Deloitte & Touche

Executive Briefing

An International Financial Reporting Standard (IFRS) for Insurance Contracts Summary of Exposure Draft and Related Issues

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International Financial Reporting Standards are the body of standards adopted by the IASB. They comprise:

- International Financial Reporting Standards;
- International Accounting Standards ("IAS"); and
- Interpretations originated by the International Financial Reporting Interpretations Committee (IFRIC) or the former Standing Interpretations Committee (SIC).

ED 5, the Exposure Draft of the IFRS for Insurance Contracts (Phase I), was released for comment on 31 July. The IFRS is intended to be a temporary measure prior to the introduction of a comprehensive IFRS (Phase II) dealing with the recognition and measurement of insurance contracts. These proposals introduce fundamental changes to insurance accounting that will impact the way investors and regulators assess the insurance industry.

The deadline for comments to the International Accounting Standards Board (IASB) on ED 5 is 31 October 2003. The resulting IFRS will be effective for accounting periods beginning on or after 1 January 2005.

The impetus for change

There is currently no globally accepted insurance accounting practice and insurance contracts are not dealt with elsewhere in the body of 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 business 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 concerns 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.

Background to the development of an insurance IFRS

The goal of the IASB is to develop accounting standards that can be used globally. In July 2001, after extensive consultation with standard setters, regulators, and other interested parties, the IASB announced the launch of a series of technical projects with the aim to "provide leadership, promote convergence, and enforce global accounting standards" – one of these projects was the *insurance contracts project*.

The European Union (EU) will require all companies listed on an EU stock exchange to prepare consolidated financial statements under IFRS for periods beginning on or after 1 January 2005, with certain limited exemptions. In addition, several other non-EU countries have either already adopted IFRS or are expected to adopt IFRS over the next few years.

A phased approach to an insurance IFRS

The IASB insurance project aims at establishing a common standard for financial reporting for insurance companies, based on fair values. The development of the IFRS for insurance contracts is proving to be complex and controversial and in May 2002 the IASB decided to split the insurance project into two phases.
The drivers of this decision were the need to adopt a pragmatic approach in order to meet the 2005 deadline and the acceptance that some difficult issues had to be deferred. Phase I of the project provides a specific definition of an insurance contract, temporary dispensations from certain standards, and guidance on implementing current standards not covered by the dispensations. Phase I is designed to enable insurance companies to report under IFRS by 2005. This phase is addressed in the current Exposure Draft and is expected to result in a new standard in 2004. For all aspects of their business not addressed in

The IASB insurance project: a fundamental change to insurance accounting

Under the IASB Framework, the "deferral and matching" approach commonly applied to insurance accounting is replaced with an approach that depends on the valuation of assets and liabilities using market values or fair value estimates. The "deferral and matching" approach by its nature tends to stabilise financial results. The change to an "asset and liability" approach based on fair values is likely to require major systems changes and the development of accepted methods to estimate fair values.

Impact on US GAAP

Companies reporting under US GAAP are likely to be affected by IFRS as well. In October 2002 the US accounting standards setting body, the Financial Accounting Standards Board (FASB), and the IASB issued a "memorandum of understanding" stating that both boards had made a formal commitment to converge US GAAP standards and IFRS. The FASB's timing is not known, but this convergence may need to happen swiftly, in order to keep in step with the adoption of IFRS globally.

this standard, such as accounting for investments, insurers will be expected to apply IFRS in the same manner as other types of business.

Phase II, for which an exposure draft is expected in 2004, will produce the comprehensive standard on the recognition and measurement for insurance contracts based on fair values. This standard will replace the temporary dispensations and interim accounting standards developed in Phase I. The current timetable calls for the fair values of insurance liabilities and assets to be disclosed for year-ends from 31 December 2006 with implementation of the final standard for periods beginning from 1 January 2007.

With regard to the completion of Phase II, the introduction to the Exposure Draft states that the IASB is fully committed to it, "without delay once it has thoroughly investigated all relevant conceptual and practical questions and completed a full and extensive due process."

Phase I: Implications for insurance contracts

A key issue for Phase I is the definition of an insurance contract (see inset). The definition is required to identify which insurance contracts will fall within the financial instruments standard (*IAS 39*) and which are in the scope of temporary dispensations of Phase I. The Exposure Draft includes a very broad definition of an insurance contract that limits the types of contracts that would not qualify as insurance contracts.

Definition of an insurance contract

"A contract under which one party (the insurer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder or other beneficiary if a specified uncertain future event (the insured event) adversely affects the policyholder or beneficiary."

An appendix to the Exposure Draft defines insurance risk, provides guidance on the terms "significant insurance risk" and "uncertain future event" and gives examples of types of contracts that do and do not meet this definition.

Contracts that do not meet this definition of insurance and will fall within *IAS 39* include:

- Savings contracts with no discretionary profit sharing.
- Accumulation phase of non-guaranteed deferred annuities.
- Unit-linked or index-linked savings contract with no death benefit.
- Index-based derivatives.
- Weather derivatives.

In the absence of a comprehensive IFRS for insurance contracts, the IFRS hierarchy would have to be applied in accounting for the rights and obligations arising from insurance contracts. This would require businesses either to apply the "asset and liability" approach of the IASB Framework without specific guidance or to apply the accounting principles of another country that more closely complies with the framework. The Exposure Draft addresses this issue by introducing a temporary dispensation from these requirements until accounting periods beginning on or after1 January 2007 (the "sunset clause"). The dispensation allows insurers to continue using locally accepted accounting practice. An insurer may make accounting changes only if the changes are more relevant and reliable, judged by the current IAS criteria. For example, an insurer may continue to measure insurance liabilities on an overstated or undiscounted basis, if by doing so it is following locally accepted accounting practice. An insurer may not, however, change its accounting policies to measure insurance liabilities on an overstated or undiscounted basis.
The Exposure Draft also prohibits insurers from recognising catastrophe or equalisation provisions.

Financial instruments that are issued with a discretionary participation feature and do not meet the definition of an insurance contract are covered by a specific Phase I dispensation. For such instruments, however, insurers must recognise a liability measured at no less than the measurement that *IAS 39* would apply to the fixed element of the instrument. The Exposure Draft does not require the insurer to perform the *IAS 39* measurement of the fixed element "if the total reported liability is clearly higher."

Furthermore, the Exposure Draft specifies that insurers must carry out a loss recognition test at each reporting date using a test based on current information. The test uses all current estimates of insurance contracts' future cash flows and requires an insurer to recognise immediately any deficiency in recorded liabilities identified from the loss recognition test, net of deferred acquisition costs and related intangible assets, in its income statement. For insurers with a current requirement to test for loss recognition, there may be no need to amend practice – provided the test uses the most up-to-date information and meets the minimum requirements of the test set out in the Exposure Draft.

Regardless of the Phase I dispensations, insurance contracts will have to be examined for:

- "Embedded" financial derivatives; and
- "Unbundling" of insurance and deposit components in certain circumstances.

The Exposure Draft also sets out principles for the accounting for reinsurance and the disclosure requirements for insurance contracts.

Embedded derivatives

The concept of embedded derivatives was introduced in *IAS 39*. Embedded derivatives were originally flagged as an issue as they could trigger major system changes for some life insurance contracts. It was recognised that these system changes would be difficult to implement in time for the 2005 deadline. To alleviate this, special exclusions have been introduced for Phase I. For example, all discretionary profit sharing contracts are covered by a specific exemption from this requirement. However, if an embedded derivative within a host insurance contract does not meet the definition of insurance itself, and is not merely an option to surrender the contract for a fixed amount, it must be separated and measured at fair value – with changes in fair value recognised in the income statement. This is a complex area, and although the Exposure Draft contains a number of examples (mainly focused on life insurance), it is open to further interpretation.

Unbundling

With regard to "unbundling," if an insurance contract contains both an insurance component and a deposit component, and the cash flows from the insurance component do not affect the deposit component, then the deposit component is required to be unbundled and reported as a financial asset or liability (under *IAS 39*) at fair value or amortised cost. If unbundling is required, receipts (or payments if for a reinsurance contract purchased) for the deposit component would not be recognised as premium income or reinsurance, but as movements in the deposit. The receipts or payments for the insurance component would continue to be treated as insurance contracts under the Exposure Draft.

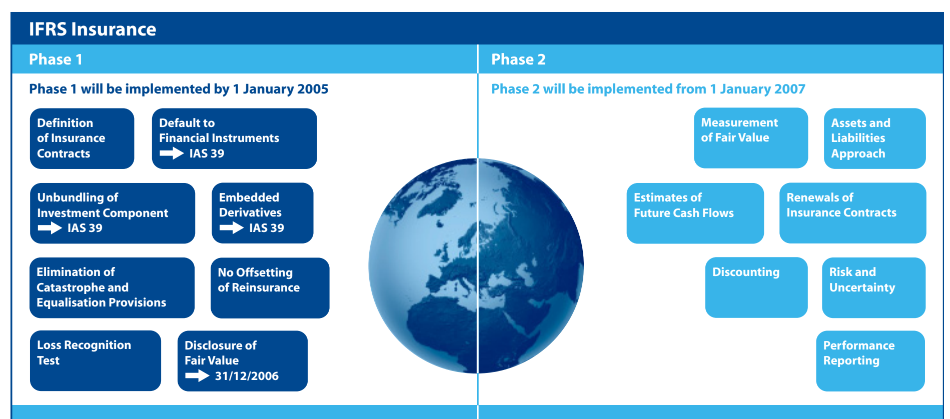
This part of the Exposure Draft seems designed to capture certain financial reinsurance contracts in which a payment by one party leads to automatic repayments by the other party in the future. A specific example is given in the implementation guidance to the Exposure Draft.

Although the same principles could be applied to direct insurance contracts, the Exposure Draft does not require unbundling for many traditional life contracts with surrender or maturity values "if the insurer's existing accounting policies mean that it recognises all liabilities under those contracts to pay benefits to policyholders".

Reinsurance

The Exposure Draft formally establishes certain key principles for the accounting by a cedant for reinsurance. In summary:

- Reinsurance purchased does not change the measurement basis for direct insurance liabilities.
- Reinsurance assets are not offset against direct insurance liabilities. The income or expense from reinsurance contracts is not offset against the income or expense from related insurance contracts.
- A cedant should not recognise a gain at the date of inception of a reinsurance contract, other than to the extent receipts from the reinsurer compensate the cedant for acquisition costs it has recognised as an expense. If the net amounts paid by the cedant to the reinsurer are less than the liability ceded, then the difference is recognised in income on a "systematic and rational" basis over the period of the underlying risk exposure.



IAS 32 and *IAS 39*

IAS 32 addresses the disclosure and presentation of financial instruments. *IAS 39* establishes principles for the recognition and measurement of financial assets and financial liabilities, including detailed rules on the accounting for derivatives and hedge accounting. Under *IAS 39* financial assets and liabilities are measured at fair value or amortised cost. For financial assets the valuation method depends on the asset category. Financial instruments meeting the definition of a derivative in *IAS 39* are always measured at fair value. Instruments that meet the definition of an insurance contract fall outside the scope of *IAS 39*. At its July 2003 meeting the IASB took the tentative decision not to require companies to present comparative information in respect of *IAS 39* in their first set of IFRS financial statements.

- The net assets and liabilities arising from reinsurance are included in the loss recognition test (described above).

Moreover, the Exposure Draft requires a cedant to apply *IAS 36* (dealing with impairment of assets) to its rights arising from reinsurance contracts. *IAS 36* requires an asset to be written down to its "recoverable amount" under certain circumstances where the carrying amount of an asset exceeds its recoverable amount. "Recoverable amount" is defined in *IAS 36* as the higher of an asset's net selling price or its value in use.

Extensive Disclosure

For preparers of financial statements the Exposure Draft has a "sting in its tail" in the form of the disclosure requirements. Fair values of insurance contracts must be disclosed from 31 December 2006 (without comparatives). For year-ends from 31 December 2005, extensive claims development information is required, together with narrative disclosures on:

- Insurance risk management policy, sensitivity, key variables, and risk concentrations;
- Terms and conditions of insurance contracts with the most material impact on future cash flows; and
- Information about interest risk, credit risk and, in some cases, also market risk exposures.

Applying *IAS 39* to life insurance contracts

Under Phase I, life insurance contracts not meeting the IFRS definition of insurance contracts will be accounted for as financial instruments under *IAS 39*. The major problem that this presents is that in some countries the majority of life insurance business may have to be accounted for under *IAS 39*, due to accumulation type features. Many financial products sold by the life insurance industry are complex and this is a potential problem, as most of the products' complexities are not recognised in current standards for financial instruments. The IASB has proposed that insurers will have the choice of valuing their liabilities for financial instruments which do not meet the definition of insurance contracts using either the amortised cost method or at fair value. The choice between the two methods may well depend on the impact on factors such as: capital adequacy, stability of earnings, the need for comparability of results between entities, and the ease of conversion from current systems.

Amortised cost method explained

At inception of a contract, the amortised cost value of a financial liability is the sum of the consideration received, less external acquisition costs incurred. An effective interest rate (EIR) is calculated at inception, based on best estimate future policy cash flows (i.e. cash flows exchanged between the policyholder and the insurer, including surrenders, but not expenses and commissions). Subsequent values are calculated using the value at the end of the previous period, plus or minus contract payments, plus or minus the period's amortisation (using the EIR).

Fair Value under *IAS 39*

Fair value is defined as "the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties, in an arm's length transaction".

Fair value calculations are meant to be market consistent and therefore, independent of asset performance, i.e. no investment returns should be modelled in the cash flows, unless they impact the benefits to the policyholder. For contracts where policyholders' behaviour might affect assumptions used (e.g. lapse assumptions affected by market interest rates), a dynamic approach, as opposed to a deterministic one, is necessary. This could require using stochastic projections if options are involved.

Implications of the Exposure Draft for non-life insurance business

Due to the broad definition of insurance contained in the Exposure Draft, it is not likely that major changes to systems and bases of accounting will be required for non-life insurers. Non-life insurers will have to compare the loss recognition test methodology they currently apply with that set out in the Exposure Draft, and amend their approach if necessary.
The most significant implications for non-life insurers may be in the details involved in applying the requirements for reinsurance, embedded derivatives and unbundling. The latter two are complicated areas and the guidance given in the Exposure Draft is not particularly clear, lending itself to varying interpretations. However, insurance contracts where these two features are significant are likely to be rare for many non-life insurers. Creating the detailed disclosures, some of which seem more applicable to life insurance, may prove time-consuming.

Implications beyond accounting practice

In addition to addressing the accounting practice for insurance contracts and other relevant IFRS, insurers will need to address both the systems and human resources implications arising from the application of IFRS. Prior to the full implementation of IFRS, insurers will need to consider the implementation of new, more sophisticated modeling systems and to assess and to measure their capability to comply with these major reporting changes.

Non-life insurers are likely to have more issues in applying the fair value principles of Phase II (detailed below), as the modelling techniques required are not yet well developed.

Phase II: a comprehensive accounting standard for insurance contracts

Phase II will address recognition and measurement issues for insurance contracts using a fair value approach. This means that all insurance contracts will have to be measured at fair value, using best estimate assumptions for projection purposes and the risk free rate for discounting purposes. However, key questions remain to be answered, such as:

- Should non-economic assumptions be entity specific, that is, should the insurer's own experience be used, especially for those such as lapses and expenses?
- To what extent will insurers be able to include the cash flow from future renewal premiums in their fair value calculations?
- Will adjustment for risk be allowed for through "Market Value Margins" (the amount that the market would add to an insurer's best estimate to arrive at an arms' length valuation)? How will these be calculated?

It is likely that the fair value, in absolute terms, of an insurance contract will be "floored" at the price for which a contract with the same characteristics could be transferred at the same date, implying a loss, or at best breakeven at the inception of the contract.

Next steps for UK life insurers

A lot of work for Phase I will need to be done in classifying products and deciding which are the ones meeting the definition of insurance, and for those that do, whether a financial component needs to be unbundled.

As previously mentioned, *IAS 39* requires a financial instrument to be valued at either amortised cost or fair value on initial recognition. We believe that most UK life insurers will choose the fair value method for their insurance contracts that fall to be accounted under *IAS 39*, as this is the basis of accounting for the investment portfolio, and also due to factors such as data availability, systems, product types and the regulatory requirement for a realistic balance sheet. However, for contracts that fall under the treatment of *IAS 39* and are valued at amortised cost, the issue will be to identify embedded derivatives and separately fair value them. This classification work will need the input of internal and external actuaries and accountants. We anticipate that a large portion of the UK life insurance business will fall under *IAS 39*. For products valued at amortised cost, data issues may arise for companies that do not already report under US GAAP, which requires a similar approach, such as locking in of assumptions and "backcasting" for in force business.

In August 2002, the Financial Services Authority (FSA) required major life insurers in the UK to produce realistic balance sheet information as at June 2003 by the end of September 2003. This having strong similarities with fair value, insurers will certainly be able to recycle some of this realistic balance sheet work to use in Phase II of the insurance project, although there will be room for refinement of methodologies and for building more robust and auditable systems for producing these figures. The change to fair value for life insurance liabilities has a major impact on systems when it comes to valuing with profits business because it is likely to require stochastic modelling. Until the recent regulator's requirement for realistic balance sheet information, few companies had invested significant time and resources in this field.

Next steps for UK general insurers

The generic comments above for non-life insurance business apply equally to UK general insurers. Some specific areas of difference between these proposals and current UK GAAP for non-life insurers are:

- The loss recognition test in the Exposure Draft is based on all current information rather than information known at the balance sheet date.
- A subtly different approach to unbundling deposit and insurance components in the same contract.
- Introduction of the concept of an embedded derivative and fair value accounting for such instruments.
- The deferral of gains arising at the inception of a reinsurance contact under certain circumstances.

Writers of direct, mass risk business are unlikely to have significant issues in applying the Exposure Draft, unless their reinsurance accounting is affected. Lloyd's and London market businesses writing complex direct business, or writing or buying complex reinsurance may need to carefully examine the requirements for reinsurance, embedded derivatives and unbundling.

Conclusion

ED 5 is an interim standard for insurance contracts with temporary dispensations from certain standards and the IASB Framework. If the Exposure Draft were a proposal for a final standard on how to deal with insurance contracts under IFRS, it would be unsatisfactory, as it allows for different accounting treatments in different countries under IFRS, which conflicts with the IASB Framework. However, an interim solution is necessary due to the 2005 deadline for compliance.

We recognise that work will continue to develop the final and comprehensive financial reporting standard on the recognition and measurement of insurance contracts. While progress has been made, there are still some major challenges ahead for the insurance contracts project.

In our opinion, the key issues for insurers converting to IFRS will be:

- Complying with all standards under IFRS generally (not only the Phase I standard) – especially *IAS 39* on financial assets, financial liabilities and derivatives.
- Treating some insurance products as financial instruments.
- Identifying embedded derivatives and measuring them at fair value.
- Unbundling deposit components in some insurance contracts and accounting for them separately from the insurance component.
- Creating the extensive disclosure requirements, including insurance risk management policy, interest and credit risk information and terms and conditions of insurance contracts with the most material impact on future cash flows.
- Calculating fair value disclosures for insurance contracts from 31 December 2006.
- Preparing for the implementation of the Phase II standard in 2007 – including recognition and measurement of insurance contracts at fair value, estimates of future cash flows, discount rate and performance reporting.

Conversion to IFRS for insurance companies may prove to be costly, depending on the systems implications and human resources impact. However, the investment may also create value for the insurer by improving risk management, management reporting, and external reporting to investors and other stakeholders.

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