

# Insurance Contracts

## Overview of FASB DP and IASB ED

### **Moderator:**

Marc F. Oberholtzer, FCAS, MAAA, PricewaterhouseCoopers

### **Presenter:**

Akwasi A. Ampofo, FASB Project Manager



# Disclaimer

---

This document has been prepared by the staff of the FASB to help constituents understand the IASB's proposals and FASB's preliminary views regarding the accounting for Insurance Contracts.

The views expressed are those of the presenter's and do not represent the views of the FASB or IASB.

FASB and IASB decisions are reached only after extensive due process and deliberations.



# Content Outline

---

1. Project objective and background
2. Definition and scope
3. Recognition and measurement
4. Subsequent measurement
5. Alternative approach for short-duration contracts
6. Acquisition costs
7. Reinsurance
8. Financial statement presentation
9. Disclosures
10. Transition and effective date
11. Q&A and websites



# Project objective

---

- The objective of the insurance contracts project is to develop a common, high-quality guidance that will address recognition, measurement, presentation, and disclosure requirements for insurance contracts.
- Specifically, this project is intended to:
  - ✓ Improve and simplify the financial reporting requirements for insurance contracts.
  - ✓ Provide investors with more decision-useful information.



# Terms

---

IASB, IFRS and IAS

- IFRS 4 – Insurance Contracts
- Phase II

FASB and US GAAP

The IASB and FASB Boards

IASB and FASB Project Teams

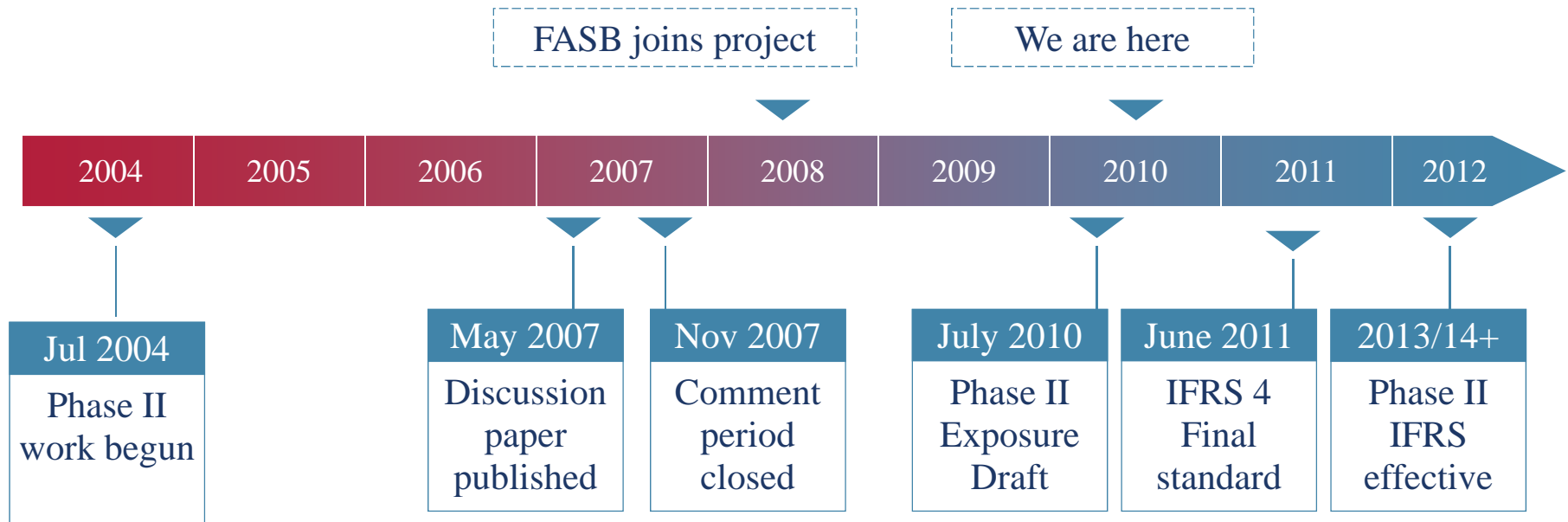
Convergence of US GAAP and IFRS

Stages of Development of Financial Reporting Standards

- Discussion Paper
- Exposure Draft
- Final Standard

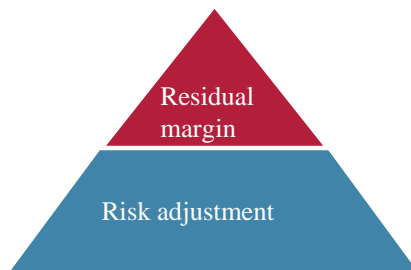


# Background - evolution



# Overview of the proposed model

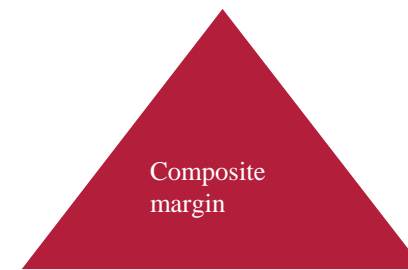
## IASB Preference



Time value of money

Current unbiased probability weighted estimates of future cash flows

## FASB Preference



Time value of money

Current unbiased probability weighted estimates of future cash flows

Fulfillment rather than an exit value objective

- One model for all insurance contracts
- Remeasured each period using current estimates
- Combination of rights and obligations (inflows and outflows)
- Potential for day 1 loss in income statement, but no day 1 gain
- Adjustments/margins are part of liability
- Discount rate is risk free plus liquidity adjustment

## Next steps

---

- FASB and IASB will jointly re-deliberate the IASB ED and FASB DP
  - IASB has published an Exposure Draft (ED) on July 30, 2010 (comment deadline: November 30, 2010)
  - FASB published a Discussion Paper (DP) on September 17, 2010 (comment deadline: December 15, 2010)
- Roundtables:
  - FASB and IASB have planned roundtables for Europe, Asia and U.S. in December 2010:
    - Tokyo – Tuesday December 7, 2010
    - London – Thursday December 16, 2010
    - Norwalk, CT – Monday December 20, 2010





# Why FASB issued discussion paper

- FASB issued a DP rather than ED for the following reasons:
  - Different starting points for FASB and IASB
    - U.S. GAAP comprehensively address insurance accounting
  - FASB has not determined whether one model or two models would result in more decision-useful information about insurance contracts
  - Scope considerations about employer-provided health insurance



# Background – desired improvements

---

10

- Potential improvements to existing U.S. GAAP include:
  - Insurance entity vs. insurance contracts orientation
  - Definition of insurance contracts (indemnification versus compensation)
  - Deferral of acquisition costs
  - Lock-in assumptions for long-duration contracts
  - Discount rate assumptions (life versus nonlife)
  - Lack of discounting for most short duration contracts



# Background – desired improvements

---

11

- After considering constituent feedback, FASB may:
  - Pursue an approach based on IASB ED
  - Pursue an approach based on IASB ED with changes
  - Pursue an approach based on FASB preliminary views with changes
  - Make targeted changes to address specific concerns on U.S. GAAP



# Definition and scope of insurance Contracts

---

12

- **Definition**

- A contract under which one party (the insurer) accepts significant insurance risks from another party (the policyholder) by agreeing to compensate the policyholder if specified uncertain future events (the insured event) adversely affects the policyholder.

- **Scope**

- All insurance contracts (life and nonlife, and reinsurance) regardless of the type of entity that issued it.



# Definition and scope of insurance Contracts

13

- **Scope exclusions:**
  - Product warranties issued by manufacturer, dealer or retailer
  - Defined benefit retirement plans
  - Health insurance provided by employer (IASB only; FASB seeking feedback)
  - Fixed-fee for service contracts
  - Leases
  - Residual value guarantees provided by manufacturer, dealer or retailer
  - Contingent consideration payable or receivable
  - Direct insurance contracts with entity as policyholder
  - Participating investment contracts (FASB only)



# Recognition and measurement - recognition

14

- **Recognition**

- When insurer becomes party to the insurance contract defined as the earlier of being bound by:
  - The terms of the contract, or
  - Initial exposure to risk under the contract
- Insurer can become party to an insurance contract before the coverage period starts (e.g., due to further underwriting):
  - Before coverage begins, insurer would update the measurement of the insurance contract with cash received and paid, accretion of interest, changes in cash flows estimates and discount rate, but the insurer would not recognize residual or composite margin in earnings until after the coverage period begins.



# Recognition and measurement - recognition

---

15

- **Contract Boundary**

- Boundaries of existing versus new insurance contracts (cash flows)
  - Insurer is no longer required to provide coverage, or
  - Insurer has the right or practical ability to reassess and fully reprice risk



# Recognition and measurement - measurement

- **Measurement objective**
  - Measure rights and obligations created by an insurance contract that results in a series of cash inflows and outflows.
  - Not based on a fair value measurement objective as defined in U.S. GAAP
- **Measurement approaches**
  - Two approaches being considered:
    - Approach 1: Building-block approach
      - ✓ Present value of probability-weighted estimate of net cash flows
      - ✓ Time value of money (discounting)
      - ✓ Risk margins (composite margin or risk adjustment + residual margin)
    - Approach 2: Modified approach for certain short-duration contracts
      - ✓ See next slide





# Recognition and measurement - measurement

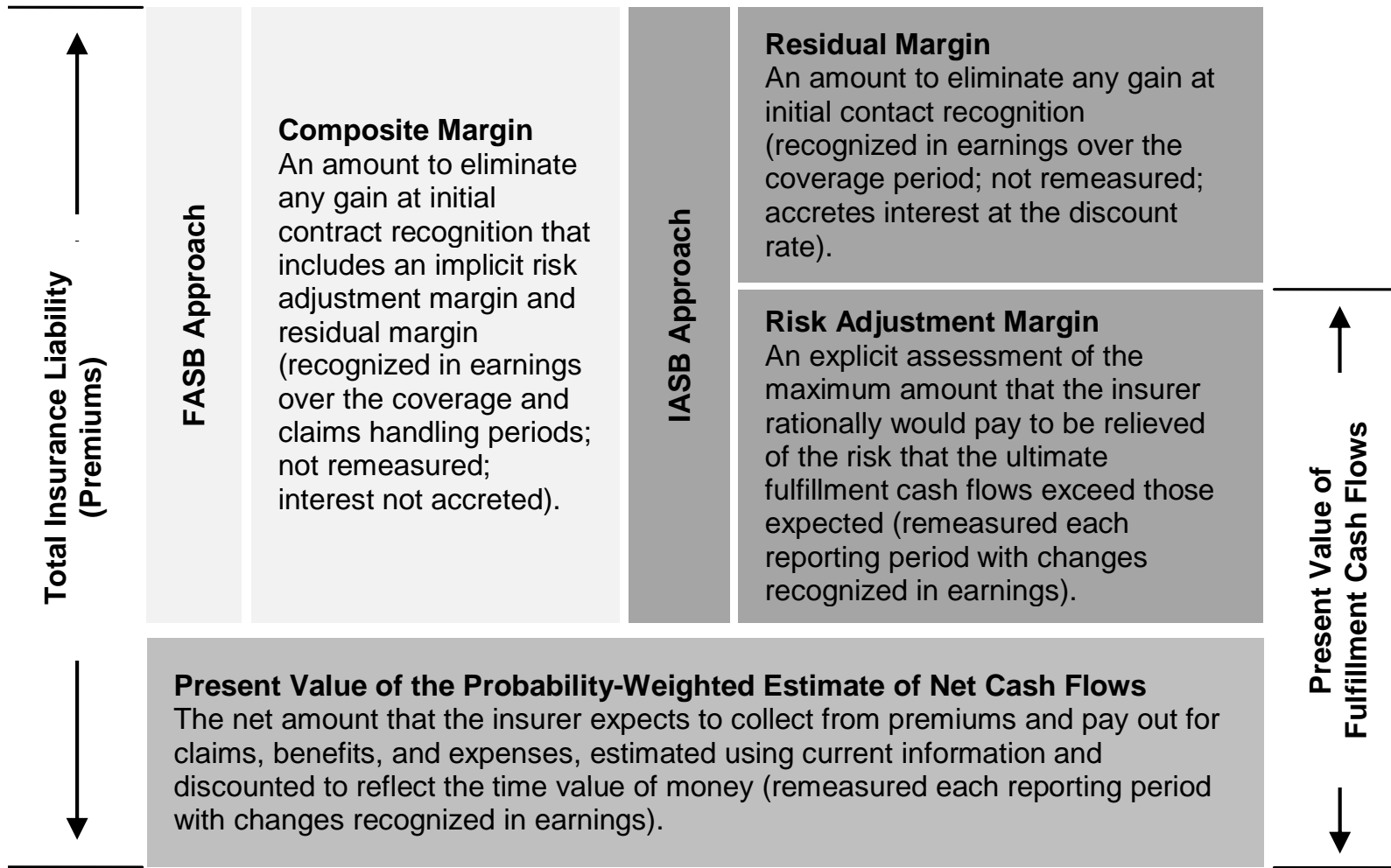
17

- **Measurement approaches**
  - Approach 2: Modified approach for certain short-duration contracts
    - ✓ Also called unearned expected premium approach (UEP)
    - ✓ Similar to preclaims liability (UPR) under existing U.S. GAAP on short-duration contracts
    - ✓ **IASB only**: Would apply to contracts with (a) one-year or less coverage period, (b) no embedded options or derivatives that significantly affects the variability of cash flows.
    - ✓ Most appropriate for contracts that do not contain deposit elements
    - ✓ IASB ED requires this approach; FASB seeking additional feedback



# Approach 1 – initial measurement

## The Building Blocks of the Proposed Approaches



## Initial measurement – present value of expected cash flows

- **Expected cash flows**
  - Unbiased and probability-weighted estimate of net cash flows related to existing contracts
  - Incremental contract fulfillment cash flows (net of premiums)
  - Includes, but not limited to:
    - Expected benefits, claims and claims expenses
    - Incremental acquisition costs
    - Premiums cash inflows
    - Other cash flows...
- **Discounting for time value of money**
  - Reflects characteristics of liability; i.e., risk free, considering currency and liquidity
  - No reflection of own credit standing (or changes in it)
  - No consideration of investment rates (limited exceptions)



## Measurement – risk margins compared

| FASB composite margin (CM)  | IASB risk adjustment + residual margin   |
|---|--|
| <ul style="list-style-type: none"> <li>•Composite margin is potential profit on the contract that implicitly includes risk of uncertainties in the cash flows</li> </ul>  | <ul style="list-style-type: none"> <li>•Risk adjustment is a measure of uncertainty about amount and timing of future cash flows</li> <li>•Residual margin is refers to contract profit</li> </ul>   |
| <ul style="list-style-type: none"> <li>•CM is measured as the difference between:               <ul style="list-style-type: none"> <li>(a) Present value of expected premiums, and</li> <li>(b) Present value of claims, benefits and expenses</li> </ul> </li> </ul> | <ul style="list-style-type: none"> <li>•Risk adjustment is measured using one of three permitted methods (confidence level, conditional tail expectation, cost of capital)</li> <li>•Residual margin is a “plug” to get present value of cash flows and risk adjustment to equal premiums</li> </ul> |
| <ul style="list-style-type: none"> <li>•CM is not remeasured at each reporting period</li> </ul>  | <ul style="list-style-type: none"> <li>•Risk adjustment is remeasured at each reporting period</li> <li>•Residual margin is not remeasured at each reporting period</li> </ul>   |
| <ul style="list-style-type: none"> <li>•CM eliminates a day 1 gain, but day 1 loss is immediately reflected in P&amp;L</li> </ul>   | <ul style="list-style-type: none"> <li>•Residual margin eliminates day 1 gain, but day 1 loss is immediately reflected in P&amp;L</li> </ul>   |

## Measurement – risk margins compared

| FASB composite margin (CM)   | IASB risk adjustment + residual margin   |
|--|--|
| <ul style="list-style-type: none"> <li>•CM does not accrete interest over time</li> </ul>  | <ul style="list-style-type: none"> <li>•Residual margin accretes interest over time</li> </ul>   |
| <ul style="list-style-type: none"> <li>•CM is released over both the coverage and claims handling period using the CM YTD formula</li> </ul> | <ul style="list-style-type: none"> <li>•Risk adjustment is released over both coverage and claims handling period (remeasurement)</li> <li>•Residual margin is released over coverage period only</li> </ul> |
| <ul style="list-style-type: none"> <li>•Changes in cash flows experience is also reflected separately in P&amp;L</li> </ul>                  | <ul style="list-style-type: none"> <li>•Changes in cash flows experience is also reflected separately in P&amp;L</li> </ul>  |
| <p>No need for complex computational techniques that may yield incomparable results</p>  | <ul style="list-style-type: none"> <li>•Needs complex computational techniques the outcome of which may not be comparable</li> </ul>   |

## Measurement – FASB composite margin

- **Composite margin (CM) reflects the profit, risks/uncertainty in the present value of the cash flows**
- CM is recognized in earnings over both the coverage and claims handling period using the following ratio:
  - $\text{YTD CM ratio} = (\text{premiums allocated to date} + \text{claims and benefits paid to date}) / (\text{total expected premiums} + \text{total expected claims and benefits})$
  - $\text{Current period earnings} = [(\text{CM amount} * \text{CM YTD ratio}) - \text{cumulative prior earnings recognized}]$
- CM amount determined at initial recognition does not change.
- YTD CM ratio changes to reflect changes in numerator and denominator
- Total expected premiums are allocated over the coverage period in a systematic way to reflect exposure to insurance risk on the basis of:
  - Passage of time, but
  - Expected timing of claims and benefits, if that pattern differs from time passage



## Measurement – FASB composite margin

---

- **Advantages of CM approach include:**
  - Consistent with allocated transaction price in Revenue Recognition proposed ASU
  - Eliminates the use of subjective methods
  - Simpler and more understandable approach to account for risk and profit
  - Reflects changes in probability-weighted cash flows at the reporting date



# Measurement – IASB Explicit Risk Adjustment 24

---

- Risk adjustment represents the maximum amount that the insurer would rationally pay to be relieved of the risk that the liability cash flows would exceed those expected
- Risk adjustment is estimated at the portfolio level and reflects diversification within a portfolio but not across different portfolios
- Advantages include:
  - Reflects uncertainty in possible cash flows outcome, as distinct from profit (residual margin)
  - Reflects changes in uncertainty of possible cash flows outcome through subsequent remeasurement





## Measurement – IASB Explicit Risk Adjustments Methods

- Building block – Explicit Risk Adjustment – Comparing the Methods:
  - Confidence level
    - Loss distribution is estimated
    - Adjustment results in a stated level of confidence
    - Express uncertainty in terms of a disclosed amount of confidence; easiest to calculate and understand
    - Not appropriate for risks that are highly skewed

## Measurement – IASB Explicit Risk Adjustments Methods

- Building block – Explicit Risk Adjustment – Comparing the Methods:
  - Conditional tail expectation
    - Loss distribution is estimated
    - Explicit risk adjustment equals average loss among a set of scenarios between an X% level of confidence and the worst case scenario
    - Better reflects potentially extreme losses; incorporates the expected value of those extreme losses
    - Not as easy to understand

## Measurement – IASB Explicit Risk Adjustments Methods

- Building block – Explicit Risk Adjustment – Comparing the Methods:
  - Cost of Capital
    - Loss distribution is estimated, amount of capital required is determined based on the amount of tail risk
    - Economic capital, reflecting high level of confidence (example given uses 99.5%) that the insurer will be able to fulfill the obligations
    - Multiplied by annual capital rate (example given uses 8%)
    - Common in pricing and valuation
    - Release tends to be faster than the other two methods

## Measurement – IASB Residual Margin

---

- Per the Exposure Draft:
  - An amount that eliminates a day 1 gain
    - Day 1 losses are reflected immediately in P/L
  - Allocated over coverage period based on passage of time if reflective of risk exposure
  - Not subsequently remeasured

# Subsequent measurement

---

- Changes in present value of probability weighted cash flows are recognized immediately in earnings under both FASB and IASB proposals
- FASB
  - Composite margin is not subsequently remeasured
  - No accretion of interest on composite margin
  - Composite margin recognized over both coverage and claims handling periods (exposure periods)
- IASB
  - Risk adjustment is subsequently remeasured over both coverage and claims handling periods
  - Residual margin is not remeasured but recognized over coverage period on a straight line basis on unless the claims incurred pattern is different
  - Residual margin would accrete interest



## **IASB's Modified approach for short duration contracts**

30

- Defined as insurance contracts with coverage period of 12 months or less, that do not have embedded options or derivatives containing significant cash flow variability
- IASB decided to use a modified approach (unearned expected premium approach) for the pre-claim liability (UPR) on short-duration contracts because it provides a reasonable, less costly alternative to building block approach



## IASB's Modified approach for short-duration contracts <sup>31</sup>

- Pre-claim period would follow unearned premium approach
  - Single insurance contract asset or liability presented on balance sheet for pre-claim obligation and present value of future premiums
  - Interest accretes on insurance contract asset or liability if the effect of time value of money is material (IASB only)
  - Onerous contract test at portfolio level using present value of fulfillment cash flows
  - Incremental acquisition cost is not presented as asset, but reduction of UPR
- Post-claim period would use building block approach
- FASB seeking feedback on whether or not a different insurance accounting model is needed for short duration contracts



# Acquisition costs

---

- Differentiates between incremental and other acquisition costs (non-incremental);
- Incremental acquisition expenses are costs that would not have been incurred if the entity had not issued the contract (e.g., external and internal commissions, third party medical inspection fees, premium taxes)
- Incremental acquisition expenses:
  - Included in the measurement of the liability as cash outflow
  - Reduces composite margin at initial recognition
  - Therefore, affects profit over coverage and claims handling periods
  - Not explicitly amortized or recognized in subsequent periods
- Other acquisition expenses (non-incremental):
  - Expensed on day 1, and . . .
  - NO earned premium offset
- EITF 09-G expected to be published 2Q 2010
  - Would clarify that direct response advertising costs that meet certain criteria in Topic 340 may be capitalized and included as part of the premium deficiency testing.





# Reinsurance contracts

---

- Summary of key points assumed and ceded:
  - Assumed reinsurance - reinsurance companies would follow the same recognition/measurement approach as insurance companies
  - Ceded reinsurance
    - Use the building block approach to establish asset using same recognition/measurement approach as for the liabilities
      - No negative residual margins
    - Consider risk of non-performance
    - Ceding commissions are netted against premiums and the net amount is considered the premium under the contract

# Financial statement presentation

---

- Statement of financial position
  - Present single insurance contracts net asset or liability (or single net asset for reinsurance)
  - Consistent with measurement approach for cash inflows and outflows
  - FASB: seeking feedback on level of aggregation (portfolio level)
  - IASB would present each portfolio of insurance contract separately



# Financial statement presentation

- Statement of comprehensive income
  - Margin approach (if building-block approach is used)
    - ✓ Presents composite margin (FASB)
    - ✓ Presents risk adjustment margin and residual margin (IASB)
    - ✓ Revenues, claims and benefits are thereby recognized in earnings through the margin approach
    - ✓ Also present separately experience adjustments, changes in estimates of future cash flows, accretion of interest, investment income
    - ✓ Key merit is that it links measurement of liability to presentation and obviates the need for unbundling
    - ✓ Key disadvantage is that it obscures profitability, risk and loss experience because it does not show revenues and expenses directly on the face of the income statement
  - Two different premium approaches (FASB only seeking feedback)
    - ✓ Written premium approach
    - ✓ Premium allocation approach



## Example 1 – Base Case

---

- An insurer issues an insurance contract for premium of \$1,000. The insurer incurs acquisition costs of \$70 of which incremental acquisition costs are \$40. The insurer estimates that the present value of future claims is \$900. Risk adjustment is estimated to be \$50, and a residual margin is \$10 giving a composite margin of \$60.
- The two-margin (IASB) and composite margin (FASB) approaches are compared on the next slide



# Comparison of risk margin approaches

| Description  | IASB Two-margin approach | FASB Composite margin approach |
|--|--------------------------|--------------------------------|
| Present value of future cash inflows (premiums)  | 1,000                    | 1,000                          |
| Less: Present value of cash outflows (claims and incremental acquisitions costs = 900+40)            | <u>(940)</u>             | <u>(940)</u>                   |
| Net present value of cash flows  | 60                       | 60                             |
| Composite margin   | N/A                      | 60                             |
| Risk adjustment  | 50                       | N/A                            |
| Residual margin  | <u>10</u>                | <u>N/A</u>                     |
| Insurance liability at initial recognition   | <u>0</u>                 | <u>0</u>                       |
| Non-incremental acquisition cost of \$30 will be expensed immediately on day 1 under both approaches |                          |                                |



# Financial Statement Presentation – Example 2

## Traditional income statement

|                               | Inception<br>1 January | Six months to<br>30 June | Six months to<br>31 December |
|-------------------------------|------------------------|--------------------------|------------------------------|
| Premium revenue               | 0                      | 500                      | 500                          |
| Investment income             |                        | 40                       | 38                           |
| Claims and benefits           |                        | 60                       | 875                          |
| Change in insurance liability |                        | 421                      | (421)                        |
| Expenses                      |                        | 40                       | 40                           |
| Acquisition costs             | 0                      | 0                        | 0                            |
| Total expenses                | 0                      | 521                      | 494                          |
| <b>Profit</b>                 | <b>0</b>               | <b>19</b>                | <b>44</b>                    |
| <b>Balance Sheet</b>          | <b>1-Jan</b>           | <b>30-Jun</b>            | <b>31-Dec</b>                |
| Cash                          | 1,000                  | 940                      | 63                           |
| Insurance liabilities         | (1,000)                | (921)                    | 0                            |
| Equity                        | 0                      | 19                       | 63                           |

## Summarized margin

|                                 | Inception<br>1 January | Six months to<br>30 June | Six months to<br>31 December |
|---------------------------------|------------------------|--------------------------|------------------------------|
| Risk adjustment                 |                        | 21                       | 26                           |
| Residual margin                 |                        | 13                       | 13                           |
| Insurance margin                | 0                      | 33                       | 39                           |
| Experience adjustments          |                        | (10)                     | (10)                         |
| Changes in estimates            |                        | (20)                     | 0                            |
| Acquisition costs               | 0                      |                          |                              |
| Net gain at inception           | 0                      | 0                        | 0                            |
| Investment income               |                        | 40                       | 38                           |
| Interest on insurance liability |                        | (25)                     | (23)                         |
| Net interest and investment     | 0                      | 15                       | 15                           |
| <b>Profit</b>                   | <b>0</b>               | <b>19</b>                | <b>44</b>                    |



- Selected disclosure requirements include:
  - Qualitative and quantitative information to help users understand the amount, nature and extent of risks arising from insurance contracts at a reasonable level of aggregation/disaggregation
  - Explanation of recognized amounts including reconciliation of opening and closing balances, and measurement methods and inputs
  - Explanation of risk adjustment method including confidence level used, and how discount rate was determined, measurement uncertainty analysis of key inputs that have significant effect on the measurement
  - Others



# Transition and effective date

- IASB ED contains the following transition and effective date information:
- At the beginning of the earliest period presented, an insurer shall, with a corresponding adjustment to retained earnings:
  - (a) measure each portfolio of insurance contracts at the present value of the fulfillment cash flows. It follows that for insurance contracts to which these transitional provisions are applied, the measurement, both at transition and subsequently, does not include a residual margin.
  - (b) derecognize any existing balances of deferred acquisition costs.
  - (c) derecognize any intangible assets arising from insurance contracts assumed in previously recognized business combinations. That adjustment does not affect intangible assets, such as customer relationships and customer lists, which relate to possible future contracts
- Effective date to be determined





# Q&A

---

- Q&A



- Additional resources:

- IASB

- <http://www.iasb.org/Current+Projects/IASB+Projects/Insurance+Contracts/Insurance+Contracts.htm>

- FASB

- [http://www.fasb.org/project/insurance\\_contracts.shtml](http://www.fasb.org/project/insurance_contracts.shtml)

