

IASB/FASB ***Board meeting*** **Insurance contracts**

Sharing insights on key industry issues.
PwC summary of meeting

15 December 2010

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 FASB actions published in the FASB's Action Alert and IASB Updates. 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 an Exposure Draft or Standard.

Highlights

The IASB and FASB held a joint Board meeting on 15 December which was educational and no decisions were made. The staff outlined the proposed timetable for discussing the issues arising from the insurance contracts exposure draft. They also tabled a summary of the critical issues arising from their outreach programme.

Project Timetable and reasons for proposed model

The staff explained that Paper 7 outlined the timetable for discussing the issues arising from the exposure draft. The staff noted that the biggest issue is volatility and it proposes to initially discuss this with the discount rate alongside presentation. It was noted that they will consider the short duration model alongside the other topics, but do not intend to debate this until the main model is settled.

The staff introduced paper 7A which outlines the criticisms of current accounting and the reasons for rejecting it including insurance contracts within current projects (financial instruments, revenue recognition and liabilities). The staff introduced paper 7B which compared the exposure draft proposals with existing national GAAPs. It was noted that while non-life business is fairly similar across different geographies, there is a large diversity in life insurance accounting. The staff noted that in the past they have tried to do detailed comparison of existing GAAPs with limited success and this paper was a general high level overview. A staff member noted that back in 2004 one of his biggest surprises was discovering that insurers do not use consistent accounting policies within a group for insurance contracts and this diversity needs to be addressed.

Outreach summary

The staff noted that paper 7C does not attempt to summarise the comment letters but identifies the critical issues where it believes the boards will require more time to address, either because there are divergent views or because there are issues that have not been discussed in the past. The staff noted that most people recognise the need for the standard but had some concerns with the proposed timetable. The critical issues that have been identified are volatility in profit or loss, unbundling, residual versus composite margin, presentation and short duration contracts. The staff noted that there are other issues such as

transition and acquisition costs but it does not believe these will need a significant amount of time as there are limited options available. It noted that transition will be discussed at the end as it will depend on the final proposed model.

The staff noted that there does not appear to be a consensus on the big issues and views are often split by geography. In terms of the discount rate, the staff noted that they intend to discuss with the boards the different families of discount rates, together with the question of whether the discount rate should be locked in. The staff noted that the proposals range from expected asset return through to the exposure draft proposals of risk free with solutions to volatility including the use of OCI and presentation. It was noted that supporters of an asset backed discount rate would deduct expected defaults and an additional risk adjustment (a “top down approach”). Another solution is to use theoretical assets such as a replicating portfolio with expected defaults.

One of the FASB members noted his concern with the views that the proposals need to reduce volatility. He expressed his view that the accounts should reflect volatility in insurance results and the staff confirmed that the concern is with introducing artificial volatility that is not decision-useful.

One IASB member expressed disappointment that there was not a consensus on the discount rate with the four large accounting firms responding with different solutions. There was some discussion on the interaction with IFRS 9 for assets and the concern that the proposals would result in insurers not being able to use amortised cost without introducing a mismatch. Another noted that while there may be a desire for the accounting to show duration mismatches for insurers the current accounting for banks does not require this. One board member noted that they need to make sure that the proposals do not encourage insurers not to hold equities. One IASB member expressed a concern with the direction of the comments as they are focusing on the whole insurance business whereas the standard is for insurance contracts, not businesses. An IASB member noted that the new hedging model may be able to solve some of the issues. It was noted that in Japan they have duration mismatches because there are no long-dated assets and so insurers want the fair value movements to be reflected in equity, although they were unclear as to whether that would involve recycling. It was noted that one response had proposed an interesting solution involving the residual margin which may help. One of the staff members noted that in some jurisdictions insurers have products with high guaranteed rates and so any discount rate other than expected return will be an issue. A FASB member noted that the responses to the FASB financial instrument proposals included requests to look at the available for sale category for bonds and so they would like to progress their discussions in this area before reaching a conclusion.

On a different topic, it was noted that some concerns had been expressed around the use of probability weighted cash flows. The staff noted that in some jurisdictions current models do not necessarily employ probability weighted techniques and so some would prefer a reference to the statistical mean. A staff member thought this was more of a drafting concern but perhaps an education paper on this topic would help.

One staff member noted that the board needs to be aware that insurers have a range of sophistication and some of the exposure draft proposals such as the risk adjustment will be cutting edge and in some jurisdictions the short duration approach will be critical.

An IASB member asked whether there had been any consensus around the use of a risk adjustment or composite margin. The staff noted that there had been a geographical split with Europe and others looking at Solvency II preferring the risk adjustment. A staff member noted there had been a lot of concerns around the residual margin and that its pattern of amortisation depends on what people think it means – if it is expected profit, people do not like it being locked in. It was noted that the majority of people do not want accretion of interest although agree it is theoretically the correct answer. One IASB member noted that he had seen some examples of the risk and composite adjustment applied to different example products. He questioned whether in situations where the risk adjustment is small then the two approaches would be similar and so the standard could just require disclosure of the risk adjustment although it was noted that the overall materiality concept would already apply. It was noted that there is very little support for disclosure of the equivalent confidence interval for the risk adjustment.

It was noted that the contract boundary is an issue for some health insurers and the solution will to some extent depend on where the short duration modified approach discussion lands.

An IASB member asked about the reaction to the financial guarantee proposals. The staff noted that credit insurers want these within the scope of the insurance standard but banks do not want to use different models for similar risks. The staff noted that they will need to do more outreach on this topic and they have received a number of comment letters on this topic alone.

The staff noted that the proposals on unbundling are unclear and to some extent the concerns are linked to the volatility question and whether this could reduce volatility in results. It was noted that some of the confusion is whether unbundling is for measurement of just presentation and since the insurance contract model is a current model some board members questioned why there is a need to unbundle. It was noted that if discretionary participating contracts are unbundled then it does not make a lot of sense to put them within the scope of the insurance standard if they are then required to be unbundled.