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Topic

Insurance contracts – Joint IASB and FASB project – An observer's view on open issues

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Insurance Contracts – Joint IASB and FASB project

An observer's view on open issues

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Insurance Contracts Project – Background

- The only “non-MoU” and “non-financial crisis” joint project on the current active agenda
- Known as the “IFRS 4 Phase II” project following the completion of the “interim solution” IFRS 4 in March 2004
- Joint project since Q4 2008
- Open issues in four major areas:
  - Insurers’ Asset-Liability Management (ALM) and the interaction of standard setting decisions across the balance sheet
  - The accounting for uncertainty and the Boards’ disagreement on the risk adjustment liability
  - Profit emergence and insurance portfolios’ economics
  - Presenting success and failure: fitting volume and profit disclosures on the same page

Insurers’ ALM and the interaction of standard setting decisions across the balance sheet

- Characteristics of insurance business that create difficult asset-liability accounting problems:
  - Reverse of the typical business cash cycle: proceeds are received before most expenses are paid
  - High leverage: similar to banks, “on balance sheet” accumulation of customer receipts creates a leverage effect on profits and makes the management of asset-liability matching a critical business activity
  - Mutualisation of risk transfer: to deliver this key service insurers assemble and manage portfolios of contracts
  - Profit sharing with customers: insurers offer extensive opportunities to share profits with their customers – a legacy of their mutual past

Insurers' ALM and the interaction of standard setting decisions across the balance sheet (cont.)

- The reversal of the cash cycle makes the liability estimation a critical component
- The Boards agreed that a 3-building-block approach is the best route to deliver transparent information on this component
- The Boards implicit solution to reporting the matching of assets and liabilities is a current measurement through profit or loss of the entire balance sheet
- Insurers are dissatisfied because they view a similar situation being solved for banks with a cost measurement approach – level playing field
- The Boards agreed on discount rate allowing a "top down" option. This new guidance will allow a better link to ALM practices
- The IASB proposed a closer link to asset accounting when sharing with customers is in place (participating contracts)
- An "OCI solution" has been considered, but not approved so far, to address:
  - Credit risk volatility; and
  - Reinvestment risk and discounting for ultra long liability durations

The accounting for uncertainty and the Boards' disagreement on the risk adjustment liability

- Boards' views on the use of statistical probabilities within financial reporting for insurance contracts
  - Agreement on the use of the statistical mean for the estimate of the probability weighted present value of expected cash flows;
  - Disagreement on the use of information on the uncertainty surrounding the mean
- Boards acknowledge that practices to develop reliable techniques to measure uncertainty from a financial reporting perspective are evolving
- Boards appear to have accepted the use of portfolios as the unit of measurement for insurance contracts
- Is this decision on unit of measurement making a real difference without an explicit risk adjustment liability to capture the evolving uncertainty around the mean?

The accounting for uncertainty and the Boards' disagreement on the risk adjustment liability (cont.)

- Boards accept that the answer should be positive: both have decided that the insurance liability would have a component (a third building block) in addition to the expected present value based on the mean
- However they have fundamentally different ways on how to apply this principle in practice
- IASB retains an explicit link with the pool of contracts as a whole by requiring the remeasurement of the risk adjustment liability at a portfolio level until uncertainty disappears
- FASB adopts two different solutions on the grounds that there are two separate accounting models for insurance contracts:
  - For claims liabilities arising from short duration contracts it will not measure this uncertainty leaving the expected present value based on the statistical mean only; and
  - For all other contracts it will use a measure of cash flow variability to account for the reduction of the third building block

The accounting for uncertainty and the Boards' disagreement on the risk adjustment liability (cont.)

- It could be argued that the FASB model would be able to operate without a portfolio based measurement given that statistical means are not affected by the shape of the probability distribution
- The view on the role of the portfolio creates a second point of divergence in relation to acquisition costs
- Both Boards agree that these costs should be treated as a component of the contractual cash flows to properly reflect the economics of portfolio management
- IASB views the assembly of portfolios as inclusive of unsuccessful efforts in selling individual insurance contracts
- FASB views the cost of assembling a portfolio as comprising only the costs associated with successful sales of individual contracts to be more consistent with other projects, such as revenue recognition
- This creates a difference on the third building block at initial recognition with an impact on subsequent measurement

Profit emergence and insurance portfolios' economics

- The divergent conclusions on the accounting for uncertainty have a knock on effect on how profit will emerge from a portfolio of insurance contracts
- Both Boards agree that it is the fulfilment of the obligations that should drive the profit recognition
- IASB approach is a single model with two drivers:
  - Release from risk – actively measured via the risk adjustment liability; and
  - All other profit drivers – resulting from the release of the residual margin over the coverage period combined with an "unlocking" principle
- FASB approach comprises two models
  - Short term contracts – full profit is earned via the earning of premiums over the coverage period
  - Other than short term contracts – based on measuring reduced variability of cash flows assessed with reference to two contract categories (variability from timing and variability from severity and frequency)

Profit emergence and insurance portfolios' economics (cont.)

- Profit when things change: the IASB has agreed that it would "unlock" prospectively the amortisation of the residual margin including the possibility of "write back" past earned margins.
- FASB has decided to release to profit the single margin based on reduced cash flow variability. Increase of variability would be applied prospectively without "writing back" past earned margins
- Profit at the point of sale: divergence on the acquisition costs noted earlier creates a different loss on sale and a different margin within the liability
- Profit from other components: both Boards have agreed to separate bundled components when the criteria set out in the revenue standard are met and for "explicit account balances"
- Profit from sharing with customers: both Boards have agreed to measure the prospective distribution of participating assets to policyholders with the insurer's share recognised as it emerges from the retained assets' returns

Presenting success and failure: fitting volume and profit disclosures on the same page

- The Boards agreed that the margin-based presentation did not offer a prominent indicator of the volume of activity an insurer carries out
- The agreement has selected “premiums due” as the compromise basis for the building blocks contracts with the understanding that
  - The amounts of premiums due do not represent revenue; and
  - They may relate to contracts sold in prior periods (e.g. premiums due from regular premium long term contracts such as pension plans)
- “Premiums earned” will be used for short duration contracts
- The configuration for the statement of comprehensive income will include two sections:
  - Building-blocks
  - Short duration contracts
- The IASB, although initially split on this proposal, indicated they would not oppose proceeding on this basis

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