Southeastern Actuaries Conference

Valuation Update

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cutting through complexity

FASB Insurance Contracts

How the world has changed

2008 to February 2014
IASB and FASB joint insurance contracts project

IASB ED and FASB proposed ASU
June 2013

IASB – Moving toward completion of insurance contracts project

FASB – targeted improvements to U.S. GAAP

FASB developments

FASB changes direction and scope of Insurance Project

- Scope limited to insurance entities, consistent with current U.S. GAAP
  - Contracts written by non-insurers may be added back as project progresses
- Project direction limited to targeted improvements to current U.S. GAAP
- Reinsurance accounting will not be addressed
- Change likely to lead to further non-convergence with IASB

FASB developments (continued)

Short-Duration Contracts (Decisions Reached)

- Focus efforts on targeted improvements to disclosures
- No change to current U.S. GAAP model for recognition and measurement

Long-Duration Contracts (Beginning)

- Focus efforts on targeted improvements to current U.S. GAAP
- Evaluate how improvements compare to building block approach as determined by IASB

FASB – Short duration contracts

Decisions reached on:

- Incurred and paid loss development tables
- Information about the frequency of claims and incurred but not reported claims
- Discounted claim reserves
- Estimation and changes in judgment
- Claim reserve duration
- Rollforwards of claims liabilities
- Health insurance contracts

August 13 meeting – ASU being drafted for written vote

- Subject to a four-week fatal flaw review

Board decisions – Short duration contracts (continued)

Health insurance contracts

- Disclose, in *both interim and annual* financial statements, the incurred but not reported liabilities included in the liability for unpaid claims and claim adjustment expenses
  - Either as a separate disclosure or as a component of the rollforward of the liabilities for unpaid claims and claim adjustment expenses
- The rollforward of the liabilities for unpaid claims and claim adjustment expenses to be disaggregated
  - So that useful information is not obscured by either the inclusion of a large amount of insignificant detail or the aggregation of items that have different characteristics
- Claim reserve duration disclosures are not required for health insurance

Transition and effective date

- Comparative disclosures for each prior period presented, except:
  - Loss development tables
  - Material changes in judgment
- Loss development tables need not exceed 5 years in the year of transition, growing to a period of time that does not need to exceed 10 years
- Application of transition disclosure guidance in Subtopic 250-10 on accounting changes and error corrections is not required
- Effective for public entities for annual reporting periods beginning after December 15, 2014 and interim reporting periods within annual reporting periods beginning after December 15, 2015
  - One year deferral for other entities
  - Early adoption is allowed

FASB – Long duration contracts

Potential targeted improvements for:

- Liability for future policy benefits
- Deferred acquisition costs (DAC)
- Premium deficiency and loss recognition
- Disclosures about revenue recognition

FASB – Long duration contracts (continued)

Liability for future policy benefits

- Periodic updates of assumptions, including frequency and recognition in the financial statements [Discussed August 27]
- Guidance for the discount rate used in determining the liability [Discussed August 27]
- Disclosures about methods and assumptions used to determine the liability [Discussed August 27]
- Measurement of options and guarantees that are not accounted for as derivatives
- The need for provisions for adverse deviation (currently used in accounting for traditional long-duration contracts that have locked-in assumptions) [Discussed August 27]

Portfolios and the unit of account (consider broadly – may be brought as a separate topic or with each of the other topics)

FASB – Liability for future policy benefits

What did the Board decide on August 27?

- For traditional long-duration contracts, limited payment contracts, and participating life insurance contracts:
  - Update annually all assumptions used in calculating the liability for future policy benefits
  - No provision for adverse deviation should be included in the assumptions
  - Update during the fourth quarter
  - Include the effects of changed assumptions in the determination of net income
- Guidance would also apply for updating assumptions used to calculate the additional liability for universal life-type contracts

FASB – Liability for future policy benefits (continued)

What did the Board decide on August 27? (continued)

- Disclose information about the liability for future policy benefits and the assumptions used:
  - Disaggregated balance of the liability and the weighted-average discount rates used in time bands, and any additional information about amounts and rates within the time bands provided that significantly affect the discount rates
  - Disaggregated quantitative and qualitative information about the methods and inputs used, including disclosure of assumptions used (such as discount rate, mortality, morbidity, termination [lapse], and expense assumptions)
  - Disaggregated reconciliations from the opening to the closing balance of the liability, with separate disclosure of changes due to new contracts, benefit payments, changes in assumptions, and derecognition of contracts

FASB – Long duration contracts

Deferred acquisition costs

- The manner in which DAC should be amortized, including:
  - Whether adjustments should be retrospective or prospective when using estimated gross profits or estimated gross margins
  - If retrospective unlocking is required, whether additional disclosure about the determination and future effects of retrospective unlocking is necessary
- Disclosure of a DAC rollforward

Disclosures about revenue recognition

- Whether certain disclosures should be required, such as amounts included in revenue that are required to be returned to policyholders or their beneficiaries regardless of whether an insured event occurs

FASB – Long duration contracts (continued)

Premium deficiency and loss recognition [Discussed August 27]

- Level of aggregation for performing the analysis
- Additional disclosures for loss recognition margin, level of aggregation, significant assumptions and amount of premium deficiency recorded during the period

FASB – Premium deficiency and loss recognition

What did the Board decide on August 27?

- No premium deficiency test would be required

FASB – Discount Rates

What did the Board decide on November 19?

- *Note: No information available at the time of publishing slides*
- To be discussed – Hot off the press!

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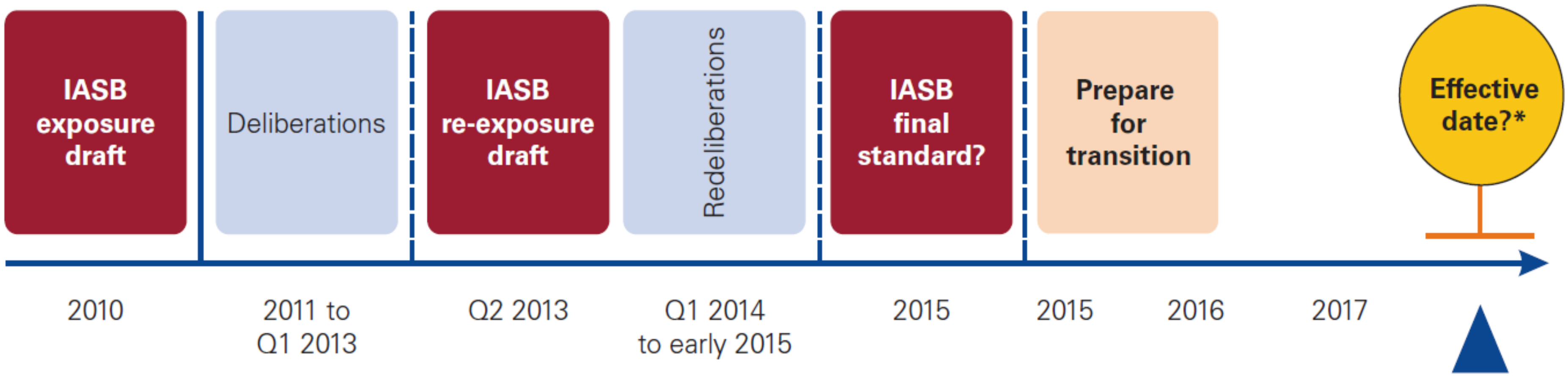
IASB
Insurance Contracts Project

Background and overview
Project milestones



Jan 2019?

Potential effective date

* The effective date of the final IFRS is expected to be approximately three years after the standard is issued. The IASB staff estimates that the issue date would be in 2015. Given an expected three-year lead time from publication to implementation, the new standard's effective date is likely to fall after that of IFRS 9 Financial Instruments – i.e. 1 January 2018

<u>Note on the FASB</u>: The IASB developed the proposals in the exposure draft jointly with the FASB which reached the same conclusions in many, but not all areas. In June 2013, the FASB issued a separate exposure draft. However, at its meeting in February 2014 the FASB decided to limit its project to targeted improvements to the current U.S. GAAP standards.
This decision is likely to significantly limit convergence between the IASB's and FASB's insurance contracts projects.

Background and overview

Focus areas of re-exposure draft

- IASB re-exposure included full text of proposed standard
- Limited questions to avoid re-opening of issues
- IASB undertook outreach activities and fieldwork during re-exposure

Key concerns identified through feedback received included:

- complexity;
- accounting mismatches;
- participating contracts; and
- presentation.

Measurement proposals

- Treatment of contractual service margin
- Treatment of participating contracts

Presentation proposals

- Presentation of revenue, claims and expenses in profit or loss
- Presentation of changes in discount rate in OCI

Approach to transition

- Retrospective application
- Some practical expedients provided

In addition, the ED included questions on cost/benefit aspects, and the clarity of drafting of the proposals.

Background and overview
Board activities in 2014

Topics discussed at past meetings:

- **Targeted issues**
  - Adjusting the contractual service margin (March 2014), including the rate used for subsequent measurement of the contractual service margin (July 2014)
  - Presenting the effects of changes in discount rates (March 2014), including requirements for changes in accounting policy (July 2014)
  - Insurance contract revenue / presentation (April 2014)
  - Premium allocation approach, revenue recognition pattern and determination of interest expense (September 2014)
  - Transition for contracts with no participating features (October 2014)

Background and overview
Board activities in 2014 (continued)

Topics discussed at past meetings:

- **Non-targeted issues (May to July 2014):**
  - Recognising the contractual service margin in profit or loss
  - Fixed-fee service contracts
  - Significant insurance risk
  - Portfolio transfers and business combinations
  - Determining discount rates when there is a lack of observable data
  - Asymmetrical treatment of gains from reinsurance contracts
  - Level of aggregation

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Proposed measurement model

Initial recognition and presentation of changes in profit or loss and OCI

Initial recognition:

Building block 1
- Expected cash inflows
- Expected cash outflows

Building block 2
- Discounting[+]

Building block 3
- Risk adjustment

Building block 4
- Contractual service margin

Zero gain at initial recognition

Presentation of changes in profit or loss and OCI:

Building block 1
- Changes in cash flows unrelated to services: profit or loss
- Changes in cash flows related to past and current services: profit or loss
- Changes in cash flows related to future services: offset against the margin*

Building block 2
- Unwind of locked-in discount rate: profit or loss
- Changes in discount rate: profit or loss or OCI [!]

Building block 3
- Changes related to past and current service: profit or loss
- Changes related to future service: offset against the margin *[!]

Building block 4
- Release of margin: profit or loss
- Offset changes related to future services

* Recognized in profit or loss if no contractual service margin or if rebuilding previously recognized losses [!]

[!] Change to requirements contained in the 2013 ED

[+] Change to the application guidance contained in the 2013 ED

Presentation of changes in profit or loss and OCI

Building block 2 – discounting

Proposal

An entity would be required to present the effects of changes in discount rates in OCI

Feedback

Providing an option to present the effects of changes in discount rates in OCI or in profit or loss may reduce accounting mismatches

What did the IASB decide?

- To provide an accounting policy choice to present the effects of changes in discount rates in profit or loss or in OCI
- In accordance with IAS 8, an entity would select and apply its accounting policies consistently for similar contracts, considering the portfolio in which the contract is included, the assets the entity holds and how those assets are accounted for.
- An entity presenting the effects of changes in discount rates in OCI would recognise:
  - *in profit or loss*, interest expense determined using the locked-in discount rate; and
  - *in OCI*, the difference between the carrying amount of the insurance contract measured using the discount rate~~s~~ that applied at the reporting date and the locked-in discount rate

Presentation of changes in profit or loss and OCI

Building block 3 – risk adjustment

Proposal

- Contractual service margin is unlocked for differences between current and previous estimates of the present value of cash flows relating to future coverage and other services
- Changes in the risk adjustment are recognized in profit or loss

Feedback

Lack of support for recognizing all changes in the risk adjustment in profit or loss

What did the IASB decide?

- The contractual service margin would be unlocked for changes in the risk adjustment that relate to future coverage and other services, provided that the contractual service margin should not be negative
- Changes in the risk adjustment that relate to the coverage and other services provided in the current and past periods would be recognized immediately in profit or loss

Presentation of changes in profit or loss and OCI

Building block 4 – contractual service margin

Proposal

Remaining contractual service margin would be recognized in profit or loss over the coverage period in a systematic way that best reflects the remaining transfer of services provided under the insurance contract

Feedback

Subjectivity in determining the pattern of underlying services would result in significant diversity in the recognition pattern for the contractual service margin

What did the IASB decide?

- For non-participating contracts, the service represented by the contractual service margin would be insurance coverage that:
  - is provided on the basis of the passage of time; and
  - reflects the expected number of contracts in force

Proposed measurement model

Fundamentals [!]

Proposal

Rather than prescribe a single level of aggregation for recognizing and measuring insurance contracts, the ED:

- Included principles for measuring particular components of an insurance contract
- Indicated the levels of aggregation needed to meet those principles

Feedback

Sought clarification and additional guidance on how to apply the different levels of aggregation

What did the IASB decide?

Level of measurement

- Objective of the proposed standard is to provide principles for measuring an individual insurance contract
- Insurance contracts could be aggregated – provided the aggregation meets the objective.

Portfolio

- Insurance contracts that provide coverage for similar risks and are managed together as a single pool

Margins

- Onerous contracts would not be aggregated with profit-making contracts in determining the contractual service margin or loss at initial recognition
- Unit of account used to release not prescribed, but should be consistent with the objective of release

Examples of aggregation to be provided

Insurance contract revenue
Presentation

The Board re-confirmed proposals related to insurance contract revenue in the 2013 ED and clarified that presentations not consistent with commonly understood definitions of revenue are prohibited.

Simplified example of insurance contract revenue presentation

Assumptions

- Portfolio of 3-year contracts
- Claims and benefits paid immediately
- Time value of money immaterial
- No investment component, acquisition costs, expenses, changes in estimates or experience adjustments, losses on initial recognition

* Insurance contract revenue is the sum of expected claims and benefits, release of risk adjustment and release of contractual service margin.

Expected cash flows	1	2	3	Total
Premiums received	420	400	380	1,200
Expected claims and benefits	-200	-350	-500	-1,050
Fulfilment cash flows	**220**	**50**	**-120**	**150**
Release of risk adjustment	32	30	28	90
Release of contractual service margin	23	19	18	60

Presentation	1	2	3	Total
Insurance contract revenue*	255	399	546	1,200
Actual claims and benefits (amounts incurred)	-200	-350	-500	-1,050
Underwriting margin	**55**	**49**	**46**	**150**

Transition

For contracts with no participating features (1/2)

Proposal

- Entities should apply the retrospective approach in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* unless impracticable; and
- When retrospective approach is impracticable, apply the simplified approach

Feedback

Concerns about practicable application require an alternative retrospective approach

Transition

For contracts with no participating features (2/2)

What did the IASB decide?

- Confirm proposals for retrospective approach in accordance with IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors unless impracticable; and

- When retrospective approach is impracticable, apply the simplified approach proposed in the 2013 ED with a modification for the Risk Adjustment (RA):
  - ✓ to determine risk adjustment at initial recognition, adjust the RA at transition date for the assumed risk release prior to transition date.

- When the simplified approach is impracticable, apply fair value approach, where
  - ✓ the CSM is the difference between fair value of the contract and fulfilment cash flows at that date
  - ✓ the OCI in equity is estimated by using the method specified in the simplified approach

- When the simplified approach or fair value approach are used, disclose the information proposed in the 2013 ED separately for contracts measured using each approach.

Next on the IASB's agenda
Issues to be redeliberated

What are the issues?

Contracts with participating features

- Is there a need for adaptations to account for the entity's share of underlying items?
- What is the appropriate recognition pattern for the contractual service margin for contracts with participating features?
- How should changes in estimates of investment returns that affect the amount paid to the policy holder be treated? Book yield and effective yield approaches are being considered.
- How should an entity account for changes in the values of options and guarantees?
- Are there any contracts with participating features for which an OCI approach provides useful information? If so, how should interest expense in profit or loss be determined?
- Would any form of 'mirroring exception' be necessary?

Transition and effective date

- The IASB plans to consider their tentative decisions on transition for contracts with participating features
- Effective date needs to be addressed

What questions do you have?