FASB / IASB Insurance Contracts Project Update Webinar

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International Accounting Standards Task Force

Presenters

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Agenda

- Insurance Contracts Refresher
- Update on Discussion and Decisions
  - Scope
  - Future cash flows and acquisition costs
  - Contract boundary
  - Margins and risk adjustment
  - Short duration contracts methodology
  - Reinsurance
  - Unbundling
  - Presentation
  - Transition
- Key FASB-IASB differences
- Recent Academy activity
- Outlook

Polling Question

How familiar are you with current IASB and FASB proposals regarding insurance accounting?

a) What does IASB stand for?

b) I have read the 2010 IASB Exposure Draft and FASB Discussion Paper

c) I regularly follow the project via Academy/CAS/SOA updates and presentations

d) I have Andrea Pryde/Jennifer Weiner on speed dial

Insurance Contracts – A Quick Refresher

- Joint project by IASB and FASB
- IASB Exposure Draft released July 2010, with corresponding FASB Discussion Paper released September 2010
  - Some differences between FASB and IASB frameworks (discussed later)
  - Current fulfillment value
    - Building Block approach to valuation
    - Premium Allocation Approach for short duration contracts

Scope

- Proposed standard will cover insurance contracts
  - Defined as a contract transferring significant insurance risk
  - No change from current IFRS 4 definition
- IASB standard also covers investment contracts with discretionary participating features
  - FASB standard excludes these contracts

Insurance Contracts – Building Block Approach

- Expected future cash flows
  - Unbiased estimate of expected value of future cash flows that will arise as the insurer fulfills the contract
- Time value of money
  - Discount at current market rates
- Risk Adjustment and Margins
  - Explicit estimate of the effects of uncertainty about the amount and timing of future cash flows – IASB
  - Residual Margin (IASB) and Single Margin (FASB)

Future Cash Flows and Acquisition Costs

- All cash flows based on current estimates
- Model reflects expected value (mean)
  - Considers all relevant information
  - No need to identify and quantify all possible scenarios
- Acquisition costs are included in the cash flows for determination of margins
  - Acquisition costs should be incremental to the portfolio of contracts
    - Previous drafts defined acquisition costs at the policy level
  - IASB makes no distinction between successful and unsuccessful acquisition efforts

Residual Margin Re-measurement

- Residual margin should not be locked in at inception
  - Changes in estimates of expected cash flows result in adjustments to the residual margin
  - Residual margin should not be less than zero
- IASB has not prescribed a method for allocating the residual margin
  - Guidance indicates that residual margin should be allocated over the coverage period on a “systematic basis that is consistent with the pattern of transfer of services”
  - Previous guidance indicated with the “passage of time”

Contract Boundary

- Cash flows are defined by the boundary
- Contract:
  - Begins when coverage is effective
  - Ends when is no longer required to provide coverage, or
  - Has the right to reassess the risk of the policyholder
- Contract modification could create a new contract if, for example:
  - Modification changes the accounting model (e.g., insurance vs. investment contract, building blocks vs. premium allocation approach)
  - Modification changes the portfolio the contract is allocated to

IASB Risk Adjustment Objective

- Revised objective:
  - ‘The risk adjustment shall be the compensation the insurer requires for bearing the uncertainty inherent in the cash flows that arise as the insurer fulfils the insurance contract.”
- Clarifies that the insurer should consider both favorable and unfavorable outcomes i.e., the risk is “two-sided”
  - IASB does allow for consideration of the degree of risk aversion
- IASB has decided to not limit the range of available techniques for estimating the risk adjustment
  - Previously limited to three methods: confidence level, CTE, cost of capital
  - IASB has defined necessary characteristics for risk adjustment method

Short Duration Contracts

- IASB ED – Premium allocation approach for short duration contracts
  - Covers contracts up to 12 months (i.e., most P&C and health contracts)
  - Includes unearned premiums for pre-claim period, building block approach without residual margin in post-claim period
  - If premium allocation approach elected, additional liability required for onerous contracts
- FASB requires premium allocation approach for short duration contracts

Short Duration Contracts

- Key issue: status:
  - Whether 12-month coverage period is a bright line or a principle
    - IASB current view is that premium allocation approach permitted only if it produces a "reasonable approximation" of building block approach
  - Whether mandatory or voluntary
    - IASB - voluntary
    - FASB - mandatory
  - Whether discounting be required for all cash flows
    - Discounting required when material
    - Not required for claims paid within 12 months

Reinsurance

- Ceded portion of contract measured using same process as direct contract
- Adjusted for non-performance risk of reinsurer
- For “normal” reinsurance for future events (PV reins premium > PV recoveries including risk adjustment), the cedant should recognize net cost as a part of the reinsurance recoverable and should recognize the net cost over the coverage period
- Where PV reins premium < PV recoveries, the cedant should recognize the net gain as a residual margin over coverage period

Unbundling

- Exposure draft proposes unbundling for:
  - Products with defined account values
  - Embedded derivatives which are not closely related to host contract and which are not insurance themselves
- Revised Guidance
  - Unbundling required:
    - If an investment component and an insurance component are not highly interrelated
    - If an embedded derivative not clearly and closely related to a host insurance contract

Presentation

- Revised proposal
  - Insurers required to present premiums, claims, benefits and the gross underwriting margin in income statement
  - BUT their definition of premium different from definitions commonly used today
- Other comprehensive income (OCI)
  - Changes in liability due to changes in discount rate will be reflected in OCI
  - Potential FVOCI asset category within IFRS 9

Presentation – Earned Premium

- Under building block approach earned premium should be consistent with Revenue Recognition standard
- Revenue stream will look like YRT premiums
- Cannot be derived from collected premium and doesn't affect bottom line
- When experience differs from assumed the EP is affected

Transition

- Measure the present value of fulfillment cash flows using current estimates
- Derecognize current DAC balances
- Determine the single or residual margin:
  - Through retrospective application of new principles to all prior periods where it is practical to do so
  - For earlier periods where the retrospective application is not practical, estimate the margin
- Determine the discount rate for a minimum of 3 years
  - Use difference from a reference rate for prior periods if necessary

Key FASB-IASB Differences

- One margin or two margins
- Margin unlocking
- Acquisition costs
- PAA optional or mandatory

Recent Academy Activity

- Prepared and sent to the Boards comments on three specific areas where the staff had requested input (http://www.actuary.org/files/Comments_to_IASB_on_working_drafts.pdf)
- Members of the International Accounting Standards Task Force maintain informal contacts with the staff of both Boards
- Webinars for Academy members
- Preparation for commenting on exposure drafts

Looking Ahead

- New IFRS ED for Insurance Contracts mid-2013
  - This will be an Exposure Draft but they are only asking for comments on five areas:
    - Presentation of premium
    - Unlocking residual margin
    - Changes in discount rate go through OCI
    - Transition requirements
    - Participating contract mirroring
- FASB Exposure Draft for Insurance Contracts expected later in 2013
- Final standards adopted in 2014; effective in 2018

Questions and Answers

For More Information / Provide Feedback

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