Deloitte.

December 2008

Heading in the same direction?
IFRS Phase II and Solvency II

Solvency II ("SII"), the name given to the activities that will produce the new solvency regime for European Insurers, has been moving to the forefront of most insurers' minds over the last year, with more companies taking part in the most recent Quantitative Impact Study and initiating programmes to prepare for the implementation of the future SII requirements

However, the implications from Phase II of the International Accounting Standards Board ("IASB") project on insurance contract accounting ("Phase II") do not seem to rank as highly on managements' priority list, despite both proposals sharing similar timelines and issues. Although SII and phase II have different objectives, companies will have to address similar questions and issues when dealing with their implementation.

An integrated or closely aligned approach to the implementation of the two projects is likely to minimise implementation costs and maximise benefits.

This article explores the similarities and differences of SII and Phase II and provides ideas on what insurers could be doing to prepare for the adoption of these regulatory and accounting developments.

Summary of Solvency II

The goal of SII is to offer reduced capital requirement incentives for better risk and capital management systems and sound internal controls. The new regime is expected to be implemented in the EU in 2012 at the earliest. The new regulations will be developed using a three-pillar approach in which each pillar covers different aspects of the solvency position of insurance companies. Pillar 1 considers the quantitative requirements, including the calculation of market consistent technical provisions reported with an explicit Risk Margin (RM), as well as rules relating to investment management and solvency capital. Pillar 2 deals with the qualitative aspects of internal controls, risk management and supervision, including the Own Risk and Solvency Assessment (ORSA). Finally, Pillar 3 is concerned with disclosure requirements in order to increase transparency for all users including customers, investors, regulators and tax authorities. The resulting Solvency Capital Required (SCR) is a function of the various risks faced by the insurer, and for which the Minimum Capital Requirement (MCR) will be formula based with limits calculated as a percentage of the SCR.

Insurers have continued to assess where their current capital and risk management processes are, compared to these new requirements as more clarity and details emerge. This continuous assessment aims at identifying gaps and deciding adequate actions accordingly, ensuring the resulting implementation activity delivers value to the organisation as a whole as well as to policyholders and other stakeholders.

Summary of Phase II

The Discussion Paper on accounting for insurance and reinsurance contracts entitled 'Preliminary Views on Insurance Contracts' ("the DP") issued by the IASB in May 2007 is a key step in the second phase of their insurance contracts project. Phase I was completed in 2004 with the publication of International Financial Reporting Standard 4 "Insurance Contracts" (IFRS 4). IFRS 4 is an interim solution that left insurance accounting in the European Union virtually unchanged from what existed prior to the transition to IFRS. For that reason the proposals set out in the DP will represent a fundamental change to insurance accounting under IFRS.

The overriding goal for the new IFRS is to assist investors' understanding of insurance companies' profitability and financial position. The IASB intends to achieve this goal by producing a new IFRS with a principle-based measurement of insurance contracts that maximises the use of current market data and that aligns insurance accounting with the general principles in use for all the other IFRS. After receiving several comments on its DP, the IASB is now at work to produce an Exposure Draft ("ED") of the new IFRS which is expected to be issued in October 2009, with the final standard on accounting for insurance contracts issued during 2011 for likely implementation two years later.

The IASB proposals in the DP to provide a more relevant method of valuing insurance contracts focussed on an extensive use of market-based assessments of expected risks and rewards arising from the acceptance of insurance risks. This approach is aimed at achieving consistency of valuation across insurance companies and with companies in the rest of financial services and other sectors. The key features of the proposals in the DP were:

- a prospective valuation of the insurance contract (i.e. not one that is "locked-in") based on estimating the present value of all expected future contractual cash flows, subject to the future inflows passing the "guaranteed insurability test" as described in the DP;

- the calibration of this valuation to a "current exit value" which represents the hypothetical price an insurer would be prepared to pay/receive to transfer to another entity at the balance sheet date the residual contractual rights and obligation from its insurance contracts; and

- the application of this measurement model to all insurance and reinsurance contracts as defined under the current text of IFRS 4.

Typically, the current exit value of an insurance liability is rarely an observable price, for this reason the IASB's proposals suggest the current exit value of insurance contracts is calculated using three building blocks:

1. estimate of future cash flows: explicit, unbiased, market-consistent, probability weighted and current estimates of the contractual cash flows;

2. effect of time value of money: current market discount rates that adjust the estimated future cash flows for the time value of money; and

3. 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).

After spending 2008 analysing the comments received and understanding the alternative proposals to certain features of the model contained in their DP, the IASB will use its 2009 meetings to reach its decisions and put them forward in the Exposure Draft of the new IFRS in October 2009. Following their decision on 29 October 2008, the American Financial Accounting Standards Board (FASB) will be joining the IASB in their work next year resulting in the Exposure Draft being published also as a draft accounting principle for US GAAP companies.

For the purposes of this article similarities and differences are commented with reference to the current exit value described in the DP.

How is the liability calculation similar under SII and Phase II?

As illustrated in Figure 1 there are significant similarities when one compares the composition of assets and liabilities under both proposals, given both are seeking to achieve market consistent valuations. It should be noted that there will be some differences in the "market value of assets" caused by valuation rules and counterparty limits under SII. No such rules apply under IFRS and we do not aim to cover these differences in this article.

Market consistent approach

Both require liabilities to be estimated on the basis of the price that would be paid to transfer the liabilities to a market participant and where market values are available, these should be used in determining the value of the liabilities.

Best estimates similarities

Both require the explicit reporting of the amount representing the unbiased best estimates of probability weighted cash flows on a prospective basis including estimates of relevant claim inflation. The best estimate approaches for SII and Phase II are not identical; the differences are highlighted in the next section.

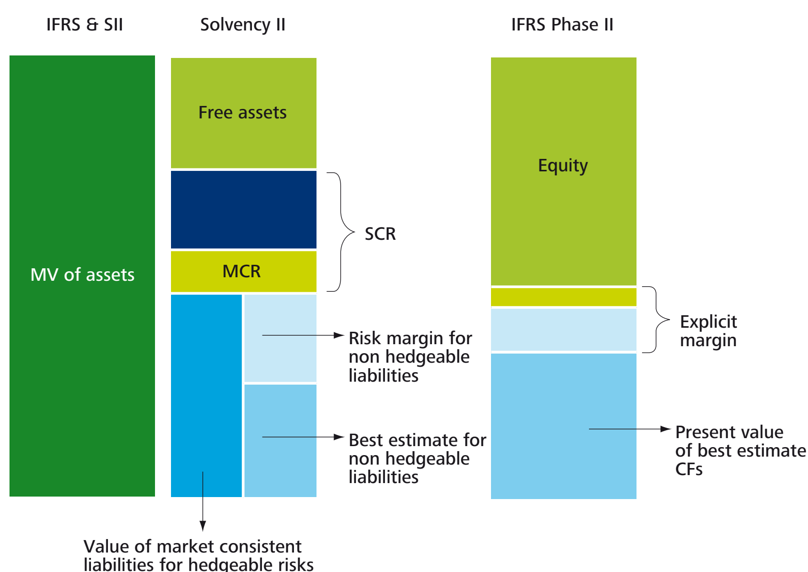
Discounting

Both require liabilities to be explicitly discounted at a rate that is independent of the assets held to match those liabilities. As per the fourth Quantitative Impact Study ("QIS4") completed in July 2008, insurance liabilities under SII could be discounted using swap rates. Phase II prescribes the market rate should be calculated to match the currency, duration and liquidity of the contractual cash flows. Phase II is not prescriptive on which building block the insurance contract default risk should be taken into account. It is possible that the selected discount rates under Phase II would differ from that in SII if the risk of default is considered as an adjustment of the discount rate rather than reflected in the probability distribution used to calculate the best estimate (first building block).

Risk margins

Both require liabilities to include a margin that is functional to the estimation uncertainty in the best estimates. In both cases the risk margin is explicitly determined – in contrast to "margins" that are often implicit under current accounting and regulatory practices.

Figure 1. IFRS and Solvency II



Relative size of liabilities and margins are for illustration purposes only and could differ significantly by company/product line.

Reinsurance

Both require calculations to be performed gross and net of reinsurance and require a prospective allowance for counterparty default risk on reinsurance assets.

> …representing the unbiased best estimates of probability weighted cash flows on a prospective basis including estimates of relevant claim inflation

How do SII and Phase II differ?

Objectives

The objectives of each regime are of course different in nature. Whilst both proposals are aiming to satisfy the needs of users of the reported figures to understand the value of insurance contracts on a realistic basis, Phase II proposals in the DP aim at the existing and potential shareholders, to give them a value of the insurance contract for investment decision purposes. On the other hand, SII focuses on protecting policyholders' interests above all and to achieve that, it aims at building a new risk based regime for solvency purposes using a very similar approach to measure how insurance liabilities affect the regulated insurer's MCR.

Scope

Under IFRS, insurance is defined in terms of "transfer of risk" whereas SII will apply to all regulated business within the entity. Therefore, regulated products which are not "insurance" products under IFRS 4 will still be subject to the SII requirement to hold capital and the resulting liability will have to be re-measured under the SII rules which may be different from the applicable IFRS (IAS 39 for most of these cases). Furthermore, IFRS applies to all listed entities in the European Union (others can opt in) whilst SII applies to all regulated insurers in the European Union except for the smallest (criteria to be determined) irrespective of their listed status.

Risk mitigation techniques

Reinsurance without transfer of risk and other techniques such as securitisation and use of derivatives will be outside the scope of Phase II and captured by other IFRS standards (once again IAS 39 will apply in most of these cases). These assets will have to be recalculated according to the SII rules which may result in different amounts than those reported under IFRS.

Market consistent expenses estimate

Phase II requires all cash flows to be market consistent. When they cannot be observed directly, the DP accepts the use of entity specific data because that would be the approach any market participant would take in that scenario. However, the DP requires that entity specific efficiencies or inefficiencies be excluded from the estimate because they would not be consistent with market participants' view. Under SII, the modelling to calculate the best estimate of cash flows affected by non-hedgeable risks uses company specific factors without adjustments. This could result in different amounts for the same liability if the reporting insurer has significant efficiencies/inefficiencies compared to the level of expenses market participants would assume.

Most commentators on the DP suggested that these adjustments for market consistency on a variable that is not easily observable should be reconsidered for a number of reasons. For example the judgment necessary for the adjustment may reduce the reliability of the whole accounting model.

Risk margin for uncertainty in estimates

An agreement has been reached under SII that the risk margin will be based on a cost of capital approach. A risk premium, currently equal to 6%, is applied to future SCRs to determine the cost of capital. The DP does not propose a single method to calculate the risk margin and accepts cost of capital as one of the possible techniques. The DP proposes that the risk margin is determined on a market consistent basis to reward the bearing of insurance risk uncertainty unexpired at each reporting date.

Service margin

There is no separate service margin in SII as this is included in the best estimate cash flows. The proposal in the DP to recognise a separate margin for future services has not been welcomed and the debate at the IASB seems to suggest that this feature of the new IFRS may be reconsidered.

Guaranteed insurability

The SII liability includes all cash flows expected under the legal terms and conditions of the contracts in force at the measurement date. For example it would calculate the probability of collecting all premiums from a 25-year contract if that is the legal term of the policy even if the contract can be cancelled at any time. SII would reflect the possibility of cancellation in the probability to collect premiums. Instead Phase II attempts to develop an approach which attempts to identify before measurement which premiums should be considered. The DP proposes to consider in the best estimate all future premiums if the insurer can enforce their payment or if the policyholder must pay them to maintain his right to obtain "guaranteed insurability". For example, if the same 25-year contract noted above allowed the insurer to re-price the risk after 15 years and set a new premium, the DP would only consider premiums from this shorter 15-year period in the calculation of the best estimate resulting in a potentially higher contract liability. This issue is particularly sensitive from the IASB perspective because of their goal to develop an IFRS for insurance that is consistent with the revenue accounting for all other long term contracts where future customer payments are subject to the risk of contract cancellation.

Credit standing

The DP required an insurer to take into account credit standing of the insurance contract issued, inclusive of guarantees which may come from parties external to the reporting insurer (e.g. a policyholder protection fund). Based on such principle, changes in the insurance contract credit characteristics would be expected to have an impact on the value of the insurance liabilities. This is one of the more controversial aspects of the Phase II proposals and has attracted much debate because one of the factors that can change the credit characteristics of an insurance contracts is the insurer's own credit standing. This issue is particularly relevant for an insurance contract where no external policyholder protection exists such as those issued by reinsurers. Any such adjustment is prohibited under SII.

Will they converge or diverge?

On the surface, it appears both SII and Phase II will be launched around the same time, i.e. around 2012/2013. However, progress made with Phase II appears slower than with SII; with an ED on Phase II not expected before October 2009 and no planned field testing yet, it seems unlikely that a final accounting standard for insurance will be in place by 2012. SII on the other hand, has gone through its fourth Quantitative Impact Study and companies are already looking at how they will implement the requirements set out in the draft directive and, particularly, those around internal models and the "use test". The FSA published a Discussion Paper (DP 08/4 "Insurance risk management: the path to Solvency II") in September which sheds further light on the key requirements of the Directive and internal model approval, as well as identifying the actions insurers should be taking now.

We believe, regardless of the differences between the two regimes, there are already tangible opportunities for synergies and companies should consider the requirements of SII and Phase II in an integrated way to minimise implementation costs and maximise benefits for their businesses. In particular, the common ground on the use of unbiased cash flow estimates and observable market rates is a reasonably clear indicator of overlaps in data and technology requirements, training and awareness programmes and when the insurer plans to design new suites of management information. Planning upfront to achieve these synergies, in our view, will be essential to ensure a successful implementation of both regimes and build a stronger framework for both risk and financial reporting purposes.

What will this mean for tax in the UK?

For UK life insurers, as tax is based on the FSA return, SII could bring significant changes and impact also their tax liabilities. The changes both to the FSA return and to the financial statements may also prompt the UK government to review again the basis of tax for life companies. In particular, if Phase II provides a reliable (and possibly higher) profit number earlier on in the contract life, this could provide an incentive for change. Additionally, any tax impact arising from SII/Phase II will need to be taken into account in calculating embedded values, financial statements and internal models.

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For UK non-life insurers tax is largely based on the financial statements, but the UK government is considering whether current accounting standards provide a suitable basis for a tax deduction for technical provisions. The UK tax authorities are following closely the Phase II and SII work on technical provisions. How this work develops may have an influence on the current prolonged debate on implementing new rules to cap the tax deduction for those provisions, with Regulations now expected in the first quarter of 2009.

Non-life insurers will also be concerned that, if Phase II leads to reduced technical provisions, there could be a significant one-off tax liability as a result unless tax authorities are persuaded to phase in any changes over a period of time.

It is expected that SII will remove the requirement for claims equalisation reserves ('CERs') and with it the tax deduction for transfers into the reserve. Without a change to the tax rules, the resulting unwinding of the CER will be taxed, although insurers accounting under IFRS should already have a deferred tax liability to offset the tax payable following their adoption of IFRS 4 in 2005. The government has recognised this issue and in the 2008 Pre-Budget Report announced that it will consider the case for extending some form of successor tax regime, although the outcome remains uncertain.

Finally, for both life and non-life UK insurers the changes to capital requirements can provide the opportunity to review the location and structure of their operations, including whether to operate through subsidiary companies or branches. Tax considerations are highly relevant to any decision on these issues.

Conclusion

Although there is still uncertainty around the final outcomes of SII and Phase II, we believe that the calculation of the core components of an insurance liability can be carried out using similar bases and models, with the possibility to develop adjustments that reflect the differences as they emerge from the parallel refinement of the detailed requirements. Such an approach should avoid the proliferation of different reporting regimes within the entity and the resulting additional costs.

For this reason, we believe that companies should consider both projects in parallel to ensure possible synergies between both regimes are exploited and implementation costs are minimised. In our view, this demands an implementation plan which takes into account the requirements of SII and Phase II as currently put forward, a good understanding of the aims and rules of both regimes, a mechanism to track the next steps in the two standard setting processes and a team which combines actuarial, finance and risk management skills.

The benefit of proactive and coordinated project management appears particularly compelling for non-life insurance companies where liability measurements based on premium reserves and undiscounted outstanding claims reserves with implicit margins are likely to require fundamental rethinking.

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Designed and produced by The Creative Studio at Deloitte, London. 28141