
Insurance alert

IASB/FASB Board Meeting

Insurance Contracts

PwC Summary of Meetings

21 July 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 21 July 2011 where they discussed the outcome of the outreach effort the staff had undertaken with US insurance analysts. The Boards also discussed the modified or simplified approach for short duration contracts (now termed the premium allocation approach) and whether it is an approximation of the building block model or a separate model. The debate centred around which contracts should be eligible for the premium allocation approach. No decisions were made. Questions about the detailed methodology of the premium allocation approach, for example if it should be permitted or required, whether amounts should be discounted, and how it should be presented were not discussed at this meeting. The topic of unbundling had been included in the agenda papers but was not discussed at this meeting.

Outreach with US investors

The staff summarised the main points that were raised by US insurance analysts in their recent outreach. Some users felt that US GAAP for insurers (particularly for non-life contracts) was not 'broken' and therefore the need for change needed to be better justified. In addition, there were concerns that the significant amount of historical US GAAP data for trend analysis would be lost moving to a new standard. However other users noted that a common insurance standard would be beneficial.

Other concerns were expressed about whether the proposed accounting model focused too much on regulatory needs, the increased reporting of volatility in earnings and the different income statement presentation for insurance contracts which could discourage investors from investing in the insurance sector. While many sell side US analysts thought there was too much unlocking and preferred a cost over a current value measurement, buy side analysts seemed to prefer the latter.

Some analysts commented that adding a discounting factor for non-life liabilities was too subjective, while others considered time value to be an integral component of the measurement model.

One of the IASB Board members recommended that the staff involve general investors in their outreach and not only focus on specialist insurance analysts. Another IASB member suggested that the staff bring together investors from the US and from Europe with the aim of finding some common ground. In addition, one of the IASB Board members strongly emphasised the different starting points of the US compared to the IFRS community. He pointed out that it is very important to the IFRS community to develop an insurance standard but he questioned whether a converged position was needed if US GAAP was currently felt to work for the US. Another IASB member agreed and noted that in many emerging countries the insurance industry was still developing and needed an insurance standard. Some IASB members and staff also challenged the view of some analysts that the proposed model focused on regulatory objectives.

Staff explained that the outreach with the US specialist analysts was the beginning of their planned outreach and that they would be talking to analysts in other parts of the world and would endeavour to include non specialist analysts.

Premium allocation approach (modified approach for short duration contracts)

The staff noted that the terminology in the latest staff papers was changed from the IASB exposure draft and FASB discussion paper (ED/DP) to clarify the components of the approach. The "modified or simplified approach" would now be referred to as the "premium allocation approach," the "pre-claims liability" would be replaced with the "liability for remaining coverage," and the "claims liability" would be termed the "liability for incurred claims."

The staff presented two papers setting out different staff views on the premium allocation approach. The staff explained that although the premium allocation approach had generally been welcomed by respondents to the ED/DP, many commentators had criticised the proposals as being over-engineered. In addition there had been criticism of the fact that the premium allocation approach was required rather than permitted.

The IASB staff recommended that the premium allocation approach should be viewed as a simplified approximation of the full building block model (one model approach). They explained that contracts would be eligible for the premium allocation approach when that approach resulted in a reasonable approximation of the building block model. In addition, this condition

would be deemed to be met without further investigation when the coverage period was approximately one year or less and the contract does not contain any embedded options or derivatives that significantly affect the variability of cash flows (after unbundling any embedded derivatives). This approach would be permitted and not required. In a change from the Boards' views expressed in drafting the ED, guidance would be added to avoid overly restrictive interpretations of "approximately one year", clarifying that contracts could meet the definition even if they are several months longer than one year and even if there are a few longer-duration contracts within a portfolio of predominantly one-year contracts.

The FASB staff recommended that premium allocation approach be viewed as a separate model from the building blocks as non life contracts were economically different from life contracts (two model approach). Contracts should be eligible for the premium allocation approach where: the compensation to the policyholder is based on the incurred loss and not a specified amount, the period between the premium receipt and the date of loss is insignificant and the pricing of the premiums excludes risks relating to future renewal periods. The FASB staff indicated that a key challenge, in particular for US insurers, of the one model approach would be the need to prove that the premium allocation approach is an approximation of the building block model. This would require entities to perform calculations under both the building block and the premium allocation models.

An IASB member asked the staff to explain which contracts would be caught by the different eligibility criteria of the two approaches. The staff indicated that a very high percentage (say 90%) of contracts would be equally eligible for the premium allocation approach irrespective of which set of eligibility criteria were used

The chair of the IASB questioned the rationale behind the different staff perspectives about one versus two models when there was such a high degree of overlap in the eligible contracts.

A FASB member agreed that in his view the main question was the eligibility for the premium allocation approach rather than whether there were one or two models. Although he supported the FASB staff concerns regarding the need to prove approximation to the building blocks, he had some reservations about the implications of having two different models for other aspects of insurance accounting such as discounting claim liabilities and reinsurance.

In the resulting discussion several members of both Boards expressed their confusion as to the objective of the eligibility criteria and whether they aimed to identify;

- a distinction between contracts that could be viewed as economically different or with greater/lesser importance of underwriting results (that is, life and non-life contracts),
- contracts with a significant degree of financing (that is short versus long duration contracts), or
- contracts with different degrees of variability in cash flows.

Members of the Boards expressed divergent views about there being a significant difference in the underlying economics of life and non life contracts and therefore whether there should be one or two models. There was no poll of views but a majority of the FASB members who expressed an opinion tended to believe that there were two models but a majority of the IASB members who expressed an opinion favoured there being one model.

One of the IASB Board members stated her view that the premium allocation approach was primarily a different presentation model (rather than a different measurement model) and disagreed strongly that there was a significant difference between the importance of investment returns for life and non-life business. As evidence that non-life companies also consider investment return as well as underwriting, she noted that non-life companies often, in presentations to analysts, describe that while they may have a loss ratio over 100%, their business is still profitable because the interest inherent in collected premiums will cover the shortfall.

An IASB member queried whether an annual travel insurance policy that paid out variable amounts for property claims such as lost baggage, but also paid fixed amounts for specified injuries or death would fall outside the criteria of the two model approach and therefore be accounted for using the full building block approach or be bifurcated into two components. The FASB staff indicated that their intention was not to bifurcate contracts in this way.

A member of the FASB questioned how the premium allocation approach could be viewed as an approximation of the building block approach since the building block approach results in one insurance liability and a net margin in the income statement whereas the premium allocation approach results in recognising two separate liabilities (one effectively a performance obligation with related revenue and the other a claim liability that is treated as an expense. In his view this represented a fundamental difference between the two models.

One of the IASB members stated his preference to have coverage periods up to one year (for contracts that do not contain embedded derivatives) as the initial eligibility criteria. No proof of approximation to the building block model was required for these contracts, however insurers could still use the premium allocation approach for longer duration contracts if they proved it was a reasonable proxy. The IASB staff indicated that this had been their intention.

Despite the different views expressed, some members of both Boards reiterated the need to focus on arriving at a converged set of criteria given the 90% overlap in the relevant contracts that would be eligible for the premium allocation approach.

The chair of the FASB reminded Board members that questions about the premium allocation model itself, for example if it should be permitted or required or if amounts should be discounted would be discussed in later meetings.

No decisions were taken. The staffs were asked to identify types of contracts where the two sets of eligibility criteria would give different results, then bring this analysis back to the Boards.

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