benefits", which are accounted for using other IFRSs.

Unbiased: The measurement should start with an estimate of the expected present value² (PV) of the cash flows generated by the contract. Furthermore, when estimating the PV using all the possible scenarios, each of these should be neutral, i.e. the estimates and their probability should not include a margin for prudence or optimism.

¹ Estimates calculated by reference to the expected cash flows rather than as prudent estimates based on other factors.

² The expected present value is the probability-weighted mean average of the present value of the cash flows.

Consistency with observed market prices: More relevant and reliable measurements will result from using inputs consistent with observed market prices. Examples of such observable inputs are interest rates and mortality rates for which industry standard tables are used across companies. In developing estimates that are observable from market transactions, insurers will need to consider all available data, external and internal, ensuring the resulting assumptions do not contradict current market variables. This is achievable for estimates of variables which are clearly observable in the market. However, this may be difficult to demonstrate where there is no readily observable market such as obtaining a "market value" for service margins.

Current estimates: The approach to estimate cash flows for claims liabilities should use all currently available information as opposed to using a "lock in"³ approach. The view is that it gives more faithful representation of the insurer's contractual obligations and rights, and provides more useful information about the amounts, timing and uncertainty of the cash flows generated by the contract. Using current estimates avoids the need for a separate liability adequacy test⁴ and may also reduce the need to separate embedded derivatives. Another advantage noted by the Board is the improved consistency with other IFRSs that use current estimates of future cash flows, such as IAS37 and IAS39. This is discussed more at length in the "Assets backing insurance contracts" section.

Entity-specific cash flows: The measurement of an insurance liability should reflect the cash flows generated by that liability, without taking into account those generated by other assets and liabilities or resulting from internal synergies. Two different insurers reserving for an identical contract should arrive at the same measurement of the liability borne from the obligations of that contract. "Entity-specific" should not be confused with "portfolio-specific". For example, estimated mortality related cash flows are portfolio specific and may differ from one company to another for an otherwise identical contract, simply because the insured population characteristics differ between the companies.

Current estimates – Implications for insurers

- Calculating the expected PV of all the cash flows arising from a contract means an insurer will have to take into account all possible scenarios, including unlikely ones, determine the PV of the cash flows in that scenario and then make an unbiased estimate of the probability of that scenario occurring.
- Until recently, many accounting models did not attribute a value to guarantees that are embedded in insurance contracts if those were out of the money⁵ at the reporting date. However, these guarantees may have a time value to the policyholder as they may become in the money some time before the expiry of the contract. Using an expected PV approach implies that future cash flows will need to consider the scenarios in which the guarantees/options are in the money as well as out of the money before expiry.
- Using current estimates will require insurers to consider actively whether circumstances have changed and review assumptions accordingly. Another impact of using current estimates is instant recognition of profit or loss rather than recognising it over time, as it is done currently in many existing insurance accounting approaches. This approach should lead to more frequent, but smaller, changes in the carrying amount of insurance liabilities.



Current estimates – Considerations

Having to use inputs that are, as far as possible, consistent with observed market prices raises some practical issues. Interest rates assumptions are easily derived from an observed market however, significant assumptions (e.g. lapses, claims severity) used in valuing insurance liabilities cannot be observed from market prices.

The Board's view is that inputs used to develop cash flows should, as far as possible, be consistent with observed market prices. The principal cash outflows relate to claims, for which the underlying variables such as claims frequency do not have market prices. For some classes of insurance e.g. direct motor, "market" estimates are available for claims frequency, claims inflation, etc., although portfolio-specific variables may not be readily available. For many other classes and sectors, there is no observable market price for cash flow inputs. Therefore, for many non-life insurance liabilities, the cash flows may be based on inputs that may not be demonstrable to be current market variables.

The expected present value is the probability-weighted mean average of the present value of the cash flows. Practically, it is difficult to estimate the mean liability if extreme tail events and data weaknesses are considered. The techniques may range from using simple scenarios for small portfolios to complex simulation models for large portfolios. Many insurers are already using an approach in areas other than for financial reporting – estimating an Individual Capital Assessment (ICA)⁶ in the UK, for example – that involve the use of explicit probability-weighted estimates. The estimation of insurance liabilities will move further from a deterministic to a stochastic basis. These approaches could be embedded further into the business operations as part of day to day management of risk and not just for financial and regulatory reporting.

³ Estimates made at inception that are locked in and ignore information that becomes available later, except for the liability adequacy test.

⁴ The Liability Adequacy Test (LAT) is a test to determine whether the carrying amount of a liability needs to be increased, based on a review of future cash flows. (The equivalent, for a liability, of an impairment test for an asset).

⁵ A guarantee is out of the money when it would not financially benefit policyholders to exercise their option.

⁶ As per FSA's regulation ... "an insurer must undertake an assessment of the adequacy of its capital resources to include all risks that, if they were to crystallise, would lead to a material reduction in the insurer's current level of capital resources, using a balance sheet on a realistic basis, for comparison with its capital resources requirement; and to include a quantitative analysis of the effects of any management actions that have been applied within the assessment of the adequacy of its capital resources, and demonstrate that the action is not precluded by weaknesses in systems and controls."

II. Time value of money

Cash flows measured on the basis that reflects the time value of money means they are discounted. The DP raises two questions under this heading: whether the carrying amount of insurance liabilities should reflect the time value of money and if it does, how should the discount rate be determined.

Life insurers are used to the concept of discounted liabilities. On the other hand, non-life insurers do not generally use discounting when valuing their claims liabilities, with the exception of a few countries or a limited range of liabilities, particularly where there is an extended settlement period.

The Board's view is that discounting should be used for all insurance liabilities, including non-life claims liabilities. Although it recognises it may cause some increase in both subjectivity and cost, the Board feels the increase in relevance resulting from discounting is greater than the drawbacks. The DP however points out that IAS8 (Accounting Policies, Changes in Accounting Estimates and Errors) would allow cash flows not to be discounted when the effect of discounting is immaterial.

When reflecting the time value of money, the discount rate should adjust estimated future cash flows in a way that captures the characteristics of the liability, not those of the assets backing the liabilities. It is the Board's view that the discount rate should therefore be consistent with observable current market prices for cash flows whose characteristics match those of the insurance liability. Whichever assets are held to back the insurance obligations, the value of those liabilities bears no relationship to these assets and therefore, it would be inappropriate to base the discount rate on the expected returns on the backing assets.

Time value of money – Implications for insurers

- General insurers will need to estimate the claim settlement pattern of all business written and determine an appropriate discount rate or yield curve.
- Life insurers currently discount their liabilities but the proposals may lead to more consistency in the selection of discount rates and yield curves used to discount liabilities.

Time value of money – Considerations

There is no intention for the final standard to include detailed guidance on how to set the discount rate. Although it is likely to be a risk-free market rate, it remains to be determined whether a swap or government bond rate would be the most appropriate.

The Board's view is that all liabilities should be discounted, regardless of the remaining term of the cash flows. Currently in most countries, non-life insurance claim liabilities are not discounted, certainly not explicitly. In some insurance markets, e.g. Lloyd's, discounting is not permitted.

For non-life insurance, the impact of discounting may not be material for many short-tailed portfolios. It has been argued that this would result in a disproportionate cost of estimation compared to the materiality of the discounting. However, if the effect of discounting is not material, a simplistic cost effective model could be used. There are strong arguments for discounting, such as the elimination of opportunities for transactions that make use of differences between the accounting treatment and the economic value of liabilities.

The application of discounting to all non-life insurance will increase the volatility of non-life insurers' results due to changes in the discount rate and in the estimated settlement pattern of the expected cash flows.

There is no guidance yet on whether a single discount rate or a yield curve is to be used in discounting the future cash flows. However, a single rate would be influenced by the relative size and timing of these cash flows. For non-life insurance liabilities which are subject to uncertainty in not just claims frequency but claims severity, this issue could be more significant than for life business.

III. Margins

The third building block of the CEV approach is the use of explicit margins; one for bearing risk (risk margin) and one for services provided (service margin).

Risk margins

It is the Board's view that the measurement of liabilities needs to include margins that reflect the extent of the uncertainty inherent in insurance cash flows. Its views are as follows:

The **purpose** of a risk margin is that it measures the compensation that entities demand for bearing risk, adjusting the margin at each reporting date by assessing how much risk remains in the liabilities. The risk margin that would be demanded by market participants cannot be observed in the absence of a market and will need to be **estimated** both at inception and subsequently by the insurer, based on market data and internal information on the liabilities.

When **calibrating** the risk margin, the premium paid at inception is an important reasonableness check on the initial measurement of the insurance liability. However, it should not override an unbiased estimate of the margin that market participants require for bearing risk.

The **risk margin** should provide relevant information about the uncertainty associated with future cash flows and for that to be the case, the risk margin should be an explicit and unbiased estimate of the margin market participants require for bearing risk.

Risk margins – Implications for insurers

As the risk margin cannot be observed, insurers will need to estimate it, both at inception and subsequently. The Board suggests, insurers will have to:

- assess how market participants would measure the quantity of risk, and determine the units that they would use to express it,
- use the cash flow scenarios to estimate the number of units of risk present in the liability,
- estimate the margin per unit of risk,
- multiply the estimated margin per unit by the estimated number of units to determine the aggregate margin, and
- test for possible errors and omissions by reconciling the change in the risk margin to changes in the number of units of risk and the margin per unit.

Risk Margins – Considerations:

The implementation method favoured by the Board does not prohibit **profit recognition at inception**. One of the key reasons for such profit to arise could be the ability to sustain higher pricing than other insurers require. However, even if an insurer could recognise some profit at inception, it would recognise the compensation for bearing risk, investment margin and experience adjustments as income or expense subsequent to inception.

The Board views the risk margin as compensation for bearing risk and requires it to be explicit. However, the Board does not intend to prescribe specific techniques for developing risk margins. How they should be determined is an area of much debate within both the life and non-life insurance industries, particularly with the impending arrival of the Solvency II framework. Solvency II is still developing and one of the main challenges for both CEIOPS⁷ and the Board is to minimise divergence between the two frameworks.

Although regulators in some countries already prescribe specific approaches to the setting of risk margins, further work is necessary by practitioners, such as actuaries, to develop and define approaches to determine risk margins in order to achieve greater consistency. Practically, this may yield several acceptable approaches for determining risk margins, including cost of capital, confidence levels, etc. There may be practical constraints if a single approach is used in all cases.

Risk margins should be determined for each portfolio in isolation and should not consider diversification between portfolios. This is at variance with approaches in a number of other areas, such as the calculation of regulatory capital, where diversification between portfolios is considered resulting in lower risk margins compared to the Board's proposal. A multi-line insurer, that does not benefit from diversification in its estimation of the risk margin under the Board's proposal, is at a relative disadvantage

(i.e. risk margin not as low as it could be if diversification was taken into account) compared to a mono-line insurer that would be unaffected.

Although ignoring portfolio diversification will increase the consistency of reserving for similar portfolios in different insurers it will be an area where the accounting model diverges from the realities of an insurer's business strategy.

The market does not currently provide the evidence required to implement the Board's approach, nor is it expected to do without a sufficiently liquid market in trading insurance portfolios from which such margins could be established. For insurers, a measure of risk is provided by their level of capital requirements (which the Board do not address although they may do so in their future deliberations) and in the UK we have seen this in practice in the UK regulator's move to realistic reporting and the ICA regime.

Service margins

As well as bearing risk, insurance contracts generally require an insurer to provide other services, such as investment management services in participating type contracts or claims handling costs, for which adequate compensation should be paid. Therefore, when measuring its liability, an insurer should include a service margin that market participants typically require for such services.

The Board's view is that the measurement of an insurance liability should incorporate, in addition to the margin for the service of bearing risk, an unbiased estimate of the margin, if any, that market participants would require for rendering other services. The DP notes that the CEV approach to service margin is significantly different to the IAS18 model. Under the CEV, profit may be recognised at inception and subsequent recognition of service margin is based on the margin market participants would require not the service margin implicit or explicit in the contract.

The CEV principle of excluding entity-specific cash flows means that, in measuring its insurance liability, an insurer should in theory use servicing costs that market participants would incur as opposed to its own. However, in practice, it is expected that an insurer would use its own cash flows unless there is clear evidence that it is significantly more or less efficient than other market participants, in which case the insurer would use the market's assumption.



Service margins – Implications for insurers

All expenses incurred at inception should be booked at actual cost (e.g. acquisition costs) and all services rendered after inception will be booked at the market rate using the CEV model. Therefore, if a contract includes a service margin in line with what is required by the market, the liability at inception would be the premium received less acquisition costs.

If the service margin is lower than what is required by the market, the liability recognised by the insurer is higher than what is measured and a loss is recognised at inception. Conversely, if the service margin is higher than what is required by the market, the liability is lower and a profit is recognised at inception. The profits or losses would unwind in subsequent periods. If the acquisition costs incurred are higher than those included in the contract, the additional cost would be recognised at inception.

⁷ Committee of European Insurance and Occupational Pensions Supervisors.

Service margins – Considerations

If an insurer is required to use the market's service margin because there is clear evidence it is significantly more or less efficient than other market participants, this will translate into an artificial profit or loss at inception. For example, if an insurer's inefficiency translates into a higher service cost that it cannot pass on to the policyholder (i.e. premium equals the market premium), then the effect of that higher expected service cost will not be recognised at inception. It will be recognised in later periods.

If an insurer observes that other insurers incur different servicing costs than it does, an assessment has to be made as to whether these differences are in the characteristics of the contracts or due to efficiencies. For example, an insurer would not be allowed to take advantage of efficiencies by using its lower resulting servicing costs in measuring its liability. In this case, it would have to use market costs and recognise the profits as they unwind in later periods. However, an aggressive claims management strategy leading to higher costs but lower claims could be recognised as a different characteristic and such an insurer would be permitted to recognise a different overall liability using its own claim and service margin estimates.

The practical difficulties in determining a market consistent service margin could mean that initially an insurer's estimates for service margin are likely to be significantly influenced by its expected servicing costs and its basis of pricing current business.

The differences in treatment of service margin under IAS18 and the CEV model will mean that the classification between insurance and investment business and unbundling policies are likely to have a significant effect on the reported results of insurers.

IV. Consideration of other measurement methods

Before concluding on a preliminary view of using the CEV as the measurement model, the Board considered other possibilities for a suitable insurance liability measurement attribute. We describe these in turn in the following paragraphs.

Current entry value

Two versions of the current entry value were explored by the Board. The first version was defined as the amount that the insurer would charge a policyholder today for entering into a contract with the same remaining rights and obligations as the existing contract. For various reasons outlined in the DP, the Board concluded this version would not be fruitful. The second version of the current entry value is the amount a rational insurer would charge a policyholder today for entering into a contract with the same remaining rights and obligations. This version was considered to be too close to the definition of the CEV, only differing in how the margins are determined.

Value in settlement with the policyholder

Some argue that CEV is irrelevant if an insurer does not intend to transfer the liability to another party and believe the accounting model should reflect this intention to discharge its obligation by making contractually required payments to or for the policyholder. The DP notes that in estimating the CEV, an insurer would include cash flows with the policyholder (excluding entity specific cash flows). However, the CEV risk and service margins include amounts other than cash flows with the policyholder.

Fair value

The Board published in November 2006 a Discussion Paper 'Fair Value Measurements' (FVM). It contains the unmodified text of the FASB's Statement on Financial Accounting Standards No. 157 'Fair Value Measurements' ("SFAS 157") along with the Board's views on the principal issues in SFAS 157.



The objective of the IASB's Fair Value project is to define fair value more clearly and provide guidance on measuring fair value when another standard requires its use. The Board has not yet reached final conclusions on the definition of fair value and therefore has not yet determined whether the notions of CEV and fair value are the same, although it notes that no significant differences have been identified as yet.

Embedded value

The CFO Forum⁸ published European Embedded Value Principles in which they define Embedded Value (EV) as the present value of shareholders' interests in the earnings distributable from assets allocated to the covered business after sufficient allowance for the aggregate risks in the covered business⁹. EV information is much more widely used now, for example by Bancassurers and some life insurers report it as supplementary information, outside financial statements. Non-life insurers do not typically report EV information. EVs are often an important consideration in determining prices for mergers and acquisitions and are often used in accounting for the insurance liabilities assumed in these transactions.

Market consistent EV techniques have a number of similarities with CEV. Both take into account the best estimate of all cash flows and do not use risk adjusted discount rates. However, there are differences, for example in their approaches to risk margins and market consistent EV does not include a service margin.

Notwithstanding the advantages of EV, the Board's view is that CEV is a more relevant measurement attribute.

⁸ The CFO Forum is a high-level discussion group formed and attended by the Chief Financial Officers of major European listed, and some non-listed, insurance companies. Its aim is to discuss issues relating to proposed new accounting regulations for their businesses and how they can create greater transparency for investors. The Forum was created in 2002.

⁹ The EV consists of the following components and excludes the value of future new business:

- Free surplus allocated to the covered business.
- Required capital, less the cost of holding that capital.
- Present value of future shareholder cash flows from in-force covered business (PVIF).

Unearned premium

An unearned premium approach is usually used to value short-term duration non-life insurance pre-claims liabilities. This approach would measure the liability initially at the net premium¹⁰ and subsequently, at the unearned portion of that net premium. For many short-term contracts, especially if expected profitability has not changed since inception, using an unearned premium approach may produce a reasonable approximation to the CEV. However, an insurer should not make this assumption without testing it. For all insurance contracts, including non-life ones, the Board's view is that CEV is the most relevant and reliable measurement attribute.

Unearned premium – Considerations

An approach that is based on currently available information is favoured by the Board. This approach would preclude the automatic use of an unearned premium reserve (supplemented by an unexpired risk reserve) for the unearned elements of insurance contracts. The liabilities will be on a composite "written" basis rather than a separate earned and unearned element. For short-tailed liabilities, the unearned premium reserve approach may be a good approximation to the CEV. However, the CEV approach could result in profit at inception of a contract, whereas the unearned premium reserve approach would not.

In hard markets when premiums are relatively high, the use of a prospective basis for the unearned elements, should lead to a more realistic valuation of liabilities compared to a potential overstatement of liabilities based on unearned premium where the transfer value of the liabilities is not affected by the hard market. However, if the transfer value is relatively higher in a hard market compared to a soft market, then the difference between the unearned premium reserve and the CEV in a hard market may not be significant.

Allocated customer consideration

The customer consideration model is currently being explored by the IASB and FASB in their joint project on revenue recognition. This model initially measures the insurance liability by allocating the amount of consideration received from the customer. Many questions are still to be addressed in the development of this model.

However, because of the nature of insurance contracts and the risk transferred to the insurer, the Board feels this model is unlikely to be suitable for measuring insurance liabilities unless it is developed to include explicit current estimates and margins.

Measurement – other issues

Assets backing insurance contracts

The Board considered different measurement models (e.g. cost-based and current estimate approaches) in an effort to eliminate accounting mismatches from financial reporting. Accounting mismatches can arise in instances where changes in economic conditions affect assets and liabilities to the same extent, but the reported amounts of those assets and liabilities do not respond equally to those changes due to differing measurement treatments (e.g. where an insurance liability is measured on a basis that does not reflect current interest rates while measuring interest-bearing financial assets at fair value). Accounting mismatches experienced under Phase I have been criticised by many commentators as these have resulted in increased volatility of insurers' reported results which often reduced transparency into the underlying performance of the insurer and which was costly for insurers to explain.

However, the measurement models considered by the Board do not look to eliminate any economic mismatches as this information is relevant to the user. Economic mismatches arise if the values of, or cash flows from, assets and liabilities respond differently to changes in economic conditions (e.g. if the duration of insurance liabilities differs from the durations of fixed interest assets backing those liabilities).

The Board's view is that current estimate approaches for the measurement of insurance liabilities are the most appropriate as they provide more relevant and reliable information to users.

The fair value options available to insurers for asset valuations under IFRS enable them to reduce accounting mismatches but the Board does not intend to extend the options available to insurers nor to require insurers to exercise these options.

Unit of account

The Board considered whether measurement should be applied at contract or portfolio level and, if at portfolio level, what level of aggregation should be used. In considering the first question, the Board

agreed that, in principle, the expected present value of future cash flows is not affected by the unit used. In practice however, participating contracts and other estimates (such as IBNR) may have to be measured in aggregate.

If a decision is made to measure the liability at portfolio level, the second question remains as to what level of aggregation should be used. IFRS 4 refers to a liability adequacy test for a "portfolio of contracts that are subject to broadly similar risks and managed together as a single portfolio" and the Board has decided to keep this definition unchanged for now.

Risk margins are often managed by insurers at an aggregate level rather than on a contract by contract basis. The Board has concluded that risk margins should be determined for a portfolio of insurance contracts that are subject to broadly similar risks and are managed together.

In developing its conclusion, the Board has given consideration to techniques the insurance industry applies in practice. By measuring risk margins at a portfolio level it is accepted that this will make it easier to perform certain types of estimates and will also allow any costs that are not incremental at a contract level to be captured (this is consistent with Board's CEV approach for valuing insurance liabilities).

Although the Board notes that some insurers reduce their risk through diversification between portfolios and can benefit from negative correlation with other portfolios they manage (e.g. annuity versus term life insurance), it has concluded that risk margins should not be adjusted to reflect these effects as CEV should be independent of the entity that holds the asset or liability. Therefore, risk margins should be determined for each portfolio in isolation.

Unit of account – Considerations

As noted above under Risk Margins, portfolio diversification is taken into account by insurers in business pricing decisions and in establishing their business mix. Although ignoring portfolio diversification will increase the consistency of reserving for similar portfolios in different insurers it will be an area where the accounting model diverges from the realities of an insurer's business strategy.

¹⁰ Net premium is the premium received less relevant acquisition costs.

Reinsurance assets

The Board's view is that a cedant should measure reinsurance assets using the CEV. The risk margin used in the measurement of the reinsurance asset should be equal to the risk margin of the underlying insurance contract, and will therefore typically increase the measurement of the reinsurance asset.

The CEV of reinsurance assets should be adjusted to reflect the risk of default or loss from disputes with the re-insurer. This adjustment for impairment should be calculated on an expected (probability-based) present value basis, with a further reduction for the margin that market participants would require for bearing the risk that defaults or disputes exceed the expected value.

The Board does not intend to change the presentational requirements (reinsurance assets should not be offset against the related insurance liability; reinsurance income and expense should not be offset against the related insurance expense and income) as currently set out in IFRS 4.

Unbundling

Some insurance contracts contain both an insurance and a deposit component (e.g. some types of unit-linked contracts). The Board's view is that both components should be unbundled unless they are so interdependent that the components can be measured only on an arbitrary basis. Where the components are not interdependent, the Phase II standard would apply to the insurance component and IAS39 would apply to the deposit component.

However, if the components are interdependent but can be measured separately on a basis that is not arbitrary, the Board suggests that:

- the whole contract be measured using the Phase II standard,
- the deposit component be measured using IAS39 and
- the insurance component be valued as the difference between the total value and that of the deposit component.

Credit characteristics of insurance liabilities

The Board's view is that, in measuring its insurance liabilities using CEV, an insurer should reflect the liabilities' credit characteristics and disclose the effect that the credit characteristics have on the liabilities' initial measurement and subsequent changes in their effect.

The Board's view is that an insurer would not willingly pay a transfer price that improved the credit characteristics of the liabilities and would not be permitted to enter into a transfer that reduced these credit characteristics.



Unbundling – Implications for insurers

- The DP proposals are likely to require insurers to unbundle more contracts than at present. If so, this will lead to increased costs of reporting.
- The Board notes that it has not yet determined whether it will be appropriate to develop CEV and IAS18 to eliminate accounting differences. This decision will have a key impact on the effect of any unbundling that may be required.

Credit characteristics – Considerations

It is counter-intuitive that an insurer should realise an accounting gain or loss if its credit characteristics change unless it has reached a position where its estimate of the cash flows required to settle its obligations has changed. For example, where an insurer expects to reach a negotiated settlement with its policyholders.

The Board proposes that the insurer should disclose the effect that credit characteristics have on the initial CEV and subsequent changes. In the absence of a market consistent credit standard it is unclear what disclosures would be appropriate on initial establishment of a CEV other than the credit status of the insurer which would be implied in the CEV.

Investment contracts

Contracts that do not transfer significant insurance risk fall within the scope of IAS39. The Board acknowledges that there are differences between its preliminary views on insurance contracts and existing requirements in IAS39 and IAS18. Because the Board has not yet assessed whether eliminating these differences will be appropriate, the DP does not include any proposals regarding investment contracts.

Benefits arising from unit-linked contracts are often dependant on the performance of the designated pool of assets. The Board acknowledges accounting mismatches may occur when these assets are not measured at fair value through profit and loss and when the related liabilities are recorded at CEV. As pointed out above, although the Board would prefer to eliminate such mismatches, it has not yet formed a preliminary view on whether this is appropriate nor has it formed a view on the recognition and presentation of those assets.

For index-linked contracts, the Board has noted that existing requirements in IFRSs remain appropriate as the insurer is not compelled to hold the underlying assets and as it could transfer the resulting liability without a simultaneous transfer of the assets.

Concluding remarks:

The approach proposed by the Board when valuing insurance liabilities is a market consistent discounted best estimate of explicit liabilities plus explicit risk and service margins.

If adopted, the Board's CEV approach would mean a significant change to the way liabilities are valued and introduce more subjectivity and volatility. It is likely to increase the costs of reporting for insurers as new accounting and actuarial systems and techniques will be required to estimate the CEV. However, the building blocks to the CEV approach are increasingly being used in the management of the business by insurers, and so the valuation bases for reporting and management of the business are likely to converge.

Block I and block II of the Board's approach essentially overlap with the move to realistic financial and risk reporting for large UK with-profits life funds. As a result, the financial performance has become more transparent and a feature that would potentially be retained under the Board's approach. The Board's extension to include risk and service margins, block III, as part of the liability measurement is a new feature and is different to the prevailing business model. The Board acknowledges the lack of observable evidence for calibrating the margins and development of industry practice will be key to the application of these proposals in a manner that enhances consistency of reporting.

The level of uncertainty in insurance gives management wide discretion to determine cash flow assumptions. In addition, the lack of observable data for risk and service margins will lead to significant subjectivity and discretion available to management in determining these margins. The challenge for management will be to document and justify the judgement applied. Detailed disclosure of the assumptions and methodologies used to calculate risk and service margins will be crucial to the effect of market disclosure in promoting the development of established industry practice for the consistent estimation of these margins.

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