Boards discuss reinsurance accounting, insurance contracts and decisions on policy loans and riders

Overview

During a joint meeting on 18 April 2012, the International Accounting Standards Board and the Financial Accounting Standards Board (respectively, the IASB and the FASB, or collectively, the Boards) re-deliberated decisions in the IASB's Exposure Draft, Insurance Contracts (ED) and in the FASB's Discussion Paper, Preliminary Views on Insurance Contracts (DP). The following topics were discussed:

1. Issues relating to reinsurance accounting
2. Amendments and modifications, as well as commutations of insurance contracts
3. Applying decisions on unbundling and disaggregation to policy loans and riders

The Boards also held non-decision-making joint education sessions to consider the FASB's single margin approach and the use of other comprehensive income (OCI) for recognising some of the changes in the insurance liability. The OCI discussions were held on the working assumption that the IASB would develop a fair value through the OCI category for certain debt instruments.

Issues relating to reinsurance accounting

The Boards continued their discussions on reinsurance accounting, including amortisation of the single margin (FASB) and the residual margin (IASB) for retroactive reinsurance, loss sensitive features and the basis for determining the model (Premium Allocation Approach-PAA or Building Block Approach-BBA) for reinsurance contracts.

What you should know

- The IASB agreed on criteria for determining when a modification to an insurance contract terminates that contract and creates a new one. The FASB has agreed to some of the criteria, but will continue its evaluation at future meetings.
- The Boards expressed a desire, during the education session, to eliminate a key difference between their models on the use of a single margin.
- The Boards are continuing to evaluate how other comprehensive income could be used for changes in the insurance contract liability.

1 The Board materials for this meeting are IASB/FASB Agenda Papers 2-2I, and a summary of the Board decisions is available through IASB Update and FASB Summary of Decisions.
The Boards tentatively decided that:

1. For retroactive reinsurance contracts (those in which a reinsurer agrees to reimburse a cedant for liabilities incurred as a result of past events), the residual or single margin included in the cedant’s recoverable and the reinsurer’s insurance contract liability should be amortised over the remaining settlement period on the same basis as the single/residual margin is released, i.e., in line with the pattern of services (for the IASB) or release from risk (for the FASB).

2. An insurer should treat the cash flows from contractual features that affect the amount of premiums and ceding commissions that are contingent on claims or benefits experience (often referred to as “loss sensitive features”) as part of the claims and benefits cash flows (rather than as part of the premiums). Those cash flows do not relate to the investment component. An insurer should treat any premium adjustments that are not loss sensitive in the same way as other changes in estimates of premiums arising from the contract. Any features that provide cedants with a unilateral right (but not an obligation) to pay a premium and reinstate a reinsurance contract should not be considered to be loss-sensitive features for the purpose of applying this guidance.

The IASB tentatively decided that both the cedant and reinsurer should evaluate whether to account for the reinsurance contract using the BBA or the PAA in the same manner in which an insurer should evaluate a direct insurance contract. In other words, the PAA would be permitted if it were to produce measurements that are reasonable approximations to those that are produced by the BBA.

The FASB tentatively decided that:

1. The reinsurer should evaluate whether to classify the reinsurance contract under the BBA or PAA using the criteria established for classifying direct insurance contracts.

2. The cedant should account for a reinsurance contract using the same approach (either BBA or PAA) that it uses to account for its underlying direct insurance contracts. Reinsurance contracts that reinsure both insurance contracts measured using the BBA and those measured using the PAA should be separated based on the underlying contract measurement model. Each component should be accounted for by applying the same approach used to account for the underlying direct insurance contracts.

Amendments, modifications and commutations

Substantial modifications

The Boards discussed the accounting for amendments and modifications of insurance contracts, as well as the treatment of reinsurance commutations. They tentatively decided that the insurer should derecognise an existing contract and recognise a new one when a contract modification is considered to be substantial. A contract modification is considered to be substantial in those circumstances where, if the amended terms had been in place at the inception of the contract, a different assessment of either of the following would have resulted:

1. Whether the amended contract is within the scope of the insurance contract standard

   Or

2. Whether to use the PAA or the BBA to account for the insurance contract

In addition, the IASB tentatively decided that an insurer must derecognise an existing contract and recognise a new one if it amends the contract in a way that would have resulted in the contract being included in a different portfolio than the one where it appeared at initial recognition. However, the FASB felt a change in portfolio would lead to more contract modifications being deemed substantial than was desirable. Therefore, it plans to consider which additional circumstances will result in derecognition and whether they should develop application guidance.

How we see it

The decision to amortise margins over the settlement period for retroactive reinsurance does not mirror the accounting for direct insurance and prospective reinsurance contracts. Although the Boards decided to recognise the margin release on direct insurance and prospective reinsurance during both the coverage and claim settlement period, they believe recognition over the remaining settlement period is more appropriate for retroactive reinsurance, to avoid a day one gain.

When an insurer makes a substantial modification to an insurance contract, the new/modified/amended contract is measured at the current entity-specific price that the insurer would
hypothesically charge the policyholder for a contract equivalent to the new/modified/amended insurance contract. Any difference with the carrying amount of the existing (old) insurance contract is an extinguishment gain or loss recognised in comprehensive income.

Non-substantial modifications

The Boards decided to treat non-substantial modifications that reduce the obligation to provide benefits as a partial derecognition of the insurer’s obligation. As a result of this partial derecognition, the insurer should record in profit or loss a change in estimates of future cash flows and a release of any related portion of the residual/single margin. If a non-substantial modification provides further benefit, the amendment must be treated as a new standalone contract (i.e., the margin is determined in the same way as for a new standalone contract with no effect on the measurement of the original contract).

The Boards also decided that reinsurers and cedants must present any gains or losses on commutations as adjustments to claims or benefits on a net basis on the statement of comprehensive income. The Boards noted that they would consider disclosures about commutations at a future meeting.

How we see it

Insurance contracts are often modified as policyholders’ insurance coverage needs change over time and market competition sometimes causes insurers to offer enhancements to policyholders to avoid them from cancelling their product. Whether changes are substantial to the original terms often will remain a matter of significant judgement. The Boards’ tentative decision attempts to utilise criteria to identify the extent of the modification and may promote less diversity when companies decide when a modification is substantial.

The opposing positions of the Boards may stem from their differing views on portfolios. The FASB defined a portfolio at a more granular level, closer to the line of business, while the IASB defined the portfolio at a higher level, closer to the reporting segment. The FASB felt that too many typical modifications would cause a change in portfolio and, therefore, expedite the recognition of gains and losses. As the cost to acquire the insurance contracts are embedded in the insurance liability, companies may not be troubled by having to extinguish the old and set up the new if the pattern of profit emergence is not significantly altered. However, the administrative costs of updating systems for this change may prove burdensome for some insurers.

The decision to consider non-substantial modifications that provide further benefit affects the insurer’s calculation of the onerous contract test. If the insurer provides additional benefit at a discount, it may not be able to use the profitability embedded in the original contract cash flows to reduce the likelihood of recognising an onerous contract for the new stand-alone one relating to the modification. For example, upon a contract modification, the remaining original contract cash inflows exceeded outflows by CU 20 and the net cash outflows for a contract modification were CU 5. Under the Boards’ proposed approach, the insurer may need to recognise the CU 5 loss at the point of the contract modification while continuing to amortise the CU 20 gain, rather than amortising CU 15 and not recognising the onerous contract of CU 5.

Treatment of policy loans and contract riders

The Boards discussed whether and how the effects of the earlier decisions on unbundling and disaggregation would be applied to contract riders that exist at inception of the contract and policy loans. Typically, policy loans exist on contracts with an explicit or implicit account balance and would likely be a reduction in the insurance contract liability, with the loan amount being considered a prepayment for expected future claims. The Boards tentatively decided that, in applying the general decisions on unbundling and disaggregation, policy loans should be considered in determining the amount of the investment component to which they relate. If a deposit component were to be unbundled, the insurer may have to consider the policy loan as a portion of the investment component. The Boards noted they would consider disclosures about the amount of policy loans taken out at a future meeting.

Furthermore, the Boards agreed that an insurer should account for riders that are included in the insurance contract at inception as part of the contractual terms of the contract. Thus, the general decisions on unbundling and disaggregation should apply to riders.
Education session on FASB’s single margin approach

The Boards held a non-decision making education session on the mechanics of the single margin. The objective was to understand the effects of one of the more significant differences in the IASB and FASB decisions. In previous meetings, to eliminate day one gains when using the BBA, the IASB decided to use a residual margin, while the FASB uses a single margin. The FASB also decided that the measurement of a contract would not include a single margin for the claims liability if the PAA is used during the coverage period, whereas the IASB would require a risk adjustment over the claims payout period. The session focused on how to account for changes in expectations and their effects on the financial statements. Under the BBA, the single margin approach (FASB) would not accelerate additional profits during that period should they improve from the initial assessment; and when expectations deteriorate, losses may be recognised if the contract becomes onerous. However, the risk adjustment approach (IASB) can be adjusted in either direction for changes in assumptions.

Another key difference to be reconciled is the amortisation period for the residual margin (coverage period) and the single margin (settlement period). To reach common ground and eliminate the difference in the use of the risk adjustments and margins in the approaches, the Boards agreed they would need to resolve three differences. Converging on those differences will require the FASB and the IASB to both modify previous decisions. Specifically, the FASB would need to permit the unlocking of the margin assumptions and align the amortisation periods of the margin, while the IASB would need to evaluate the merits of splitting the margin into the risk adjustment and residual margin.

Impact of OCI on changes in insurance contract liability

The Boards held a joint education session to explore the use of OCI to present some of the changes in the insurance contract liability. The purpose was to consider the use of OCI to record some of the changes, determine whether to require or permit the use of OCI and when that determination can be made, as well as review the frequency of election/determination and the unit of account. This discussion was held on the working assumption that the IASB would consider the fair value through OCI category for financial instruments.

The staff explained that, based on the respondents’ feedback to the ED/DP and the staff’s own research, there was a need to consider the use of OCI for some of the changes in the insurance contract liability. The objective of this approach would be to reduce the accounting mismatch in the profit and loss account presented by the measurement and recognition of the insurance contract liability and the financial instruments backing the insurance liability. It would also provide useful and relevant information on the insurers’ performance, reflecting the long-term nature of insurance contracts. The staff requested the Boards to consider whether the impact on the insurance contract liability arising from changes in the discount rate and interest-sensitive assumptions should be recognised in OCI. They asked the Boards’ views on whether to permit or require this recognition and what unit of account should be used in determining the use of OCI.

Board members expressed different views on the use of OCI. Most of the opponents argued that the use of OCI would increase complexity in the measurement of a liability, may reduce transparency and would not provide helpful information to the users of
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financial statements. The proponents for the use of OCI explained that the information could be made useful by having meaningful disaggregation of the components presented in OCI in a clear and transparent manner.

How we see it
While no decisions were made at this meeting, the discussions indicated caution in taking this approach. The Boards continue to demonstrate their desire to fully explore potential changes to the proposals in the ED/DP based on the feedback they have received, and, at the same time, a strong interest in not over-complicating the model in a way that reduces transparency.

Next Steps
The Boards remain committed to the current timetable. The IASB expects to issue a revised exposure draft or review draft and the FASB expects to issue an exposure draft during the second half 2012. The Boards will meet again in May; the topics have not yet been announced.
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