Is the joint FASB/IASB insurance project coming to a conclusion?

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An exposure draft of an accounting standard for insurance contracts is scheduled for release in June 2010. Does this mean the 13-year search for a new way to account for insurance contracts is about to end? Yes and no. It seems quite likely we will see an exposure draft (ED) this summer on insurance accounting. However, given the lack of agreement between the FASB and the IASB on key elements of the developing accounting model, convergence may be somewhat delayed. In our estimation the two most likely scenarios are either 1) the boards issue a joint exposure draft based on each board's respective points of view or 2) the IASB issues an exposure draft based on its views and the FASB asks for comment on the ED without committing to change U.S. GAAP accounting for insurance.

SCOPE OF INSURANCE CONTRACT STANDARD

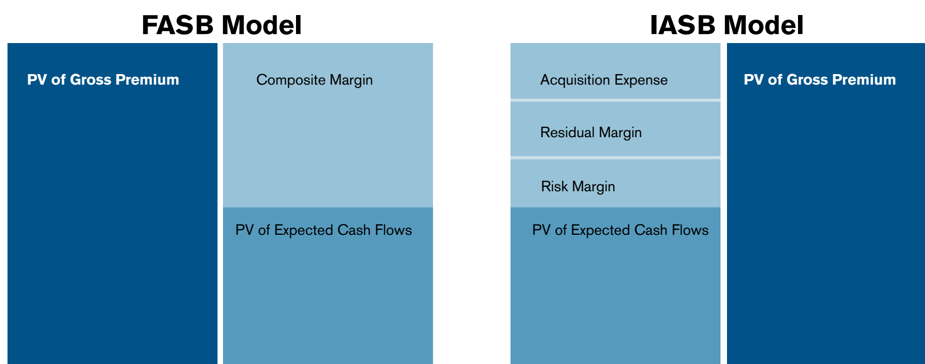
The boards have agreed that the definition of insurance risk included in the current International Financial Reporting Standard (IFRS) 4 will continue to be used in the new standard–based on the presence of significant insurance risk measured on a present value (PV) basis. However, the boards disagree on how the significance of insurance risk should be evaluated. The IASB proposes to evaluate significance based on the range of possible outcomes. The FASB proposes to only consider those outcomes where the PV of outflows exceeds the PV of premium. Thus, the FASB would count as insurance only those contracts where it would be possible for the insurer to experience a loss. It is not clear how or if the boards intend to come to agreement on this issue prior to issuing the ED.

THE MODELS UNDER DISCUSSION

There are essentially two models under discussion by the boards–one favored by the IASB and one favored by the FASB.

The model favored by the IASB measures the net rights and obligations as 1) the present value of expected future cash flows discounted at a risk-free rate plus a liquidity premium, plus 2) a risk margin for the uncertainty inherent in the projected cash flows, plus 3) a residual margin that is calibrated to the premium charged less incremental acquisition costs so that no gain is produced at issue of the contract. This model will likely produce a higher initial liability than current U.S. GAAP. Two of the reasons are 1) the use of lower discount rates under the IASB model and 2) the definition of acquisition cost is likely to be more restrictive than used today under U.S. GAAP. The margins are to be included in the insurance contract liability when reported on the balance sheet, but the residual margin is to be disclosed separately. The projected cash flows, discount rate, and risk margin are to be updated at each valuation date. The residual margin would be fixed at issue and amortized systematically over the coverage period.

The model favored by the FASB measures the net rights and obligations as 1) the present value of expected future cash flows discounted at a risk-free rate plus a liquidity premium, plus 2) a single composite margin that is calibrated to the premium charged with no adjustment for acquisition costs. Instead of preventing a gain at issue this method of calibration will force a loss at issue equal to the acquisition expenses. The composite margin will capitalize into the liability all of the expected recovery of the acquisition expense. Thus, the margins required under the FASB approach will be significantly larger than that under the IASB approach and could produce liabilities that exceed those required under statutory accounting. As with the residual margin, the composite margin will be included in the insurance liability and will be disclosed separately. However, unlike the margins in the IASB model, the FASB model would not accrete interest to the composite margin.



Both models reflect probability-weighted expectations of future cash flows and thus do not require a deposit floor to the liability. Also, both do not reflect the impact of changes in "own" credit risk.

WHAT DO THE MARGINS TELL YOU?

Some observers have stated that the residual margin and a portion of the composite margin are a proxy for embedded value, the expected profit to be earned on the business in force. With the requirement to separately disclose the residual or composite margins some observers feel that users of the financial statement will be able to better understand the expected profitability of insurers. This is unlikely to be true as 1) these margins will not be re-measured after issue and 2) they are to be released in a systematic way that may bear no resemblance to how the

economic profit is expected to emerge. The underlying best-estimate liability and risk margin will be updated at each valuation date. This would directly affect the expected profitability of the products. However, the residual and composite margins will not be affected, causing them to be disconnected with the expected remaining profit. Both margins are to be released in some systematic way over the coverage period or coverage and claim period. The presumption is that the margin would be released ratably over time unless the expected benefits or expected claims would not be incurred evenly over time. In that case, the margins would be released in proportion to expected claims/benefits. Many insurance products rely on profit sources other than those charged based on the expected claims/benefits (e.g., interest margins, account-value-based charges, per-policy expense charges). Thus it is very likely that the release of the margins will not coincide with the timing of the actual product profits.

WHERE ARE WE HEADED?

With one month to go before the ED is published, significant difference in opinion between the two boards on several key issues, and several other key issues not fully debated (e.g., presentation, participating contracts, unbundling), it may seem like a stretch to believe a joint position can be reached. The IASB is most likely to move ahead with an ED that represents its point of view as they are in need of a full accounting standard for insurance. The FASB does not have the same urgency as they already have standards in place for insurance contracts. FASB will need to decide whether to participate in the ED or delay their decision on changing insurance accounting for a later time. Either way, an ED seems sure to be published this summer.

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