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Insurance Accounting Alert

IASB to discuss measurement model, margin and discount rate

Overview

On 18 September 2009, the IASB (the Board) will meet to continue their debate on accounting for insurance contracts. The Board will be asked to select a measurement approach for insurance contracts, choosing between approaches based on either: a) the current project to amend IAS 37 *Provisions Contingent Liabilities and Contingent Assets*; or b) a current fulfilment value including a composite margin.

The IASB Staff (the Staff) will recommend to the Board that a measurement approach based on the amendments to IAS 37 (the updated IAS 37 model) should be selected by the Board. This recommendation is based on the Staff's view that using the updated IAS 37 model will require less additional guidance than a current fulfilment value model and because the model provides a basis for rationalising and measuring risk (and possibly service) margins. The Staff specifically cite the consistency with IAS 37 as justification for their recommendation.

The Staff recognises that this decision would conflict with the decision of the US Financial Accounting Standards Board (FASB) to select a measurement approach that is based on a current fulfilment value which includes a composite margin. As such, the Staff recommend that both measurement bases be included in the upcoming Exposure Draft. Input will be sought from constituents on both bases but the Exposure Draft will reiterate the objective of a converged approach.

In addition to its recommendation for the selection of the updated IAS 37 model the Board will discuss:

- The accounting for subsequent releases of margins
- The objective of discount rates, and a high-level outline of possible guidance for determining discount rates.

We consider each of these topics further in this alert. The Staff will also present an updated timetable for the project, which anticipates publication of an Exposure Draft in December 2009. Policyholder accounting has been dropped from the project and publication of a final standard is now targeted for June 2011.

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The story so far

A summary of topics discussed and tentative decisions by the IASB and FASB (the Boards) to date are set out in the table below.

Summary

Topic	IASB	FASB
Candidate measurement approaches	The IASB decided tentatively to include in the list of candidates a measurement approach based on the updated model being developed in the project to amend IAS 37 (modified to exclude day one gains).	The FASB decided tentatively to select a current fulfilment approach with a composite margin as the measurement approach for insurance contracts.
Features of a measurement approach for insurance contract liabilities	A measurement approach for insurance contracts conceptually should: ▶ Use estimates of financial market variables that are as consistent as possible with observable market prices. ▶ Use explicit current estimates of the expected cash flows. ▶ Reflect the time value of money. ▶ Include an explicit margin.	A measurement of the fulfilment value of an insurance contract should use expected cash flows rather than a best estimate of cash flows. Those expected cash flows should be updated in each period. The measurement of cash flows should consider all available information that represents the fulfilment of the insurance contract. All available information includes, but is not limited to, industry data, historical data of an entity's costs, and market inputs when those inputs are relevant to the fulfilment of the contract. The measurement of cash flows should be discounted and the discount rate should be updated each reporting period. The FASB will discuss the appropriate discount rate at a future meeting.
Unearned premium	The IASB decided tentatively: ▶ That an unearned premium approach would provide decision-useful information about pre-claims liabilities of short-duration insurance contracts. ▶ To require, rather than permit, the use of an unearned premium approach for those liabilities.	The FASB will discuss an unearned premium approach at a future meeting.
Measurement of the margin at inception	The margin at inception should be measured by reference to the premium. Therefore, no day one gains should be recognised in profit or loss (except for the part of the premium that covers acquisition costs, as discussed in more detail below). If the initial measurement of an insurance contract results in a day one loss, the insurer should recognise that day one loss in profit or loss.	In principle, the initial recognition of an insurance contract should not result in the recognition of an accounting profit. The FASB will discuss this issue (day one losses) at a future meeting.

Topic	IASB	FASB
Acquisition costs	The Board discussed an example in which two insurers issue identical insurance contracts, but incur different acquisition costs and, as a result, charged premiums that differ by the same amount. The Board decided tentatively that those contracts should have the same initial measurement. As a follow-up, the Board decided tentatively that, at inception, an insurer should recognise as revenue the part of the premium that covers acquisition costs. For this purpose, acquisition costs should be limited to the incremental costs of issuing (i.e., selling, underwriting and initiating) an insurance contract and should not include other direct costs. Incremental costs are those costs that the insurer would not have incurred if it had not issued those contracts.	An entity should: ▶ Expense all acquisition costs when incurred ▶ Not recognise any revenue (or income) to offset those costs incurred.
Policyholder behaviour and contract boundaries	The measurement should include the expected (i.e., probability-weighted) cash flows (future premiums and other cash flows resulting from those premiums, e.g., benefits and claims) resulting from those contracts, including those cash flows whose amount or timing depends on whether policyholders exercise options in the contracts. To identify the boundary between existing contracts and new contracts, the starting point would be to consider whether the insurer can cancel the contract or change the pricing or other terms. The Staff will develop more specific proposals for identifying the boundary.	The FASB will discuss this issue further at a future meeting.

Source: IASB Staff Agenda Paper 17, Ernst & Young

Recommendation of the updated IAS 37 model

The two candidates on the list currently being considered by the Board include: a current fulfilment value with a composite margin and the updated IAS 37 model.

At the September 2009 meeting, the Staff will recommend that the updated IAS 37 model be selected by the Board as the measurement candidate in a future standard.

Below, the key similarities and differences between the two remaining candidates are highlighted:

Similarities

The following similarities exist between the two remaining candidates:

- Both candidates measure the insurance liability from the perspective of the insurer and not other market participants. Therefore, they do not exclude cash flows specific to the insurer.
- Both candidates use the three building blocks (current estimates of future cash flows, time value of money, and explicit margin) that have been tentatively selected by the Board as a basis for measurement of an insurance liability.
- Both candidates consider all available information (including financial market variables) that are as consistent as possible with observable market prices.
- Both candidates are hybrid approaches of a current measure and an allocation model for day one differences (i.e., residual or composite margin).

Differences

The following differences exist between the two remaining candidates:

- The updated IAS 37 model finds a precedent in the Board's IAS 37 project, whereas current fulfilment value has specifically been developed within the insurance contracts project.
- The updated IAS 37 model measures the amount an insurer would rationally pay to be relieved of an obligation, while current fulfilment value measures the present value of the cost of fulfilling the obligation to the policyholder over time.
- The updated IAS 37 model requires inclusion of a risk margin and may require the inclusion of a service margin (depending on conclusions of the IAS 37 project) that would require remeasurement at each reporting date, while current fulfilment value implicitly incorporates these margins into a composite margin that is released over time.
- The updated IAS 37 model allows an insurer to record a lower amount than its estimate of the burden of fulfilling the contract if objective evidence is available that the insurer can cancel or transfer its obligation to a third party at this amount.

Subsequent release of margins

In Agenda Paper 17C, primarily devoted to the subsequent release of margins, the Staff discuss the basis and period for releasing either the residual or composite margins and the impact of changes in estimates, requesting that the Boards select between different options presented as set out below.

The Staff recommend that day one losses should be recognised in the profit and loss. However, where the expected present value of premiums exceeds the prospective measurement of the obligation under either approach (resulting in a day one profit), the Staff provide multiple recommendations for releasing margins and the relationship with subsequent changes in estimates.

Driver for release

Some of the Staff believe that the Boards should not prescribe a particular driver for releasing margins, but that the insurer should select the driver that best depicts its performance under the contract. Other Staff recommend that the Boards should prescribe the use of a release from risk approach as the driver in all cases. If the first alternative is selected, other candidates for a driver identified by the Staff include:

- Funds under management
- Expected benefit and claim payments
- Premium receipts
- Passage of time
- A mix of two or more drivers.

Period of release

The Staff recommend different periods of release depending on the measurement basis selected by the Boards. If the updated IAS 37 model is used, the period of release should be the period of coverage provided by the contract, while under the current fulfilment value measurement basis, the period of release should be the claims handling period. The Staff define the 'coverage period' as the period during which the contract is in force and the 'claims handling period' as the period from when the first claim arises until the last claim is paid.

Change in estimates

The Staff Papers also consider the impact of changes in estimates and the release of margins. Again, the Staff identify two views:

- If the Boards believe that a current measurement is integral to understanding and reporting insurance contracts, then the margins should be set at inception and released in accordance with the basis and period selected above regardless of subsequent changes in estimates. All changes in estimates should be reported in the profit or loss (or other comprehensive income).
- If the Boards believe that the guidance in revenue recognition is integral to all components of the insurance liability, then the margins should be adjusted for changes in estimates of all non-financial market variables (provided the margin does not become negative). Changes in financial market variables are reported in the profit or loss (or other comprehensive income).

Discount rates

The Staff believe that the discount rate for an insurance liability should be based conceptually on the characteristics of the liability rather than the assets backing the liability. They suggest that cash flows from assets backing an insurance liability are irrelevant to the measurement of the liability.

Suggested characteristics of the liability include, but are not limited to: timing, currency and liquidity. While non-performance risk is another characteristic, this is specifically excluded from the scope of the current paper by the Staff as it is the subject of another IASB project. Conversely, characteristics that impact an observed rate, but are not relevant to the insurance liability should not be included in the discount rate.

The Staff separate an observable market rate into the following conceptual components:

(a) A risk-free rate

(b) Expected losses from credit defaults

(c) Premium for uncertainty in expected losses from credit defaults

(d) Liquidity premium for holding an instrument that is not readily transferable

(e) Other elements, including taxes, conversion costs and market imperfections.

Considering the above components and the requirement to base a discount rate on the characteristics of the insurance liability, the Staff state that components (a) and (d) above should be included in the discount rate and matched to the characteristics of the insurance liability, while (b), (c), and e should not be included in the discount rate since they are specific to the observed instrument and not likely to be relevant to the insurance liability. Also at this September meeting the Board will discuss whether to incorporate own credit risk in initial recognition and subsequent measurement of liabilities (which would include insurance contract liabilities) when reviewing the responses received on the discussion paper on the same topic. The Board does not intend to take any decisions at this stage.

In a quest for a comparable and less complex approach, the Staff present an alternative view for discounting insurance contract liabilities that would prescribe a particular observable market rate or set of observable market rates, including:

- High-quality corporate bonds
- High-quality fixed-income debt instruments, or
- A risk-free rate, e.g., government bonds.

Arguments for the alternative view, specifically corporate or fixed-income debt, primarily focus on the potential for day one accounting losses that would result from valuing insurance liabilities using a risk-free rate. As insurance contracts are typically priced using a discount rate based on the return on the assets backing the insurance liability, valuing them using a risk-free discount rate would result in accounting day one losses, but the product may ultimately prove profitable.

The Staff request that the Board decide whether to include a principles-based approach or require the use of a specific rate for determining discount rates. In addition, the Staff intend to provide cross-references to guidance on fair value measurements as opposed to including specific guidance on how to estimate a discount rate.

Updated timetable and next steps

The Staff will present an updated project timetable for the Board aiming for an Exposure Draft in December 2009. The updated timetable sets out the following timeline for key discussions.

Meeting date	Key discussion topics
October 2009	▶ Presentation, including the use of other comprehensive income
October and November 2009	▶ Participating, unit-linked and index-linked insurance contracts and investment contracts and universal life contracts (including unbundling) ▶ Disclosures ▶ Policyholder participation (classification and measurement)
November 2009	▶ Definition and scope ▶ Recognition and derecognition
November and December 2009	▶ Summary of field testing results ▶ Pre-balloting ▶ Sweep issues
December 2009	▶ Publication of Exposure Draft
May 2010	▶ Comments due
June 2010	▶ Summary of comments
July 2010 – February 2011	▶ Discussion of issues from comment letters
March and April 2011	▶ Pre-balloting
May 2011	▶ Sweep issues
June 2011	▶ Publication of final standard

Source: IASB Staff Agenda Paper 17E, Ernst & Young

Follow the debate

The IASB will discuss the insurance project (and the Agenda Papers referred to in this summary) on 18 September 2009 from 1:45 pm to 3:45 pm UK time. Observers can register to view the meeting via webcast on the IASB website (www.iasb.org).

We welcome your feedback on *Insurance Accounting Alert*. Please get in touch with your local Ernst & Young insurance contact with any enquiries.

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