IFRS Update

Q4 2010

William Hines
FSA, MAAA

Henny Verheugen
AAG

As we approach the beginning of 2011, another chapter in the IASB/FASB joint insurance project has been concluded. The comment periods have ended and roundtable discussions were held. The boards will next consider the comments made on the respective papers and re-deliberate the issues with the goal of completing the project by mid-year. This document provides an update on the project status and expected future steps as well as a summary of the key issues that remain open in the project.

PROJECT STATUS

The International Accounting Standards Board (IASB) issued an exposure draft (ED) of an accounting standard for insurance contracts in July 2010. The U.S. Financial Accounting Standards Board (FASB) issued its own discussion paper on the topic in September 2010. Comment periods ended in November and December respectively.

The boards conducted an outreach program during the comment period where a few board members and staff from each organization visited with industry, actuarial, and accounting groups to discuss the issues. In addition, the boards held three roundtable discussions with constituents (in London, Tokyo, and Norwalk, Conn.) to discuss specific issues further.

The boards started reviewing comments in December and will continue the re-deliberation process during the first half of 2011. The stated goal of the boards is to approve a final IASB standard and a draft FASB standard by the end of June 2011.

BIGGEST REMAINING ISSUES

The most significant issues for long-term insurance contracts that remain are:

- Volatility of income
- Treatment of acquisition expenses
- Whether the measurement will include one or two margins
- Presentation of income

Volatility of income

The liability for long-term contracts will equal the expected present value of future cash flows plus an adjustment for the risk of actual cash flows exceeding the expected cash flows and a residual margin that will eliminate any gain from occurring at issue of the policy. While the IASB ED specified that only new business would include a residual margin it is now expected that in-force business will also have one. The discount rate is to be based on the characteristics of the liability, not the assets backing the liabilities, unless the liability cash flows are dependent on the performance of the assets.

The expected present value of future cash flows and the risk adjustment will be remeasured at each valuation date. The residual margin, which can be a very significant portion of the liability,[1] will not be remeasured, but will instead be amortized over the life of the product akin to an amortized cost model. As there is no corresponding hybrid asset measurement model under IFRS, only fair value and amortized cost (the use of which is expected to be quite limited), there will be volatility in income that is due to the mismatch in accounting between assets and liabilities. Adding to the volatility will be the impact of changes in the default component of credit spreads, which will be reflected in the valuation of most assets, but not reflected in the discount rate used for liabilities.

Treatment of acquisition expenses

One of the key reasons why the residual margin will be a significant portion of the liability is due to the treatment of acquisition costs. Under the proposed model, acquisition costs are to be split into those that are incremental at the contract level and those that are not. Incremental at the contract level is any acquisition cost that would not have been incurred had that contract not been issued. Those costs that are incremental will be included as a cash flow in the measurement model. Those that are not incremental will be excluded from the cash flows, causing the revenue that is expected to cover these costs to be capitalized into the residual margin and amortized into income over time. This will cause a significant mismatch in the timing of the recognition of the acquisition costs and the revenue charged to cover those costs, regardless of when the revenue is actually received. Many commenters have recommended that *incremental* be defined in relation to the portfolio of contracts consistent with how the contracts are priced. The boards have concerns about how this might operate in practice.

One margin vs. two

The IASB has proposed a measurement model in which there is a risk adjustment to account for the variability in expected cash

1 A study of the potential impact of the IASB ED was conducted by the Society of Actuaries. The results showed that, depending on the product, the residual margin could be the majority of the liability. The study report is available at http://www.soa.org/files/pdf/research-2010-12-fr-insurance-contracts.pdf.

flows and a residual margin that would prevent any gain from being recognized at issue. The board feels that there is value in having a risk adjustment in a liability, in particular for onerous contracts where the residual margin would be zero or theoretically negative. The FASB prefers a single-margin approach as they question the reliability and comparability of a separate risk margin to which is added a *plug* to produce no gain at issue. They prefer a single composite margin. It appears from the comment letters and discussions at the roundtables that the European industry prefers a two-margin approach whereas the U.S. industry prefers a single composite margin approach. It is possible that the European industry prefers the two-margin approach as it is consistent with the two-margin approach required under Solvency II, where a risk margin is included in the liability but no residual margin is required.

Presentation of income

The boards have proposed a summarized margin approach to presenting income. This is driven largely by the valuation model they have proposed. The key elements would include:

- Release of risk and residual or composite margins
- Gains and losses on initial recognition of insurance contracts
- Acquisition costs not considered incremental
- Differences between actual and expected cash flows
- Changes in future estimates and discount rates

The proposed performance statement is not to include premiums, claims, or expenses, while requiring them to be shown in other forms in the disclosures. Many commenters agree that margins should be shown in the performance statement, noting that some type of source of earnings analysis is commonly used, but they disagree with the elimination of the cash flows themselves from the primary statement. It is possible that an expanded margin presentation would satisfy everyone, but an acceptable solution has yet to be proposed.

CONVERGENCE

Much progress has been made during the project to get to this point. Both boards have agreed to continue to work together on this project while no agreement has been made to produce the same ultimate result. The IASB needs to produce a standard and is not considering U.S. GAAP as an alternative. The FASB already has a comprehensive set of standards and is not under the same pressure to produce an alternative measurement system for insurance. It is quite possible that the FASB will make targeted changes to the existing U.S. GAAP requirements rather than make a wholesale change to the proposed new model. However, those targeted changes may very well spring from the re-deliberations over the next six months. The staff and board members of both organizations are very receptive to input from their constituents to help resolve the issues noted above.

The materials in this document represent the opinion of the authors and are not representative of the views of Milliman, Inc. Milliman does not certify the information, nor does it guarantee the accuracy and completeness of such information. Use of such information is voluntary and should not be relied upon unless an independent review of its accuracy and completeness has been performed. Materials may not be reproduced without the express consent of Milliman.

Copyright © 2011 Milliman, Inc.

William Hines, Henny Verheugen

289 Edgewater Drive
Wakefield, MA 01880-6215
+1 781 213-6200
www.milliman.com