

IASB publishes Exposure Draft - *Accounting for insurance contracts* : 10 Key Critical Issues

Abstract

The IASB has published its Exposure Draft of the new IFRS for insurance contracts. This is a major milestone in the creation of an improved reporting standard for insurance under IFRS. It will require significant investment to prepare for, and the detailed assessment of the new proposals will be a key step in what is expected to be a complex implementation challenge. The benefits of these efforts, however, will come from making insurance reporting more consistent and transparent than it is under the current IFRS regime thus enhancing insurers' ability to raise capital.

A high level summary of what the exposure draft contains is outlined below.

Overview of the Key New Requirements

Some of the key *new requirements* will include:

1. A new measurement basis that uses a *"building blocks approach"* : a transparent accounting model requiring insurers to report an unbiased estimate of future cash flows separately from a liability that captures the underlying volatility of this estimate (the "risk adjustment" liability) and any future profit yet to be earned (the "residual margin" liability), where applicable;
2. Estimates of future cash flows should be discounted at market rates together with a current assessment of the probability attached to the insured events to produce a *"probability weighted average of future discounted cash flows"*. This is to be remeasured at each reporting date;
3. Profits from insurance business will be reported in line with the release from risks, i.e. profits will flow to the income statement as the risk adjustment and the residual margin liabilities are released. The standard will require the application of considerable judgement to determine that pattern of release;

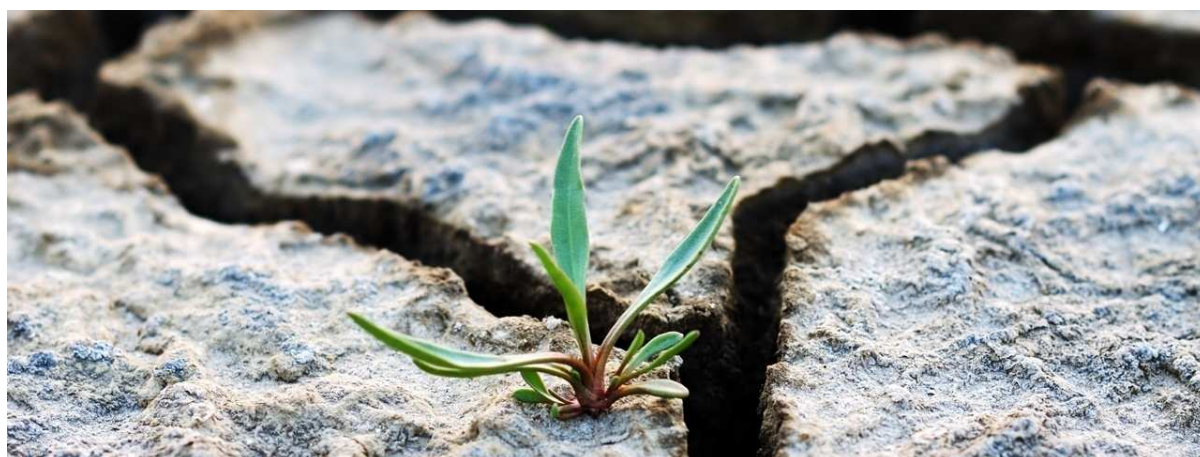
4. The profit emerging from the risk adjustment will be calculated for each portfolio of insurance contracts in-force using either a cost of capital approach or two other methods based on statistical analysis of the underlying probabilities (confidence intervals and CTE);
5. The residual margin will be earned more simply on a systematic basis over the insurance coverage period for each contract. The new accounting standard proposes that these streams of profits are reported in a more transparent manner, requiring separate disclosures for experience variances, changes of assumptions and unwind of the discounting, all of which will also have a separate line in the income statement;
6. This accounting basis will apply to all types of insurance contracts meeting the definition of a **“contract that transfers significant insurance risk”**. However, the new standard requires a simplified approach to short term business for contracts in the pre-claim period, where measurement will be similar to the current unearned premium method. Savings contracts that do not expose the insurer to insurance risk will not be captured by these requirements and will continue to be accounted for under the existing standards for deposits and savings liabilities, also used by banks;
7. The new standard will also require separate accounting for all saving components that are **“bundled”** within insurance contracts, but not closely related to the insurance coverage offered, and operate as “account balances”. The same separation from the insurance contract will be required if there are derivatives embedded in the contract that are not interdependent with the insurance risk. With this provision, the IASB aims at achieving a level playing field between banks' and insurers' accounting requirements for similar products. There will be **one exception** to this approach in relation to participating savings contracts (e.g. “with-profit” in the Bulgaria) issued from life insurance participating funds. In that case, these financial liabilities will be measured in the same way as the insurance liabilities backed by the same fund and;
8. On transition to the new accounting regime, insurers will be required to write off all of their deferred acquisition costs and to remeasure in-force books of business using the **“building blocks”** model already described; The adoption of the new IFRS is penciled in for 1 January 2013 which is the date the new IASB accounting regime for investments (IFRS 9) will become mandatory. The IASB is conscious of the challenge this may give to insurers and it is prepared to consider moving the two dates in parallel to facilitate a successful implementation world-wide.
9. The residual margin will be earned more simply on a systematic basis over the insurance coverage period for each contract. The new accounting standard proposes that these streams of profits are reported in a more transparent manner, requiring separate disclosures for experience variances, changes of assumptions and unwind of the discounting, all of which will also have a separate line in the income statement;

10. On transition to the new accounting regime, insurers will be required to write off all of their deferred acquisition costs and to remeasure in-force books of business using the “building blocks” model already described;

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In the IFRS 4 Phase II exposure draft ED/2010/8, guidelines are set out for the statements of comprehensive income. These guidelines will lead to new key performance indicators, such as underwriting margin and the difference between expectation and realization of actuarial and economic assumptions.

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