

Insurance accounting alert

IASB and FASB make further progress

On 21-22 March 2011, the International Accounting Standards Board and the Financial Accounting Standards Board of the United States (the IASB and the FASB, respectively, or collectively, the Boards) made further progress towards their joint objective of a uniform, global insurance contracts standard. The Boards made decisions on the measurement objective for the risk adjustment and a modification to the definition of contract boundaries. They rejected the idea of presenting changes in the discount rate for long-term contracts in other comprehensive income (OCI). In a non-decision making session, they discussed the objectives for unbundling. In addition, the Boards held a meeting on March 29 to discuss the possibility of unlocking the residual or composite margin.

The adjustment for risk

While the Boards are committed to not reporting a profit at the issue of an insurance contract through the use of a margin, they have not yet decided between a risk adjustment with a residual margin or a composite margin. At a previous meeting, the Boards concluded that if a risk adjustment can be determined reliably, then that information would be useful.

At the 21-22 March meeting, the Boards' discussion focused on the measurement objective for a risk adjustment. The IASB's exposure draft on Insurance Contracts (ED) stated the risk adjustment was the maximum amount the insurer would rationally pay to be relieved of the risk that the ultimate fulfilment cash flows exceed those expected. Based on feedback in comment letters, the Boards decided that the objective should be revised to avoid the perception that the adjustment for risk relates to an exit price. There was significant discussion regarding whether the objective should incorporate the notion of indifference (being the point at which the explicit risk adjustment should be measured). They settled on a revised objective that defines the risk adjustment as the amount the insurer requires as compensation for bearing the risk that the ultimate fulfilment cash flows could exceed those expected.

The Boards also asked the staff to clarify in the guidance that the word 'exceed' does not mean that an insurer should only consider the adverse development of cash flows when estimating the risk adjustment. Instead, it is intended to emphasise the risk-averseness of the insurer (i.e., the fact that an insurer places more weight on unfavourable outcomes than on favourable outcomes). The staff will also consider how the notion of indifference could be reflected in the guidance.

Although the Boards reached agreement on a revised objective, the determination of whether it will result in a reliable amount remains an open question. As part of the process to evaluate whether a risk adjustment can be determined reliably, there were two educational sessions focusing on how explicit risk adjustments are being used today.

Unlocking residual or composite margin

The Boards discussed the possibility of requiring the residual or composite margin to be unlocked and adjusted to offset the effects of changes in estimates of cash flows. Board members also expressed concern about using a measurement model based on current estimates, then reversing the effects of current changes through unlocking the margin. They noted that such an approach results in 'smoothing' of income and may obscure important information about the underlying measurement changes in the liabilities. Additional concerns were raised about the complexity that unlocking would add to the calculation of insurance liabilities.

Aside from these foregoing concerns, the Boards noted that if they were to conclude that the margin would be unlocked, then it should be done in a

strictly prospective way. The Boards' members also expressed differing views on which changes in assumption (i.e., financial or nonfinancial) would be unlocked. Some indicated that unlocking should be for all changes in inputs of insurance liabilities, while others preferred unlocking for nonfinancial inputs only.

Contract boundaries

The definition of contract boundaries is important in the determination of which future cash flows should be considered in the measurement of liabilities. The Boards are seeking a definition that would require consideration of those cash flows associated with an existing contract with the policyholder, but would prevent consideration of cash flows from future contracts. The ED and the FASB's discussion paper on Insurance Contracts (DP) indicated that the cash flows included in an insurance contract are those that occur until the point at which an insurer is either no longer required to provide coverage, or can set a price that fully reflects the current risk assessment of the policyholder. Based on feedback from the comment letters, the Boards modified the definition for contracts that do not contain a pre-funding element. The modified definition makes it clear that, for those contracts, the ability to re-price does not have to be assessed at the contract level, but rather at the portfolio level. This change would allow the contract boundary for certain contracts, such as certain health insurance contracts, to be one year rather than the expected life of the relationship with the policyholder. The Boards asked their staff to investigate whether the change in definition would have unintended consequences in the classification of some life contracts.

How we see it

Compared with the ED/DP proposals, the above change would result in a fundamentally different reflection of the economics for contracts that can be re-priced annually to reflect the risk of a portfolio of those contracts. The change means that these contracts will likely be measured by the alternative measurement model for short-duration contracts based on an allocated premium approach, rather than the building blocks approach, if the Boards require or permit the use of the alternative model.

Long-term discount rates and the use of OCI

The Boards' staff, proposed that insurers present in OCI the effects on the measurement of insurance liabilities for a portion of the change in long-term discount rates. The use of OCI would apply for terms beyond observable rates, i.e., discount rates that are determined by extrapolation of rates related to shorter terms. The Boards rejected this proposal; they did not see the need to use different treatment for long-term discounts rates from the treatment of other inputs that require judgment when measuring insurance liabilities. They will address the possible use of OCI to present some changes in the measurement of liabilities at a future meeting. These discussions will address the topic comprehensively; that is, a broader consideration of elements of changes in insurance liabilities that might be better reflected in OCI.

How we see it

Despite the rejection of this particular staff proposal for the use of OCI, the Boards are mindful of the concerns raised in the comment letters about the potential for volatility in net income that could result from changes in inputs. The Boards seem committed to finding a useful presentation of the effects of changes in short-term market rates, for example, through the use of OCI, or by separating information about changes in financial market information from other changes in profit or loss.

Unbundling

The Boards confirmed the proposal in the ED/DP to separate embedded derivatives from their host insurance contract, based on existing requirements in their respective financial instruments standards. They concluded that practitioners are familiar with the existing guidance for embedded derivatives and it would not be productive to try to develop new separation proposals.

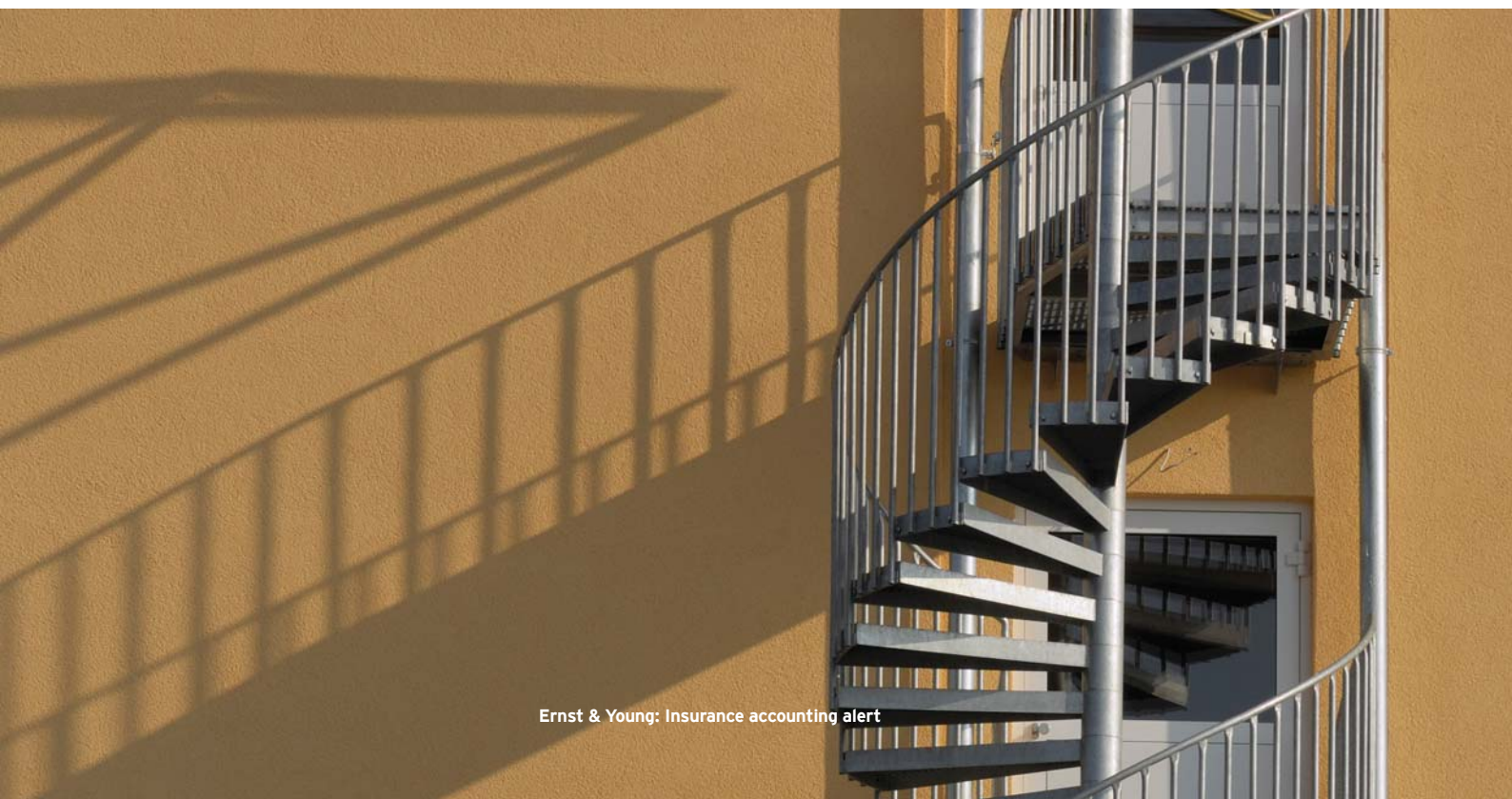
In a non-decision making session, the Boards discussed the objective for unbundling in a broader perspective. They wish to pursue unbundling to the extent that it improves the usefulness of information. However, they have not yet reached consensus on when unbundling would provide more useful information. For example, Board members have differing views on whether the measurement of financial components would be significantly different under the insurance standard, compared with measurement under the principles applicable to financial instruments, or whether the difference is a matter of concern. For some Board members, unbundling of deposits for measurement purposes would also provide a more appropriate representation of the remaining insurance elements.

How we see it

The discussions suggest that the Boards' perception of the appropriateness of the presentation and the emergence of profit under the proposed insurance model will be an important factor in their solution for the unbundling issue.

Summary

The Boards continue to progress towards the goal for final decisions to be made on accounting for insurance in a ballot by June 2011 with a final release in the second half of 2011. To achieve this, insurance topics will be included on almost every agenda for the Boards' joint meetings scheduled in April and May.



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EYG no. AU0811
1103-1244764 NY



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