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Update from the IASB meeting on insurance accounting on 18 September 2009

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Agenda

- Outcomes of the September IASB meeting on insurance accounting
- Recap on decisions to date and similarities and differences between the IASB and FASB positions
- Next steps

Highlights of IASB September meeting

"Updated" IAS 37 or Current Fulfilment Value (CFV) models

- 8 v. 7 majority in favour of IAS 37 (9 votes needed to publish the Exposure Draft - ED)
- CFV supported by FASB may be included in the exposure draft

Accounting for margins under the IAS37 model

- Risk margin MUST be remeasured at each balance sheet date
- Residual margin to be earned over coverage period
- Residual margin is released to income independently of adverse or favourable experience
- No agreement on drivers to earn residual margin

Discount rate

- Principles based approach – based on liability characteristics – currency, duration and liquidity

Policyholder accounting

- Exclude from the ED but to be included in the final IFRS (no exposure will take place)

Choice of the new measurement model

IASB's staff proposals

- Two approaches considered – both excluding day one profits:
  1. Updated IAS 37 model
  2. Current Fulfilment Value (CFV) with a composite margin
- Staff recommended to select the updated IAS 37 model as measurement for insurance liabilities
- FASB tentatively selected CFV and unlikely to change decision
- ED could ask for responses on two approaches

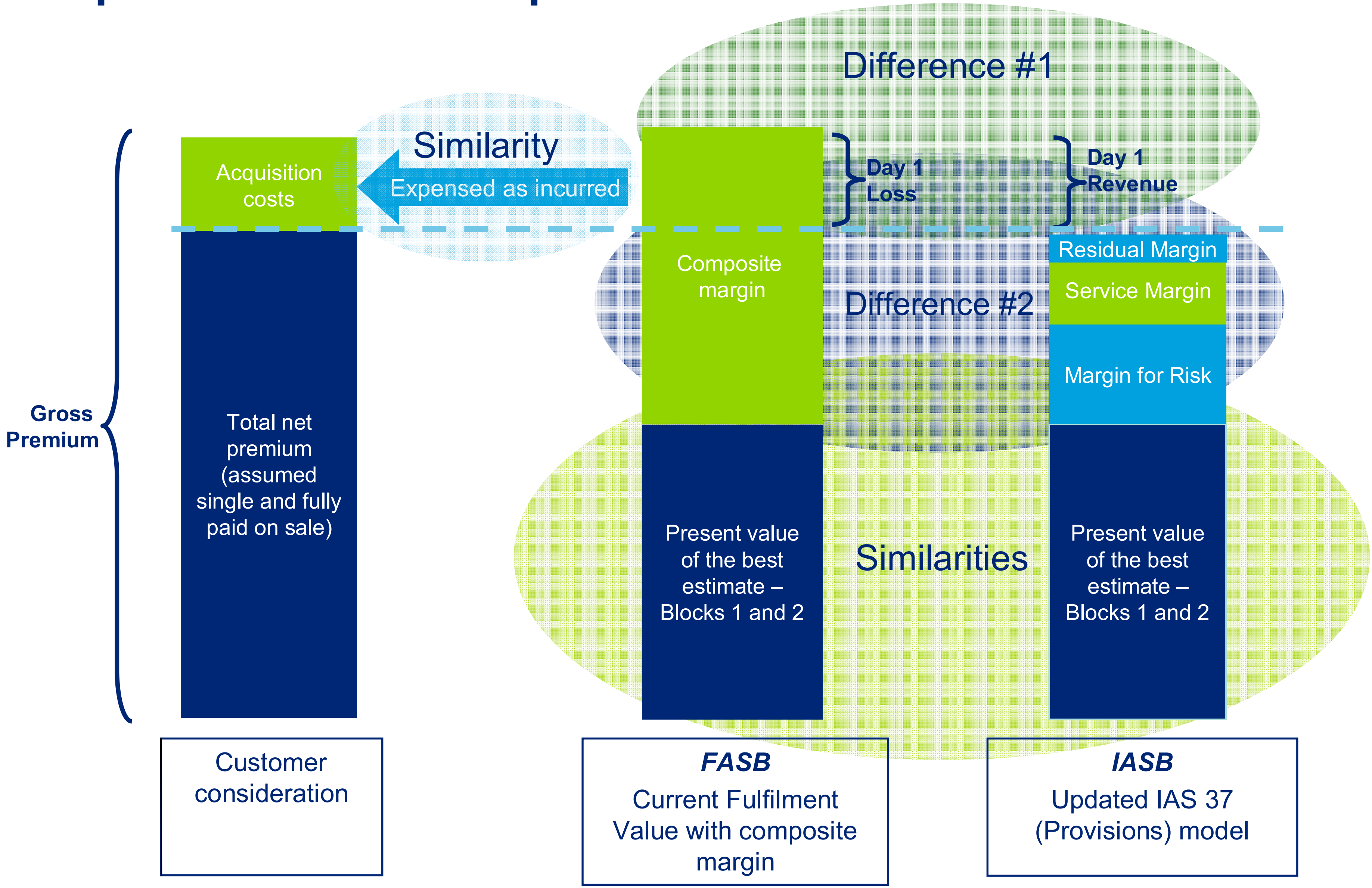
Question to the Board

- "Do you agree with staff recommendation to select the updated IAS 37 model (modified to exclude day one gains) as the measurement approach for insurance contracts?"

Vote of the Board

- 8 members in favour of the IAS 37 model
- 7 members in favour of the CFV (same choice as FASB)

Proposed models recap



Updated IAS 37 versus CFV – summary comparison

Similarities

- Measure from perspective of insurer and include insurer's specific cash flows when no directly observable market price is available to estimate variables
- Estimates of financial market variables as consistent as possible with observable market prices
- Use of 3 building blocks, first two blocks are identical
- Prohibition of day 1 accounting profit => residual / composite margins
- Requirement of day 1 accounting loss

Differences

- Measurement objective
  - Updated IAS 37: amount insurer would pay to be relieved of the obligation
  - CFV: measure expected probability-weighted present value of the cost of fulfilling the obligation over time
- Service and risk margins – explicit in IAS 37 to account for expected profit required for other services and uncertainty. Implicit components of the composite margin in CFV

A closer look to the vote declarations of Board members

Supporters of the Updated IAS 37 model

- The basis of IAS 37 is a good compromise to bring IFRS for insurance in line with mainstream IFRS for liability measurement
- Fixed composite margin is not acceptable to reflect faithfully the underlying estimation uncertainty
- Much support for building blocks approach emerged from which is a feature of IAS 37
- The revenue recognition model does not re-measure the obligation other than in an onerous contract situation resulting in biased profit recognition

Supporters of the CFV model

- Still unclear whether margin for risk in IAS 37 is a *cost* or *price* of risk
- CFV seems more consistent with Revenue Recognition model
- Not much support for service margin concept and on how to separate it from the risk margin
- Difficult to decide until IAS 37 is finalised
- The proposal creates a dependency: if IAS 37 changes further there may be a need to revisit the change for the insurance model

Accounting for residual margin

IASB's staff proposals

- Drivers for release of margins developed with two distinct views (no staff consensus) for the release to income:
  – Consistent with insurer's performance of the contractual obligations
  – Based on the release from risk, a function of the margin for risk
- Period over which to release the margins:
  – Coverage period (staff recommendation)
  – Claims handling period – staff recommendation only for composite model – NOT RELEVANT FOR THE IAS 37 MODEL
- Interaction of margin release and change in estimates (e.g. due to adverse or favourable experience) (no staff consensus)
  – Independent release of margin irrespective of the sign in the revised estimates
  – Changes in estimates from financial variables taken to income as incurred with recalibration of the residual margin for all other changes in estimates.

Accounting for residual margin (continued)

Questions to the Board:

1. Which approach should the boards select for the release of residual and composite margins?
   a) The boards should not prescribe particular drivers; rather, the insurer should select the driver(s) that result(s) in recognising that margin in income in a systematic way that best depicts the insurers performance under the contract.
   b) An insurer should use release from risk as the driver in all cases.

   If you do not support either approach, which approach would you select for the release of residual and composite margins and why?

   No clear consensus reached
2. What period should be used for release of the residual margins?

   Small majority (8) voted for coverage period
3. Which approach should be applied when there are changes in estimates?

   A: the margin remains locked-in at the amount determined at inception and is released over the remaining period of the contract

   B: the margin is adjusted for the changes in estimates other than financial market variables. Consequently no expense is recognised in the income statement for such changes unless the margin would become negative

   Majority (11) voted for approach A

Selecting the discount rate

Q1 – discount rate to reflect liability characteristics, not asset characteristics

- Unanimous agreement that the discount rate should not reflect the characteristics of assets held to match the liabilities unless the assets determine the liabilities
- The insurer's own credit risk is NOT reflected in the discount rate

Q2 – principles based approach or prescribe "high quality fixed interest rate"

- Strongly in favour of a principles based approach
- Prohibition of a risk adjusted discount rate other than liquidity risk because it would combine blocks 2 and 3 and dilute reporting transparency

Q3 – should board provide specific guidance on determining the discount rate

- Agreed to tentatively accept suggestion of a cross-reference to fair value measurement guidance

Selecting the discount rate (continued)

Should liquidity of the liability be taken into account?

- Agreed the principle that liquidity of the liability is a characteristic that should be taken into account in determining the discount rate
- Concern noted that, to date, there is no widely accepted basis of determining the liquidity component of the discount rate applicable to risk free government bonds
- Disclosure and sensitivity will be important
- Field testing will attempt to address the effects of using a risk free rate for illiquid liabilities and seek to identify alternative bases for identifying the illiquidity adjustment
- IASB will consider the need for further guidance on illiquidity premium and discount rates when discussing the results of the targeted field testing

Recap on previous decisions

IASB /FASB agreement on several principles

- The new model will be based on a “three-building-blocks” approach
- Block 1: the undiscounted probability weighted estimate of future cash flows
- Block 2: a market consistent discount rate
- Blocks 1 and 2 must be updated at each balance sheet date – no locked-in assumptions
- Immediate loss through income at point of sale if premium insufficient – “onerous contract test”

IASB/FASB disagreement in two key areas affecting the accounting profit pattern

1. Objective of the initial measurement of an insurance contracts – the role of acquisition costs
2. Nature and purpose of Block 3 (margins)

Timetable

Commitment to a December 09 exposure draft

- Exposure draft issue date remains in December 2009
- Comment period ends May 2010
- Standard due in June 2011

Policyholder accounting (other than R/I)

- IASB rejected exclusion of policyholder accounting from Phase II
- However it agreed to exclude from the December 09 exposure draft and to work on this in the exposure period in 2010
- No exposure of policyholder accounting provisions is likely

Field testing

- 15 companies involved
- Questionnaire sent out on acquisition costs
- Further questionnaire on release of margins following this meeting
- Will continue before and after exposure draft

Next steps

IASB

- Paper 17E sets out the details of the topics for the rest of the year. Accounting for participating business, presentation and disclosure are the main topics left
- In addition the decision on the drivers to release residual margin will be brought back to be resolved in the context of the Updated IAS 37 model

FASB

- To catch up on matters already decided at IASB
  – e.g. renewal and cancellation options, unearned premium method, and earning of margins
  – Education session on discount rates 24 September
  – Margin accounting scheduled on 7 October

Exposure draft

- Dealing with both measurement models (detail on CFV to be determined)
- Other IASB / FASB differences on CFV also need to be addressed (to date these include the use of acquisition costs in the initial calibration)

Joint FASB / IASB meeting

- 26-28 October in the USA

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