

IASB/FASB

Board meeting

Insurance contracts

PwC Summary of Meetings

17-18 May 2011

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

The IASB and FASB held a joint Board meeting on 17-18 May 2011 where they discussed a series of issues leading up to the ultimate question of whether the building block approach should include an explicit risk adjustment with a residual margin, or alternatively, a composite margin.

The staff developed examples comparing the composite margin run-off to the explicit risk adjustment as requested by the boards during the meeting on 17 May 2011. After extensive discussion of the two models, a clear majority of the IASB voted in favour of an explicit risk adjustment approach. The FASB Board supported the composite margin approach without any subsequent remeasurement of the composite margin. The FASB would however consider an onerous contract test under the composite margin approach going forward.

The Boards asked the staff to develop some disclosure with the aim of reconciling the composite margin approach to the risk adjustment approach. The Boards also asked the staff to keep the examples current going forward based on tentative decisions in order to be able to compare the risk adjustment and composite margin approaches.

The Boards did not discuss the paper on reinsurance due to time constraints and this will be discussed at a future meeting.

The staff also provided a brief summary of the Insurance Working Group meeting held on 16 May.

Explicit risk adjustment approach

The staff introduced the discussion noting that insurance is characterised by uncertainty, and as a result of this the revenue recognition model was generally not well suited for insurance contracts, prompting the need for a different model. While the IASB favours an explicit risk adjustment, the FASB prefers an implicit depiction of the risk within the composite margin.

The staff noted that there is a geographic split on this issue, with the US constituents supportive of the composite margin approach, while users, regulators, and those required to include an explicit risk adjustment for regulatory purposes are generally supportive of the explicit risk adjustment approach. Opponents of the explicit risk adjustment approach believe the calculation can be arbitrary, complex to understand and apply, and results in excessive prudence. Another staff member later noted that views were split among regulators, preparers, and users in territories such as Korea, China, and Japan.

The staff noted that FASB Concept Statement 7 acknowledges the need to include a measure of uncertainty in computing present value measurements. They provided an example of two contracts, one contract having a 100% chance of a payment of \$500, and the other having a 50% chance of a zero payment and 50% chance of a \$1,000 payment. Both contracts have the same mean of \$500, but the latter has more uncertainty in the range of outcomes. An insurer who is indifferent to risk would value the outflows of two contracts at the same amount, while an insurer which is risk adverse would demand a higher payment as compensation to fulfil the obligation. This, they argued, is the concept behind the risk adjustment, a concept that the IASB staff noted is appropriate for a fulfilment value approach.

An IASB member asked whether the debate was split between life and non-life. The staff responded that it seemed to be a geographical divide, not a life/non-life split, but also pointed out that in life insurance contracts, the risk adjustment was not expected to be very significant (aside from investment risk), and would tend to have a narrower distribution than property/casualty risk.

A FASB member noted that both the staff paper supporting the risk adjustment and the staff paper supporting the composite margin each suggested that users supported that approach and asked for clarification. The staff noted that in terms of users, a small percentage had responded, and of those that did, the split between those supporting the risk adjustment versus composite margin was based in part on geography. The explicit risk adjustment approach is supported by those users in Europe who have more familiarity with risk models due to the implementation

of Solvency II, and by those users with insurance expertise versus general users.

An IASB member noted that the staff had analogised the insurance measurement to a "Level 3" unobservable measurement under fair value guidance and asked how the calculation of the explicit risk adjustment in the insurance model would compare to the calculation of a risk adjustment in a Level 3 fair value measurement. One staff member noted that fair value requires the use of "market participant" assumptions, versus the insurance model which uses entity-specific assumptions. Several IASB members noted that the use of entity-specific assumptions was a key concern in that different insurers (or the old versus the new CEO of the same company) could come up with different risk adjustments depending on their level of risk aversion. They thought the objective of the risk adjustment needed to be better articulated. However, another staff member noted that in practice, a Level 3 measurement would most likely use entity-specific assumptions anyway, given the lack of observable market inputs.

Another IASB member noted that there is substantial support for the inclusion of an explicit risk adjustment in the building block approach (other than the US), and that while there were subjectivity, comparability, and systems cost concerns, these are no different than concerns faced in Level 3 and IAS 37 contingent liability measurements. However, he thought that one answer to reduce the concern raised by the other IASB member about potentially different levels of risk aversion being used in entity-specific measures would be to instead require an exit value objective for the risk adjustment (but leaving cash flows as entity-specific).

Another IASB member asked how different the two approaches would be in terms of day 2 accounting, with the staff replying that the risk adjustment resulted in a remeasurement each period, up or down, while the composite margin would be run off over time. For some risks, the explicit risk adjustment would lessen over time, while for other types of latent exposures, such as asbestos, it could increase, while the composite margin would not increase. A court ruling in one period could cause cash flows to increase substantially but put an end to uncertainty, reducing the remaining risk adjustment. However, in another situation, indications of oncoming court cases with uncertain outcomes could increase both the estimate of future cash flows as well as the risk adjustment.

A FASB member suggested that perhaps the risk adjustment could be disclosed in the notes rather than explicitly calculated in the liability measurement, and only recorded when the cash flows significantly increased as a component of an onerous contract. An

IASB member seemed supportive of this approach, describing this as a path toward a converged approach.

Composite margin approach

The FASB staff started the discussion of the composite margin by describing its new proposed methodology for recognising the amortisation of the composite margin. This would be based on the expected release from risk rather than the formulaic approach based on premiums and paid claims that was proposed in the FASB discussion paper ("DP"). An insurer would recognise profit from the single margin as it satisfied its obligation to stand ready to compensate the policyholder in the event of the occurrence of an insured event. The release from risk would be evidenced by the reduction in the variability of cash flows. In some types of business, such as life insurance, this could occur through the passage of time. In other lines of business, where the variability in cash flows could be due to the frequency and severity of an event, the release could occur as the insurer is released from the variability in cash flows. This could be determined by using an adjusted baseline ratio of actual claims reported to total expected cash outflows each period. A question was raised as to how the composite margin approach would deal with situations where the degree of uncertainty of the cash flows increased over time. The staff noted that this could be handled through application of an onerous contract test or the recalibration of the margin.

The FASB staff characterised the proposed approach as yielding results that would not be that far off from the explicit risk adjustment approach but simpler to apply. Several IASB members challenged that assertion for various reasons. One noted that using an adjusted ratio of actual claims reported to total expected claims, updated each period for loss development experience as the staff had described, and applying that adjusted ratio to the remaining composite margin balance would only be an appropriate depiction of the remaining risk in certain scenarios. As illustrated in a previous example, in some lines of business, the expected variability in cash flows could actually increase over time.

An IASB member asked what would be done in the case of an onerous contract - would the calculation include an explicit risk adjustment? The staff member responded that he thought it would not, but would only consist of expected cash flows. A FASB member responded that perhaps a risk adjustment could be included in the onerous contract test.

Another IASB member suggested that the run-off methodology proposed by the FASB staff seemed too complex, and that there is a weakness in the model in that even with recalibration, one could change the quantum of risk but not the price of risk. In addition, he was against amortisation of the margin based on the

release from risk, noting that in many lines of business, such as certain life insurance, there is little risk, and mostly profit to cover other costs or investment management activities. For these reasons, he prefers to separate the risk and residual margin components. The FASB staff responded that perhaps the composite margin could be divided between the portion related to risks that run off based on passage of time from that which runs off based on reduction in cash flow variability.

An IASB member noted that he had doubts as to whether the release from risk approach proposed in the composite margin approach was actually simpler. He pointed to the staff paper provision whereby a qualitative assessment could be necessary in some instances to adjust the initial baseline ratio used to amortise the margin in situations where the insurer's past experience indicates that exposure to variability in cash flows continues between the claim reporting date and the end of the contract.

Several FASB members commented that the staff paper was a good starting point for the proposed composite margin approach, but that more work was needed, especially to deal with situations where there could be increased risk exposure in periods subsequent to contract inception. One FASB member reiterated his view that the model could work by requiring a remeasurement of the margin when a significant event occurred rather than the continuous remeasurement proposed by the explicit risk adjustment model. He suggested that perhaps the explicit risk adjustment model would in practice not result in a continuous remeasurement of the risk adjustment in most situations anyway, and thus that an onerous contract test could be sufficient. He disagreed with a prior comment that the risk component and "other profit" component should be separated for subsequent recognition purposes and instead prefers an approach that recognises the margin based on the predominant factor.

The IASB chair suggested that it would be worthwhile for the staff to prepare a simple example that compared the explicit risk adjustment approach with the composite margin approach to see how similar or dissimilar the two approaches might be. The fact pattern would be one in which the initial estimate of the risk adjustment would be 10 units of risk, would change to 6 units in year 1 and 9 or 11 units in year 2. The example would also include increases in expected cash flows in a subsequent period. This illustration would show how each of the models reacted to changes in the quantum of risk, including an increase beyond the risk estimate at inception.

Comparison of composite margin to explicit risk adjustment examples

The staff presented the examples of the composite margin run-off compared to the re-measurement of the risk adjustment as requested by the boards during the meeting on 17 May 2011. With regards to the examples, the staff mentioned that they have not analysed whether any of the examples are theoretically sound, meaningful, or meet the objectives the Boards intended for the composite margin. The examples were prepared over night in a short space of time and therefore may have inherent limitations. The examples show the four different scenarios on how the composite margin run-off compares to the remeasurement of the explicit risk adjustment.

In the base case a coverage period of 1 year and claims run-off period of 5 years were assumed. The example shows that the explicit risk adjustment reduces in line with the decrease in standard deviation (risk) of the insurance liability on a straight-line basis over time. The residual margin is recognised over the coverage period being the first year. The Boards noted that the present values of the cash flows are assumed to be unchanged in this example. In the composite margin approach, the entire margin is run off on a straight line over the five years. The Boards noted that the main difference that arises is as a result of the treatment of the residual margin.

An IASB member noted that the “residual margin” component in the composite margin is an amalgamation of elements and that its run off is arbitrary and not directly related to risk. He questioned why this was amortised over the claims period in the composite margin model. The FASB staff noted that the entire composite margin model is seen as profit and the profit on the contract is only determined once all the claims have been settled. Another IASB member observed that she struggled to see how the inclusion of deferred profit element in the composite margin fits into the measurement of the insurance contract liability. A FASB member later responded that under both models the liability measurement includes deferred profit on day 1.

An IASB member questioned whether the run-off pattern of the composite margin could be other than straight-line. The staff noted workers compensation contracts as an example where the pattern of release of the composite margin could change over the long duration of the claims run-off period, given the inherent uncertainty of cash flows for this type of business.

A FASB member noted that if the insurance contract liability is seen as a performance obligation, the inclusion of the residual margin element in the composite margin would be consistent with the principles in the revenue recognition project. He noted

that the IASB views the model being developed more as a liability measurement model but inclusive of a profit element which is deferred on day 1 as part of the residual margin.

An IASB member questioned if the residual margin element of the composite margin is seen as a performance obligation, why the FASB would not recognise it over the coverage period during which the insurer stands ready to pay claims.

An IASB member questioned how the composite margin would react to increases in the variability of cash flows during the claims run-off period noting that the explicit risk adjustment would be increased to make allowance for this. The staff responded that if the composite margin is not remeasured, this increase would only be reflected in the change of the prospective amortisation pattern of the composite margin.

The discussion then focussed on the second example which includes a scenario where the risk in the contract cash flows increases (without a change to the mean cash flows) and it reflects the treatment of the composite margin with and without re-calibration of the composite margin. It was noted that in the scenario with no recalibration, there would be a loss recognised using the explicit risk adjustment approach when the risk increases above the initial levels coupled with an increased subsequent release of the risk adjustment to profit and loss. In the composite margin approach there would be no loss recognised but the income statement would not reflect any composite margin release in such a period. It was noted by the Board members that the overall profit over the 5 year period would remain the same under both models.

Should the composite margin be re-calibrated, it was noted that the total liability would also change under the composite margin approach as the margin is now re-calibrated to include the higher risk in the variability of the cash flows. This approach would be more in line with the explicit risk adjustment approach but would still differ on account of the recognition of the residual margin over the coverage period.

An IASB member observed that for contract liabilities such as asbestos, there may be scenarios under the composite margin approach where too much margin has been recognised but the insurer becomes aware of increased uncertainty about claims. He noted that under such a scenario, an onerous contract test/recalibration would be required for the composite margin model while the risk adjustment approach would automatically reflect the increased risk in the contract.

A FASB member noted that in such a scenario where the variability of cash flows increases, an onerous contract

test may need to be considered. However, he later expressed his reservation about increasing the liability for the increased variability of the cash flows when this will be released to profit and loss in future periods. Another FASB member also disagreed that an additional liability should be recognised for an “onerous contract” when the mean cash flows remain unchanged.

An IASB member noted that for life insurance contracts, the risk adjustment component is expected to be much less than the residual margin element and he questioned whether the release of risk would be an appropriate driver for the release of the composite margin. He also noted that under the explicit risk adjustment approach, there should be restraint over changes to the confidence level applied in determining the risk adjustment. He noted that if the level of confidence is kept consistent, the risk adjustment and composite margin approaches would provide consistent results.

Many IASB members noted that if the risk component and the “residual margin” component of the composite margin are run off using different drivers, the two models being considered should result in a fairly consistent measurement of the insurance contract liability.

The last example reflected the treatment of changes in the mean cash flows which is treated consistently under both models. A FASB member observed that the FASB is currently only considering the composite margin treatment for life/long duration contracts where the risk adjustment is expected to be relatively small due to the FASB’s current view that the modified model is a separate measurement model.

In a vote, only two IASB Board members supported the composite margin approach. However, five of the FASB members supported the composite margin approach with no recalibration of the composite margin.

The FASB noted that their preference for the composite margin approach is driven by their outreach to US investors who clearly prefer this method. The IASB chair floated the idea of possibly allowing both approaches in a final IFRS on insurance contracts with explaining disclosures to reconcile the two approaches but this was met with strong opposition from another IASB member which indicated the need for a common high quality reporting standard throughout the world and he noted that any choices between approaches would not be beneficial to industry and users of financial statements.

The FASB staff noted that the FASB would consider an onerous contract test under the composite margin approach. The Boards asked the staff to develop some disclosure with the aim of reconciling the composite margin approach to the risk adjustment approach. The Boards also asked the staff to keep the examples current going forward based on tentative decision in order to be able to compare the risk adjustment and composite margin approaches.

Insurance Working Group Meeting

The staff noted that items discussed at the working group included unbundling, the modified approach for non-life insurance contracts, the use of other comprehensive income (OCI), and participating contracts. With regard to unbundling, the staff noted that working group members seemed to be generally supportive of the latest proposal that uses criteria from the revenue recognition project, with the staff noting that there would be very little unbundling.

On application of the modified approach, the staff observed that a geographic split exists as to whether this approach should merely be a proxy for the building block approach (the IASB view) or a separate model similar to revenue recognition (the FASB view). Those supporting the latter view suggested that perhaps the claims period (in addition to the pre-claims period) should be subject to this separate model.

With regard to OCI, working group members commented on the importance of a converged standard, and noted that “single sided OCI”, i.e., adjusting only the insurance liability for changes in the discount rate through OCI, but not reporting fair value changes in assets through OCI, would not work. Members commented that they would prefer the “current/current” approach through OCI, or, as a possible second choice, a disaggregation of presentation within the income statement.

On the subject of participating and unit-linked contracts, the working group noted that the IASB proposal to measure the participation feature in insurance contracts on the same basis as the measurement of the underlying items in which the policyholder participates is a step in the right direction. However, some were concerned with the move away from measuring the insurance contract using a building block approach. In addition, questions were raised as to whether the approach would be extended to contracts where there wasn't a contractual link with specified assets.

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