IASB/FASB Insurance Contracts project, summer 2011 update

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As the summer draws to a close, the joint International Accounting Standards Board (IASB)/Financial Accounting Standards Board (FASB) Insurance Contracts project has moved into a new phase. The boards have extended the deadline for making decisions on this project and now expect to issue their next round of documents for comment in late 2011 or early 2012. This document provides a summary of some of the recent discussions between the boards and the decisions they have made over the last few months, as well as some activity with regard to the IASB's overall agenda and the contemplation by the U.S. Securities and Exchange Commission (SEC) of adopting International Financial Reporting Standards (IFRS) for all companies.

EXPLICIT RISK MARGIN VS. COMPOSITE MARGIN

The IASB voted in favor of an explicit risk adjustment approach with the margin being remeasured at each valuation date. The FASB voted in favor of using a composite margin with no subsequent remeasurement, but with potential consideration of an onerous contract test. The composite margin would be released as the insurer satisfies its performance obligation as evidenced by a reduction in the variability of cash outflows.

RISK ADJUSTMENT AND RESIDUAL MARGIN

The IASB has proposed that the insurance contract reserve will be set equal to a best-estimate liability plus a separate risk adjustment and residual margin. The best-estimate liability and the risk adjustment would be calculated directly, but the residual margin would have to be solved for, based on the premium charged for the policy. The residual margin would thus be dependent on the measurement of both the best-estimate liability and the risk adjustment. No agreement between the IASB and the FASB has yet been reached on whether or not the residual margin should be locked in.

Both boards agreed on the following:

- Residual margin cannot be less than zero. If an insurer's premium is too low, it is not permissible to offset that in the liability.
- Residual margin should be allocated over a coverage period on a systematic basis, consistent with the pattern of transfer of services under the contract, which effectively could be the provision of insurance or possibly some measure of the cash flows expected.

As noted above, significant differences remain between the two boards on the issues of locking in the residual margin, and whether and when it would be remeasured. The IASB voted 8-7 to unlock the residual margin and remeasure it at each date, whereas the FASB voted to lock it in at inception. It should be noted that in general the FASB favors combining the risk adjustment and residual margin into a single measure, and its position on remeasurement is thus more hypothetical, based on the three-component approach that it currently opposes.

The IASB has given some indication of the requirements to remeasure the residual margin:

- Adjustment would be made to the residual margin for favorable and unfavorable changes in estimates with no artificial limit.
- No adjustment would be made for changes in estimates of the risk adjustment.
- Changes in the risk adjustment should be recognized in profit or loss in the period of the change.
- Adjustments to the residual margin should be made prospectively.

ACQUISITION COSTS

Both the IASB and the FASB have decided that only direct costs incurred in acquiring a portfolio of insurance contracts should be included in measuring the liability. This is at a higher level of aggregation than the contract-specific definition included in the IASB's exposure draft. However, the boards differ on what would be considered at the portfolio level. The FASB would restrict costs to only those related to successful sales consistent with its Emerging Issues Task Force (EITF) 09-G statement. The IASB would include costs related to both successful and unsuccessful sales.

MEASUREMENT OF POLICYHOLDER PARTICIPATION

The IASB staff proposed measuring a participating element of a contract on the same measurement basis as the underlying items in which the policyholder participates. The goal was to eliminate accounting mismatches. The IASB voted in favor of this approach. The FASB unanimously voted against it.

The FASB indicated it would consider adjusting the value of assets backing the liability to deal with accounting mismatches (i.e., allow fair value option). The IASB has voted not to revisit IFRS 9 and not to amend it with new requirements for assets backing insurance liabilities.

REINSURANCE

Both boards discussed and agreed on a number of points regarding how to reflect reinsurance from a ceding company point of view. They agreed on the following:

- If a reinsurance contract does not transfer significant insurance risk but does transfer substantially all insurance risk from the reinsured portion of an underlying contract, then the reinsurance contract is deemed to transfer significant insurance risk. In many ways, this is analogous to "safe harbor" provisions in other types of contracts.

- Assessment of significant insurance risk should be done at the individual contract level.

- A cedant should not recognize a reinsurance asset until the underlying contract is recognized, except for onerous contracts. This is a simple way to preclude insurers from establishing an asset value on their books until they have something concrete to reinsure.

- Recognition of gains and losses are to be determined as follows. If the present value (PV) of fulfillment cash flows for the reinsurance contract is:

  - **Less than zero and coverage is for future events**: The cedant establishes the amount of reinsurance recoverable as part of the prepaid reinsurance premium, recognizing the cost over the coverage period of the underlying contracts.

  - **Less than zero and coverage is for past events**: The cedant recognizes the loss immediately.

  - **Greater than zero**: The cedant should recognize a residual or composite margin.

  The result is to recognize Day 1 losses immediately and to defer Day 1 gains.

- Measure PV of fulfillment cash flows for a reinsurance contract in the same manner as direct liability for the corresponding reinsured part of the underlying contract, which can be calculated either directly or on a with- and without-reinsurance basis. The basic idea here is to make the reinsurance credit consistent with the liability an insurer puts up for the direct contract itself, or at least calculated on the same basis, as an alternative to calculating the reinsurance credit directly from reinsurance contract cash flows, which has proved more difficult than it initially appeared.

- In terms of how best to discount reinsurance credits for the probability that a reinsurer will not reimburse, i.e., for non-performance, the impairment model for financial instruments is to be used, including collateral and expected losses arising from disputes.

PRESENTATION

Both the IASB and the FASB indicated a preference for the presentation model outlined in Example 2 in Appendix A of Agenda Paper 3A/FASB Memo No. 70A. This example presents the underwriting results as follows. The building-block approach is presented differently than the modified approach.

APPENDIX A - EXAMPLE #2

MODIFIED APPROACH

PREMIUMS EARNED		2,139
CLAIMS INCURRED		(1,422)
EXPENSES INCURRED		(341)
RELEASE OF COMPOSITE MARGIN		123
CHANGE IN RISK MARGIN		-
EXPERIENCE ADJUSTMENT		(22)
CHANGES IN ADDITIONAL LIABILITY FOR ONEROUS CONTRACTS		-
AMORTIZATION INCREMENTAL ACQUISITION COSTS		(331)
CHANGE IN ASSUMPTIONS		3
UNDERWRITING MARGIN (MODIFIED APPROACH)		149

BUILDING BLOCK APPROACH

RELEASE OF COMPOSITE MARGIN		252
CHANGE IN RESIDUAL MARGIN		-
CHANGE IN RISK MARGIN		-
		252
PREMIUMS DUE	4,228	
LESS PREMIUMS EXPECTED	(4,221)	7
ACTUAL BENEFITS	(2,992)	
LESS BENEFITS EXPECTED	2,919	(73)
ACTUAL EXPENSES	(607)	
LESS EXPENSES EXPECTED	611	5
EXPERIENCE ADJUSTMENT		(61)
CHANGE IN ASSUMPTIONS		(39)
UNDERWRITING MARGIN (BUILDING BLOCK APPROACH)		152

OTHER

NON-INCREMENTAL ACQUISITION COSTS		(196)
		105
INTEREST ACCRETED ON THE EXPECTED NET CASH FLOWS		(1,300)
INVESTMENT INCOME		1,228
		(72)
PROFIT BEFORE CHANGE IN DISCOUNT RATE		33
CHANGE IN DISCOUNT RATES		9
INCOME BEFORE TAX		43
INCOME TAX EXPENSE		(11)
NET INCOME		32

No decision was made as to whether all insurers are required to present each of the line items in all cases on the statement of comprehensive income, rather than in the notes.

IASB AGENDA CONSULTATION

The IASB has issued for comment an agenda consultation document in which it asks constituents to suggest projects the board should consider adding to its agenda. The board confirms in the document that the Insurance Contracts project is among four projects that it is giving its highest priority. Also of interest to insurers are several projects that the IASB previously added to its agenda but subsequently deferred in response to the global financial crisis and completion of projects identified in the memorandum of understanding with the U.S. FASB. Some of those deferred projects include:

- Discount rate
- Equity method of accounting
- Financial instruments with characteristics of equity
- Financial statement presentation
- Income taxes
- Intangible assets
- Postemployment benefits (including pensions)
- Rate-regulated activities

The IASB notes in the document that if the board chooses to continue working on these projects, it will leave less capacity for new projects to be added.

The agenda consultation paper is available at:
http://go.ifrs.org/agenda+consultation+2011+CLs.

REPLACEMENT OF U.S. GAAP WITH IFRS

The SEC has stated it will make a decision on whether to pursue the use of IFRS for GAAP reporting purposes within the United States during 2011. Certain SEC staff members have floated the idea of a “condorsement” as a way forward. Under this approach, the United States would maintain U.S. GAAP but make efforts to converge it with the IFRS, potentially over a phased transition period of five years or more. The framework of this approach was explored as one of the possible methods of convergence with IFRS in the staff paper issued by the SEC in May 2011.

In developing the transition plan, one of the highest priorities is to minimize the possible adverse impact but still provide useful information to investors. Under this multi-phased approach, the cost of transition can potentially be reduced by maximizing prospective application and minimizing situations where an existing IFRS is adopted only to be replaced shortly after by a new IFRS, as well as allowing for tailoring the transition for individual standards. A multi-staged transition could also allow both insurers and investors enough time to understand and adapt to the new financial standards, and spread the implementation cost over a number of years.

The SEC may perceive it as beneficial to have a transition plan that is endorsed by the FASB rather than direct incorporation of IFRS, as this could potentially provide more protection to the U.S. investors and capital markets.

However, a staggered transition could also cause confusion if certain interim standards in between U.S. GAAP and IFRS were to evolve during the transition period, leading some to question if the convergence will ultimately be successful.

The SEC has not made a decision as to if and how the incorporation of IFRS will occur. The SEC plans to continue to assess the potential costs and benefits of various transition frameworks. The timeline may be further evaluated and revised.

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