The spring marathon has started
IFRS 4 Phase II Update

IASB and FASB joint meetings – March 2011

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Agenda

- Highlights of the decisions on March joint meetings
- Detailed analysis of Staff recommendations and Boards decisions for the joint meetings held on 1-2, 14-15 and 21-22 March 2011
- Highlights of the IWG meeting on 24 March 2011
- Update on the timetable and next steps

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Highlights – March 2011

- Acquisition costs – divergent decisions (2 March)
- Discount rates for non-participating contracts: unlocking and proxy rejected (1 and 14 March)
- Discount rates for participating-contracts: principles set (15 March, incl. educational session)
- Discounting for post-claim liabilities required for long tails (1 March)
- Discounting ultra-long duration contracts may go to OCI (21 March)
- Explicit risk adjustment clarified and redefined (2, 15, 21 and 22 March, incl. educational sessions)
- Scope and definition of insurance contracts broadly confirmed (1, 2 and 15 March)
- Contract boundary amended (22 March)
- Unbundling is desired but no decisions yet (21 March)
- Bifurcation of embedded derivatives required as in Phase I (21 March)
- Miscellaneous (2, 14 and 15 March)

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Detailed commentary on joint meetings

Acquisition costs (2 March)

- In February the Boards decided to assess acquisition costs at the portfolio level abandoning the incremental test on a contract level.
- Following on from that decision, the staff were unable to agree on a single recommendation on which costs should be included and so recommended that either:
  - Only direct costs related to successful contract acquisition should be included; or
  - Direct costs related to successful *and* unsuccessful contract acquisitions should be included.
- Both methods require cost allocation (and are therefore subject to judgement). As such, the Boards will include mandatory application guidance in the final standard.
- FASB decided unanimously to support the first recommendation, and to limit acquisition costs to those arising only from successful efforts.
- IASB decided (majority of 10 out of 12 present) to include acquisition costs arising from unsuccessful efforts as well. This is to ensure that:
  a) the definition of acquisition costs is consistent with the portfolio-based definition applied to all other fulfilment cash flows; and
  b) the cost of assembling a portfolio shall include the costs of unsuccessful efforts. This reduces the potential for accounting arbitrage between distribution channels.

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Detailed commentary on joint meetings (cont.)

Non-participating contract discount rates locking and use of proxy (1 and 14 March)

- Continuing from decisions made in February, the staff tackled the issue of locking discount rates.

- The staff presented a paper to the Boards on locking in the discount rate and noted that many respondents had indicated that an unlocked discount rate would not faithfully reflect the economics of many insurance contracts.
- The staff did not find merit in the arguments presented and recommended to the Boards that the discount rate should remain unlocked.

- With minimal discussion, the Boards unanimously supported the staff recommendation.

- The staff also presented a paper on using a proxy rate as a practical expedient for the discount rate. Having performed the analysis, the staff recommended that the Boards do not permit insurers to use a proxy rate instead of selecting a discount rate that reflects the characteristics of the insurance contract's cash flows.

- The majority of both Boards agreed with the staff recommendation. The FASB noted that they may reconsider this issue if the decisions on scope result in a large number of non-financial institutions having to apply the new insurance standard.

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Detailed commentary on joint meetings (cont.)

Discounting post-claims liabilities (1 March)

- Respondents to the ED/DP raised concerns that the treatment of short-term insurance contracts under the building blocks model was excessively complicated and that discounting would not result in faithful presentation.

- The staff sympathised with these concerns and recommended to the Boards that:
  - Contracts with short pre-claim periods and short claims settlement periods (< 1 year each) should be exempted from discounting.
  - All other contracts should be discounted.

- Despite significant discussion including the issue of materiality when there is a potential two-year undiscounted period, the Boards were unable to decide whether they would or would not permit an exemption.
- They instructed the staff to reconsider the issue once more decisions about the modified approach for the pre-claim liability have been taken.
- There were no disagreements with the staff's second recommendation.

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Detailed commentary on joint meetings (cont.)

Discount rates for participating-contracts (15 March, incl. educational session)

- The Boards received an education session on the discount rate for participating contracts (the “Asset Liability Rate” – ALR proposal) delivered by Jean-Michel Pinton and Baptiste Brechot of CNP Assurances and Eric Meistermann of Deloitte who advised CNP Assurances on the development of their proposal.
- The ALR proposal:
  - Determines a discount rate for participating contracts. These are insurance and investment contracts where the benefits payable to the holder are dependent on the value of the assets backing the contracts' cash flows.
  - Selects a discount rate based on a yield curve derived from the expected return of the assets held in the participating funds backing the insurance participating liabilities being measured.
  - Uses the same basis selected for accounting purposes for each of the asset classes that form the participating fund. This means the yield curve is not necessarily market consistent and it results in a locked in rate if the assets are at amortised cost.
  - Adjusts the yield curve determined with reference to these assets accounting values 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.
  - Discounts in a way similar to the IASB tentative decisions to date all the cash flows for durations that are not matched by the assets and all the options and guarantees cash flows.

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Detailed commentary on joint meetings (cont.)

Discount rates for participating-contracts (15 March, incl. educational session) (cont.)

- After the educational session, the Boards arrived at two important decisions:
  - The objectives for discount rates on participating contracts should be aligned with those tentatively agreed for non-participating contracts; and
  - The staff paper released in November 2010 would constitute the basis to develop mandatory guidance on this issue. The guidance would address how the dependency on asset values should be reflected in the cash flows and in the discount rate.
- The staff paper referred above proposed to determine par-contracts discount rates based on three sets of cash flows that:
  1. directly reflect asset values where the measure of the liability can be effectively and fully replicated by the use of the asset values;
  2. are independent of asset values thus identical to those in non-participating contracts; and
  3. indirectly reflect asset values as a result of being cash flows from embedded options and guarantees.

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Detailed commentary on joint meetings (cont.)

Discounting ultra-long duration contracts (21 March)

- The staff prepared a paper for the Boards analysing the additional considerations for discount rates where the yield curve extends beyond observable data.

- The staff recommended that changes in 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 this recommendation because it created an exception within the new accounting model principle to recognise all changes through profit or loss.
- Overall, the Boards concluded that this issue should be assessed at a later date when the re-deliberations on the overall accounting model were nearing completion.

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Detailed commentary on joint meetings (cont.)

Explicit risk adjustment (2, 15, 21 and 22 March, incl. educational sessions)

- On 2 March, the staff presented the Boards with a paper written to address members' concerns that risks and other measurement items may potentially be double-counted. The staff concluded that there was no significant risk of double-counting, and the Boards (commenting on the high quality of the papers) approved the staff conclusions.

- On 15 March, Joachim Oechslin of Munich Re presented on the use of market-consistent valuations in insurance liabilities and how these can be used in practice. The session broadly supported the use of a risk adjustment.
- On 22 March, Tony Coleman of Lonergan, Edwards and Associates presented on a number of key features of the Australian accounting models and standards. Again, this session broadly supported the use of a risk adjustment.
- Also on 22 March, Mark Swallow and Leopoldo Camara of Swiss Re presented their management accounting framework (called Economic Value Management). This model focuses on using the cost of capital to calculate risk adjustment liabilities.

- Overall, the presentations highlighted that the quality of disclosure would be the "make or break" of accounting for risk adjustments.

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Detailed commentary on joint meetings (cont.)

Explicit risk adjustment (2, 15, 21 and 22 March, incl. educational sessions) (cont.)

- In a session on 21 March, the Boards discussed the objective of an explicit risk adjustment. The staff recommended an approach focused on measuring the liability at the point at which an insurer becomes indifferent between retaining or transferring an insurance liability.
- The Boards found this proposal confusing and many members commented that it appeared to be a return to the exit value model previously discarded. There was also a significant amount of criticism focusing in the proposed wording.
- A Board member proposed an alternative wording which simplified the approach taken in the ED/DP. After discussing some minor wording variations of this alternative, the Boards reached consensus around:

"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 agreed to include guidance that, in quantifying the risk adjustment liability, insurers should take the possibility that cash flows may also be less than expected into account.
- Finally, they instructed the staff to attempt to draft application guidance to explain that the measure of the risk adjustment liability should increase the expected cash flows amount to make insurer indifferent to the same liability amount where there was no uncertainty.

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Detailed commentary on joint meetings (cont.)

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

- The Boards held three sessions to discuss the scope of the insurance contracts standard and the definition of an insurance contract at which several issues were discussed.

- The staff proposed that the scope exclusion for fixed-fee service contracts should be narrowed to exclude only those contracts which have the primary purpose of providing services and which would qualify for the modified approach.

- The Boards raised significant concerns on this approach, primarily focused on how onerous it would be for non-insurance companies to perform in order to test whether their (clearly not insurance) contracts fell within the scope of this exclusion or not.
- The Boards tentatively directed the staff to draft new wording based on “contracts aimed at the provision of non-insurance services” and to remove the reference to the modified approach.
- Some Board members were concerned that this exclusion was not tight enough, but agreed to deal with the issue later, in drafting.
- Some Board members also indicated that, possibly the problem was in the definition of an insurance contract and asked the staff to consider that issue later.

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Detailed commentary on joint meetings (cont.)

Scope and definition of insurance contracts (1, 2 and 15 March) (cont.)

- The staff further proposed that financial guarantee contracts should remain scoped out of the standard on insurance contracts, unless the issuer of those contracts previously asserted that they were insurance contracts.
- The staff also recommended that there should not be an exemption from accounting for intra-group guarantees in standalone financial statements.
- FASB staff proposed that the FASB retain current US GAAP treatments.

- The Boards agreed with the proposals put forward by the IASB staff for both IFRS and US GAAP.
- The FASB suggested that the treatment of financial guarantee contracts could be resolved in a joint project at a later date and to that end agreed to scope the contracts out of the insurance standard in the same exact way as it would be done under IFRS.

- All other scope exclusions were agreed unanimously as drafted in the ED.

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Detailed commentary on joint meetings (cont.)

Scope and definition of insurance contracts (1, 2 and 15 March) (cont.)

- The staff proposed that the definition of an insurance contract should be retained from IFRS 4. The staff also proposed alternative recommendations that additions should/should not be made to the definition of an insurance contract in current IFRS 4.
- These conditions are to be used in assessing whether there is a significant transfer of insurance risk and are consideration of the time value of money and the existence of potential loss scenarios.

- The Boards tentatively decided to retain the IFRS 4 definition, but to include the additional guidance recommended by the staff as drafted in the ED on:
  - time value of money to test significant risk transfer; and
  - loss making scenarios to assess presence of commercial substance.
- However, the Boards instructed the staff to develop mandatory application guidance to address situations where a reinsurer has accepted substantially all the insurance risk inherent in the underlying policies but may have only a limited likelihood of suffering a loss.

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Detailed commentary on joint meetings (cont.)

Contract boundary (22 March)

- Staff noted that most respondents agreed with the ED/DP proposals on contract boundaries, but noted concerns that certain short-duration contracts (e.g. health insurance) may be adversely affected by the proposed model.
- The staff noted distinctions between contracts that are priced for future risk and those that are re-priced annually.
- The Board discussion focused on how to treat new contracts and whether to assess the contract boundary at a contract or a portfolio level.
- After extensive debate on the nature of risk transfer, the various approaches to price it and the interaction between contract-based tests and the portfolio accounting model developed in the ED, the Boards concluded that:
  - A contract renewal should be treated as a new contract when the existing contract does not confer on the policyholder any substantive rights.
  - This assessment should be made at the portfolio level only if the pricing does not include risks related to future periods.
  - All renewal rights should be considered in determining the contract boundary, whether arising from contract, law, or regulation.

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Detailed commentary on joint meetings (cont.)

Unbundling (21 March)

- The staff presented a paper to the Boards for discussion and to provide further guidance on the next steps.
- The paper focused on the background to unbundling, the objectives of unbundling, what should be unbundled and what the next steps in addressing unbundling could be.
- Board members expressed divergent views (even within the two Boards) arguing for or against unbundling.
- Concerns raised centred on whether the components would have been measured or recognised differently if they were not part of the insurance contract and the level of judgement that unbundling would require.
- Based on our own observations several members in each Board support unbundling but this was not sufficient to articulate a consensus on what should be unbundled and how unbundling could practically be performed.

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Detailed commentary on joint meetings (cont.)

Bifurcation of embedded derivatives (21 March)

- Without discussing:
  - Investment components and obligations to deliver goods or services (these are dealt with under the unbundling discussion);
  - Riders; or
  - Investment contracts with DPF (all of which will be discussed later).
- The Boards considered whether embedded derivatives should be separated out from the host contract and fair valued through profit or loss.

- The staff recommended that current practice (i.e. separating out embedded derivatives that are not closely related to the host insurance contract) should be maintained.

- With limited discussion, the Boards expressed strong support for the staff proposal.

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Detailed commentary on joint meetings (cont.)

Miscellaneous (2, 14 and 15 March)

Recognition

- The staff proposed that recognition should take place either:
  - at the start of the coverage period; or
  - at the start of the coverage period subject to an onerous contract liability test.
- The Boards tentatively agreed with this approach and supported the inclusion of an onerous contract liability test prior to contract inceptions.

Release of profit margins

- The Boards received an educational session on the release of profit from a composite margin.
- Based on this session, the Boards directed the staff to prepare a paper on using a floating margin (i.e. inclusive of favourable and unfavourable changes) with only changes in non-financial assumptions affecting the margin measurement.

Presentation models

- The Boards received an educational session on presentation models, with no decisions made.
- However, the Boards indicated that so far no model had demonstrated “clear superiority” and directed the staff discuss the issue with the IWG on 24 March and then continue their work.

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Detailed commentary on joint meetings (cont.)

Miscellaneous (2, 14 and 15 March) (cont.)

Field testing

- The staff presented a paper to the Boards on the objectives of the field testing undertaken between September and December 2010.
- They explained that there were no indications that the Boards would need to reconsider decisions taken to date and asked if the Boards wanted them to consider any other issues.
- The Boards asked the staff to obtain or prepare information on:
  - A full list of issues raised, reconciled to how these issues were considered or resolved by the Boards to ensure that everything has been covered.
  - The extent to which non-GAAP disclosures would be included before and after the implementation of the new insurance standard as a measure of whether the standard addresses the needs of users and preparers.
- The staff indicated that they would prepare this information for the Boards subject to any restrictions that the field test confidentiality agreements may impose.
- The full report on the field testing results should be ready in April.

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Highlights – IWG Meeting – 24 March 2011

Discussion on discount rates

- IASB decision to allow the “top down” approach was welcomed by many companies present with an indication that they will take that option in their own implementation.
- IASB members are still keen to explore the reconciliation to the “bottom up” approach:
  – The deduction of a spread representing the credit risk margin (unexpected credit losses) was criticised for being almost as complex as the illiquidity premium and inconsistent with the IFRS 9 impairment approach.
  – Several IWG members suggested to include all asset classes in the reference asset portfolio and not to restrict them to debt instruments.
- IASB invited volunteers to test any reduction in volatility with a “top down” approach.

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Highlights – IWG Meeting – 24 March 2011 (cont.)

Sounding of the IWG on alternative presentation models

- Feedback was positive on the expansion of the summarised margin to include some volume information.
- Several IWG members pressed the IASB to consider OCI solutions to the issue of accounting volatility ideally for both assets and liabilities.
- IASB members and staff seem to have committed to consider the separation of short term market fluctuations as a separate line to address volatility in presentation.

Profit patterns – accounting for the residual margin

- Feedback called for a “floating” accounting for the residual margin.
- Experience variances could be taken to income as incurred with changes in assumptions reflected against the residual margin.

News on the timetable

- A new IWG meeting will be convened in May.
- A staff draft of the new IFRS will be published in early June.

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Timetable

- IASB is still committed to releasing the final standard in June 2011, commenting that additional meetings will be scheduled as necessary.
- FASB is committed to release a US GAAP ED on the same timetable.
- There are still no indications on the effective date.
- The IASB and FASB spring marathon on insurance accounting continues. Meetings are tentatively scheduled for 29 March, 5-6 April, 11-15 April and 27 April.
- Based on the staff plan the topics that will be discussed are:
  - Risk adjustment
  - Residual/composite margin earning pattern
  - Participating features (including investments with DPF);
  - Short term contract measurement and presentation
  - Unbundling
  - Presentation and OCI options
  - Reinsurance purchased
  - Field testing full report

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