

Insurance accounting alert

IASB and FASB begin re-deliberations

Overview

Recently, the International Accounting Standards Board (IASB) started the re-deliberations on its accounting proposals on insurance contracts. The IASB was joined by the Financial Accounting Standard Board of the United States (FASB), which, last week, reaffirmed its commitment to work with the IASB on a single, high quality, converged accounting standard for insurance contracts. The re-deliberations allow the IASB and FASB (the Boards) to reconsider their decisions on the accounting for insurance contracts with the benefit of the comments they received on the IASB's Exposure Draft *Insurance Contracts* (the ED) and the FASB's Discussion Paper *Preliminary Views on Insurance Contracts* (the DP).

The Boards commenced their re-deliberations in early February with a discussion on acquisition costs. During this meeting, the Boards tentatively decided that the contract cash flows should include acquisition costs that relate to a portfolio of insurance contracts instead of at the contract level as proposed in the ED/DP. They will continue their debate on certain aspects of acquisition costs, such as which acquisition costs should qualify to be included in the cash flows, at a future meeting.

Insurance is on the agenda for the meetings on Wednesday, Thursday and Friday, 16-18 February, with the following items:

- ▶ Discussions that may lead the Boards either to confirm certain aspects of the model proposed in the ED/DP, or to modify the model on those aspects. Topics include:
 - ▶ Axioms and assumptions that underlie the development of the standard
 - ▶ Day one gains and losses
 - ▶ Locking in the discount rate
 - ▶ Discount rate for non-participating contracts
 - ▶ Discounting non-life contract liabilities
 - ▶ Cash flows
 - ▶ Explicit risk adjustment
- ▶ Education sessions on three topics:
 - ▶ Unbundling
 - ▶ Presentation
 - ▶ Margins



Discussion topics

Project assumptions

The IASB and FASB staffs (the staff) have prepared a paper to articulate the axioms and assumptions that underlie the development of the insurance proposals. They consider the axioms to be self-evident and conclude that the Basis for Conclusion to the ED/DP holds sufficient arguments in support of the project assumptions. Although the Boards will be asked to confirm the project assumptions, they may be subject to revision during future discussions.

The axioms envisaged by the staff are that:

- ▶ An ideal measurement model would report all economic mismatches (including duration mismatches) that exist, and would not cause any accounting mismatches.
- ▶ An ideal accounting model should reflect both the intrinsic value and time value of options and guarantees embedded in insurance contracts.
- ▶ Money has a time value and an entity more faithfully represents its position when liabilities are measured in a way that includes the time value of money.

The assumptions are that the Boards will:

(a) Develop a separate standard for insurance contracts, rather than requiring application of other, more generic, accounting guidance in other (future) standards (e.g., financial instruments or revenue recognition) to insurance contracts

(b) Address in the standard the accounting for insurance contracts, but not the accounting for financial instruments that the insurer holds or accounting by a particular type of entity

(c) Develop a standard based on an accounting model that regards insurance contracts as creating a bundle of rights and obligations that

work together to generate a package of cash inflows and outflows

(d) In general, the final standard will measure insurance contracts at the portfolio level

(e) The accounting model should be based on:

- (i) Current estimates, rather than carrying forward estimates made at contract inception
- (ii) Inputs that are consistent with observable market data

(f) The cash flows incorporated in the measurement of the insurance liability are those that will arise as the insurer fulfils the insurance contract

(g) The model will use the expected value of future cash flows rather than a single, most likely outcome

(h) The measurement of the liability will not reflect changes in the insurer's own credit standing

Day one gains and losses

The ED/DP requires that insurers recognise a residual or composite margin as a component of the liability at the inception of the contract that prevents the occurrence of a gain. In addition, the ED/DP indicates that the residual or composite margin cannot be negative; that is, a loss at inception must be recognised.

A large majority of the comment letters supported the proposed guidance in the ED/DP. The staff believes that:

- ▶ The proposed guidance on day one gains and losses is consistent with those in the emerging standard on revenue recognition
- ▶ A margin implicitly provides for items not included in cash flows (such as future overheads) and, hence, it is not appropriate to recognise the entire margin as a day one (or day two) gain

For these and other reasons, the staffs recommend that the Boards reaffirm the day one proposals in the ED/DP.

Locking in the discount rate

The ED/DP proposes to re-measure the discount rate every reporting period. In response to some comment letters, the staffs have considered the possibility that the time value of money should be based on a discount rate that is set at contract inception and locked in. Subsequent valuations would be made using this discount rate regardless of current market rates. Proponents of this idea include insurers that expect to measure investments backing insurance liabilities at amortised cost. Those respondents believe that the combination of an amortised-cost measurement for investments and a locked-in discount rate is a proper reflection of their business model. Furthermore, it prevents the accounting mismatch that occurs when the measurement of liabilities moves with changes in interest rates, but the measurement of backing investments does not.

The staff considered the arguments for a locked-in rate, but they noted that insurance contracts have cash flow characteristics that differ from financial instruments. Most significantly, there is greater uncertainty in the cash flows, and insurance contracts often contain options and guarantees that are not separated. To be comparable with the treatment of financial instruments, these options and guarantees should be separated and measured at fair value, but the staffs believe that this bifurcation is complex and impractical in many cases. They also note that the use of locked-in discount rates would have to be optional, as not all insurers purchase investments with the intention to hold them. Some insurers would want to measure investments at fair value through profit and

loss together with discounting liabilities at a current market rate. For these and other justifications, the staff recommends that the discount rate used to measure all insurance contracts should be a current rate that is updated each reporting period.

Discount rate for non-participating contracts

The ED/DP stated that the discount rate should reflect the characteristics of the liability and concluded that for contracts for which the benefits do not depend on the performance of assets (referred to as 'non-participating' contracts in the staff paper), the discount rate should be the risk-free rate adjusted for liquidity.

The staff paper articulates the concerns with the proposal in the ED/DP and the alternatives suggested in the comment letters for the Boards' consideration. Concerns raised include:

- ▶ Possibility of volatility in profit or loss that does not represent the nature of the insurance business
- ▶ Potential for day one losses for long duration contracts
- ▶ Insufficient guidance on how to determine the liquidity premium and the fact that no standard methodology exists for its calculation

The alternatives suggested in the comment letters are:

- ▶ Risk-free rates, perhaps adjusted for characteristics of the liability, such as illiquidity ('bottom-up approach')
- ▶ Asset-based rates, such as yields on current and future investments adjusted for expected defaults ('top-down approach')
- ▶ Prescribed rates, such as use of high quality corporate bond rates
- ▶ Rates based on an insurer's pricing strategy

The staff notes in the paper that entities can come to very similar results by beginning at different starting points and adding or subtracting the applicable risks. Considering this observation, the staff recommends that the Boards:

(a) Confirm that the objective of the discount rate is to adjust the future cash flows for the time value of money

(b) Do not prescribe a particular methodology for determining the discount rate

(c) Provide guidance that the discount rate should:

(i) Be consistent with observable current market prices for instruments with cash flows whose characteristics reflect those of the insurance contract liability, including in terms of timing, currency and liquidity, but excluding the effect of the insurer's non-performance risk

(ii) Exclude any factors that influence the observed rates but are not relevant to the insurance contract liability (e.g., risks not present in the liability but present in the instrument for which the market prices are observed, such as any investment risk taken by the entity that cannot be passed to the policyholder)

In addition, the staff will also ask the Boards whether they wish to consider a practical expedient; for example, based on a high-quality corporate bond rate, for insurers that cannot determine a rate that generates a more faithful representation. If the Boards decide to allow a practical expedient, the staff will bring more specific proposals to a future meeting.

The staff paper reminds the Boards that the decision on discount rates affects many other components of the measurement of liabilities; for example, one of the factors that determines the size of the residual (or composite) margin is the discount rate used at inception of the contracts.

Discounting claim liabilities of non-life contracts

The ED/DP proposes to discount claims liabilities. The staff considered arguments in the comment letters to eliminate or reduce the extent of discounting for non-life claims liabilities. The arguments were along the lines that:

- ▶ Discounting, for claims liabilities of most types of non-life contracts, does not reflect the business model as non-life insurance is based on underwriting results rather than

asset/liability management. The strongest support for this view came from the United States.

- ▶ Some claims liabilities are too unpredictable with respect to timing and amount of payments, making discounting not reliable.
- ▶ Discounting is immaterial for some claims liabilities.

Having endorsed the time value of money as a fundamental aspect of measurement of insurance liabilities, the staffs were not persuaded by the first two arguments. Citing precedents in accounting for short term leases and for receivables and payables, the staff have accepted the view in the third argument.

The staffs recommend:

- ▶ An exception to discounting should be made for short-duration, short-tail claims in lines where the claims settling period is typically less than one year.
- ▶ Discounting should be applied to long-tail claims (claims typically settled after more than one year) where the expected payout pattern is reasonably determinable.
- ▶ Discounting should also be applied to long-tail claims in which it is questionable whether the insurer will have to pay, when they will have to pay, or how much they will pay.

Cash flows

The staff paper addresses concerns in the comment letters about:

- ▶ Estimates of cash flows and especially the derivation of expected cash flows
- ▶ Inclusion of certain cash flows, such as overhead expenses
- ▶ Level of guidance in the ED/DP

The paper states that the reference to probability-weighted cash flows in the ED/DP is meant to explain the objective, rather than requiring the use of an explicit probability distribution in all cases. The guidance is intended to make a distinction between the expected value and a most likely outcome, but it is not intended to limit or restrict the methods used to estimate the expected value.

In addition, the staff discusses the types of expense that might be considered for inclusion in the cash flows, and concludes that they should include those that an insurer incurs to meet its responsibility to fulfil the contract

obligations. Citing precedents in guidance on inventories and construction contracts, the paper states that fulfilment costs include overhead expenses that relate to fulfilment activities and must be allocated to specific portfolios. It does not include costs associated with abnormal activities, unabsorbed capacity or general administration.

The comment letters are generally supportive of the level of detail in the guidance on cash flows. Therefore, the staff concludes there is no need to change the level of detail in the guidance for determining the probability weighted cash flows, but does recommend that the Boards should:

- ▶ Clarify that the measurement objective of expected value refers to the mean, considering all relevant information
- ▶ Clarify that, in meeting the measurement objective, practical implementation would depend on the circumstances and there is no need for all possible scenarios to be identified and quantified. This is provided that the insurer is satisfied that the estimate is consistent with the measurement objective of determining expected value
- ▶ Confirm that the costs included in the cash flows used in measuring a portfolio of insurance contracts should be all of the costs that the insurer will incur in fulfilling the contracts, including:
 - ▶ Costs that relate directly to the fulfilment of the contracts in the portfolio, i.e., payments to the policyholders, claims handling, etc (described in paragraph B6.1 of the ED)
 - ▶ Costs (including fixed and variable overheads) that are attributable to contract activity as Part of fulfilling that portfolio of contracts and that can be allocated to those portfolios
 - ▶ Such other costs as are specifically chargeable to the policyholder under the terms of the contract
- ▶ Confirm that costs that do not relate directly to the insurance contracts or contract activities should be recognised as expenses in the period in which they are incurred
- ▶ Eliminate the term 'incremental' in the context of fulfilment cash flows

Explicit risk adjustment

The IASB proposes a two-margin approach (risk adjustment plus residual) in its ED, while the FASB expressed a preference for a single composite margin in its DP. The staff paper discusses both the need for and usefulness of a separate risk adjustment. It concludes that the concept of a risk adjustment reflects the uncertain nature of insurance liabilities. The staff also believes that a risk adjustment is appropriate to a fulfilment measure because it reflects the economic burden to the entity associated with an uncertain obligation. The risk adjustment is also useful because it is relevant and potentially capable of providing faithfully representational information.

The staff recommends that the Boards conclude that, in principle, the inclusion of an explicit risk adjustment in the measurement of insurance liabilities would provide relevant information to users.

The paper notes that the final decision on whether to actually include an explicit risk adjustment in the model depends on other factors, such as the verifiability and comparability of the risk adjustment and cost-benefit considerations. This matter will be discussed in later meetings.

Education sessions

These sessions are intended to refresh the Boards on their previous discussions and the basis for their decision or to enhance their understanding of the technical issues. The educational sessions slated for this meeting are on three topics, as follows:

Unbundling - The purpose of this session that will include external presenters is to understand the effect, costs and benefits of separating insurance contracts into insurance and non-insurance components. The Boards plan to discuss unbundling further in March.

Presentation models - The ED¹ proposes a summarised margin approach to presentation that emphasises the emergence of margins, experience deviations and re-measurements. This session will review the proposed summarised margin approach and other presentation approaches that the Boards may consider when re-deliberating the presentation model. One other approach is the allocated

premium approach, which the ED would require for short duration contracts. Other approaches, that the IASB considered but rejected when developing the ED, include approaches based on expanded margins, written premiums, or fees.

Margins - This session is intended to prepare the Boards for a future decision whether the residual (or composite) margin should be unlocked or re-measured, with the former notion focusing on 'consuming' the residual margin for unfavourable changes in estimates. The latter notion provides potentially broader adjustment by also considering favourable changes. The debate revolves around whether it is more appropriate for changes in estimates of liabilities to affect profit or loss in the current period or if the margin should be re-measured to offset the changes. The ED/DP proposed that the residual or composite margin is not unlocked or re-measured, except to reflect greater-than-expected policy terminations in the amortisation.

Next steps

The Boards have scheduled another substantial meeting on Insurance for March. During this March meeting, the Boards intend to address a considerable number of items, including key topics like unbundling and presentation. The IASB remains committed to issuing a final standard in June 2011, with the FASB working towards publication of an Exposure Draft as its next due process stage.

You can register to follow the discussion at www.ifrs.org.

¹In its DP, the FASB indicates that it is in favour of using the margin presentation approach for insurance contracts measured under the building block approach. It also has indicated a preference for the allocated premium approach for those contracts that qualify for the modified model, although the FASB has not determined which contracts would be measured under the modified model. In this respect, the FASB expressed concerns with having two different presentations for insurance contracts and requested input from respondents on the usefulness of the information provided by each approach.

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