



## **IASB and FASB to discuss risk adjustment, residual margin and policyholder behaviour**

### **Overview**

At their December and early January meetings the International Accounting Standards Board (IASB) and Financial Accounting Standards Board (FASB) (collectively, the Boards) continued their joint discussions on the measurement model for insurance obligations. The Boards discussed the objective of the measurement model, the building blocks to be applied to that model and the role of a risk adjustment in the measurement of an insurance liability. At their meeting on 19 January, the Boards will continue these discussions to further clarify the measurement objective and role of the risk adjustment. They will also discuss whether the proposed measurement model should apply to the rights and obligations arising from an insurance contract as a whole or only to a subset of those insurance obligations.

The Boards will discuss the accounting treatment for residual margins in an insurance contract, both at inception of the insurance contract and at each subsequent reporting period, including recognition of day-one losses.

Finally, they will discuss how to account for expected cash flows resulting from insurance contracts whose amount or timing depends on whether policyholders exercise options in the contracts.

## The story so far

A summary of topics discussed and tentative decisions by the IASB and FASB to date, including the additional meeting held on 5 January, are set out in the table below.

Topic	IASB	FASB
<b>Building blocks</b>	<p>The Boards tentatively decided that the measurement for insurance obligations should include four building blocks:</p> <ul style="list-style-type: none"> <li>▶ The unbiased, probability-weighted average of future cash flows expected to arise as the insurer fulfils the obligation</li> <li>▶ Incorporation of time value of money</li> <li>▶ A risk adjustment for the effects of uncertainty about the amount and timing of future cash flows</li> <li>▶ An amount that eliminates any gain at inception of the contract</li> </ul>	
<b>Measurement approach</b>	<p>The Boards decided tentatively that the measurement approach should portray a current assessment of the insurer's obligation, using the above building blocks.</p>	
<b>Risk adjustment</b>	<p>The Boards decided tentatively that the risk adjustment should measure the insurer's view of the uncertainty associated with the future cash flows. The Boards discussed various sources of information that an insurer might use to estimate this amount (e.g., the price the insurer would charge if it were taking on identical obligations with the same remaining risk exposure, or reinsurance prices) and asked the Staff to investigate this question further.</p>	
<b>Non-performance risk</b>	<p>The Boards decided tentatively that the measurement of an insurance liability should not be updated for changes in the risk of non-performance by the insurer.</p>	
<b>Use of inputs</b>	<p>The Boards decided tentatively that the measurement should:</p> <ul style="list-style-type: none"> <li>▶ Consider all available information that represents the fulfilment of the insurance contract. All available information includes, but is not limited to, industry data, historical data of an entity's costs, and market inputs when those inputs are relevant to the fulfilment of the contract.</li> <li>▶ Use current estimates of financial market variables that are as consistent as possible with observable market prices.</li> </ul>	
<b>Exclude discounting and margins in some instances</b>	<p>The IASB noted the arguments for and against an approach that uses an estimate of future cash flows with no margins and no discounting. The IASB considered whether to use such an approach for non-life claims liabilities and tentatively decided not to add it to the list of candidates.</p>	<p>The FASB will consider at a future meeting whether, in certain instances, a measurement of insurance contracts would use future cash flows with no margins and no discounting.</p>
<b>Unearned premium</b>	<p>The IASB decided tentatively:</p> <ul style="list-style-type: none"> <li>▶ An unearned premium approach would provide decision-useful information about pre-claims liabilities of short-duration insurance contracts</li> <li>▶ To require rather than permit the use of an unearned premium approach for those liabilities</li> </ul>	<p>The FASB will discuss an unearned premium approach at a future meeting.</p>
<b>Measurement of margins at inception</b>	<p>The margin at inception should be measured by reference to the premium. Therefore no day-one gains should be recognised in profit or loss.</p> <p>If the initial measurement of an insurance contract results in a day-one loss, the insurer should recognise that day-one loss in profit or loss.</p>	<p>In principle the initial recognition of an insurance contract should not result in the recognition of an accounting profit.</p> <p>The FASB will discuss this issue (day-one loss) at the January joint meeting.</p>

Topic	IASB	FASB
<b>Subsequent treatment of margins</b>	<p>On the residual margin, the IASB decided tentatively that:</p> <ul style="list-style-type: none"> <li>▶ The driver selected for releasing the residual margins should result in recognising those margins in income in a systematic way that best depicts the insurer's performance under the contract</li> <li>▶ The residual margin should be released over the period during which the insurer is standing ready to accept valid claims (the coverage period)</li> <li>▶ The insurer should not adjust the residual margin in subsequent reporting periods for changes in estimates</li> </ul>	<p>The FASB will discuss the subsequent treatment of margins at the January joint meeting.</p>
<b>Discount rates</b>	<p>The IASB decided tentatively that:</p> <ul style="list-style-type: none"> <li>▶ The discount rate for insurance liabilities should conceptually adjust estimated future cash flows for the time value of money in a way that captures the characteristics of that liability, rather than using a discount rate based on expected returns on actual assets backing those liabilities</li> <li>▶ The standard should not give detailed guidance on how to determine the discount rate</li> </ul>	<p>The FASB will discuss this issue further at a future meeting.</p>
<b>Acquisition costs</b>	<p>The Boards decided tentatively that an insurer:</p> <ul style="list-style-type: none"> <li>▶ Should expense all acquisition costs when incurred</li> <li>▶ Should not recognise any revenue (or income) to offset those costs incurred</li> </ul>	
<b>Policyholder behaviour and contract boundaries</b>	<p>The measurement should include the expected (i.e., probability-weighted) cash flows (future premiums and other cash flows resulting from those premiums, e.g., benefits and claims) resulting from those contracts, including those cash flows whose amount or timing depends on whether policyholders exercise options in the contracts.</p> <p>To identify the boundary between existing contracts and new contracts, the starting point would be to consider whether the insurer can cancel the contract or change the pricing or other terms. The Staff will develop more specific proposals for identifying the boundary.</p>	<p>The FASB will discuss this issue in January.</p>
<b>Deposit floor</b>	<p>The IASB confirmed that, applying tentative decisions it has already made on policyholder behaviour, no deposit floor applies in measuring insurance contracts.</p>	<p>The FASB will discuss this issue in January.</p>

Topic	IASB	FASB
<b>Participating features in insurance contracts</b>	The IASB expressed an initial preference for an approach that includes all cash flows that arise from a participating feature in the measurement of the insurance liability on an expected present value basis.	The FASB expressed an initial preference for an approach that analyses cash flows expected to arise from a participating feature to determine whether those flows are required (e.g., by the contract or by a statute) or are discretionary. Required cash flows (if there are any) will be included in the measurement of the insurance liability.  Discretionary cash flows will be recognised when the entity has an obligation to make payments.
<b>Recognition</b>	The IASB discussed the recognition of rights and obligations arising under insurance contracts, including the treatment of the contract in the period (if any) between entering into the contract and the start of the coverage period. No clear consensus emerged. The Boards will return to the topic of recognition at a future meeting.	The FASB tentatively decided that an entity should recognise an insurance obligation at the earlier of: <ul style="list-style-type: none"> <li>▶ The entity being on risk to provide coverage to the policyholder for insured events, or</li> <li>▶ The signing of the insurance contract.</li> </ul>
<b>Derecognition</b>	The IASB discussed derecognition of insurance liabilities and decided tentatively that an insurer should derecognise an insurance liability when it no longer qualifies as a liability of the insurer, applying the derecognition principle in IAS 39 <i>Financial Instruments: Recognition and Measurement</i> .	The FASB tentatively decided on a principle that an insurance liability should be derecognised by an entity when that obligation no longer qualifies as a liability. The liability is eliminated when the entity is no longer on risk and no longer required to transfer any economic resources for that obligation.
<b>Unbundling</b>	The IASB decided tentatively for recognition and measurement, an insurer should: <ul style="list-style-type: none"> <li>▶ Unbundle a component of an insurance contract if it is not interdependent with other components of that contract</li> <li>▶ Not unbundle a component that is interdependent</li> </ul>	The FASB decided tentatively that if unbundling is not required for recognition and measurement, it should not be a permitted option. The FASB asked the Staff to clarify further how unbundling for recognition and measurement relates to: <ul style="list-style-type: none"> <li>▶ The definition of an insurance contract and the scope of the proposed standard</li> <li>▶ The presentation models for the performance statement</li> <li>▶ Bifurcation of embedded derivatives</li> </ul>
<b>Presentation of the performance statement</b>	The Boards tentatively rejected a model that recognises revenue on the basis of written premiums (rather than recognising revenue as the insurer performs under the contract).	

Source: IASB Staff Paper 6, Ernst & Young.

## The objective of the measurement model for measuring an insurance contract

At the December joint meeting, the Boards considered the merits of a measurement objective for insurance liabilities that references future cash flows arising from an insurance contract, rather than an approach that applies the principles being developed in the project on revenue recognition.

The Boards then discussed the measurement approach and tentatively decided that it should portray a current assessment of the insurer's obligation, using the following building blocks:

- ▶ The unbiased, probability-weighted average of future cash flows expected to arise as the insurer fulfils the obligation.
- ▶ The time value of money.
- ▶ A risk adjustment for the effects of uncertainty about the amount and timing of future cash flows.
- ▶ An amount that eliminates any gain at inception of the contract.

In January, the Staff will ask the Boards to clarify the decision that the building block approach should be applied to the **net rights and obligations** present in an insurance contract rather than separately to the gross obligations under the contract. In addition, the Staff will recommend that the net rights and obligations arising under an insurance contract be presented net (i.e., as a single asset or liability) in an entity's financial statements, rather than separately disclosing a gross asset and gross liability.

In December the Boards also tentatively decided that:

- ▶ The risk adjustment should measure the insurer's view of the uncertainty associated with the future cash flows. The Boards discussed various sources of information that an insurer might use to estimate this amount (e.g., the price the insurer would charge if it were taking on identical obligations with the same remaining risk exposure, or reinsurance prices) and asked the Staff to investigate this question further.
- ▶ The measurement of an insurance liability should not be updated for changes in the risk of non-performance by the insurer.

The Staff will present additional analysis to the Boards this month seeking confirmation that the risk adjustment should reflect the amount an insurer requires for bearing the uncertainty about resources it needs to fulfil the remaining net obligations in the insurance contract. Effectively, the Staff will recommend that the insurer should not be required to base the risk adjustment on a market participant view, as had been previously proposed. Information on the amount that an insurer would require for bearing such risk might be derived from inputs such as:

- ▶ Reinsurance prices.
- ▶ Entry prices for similar contracts, adjusted to reflect the remaining exposure of the contract being measured.

An issue that will not be discussed this month is whether an insurer should take into account diversification benefits arising from a large pool of similar insurance contracts when measuring the risk margin. This discussion will be deferred to a subsequent meeting.

## Residual margins

A residual margin on an insurance contract will arise if the premiums on the contract differ from the discounted cash outflows (plus risk adjustment) from that contract. The purpose of the residual margin is to eliminate any positive day-one difference (day-one profit) and report the release of that residual profit in the income statement during an accounting period. The Staff will recommend that the residual margin is calculated at the inception of the insurance contract and that it is not re-measured over the life of the contract. The Staff argue that subsequent re-measurement of the residual margin has no intrinsic meaning, lacks substance and would not provide relevant information to financial statement users.

The Boards will continue their discussion on how a positive residual margin, measured at inception, should be subsequently released to profit and loss. Possible drivers for such release to reflect performance under the insurance contract include:

- ▶ Release from risk
- ▶ Expected benefit and claims payments
- ▶ Premium receipts
- ▶ Passage of time
- ▶ Funds under management
- ▶ Some combination of the above

Earlier discussions on the most appropriate basis for releasing residual margin, based on the above drivers, have identified pros and cons for each driver (or a combination thereof). As a result, no clear consensus has emerged. The Staff will recommend that, as a way forward, the Boards could select either:

- ▶ An approach that gives detailed guidance, perhaps even prescribes, a particular driver for releasing the margin (e.g., drivers like funds under management or claim payments), or
- ▶ A principles-based approach in which the insurer must determine what the driver or drivers are for the particular insurance contract.

In the latter scenario, if the contract involves a significant service element, the pattern of provision of those services is likely to be a main driver. For some contracts, the main driver may be protection (generally short-duration contracts). For more investment-oriented contracts, the liability carrying amount may be a more significant driver (similar to funds under management). For other insurance contracts, a blend of drivers may be appropriate.

There will be instances where the residual margin will result in a negative day-one difference because the insurance contract is onerous from inception. This could occur, for example, when an insurer sells a contract at a loss to gain market share as part of a broader growth strategy. The Staff will recommend that such negative day-one differences should be recognised directly in profit or loss. As a consequence, the residual margin cannot be negative at inception.

## Policyholder behaviour

The Staff will present a paper on the treatment of contractual features that permit a policyholder to take actions that change the cash flows resulting from an insurance contract. An example of such a contractual feature would be an option which allows the policyholder to suspend or terminate the payment of premiums under the policy. The IASB has tentatively reached a number of conclusions in this area, while the FASB is yet to hold a comprehensive discussion on the topic.

The Boards will discuss two approaches to the treatment of policyholder options (and other features that permit the policyholder to vary cash flows under the contract). These are:

- ▶ An approach that treats the existence of options as forming part of the measurement of the insurance contract itself (i.e., measure the insurance liability, when the insurer enters the contract or otherwise becomes obliged to the policyholder, inclusive of a probability weighted assessment of cash flows that would arise if the options in the contract were exercised), or
- ▶ Adopt a component approach and only account for any optionality when that individual component would meet the definition of an asset or liability.

The Staff will recommend that options, and other features, that relate to existing insurance contract cash flows (i.e., that are within the insurance contract boundary) should be included in the measurement of the insurance liability. As a consequence, no deposit floor would apply. All other options, forwards and guarantees that do not relate to the existing insurance contract coverage should be excluded from the measurement of the contract.

### **Timetable for Board discussion**

The Staff will present a revised project timetable at the January meeting. An insurance Exposure Draft is now expected to be published in May 2010.

### **Follow the discussion**

Accounting for insurance contracts will be discussed by the IASB and FASB at their joint meeting on Tuesday 19 January between 08:00 and 10:00 GMT. You can register to follow the discussion at [www.iasb.org](http://www.iasb.org).

We welcome your feedback on *Insurance Accounting Alert*. Please get in touch with your local Ernst & Young insurance contact with any enquiries.

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