

  Staff Paper	IASB/FASB Meeting December 2010	IASB Agenda reference	7A
		FASB Agenda reference	54A
Project	Insurance Contracts		
Topic	Reasons for the proposed model		

Objective

1. The objective of this paper is to provide a refresher on the reasons for the boards' developing the proposed model for insurance contracts. (Agenda paper 7B discusses the essential features of the proposed model). The paper describes:
 - (a) the need for a converged global accounting standard for insurance contracts (paragraph 3); and
 - (b) the alternatives considered and rejected by the boards when they chose to develop separate requirements (paragraphs 4-20).
2. This paper does not contain recommendations, and nor are we asking the boards to make any decisions.

This paper has been prepared by the technical staff of the IFRS Foundation and the FASB 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.

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Background

Insurance accounting around the world

3. Currently there is no converged global accounting standard on insurance contracts. IFRS 4 *Insurance Contracts* is an interim standard that permits insurers to continue using various existing accounting practices that have developed in a piecemeal fashion over many years. We want to emphasise two points:
 - (a) Many current requirements result in information that has been criticised as being opaque. They are therefore not producing useful information, especially for insurance products that have been created since the requirements were developed. Financial reporting by insurers is nicknamed ‘the black box’.
 - (b) Because of the numerous variations in insurance accounting across the globe, comparability is impaired. It is impossible to overemphasise the variations that exist in national GAAPs today. Within a specific national GAAP:
 - (i) an insurance contract with similar features may be treated differently depending on the entities issuing the contract. Most national GAAPs address the financial reporting of insurance entities.
 - (ii) different requirements may exist according to product types.

Options considered

4. During the course of this project’s life, the IASB initially, and later jointly with the FASB, considered a variety of options for the treatment of insurance contracts:
 - (a) apply requirements for financial instruments, and/or revenue (and for the IASB only IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*) (discussed in paragraphs 5-14);

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- (b) adopt a national GAAP (paragraphs 15-19); or
- (c) develop separate requirements (paragraph 20).

Apply current GAAP

5. There are different types of insurance product around the world. Insurance contracts are a bundle of rights and obligations that generate a package of cash inflows and cash outflows, including:
 - (a) premiums and surrender charges;
 - (b) benefits paid to policyholders to satisfy valid claims;
 - (c) costs of investigating whether claims are valid and of settling those claims (claims handling costs);
 - (d) service costs (eg asset management costs);
 - (e) additional payments to holders of participating insurance contracts (eg dividends and bonuses);
 - (f) interest credits to holders of account-driven contracts (eg universal life contracts); and
 - (g) payments resulting from the options, guarantees and other embedded derivatives.
6. Some argue that current IFRSs or US GAAP requirements could adequately account for insurance contracts. At first glance, some of those cash flows can be categorised as relating to:
 - (a) features that would meet the definition of a financial instrument (eg the features in paragraphs 5(e), 5(f) and 5(g) above). Consequently, some believe that insurance contracts could apply the requirements for financial instruments.

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- (b) the provision of services (eg the features in paragraphs 5(b), 5(c) and 5(d) above). Hence, they argue that insurance contracts could be accounted for under the proposals in the exposure draft *Revenue from contracts with customers* (revenue ED) and the liability could be accounted for, for the IASB only, under the standard for liabilities of uncertain timing or amounts, *IAS 37 Provisions, Contingent Liabilities and Contingent Assets*.

Financial instruments

- 7. Some insurance contracts arguably meet the definition of a financial instrument. Some of the insurance products contain a significant investment component. However, some think that the two measurement attributes for financial instruments in IFRSs and US GAAP are unsuitable for insurance contracts, for the following reasons:
 - (a) Amortised cost. The IASB believes that amortised cost is appropriate for contracts with cash flows that are solely payments of principal and interest. For financial instruments with uncertain cash flows (for example with embedded derivatives) fair value is considered to be more appropriate.
 - (b) Fair value. Many strongly object to measuring insurance liabilities at fair value because it produces counter intuitive results. First, insurance contracts are rarely, and often cannot be, transferred. Second, the inclusion of non-performance risk in the measurement of insurance liabilities will result in gains and losses as a result of changes in the entity's own credit risk.
- 8. Consequently, the boards did not propose applying their financial instruments requirements to insurance contracts.

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Revenue from contracts with customers

9. The proposals in the revenue ED might result in useful information for some short-duration insurance contracts (eg property and casualty insurance) because these are akin to service contracts and have a small or insignificant investment component. However, some argue that accounting for insurance contracts with a significant investment component using the model proposed in the revenue recognition ED results in information that is less useful and less representationally faithful. The following is a high-level summary of the arguments (Appendix A sets out in more detail arguments taken from the IASB ED).
- (a) The deposit component of the premium would be recognised as revenue. Consider an annuity product where the policyholder pays a one-off premium at inception for an annuity that is payable until the policyholder's death. The revenue proposals would recognise the entire premium amount as revenue even though there is a significant investment component.
 - (b) Complexity in determining when to recognise revenue. Consider the previous example: the insurer would have to recognise the premium over the expected life of the contract. How would the insurer adjust revenue when the life of the contract is longer than expected? To avoid this issue, the insurer could assume a contract life with 100 per cent certainty that the contracts will end during that period. Consequently, the insurer will recognise the remaining revenue in the period when the final policy ends. Such a pattern of revenue recognition is unlikely to produce useful information.
 - (c) The revenue proposals address only one side of the transaction and leaves unanswered the question of how the insurance liability is measured. For the IASB, some argue that the liability could be measured under IAS 37 (discussed in paragraph 13).

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10. To address the concerns above, some argue that an insurance contract could be unbundled and that the components could then be measured under current relevant requirements. For example, the service components could be measured under the revenue requirements, and the investments under the financial instruments requirements.
11. However, this is unlikely to result in useful information for the majority of insurance products, because:
 - (a) the cash flows are commingled (eg the premiums are not a simple addition of the pricing of individual components); and
 - (b) requirements for separation increase complexity and are costly. Many argue that these costs outweigh the benefits of doing so.
12. For the reasons above, the boards did not propose treating insurance contracts under the revenue proposals.

IASB's project Liabilities

13. If the revenue recognition proposals are applied to insurance contracts, to address the measurement of liability some consider that insurance contracts could be included in the IASB's liabilities project (the replacement for IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*), as discussed in paragraph 9(c) above. The IASB issued an exposure draft in January 2010 that is broadly consistent with three of the four building blocks of the proposed model in the ED (ie expected cash flows, discount rate and risk margin). However, the liabilities project is:
 - (a) conducted solely by the IASB, while the insurance contracts project is a joint project between the IASB and FASB.
 - (b) a moving target. The IASB is developing proposals for a future exposure draft. Commentators on the recent exposure draft raised significant concerns on the proposals, especially for contracts with binary outcomes (eg lawsuits).

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Hence, this alternative was not pursued for insurance contracts.

14. The difficulty in applying the revenue recognition proposals for the revenue recognition and the liability measurement under the IASB's liabilities project is that essentially:
 - (a) revenue recognition is a deferral model; and
 - (b) liability measurement is a prospective model.

Reconciling both of these approaches is complex.

National GAAP for insurance contracts

15. In response to the IASB's discussion paper *Preliminary views on insurance contracts*, some recommend that the IASB should adopt a national GAAP for insurance contracts as a solution to the lack of comparability arising from the various national requirements for insurance contracts. Because this is a joint project with the FASB, some would prefer the IASB to adopt US GAAP.
16. Topic 944, *Financial Services—Insurance*, of the *FASB Accounting Standards Codification*TM addresses insurance. The scope of US accounting guidance is based on the entity providing insurance, rather than upon the insurance contract. Topic 944 has different requirements developed at different times in response to new insurance products, terms and features. There is one model for short-duration insurance contracts (that is, for most property and casualty contracts) and others for long-duration insurance contracts (that is, most life and annuity contracts), as well as more specific requirements for others, such as reinsurance, financial guarantee insurance and title insurance.
17. Besides convergence, the FASB's objective for this project is to improve and simplify accounting for insurance contracts. Topic 944 has not been subject to comprehensive reconsideration by the FASB before this project. The table following paragraph 18, based on a similar table in the FASB's discussion paper,

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is a summary of the concerns that have been expressed about existing US GAAP insurance requirements.

18. The IASB did not consider developing an IFRS based on current US GAAP because of the differing requirements, developed at various times, for specific product types.

Current US GAAP	Desired improvement
<i>Insurance entity orientation</i>	
Requirements do not apply to contracts issued by non-insurance entities even if contracts are economically and functionally equivalent to insurance contracts.	Regardless of the type of entity issuing the contracts, contracts that transfer significant insurance risk should be accounted for in a similar manner.
<i>Estimates for traditional long-duration contracts</i>	
The estimates used to calculate long-duration contract policyholder benefits are locked in (unless the existing liabilities, together with the present value of future gross premiums, become insufficient to cover the present value of future benefits to be paid and to recover unamortised acquisition costs).	To reflect the risks and uncertainties inherent in long-duration contracts, some or all of the estimates should be re-evaluated and updated at each reporting period.
<i>Discount rate for traditional long-duration contracts</i>	
Estimates for the discounting of liabilities on traditional long-duration contracts are based on the estimated investment yields (net of related investment expenses) expected at inception.	The discount rates used to measure the liabilities should be based on current rates that reflect the characteristics of the liabilities.

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Current US GAAP	Desired improvement
<i>Lack of discounting of liabilities for short-duration contracts</i>	
Most liabilities for short-duration contracts are not discounted even though some of the expected claims settlement periods may extend for many years. The estimations at inception ignore the effects of inflation.	Measurement of all contract liabilities should be discounted at current rates to reflect the time value of money.

19. The IASB also decided that it is not appropriate to account for insurance contracts using existing accounting models (other than US GAAP) because many of those models:
- (a) do not use current estimates of all cash flows.
 - (b) do not include an explicit risk margin.
 - (c) fail to reflect the time value and intrinsic value of all embedded options and guarantees, in a way that is consistent with current market prices.
 - (d) present financial performance, especially of life insurers, in a manner that is hard for users to understand .

Develop separate requirements

20. The boards have been developing separate requirements for insurance contracts because:
- (a) they rejected applying the current requirements in its respective GAAPs (eg financial instruments) to insurance contracts (discussed in paragraphs 5-14); and
 - (b) the IASB rejected applying a national GAAP (such as US GAAP) to insurance contracts (discussed in paragraphs 15-19).
21. Agenda paper 7B discusses the essential features of the model developed by the boards.

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Appendix A: Extracts from the basis for conclusions of the IASB ED**Revenue recognition**

- BC20 If an insurer applied the proposals in the exposure draft *Revenue from Contracts with Customers* ('the proposed revenue recognition model'), to the service elements of the premium, the insurer would:
- (a) identify the separate performance obligations in the contract, and allocate the revenue element across those performance obligations to determine the transaction price for each performance obligation.
 - (b) measure those performance obligations that remain unsatisfied at the amount of transaction price that is allocated to those performance obligations.
 - (c) recognise an additional liability if a performance obligation is onerous.
 - (d) recognise revenue as the insurer satisfies a performance obligation by providing insurance coverage. Typically, revenue would be recognised continuously over the coverage period.
 - (e) recognise a claims liability when a claim is incurred.
- BC21 It would not be difficult to apply the revenue recognition model to some types of insurance contract, eg many short-duration contracts, and that model would provide useful information for users. Indeed, the result of applying the revenue recognition model to those contracts would be largely similar to the approach proposed in the draft IFRS on insurance contracts. Paragraphs BC145–BC148 explain this in more detail.
- BC22 However, for other types of insurance contract, it would be much more difficult to apply the revenue recognition model and the results would be of limited use to users. Examples of some of the problem areas are:
- (a) stop-loss contracts and some contracts with significant deductibles.
 - (b) contracts for which the expected cost of an insured event is likely to fluctuate both up and down over time (eg for some types of guarantee).
 - (c) contracts that implicitly provide protection against a decline in insurability.
 - (d) annuities.
 - (e) investment management services in participating insurance contracts.
- BC23 The following example illustrates the problem with applying the proposed revenue recognition model to stop-loss contracts and to contracts with deductibles. Suppose a stop-loss contract covers 90 per cent of aggregate losses during 2010 that exceed CU10 million,¹ up to a maximum payment of CU9 million (ie 90 per cent of aggregate losses in the layer between CU10 million and CU20 million). The premium is, say, CU1.2 million. Consider now the position at 30 June 2010. Suppose that aggregate losses for the first six months are CU5 million, and aggregate losses for the rest of the year might be less than CU5 million (probability 60 per cent), between CU5 million and CU15 million (total probability 35 per cent, with all amounts within that range equally likely) or CU15

¹ In this Basis for Conclusions monetary amounts are denominated in 'currency units (CU)'.

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million or more (probability 5 per cent). To apply the revenue recognition model to this contract, it would be necessary to answer the following questions:

- (a) To what extent has the insurer satisfied its performance obligation at 30 June 2010? How much revenue should the insurer recognise at that date as a result?
- (b) How much, if any, should the insurer recognise as a claims liability at 30 June 2010? At that date it does not yet know whether it will be required to pay any claims at all for the year, but it could have to pay as much as CU9 million for the year as a whole, and the expected value of its payments for the whole year is CU2,025,000.²

BC24 Applying the model proposed in the draft IFRS, the insurer does not need to identify an amount of revenue attributable to the coverage for the six months to 30 June 2010, or to identify an amount of ‘incurred’ losses at that date. It simply measures the contract as the sum of the expected present value of the remaining cash flows (the present value of CU2,025,000) plus a risk adjustment plus the remaining amount of the residual margin identified at inception.

BC25 The revenue recognition model is also not particularly well suited to contracts for which the risk is likely to fluctuate both up and down over time (eg for some types of guarantee). Suppose an equity-linked life insurance contract provides a death benefit equal to the higher of (a) the account value and (b) 100 per cent of the amount invested. Thus, the insurer bears the risk that the policyholder may die at a time when the account value is less than the amount invested. For bearing this risk, the insurer charges an explicit or implicit additional premium of CU1,000. Halfway through the life of the contract, what part of the insurer’s performance obligation has it satisfied if the account value stands at (a) 130 per cent of the amount invested? (b) 100 per cent of the amount invested? (c) 70 per cent of the amount invested? What if the account value goes down to 70 per cent of the amount invested and then goes back up to 100 per cent? The revenue recognition model does not provide ready answers to these questions.

BC26 Many life insurance contracts pose another difficulty for the revenue recognition model. Consider a 20-year life insurance contract with monthly fixed level premiums, with the insurer having no ability to reprice the contract during its term. The premium paid for each month provides the policyholder with two benefits:

- (a) coverage against death during that month.
- (b) coverage against the possibility of a decline in insurability, or even against becoming uninsurable, in the event of bad health.

BC27 In principle, the revenue recognition model would require the insurer to estimate at inception the stand-alone selling price for each month of coverage, or find some reasonable approximation that would allocate the total premium in a reasonable way across each month of coverage. Moreover, for the coverage for, say, the 70th month of cover, the revenue recognition model would require the insurer, at least in principle, to estimate the stand-alone selling price at inception for that month’s coverage. Estimating that price is likely to be difficult because insurers do not generally sell such forward coverage separately. The pricing of such forward cover would need to consider how the characteristics of a portfolio might change between inception and the 70th month for

² There is a 35% probability that the insurer will pay CU4,500,000 and a 5% probability that it will pay 9,000,000. Thus, the expected value of losses for the whole year = (35% × 4,500,000) + (5% × 9,000,000) = CU2,025,000.

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example, because of adverse selection (ie the fact that the policyholders with different characteristics are likely to exercise lapse or other options in different ways, leading to an increasing concentration of policyholders who present above-average levels of risk).

- BC28 A life-contingent annuity can be viewed as a series of pure endowments. A pure endowment is a contract that pays a specified benefit if the policyholder is alive on a specified date. Each of those pure endowments obliges the insurer to stand ready to pay out the specified benefit if the policyholder survives to the specified date. Thus, for annuities, the revenue recognition model would, in principle, require the insurer to allocate the total transaction price across each pure endowment contained in the contract. Assuming the annuity requires monthly payments, the insurer would recognise each month as revenue the portion of the transaction price allocated to the obligation maturing in that month. Furthermore, for policyholders who die during the month, the insurer no longer has any performance obligations to them and so would recognise the remaining transaction price as revenue during that month. And if the policyholders are expected to live longer than previously expected, the insurer would need to reallocate transaction price across performance obligations accordingly. The resulting model is not likely to provide useful information to users and it is likely to be complex to implement.
- BC29 For some participating insurance contracts, the insurer provides investment management services and provides a guarantee of minimum investment returns, receiving in exchange a portion of the upside potential on the underlying assets. The revenue recognition model would require the insurer to identify and estimate the amount of consideration receivable from the policyholder (in the form of a portion of the upside potential) and allocate it across satisfied and unsatisfied performance obligations.
- BC30 A further problem arises because the revenue recognition model applies different approaches to contract rights and unsatisfied performance obligations, by measuring:
- (a) the contract rights on an expected present value basis.
 - (b) the unsatisfied performance obligations at the amount of consideration allocated to those obligations, supplemented by an onerous contract test based on future cash flows.
- BC31 Applying different approaches to contract rights and performance obligations amounts to an implicit assumption that the contract generates two separate streams of cash flows that are independent of each other. However, that is not the case for many insurance contracts. As an example, consider a 20year life insurance contract with monthly premiums. If the contract lapses because the policyholder does not pay the premium for month 60, the insurer will not pay death benefits if the policyholder dies in month 61 or after. Similarly, if the policyholder dies in month 35, the insurer will not receive premiums for month 36 or after. Accounting for the inflows separately from the outflows would not represent their nature faithfully because it would imply that the inflows and outflows do not affect each other. In contrast, the approach proposed in the draft IFRS treats all inflows and outflows in the same manner.
- BC32 In summary, applying the revenue recognition model would be relatively easy for some insurance contracts (eg many short-duration contracts) and would provide relevant information for users, but would be complex and produce information of limited relevance for other types of insurance contracts. In contrast, the model proposed in the draft IFRS would provide useful information for all types of insurance contract.