

Sharing insights on key industry issues

IASB/FASB Board Meeting – Insurance Contracts

PwC Summary of Meeting – September 19, 2011

Since a variety of viewpoints are discussed at FASB and IASB meetings, and it is often difficult to characterize 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.

PwC summary of meeting:

- Risk adjustment: objective
- Risk adjustment: confidence level disclosures
- Risk adjustment: techniques and inputs
- Disclosures: aggregation level
- Disclosures: methods & inputs and measurement uncertainty
- Disclosures: nature and extent of liquidity risk

Highlights

The IASB and FASB held a joint Board meeting on September 19, 2011 where they discussed two topics; risk adjustment and disclosures. In addition they reported back on the FASB's discussion of the FASB's single margin approach.

All IASB members were in favor of the proposals for the risk adjustment to be defined as the 'compensation the insurer requires for bearing the uncertainty inherent in the cash flows that arise as the insurer fulfills the insurance contract'. In addition, they agreed with the spirit of the proposals for additional application guidance for the risk adjustment objective subject to the redrafting of some wording. However the IASB board by a large majority rejected proposals to remove the confidence interval disclosures that were included in the exposure draft (the "ED") and the proposal to replace this requirement with quantitative disclosure as if the risk adjustment inputs had been determined from a market participant perspective.

The IASB board voted to eliminate the limitation that existed in the ED of three permitted techniques to measure the risk adjustment, in line with the application of valuation techniques for Level 3 measurements in IFRS 13. However the three techniques proposed in the ED would be retained as examples with the related application guidance. Furthermore, the majority agreed that the 'desirable characteristics' in paragraph B72 of the ED that a risk adjustment technique should exhibit to meet the overall objective of the risk adjustment should be retained within application guidance.

The FASB did not vote on risk adjustment topics as this is not relevant to their model.

On disclosures, the IASB board agreed: on principles based aggregation levels, and hence not to retain the ED's minimum disaggregation level which prohibits aggregation of information relating to different reportable segments; to retain the



requirement to disclose information about methods and inputs used; to disclose effects of changes in each input used to measure insurance contracts; to delete the proposed requirement to disclose a measurement uncertainty analysis; and to require the maturity analysis based on expected maturity (as opposed to an option to use contractual maturities) and require time bands for maturity disclosure similar to the leasing standard. The FASB majority agreed with most of these proposals except with the proposal to delete the measurement uncertainty analysis. In this regard, it was noted that the FASB has an ongoing project on financial instruments that will address a full range of risk disclosures including those relating to insurance contracts, also covering measurement uncertainty.

Risk adjustment: objective

Following the March and May 2011 Board meetings, the staff were tasked with further defining the objective that describes how to translate the risk in the insurance contract into a single monetary amount. The staff were also asked to ensure the application guidance reflects the two-sided nature of the risk adjustment (i.e. consideration of both favorable and unfavorable cash flows within the measurement of the amount). In addition, the application guidance should include the notion of a point of indifference being the basis to quantify the amount of compensation that the insurer requires to bear the risk inherent in the insurance liability. The staff therefore further clarified the wording of the risk adjustment objective by aligning it substantially with IFRS 13. In addition the staff put forward proposals for changes in the application guidance for a better understanding of a) the underlying notion of the point of indifference and b) the two-sided nature of risk.

One IASB member questioned the ability of insurers to be able to simply pick a number, given that the insurance definition of risk adjustment calls for an entity-specific estimate rather than a market participant estimate, and the inability of users to challenge the wide range of outcomes, noting that they would be more comfortable if the range is quantified. Another IASB member noted that this concern could be addressed through disclosure.

Another IASB member noted the resolution of the use of the word 'exceed' within the objective, however they were still concerned by proposed wording which seemed to direct insurers to weigh more heavily the unfavorable cashflows and that this did not appear to be from the insurer's perspective. The staff further clarified this point stating that should the insurer be risk averse then they should place more weight on unfavorable cashflows.

Another IASB member questioned whether the wording referencing unfavorable cash flows weighting was really necessary as this may then lead to further questions as to how much weighting should be applied.

A number of the IASB members questioned the wording proposed within the application guidance on the point of indifference. The staff further clarified what the proposals were seeking to explain by way of an example. Several IASB members further highlighted that the wording could be clearer and an example would help articulate the point.

In light of further clarification provided by the staff during the meeting, all IASB members were in favor of the spirit of proposals subject to some wording redrafting.

Risk adjustment: confidence level disclosures

The ED proposed that insurers should disclose the confidence level to which the risk adjustment corresponds as this would allow users to understand 'how far' actual cash flows could be from those expected and how, all else being equal, this assessment might differ from entity to entity. The staff noted that most respondents to the ED objected to this on the basis that it would not achieve its intended objective and would therefore impose excess cost for little benefit, in particular for those using measurement not based on the confidence level technique.

The staff noted that some believe fair value measurement presents a more robust objective for the risk adjustment (than that currently proposed for insurance) as risk is considered from the perspective of a hypothetical market participant. As such the staff put forward an alternative disclosure requirement to help users to understand how different an entity-specific estimate of the risk is compared to the market view of the risk. The requirement would be to provide quantitative disclosure of the range of values within which key inputs for the risk adjustment would lie if they had been determined from a market participant's perspective.

A number of the IASB board members were not in favor of the new proposals, noting that gaining information to disclose a market participant perspective would be operationally difficult. Several noted that the objective of the measurement of insurance liabilities was of a fulfillment nature and therefore it was confusing why the guidance was now circling back to a fair value perspective. One IASB member further discussed the merits of confidence interval disclosure and noted that while it may not be perfect for skewed distributions, it was still better than the proposals put forward. Several also noted that they were willing to accept, as a second preference, an alternative proposition put forward by a respondent to require insurers to disclose information regarding the relative magnitude of the risk adjustment compared to total insurance liabilities rather than prescribing the use of a confidence level equivalent.

The majority of IASB members rejected the new proposals put forward by the staff in favor of retaining the confidence interval disclosure.

Risk adjustment: techniques and inputs

The staff noted that the ED permits only a closed set of three techniques to calculate the risk adjustment on the basis that these techniques were widely understood and applied in practice. However many respondents commented that limiting the range of techniques to three was inappropriate as this would preclude the use of new risk measures that may more faithfully represent an entity's risk position and it would be inconsistent with a principles-based approach. Some respondents stated that if the objective was better defined then there would be no need to limit the range of available techniques to determine the risk adjustment. Others stressed the importance of ensuring that the techniques used satisfy the characteristics identified within paragraph 72 of the ED and applying these consistently over time.

The staff further noted that some might argue that allowing the use of a wide range of techniques would result in information that is not readily comparable. However they believed that sufficient comparability can be achieved by a) setting an objective for the risk adjustment (which the boards have already tentatively agreed on) and b) requiring appropriate disclosures (as discussed above). By satisfying this objective, it would ensure that different measurement techniques would depict the same economic phenomenon as well as having a consistent approach with the board's conclusions in IFRS 13.

The majority of the IASB board voted in favor of eliminating the limitation of the permitted techniques for quantifying the risk adjustment, i.e. that an insurer should apply a valuation that meets the objective of the risk

adjustment. In addition the majority agreed that the application guidance should retain the desirable characteristics consistent with the risk adjustment objective and also retain the three techniques as examples.

Disclosures: aggregation level

The staff proposed several improvements to the proposed disclosure requirements in the ED. In the first of the staff's proposals, it asked the Boards to consider not retaining the minimum disaggregation level for disclosures in the ED which prohibit aggregation of information relating to different reportable segments (Appendix A paragraph 83). Rather, the staff proposed that the aggregation level of disclosures should be principles based. The staff noted an apparent inconsistency between the requirement to aggregate or disaggregate information so that the information is useful and not obscuring for the reader and on the other hand the ED currently prohibiting aggregation of information related to different operating segments.

One IASB member noted that the proposed wording appeared not strict enough in that he would have liked to have seen an explicit requirement to disaggregate information across segments to the extent it meets the principles of sound disclosures as outlined by the ED. The Boards were leaning overall towards explicit disclosures, for example in risk adjustments; therefore not requiring disaggregation explicitly would counteract core pillars of the project. Another IASB member voiced concern that failure to explicitly require disaggregation may result in information and data loss as insurance companies would generally define their segments at the same levels as are reported to the highest level of management, i.e. at a very high level.

The staff noted that there is still an implicit need to disaggregate if this is required to arrive at disclosure of useful information.

Other IASB members fully supported the proposals as they voiced concern of clutter in the accounts; also it would put the insurance project in line with other standards. It would be better not to define granularity levels for aggregation and disaggregation rules, but rather follow a broader objective.

Another IASB member noted that there is inherent inconsistency between the objectives and the prohibition to aggregate across segments as in some cases it may be more meaningful to show results by type of contracts rather than geography and therefore in some cases necessitating a cut across segments.

In a majority vote, the IASB and FASB members agreed with the staff recommendations.

Disclosure: methods & inputs and measurement uncertainty

The staff recommended requiring the insurer to disclose separately the effect of each change in inputs and methods to the measurement of insurance contract liabilities, together with an explanation of the reasons for the change. The staff further proposed to require yield curve disclosures for non-participating contracts as well as not to retain the measurement uncertainty analysis as currently proposed in the ED.

A number of FASB and IASB Board members expressed approval of the requirement to require disclosure of changes in inputs and methods from previous periods as well as explanations of reasons for changes and type of contracts affected.

The FASB noted that in relation to the measurement uncertainty, the FASB is in the process of developing enhanced disclosures on their financial instrument project with all risk disclosures including interest rate and liquidity. The FASB noted that both projects should be coordinated. A FASB member pointed out that investors need to not only understand what the sensitivity is today but what the measurement uncertainty is going forward and that these sensitivities and uncertainty disclosures are useful and it would make sense that they are both required by the ED. The FASB chair noted that sensitivity and uncertainty disclosures on insurance contracts would specifically be considered in the overall financial instrument project analysis on enhanced risk disclosures.

An IASB member noted that the measurement uncertainty analysis is very important but it should not be unilaterally included in the insurance standard but rather be considered as part of the IFRS 13 risk analyses. Another IASB member noted that a parallel disclosure on assets would be needed in that if there is no requirement for the analysis for assets, then it is not meaningful to include it for liabilities in the insurance standard on a stand-alone basis.

With a clear majority the IASB voted in favor of the staff proposals. The FASB majority agreed to these proposals except for the proposal to delete the measurement uncertainty analysis. Those disagreeing would like to see a full replacement of the requirements elsewhere.

Disclosure: nature and extent of liquidity risk

Thirdly, the staff asked the Boards to consider the nature and extent of liquidity risk arising from insurance contracts. The staff recommended requiring the maturity analysis to be based on expected maturities and remove the option to disclose an analysis based on remaining contractual maturities. Further the staff recommended aligning time bands with those of the leases project, requiring insurers to disclose the expected net cash outflows for each of the first five years and a net total for the remaining years as well as not to require further prescriptive liquidity disclosures.

The staff argued that a maturity analysis on expected maturities would be more logical and in line with the building block model. An IASB member agreed with this.

An IASB member noted that he would like to see a maturity analysis at least as long as the effective duration of the insurance liabilities. For example if a contract spans 15 years, then a maturity analysis for 15 years would be required. Aggregation into the existing buckets for leasing (years 1-5 and 5+ years) would not be sufficient. Insurance companies may intentionally enter into the risk of duration mismatch and highlighting this would be useful for the reader.

The IASB staff asserted that 5 years would be sufficient as a horizon as data beyond 5 years would not be useful to estimate liquidity risk of the entity. It was further noted that the disclosure in question here is about liquidity risk which is not identical to interest rate risk. Short term disclosure in the leasing type buckets would be sufficient for liquidity risk.

A FASB member noted that not only is the liquidity risk important on the liabilities side, but rather a holistic view is needed to be taken as liquidity is an entity wide issue. This will be addressed in the financial instrument proposal which looks at outflows and inflows from assets and liabilities. A look at liquidity on insurance liabilities would be a partial look only.

The staff confirmed they had looked at the net cash outflows which include premiums but not financial assets in general. The disclosure framework project should look at this comprehensively. This disclosure here focuses on insurance only. The FASB chair noted that their financial instrument project would likely come to the same disclosure requirements but FASB would not want to change their holistic project view.

The IASB voted in full support for the staff's proposals but left the option open to revisit once the FASB's work on their financial instrument disclosure project was available. The FASB will rely on its tentative decisions at their Board meeting on September 7, 2011 relating to risk disclosures for financial institutions which includes insurance entities.

Report back on FASB single margin discussions

In May 2011 the FASB voted for a single margin model. The FASB had a Board meeting on September 7, 2011 in which they discussed the amortization of such single margin. The FASB staff reported back on the status of the continuing discussions.

The FASB staff explained that the Board viewed the single margin as representing profit at risk. They further tentatively decided on recognizing the single margin in profit reflecting the ways in which the insurer is released from risk. This could be either when the variability of the cash flows of the specified uncertain future event reduces primarily due to timing of the insured event, or when the variability reduces primarily due to more information coming to light about the frequency and severity of the insured event. The Board tentatively decided that the amortization guidance should be principles based and not dictate any specific pattern of amortization, but that the following general concepts should be used:

- 1) If the variability of the cash flows of an insured event is primarily due to the timing of that event (such as in a whole life insurance or annuity contract), an insurer is generally released from risk on the basis of reduced uncertainty in the timing of the event.
- 2) If the variability of the cash flows of an insured event is primarily due to the frequency/severity of the event, variability in the cash flows is generally reduced as more information about expected cash flows becomes known throughout the life cycle of the contract.

Overall therefore the recognition of profit should be in line with the reduction of the variability of cash flows the insurer is exposed to. This would be applicable for the building block model contracts.

If accounting for the liability for incurred claims under the premium allocation approach, the FASB tentatively decided that the liability for incurred claims should be measured as the present value of the expected cash flows without a single margin. The premium would be recognized over the coverage period which is consistent with the revenue recognition model where there is also no risk adjustment.

An IASB member noted that the risk adjustment and its allocation, as well as the single margin approach and its allocation both have a notion of arbitrariness within them: The building block model by the FASB, which allocates all of the profit on the basis of the release of risk and no profit is allocated for provision of insurance services, is an arbitrary allocation. Also the run off basis can be seen as arbitrary because different models on the measure of risk give different allocations. Likewise the premium allocation approach is arbitrary as all profit is allocated to the provision of insurance services and nothing due to the release from risk. Therefore the FASB's margin allocation would be no worse or no better than any other allocation.

The IASB staff noted that the differences between IASB and FASB model are in the re-measurement of risk in the IASB model. Differences depend on the type of contracts: In a life contract or a short coverage short settlement period contract, the differences may not be very large. However, there will be more differences due to the re-measurement of risk in short coverage long tail contracts where the risk re-measurement could have more impact.

Additional information

Questions on this summary and the FASB/IASB joint project can be directed to:

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