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# ***IASB/FASB***

## ***Board meeting***

### ***Insurance contracts***

PwC Summary of Meetings

16-18 February 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 16-18 February 2011 where they discussed the discount rate for non-participating contracts, contract cash flows, the risk adjustment as a principle, the treatment of day one gains/losses, and project assumptions. The Boards also had education sessions on unbundling, presentation and the unlocking of the residual margin. An announcement was made at the start of the meeting that a recent press release indicating that the insurance project completion date would be delayed until the end of the year was incorrect. The IASB confirmed that they still expect to have a final standard by mid-2011. The Boards did not discuss the observer papers on locking in the discount rate or the discounting of non-life contract liabilities.

The Boards agreed with the staff proposal that the standard should not prescribe a rate or method for determining the discount rate but instead should explain that the objective is to adjust future cash flows for the time value of money and reflect the characteristics of the insurance contract liability. The rate should be consistent with observable current market prices for instruments with cash flows whose characteristics reflect those of the insurance contract liability, excluding the effect of the insurer's own non-performance risk. The rate should reflect only the effect of risks and uncertainties that are not included elsewhere in the measurement of the insurance contract liability, and should exclude any factors that influence the observed rates but are not relevant to the insurance liability such as investment risk not passed along to the policyholder. The Boards also agreed to explore further the possibility of whether and under what circumstances a practical expedient (such as a high quality bond rate with appropriate adjustments) would be allowable.

The Boards agreed with the staff recommendation that the expected value of the estimated cash flows is the mean and that depending on circumstances not all possible scenarios need to be modelled. The Boards also accepted the staff recommendation that the costs to be included in the cash flows should be those directly related to the fulfilment of the contracts, which can include direct overheads and should be identified at a portfolio level.

The Boards asked the staff to continue their work on an explicit risk adjustment. Many Board members agreed that at a conceptual level an explicit risk adjustment provided useful information to users. Later meetings will address the practical and cost/benefit issues.

The staff also reviewed with the Boards their paper on axioms and assumptions, noting that the paper describes propositions the staff believes are self-evident as well as assumptions that the staff believe do not require further consideration by the Boards given comment letter feedback. The Boards agreed with the way forward for the project as set out in the staff paper but noted that IASB redeliberations on the insurance contracts project should consider IFRS 9 financial instruments guidance as it is currently written. For the FASB, the revised US recognition and measurement model for financial instruments is still under development, and the FASB therefore needs to consider the financial instruments model during its deliberations on insurance.

In the unbundling education session, the Boards noted that they need to agree on the objective of what they want to achieve with unbundling insurance contracts. If the objective is to present the risk from the underwriting activities separate from the investment activities it would lead you to unbundle. The Boards also acknowledged the level of judgement that will be involved in allocating to contract components if contracts were required to be unbundled.

The Boards are willing to explore a “floating” residual/composite margin approach which remeasures the margin for favourable and unfavourable changes in non-financial estimates but need to consider whether the residual margin could be negative. Recognising a negative residual margin would go a long way to converge the two Boards’ views on the residual/composite margin but the Boards noted they will have to consider the presentation of the insurance liability in such a scenario. Most Board members would remeasure the margin for changes in non-financial variables with changes in financial variables recognised in profit or loss but it was noted that this would cause volatility for those insurers that measure their financial assets at amortised cost.

### Discount rate for non-participating contracts

The staff noted that many respondents disagreed with the IASB Exposure Draft (ED) and FASB Discussion Paper (DP) requirement to utilise a risk-free rate plus a premium for illiquidity to present value the cash flows of an insurance contract for several different reasons. One concern is that the rate results in volatility due to an accounting mismatch with related assets. A second concern is with day one losses that result from discounting at a rate that is lower than the rate reflected in pricing of contracts. A third issue is the lack of a standard methodology for determining the liquidity premium.

The staff provided an analysis of both the bottom up approach proposed in the ED (and DP) and the alternative top down approaches suggested by some constituents. Because the ED rate starts with the risk free rate on liquid assets such as government bonds and then adds back a component to capture the less liquid nature of an insurance contract liability to arrive at the liability discount rate, it is referred to as a bottom up approach. Most US constituents and some non-US constituents attempting to alleviate the concern with the lack of a standardised method for determining the illiquidity adjustment instead seem to prefer a “top down” approach, which starts with an asset rate and then subtracts out components not relevant to the liability characteristics such as expected defaults. The staff noted that they did not have any objection to the top down approach, assuming that it could be adjusted to arrive at a rate that is equivalent to the risk free plus illiquidity premium rate proposed in their bottom up approach.

In discussing the ED bottom up approach starting with the risk free rate, the staff noted that in some territories, government rates are not risk free, so that in addition to the liquidity adjustment, the risk free rate itself may not be easy to determine. However, the staff noted that the interest rate swap curve may provide a reasonable alternative, with an adjustment to exclude any counterparty credit risk inherent in that rate. Another issue with an approach that starts with the risk free rate is that risk free rates for very long durations are difficult to observe in the marketplace, requiring extrapolation of the yield curve using one or more statistical techniques. It was later observed that this would be an issue with any rate, whether top down or bottom up.

In discussing the various top down approaches suggested by respondents, the staff noted that either an actual portfolio rate or reference portfolio rate could be used as starting points, assuming the cash flows of the actual portfolio closely match the insurance liability cash flows. These rates would then need to be adjusted for expected losses as well as unexpected losses (the risk of

losses exceeding the expected value). In contrast, they do not believe that pricing rates could meet the objective because they reflect long term expectations rather than current measurements.

Based on the input from constituents, the staff proposed that the standard should not prescribe a rate or method for determining the discount rate but instead should explain that the objective is to adjust future cash flows for the time value of money. The rate should be consistent with observable current market prices for instruments with cash flows whose characteristics reflect those of the insurance contract liability, excluding the effect of the insurer's own non-performance risk. The rate should exclude the effect of risks and uncertainties included in the cash flows or the risk adjustment, and should exclude any factors that influence the observed rates but are not relevant to the insurance liability such as investment risk not passed on to the policyholder.

Several Board members commented that the revised objective that the discount rate reflect the time value of money was too broad an objective, and the Boards asked the staff to revise the objective to bring back into it the concept that the rate reflect the characteristics of the insurance liability.

One IASB member noted that theoretically, the discount rate for the insurance liability should be a borrowing rate. The rate would not be the same as the insurer's borrowing rate with creditors, but instead should be a rate reflecting the seniority of policyholder payments over general creditor payments. He is therefore theoretically opposed to excluding credit risk, but is doing so not because of the counterintuitive nature of the result of reducing liabilities as credit risk increases, but based on his understanding that own credit risk is immaterial for such contracts.

Some Board members noted that in some instances, where uncertainty is not captured in the cash flows or risk adjustment, such uncertainty could potentially be captured in the discount rate. A staff member cautioned that this would inherently assume that risk expires on a basis consistent with the payment of cash flows, which was not likely in many cases. However, the idea that in some instances the discount rate might be used to capture certain of the risks and uncertainties of the contracts was not dismissed, and was noted as being acceptable in the fair value measurement proposal. The Boards agreed that the guidance should be clear that the discount rate should exclude whatever risks and uncertainties are already captured in the cash flows or risk adjustment to avoid double counting.

A FASB Board member noted that the staff paper did not discuss the implications of the fact that in insurance contract measurement, there are both cash inflows

coming from policyholders (which therefore have policyholder credit risk) as well as cash outflows, and the paper seems focused only on the outflows. The staff responded that there is no significant credit risk on the inflows side, given that, if the policyholder failed to pay, the policy would be cancelled. As a result, one could look at the pure time value of money for discounting the inflows.

It was noted that at least one of the top down approaches provided to the Boards by constituents started with an asset portfolio rate and then subtracted out expected defaults, but not the "reward" for the default risk (which is similar to a risk adjustment to reflect the fact that actual defaults can be greater than expected defaults). Many Board members seemed to support the notion that both expected defaults *and the reward for default risk* should be subtracted out to arrive at a rate that is consistent with the bottom up risk free rate plus liquidity adjustment. The staff noted that the constituent proposal chose not to deduct the additional amount, in part due to the difficulty in estimating the reward for default risk. An IASB member noted that if the Boards allow a top down approach, they will be agreeing to a "quasi-asset" rate which would vary based on the insurer's asset portfolio. He therefore would require disclosure of the yield curve if this rate were used, or, alternatively, he would prefer the use of a reference market rate to impose some discipline on the calculation.

One FASB member asked how the staff proposal would address the three major concerns raised by constituents that the staff had mentioned at the outset (volatility, day one loss, and complexity). The staff responded that the purpose was not to reduce true economic volatility, but only accounting volatility and that discussion on subsequent papers would consider these concerns further.

At the end of the discussion the Boards voted in favour of the staff proposal, but with potential enhancement to the objective to state that the rate should reflect the characteristics of the liability, and subject to any later discussions on a proposed practical expedient rate.

### **Practical expedient for the discount rate**

The staff noted that some commentators indicated that the complexity in determining the discount rate would be reduced if the Boards were to prescribe a discount rate (such as a high quality bond rate) as a practical expedient.

Several Board members highlighted the difficulty in determining an appropriate rate to use as previous Board research had identified only 4 countries that had deep and liquid corporate bond markets. Other Board

members were concerned that if a high quality bond rate were selected there would still need to be an adjustment for credit risk as the Boards had previously indicated it should not be in the measurement of the insurance liability.

Despite the concerns expressed the Boards agreed that the staff should explore further the possibility of a practical expedient discount rate and the circumstances in which it could be used.

### **Cash flows**

The staff informed the Boards that many commentators had asked for clarification on the 'expected value' measure of cash flows and to clarify which costs should be included in the measurement of the cash flows. The Boards agreed with the staff recommendation that the measurement objective of expected value refers to the mean and also agreed there is no need for all possible scenarios to be quantified in all circumstances. Some Board members asked for an education session on the different actuarial methodologies for arriving at a mean as it was not clear whether some methodologies may give rise to problems in calculating a risk adjustment.

In the discussion on which cash flows and costs should be included in the estimated cash flows, the staff recommended that all direct cash flows necessary to fulfil the contract should be included. The staff recognised that there is a balance between identifying the direct costs and including them in the liability and excluding period costs.

There were mixed views among the Board members whether direct costs should include an allocation of overheads and if so which overheads. Several Board members highlighted the interaction between the costs that are included in the cash flows and the impact on the residual or composite margin; the more costs that are included in the expected cash flows, the lower the residual/composite margin. Some Board members were concerned that too wide a definition would allow general overheads to be included in the liability measurement. However the Boards agreed broadly with the direction of the staff's recommendation that the estimates of cash flows should include costs that relate directly to the fulfilment of the contracts (for example payments to policyholders) and that these can include direct overheads. The Board agreed that the primary notion was the direct relationship of the costs to the fulfilment of the contracts and not whether the costs were incremental. The Board also confirmed that the direct relationship was at the portfolio and not at the contract level.

### **Risk adjustment**

The staff highlighted that the key difference between the IASB ED and the FASB DP was the explicit risk adjustment. The staff indicated that views from commentators had been largely divided along geographical lines with US constituents generally not in favour but constituents from other jurisdictions generally being in favour of an explicit risk adjustment. The staff asked the Boards whether or not in principle they agreed that conceptually the measurement of an explicit risk adjustment would provide relevant information to users and be understandable. They asked the Board members to put aside all questions of practicality, comparability and cost/benefit which would be dealt with separately at a later meeting if the Boards confirmed that in principle an explicit risk adjustment was useful.

Several Board members indicated strongly that on a purely conceptual basis it was difficult to contradict the assertion that an explicit risk adjustment provided useful information. However, other Board members were concerned that the risk adjustment made insurance contract accounting more opaque to users and that it was impossible to answer this question at the purely conceptual level. Other Board members agreed that there was information value in the risk adjustment but it was not clear that that meant it had to be recognised and measured separately or simply disclosed. There were also concerns as to whether the risk adjustment would double up on risks accounted for elsewhere either in the discount rate or the cash flows and whether it was possible to have genuinely unbiased cash flows. Some Board members asked for an education session from preparers who already perform risk adjustment calculations and particularly how it would work for property and casualty insurers who are more likely to have skewed distributions and potentially have more uncertain cash flows. One Board member suggested that if the residual margin was unlocked and any negative residual margin could be adjusted against the risk adjustment then it may get to a similar result as the composite margin (as long as the contract overall was profitable). This was discussed more in the debate on unlocking the residual margin. The Boards asked the staff to continue their work on the other practical questions on the risk adjustment and also to schedule an education session.

### **Day1 gain and losses**

The Boards reconfirmed the position in the ED and the DP that there should be no day 1 gain on initial recognition of the contract. They also confirmed that any day 1 loss should be recognised immediately in profit or loss and that the residual or composite margin could not be negative. However, it was noted that the decision on whether the residual margin could become negative

would be addressed as part of the staff's work on the remeasurement of the residual margin.

### Project assumptions

During the relatively brief discussion of the staff paper, an IASB Board member noted that an additional assumption he would like to see added is that the IASB redeliberations on the insurance contracts project should consider IFRS 9 financial instruments guidance as it is currently written, as the Board has no intention of changing IFRS 9 at this point. The FASB chair remarked that unlike IFRS 9, the FASB is still developing its new financial instruments model. The FASB chair noted that unlike the IASB, the revised US recognition and measurement model for financial instruments is still under development, and thus the FASB needs to be considering the financial instruments model during its deliberations on insurance. Another IASB Board member noted that while he agreed that IFRS 9 was not currently in play, eventually the IASB would need to review IFRS 9 when the FASB finishes its financial instruments project. In response to a question from a Board member, the staff confirmed that the assumptions made in the paper regarding discounting and other elements of the building block model would not preclude consideration of a modified approach for certain (short duration) contracts. The Boards agreed with the way forward for the project as set out in the staff paper.

### Unbundling

In this education session the external presenters (Gail Tucker and Sam Gutterman from PwC and Leonard Reback from MetLife) addressed the Boards to help them understand the effect, costs and benefits of separating insurance contracts into insurance and non-insurance components.

The PwC presentation explained, using a simplified unit-linked example, the accounting implications if you (a) do not unbundle a contract, (b) unbundle a contract by allocating all fees and charges to the insurance component and (c) allocate elements of the contract to the account balance, investment management services and the insurance component. Some of the key messages from the examples were the profit profile of the insurance component is driven by the residual margin amortisation pattern, the different treatment of changes in estimates when you unbundle, the judgement involved when allocating fee/charges, acquisition costs and expenses to the different contract components and the differences that occur when unbundled components are measured at amortised cost. The presentation then focused on typical features that exist in universal life contracts and the complexity these features add when attempting to unbundle these contracts. It was noted that the same universal life contract can be sold with a

significant upfront premium (similar to the unit-linked or accumulation contract) or with regular minimum premiums (which perform similar to term insurance contracts) which impact on the comparability with other contracts when unbundling.

The Board members noted the judgement that is required when allocating fees/charges between the different components of the contract as well as the discount rate used to present value the account balance component even when not unbundling a contract. One Board member questioned whether the unbundling requirements under US GAAP has added value to users of the accounts and also noted that the ultimate return on capital is unchanged whether you unbundle or not. The presenters observed that it was unclear whether users fully understood the impact that unbundling has on the presentation of the results of insurers in the US but that disclosure of sources of profit would be far more useful information for users.

Leonard Reback next provided insight on unbundling from one US life insurer's perspective. He noted that some benefits of unbundling are the consistent treatment of financial instrument components included in insurance contracts with financial instrument accounting and that it reduces some potential accounting mismatches. He also observed that cash flow information needed for unbundling would need to be captured in the measurement model in any event due to the ED requirement to apply different discount rates to different contract components. He took the Boards through an example of a single premium immediate annuity which includes both a guaranteed payment period (for example 15 years) and a period where payment is contingent on the policyholder being alive which are backed by two bond portfolios for the term certain and contingent components respectively. Using mean durations, he highlighted the impact of unbundling on the results presented for this contract. He illustrated the impact of a parallel shift in the risk free rate, a change in market interest spreads as well as a non-parallel change in the risk free rate.

One Board member questioned what the expected cost implication was to unbundle contracts. The presenters noted that it depends on whether there are other requirements (e.g. regulatory requirements) that already require unbundling and hence this would differ from territory to territory. There were also some differing views expressed on whether the mismatches that arose due to the changes in assumptions in the examples were accounting or economic in nature.

A Board member observed a difference in the objective of the two presentations and noted that the Boards need to agree on the objective of what they want achieve by requiring (or not) unbundling of insurance contracts.

Another Board member observed that if the objective is to present the risk from the underwriting activities separate from the investment activities it would lead you to unbundle.

### Margins

The objective of the paper on margins was to educate the Boards in anticipation of a future decision on whether the residual or composite margin should be unlocked or remeasured and the staff did not request the Boards to make a decision at the meeting. The purpose was only to give the staff a steer whether they need to explore some of the following notions in more detail. The staff illustrated through numerical examples some approaches and the implications of unlocking the margin.

The examples are set out in observer paper 3M and illustrate how changes in estimates would be reflected under the following approaches:

- all changes are recognised in profit or loss (ED proposal);
- unfavourable changes consume the residual margin but the residual margin cannot be negative;
- unfavourable changes consume the residual margin and the residual margin can be negative;
- changes recognised in profit or loss if “realised” and against residual margin if “unrealised”; and
- changes adjust the residual margin retrospectively to the amount that would have been determined if the new estimates had been used at inception.

An IASB member observed that if the Boards decide to include contract acquisition costs at the portfolio level (not incremental at contract level) and also direct overheads in the contract cash flows, it would reduce the quantum of the residual margin recognised and it should take some of the pressure off the amortisation pattern of the residual margin. Another IASB member observed that if the Boards decide not to include overheads in the contract cash flows, the residual margin would capture an element of the insurance contract that was priced to cover future costs that will be incurred as the contract is fulfilled. He would be against allowing the consumption of the residual margin to the extent that no liability is recognised for expenses that will be incurred in future years (with no further revenue inflows).

Most Board members expressed a preference for a floating residual margin which would remeasure the margin for both favourable and unfavourable changes in the other building blocks. Some Board members that previously supported a composite margin approach and view an explicit risk adjustment as part of the deferred profit on a contract would allow for the residual margin to become negative as long as the combined risk and residual margin would not become negative. The view

was expressed that this would result in a treatment similar to the composite margin approach. Other Board members that support the explicit risk adjustment and view the risk adjustment as part of the insurance contract liability expressed concern with allowing for the residual margin to become negative.

The Board members expressed some concern that unlocking the residual margin would add complexity to the model. Some Board members would only remeasure the residual margin for non-financial variables (with changes in financial variables recognised in profit and loss) in order to avoid accounting mismatches with assets that are measured at fair value. Another Board member highlighted that the Boards also needed to consider those insurers that measure financial assets at amortised cost. These insurers would prefer to remeasure the residual margin for both financial and non-financial variables otherwise a residual margin that is remeasured for non-financial variables only would introduce an accounting mismatch. A FASB member highlighted the importance to consider the views of users whether they would prefer the immediate recognition of changes in estimates in profit and loss or whether they would prefer a remeasured residual margin. An IASB member noted that irrespective of the conclusions the Boards may reach, information on the impact in the current period due to a change in estimates should always be provided (as proposed in the ED).

The IASB chair summarised the session noting that the Boards are willing to explore a floating residual/composite margin approach but need to consider whether the residual margin could be negative and how the insurance liability would be presented in such a scenario. The Boards would have to consider the onerous contract test if the residual margin would be allowed to become negative.

### Presentation models

The staff presented a paper on presentation models to serve as a refresher for the Boards on the previous deliberations and presentation models considered. The models considered before were the summarised margin approach (included in ED), the expanded margin approach, the written premium approach (traditional life model) and the premium allocation approach (traditional non-life model).

The Board members observed that in the outreach it was clear that users had a need for volume information. However, it was not clear for the Boards whether the information required was on a premiums written or allocation basis. There was some support to present a memo volume/revenue number at the top of the performance statement.

The Boards noted the importance of the impact of the unbundling decision on the presentation of insurance contracts. One approach could be to unbundle insurance contracts for measurement and presentation but an alternative could be to unbundle the contracts for performance reporting only but still present a single insurance contract liability. It was noted that the Board struggled to develop the expanded margin approach due to the complexity involved in grossing up the margin presentation for both revenue and expenses that are included in the liability measurement model. It was noted that an earned premium approach would be more aligned with the proposals in the revenue recognition project but that the information as provided by the summarised margin approach was also very useful.

The staff noted that they were working on a presentation model that included information on both a traditional and margin approach but that it would need to be updated following the information gathered from the Board during the insurance contract discussions this week. It was also noted that the EFRAG was working on a similar approach which was expected to be available in the near future. The Boards noted that they should also consider a presentation approach that reflects an operating profit measure. The Board members stressed the importance that the presentation model being developed should address the needs of users and be useful to such an extent that insurers will not present a significant amount of other non-GAAP measures.

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