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Project **Insurance**

Topic **The role of timing in insurance risk**

Introduction

1. The purpose of this paper is to analyse the role of timing risk in the definition of insurance risk. Today, the FASB's definition of insurance risk requires the presence of both underwriting and timing risk. The definition in IFRS 4 does not require both.

A brief history

2. Paragraph 44 of FASB Statement No 5, *Accounting for Contingencies,* made the following observation:

> To the extent that an insurance contract or reinsurance contract does not, despite its form, provide for indemnification of the insured or the ceding company by the insurer or reinsurer against loss or liability, the premium paid less the amount of the premium to be retained by the insurer or reinsurer shall be accounted for as a deposit by the insured or the ceding company. Those contracts may be structured in various ways, but if, regardless of form, their substance is that all or part of the premium paid by the insured or the ceding company is a deposit, it shall be accounted for as such. (Codification Section 944-20-15-1B)

3. That paragraph seemed to be enough, because FASB Statement 60, *Accounting and Reporting by Insurance Enterprises,* did not include a definition of what constituted an

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insurance contract, other than as something that insurance enterprises issue. (It did carry forward the FAS 5 guidance in reference to reinsurance contracts.) Paragraph 15 of FASB Statement 97, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments,* defined *investment contracts*, as:

> Investment contracts issued by an insurance enterprise, as defined in this Statement, do not incorporate significant insurance risk as that concept is contemplated in Statement 60 and shall not be accounted for as insurance contracts. Amounts received as payments for such contracts shall not be reported as revenues. Payments received by the insurance enterprise shall be reported as liabilities and accounted for in a manner consistent with the accounting for interest-bearing or other financial instruments.

4. FASB Statement 113 defined insurance risk as:

> The risk arising from uncertainties about both (a) the ultimate amount of net cash flows from premiums, commissions, claims, and claim settlement expenses paid under a contract (often referred to as underwriting risk) and (b) the timing of the receipt and payment of those cash flows (often referred to as timing risk). Actual or imputed investment returns are not an element of insurance risk. Insurance risk is fortuitous—the possibility of adverse events occurring is outside the control of the insured.

5. The FASB Codification Master Glossary breaks the definition into three parts:

(a) Insurance risk

> The risk arising from uncertainties about both underwriting risk and timing risk. Actual or imputed investment returns are not an element of insurance risk. Insurance risk is fortuitous; the possibility of adverse events occurring is outside the control of the insured.

(b) Underwriting risk

> The risk arising from uncertainties about the ultimate amount of net cash flows from premiums, commissions, claims, and claim settlement expenses paid under a contract.

(c) Timing risk

> The risk arising from uncertainties about the timing of the receipt and payments of the net cash flows from premiums, commissions, claims, and claim settlement expenses paid under a contract.

6. FAS 113 was designed to address a growing number of reinsurance contracts, including those known as *financial reinsurance*, that were used to change the financial picture of an insurance enterprise. For many of those contracts, the emphasis was clearly on the word “financial.” A 1992 FASB staff memorandum quotes an industry advertisement

describing financial reinsurance as "a contract that removes reserves from the balance sheet in excess of the consideration paid."

7. One of the key techniques used in structuring financial reinsurance was to disconnect the timing of payments by the reinsurer from payments by the ceding company to its policyholders. Consider a simple example. A ceding company pays a reinsurance premium of CU 900. The reinsurer agrees to reimburse claims from a book of one-year auto insurance policies of up to CU 1,400. In previous years, the claims on similar policies have ranged from CU 1,000 to CU 1,500. That seems like the reinsurer has taken on significant underwriting risk from the ceding company.

8. However, this reinsurance contract provides that the reinsurer's payment will be ten years in the future – long after the underlying claims have settled. There is no timing risk to the reinsurer. Many would argue that the reinsurer has really provided a financing contract with a maximum effective interest cost to the reinsurer of about 4.52 percent. If we discount the cash flows at an assumed 5 percent[1], the reinsurer's potential "loss" is a gain ranging from about CU 272 (if claims total CU 1,000) to about CU 39 (if claims total CU 1400).

9. Why would ceding companies enter into such contracts? First, because claim liabilities under US GAAP are not discounted, but reinsurance prices obviously incorporate the time value of money. Before FAS 113, an insurer could cede CU 500 of **incurred** claims for a premium of CU 450 and recognise an immediate gain of CU 50. Second, because Statement 60 (which carried forward existing AICPA guidance) required offsetting of amounts due from reinsurers and related liabilities to policyholders. An insurer could enter into a reinsurance contract that shrank the balance sheet and accelerated recognition of what would otherwise have been future investment earnings.

10. My files do not contain a complete set of the staff memoranda on Statement 113, but those that I have make it clear that both underwriting and timing risk were inherent to the FASB's idea of insurance risk from the early days of its work on the standard.

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[1] FAS 113 introduced a present value test but did not specify an interest rate. Looking back to old memoranda, I think one basis for a rate could be described as interest income forgone as a consequence of the transaction. That is, comparing the interest rate on an investment in this reinsurance contract with an alternative investment.

Timing Risk

11. IFRS 4 incorporates the idea of timing risk, but not in the same way as US GAAP. Paragraph B2, which is an integral part of the standard, says:

> Uncertainty (or risk) is the essence of an insurance contract. Accordingly, **at least one of the following** is uncertain at the inception of an insurance contract:
>
> (a) whether an *insured event* will occur;
>
> (b) when it will occur; or
>
> (c) how much the insurer will need to pay if it occurs. [Emphasis added.]

Staff analysis

12. In my view, both underwriting and timing risk are important to the definition of insurance risk. The notion of *financial risk* that IFRS 4 borrows from IAS 39 would not capture the contract described in paragraph 7. The variation in the reinsurer's cash flows is still due to variation in underwriting results. As a reminder, the definition of financial risk in IFRS 4 is:

> The risk of a possible future change in one or more of a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract.

13. As I read the definition and guidance on insurance risk in IFRS 4, the contract would be considered an insurance contract. Both conditions (a) and (c) are satisfied.

14. The question, I think, is whether underwriting and timing risk are equally important. For example, consider the reinsurance contract in paragraph 7, but now the contract provides that the reinsurer will pay the ceding company in a single payment at the end of one year. Claims from policyholders are submitted to the ceding company, which pays them as they are received and evaluated. That process usually takes about a week. The ceding company has timing risk, because claims might cluster at the beginning of the policy term. The reinsurer does not, but the effect of the payment delay is nowhere near as significant as in the original example.

15. Giving underwriting and timing risk equal prominence creates the possibility of a contract that has all underwriting risk (as just described) and no timing risk being accounted for as something other than an insurance contract. FASB Codification

Section 340-30-05-6 describes the accounting for those contracts, as deposits rather than as insurance.

16. On the other hand, a contract that most would consider insurance can have timing risk only. Consider the possibility of a single-premium, non-cancellable, life insurance policy for life. The policyholder cannot, and would not want to, surrender the policy because there is no cash surrender value. The insurer cannot cancel. The death benefit is fixed. The only uncertainty is timing – when the policyholder will die.

17. IFRS 4 would treat both of those contracts as insurance.

18. One approach to the question of timing risk would be to borrow an idea from the Framework team. We could make timing risk an enhancing, or in our case, disqualifying characteristic. We could address the concern about a lag between claim verification and payment, mandated by the contract rather than normal processing time, that distorts the usual insurance relationship. With a little rewriting, we could add the second sentence of FASB Codification Section 944-20-15-46 to the guidance in paragraph B2 of IFRS 4.

> Contractual provisions that delay timely reimbursement to the ~~ceding entity~~ <u>policyholder</u> ~~would prevent this condition~~ <u>can eliminate or significantly reduce uncertainty</u> ~~from being met~~ because they prevent the ~~re~~insurer's payments from directly varying with the claims ~~settled~~ ~~under the reinsured contracts~~.

19. Another approach would be to base the evaluation of uncertainty on the present value of possible outcomes rather than their absolute amounts. The IASB considered but rejected that approach in IFRS 4, as outlined in paragraph BC 35:

> The Board also rejected the notion of defining the significance of insurance risk by expressing the expected (ie probability-weighted) average of the present values of the adverse outcomes as a proportion of the expected present value of all outcomes, or as a proportion of the premium. This notion had some intuitive appeal because it would consider both amount and probability. However, it would have meant that a contract could start as an investment contract (ie a financial liability) and become an insurance contract as time passes or probabilities are reassessed. In the Board's view, requiring continuous monitoring over the life of the contract would be too onerous. Instead, the Board adopted an approach that requires this decision to be made once only, at the inception of a contract. The guidance in paragraphs B22-B28 of the IFRS focuses on whether insured events could cause an insurer to pay additional amounts, judged contract by contract.

20. On careful reading, though, that paragraph seems to mix three ideas.

(a) One is an assessment based on the present values of possible outcomes, as currently mandated by US GAAP.

(b) The second is an assessment based on a probability-weighted average rather than the existence of a reasonable possibility of a single loss scenario.

(c) The third is continuous monitoring and the possibility that a contract might switch between financial instrument and insurance over the course of its term. Switching and present value could be, but are not necessarily, connected. Continuous monitoring and possible switching would be onerous, but that can be eliminated by making the judgement about insurance risk at inception (as both IFRS 4 and US GAAP do) and not changing the classification after that.

21. Basing the evaluation of risk transfer on present values, rather than absolute amounts, would likely result in fewer contracts being classified as insurance than is currently the case under IFRS 4. However, we should remember that insurance risk in IFRS 4 is evaluated based on an individual contract. While insurers expect the performance of a book of contracts to be profitable, any individual contract can produce a loss, measured as a present value.

22. The staff would not recommend basing the evaluation on the expected present value of all reasonably possible outcomes. Again, the question is whether the insurer is exposed to the possibility of loss from an individual contract, not whether it expects the contract, on average, to be profitable.

Staff recommendation

23. In the staff's view, the role of timing risk in the definition should be a disqualifying, rather than a primary condition for judging insurance risk in a contract. We would therefore depart from the US GAAP approach in which underwriting and timing risk are given equal prominence. However, we recommend that the role of timing risk be emphasised by incorporating both of the approaches just discussed. That is:

(a) Adding the following to paragraph B2 of the IFRS 4 definition:

> Contractual provisions that delay timely reimbursement to the ~~ceding entity~~ policyholder ~~would prevent this condition~~ can eliminate or significantly reduce uncertainty ~~from being met~~ because they prevent the

~~re~~insurer's payments from directly varying with the claims ~~settled under the reinsured contracts~~.

(b) Changing the evaluation of insurance risk from absolute amounts to present values.

24. The staff expects that this recommendation would reduce the number of contracts that qualify as insurance under IFRS 4, but perhaps not significantly. We expect that it would increase the number of contracts that qualify as insurance under US GAAP, because it would allow the possibility that underwriting-only contracts (as in paragraph 15) or timing-only contracts (as in paragraph 16) would meet the definition of insurance risk.

Question 1 for the boards
The staff recommends that the role of timing risk in identifying insurance risk should be addressed through amendments to IFRS 4 described in paragraph 23. Do you agree? If not, what approach would you prefer?

Applying the staff recommendation, or, compared to what?

25. How then would the example in paragraph 7 be classified – as insurance or financial instrument? Here, the staff is of two minds.

26. View One would look at the range of possible present value outcomes: CU 39 to CU 272. Assume for ease of discussion that the possibilities are uniformly distributed. The distribution has a mean value of CU 155.5, plus or minus CU 116.5. The range is significant both in comparison to the mean and to the premium of CU 900. The contract would be classified as insurance. The staff who hold the view consider the analysis consistent with IFRS 4.

27. Those who hold view one are especially concerned about the potential unanticipated consequences of what they consider a fundamental change in definition. They question whether a change to IFRS 4 is either necessary or an improvement in practice. In particular, they observe that the measurement approach adopted in this project reduces the incentive for many of the most abusive practices addressed by FAS 113.

28. View Two, perhaps influenced by the development of US GAAP, focuses on the idea of *exposure to loss* that traces back to FAS 5 and continues through FAS 113. In this

view, the paragraph 7 contract is not insurance because there is no possible situation in which the reinsurer can incur a loss, on a present value basis. The word *loss* in this view means “present value of outflows exceeds present value of inflows.”

29. Those who hold View Two are especially concerned about the possibility for abuse. In their view, allowing insurance accounting for contracts like the one in question gives blessing to structuring opportunities, of which the example contract is the simplest. If adopted, View Two would reduce the number of contracts that meet the definition of insurance. Those contracts would be accounted for as financial instruments.

30. The staff sees merit in both views, but clarity is most important. Identifying the existence of insurance risk is the threshold issue in this project. The Exposure Draft should be clear.

Question 2 for the boards
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.

Outreach

31. The staff is concerned that we do not fully appreciate the consequences of the choice posed in Question 2. We know the directions, as already described, but we are concerned about unintended consequences. As we see the situation, either of the approaches in Question 2 might open structuring opportunities, but they would be different opportunities. We plan to discuss this paper with insurance specialists at the major accounting firms, and hope to report the results of those conversations at the joint board meeting.