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Insurance Accounting Newsletter
The new accounting model takes shape

After the summer break, the International Accounting Standards Board (IASB) met again on the 18 September to discuss insurance accounting. Important decisions were reached by the Board, moving us closer to the publication of the Exposure Draft (ED) of the new International Financial Reporting Standard for Insurance that will replace IFRS 4.

Unlike the IASB, the American Financial Accounting Standards Board (FASB) did not suspend its deliberations on accounting matters during the month of August. However, during the various meetings held since the July joint meeting with the IASB, insurance accounting did not feature other than for an education session on the selection of discount rates held on 24 September. A decision making session on the same topic scheduled on 30 September was cancelled at the last minute.

Based on the joint board paper we also expected that the FASB would have met on 7 October to discuss the approach to the accounting for margins that the IASB considered at its last meeting. This discussion has also been postponed. The reduced pace at FASB raises doubts in our mind on whether the US GAAP timetable could continue to move in parallel to that of the new IFRS.

By a whisker, a majority has emerged in favour of the Updated IAS 37 model

The IASB has chosen the Updated IAS 37 model against the Current Fulfilment Value (CFV) approach; the latter received unanimous support from the FASB earlier in the year. The majority was however a slim one; only 8 Board members out of the fifteen attending the meeting voted in favour of the Updated IAS 37. It is important to note that in order to vote for the publication of an ED, at least 9 Board members will have to be in agreement.

Prior to the September meeting, the IASB Staff made available papers in which it puts forward the two models already discussed in the last few meetings: the Updated IAS 37 model and the CFV. The latter is characterised by an indistinct composite margin inclusive of risk, service and profit which are separately reported in the former model.

The staff recommendation was to select the updated IAS 37 model as the measurement for insurance liabilities under IFRS. If the disagreement between the two Boards persists, as we expect, the ED will ask respondents to indicate their preference between the two models to help the two Boards finalise their decisions as they develop the final accounting standard for insurance.

This is likely to be the most important question respondents will have to answer as this will be the last opportunity for the insurance industry to influence the outcome of the accounting model selection.

Our **August edition** of this newsletter included a summary of the characteristics of each model, as well as the similarities and differences between them.

Accounting for profit

The CFV has a simple approach to the accounting for margins at the inception of an insurance policy, which is defined as the difference between the gross premium and the present value of best estimate weighted probability cash flows. Because no attempt is made to analyse the components of this margin, it is called a "composite margin".

The Updated IAS 37 model uses a more articulated approach to margins and looks at three components. The first one is the margin to reflect the uncertainty in the calculation of the net present value of expected cash flows reflected in building blocks 1 and 2. We refer to this component as the "margin for risk". The second margin, which is present to the extent the three building blocks liability is lower than the premium received (net of incremental acquisition costs), is the "residual margin". The residual margin is accounted for to apply the principle that has been agreed by both Boards of prohibiting any profit at the issue of an insurance policy.

The residual margin is an additional component of the insurance liability and it could be argued that it represents the additional profit not explained by the recognition of the margin for risk that the insurance company has managed to include in the price for the insurance contract.

The three building blocks, including the residual margin, would make up the insurance liability for all those contracts where the obligation under the contract is purely the transfer of insurance risk. However, when the insurance company has sold other services to the policyholder, the Updated IAS 37 model includes a third margin. It requires the estimation of an additional and separate liability called the service margin.

Our own understanding of the service margin is that it is essentially the estimated future expected profit that the insurer will receive for any service other than standing ready for the payment of insurance claims and benefits. The logic for separating the risk and service components of the margin could be associated with the different economic characteristics of the two sub-sets of obligations: insurance risk obligations are contingent on the uncertainty of the future insurance event whilst the service obligations are non-contingent. This difference would impact the way in which the two margins will evolve over time, and it could be argued that it would be useful financial information to report them separately.

According to the Updated IAS 37 model, the calculation of the service margin should use a two level hierarchy – with the first being the requirement to look for the "sub contractor market", i.e. to look for how much would this subcontractor charge to perform exactly the same service obligations if the insurer were to subcontract the service obligations to a third party. Absent an efficient subcontractor market, the Updated IAS 37 would require the insurer to estimate from its own perspective what would be the expected profit to perform those service obligations on a stand alone basis.

In our opinion, it is plausible to expect that a service margin calculated on these bases would leave no residual margin to be reported because the entity's own estimate at the initial measurement date is highly likely to be influenced by the price negotiated with the policyholder. This would result in insurance contracts with risk and services obligations having a margin for risk and service margin reported as the components of the third building block whilst only "pure risk" insurance contracts liabilities would report a residual margin in addition to the margin for risk.

At the IASB meeting, several IASB members commented on the rationale for their votes. These offer insight in the direction the IASB will take to finalise the details of the new IFRS and we report below a selection of comments that in our opinion are particularly relevant to that extent.

- The development of the IFRS 4 Phase II exposure draft using the same basis of IAS 37 is a good compromise to bring IFRS for insurance contracts in line with mainstream IFRS for liability measurement.

- After initial measurement, the fixed composite margin of the CFV model does not faithfully represent in the financial statements the underlying current uncertainty of the estimates. The CFV model does not update the liability as the uncertainty changes – although the discounted best estimate changes if the mean of the underlying probability distribution changes, there is no impact on the liability from changes in the standard deviation around the same mean (e.g. when the probability distribution becomes wider or narrower around the mean).

- Respondents to the discussion paper (May 2007) were supportive of the building blocks approach, which is a feature of the Updated IAS 37. However the IASB members in favour of the CFV observed that the respondents also criticised the proposal of a service margin which is part of the model voted by the majority of the IASB.

- The CFV model is based on the proposals for the new revenue recognition IFRS and therefore may restrict the re-measurement of the obligation, possibly to onerous contract situations. Such an approach would introduce an implicit measurement bias that would be inappropriate for transactions with significantly variable outcomes such as insurance contracts. However, until decisions are taken on the subsequent release of the CFV composite margin, the overall effect of the CFV model on liability measurement is unclear. The IASB minority group indicated that consistency with the IFRS for revenue recognition is instead a positive characteristic in their eyes.

Profit pattern for residual margins

The Board reached important decisions on the time pattern that should be used to earn the residual margin liability and the interdependency with the changes on the current re-measurement of the three building blocks.

The ED will require that the residual margin liability is released to profit over the coverage period. Our understanding is that this would equate with the "contract boundary" that the IASB defined at its May meeting. The contract boundary was defined as the date at which point a new contract begins and an existing contract ends. The IASB identified that date as the time when the insurer has the power to cancel the contract or change the pricing or other terms. This high level principle will be expanded with additional guidance in the upcoming meetings.

The alternative approach that did not receive the support of the majority (although the majority was again a slim one: 8 against 7) would have used the full life of an insurance contract inclusive of the claims handling period.

In practical terms, the majority of non-life insurance contracts would present a coverage period that is often 12 months long. The residual margin will be required to be earned over that period.

This approach eliminates the issue we flagged in our Insurance Accounting Newsletter last August as it will provide the same profit pattern for insurance contracts required to be accounted for using the unearned premium method or those that will be accounted for using the three-building-blocks approach.

Contracts with longer duration periods, more frequently observed in the life insurance sector, would need to use a slower earning pattern. For example a 20 year term assurance with guaranteed fixed premium would have a contract boundary equal to the legal term. The coverage period would be 20 years and the residual margin would be earned over that period.

In relation to the interaction of the release of the residual margin with the changes in the three-building-blocks, the IASB voted overwhelmingly (11 members were in favour) for the two to be independent of each other. With this decision, the ED will require that residual margins are released to profit independently of the positive or negative experience arising from the revised estimates of the three-building-blocks liability rather than adjusting the unearned residual margin with a re-calibration process.

This is an important factor in understanding how profit will be recognised under the new accounting model. The release of the residual margin will be a regular component of profit recognised in the income statement. The length of the coverage period will be one of the key drivers for the speed at which the residual margin contributes to annual profits.

The other component to complete the shape of the earning pattern will be the choice of a variable to determine the pace of the residual margin release. At this meeting the IASB did not reach a conclusion on this final important matter and it asked the Staff to elaborate the proposals in preparation for the October meeting. The two main alternatives under consideration are a choice of drivers to be determined by the insurer based on the economic characteristics of the contract or reference to the release from the obligation to stand ready to pay claims (the risk release driver).

All the other components of the Updated IAS 37 model, i.e. the expected present value of future cash flows, the margin for risk and the service margin, will always be remeasured with their release to profit or loss to be a function of their active re-measurement at each balance sheet date.

Discount rates adjusted for illiquidity

The IASB also decided that the ED will contain principle-based criteria for the selection of the discount rate which will not indicate a particular rate for the discounting of insurance liabilities.

The ED will require selecting market interest rates that match three characteristics of the insurance contract cash flows: currency, duration and illiquidity.

The decision to take account of the liquidity of the liability cash flow is a very important step for the ED; it will avoid purely accounting losses on illiquid insurance liabilities such as those for annuity contracts. However, the IASB acknowledged that there is no widely accepted technique for determining the liquidity component of a liability discount rate and decided that it will leave this matter to insurers' judgement so that better techniques can be incorporated in the IFRS financial statements without the need to amend the text of the new IFRS. The ED will require extensive disclosure on how this adjustment is determined and the final decision on this matter will be taken during the November and December IASB meetings when the full set of disclosure requirements will be tabled.

The IASB Staff reported that the fifteen insurers that have agreed to take part in the targeted field testing will be asked to look at the effects of using a risk free rate for illiquid liabilities and to report back to the IASB on the practical bases they use to identify the illiquidity adjustment that will be required under the ED. Once the results of this field testing are available, the IASB will take the opportunity to consider whether further guidance on these matters should be added to the selected core principle.

The IASB decided that the ED will also prohibit determining the discount rate based on the expected return of the assets backing those liabilities except where asset performance is a component of contractual benefits, such as for participating contracts.

The ED will also prohibit the use of risk adjusted discount rate techniques for the discounting of insurance liabilities; the risk and uncertainty have to be captured explicitly in the margin for risk rather than added to the rate used to discount future cash flows. This is in line with the IASB's objectives of transparency and consistency.

The IASB deferred to the final outcome of its debate on own credit risk the confirmation that this component of market interest rates should not be included for insurance contracts accounting. Following the abandonment of the current exit price approach last June, we believe this decision will follow suit.

On a point of detailed planning for the ED, the IASB decided to avoid very prescriptive guidance; the intention is that all the standards that use time value of money as a component of the accounting model should have a single reference point, being the guidance contained in the future IFRS on Fair Value Measurement.

Timetable

The IASB Staff confirmed its commitment to publish an ED before the end of the year 2009, with a comment period that will end after five months, in May 2010. The IASB will then consider all the comments received with an aim to issue a final IFRS 4 Phase II in June 2011.

Policyholder accounting other than for reinsurance contracts held will be excluded from the ED. The Staff will therefore concentrate its efforts over the next few months on the principles for the issuers' accounting requirements, rather than the holders of insurance contracts. The five month consultation period will be used by the IASB to develop accounting principles for policyholders, which will be included directly into the final standard, without prior exposure.

As noted earlier, targeted field testing is now in progress with the first questionnaire on acquisition costs having been sent out to the fifteen companies involved. Following the decisions on margins, further questionnaires are being developed by the staff on that topic and on illiquidity premium for discount rates.

The plan is for the field testing to continue on a wider basis after the ED is published.

Next Steps

Paper 17E from the IASB meeting of 18 September sets out the details of the topics to be discussed for the rest of the year.

Accounting for participating business, presentation and disclosure are the main topics left for discussion in 2009. 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.

A joint FASB/IASB meeting is scheduled for the 26-28 October in the USA.

Appendix: Summary of tentative decisions to date

Converging views	IASB & FASB
Measurement approach	Basic features of measurement approach: • use estimates of financial market variables consistent with market prices. • use explicit current estimates of the expected cash flows. • reflect the time value of money.
Accounting profit	Prohibition from recognising accounting profit at initial contract recognition.
Negative day one difference	Recognise negative day one difference immediately as a day one loss.
Acquisition costs accounting	Expense as incurred through income.

Divergent views	IASB	FASB
Measurement objective	IASB has voted in favour (8 v. 7) of the Updated IAS 37 model versus the CFV model. Both models will be presented in the exposure draft.	FASB in favour of CFV.
Measurement approach – Margins	**Risk margin** – Include an explicit and remeasured margin for uncertainty. **Service margin** – Include an explicit and remeasured margin related to other services' profit. **Residual margin** – Include an explicit margin for initial calibration to premium net of acquisition costs. The residual margin will be earned over the coverage period, and its release to profit will be independent of changes in the three-building-blocks.	Include a single composite margin calibrated to premium (arguing that uncertainty is already taken into account in the probability-weighted estimates).
Acquisition costs definition	All costs expensed through income as incurred. However incremental costs directly attributable to secure the contract shall be used in the calibration of the initial measurement of the insurance contract.	Not considered as all acquisition costs expensed.
New business revenue recognition on day one	Recognise to the extent of incremental acquisition costs and the presence of a Residual Margin liability.	No revenue recognised at initial measurement since the liability is calibrated to the gross premium received from the policyholder.

IASB decisions not yet discussed by FASB	
Discount rates	• Principles based approach, based on liability characteristics (currency, duration and liquidity).
Policyholder accounting	• Excluded from the ED but to be included in the final IFRS.
Policyholder behaviour	• Cash flows from renewal and cancellation options are part of the contractual cash flows rather than part of a separate customer intangible asset. • Measurement of these options shall be based on a "look through" approach when reference to standalone price is not available.
Contract boundary	An existing contract terminates when the insurer has an unconditional right to re-underwrite/re-price that individual contract.
Unearned Premium Method	Requirement to use the unearned premium method to account for the pre-claim liability for all contracts which meet all of the following conditions: • cover 12 months or less; • no embedded options or guarantees; and • where the insurer is unlikely to become aware of events which could result in significant decreases in the expected cash outflows.

■ Recent changes

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