IASB/FASB Meeting
Week beginning 14 February 2011

IASB Agenda reference	3E
FASB Agenda reference	58E

Staff Paper

Project **Insurance contracts**

Topic **Discounting Non-life Contract Liabilities**

What is this paper about?

1. The purpose of this paper is to determine whether discounting particular non-life insurance contract liabilities is appropriate. The boards should read this paper with Agenda papers 3C and 3D to obtain a comprehensive view of the staff's recommendations about discounting and the selection of the discount rate.

2. Some respondents to the IASB's Exposure Draft *Insurance Contracts* (the ED) and the FASB's *Preliminary Views on Insurance Contracts* (the DP), primarily property / casualty and health insurance preparers in the United States, have suggested that discounting non-life insurance contract liabilities is not a faithful representation of those contracts. They argue the building blocks proposal does not reflect the economics of how they manage their business. Further, they suggest that the incremental effort of discounting these relatively short-duration contracts exceeds the benefits obtained by users of financial statements.

Staff recommendation

3. The staff recommends:

(a) An exception to discounting should be made for short-duration, short-tail claims in lines where the claims settling period is typically less than one year.

(b) Discounting should be applied to long-tail claims where the expected payout pattern is reasonably determinable.

(c) Discounting should be applied to long-tail claims in which it is questionable if the insurer will have to pay, when they will have to pay, or how much they will pay.

Issues

4. The principal issues addressed in this paper are:

(a) The relevant comments received from respondents to the ED and the DP about the discount rate for non-life (eg property / casualty and health) insurance contracts.

(b) An analysis of particular non-life contracts to determine if discounting is appropriate. Specifically the staff will examine contracts with the following characterisitics:

(i) Short-duration contracts with short-tail lines where claims are typically paid in less than one year and the expected payment patterns are reasonably determinable. These types of contracts include: auto (physical damage), homeowners, and health.

(ii) Short-duration contracts with long-tail lines where the expected payment patterns are reasonably determinable at a portfolio level. These types of contracts include: auto (bodily injury), structured settlements, and workers compensation (indemnity and medical).

(iii) Short-duration contracts with long-tail lines where it is questionable if the insurer will have to pay, when they will pay or how much they will pay. These types of contracts include: liability (product and general), and asbestos and environmental (mass tort and injury).

(c) The staff recommendations to address the concerns raised by respondents during the comment letter period, outreach, and field testing.

Background

Summary of the IASB's proposals and the FASB's preliminary view

5. The boards decided that the carrying amount of all insurance liabilities should depict the time value of money to faithfully represent the financial position of an insurance entity[1]. Some non-life (property and casualty) insurer respondents to the IASB's 2007 discussion paper suggested that non-life insurance contracts should not be discounted. Paragraph BC90 of the Basis for Conclusions of the ED reiterated the arguments provided:

> **Some respondents to the discussion paper suggested […] measuring non-life insurance contracts at a discounted amount would produce information that is less reliable because non-life insurance contracts are more uncertain than life insurance contracts with respect to:**
>
> > **(a) whether the insured event will occur (whereas the insured event in a life insurance contract is certain to occur unless the policy lapses);**
> >
> > **(b) the amount of the future payment that would be required if an insured event occurs (whereas the amount of the future payment obligation is generally specified in, or readily determinable from, a life insurance contract); and**
> >
> > **(c) the timing of any future payments required because of the insured event (whereas the timing of future payments in a life insurance contract is typically more predictable).**

[1] The boards' decisions were consistent about the discount rate.

6. These respondents argued that the uncertainties depicted in paragraph 5 above meant that the selection of an appropriate discount rate, and the measurement of non-life insurance liabilities would be more subjective thereby making the measurement susceptible to earnings management. Therefore, because of these reasons, non-life insurers expressed that the cost of presenting a discounted measure of insurance liabilities outweighed the benefits obtained by users of financial statements.

7. These arguments did not persuade the IASB during the deliberations for the ED. The IASB discussed in paragraph BC92 of the Basis for Conclusions its rationale for concluding that discounting all insurance contract liabilities (with the exception of those noted in paragraph 24 of the ED) provided a faithful representation of an insurer's financial position, as follows:

> **(a) discount rates and the amount and timing of future cash flows can generally be estimated in a sufficiently reliable and objective way at a reasonable cost. Absolute precision is unattainable, but it is also unnecessary. Discounting can be applied in a way that leads to measurements within a reasonably narrow range and results in more relevant information for users. Furthermore, many entities have experience in discounting, both to support investment decisions and to measure items for which IFRSs require discounting (eg employee benefit obligations and long-term non-financial liabilities).**
>
> **(b) in some cases, discounted measures may be more reliable, and less subjective, than undiscounted measures. When measurements include the effect of inflation explicitly or implicitly, insurers need to estimate the timing of payments. The effect of the time value of money tends to offset much of the effect of inflation, and variations in estimates of cash flows far in the future are smaller when reduced to their present values.**

Relevant questions in the Discussion Paper

8. The DP posed the following question about the discount rate and discounting insurance contract liabilities in general.

9. Question 12 of the DP asked respondents the following:

> Do you agree that the carrying amount of all insurance contracts should be discounted if the effect is material? Do you agree with the proposed guidance on the discount rate that should be used to measure the carrying amount of insurance contracts? If not, which discount rate should be used?

Overview of comments on the DP and ED

10. The majority of property and casualty insurance preparers in the U.S. opposed discounting insurance contract liabilities. They argue that the business model of non-life insurers is fundamentally different when compared to life insurers and therefore warrants a different measurement model. They commented that the business model of a life insurer focuses a considerable amount of time on asset and liability management over the long term through investment strategies to manage the profitability of the business. Non-life business focuses primarily on underwriting results, which does not include investment income, and insurers are not dependent on investment income to pay claims.

11. In general, most non-life insurers believe the discounting of such contracts would be immaterial for short-tail claims. Therefore, discounting these amounts would add complexity and costs that would outweigh the benefits gained. Furthermore, the payments to policyholders are known amounts and discounting would not be appropriate.

12. For long-tail claims, when the amount and timing of payments are unpredictable (eg catastrophe), non-life insurers believe that discounting is not appropriate because of the uncertainty over the amount and timing of the cash flows. They believe that discounting these uncertain amounts does not provide useful and understandable information. For these types of contracts,

the undiscounted amounts provide the user of the financial statements with a faithful representation of what the insurer expects to pay to the policyholder to settle the liability.

13. Although some insurers opposed discounting of all non-life contracts, most agreed that discounting may be appropriate for other long-tail line claims in which the amount and timing of payments are fixed and reliably determinable on an individual claim basis. Still some respondents conditionally agreed with discounting provided that it was in line with the business model of the insurer.

14. Although the majority of U.S. respondents disagreed with discounting in all situations regardless of the type of non-life contract, the majority of respondents from other countries agreed that the non-life insurance contract liabilities should be discounted.

Staff analysis and recommendation

15. Some respondents commented that insurance contract liabilities should be discounted only when this aligns with the insurer's business model. However, the staff view discounting as an accounting convention and not an element of an entity's business model. Additionally, few respondents provided a working definition of a business model. Therefore, the staff separated the discussion into the types of contracts that we believe represent the concerns of respondents. The staff determined that three types of non-life insurance contracts require examination:

(a) Short-tail claims paid within one year from the incurred claim.

(b) Long-tail claims with expected payment patterns that are reasonably determinable.

(c) Long-tail claims in which it is questionable if the insurer will have to pay, when they will need to pay, or how much they will pay.

16. As a starting point for the analysis, the staff researched the current guidance provided by the Securities and Exchange Commission from the Staff Accounting Bulletin (SAB) Topic 5.N *Miscellaneous Accounting: Discounting by Property-Casualty Insurance Companies*. The SAB states the following:

> **The staff is aware of efforts by the accounting profession to assess the circumstances under which discounting may be appropriate in financial statements.**
>
> **Pending authoritative guidance resulting from those efforts however, the staff will raise no objection if a registrant follows a policy for GAAP reporting purposes of:**
>
> **Discounting liabilities for unpaid claims and claim adjustment expenses at the same rates that it uses for reporting to state regulatory authorities with respect to the same claims liabilities, or**
>
> **discounting liabilities with respect to settled claims under the following circumstances:**
>
>> **The payment pattern and ultimate cost are fixed and determinable on an individual claim basis, and**
>>
>> **The discount rate used is reasonable on the facts and circumstances applicable to the registrant at the time the claims are settled.**

17. Although the SEC staff did not make the above treatment a requirement but rather left it to the determination of the registrant, the FASB staff believe the SAB provides a starting point for discussion.

18. The decision of whether or not to discount short-duration insurance contracts (at least from the perspective of the SEC) appears to primarily focus on whether the payment pattern and ultimate costs are fixed and determinable on an individual claim. In practice, based on this guidance, for U.S. GAAP reporting, non-life insurers have discounted only those insurance liabilities that met this criterion, such as workers compensation indemnity claims,

structured settlements, medical malpractice settlements, etc. This criterion also appears to be the focus of many respondents to the ED and DP.

Short-tail claims that are paid less than one year after the incurred date

19. For those that argue against discounting short-tail claims that are paid less than one-year after the incurred date, the primary issue is not the reliability of the measure but rather the likely immaterial nature of the discounting. Although discounting would certainly cause an adjustment to the measurement, the added costs and complexity to perform the discount calculation and update the measurement each reporting period would likely outweigh the benefit to users of financial statements.

20. Additionally, many non-life insurers would argue that the undiscounted liability represents what is owed and will be paid to the policyholder and therefore should be the measurement reflected in the financial statements. The non-life insurers are not relying on investment income, and therefore the unwinding of the discount and the investment income earned are not necessarily managed to offset.

21. To illustrate the short-term nature of these particular claims, the staff provided in the Appendix a table that details the percentage of claims paid within "x" years of occurrence for particular lines of business based on 2009 data from the National Association of Insurance Commissioners. While this data is based solely on U.S. insurers, we have assumed that these payout patterns would be representative of the payout patterns in other geographies for identical or similar lines of business.

22. For health insurance, greater than 90 percent of claims are paid within 90 days with essentially all paid within one year.

23. There are current and proposed guidance that differentiate between long and short-term contracts.

(a) The current guidance for the imputation of interest under Accounting Standards Codification Topic 835 Interest scopes out short-term receivables and payables. Paragraph 835-30-15-3 states:

> **…the guidance in this Subtopic does not apply to the following:**
>
> **Receivables and payables arising from transactions with customers or suppliers in the normal course of business that are due in customary trade terms not exceeding approximately one year.**

(b) The FASB's and IASB's respective exposure drafts, *Leases*, addresses short-term leases. Paragraphs 64 and 65 of the Proposed Accounting Standards Update states the following:

> **At the date of inception of a lease, a lessee that has a short-term lease may elect on a lease-by-lease basis to measure, both at initial measurement and subsequently, (a) the liability to make lease payments at the undiscounted amount of the lease payments and (b) the right-of-use asset at the undiscounted amount of lease payments plus initial direct costs. Such lessees shall recognize lease payments in the income statement over the lease term.**
>
> **At the date of inception of a lease, a lessor that has a short-term lease may elect on a lease-by-lease basis not to recognize assets or liabilities arising from a short-term lease in the statement of financial position, nor derecognize any portion of the underlying asset. Such lessors shall continue to recognize the underlying asset in accordance with other Topics and shall recognize lease payments in the income statement over the lease term.**

24. Those opposed to providing an exception to the measurement model would argue that time has a value regardless of the materiality. Furthermore, to implement this exception the boards would likely have to establish a materiality threshold or a bright line cut-off for the number of months or years considered to be *immaterial.* Additionally, it is likely that others could conceivably establish other criteria that might make the adjustment

immaterial forcing the boards to consider that criteria as well. Opponents of such an exception would rely on the fact that entities are not compelled to apply the requirements of IFRSs and US GAAP when the effect is immaterial.

25. Based on the arguments above, the staff recommend that similar to current and proposed guidance an exception to discounting should be made for short-duration, short-tail claims in lines where the claims settling period is typically less than one year. Discounting for these contracts could add costs and complexities to the measurement that outweigh the benefits as discounting of these amounts will likely be immaterial.

Long-tail claims with expected payment patterns that are reasonably determinable at a portfolio level

26. Those opposed to discounting these types of contracts would argue that it is inconsistent with the insurer's business model. They argue that the non-life insurance business is fundamentally different from the life insurance business. As stated in the comment letter responses, non-life insurers argue that they do not manage their business through investment returns but rather the underwriting. This strategy is better reflected in the undiscounted amounts that will ultimately be paid to the policyholder.

27. The definition of a business model differs depending on the geography, policyholder base, and risk management strategy of a particular entity. That definition has ranged significantly depending on the respondent. For example, some respondents suggest if the results of the entity are primarily concerned with underwriting as opposed to investment returns for a particular group of contracts, the entity should not have to discount those contracts. Others suggest that if the business model does not contemplate discounting, then discounting should not be required as long as the entity discloses the business strategy in the notes to the financial statements.

28. The staff believe that defining the business model is somewhat arbitrary given the range of views and interpretations. Additionally, as previously stated, the staff views discounting as an accounting convention and not a business model. Therefore, the staff examined the reliability of the measure for these particular types of contracts. Some of these contracts have defined payment patterns that can be reasonably estimated over time. The payment pattern for other lines of business that would fall into this category (that are not fixed and determinable by amount and timing of payment) can be reasonably estimated at a portfolio level based on historical data and current market assumptions. Many non-life insurers produce payment development tables that do not fluctuate significantly from year to year. Further, the difficulty and subjectivity in the estimation is no more than that of life insurance contracts. Therefore, the staff recommend that discounting should be applied to long-tail claims where the expected payout pattern is reasonably determinable at a portfolio level.

Long-tail claims in which it is questionable if the insurer will have to pay, when they will have to pay, or how much they will pay.

29. Those opposed to discounting these types of contracts argue specifically that the reliability of the measure is suspect and that adding an uncertain discount (due to not knowing when these claims will be paid) to an already uncertain amount would not faithfully represent the financial position of the insurer.

30. While under current U.S. GAAP, provisions are only discounted if the ultimate amount of the liability and the timing of future cash payments are fixed or reliably determinable, under IFRS, provisions within the scope of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* are discounted.

31. Under US GAAP, FASB Statement of Concepts 5 *Recognition and Measurement in Financial Statements of Business Enterprises* (paragraph 67 e) states, that when material long-term payables be reported at their present value (discounting at the implicit or historical rate) which is the preset or

discounted value of future cash outflows expected to be required to satisfy the liability in due course of business. Because of the discussion about discounting liabilities in Statement of Concepts 5, specific standards generally do not discuss discounting of the basic elements of the financial statements. However, ASC 410-30 specifically provides that the measurement of an environmental liability may be discounted to reflect the time value of money only if the aggregate amount of the liability and the amount and timing of cash flows related to that liability are fixed or reliably determinable.

32. While there is additional uncertainty for liability coverage (general and product) and other coverage, insurers do maintain data and produce claim payment development tables. The staff believe that payment pattern for this category can be reasonably estimated at a portfolio level. The boards have decided and the IASB expressed the view in the Basis for Conclusions on its Exposure Draft that exact precision is unattainable and not required.

33. Based on these arguments, the staff believe that if the boards decide that the expected cash flows for these types of insurance liabilities can be estimated to a reasonable level, the uncertainty of the measure should not preclude discounting.

Staff recommendation

34. The staff recommend that an exception to discounting should be made for short-duration, short-tail claims that are less than one year. Discounting for these contracts could add costs and complexities to the measurement that outweigh the benefits as discounting of these amounts will likely be immaterial.

35. The staff recommend that discounting should be applied to long-tail claims where the expected payout pattern is reasonably determinable. Many non-life insurers produce payment development tables that do not fluctuate

significantly from year to year. Further, the difficulty and subjectivity in the estimation is no more than that of life insurance contracts.

36. The staff recommend that discounting should be applied to long-tail claims in which it is questionable if the insurer will have to pay, when they will have to pay, or how much they will pay.

Questions for the boards
1) Do the boards support the staff recommendation that an exception to discounting should be made for short-duration, short-tail claims in lines where the claims settling period is typically less than one year? If not, why not? 2) Do the boards support the staff recommendation that discounting should be applied to long-tail claims where the expected payout pattern is reasonably determinable? If not, why not? 3) Do the boards support the staff recommendation that discounting should be applied to long-tail claims in which it is questionable if the insurer will have to pay, when they will have to pay, or how much they will pay? If not, why not?

Appendix A: National Association of Insurance Commissioners Data

Table 1

Line of Business	Percentage of claims paid within "x" years of occurrence								
	< 1	1-2	2-3	3-4	4-5	5-6	6-7	7-8	8-9
Homeowners & Farmowners	76%	93%	97%	98%	99%	99%	100%	100%	100%
Private Passenger Auto Liability	52%	74%	87%	94%	97%	99%	99%	100%	100%
Commercial Auto Liability	35%	52%	72%	85%	93%	97%	98%	99%	100%
Workers' Compensation	39%	61%	78%	86%	91%	94%	96%	98%	99%
Commercial Multiple Peril	52%	69%	78%	86%	92%	95%	97%	98%	99%
Medical Professional Liability (Occurrence)	8%	12%	27%	45%	64%	79%	88%	94%	97%
Medical Professional Liability (Claims Made)	16%	32%	59%	77%	86%	92%	96%	98%	98%
Special Liability	46%	71%	84%	91%	95%	97%	98%	99%	100%
Other Liability: Occurrence	31%	40%	57%	71%	81%	88%	93%	96%	98%
Other Liability: Claims Made	19%	32%	53%	70%	80%	87%	92%	95%	98%
International	28%	58%	76%	87%	92%	95%	98%	103%	98%
Reinsurance: Nonproportional Assumed Property	38%	68%	86%	92%	94%	94%	96%	96%	99%
Reinsurance: Nonproportional Assumed Liability	30%	40%	55%	68%	78%	83%	88%	92%	97%
Reinsurance: Nonproportional Assumed Financial	34%	56%	79%	93%	101%	102%	103%	103%	100%
Product Liability: Occurrence	18%	21%	36%	53%	68%	78%	85%	92%	96%
Product Liability: Claims Made	14%	25%	53%	67%	78%	87%	89%	89%	88%

Table 2

Special Property	59%
Auto Physical Damage	95%
Fidelity & Surety	41%
Other (Credit, Accident & Health)	58%
Financial & Mortgage Guaranty	23%
Warranty	88%

A1. As shown by the table above, the majority of claims for particular lines of business are paid out within less than one-year of the occurrence of the claim.

A2. The data is distorted slightly because coverages are combined in certain lines of business. For example, auto liability includes both physical damage and bodily injury. As indicated by the second table, 95 percent of the auto physical damage claims are paid within one-year of the occurrence of a claim. Similarly, commercial multiple-peril results are distorted due to both property and liability coverages being combined as they are rated as one coverage. Most, if not all, non-life insurers have the data below the line of business to be able to determine which claims are paid out within less than one-year and which claims have a longer tail and thus which claims should be discounted.