Project **Insurance Contracts**

Topic **Recognition**

Purpose of this paper

1. This paper discusses the recognition of rights and obligations arising under an insurance contract, including the treatment of the contract in the period (if any) between when the two parties (insurer and policyholder) enter into the contract and the start of the coverage period.
2. The boards last discussed this issue in November 2009 when the FASB tentatively decided that an entity should recognise an insurance obligation at the earlier of (1) the entity being *on risk* to provide coverage to the policyholder for insured events or (2) the signing of the insurance contract. The IASB did not reach a conclusion.
3. At this meeting staff ask the:
   (a) FASB to reaffirm its tentative view on the recognition issue.
   (b) IASB whether it agrees with the staff recommendation (which is consistent with the FASB's tentative decision).
4. This paper does not address embedded options, forwards and guarantees that are unrelated to the existing insurance contract coverage – the boards discussed this issue in January 2010 and tentatively decided to exclude such features from the measurement of the contract.

This paper has been prepared by the technical staff of the FASB and the IASCF for discussion at a public meeting of the FASB or the IASB.

The views expressed in this paper are those of the staff preparing the paper. They do not purport to represent the views of any individual members of the FASB or the IASB.

Comments made in relation to the application of U.S. GAAP or IFRSs do not purport to be acceptable or unacceptable application of U.S. GAAP or IFRSs.

The tentative decisions made by the FASB or the IASB at public meetings are reported in FASB *Action Alert* or in IASB *Update*. Official pronouncements of the FASB or the IASB are published only after each board has completed its full due process, including appropriate public consultation and formal voting procedures.

Staff recommendation

5. This paper recommends that an insurer should recognise the rights and obligations arising from an insurance contract when the insurer becomes a party to the contract which is the earlier of:

   (a) the insurer being *on risk* to provide coverage to the policyholder for insured events and

   (b) the signing of the insurance contract.

Structure of the paper

6. The rest of this paper is divided into the following sections:

   (a) When should an insurer recognise an insurance contract? (paragraphs 7-14)

   (b) Treatment of the contract before the start of the coverage period (paragraphs 15-33)

   (c) Other issues (paragraphs 34-35)

   (d) Staff recommendation (paragraphs 36-37)

When should an insurer recognise an insurance contract?

Approach in the Discussion Paper

7. The IASB's discussion paper (DP) *Preliminary Views on Insurance Contracts* proposed that an insurer should recognise an insurance contract when it becomes a party to the contract, applying the recognition principle in IAS 39 *Financial Instruments: Recognition and Measurement*. Paragraph 14 of IAS 39 states:

> An entity shall recognise a financial asset or a financial liability in its statement of financial position when, and only when, the entity becomes a party to the contractual provisions of the instrument.[1]

Respondents generally agreed with this approach.

When does an insurer become a party to a contract?

8. When the IASB discussed the recognition issue there was some debate as to when an insurer becomes a party to a contract. Is it when:
   (a) the insurer makes a verbal or written offer?
   (b) the policyholder pays the first premium?
   (c) the contract is signed?
   (d) insurance coverage begins?
9. Staff conclude that the answer to this question is dependant on the facts and circumstances of the transaction, including the terms and conditions of the contract and local law.
10. In many jurisdictions, for example, signing a contract and collecting the first premium occur at the same time. However for some insurance products there are no premiums, such as life insurance provided by credit cards – in such circumstances it is not possible to determine when the insurer becomes a party to the contract by reference to the point at which the premium is collected.

Illustrative example

11. This example illustrates how the recognition point differs according to when the insurer is bound by the contractual terms. The fact pattern is as follows:
    (a) a policyholder submits an application for life insurance on 15 October
    (b) the underwriting process is completed on 30 October

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[1] IFRS 9 contains the same principle. 'An entity shall recognise a financial asset in its statement of financial position when, and only when, the entity becomes party to the contractual provisions of the instrument'. (Paragraph 3.1.1).

(c) the contract is signed by both parties on 5 November

(d) insurance coverage starts on 1 January.

Applying the fact pattern above, if the insurer is able to refuse cover until the contract is signed, then the contract is recognised on **5 November**. If however the insurer is bound to pay out for deaths that occur during the underwriting process and is free to set the premium for coverage after underwriting, then:

(a) a preliminary contract covering the initial coverage period (during underwriting process) is recognised on **15 October** and

(b) the main contract is recognised on **5 November** (when the contract is signed).

Staff recommendation

12. Staff recommend the following principle for inclusion in the forthcoming exposure draft:

An insurer should recognise the rights and obligations arising from an insurance contract when the insurer becomes a party to the contract which is the earlier of:

(a) **the insurer being *on risk* to provide coverage to the policyholder for insured events and**

(b) **the signing of the insurance contract.**

13. The term 'on risk' does not necessarily refer to the coverage period and can be a period prior to the start of the coverage period. It may represent, for example, the point at which the insurer is bound by the contract[2] (ie when it can no longer withdraw from its obligation to provide insurance coverage for insured events and is no longer free to re-underwrite the contract).

14. We conclude that the principle requires the insurer to apply judgment and consider its legal and jurisdictional context when assessing when it becomes a

[2] This may relate to the main contract or a preliminary contract that binds the insurer to the risk until, for example, the underwriting process is completed as illustrated by the example in paragraph 11.

party to the contract. It is not possible to provide additional implementation guidance to cover every type of contract and jurisdiction.

Treatment of the contract before the start of the coverage period

15. As discussed above, an insurer may become a party to an insurance contract before the start of the coverage period. Often the period between entering into a contract and the start of the coverage period is relatively short and the impact of the timing difference will probably be limited. However in some cases the period between becoming party to a contract and the start of the coverage period can be significant (for example a few months).

16. At the November meeting staff identified two alternative recognition principles that recognise an insurance contract **when coverage starts** as opposed to when the insurer becomes a party to the contract and that deal with the intervening period before coverage starts separately from the coverage period. The two alternatives are to treat the insurance contract as:

    (a) fully executory until the start of the coverage period (paragraphs 17-21)

    (b) a forward contract or option (derivative) until the start of the coverage period (paragraphs 22-26).

Treat the insurance contract as executory

17. Some viewed insurance contracts as service contracts, but believed that the DP's approach to recognition was consistent with a view that insurance contracts are financial instruments. Those holding this view preferred to treat insurance contracts as fully executory until the coverage period begins.

18. Under that approach, until the coverage period begins, the insurer would treat any premium received as a deposit, with a liability adequacy test applied to establish whether the contract is onerous.

Staff analysis and recommendation

19. Staff believes that selecting the recognition approach should not necessarily depend on how one looks at an insurance contract (ie whether it is a financial instrument, a service contract or something else). More relevant is in our view the potential impact in terms of measurement.

20. The outcome of an insurance contract can be highly variable because uncertainty is an inherent characteristic of insurance contracts. Thus, changes in circumstances might even occur between signing a contract and the start of the coverage period, for example:

    (a) updates of estimated longevity for, for example, long-term annuity business.

    (b) changes in the underlying variables that drive the value of embedded derivatives.

    (c) changes in discount rates, particularly when the duration of the cash inflows (premiums) and cash outflows (benefits and expenses) differs significantly.

21. If a contract were not recognised until the start of the coverage period, the financial statements of the insurer would not report changes in circumstances unless the contract becomes onerous.

Treat the insurance contract as a derivative

22. If the insurance contract provides coverage starting at a future date (ie a date later than the date the insurer becomes a party to the contract), that contract gives rise to:

    (a) the insurance coverage specified in that contract starting at a future date (ie the start of the coverage period), and

    (b) until the coverage period starts, a free-standing (ie not part of a combined insurance contract) derivative for future insurance coverage.

23. A free-standing derivative for future insurance coverage itself meets the definition of an insurance contract in IFRS 4 *Insurance Contracts* and is within

the scope of IFRS 4. Applying the tentative decisions the boards made on definition and scope so far, derivatives meeting the definition of an insurance contract would remain in the scope of the future insurance standard. As a consequence, no difference in measurement outcome would exist between:

(a) recognising and measuring the contract as an insurance contract as from the date the insurer became a party to the contract and

(b) a two-step process that:

    (i) first recognises and measures the contract as a derivative that meets the definition of an insurance contract as from the date the insurer became a party to the contract up to the start of the coverage period and

    (ii) second recognises and measures it as an insurance contract from the start of the coverage period.

Staff analysis and recommendation

24. The approach under 23(a) results in a single recognition trigger at the inception of the contract and a single measurement approach throughout its life cycle. The approach under 23(b) uses two recognition triggers, one for the derivative and one for the resulting contract, but for both sections of the overall life cycle, the **same** measurement model would apply. For measurement, it therefore does not matter whether one measures:

(a) the entire contract, including the derivative, under the future insurance model or

(b) first the derivative and subsequently the resulting insurance contract under the future insurance model.

25. We believe that a two-step approach (as in 23(b) above) leads to unnecessary complexity and results in the same measurement outcome. We illustrate this with an example in appendix A which looks at a renewal option. In addition, we believe that a two-step approach is inconsistent with the terms of the contract. There is not a separate derivative contract at inception, settled later by delivery of a non-derivative. The contract is a single contract throughout its life cycle.

26. IAS 39 allows settlement date accounting in some cases. If settlement date accounting in accordance with IAS 39 were to be applied to an insurance contract, the insurer would account for changes in the value between the 'trade date' and the 'settlement date' in the same way as the insurance contract it entered into. In other words, 'settlement date accounting' would have the same measurement impact on profit or loss as if the contract were to be recognised at the date it was signed. We therefore do not see a particular merit in applying 'settlement date accounting'. It would add complexity, for no benefit in terms of improved information for users.

Forward versus option

27. In the previous section staff argued for a single recognition trigger throughout the life cycle of a free-standing derivative for future coverage and then the resulting contract. A free-standing derivative for future insurance coverage can be either

    (a) a **forward** if both the insurer and the policyholder cannot cancel or decline the future coverage or change the terms and conditions of that coverage (see paragraph 28), or

    (b) an **option** if the policyholder has the possibility to cancel the future coverage between signing the contract and the start of the coverage period but the insurer cannot decline coverage or change the terms and conditions during that period (see paragraphs 29-33).

Forward for future coverage

28. The approach of a single recognition trigger can be applied to a forward contract because neither party can get out of the contract before the coverage period starts.

Option for future coverage

29. In some cases, the policyholder has the option to cancel the insurance coverage before the coverage period starts. This option is in our view very similar to an option that allows the policyholder to cancel the contract during the coverage

period. In both cases, cancellation means that the policyholder loses coverage for the remainder of the original coverage period.

30. In January 2010 the boards tentatively decided that policyholder options (such as renewal options), as well as other options related to existing coverage should be included in the measurement of the insurance contract on a 'look through' basis using the expected present value of future cash flows (to the extent that these options are within the boundary of the existing contract). Agenda Paper 11A deals with the issue of the contract boundary.

31. A free-standing option for future insurance coverage currently meets the definition of an insurance contract itself (see paragraph 23). Such an option remains within the scope of the future insurance standard and it would be measured under the future insurance model, including the treatment of cash flows from policyholder behaviour on an expected present value basis. Staff therefore concludes that the measurement of a free-standing option for future insurance coverage can be dealt with by:

    (a) using the single recognition trigger (ie the point at which the insurer becomes a party to the contract) at the beginning of the whole life cycle of the contract (i.e. the option and then the resulting coverage period).

    (b) including the cash flows that depend on policyholders exercising their options in accordance with the proposed treatment of policyholder behaviour.

32. Typically, the free-standing option will not give the insurer the ability to decline future coverage or change the pricing or other terms of that coverage. In that case, all other things being equal, the outcome of the measurement will be the same for a forward contract and an option contract.

33. In addition we note the following:

    (a) If both the insurer and the policyholder have the right to decline future coverage or change terms and conditions of the future coverage, there will be no basis for recognising the derivative or the resulting contract before at least one of the parties is committed (eg before the coverage actually starts). Such a contract would, in the staff's view, not meet the

IASB's current definition of an insurance contract at issuance because at that stage the contract transfers no risk to the insurer.

(b) We did not analyse in detail a situation where the insurer has the option to cancel or amend future coverage, but the policyholder has no such option. Staff is not aware of such cases.

Other issues

34. The IASB has tentatively decided to require an unearned premium approach for pre-claims liabilities of short-duration insurance contracts. [The FASB will discuss this topic at a future meeting.] In our view, it would be quite straight-forward to apply an unearned premium approach from the date when the insurer becomes a party to the insurance contract. If the insurer receives no premium before the start of coverage, the measurement will be nil until coverage starts, as illustrated by the example in appendix A (unless the contract is onerous). If the insurer has received some or all of the premiums before the beginning of coverage, all those premiums are treated as unearned until coverage starts.

35. Many respondents to the DP felt that recognising a contract when the insurer becomes a party to the contract would lead to practical issues of data collection and that the associated cost would exceed any benefits. However, staff believes those issues may not be very different from the challenges an insurer might have with data collection at the start of the coverage period.

Staff recommendation

36. In the staff's view, the proposal in the DP to recognise an insurance contract at the date the insurer becomes a party to the contract is appropriate; any other approach would either:

    (a) ignore some changes in circumstances between the date the insurer entered into the contract and the start of the coverage period, or

    (b) create unnecessary complexity.

37. Staff therefore recommends that an insurer should recognise an insurance contract when the insurer becomes a party to the contract which occurs at the earlier of the insurer being on risk to provide coverage and the signing of the contract.

Question for the boards

Staff recommend that an insurer should recognise the rights and obligations arising from an insurance contract when the insurer becomes a party to the contract which is the earlier of:

the insurer being *on risk* to provide coverage to the policyholder for insured events and

the signing of the insurance contract.

Do you agree with the staff recommendation?

Appendix A Illustrative example

Fact pattern

A1. This example relates to an insurer issuing insurance contracts to policyholders, renewable on the same terms and conditions on the first anniversary of the contract for one further year only. The example below looks at the measurement of a portfolio of these insurance contracts (all issued at the same time) at the point when the:

(a) insurer becomes a party to the contract (1 October X0)

(b) the insurance coverage period starts - which coincides with the point at which the first premium is paid by the policyholder (1 Jan X1). The first premium covers the period from 1 Jan X1 to 31 Dec X2.

(c) the contract is renewed by the policyholder (1 Jan X2). The premium is fixed at inception and covers the period 1 Jan X2 to 31 Dec X2.

A2. In the example the insurer is restricted in its ability to re-underwrite and re-price the contract. This results in the renewal covering the period 1 Jan X2 to 31 Dec X2 being issued on the same terms and conditions as in the original policy (therefore included in the contract boundary). The example illustrates that there is no difference between measuring the contract as a whole from the point the first premium is paid by the policyholder and separating out the renewal option.

A3. The insurer is required to re-measure the liability for any new information that comes to light between the date of recognition (1 October X0) and the date the insurance coverage starts (1 Jan X1). For this example, it is assumed that the insurer re-measures the contract at 1 Jan X1 but this re-measurement results in no gain or loss at that date. In addition, to avoid complicating the example with factors not relevant to the point at issue, this example ignores the time value of money.

What the example illustrates

A4. If the measurement of the contract at 1 Oct X0 and 1 Jan X2 **includes** the cash flows resulting from policyholder renewal at 1 Jan X2, the result will be as follows:

(a) At 1 Oct X0, the contract is measured at nil (future cash outflows 1,600 plus risk adjustment 300 plus residual margin 100 less future cash inflows 2,000).

(b) At 1 Jan X1, the contract is measured at 1,000 (future cash outflows 1,600 plus risk adjustment 300 plus residual margin 100 less future cash inflows 1,000). (In principle, at least some and perhaps all these amounts would be adjusted for the accretion of interest if material).

A5. If the measurement of the contract at 1 Oct X0 and 1 Jan X2 **excludes** the cash flows resulting from policyholder renewal at 1 Jan X2, the result will be as follows:

(a) At 1 Oct X0:

(i) the contract to provide coverage in X1 is measured at nil (future cash outflows 800 plus risk adjustment 150 plus residual margin 50 less future cash inflows 1,000).

(ii) the option for the policyholder to receive coverage in X2 is measured at nil (future cash outflows 800 plus risk adjustment 150 plus residual margin 50 less future cash inflows 1,000).

(b) At 1 Jan X1:

(i) the contract to provide coverage in X1 is measured at 1,000 (future cash outflows 800 plus risk adjustment 150 plus residual margin 50). (In principle, at least some and perhaps all these amounts would be adjusted for the accretion of interest if material).

(ii) the option for the policyholder to receive coverage in X2 is measured at nil (future cash outflows 800 plus risk adjustment 150 plus residual margin 50 less future cash inflows 1,000). (In

principle, at least some and perhaps all these amounts would be adjusted for the accretion of interest if material).

Supporting tables

Paragraph ref above: A4.(a)

Measurement of contract liability on recognition (1 Oct X0) (contract includes cash flows resulting from policyholder (PH) renewal at 1 Jan X2)	**@ 1 Oct X0** CU 000
Expected present value of future cash flows at 1 Oct X0:	
- 1st year claims	800
- 1st year premiums	-1,000
- 2nd year claims	800
- 2nd year premiums	-1,000
Total EPV of cash flows	-400
Risk adjustment at 1 Oct X0	300
EPV of cash flows plus risk adjustment	-100
Residual margin	100
Total	**0**

Paragraph ref above: A4.(b)

Measurement of contract on date insurance coverage starts (1 Jan X1) (contract includes cash flows resulting from PH renewal at 1 Jan X2)	**@ 1 Jan X1** CU 000
Expected present value at 1 Jan X1 of future cash flows:	
- 1st year claims	800
- 2nd year claims	800
- 2nd year premiums	-1,000
Total EPV of cash flows	600
Risk adjustment at 1 Jan X1	300
EPV of cash flows plus risk adjustment	900
Residual margin	100
Total = first year premium	**1,000**

Paragraph ref above: A5.(a)

Measurement of contract liability on recognition (1 Oct X0)
(contract excludes cash flows resulting from PH renewal at 1 Jan X2)

	Contract **@ 1 Oct X0** CU 000		*Option* **@ 1 Oct X0** CU 000
Expected present value at 1 Oct X0 of future cash flows:		Future cash flows of option for PH to receive coverage in X2.	
- 1st year claims	800	- 2nd year claims	800
- 1st year premiums	-1,000	- 2nd year premiums	-1,000
Total EPV of cash flows	-200	Total EPV of cash flows	-200
Risk adjustment at 1 Oct X0	150	Risk adjustment at 1 Oct X0	150
EPV of cash flows plus risk adjustment	-50	EPV of cash flows plus risk adjustment	-50
Residual margin	50	Residual margin	50
Total	**0**	**Total**	**0**

Paragraph ref above: A5.(b)

Measurement of contract liability on date insurance coverage starts (1 Jan X1)
(contract excludes cash flows resulting from PH renewal at 1 Jan X2)

	Contract **@ 1 Jan X1** CU 000		*Option* **@ 1 Jan X1** CU 000
Expected present value at 1 Jan X1 of future cash flows:		Future cash flows of option for PH to receive coverage in X2.	
- 1st year claims	800	- 2nd year claims	800
		- 2nd year premiums	-1,000
Total EPV of cash flows	800	Total EPV of cash flows	-200
Risk adjustment at 1 Jan X1	150	Risk adjustment at 1 Jan X1	150
EPV of cash flows plus risk adjustment	950	EPV of cash flows plus risk adjustment	-50
Residual margin	50	Residual margin	50
Total = first year premium	**1,000**	**Total**	**0**