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Global Insurance GAAP

Update from the joint FASB-IASB meeting on insurance accounting on 23 July 2009

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Agenda

- Outcomes of the July joint FASB-IASB meeting on insurance accounting
- Similarities and differences between IASB and FASB's positions
- Other IASB decisions
- Next steps

Outcomes of the July joint FASB-IASB meeting on insurance accounting

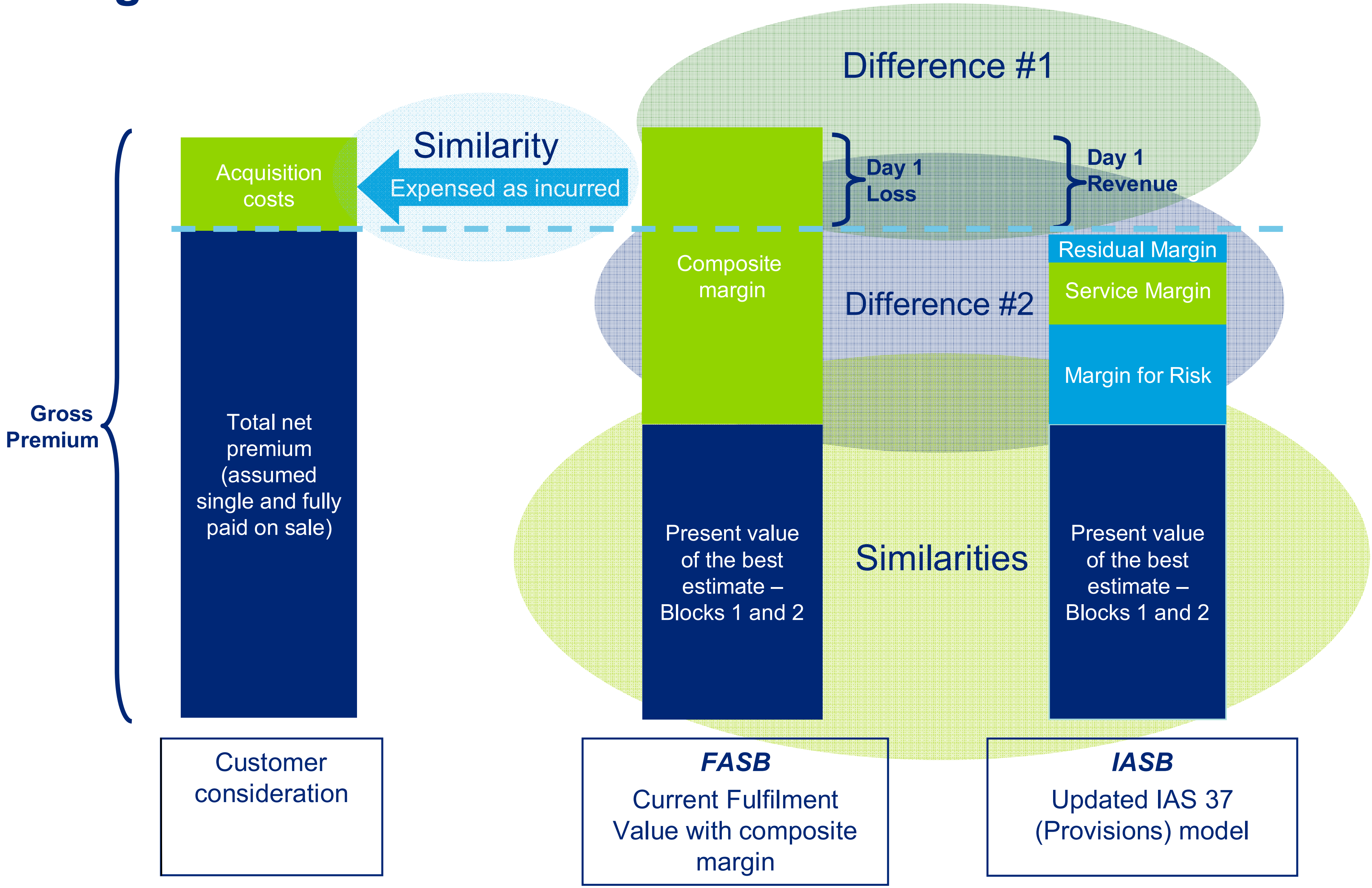
Agreement on several principles

- 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"

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)

Filing for divorce?



Difference #1 – Initial measurement objective

IASB Position

- Contract liability should be the same for the same risk – the entity's choice on how to sell the contract should not impact the initial measurement
- Day one revenue follows from this principle but no profit (initial calibration would cap the revenue against acquisition costs incurred)
- Acquisition costs considered for calibration must be incremental and directly attributable – all other costs are excluded from calibration

FASB Position

- Contract liability should be based on the policyholder's consideration to receive insurance protection
- Initial calibration of the contract liability produces no revenue because at the point of sale no service is delivered
- All acquisition costs must be expensed as incurred – same as under IASB position

Differences on day 1 – IASB model

		CU
AC	Acquisition Cost (all incremental)	(10)
SP	Single Premium	100
MfR	Margin for Risk	(15)
SM	Service Margin	(3)
Block 1 & 2	Probability weighted present value of future cash flows (in our example, resulting in a net cash outflow as no future premiums will be received but future claims and expenses will have to be paid)	(70)
RM	Residual Margin	(2)

Asset	
Premium receivable	100
	100

Liabilities	
Commission payable	10
Insurance contract liabilities	90
	100

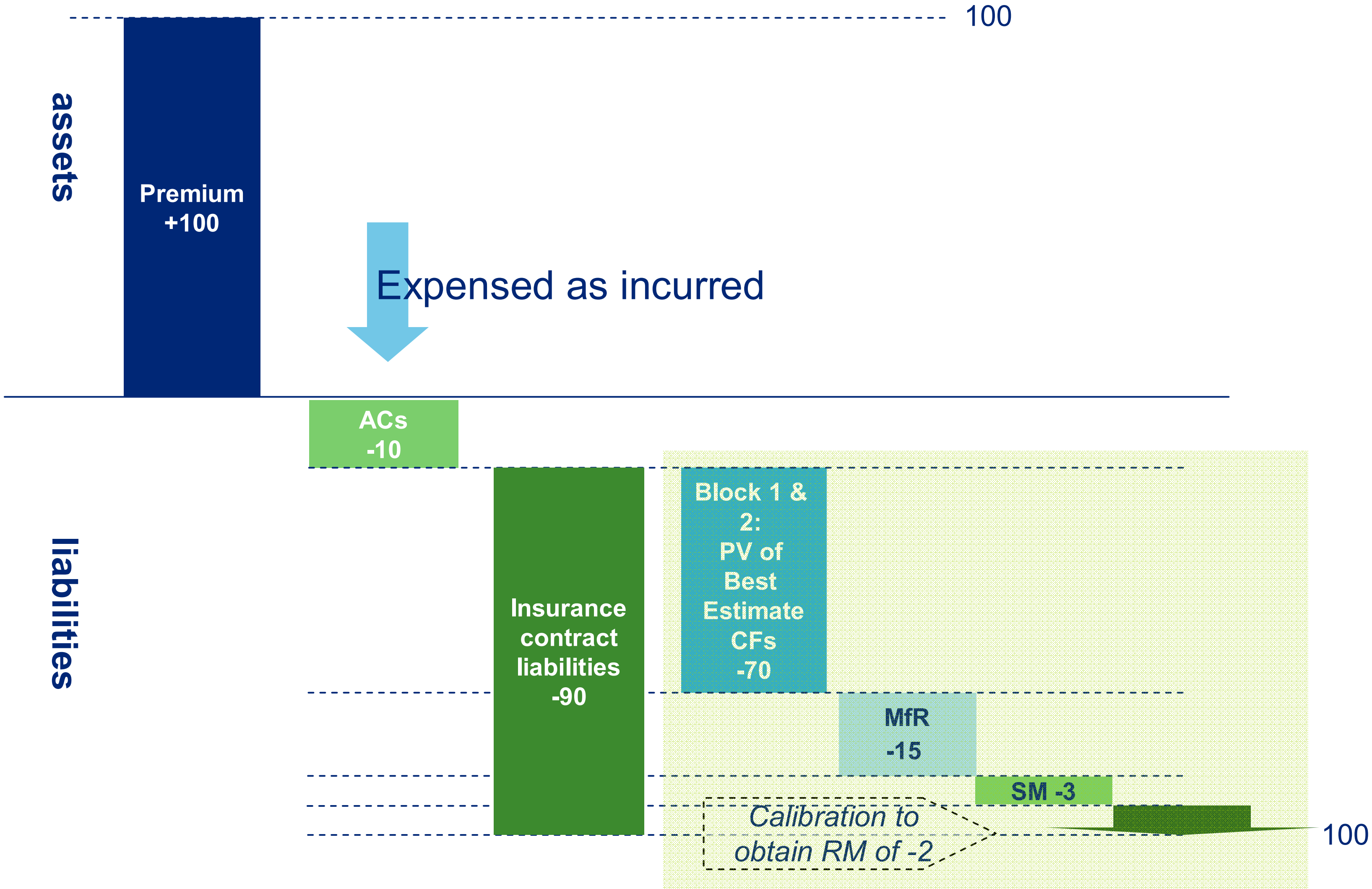
Income Statement*	
Revenue	10
Less: comm	(10)
Net Result	-

** Deposit accounting format*

Income Statement**	
Revenue	100
Less: ins liab	(90)
Less: comm	(10)
Net Result	-

*** Gross presentation format*

IASB calibration diagram



Differences on day 1 – FASB model

		CU
AC	Acquisition Cost	(10)
SP	Single Premium	100
CM	Composite Margin	(30)
Block 1 & 2	Probability weighted present value of future cash flows (in our example, resulting in a net cash outflow as no future premiums will be received but future claims and expenses will have to be paid)	(70)

Asset	
Premium receivable	100
	100

Liabilities	
Commission payable	10
Insurance contract liabilities	100
Retained loss	(10)
	100

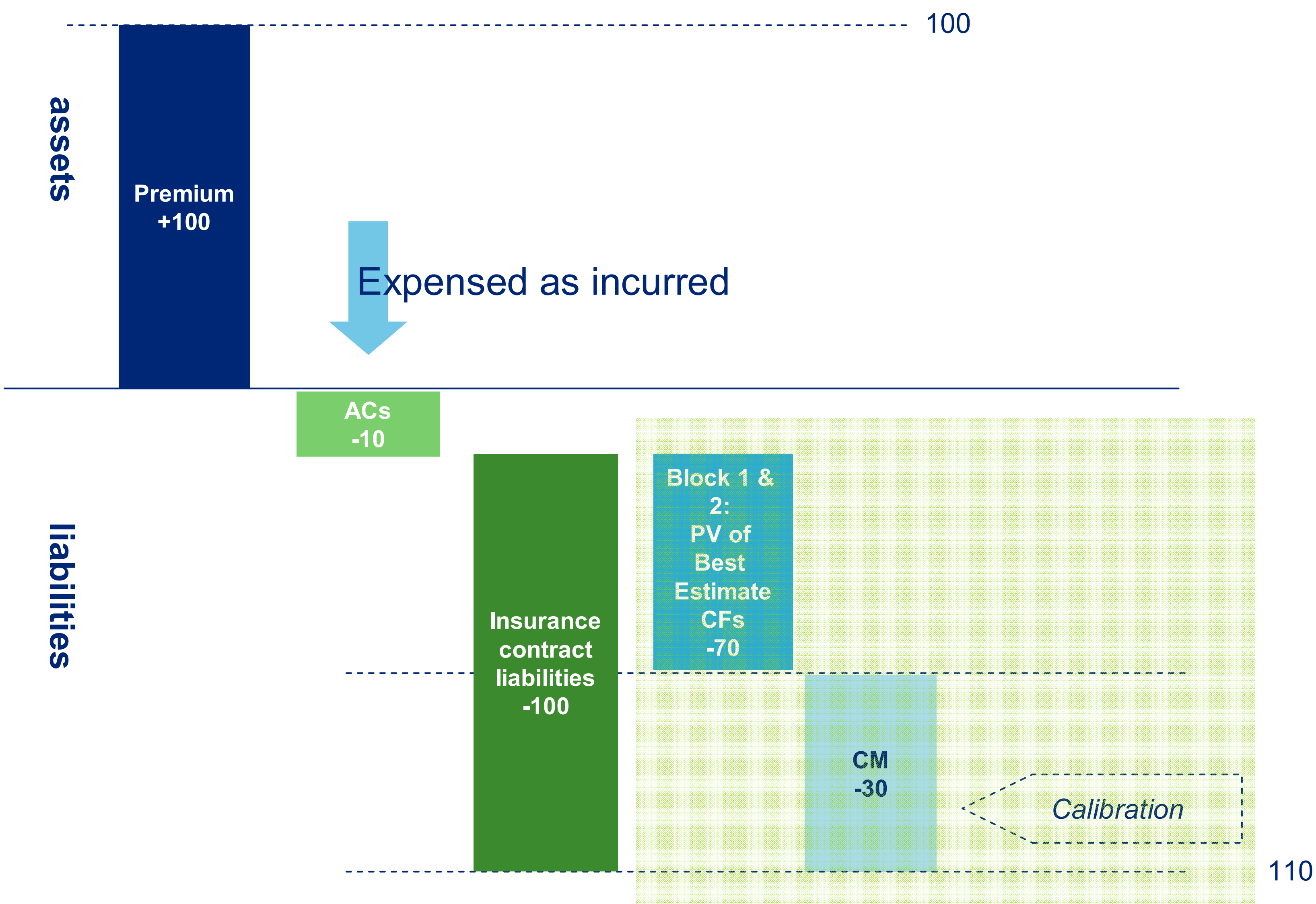
Income Statement*	
Revenue	-
Less: comm	(10)
Net Result	(10)

** Deposit accounting format*

Income Statement**	
Revenue	100
Less: ins liab	(100)
Less: comm	(10)
Net Result	(10)

*** Gross presentation format*

FASB calibration diagram



Difference #1 – Summary of the debate

IASB Position

Tentative vote:

- 8 supported existing IASB position
- 3 supported recognising a contract asset based on acquisition costs which would be amortised subsequently
- 4 supported FASB position

FASB Position

- Unanimous in prohibiting DAC – Insurers should not be given different treatment
- No performance obligation has been delivered on sale – No reason to recognise revenue

Decision

- Unless agreement can be reached at next joint meeting on 26-28 October 2009 both options will be included in the Exposure Draft and respondents will be asked to choose between them

Difference #2 – Nature and purpose of Block 3, the margin(s)

Preamble

- IASB Staff has developed a more articulated proposal than FASB staff
- IASB Members have expressed a directional preference for their staff proposal but no “firm” vote in its favour yet
- FASB members have a clear view of their model only at initial measurement but no decision yet on subsequent measurement

IASB model

- The idea is to align insurance contracts with the accounting for all other liabilities (e.g. provisions)
- All other liabilities are accounted for under IAS 37 – an IFRS currently revised
- Revisions of IAS 37 significantly affected by insurance accounting debate
- Key characteristics of the “IAS 37” model are:
  - Has a conceptual measurement attribute that IASB majority approved;
  - Absent a transfer market, estimates are entity specific;
  - Entity specific estimates use market inputs whenever observable prices exist;
  - Estimate is done using a “three-building-blocks” approach; and
  - Margin includes two components: risk and profit.

Difference #2 – Nature and purpose of Block 3, the margin(s) (continued)

Adapting the "IAS 37 model" to insurance

- Key modification to reflect the economics of the contractual relationship
- IASB Staff proposal: include the requirement of calibration against price less incremental acquisition costs
- Benefits
  - – Insurance brought clearly within mainstream IFRS
  - – Mainstream IFRS benefits from insurance discussion
  - – Relatively small modification to adapt IAS 37 to insurance economics
  - – Mostly in line with certain industry positions (Current Fulfilment Value)

FASB rejected the "IAS 37 model" in favour of a Current Fulfilment Value

- Margin for risk is not required in a fulfilment notion – uncertainty is captured in the probability distribution (Block 1)
- Margin/Block 3 should be
  - – comprehensive of all risks and obligations (a "composite margin")
  - – the result of the calibration to the gross premium to stay in line with Revenue project
  - – FASB has not yet decided how the composite margin is released to profit

Difference #2 – Nature and purpose of Block 3, the margin(s) (continued)

Reflecting estimation uncertainty in financial reporting

- IASB Position
  – Uncertainty should be measured explicitly – risk margin does that
- FASB Position
  – Uncertainty is captured in Block 1 by applying to cash flows the probability distribution. No separate measurement is necessary

Example:

- Consider two insurance contracts and their possible outcomes:
  – Contract A – Two possible outcomes 1) 50% chance of 90 payout; 2) 50% chance of 10 payout
  – Contract B – Also two possible outcomes 1) 50% chance of 49 payout; 2) 50% chance of 51 payout
  – IASB – because the uncertainty in contract A is higher and the simple application of the probability distribution (the mean) would not convey that information it is more decision useful to require its explicit measurement
  – FASB – no, any measure of the variability of cash flows implies a market concept alien to the objective of a fulfilment value approach. The measure of the expected value (the mean) already captures the uncertainty

Other decisions taken by IASB only during July

Unearned Premium Method

- IASB decided to require the use of the unearned premium method for all contracts that:
  – Have coverage of 12 months or less;
  – Have no embedded options or guarantees; and
  – The insurer is unlikely to become aware of events during the coverage period that could cause significant decreases in the expected cash out flows (i.e. actual incurred claims during coverage period must be in line with expected claims at inception).

Potentially creating a different profit pattern among insurers

- Under the unearned premium model:
  – All margins earned over cover period not the settlement period; and
  – Post claim liability recognised as claims incurred. After the end of the cover period the only remaining margin could be the margin for risk
- Under the three-building-blocks model (both versions):
  – Both residual margin and risk margin could be released to profit over the cover and settlement periods
  – Residual margin released to profit more slowly

Next steps

Urgent work is required in a number of areas and is planned for September meetings:

- Accounting principles for the release to income of margins
- Finalise the parallel development of the IAS 37 model for other liabilities
- Presentation of premiums and claims in the income statement

To follow …

- Completion of the analysis and decision on all other aspects of the model to finalise the ED, among the more notable issues:
  – Criteria for the selection of the discount rate
  – Accounting for participating contracts
  – Unit of measurement (portfolio or wider diversification benefits)
- If IASB/FASB continue to disagree at their next joint meeting (26-28 October) the ED due in December will be different under IFRS and US GAAP with questions to address differences.
- FASB is expected to catch up on its own model to deal with all the other matters already decided at IASB (e.g. renewal and cancellation options, unearned premium method)

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