Deloitte.

# Publication imminent!
# IFRS 4 Phase II Update - Global Insurance GAAP

**IASB and FASB joint meeting – July 2010**

**Francesco Nagari**

**26 July 2010**

# Agenda

- Highlights of the 19 July joint meeting
- Analysis of Staff recommendations and Boards’ decisions
- Timetable and next steps

# Highlights of joint IASB / FASB meeting – 19 July

## Unbundling

- Unbundling will be required for specified components – deposits and embedded derivatives
- The resulting set of rules will be drafted as emanating from a principle that deems these components as not interdependent with the insurance component of an insurance contract
- Unbundling regime could be extensive

## Unit-linked (UL) contracts

- More accounting mismatches experienced in IFRS 4 Phase I will be eliminated with the Phase II ED
- This decision appears to apply to all UL contracts whether they transfer insurance risk or not
- Principles apply only where the assets and UL fund <u>contractually</u> linked
- Single line presentation adopted (similar to US GAAP)

# Highlights of joint IASB / FASB meeting – 19 July (cont.)

## Simplified measurement model – Unearned premium method

- To be considered by the FASB on Wednesday 28 July
- The simplified method will be required contracts of short duration and with no significant embedded options or guarantees
- Acquisition costs to be treated as a reduction in the related liability
- A current  interest rate will be used for accreting interest to the unallocated premium liability  over the 12 month period (if material)

## Residual margin for contracts with discretionary participation features

- Recognised over the life of contract on a systematic basis that reflects the asset management services

## Publication of ED – Final IASB vote

- Two members dissented, one member abstained and twelve voted in favour of publishing it
- Publication is expected by the end of this month

# Details of IASB/FASB joint meeting

## *Paper 3A – Unbundling*

### Unbundling

**Staff proposal:** An insurer shall unbundle the following components of a contract that are not closely related to the insurance coverage specified in that contract:

a) policyholder account balances bearing an explicit rate of return based on a market rate (with additional guidance);

b) embedded derivatives that are separated under existing guidance; and

c) goods and services included in the contracts which are not closely related to the provision of insurance coverage (with additional guidance).

- The rule on deposits to be unbundled requires the condition of being an account balance. This would appear to exclude surrender values from the unbundling regime
- Embedded derivatives rules in IAS 39 do not require extensive bifurcation under IFRS 4 Phase I due to extensive exemptions from bifurcation
- Helpfully the Staff clarified the reasons why they believe surrender options (the most common embedded derivative in insurance contracts) are interdependent with the insurance contract and should not be bifurcated
- Revenue/fees from certain asset management bundled services may be unbundled

# Details of IASB/FASB joint meeting
## *Paper 3A – Unbundling (cont.)*

### Unbundling

- The proposal to have specific rules was accepted but modified as follows:
  - *"An insurer shall unbundle the components of a contract that are not closely related to the insurance coverage specified in that contract, the following being the most common examples: ..."*
  - In the first example, "market rate" will be replaced by *"rate based on performance of an underlying investment"*
- The umbrella principle could capture other components
- This decision introduces an unbundling regime with frequent application. A potentially significant implementation challenge

| Recommendation | IASB | FASB |
| --- | --- | --- |
| Against | 3 | n/a |
| In favour but with modified wording | 11 | majority |

# Details of IASB/FASB joint meeting

## *Paper 3B – Unit linked follow up issues*

### Q1 – Accounting mismatches

**Question:** Which of the following approach do the Board support to eliminate asset-liability accounting mismatches in accounting for UL contracts?

a) Expand the list of items that currently qualify for the application of the FV option and specify that holdings of the insurer's own shares would qualify for recognition as an asset if the shares back UL contracts;

b) Reduce the measurement of the liability for these contracts by the amount of the excess of the FV of the contractually linked assets over their carrying amount;

c) Do not address these mismatches in this project.

| Recommendation | IASB | FASB |
|---|---|---|
| a) Expand list and treat own shares as assets | 10 | 5 |
| b) Require FV of assets | n/a | n/a |
| c) Do not address here | 4 | 0 |

# Details of IASB/FASB joint meeting

## *Paper 3B – Unit linked follow up issues (cont.)*

### Q1 – Accounting mismatches (cont.)

This decision eliminates several accounting mismatches experienced in Phase I:

a) Own-shares backing the UL liabilities to be treated as assets and to be accounted at FV through income

b) Shares in associates and owner occupied properties could be designated at FV through income if backing UL liabilities

- The only known issue that will not be resolved with these Phase II decision is the investment in subsidiaries backing the UL liabilities where the fair value option can only apply to the assets and liabilities of that subsidiary AFTER it has been consolidated
- No fair value of subsidiaries held in a UL fund is possible

# Details of IASB/FASB joint meeting

## *Paper 3B – Unit linked follow up issues (cont.)*

### Q2 – Presentation

**Staff proposal:** An insurer shall present the pool of assets underlying UL contracts as a single line item, and not commingle them with the insurer's other assets.

| Recommendation | IASB | FASB |
|---|---|---|
| In favour | unanimous | |
| Against | n/a | |

### Q3 – Income and expense

**Staff proposal:** An insurer shall present income and expense from the pool of assets underlying UL contracts as a single line item, presented on the face of the statement of comprehensive income or disclosed in the notes, and not commingle them with income or expense from the insurer's assets.

| Recommendation | IASB | FASB |
|---|---|---|
| In favour | unanimous | |
| Against | n/a | |

# Details of IASB/FASB joint meeting
## *Paper 3C – Simplified measurement*

### Q1 – Criteria for application

**Staff proposal:** That the required application of the premium allocation model should be restricted to the pre-claims liability of short duration contracts, which incorporate the following features:

a) The coverage period is approximately 12 months or less;
b) The insurer is unlikely to become aware of events during the coverage period that could cause significant decreases in the expected cash out flows; and
c) Do not contain significant embedded options or guarantees

- The FASB did not vote on this issue and will consider it on Wednesday 28 July
- However their views helped the IASB support the staff recommendation with the word “approximately” removed.
- The requirement or the optionality of this regime was hotly debated. The FASB was unanimous in supporting the requirement choice eventually convincing the IASB majority

| Recommendation | IASB |
|---|---|
| Against | n/a |
| In favour | Majority |

# Details of IASB/FASB joint meeting
## *Paper 3C – Simplified measurement (cont.)*

### Q2 – Treatment of acquisition costs

**Staff proposal:**

a) Defer incurred incremental ACs associated with insurance contracts that are measured and presented using the premium allocation model, and

b) Present those incremental ACs as a deferred item as a deduction from the unallocated premium liability.

- The substance of this decision is a net of transaction costs unearned premium liability
- As noted earlier the FASB did not vote on this issue, and will consider it on Wednesday
- The IASB supported the staff recommendation with no dissent

| Recommendation | IASB |
|---|---|
| Against | n/a |
| In favour | Majority |

# Details of IASB/FASB joint meeting

## *Paper 3C – Simplified measurement (cont.)*

### Q3 – Discount rate

**Staff proposal:** use a current rate for the accretion of interest to an unallocated premium liability.

- The approach is that of a floating rate accretion accounting model with a declining balance
- Earnings from the derecognition of the liability will be partially offset by an interest expense
- Interest rates will be short term risk free rate – unlikely to attract an illiquidity premium
- The time span where this is applicable is short – 12 months or less
- In a low interest rate environment the accretion is potentially immaterial

| Recommendation | IASB |
|---|---|
| Against | n/a |
| In favour | Majority |

# Details of IASB/FASB joint meeting

## *Paper 3D – Residual margin for investment contracts with DPF*

### Q – Recognition of residual margin

**Staff proposal:** The residual margin for an investment contract with DPF should be recognised over the life of the contract in a systematic basis that best reflects the asset management services, as follows:

a) On the basis of passage of time, but

b) if the insurer expects to provide asset management services in a pattern that differs significantly from passage of time, it shall release the residual margin on the basis of assets under management.

- The boards supported the staff recommendation with no dissent

| Recommendation | IASB | FASB |
|---|---|---|
| In favour | unanimous | |
| Against | n/a | |

# Timetable

## Commitment to an exposure draft in 2010

- 12 IASB members voted in favour of the release of the exposure draft
  - 2 dissenting votes (John Smith and Jan Engström)
  - 1 abstention (Paul Pacter)
- the publication is expected to go ahead by the end of July
- 4 months comment period
- Target date for the publication of the final IFRS remains the end of June 2011
- The FASB is more likely to take a longer time to reflect on the work done with the IASB and we expect them to publish a consultation paper rather than an ED of a new US GAAP

## Future meetings

- No more IASB meetings are expected before publication of exposure draft
- FASB will meet again on Wednesday 28 July

# Contact details


Deloitte.

Insurance Accounting Newsletter
Insurance Working Group meeting

**Francesco Nagari**

Deloitte Global IFRS Insurance Leader

+44 20 7303 8375

fnagari@deloitte.co.uk

Link to **Deloitte Insurance Accounting Newsletter:**

http://www.deloitte.com/view/en_GB/uk/industries/financial-services/sector-focus/insurance/article/ac9955baf1001210VgnVCM100000ba42f00aRCRD.htm

Insurance Centre of Excellence:

insurancecentreofexc@deloitte.co.uk