

Insurance contract accounting update

May 2012



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Progress continues to be made by the International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) toward the next exposure draft of an accounting standard for insurance contracts. In addition, the boards are moving closer to further changes to the accounting for the assets backing insurance contracts. However, convergence between the FASB and IASB appears to be limited, both for the insurance contract project and more generally. In the paragraphs that follow, we provide an update on recent activity on these topics.

JOINT INSURANCE CONTRACTS PROJECT

The boards continue to discuss the feedback and issues raised regarding their respective 2010 documents. While the overall measurement model, known as the building block approach (BBA), remains consistent with what was proposed in those documents, key changes have been made in response to the feedback.

The staffs of both boards anticipate further decisions to be made throughout the summer, with the target of releasing exposure drafts by the end of 2012. The IASB has stated it will not require implementation prior to January 2015. Many believe that the FASB will follow a similar time frame.

Three topics that have been the subject of most recent discussion are the applicability and calculation methodology for the premium allocation approach (called the *modified measurement* approach in the IASB's 2010 exposure draft), the measurement of participating contracts, and unbundling of insurance contracts.

Premium allocation approach (PAA)

In the 2010 IASB exposure draft (ED) a modified measurement model was proposed for short-duration contracts. The boards have since decided that a better name for this measurement approach is the premium allocation approach (PAA). However, the boards have a fundamental difference in views of the model itself. The IASB views the PAA as a simplification of the building block approach. The FASB views the PAA as an entirely separate measurement model and not just a simplification of the BBA. As a result, they have different views on the eligibility for and methodology of applying the PAA.

The IASB would permit the use of the PAA if it is a reasonable approximation of the building block approach, the coverage period is one year or less, no significant changes in estimates are likely to occur before claims are expected to be incurred, and no significant judgment is needed to allocate premium to each valuation period.

The FASB would require the use of the PAA if the coverage period is one year or less, no significant changes in estimates are likely to occur before claims are incurred, and no significant judgment is needed to allocate premium to each valuation period.

Claim liabilities associated with contracts that are measured using the PAA are to be set equal to the present value of expected claims plus, for the IASB only, a risk adjustment for the uncertainty in the underlying claim payments. The FASB requires that no margin be added.

The IASB model appears to be similar in aggregate to current practice of using an unearned premium liability for the pre-claim period and a best-estimate claim liability that includes a margin. The key difference versus current practice will be the use of an explicit risk adjustment and discounting of expected cash flows. The FASB model appears to be more different from current practice in that it requires the use of the PAA and will remove any margin from claim liabilities. This could have a very significant impact on the pattern and volatility of income as well as capital and surplus.

Participating contracts

The boards discussed the measurement of participating contracts and came to very similar conclusions regarding the measurement model to use, although they arrived at this point from different paths. Both would measure the obligation for the performance-linked participation feature in a way that reflects how those underlying items are measured in U.S. GAAP or IFRS financial statements. They believe that this could be achieved by two methods, both of which would lead to the same measurement:

1. Eliminating from the building block approach changes in value not reflected in the measurement of underlying items
2. Adjusting the insurer's current liability to eliminate accounting mismatches that reflect timing differences between the current liability and the measurement of the underlying items in the U.S. GAAP/IFRS balance sheet that are expected to reverse within the boundary of the insurance contract

An example of these adjustments would be for a participating contract whose cash flows depend on the performance of an underlying pool of assets. When those assets are measured at amortized cost but the discount rate for the insurance contract is

unlocked there is an accounting mismatch. Unrealized gains and losses are not reflected in the valuation of the underlying assets, but are effectively assumed in the unlocked discount rate. The method proposed by the boards would be to eliminate from the valuation of the insurance contract the impact of these unrealized gains and losses that are not reflected in the assets. Presumably this would be through the use of a discount rate that is based on amortized cost valuation.

While amortized cost valuation may be an implied option for participating contracts, the boards have also stated that options and guarantees embedded in insurance contracts that are not separately accounted for as derivatives need to be measured within the insurance contract using a current market-consistent, expected value approach.

Unbundling

The boards have significantly expanded their discussions regarding the separation of insurance contracts into insurance and noninsurance components. The boards confirmed their proposal in the 2010 documents that an insurer should account separately for embedded derivatives contained in an insurance contract that are not closely related to the contract itself. The boards have, however, gone beyond that to propose that certain goods and services and certain investment components of insurance contracts be separated either for measurement purposes or presentation purposes or both. It is often difficult to distinguish between when someone is referring to separation for measurement and when the reference is to separation for presentation only. In this document we will refer to separation for measurement as *unbundling* and separation for presentation as *disaggregation*.

The boards have conceptually divided an insurance contract into five components:

1. **Insurance component:** Pure insurance component of the insurance contract (e.g., insurance coverage provided based on net amount at risk)
2. **Distinct investment component:** Amounts that the insurer is obligated to pay the policyholder or beneficiary regardless of whether an insured event occurs and that are sufficiently distinct from insurance contracts that they should be recognized and measured separately (e.g., possibly explicit account values could fall into this category, but this is still under discussion)
3. **Non-distinct investment component:** Investment components that are not sufficiently distinct that they should be measured separately (e.g., implicit cash values)
4. **Distinct service component:** A service that is sold separately from a service that a customer can use in conjunction with his or her own resources (e.g., administrative services only)
5. **Embedded derivatives:** Options or guarantees that are not closely related to the host insurance contract (e.g., guaranteed minimum benefits not contingent on insurance risks)

The table in Figure 1 summarizes the accounting standards applicable to each component.

FIGURE 1: ACCOUNTING STANDARDS FOR INSURANCE CONTRACT COMPONENTS

INSURANCE CONTRACT COMPONENT	APPLICABLE ACCOUNTING STANDARD
INSURANCE CONTRACT COMPONENT	INSURANCE CONTRACT STANDARD
NON-DISTINCT INVESTMENT COMPONENT	INSURANCE CONTRACT STANDARD, BUT DISAGGREGATE PREMIUMS
DISTINCT INVESTMENT COMPONENT	FINANCIAL INSTRUMENT STANDARD
EMBEDDED DERIVATIVES	FINANCIAL INSTRUMENT STANDARD
DISTINCT SERVICE COMPONENT	REVENUE RECOGNITION STANDARD

While the boards are still discussing how the investment components should ultimately be defined, they have agreed that the insurance component and non-distinct investment components should be measured using the insurance contract standard. The premiums for non-distinct investment components are to be disaggregated similarly to what is currently done for presentation purposes under U.S. GAAP for universal life types of designs. Distinct investment components and embedded derivatives that are not closely related to the insurance contracts will be measured using the financial instruments standard. Distinct goods and services will be measured using the revenue recognition standard.

If the typical investment components of insurance contracts (i.e., account balances and cash values) are deemed to be non-distinct investment components, then the main impact of these requirements will be on presentation. However, if there is to be measurement impact, the valuation model could become extremely complicated, as every element of an insurance contract will need to be bifurcated into what is considered related to the insurance and investment components.

Key remaining issues

Key open issues remaining to be decided include:

- Defining volume information (e.g., premium) in income statement
- Determining which changes in the best-estimate liability should affect residual margin re-measurement
- Determining if interest should be accreted on margins
- Determining if certain changes in the insurance contract liability should be presented in other comprehensive income (OCI)
- Determining transition provisions
- Defining required disclosures

FASB, IASB CONVERGENCE APPEARS TO BE LIMITED

Despite working on this project jointly for almost four years, the IASB and FASB continue to reach different conclusions on key elements of the project. Differences as of April 2012 include:

- Single margin (FASB) vs. risk and residual margin (IASB) in measurement model
- Whether margins are remeasured each period (the FASB says no, the IASB yes)
- Definition of acquisition costs that are included in the measurement model (the FASB argues for only costs related to successful sales, the IASB for costs related to both successful and unsuccessful sales)
- Applicability of premium allocation approach (the FASB wants it required, the IASB optional)
- Scope of standard with regards to financial instruments with discretionary participation features (the FASB wants to measure with financial instruments, the IASB with insurance)

More generally the IASB and FASB appear to be nearing the end of their convergence effort. According to IASB Chairman Hans Hoogervorst, the boards will not pursue any other specific convergence work after the current list of projects is completed. As reported in BNA's *Daily Report for Executives*, Hoogervorst commented at the April 13 IFRS Foundation trustees meeting, "It is not a stable way of working in the long term. We have to start working in a new way. So the perspective is very clearly that convergence is coming to an end." The form of the future working relationship between the FASB and the IASB may very well depend on the impending decision of the U.S. Securities and Exchange Commission (SEC) regarding the incorporation of IFRS into the U.S. financial reporting structure. The decision is expected sometime during 2012.

FINANCIAL INSTRUMENTS PROJECT

For about a year, the FASB and IASB have been working together and separately to reconsider their respective accounting for financial instruments. They have recently come to a joint view on the future measurement. The boards are converging on a two-valuation-categories approach based on the entity's business model. If the business model of the entity is to hold debt instruments to collect the

contractual cash flows, then they may be valued at amortized cost (AC). The alternative is to measure financial instruments at fair value. The business model assessment is focused at the portfolio level rather than the individual asset level and does not preclude sales of assets that are no longer consistent with the business model, such as in response to credit degradation. The boards are expected to add guidance on the types of business activities and the frequency and nature of sales that would and would not qualify for AC measurement. Many observers expect that sales will be permitted for managing credit risk and for changes in tax or regulatory requirements.

The boards have further agreed to an impairment model based on expected losses that reflects:

- All reasonable and supportable information considered relevant in making the forward-looking estimate
- A range of possible outcomes that considers the likelihood and reasonableness of those outcomes
- The time value of money

While issues such as off-balance-sheet items, disclosure, and transition are still to be worked out, convergence on the general topics of measurement model and impairment goes a long way towards consistent measurement between U.S. GAAP and IFRS for financial entities. The boards expect to issue an exposure draft of a new standard in late 2012.

THE LONG AND WINDING ROAD

The road has been long for the development of an internationally consistent approach to the accounting for insurance contracts, and there is more work to be done before it is achieved. Both boards are committed to seeing this project through to the end. Many hope that revised documents will be issued by both boards this year and insurers can start thinking more seriously about implementation. Then the real work begins.

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