Financial Accounting Standards Board

IFRS™

Insurance Contracts Roundtable Meeting—Afternoon Session
December 20, 2010
1:00PM–4:30PM EST
Norwalk, CT

Participants

Ralph Blanchard	American Insurance Association (AIA)
Darryl Briley	KPMG
Dave Christenson	GNAIE—P/C
David Doherty	Health Insurers Group
John Doyle	Liberty Mutual
Bill Findlay	Assured Guaranty Ltd.
Joseph Fritsch	National Association of Insurance Commissioners (NAIC)
Sam Gutterman	International Actuarial Association (IAA)
Andrew Heiskell	Wellington Management
William Hines	American Academy of Actuaries (AAA)—Life
Todd Daniels	Aflac Inc.
Rick Lynch	Ernst & Young
Douglass N. Miller	ACLI
Jenifer Minke-Girard	Securities and Exchange Commission (SEC)
Tricia O'Malley	Canadian Accounting Standards Board
Sharon O'Sullivan	Swiss Re
Jeong Hyeok Park	Korea Accounting Institute
Kevin Spataro	Allstate Corporation
Dave Stewart	Ameriprise Financial, Inc.
Pinto Suri	Corporate Reporting Users Forum
Chris Swift	Hartford Financial Services Group
Alan Zimmermann	Macquarie Securities

FASB and IASB Participants

Leslie Seidman	FASB Acting Chairperson
Russ Golden	FASB Board Member
Tom Linsmeier	FASB Board Member
Marc Siegel	FASB Board Member
Larry Smith	FASB Board Member
John Smith	IASB Board Member
Patrick Finnegan	IASB Board Member
Peter Proestakes	FASB Assistant Director
Jennifer Weiner	FASB Senior Practice Fellow
Shayne Kuhaneck	FASB Assistant Project Manager
Trent Handy	FASB Practice Fellow
Emily Montgomery	FASB Postgraduate Technical Assistant
Candace Jones	FASB Postgraduate Technical Assistant
Peter Clark	IASB Director of Research
Wayne Upton	IASB Director of International Activities
Andrea Pryde	IASB Senior Technical Manager

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DISCUSSION SUMMARY

Welcome

On September 17, 2010, the FASB issued, for public comment, a Discussion Paper, *Preliminary Views on Insurance Contracts.* On July 30, 2010, the IASB issued for public comment an Exposure Draft, *Insurance Contracts.*

The Board and staff members of both the FASB and the IASB performed extensive outreach activities. Those activities included live and recorded webcasts, question and answer sessions, participation in conferences, and meetings with insurance industry trade groups, individual preparers, accountants, actuaries, auditors, regulators, and users (investors and analysts) from a wide variety of geographical regions.

The comment period for the FASB's Discussion Paper ended on December 15, 2010. The comment period for the IASB's Exposure Draft ended on November 30, 2010.

We have arranged this roundtable meeting to listen to your views and to further develop our understanding of the issues you raised or alternatives you proposed in your comment letters.

We expect to cover the following topics (with suggested time allotments):

- Topic 1 (40 minutes): Probability-weighted expected cash flows
- Topic 2 (40 minutes): Discount rate
- Topic 3 (20 minutes): Unbundling
- Topic 4 (35 minutes): Composite margin versus risk adjustment and residual margin
- Topic 5 (20 minutes): Modified approach for short duration contracts
- Topic 6 (35 minutes): Presentation.

If time permits, we will discuss any other topics at the end of the session.

The Boards and staff will analyze feedback received through all outreach activities as part of the Boards' redeliberations process.

Topic 1: Probability-weighted expected cash flows

FASB Discussion Paper Preliminary Views and *IASB Exposure Draft Proposals*

An insurance contract would be measured on the basis of the rights and obligations created by that contract that result in a series of cash inflows (for example, premiums and deposits) and outflows (for example, benefits, claims, and expenses). Insurers would measure insurance contracts, in part, on the basis of the difference between net cash inflows and outflows expected to arise over the remaining coverage and claims handling periods and should reflect an explicit, unbiased, and probability-weighted estimate of those future cash flows.

An insurer would recognize an insurance obligation when it becomes a party to the contract, which is defined as the earlier of the date on which the insurer is bound by either of the following:

a. The terms of the contract

b. Initial exposure to risk under the contract (that is, when the insurer can no longer withdraw from its obligation to provide insurance coverage to the policyholder for insured events and when it no longer has the right to reassess the risk of the particular policyholder and, as a result, cannot set a price that fully reflects that risk).

The boundary of an insurance contract would distinguish the net cash flows that relate to existing insurance contracts from those that relate to future insurance contracts. The boundary of an insurance contract would be the point at which an insurer either:

a. Is no longer required to provide coverage; or

b. Has the right or the practical ability to reassess the risk of the policyholder and, as a result, can set a price that fully reflects that risk.

Main discussion points:

- Does the use of the probability-weighted cash flows reflect the economics of insurance contracts?
- Is the use of the probability-weighted cash flows an improvement over current U.S. GAAP?
- Which cash flows should be included in the measurement of the contract (for example, investment income, overhead, etc.)?
- Should acquisition costs be included in the measurement of cash flows (for example, incremental acquisition costs determined at the contract or portfolio level)?
- Which cash flows should be included for situations in which the insurer is limited on actions based on jurisdictional regulations?

Topic 2: Discount rate

FASB Discussion Paper Preliminary Views and *IASB Exposure Draft Proposals*

The carrying amount of an insurance liability would include the present value of the probability-weighted estimate of net cash flows at the end of each reporting period using discount rates that:

a. Are consistent with observable current market prices for instruments with cash flows whose characteristics reflect those of the insurance contract liability (that is, , in terms of timing, currency, and liquidity)
b. Exclude any factors that influence the observed rates but are not relevant to the insurance contract liability (for example, risks that are not present in the liability but are present in the instrument for which the market prices are observed).

If the cash flows of an insurance contract do not depend on the performance of specific assets, the discount rate would reflect the yield curve in the appropriate currency for instruments that expose the holder to no credit risk or negligible credit risk, with an adjustment for illiquidity.

Main discussion points:

- Should the discount rate used reflect only the characteristics of the insurance liability?
- Should the discount rate used be updated each reporting period?
- Should all insurance contracts be discounted?
- Should the impact from changes in the discount rate be included in the income statement or other comprehensive income?
- How should accounting mismatches that may result because of the accounting for financial instruments be minimized (that is, *FASB Accounting Standards Codification*™ Topic 825, Financial Instruments, and the proposed Accounting Standards Update, *Financial Instruments (Topic 825) and Derivatives and Hedging (Topic 815): Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities*)?

Topic 3: Unbundling

FASB Discussion Paper Preliminary Views and *IASB Exposure Draft Proposals*

The cash flows that arise from components of an insurance contract that are not closely related to the insurance component should not be included in the measurement of the insurance contract, but should be accounted for separately.

Main discussion points:

- Should noninsurance components of a contract be unbundled (that is, costs and benefits of unbundling)?
- Which noninsurance components should be unbundled (that is, the extent of unbundling)?
- Should financial instruments with discretionary participation features be included in scope?

Topic 4: Composite margin versus risk adjustment and residual margin

FASB Discussion Paper Preliminary Views

Under the Board's preliminary view of the building block approach (*the composite margin approach*), risk and uncertainty would be reflected implicitly through a single composite margin. The composite margin also would implicitly include the potential profit on the contract and represents the excess of the expected present value of cash inflows over the expected present value of cash outflows.

An insurer would determine the composite margin or residual margin (IASB Exposure Draft) at the level that aggregates insurance contracts into a portfolio of insurance contracts within a portfolio, by similar date of initial recognition of the contract and coverage periods.

To reflect the uncertainties about the amount and timing of expected net cash flows, the composite margin would be recognized in earnings over the coverage and claims handling periods using the following ratio:

$$\frac{\text{(Premiums allocated to date + Claims and benefits paid to date)}}{\text{(Total expected premiums + Total expected claims and benefits)}}$$

The composite margin would not accrete interest.

IASB Exposure Draft Proposals

The Exposure Draft proposes the following:

- Measurement of insurance contracts should include an explicit risk adjustment.
- Only three techniques for measuring the risk adjustment are permitted: confidence level, conditional tail expectation (CTE) or cost of capital.
- An insurer using CTE or cost of capital should translate the risk adjustment into a confidence level for disclosure.
- Recognize 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
    - On the basis of the expected timing of incurred claims and benefits, if that pattern differs significantly from the passage of time.
- Accrete interest on the carrying amount of the residual margin.

Main discussion points:

- Should insurance contracts be measured with a single composite margin or with a risk adjustment and a residual margin?
- What is the objective of the risk adjustment and do the IASB Exposure Draft's proposed techniques meet that objective?
- Should the number of methods for determining the risk adjustment be limited?
- Should the composite margin be remeasured at each reporting period or released in a manner that reflects the uncertainties about the amount and timing of expected net cash flows (for example, using the ratio described in above)?
- Under the two-margin approach, should the residual margin be recognized on the basis of the passage of time or remeasured at each reporting period?
- Should interest be accreted on the composite (residual) margin?

Topic 5: Modified approach for short-duration contracts

FASB Discussion Paper Preliminary Views and *IASB Exposure Draft Proposals*

The Boards are considering requiring a modified measurement approach for the preclaims liability of most short-duration contracts. The IASB Exposure Draft proposes that a modified approach should be required for short-duration contracts that meet the following conditions:

- The coverage period of the insurance contract is approximately one year or less.
- The contract does not contain embedded options or other derivatives that significantly affect the variability of cash flows, after unbundling any embedded derivatives.

For those contracts that meet the criteria above:

- The entity would measure the contract during the preclaims period using an allocation of the premium received, on a basis largely similar to most existing practice.
- The entity would use the building block approach to measure claims liabilities for insured events that have already occurred.

If a contract is onerous, the entity would recognize an additional liability and a corresponding expense, measured as the difference between the carrying amount of the preclaims obligation and the present value of the fullfilment cash flows, determined at a portfolio level and within a portfolio, by similar date of inception.

Interest would be accreted on the carrying amount of the preclaims liability.

Main discussion points:

- Should all insurance contracts be recognized and measured using one approach or two or more approaches?
- If multiple approaches are used, how should the scope of insurance products be defined for each approach (for example, duration of coverage period, duration of claims payment period, type of insurance, etc.)?
- If multiple approaches are used, should the alternative approach be required or permitted to be used?
- Should the accounting for reinsurance follow the accounting for the underlying policies being reinsured?
- Is the onerous contract test performed at the right level and does it include the right components (for example, risk adjustment under the two-margin approach)?

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Topic 6: Presentation

FASB Discussion Paper Preliminary Views and *IASB Exposure Draft proposals*

The presentation approach in the statement of comprehensive income is driven by the measurement model. Accordingly, income and expense is presented in a manner that highlights the following:

- The underwriting margin (that is, changes in the risk adjustment and release of the margin);
- Experience adjustments (that is, differences between actual cash flows and previous estimates) and changes in estimates (that is, changes in current estimates of cash flows and discount rates)
- Interest on insurance contract liabilities (presented or disclosed in a way that highlights its relationship with the investment return on assets backing those liabilities).

Accordingly, revenues and claims and benefits expenses would not be presented separately. Instead, earnings would present changes in the composite margin (or residual margin) determined at initial recognition of the insurance contracts.

If the entity applies the modified approach for short-duration contracts, an entity would present (or disclose) additional information about premiums, expenses, and claims.

The FASB's Discussion Paper considered the following two premium presentation approaches for revenues and expenses in the statement of comprehensive income:

a. Written premium presentation approach—Premiums would be presented as revenue when receivable. The corresponding increase in the liability would be presented as an expense when incurred.

b. Allocated premium presentation approach—Premiums received would be presented as preclaims liabilities in the statement of financial position (that is, as performance obligations). As the insurer performs under the contract by providing insurance coverage, the preclaims liability would be recognized in the statement of comprehensive income as premium revenue. Claims liabilities would be recognized as expenses when incurred.

Main discussion points:

- Should the presentation approach be driven by the measurement approach (that is, margin presentation)?
- Does the information from the margin approach provide useful information and the right type of information?
- Should present information about premiums and expenses (volume information) be presented on the face of the performance statement or only in the footnotes to the financial statements?
- Should all contracts be presented similarly?

Other topics

After considering your views on the specific issues contained in the FASB Discussion Paper and in the IASB Exposure Draft, what do you think would represent the most appropriate improvement to U.S. GAAP?

- Pursue an approach based on the IASB's Exposure Draft with some changes?
- Pursue an approach based on the Board's preliminary views in the FASB Discussion Paper with some changes?
- Make targeted changes to address specific concerns about current U.S. GAAP (for example, items included in paragraph 7 of the Discussion Paper)?