IFRS / FASB	**IASB/FASB Meeting** **Week beginning 13 December 2010**	IASB Agenda reference	**7B**
Staff Paper		FASB Agenda reference	**54B**
Project	**Insurance Contracts**		
Topic	**Proposed measurement model**		

Objective

1. This paper sets out:

   (a) a high-level summary of the proposals in the FASB discussion paper *Preliminary Views on Insurance Contracts* and the IASB exposure draft (ED) *Insurance Contracts* (paragraphs 3-16).

   (b) a comparison of those proposals with existing:

      (i) national GAAPs (paragraph 17); and

      (ii) US GAAP (paragraph 18).

2. This paper provides context and is intended to be a refresher of the essential features of the model. This paper does not contain recommendations, nor are we asking the boards to make any decisions.

Proposed model

3. The boards' objective is to develop a converged standard where insurance contracts[1] with identical or similar economic characteristics would be accounted for similarly regardless of the issuing entity.

4. The IASB ED proposes a measurement model for all types of insurance (and reinsurance) contracts with a modification for some short-duration contracts. This model features:

   (a) a direct measurement that incorporates estimates of future cash flows that will arise through fulfilment—fulfilling the liability through payment of benefits and claims to policyholders as they become due arising from existing contracts (discussed further in paragraphs 6-7).

   (b) a discount rate that reflects the characteristics of the liability. The discount rate reflects the time value of money and an adjustment for illiquidity.

   (c) an adjustment for the effects of uncertainty about the amount and timing of those future cash flows (ie a risk adjustment).

   (d) a margin that reports profitability of the contracts over their coverage period (ie a residual margin) (discussed further in paragraphs 8-10).

   (e) remeasurement of the liability at every reporting date using updated estimates of future cash flows, discount rates and risk adjustment with changes in profit or loss.

   (f) unbundling of the contract into insurance and non-insurance components only when the insurance components are not closely related.

[1]The proposed definition of an insurance contract is: 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.

(g) a summarised margin presentation approach that presents margin information as the key drivers of profitability.

5. The FASB reached a different conclusion on the risk adjustment and residual margin. (This is discussed in paragraphs 11-12 below.)

Cash flows

6. The cash flows represent both the rights and obligations arising from the contract (as opposed to separately identifying the gross rights and obligations and recognising these separately as assets and liabilities). To identify cash flows from existing contracts, the proposals are that the boundary of an insurance contract is the point at which an insurer either:

   (i) is no longer required to provide coverage, or

   (ii) has the right or the practical ability to reassess the risk of the policyholder and, as a result, can set a price that fully reflects that risk.

7. Insurers often incur significant costs to sell, underwrite and initiate a new insurance contract (ie acquisition costs). The proposals require an insurer to include, as part of the contract cash flows, incremental acquisition costs for contracts that are issued in the initial measurement. As a result, those incremental costs affect profit over the coverage period, rather than at inception. (All other acquisition costs are expensed as incurred.)

Residual margin

8. Under the IASB approach, the residual margin is calibrated at inception to an amount that eliminates the excess of (a) the expected premiums over (b) the expected claims, benefits and claims handling expenses and incremental acquisition costs plus a risk adjustment. (If a loss arises at inception, it is recognised in profit or loss immediately.)

9. The residual margin is to be released over the coverage period based on either:

   (a) the passage of time; or

   (b) the timing of expected claims and benefits incurred if the insurer expects to incur claims and benefits in a pattern that is significantly different from the passage of time.

10. In addition, the release of the residual margin should include the accretion of interest. In summary, the amount and amortisation pattern of the residual margin are fixed at inception of the contract.

Composite margin

11. The FASB concluded that the model should not include a separate risk adjustment and residual margin, but should instead combine these in a single composite margin. The composite margin eliminates, at inception of the contract, any excess of the expected present value of cash inflows over the expected present value of cash outflows.

12. The composite margin is released to earnings over the coverage period and the claims handling period according to the following formula, which is intended to reflect the insurer's exposure to uncertainties to the amount and timing of future cash outflows:

    (Premium allocated to date + claims and benefits paid to date)/(Total expected premiums + Total expected claims and benefits).

Implications of the differences

13. The differences between the IASB and FASB decisions are that:

    (a) at inception, the estimation of the risk margin may result in more recognition of day-one losses under the IASB's model.

(b) after initial recognition, under the FASB model:

(i) the composite margin would not be remeasured to reflect any changes in the quantity of risk and uncertainty nor to reflect any changes in the insurer's perception of the burden of bearing the exposure to a given quantity of risk and uncertainty.

(ii) the composite margin would be amortised over the coverage period and claims handling period in contrast to the residual margin which is amortised over the coverage period. The two margins would be using different formulae for amortisation.

(iii) interest is not accreted on the composite margin. The FASB views the margin as a deferred credit rather than as a representation of a component of an obligation.

Modified approach

14. The exposure draft proposed a modified measurement and presentation (unearned premium allocation approach) for pre-claims liabilities of short-duration insurance contracts, except when these contracts are onerous[2]. The modified approach measures the pre-claim obligation as the premium received at inception, if any, plus the expected present value of future premiums less the incremental acquisition costs. The pre-claim obligation is released over the coverage period based on the passage of time or the timing of expected claims and benefits incurred if the insurer expects to incur claims and benefits in a pattern that is significantly different from the passage of time. Interest should be accreted on the pre-claim liability.

15. The proposal is to present these liabilities using a premium approach.

[2] The ED proposed modified measurement for contracts with both of the following features:
1. the coverage period is approximately one year or less; and
2. the contract does not contain embedded options or other derivatives that significantly affect the variability of cash flows.

16. The IASB believes that for these liabilities, the unearned premium allocation approach achieves a similar result to the model discussed in paragraphs 3-10 and at a lower cost. The FASB has not determined the extent to, or the conditions under which, a modified approach would apply, and is seeking feedback from respondents.

Generalised comparison

17. The following is a generalised comparison between the proposed model and current insurance reporting around the world. The comparison is at a very high-level. As mentioned in agenda paper 7A, numerous variations of insurance reporting exist around the world.

Proposals	**Current national GAAPs**
Addresses the treatment of insurance contracts.	Most national GAAPs address the financial reporting of insurance entities.
Estimates of future cash flows that will arise through fulfilment. These cash flows include expected premiums, claims, benefits and claims handling expenses and incremental acquisition costs.	Consistent with most national GAAPs. Typically those cash flows include future premiums and policyholder participation.
Estimates of future cash flows include incremental acquisition costs at the contract level.	Most national GAAPs recognise incremental and indirect acquisition costs as an asset (ie deferred acquisition costs). Some national GAAPs recognise all acquisition costs as an expense.

Proposals	**Current national GAAPs**
Discount rate that is based on the time value of money and an adjustment for illiquidity.	Some national GAAPs use a discount rate based on the expected return of the assets backing the insurance liabilities. A few use the risk-free rate discount rate. Most national GAAPs do not discount most non-life claims liabilities.
Risk adjustment	Some national GAAPs require an explicit or, more commonly, an implicit risk adjustment. Others use a risk adjustment for regulatory reporting only. Other national GAAPs do not use a risk adjustment for either financial reporting or regulatory reporting. Some national GAAPs use a risk adjustment for some contract types but not for others.
The liability is updated based on current estimates of future cash flows, discount rate and risk adjustments.	The majority of national GAAPs use estimates that are wholly, or partially, locked in at the inception of the contract. Typically, some or all of these assumptions will be updated only when the contract has failed the liability adequacy test. A few jurisdictions require current estimates of future cash flows, discount rates, and risk adjustments.

Proposals	**Current national GAAPs**
Margin proposals: IASB—residual margin FASB—composite margin	For life insurance, national GAAPs typically release margins over the life of the contract on the basis of drivers that vary by country and product.
Modified measurement for pre-claim liabilities of short-duration insurance contracts.	National GAAPs typically use an unearned premium approach for pre-claim liabilities of non-life insurance contracts.
Embedded options and guarantees	Many national GAAPs account for some, but typically not all, embedded options and guarantees. Treatments vary: • In some cases, they are not recognised until they come into the money (ie the measurement reflects their intrinsic value only). • In other cases, the measurement reflects not only their intrinsic value, but also their time value (ie the possibility that they may come into the money). • Some measurements are at fair value, while others are at management's estimate of the most likely outcome.

Comparison with US GAAP

18. The following tables compare current US GAAP to the FASB's preliminary views and the IASB's proposed approach for four types of insurance contracts: traditional life, universal life and deferred annuity, property and casualty and health insurance. These tables are not intended to include all components of a contract but rather to highlight the similarities and differences between current practice and the proposed approaches.

Traditional life insurance contract						
Current US GAAP			**Proposed model in the FASB DP**			
	Locked-in (L) / Updated (U)	**Includes PAD**		**Included in probability weighted estimate**	**Locked-in (L) / Updated (U)**	**Includes risk adjustment**
Reserve = Benefit reserves			Reserve = Fulfilment value			
Less PV of **net** premiums (a)			Less PV of cash in-flows (**gross** premiums)	**Yes (b)**	**U**	
Plus PV of benefits & maintenance expenses			Plus PV of cash out-flows (benefits & maintenance expenses)			
• Mortality and morbidity	**L**	5% to 10% PAD is common	• Mortality and morbidity	**Yes (b)**	**U**	**No (c)**
• Termination (lapse and surrender)	**L**	Typically none unless lapse supported product	• Termination (lapse and surrender)	**Yes (b)**	**U**	**No (c)**
• Maintenance expenses	**L**		• Maintenance expenses	**Maybe**	**U**	**No (c)**
• Policyholder dividends	**L**		• Policyholder dividends	**Yes**	**U**	
			Plus incremental acquisition costs		**U**	
= Benefit reserves			= Fulfilment Value			
			Plus composite margin			
Deferred acquisition costs	Recorded as separate asset when incurred and amortised in proportion to premiums					
Discount rate: based on estimated pre-tax investment yields (net of related investment expenses) expected at the contract issue date, adjusted for adverse deviation (.25% to .50% is common)			Discount rate: based on the characteristics of the liability (risk-free rate plus illiquidity adjustment)			
(a) Net premiums: a portion of the premium to prevent gain at issue calculated as follows: PV gross premiums* (PV Benefits & Maintenance Expenses/PV gross premiums (at issue))						
			(b) Performed on a nominal basis			
			(c) Considered in explicit risk adjustment in IASB ED			

Universal life and Deferred annuity					
Current US GAAP		**Proposed model in the FASB DP**			
	Characteristic of activity		**Included in probability weighted estimate**	**Locked-in (L) / Updated (U)**	**Includes risk adjustment**
Reserve = account value (roll forward is therefore updated)		Reserve = fulfilment value			
Plus: premiums received	Cash in-flows	Less: expected premium over entire expected life	Yes (a)	U	No (c)
Less: loads (other charges and fees)	Cash transfer to insurers account				
Less: account value withdrawn at surrender or death	Cash outflow to policyholder	Plus: expected benefits at surrender or death			
Plus: credited interest	Expected cash outflow	• Credited interest	Yes (a)	U	No (c)
	Expected cash outflow	• Excess of total benefit over credited interest	Yes (a)	U	No (c)
	Expected cash inflow (from insured to insurer)	Less: surrender charges	Yes (a)	U	No (c)
Less: cost of insurance charges	Cash transfer to insurers account	Less: cost of insurance charges	Yes (a)	U	No (c)
= Account value					

(a) Performed on a nominal basis

(b) Considered in explicit risk adjustment in IASB ED

Example continued on next page.

Universal life and Deferred annuity continued					
Current US GAAP		**Proposed model in the FASB DP**			
	Characteristic of activity		**Included in probability weighted estimate**	**Locked-in (L) / Updated (U)**	**Includes risk adjustment**
Plus: unearned revenue liability for advanced premium	Cash in-flow				
Plus: liability for bonuses (i.e., persistency)	Expected cash outflow (from insurer for policyholder)				
Plus: liability for 'other insurance benefit features' (ie guaranteed minimum benefits)	Expected cash outflow to policyholder				
	Cash outflow	Plus Incremental acquisition costs		U	
= Benefit reserves		= Fulfilment value			
		Composite margin			
Deferred acquisition costs—recorded as separate asset and amortised in proportion to EGPs calculated as:					
Plus cost of insurance charges less death benefits in excess of account value released					
Plus investment income earned					
Less Interest credited					
Plus recurring expense charges					
Less maintenance expenses					
Plus surrender charges collected					
Note 1: Assumptions must be best estimates Note 2: Assumptions are continually unlocked Note 3: EGPs does not include - Deferrable and non-deferrable acquisition expenses - Overhead expenses Note 4: DAC discount rate equals credited rate (option to lock in at issue or float) Note 5:Realised capital gains included in gross profits					

Property/Casualty insurance contract (modified approach)					
Current US GAAP			**Proposed model in the FASB DP**		
	Locked-in (L) / Updated (U)	**Includes Expected PAD**		**Locked-in (L) / Updated (U)**	**Includes risk adjustment**
Unearned premium reserve = premiums written		No	Pre-claims liability = Premiums received plus expected present value of future premiums	**U**	No
Loss and loss adjustment expenses—nominal amounts			Post-claims liability = PV of expected cash outflows		
• Case reserves and IBNR			• Case reserves and IBNR		
- Current expected losses	**U**	No (a)	- Current expected losses	U	No (b)
- Provision for inflation	U	No (a)	- Provision for inflation	**U**	No (b)
• Allocated loss adjustment expenses (costs directly attributed to settling the claim)	U	No	• Allocated loss adjustment expenses (costs directly attributed to settling the claim)	**U**	No
• Unallocated loss adjustment expenses (internal, indirect costs for processing claims)	U	No	• Unallocated loss adjustment expenses (internal, indirect costs for processing claims)	U	No
•			Less: incremental acquisition costs	**U**	
= Loss and loss adjustment expense reserves			= Fulfilment value		
Deferred acquisition costs	Recorded as separate asset and amortised in proportion to premiums earned				
Discount rate: most non-life insurance reserves are not discounted. When the payment pattern and ultimate costs are fixed and determinable, claim reserves may be discounted using a reasonable rate, typically, risk-free, investment yield or state regulatory approved rates.			Discount rate: based on the characteristics of the liability (risk-free rate plus illiquidity adjustment)		
(a) Companies may estimate their liabilities on a conservative basis and indirectly include what may be deemed a PAD.			(b) Considered in explicit risk adjustment in IASB ED in post claim liability.		

Health Insurance contract (modified approach)

Current US GAAP			Proposed model in the FASB DP		
	Locked-in (L) / Updated (U)	**Includes PAD**		**Locked-in (L) / Updated (U)**	**Includes risk adjustment**
Unearned premium reserve = Premiums receivable/collected (typically one-month)		No	Pre-claim liability = Premiums received plus expected present value of future premiums	**U**	No
Loss and loss adjustment expenses—nominal amounts			Post-claims liability = PV of expected cash flows		
• Case reserves	**U**	No	• Case reserves	U	No (b)
• IBNR	**U**	Yes	• IBNR	U	No (b)
• Allocated loss adjustment expenses (costs directly attributed to settling the claim)	U	No	• Allocated loss adjustment expenses	**U**	No
• Unallocated loss adjustment expenses (internal, indirect costs for processing claims) (a)	U	No	• Unallocated loss adjustment expenses	U	No
			Less incremental acquisition costs	**U**	No
= Loss and loss adjustment expense reserves			= Fulfilment value		
Deferred acquisition costs	Diversity in practice—some expense as incurred and others recorded as separate asset and amortise in proportion to premiums earned				
(a) Diversity in practice: some health insurers do not record a reserve for unallocated loss adjustment expenses.					
Discount rate: most health insurance reserves are not discounted and the majority of claims are paid within 90 days.			Discount rate: based on the characteristics of the liability (risk free rate + illiquidity adjustment)		
			(b) Considered in explicit risk adjustment in IASB ED		

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