



# Global Insurance GAAP

Standard setting crunch time

IASB and FASB March joint meetings

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# Agenda

- Highlights of March joint meetings – 6 individual meetings for a total of 12 hours of Boards discussion
  
- Analysis of Staff recommendations and Boards' decisions
  - New “old” areas of disagreement
  - Agreement on new decisions
  
- Timetable and next steps

## Highlights of March joint meetings – disagreement

### Acquisition costs (16 March)

- FASB in favour of a calibration to Gross Premium (as previous tentative decision)
- IASB in favour of a calibration to Net Premium (reverted to initial 2009 position)

### Risk adjustment and option pricing (17, 22, 23 March)

- FASB in favour of a composite margin with no explicit re-measured risk margin (change of position from December 2009 acceptance of IASB approach)
- IASB reiterated its support for a clear objective for the risk adjustment consistent with IAS 37 (amount insurer would rationally pay to be relieved from the risk)

### Definition of significant insurance risk (22 March)

- In the middle of substantial agreement to use the IFRS 4 approach, one difference remained
- FASB in favour of requiring a contract loss scenario to test insurance risk (premium less claims) in addition to a variability of cash flows test
- IASB in favour of variability of cash flows only as in current IFRS4

# Highlights of March joint meetings – agreement

## Definition (22 March)

- Use of IFRS4 “compensation” instead of USGAAP “indemnification” in definition of insurance
- IFRS 4 definition of “significant insurance risk” carried forward to the ED
- Reduced timing risk should be a potential disqualifying feature in identifying insurance risk, rather than a primary condition for identifying insurance risk in a contract.

## Scope (22 March)

The Boards agreed the following would not be in scope of insurance accounting:

- Insurance contracts arising from employers’ obligations under pension plans
- Contingent consideration payable or receivable in a business combination
- Product warranties from a manufacturer, dealer or retailer (but warranties issued by a third party are in scope)
- Residual value guarantees embedded in a lease or issued by a manufacturer, dealer or retailer

# Highlights of March joint meetings – agreement (continued)

## Residual margin (15 March)

- In favour of residual margin being released over the coverage period normally using a straight line method based on passage of time unless expected claims/benefit pattern provides a better systematic and rational basis

## Participating contracts (23 March)

- IASB in favour of treating participating feature as contractual cash flows
- FASB narrowly supported this decision

## Disclosures (24 March)

- General principles agreed although much more work required to draft the detailed disclosure requirements
- Proposed disclosures were noted but not considered in detail pending further work:
  - participating contracts
  - risk adjustment

# Details of IASB/FASB joint meeting – 16 March

## Paper 6H – Acquisition costs

### Q1 – Approach to acquisition costs (AC)

#### Which approach should the ED propose?

- A) Recognise all AC as expense when incurred and no revenue recognised (current tentative decision).
- B) Direct measurement of the contract liability should be calibrated to the premium net of incremental AC.
- C) Incremental AC should be included in the contract CFs to determine the RM at the inception of the contract.

Recommendation	IASB	FASB
In favour of A	6	4
In favour of B or C	9	1

## Details of IASB/FASB joint meeting – 16 March

### *Paper 6H – Acquisition costs*

#### Consequences and next steps

Will the ED propose both options or will the Boards attempt further convergence?

Staff will investigate further the advantages and disadvantages of B and C.

- the distinctions are expected to be presentational rather than affecting profit or loss and will be most relevant where acquisition costs are incurred over an extended period not just at, or shortly after, inception of the contract.

The Boards noted that some acquisition costs may be recoverable either from the policyholder or from third parties. Staff were asked to investigate this further and whether these features could enable the Boards to reach some convergence.

- many long term policies contain implicit or explicit recoveries of amounts from policyholders on early termination that are designed to mitigate the economic effect of acquisition costs

# Details of IASB/FASB joint meeting – 17 March

## *Paper 6E – Option pricing and risk*

### Educational session

- The paper presented techniques for estimating the Risk Adjustment (RA):
  - Lattice models
  - Black-Scholes models
  - Incomplete markets
  - Option pricing
- The IASB Staff very much in favour of the 3BB approach and noted:
  - No single model will achieve all that is sought;
  - Need to ensure ease of use and understandability.
- Staff confirmed guidance could not go much beyond:
  - Objective of the RA
  - Desirable characteristics of the RA
- To complete their deliberations the Boards directed the staff to develop:
  - A clear expression of the objective of the RA;
  - More certainty over the choice of method;
  - Guidelines to evaluate what model is appropriate in what circumstances;
  - Real life numerical examples with comparison between methods

## Details of IASB/FASB joint meeting – 17 March

### *Paper 6D – Risk adjustment*

#### Q1 – Method for determining the risk adjustment

#### Staff recommendation:

- Not to require a particular method for determining a risk adjustment (RA).
- Include in the ED disclosures by line of business (or similar grouping) relating to:
  - amount of RA at reporting date;
  - type of approach and methodology chosen to determine the RA and reasons;
  - reasons for methodology differences between lines of business;
  - reasons and impact of change in methodology since last reporting period;
  - inputs used (description, sensitivity analysis);
  - roll forward (identifying new business, expired business, changes)
  
- The Boards did not vote at this session because more time for them to debate and work from Staff are needed

## Details of IASB/FASB joint meeting – 17 March

### *Paper 6D – Risk adjustment*

#### **Q2 – Risk adjustment definition**

**Staff recommendation:** That the Boards reaffirm their decision that the risk adjustment should be the amount the insurer requires for bearing the uncertainty that arises from having to fulfil the net obligation arising from an insurance contract.

- No consensus was reached and discussion deferred awaiting new Staff analysis. This was presented on 23 March.

# Details of IASB/FASB joint meeting – 23 March

## Paper 6L – Follow-up on risk adjustment

### Q – How to proceed on risk adjustment?

**Staff question:** How would the Boards like to proceed?

- 1) Follow staff recommendation not to require a particular method (as per paper 6D)
- 2) Limit the available methods
- 3) Refine the objective for the risk margin – where possibilities are:
  - a) The amount a market participant requires for bearing risk when **taking over** the insurance obligation (exit notion)
  - b) The amount the insurer would require today for **assuming the (remaining) risk** from the policyholder or another party (entry notion)
  - c) The amount the insurer would **rationally pay to be relieved** of the risk (the objective for the risk adjustment used in the IASB’s recent ED on IAS37)
- 4) Adopt a composite margin

Recommendation	IASB	FASB
3) Refine objective	8	1
4) Composite margin	7	4

Refine objective	IASB	FASB
a) exit notion	3	n/a
b) entry notion	4	
c) IAS 37	majority	

## Details of IASB/FASB joint meeting – 23 March

### *Paper 6L – Follow-up on risk adjustment*

#### Consequences and next steps

- The Boards are divided again on this key decision
- Both decisions could be reflected in the ED if the Boards fail to achieve convergence
- If a composite margin is selected many risk adjustment issues remain
  - the method of releasing that margin will need to be readdressed to take into account the risk adjustment included therein
  - inclusion of a risk adjustment within a liability adequacy test at inception for contracts with a day 1 loss will need to be considered
  - effect of no explicit remeasured risk margin on liability adequacy tests after inception
  - if there is no remeasured risk adjustment the earlier decision that embedded derivatives will not be unbundled unless not interdependent may need to be revisited
- The staff will
  - refine the measurement objective,
  - produce additional guidance on desirable features of a selected methodology, and
  - further consider proposed disclosures

# Details of IASB/FASB joint meeting – 23 March

## Paper 6I – Participating contracts

### Q – How to treat the participating feature / cash flows?

**Staff recommendation:** The Staff asked the Boards to choose from two views:

**View 1:** to consider payments arising from participating features as *contractual cash flows* as any other, or

**View 2:** to recognise a liability up to amount of legal or constructive obligation and the remaining part as *equity*.

### Proponents of view 1:

- participating contract is seen as one
- payments interrelated and depend on each other
- assessing which part is liability and which is equity too difficult and not useful

Recommendation	IASB	FASB
In favour of View 1	11	3
In favour of View 2	3	2

# Details of IASB/FASB joint meeting – 23 March

## *Paper 6I – Participating contracts*

### Consequences and next steps

- The Boards joint decision is not grounded on a solid FASB majority
- Absent positive confirmation, both decisions will be reflected in the ED as per due process requirement
- The Boards have still to consider the issue of contracts without significant insurance risk (i.e. investment contracts) that have discretionary participation features
- Staff will continue to research issues relating to mutual insurers and may identify further issues to be considered by the Boards
- Disclosures for participating contracts were not considered in detail but agreed that the staff will research disclosures further based on the requirements of IFRS4 and as summarised in the agenda paper for the Boards

# Details of IASB/FASB joint meeting – 22 March

## Paper 6A – Definition of insurance contract

### Q1 – “compensation” rather than “indemnification”

**Staff recommendation:** That the word “compensation” be used in the definition of an insurance contract instead of “indemnification”.

- Currently no definition of insurance contract in USGAAP.
- Used in the context of the IFRS 4 definition, both words appear similar.
- Compensation is more appropriate for some types of insurance (e.g. life insurance and “new for old” insurance)

Recommendation	IASB	FASB
In favour of	unanimous	
Against	n/a	

# Details of IASB/FASB joint meeting – 22 March

## Paper 6A – Definition of insurance contract

### Q2 – Determining insurance risk

**Staff recommendation:** That the description of significant insurance risk contained in IFRS 4 be brought forward to the ED (amended to change the factors considered in evaluation of significance of insurance risk from absolute amounts to present values).

- The decision on whether insurance risk is significant or not is the key component of the definition
- Staff commented on this topic indicating that:
  - Judgement required and decision dependant on context;
  - Assessment made on a contract by contract basis;

Recommendation	IASB	FASB
In favour of	unanimous	
Against	n/a	

# Details of IASB/FASB joint meeting – 22 March

## Paper 6C – The role of timing in insurance risk

### Q1 – The role of timing risk

**Staff recommendation:** That the role of timing risk in identifying insurance risk should be disqualifying, rather than a primary condition for judging insurance risk in a contract. This would depart from the current USGAAP approach in which underwriting and timing risk are given equal prominence.

- USGAAP currently requires both risks to be present, for historical reasons.
- IFRS 4 currently requires either to be present.
- Contractual terms that delay timely reimbursement to the policyholder can significantly reduce insurance risk, so that some contracts containing such terms might not transfer significant insurance risk

Recommendation	IASB	FASB
In favour of	unanimous	
Against	n/a	

# Details of IASB/FASB joint meeting – 22 March

## Paper 6C – The role of timing in insurance risk

### Q2 – Identifying existence of risk

**Staff question:** In applying the analysis of insurance risk to possible outcomes under a contract, should the focus be on:

- A. the range of possible outcomes and the significance of reasonably possible outcomes relative to the mean, or
- B. the existence of a possible outcome in which the present value of the net cash flows is negative.

- View A assesses whether there is variability
- View B assesses whether there is variability and the possibility of a loss

Recommendation	IASB	FASB
In favour of A	9	2
In favour of B	6	3

## Details of IASB/FASB joint meeting – 23 March

### *Paper 6A and 6C – significant insurance risk*

#### Consequences and next steps

- The Boards agreed on most aspects and remained divided only on the requirement for the possibility of loss test in addition to the variability of cash flows test
- This issue is likely to be significant for certain reinsurance contracts and may also be relevant to other types of contract as the Boards have still to discuss
  - financial guarantee contracts and
  - health insurance contracts issued by an entity that is not a regulated insurer
- The Boards expect to discuss this issue further and may reach agreement before the ED is prepared

# Details of IASB/FASB joint meeting – 22 March

## Paper 6B – Scope

### Q – Exclusions from scope

**Staff recommendation:** That the following contracts should be excluded from the scope of the forthcoming exposure draft on insurance contracts:

- a) residual value guarantees embedded in a lease;
- b) employers’ assets and liabilities under employee benefit plans and retirement benefit obligations reported by defined benefit retirement plans;
- c) contingent consideration payable or receivable in a business combination.

In addition, the Boards voted the following to be out of scope:

- insurance warranties issued directly by a manufacturer, dealer or retailer
- residual value guarantees embedded in a lease or issued by manufacturer dealer or retailer

Recommendation	IASB	FASB
In favour but with further exclusions	unanimous	
Against	n/a	

# Details of IASB/FASB joint meeting – 23 March

## *Paper 6B – scope*

### Consequences and next steps

- Fixed fee service contracts
  - The Boards expressed an initial view that these should be out of scope but noted that it may not be appropriate to exclude such contracts because they provide benefits in kind rather than cash.
  - The Boards expect to discuss this issue further when they also consider whether health insurance contracts issued by non insurers should be within the scope of the insurance standard
- The Boards will consider whether financial guarantee contracts should be within the scope of the insurance standard at a future meeting.

## Details of IASB/FASB joint meeting – 15 March

### *Paper 6F – release of residual margins and recognition of revenue*

#### Q1 – Residual margin

**Staff recommendation:** that the insurer should release the residual margin in a systematic way that best reflects the exposure from providing insurance coverage from providing insurance coverage. For this purpose, the insurer uses the expected value of claims and benefits to be incurred over the coverage period.

=> Residual margin released over the coverage period.

The Boards tentatively decided that the insurer should release the residual margin over the coverage period in a systematic way that best reflects the exposure from providing insurance coverage, as follows:

- on the basis of passage of time; but
- if the insurer expects to incur benefits and claims in a pattern that differs significantly from passage of time, the residual margin should be released on the basis of the expected benefits and claims

# Details of IASB/FASB joint meeting – 15 March

## *Paper 6F – release of residual margins and recognition of revenue*

### Consequences and next steps

- The Boards will discuss at a future meeting whether the residual margin will accrete interest.
- Members noted that as the residual margin is the net effect of expected inwards and outwards cash flows expected under the insurance contract measured on a present value basis the residual margin should similarly be measured on a present value basis rather than considered a fixed amount determined on inception of the contract.
- If the Boards do not reach agreement on inclusion of a separate risk adjustment and instead propose a composite margin the release of that composite margin will require consideration by the Boards.

Recommendation	IASB	FASB
In favour	10	4
Against	5	1

# Details of IASB/FASB joint meeting – 24 March

## *Paper 6J – Disclosures*

### **Q – Disclosures principles**

**Staff recommendation:** That an entity shall disclose information that:

- a) Explains the characteristics of its insurance contracts;
- b) Identifies and explains the amounts in its financial statements arising from insurance contracts; and
- c) Helps users of its financial statements to evaluate the nature and extent of risks arising from insurance contracts.

And that those principles be supplemented by specific disclosure requirements and that should, as a minimum, include the specific disclosure requirements that are currently in IFRS 4.

Additional disclosures proposed for:

- participating contracts;
- risk adjustment; and
- other specific issues to be considered.

# Details of IASB/FASB joint meeting – 24 March

## *Paper 6J – Disclosures*

### **Q – Disclosures principles**

#### **Comments from the Boards:**

- Agreement with general principles (b – amounts) and (c – risks) but noted particularly in relation to (a – characteristics) there needs to be clear explanation of requirements to strike an appropriate balance between excessive detailed disclosure and high level boiler plate disclosure
- Principle (c – risks) needs to be more specific re: uncertainty in cash flows
- Level of disaggregation is important
- The Boards will need to agree on presentation before agreeing on disclosures
- Other issues still to be considered by the Boards may result in additional disclosure requirements
- Disclosure requirements should not refer to other standards (e.g. reference to IFRS7 in IFRS4) All relevant disclosure principles and requirements should be brought into the new insurance standard

# Outstanding issues to be discussed before the ED

## Outstanding issues from March meetings – to be tabled

- Divergence between the Boards (acquisition costs and risk adjustment)
- Residual margin (interest accretion)
- Scope (financial guarantee, fixed fee and health insurance contracts)
- Investment contracts with DPF (scope allocation IFRS 4 v. IFRS 9)
- Presentation and disclosures detailed guidance

## Outstanding Issues – tabled for April 2010 meetings

- Unbundling and embedded derivatives (FASB request)
- Level of aggregation – diversification benefits
- Contract boundaries detailed guidance
- Discount rate selection criteria (IASB decision as the starting point)
- Unearned premiums approach (IASB decision as the starting point)
- Transition in conjunction with financial instruments project
- Recognition and derecognition (different views)
- Business combinations

# Timetable

## Commitment to an exposure draft in 2010

- No changes proposed this month although a delay to June is likely in Deloitte's opinion:
  - Exposure draft issue date still May 2010
  - Comment period closure still September 2010
  - Standard remains due in June 2011

## Future meetings

- Additional joint and individual meetings are scheduled in April focussed around the board week on 19 April

## Will the timetable be met?

- Given the outstanding issues still to be resolved an exposure draft in May looks optimistic
- Boards are converging on many new areas despite reopening two old differences
- Their commitment to delivering a standard in June 2011 before there is substantial change in the composition of the IASB is also very high

# Contact details

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