



Slow convergence

IFRS 4 Phase II Update

IASB and FASB joint meeting – February 2011

Francesco Nagari

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Agenda

- Highlights of the decisions on February joint meetings
- Detailed analysis of Staff recommendations and Boards decisions for the joint meetings held on 2 and 16-18 February 2011
- Decisions and comments from FASB only meetings on 9-11 February
- Update on the timetable and next steps

Highlights – February 2011

Project assumptions (2 and 17 February)

- Proposed axioms and assumptions under which the insurance contracts project will proceed for the Boards approval.
- Boards approved the axioms and assumptions and requested an explicit reference to IFRS 9 for the accounting of underlying assets.

Acquisition costs (2 February)

- The Boards tentatively removed the incremental test for including acquisition costs in the contract measurement reducing the associated day one loss.
- More discussion will take place on this in March due to partial quorum of FASB and non-vote on a number of associated issues by IASB.

Educational session – Unbundling (16 February)

- The Boards received an educational session on unbundling, presented by PwC and MetLife – No decisions made.

Highlights – February 2011 (continued)

Discount rate for non-participating contracts (17-18 February)

- Boards agreed that both top-down and bottom-up approach are valid if they meet principle based objectives.
- The discussion included whether the IFRS would permit the use of proxy rates as a practical expedient.
- The Boards indicated that they the idea could be explored further before being abandoned.

Cash flows (18 February)

- The Boards agreed that:
 - The liability should be based on a mathematical mean not a single, most likely scenario.
 - The insurer should measure sufficient (not all) scenarios to arrive at a measurement value.
 - Direct costs, rather than incremental or attributable, will be the cost identification principle.

Explicit risk adjustment (18 February)

- The Boards discussed whether to use a combined margin approach or the proposed explicit risk margin approach.
- No consensus could be reached, and the Boards requested that the staff arrange an educational session.

Highlights – February 2011 (continued)

Day-one gains and losses (18 February)

- There was no significant support amongst the Boards for the recognition of day-one gains.
- General agreement that day-one losses should be immediately recognised.
- Some members supported the possibility of a negative residual margin, but only where the sum of the risk and residual margins remained positive. It will be discussed in March.

Educational session – Profit from margin release (18 February)

- The staff presented an educational session to the Boards on the implications of unlocking and remeasuring the residual / composite margin.
- The Boards provided guidance to staff on their current thinking and requested the staff to prepare a paper for later consideration.

Educational session – Refresher on presentation models (18 February)

- The staff provided the Boards with a refresher on presentation models along with the feedback received from the respondents. No decision was made, and there is no indication of a “clearly superior” presentation format.

Discounting non-life contracts and Locking the discount rate

- These papers were not be discussed and will be deferred to a later meeting

Detailed commentary on joint meetings

Project assumptions (2 and 17 February 2011)

Axioms

“axioms are propositions that we consider to be self-evident, to be taken as a starting point for further decisions”

- The ideal measurement model would report all economic mismatches without creating accounting mismatches.
- The accounting model should reflect both the intrinsic value and the time value of options and guarantees embedded within an insurance contract.
- That money has a time value and faithful representation of the liabilities should take this into account.

Detailed commentary on joint meetings

Project assumptions (2 and 17 February 2011) (cont.)

Assumptions

“assumptions are decisions that the Boards took in developing the ED/DP which we do not think will need detailed reconsideration by the Boards”

- An insurance standard should be created rather than requiring currently extant standards.
- The standard takes an insurers' perspective and does not consider underlying assets.
- The accounting model uses a bundle of rights and obligations represented by a package of cash inflows and outflows.
- Measurement will take place at the portfolio level.
- The accounting model is based on current estimates and uses observable market data for inputs.
- Liability cash flows are measured on a fulfilment basis.
- Model uses expected value rather than a single, most likely outcome.
- Liability measurement will not include own credit.

Detailed commentary on joint meetings

Project assumptions (2 and 17 February 2011) (cont.)

- The axioms and assumptions agreed at this meeting shall not be binding on the Boards' later decisions. Cost and practicality considerations may become evident later which would change the decisions of the Boards on that axiom or assumption.
- One Board member raised concerns about the lack of presentation and disclosure considerations.
- Staff noted the decisions were not made with an assumed presentation and disclosure approach and may be inappropriate to assume limited redeliberations.
- Another Board member requested specific references in the axioms and assumptions to the assumption that the Board will not change IFRS 9 for the measurement of assets, as the insurance contracts project focused only on liabilities.
- The Boards agreed to include this additional assumption.
- Overall the Boards approved the axioms and assumptions subject to the inclusion of IFRS 9 assumption of "no change".

Detailed commentary on joint meetings

Acquisition costs (2 February 2011)

- The staff recommended that:
 - Some acquisition costs should be included in the measurement of contract cash flows, and the remainder should be expensed.
 - Acquisition costs included in the liability cash flows should be limited to direct and incremental costs at the portfolio level only.
 - Implementation guidance should be issued on acquisition costs.
- There was strong support amongst the Board members for including acquisition costs within the measurement of contract cash flows. Only 2 Board members remained unconvinced, and there was 1 abstention.
- Despite an intense debate there was no final consensus about the measurement of costs at the portfolio level although there appeared to be willingness to remove the restriction to “incremental” costs only.
- The Boards asked the staff to provide further clarification on how to define incremental costs, direct costs, or direct and incremental costs to better understand the acquisition costs that would be included in the contract and not charged to income as incurred.

Detailed commentary on joint meetings

Education on unbundling (16 February 2011)

- The staff introduced the educational session to the Boards and discussed the results of the consultation paper for unbundling.
- Key points raised by PwC include:
 - A significant amount of work is required for unbundling.
 - Much unbundling is going to be the result of judgement, potentially reducing consistency and the relevance and usefulness of information.
 - Economically similar contracts may be differently measured because some would be unbundled and others would not.
- MetLife presented two examples – a single premium immediate annuity and a variable annuity with guarantees.
- Benefits identified include the consistent treatment of financial instruments and the reduction of some potential accounting mismatches.
- However, many of the accounting mismatches could also be reduced in other ways without requiring unbundling.
- Unbundling will require significant implementation costs.

Detailed commentary on joint meetings

Education on unbundling (16 February 2011) (cont.)

- Boards' members noted that economic mismatches *should* be reflected as such, and that clarity and consistency could be improved through an unbundling approach.
- Other members noted that valuable information might be better achieved through disclosure of a source of earnings analysis.
- No decisions were taken at the meeting.

Detailed commentary on joint meetings

Discount rate for non-participating contracts (17-18 February)

- The paper did not discuss participating contracts, alternative presentation approaches, locking in the discount rate or situations where discounting may not be appropriate.
- The Boards then undertook an extensive discussion on the discount rate and considered, among other things:
 - How to apply illiquidity adjustments.
 - Whether using a top-down or bottom-up approach.
 - Whether an appropriate “borrowing rate” could be used as a proxy for the discount rate.
 - Double counting or omitting risks vis-à-vis the risk adjustment.
 - The implications of own credit adjustment.

Detailed commentary on joint meetings

Discount rate for non-participating contracts (17-18 February) (cont.)

Staff recommendation: The objective of the discount rate is to adjust the future cash flows for the time value of money and reflect the characteristics of the insurance contract liability

- The Boards had no significant disagreements with this recommendation, but noted that the wording was vague and subject to interpretation, so would have to be tightened up.

Staff recommendation: The Boards should not prescribe a method for selecting a discount rate.

- The Boards had no disagreements with this recommendation, but noted that any discount rate selected would need to meet the requirements of their objective.
- These decisions remove the issue of the ED bottom up approach and allow the use of a top down method as an alternative.

Detailed commentary on joint meetings

Discount rate for non-participating contracts (17-18 February) (cont.)

Staff recommendation: The Boards should provide guidance on the discount rate to be clear on what considerations are appropriate:

- Consistency with observable market prices.
- The inclusion of timing, currency and liquidity risks but not own credit risk.
- The exclusion of factors influencing the rate which are not applicable to the insurance liability.
- To reflect only the effect of risks and uncertainties that are not reflected elsewhere in the liability measurement.

- The Boards broadly agreed with this recommendation.
- Staff will have to perform additional work on the wording to clarify that this includes / excludes issues captured by the risk margin, cash flow expected value, risk margin etc. as appropriate.
- In addition the IFRS will require the disclosure of the yield curve used for discounting by each currency considered in the measurement of insurance portfolios.

Detailed commentary on joint meetings

Discount rate for non-participating contracts (17-18 February) (cont.)

- The Boards debated whether the Boards would permit the use of a proxy rate as a practical substitute for the discount rate.
- Certain Board members expressed support for this concept, sometimes with limited application, based on simplicity, observability and consistency.
- Although they support the concept, some members disagreed with the staff proposals.
- Other Board members were opposed to the concept because it may lead to inconsistency in approach between countries, or between similar companies.
- The Boards directed the staff to investigate the possibility and the implications of allowing the use of a proxy rate.

Detailed commentary on joint meetings

Cash flows (18 February)

- The staff presented a paper to the Boards focusing on the estimation of future cash flows and the treatment of specific cash flow items (e.g. general overheads).
- The paper did not address acquisition costs, taxation, participation features or cedant's cash flows from reinsurance contracts.

Staff recommendation: The measurement objective of expected value refers to the mean, considering all relevant information.

- Approved by the vast majority of both Boards.

Staff recommendation: No need to consider all possible scenarios, only sufficient scenarios are required to be consistent with the objective measurement of expected value.

- Approved by the vast majority of both Boards.
- In both cases some Board members noted that these decisions may be potentially difficult for general insurers.

Detailed commentary on joint meetings

Cash flows (18 February) (cont.)

Staff recommendation: Costs included in the cash flows should include direct costs, attributable costs and costs specifically chargeable to the policyholder. All other costs should be expensed as incurred. The term “incremental” should not be used in the context of fulfilment cash flows

- There was significant debate on this item.
- Many members referenced to similar wording in current US GAAP and pointed out the large variety of interpretations that had arisen.
- The Boards finally agreed to discard both “incremental” and “attributable” and instructed the staff to draft the words around the concept of “directly related to contract activity”.
- There was no objection to expensing other costs as incurred.

Detailed commentary on joint meetings

Explicit risk adjustment (18 February)

- The staff presented a paper for the Boards to consider focused on the use of either an explicit risk margin or a composite margin.
- The staff asked the Boards to conclude on whether, on a conceptual basis, an explicit risk margin would provide decision-useful information to users of the financial statements.
- A number of Board members discussed the issues presented and several noted that it was difficult to disagree with the staff query, as it was vaguely phrased.
- It was clear, however, that many Board members felt that an explicit risk margin is conceptually superior.
- The session concluded without a recorded consensus.
- Staff were requested to prepare an educational session for the Boards on how risk margins could be calculated in the market.
- The Boards would decide after receiving this education session.

Detailed commentary on joint meetings

Day-one gains and losses (18 February)

Staff recommendation: No gain on inception should be recognised.

- There was no significant support for the recognition of day-one gains amongst the Board members.

Staff recommendation: Day-one losses should be recognised immediately.

- There were no objections to immediate recognition of day-one losses, but one Board member raised the concern that day-one losses should not be created by over-allocating costs in the measurement model.

Staff recommendation: The residual / composite margin should not be less than zero.

- The majority of the Board members agreed with the staff recommendation.
- Some Board members raised the possibility of allowing a negative residual margin provided that the net risk and residual margin was positive.
- A Board member raised a concern about recognising a day-one loss while carrying a positive residual margin – effectively deferring profits.

Detailed commentary on joint meetings

Education on profits from release of margins (18 February)

- The staff presented an educational session to the Boards on the implications of unlocking and remeasuring the residual / composite margin.
- The Boards instructed the staff to prepare a paper for discussion based on the following guidance:
 - A floating margin should be used (i.e. remeasuring the residual / composite margin for both favourable and unfavourable changes in non-financial assumptions).
 - An onerous contract test should be included.
 - Only non-financial assumptions could be considered in the adjustment of the residual margin.
- The Boards also requested that staff discuss the proposals with users of financial statements prior to finalising and presenting them to the Boards.

Detailed commentary on joint meetings

Refresher on presentation models (18 February)

- Key issues that the Boards would need to consider if following an expanded margin approach include:
 - Whether premiums should be presented on a written or an earned basis.
 - Whether all elements of premium really constitute revenue.
- The staff presented numeric examples for
 - A written premium approach.
 - An earned premium approach.
 - A summarised margin approach.
 - An expanded margin approach.
- The Boards could not agree on a “clearly superior” framework and so asked the staff to consider the results of the EFRAG work that would be presented to the Boards later in February.
- Decisions could be made based on the results of that work.

FASB only meetings

9 February meeting

- FASB staff presented a summary of the responses received from the DP, and recommended that the FASB continue with the insurance project and pursue convergence with the IASB.
- Overall, the Board agreed with the staff recommendation, but requested that they return with an analysis of the different options raised during the discussion for the Board to consider.

10-11 February meetings

- FASB held meetings on 10 February and 11 February to discuss the papers to be tabled at the joint meetings on 16-18 February.
- FASB members seem focused on achieving convergence and are not finalising decisions separately to the IASB.
- Concerns raised during these meetings were expressed during the joint IASB / FASB deliberations, with joint decisions made then.

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 were indications on the effective date. Nothing concrete has arisen yet.
- An additional meeting is now scheduled for 1-2 March followed by additional sessions in the week commencing 14 March.
- Overall, the Boards are meeting for 12 days in March, and we anticipate a reasonable amount of time will be devoted to the insurance contracts standard.

Contact details

Francesco Nagari

Deloitte Global IFRS Insurance Leader

+44 20 7303 8375

fnagari@deloitte.co.uk

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