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

21–23 April 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/FASB held a joint Board meeting on 21-22 April 2010 where they discussed risk adjustments and residual margins, composite margins and discounting of insurance contracts. The purpose of the margin discussions was for the Boards to develop both the risk margin and composite margin models. The Boards intend to make a decision on which margin model to proceed with at an additional joint board meeting which is scheduled for 4 May 2010. The IASB also discussed contract boundaries and the recognition of insurance contracts at an IASB only meeting on 23 April 2010.

The IASB and FASB agreed that in a composite margin model the measurement of any day one loss would not include a risk margin and any loss would be recognised in the income statement on day one. The composite margin would be recognised over both the coverage and claims handling period and would be part of the insurance liability. In an explicit risk margin model the boards also agreed that the residual margin would be part of the insurance liability. The IASB appear to support the accretion of interest on the composite margin whereas the FASB would not accrete interest.

Both Boards agreed that the discount rate to be applied to insurance contracts should have as an objective to adjust estimated future cash flows for the time value of money in a way that captures the characteristics of the liability which may include an adjustment for liquidity. Those characteristics are not best reflected in a discount rate based on expected returns on assets backing those liabilities (unless those asset returns affect the cash flows to policyholders). It was agreed that the exposure draft would not propose including an adjustment for own credit risk but that it should ask specific questions on own credit risk.

The IASB proposed defining the boundaries of the contract as "up to the point when the insurer can cancel the contract or, reassess the risk in the contract and re-price at or above the market rate for the risk in that contract". The IASB staff will consider with board members by e-mail whether the proposed definition has any unintended consequences not considered in the meeting.

The IASB decided that an insurer should recognise the rights and obligations arising from an insurance contract when the insurer becomes a party to the contract. This is the earlier of the insurer being on risk to provide coverage to the policyholder for insured events and the commencement of the insurance contract.

The Board papers outlined a revised timetable which proposes publishing the exposure draft in June 2010 with comments due in October 2010 and a final standard in June 2011.

Approaches for measuring margins in insurance contracts

The staff presented two papers on margins to the Boards. One paper dealt with an approach preferred by the IASB which included the expected contract net cash flows plus an explicit risk adjustment and a residual margin. The second paper set out an approach preferred by the FASB which included the expected contract net cash flows plus a composite margin. The difference between the two approaches is the risk adjustment that is explicitly included in the first approach and becomes an implicit part of the composite margin in the second approach.

The purpose of the two papers was for the Boards to develop both models. The Boards intend to make a decision on which margin model to proceed with at the additional joint board meeting on 4 May 2010. The first paper provided information about how refining the objective for a risk adjustment under the proposed measurement might narrow or put discipline around the methodology used to determine a risk adjustment. The paper defined the objective for the risk adjustment as the amount the insurer would rationally pay to be relieved of the risk. The second paper discussed the nature of the composite margin, the subsequent release of the composite margin to the income statement, whether the composite margin is part of the insurance liability and whether interest should be accreted on the composite margin.

One FASB member described the explicit risk margin as the amount in excess of the estimated future cash flows that an insurer would be willing to pay for another party to accept the uncertainty in the expected cash flows. Another FASB member noted that a third party in a transfer situation would require a profit element in excess of the risk margin. He also noted that the amount that another party would require in a transfer would be impacted by factors such as the pricing cycle the industry was in, whether it was in a niche markets etc. He noted that if the amount

the insurer would be willing to pay to be relieved of the risk includes both a risk margin as well as a profit element then this should be in the objective. The staff noted that if the cash flows did materialise exactly as expected the risk margin would also emerge as a profit.

An IASB member noted that he prefers the composite margin. Although he complimented the staff for the paper on explicit risk margins, he does not believe that it will instil a robust discipline in the determination of the explicit risk margin. However, he noted that the disclosure requirement that each insurer translates the risk methodology used into one common benchmark risk methodology is a step forward. The paper proposed that insurers could be required to translate the risk methodology used into the confidence interval that corresponds with the risk adjustment that they have estimated. Another possibility would be to disclose the risk adjustment both as an absolute amount and a percentage of the expected present value of remaining cash flows. The board member also noted that the paper indicated that an insurer can use a replicating portfolio approach. He would have mandated its use if possible. The staff noted that it would not be mandated because adjustments would be required to adjust for the effect of expenses in projecting future cash flows.

An IASB member noted that he did not find the definition of risk adjustment all that helpful. He noted that the paper referred to reinsurance but an element of the amount received from a reinsurer would be compensation for acquisition costs incurred. He noted that in a composite margin approach one should also subsequently adjust the margin for the effects of changes in, for example, lapse rates.

An IASB member supported an explicit risk margin. Although an explicit risk margin would not be 100% correct, he would prefer an approach whereby the insurance liability is adjusted for changes in risk (i.e. increasing the liability for increases in the inherent risk). He also noted that appropriate disclosure requirements would result in most insurers migrating to a consistent basis in the determination of risk margins.

An IASB member observed that much of the confusion was caused by trying to achieve consistency with the different projects that the boards are working on but where inconsistent decisions have been taken. He referred to the revenue recognition project where no risk adjustment is included and the IAS 37 liabilities project which proposes the inclusion of a risk margin. Reference was made to the exit price notion and one IASB member observed that most IASB members that supported an explicit risk margin probably would support an exit price model. Another IASB member observed that the principles of a market participant view would ensure the adoption of appropriate discipline in determining the risk margin.

A FASB member questioned how one would release the composite margin in a scenario where the investment elements of the contract would seldom be unbundled. He noted that if one accepts that the proposed objective in the staff paper on explicit risk margins would adequately define the risk margin, then he would include paragraph 18-32 of the staff paper in the application guidance In the exposure draft. He noted that the way in which the disclosure requirements has been proposed in effect mandates the method that insurers would have to use.

The staff noted that at the discussion paper stage there was a clear measurement objective of having to reflect risk in the measurement of the liability, having an up to date measure and using a market participant view where available. He noted that the respondents voiced their dislike of the proposal due to it being fair value in a market where these contracts are seldom transferred. As a result of the push back at that level, no detailed comments were received on the proposed risk margin.

An IASB member commented that he perceived the inclusion of an explicit risk margin to be similar to the process that has to be performed in fair valuing financial instruments that are contained within level 3 of the fair value hierarchy. However, he noted that a composite margin was simpler to apply and he would be willing to progress with a composite margin approach.

A FASB member noted that the paper on the explicit risk margin still did not sway him to support the explicit risk margin approach. The proposed objective for an explicit risk margin in his mind was “common sense” and would not provide sufficient guidance to determine the best methodology to apply in calculating a risk margin. Another FASB member noted that it was a start but the guidance was still not sufficient. A FASB member observed that the Boards could “mandate” the quantile approach by stating the objective of the risk margin as having the purpose to measure the insurance liability at a specific confidence level taking into account the skewness of the distribution of outcomes in the measurement. The staff responded that the insurance industry would not be supportive of an objective that in essence mandates a specific approach in calculating an explicit risk margin due to the ongoing developments in this area.

A FASB member questioned how one would release the composite margin. If one is unable to determine the separate risk margin with a certain level of certainty, how would the appropriate driver be determined?

An IASB member noted that he views the residual margin as deferred income which should be run-off over the coverage period. He would prefer to recognise the residual margin as a day one gain but would also be willing to use it as a shock absorber.

An IASB member observed that he sees similarities between a risk and residual margin approach compared to a composite margin approach as both include a profit element and they are run off on a systematic basis. The inclusion of an explicit risk margin could cause the contract to be onerous on day one and the recognition of a day one loss which would not be recognised under the composite margin approach. It was noted that the other difference is that risk would only be re-measured under an explicit risk

margin method. The board member believes the composite margin should be recognised in the income statement as the insurer performs under the contract. This would include both the period of insurance coverage and the claims handling period.

A staff member noted that under the two margin approach (explicit risk margin and a residual margin) the current proposal is that the residual margin is recognised over the coverage period and the explicit risk margin is recognised over both the coverage and claims handling period. He also asked the Boards to consider the risks that arise from embedded derivatives which fluctuate over the term of the contract. This fluctuation in risk will not be captured in the composite margin model if the composite margin is recognised on a systematic basis. He also asked the Boards to consider contracts with large excesses or stop loss reinsurance contracts where there are losses accruing towards the loss recognition level but where this has not yet been reached. He noted that under the explicit risk margin approach, an insurer would take a balance sheet snapshot of the level of risk in the cash flows with a prospective view.

A FASB member noted that under the composite margin approach, changes in cash flows would be recognised in the income statement. He noted that the method selected to run off the composite margin may give some information on the change in risk but would not specifically re-measure the risk in the expected cash flows.

An IASB member noted that other accounting standards measure risk inherent in an item, for example financial instruments and liabilities. The risk in insurance contracts fluctuates and this should be reflected in the measurement of the contract.

A FASB member proposed an alternative approach whereby the composite margin is reset at each period with reference to the expected future cash inflows and outflows at each reporting period. This approach would recognise profits as they are realised over the duration of the contract.

The Boards then answered the questions put to them by the staff on the premise that the questions are intended to develop an appropriate composite margin approach. Both Boards voted in favour of recognising a day one loss in the income statement measured as the difference between the cash inflows and outflows. Under the composite margin approach this measure would not include a risk margin.

The Boards had some discussion on the driver to recognise the composite margin. Some IASB members were uncomfortable having more than one driver (including the release from risk but at the same time not recognising an explicit risk margin) or selecting a driver at inception of the contract and using that over the entire term of the contract. Another IASB member who supports a composite margin would not be uncomfortable with using more than one driver to recognise the composite margin.

In a vote on the period over which the composite margin should be recognised, the majority of the IASB and FASB were in favour of recognising it over both the coverage period and the claims handling period as opposed to only the coverage period. The majority of the IASB and FASB voted in favour of recognising the composite margin as part of the insurance contract liability. Both Boards also agreed that the residual margin in the explicit margin model would be part of the insurance liability.

The Boards discussed the accretion of interest on the composite and residual margin. There were mixed views on the accretion of interest. The IASB appeared split but the chairman summarised that the majority of the IASB would support the accretion of interest on the margins whereas the FASB would not accrete interest.

Discounting

The staff put forward two proposals for the discount rate to be applied to insurance contracts. Some recommended an objective to adjust estimated (probability-weighted) future cash flows for the time value of money in a way that captures the characteristics of the liability. Those characteristics are not best reflected in a discount rate based on expected returns on assets backing those liabilities (unless those asset returns affect the cash flows to policyholders). They acknowledged liquidity as one of the relevant characteristics of an insurance liability that should be reflected in the discount rate. Other staff members argued that for comparability reasons and to be consistent with the accounting for pensions, a discount rate described as a high-grade corporate debt rate should be required for non-participating insurance contracts. The staff recommended that the measurement of participating contracts should consider the fact that the amount, timing and certainty of the insurance contract's cash flows (partially) depend on performance of specific assets. The staff noted that this is a significant issue for long dated contracts.

An IASB member noted that there is theoretical support to add a liquidity margin to a risk free rate to determine an appropriate rate but he was not convinced that the liquidity premium could be separated from the credit risk element in practice. He would support a discount rate that also reflects the insurer's own credit standing. He noted that he would not be supporting the notion to use a high-quality bond rate. This would not be reflective of the characteristics of the liability. He also noted that companies that back their insurance liabilities with risky assets such as equities and currently use the discount rate based on expected returns on assets backing those liabilities to discount the liability may reflect a loss on day one if those investment returns were used to price the product. This in his view is appropriate and then to recognise the profits as a result of investing in high-risk assets in the future periods. If a day one loss arose as a result of including a liquidity premium he would prefer that this be addressed and avoided.

In a vote the IASB members noted that they do not support a discount rate based on expected returns on assets backing those liabilities. One IASB member noted that insurers could use their own borrowing rate. Another IASB member questioned why the insurer's own credit standing would not be included in determining the discount rate if the objective of the discount rate is considered. He noted that this should be expressly stated in the guidance.

A FASB member questioned whether a replicating portfolio approach should be used. The staff responded that there are two notions of a replicating portfolio. The first is a replicating portfolio that exactly matches the liability which he indicated in his view it would be appropriate to use. The other scenario is a replicating portfolio that does not exactly match the pay-off of the insurance contract in all circumstances. The staff indicated that it was unclear what adjustments would be required to get the rate to achieve a replicating portfolio.

A FASB member noted that it is important that risk be reflected only once, either as part of the cash flows or as part of the discount rate. He noted that if one fair values a debt instrument, the contractual cash flows are valued using a discount rate that include adjustments for risk. It would therefore not be appropriate to use this rate to discount the insurance liability where an adjustment for risk is included in the margin. He would support the use of a risk-free rate with an adjustment for liquidity and may be own credit standing. He also shared the concern about how the liquidity adjustment would be determined in practice. Another FASB member noted that she would be more pragmatic by mandating a method that includes both the liquidity and credit risk premium.

An IASB member observed that mandating the use of a high-quality corporate bond would be challenging in territories where there isn't a deep and liquid market for corporate bonds.

It was noted by an IASB member that changing the requirements for the discount rate adjusts the allocation between the cash flow component and the residual margin in the measurement model on day one. The current model is more aligned with a performance obligation model whereby any day one gain is eliminated through the residual margin. It is therefore not a big issue to him whether the insurance contract's credit characteristics were included in the discount rate or not.

An IASB member noted the importance of eliminating measurement mismatches and therefore would support the inclusion of own credit risk in the discount rate. This would be true for territories where financial assets are measure at fair value. Other IASB members noted that in some territories the majority of financial assets comprise debt securities measured at amortised cost.

A FASB member observed that the discount rate should reflect the credit characteristic of the insurance contract and not the insurance entity. The staff agreed with this and noted that the discount rate should consider the relative priority of insurance liabilities compared to the insurer's other liabilities.

On a vote the Boards did not support the use of a high-grade corporate debt rate. They agreed that liquidity is one of the relevant adjustments to the risk-free rate to be reflected in the discount rate. A FASB member suggested that the exposure draft propose not to include an adjustment for own credit risk but that the exposure draft should ask specific questions on own credit risk.

The boards next discussed the discount rate to be applied to participating contracts. An IASB member questioned whether the contract being considered was a participating contract where the policyholder shares in the investment result of backing assets or whether it is based on the profitability of a portfolio of contracts. He would support that the discount rate is based on expected returns on assets backing the former participating liabilities.

A FASB member noted his support for the proposal but questioned the appropriateness of the asset rate equalling the liability rate where a margin is included. The staff noted that where the projected cash flows include an adjustment for risk then this would not be included in the discount rate as well. An IASB member noted that if the asset cash flows equal the liability cash flows then there would not be a requirement for a risk margin because the liability would always equal the assets.

The staff noted that for participating contracts where the future cash flows on contracts are impacted by the assets that are held, it is difficult to incorporate this discretion in the discount rate. This is especially the case where asset returns are allocated between different generations of policyholders.

In a vote, both Boards agreed with the staff's proposal that the measurement of participating contracts should consider the fact that the amount, timing and certainty of the insurance contract's cash flows depend on performance of specific assets.

Boundaries of the contract

At an IASB only board meeting the IASB discussed the boundaries of an insurance contract. The staff recommended that the contract boundary is defined as including all cash flows arising under the contract as a result of events occurring during the period ending on the earlier of the contract coverage period (as extended by any renewal options available to the policyholder) and the point at which the insurer has an unrestricted ability to cancel or re-underwrite and re-price coverage of the individual contract. For this purpose, restrictions would be ignored if they have no commercial substance (i.e. no discernible effect on the economics of the contract). The proposal was following input from the International Association of Insurance Supervisors and industry groups representing the insurance sector in some countries.

One of the IASB members was of the view that to use the words "unrestricted ability" to re-price was too broad and open-ended. If one could re-price to a level where it serves as a disincentive for the policyholder to continue with the insurance contract the term of the contract should end at that point. He would allow within the contract term instances where the method to re-price has been set at the inception of the contract. Another Board member noted that the definition of the contract boundary could not be changed to eliminate the ability to re-price as many long duration contracts include premium increases, for example indexed to the consumer price index.

A board member noted that he would categorise a 10 year term assurance contract where the insurer had the ability to re-price the contract annually to the then market price as ten contracts with a one year duration. He was of the view that the contract boundary should be defined as the concept of guaranteed insurability and at a fixed price.

Another board member agreed with the staff proposal because if the insurer is obliged to accept premiums from the policyholder, the insurer is on risk under that contract. She would be uncomfortable not to account for such a contract where the insurer could incur a significant claim in, for example, the next "period".

Another board member was uncomfortable with the staff proposal. His concern was with contracts where the insurer could re-price without being able to underwrite. The contract in essence contains an option to be extended but at a market price (which would not have a value). He would only consider these options within the boundary of the contract if they were at a fixed price.

One board member observed that it is important that the definition of an insurance contract captures those options that have a value to the policyholder.

One Board member asked how no-claim bonuses would work where premium would be reduced if there was not an accident in a predetermined period. There was a view that as long as the insurer does not have discretion in the pricing decision that it would be within the boundary of a contract as it was not re-underwritten at that point in time. The staff will consider no claim bonuses further.

A board member proposed to define the boundaries of the contract as "up to the point when the insurer can cancel the contract or reassess the risk in the contract and re-price at or above the market rate for the risk in that contract". If the insurer is constrained in the pricing to below market levels, the contract would be within the boundary of the contract. The Board tentatively agreed to this proposal. The staff will consider with board members by e-mail whether the proposed definition has any unintended consequences not considered in the meeting.

Recognition of insurance contracts

The FASB had at a previous meeting tentatively agreed with the staff proposal as set out in the paper. The staff recommended that an insurer should recognise the rights and obligations arising from an insurance contract when the insurer becomes a party to the contract. This is the earlier of the insurer being on risk to provide coverage to the policyholder for insured events and the signing of the insurance contract.

A board member asked if one has a portfolio of binding insurance proposals/offers and the risk inherent in those contracts adversely changed whether the insurer would have to recognise a loss. The staff responded by noting that the important consideration is whether the offer is binding or not. This will be facts and circumstances specific based on the specific territory's laws and regulations.

One board member noted that if a binding offer is made then the insurer is standing ready in the period before coverage starts and so he is exposed to insurance risk and this should be accounted for. If the insurer can cancel the contract before the risk period incepts he would not account for the contract. Another Board member observed that the signing date of the contract should be changed to the contract inception date in the proposed wording.

One board member noted that in his view the amortisation of the residual margin should also be from the earlier period when the insurer is exposed to insurance risk.

The IASB agreed with the staff proposal subject to some minor wording changes.

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