
IASB/FASB

Board meeting

Insurance contracts

PwC Summary of
Meetings

14-15 March 2011

Since a variety of viewpoints are discussed at FASB and IASB meetings, and it is often difficult to characterise the FASB and IASB's tentative conclusions, these minutes may differ in some respects from the actions published in the FASB's Action Alert and IASB Observer notes. In addition, tentative conclusions may be changed or modified at future FASB and IASB meetings. Decisions of the FASB and IASB become final only after completion of a formal ballot to issue a final standard.

Highlights

The IASB and FASB held a joint Board meeting on 14-15 March 2011 where they reached a tentative decision that a practical expedient discount rate should not be permitted and clarified the application of the discount rate principle to participating contracts. They also reaffirmed the IASB exposure draft (ED) and FASB discussion paper (DP) definition of an insurance contract, namely the IFRS 4 definition plus the requirement for at least one possible loss scenario and that the time value of money should be considered in the analysis. Guidance will be added that for reinsurance contracts, if the underlying individual contracts qualify as insurance, the reinsurance of a portfolio of such contracts will also be deemed to transfer insurance risk.

The Boards changed their position from the ED and DP with regard to the timing of initial recognition of a contract, responding to constituent cost/benefit concerns. For practical purposes the Boards agreed to use the date that coverage begins as the starting point for contract recognition, with the earlier recognition of an onerous contract in the pre-coverage period.

The Boards also discussed but were not asked to reach conclusions on both the presentation model and alternative amortisation approaches for the composite margin. They heard presentations from outside speakers on the calculation and use of the risk adjustment in present practice and an alternative approach to the discount rate, the ALR (asset liability rate).

Presentation models

The purpose of the session was to present to the Boards alternative presentation approaches for the performance statement for insurance contracts. The staff did not ask the Boards for a decision on a definition of revenue or a presentation alternative as they first want to finalise other aspects of the measurement model before asking the Boards to conclude on the presentation format. The staff presented the following examples illustrating the alternative approaches to the pure summarised margin approach proposed in the ED:

- Summarised margin with volume disclosure on the face
- Expanded margin
- As written (expected cash flows)
- Dual statement

A FASB member acknowledged the demand by users for volume information in order to have the performance reporting of insurers on a basis which is comparable to other industries. He noted that to be comparable to other industries the performance statement would have to be presented on an “earned basis” consistent with the revenue recognition project, but he acknowledged that an allocation of premium approach would be a challenging prospect within this liability measurement model. He would prefer a model that presents cash inflow and outflow information (the “as written” alternative) as this would be consistent with the measurement model providing interesting volume information without trying to look like another method. He noted that he found volume information presented as memo information in a box on the face of the performance statement confusing as this could not be related to any of the other information presented in the performance statement (underwriting margin).

Several FASB members noted that they would potentially favour a separate model for long duration (perhaps a margin approach) and short-duration contracts (an unearned approach) subject to it being supported by users/preparers, to reflect the way that different products are analysed. It was also noted that the unbundling decision would have a significant impact on the Boards’ ultimate decision on the most appropriate presentation model and that the deposit element would have to be properly defined.

An IASB member noted the difficulty in deciding between the different methods proposed by the staff. He indicated his preference to clearly present margin information on the face of the performance statement (this was also supported by other IASB members) although he acknowledged the need of users for the presentation of volume information. He noted that he could accept, in addition to the margin information, volume information being presented on the face of the performance statement as long as it was presented on a

reasonable basis. He asked the staff to reach out to users and preparers to assess which of the methods proposed by the staff they would find most useful and whether the preparers would be able to prepare the information on a reasonable basis. Another IASB member noted the need to present margin information but noted that she was undecided whether this should be on the face of the performance statement or presented in the notes since she would prefer a performance statement that is comparable to other industries.

An IASB member noted the need to keep the presentation format simple to ensure that general users would also be able to understand the performance information presented noting his preference for an earned model. An IASB member agreed with this indicating that it would then be consistent with the information presented under the revenue recognition project. He noted the inconsistent presentation of the interest accretion on insurance liabilities and noted a preference to present this with the investment income and not as part of the underwriting result as proposed by some of the staff examples.

An IASB member noted that the sources of earnings information presented in the dual statement example was very useful information and noted that the Boards could consider a supplementary statement which contained this and margin information which would be presented with the primary statements as part of companies’ primary reporting.

A number of IASB members favoured the approach whereby volume information was presented in a box on the face of the performance statement. It was noted that the information presented was very similar to the expanded margin approach that the Boards considered as part of their deliberations on the ED and noted the difficulty the staff had in trying to develop this method.

The staff indicated that allocating premiums on an earned basis could be challenging especially for annuity and stop loss contracts. The staff also noted that a presentation model consistent with the revenue proposals could work for simple insurance contracts but noted the challenge for contracts which contained more complex features such as guarantees and options. They noted that it would not be ideal to require a second model to be developed to estimate the amount of revenue to be recognised in the performance statement. The staff also observed that the volume information presented in the box was not in line with the cohesiveness principle that is contained in the financial statement presentation project. An FASB member reiterated the importance of providing information that will be used by users and noted that the outreach to users/preparers should specifically address this.

In summary the IASB was leaning towards an approach that included volume information in addition to the summarised margin information as proposed in the ED.

Composite margin

The purpose of the session was to present to the Boards alternatives on the amortisation pattern for the composite margin in the statement of comprehensive income and for the Boards to provide guidance for the staff to further develop the models. The staff identified two alternatives for incorporating the principle for recognition of the composite margin into the recognition criteria. The first approach would be to provide only a principle for recognition, whereas the second approach would be to provide a principle with illustrative examples using recommended or required ratios for recognition. The staff did not ask the Boards to make any decisions.

A FASB member requested the staff to apply the proposed examples to real life products to show how the principles would be applied. Another FASB member noted that it would be desirable to have principles but noted that guidance was lacking for the period over which the composite margin should be recognised (e.g. coverage period only or both the coverage and claims period). Guidance should be developed in order to select the most appropriate amortisation formula for the different types of insurance contract.

A FASB member noted that the formula should amortise the composite margin on the basis of how the insurer is released from risk. He noted that risk is not necessarily correlated to the amount of specific claims and noted that if the formula uses claim values it could result in the deferral of revenue recognition to the latter part of the contract duration. He supported incorporating a principle for the recognition of the composite margin but would not necessarily require the use of specified formulas. He noted that factors that may be considered by actuaries and management in determining the weighting could include the entity's relative experience with the types of contracts, past experience in estimating expected cash flows, inherent difficulties in estimating expected cash flows, the relative homogeneity of the portfolio and within the portfolio, and past experience not being representative of future results. He was hesitant that if formulas were provided, preparers would only use those provided, even if an alternative approach would be more appropriate.

An IASB member noted that these proposals for a risk based composite margin amortisation would align the measurement proposal closer to the IASB's preferred risk adjustment approach. However, another IASB member later commented that the explicit adjustment would be remeasured each period using current estimates while the composite margin approach would merely amortise the original margin.

An IASB member observed that the proposed composite margin amortisation formulas focused on the release from risk but noted that there are also other elements included in the composite margin such as reward for investment management services. He noted that the proposals did not make allowance for the other elements included in the composite margin.

Sir David Tweedie noted that the proposal brought the two Boards closer with regards to the treatment of the composite margin/risk adjustment. An IASB member observed that the risk adjustment is remeasured at each reporting period whereas the FASB composite margin is not, and the FASB has not yet considered whether the composite margin would be unlocked.

Practical expedient for the discount rate

At a previous joint Board meeting the staff was asked to explore the feasibility of providing a practical expedient to determining the discount rate for a particular subset of entities. Following this, the staff recommended in the meeting that the Boards should not provide a practical expedient for determining the discount rate.

A FASB member noted his agreement with the staff proposal not to introduce a practical expedient and noted that the whole proposed measurement model is complex. He did not see compelling support to provide a practical expedient for just an element of the measurement model. In his view, a practical expedient would have to be provided for the entire model to be beneficial. He would however consider a practical expedient for insurance contracts issued by non-insurance entities depending on the final decision on the scope of the future standard with regards to fixed fee service contracts. He would prefer a risk free rate if a practical expedient was introduced as this would be simpler than applying a top down approach. A minority of the FASB would be willing to explore a practical expedient for smaller entities.

An IASB member noted that a practical expedient could be considered for certain types of insurance contracts and noted that it would be useful for non-life insurance contracts. Other IASB members disagreed noting the large variety of insurance contracts issued by insurers and noted that a specific rate such as risk free or high quality corporate bond rate should not be mandated. They noted that local associations in various territories would probably come up with local guidance on the appropriate discount rate to use to comply with the discount rate principles in the standard.

Other than one IASB member, all voted in favour of the staff proposal not to provide a practical expedient for the discount rate. The FASB also generally supported the staff proposal but noted that they would consider it for fixed fee service contracts if these contracts were in the scope of the future insurance standard.

Risk adjustment

The Boards heard the first of three expected presentations on the practical considerations in implementing an explicit risk adjustment approach in measuring insurance contracts. The presenter from Munich Re noted that the market consistent valuation of insurance liabilities (using an explicit risk adjustment) is deeply rooted in Munich Re's key performance measures. Performance indicators such as economic risk capital are the basis for all relevant management processes including risk strategy, value based management, product design and pricing, asset liability management and annual planning, and will be used in the future for Solvency II metrics.

The presenter noted that Munich Re uses the cost of capital approach to measure risk, both for its life and property/casualty business. He noted that the key to having a risk measure which is useful is to employ consistency in application in terms of the specific time horizon selected to calculate risk and the confidence level chosen. In addition, avoidance of double counting of risk is important, for example, capital market dependent components would already have risk built into the market consistent stochastic scenarios generated to arrive at the expected cash flows in building block one, and thereby would not require an additional risk adjustment calculation, while non-hedgeable risks such as insurance cash flows would require a separate risk adjustment.

An IASB Board member asked what the company is actually measuring in the risk margin; is it really risk, or is it profit? The presenter noted that if everything turns out as expected, the risk margin would in effect translate into a profit margin over time, but uncertainty matters at any point in time prior to ultimate settlement. He views the risk adjustment as determining the "production cost of capital" rather than the "pricing cost of capital" and noted that only where the premium exceeds the best estimate of cash flows plus the risk adjustment is there the creation of value (profit).

A FASB member asked whether the estimation of expected cash flows was independent of the risk margin calculation. The Munich Re presenter that in fact they were very dependent, noting that the same actuarial techniques used to determine the expected cash flows were used to determine the risk capital in the cost of capital approach. The FASB member also asked whether risk calculations could ever be comparable across companies based on the presenter's previous remark that consistency in choices of time horizons and confidence levels was critical to year on year comparability within a company. The presenter noted that while transparency would be increased if all companies used the same bases, different calibrations could still be compared if their bases were disclosed, as

certain elements of the cost of capital calculation are entirely proportional and thus easily adjustable.

Picking up on the topic of comparability, an IASB member asked whether the presenter has seen convergence over time between methods used to estimate market consistent liabilities. The presenter noted that perhaps not to the degree he would like, due in part to dispersion in estimates of the risk free rate, the illiquidity premium, and the extrapolation of the yield curve for long dated contracts (e.g. does this occur beyond 15, 30, or 50 years?). Another IASB member asked at what level diversification of risk was considered, and whether the ED portfolio level was appropriate. The presenter responded that the enterprise level in his view is the appropriate level to measure risk, as it is the purpose of the risk margin to measure the production cost of risk for the enterprise.

Alternative discount rate method

The Boards heard a presentation by the French insurer CNP with assistance from Deloitte on an alternative approach for determining the discount rate. The approach, referred to as the ALR (asset liability rate) approach, is meant to address concerns that when current discount rates are used in valuing insurance liabilities, and changes in credit spreads change on the assets that back them, this causes volatility in reported results.

The approach essentially divides cash flows from insurance contracts into three categories and then assigns a discount rate to each category. Insurance contract cash flows for which the insurer currently holds assets that are expected to generate cash flows that match them in duration are discounted using a locked in discount rate determined at inception date, if the assets are recorded at amortised cost or a current rate if the assets are at fair value. The rate is the risk free rate plus liquidity premium. For cash flows that are mismatched in duration, the approach assumes reinvestment at the current market forward rate for risk free investments plus a liquidity premium. Thus, economic mismatches would be reflected currently through income. Embedded options and guarantees, such as minimum interest rate guarantees, would be valued considering both the intrinsic and time value of these components, to yield essentially fair value measures through income.

The presenters noted that they had field tested the model using participating contracts, but that theoretically, the approach could be used for non-participating contracts as well. Some Board members questioned the practicality of the application to non-participating contracts, noting that it might prove challenging to identify and segregate assets that aren't contractually linked to liabilities for purposes of determining duration matched cash flows. The presenters noted that this might be even more difficult for property/casualty contracts.

The presenters pointed out that an advantage of this approach is that for portfolios of participating contracts that are duration matched, changes in credit spreads will not cause unnecessary volatility in the income statement. This is true whether the assets are at fair value or amortised cost, because the discount rate on the insurance contracts would be based on either the current asset-based rate or a locked in asset-based rate, depending on the designation of the matched assets. At the same time, the economic volatility caused by duration mismatches and contract guarantees would be reflected currently. An IASB Board member noted that the model seemed rather complicated, as it required tracking of various categories of cash flows, and the setting of a new rate each time assets were sold and reinvested.

Discount rate - participating contracts

The staff noted that at a previous meeting, the Boards had reconfirmed the principle with regard to the discount rate used to discount expected cash flows, namely that the rate should reflect the characteristics of the insurance liability, and should be a current rate, updated at each reporting period. The Boards had also decided not to prescribe a specific method for calculating the rate, meaning that the rate could be a bottom up approach as originally proposed in the ED and DP (risk free plus illiquidity premium), or a top down approach that started with an asset rate, as long as that rate was adjusted to take out risks present in the market rate for the asset but not present in the liability, such as any investment risk taken by the insurer that cannot be passed to the policyholder.

The intent of the Boards in writing the ED/DP was that this same principle be used for participating contracts (including unit-linked or variable contracts, with-profits contracts in the UK, and universal life contracts). However, some constituents were confused by paragraph 32 of the ED, which to them suggested an entirely different approach for determining the discount rate for such contracts. Paragraph 32 noted that if the amount, timing or uncertainty of the cash flows arising from an insurance contract depends wholly or partly on the performance of specific assets, the measurement of the insurance contract should reflect that dependence. It noted that in some instances a replicating portfolio technique would be appropriate. The staff released a paper in November 2010 to clarify the Boards' intent on this issue.

At the meeting, the staff again clarified that paragraph 32 was meant to build on the discount rate principle that the rate should reflect the characteristics of the liability, noting that in the case of participating contracts, to the extent there is linkage with the assets supporting the contracts, it should be reflected in the rate. Therefore, they proposed that wording be added to the standard to clarify that the objective of the discount rate used to

measure participating and non-participating contracts should be consistent, and to provide guidance on how the insurer should adjust the cash flows in a participating contract using a discount rate that reflects any dependence that exists with the performance of specific assets. For example, where there is asymmetric risk sharing (such as a unit-linked contract that provides for 90% participation in the upside of asset returns but a minimum guaranteed return), that risk retained by the insurer would need to be reflected in the measurement.

The Boards supported the staff proposal, noting in addition that it should be made clear that a replicating portfolio could be used, but was not a requirement. Some questioned how a replicating portfolio would be appropriate in a contract that provided a pass through of the return of a specified pool of assets, but with a minimum guarantee. An IASB member noted, and a staff member agreed, that a replicating portfolio could be used, along with a put option, to measure such a contract.

A FASB member asked what rate would be appropriate for a "fully discretionary" participating feature (for example sharing in the net income of a company) with little or no history. The staff noted that this would reduce the risk of having to provide a specified return, and, as a result, could result in projecting cash flows and discounting back at the same rate. However, she noted that many such contracts have minimum guarantees that also would need to be taken into account.

The staff noted that they expected this issue would be discussed at the upcoming Insurance Working Group meeting and that feedback would be provided on this issue.

Timing of initial recognition

Certain staff proposed that the Boards reaffirm the ED and DP principle that an insurance contract should be recognised as an asset or liability from the date at which it becomes a party to the contract (which could sometimes be before the contract coverage period begins). However, the staff noted that emphasis would be added that insurers need not change their accounting systems to implement this requirement if any gains or losses that arise before the start of the coverage period are not material to the financial statements. The staff believes the principle for recognition is consistent with the entire insurance model, which focuses on measuring obligations accepted by the insurer, rather than the revenue recognition model, which focuses on measuring performance. The staff also noted that changing initial recognition to the coverage date could have unintended consequences, including calling into question the proposal's requirement to include future expected renewal premiums for which the insurer does not have the right to change the price in the building block measurement.

While other staff recognise and accept the principle behind the main staff proposal, but believe that the high cost to implement system changes necessary to evaluate the impact to determine if it is immaterial outweigh the benefits. These staff recommend an alternative approach under which for practical purposes the insurer should recognise an insurance asset or liability at the start of the coverage period, but with earlier recognition of an onerous contract in the pre-coverage period if management becomes aware of an event occurring prior to the balance sheet date that would cause a portfolio of contracts in the pre-coverage period to have a material adverse impact on the financial statements. Examples noted by the staff where recognition prior to the coverage period would be difficult to apply include health insurance contracts that provide open enrolment periods for months prior to contract coverage, and reinsurance contracts that insure contracts to be written by the cedant over the upcoming annual period.

Both the Boards favoured the alternative staff proposal to recognise an insurance contract at the start of the coverage period, some for practical reasons, and others for consistency with other projects such as revenue recognition and leasing. 10 of 15 IASB Board members supported this revised provision, as did all 7 FASB members.

Definition of insurance contract

The staff presented a recommendation to the Boards that they withdraw the ED/DP proposal to add two additional criteria to the IFRS 4 guidance on the definition of an insurance contract. In addition to carrying forward existing IFRS 4 guidance on the definition of an insurance contract, the ED/DP proposal would (a) require that the insurer consider the time value of money in assessing risk transfer and whether additional benefits payable in any scenario are significant and (b) note that a contract does not transfer significant insurance risk if there is no scenario that has commercial substance in which the insurer can suffer a loss (i.e., no scenario where the present value of net cash outflows exceed present value of premiums). The latter requirement was added based on input from the FASB, as a means of reflecting what the FASB believes is the very essence of an insurance contract, the chance of loss, and which is a current US GAAP requirement for reinsurance contracts.

The staff noted that while less than 30% of IASB respondents commented on this topic, most disagreed with revisions to the IFRS 4 definition, noting that the current definition is well understood and has not generated any issues in practice. Some respondents believed that the second additional criteria would force companies to redo their insurance contract analyses for all of their insurance contracts with little benefit. The requirement to consider the time value of money was less contentious, with many believing that this was either implied in IFRS 4 or at least followed in practice.

Other staff expressed their view that the two additional criteria were reasonable and necessary criteria to ensure that only insurance contracts would receive insurance accounting, and that contracts that were merely financings would be accounted for as financial instruments. They rejected the staff recommendation to eliminate these criteria and their suggestion that the potential structuring of financings as insurance could be avoided if unbundling of deposit elements were required.

An IASB Board member reminded the group that one issue raised by constituents was that the revised definition might be problematic for certain reinsurance contracts that cover an entire pool of risks, where individual contracts in the pool would typically have significant insurance risk, but as a reinsured pool of contracts the chance of loss might be extremely remote. Both Boards agreed with a suggestion that the requirements be supplemented with guidance stating that risk transfer is deemed significant if the reinsurance contract transfers substantially all of the risk in the underlying contracts (consistent with an existing US GAAP provision).

The chair then called for a vote, whereby all 7 FASB members and 12 of 15 IASB members supported the alternative staff proposal to retain the two amendments to IFRS 4 (with the supplemental guidance noted above for pools of reinsured contracts).

This publication has been prepared for general guidance on matters of interest only, and does not constitute professional advice. You should not act upon the information contained in this publication without obtaining specific professional advice. No representation or warranty (express or implied) is given as to the accuracy or completeness of the information contained in this publication, and, to the extent permitted by law, PricewaterhouseCoopers LLP, its members, employees and agents do not accept or assume any liability, responsibility or duty of care for any consequences of you or anyone else acting, or refraining to act, in reliance on the information contained in this publication or for any decision based on it.

© 2011 PwC. All rights reserved. Not for further distribution without the permission of PwC. "PwC" refers to the network of member firms of PricewaterhouseCoopers International Limited (PwCIL), or as the context requires, individual member firms of the PwC network. Each member firm is a separate legal entity and does not act as agent of PwCIL or any other member firm. PwCIL does not provide any services to clients. PwCIL is not responsible or liable for the acts or omissions of any of its member firms nor can it control the exercise of their professional judgment or bind them in any way. No member firm is responsible or liable for the acts or omissions of any other member firm nor can it control the exercise of another member firm's professional judgment or bind another member firm or PwCIL in any way.