Society of Actuaries

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Convergence Once Again

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con·verge

1. **a. To tend toward or approach an intersecting point**

   b. To come together from different directions; meet
2. **To tend toward or achieve union or a common conclusion or result**
3. **Mathematics: To approach a limit.**

Source: *www.thefreedictionary.com*

Since the FASB joined the Insurance Contract Project, making it a joint project with the IASB, the goal has always been to develop a converged standard. There has never, however, been agreement on what "converged" means in an accounting context.

Some have said it means that the two boards would adopt identical standards. Others have said that the standards just needed to be close, without defining how close was close enough. It was therefore inevitable that there would be disagreement on whether or not a converged standard could be or had been achieved.

It was nonetheless a surprise to some when FASB Chair Leslie Seidman publicly acknowledged on June 5 what anyone following the project already knew; the two boards had not reached agreement on several important issues, and a converged standard was unlikely to emerge. Given that recognition, she further stated, the FASB was going to take a step back and discuss how to proceed on the project. What she definitely did not say, however, was that the FASB was considering abandoning the project, and indeed, the two boards continue to work together on the remaining outstanding issues.

It was another surprise, and definitely not part of the agenda, when on June 25, at the opening of a meeting of the IASB's Insurance Working Group (IWG), Burkhard Keese of Allianz, a member of the IWG, strongly raised the need for a converged standard. I immediately supported this comment as did other industry representatives. In doing so, we asked both boards to go back and review again the issues that they had not agreed upon, and consider whether they are really so important that compromise was impossible.

Table 1 identifies the four major issues that the boards have not agreed upon (other minor issues exist as well). In my view, none of these issues should be prohibitive to convergence. In fact, the ACLI has recently published a study that arrived at this same conclusion for the first and third issues. So let's briefly (there are many more arguments on both sides of each issue) review each of these items.

Table 1: Major Outstanding Disagreements Between IASB and FASB

Issue	FASB's view	IASB's view
Measurement and presentation of premiums in excess of present value of expected cash flows	For contracts accounted for under the building block approach record as single margin	For contracts accounted for under the building block approach split between measurement of explicit risk adjustment and residual margin
Unlocking the single/residual margin for changes in cash flow assumptions	Adjust only amortization of single margin	Unlock the residual margin for favorable and unfavorable changes
Acquisition costs: Agreed to include costs directly attributable to obtaining insurance contracts	Limit to costs of successfully acquiring contracts within a portfolio Note: this is consistent with US GAAP	Include both successful and unsuccessful costs of acquiring portfolio
Investment contracts with discretionary participation features (DPF)	Do not explicitly scope into the insurance contracts standard	Specifically scope into insurance contracts standard Currently scoped into IFRS 4

Should there be one margin or two? I'm sure we could live with either alternative. I prefer adoption of a single margin because it is simpler to implement and understand and because I suspect calculating the risk margin will add to rather than reduce the "black box" complaints of users. On the other hand, I can see that having an explicit risk margin could be helpful and we could simply treat it as another item in the cash flow calculations. Earnings would be mostly unaffected whichever alternative is chosen.

Should acquisition costs include only costs for successful efforts? Well yes, those already using US GAAP would prefer including only successful efforts. But the ACLI concluded that the difference is small (around 10 percent), and if we had to return to includ-

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ing the total, we could. Is this something worth going to war over? It may be difficult for the FASB to compromise on, but I don't think the issue should be a deal breaker for either side.

Should unlocking of the residual margin be allowed? This is probably the most challenging issue to resolve. The industry points out that having the ability to unlock the residual margin will reduce volatility in earnings. This is true, but it wouldn't be the end of the world if the residual margin wasn't unlocked either. The entire industry is going to provide more details about their earnings in the financial statement notes; the effects of assumption changes is going to be a disclosure many firms will make in any event.

Should investment contracts with DPF's be scoped into the insurance standard? This issue hardly seems worth arguing about. The result is largely the same under either alternative; although some differences do exist (e.g., should there be an account value floor?).

So we have a situation, familiar to all who have negotiated an M&A transaction, where there is a list of outstanding differences and the two sides need to sit down together and reach a deal. Most of the dispute is over philosophical issues that should be the subject of compromise. This is the message the industry gave to the board members and staff at the IWG meeting. It remains to be seen if the boards will continue to be adamant in their positions.

The remainder of this paper describes the results of the joint board meetings during the quarter.

APRIL JOINT BOARD MEETING

The IASB and FASB continued their discussions on insurance contracts by considering reinsurance, as well as issues related to policy loans and contract modifications (including riders). They also held an education session on the single margin approach tentatively adopted by the FASB. This was one instance where the boards made a serious effort to move towards a converged result.

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Reinsurance

The boards tentatively decided that:

- For retroactive reinsurance contracts, the residual or single margin included in the cedant's reinsurance recoverable and the reinsurer's insurance contract liability should be amortized over the remaining settlement period in the same manner as the release of the corresponding direct single/residual margin (i.e., in line with the pattern of services for the IASB or release from risk for the FASB).
- An insurer should treat cash flows resulting from contractual features affecting the amount of ceded premiums and 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) if they are not accounted for as investment components. 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.

Measurement of the Contract

Both boards tentatively decided that both the cedant and the reinsurer should evaluate whether to account for the reinsurance contract using the building block approach (BBA) or the premium allocation approach (PAA) in the same manner in which an insurer should evaluate a direct insurance contract.

Of course, as noted, the two boards have different ways at arriving at this determination.

The FASB also concluded that reinsurance contracts that reinsure both insurance contracts measured using the building block approach and insurance contracts measured using the premium allocation approach, should be separated based on the underlying contract measurement model, with each component being accounted for using the same approach used to account for the underlying direct insurance contracts.

Policy Loans and Contract Modifications (Including Riders)

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.

The boards also tentatively decided that:

- An insurer should account for contract modifications (i.e., riders) that are part of 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.
- An insurer should de-recognize an existing contract and recognize a new contract (under the applicable guidance for the new contract) if it amends the contract in a way that would have resulted in a different assessment of either of the following items had the amended terms been in place at the inception of the contract:
    - whether the contract is within the scope of the insurance contract standard; or
    - whether to use the premium allocation approach or the building block approach to account for the insurance contract.

This can be considered the equivalent of SOP 05-1 of US GAAP. It remains to be seen if this is a material improvement; it certainly couldn't make things worse.

In addition, the IASB tentatively decided that an insurer shall de-recognize an existing contract and recognize a new contract if it amends the contract in a way that would have resulted in the contract being included in a different portfolio than the one in which it was included in at initial recognition. The FASB plans to consider in the future which additional circumstances will result in de-recognition and whether there needs to be application guidance.

- When an insurer makes a substantial modification to an insurance contract, the gain or loss on extinguishment of the original contract should be determined by measuring the existing insurance contract using the current entity-specific price that the insurer would hypothetically charge the policyholder for a contract equivalent to the newly recognized insurance contract.

- Insurers should account for non-substantial modifications as follows:

    - If the modification eliminates the insurer's obligation to provide some of the benefits that the contract would previously have required, the insurer shall de-recognize that portion of its obligation (including any related portion of the residual/single margin).

    - If the modification entitles the policyholder to further benefits, the insurer shall treat the modification as if the amendment was 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).

Reinsurers and cedants shall present any gains or losses on commutations as a net adjustment to claims or benefits and shall not gross up both the premiums and claims, or benefits in recognizing the transaction on the statement of comprehensive income.

MAY JOINT BOARD MEETING

The IASB and FASB continued their discussions on insurance contracts by considering the separation of investment components from the insurance contract. In addition, the IASB considered its previous decisions on risk adjustment and residual margin.

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Separation of Investment Components from the Insurance Contract (Unbundling)

The boards tentatively decided that if the investment component is distinct, an insurer shall unbundle the investment component and apply the applicable IFRSs or US GAAP in accounting for the investment component.

The boards tentatively decided that an investment component is distinct if the investment component and the insurance component are not highly interrelated.

Indicators that an investment component is highly interrelated with an insurance component are:

- a lack of possibility for one of the components to lapse or mature without the other component also lapsing or maturing;
- if the products are not sold in the same market or jurisdiction; or
- if the value of the insurance component depends on the value of the investment component or if the value of the investment component depends on the value of the insurance component.

An insurer shall account for investment components that are not distinct from the insurance contract together with the insurance component under the insurance contracts standard. Most observers feel that the unbundling required by these criteria will be relatively infrequent.

The boards also confirmed their previous tentative decisions regarding separation from insurance contracts, as follows:

- Embedded derivatives: unbundled when the embedded derivative is not closely related (for the IASB) or clearly and closely related (for the FASB) to the insurance component.
- Non-insurance goods and services: unbundled when the performance obligation to provide the goods or services is distinct, as previously defined by the boards.
- Investment components: exclude from the premium presented in the statement of comprehensive income an amount for an investment component as previously defined by the boards.

The boards also tentatively decided that insurers should be prohibited from applying revenue recognition or financial instrument standards to components of an insurance contract when unbundling is not required.

Risk Adjustment and Residual Margin - IASB Only

Following its education session in April, the IASB again reviewed its previous decisions on the risk adjustment and residual margin and decided to confirm them, namely:

- that the measurement of an insurance contract should include an updated, explicit risk adjustment; and
- that changes in estimates of future cash flows should be offset in the residual margin. The IASB also decided that it would not explore whether other changes in estimates should be offset in the residual margin.

This became one of the issues that Chairman Seidman was referring to in her June 5 comments, since FASB decided not to offset those changes in the single margin.

Use of Other Comprehensive Income (OCI)

The boards tentatively decided that an insurer should:

1. present in OCI changes in the insurance liability arising from changes in the discount rate;
2. not present in OCI changes in the insurance liability arising from changes in interest sensitive cash flow assumptions such as lapses; and
3. present interest accrual in interest expense using the discount rate locked in at inception of the insurance contract.

The boards also tentatively decided:

1. that the discount rate locked in at inception of the

insurance contract would be applied to changes in expected cash flows; and
2. not to include a loss recognition test in their proposed requirements.

The boards will consider at a future meeting how the above decisions will apply to participating insurance contracts, including the interaction with previous tentative decisions for participating insurance contracts.

Acquisition Costs in the Building Block Approach
The IASB tentatively confirmed that an insurer should include acquisition costs in the cash flows used to determine the margin (and hence the insurance contract liability), rather than account for them as a separate deferred acquisition cost asset.

The FASB tentatively decided against an approach that would require an insurer to expense the acquisition costs and recognize income equal to, and offsetting, those costs when the acquisition costs are incurred.

JUNE JOINT BOARD MEETING

The IASB and FASB continued their discussions on insurance contracts by exploring a method of measuring earned premiums for presentation in the statement of comprehensive income and considering how to attribute cash flows to the unbundled components of bundled insurance contracts, in order to measure those unbundled components.

Method of Measuring Earned Premiums
The boards discussed an approach to derive a measurement of earned premiums. The boards agreed to explore further the usefulness of the information and the extent of any operational difficulties. No decisions were made at this meeting.

Unbundled Components
The boards tentatively decided that:

1. an insurer should attribute cash flows to an investment component and to an embedded derivative on a stand-alone basis. This means that an insurer would measure an investment component or embedded derivative as if it had issued that item as a separate contract. The insurer would thus not include the effect of any cross-subsidies or discounts/supplements in the investment component.
2. after excluding the cash flows related to unbundled investment components and embedded derivatives:
   a. the amount of consideration and discounts/supplements should be attributed to the insurance component and/or service component in accordance with proposals in paragraphs 70-80 of the exposure draft *Revenue from Contracts with Customers*; and
   b. cash outflows (including expenses and acquisition costs) that relate directly to one component should be attributed to that component. Cash outflows related to more than one component should be allocated to those components on a rational and consistent basis, reflecting the costs that the insurer would expect to incur if it issued that component as a separate contract. Once cash outflows are attributed to components, the insurer would account for those costs in accordance with the recognition and measurement requirements that apply to that component.

This item will probably not be a major problem for life insurers since the amount of unbundling will be relatively rare. It basically says that if you do unbundle, value the investment component based on how you would separately value it, rather than doing some allocation of costs.

Both boards are now aiming to release their next exposure document at the end of this year. We will see how each of them approaches the problem of convergence. There are many major issues on which the boards agree. Hopefully, they will find a way to come close enough on the others to declare success. This is another situation showing why

Insurance accounting is too important to be left to the accountants!