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# ***IASB/FASB***

## ***Board meeting***

### **Insurance contracts**

*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 actions published in the FASB's Action Alert and IASB Observer notes. 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 a final standard.*

PwC Summary of  
Meetings

12 April 2011

#### **Highlights**

The staff opened the meeting with an announcement that the timetable has been revised such that June will be a "working" month. The official IASB timetable now shows issuance of a final standard in the 2nd half of 2011, and the FASB timetable shows the issuance of an exposure draft in the 3rd quarter 2011.

The main purpose of the meeting was to clarify the application of the top down approach to estimating the discount rate used to present value cash flows in the insurance model. The staff presented a paper clarifying the types of adjustments that would be needed to either a reference portfolio or actual portfolio of assets to arrive at a discount rate that reflects only the characteristics of the liability. Those adjustments would include adjustments for differences between the timing of cash

flows of the assets in a portfolio and the timing of the liability cash flows as well as risks inherent in the assets that are not inherent in the liabilities such as credit risk, market risk and other price risk. The staff identified differences in liquidity that are inherent in the asset cash flows versus the liquidity inherent in the liability cash flows as the third conceptual difference that could be challenging to quantify. They described what they believed was the Boards' previous decision that an insurer applying the top down approach need not adjust for this difference as a practical expedient. The Boards generally agreed with the staff's analysis and directed the staff to proceed with drafting application guidance, with consideration of the several points raised by various Board members as described more fully below.

### Top down approaches to discount rates

The Boards had decided at their February meeting that the final guidance should not prescribe a rate or method for determining the discount rate but instead should explain that the objective is to adjust future cash flows for the time value of money. The rate should be consistent with observable current market prices for instruments with cash flows whose characteristics reflect those of the insurance contract liability, excluding the effect of the insurer's own non-performance risk. The rate should exclude the effect of risks and uncertainties included in the cash flows or the risk adjustment, and should exclude any factors that influence the observed rates but are not relevant to the insurance liability (such as investment risk not passed on to the policyholder).

At the February meeting, the Boards discussed how either a "bottom up" or "top down" approach could potentially satisfy the objective of the discount rate. The rate described in the IASB exposure draft (the "ED") is a bottom up approach that starts with the risk free rate on liquid assets such as government bonds and then adds back a component to capture the less liquid nature of an insurance contract liability to arrive at the liability discount rate. Due to concern with the lack of a standardized method for determining the illiquidity adjustment, many constituents noted their preference for a "top down" approach, which starts with an asset rate and then subtracts out components not relevant to the liability characteristics such as expected defaults and the related premium for bearing that risk.

At this meeting, the staff noted that subsequent to the February meeting they had received requests from various constituents to clarify the adjustments that would be made in the top down approach, and as a result had prepared the current staff paper. The paper provides application guidance for determining the discount rate using a top down approach, clarifying the types of adjustments that would be needed to either a reference portfolio or actual portfolio of assets to arrive at a discount rate that reflects only the characteristics of the liability. Adjustments for differences between the timing of cash flows of the assets in a portfolio and the timing of the liability cash flows are referred to as Type I adjustments. Risks inherent in the assets that are not inherent in the liabilities and thus need to be adjusted out such as credit risk, market risk and other price risk are referred to as Type II adjustments. Differences in liquidity between asset cash flows and liability cash flows are referred to as Type III adjustments. The staff described their understanding of the Boards' previous decision that an insurer applying the top down approach need not adjust for this difference as a practical expedient due to the difficulty in determining this amount.

Board members had various comments and questions regarding the staff's proposed application guidance. Two

IASB Board members were surprised by the staff's introductory remarks that some people had misinterpreted the February Board discussion of the top down approach as implying that an asset rate could be used as the discount rate. These Board members as well as the staff reiterated that it was not an asset based approach; the asset rate is merely the starting point that after adjustment theoretically arrives at a rate that reflects the characteristics of the liability, the same objective as the ED.

One FASB Board member commented that while the estimation of a discount rate might be routine for insurers, it would not be for non-insurers who might be subject to the insurance contract accounting due to its wide scope. He suggested that a practical expedient to the discount rate be permitted for non-insurers (which would need to be defined) or that the scope be revised to exclude them.

An IASB Board member suggested that a definition of "reference portfolio" was needed, to which the staff replied that it was not meant to be a replicating portfolio but instead should closely resemble the cash flow characteristics of the liability. Another IASB Board member commented that if one started with a reference portfolio, given the staff's definition, there would be no need for a Type I adjustment. The staff clarified that an adjustment might still be needed if, for example, a reference portfolio was only available for say, 30 years, while the liability cash flows were estimated to be 50 years.

A FASB Board member questioned whether there was symmetry between the top down and bottom up approach in terms of being able to use a practical expedient. That is, if differences in liquidity between the asset starting point and the liability could be ignored in the top down approach, could it also be ignored in the bottom up approach to allow a pure risk free rate as the discount rate? The staff said that the illiquidity adjustment could not be ignored in the bottom up approach, and explained that in the top down approach, the point wasn't to exclude a liquidity adjustment but merely to recognize that it might be too difficult to measure. It was the staff's expectation that a company would select an asset portfolio that had characteristics, including perhaps liquidity characteristics, that were similar to those of the liability, and thus the difference might not be that significant anyway.

Another FASB Board member said that he did not believe he voted in February to tell insurers that they needn't make an illiquidity adjustment in all cases in a top down approach. If an insurer starts with a portfolio of debt securities that are very liquid, and the liability is not liquid, he believes an adjustment for this liquidity difference would be needed. He suggested that perhaps the guidance should state that if the liability is illiquid,

an illiquid asset would also need to be used as the starting point in the top down approach.

Several IASB Board members and a staff noted the potential difficulty with determining adjustments from the top down rate where equity securities and/or real estate are used as the assets in the portfolio. The staff commented that due to the difficulty in determining the necessary adjustments, it would seem easier to use a reference portfolio rather than an actual asset portfolio in such situations.

An IASB Board member noted that in certain territories, especially in developing countries such as India, an insurer's asset portfolio might be dictated by regulators, and might be limited to government securities. In that situation, using the risk free rate as the starting rate in the top down approach presented a dilemma, as the risk free assets would typically be more liquid than the insurance liabilities they are supporting. Would insurers in these territories be permitted to use the risk free rate as the practical expedient, even though, if using a bottom up approach, an adjustment for illiquidity would be required? This question even when posed again later to the staff, was not explicitly answered.

One IASB Board member commented that more application guidance is needed to ensure a more faithful representation of the split of the market spread between the credit component and the liquidity component. In his view, without this guidance, insurers would be likely to treat almost all changes in market spread from period to period as liquidity changes rather than credit changes to get the answer they want (presumably a better matching with changes on the asset side). He believes guidance and perhaps examples should indicate that not all changes in rates relate to liquidity.

A FASB Board member commented that the goal of the discount rate is more important than the steps and that she does not believe that detailed numerical examples such as those presented in the staff paper are

appropriate, noting that during the financial crisis the Boards did not issue detailed numerical guidance for determining the liquidity and credit components of rate changes. An IASB Board member partially agreed, noting that the Boards should provide a solid principle and not get caught up in granular calculations of items that are so subjective anyway. However, they did still need to recognize both bottom up and top down approaches given the different markets that exist worldwide. The additional disclosures of information such as the yield curve suggested at the February meeting would help deal with some of the subjectivity.

Another FASB Board member noted that the Type II adjustment for investment risk would cover not only credit risk (both expected defaults and the market risk premium for the uncertainty of defaults), but also other investment risks such as the potential variability in cash flows from a variable rate instrument and the related market risk premium for uncertainty in those cash flows. This made the top down approach appear rather complicated, and as a result the Board member suggested that perhaps the bottom up approach was actually less complicated, as only an illiquidity adjustment needed to be calculated. It was his understanding that the insurance industry actuaries were coming up with at least five different approaches for measuring the illiquidity adjustment. An IASB Board member responded that it was his understanding that most of the approaches for calculating the illiquidity adjustment actually started with a top down approach anyway.

At the end of the discussion, the Boards noted their general agreement with the staff's analysis and directed the staff to proceed with drafting application guidance, with consideration of the several points raised by various Board members as described above.

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