

Insurance alert

IASB/FASB Board meetings - Insurance Contracts 18-19 April 2012

PwC Summary of Meetings

18-19 April 2012

IASB and FASB joint decision-making board meeting and FASB only education session:

- Reinsurance
- Policy loans and riders
- Amendments, modifications and commutations of insurance contracts

IASB and FASB education sessions:

- The FASB single margin
- Recognising changes in insurance liabilities in OCI

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.

Highlights

Several remaining issues relating to both cedant and reinsurance accounting were discussed. Among other decisions made, all IASB and FASB members voted in favour of amortizing any positive single/residual margin relating to retroactive contacts over the remaining settlement period, as opposed to recording an upfront gain. On the question of whether a cedant should account for a reinsurance contract using the same approach the cedant uses for the underlying direct contracts, i.e., building block (BBA) or premium allocation approach (PAA), the FASB voted that it should. However, the IASB, viewing the PAA as a proxy for the BBA, voted to require evaluation of a ceded reinsurance contract for PAA in the same manner in which direct contracts are evaluated.

The majority of the IASB and all of the FASB voted in favour of considering policy loans in conjunction with the deposit component to which they relate, rather than as separate financial instruments.

The IASB voted in favour of treating contract modifications as

extinguishments if they would have changed any of the following had they existed at inception: whether the contract was in scope of the standard, whether it was accounted for under the BBA or PAA model, or which portfolio it was in. The FASB members were generally supportive of the first two criteria, however they requested that the staff come back to the board on the third criteria.

The boards voted in favour of the gain or loss on extinguishment being the difference between the carrying value pre-modification and the hypothetical entity specific value. Modifications that decrease contract benefits would result in as partial de-recognition of the obligation and related margin, and those that increase benefits to be measured as if they were a standalone contract.

The first non-decision making education session discussed the principles and mechanics of the FASB single margin approach, while the second focused on possible solutions for recognising certain changes in insurance liabilities in OCI.

Reinsurance (IASB and FASB Joint board meeting)

The reinsurance discussion focused on the remaining issues relating to both cedant and reinsurer accounting that had not been addressed at the May 2011 meeting. The first issue focused on the period over which the FASB single margin or IASB residual margin from retroactive reinsurance contracts with positive expected net cash flows should be released.

The staff proposed that this should be the *settlement period*, given that the only other alternative would be immediate gain recognition (since the coverage period of the underlying contracts has already passed). This proposal would apply not only to retroactive reinsurance contracts accounted for under the FASB BBA, but also to those under the IASB BBA and the PAA. This would be an exception from the typical IASB BBA model where residual margin on direct contracts is recognised over the coverage period, and the typical PAA approach in both the IASB and FASB approaches, where the margin is effectively recognised over the coverage period as well.

At the previous week's FASB only education session, a board member suggested that when a contract is purchased that provides retroactive coverage, perhaps the "coverage period" hasn't really passed, but in effect, the coverage period is the settlement period since there is still risk of changes in the amount or timing of claims. At the FASB education session, a staff member agreed with this analysis, and pointed out that for this reason, he thought that even under the PAA approach relating to direct contracts, a portion of margin should be deferred past the coverage period and recognised over the settlement period. He made this argument despite the fact that the FASB board had previously decided that under the PAA approach the margin would implicitly be recognized over only the coverage period. The staff reiterated his point at the board meeting, noting that even for prospective direct contracts, the "discovery period" for claim estimates extends beyond the coverage period and into the settlement period.

In a vote all IASB and FASB members voted in favour of the staff's proposal to amortise the single/residual margin relating to retroactive contracts with positive expected net cash flows over the remaining settlement period.

The staff then discussed the issue on how to account for the effect of loss sensitive features. Examples of such features include retroactive premium adjustments, profit commissions, sliding scale commissions and mandatory reinstatement premiums, all of which typically penalize the cedant for unfavourable experience and reward the cedant for favourable experience.

The staff proposed that such features that are not accounted for as investment components should be treated as part of claims and benefits (as incurred based

on experience to date under the PAA, or as estimates change under the BBA). The staff noted that this would establish a uniform practice, whereas under current practice, some insurers account for such loss experience adjustments as adjustments to premiums or commissions (i.e. based on contract terminology as to what they relate to rather than on the substance). Conversely the staff also proposed that if a cedant was actually required to pay more premium for future coverage (e.g., workers compensation premium adjusted based on payroll hours or dollars), such non-loss sensitive premium adjustments would be treated in the same way as other changes in premium estimates.

The board members did not raise any further points for discussion. In a vote all IASB and FASB members voted in favour of the staff's proposals to include the effect of loss sensitive features as part of claims and benefits, and the effect of non-loss sensitive premium adjustments (for example, the extension of coverage) in the same way as other changes in premium estimates.

The next issue relating to reinsurance discussed at the meeting was whether the cedant should account for a reinsurance contract using the same approach the cedant uses for the underlying direct contracts (BBA or PAA). The staff proposed that under the FASB approach the cedant should account for reinsurance contracts using the same approach as used to account for the underlying insurance contracts. Under the IASB approach, the staff proposed that where the PAA is viewed as a proxy for the BBA, the reinsurance contract would be evaluated for PAA in the same manner in which direct contracts are evaluated. The staff paper also recommended for both the IASB and FASB approach that the reinsurer should evaluate whether a reinsurance contract should be treated as BBA or PAA in the same manner that a direct insurance contract is evaluated.

The FASB chair noted that she perceived reinsurance to be a form of hedge. She was concerned that if insurers could use different models for the reinsurance than for the underlying direct business, and therefore the result of reinsurance and underlying would be presented in different lines items, then the residual exposure on the same risk would not be transparently presented. The staff however noted that the alignment of presentation would be dealt with as a future decision.

In a vote, a large majority of the FASB voted in favour of the staff's proposals for the cedant to use the same model for reinsurance as used for the underlying business (the FASB approach). A large majority of the IASB voted in favour of the IASB approach for the cedant to evaluate the reinsurance contract in the same manner in which direct contracts are evaluated. Both boards voted by a majority in favour of reinsurers evaluating use of the BBA/PAA in the same manner that a direct insurance contract would be evaluated.

Policy loans and riders (IASB and FASB Joint board meeting)

The staff noted that many constituents responding to the IASB exposure draft (ED) and FASB discussion paper (DP) indicated that it was unclear whether and how the guidance on unbundling would apply to policy loans and riders (contract modifications). As a result, the staff developed proposals on these topics.

For policy loans, the staff recommended that in applying decisions on unbundling and disaggregation of deposit elements, policy loans should be considered in conjunction with the deposit component to which they relate rather than as entirely separate financial instruments. This would avoid a situation where policy loans are potentially measured on a different basis than the related account balance/cash surrender value.

The staff also proposed that riders should be accounted for at inception as part of the contractual terms of insurance contract and therefore the unbundling/disaggregation principles should be applied to these modifications. For those riders that modify a contract after inception, these are considered as part of the modification/amendment proposals discussed that were considered later in the meeting.

One question raised by a FASB member was whether the insurance model would require an insurer to project the possibility of policy loan issuances (technically, being an expected cash flow model, it would) rather than just reflect those that are currently outstanding, and whether it would be worth the cost and effort to do so. As these loans would likely be taken out at a much earlier date than the expected payout of the death benefit, he questioned whether the staff had considered if this timing difference may have a significant impact on the present values of expected cash flows. The staff noted that although they had not performed a detailed analysis, in many circumstances they would not expect the difference to be significant e.g. lower interest received on the loan would be compensated by lower amounts credited to the account.

The majority of the IASB and all of the FASB voted in favour of the staff's proposals to consider policy loans in conjunction with the deposit component to which they relate, rather than unbundling from the account balance. All IASB and FASB voted in favour of the proposals that general decisions on unbundling and disaggregation should be applied to riders.

Amendments, modifications and commutations of insurance contracts (IASB and FASB Joint board meeting)

The boards' initial proposals within the ED and the DP noted that when an insurance contract is extinguished, an insurer should remove all components of it from its

balance sheet. However, neither the ED nor the DP dealt specifically with the issue of when an amendment or modification is so substantial so as to result in an extinguishment. Several respondents noted that further guidance was needed on this topic to provide a consistent framework for determining what constituted an extinguishment, as earnings recognition patterns could be impacted through the elimination of any remaining single or residual margin upon extinguishment.

The staff proposed that insurers would consider whether a contract modification would constitute an extinguishment based on whether any of the following assessments made at contract inception would have resulted in a different conclusion using the amended terms as if they had been in place at the inception of the contract:

- (i) Whether the insurance contract is within the scope of the insurance contract standard;
- (ii) Whether an insurance contract should be accounted for under the PAA or the BBA; or
- (iii) Which portfolio the insurance contract would be included in.

Any modification that would have changed one or more of these conclusions would be deemed a *substantial modification* for which insurers would extinguish the old contract and recognise the new contract. When it is determined that a substantial modification has occurred, resulting in an extinguishment, the follow-on issue is how the extinguishment gain or loss should be measured. The staff proposed that the carrying value just before the modification would be compared to the consideration paid (including any non-cash assets transferred or liabilities assumed), and that such consideration be measured using the hypothetical entity specific current value. Any difference between these two amounts would be recorded as the extinguishment gain or loss. Any original single/residual margin would therefore be reversed and then a new contract would be recorded using the hypothetical entity specific current value as the entry price to compute the new single/residual margin.

The staff further explained that the hypothetical entity specific value is the price that the insurer would hypothetically charge the policyholder for a contract equivalent to the substantially modified contract. This valuation would allow for better comparability with other insurance contract liabilities. The staff paper rejected fair value as being too subjective and not worth the cost, and also rejected using the carryover basis of the contract as the consideration for the new contract.

The majority of the boards' discussions then focused on whether the third criterion, "*Which portfolio the insurance contract would be included in,*" should be a determining factor as to whether to derecognise a contract. Some noted that this criteria was too broad and

therefore this would result in extinguishment accounting occurring too often. Also members discussed that an operational change in portfolio, for example a reallocation of a contract between portfolios, does not mean a new contract has been written and therefore should not always lead to derecognition.

To help with the concern that every change to a contract might be considered an extinguishment with the criteria as drafted, the FASB chair noted that in their education session, the FASB discussed a situation where a rider is added at a later date to an existing contract. The board thought that the rider could be accounted for as a new standalone contract without impacting the existing contract. The IASB staff then followed this up with an example of an increase in coverage on an existing contract, noting that perhaps this type of non-integrated contract amendment could also be treated as if it were a rider or second "layer," i.e. a new standalone contract with no extinguishment event on the original contract.

However, the FASB chair also suggested that in some cases, she had the opposite concern, i.e., that the triggers were not sufficient, and she suggested that perhaps the indicators within paragraph 22 of the staff paper should be worked into the actual criteria. The paragraph 22 indicators were taken from existing US GAAP guidance on insurance contract modifications, and include consideration of significant changes to the insured event, risk, or period of coverage as well as the nature of investment return rights. She also noted that in other standards, derecognition tends to be based upon a substantial change in cash flows, however this concept was not captured within the staff's proposals. She therefore proposed that perhaps the paragraph 22 indicators could be elaborated upon to say "in a way that substantially affects cash flow estimates."

In a vote over the criteria to be applied when determining if a substantial modification has occurred and therefore whether the contract should be extinguished, all IASB members voted in favour of the staff proposals. The FASB members were generally supportive of the first two criteria, however they requested that the staff come back to the board to clarify whether the third criteria should be used or amended as suggested by the FASB chair.

In a vote on the gain or loss on extinguishment being the difference between the carrying value pre modification and the hypothetical entity specific value, a large majority of the IASB and FASB members voted in favour of the staff's proposals.

The final modification issue dealt with in the staff paper was how to account for contract modifications and amendments that are not significant enough to result in an extinguishment. The staff proposed to account for those that decrease contract benefits as partial derecognition of the obligation and related margin. Those

that increase benefits would be measured as if they were a standalone contract.

Several IASB members, whilst not disagreeing with the staff's proposals, noted a concern when deriving the measurement for a non-substantial modification that increases benefits as a relationship exists between the original and modified contract such that it may be difficult for insurers to derive a standalone price for the modification. Another member noted that operationally it would be difficult to trace the residual margin for each modification.

In a vote a large majority of the IASB and FASB members voted in favour of the staff's proposals to account for those modifications that decrease contract benefits as partial derecognition of the obligation and related margin, and those that increase benefits to be measured as if they were a standalone contract.

The final issue presented by the staff was on commutations (contract terminations) and whether an insurer should present a commutation on a gross or net basis in the statement of comprehensive income. The issue relates to both direct and reinsurance contracts that are commuted, although it is more prevalent for reinsurance. The staff proposed that insurers, reinsurers, and cedants should present gains and losses on commutations (i.e., the difference between the consideration exchanged and the existing book balances relating to the contract) as a net adjustment to claims and benefits rather than grossing up premiums and claims or benefits. The net presentation reflects the transaction in a manner consistent with a settlement of claims. The "gross up" treatment is sometimes done in practice today under the theory that it is the unwinding of the original contract and thus should be recorded in the same line items (only inversely) at the commutation date.

A large majority of the IASB and FASB members voted in favour of the net presentation of commutation within claims and benefits proposed by the staff as opposed to a 'grossed up' presentation. It was noted that disclosure over the gain or loss would be brought back to the boards at a later stage.

Single margin (joint education session)

As a follow-on to the decisions made by the FASB regarding single margin at the board in September 2011, this non-decision making education session discussed the principles and mechanics of the FASB single margin approach.

The staff began the session by explaining what the single margin represents. It is the entire profit potential for the contract that is at risk based on the uncertainty in net cash flows. The staff noted that this represents a change from the DP to recognise the concept of risk. The reference to profit potential is based on the premise that an insurer is

not able to determine ultimate profit until they have certainty. The entire profit is therefore at risk due to the uncertainty of expected cash flows. The FASB support the notion of no day one gain and therefore the margin represents the difference between the premium and the present value of expected cash flows.

As the insurer satisfies its performance obligation, it is released from risk, which is evidenced by a reduction in the variability of cash flows. Uncertainty of the cash flows relates to both the timing and amount, therefore when these forms of uncertainty become more certain, then the insurer can recognise the margin as profit.

The staff explained that an entity is released from risk depending on whether the variability of cash flows is primarily due to i) the timing of the event where margin is released over the passage of time or as uncertainty reduces if significantly different, or ii) the frequency (whether the event will occur) and severity (the ultimate magnitude of the claim payout is unknown) of the event whereby variability in cash flows is reduced as information about expected cash flows becomes less uncertain.

The variability of cash flows may depend on a number of facts and circumstances such as the entity's relative experience of specified business and in estimating cash flows, inherent difficulties in estimation for certain products, the relative homogeneity of the portfolio and past experience not being representative of future results.

The staff also walked through a number of examples to demonstrate the mechanics of the release of the single margin to the income statement.

The staff discussed that where there is a change in an assumption that impacts the income statement (for example a large unexpected claim), although the margin under the FASB approach is not remeasured for such a change, the entity may decide in this case to slow down the release of profit from the margin following a reassessment of the residual risk. As such the entity may change the rate at which amounts are amortised to the income statement. However the total amount that will be amortised does not change. In addition, the margin does not serve as a buffer to absorb changes in expected cash flows, which differs from the latest IASB proposal, where changes in expected cash flows result in a decrease or increase to the residual margin.

In reviewing the example single margin amortization calculations presented in the FASB staff slides, several questions were raised. One example presented a life insurance contract for which the single margin was being amortized based on the likelihood of death, thereby back-ending the margin recognition as the policyholder aged. An IASB staff commented that given that the pattern of single margin amortization was supposed to be based on release from risk (i.e., reduction in the variability of

expected cash flows), and not likelihood of payment, it was unclear why the example proposed this pattern. In contrast, he noted that the non-life example, which proposed an amortization pattern for the margin release based on reduction in the standard deviation, seemed more in line with a release from risk concept.

In addition, there was some question as to whether the non-life example was illustrating a BBA approach or PAA approach since it combined terminology and elements of both models. The staff responded that it could be either, but later pointed out that the FASB PAA approach differs from the BBA approach in that the PAA implicitly recognizes the single margin over the coverage period while the BBA approach recognizes the single margin over the coverage and settlement period. The staff noted that a board member has explained this difference as being consistent with the FASB board's view that the PAA was more of a revenue recognition approach. Under such an approach, margin is not deferred beyond the period of contract performance. For example, a builder will have recorded all revenue on a project at the time the building is ready for use, even though there may be warranty and similar costs incurred subsequent to that point. The board views the coverage period, rather than the coverage and settlement period, as the period of performance.

An IASB member commented that he viewed the lack of a margin in the post coverage period for PAA contracts as the weakest part of the FASB model. He noted that there are many cases where uncertainty and thus risk exists in the post-coverage (settlement) period.

He suggested that if that component of the FASB model were changed, it would bring the two models closer together (given that the IASB model has a risk adjustment through the settlement period). It was later noted that to bring the models even closer to one another, the IASB would need to extend the amortization period for their *residual* margin to the settlement period as well.

These suggestions for potential compromise were reiterated during the FASB chair's wrap up of the education session. However, it was also noted that difference would remain, including the fact that the IASB risk adjustment model adjusts for increases in the amount of risk, and changes in the price of risk, while the FASB method has a locked in margin amount (but with unlocking of amortization pattern where needed). In addition, the IASB method offsets changes in expected cash flow estimates against the residual margin, while the FASB approach would recognize all such changes in estimate in the current period.

Recognising changes in the insurance liabilities in OCI (joint education session)

Following the previous month's IASB only education session, IASB and FASB held a joint education session covering the potential use of OCI (other comprehensive income) for reporting certain changes in insurance liabilities as opposed to the Exposure Draft's (ED) proposal of reporting all changes in profit or loss.

The objective of the session was to discuss issues (the same topics that were covered in last month's IASB only education session) around the use of OCI prior to next month's joint decision-making meeting.

In its presentation the staff assumed that a later Financial Instrument - Classification and Measurement paper will consider a third category of financial assets – Fair Value through OCI for eligible debt instruments.

Background – feedback received from constituents

The ED proposed current measurement for insurance liabilities where all the movements in liabilities are recognised in profit or loss. While most of the respondents agreed with the current measurement itself, they did not agree with recognition of short-term volatility in profit or loss caused by changes in discount rate. They felt it does not reflect the long-term nature of the insurance liability, it will obscure the underlying long-term performance and the impact of changes in interest rates will naturally reverse over time as claims are ultimately paid. They therefore suggested that short-term volatility caused by changes in discount rate should be presented in OCI.

The staff explained that different approaches could be taken to address the volatility. One of them would be locking in the discount rate but the boards previously voted against this. The other would be separation of the changes in liability due to changes in the discount rate either within the income statement (presenting it in a separate section within the income statement to make the actual results transparent – several board members expressed their supporting views to this alternative) or presenting part of the changes in OCI.

While some of the constituents would find the split within the income statement satisfactory others say it is not enough and the accounting mismatch within the income statement should be addressed by the boards. The staff added that the ongoing re-deliberations on IFRS9 are expected to address part of the volatility within equity by a potential introduction of fair value measurement of qualifying debt securities through OCI and users generally are less concerned with volatility in equity than volatility in the income statement.

To the sceptical comment on why the boards spent seven years on developing the model that turns out not to be accepted by the industry, the staff clarified that measurement of the liability would not change (would be still current measurement) but the resulting accounting mismatch would be eliminated.

An IASB member expressed his view that the question addresses performance reporting that could be solved by requiring one single statement presentation (of net income and other comprehensive income). However, the FASB chairman strongly disagreed with changing the presentation requirements since the US GAAP standard

on presentation (allowing consecutive reporting of income statement and other comprehensive income) just came into effect.

Whether to use OCI

The staff explained that the feedback received confirmed most users believe the insurance liability discounted with a current rate is useful information in the statement of financial position. However reporting all the changes in the profit or loss would not give a useful metric for readers. With the use of OCI the accounting mismatches could be reduced and underwriting results would not be overshadowed by market movements. Also since asset-liability management is important to the insurance industry reporting the effects from measurement in the same part of the financial statements would be preferred.

Arguments for and against the use of OCI were raised by the staff. However, several board members noted that recycling from OCI was missing from the discussion, which they thought was a critical area to be addressed. The staff promised to consider it in a future meeting.

Many of the members agreed with a question raised by an IASB member on whether the amounts of the illustrative example developed by the staff and presented in income statement and in OCI are meaningful at all. While everybody shared the view that the balance sheet measurement of the insurance liability does make sense, and the figures mathematically add up, there was not a consensus on whether the split of the amounts between the income statement and the OCI is sensible.

Several board members referred to the IFRS9 discussions and said that they would prefer if the voting on a potential third business model for IFRS9 could take place together with deciding on the OCI solution for insurance liabilities, due to the interaction of the two projects. Board members mentioned the difficulties they are facing without having decisions on the asset side throughout the whole session.

When addressing the next question from the staff on whether the use of OCI for changes in liability caused by short-term movements in the discount rate should also include the changes in the liability caused by changes in assumptions that are directly linked to the discount rate (e.g. lapse assumptions or embedded interest rate guarantees) board members challenged the staff by requiring explanation of whether this is needed due to an accounting mismatch that they originally thought as a reason for developing the potential OCI solution. The staff explained that this question rather addresses the way of measurement of the split between the income statement figure and the OCI figure. Board members emphasised here the need for investigation of the alternatives for recycling as well as addressing the question of measurement of guarantees. They also expressed concerns whether users would understand the figures.

The next topic raised by the staff was whether the use of OCI should be required or permitted. Board members were most concerned with consistency across the IFRS/US GAAP literature and also with the additional burden it might place on entities since they would need to identify the assets backing the liabilities.

The discussion led to the unit of account issue. The staff summarised that the OCI solution could be applied at different units of account, subject to the boards' future decision (entity, portfolio, product and contract). Board members asked the staff to reach out to users and ask how they match the liabilities with the assets (also in dynamic scenarios – how they rebalance the asset-liability portfolio) and how they would model the calculation.

The staff also mentioned that the frequency of the determination/election to use OCI should also be considered by the boards when making a decision on OCI.

Loss recognition test

The staff also presented the concept of the 'loss recognition test' under which a contract is considered loss making when the asset returns (that were taken into consideration when pricing the contract) are lower than expected. A board member raised the potential issue of earnings management since the decision on short-term and long-term changes in the interest rate seems to be a judgmental one. The overall discussion around the table noted this was stretching the limits of the insurance project and was more about the overall objective of OCI, the meaning of net income and single performance reporting.

Overall, there was a high level of scepticism throughout the education session on the use of OCI for presenting certain changes in insurance contract estimates. However, at the end of the session the chairs of both boards emphasised that despite the scepticism they are hearing from members, the boards should work toward the goal of providing an OCI solution. The IASB chair noted that many objections were raised by constituents with the ED and DP proposals that all the changes in estimates be presented in the income statement and that there are reasonable arguments supporting the OCI solution. Also, the FASB chair added that throughout the project the expectation has been that at the end of deliberations the boards would look at the whole picture and assess whether the financial statements overall make sense, which they are currently doing. Being an education session, no decisions were made. The staff will bring the papers on the OCI solution to the May boards meeting.