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FASB/IASB Insurance Contracts Project –

CLRS 2013

September 2013

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Agenda

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Section 1

Overview

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Objectives of the proposed FASB and IASB standards:

Keep these objectives in mind as we walk through the models

1. Improve, simplify and converge the financial reporting requirements for insurance contracts
2. Eliminate numerous pieces of current US accounting literature
3. Provide a comprehensive insurance standard for IFRS reporting
4. Provide investors with more decision useful information

Consider them as you draft your comment letters

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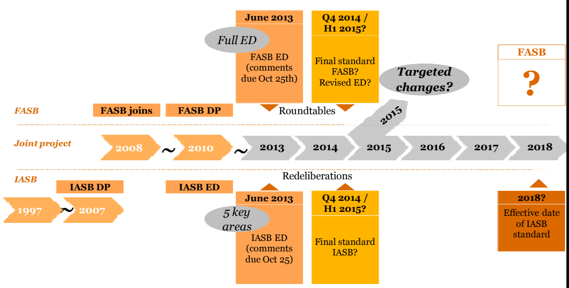
Background and timeline



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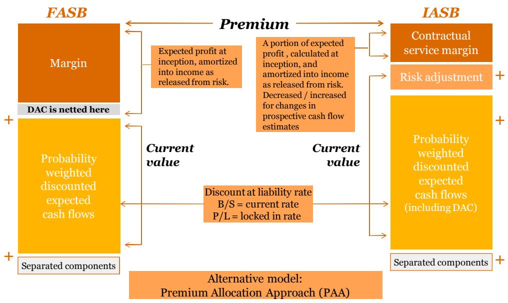
Overview of the model – Building block approach (BBA)



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Premium allocation approach

- Expected to apply to most property/casualty contracts and annual health contracts
  - FASB views it as a separate measurement model
  - IASB views it as proxy for building block approach
- Similar to current US GAAP unearned premium approach, but with:
  - Discounting of incurred claims
  - Revenue pattern based on expected claims
  - Use of "mean" rather than "best estimate" for incurred claims
  - Exclude deposit component from revenue
  - and claims incurred expense
  - Ceding commissions netted against reinsurance premiums
  - Net DAC against liability, and lower grouping level for UPR deficiency test
  - IASB only – an additional liability, a "risk adjustment," recorded reflecting uncertainty in ultimate amount and timing of unpaid claims

Section 2

Definition

Definition of insurance contract

"A contract under which one party (the issuing entity) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder or its designated beneficiary if a specified uncertain future event (the insured event) adversely affects the policyholder."

- Based on nature of contract, not entity issuing contract
- Change from current US GAAP, which applies to insurance *entities*
- Insurance risk = risk other than financial risk
- Financial risk = interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index or other variable

Definition of insurance contract

Definition of *significant* insurance risk:

Insurance risk is significant:

"…if, and only if, an insured event exposes an entity to a significant loss. Existence of one scenario in which the present value of the cash flows expected to be paid by entity can significantly exceed the present value of the premiums and other cash inflows will be considered to satisfy the existence of significant insurance risk."

Must be at least one scenario in which insurer can suffer a loss (PV net outflows > PV premiums)

Applies to both insurance and reinsurance contracts

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Section 3

Premium allocation approach (PAA)

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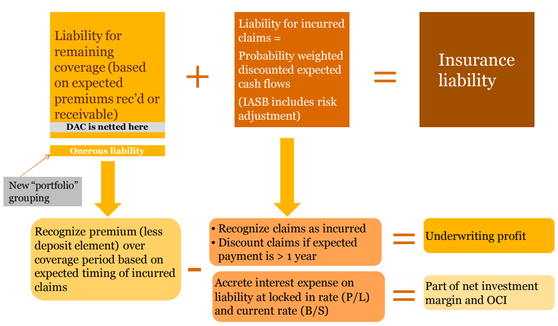
Premium allocation approach (PAA)



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Premium allocation approach - Eligibility criteria

FASB

PAA required when either of the following conditions are met:

a. Coverage period is 12 months or less

b. At contract inception:

It is unlikely that during the period before a claim is incurred, there will be significant variability in the expected value of the net cash flows

IASB

Permitted if reasonable approximation to the building block approach.

Practical expedient: may be applied to contracts if coverage period is 12 months or less.

Indicators when PAA may not be proxy for BBA, so use BBA:

At contract inception:

- It is likely that during the period before a claim is incurred, there will be a significant change in expectations of *(discounted?)* net cash flows

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Premium allocation approach eligibility criteria – Examples

Contract Type	Measurement Model
Workers' compensation (18 months coverage)	PAA *
Catastrophe insurance (1 year coverage)	PAA*
Catastrophe insurance (2 year coverage)	PAA? BBA?
Directors and officers insurance (1 year coverage)	PAA*
Directors and officers insurance (2 year coverage)	PAA? BBA?
Construction surety bond (3 year)	PAA?*
Term life (5 years, with additional renewal rights)	BBA*
Term life (3 years, no renewal rights after 3 yrs)	BBA? PAA?
Long term disability (individual, guaranteed renewable)	BBA*
Long term disability (group) with conversion option guaranteed renewable individual coverage	BBA? PAA?
Adverse Development Cover	BBA? PAA?

*Excerpted from the FASB's ED – 834-10-55-53

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Premium allocation approach
Liability for remaining coverage

Subsequent recognition

•Recognize premium revenue (reduce pre-claims obligation)
- over the coverage period
- on the basis of time, but
- on the basis of expected timing of incurred claims and benefits if that pattern differs significantly from passage of time

•Acquisition costs amortized on same basis as premium revenue, and classified as an expense

Current US GAAP

•Recognize premium revenue over coverage period in proportion to amount of insurance protection provided

•Acquisition costs amortized on same basis as premium revenue, and classified as an expense

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Premium allocation approach
Example: Pattern of revenue recognition

	Q1	Q2	Q3	Q4	Total
Contractual premium payments	$25k	$25k	$25k	$25k	$100k
Expected timing of incurred claims	-	5%	65%	30%	100%
Premium revenue earned	-	$5k	$65k	$30k	$100k

Premium allocation approach
Liability for incurred claims measurement

Apply building block measurement to incurred claims

- Expected cash flows (unbiased mean) without a margin
- Calculated at present value
  – Current rates for balance sheet, however
  – Rates from contract inception for income statement
- IASB has risk adjustment during payout phase

Current US GAAP

- Best estimate (as opposed to a prescribed unbiased mean)
- Typically not discounted if flows not fixed and reliably determinable
- Potential impact:
  – Front ending of income due to using mean of discounted cash flows
  – Differs from BBA where "margin" is spread over coverage and settlement period

Discount rate - Top down vs. bottom up

Top down

Actual or expected reference portfolio rate	7.0%
Duration mismatches	.3%
Market risk premium for expected credit losses	-1.0%
Market risk premium for unexpected credit losses	-.6%
Insurance contract discount rate	**5.7%**

Difference between the two methods not required to be reconciled

Bottom up

Insurance contract discount rate	**5.5%**
Liquidity premium	1.5%
Risk free rate of return	4.0%

Discount rate excludes own-performance risk

Measurement of Liabilities for Infrequent, High-Severity Events

FASB tentative view (834-10-55-136):

- Assume an infrequent/high severity insured event (e.g., a hurricane) that was impending at end of reporting period
  - Not evidence of a condition that existed at end of reporting period when it occurs or does not occur after that date.
  - Non-recognized event under FASB ASC 855, Subsequent Events
- Whether applying the BBA approach, or the onerous contract test in the PAA approach, the liability would take into account estimates of *expected cash flows* at the balance sheet date
  - i.e., it is based on expectations based on information known at balance sheet date, not adjusted for actual information known after balance sheet date

Premium allocation example

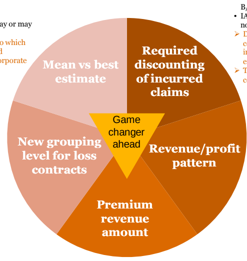
Component	Current GAAP	FASB Proposal
Risk Transfer	Significant insurance risk	Significant variability; at least 1 loss
Unearned premium/ liability for remaining coverage	Earn over coverage period in proportion to insurance protection provided	Earn over coverage period based on expected timing of incurred claims
Premium receivable	Diversity: as due or 1 year's worth	All expected future premiums
Liability for incurred claims	• Best estimate of ultimate cost • Discounting permitted if fixed or reliable determinable	• Mean cash flows without a margin • Discount if > 1 year; accretion presented as interest expense
DAC	• Amortize in proportion to premium revenue recognized • Separate DAC asset	• Amortize in proportion to revenue recognized • Net in liability for remaining coverage
Deposit elements	Diversity in application	Exclude "estimated returnable amount" from revenue and claims
Premium deficiency	Grouping consistent with acquiring, servicing, measuring profitability	Grouping level is "portfolio"
Profit margin drivers	Premiums – best estimate undiscounted claims +/- changes in estimate	Premiums – (discounted mean claims + interest) +/- changes in estimate

PAA Revenue/profit emergence

The FASB proposed premium allocation approach could alter revenue and profit emergence of an insurance company:

- Current accounting requires management best estimate; may or may not approximate the mean
  - ➢ Impact dependent on extent to which current actuarial estimates and management assessments incorporate the concept of a mean

- Liability for incurred claims would be discounted at locked in rate in P/L
- Liability would be measured at current rate in B/S; difference in OCI
- IASB has explicit risk adjustment; FASB does not
  - ➢ Discounting could move more earnings into coverage period in FASB model; reduces net investment margin in future due to interest expense accretion on claim liability
  - ➢ Tracking two discount calculations adds complexity



- Contracts subject to similar risks and priced similarly relative to risk taken on
- Contracts having similar duration and similar expected patterns of release from risk
  - ➢ More detailed calculations required; potentially more loss contracts;

- Premium recognized based on expected timing of incurred claims vs straight line
  - ➢ Potential change to revenue and profit emergence typically impacting catastrophe exposed and excess of aggregate policies

- Premium revenue excludes estimated returnable amounts paid regardless of experience
- Premium revenue not adjusted for loss sensitive premium adjustments; cash flows contingent on claims experience adjust incurred claims
  - ➢ Changes total premium revenue and claims amounts and has related impacts on loss ratios
  - ➢ Tracking deposit amount adds complexity

Section 4

Reinsurance

Reinsurance for cedants

Does the contract pass risk transfer?

- Apply insurance risk transfer criteria (broader than current US GAAP)
- Stepping in shoes exception

Which model do I use?

FASB BBA Direct PAA → BBA Reinsurance PAA

IASB PAA ~ BBA

When do I recognize the reinsurance contract?

If coverage is proportional → As direct contracts are recognized

If coverage based on aggregate losses → Start of reinsurance coverage period

Reinsurance– Classification as BBA or PAA (cedant and assuming reinsurer)

Classification of reinsurance by cedant – BBA or PAA?

FASB: ceded reinsurance contract is classified consistent with the related reinsured direct contracts

IASB: permitted to use PAA if proxy for BBA or < 12 months (i.e., no automatic default to direct contract classification)

Classification of reinsurance by assuming reinsurer – BBA or PAA?

•**Reinsurer should evaluate in same manner that a direct insurer evaluates**

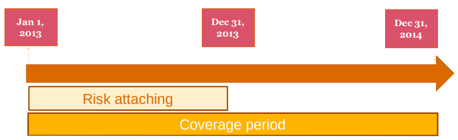
- FASB: assess as BBA or PAA using required criteria
- IASB: PAA permitted only if a proxy for BBA or < 12 months

Reinsurance– Classification as BBA or PAA (cedant and assuming reinsurer), cont.

Risk attaching considerations

•1 yr risk attaching reinsurance has 2 yr coverage period

- The reinsurance contract not eligible for PAA 12 month criteria under the FASB assumed and IASB ceded and assumed model



Reinsurance – Recognition – cedant

Recognition for cedant PAA:

If not based on aggregate limits:

- *Cedant recognizes reinsurance contract in the same manner in which the cedant determined the liability for remaining coverage on the direct policies.*

If based on aggregate limits:

- *Cedant recognizes entire contract and calculates one prepaid asset when reinsurance coverage period begins (1/1)*

Reinsurance –Ceding company initial and subsequent recognition (PAA)

Subsequent recognition for cedant PAA:

Coverage of "future events"

Amortize ceded "liability for remaining coverage" to P/L over coverage period (reinsurance premium)

Coverage of "past events"

Amortize positive implicit margin over the settlement period

Expense negative implicit margin (premium in excess of discounted covered liabilities) immediately

Reinsurance –Assuming company initial and subsequent recognition (PAA)

•Account for assumed reinsurance contracts in the same manner as a direct contract. This may result in the cedant applying a different model(BBA vs. PAA) than the assuming entity.

•Premiums would be presented net of ceding commission.

•The ED does provide limited guidance on portfolio transfers however, it appears to be limited to BBA contracts.

•There is also no explicit guidance as to how to account for an assumed retroactive contract.

•Similarly in a business combination there are questions related to:

- Reassessment of ceded reinsurance contracts upon acquisition.
- Reserve guarantees.
- Revenue recognition.

Allowance for uncollectible reinsurance

FASB:

- Assess recoverability of reinsurance asset due to credit risk of reinsurer using FASB financial instrument impairment guidance:
  - Current FASB proposal recognizes full lifetime expected losses on day one with subsequent adjustments
- Disputes recognized when current information indicates inability to collect amounts due

IASB:

- Measure expected credit losses and expected disputes under insurance model

Section 5

Presentation

FASB version of balance sheet presentation

Assets	Liabilities & Equity
Cash	Insurance contract liability (BBA)
Investments	Margin (BBA)*
Insurance contract asset (BBA)	Liability for remaining coverage (PAA)*
Premium receivable (PAA)	Liability for incurred claims (PAA)
Reinsurance contract asset (BBA)	Other liabilities
Reinsurance contract asset (PAA)	**Total Liabilities**
Other assets	Accumulated other comprehensive income
	Stock and retained earnings
Total Assets	**Total Liabilities and Equity**

**Capitalized direct acquisition costs are netted in this liability*

FASB version of Statement of Comprehensive Income

Statement of Comprehensive Income	
Insurance contract revenue (BBA) **(Excludes deposits in)**	**Derived amount**
Insurance contract revenue (PAA) **(Excludes deposits in)**	
Claims/benefits incurred (BBA) **(Excludes deposits out)**	
Claims/benefits incurred (PAA) **(Excludes deposits out)**	
Ceded reinsurance premium (expense) (BBA)	**Can't net against revenue**
Ceded reinsurance premium (expense) (PAA)	
Changes in estimates of future claims/benefits	
Amortization of acquisition costs	
Underwriting Margin	
Other expenses	
Investment income	
Interest expense	**Includes unwind of discount**
Income taxes	
Net Income	
Other comprehensive income	**Includes interest rate changes**
Total comprehensive income	

Statement of Comprehensive Income
"Earned premium" approach under BBA

Insurance revenue	- Actual claims and interest expense	= Summarized margin
+Expected claims and expenses	-Expected claims and expenses	
	+/-Differences between expected and actual	+/-Differences between expected and actual
	+/- Estimate changes	+/- Estimate changes
+Acq. cost amortization	-Acq. cost amortization	
+Release of margin		+Release of margin
+ Release of expected risk adjustment (IASB)		+Release of expected risk adjustment (IASB)
	Risk adjustment estimate changes	Risk adjustment estimate changes
	Interest expense on liability and margin	Interest expense on liability and margin

Premium allocation approach

Example: Estimated returnable amount (deposit element)

Total premium= $120k
Expected losses= $80k
Actual losses = $80k
Experience refund= 25% (premium – actual incurred losses)
= 25% ($120k – 80k = $10k)
FASB "Estimated returnable amount" = 25% (120k –$0k) = $30k

Statement of comprehensive income		Proposal	Existing practice
Insurance contract revenue	120k-30k =	**$90k**	$110k
Claims/benefits incurred	80k – 30k + 10k =	**(60)k**	(80)k
Changes in estimates of future claims/benefits		**-**	-
Amortization of acquisition costs		**-**	-
Underwriting Margin		**$30k**	$30k

Discount rate – changes in discount rates through OCI

Boards' objective:

Mandatory use of other comprehensive income (OCI) for reporting changes in the insurance liability due to changes in discount rate to:

- Reduce short term volatility caused by discount rate changes that are expected to reverse over time
- Enhance transparency of core underwriting results
- Reduce accounting mismatches in income statement between the insurance liability measurement and related assets recorded at either amortized cost or fair value through OCI
  - Consistent with joint financial instrument (FI) project proposal to have an OCI category for investments

Latest input from preparers:

Want option to record changes in rates in income

Discount rate – Changes in discount rates through OCI

Apply building block model with various inputs:
- Interest rates
- Interest-rate sensitive assumptions
- Other assumptions

Run the model using current discount rates (Balance sheet)

Record in OCI the difference between the liability at the current discount rate and the rate at initial recognition

Run the model using discount rates at initial recognition (Income statement)

Record in income other changes related to the time value of money

Section 6

Transition

Transition

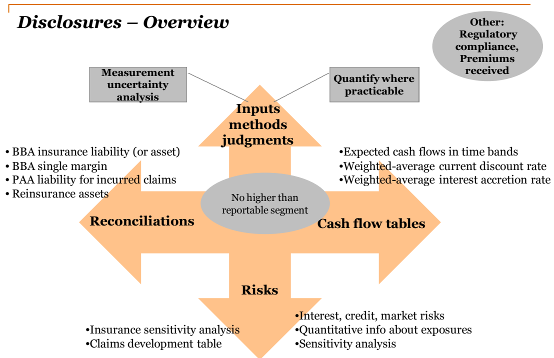
Retrospective application to all prior periods

- Measure the liability for incurred claims using current assumptions.
- Recognize a cumulative effect difference in AOCI for the difference between the current discount rate and the interest accretion rates.
- Financial asset classification: classify financial assets as if newly adopted FI standard (FASB only); IASB will permit only fair value option redesignation.

Section 7

Disclosure

Disclosures – Overview



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Thank you

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