

Insurance Accounting Newsletter

Project timetable extended by a few additional months



Introduction

The International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) continued with their joint meetings at a reduced pace in April after the very intense sessions of February and March. The plan to continue with the same intensity of the last few months seems to be less certain though. In a podcast released on Thursday 14 April the chairmen of IASB and FASB commented on the convergence timetable of their priority projects (insurance contracts, financial instruments, leases and revenue from customers' contracts) and announced that:

"After evaluating the issues yet to be addressed we jointly concluded that, without extending the work out indefinitely, we all could benefit from a few more months to develop these standards, some of which really go to the core issues of many companies."

The next joint meeting of the two Boards is scheduled for 16-20 May, although meetings on insurance have been scheduled for 27 April, 4 May, and 11-12 May. At this point, the Boards are expected to discuss possible presentation solutions to the accounting volatility issue on 27 April; for the other meetings there is not yet a clear indication of what will be on the agenda.

The possibility of the insurance project being extended to allow its quality to "to withstand the test of time", to use Leslie Seidman's words from her joint podcast with Sir David Tweedie noted above, suggests that until a new detailed IASB and FASB work plan is released there is no short term certainty on the completion date of this project other than it will be some time in 2011.

However, as we look back at the last few weeks, the Boards have successfully built consensus on the shape of the final insurance standard with the only exceptions of the accounting for distribution costs where they have reached different conclusions and unbundling of non-derivative components where no final position exists yet.

This Insurance Accounting Newsletter covers the joint IASB and FASB meetings held on 21-22 March, 29 March and 12 April, the Insurance Working Group meeting on 24 March and two FASB only meetings on held on 7 and 15 April. Topics discussed at the Boards meetings include discounting ultra-long contracts, explicit risk adjustments, contract boundaries, bifurcation, top-down discount rates and unlocking the residual/composite margins. Unbundling continues to be extremely contentious, even within individual Boards.

The Boards eventually deferred their final decisions on unbundling to a later date once more decisions had been finalised and the shape of the final standard is clearer.

In this newsletter, we offer our views on the key issues emerged from the debates held at these meetings without necessarily following the chronology of the individual meetings. The newsletter focuses instead on the decisions and issues that in our opinion have a more significant impact on the development of the final IFRS and on its implementation within insurance businesses.

Deloitte publishes in its IFRS website IASPlus (www.iasplus.com) a report on the outcome of each insurance session immediately after every IASB meeting.

Agreement on risk adjustment liabilities in the event the final accounting model includes them (21 March)

Based on our observation of Boards' activity the most important decision from the meetings covered in this newsletter is the Boards agreement on how risk adjustment liabilities should be determined and their role in the accounting model. This decision does not pre-empt the choice of the final version of the building block model that will only be selected in the next few weeks.

To achieve this important step the Staff excluded from the discussion a number of topics because they depended on the decision eventually reached at this meeting or they had already been tentatively decided upon. These were:

- the practical implementation of an explicit risk adjustment liability requirement (covered in various educational sessions throughout March);
- the tentative decision already reached that a risk adjustment liability is compatible with the fulfilment measurement attribute;
- whether a risk adjustment liability will provide comparable and verifiable information, which passes a cost-benefit analysis test and which can be implemented in practice (to be discussed at a future meeting);
- how a risk adjustment could be included within a single margin approach (to be discussed at a future meeting when the choice between the composite margin and the risk adjustment plus residual margin models will be made); and
- whether the risk adjustment should be determined at the portfolio level or some higher level to incorporate diversification benefits in line with the underlying business model adopted by the insurer (to be discussed at a future meeting).

The Staff recommended that the Boards amend the objective of the risk adjustment to focus on measuring the liability at the point at which an insurer becomes indifferent between retaining and transferring the liability. As such, the objective would no longer refer to "a maximum amount", "the amount the insurer would rationally pay to be relieved of the risk" or "the risk that the actual cash flows would exceed those expected". Based on this, the Staff recommended that the objective of the risk adjustment should be:

The risk adjustment shall be the amount that makes the insurer indifferent between:

- a) undertaking or retaining the obligation to fulfil the insurance contract; and
- b) undertaking or retaining an obligation to pay an amount equal to the expected present value of the cash flows that will arise as the insurer fulfils the liability.

Overall, there was no significant support amongst the members of the two Boards for the Staff proposal on the grounds that this appeared to be a return to the previously discarded 'exit value' model. The ensuing debate produced a consensus that the objective of the risk adjustment should be defined as follows:

The risk adjustment is the compensation the insurer would require for bearing the risk of the uncertainty that the cash flows will exceed those expected.

The Boards also concluded that, while the primary concern is that actual cash flows exceed the expected cash flows, when quantifying the risk adjustment, insurers should also take into account scenarios where cash flows are less than expected. Given the significant number of divergent opinions aired during the discussions, the Boards instructed the Staff to draft specific application guidance on this issue.

In addition to the above points, the application guidance should also explain that the measure of the risk adjustment liability should increase the expected cash flows amount to make an insurer indifferent between this liability (inclusive of its risk adjustment) and another liability of the same total amount where there is no uncertainty.

Deloitte position

The new objective of the risk adjustment seems to clearly set out the Boards intentions, without crossing over to an exit value model.

This approach should resolve the concerns that two contracts with different risk patterns would have the same accounting measurement simply because their mean values are the same.

The revised wording outlines the boundaries of the proposed risk adjustment, limiting it only to the risks of variability. Given the level of complexity involved, and the potential for divergences in practice, we strongly support the Boards intention to develop application guidance on this topic.

Contract boundary definition amended (22 March)

The comment letters highlighted a significant support for the contract boundary definition set out in the Exposure Draft (ED). However reservations remained that it would not reflect the economics of certain insurance contracts where regulations impose a particular form of risk assessment that aggregates individual risks of a group of policyholders to determine the average premium increase that all of those policyholders would have to pay on the legal renewal date of their policies.

The Staff attempted to resolve these reservations proposing an amendment of the contract boundary definition. This proposal was based on a classification of insurance contracts between those that are priced to include future risks (i.e. long-duration contracts with premiums guaranteed beyond the renewal or cancellation dates) and those that do not.

At this stage the debate deliberately excluded the application of the contract boundary in relation to purchased reinsurance (to be considered at a later meeting) and the impacts on the modified approach that an amendment to the boundary definition would cause (to be considered later as part of the modified approach discussions).

These are related concepts for the frequent practice of issuers of short term contracts (usually accounted for under the modified approach) to purchase reinsurance contracts that operate on an open portfolio basis and that would cover all reinsured contracts issued within the period of cover negotiated with the reinsurer. This issue, known as non overlapping periods, would suggest that the cedant has a substantive right that goes beyond the protection of existing reinsured risks.

This issue was noted in the Deloitte comment letter where in our response to question 9 we observed that “the guidance should specify that, when a reinsurance agreement is purchased by the cedant for contracts yet to be issued (e.g., agreement covers contracts issued in next 12 months), the initial reinsurance asset is to be represented entirely by the reinsurance residual margin asset until a contract that falls under the reinsurance agreement is sold and the basis to measure the reinsurance contract using the principles in paragraph 43 of the ED can be used.”

The Staff proposals received significant support for their analysis and recommendations on the improvement of the contract boundary definition.

The Boards took the opportunity of the extensive debate to validate their understanding of what exactly constitutes a transfer of insurance risk because they believed it would be one and the same as the economic characteristics of the contract that the boundary definition attempts to capture. In that respect they discussed how the insurance risk transferred is priced and the compatibility of the contract-based boundary tests with their decision to develop the accounting model for insurance contract utilising the portfolio as the unit of measurement.

The assessment of the Staff recommendations from all these angles confirmed the Boards in their decision to accept the introduction of a refined boundary definition that assesses the substantive nature of the renewal/cancellation right tested and sets a boundary when a portfolio-based pricing of renewal premiums is, in substance, the result of an aggregation of individual assessments.

The Boards’ tentative decisions as published in their official record state that:

- “A contract renewal should be treated as a new contract when the existing contract no longer provides coverage or does not confer any substantive rights on the policyholder. This decision was supported unanimously.
- Substantive rights are not conferred on a policyholder where the insurer has the right or practical ability to reassess the risk of the particular policyholder and can set a price that fully reflects the risk. In addition, where the pricing does not include risks related to future periods, substantive rights are not conferred on a policyholder where the insurer has the right or practical ability to reassess the risk at the portfolio level and set a price that reflects the risk in the portfolio. This decision was supported unanimously by FASB and by a majority of the IASB. Five members of the IASB continue to prefer assessment of the contract boundary at the individual policyholder level.

- All renewal rights arising from contract, law or regulation, shall be considered in determining the contract boundary. This decision was supported unanimously.”¹

Deloitte position

In our comment letter we recommended “that the Board amends the definition of contract boundary in paragraph 27(b) to replace the reference to “the particular policyholder” with “the particular class of insurance contracts”. This change would allow underwriting actions carried out for a specified group of policyholders for a single risk known as “community ratings” to be included in the contractual clauses that create a contract boundary. We believe that in these circumstances it is appropriate that the future premiums and associated benefits are excluded from the expected value if they arise subsequent to the date on which the insurer has the practical ability to introduce a new risk rating for the specified group of policyholders.”

Deloitte also recommended the inclusion of terms and conditions imposed by statute and regulation as if they were part of the contract.

Both of these recommendations have been included in these tentative decisions within a conceptual basis that we believe would require substantial judgment. First of all the new IFRS would require the identification of “substantive rights”. Second of all, insurers would need to test that the pricing factors used for “community rating” are focused on the update of the period under the cover and do not extend beyond the renewal period. In all other cases the insurer’s ability to carry out an individual policyholder risk reassessment will determine the boundary of the contract.

Clarification of the top down approach to discount rate selection for non-participating contracts (12 April)

The tentative decision to open the future IFRS to a top down discount selection approach has been welcomed by several commentators. The approach required further discussion and refinement following the input received.

The Boards took the opportunity of their meeting on 12 April to clarify in more detail their tentative decision on 17 February to permit both top-down and bottom-up approaches to determining the discount rate, with a focus on non-participating contracts. This issue was also discussed at the Insurance Working Group (IWG) meeting on 24 March and some of the concerns raised at the IWG meeting were discussed at this joint Boards meeting.

The Boards’ members asked a number of questions largely focused on clarifying their understanding of the issues involved. A member suggested the use of a practical expedient for the discount rate selection process when the issuer of an insurance contract is an entity other than a regular insurance company. This call for simplification, which had already been discarded in previous meetings, continued to receive support only from a small minority.

We noted that the Staff clarified that the top-down discount rate is not an asset-based discount rate (in the same way that a bottom-up rate is not a risk-free discount rate). It continues to incorporate the basic features of the ED which require the discount rate to reflect the characteristics of the liability’s cash flows.

Overall the Boards’ members supported the Staff analysis and the conclusions they had reached without dissension. The Staff should now finalise the analysis and prepare final wording for the standard on the valuation of discount rates for non participating insurance contracts. In the meantime we report the Staff text drafted for inclusion in the Boards official records of decisions:

- a. “An insurer shall determine an appropriate yield curve based on current market information. The insurer may base its determination of the yield curve for the insurance contract liability on a yield curve that reflects current market returns for the actual portfolio of assets the insurer holds or for a reference portfolio of assets with characteristics similar to those of the insurance contract liability.
- b. If there are no observable market prices for some points on that yield curve, the insurer shall use an estimate that is consistent with the boards’ guidance on fair value measurement, in particular for Level 3 fair value measurement.
- c. The cash flows of the instruments shall be adjusted so that they reflect the characteristics of the cash flows of the insurance contract liability. In adjusting the cash flows, the insurer shall make both of the following adjustments:
 - i. Type I, which adjust for differences between the timing of the cash flows to ensure that the assets in the portfolio (actual or reference) selected as a starting point are matched with the duration of the liability cash flows.
 - ii. Type II, which adjust for risks inherent in the assets that are not inherent in the liability. In the absence of an observable market risk premium for risks inherent in the asset but not inherent in the liability, the entity uses an appropriate technique to determine that market risk premium, consistent with (b).

d. an insurer using a 'top-down' approach need not make adjustments for remaining differences between the liquidity inherent in the liability cash flows and the liquidity inherent in the asset cash flows.”²

The Boards can now approach the remaining issues associated with discounting: the development of the selection approach for participating contracts and the assessment of the need for discounting when accounting for short duration claims liabilities.

Deloitte position

We strongly supported the use of a top-down discount rate approach, especially given the difficulties inherent in measuring the illiquidity adjustment required to perform a bottom-up approach.

In our comment letter we recommended to include in the final IFRS a similar definition of the adjustment to remove the credit risk for the reference asset portfolio's expected loss of default as developed for IFRS 9. This would also provide a consistent basis between the recognition of credit risk in the accounting for the assets backing the insurance contracts and the discount rate used on the liabilities.

The detailed explanations that the Staff included in their paper (guidance on Type II adjustments) appear to support an entity specific approach to the estimate of expected defaults increased for an allowance that factors the inherent uncertainty of the estimate whenever there is no observable market price for such credit risk.

The Boards' position on unbundling requirements remains unclear other than for their intention to include them in the final accounting model (21 March)

The Staff presented a paper on unbundling for the consideration of the two Boards. The paper was largely a discussion paper, and was intended to provide guidance to the Staff for the development of future decision-making papers. As such, the Boards were not asked to make decisions in this paper.

In the paper, the Staff focused on the background to unbundling, the objectives of unbundling, what components of a contract should be unbundled and how to progress the unbundling discussions.

Based on our observation of the debate, the Boards appeared almost unanimously in support of unbundling. With the exception of their stated intention though, almost everything else remains unclear even within individual Boards.

The key concerns we noted from the debate include:

- the Boards inability to agree on an approach to decide whether or not decision-usefulness of unbundled financial information could be determined objectively. In other words to decide whether the unbundled components would be measured and recognised in a significantly different way if they were not part of the insurance contract;
- the potential for accounting arbitrage if components bundled in an insurance contract are measured differently;
- the degree of judgement that alternative unbundling regimes would demand and their relative impact on comparability of financial statements; and
- the impact that unbundling would have on faithfully reporting economic mismatches and whether unbundling would create or mitigate known accounting mismatches.

Deloitte position

We remain convinced that there is a way to define an unbundling regime that provides decision-useful information without being onerous on preparers of financial statements.

We believe that the Boards should require unbundling from an insurance contract only for 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.

Preparatory work on the approach to unlock profit margins (29 March)

Unlocking of profit margins is one of the most material items of the new accounting model that has attracted significant attention since the re-deliberation process started last December. The future profit patterns of insurance businesses and the issue of accounting volatility are dependent on the final decisions the Boards will take in this area.

For these reasons is understandable the Boards are keen to take as an informed decision as possible and a new educational paper was presented on 29 March which was also presented at the IWG meeting on 24 March 2011.

The ED recommended reducing the residual and composite margins in a systematic and rational basis. For the composite margin a formula based reduction was proposed.

Although this was not an official vote, the IASB members expressed a tentative support (10:4) for unlocking and noted that if unlocking is to be applied, it should reflect future changes in assumptions about non-financial inputs, adjust the margin prospectively and “float” it. The concept of “floating” means that the residual/composite margin liability changes for both favourable and unfavourable movements in the prospective measurement of the underlying expected cash flows.

FASB members were unwilling to display their current views on the matter and reserved their vote for the formal decision making session on this topic.

We noted that both Boards agreed to have further discussion on the principles to determine which changes should be reflected in profit and loss or utilised to produce the “floating” adjustments to the margin brought forward. The guidance on the future debate included their need to define the conceptual basis for the “floating” adjustment and the analysis to ensure that the final set of requirements is of tolerable complexity and offers a practicable implementation in most cases.

Several members of the IASB observed that the final decision on “floating” the residual margin should take into account all other related decisions addressing accounting volatility such as the use of other comprehensive income.

FASB members raised concerns about the conceptual relevance of smoothing and profit deferral that this proposal could introduce into the new accounting model.

Deloitte position

We believe that the “floating” of the residual profit margin properly represents the economics of assembling and managing open portfolios of insurance contracts. The pre-funded nature of the insurance economic cycle with the inflows regularly received in advance of most contractual cash outflows creates a conceptual justification for the utilisation of the excess over the initial current fulfilment value against its remeasurement at each reporting date.

Prospective changes in the actively measured building blocks should be used to drive the release of the margin after applying a systematic release to profit.

In addition, should a portfolio become onerous, the remaining margin ought to be released to income to the extent required.

We believe that this would reduce accounting volatility in the income statement while preserving those elements of economic volatility that should be part of the reported results for the period.

A positive Insurance Working Group meeting (24 March)

The IWG, established by the IASB to help it analyse accounting issues arising within the insurance industry, held a meeting on 24 March.

Key topics at the meeting included the progress of the joint project on insurance contracts, discussions on the discount rate decisions to date, the presentation of information and the issue of accounting profit volatility, the presentation of volume information and unlocking the residual margin.

The decision to allow a top-down approach to determining a discount rate was welcomed by many of the industry representatives at the IWG, indicating that their own companies may well follow this approach. As we reported above the Boards reached a good level of agreement in their subsequent meeting on 12 April which appears to have satisfied their need to embed in the final IFRS a conceptual reconciliation between the top down and the bottom up rates.

At the IWG meeting representatives from the insurance industry and some investors recommended that the final IFRS permits the inclusion of all asset types within the reference asset portfolio to avoid any unintended asset allocation bias driven by accounting advantages.

There was a positive response to the proposal to expand the summarised margin to include volume information. The debate also highlighted a strong appetite for the IASB to reconsider the use of Other Comprehensive Income (OCI) to mitigate accounting volatility.

Finally, we noted there was a positive reception given to the idea to allow some flexibility in determining the sub-totals to separate the market driven short term fluctuations from the rest of the income and expense items. The cautious reaction to this proposal from the IASB and its Staff was merely to acknowledge the possibility that short-term volatility be reflected through a separate line item in presentation.

As noted above the IWG reception to the idea of a 'floating margin' was positive.

We have been informed that the IASB is expected to call another IWG meeting on 16 May and a third meeting in June. These plans could change following the joint chairs announcement explained above.

Other tentative decisions and educational sessions

Explicit risk adjustment educational sessions (22 March)

The Boards invited a number of speakers to present educational sessions to the Boards on the topic of the explicit risk adjustment. The purpose of these sessions was to provide the Boards with an indication of how an explicit risk adjustment could be calculated in practice and the issues involved therein. As these sessions were educational in nature, the Boards were not requested to make any decisions.

Tony Coleman of Lonergan, Edwards and Associates gave a presentation to the Boards focused on the key features of the Australian accounting models, standards and practices. Overall, the session supported the use of a risk adjustment as providing useful information to market participants without being unduly onerous for preparers.

Mark Swallow and Leopoldo Camara from Swiss Re gave a presentation to the Boards focused on their management accounting framework, known as Economic Value Management. The model focuses on using the cost of capital to calculate risk adjustment liabilities.

The key point raised by both presentations is that, regardless of the final model chosen by the Boards, the quality of the disclosures required would be the deciding factor on whether the model meets the needs of preparers, users and other stakeholders.

Discount rate for ultra-long duration contracts (21 March)

The Staff presented a paper to the Boards analysing the additional considerations necessary where the yield curve extends beyond the observable data. In order to deal with such contracts, the Staff recommended that changes in the discount rate for ultra-long duration cash flows should be reflected in OCI and should contain all changes in measurement attributable to non-observable portions of the yield curve.

The Boards were not receptive to the Staff recommendations because this created an exception within the new accounting model principle to recognise all changes through profit and loss. In addition, the Boards wanted to maintain a single accounting model for all insurance contracts, and did not see any reason to create a separate approach for this type of contract. As such, the Boards decided to reassess this issue at a later date when the re-deliberations on the overall accounting model near completion.

Bifurcation of embedded derivatives (21 March)

The Boards approved the requirements published in the ED to separate and fair value through income any derivatives embedded in an insurance contract that are not closely related to the host insurance contracts. The decision did not cover the treatment of a discretionary participation feature, the unbundling of deposit components or bundled obligations to deliver goods or services. These three instances will be discussed at a later date at specific sessions.

The Boards also clarified that their decision did not include embedded features that have non-financial risk as their underlying. An example of this type of embedded features is an option to add at a future date new insurance covers to an existing insurance contract.

Top down approach to discount rates – FASB only educational session (7 April)

The FASB held an educational session on 7 April to discuss the paper to be presented at the joint meeting on 12 April.

Accounting for insurance liabilities discount rate changes through OCI – FASB only educational session (15 April)

A second educational session held the following week focussed on a new proposal from the FASB Staff to allow an irrevocable election to account in OCI all discount rate changes from the current fulfilment value of a group of insurance liabilities. This group would be defined as a “business line” and it would be a sub-set of the portfolio defined in the ED.

The amount recognised in OCI would be recycled through profit or loss with the unwinding of discounting.

Although the FASB members were not required to decide on this proposal the comments we noted were mostly critical of the Staff recommendation.

We understand that OCI solutions to the issue of accounting volatility are likely to be the subject of the joint meeting of the Boards on 27 April.

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