

IASB Board Meeting – Insurance Contracts

PricewaterhouseCoopers Summary of Meeting

18 September 2009

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

Highlights

The IASB held a board meeting on the 18 September. At the start of the session Sir David Tweedie emphasised the importance of making a decision on the measurement model to get the project completed before June 2011, given the anticipated changes in Board members after that date.

Peter Clark noted that they have 15 companies who are doing field testing on acquisition costs and after this meeting they hope to ask them to look at margins and discounting.

At this meeting the Board discussed 3 issues:

- **Issue 1:** Making a decision on the measurement approach
- **Issue 2:** Subsequent treatment of residual/ composite margins
- **Issue 3:** Discount rate

On Issue 1 the Board decide by a narrow majority to use the IAS 37 model (with explicit margins) rather than the current fulfilment model favoured by the FASB.

On issue 2 the Board concluded that the residual margin should be recognised over the coverage period (rather than the coverage and settlement period). The staff will consider further the pattern of amortisation used under the Australia MOS model and discuss this issue with the field test companies and bring back to the Board at a later date. The Board decided that subsequent changes in estimates should be recognised immediately in the income statement rather than adjusting for these in the residual margin.

On issue 3 the Board concluded that a discount rate that reflects the characteristics of the liability should be used rather than requiring the use of a prescribed rate. The staff is seeking further input from the field test companies on whether an adjustment for liquidity should be made.

Issue 1: Measurement approach

A number of Board members expressed concern at being asked to decide between the IAS 37 and current fulfilment models when the IAS 37 model was still under discussion. However,

it was noted that the differences were sufficiently clear that they could make a decision although they may have to revisit this if IAS 37 changes.

A number of Board members expressed support for the current fulfilment model because this was more consistent with the revenue recognition project, avoids the difficulty of distinguishing between the risk and profit margins and will achieve convergence. Another Board member noted that he would support fulfilment because he is unclear how IAS 37 would apply to some of the costs (such as claims handling) and unclear whether the risk margin is based on a cost or price of risk. He also expressed a concern that if an entity was exposed to say longevity risk and purchased an instrument to hedge this risk, it was unclear whether this would effect the measurement of the risk margin. It was also noted that IAS 37 would require a service margin for which there had been little support in the responses to the Discussion Paper proposals. Another Board member noted that some of these issues would also be issues under a current fulfilment model.

There was some discussion as to whether the current fulfilment model was consistent with the revenue recognition model as a number of Board members noted that it would allow remeasurement of future cash flows which for most contracts under the revenue recognition proposals would only happen if the contract is onerous.

A number of Board members expressed support for the IAS 37 model with a re-measurement of the risk margin and one noted that respondents to the Discussion Paper had supported the building block approach that would underpin IAS 37.

On the vote 8 Board members were in favour of the IAS 37 model (out of a total of 15 board members). There was a discussion as to whether both models would be included in the exposure draft. It was noted that this may not be possible as the model used may affect future decisions to be taken by the Board. It was noted that the FASB will be exposing the current fulfilment model. The FASB staff in passing noted that they will be discussing with the FASB Board whether under the current fulfilment model there will be several performance obligations, such that more than one margin is needed, The IASB noted that they will need 9 votes to publish an exposure draft but that they might be able to get this support once the exposure draft as a whole is prepared.

Issue 2: Subsequent treatment of residual/composite margins

Having concluded they are now using an IAS 37 model the IASB staff asked how the residual margin should be recognised in the income statement. The staff noted it had not reached a conclusion on this topic. Some Board members noted that if a separate risk margin was being recognised the unwind of the residual margin should not be linked to risk. Others suggested it should be unwound in line with the cash flows, but it was noted that cash flows may be much later in a non-life contract when the risk of further claims will have expired. One Board member wanted “the plug” to be eliminated as fast as possible! An example of a one year non-life contract for which claims are settled over 3 years was considered. 8 Board members (but a different 8 from the previous vote) voted to recognise the residual margin over one year rather than the three years. It was noted that for long term life insurance contracts the difference between the coverage and settlement period would not normally be significant.

The Board were asked whether companies should determine the driver for the pattern to unwind the residual margin or should they specify the pattern as being the unwind from risk. A number thought it should be based on the passage of time. There seemed to be a reluctance to conclude on this question and so the IASB staff will find out how this is done under the Australian MOS model and also get further input from the companies participating in the field testing.

The Board then discussed how to account for subsequent changes in estimates. The IASB staff had identified three approaches. Approach A would recognise 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 estimates and would be reflected as this margin is amortised over the remaining period. Approach C would update the margin as a fixed proportion of expected cash flows determined at inception. One Board member noted this made him think of Snow White and the Seven Dwarves with Lumpy, Smoothy and Dopey respectively!

Most Board members concluded that Approach A was consistent with an IAS 37 model and Approach B was more consistent with a fulfilment model. 11 Board members voted in favour of Approach A to recognise changes in estimates immediately in the income statement.

Issue 3: Discount rate

The staff recommended that the discount rate used for insurance contract liabilities should be a rate that captures the characteristics of the liability. The Board agreed that it should not be a rate based on the assets backing the liability, unless these assets determine the cash flows payable under the contract.

These was a discussion by the Board as to whether the exposure draft should simply state the principle of using a discount rate that reflects the characteristics of the liability or whether it should require the use of a high-quality fixed income instrument. The staff noted that it had been unable to conclude on the preferred approach. The staff noted that in this discussion the Board is not considering the implications of non-performance risk, as this will be addressed in considering the responses to the separate IASB discussion paper.

The discussion was a little confused as to whether a risk free rate represented “far value”. One Board member noted that in his view it would be important to disclose the discount rate and sensitivity to changes. The Board voted to agree that the exposure draft should state the principle of a discount rate that reflects the characteristics of the liability, rather than a prescribed rate.

IASB staff noted that there was a concern that significant day 1 losses could arise on certain contracts where the liabilities are illiquid (such as annuity contracts). It noted that they are seeking further input on this issue from companies involved in the field testing.

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