Deloitte.

Insurance Accounting Newsletter
"Unsuccessful efforts" split the Boards

Introduction

The joint meetings between the International Accounting Standard Board (IASB) and the Financial Accounting Standard Board (FASB, and together with IASB, the Boards) have continued with great intensity since our previous newsletter. The progress of the joint project on insurance accounting has hit the first stumbling block as the Boards disagreed on how to account for distribution costs incurred to add new business to insurance portfolios.

The contentious issue relates to the cost associated with unsuccessful efforts to sell an insurance policy. IASB believes that the associated costs are still part of the costs of the portfolio with no accounting loss at the point of sale if the insurer is able to assemble a portfolio that is capable of absorbing all the distribution costs. On the contrary, FASB believes that costs that did not result in a successful sale should be taken as an expense immediately with the portfolio carrying a larger deferred profit for release in later years.

A convergent decision was reached on the difficult topic of discount rate selection for non-participating contracts. After a number of education sessions (including one from Deloitte) and intense debate the Boards agreed to permit both "top down" and "bottom up" approaches to the selection of discount rates.

This represents an important breakthrough in an area where several parties have been calling for the "top down" approach to be accepted in the final International Financial Reporting Standard (IFRS) to reduce the accounting volatility from the interaction of insurance liabilities and the financial assets backing them.

These and many other issues were discussed at several meetings starting from the FASB only meetings held on 10 and 11 February. The Boards met in a series of joint meetings on 16, 17 and 18 February, and then again on 1 and 2 and on 14 and 15 March. In our newsletter we comment on the key issues without following the chronology of the events[1] in an attempt to offer to our readers our insights on the key issues as they often resurface at different meetings prior to being resolved with a Boards' tentative decision.

The Boards will meet again on 21 and 22 March in the US and then the IASB will host an Insurance Working Group meeting in London on 24 March to discuss with its insurance advisors where the project stands as it approaches the mid-point of its timetable that, if met, would deliver the final IFRS for insurance contracts by the end of June.

1 Deloitte publishes updates on the insurance project immediately after each IASB meeting on http://www.iasplus.com/agenda/insure2.htm

Diverging views on acquisition costs (2 March)

The Boards had already reached a decision at their 2 February meeting that acquisition costs should be included at the portfolio level, departing from the criterion to only allow incremental cost at contract level proposed in the Exposure Draft but demanding a new opportunity to discuss the details of this decision to ensure consistent application in practice.

Exactly a month later the Staff presented a paper where it acknowledged its own inability to recommend a single approach on acquisition costs. Together with a main Staff recommendation the paper contained also an alternative view.

The main recommendation was that the acquisition costs to be included in cash flows of a portfolio of insurance contracts are direct costs that relate only to successful contract acquisition. The recommendation also highlighted application guidance that Staff indicated would need to be detailed and compulsorily applied.

The rationale for limiting acquisition costs to those related to successful contract acquisitions included the following arguments:

- unsuccessful efforts do not have a future benefit;
- consistency with the Boards view in the Exposure Draft Basis for Conclusions that these costs can be clearly identified with contracts issued; and
- consistency with other standards that these costs are determined at the contract level only for successful sales.

The Staff also recommended that these costs shall be direct costs only with further application guidance on how to implement this concept pending the Boards' decision.

The alternative Staff recommendation suggested that the acquisition costs to be included in the expected cash flows should not be limited to costs for successful contract acquisitions and their identification should be the same as the criterion to identify fulfilment cash flows at a portfolio level.

The debate established that both Staff recommendations would require a degree of allocation of costs that related to the contractual activity. This confirmed the February decision to abandon the incremental test but resulted in the Boards asking for the Staff to conduct further work on the definition of the relevant cost basis and the associated application guidance that will be included with mandatory status in the final IFRS.

The divergence occurred on the question of whether to restrict acquisition costs to those related to successful efforts or not.

The FASB voted unanimously in favour of the Staff's recommendation of a successful efforts approach whilst 10 IASB members voted in favour of the Staff's alternative recommendation, to include costs arising from both successful and unsuccessful efforts.

Many IASB members motivated their vote observing that the definition of acquisition costs must be consistent with that applicable for all other fulfilment cash flows as acquisition costs are a sub-set of those cash flows.

Another angle that would seem to support the IASB position is that the accounting model for insurance contracts is now clearly based on a portfolio as the unit of account thus the cost of assembling a portfolio should not distinguish whether or not the attempt at contract level was successful or not. This approach would not create the need for a potentially complex system that would need to separate costs based on the outcome of the selling efforts. As an example, an IASB member noted that even commissions paid for successful sales compensate the intermediary also for the time he had to spend to unsuccessfully contact other potential policyholders. The adoption of the FASB approach would require also for these costs to be separated between those associated with successful and unsuccessful efforts.

Deloitte position
While the Boards appear to be approaching a similar basis for identifying acquisition costs the principle to include them in the measurement of insurance liabilities has created a disagreement between the Boards.

In our comment letter to the ED's incremental cost approach, we recommended abandoning it in favour of a direct cost basis. In that respect we noted the recent development of US GAAP where the principle of successful effort has been incorporated in the current text for insurance accounting under the FASB Accounting Standards Update (ASU) No. 2010-26 Financial Services – Insurance (Topic 944).

This approach is in line with the FASB's preference for a principle of inclusion of successful efforts expenses only.

Allowing "top down" methods to select discount rates for non-participating life contracts (17 and 18 February and 15 March)

As reported in previous issues of our newsletter the selection of the discount rate to account for insurance contracts is a crucial component of the new IFRS.

The selection of the discount rate for non-participating life insurance contracts is probably the issue that mostly contributes to the importance of this debate and the Boards focused their discussion on this during the joint mid-February session.

As reported in their official record of tentative decisions, the Boards decided that:

1. The objective of discounting is to take the time value of money into account and to reflect the characteristics of the insurance contact;

2. The IFRS shall not prescribe a method for determining a discount rate;

3. A discount rate should:

   a) be consistent with observable current market prices for instruments with cash flows whose characteristics reflect those of the insurance contract liability, including timing, currency and liquidity, but excluding the effect of the insurer's non-performance risk;

   b) exclude any factors that influence the observed rates but that are not relevant to the insurance contract liability (e.g. risks not present in the liability but present in the instrument for which the market prices are observed, such as any investment risk taken by the insurer that cannot be passed to the policyholder);

   c) and reflect only the effect of risks and uncertainties that are not reflected elsewhere in the measurement of the insurance contract liability.

The key decision is the clear statement in 2. above that the IFRS will not prescribe a method to select the discount rate. This removes the requirement in the Exposure Draft (ED) to construct the discount rate using a liquidity premium in addition to the risk free rate yield curve and it allows insurers to use also “top down” techniques that adjust reference assets market yield curves for specific deductions to achieve the objectives of the IFRS.

The agreement that the final text of the IFRS would not prescribe a specific model for selecting the discount rate reinforced the need for a clear objective which will give users the criteria against which to judge the appropriateness of the methods selected by preparers. This text refinement would be part of the pre-ballot process the Boards will start in a few weeks time when the draft text of the IFRS will be circulated privately for comments among them.

The Boards agreed with the Staff that they would require a deduction for both the expected cost of defaults and the risk associated with it. Having observed the debate on this subject, it is not clear how far the guidance will go in terms of requiring an adjustment for credit risk in a “top down” approach.

Deloitte supported the approach of an adjustment aligned with the IFRS 9 approach to impairment of debt instruments which is based on the expected cost of defaults associated with a particular debt instrument. As currently drafted the IFRS 9 approach would only require the estimate of the mean of the probability weighted default costs that a particular asset (or portfolio of assets) would suffer. For the insurance discount rate the Boards agreed instead that in addition to the spread for expected defaults, insurers would also need to deduct a spread to represent the risk surrounding the expected costs.

The Boards also directed the Staff to include a disclosure requirement that yield curves for each major relevant currency should be disclosed in the financial statements.

At the 14 March joint Boards’ meeting the Staff presented a paper that further explored the possibility of a proxy rate, articulated a number of bases for the selection of such a rate and when it could be used. The majority of both Boards agreed with the Staff recommendation that such an expedient should not be introduced in the final IFRS because it would not allow the achievement of the stated objectives of a discount rate that reflects the characteristics of the insurance contract cash flows.

However the FASB members reserved their right to reconsider their decision when the scope of the new US accounting standard will be debated because the expedient may be useful if the scope requires a large number of non-financial institutions to be under the scope of the new standard for insurance contracts.

Deloitte position

We endorse the idea that insurers should be able to select a discount rate that best reflects the characteristics of the cash flows underlying their insurance liabilities, and that they should be able to determine it using a reference asset portfolio with a deduction for expected default costs. We would prefer that the adjustments in a “top down” approach for expected cost of defaults are consistent with the IFRS 9 method.

Disclosure of yield curves supporting discount rates would also offer investors with an appropriate level of comparability across the industry and understanding of the effect of different discount rates on the financial results.

The discount rate will not be locked-in (1 March)

In line with their redeliberation plan that had the decisions on discount rate reached by the end of March the Boards continued their discussion on this crucial component of the future accounting model throughout the March sessions.

Based on the feedback received during the consultation period, the Staff reported that there are significant concerns amongst insurance companies that an unlocked discount rate would not faithfully represent the economics of the underlying contract, increasing volatility above the level representative of the economic mismatches. Many respondents drew parallels between the treatment of insurance contracts and financial instruments and suggested that a locked in discount rate (similar to that applied to amortised cost models) would be more appropriate for a fulfilment model approach.

The Staff discussed the concerns raised by respondents but found limited merit in the arguments put forward. The Staff therefore recommended that the Boards retain an unlocked discount rate. With almost no discussion, the Boards unanimously agreed with this recommendation.

Deloitte position
In our comment letter we support a current discount rate using a "top down" approach that removes the expected cost of default from a reference asset portfolio matching currency and duration of the liability's cash flows.

Our preference is indicative of the fact that Deloitte did not accept as a viable solution the locking in of discount rates to account for portfolios of insurance contracts. We recommended dealing with the situation where an insurer has amortised cost financial assets by requiring that the prospective changes arising from the reference asset portfolio discount rate are part of our proposed recalibration of the residual margin.

Discounting non-life insurance contracts (1 March)

Immediately after deciding against the use of a locked-in discount rate the Boards focused on the concerns raised by respondents, primarily property and casualty insurers in the United States, regarding the treatment of short-term non-life insurance contracts under the proposed building blocks model. These respondents were largely concerned that the model proposed in the ED was overly complicated and that applying discounting to property and casualty contracts would not result in faithful presentation.

The Staff agreed with the concerns, and proposed that:

- contracts with a short pre-claim period (e.g. the twelve month or less proposed in the ED) and a claims settlement period of less than a year from the claim event should be exempted from the discounting requirement (short-duration, short-tail contracts);

- contracts with a long claim settlement period that have a reasonably determinable payout pattern should be discounted; and

- contracts with a long claim settlement period with cash flows that are uncertain in terms of timing and/or amount should also be discounted.

The Boards discussed extensively the first Staff proposal. Some members were concerned that the current proposal would allow two years to elapse between contract inception and settlement date without discounting (i.e. one year contract coverage period plus one year settlement period if the claim was incurred on the last day of the contract's coverage period). Other Board members were concerned that the current wording of the Staff proposal, although intended only for non-life, would apply equally to certain types of life insurance contract (e.g. short-duration term insurance) and they were unsure this would be an appropriate decision.

Some Board members questioned whether a better approach to this problem would be to apply the materiality concepts used elsewhere in IFRS to avoid discounting short-duration, short-tail contracts where the discounting would be immaterial, but other members noted that the Boards had not defined the concept of materiality and would therefore be leaving this matter largely to the judgement of preparers and auditors. Members noted that it would also vary from jurisdiction to jurisdiction, so this proposal was dropped.

Overall, despite significant debate on the issue, the Boards were unable to conclude whether they would permit an exemption. The Boards suggested that the Staff should reconsider the proposal when they subsequently present the paper to redeliberate the modified approach for short-duration contracts.

There were no disagreements with the second Staff proposal, but Board members questioned the substance of the different wording used between the second and the third proposal. Even though the timing and amount of cash flows may be uncertain, insurers would still be able to make estimates and these estimates would be discounted at the discount rate. The Staff explained that this was purely a drafting issue, resulting from suggestions arising from respondents in the comment period. They clarified that they could foresee no real circumstances where proposal two and three would be different in practice. On that basis the Boards agreed to support both proposals two and three, but requested a careful revision of the wording in light of the comments provided.

Deloitte position
In our comment letter we have supported the principle of a discounted expected value of insurance contracts cash flows and noted that "the measurement of an insurance contract should include the expected present value of the future cash outflows less future cash inflows that will arise as the insurer fulfils the insurance contract, as this is consistent with the Board's objectives. As the cash flows that are being discounted are received/paid out at different points in time, the wording of the ED could be improved to clarify whether a full yield curve should be used for discounting, or a single discount rate."

First steps on discount rates for participating contracts (15 March – inclusive of an educational session)

The series of redeliberations on discount rates was concluded at the joint meeting on 15 March when the Boards started to address the other large family of insurance contracts: those with participating rights. These are insurance and investment contracts where the benefits payable to the holder are dependent, at least in part, on the value of the assets backing the contracts' cash flows. At this meeting the Boards reached two important tentative decisions on the discount rate for participating contracts:

a) to align the objectives for discount rates on participating contracts to those tentatively agreed last month for non-participating contracts; and

b) to include guidance in the final IFRS that explains how an insurer should reflect the dependency on asset values of participating contract cash flows

In reaching these unanimous decisions the Boards made reference to a Staff paper that was released in November 2010 where the cash flows of participating contracts were analysed across three sets of cash flows that:

- directly reflect asset values where the measure of the liability can be effectively and fully replicated by the use of the asset values;
- are independent of asset values thus identical to those in non-participating contracts; and
- indirectly reflect asset values as a result of being cash flows from embedded options and guarantees.

The Boards noted that this paper could be a valid basis for the development of the mandatory application guidance that would be included in the final IFRS.

Prior to these redeliberations the Boards had received a presentation on the same subject delivered by Jean-Michel Pinton and Baptiste Brechot respectively Group Accounting Director and Actuary at CNP Assurances. Messrs. Pinton and Brechot co-presented with Eric Meistermann, a Deloitte partner who advised CNP Assurances in the development and testing of the results presented to the Boards. The "Asset Liability Rate" ('ALR') is a proposal to determine a discount rate for participating contracts.

The ALR method determines the discount rate using a yield curve derived from the expected return of the assets held in the participating funds backing the insurance participating liabilities being measured.

The yield curve is not necessarily market consistent; instead it uses the same basis selected for accounting purposes for each of the asset classes that form the participating fund. The yield curve determined with reference to these assets' accounting values is then adjusted with the deduction of a credit spread (in a "risk neutral" environment) and the addition of a liquidity premium to arrive at the ALR curve.

The presentation explained that the ALR method would give full account of the cash flows on options and guarantees and use a forward market consistent risk free rate to discount cash flows in excess of the asset durations.

Deloitte position
In our comment letter we acknowledge that the ED "has recognised that when the amount, timing or uncertainty of the cash flows of insurance liabilities contractually depend on the performance of matching assets (i.e., cash flows from participating insurance contracts), the insurance liabilities should be measured taking into account this link. We support this principle."

In addition, within our detailed recommendations on the selection of discount rates for insurance contracts we observe that the IASB Staff issued a paper on discount rates on 8 November 2010. In the example illustrated in that paper, the Staff highlights the fact that within a single insurance contract there may be three different types of expected cash flows to discount, each with their own appropriate methodology:

1) cash flows that do not vary with the assets backing them (referred to as "fixed cash flows" in the Staff paper) which can be discounted using a single yield curve;

2) cash flows that vary with asset performance, which can be measured as a function of the assets; and

3) options and guarantees, which should be measured using option pricing techniques.

We agreed with this analysis as the basis to develop guidance in the final IFRS. A balanced and detailed guidance for both participating and non-participating contracts is a necessary step to produce a high quality IFRS.

Project axioms and assumptions (17 February)

The Staff published a paper on the axioms and assumptions underlying the insurance project for the Boards consideration in late January. This paper defined axioms to be those "propositions that we consider to be self-evident, to be taken as a starting point for further decisions" and the assumptions as those "decisions that the Boards took in developing the ED which we do not think will need detailed reconsideration by the Boards."

The Boards approved both axioms and assumptions with the addition of an assumption on IFRS 9 remaining the only IFRS where guidance on the accounting for financial assets will be found irrespective of whether they are held to back insurance liabilities or for other investment purposes.

The approval of these axioms and assumptions was taken with the caveat that these axioms and assumptions would not lock the Boards into a specific approach and could be re-examined later should subsequent decisions necessitate such re-examination.

The axioms are[2]:

- An ideal measurement model would report all economic mismatches (including duration mismatches) that exist and would not cause any accounting mismatches.

- An ideal accounting model should reflect both the intrinsic value and time value of options and guarantees embedded in insurance contracts.

- Money has a time value and an entity more faithfully represents its position when it measures its liabilities in a way that includes the time value of money.

The assumptions are:

- The Boards will develop a standard for insurance contracts, rather than requiring current or proposed generic standards that might otherwise apply.

- The standard will deal with the accounting for insurance contracts from the perspective of the insurer, and not for the assets backing the contracts or for the entities that issue those contracts. For the IASB, the financial assets backing the contracts would be measured in accordance with IFRS 9.

- The Boards will develop a standard based on an accounting model that regards insurance contracts as creating a bundle of rights and obligations that work together to generate a package of cash inflows and outflows.

- In general, the final standard will measure insurance contracts at the portfolio level.

2 As reported in the IASB Update for the meeting held on 17 February 2011.

- The accounting model should be based on current estimates, rather than carrying forward estimates made at contract inception and inputs that are consistent with observable market data, where available.

- The cash flows incorporated in the measurement of the insurance liability are those that will arise as the insurer fulfils the insurance contract.

- The model will use the expected value of future cash flows rather than a single, most likely outcome.

- The measurement of the liability will not reflect changes in the insurer's own credit standing.

Deloitte position
We believe that the current starting position set out in the axioms and assumptions is in line with our recommendations expressed in our response letter to the ED and reflects a reasonable basis under which the insurance contracts project should proceed.

However we continue to hold the view that "it is important to ensure that the interaction of the ED's accounting model with IFRS 9 produces a meaningful reflection of the insurance business model."

In addition, we are also of the view that the IFRS 9 project could offer new opportunities that would help achieving this important goal. For example, the Board may wish to consider the development of a macro hedge accounting approach capable of reflecting an insurer's asset-liability management under the Board's proposed hedge accounting amendments to IFRS 9.

Developing the application guidance for cash flow projections (18 February)

The Boards addressed the estimation of future cash flows, the treatment of specific cash flow items such as general overheads, and the level of detailed guidance proposed in the ED. The Staff requested that the Boards:

- clarify the measurement objective of expected value to refer to the mathematical mean;

- clarify that implementation would require enough scenarios to be considered to satisfy the measurement objective rather than requiring all possible scenarios to be considered;

- confirm which costs could be included within the cash flow;

- confirm that indirect costs should be expensed; and

- eliminate "incremental" from the definitions.

The Boards agreed with the Staff that the measurement objective should be based on the mathematical mean of the expected future cash flows.

They commented that illustrative examples would be needed for general insurance contracts with either a very limited number of scenario's (e.g. total loss property contracts) or an extremely wide variety of outcomes (e.g. liability insurance, where an mathematical mean may be significantly different from the actual ultimate loss when it is known). These comments will be dealt with in the pre-ballot drafting of the final IFRS.

The Boards also agreed with the Staff to amend the ED requirement to estimate all possible scenarios and concluded that "sufficient" scenarios rather than all scenarios should be considered by the insurers when assessing the expected value.

The Boards concluded that only costs "directly related to contract activity" should be included within the liability cash flows thereby discarding the wider concept of attributable costs proposed by the Staff.

They agreed though with the Staff proposal to delete the "incremental" test at a portfolio level as it was deemed redundant.

Both Boards approved all other proposals as presented.

Deloitte position
As proposed in our comment letter, we agree with the Boards' decision to base the measurement objective on the mathematical mean of the expected future cash flows.

The decision to focus only on "sufficient" scenarios could require guidance or disclosure on what level of statistical certainty is necessary to achieve "sufficiency" of the probability weighted estimate.

Attempts to converge the Boards on an explicit risk adjustment approach (18 February, 2 and 15 March)

At the 18 February meeting the Staff presented a paper on a model based on either an explicit risk adjustment or one that utilises a composite margin. The Boards were not asked complete their redeliberations at this stage. Instead, the Staff proposed to divide this in two parts with the first being a decision as to whether an explicit risk adjustment would provide useful information to users of financial statements assuming that a reliable valuation technique could be identified.

The Staff proposed that the second part of the redeliberation on this important issue would consider the issue of reliability associated with risk adjustment valuation techniques. Several comment letters had raised the lack of reliability of risk adjustment estimation as an inherent weakness of this model.

The majority of the Boards commented that it was difficult to disagree with the Staff's view on risk adjustments as the question of relevance deliberately avoided the issues that had divided them in previous discussions on this subject. In summary the comments indicated that if it could be properly performed, the valuation of a risk adjustment will provide useful information to users but without assessing how practical its valuation can be it cannot be established as something better than the alternatives.

The effective use of a risk adjustment is a function of the quality of the unbiased estimate of the liability cash flows. Some Board members were not convinced that an unbiased estimate was always possible and estimation processes would inherently capture elements in the probabilities that would theoretically belong to the risk adjustment. In other words the mean of the probability weighted cash flows would already incorporate an allowance to give more weight to the negative outcomes than the positive ones.

The Boards decided that the Staff should arrange educational sessions on how risk margins are calculated in the market and the Boards will reconsider the issue at that point.

In preparation for the educational sessions on risk adjustment techniques the Staff presented a paper at the 2 March joint meeting focused on addressing concerns expressed by Board members about the potential for double-counting risks and other measurement items within the building blocks model. The Staff concluded that there is no significant risk of double-counting should the building blocks model be applied appropriately. The Boards approved the conclusions in the paper as a valid step in preparation for the educational sessions on risk adjustment techniques.

The first of these sessions was delivered at the 15 March joint meeting. The presentation came from Joachim Oechslin, Chief Risk Officer at Munich Re. We would characterise the presentation as one that supports the use of a model with risk adjustment liabilities for insurance contracts. Mr Oechslin explained the use of market-consistent valuation of insurance liabilities developed at Munich Re and the use that the company has made of these measures for a number of purposes including external market disclosure.

Mr. Oechslin explained the basis for Munich Re's calculation is a replicating portfolio that models the insurance liabilities cash flows. This calculation includes a risk margin that is determined using a cost of capital technique. The presentation highlighted that for this technique the key components that need to be defined for its consistent application are the level of confidence that the technique has to achieve (e.g. a 99.5 percentile confidence level); the time horizon over which the confidence level applies (e.g. the next twelve months) and the cost of capital rate.

A second educational session on the same subject is planned for 22 March with presentations from Mark Swallow of Swiss Re and from Tony Coleman of Lonergan, Edwards & Associates.

Deloitte position

In our response letter we stated "We support the ED's proposal to measure the underlying estimation uncertainty explicitly because it enables users to assess management's most current view of the different degree of volatility of outcomes from the future cash flows of insurance portfolios in force at the reporting date. We believe this approach is preferable to the composite margin because it updates the assessment of the residual uncertainty based on information obtained subsequent to initial recognition of insurance contract amounts.

The explicit measurement of the risk adjustment will be a key element of the ED's overall model; however, its application could be improved if the final IFRS clarifies the following areas:

1. We have found the principle surrounding the measurement of the risk adjustment set out in paragraph 35 of the ED confusing and thus potentially leading to diversity in practice. We believe that the ED should define the risk adjustment as "the amount the insurer would rationally pay to eliminate the uncertainty in the amount and timing of the ultimate fulfilment cash flows".

2. The definition of a portfolio is not supported by any application guidance. This may lead to diversity in practice. We recommend that guidance should be included in the final IFRS to explain how portfolios are defined vis-à-vis different legal structures. We believe that it would be more relevant for users if the definition of portfolio is independent of the insurer's legal structure.

Deloitte position (continued)
Guidance would need to be developed in the final IFRS to explain that the degree of diversification in a portfolio is established at the highest level at which a reporting entity is consolidated if enforceable intercompany agreements exist that would allow access to the portfolio diversification benefits. In addition we believe that our recommendation to designate the recalibration approach at a portfolio level would also contribute to the application of the definition and it should be included in the application guidance.

3. We believe the Board should specify in the final IFRS that when the insurer determines the risk adjustment the portfolio it considers would include the group of contracts as defined and the benefits from the purchased reinsurance contracts that reinsure those insurance contracts. The calculation of the risk adjustment before and after the benefit of the purchased reinsurance contracts will be used to measure the reinsurance asset."

Scope and definition of an insurance contract (1, 2 and 15 March)

Over the course of these three sessions the Boards appear to have reached a converged agreement on the scope of the new accounting standard and how an insurance contract will be defined in it.

Although not as controversial as the debates on discount rate and risk adjustment, these are fundamental decisions for the future implementation of the new IFRS as they set the parameters for the application of the measurement model. Any transactions that do not meet the definition or that are deliberately excluded from the scope of the new IFRS and US accounting pronouncement will have to be accounted for under a different IFRS.

The Staff identified respondents' concerns on the proposed scope and proposed a solution for all of these with the exception of those surrounding the decision to include in the scope virtually all participating contracts even if they do not meet the definition of an insurance contract.

The Staff first proposed to narrow the scope exclusion for fixed-fee service contracts such that it applies only to those contracts that have the primary purpose of the provision of services and that would qualify for the modified approach for short-duration contracts. This would resolve the constituent concern that the wording of the scope exclusion for fixed fee service contracts would result in contracts that are clearly not insurance related (e.g. fixed-fee contracts for the provision of legal services) being included within the scope of the new IFRS.

A number of Boards' members raised concerns that the Staff proposal would require many non-insurers having to assess their contracts against the insurance contracts definition and to determine whether these contracts (including those clearly not intended to provide insurance services) would fall within the scope of the modified approach. The Boards considered that these procedures were unduly onerous on non-insurers applying the exemption to their contracts.

After an extensive debate the majority of the Boards agreed that the scope exclusion was required, and that it would not be unduly onerous to apply. The Boards tentatively directed the Staff to base the scope exclusion on contracts primarily aimed at the provision of non-insurance services and to delete the reference to the modified approach. The Boards considered that the problems experienced here may result from the definition of insurance contracts not being tight enough and instructed the Staff to review this issue when the definition was discussed later.

The Staff secondly asked the Boards to comment on the scope exclusions that were not being tabled for discussion, now or at future meetings. These exclusions were:

- product warranties issued by a manufacturer, dealer or retailer;
- employers' assets and liabilities under employee benefit plans and retirement benefit obligations reported by defined benefit retirement plans;
- contractual rights or contractual obligations that are contingent on the future use of, or right to use, a nonfinancial item;
- residual value guarantees provided by a manufacturer, dealer or retailer, as well as a lessee's residual value guarantee embedded in a finance lease;
- contingent consideration payable or receivable in a business combination; and
- direct insurance contracts that the entity holds (i.e. direct insurance contracts in which the entity is the policyholder).

Subject to a later discussion on the definition of an insurance contract, the Boards unanimously approved that the above exclusions should remain as proposed in the ED.

The Staff returned with a third issue on scope at the meeting on 2 March where they recommended that the new IFRS maintains the scope regime that currently exists within the IFRS today, that is to scope financial guarantee contracts out of the insurance standard and account for them as financial instruments unless the issuer has previously asserted that it regards them as insurance contracts in which case it may designate them to be accounted for as insurance contracts.

The IAS 39 regime measures financial guarantee contracts at fair value on day one with a systematic and rational release to profit of the liability in the subsequent periods subject to a test for incurred and expected credit losses performed under IAS 37.

The Staff further recommended that the future IFRS makes it clear that it does not provide an exception from these requirements for intercompany guarantees accounted for in a set of standalone financial statements.

The IASB fully supported the Staff recommendations.

Despite the Staff proposal to retain the complex and diverse accounting treatment that financial guarantee contracts receive currently under US GAAP the FASB members took the opportunity of the debate with IASB to agree that it would be preferable for the Boards to work together to resolve the issue of accounting for these contracts that cut across the scope of insurance contracts and financial instruments accounting standards. They also recommended that this is a project that should be separate from the current insurance contract project. FASB thus proposed to IASB that the insurance contracts project should be completed as planned and when the Boards' impairment project is also completed a joint convergence project on the treatment of financial guarantee contracts should start.

The Boards approved this proposal and FASB also approved the adoption of the current IFRS scope in the US draft accounting standard they will be publishing in June so that both US GAAP and IFRS will treat financial guarantee contracts in the same way when the new dedicated convergence project is completed.

The series of debates on scope was completed at the joint meeting on 15 March when the Staff presented their proposals on the definition of an insurance contract.

The ED proposes to retain the IFRS 4 approach where a contract is not an insurance contract if it does not transfer significant insurance risk.

For the future IFRS the Staff presented two alternative proposals:

a) to reaffirm the additional conditions included in the ED but not in the current text of IFRS 4 (consideration of time value of money in determining cash flows and the significance of additional benefits payable in certain scenarios and whether there is a possibility of loss by the insurer) to assess whether there is a significant transfer of insurance risk; and

b) to withdraw those additional conditions in assessing whether there is a significant transfer of insurance risk.

The Boards decided tentatively to confirm the following additional conditions not in IFRS 4 as proposed in the ED that:

a) in determining whether it will pay significant additional benefits in a particular scenario, the insurer takes into effect of the time value of money; and

b) a contract does not transfer significant insurance risk if there is no scenario that has commercial substance in which the present value of the net cash outflows paid by the insure can exceed the present value of the premiums.

However, the Boards requested that the final IFRS includes additional guidance to address the situations where a reinsurer accepts substantially all the insurance risk inherent in the underlying ceded policies (e.g. risk transferred under a quota share reinsurance treaty) but there may be only very limited likelihood that the reinsurer may suffer a loss as defined in IFRS 4 on that reinsured portfolio of business. The additional guidance will explain that although unlikely this scenario is one with commercial substance.

FASB members voted unanimously for this decision with a large majority of IASB members also voting for this decision.

Deloitte position

In our comment letter we did not agree with the proposed amendment to the scope exclusions leaving out fixed fee service contracts. This scope exclusion is not well defined and it could result in less relevant information than if these contracts were in the scope of the final IFRS. The Boards' decision may address this in the final text of the new IFRS.

On the issue of financial guarantee contracts Deloitte recommended providing an entity with the accounting policy choice to account for financial guarantee contracts in accordance with IFRS 9 if the entity's business model treats these contracts as financial instruments, rather than as insurance. This approach would retain the existing scoping requirements, which have worked well in practice. This is the approach the Boards have now tentatively decided to take.

We agreed in our comment letter with the definition of an insurance contract and the related guidance, because we consider the changes in the ED to be of an explanatory nature, clarifying further the classification principles that already exist in IFRS 4. To our knowledge, the application of IFRS 4 has been consistent with these two additional clarifications, which the Boards have now tentatively decided to include in the final IFRS, and therefore we do not expect a change in the way contracts are currently classified in jurisdictions where IFRS 4 is applied.

Learning about the complexities of unbundling (16 February – Educational session)

Due to the serious concerns raised about the proposed unbundling model, the Staff arranged an educational session for the two Boards focusing on the effects, costs and benefits arising from separating out the insurance and non-insurance components of a contract. In addition to the Staff briefing, external presenters from PwC (Sam Gutterman and Gail Tucker) and MetLife (Leonard Reback) also gave presentations to the two Boards focusing on the practical implications of unbundling as proposed in the ED/DP.

The main concerns about the proposed unbundling model include:

- The time and costs involved in unbundling had the potential to be significant. One presenter noted that, if the unbundling requirements were clear and well constructed, it may be possible to include unbundling within the development of the new systems that will be required for IFRS 4 Phase II such that the marginal cost of unbundling may be small.

- Due to the application of judgement in allocating costs and charges between different components (particularly given the potential for engineering arising from the different treatment of those costs within each component), and in allocating cash flows and fees between insurance and non-insurance elements, it was likely that unbundling would not result in consistent treatment or decision-useful information.

- The profit profile of the contract would depend on the amortisation of the residual margin and may not be significantly different between an unbundled contract and a non-unbundled contract. Conversely, economically similar contracts may be measured differently, should one contract be unbundled and the other not.

Neither of the two presenters identified significant benefits from performing unbundling as proposed in the ED/DP, but possibly minor benefits include:

- Treating the financial instrument portion of an insurance contract consistently with standalone financial instruments.

- The possible reduction (but not elimination) of certain accounting mismatches associated with deposit elements and embedded derivatives. In both cases, however, other measures were also identified that could result in similar reductions.

The Boards were not asked to make decisions at the meeting, and no decisions were taken. However, some Board members raised the possibility that disclosing 'source of earnings' may well provide the same information that unbundling would present, and may be easier to prepare consistently. In response, some Board members noted that unbundling does provide clarity on the costs and earnings in the period and, properly done, often limits the variability of reporting. They admitted, however, that the clarity on costs and limited variability was dependent on the Boards being able to provide a clear, relevant and understandable accounting standard with commonly understood guidance. Based on the feedback from the ED/DP, it is clear however that the Boards have not yet achieved this clarity and understandability.

Deloitte position

We remain convinced that unbundling should provide decision-useful information without being unduly onerous on preparers of financial information, and we do not yet believe that the Boards have achieved this outcome. We believe that the Boards should modify the proposed unbundling model to require unbundling from an insurance contract only those components that (i) are not interdependent with the insurance contract; and (ii) have been combined with the insurance contract for reasons that do not have commercial substance.

This will have the effect of applying unbundling accounting to only those components that are clearly outside the scope of the insurance standard and will result in the presentation of more meaningful information. It will also likely result in unbundling being required for a significantly smaller proportion of insurance contracts than under the present proposals.

Other tentative decisions and educational sessions

Confirmed the prohibition of day-one gains and the requirement to account for day-one losses (18 February meeting)

The Boards re-examined the decisions on the recognition of day-one gains and losses. As expected, there was no support for the recognition of day-one gains and general agreement with the recognition of day-one losses. The Boards also considered whether margins could become negative rather than recognise immediate losses that may not occur, but overall the Boards did not support this.

In response to the concerns that immediate losses could be recognised while profit was being deferred with the margins, a few Board members suggested the possibility that the residual margin could become negative, but only where the sum of the risk adjustment and the negative residual margin remained a net liability. There did not appear to be any significant support for this proposal though, and no further discussion took place.

Amended timing of initial recognition of an insurance contract aligns to industry practice (15 March meeting)

The Staff presented two alternative proposals:

- to reaffirm the principles in the ED and emphasise that insurers need not recognise insurance contracts before the start of coverage where the effect on the financial statements would not be material; and

- that insurance contract assets and liabilities should initially be recognised when the coverage period begins, but to require the recognition of an onerous contract portfolio liability in the pre-coverage period if management becomes aware of an event that would cause a portfolio of contracts to become onerous in the pre-coverage period.

Both Staff alternatives would require recognition of a liability for a contract portfolio that becomes onerous after an insurer becomes a party to the contracts but before the start of coverage. Some members in both Boards were not comfortable with the proposed emphasis on materiality in the first alternative and the complex processes that would be required for many insurers to monitor contracts prior to the start of the coverage period. One Board member questioned whether the alternative view would affect the contract boundary principle set out in the ED. The general view was that the contract boundary principle would not be affected. This point is expected to be considered further by the Staff.

The Boards decided tentatively that insurance contract assets and liabilities should initially be recognised when the coverage period begins, but to require the recognition of an onerous contract portfolio liability in the pre-coverage period if management becomes aware of an event that would cause a portfolio of contracts to become onerous in the pre-coverage period.

FASB members voted unanimously for this decision with a large majority of IASB members reaching the same decision.

Exploring the release of profit margins (18 February and 14 March – educational sessions)

The Staff presented two educational sessions to the Boards focused on the implications of unlocking and remeasuring the residual margin (18 February) and composite margin (14 March). This session focused on examples prepared by the Staff of how various scenarios would play out under different unlocking and measurement assumptions (e.g. only losses taken into account, or only adjust for changes in discount rate). Based on this discussion, the Boards felt that they had a better understanding of the complexities involved, and directed the Staff to prepare a discussion paper using floating margins (i.e. both favourable and unfavourable changes in non-financial assumptions will be reflected in the margin) with only changes in non-financial assumptions affecting the measurement of the margin.

The most interesting factor is the potential use of a floating margin. This is likely to impact long-term portfolios more than short-term ones, and make the measurement of an insurance contract more variable, with short-term fluctuations being reflected in the results rather than the longer view that is expected to appear as the contract is fulfilled.

At the Staff-led educational session on 14 March, focusing on the accounting approach for the composite margin release to profit, the Boards were reminded of the negative feedback received in the comment letters on the ED proposals to use a formula driven approach to release to profit this liability. The Staff illustrated alternative methods including those that would require a risk based release. This approach could be analogous to the risk adjustment/residual margin approach favoured by the majority of IASB members in the Exposure Draft.

Alternative presentation models (18 February and 14 March – educational sessions)

Over two sessions the Staff walked the Boards through a number of examples of statements of comprehensive income all aimed at reconciling the summarised margin approach proposed in the ED with the key comment received from the comment letters that users of financial statements need prominent volume information.

The Boards invited the Staff to continue their work and to validate the various alternative models with the representatives of the insurance stakeholder groups at the Insurance Working Group meeting on 24 March.

Field testing results (2 March meeting – informational session)

The Staff presented a paper on the objectives of the field testing performed last year and noted that they were busy preparing summaries and analysis of the results for the Board. The Staff requested that the Boards identify any additional questions or issues the Staff should consider when preparing the report for the Boards. The Staff further indicated that none of the results so far indicate a need for the Boards to reconsider decisions taken to date.

A FASB member requested that the Staff prepare a report showing all the issues identified and where these issues were discussed and resolved by the Boards. The Boards also requested that the Staff obtain information about the extent to which non-GAAP disclosures were likely to be used pre- and post-implementation in order to identify areas in which the standard may not be addressing the needs of preparers and users. The Staff agreed to perform these tasks, but noted that their work would be conducted within the limitations of the confidentiality agreements of the field tests.

Next steps

The Boards are in session again on 21-22 March and will meet the Insurance Working Group on 24 March to discuss their progress to date with the representatives of users and preparers.

Deloitte Insurance contacts

Global insurance network

Joe Guastella
Global Insurance Leader
U.S.
+1 212 618 4287
jguastella@deloitte.com

Francesco Nagari
Global IFRS Insurance Leader
U.K.
+44 20 7303 8375
fnagari@deloitte.co.uk

Asia Pacific

Kumiko Aso
Japan
+81 90 3910 2898
kumiko.aso@tohmatsu.co.jp

Simon Walpole
Hong Kong
+852 2238 7229
siwalpole@deloitte.com.hk

EMEA

Fabien Sauvage
France
+33 1 55 61 41 63
fsauvage@deloitte.com

Mark FitzPatrick
U.K.
+44 20 7303 5167
mfitzpatrick@deloitte.co.uk

Mark Ward
Switzerland
+41 44 421 62 72
maward@deloitte.ch

Peter Wright
Czech Republic
+420 246 042 888
pewright@deloitte.com

Latin America

Gustavo Bohórquez
Mexico
+52 55 50806201
gbohorquez@deloittemex.com

Carlos Srulevich
Argentina
+54 11 43202734
csrulevich@deloitte.com

North America

Rebecca Amoroso
U.S.
+1 973 602 5385
ramoroso@deloitte.com

Aniko Smith
U.S.
+1 213 688 4110
anikosmith@deloitte.com

Neil Harrison
Canada
+1 416 601 6307
nharrison@deloitte.ca

John Johnston
Bermuda
+441 292 1500
jojohnston@deloitte.com

Deloitte refers to one or more of Deloitte Touche Tohmatsu Limited, a UK private company limited by guarantee, and its network of member firms, each of which is a legally separate and independent entity. Please see www.deloitte.com/about for a detailed description of the legal structure of Deloitte Touche Tohmatsu Limited and its member firms.

"Deloitte" is the brand under which tens of thousands of dedicated professionals in independent firms throughout the world collaborate to provide audit, consulting, financial advisory, risk management, and tax services to selected clients. These firms are members of Deloitte Touche Tohmatsu Limited (DTTL), a UK private company limited by guarantee. Each member firm provides services in a particular geographic area and is subject to the laws and professional regulations of the particular country or countries in which it operates. DTTL does not itself provide services to clients. DTTL and each DTTL member firm are separate and distinct legal entities, which cannot obligate each other. DTTL and each DTTL member firm are liable only for their own acts or omissions and not those of each other. Each DTTL member firm is structured differently in accordance with national laws, regulations, customary practice, and other factors, and may secure the provision of professional services in its territory through subsidiaries, affiliates, and/or other entities.

This publication contains general information only, and none of Deloitte Touche Tohmatsu Limited, its member firms, or its and their affiliates are, by means of this publication, rendering accounting, business, financial, investment, legal, tax, or other professional advice or services. This publication is not a substitute for such professional advice or services, nor should it be used as a basis for any decision or action that may affect your finances or your business. Before making any decision or taking any action that may affect your finances or your business, you should consult a qualified professional adviser.

None of Deloitte Touche Tohmatsu Limited, its member firms, or its and their respective affiliates shall be responsible for any loss whatsoever sustained by any person who relies on this publication.

© 2011 Deloitte Touche Tohmatsu Limited

Designed and produced by The Creative Studio at Deloitte, London.10323A