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# ***IASB/FASB***

## ***Board meeting***

### ***Insurance contracts***

PwC Summary of Meetings

21-22 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 March 21-22, 2011 where they discussed the pros and cons of unbundling various components of insurance contracts. They reached a tentative decision on one aspect of unbundling, agreeing to carry forward the existing separation requirements in IFRS 4 and IAS 39/IFRS 9 and Topic 815 under US GAAP for derivatives embedded in insurance contracts. They expect to continue the unbundling discussion at a future meeting.

The Boards agreed to amend the objective of the explicit risk adjustment after taking into consideration constituent concerns that the IASB exposure draft ("ED") reference to "the amount the insurer would pay to be relieved of the risk" implied an exit value notion rather than a fulfilment value notion and the "maximum amount" suggested the application of conservatism.

The objective was revised during the meeting to "the compensation the insurer requires to bear the risk that the ultimate fulfilment cash flows exceed those expected."

The staff introduced a paper proposing the effects of changes in the discount rate for "ultra-long duration" cash flows would be presented in other comprehensive income ("OCI"). The amount would reflect all changes in measurement attributable to changes in the unobservable part of the yield curve. The Boards' general reaction to the proposal was that the use of OCI for insurance contracts should be looked at more holistically than just for one piece of the discount rate. The Boards suggested that the staff reach out to preparers and users as well insurance working group members later this week to gather views on OCI presentation for certain components of the change in the insurance liability.

The staff proposed that a contract renewal should be treated as a new contract when the insurer is no longer required to provide coverage or when the existing contract does not confer on the policyholder any substantive rights. Both Boards agreed that contracts for which the pricing of the premium does not include risks relating to future periods, no substantive rights are conferred on the policyholder when the insurer has the right or the practical ability to reassess the risk of the portfolio the contract belongs to and, as a result, can set a price that fully reflects the risk of that portfolio.

### **Unbundling - overall considerations**

The staff noted that with regard to unbundling, the ED and FASB discussion paper ("DP") proposal was that components not closely related should be separated, a concept consistent with IFRS 9 and ASC 815. However, constituents noted that they were uncertain how to apply the guidance for deposit and service components, and feedback varied on whether preparers wanted to unbundle or not. The staff believes that a clearer objective needs to be developed for unbundling and asked the Boards their views on this.

One IASB member noted that in one place, the staff paper said that unbundling would get rid of arbitrage, but in another section it said it could result in arbitrage. The staff noted that the first reference was talking about eliminating arbitrage between different industries by requiring that the same types of instruments be treated in a similar manner (e.g., as financial instruments, whether issued as part of an insurance contract or separately), while the latter reference was referring to ways an individual company could use unbundling for its benefit, for example to get amortised cost accounting for a portion of an insurance contract.

An IASB member commented that it is not worthwhile to unbundle if the measurement outcome is not expected to be materially different, given the complexity, time and effort needed to unbundle. An exception might be situations where presentation on a different basis would matter, or where the combination of components lacked commercial substance. He noted that one concern with the insurance project was the use of different discount rates between insurance contracts and derivatives, which could result in material differences.

Another IASB member stated his agreement with the above. He is not concerned with people "throwing in a little insurance" to get insurance accounting, and believes that the insurance model produces high quality information. He acknowledges that in some cases you may get a slightly better answer if you unbundle because you won't have as much of an asset/liability mismatch. However, as constituents noted, in many instances the components will be hard to allocate due to the integration of various provisions within the contract, adding complexity without adding much benefit. In summary, he would make the decision based on whether

accounting would be significantly better with unbundling. He would not object to leaving an option to unbundle where it is straightforward to do and the product is built that way.

Several other IASB members echoed these comments, noting that the objective should not be to search for as much unbundling as possible or "delve too deeply," and that unbundling could lead to more arbitrage opportunities based on the somewhat arbitrary nature of the unbundling exercise in certain more integrated products. However, they acknowledged that in some cases unbundling for presentation purposes might produce more decision useful information, such as for deposit premiums and embedded derivatives.

A FASB Board member noted that keeping the deposit component bundled wouldn't help the asset/liability mismatch issue. He indicated that subtle differences between current value (of insurance contracts) and fair value (of financial assets) may make this important, as commentators said that whether or not you have a credit component in the rate matters. He also had concerns with not unbundling as to whether any revenue number presented in the statement of comprehensive income would actually represent revenue; as in some instances premiums are really just deposits.

An IASB member later agreed with the FASB member concern with bundling, noting that presentation matters. Another FASB member also agreed, noting that the more they talk to investors and analysts, the more they hear about concern with the "black box" issue that is insurance. As products get comingled with other industries, he believes it doesn't make sense to get different answers. Another IASB member agreed that insurance risk should be separated from other risks.

An IASB member suggested to the staff that an outreach effort to investors and analysts on this issue would be helpful to gather information for a future meeting.

### **Unbundling - embedded derivatives**

The staff noted that not many constituents commented on the ED and DP proposal to require separation of embedded derivatives, and asked the Board members their views. The Boards reached a tentative decision to carry forward the existing separation requirements in IFRS 4 and IAS 39/IFRS 9 and Topic 815 under US GAAP for derivatives embedded in insurance contracts.

The staff noted that some constituents had suggested that the cost of unbundling would outweigh the benefits, especially since the building block approach is a current value model that requires use of market observable data, where available. Thus, there would be no significant difference between the insurance model valuation and fair value (other than perhaps the insurer's own credit risk which is not considered in the insurance model). However, the Boards noted that there is already existing literature in place requiring bifurcation, and as a result

there is also existing practice on how to unbundle embedded derivatives. In addition, several Board members noted the increased transparency that separation would yield.

One FASB member asked whether bifurcation of embedded derivatives for insurance contracts would now be inconsistent with the IASB conclusion not to bifurcate embedded derivatives from assets. He also noted that the FASB's answer was contingent on decisions reached in their financial instrument project, for example, whether the clearly and closely related criteria would remain the same.

An IASB member questioned why, for embedded derivatives, the view is that you are always required to unbundle, whereas for other components, such as deposit and service elements, the group had earlier suggested that whether or not you unbundle depended on how different the measurement was between the models. The staff plans on addressing deposit and service component unbundling issues at a future meeting. They will then circle back to consider the Boards decisions as a whole and whether there are internal inconsistencies that should be eliminated and whether an overall principle can be developed.

### **Objective of the explicit risk adjustment**

The staff noted that while constituents responding to the ED generally agreed with the concept that the risk adjustment conveys the uncertainty of the expected cash flows, they had issues with the clarity of the objective and the use of certain terminology. The ED notes that "the risk adjustment shall be the maximum amount the insurer would rationally pay to be relieved of the risk that the ultimate fulfilment cash flows exceed those expected." Respondents noted that the risk adjustment would be affected by both favourable and unfavourable outcomes, and thus objected to the ED reference to the words "exceed those expected." They also noted that the reference to amounts an insurer "would pay" to be relieved of the risk sounded more like an exit concept than a fulfilment value concept, and some thought that the reference to the "maximum amount" implied that a level of prudence or conservatism was supposed to be applied.

As a result of these comments, the staff redrafted the objective of the risk adjustment and presented it to the Boards for discussion. They noted that "the risk adjustment shall be the amount that makes the insurer indifferent between (a) undertaking or retaining the obligation to fulfil the insurance contract; and (b) undertaking or retaining an obligation to pay an amount equal to the expected present value of the cash flows that will arise as the insurer fulfils the liability."

Many IASB and FASB members found the proposed staff words, laid out in a "with and without" type explanation, to be unclear and unnecessarily complex. Some found the suggestion made by the American Academy of Actuaries to be clearer: "An equivalent amount where the insurer is indifferent between paying a certain amount (to eliminate the uncertainty) and keeping the uncertain cash flows."

A FASB member noted that although constituents objected to the "risk that cash flows would exceed those expected" wording, in his view this terminology is necessary because the concept behind the risk adjustment is a risk aversion notion, meaning that an amount is added to the mean to reflect the fact that people want to be compensated for the chance that the outcome could be worse than expected. In response to the FASB member's remarks, the staff explained respondents views, noting that the fact that you are risk averse doesn't mean you ignore the good, you just concentrate more on the bad; but you consider both.

By the end of the discussion, the Boards had settled on some draft wording for the objective of the explicit risk adjustment as follows: "The risk adjustment shall be the compensation the insurer requires to bear the risk that the ultimate fulfilment cash flows exceed those expected." The staff will also include a follow on sentence to address constituent concerns with the "exceed" wording. One staff member expressed his view that the idea of "indifference" still needed to be included in the objective because without it, there is no way to indicate how much compensation the insurer would require.

### **Discounting ultra long duration cash flows**

The staff introduced a paper whereby the effects of changes in the discount rate for "ultra-long duration" cash flows would be presented in other comprehensive income. The amount would reflect all changes in measurement attributable to changes in the unobservable part of the yield curve. It was suggested by the staff in light of constituent concerns with how to extrapolate the yield curve with reasonable accuracy beyond the period that observable long term discount rates are available.

One IASB member commented that there are a lot of items that need to be estimated that are not observable in the insurance model, for example the risk margin, and questioned why this one particular piece of the model was being singled out for OCI treatment. Several other IASB members as well as FASB members echoed these concerns. One asked whether users would consider this an improvement, and whether preparers would think it would meet a cost/benefit test given the potential added burden and complexity of tracking this particular component.

A FASB member noted that to the extent that liability payments occur in years beyond the point when there are duration matched assets, this is real economic volatility, i.e. a real mismatch and thus questioned why it should be shown in OCI rather than income. An IASB member noted that the user community was almost unanimous that they want to see economic volatility; they want it to be transparent. The staff responded that although this is real volatility that should be reported, the question is whether it should be reported in income versus OCI.

Another FASB member noted that ultra long insurance contracts were no different than long dated derivatives. The insurer took the risk by writing the contract, and if the model requires the use of current data, then it should be measured as such.

It was suggested by several IASB members that the staff should do an outreach to users as well as raising the issue with the insurance working group. Several FASB clarified that the OCI suggestion should be raised more holistically and not just in regard to changes in the unobservable part of the yield curve.

### **Education session on explicit risk adjustment**

Tony Coleman, from Lonergan, Edwards & Associates presented to the Boards on experience with the practical implementation of a risk adjustment in the Australian non-life insurance market. He noted that the Australian market was the 10th largest in the world and that both large and small insurance companies applied explicit risk adjustments. He noted that QBE, which is one of the larger writers in the local market, also has significant operations worldwide and all insurance subsidiaries are required to determine an explicit risk adjustment using Australian Accounting Standards for group reporting purposes.

He explained that the Australian model for non-life insurance is very similar to the proposals in the modified measurement model proposed in the ED. The model uses an unearned premium liability for the pre-claims period and discounts the insurance liabilities at the risk free interest rate. The liability for outstanding claims is based on central estimates which he indicated was the same as the proposed expected cash flows in the ED and also requires the estimation of an explicit risk adjustment. A liability adequacy test has to be performed which includes an explicit risk adjustment. He also indicated that in terms of the standard for insurance companies, AASB 1023, all assets backing the insurance liabilities have to be measured at fair value. He noted that the local standard requires disclosure of the expected cash flows as well as the risk adjustment with mandatory disclosure of the probability of adequacy (PoA) of the insurance liabilities including the risk adjustment.

Tony briefly noted that the accounting model for life insurance contracts does not require an explicit risk adjustment but follows a methodology more in line with the composite margin approach. He noted that the difference between previously expected and current year actual results is recognised in the income statement. However, the margin is unlocked and adjusted for changes in expected future non-financial estimates/assumptions.

He noted a high-level classification of insurance business into (i) high frequency/low severity business where the outcomes are relatively easy to predict (e.g. motor business), (ii) low frequency/high severity business where the outcomes are harder to predict reliably (e.g. earthquake business) and (iii) low outstanding claims risk (life business) versus high outstanding claims business (asbestos).

He explained the broad steps in the Australian model as follows:

1. Assess the expected cash flows of the liability for each class of business;
2. Assess the coefficient of variation of the liability (a measure of the inherent variability of a distribution);
3. Select the appropriate distribution for the present value of claims (he noted that a log normal distribution was a good approximation for most classes of business);
4. Select the PoA;
5. Assess the risk adjustment by class of business before diversification.

In addition to the above steps which are in line with the ED proposals, the Australian model would allow for correlations and diversification benefits and would adjust the overall risk adjustment for the whole portfolio of contracts.

He then explained the application of this methodology with the use of a simplified example of a dice with 6 possible outcomes whereby you would have a claim in five of the six possible outcomes. He calculated the expected value, variance, standard deviation and coefficient of variation of the possible outcome of a 100 dice rolls. Using this example, he indicated at what level the risk adjustment would have to be set to achieve a 50%, 75% and 90% PoA for this example where you have a well known statistical distribution. He indicated that in his example, you would have a claim event in 5/6 of the possible dice rolls. He indicated that for a typical insurance policy the possibility of a claim would be more in line with a 1/6 chance of a claim and indicated that in such an example the variation would be much higher and the risk adjustment required to achieve the same PoA as in his example would be higher.

He noted that a risk adjustment becomes particularly important for long tail business with significant outstanding claims liabilities where a change of 1% in the expected liability value could have a significant impact on the current year profit figure. He illustrated the impact that different outstanding claim distributions have on the required risk adjustment in order to achieve the same PoA. The higher the variation in possible outcomes, the higher the required risk adjustment would be. He presented a table of typical risk adjustments as a percentage of the insurance liability for the Australian market. He noted that for regulatory purposes where the PoA is set at 75%, a reasonable level of consistency has been achieved by the industry (when compared on a liability weighted basis). He noted that the higher variation reflected by the simple average reflects the impact of the risk adjustment required by different sized companies (for small insurers the inherent variation in the portfolio of contracts is higher thereby requiring a higher risk adjustment).

He concluded by noting that consistency in the determination of risk adjustments has improved over time due to the extensive disclosure requirements which include the PoA and claims development tables. He noted that more guidance have been developed in recent years and highlighted some of the benefits of applying a risk adjustment, notably the improved transparency of the results for insurance businesses have improved. Analysts are very interested in understanding the profit impact when insurers changed their PoA (quality of earnings) and indicated that the ED proposed this disclosure.

A FASB member questioned whether investors/capital providers looked to Australian insurance groups more favourably compared to non-Australian insurers due to the transparency in the measurement of the insurance liabilities. Tony indicated that he believed they did due to the investors having a better understanding of the results of these insurers.

A FASB member questioned whether the use of log normal distributions would be a gross simplification in the case of, for example, asbestos business. Tony noted that there is a spectrum of practice that has developed. Smaller companies tend to make use of log normal distributions more often due to the lack of credible own data but they do make use of consulting actuaries who have wider experience on the appropriateness of the distribution used in the calculation. He noted that the larger insurers would typically use the distribution as derived from their own claims experience. Tony noted that reinsurance impacts on the net risk adjustment that is required for portfolios. In most cases reinsurance policies covers the risk of the tail and it is therefore not that difficult to estimate the risk adjustment for the net retained risk. Reinsurers are, however, exposed to the inherent difficulty in estimating the distribution of the

tail exposure assumed through the reinsurance policies and they tend to make use of more complicated models.

An IASB member questioned what the impact of the risk adjustment and accompanying disclosures were on the premiums charged by insurers in Australia. Tony noted that the business is cyclical and noted that the premiums are impacted by many other factors too and that it would be hard to pin point its impact on the premiums charged by insurers.

A FASB member noted that smaller companies tended to set PoA at higher levels than larger insurers and questioned how the different PoA applied by different management and changes to the PoA was assessed by auditors. Tony noted that the PoA set by the majority of companies were close to 90%, driven by the disclosure requirements and market forces. Another FASB member noted that he supported the enhanced comparability that the use of the PoA would bring to the results of insurers. He noted that the ED however allows the use of three different methods to determine the risk adjustment and questioned whether the results determine using the three different methods would be comparable. Tony indicated that in his view you would be able to compare the results presented on three different bases, especially for non-life business given that sufficient information are disclosed. He reiterated the importance of disclosing the PoA.

Mark Swallow and Leopoldo Camara from Swiss Re next presented on risk adjustments from the perspective of the economic value management (EVM) methodology used by Swiss Re to manage its diverse insurance business. They noted that EVM is used for pricing the reinsurance treaties, asset liability management and internal/external performance reporting. The EVM framework uses the cost of capital approach to calculate the required returns in the business. They noted that the cost of capital includes the group's estimate of the "frictional cost" of the capital held for taking on reinsurance risk and this equates to the risk adjustment as required by the ED. EVM is used for all their business to evaluate the economic value created by the business from an underwriting and investment activity perspective.

In the EVM methodology, the expected premiums on a contract are compared to the production costs (determined on an expected cash flow basis) which include the frictional capital costs to write the business. This frictional capital cost reduces over time and is released to the income statement over time as the liability runs off. Under this methodology, gains are recognised on day one and the business performance for all businesses is reported indicating the result of new business written and that of prior years' business. The impact of the release of capital costs are also presented separately.

They noted that the total capital costs in EVM consist of the risk free return on capital (shareholders base cost of capital), the market risk premium (excess returns shareholders expect on market risk exposure) and frictional capital costs (compensation for agency costs, cost of potential financial distress and regulatory/illiquidity costs). He noted that the frictional capital cost represented the risk adjustment as required by the ED. They noted that they typically charge a 4% frictional capital cost based on projected EVM capital required for their reinsurance treaties. They noted that the estimation of the allocation of the required frictional capital is the most complex aspect of the model and follows a method similar to that presented earlier under the Australian model. They took the Boards through the results of an actual small portfolio that was measured under this methodology and noted that the required EVM capital and run off pattern of the EVM capital is dependent on the nature of the tail of the business. They also presented the income statement and balance sheet which they use under this methodology.

An IASB member noted that the EVM income statement format followed by Swiss Re is driven by the liability measurement model similar to the proposals in the ED. He questioned whether they believed volume information should be presented. The presenters responded that the disclosure of volume information is important.

In the discussion that followed it was noted that different companies have different risk appetites and hence tend to hold different levels of capital to support the business. Reinsurers typically will tend to hold more capital but this result in the reduction in the cost of capital which has an offsetting impact on the value attributed to the risk adjustment. It was noted that the EVM results were supplementary to the financial reporting presented under Swiss GAAP.

### **Contract boundary**

The staff recommended that contract renewals should be treated as a new contract (i) when the insurer is no longer required to provide coverage or (ii) when the existing contract does not confer on the policyholder any substantive rights. The second issue deals with the level at which that assessment is made. One staff view is that a contract does not confer on the policyholder any substantive rights when the insurer has the right or the practical ability to reassess the risk of the particular policyholder and, as a result, can set a price that fully reflects that risk. This principle is in line with the proposals in the ED, in which the assessment is made at the individual contract level. However, as an alternative proposal on the "level" question, some staff recommended the following alternative proposal: for contracts for which the pricing of the premiums does not include risks relating to future periods, no substantive rights are conferred on the policyholder when the

insurer has the right or the practical ability to reassess the risk of the portfolio the contract belongs to and, as a result, can set a price that fully reflects the risk of that portfolio. The staff also recommended that all renewal rights should be considered in determining the contract boundary whether arising from contract, law or regulation.

The staff noted that the alternative proposal above is the result of concerns raised by health insurers and that the consequence of moving the unit of account for the assessment of the contract boundary to the portfolio level could result in reducing the contract term for many contracts. It was noted that legal requirements sometimes don't allow insurers to price for pre-existing risks/conditions, however this risk is spread and priced for across all policyholders at a portfolio level. Insurers often can exit business at a portfolio level. In the above scenario, the premiums charged for the portfolio represents the same aggregate premium that the insurer would have charged if policyholders were priced individually. The alternative staff view therefore proposes that if the premium charged on a policy does not include compensation for a future risk period (e.g. no deposit/financing element in the premium for future periods) it would trigger the contract boundary if assessed at a portfolio level.

An IASB member questioned what the implication would be for other contracts such as term insurance and whether far more contracts would be classified as short duration contracts to which the modified measurement approach would have to be applied. The staff responded that for many term insurance contracts the premium charged in early years contains a financing element for later years and they believe under the alternative staff proposal these would still be considered long duration contracts.

A staff member supporting the individual policyholder assessment proposal noted that the CFO Forum had done a lot of work on the contract boundary to come up with proposals which are similar to the contract boundary as proposed in the ED. The CFO Forum has raised concerns that changing the contract boundary principle could have implications which have not yet been identified. An IASB member noted that in some jurisdictions, health insurance contracts are treated as long duration contracts and suggested that the alternative proposals should be tested with insurers in the major markets to ensure there are no unintended consequences.

There was some concern raised with applying the contract boundary principle at a portfolio level in situations referred to as the “death spiral”. The concern is whether an insurer would always be able to reprice the whole portfolio in order to cover the risk of a particular bad risk in the portfolio and thus to satisfy the requirement that the insurer be able to reprice the portfolio to fully reflect that risk. In certain situations, policyholders within a particular portfolio who are good risks could decide to cancel their contracts as they could get the same cover at a better price elsewhere, leaving only bad risks in a portfolio, and raising the possibility that the insurer would not be able to fully reflect the risk at even the portfolio level. Board members were at first concerned that the risk of the alternative proposal for the contract boundary is that contracts could be treated as short duration even though economically the insurer is exposed to risk for a much longer period in such “death spiral” portfolios.

However, a FASB member observed that at the point at which the insurer can no longer reprice to fully reflect the risk of the portfolio (e.g., the “death spiral” example or caps), analysis of the contracts would lead to the conclusion that the contracts were no longer “short duration” contracts, but instead were longer duration contracts in which future years’ premiums and claims would be taken into account in the building block approach, such that the liability would not be understated. An IASB member asked whether this “reassessment” would violate the long standing position that classification of insurance contracts only be made at contract inception. However, it was pointed out that since the contracts were formerly “short duration”, this new assessment would be done at inception of the new contract period. The staff was asked to develop this concept further.

In a vote, both Boards agreed that a contract renewal should be treated as a new contract when the insurer is no longer required to provide coverage or when the existing contract does not confer on the policyholder any substantive rights. The FASB unanimously agreed that this assessment of the contract boundary should be performed at a portfolio level only if the premium does not include risks relating to future periods as described in the alternative staff proposal above. The majority of the IASB members were also in favour of the alternative proposal, but with the caveat that the insurer be able to fully reflect the risk at the portfolio level. Both Boards agreed all renewal rights should be considered in determining the contract boundary whether arising from contract, law or regulation. Several Board members noted that it would be helpful for the staff to provide examples to them of how the “death spiral” situation and contracts with caps would be analysed and accounted for.

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