

September status of the IASB/ FASB insurance contracts project

To date, the FASB and IASB have each discussed various potential measurement approaches for insurance contracts, but neither has agreed with the current exit value approach as described in the IASB's May 2007 Discussion Paper.

Both the IASB and the FASB have been debating the accounting for insurance contracts this year. Their timetable is to issue an exposure draft of new accounting guidance for insurance contracts in December 2009.

Measurement approaches for the liability

A starting point for the discussions has been the IASB Discussion Paper (DP) issued in May 2007 which proposed a single model for all insurance and reinsurance contracts, a current exit value approach based on the notion of what it would cost to transfer the insurance contracts to another party. As transfers rarely actually happen, the DP proposed a "building block approach" which consists of the following three basic elements and uses market inputs for all assumptions:

- Current estimate of the expected (i.e., probability weighted) future cash flows
- Time value of money
- A margin

To date, the FASB and IASB have each discussed various potential measurement approaches for insurance contracts, but neither has agreed with the current exit value approach as described in the DP. So far they have settled on two possible approaches:

- Current fulfillment value
- Measurement approach based on an updated IAS 37 model

Both of these approaches have the same three building blocks as their foundation. However, depending on how each of these components of the building block approach is measured (i.e., the inputs used and their objective), the valuations can differ significantly. The current fulfillment value approach favored by the FASB is the insurer-specific expected present value of the cost of fulfilling the obligation to policyholders with a "composite margin", calculated as the Day 1 difference between the expected present value of this cost and the present value of expected premiums. The IAS 37 proposed model, currently favored by a slight majority of the IASB, includes an explicit risk margin and a service margin in addition to a residual margin in its building block measurement. In addition, the IAS 37 proposed model explicitly requires using the lowest of the building block amount, the price that the market would demand to assume the liability (an exit value notion), if available; and the price that the counterparty would demand to cancel the liability, if cancellation is possible (a settlement notion).

At the July 2009 joint meeting, the FASB expressed support for the current fulfillment value approach. In its deliberations, the FASB noted that since most insurance liabilities will not be transferred to a third party, the measurement objective should be based on what is expected to happen (i.e., fulfillment of the insurer's obligations over time to the policyholder). In addition, the FASB is concerned that estimating an explicit risk margin may not be a reliable measure, adds unnecessary conservatism, reduces comparability and complicates the calculation of the liability, adding additional subjectivity on top of what is already a subjective estimate.

At its September 18 meeting, the IASB decided by a narrow majority to use the updated IAS 37 model (with explicit margins) rather than the current fulfillment model favored by the FASB. Those supporting this approach noted that the use of the updated IAS 37 model for insurance contracts would provide consistency with the measurement approach used for non-financial liabilities for all companies. However, a number of Board members expressed support for the current fulfillment model because (1) they believe it is more consistent with the conclusions of the revenue recognition project, (2) it avoids the difficulty of distinguishing between the risk and profit margins, and (3) it will achieve convergence with the FASB. It was also noted that the updated IAS 37 approach was not yet fully developed, which may cause

the Board to reconsider its tentative conclusion if the proposed IAS 37 model changes.

Given the close IASB vote, in which eight of the fifteen Board members voted to use the updated IAS 37 model in the insurance contracts project, and the fact that the FASB supports the fulfillment value model, the IASB would include discussion of both models in the IASB exposure draft scheduled to be available for comment in December.

The IASB also has expressed support for requiring an unearned premium approach for pre-claims liabilities of short duration contracts. This is based on their belief that it is a good approximation - at least for the short-term pre-claim period - of the two models proposed, which are more complex in application. The unearned premium approach also provides consistency of application for short duration contracts. This approach would recognize unearned premium over the coverage period in the place of the three building block approach, similar to current accounting for unearned premiums during the pre-claim period, but would use the three building block approach for the unpaid claims portion of the liability. The FASB will discuss an unearned premium approach at a future meeting.

IAS 37 model

- Amount the entity would rationally pay at reporting date to be relieved of obligation
- Lowest of:
 - Not having to fulfil obligation
 - Market price
 - Cancellation price with counterparty
- Explicit risk margin remeasured
- Service margin remeasured

IAS 37 v Fulfilment Model

Arguments for IAS 37

- Consistency with other uncertain liabilities
- Measurement objective more rigorous
- Provides a basis for risk and service margins

Arguments for fulfilment

- Consistent with how insurers conduct their business
- Allows boards to tailor the measurements objective to reflect specific characteristics of insurance contracts
- Will exclude risk and service margins which add complexity and can only be determined in an arbitrary way

Both the FASB and the IASB believe that there should be no Day 1 profit recognition for insurance contracts.

Day 1 Profit

Both the FASB and the IASB believe that there should be no Day 1 profit recognition for insurance contracts, supporting their view principally by analogy to the FASB/IASB joint project on revenue recognition. The revenue recognition project does not allow Day 1 revenue recognition, noting that revenue should only be recognized as an entity satisfies its performance obligation to its customer. The signing of a contract is not deemed to provide any service or benefit to the policyholder. This is a change from the DP which proposed that Day 1 profit be recognized. The IASB was then under the impression such a profit would usually be small.

There is currently a difference between the two Boards' views on how to calculate the "no Day 1 profit" amount. Both Boards view acquisition costs as past incurred costs and not a part of the future costs incorporated in the liability estimate for any of the proposed measurement approaches and, therefore, believe they should be expensed as incurred. The FASB, in accordance with the principles of the revenue recognition project, would not include these past costs in the "no Day 1 profit" calculation, thus potentially resulting in a loss in the income statement when a contract is sold equal to the acquisition costs. This difference would be a major change for insurance companies that have large costs of selling and large deferred acquisition cost assets on their books currently. The IASB recognizes that insurance companies include recovery of acquisition costs in their pricing, and believes that the premium related to recovery of direct incremental acquisition costs (primarily commissions) should be recognized in the "no Day 1 profit" calculation, with revenue recognized to offset these acquisition costs. These incremental costs would be expected to be less than the amount of acquisition costs capitalized under current US GAAP practice. The IASB has tentatively concluded that a loss making contract would result in recognition of a loss on Day 1, and although the FASB not yet discussed this issue, observers expect that it will reach the same conclusion.

Probability weighted expected cash flows

With respect to the first "building block," the current estimate of expected probability weighted future cash flows, the FASB and IASB appear to be aligned in their views. Both believe the estimate should be updated each reporting period, and, in theory, based on probability weighted cash flows (a "mean" or average) that reflect the full range of possible outcomes, rather than a single point estimate of the most likely amount to be incurred (i.e., in US GAAP literature, a "best estimate"). The Boards believe that expected cash flows best reflect the inherent uncertainty in the amount and timing of cash flows and provide the most meaningful representation of an insurance contract and its potential numerous possible outcomes. The summaries to date from the FASB and IASB staff point out that this approach in some cases could require relatively simple modeling, without the need for a large number of detailed simulations, but in other cases could involve more complex calculations and the use of stochastic modeling.

There remains an implementation issue as to whether current claims reserving practices, which involve developing an actuarial central estimate, will meet the requirement of this principle. Informal discussions with the IASB staff have indicated that the objectives of the proposed approach and US current practice for property and casualty claims reserves are the same.

With respect to the inputs used to measure the probability weighted cash flows, the FASB and IASB discussions have focused on whether and when market inputs versus entity-specific inputs should be used. Comments from constituents on the DP focused on the impracticality of obtaining “market inputs” for some of the required assumptions in the building block approach. Both Boards seem to agree that where observable market inputs are available and are both relevant and reliable, such as for certain financial variables (e.g., interest rates, equity prices, and inflation) observable market inputs should be used. For the estimation of cash flows relating to insurance claims and related costs, the DP argued that in practice, market participant cash flows such as those relating to underlying insurance claims would not differ significantly from entity-specific cash flows. While most respondents accepted this argument, some disagreed with using expense data of a market participant rather than entity-specific expenses. Preparers generally thought entity-specific estimates of such costs were more appropriate and they were concerned with their ability to obtain sufficient evidence to satisfy auditors and regulators that an entity’s expected expenses were in line with a market participant’s view of these expenses.

The FASB noted that it believes entity-specific data, such as historical data on an entity’s own administrative and claims processing costs, could be used, but also commented that if there is specific market information available relative to a factor that an entity is estimating, then such market data cannot be ignored. The IASB has been less clear in its discussions, referring to the belief expressed in the DP that entity-specific inputs would not typically differ significantly from market participant inputs for non-financial variables. The IASB staff papers have noted that both the IAS 37 proposed model and the current fulfillment value model measure the liability from the perspective of the insurer and not from the perspective of other market participants, implying an entity-specific based measure. While the IAS 37 approach starts out as a transfer sort of notion, requiring a liability based on “the amount the entity would rationally pay at the end of the reporting period to be relieved of its present obligation”, there is an entity-specific measurement to the calculation that comes into play. That is because the amount the entity would rationally pay is further defined as the lowest of (1) the value to the entity of not having to fulfill the liability (an entity-specific measure), (2) the price that the market would demand to assume the liability (an exit value notion); and (3) the price that the counterparty would demand to cancel the liability, if cancellation is possible (a settlement notion). The IASB acknowledges that insurers typically fulfill their insurance liabilities rather than transferring or settling them; accordingly, in many (if not most) cases, it is expected that an entity-specific value would be used. At the same time, the proposed IASB approach would specifically take into account transfer or settlement amounts where there is objective evidence of such amounts.

Both the IASB and FASB believe the estimate of expected probability weighted future cash flows should be updated each reporting period, and, in theory, based on probability weighted cash flows that reflect the full range of possible outcomes, rather than a single point estimate of the most likely amount to be incurred.

The IASB and FASB have been discussing whether or not future “recurring” or “renewal” premiums on existing contracts should be included in the measurement of the contract liability, and, if so, whether or not an asset could result at an individual contract or portfolio of contracts level.

Policyholder behavior and contract boundaries

This concerns whether or not future “recurring” or “renewal” premiums on existing contracts should be included in the measurement of the contract liability, and, if so, whether or not an asset could result at an individual contract or portfolio of contracts level. An essential consideration is where the existing contract ends and a new contract begins. For example, in a typical long duration life insurance contract, the policyholder has the option to keep paying renewal premiums at terms that are typically specified in the original contract, but is not obligated to do so. In contrast, a typical short duration property casualty contract may also include an option to renew, but the renewal premium may be at then current rates rather than at a rate specified in the contract.

The FASB has had an educational session on this topic but no formal Board discussions. In the educational session discussions, some Board members seemed willing to support the inclusion of future expected premium cash flows (and related benefits and claims) for existing contracts, but noted that a boundary needed to be established as to what constituted an existing contract versus a new contract. That boundary seemed to be when an insurer could unconditionally reunderwrite or reprice the contract. One stumbling block in this model is that the insurer has in substance written an option. Elsewhere in the literature, the conclusion is that written options cannot be assets.

The IASB has had some preliminary discussions on the premiums to be included in expected cash flow estimates, noting that the measurement should include future premiums and other cash flows resulting from those premiums (e.g., benefits and claims, including those cash flows whose amount or timing depends on whether policyholders exercise options in the contracts). Similar to the FASB’s preliminary thoughts, to identify the boundary between existing contracts and new contracts, the starting point would be to consider whether the insurer can cancel the contract or change the pricing or other terms. The IASB staff has indicated that they will develop more specific proposals relating to this issue for presentation to the Board at a future meeting.

Another related issue is whether the conclusions reached apply to situations in which the amount of premiums has not been indicated in the contract (e.g., in universal life contracts). This will also be discussed at a future meeting.

Discounting

Both Boards have tentatively concluded that cash flows should be discounted, including claim liabilities arising from non-life contracts. The IASB has rejected non-discounting as a proxy for the risk margin, which is the current practice in most, but not all, property and casualty insurance jurisdictions. The FASB will discuss non-discounting as a proxy for a risk margin at a future meeting.

The DP noted that the discount rate should be consistent with observable current market prices for cash flows whose characteristics match those of the insurance liability, in terms of timing, currency and liquidity. The DP rejected use of a discount rate based on the assets held to back insurance liabilities as irrelevant for a decision useful measurement of that liability unless the cash flows from those assets directly affect the cash flows arising from that liability.

The IASB recently discussed whether guidance should be based on:

- A principles-based approach in which the discount rate would reflect the characteristics of the liability, or
- A practical approach aimed at reducing complexity and fostering comparability by prescribing an observable market rate such as that used in pension or other accounting guidance.

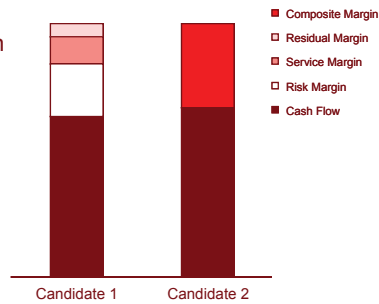
A principles-based approach might result in the use of a risk free rate, adjusted for liquidity if the risk free rate is based on government securities with different liquidity characteristics than insurance contracts. A practical approach might result in the use of a rate for high quality fixed income debt instruments, as is used in some other accounting guidance. The IASB will discuss the separate topic of including an adjustment to the rate for a company's own non-performance risk as part of its fair value project.

The IASB has tentatively agreed that the exposure draft should state the principle of a discount rate, i.e., that it reflects the characteristics of the liability, rather than prescribe an observable market rate. The IASB staff noted that the discount rate should reflect only the time value of money, not other risks inherent in the cash flows that would be captured in the other two building blocks. The discussion on the components of the potential discount rate included mention of the risk-free rate, a liquidity premium for an illiquid non-puttable liability such as a payout annuity (versus a highly liquid government security), and own performance risk (for which discussion was deferred in light of the overall fair value project). The IASB discussed the fact that there was a concern among constituents that significant Day 1 losses could arise if the risk free rate alone were used for certain contracts where the liabilities are illiquid (such as annuity contracts). An upward adjustment from the risk free rate on liquid government securities would theoretically be required in such circumstances. The IASB will be seeking further input from companies involved in the field testing as to whether they can reliably estimate a liquidity adjustment.

Both The IASB and FASB Boards have tentatively concluded that cash flows should be discounted, including claim liabilities arising from non-life contracts.

Possible measurement approaches being discussed

1. Updated IAS 37 model with explicit risk margin
2. Fulfillment margin with one margin calibrated to premium



The difference in views between the IASB and FASB Boards on the liability measurement objective is most pronounced concerning risk margins.

The FASB has not reached any decisions regarding the selection of the discount rate, but has had one education session where the staff introduced the two IASB choices noted above (principle-based rate versus prescribed rate). The staff currently supports the practical approach of prescribing a rate, such as the rate for high quality fixed income debt instruments. They noted that use of a prescribed rate is similar to other accounting guidance, such as pensions, and believe that the fulfillment value has a similar objective to a pension measurement. Use of a prescribed rate would also provide comparability among companies. Formal Board discussion is expected on this topic next week. Initial comments from the Board did not reveal a leaning in any particular direction. While there was acknowledgement of the benefits of a practical approach, including comparability, relative ease of estimation, and lack of subjectivity, there was also concern about the lack of an objective or principle in such a rate, and the potential disconnect with the economics of the insurance transaction.

Margins

The difference in views between the Boards on the liability measurement objective is most pronounced in the risk margin building block.

Under the current fulfillment value approach supported by the FASB, a “composite margin” would constitute the third building block, calculated by deduction on Day 1

as the difference between the expected present value of premiums, less the expected present value of the cost of fulfilling the obligation to the policy holder over time. This composite margin would not be remeasured and would be released as described below. There would be no explicit, separately calculated risk margin, as the FASB believes that the objective of the fulfillment approach is to measure the cost of fulfilling an obligation rather than to measure the amount at which the liability could be transferred. In addition, the FASB is concerned that estimating an explicit risk margin may not be a reliable measure, adds unnecessary conservatism, reduces comparability and complicates the calculation of the liability, adding additional subjectivity to what is already a subjective estimate.

In contrast, under the updated IAS 37 measurement approach, the “residual margin” would be the amount calculated on Day 1 as the difference between the expected present value of premiums, less the expected present value of the cost of fulfilling the obligation to the policyholder over time, less an explicit risk and service margin. The explicit risk margin would reflect the value to the entity of not having to bear the risk related to the expected cash flows and would be remeasured at each reporting date. Those supporting inclusion of an explicit risk margin in the estimate note that it is necessary to reflect the fact that an insurer would rationally pay different amounts to be relieved of two liabilities that differ in riskiness but otherwise have the same probability

weighted cash flows. As an example, inclusion of a risk margin appropriately distinguishes a liability with a 50% probability of requiring cash outflows of \$49 and a 50% probability of requiring cash outflows of \$51 from a second liability with a 50% probability of requiring cash outflows of \$0 and a 50% probability of requiring cash outflows of \$100. Both of these liabilities have the same probability weighted cash flows of \$50 but the second liability is considered to be riskier than the first.

Both models require consideration of how the margin deferred on Day 1 should be released and over what period, i.e., the recognition pattern and its term. For short duration policies, the period of release could be just the coverage period (generally one year) or could extend through the claims handling period, which in long tail business could be much longer. For long duration contracts, the coverage period and claims handling period typically are about the same, so that the decision about the term of release is not as critical.

Under the fulfillment value approach, the composite margin is comprised of an implicit, unmeasured risk and service margin and a residual margin, representing any residual profit resulting from the Day 1 deferral of expected gain. Because it implicitly includes a risk margin, some argue that the composite margin should be amortized based on the expected expiration of risk. In contrast, under the IAS 37 proposal, an explicit risk margin is already being estimated and updated each period; the residual margin represents only residual expected profit from the transaction that would otherwise have been recognized immediately if not for the Day 1 profit deferral. Therefore, to some, release from risk seems irrelevant for the unwinding of any residual margin, while others still look to release from risk as the most relevant driver.

The FASB has yet to discuss the subsequent release of the composite margin. Under the IAS 37 model, a slim majority of the IASB voted at the September meeting that the residual margin should be released over the coverage period. In terms of pattern of release, the IASB discussed

several alternatives that could drive the pattern, which included release from risk, passage of time, and cash flows. The Board has not reached a conclusion as to whether it should (1) prescribe the driver (e.g., passage of time), or (2) allow each company to select the appropriate driver. The staff will provide further input at a subsequent meeting, including input from companies participating in the field testing.

An additional issue requiring consideration is how to account for subsequent changes in estimates in cash flows for building block one, i.e., whether changes in estimate should result in the adjustment of the composite or residual margin amounts. The IASB discussed two principal approaches. Approach A would recognize any changes immediately in the income statement with the residual margin locked in at inception. Approach B would adjust the residual margin for subsequent changes in estimate, with the change in estimate reflected in income as the revised residual margin is amortized over the remaining period. Most Board members concluded that Approach A was consistent with an IAS 37 model and Approach B was more consistent with a fulfillment model. Eleven Board members voted in favor of Approach A (recognizing any changes immediately in the income statement) under the IAS 37 model. The FASB will discuss this issue at a future meeting.

Now until December

In addition, to the specific issues discussed here, the Boards have yet to discuss or conclude on policyholder behavior and the contract boundaries, unbundling (whether premium should be broken down into its insurance, service, asset management and financing components), financial statement presentation, participating and unit linked (variable) contracts and disclosures, including sensitivities, among other topics. This all adds up to a very full fall agenda for the Boards and their staff. Other major Board projects, such as financial instruments, leases, revenue recognition, liabilities and equity and non-financial liabilities include topics that may be relevant to the insurance contracts project.

Potential impacts on insurers' financial results

At this stage in the Boards' deliberations it is hard to say with any certainty how insurance company financial results will change. A few observations can be made:

- With the restriction against Day 1 gains and the expensing of acquisition costs, growing blocks of business will be less profitable even if the IASB view about recognizing revenue for direct incremental costs prevails. The effect of non-deferral or less deferral of acquisition costs will also make stable and declining blocks more profitable without the DAC amortization drag, and, will eliminate the confusing unlocking results for long duration contracts that we have today under USGAAP.
- With both Boards' leaning toward full unlocking of assumptions, the life insurance industry following USGAAP will have much more volatile results. The interest rate volatility may be offset to some degree if matching assets are also marked to market through the income statement but investment credit, policyholder behavior and the other assumptions may still create earnings volatility. The inclusion of

an explicit risk margin under the IAS 37 model that changes with the price and perception of risk also will cause volatility. Those life insurance contracts with a heavy investment element may experience reduced earlier reported profitability, as a result of the lower discount rates that will be applied. Those lines of business that utilize the accumulated account balance for the policyholder liability will now need to model prospective cash flows with potentially greater volatility.

- The short duration model will most likely extend the period profit is recognized as both Boards believe there is some performance obligation or service performed past the end of coverage; however, during the claims period, it may depend on the relative effect of the discounting process and margins held. The fulfillment model would recognize this by amortizing some portion of the composite margin over the claims settlement period. The IAS 37 model would accomplish this through the explicit margin in the claims liability. Highly uncertain claims reserves will be larger, longer tail stable reserves may be smaller. Mismatches in asset and liability durations will cause interest rate volatility.

Tentative decisions from 2009 meetings to date

Topic	IASB	FASB
Measurement approach	<ul style="list-style-type: none"> • Leaning towards IAS 37 but considering fulfillment • Unearned premiums for short-duration pre-claims liabilities 	<ul style="list-style-type: none"> • Fulfilment model with a composite margin • Not yet discussed unearned premium model
Features of measurement approach	<ul style="list-style-type: none"> • Consistent with observable market prices • Use explicit current estimates of cash flows • Reflect time value of money • Include an explicit margin 	<ul style="list-style-type: none"> • Use expected rather than best estimate cash flows • Use all available information • Reflect time value of money
Margin at inception	<ul style="list-style-type: none"> • No day 1 gain recognised (except for acquisition costs) • Day 1 loss in income statement 	<ul style="list-style-type: none"> • No day 1 gain • Not yet discussed day 1 loss
Margins	<ul style="list-style-type: none"> • Views diverge 	<ul style="list-style-type: none"> • Recognise composite margin rather than explicit risk margin
Acquisition costs	<ul style="list-style-type: none"> • Recognise as revenue premium that covers acquisition costs • Acquisition costs limited to incremental costs of issuing contracts 	<ul style="list-style-type: none"> • Expense all acquisition costs as incurred • No recognition of revenue to offset acquisition costs
Policyholder behaviour and contract boundaries	<ul style="list-style-type: none"> • Include cash flows whose amount or timing depends on whether policyholders exercise options in contracts • Detailed proposals to be developed based on whether insurer can cancel or change terms 	<ul style="list-style-type: none"> • Not yet discussed

The remaining big issues

- Margins—risk, service, residual, composite
- Discount rate
- Boundaries of a contract (policyholder behaviour)
- Policyholder participation
- Acquisition costs
- Unbundling
- Performance statement structure