Joint IASB and FASB Board Meeting – Insurance Contracts PricewaterhouseCoopers Summary of Meeting

1 June 2010

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 FASB actions published in the FASB's Action Alert and IASB Updates. 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 an Exposure Draft or Standard.

Highlights

The IASB and FASB held a joint Board meeting on 1 June 2010 where they discussed two separate topics:

1) transition requirements; and

2) measurement of insurance contracts assumed in a business combination and the measurement of a portfolio of insurance contracts assumed in a transaction other than a business combination.

On the transition issue, the Boards tentatively decided that for contracts existing at the date of adoption, an insurer should measure the transition impact on a portfolio by portfolio basis. Each portfolio of insurance liabilities would be measured using the building block approach, including both the expected (probability weighted) present value of cash flows and an explicit risk adjustment. This amount would then be compared to the existing net insurance liability recorded under the previous GAAP (i.e. the liability net of any unamortised deferred acquisition costs and present value of in- force intangible) for that same portfolio. The difference between the two amounts for each portfolio would be a charge or credit to opening retained earnings. At the meeting, the Boards discussed but did not conclude on whether the calculation and adjustment to the opening balance of retained earnings would be done in the earliest year presented or in the year of adoption.

The risk adjustment calculated at transition would be re-measured each period subsequent to transition if the explicit risk adjustment method is ultimately adopted by the Boards. Alternatively, if the composite margin method is adopted, the explicit risk adjustment would be treated as if it were a composite margin in subsequent periods and amortised over the remaining coverage and settlement periods but not re-measured.

The Boards decided that no additional disclosure requirements beyond those currently required for adoption of a new accounting standard would be required, except that disclosure of the run-off of the special transition risk adjustment should be made separate from any other disclosures of margin run off. In addition the boards agreed with the staff recommendation to provide transitional relief relating to the period to be presented in claims development tables.

The Boards also addressed financial asset reclassification at the date of adoption of the insurance contracts standard. The Boards decided that an entity should be permitted, but not required to re-designate a financial asset as measured at fair value through profit and loss if doing so would eliminate or significantly reduce a measurement recognition inconsistency that would otherwise arise from measuring assets or liabilities or recognising gains and losses on them on different bases.

The Boards also discussed the measurement of insurance contracts assumed in both non-business combination and in business combination transactions. In non-business combinations assumption transactions, often referred to as portfolio transfers, the IASB decided that the insurer should compare the measurement of the assumed contracts, using the building block approach, to the consideration received (whether in cash or assets measured at fair value). If the consideration received exceeds the building block measurement amount, the excess should be recorded as residual (or composite) margin. If the liability measurement exceeds the consideration received, the difference should be recognised as an immediate loss. The FASB seemed to question the recognition of an immediate loss, noting that in an arm's length transaction it would be illogical for the insurer to negotiate a price that resulted in a loss.

In a business combination, both Boards were in agreement that the insurer should compare the measurement of the acquired contracts, using the building block approach, to the fair value of those contracts. If the fair value received exceeds the building block measurement amount, the excess should be recorded as residual (or composite) margin. If the liability measurement exceeds the fair value received, the difference would increase the initial carrying amount of goodwill recognised.

Transition issues

The staff proposal rejected by the Boards was to determine the expected (probability weighted) present value of cash flows (plus the risk adjustment in the model that uses such an adjustment) at the start of the earliest period presented and compare that amount to the amount recognised at that date using the insurer's previous accounting policies. If the latter amount exceeded the former, the difference would be treated as the residual margin (or composite

margin in the alternative measurement approach). If the liability calculated under the new method exceeded the amount calculated under the previous accounting, the insurer would recognise the difference by reducing the opening balance of retained earnings. While the calculations would be done at a portfolio level, retained earnings would only be reduced if the aggregate difference for the whole entity were negative (i.e. positive differences would offset any negative differences in portfolios).

The majority of IASB and FASB Board members rejected the staff recommendation for several reasons:

- Many Board members disagreed with aggregating portfolios at the entity level. They thought the unit of account should be the portfolio level, consistent with the conclusions reached previously for the explicit risk adjustment. One Board member questioned why a loss in one portfolio should be masked by excess profits in another. Another questioned the appropriateness of aggregating excesses and shortfalls between different lines of business, such as life and property/casualty.
- FASB Board members objected to using the insurers' previous accounting policies (which under IFRS 4, could be a hodgepodge of accounting policies with no consistency between entities) as the anchor for determining the transition adjustment.

The Boards agreed that the transition calculations should be done at the portfolio level, and not at a higher aggregate entity level. In terms of measuring the residual margin (or composite margin in the alternative model) at transition, the staff noted that conceptually, the best way to do a retrospective calculation would be to determine the residual or composite margin as if it were calculated at inception of the contract, but the staff noted and the Board seemed to agree that this would be impractical. The staff noted that it was rather difficult to come up with a proxy for the residual margin (or composite margin), given that such amounts were "plug" amounts working off of estimates at contract inception.

Given the dissatisfaction with the staff proposal, several alternatives were discussed for estimating the residual (or composite) margin, including comparing the building block amounts to fair value or current entry value. The idea of using fair value to calculate the margin was dismissed with no discussion. Entry value was dismissed after the staff reminded the Boards that constituents had noted that current entry value was not an easily determinable amount, as it would effectively involve re-underwriting each policyholder (e.g. to determine what premium to charge a policyholder who had purchased a life insurance contract ten years ago).

Several FASB Board members suggested that perhaps the composite margin could be calculated similar to how it is done at inception, i.e. by taking the difference between the expected cash inflows and cash outflows. However, the staff and several IASB Board members pointed out that for many contracts, this would effectively result in recording no composite margin at all at transition, and thus no future profits on any such contracts. This is because many life insurance products have cash outflows that exceed cash inflows shortly into the contract as premiums are paid over time, and many property/casualty contracts have single upfront premiums.

The staff came up with an alternative proposal that was ultimately agreed to by a majority of both Boards. The Boards tentatively decided that for contracts existing at the date of adoption, an insurer should measure the transition impact on a portfolio by portfolio basis. Each portfolio of insurance liabilities would be measured using the building block approach, including both the expected (probability weighted) present value of cash flows and an explicit risk adjustment. This amount would then be compared to the existing net insurance liability recorded under the previous GAAP (i.e. the liability net of any unamortised deferred acquisition costs and present value of in- force intangible) for that same portfolio. The difference between the two amounts for each portfolio would be a charge or credit to opening retained earnings.

The Boards' conclusion to measure an explicit risk adjustment in the transition measurement applies whether the explicit margin approach or the composite margin approach is ultimately adopted by the Boards. If the "two margin" approach is ultimately adopted by the Board for the ongoing measurement model (consisting of both an explicit risk adjustment and a residual margin), the risk adjustment calculated at transition would be re-measured each period subsequent to transition; there would be no residual margin for contracts in-force at transition. If the composite margin approach is ultimately adopted by the Boards, The risk adjustment calculated at transition is a one time calculation done at transition and is meant to be a proxy for the composite margin. Therefore, the explicit risk adjustment would be treated as if it were a composite margin in subsequent periods and amortised over the remaining coverage and settlement periods but not re-measured.

With regard to the treatment of any unamortised deferred acquisition costs and present value of in- force intangibles, the Boards seemed to agree that such amounts would be "written off to retained earnings" as part of the transition adjustment. This decision is inconsistent with the staff proposal, which had included any unamortised DAC and PVIF as part of the residual (or composite margin) calculation but is consistent with the earlier decision to not carry forward any residual margin (or composite margin beyond the risk adjustment) on transition.

The Boards discussed but did not conclude on whether the calculation and adjustment to the opening balance of retained earnings would be done in the earliest year presented or in the year of adoption. The Boards seemed to favor having comparability for all periods presented, to which the staff remarked that such an approach might require a delayed effective date. The staff noted that discussion of the effective date of the insurance standard would occur in conjunction with the Boards' more general upcoming discussion for standards expected to be completed in

2011. The FASB technical director noted that the Boards had not yet decided whether early adoption would be permitted or prohibited, and that while effective dates were being discussed on a broader level, the uniqueness of the transition adjustment versus the ongoing accounting model for insurance might warrant separate consideration (i.e., implying that comparability among companies might best be achieved by prohibiting early adoption).

The Boards decided that no additional disclosure requirements would be required beyond those currently required for adoption of a new accounting standard, except that disclosure of the run-off of the special transition risk adjustment should be made separate from any other disclosures of margin run off. The Boards also appeared to agree with the staff recommendation to exempt an insurer from disclosing previously unpublished information about claims development that occurred earlier than five years before the end of the first financial year in which it applies the proposed standard.

The Boards also addressed financial asset reclassification at the date of adoption of the insurance contracts standard. The Boards decided that an entity should be permitted, but not required to re-designate a financial asset as measured at fair value through profit and loss if doing so would eliminate or significantly reduce a measurement recognition inconsistency that would otherwise arise from measuring assets or liabilities or recognising gains and losses on them on different bases. In response to an IASB Board member question, the staff noted that re-designation was only to fair value (not away from fair value to amortised cost). Another IASB member thought that perhaps the guidance should address whether insurers could pick and choose which specific assets could be re-designated or whether the re-designation needed to be applied to asset groups. A FASB member noted that under US guidance, the re-designation would be at the asset portfolio level.

In an IASB only discussion, the IASB Board members agreed with the staff recommendation that the proposed transition would apply equally to insurers already applying IFRS or US GAAP, and to insurers adopting IFRSs for the first time.

Business combinations and portfolio transfers

For non-business combinations assumption transactions, often referred to as portfolio transfers, the IASB decided that the insurer should compare the measurement of the assumed contracts, using the building block approach, to the consideration received (whether in cash or assets measured at fair value). If the consideration received exceeds the building block measurement amount, the excess should be recorded as residual (or composite) margin. If the liability measurement exceeds the consideration received, the difference should be recognised as an immediate loss.

The FASB seemed to question the recognition of an immediate loss, noting that in an arm's length transaction it would be illogical for the insurer to negotiate a price that resulted in a loss. Several FASB Board members seemed to suggest that the liability measurement should instead be calibrated to the transaction price, or at least presumed to be equal to the transaction price absent additional evidence to support an immediate loss. The IASB staff pointed out that differences between the consideration received and the liability recorded can often occur when there is a difference between fair value and the approach used to measure the liability. For example, the discount rate used in pricing the portfolio rate is often a higher rate (based off of projected asset return rates) than the rate used to discount the projected liability cash flows (e.g. risk free, or risk free plus some adjustments).

In a business combination, both Boards were in agreement that the insurer should compare the measurement of the acquired contracts, using the building block approach, to the fair value of those contracts. If the fair value received exceeds the building block measurement amount, the excess should be recorded as residual (or composite) margin. If the liability measurement exceeds the fair value received, the difference would increase the initial carrying amount of goodwill recognised.

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