

Tackling the core issues of risk diversification and discounting of claims liabilities IFRS 4 Phase II Update

IASB and FASB joint meetings – December 2011
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Agenda

- Highlights of decisions from latest joint meetings
- Detailed analysis of Staff recommendations and Boards decisions for the FASB only meeting on 30th November and the joint meetings held on 15th and 16th December 2011
- Update on the timetable and next steps

Highlights – 15th and 16th December 2011

IASB decides to remove the definition of portfolio – 16th December Joint Meeting

- The IASB decided to remove the requirement to use the portfolio as the unit of account
- This decision expands the degree of diversification benefits allowed in the insurance liability

Discounting claims liabilities – 15th and 16th December Joint Meetings

- The principle of discounting for claims liabilities when it is material was ratified
- A practical expedient will be introduced whereby claims liabilities that will be settled within 12 months from the date they are incurred are permitted to be reported on an undiscounted basis

FASB converges on participating contracts – 30th November FASB only Meeting and 15th December Joint Meeting

- FASB has converged on a previous IASB decision that the insurance liability of certain participating contracts should be measured using the carrying amount of the relevant assets

Onerous contracts – 16th December Joint Meeting

- Past decisions were confirmed with no material change

Details of joint meeting – 16th December

Topics related to the unit of account and portfolio definition

The Staff presented three papers on this extremely important subject to attempt a comprehensive discussion of the issues associated with it:

1. Agenda paper 7A/77A: Definition of portfolio;
2. Agenda paper 7B/77B: Unit of account – Residual/single margin and onerous contracts; and
3. Agenda paper 7C/77C: Unit of account – risk adjustment

It is important to understand the recommendations from the three papers to appreciate the logic that led to the final tentative decision of the IASB and the deferral of the joint topics to a future meeting

Staff recommendation from paper 7A/77A

The staff recommends that

- a. the standard defines a portfolio of insurance contracts as:

Insurance contracts that:

(i) are subject to similar risks;

(ii) have similar expectations of profitability; and

(iii) are managed together as a single pool.

- b. It also recommends that the boards add application guidance to help insurers interpret the terms ‘similar risks’, ‘similar expectations of profitability’ and ‘managed together’.

Details of joint meeting – 16th December

Topics related to the unit of account and portfolio definition (cont.)

Staff recommendation from paper 7B/77B

The Staff recommends that:

- a. the residual/single margin at initial recognition should be determined at the portfolio level.
- b. the residual margin subsequent to initial recognition should be determined at the portfolio level [IASB only].
- c. in allocating the residual/single margin to profit or loss of particular periods an entity should group contracts within a portfolio that have similar:
 - i. inception dates;
 - ii. expected end dates; and
 - iii. expected patterns of release of the residual/single margin
- d. the onerous contract test should be performed at the portfolio level both (i) during the pre-coverage period and (ii) under the premium allocation approach.

Staff recommendation from paper 7C/77C

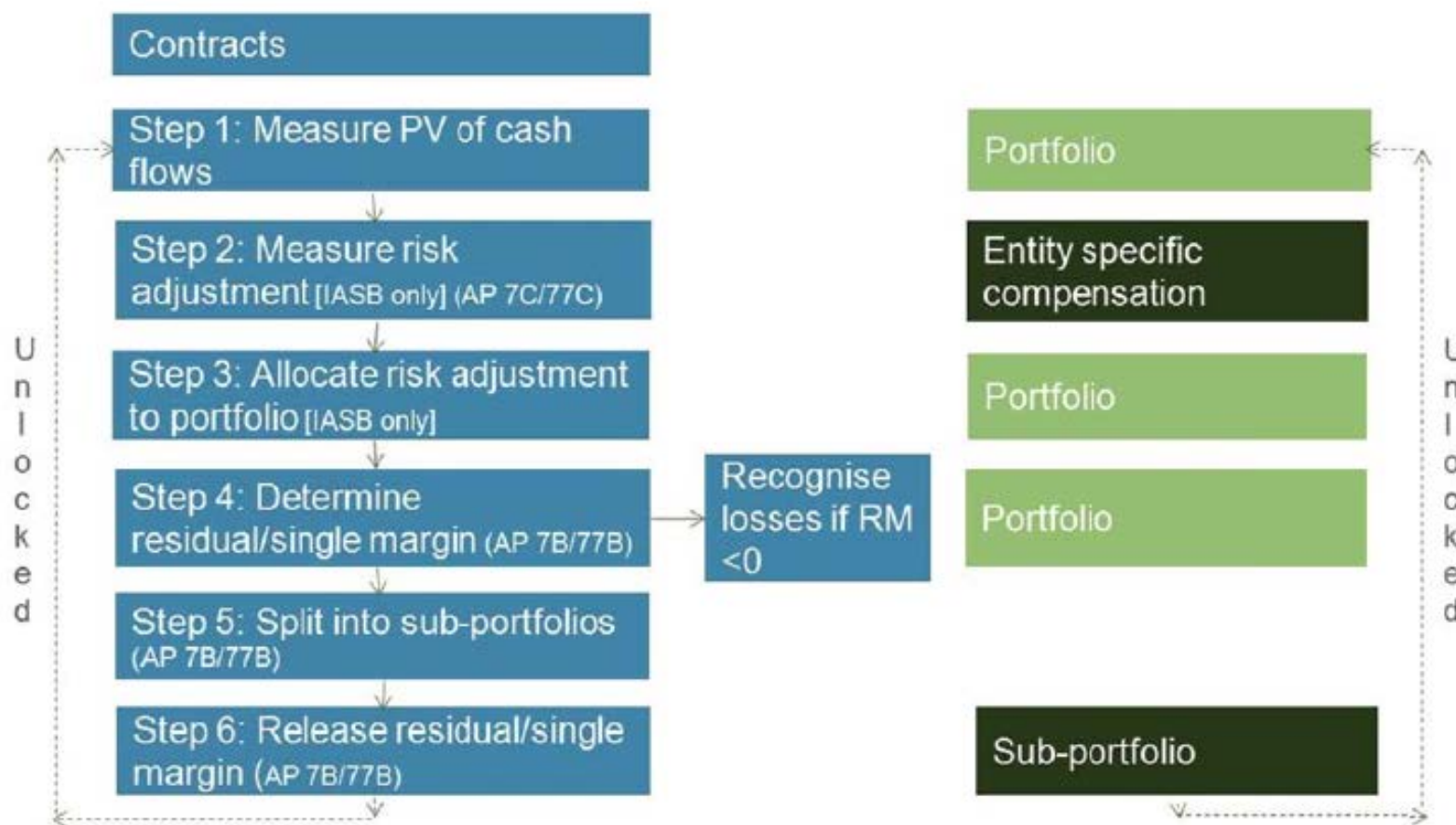
The Staff recommends that the unit of account to be used when calculating the risk adjustment should not be prescribed as long as the manner in which the risk adjustment is calculated achieves the overall objective of the risk adjustment.

Details of joint meeting – 16th December

Topics related to the unit of account and portfolio definition (cont.)

During the previous day the Staff had prepared an additional short paper (7I/77I) with a decision-tree illustration of the approach that they were recommending

Unit of account – process steps



Details of joint meeting – 16th December

Topics related to the unit of account and portfolio definition (cont.)

Discussion

- The IASB was supportive of the proposal in paper 7C/77C and with a majority of 9 members against 6 voted to measure the risk adjustment liability without relying on the definition of portfolio
- The Staff summarised well the rationale for this decision by noting that *“the objective of the risk adjustment is to measure the compensation a **particular** insurer requires for bearing the risk that the ultimate cash flows will exceed those expected. The amount of that compensation could therefore differ from insurer to insurer as the objective of the risk adjustment relies on the **entity specific** viewpoint.”*
- We believe this has two very important implications:
 1. The reporting entity determines the risk adjustment inclusive of diversification benefits emerging from different portfolios it has assembled that are negatively correlated with each other if this fact affects the compensation it would require for those combined risks;
 2. The risk adjustment liability could vary at the level of consolidated financial statements if the reporting “group” enjoys further diversification benefits across portfolios that could not be seized at individual subsidiary level

Details of joint meeting – 16th December

Topics related to the unit of account and portfolio definition (cont.)

Discussion

- The proposals from papers 7A/77A and 7B/77B attracted significant debate
- These would apply to both the IASB and FASB measurement models
- The overall response from the Boards noted that the complexity of these proposals appears to over engineer the accounting process
- In particular, the Boards were not supportive of the criterion that would group insurance contracts based on their expected profitability and asked it to be dropped
- There was an acknowledgement though that the excess of the present value of expected inflows over the expected present value of future outflows (plus risk adjustment for the IASB) needs to be allocated in a way that produces relevant and reliable information
- The Boards decided to return on this issue at a future meeting on the basis that they would accept the aggregation of contracts to consider at least:
 - Their economic duration based on the contract boundary; and
 - The risk characteristics and the associated pattern of release from that risk

Details of joint meeting – 15th and 16th December

Discounting in the liability for incurred claims (paper 7H/77H)

Staff recommendations include:

1. confirm the Boards earlier decision to require the discounting of the liability for incurred claims when the effects of discounting would be material.
2. do not provide additional guidance on determining when the effect of discounting of the liability for incurred claims would be immaterial.
3. for contracts to which the insurer applies the premium allocation approach, not to require discounting of incurred claims that are expected to be paid within 12 months of the claim occurrence date. However, insurers should discount incurred claims that are expected to be paid out after twelve months of the claim occurrence date if the effect is material.

Discussion

- The Boards dealt with this hot issue over the two days
- During the first day they unanimously confirmed their decision to require discounting of claims liabilities and that this would be subject to the usual materiality assessment applicable to all IFRS and US GAAP requirements

Details of joint meeting – 15th and 16th December

Discounting in the liability for incurred claims (paper 7H/77H) (cont.)

Discussion (cont.)

- We note that the IASB chair reported that a letter to the IASB and FASB chairs from the Hub Global Insurance Group had recommended the withdrawal of paper 7H/77H on grounds that insufficient due process had been followed on this matter. Both chairs noted their decision to decline the recommendation received
- The Boards summarised the rationale for their decision to confirm the discounting requirement:
 - Time value of money is part of economic reality and undiscounted claims liabilities would be a less reliable measurement;
 - All the undiscounted information about claims liabilities that is currently available will continue to be disclosed in the financial statements within the 10-year loss development tables

Details of joint meeting – 15th and 16th December

Discounting in the liability for incurred claims (paper 7H/77H) (cont.)

Discussion (cont.)

- During the second day they unanimously approved to not provide additional guidance around the concept of materiality for the accounting of claims liabilities
- The discussion on the third recommendation considered an expedient that partially mitigates the decision on materiality guidance and introduces an expedient for claims liabilities arising from portfolios under the Premium Allocation Approach – PAA, previously known as short duration contracts
- At the end of their discussion the Boards approved the recommendation unanimously. We noted the following practical points on the application of this decision:
 - Discussion confirmed that this expedient is only available for all portfolios of contracts under the PAA
 - Claims that are expected to settle over 12 months from occurrence would always need to be discounted, even if part of a portfolio where the expedient can be used

Details of joint meeting – 15th December

FASB converges on participating contracts

The Staff presented three papers on this to summarise and re-confirm the status of the joint work:

1. Agenda paper 7E/77E: Measurement of Contracts with Policyholder Participation: the Story so Far
2. Agenda paper 7F/77F: Options and guarantees embedded in Insurance Contracts ; and
3. Agenda paper 7G/77G: Cash flows that existing contracts require to be paid to future policyholders

Only the last two papers led to joint decisions which substantially confirmed the tentative decisions to date and the proposals contained within the ED / DP

Details of joint meeting – 15th December

FASB converges on participating contracts (cont.)

FASB decision on 30th November

- FASB had reached a decision on the accounting of certain participating contracts that converges with a prior IASB decision on the same subject
- These contracts are those with non-discretionary performance-linked participating features which contractually depend wholly or partly on the performance of the insurer's assets
- At the joint meeting the Boards ratified the convergent decision that the liability associated with these features would be measured and presented in a way that reflects the carrying value and presentation of these assets
- This approach allows the elimination of some of the asset-liability accounting mismatches

Details of joint meeting – 15th December

FASB converges on participating contracts (cont.)

Confirmation of the accounting for options and guarantees

- Given the importance of the decision on “non-discretionary performance-linked participating features” the Staff had planned to confirm the accounting treatment that would apply to the options and guarantees embedded in these and other insurance contracts
- The Boards unanimously confirmed that:
“options and guarantees embedded in insurance contracts that are not separately accounted for as derivatives when applying the financial instrument requirements should be measured within the overall insurance contract obligation, using a current, market-consistent, expected value approach.”

Details of joint meeting – 15th December

FASB converges on participating contracts (cont.)

Confirmation of the accounting for options and guarantees (cont.)

- With this in mind it is useful to note that the Boards clarified that the ultimate measure of those contracts with non-discretionary performance-linked participating features can be achieved in one or two possible ways:
 1. Develop a building blocks approach (inclusive of the expected value of options and guarantees noted above) which eliminates from it the changes in value from the assets that are not reflected in their accounting values (e.g. because they are at amortised cost); or
 2. Adjust the “normal” building block approach to eliminate those differences between the current fulfilment value of the liability and the underlying assets

Details of joint meeting – 15th December

FASB converges on participating contracts (cont.)

Clarification on the allocation of surpluses from participating funds

- The ED contained in paragraph B61(j) the following requirement on the cash flows an insurer must consider when measuring the current fulfilment value of insurance contracts:
“payments to current or future policyholders as a result of a contractual participation feature (including those features implied in the contract by regulatory or legal requirements) that provides policyholders with participation in the performance of a portfolio of insurance contracts or pool of assets.”
- The Boards clarified the nature of this requirement and unanimously approved that contractual obligations such as non-discretionary performance-linked participating features create an obligation that results in a liability for the insurer irrespective of the fact that it may be paid to a current or future policyholder
- This decision seems to move further the thorny subject of accounting for surpluses emerging from participating funds
- However it does not address the accounting of those surpluses that are not necessarily allocated to current or future policyholders often known as “inherited” or “orphan estates”

Details of joint meeting – 16th December

Onerous contract

Confirmation of previous decisions and deferral for short duration contracts

- The Staff produced paper 7D/77D which triggered broad consensus on the proposals paired with the acknowledgement that the expedient on claims liabilities from short duration contracts had not been fully reflected in the Staff analysis and that it would need to be discussed at a future meeting
- At the end of this final debate the official decision that the Boards recorded includes the following:
 1. Confirmation of the definition of an onerous contract as proposed in the ED;
 2. Confirmation of the tentative decision to link the performance of the onerous contract test to the presence of certain facts and circumstances, yet to be defined in full detail
 3. Confirmation of the need for an onerous contract test to be carried out in the pre-coverage period using the same approach as described under 1. and 2. above

Next steps and timetable

- No activity during the two weeks that followed the last set of joint meetings due to the Holyday Season
- Next joint meeting on insurance expected on 25-27 January
- FASB will hold educational session on 18 January
- Likely topic for discussion in January is the short duration contracts – eligibility criteria
- Next IWG meeting – Likely date late March 2012
- Technical plans of the IASB have been slightly amended with the same milestones reported in the FASB technical plans:
 - Release of a review draft or re-exposure (IASB) during the second quarter of 2012 (it was stated to be the first half of 2012 in the previous version)
 - Publication of an exposure draft (FASB) during the first half of 2012; and
 - Finalisation of the accounting standard in 2013

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