



Financial Accounting Standards Board

Insurance Risk Transfer Project

ABIR

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The views expressed in this presentation are my own and do not represent positions of the FASB.

Positions of the FASB are arrived at only after extensive due process and deliberations.



Insurance Risk Transfer Why?

- **Concern about accounting for finite risk insurance and reinsurance contracts**
 - *Transfer of significant insurance risk*
 - For example, the “10/10 rule”
 - The pass-fail accounting paradigm
 - Risk-limiting features in contracts
- **Insurance vs. financing (deposit)**
 - Insurance accounting generally considered beneficial
 - Income statement benefits from insurance recovery
 - Key insurance company analytical ratios benefited



Insurance Risk Transfer Bifurcation

- **Bifurcation into components:**
 - Components that *transfer significant insurance risk* are accounted for as insurance.
 - For policyholders, premiums are expensed and insured loss recoveries are recorded as a gain in the income statement.
 - Financing components are accounted for as *deposits*.
 - For policyholders, premiums paid are recorded as an asset and insured loss recoveries are a reduction to the deposit (no income statement benefit).



Insurance Risk Transfer

U.S. GAAP

- **Policyholder accounting guidance**
 - Statement 5 – “indemnification”
- **Insurance company accounting guidance**
 - Statement 5 – “indemnification”
 - Statement 60 – “indemnification” notion carried forward
 - Statement 97 – universal life-type insurance contracts
- **Reinsurance guidance**
 - Statements 5 and 60
 - Statement 113 – “indemnification” still core notion
 - Significant risk transfer conditions specified
 - EITF 93-6 – multi-year retrospectively rated contracts



Insurance Risk Transfer Project Objective

- To clarify what constitutes transfer of *significant insurance risk* in insurance and reinsurance contracts
- Project steps:
 - Define insurance contracts and related terms
 - Extend reinsurance risk transfer guidance to insurance contracts and policyholder accounting
 - Clarify current insurance risk transfer guidance, including editorial modifications
 - Explore display alternatives and expanded disclosure requirements



Insurance Risk Transfer Board Decisions

- **April 6, 2005:** Project added to agenda.
- **September 14, 2005:** Tentatively agreed to base U.S. GAAP working definitions on the IASB's IFRS 4 definition of insurance contract and related guidance.
- **December 20, 2005:** Directed staff to issue Invitation to Comment on possible bifurcation of insurance and reinsurance contracts.
- **May 26, 2006:** Invitation to Comment issued with August 24 comment deadline



Insurance Risk Transfer Insurance Contract

- Working U.S. GAAP definition of insurance contract from IFRS 4:

A contract under which one party (the insurer) accepts *significant insurance risk* from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder.
- IFRS 4 defines *insurance risk* as: Risk, other than financial risk, transferred from the holder of a contract to the issuer.



Insurance Risk Transfer

IFRS Significant Insurance Risk

- IFRS 4 describes the transfer of *significant insurance risk* as: Insurance risk is significant if, and only if, an insured event could cause an insurer to pay significant additional benefits in any scenario, excluding scenarios that lack commercial substance (ie have no discernible effect on the economics of the transaction). ...the condition in the previous sentence may be met even if the insured event is extremely unlikely or even if the expected (ie probability weighted) present value of contingent cash flows is a small proportion of the expected present value of all the remaining contractual cash flows. [Paragraph B23]



Insurance Risk Transfer

U.S. GAAP Insurance Risk

- Statement 113 defines *insurance risk* as: “the risk arising from uncertainties about both:
 - a. the ultimate amount of net cash flows from premiums, commissions, claims, and claim settlement expenses paid under a contract (often referred to as underwriting risk) and
 - b. the timing of the receipt and payment of those cash flows (often referred to as timing risk).
- Actual or imputed investment returns are not an element of insurance risk.
- Insurance risk is fortuitous—the possibility of adverse events occurring is outside the control of the insured.”



Insurance Risk Transfer

U.S. GAAP Significant Insurance Risk

- Statement 113 states: “Indemnification of the ceding enterprise against loss or liability relating to insurance risk in *reinsurance* of short-duration contracts [most property and liability insurance contracts*] requires both of the following...:
 - a. The reinsurer assumes *significant insurance risk* under the reinsured portions of the underlying insurance contracts [i.e., the probability of a significant variation in both the amount and timing of payments by the reinsurer is greater than remote].
 - b. It is *reasonably possible that the reinsurer may realize a significant loss* from the transaction [i.e., the present value of all contractual cash flows vs. the present value of amounts paid to the reinsurer].”

*Long-duration reinsurance contracts (some life and health reinsurance contracts) have a risk transfer requirement similar to paragraph b.



Insurance Risk Transfer

The Invitation to Comment (ITC)

- Threshold question: Would bifurcation of insurance and reinsurance contracts provide more decision-useful financial information to users of financial statements about the economic substance of those contracts than today's pass-fail accounting paradigm?



Insurance Risk Transfer

The Invitation to Comment (ITC)

- The purpose of the ITC is to gather information to facilitate Board discussions on bifurcation issues.
- The ITC is intended to be a neutral staff discussion document.
- The ITC applies to both property-casualty insurance contracts and life and health insurance contracts.
- The ITC applies to policyholders, insurers, and reinsurers.
- The ITC is not intended to address accounting for the insurance or deposit components of contracts.



Insurance Risk Transfer Major Bifurcation Issues

- The FASB has had no deliberations on nor made any decisions about the possible bifurcation of insurance contracts. However, *if* bifurcation were to be implemented, two major issues are:
 - Which contracts would be bifurcated?
 - How would those contracts be bifurcated?



Insurance Risk Transfer Major Bifurcation Issues

- Which contracts would be bifurcated?
- Approach A – Risk-Limiting Features
 - Contract terms where the premium plus the investment income earned approximates the expected claim payments
 - Provisions for significant profit or loss sharing between the policyholder and the insurer
- This approach attempts to describe finite risk arrangements



Insurance Risk Transfer Major Bifurcation Issues

- Which contracts would be bifurcated?
- Approach B – all insurance and reinsurance contracts not meeting definition or displaying obvious significant insurance and financing components. A broader scope might:
 - Provide more consistent accounting across all types and forms of insurance
 - Provide user's of financial information with a better depiction of a company's insurable exposures and risk management approach
 - Address *dollar trading, e.g., group health or workers compensation contracts*



Insurance Risk Transfer Major Bifurcation Issues

- How would the contracts be bifurcated?
 - Expected payout method
 - Proportional method
 - Cash flow yield method



Insurance Risk Transfer Convergence: IASB Insurance Contracts – Phase II

- Phase II of the IASB's insurance contracts project currently is a modified joint project for the FASB.
 - The FASB is monitoring phase II.
 - When the phase II initial discussion document (including the IASB's preliminary views) is ready for exposure, the FASB will issue a wraparound ITC (without deliberating the issues).
 - Based on the comments received on the ITC, the FASB will decide whether to enter into a joint insurance contracts project with the IASB.



Insurance Risk Transfer

IASB on Bifurcation

- The IFRS 4 (phase I) currently requires bifurcation only under limited circumstances—to ensure that all contractual rights and obligations are recorded.
- In phase II, the IASB has tentatively decided to stay with that conclusion—based principally on the notion that recognition and measurement for insurance and deposits will be similar.
- However, the IASB staff also has acknowledged that there may be a need for bifurcation for display purposes.



Insurance Risk Transfer

Next Steps

- Discuss comments received on the ITC with the Board.
- Board decides whether to develop bifurcation further.
- After that—Board will consider remaining project steps:
 - Extending reinsurance risk transfer guidance to insurance contracts and policyholder accounting
 - Clarifying current insurance risk transfer guidance, including editorial modifications
 - Exploring display alternatives and expanded disclosure requirements



Any Questions?

