

Insurance alert

IASB/FASB Board Meeting

Insurance Contracts

December 15-16, 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 meetings

December 15-16, 2011

- Measuring policyholder participation features
- Payments made to current or future policyholders
- Measuring options and guarantees embedded in insurance contracts
- Discounting incurred claims under the premium allocation approach
- Unit of account for different elements of the insurance contract
- Onerous contracts
- IFRS 9 discussion

Highlights

The staff noted that both Boards have now tentatively agreed to adjust the measurement of contracts with policyholder participation features that depend on underlying items to reflect how the underlying items are measured.

The Boards agreed that the obligation for contracts with policyholder participation features should include amounts that are due to policyholders as a group even where the amounts have not yet been allocated to specific policyholders.

In addition, the Boards agreed that options and guarantees embedded in insurance contracts should be measured using a current, market consistent, expected value approach.

Under the premium allocation approach the Boards agreed that incurred claims should be discounted where the effect of discounting is material. However the

Boards also agreed that there will be a practical expedient where claims expected to be paid within twelve months will not require discounting.

The Boards discussed the unit of account for measurement extensively but did not conclude on a number of matters which will be discussed at future meetings. However, there was agreement on a modified definition of portfolio of insurance contracts. Also, a majority of Board members agreed with the staff proposal not to prescribe the unit of account for calculating the risk adjustment.

Similarly, although the Boards discussed onerous contracts, several issues will return to later meetings. However, a definition and scope for onerous contracts was agreed.



Measuring insurance contracts with policyholder participation features

The staff summarized previous tentative decisions of the Boards (including those that had been reached at the November 30 FASB meeting) for measuring insurance contracts with policyholder participation features. The staff reminded the Boards how accounting mismatches can arise for these contracts; first due to differences between the building block approach (BBA) and fair value (FV) measurement principles and second, due to timing differences, for example when underlying assets are measured at FV and the performance-linked payments to policyholders depend on realized gains and losses only (on a 'statutory' or 'cost' basis).

The staff believed that, despite differences in wording, both the IASB and FASB had tentatively decided to adjust the measurement of the obligation that depend on underlying items in a way that reflects how those underlying items are measured, either by;

- Eliminating from the building block approach changes in value not reflected in the measurement of the underlying items; or
- Including in the statutory liability, changes in value that are reflected in the measurement of the underlying items.

One IASB member requested that the proposed wording within the standard should be the same for both Boards to facilitate future discussions. The staff agreed to develop consistent wording for the standard. However, they noted that the guidance and basis of conclusions were likely to differ.

Payments made to current or future policyholders

The staff then discussed participating policies where policyholders as a group are entitled to a portion of the performance earned but where this has not yet been allocated to specific policyholders. The staff asked whether the cash flows in the BBA approach should include payments that result from existing insurance contracts, regardless of whether these were paid to current or future policyholders.

In these contracts, the distribution of the performance of the portfolio may not match the period that the performance is earned. Therefore, there may be contracts in place with different policyholders at the

time the performance is earned compared to when the result of that performance is distributed. By ceasing to be a policyholder before the surplus is distributed, an individual policyholder gives up a portion of the amounts available for distribution to policyholders as a group. The insurer is often required to distribute this portion to any remaining policyholders ('the last man standing') at the date the distribution is declared. Therefore, the shareholders do not benefit from that element of the portfolio's performance.

The staff proposed that these obligations to distribute performance results, whether paid to current or future policyholders, meet the definition of a liability under the conceptual framework and therefore the related cash flows should be included in the measurement of the insurance contract.

Several IASB members questioned whether there were scenarios where shareholders could ever benefit from these distributions (and therefore whether these should be presented as liability or equity) and how this would be dealt with. The staff confirmed that there may be cases where the regulator or government would need to decide how the amounts are distributed, for example in a run off portfolio with no remaining policyholders. Staff agreed to consider relevant disclosures.

A large majority of the IASB members and all of the FASB agreed with the staff proposals.

Measurement of options and guarantees embedded in insurance contracts

The staff discussed options and guarantees embedded in insurance contracts that are not bifurcated as embedded derivatives and proposed that these should be measured using a current, market consistent, expected value approach.

An IASB member discussed the type of contract where a policyholder receives the higher of a minimum guaranteed return or the return from a participating feature that is linked to asset performance. He felt that such contracts should be measured using inputs including the fair value of the assets combined with the value of the put option (in effect, the policyholder right to exchange – to 'put' – the asset performance participation feature with the guaranteed minimum return). He believed this approach is similar to the way that replicating portfolios were treated in arriving at the BBA. His main concern was whether insurers

would use an appropriate discount rate if they measured the liability cash flows rather than measuring an asset based participation feature with a put option. He illustrated this with an example, where the return from the asset performance participation feature is significantly above the guaranteed minimum then the guarantee has nil value and a rate reflecting the performance of the assets should be used. If the asset performance is poor then the discount rate should be based on the guaranteed minimum return.

The staff noted that conceptually this approach would work in simple situations. However, they noted that it is very difficult to value the 'put option' where usually such features link to the performance of a pool of assets or the overall performance of the insurer. Another IASB member noted that such a nil value for a guarantee would only happen in an extreme case where the insurance liability is driven entirely by one asset. However, this is not a typical feature of participating contracts and conceptually the intention is that the inherent rate of the expected performance from the portfolio should be part of the liability calculation. All IASB and FASB members agreed with the staff proposal

The chair of the meeting highlighted the key principle from the staff paper as follows:

"... in those scenarios in which the minimum guarantee has effect, the cash flows used to measure the liability should be those from the minimum guarantee, not those from the underlying asset".

Premium allocation approach - discounting the liability for incurred claims

The IASB and FASB chairs introduced the discounting discussions by referring to a memo received from the Hub Global Insurance Group. The memo suggested that the Boards should not discuss discounting at the present meeting due to concerns over due process. The chairs believed the staff had performed sufficient analysis and outreach to develop an informed view, therefore it was appropriate to discuss this topic. However, the Boards' members were invited to request further background information if necessary and would welcome further stakeholder feedback. The IASB and FASB chairs said they would both respond individually to the memo.

The staff recommended that incurred claims should be discounted when the effects were considered material

and that no additional guidance should be provided about when the effect of discounting would be immaterial. In addition, the staff proposed a practical expedient that claims expected to be paid within twelve months should not be discounted. The staff reminded the Boards of the main types of incurred claims:

- Short-tail claims that are paid less than twelve months after incurred date.
- Long-tail claims where expected payment patterns are reasonably determinable at the portfolio level.
- Long-tail claims in which the existence, amount and timing of payment is unclear.

The staff confirmed they had performed an effect analysis based upon US regulatory filings as part of their analysis. This shows that discounting could be material on an aggregated basis. On the other hand the staff acknowledged some of the arguments against discounting, especially by some US users.

The Boards were asked to reconfirm their earlier decision to require the liability for incurred claims to be discounted when the effect of discounting would be material.

One IASB member challenged whether an insurer would be required to discount when there was a large degree of uncertainty associated with the timing of the claim payout. This would be an exception for 'one off' type events for example, from exposures arising from the twin towers. If the claim is for a unique scenario and therefore there is no average or historic pattern to use as precedent, he questioned what would be a reasonable timeframe for the claim payout. Another IASB member agreed with this point.

The staff commented that there may be scenarios where the past cannot predict the future but it would be very difficult to draw the line.

Another IASB member disagreed, and believed that not discounting does not faithfully represent the business.

In response, an IASB member noted that if the insurer has investments accreting interest that support this one off claim, not discounting the claim introduces a form of accounting asymmetry. On this basis, he strongly disagreed with not discounting these types of claims.

In response to some investor feedback, one IASB member was concerned that presenting claims on a discounted basis may lead to a loss of information. The staff clarified that information within disclosures would be presented on a nominal basis and reconciled to the balance sheet. Yield curves would also be disclosed, and therefore there should be no loss of information.

A large majority of the FASB and IASB members agreed to require discounting when the effects were considered material.

The staff proposed that there should be no additional guidance provided for when the effect of discounting is immaterial but instead a practical expedient should be developed. This would be in line with current literature in both IFRS and US GAAP where general guidance on materiality is available but there is no detailed guidance on materiality for specific topics.

Both Boards supported the proposal not to have specific guidance on materiality but asked that materiality be re-assessed continuously. Staff accepted that point although emphasized that they would like to avoid insurers switching back and forth between discounting and not discounting.

The Exposure Draft (ED) and the Discussion Paper (DP) did not provide any simplifications for measuring the liability for incurred claims. Tentative decisions made so far have not made any change to that. However, staff acknowledged that removing the requirement to discount the liability for incurred claims would reduce the complexity and costs of applying the premium allocation approach (PAA). Staff also indicated that in their view the only feasible practical expedient is one that is time based.

The two Boards unanimously agreed that for contracts measured using the PAA, discounting is not required for incurred claims that are expected to be paid within 12 months of the claim occurrence date. The Boards also agreed that insurers should discount incurred claims that are expected to be paid out after twelve months of the claim occurrence date if the effect is material. This expectation should be reassessed during the life of the liability.

As a clarification the staff added during the discussion that if in a certain portfolio 10% of claims are expected to be settled after 12 months, and if the effect of potential discounting is material, that 10% of claims

should be discounted while the remaining 90% can be measured on an undiscounted basis.

Unit of account

The Boards discussed various questions regarding the unit of account including:

- The definition of a portfolio of insurance contracts.
- The unit of account for different applications.
- The unit of account for the risk adjustment.

The staff presented a flowchart showing the separate steps for measuring insurance contracts (based on tentative decisions so far) and highlighted the staff's suggestions regarding the unit of account for the different phases.

Step 1: Measure PV of cash flows (measured at portfolio level)

Step 2: Measure risk adjustment (no prescribed unit of account, entity specific compensation is to be taken into consideration)

Step 3: Allocate risk adjustment to portfolio (split the risk adjustment to portfolios)

Step 4: Determine residual/single margin (measured at portfolio level)

Step 5: Split residual/single margin to sub-portfolios (if the residual/single margin is positive)

Step 6: Release residual/single margin at sub-portfolio level (if the residual/single margin is positive at initial recognition)

Definition of portfolio of insurance contracts and unit of account for different applications

The ED/DP proposed defining the portfolio of insurance contracts as “*insurance contracts that are subject to broadly similar risks and managed together as a single pool.*”

Respondents to the ED raised several concerns about the proposed definition. Some respondents commented that the more prescriptive US GAAP definition would be easier to interpret.

As a response to these comments, a modified definition of a portfolio of insurance contracts was proposed by the staff that would:

- Retain a reference to ‘similar risks’ and ‘managed together as a single pool.’
- Add a reference to ‘similar expectations of profitability.’
- Be amended to delete the term ‘broadly.’

Staff also suggested that application guidance should be provided to elaborate on whether contracts are subject to similar risks, have similar expectations of profitability and are managed together as a single pool.

The definition of insurance portfolio was discussed together with deciding what unit of account should be applied in the following situations:

- Determining the residual/single margin at initial recognition.
- Determining the residual margin subsequent to initial recognition [IASB only].
- Allocating the residual/single margin to profit or loss.
- Performing an onerous contract test during both the pre-coverage period and under the premium allocation approach.

While the staff acknowledged that the unit of account might not matter for measurement purposes in certain cases, (when irrespective of the grouping the same measurement result would arise), it does make a difference in other cases (for example when measuring onerous contracts).

The staff underlined that the unit of account has two objectives:

- To reflect pooling. For example if the group is too wide then information is omitted as loss making contracts are grouped together with profit making contracts. However, if the group is too narrow the economics of insurance is not reflected.
- To ensure all profit is recognized during the contract term.

The staff felt that these two topics (definition of a portfolio and the unit of account) are very much interrelated. Several IASB members raised concerns about adding a reference to similar expectations on profitability to the definition. They felt that the

characteristic of ‘managed together as a single pool’ already captured that feature and they thought that requiring the same profitability would be against the nature of insurance (pooling of risk). Other Board members were not clear what the staff meant by ‘profitability’ - was it only a distinction between profitable or loss-making contracts or did it refer to similar levels of profitability?

The staff responded that the term ‘profitability’ simply drew the line between profitable and unprofitable contracts in order to avoid hiding loss-making sub portfolios by offsetting them with profitable ones.

One Board member pointed out that this notion made the definition circular since the suggested wording for portfolio refers to ‘similar expectation of profitability,’ but profitable and unprofitable contracts cannot be grouped into the same portfolio since their profitability expectations are different.

Some Board members suggested changing the wording in order to avoid this circularity by referring to a ratio of claims to premiums.

When challenged whether the definition would result in consistent determination of portfolios, the staff answered that the suggested definition is narrower than the one used in the ED. However the staff would like to add application guidance.

One Board member urged that a robust definition of a portfolio is needed but said that the criteria should be reviewed to see if they really differentiate the risk.

Overall, there were questions about when the portfolio of insurance contracts will be used as a unit of account and therefore make a difference in terms of measurement. One IASB member thought that the question should be answered assuming a ‘locked in’ environment. He added that in a ‘locked in’ environment the only area when the definition is relevant would be the onerous contract test for the premium allocation approach.

Although some members (also from FASB) agreed with raising these questions, the Boards concluded that they need to determine the unit of account for all steps.

There were also suggestions on other unit of account determinations for specific steps: one Board member suggested having the onerous contract test at the level of the sub portfolio instead of at portfolio level. Staff acknowledged that that would be an option.

Board members also questioned whether changing sub portfolios would cause tracking and operational issues. However, another Board member said that the objective of accounting should be set and the insurance industry should then make that operational.

The staff was asked how the residual margin will be allocated from portfolio to sub portfolio. The staff argued that it is a judgment call but guidance would be added if required.

A majority of both Boards agreed that guidance is needed on the unit of account. The Boards agreed that a portfolio consists of insurance contracts that:

- Are subject to similar risks and
- Have similar expected patterns of release from risk.

No decisions were made on the selection of unit of account for the different steps set out above, but the staff will bring this issue back after modifying the definition of a portfolio of insurance contracts.

Unit of account: risk adjustment

Although this issue was discussed at a joint meeting it is relevant only to the IASB.

Staff recommended that the unit of account to be used for calculating the risk adjustment should not be prescribed as long as the manner in which the risk adjustment is calculated achieves the overall objective of the risk adjustment. This approach is the most consistent with the economics of insurance, namely with the concept of pooling and mitigating risks which insurers do in different ways.

The ED considered only the diversification benefits from mitigating similar risks (by setting the unit of account at portfolio level) but not the benefits from mitigating dissimilar risks. This was criticized heavily by respondents to the ED.

Discussion among the Board and staff members was partly about the calculation method and partly about the unit of account. There is a choice of two methods of ordering how the calculation is performed, either:

- Aggregating the cash flows together and calculating a risk adjustment for the entity as a whole— in this case an allocation back to portfolio level would be necessary, or

- Calculating the risk adjustment directly at the portfolio level and make a separate and transparent adjustment to get the final aggregated result.

A FASB member noted the difficulty of demonstrating the existence of diversification benefits and that calculating the risk adjustment as suggested would give extreme freedom to management. Some IASB members shared his view. Although a majority of Board members agreed that the risk adjustment and the methodology applied to calculate it should be disclosed, there was skepticism whether the diversification effect would be a meaningful disclosure. It was agreed that an overall disclosure paper will be discussed in the future.

One Board member raised concerns on possible double counting; calculation at a portfolio level might take into account the existence of the other portfolios whereas an adjustment for diversification at entity level (added to the sum of the risk adjustments calculated at portfolio level) would double-count the effects already taken into consideration at portfolio level. For this reason the Board member supported keeping the portfolio as the unit of account. The staff agreed to modify the definition to avoid possible double counting.

A majority of Board members agreed with the staff proposal not to prescribe the unit of account for calculating the risk adjustment.

Onerous contracts

The staff discussed defining, identifying and measuring onerous contracts:

- For all insurance contracts during the pre-coverage period (all contracts); and
- For the liability for remaining coverage for contracts accounted for under the premium allocation approach.

The staff explained that the onerous contract test is necessary only in situations where the insurance liability is measured using the PAA approach. When the BBA is applied (after the pre-coverage period) it automatically recognizes the full expected liability as it is measured on a current basis.

Staff recommended the following definition:

“an insurance contract is onerous if the expected present value of the future cash outflows exceeds:

- *The expected present value of the future cash inflows (for pre-coverage period) or*
- *The carrying amount of the liability for remaining coverage (for the premium allocation approach).”*

This was accepted by the Boards, but with additional guidance that investment income should be excluded for all contracts. However, potential future premium inflow for the premium allocation approach should be included in the expected present value of future cash flows.

The Boards accepted the staff’s proposal that insurers should perform an onerous contract test when facts and circumstances indicate that a contract may be onerous, but requested specific facts and circumstances to be added to the application guidance.

The staff suggested that onerous contracts should be measured in the same way as the liability recognized at the start of the coverage period, excluding anticipated investment income, but including the effect of discounting. This is suggested both in case of the pre-coverage period and during the coverage period when applying PAA. An IASB member questioned how the onerous contract test interacted with the PAA practical expedient approach for claim liabilities when the liability for claims incurred is not discounted although discounting is suggested to be required for the onerous contract test. Another Board member and the staff suggested that in this case the entity should apply discounting since there is no reason to apply the practical expedient if the discounted figures are also available.

With one dissenter the members of both Boards accepted the staff proposal. Liabilities measured using the practical expedient will be brought back to a future meeting for further discussion. The frequency of updating the measurement of onerous contracts and the inclusion or exclusion of risk adjustment in onerous contracts under IASB’s framework will also be discussed at a future meeting.

IFRS 9 discussion

On December 13 the IASB discussed potential topics for the limited improvement of IFRS 9. The staff and the Board generally agreed that IFRS 9 is sound but targeted improvements should be considered, including the following:

- Address specific practical issues raised by those who already apply IFRS 9 (such as the instrument characteristics test).
- Consider permitting bifurcation of financial assets.
- Consider use of other comprehensive income (OCI)/third business model for some debt instruments to address the interaction between the insurance contracts project and accounting for financial assets backing insurance contracts.
- Consider the modifications to the current OCI exemption for equity investments (some constituents – including some insurers – asked that the Board allow recycling of gains and losses on the derecognition of these investments).

The Board decided to pursue the first three points in its future discussions but rejected the last one.

Additional information

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

Mary Saslow (860-693-4407) a Managing Director in the National Professional Services Group, who is part of both the U.S. and Global Accounting Consulting Services groups