Change is on the horizon
Insurance contracts proposal – a summary of the comment letters
“Accounting change is upon us on a global scale.”
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Background

On 27 June 2013, the Financial Accounting Standards Board (FASB) issued a proposed Accounting Standards Update, *Insurance Contracts (Topic 834)* (ASU) and requested that the responses to the proposals be submitted to the FASB by 25 October 2013. In late October and early November 2013, EY reviewed the 150+ comment letters that were posted to the FASB website as of 13 November 2013.

The responses range in length and depth of analysis from summarized views on the ASU to detailed responses to all 48 questions posed in the ASU.
Insurance companies submitted the majority of the comment letters; banks and asset management firms also provided a large percentage of the responses. And while the “Other” category in the information above represents 25% of the total, this category represented a diverse group, including accounting firms, regulators, industry trade groups and individuals that were grouped together for our analysis.

It is worth noting that each letter was given equal weight (i.e., no adjustment was made for single letters submitted by multiple entities or multiple entities submitting the same letter), so the percentages above, while informative, should not be considered precise. In particular, a group of five managed care organizations submitted a single letter and, as a result, health insurers appear less represented in the figures to the left than they would have had each company submitted its own letter.
Responses to the proposed update can be grouped into three broad categories:

- Thirty-nine percent of respondents prefer the retention of existing US generally accepted accounting principles (US GAAP) requirements to the proposals in the ASU. Forty-five percent of the letters recommending no change to existing US GAAP are from P&C or health insurance entities.

- Twenty-four percent of respondents recommend that existing US GAAP be retained, but that the FASB make targeted improvements to it. While some letters suggest what specifically should be improved, the majority of letters do not.

- Thirty-seven percent of respondents support the proposals in the ASU but identify specific issues that need to be addressed before the new standard is finalized and implemented.

- None of the respondents support the proposals in the ASU without noting certain areas of concern.
Key themes

Based on our analysis of the comment letters reviewed, several key themes emerged

- **Cost and complexity.** Respondents suggest that the FASB consider whether the perceived benefits from proposed changes warrant the costs of implementation and potential for increased complexity.

- **Relevance and transparency.** Respondents raise concerns that the financial outcomes from the proposed standards will not produce information that supports effective decision making within the company and among analysts. In particular, increased income volatility is cited as an area of concern.

- **Quality of the standard.** Respondents who want the FASB to move ahead with the standards update make it clear that efforts should be focused on developing high-quality standards that are an improvement over existing US GAAP. They also indicate that the quality of US standards should not be sacrificed to create convergence with International Financial Reporting Standards (IFRS).

**Industry perspective**

- Respondents who have worked to understand the costs and complexity of implementing the proposed standards estimate that the resource needs will be substantial.

- As companies across the country integrate the complex changes into their processes and systems, the demand for IT talent with industry experience will be intense.

- Without further convergence, for companies that apply US GAAP and IFRS, the costs will be even more considerable.
Comment letters submitted by insurance entities (and industry trade groups) identify specific areas of focus for the FASB to consider during any re-deliberations. Of these, we have selected the topics that we believe insurers consider most critical and provide a summary of comments in those areas below.

Discounting and the time value of money
Respondents are generally supportive of the principle that discount rates should reflect the characteristics of the liability. However, comments also raise concerns about the complexity and lack of comparability that could arise when applying the principle in practice. Specifically in relation to applying a top-down method, comments identify potential challenges related to the reference portfolio of assets and adjustments to remove credit risk not present in the liability. One particular area of concern is requiring the use of points on the observable yield curve where there is not a deep and liquid market (i.e., later points on the curve).

Recommendations for alternatives or improvements include the use of explicit or implicit pricing rates, actual or expected asset yields or proxies, including the use of an unadjusted risk-free rate or a high-quality corporate bond rate.

Most respondents are supportive of the recognition of the impact of changes in discount rates in other comprehensive income (OCI); although 73% suggest that the use of OCI should be optional, noting that not all assets are financial instruments categorized as available for sale or held to maturity.

Nearly all P&C and health insurers disagree with discounting for those contracts accounted for using the premium allocation approach (PAA). There is general support for the practical expedient under the PAA not to discount incurred claims expected to be paid within one year of the insured event.

Margin(s)
Sixty-five percent of respondents agree with the use of a single margin (i.e., no explicit risk adjustment) and most agree with recognizing the margin as an insurer is released from risk. The majority disagree with locking in the margin at inception and not adjusting it for subsequent changes in estimates of future cash flows. Many of the respondents in favor of “unlocking” the margin also reject the release of all remaining margin when a portfolio becomes loss making, and comment that unlocking the margin would remove that requirement.

Expected cash flows
There were varying responses across the Life and P&C industries on the principle that cash flow projections should meet the objective of an unbiased, probability-weighted mean. Those generally in agreement with the principle seem to interpret it as a “conceptual mean” or a requirement to probability-weight outputs, but request clarification of the words in the proposal to reflect this interpretation. Those opposed to the principle appear to be concerned that it requires probability-weighting of all inputs to the projection models.

Portfolio
The overwhelming majority of respondents disagree with the definition of portfolio in the proposal. Letters recommend alternatives or improvements, including using the existing US GAAP guidance for loss recognition or adopting the International Accounting Standards Board (IASB) term “managed together as a single pool.”

1. Not all letters submitted to the FASB covered all of the topics in this section. In fact, many letters did not address all aspects of the proposals in the ASU. Therefore, throughout this section of this document, references to “most” or “practically all” or specific percentages identified refer only to the proportion of letters specifically commenting on that topic as opposed to all letters submitted.
Industry perspective

- Discount rates are the most hotly contested area of the proposed standards, which is not surprising given that discounting has been under debate for years.
- Comment letters that focus on discount rates highlight the need to avoid accounting mismatches between the measurement of insurance contracts and the assets that are held to back them.
- The P&C industry appears to reject proposals that would change existing US GAAP to discount all incurred claims liabilities. However, if discounting were required, suggested alternatives to the proposals include the use of an unadjusted risk-free rate or inclusion of a provision for uncertainty.

Additional areas of focus

Two measurement models

There is substantial support for having two models, but a majority of respondents comment that the PAA should be optional. Commenters also asked for more clarification of the phrase “variability in expected cash flows before a claim is incurred” and additional implementation guidance for applying that criterion.

Acquisition costs

Only 20% of respondents agree with the definition of acquisition costs proposed in the ASU. Some suggest expanding the definition of acquisition costs to include all costs that can be attributable to obtaining a portfolio of contracts, including costs related to unsuccessful efforts and fixed and variable overhead costs. A majority of respondents disagree with the presentation of acquisition costs proposed in the ASU and suggest alternatives that would present a separate asset or include acquisition costs with fulfillment cash flows.

Insurance contract revenue

Respondents give broad support for the inclusion of a volume metric, but disagree with the revenue recognition approach proposed in the ASU due to the complexity of the mechanical calculation and views that the results do not provide information useful for decision making.
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Next steps and the path forward

Past experience shows that FASB will consider the feedback received in comment letters and will continue to make refinements to its proposals. Re-deliberations will begin in 2014, following one-to-one meetings, roundtables and field testing. A final standard is currently expected to be issued in mid-2015.

Assuming this target is met, respondents indicated that it would take anywhere from three years to eight years to implement the standard, with corresponding effective dates ranging from 2019–24. Most respondents, 58%, recommended a four-to-six-year implementation period, which would result in effective dates ranging from 2020–22.

Stay competitive by being prepared

Given the complexity of the proposed standard and other initiatives underway by the FASB, even effective dates in 2019 or 2020 should not prevent companies from undertaking an analysis of the impacts that the proposals could have on their organization. Those who understand the final proposals and have experience attempting to apply them may gain a competitive advantage over those who have done nothing. That said, activity should be performed in a focused manner to avoid any potential wasted efforts.

Service offering: phased implementation

<table>
<thead>
<tr>
<th>Education</th>
<th>Model office</th>
<th>Field testing</th>
<th>Road map development</th>
<th>Implementation</th>
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<tr>
<td>Activities</td>
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<tr>
<td>• Conduct educational workshops</td>
<td>• Perform hypothetical analysis, including sensitivity testing using a hypothetical portfolio to understand profit emergence</td>
<td>• Prepare pro forma financials over a specific time period on selected business</td>
<td>• Prioritize improvement recommendations</td>
<td>• Assist with accounting policies and methodology</td>
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<td>• Perform high-level qualitative impact analysis</td>
<td>• Understand and explain results</td>
<td>• Understand and explain results</td>
<td>• Prepare cost-benefit analysis and business case</td>
<td>• Build out new infrastructure across the company to produce the new accounting results and required disclosures</td>
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<tr>
<td>• Understand “generic” business implications by product line</td>
<td>• Analyze sensitivity of assumptions and methodology</td>
<td>• Analyze sensitivity of assumptions and methods</td>
<td>• Develop implementation road map</td>
<td>• Validate results</td>
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<tr>
<td>• Develop “quick and dirty” profit signature analysis</td>
<td>• Training documents</td>
<td>• Example profit and valuation profiles and analysis</td>
<td>• Actual financial statements and roll forwards</td>
<td>• Automated and controlled end-to-end accounting process to produce new insurance contracts accounting under US GAAP and IFRS</td>
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<td>Output</td>
<td></td>
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<tr>
<td>• Informed actuarial, finance and risk management</td>
<td>• Hypothetical sensitivities</td>
<td>• Detailed issue logs – system/data gaps</td>
<td>• Gap log prioritization</td>
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<td>• Summary learnings</td>
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At EY, we’ve been working with companies to think through the challenges and develop processes to address them for many years. With 2019 as the expected effective date for the new standards, we have the experience you need to assist you in your insurance contracts journey.

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EY presented a webcast summarizing the results of this review on 18 November 2013. If you would like to hear more detail about the comment letter analysis and key topics for discussion, please visit our website at www.ey.com/US/insurance