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IFRS 4 Phase II Update

IASB and FASB joint meetings – April / May 2011

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Agenda

- Highlights of decisions from latest joint meetings
- Detailed analysis of Staff recommendations and Boards decisions for the joint meetings held on 29 March, 12 and 27 April and 4 May 2011
- Update on the timetable and next steps

Highlights – March, April and May 2011

- **Taking stock and timetable change (12, 14 and 21 April)**
  – Project summary presented to the Boards; release of standard was planned for July.
  – Subsequent announcement extended the timeline by a number of months.
- **Top-down approach to discount rates (12 April)**
  – Top-down rate not an asset rate: adjusted to reflect characteristics of liabilities
  – Credit risk adjustment for top-down to incorporate expected default losses and an allowance for unexpected defaults.
  – Residual spread assumed for illiquidity characteristics.
- **Short term contracts (27 April)**
  – Decision to use the unearned premium method but split on whether it is a simplified approach or a separate model – split decision.
  – Time value of money in pre-claims period to be accounted in line with revenue recognition criteria – item not finalised.
  – IASB favours a single definition of acquisition costs in line with the building blocks approach whilst FASB favours the presentation of acquisition costs as an asset – split decision.
  – Both agree an onerous contract test should be done if “qualitative factors” are met.

Highlights – March, April and May 2011 (cont.)

- **Unbundling (4 May)**
  - Criteria for unbundling should be consistent with revenue recognition principles.
  - Disagreements on the wording proposed – will be taken to IWG on 16 May.
  - General support for unbundling explicit account balances although additional work needed to define “explicit”.
- **Unlocking the margin (29 March**)
  - Educational session, with no decisions taken.
  - Tentative support from some to the unlocking of the residual margin, others have significant reservations.

- **Participating contracts** discussion scheduled for 4 May postponed.

- The FASB held two educational session meetings in April and one in May.

Detailed of joint meeting – 12 April

Top-down approach to discount rates

- Previously agreed to allow top-down and bottom-up approaches for non-participating contracts.
- Staff proposed application guidance for the future IFRS on this principle.

Staff recommendations include:

- The top-down discount rate should be clearly distinct from an asset rate and it should reflect the characteristics of the related liability, in the same way that a discount rate determined on a bottom-up approach should not be considered a risk-free rate.
- The yield-curve should be based on current, observable market data and should reflect either the actual assets that the insurer holds, or a reference (not replicating) portfolio of assets designed to reflect the characteristics of the liability.
- Where no observable data is available, insurers should use the Boards’ existing guidance on estimates, particularly the fair value guidance on Level 3 financial instruments.
- The cash flows used to determine top-down discount rates should be adjusted to reflect the liability cash flows, taking into account durations, differences in timing and asset-based risks that are not present in the liability, but no adjustment for liquidity should be made.

Detailed of joint meeting – 12 April (cont.)

Top-down approach to discount rates – discussions

- The decision explains that the top-down credit risk adjustment comprises the expected default losses for the reference asset portfolio or for the own assets held.
- In addition insurers would need to deduct a spread for the risk surrounding the expected default losses (risk of unexpected deviation).
- The decision clarifies that if this is not observable the entity develops its own market consistent estimation.

- One Board member suggested a pre-selected interest rate as a practical expedient to assist non-insurance companies; not much support received.

- Boards generally supported the recommendations.

- Boards directed the staff to finalise their analysis and draft final wording on guidance for determining discount rates for non-participating insurance contracts.

Details of joint meeting – 27 April

Paper 1 (IASB) / 66 (FASB)

Q1 - Modified approach : *Eligibility*

Staff proposal: that the modified approach be applied to insurance contracts that meet all of the following criteria:

a) The contract does not include a significant financing element;

b) The contract does not contain embedded options or other derivatives that significantly affect the variability of the cash flows, after unbundling any embedded derivatives.

- No tentative decision reached and disagreement over many aspects of the proposal.
- Boards have at least agreed that the modified approach should be based on unearned premium.
- FASB prefers to treat the modified approach as model separate from the building blocks rather than a proxy.
- IASB prefers a single measurement model with a simplified approach for short term contracts that meet certain criteria.
- Most Board members disliked the "significant financing" criterion.

IASB	FASB
NO tentative decision taken.	

Details of joint meeting – 27 April (cont.)

Paper 1 (IASB) / 66 (FASB) (cont.)

Q2 - Modified approach : *Acquisition costs (AC)*

Staff proposal: An insurer should deduct from the pre-claims obligation measurement the amount of AC as tentatively decided by the Boards. The alternatives in light of recent decisions in the revenue recognition project are:

a) Account for AC in accordance with the building blocks;
b) Account for AC in accordance with revenue recognition;
c) Permit some internal incremental AC to be expensed as incurred rather than being included in the determination of the pre-claims obligations; or
d) Require some internal incremental AC to be expensed as incurred rather than being included in the determination of the pre-claims obligation.

- IASB is in favour of retaining the principle from ED in line with the building blocks.
- IASB also in favour of using a definition of AC based on costs that directly relate to contract, on a portfolio basis.
- FASB sees an opportunity to align with revenue recognition, i.e. present AC as an asset.
- Issue to be brought back at future meeting and aim for convergence.

IASB	FASB
9 out of 13 in favour of (a)	No vote although preferred (b)

Details of joint meeting – 27 April (cont.)

Paper 1 (IASB) / 66 (FASB) (cont.)

Q3 - Modified approach : *Pre-claims obligation discounting*

Staff proposal: The measurement of the pre-claims obligation at initial recognition should include the premium, if any, received at initial recognition, plus the undiscounted value of future premiums.

- The Boards found it difficult to opine on this given the lack of agreement on the eligibility question.
- Some IASB members cautioned the Boards on this proposal because in a high interest rate market environment even one year of discounting would have a material impact.
- Tentatively agreed to consider whether pre-claims obligations should reflect the time value of money using the revenue recognition project expedient of no discount for contracts shorter than 12 months within a “significant financing component” test.

IASB	FASB
Tentatively agreed to consider discounting using revenue recognition criteria	

Details of joint meeting – 27 April (cont.)

Paper 1 (IASB) / 66 (FASB) (cont.)

Q4 - Modified approach : *Premium allocation pattern*

Staff proposal: The pre-claims obligation should be reduced to reflect satisfaction of the performance obligation to provide coverage. The performance obligation is satisfied as the insurer provides insurance coverage as follows:

a) On the basis of the passage of time, but
b) On the basis of the expected timing of incurred claims and benefits if that pattern differs significantly from the passage of time.

- The Staff asked the Boards to only consider the premium allocation part of the question, ignoring the "performance obligation" issue.
- The Boards unanimously agreed with the proposal.
- In line with the ED proposals.

IASB	FASB
Tentatively agreed with Staff.	

Details of joint meeting – 27 April (cont.)

Paper 1 (IASB) / 66 (FASB) (cont.)

Q5 - Modified approach : *Onerous contract test*

Staff proposal:

a) An onerous contract test should be performed if qualitative factors, such as combined loss ratio in excess of 100%, a significant increase in the severity or frequency of claims and/or a change in the characteristics of the risk profile.

b) An additional liability should be recognised if the present value of the expected cash outflows exceeds the carrying amount of the pre-claims obligation.

- The test and the level at which it is to be carried out still to be defined more precisely.
- Concerns raised over the complexity of the test and that the test would be done only using first two blocks ignoring the risk adjustment liability.
- Concern raised regarding the inconsistent treatment of discounting between the onerous contract test and the unearned premium approach.
- Tentatively agreed that a test should be performed if there is an indication the contract has become onerous in the pre-claims period.
- All other details will be reconsidered at another meeting.

IASB	FASB
Agreed should perform test if facts and circumstances indicate contract may be onerous.	

Details of joint meeting – 27 April (cont.)

Paper 1 (IASB) / 66 (FASB) (cont.)

Q6 - Modified approach : *Permit versus require*

Staff proposal: An insurer should be permitted but not required to apply the modified approach for contracts that meet the eligibility requirements.

- This question was not discussed as the Boards felt a consensus on the objective should be reached first, i.e. whether the modified approach is a separate model or merely a proxy of the building block approach.

IASB	FASB
No tentative decision taken.	

Details of joint meeting – 4 May

Paper 1D (IASB) / 66D (FASB)

Q1 – Unbundling goods and services

Staff proposal: Goods and services should be separated from an insurance contract in accordance with the principles on identifying separate performance obligations in the revenue recognition project. Once separated, those goods and services would be accounted for in accordance with relevant requirements under IFRS and US GAAP.

- While broadly in favour of the proposal, significant concerns (mainly from FASB) about the practicality and implications of the proposed wording.
- Main concerns focused on the effect of prohibiting unbundling when independent components have a similar “pattern of transfer”.
- Other concerns related to treating different portions of the same component differently and the wish to maintain consistency with the revenue recognition project.
- FASB: supportive if the “pattern of transfer criteria” is removed.
- IASB: supportive as worded and if altered consistency with revenue recognition would require parallel changes.
- Boards asked the staff to reconsider and bring to IWG meeting.

IASB	FASB
11 for, 3 against, 1 abstention	Tentatively in favour if modified

Details of joint meeting – 4 May (cont.)

Paper 1E (IASB) / 66E (FASB)

Q1 – Unbundling investment components

Staff proposal: To unbundle only explicit account balances.

- The Boards generally supported this proposal without dissention.
- Significant debates focused on how to define “explicit account balance”.
- Boards asked the staff to reconsider the drafting of what constitutes an explicit account balance.
- This will be brought to IWG for their consideration.

IASB	FASB
General support, subject to refinement of definition of “explicit account balance”	

Details of joint meeting – 4 May (cont.)

Paper 1E (IASB) / 66E (FASB) (cont.)

Q2 – Unbundling explicit account balances based on criteria that are being developed in revenue recognition

Staff proposal: Explicit account balances should be separated based on the separate performance obligation criteria being developed in the revenue recognition project.

- The Boards supported this recommendation with the same comments and conditions made in relation to the vote on paper 1D.

IASB	FASB
No dissention.	

Details of joint meeting – 4 May 2011 (cont.)

Paper 1E (IASB) / 66E (FASB) (cont.)

Q3 – Measuring the unbundled account balances

Staff proposal: Explicit account balances should, once separated, be accounted for in accordance with relevant IFRS / US GAAP.

- The IASB tentatively supported this recommendation with minimal discussion.
- FASB declined to vote on this as the number of issues that would affect their decision remain too high. However they express directional support to the Staff's proposals.

IASB	FASB
Tentative support	No vote

Detailed of joint meeting – 29 March

Unlocking the margins

- Educational session on whether the residual/composite margin should be unlocked over the contract life or locked from inception onwards.
- Gathering of Boards' thoughts and concerns to facilitate ongoing work of the staff.
- No tentative decisions were taken.

Staff suggestions:

- Unlock the margin to reflect only future changes about non-financial inputs, and to adjust prospectively for favourable and unfavourable changes.
- If a negative residual margin is acceptable to the Boards, the sum of risk and residual margins (or the composite margin) should remain positive.

- Significant opposition to locking-in from respondents as produces counter-intuitive results (e.g. losses on P&L even through the contracts remains profitable).
- Respondents in favour of locked-in noted that unlocking may result in the inappropriate deferral of changes in the insurance liability to later periods.
- General directional support from Boards on staff's proposals.
- Some members raised concerns that this could excessively complicate the model.

Timetable

- The IASB has now indicated that the publication of the final standard will be deferred by a number of months in order to ensure the standard “can withstand the test of time”.
- The FASB indicated their exposure draft release will continue to be in parallel with the release of the IFRS.
- The project plan indicates the standard will be issued in the fourth quarter of 2011.
- There are still no indications on the effective date. IASB and FASB chairs noted that “ample time” will be given to implement the new standards.

Next steps

- Meetings are scheduled for 11-12 May, 16-20 May and 31 May.
- An Insurance Working Group meeting is scheduled for 16 May in London with another proposed in June at a date not yet announced.
- There is currently no indication of what topics will be discussed, as a revised detailed work plan has not yet been issued.

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