Project **Insurance Contracts**

Topic **Cover note**

## Agenda papers for this meeting

1. We have prepared the following agenda papers for the January joint meeting:

| Agenda Paper No. / (FASB Memorandum) | Title | Objective |
|---|---|---|
| 6 (35) | Cover note | Outlines objectives for this meeting and next steps. |
| 6A (35A) | Measurement objective and risk adjustment | Discusses the objective for the measurement model and the risk adjustment. |
| 6B (35B) | Residual margins | Discusses the treatment of residual margins, for both initial and subsequent measurement. |
| 6C (35C) | Policyholder behaviour | Provides material on the issue of policyholder behaviour. |
| 6D (35D) | Timetable | Gives the time table for Board discussions. |

## Objective of the meeting

2. At their December joint meeting, the boards discussed the measurement model for insurance obligations, including the objective for that model and the building

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blocks that would be applied. The boards also discussed the role of a risk adjustment. Agenda paper 6A (FASB Memorandum 35A) provides a follow-up that seeks to further clarify the measurement objective and the risk adjustment. It also addresses whether the proposed model should apply to rights and obligations from an insurance contract or only to (a subset) of the insurance obligations.

3. Agenda paper 6B (FASB Memorandum 35B) discusses the accounting treatment for residual margins in an insurance contract, both at inception of the contract and for subsequent reporting periods. This paper also deals with the recognition of negative day one differences (day one losses).

4. Agenda paper 6C (FASB Memorandum 35C) discusses how to account for expected cash flows resulting from insurance contracts whose amount or timing depends on whether policyholders exercise options in the contracts.

## Tentative decisions to date

5. In previous meetings, the boards discussed a list of candidate measurement approaches for insurance liabilities. The appendix to this paper gives an overview of the topics that were addressed.

6. The table in the appendix shows one single decision for those issues on which the boards reaches a similar tentative conclusion. If the boards reached different tentative conclusions or one of the boards has an outstanding discussion for a particular topic, a status is presented for each Board separately.

# Appendix: Overview of topics discussed at previous meetings

<table>
<tr><th>Topic</th><th>IASB</th><th>FASB</th></tr>
<tr><td>Building Blocks</td><td colspan="2">The boards tentatively decided that the measurement for insurance obligations should include four building blocks:<ul><li>the unbiased, probability-weighted average of future cash flows expected to arise as the insurer fulfils the obligation;</li><li>incorporation of time value of money;</li><li>a risk adjustment for the effects of uncertainty about the amount and timing of future cash flows; and</li><li>an amount that eliminates any gain at inception of the contract.</li></ul></td></tr>
<tr><td>Measurement approach</td><td colspan="2">The boards decided tentatively that the measurement approach should portray a current assessment of the insurer's obligation, using the following building blocks.</td></tr>
<tr><td>Risk adjustment</td><td colspan="2">The boards decided tentatively that the risk adjustment should measure the insurer's view of the uncertainty associated with the future cash flows. The Board discussed various sources of information that an insurer might use to estimate this amount (eg the price the insurer would charge if it were taking on identical obligations with the same remaining risk exposure, or reinsurance prices) and asked the staff to investigate this question further.</td></tr>
<tr><td>Non-performance risk</td><td colspan="2">The boards decided tentatively that the measurement of an insurance liability should not be updated for changes in the risk of non-performance by the insurer.</td></tr>
<tr><td>Use of inputs</td><td colspan="2">The boards decided tentatively that the measurement should:<ul><li>consider all available information that represents the fulfilment of the insurance contract. All available information includes, but is not limited to, industry data, historical data of an entity’s costs, and market inputs when those inputs are relevant to the fulfilment of the contract, and</li><li>should use current estimates of financial market variables that are as consistent as possible with observable market prices.</li></ul></td></tr>
<tr><td>Exclude discounting and margins in some instances?</td><td>The IASB noted the arguments for and against an approach that uses an estimate of future cash flows with no margins and no discounting. The IASB considered whether to use such an approach for non-life claims liabilities and tentatively decided not to add it to the list of candidates.</td><td>The FASB will consider at a future meeting whether, in certain instances, a measurement of insurance contracts would use future cash flows with no margins and no discounting.</td></tr>
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| Topic | IASB | FASB |
|---|---|---|
| Unearned Premium | The IASB decided tentatively that:<br>(a) an unearned premium approach would provide decision-useful information about pre-claims liabilities of short-duration insurance contracts.<br>(b) to require rather than permit the use of an unearned premium approach for those liabilities. | The FASB will discuss an unearned premium approach at a future meeting. |
| Measurement of margins at inception | The margin at inception should be measured by reference to the premium. Therefore no day one gains should be recognised in profit or loss.<br><br>If the initial measurement of an insurance contract results in a day-one loss, the insurer should recognise that day-one loss in profit or loss. | In principle the initial recognition of an insurance contract should not result in the recognition of an accounting profit.<br><br>The FASB will discuss this issue (day-one loss) at the January joint meeting. |
| Subsequent treatment of margins | On the residual margin, the IASB decided tentatively that:<br>a) the driver selected for releasing the residual margins should result in recognising those margins in income in a systematic way that best depicts the insurer's performance under the contract.<br>b) the residual margin should be released over the period during which the insurer is standing ready to accept valid claims (the coverage period).<br>c) the insurer should not adjust the residual margin in subsequent reporting periods for changes in estimates. | The FASB will discuss the subsequent treatment of margins at the January joint meeting. |

| Topic | IASB | FASB |
|---|---|---|
| Discount rates | The IASB decided tentatively that:<br>a) the discount rate for insurance liabilities should conceptually adjust estimated future cash flows for the time value of money in a way that captures the characteristics of that liability rather than using a discount rate based on expected returns on actual assets backing those liabilities<br>b) the standard should not give detailed guidance on how to determine the discount rate | The FASB will discuss this issue further at a future meeting. |
| Acquisition costs | The boards decided tentatively that an insurer:<br>• should expense all acquisition costs when incurred.<br>• should not recognize any revenue (or income) to offset those costs incurred. | |
| Policyholder behaviour and contract boundaries | The measurement should include the expected (ie probability-weighted) cash flows (future premiums and other cash flows resulting from those premiums, eg benefits and claims) resulting from those contracts, including those cash flows whose amount or timing depends on whether policyholders exercise options in the contracts.<br>To identify the boundary between existing contracts and new contracts, the starting point would be to consider whether the insurer can cancel the contract or change the pricing or other terms. The staff will develop more specific proposals for identifying the boundary. | The FASB will discuss this issue at this meeting. |
| Deposit floor | The IASB confirmed that, applying tentative decisions it has already made on policyholder behaviour, no deposit floor applies in measuring insurance contracts. | The FASB will discuss this issue at this meeting. |

| Topic | IASB | FASB |
|---|---|---|
| Participating features in insurance contracts | The IASB expressed an initial preference for an approach that includes all cash flows that arise from a participating feature in the measurement of the insurance liability on an expected present value basis. | The FASB expressed an initial preference for an approach that analyses cash flows expected to arise from a participating feature to determine whether those flows are required (eg by the contract or by a statute) or are discretionary. Required cash flows (if there are any) will be included in the measurement of the insurance liability. Discretionary cash flows will be recognised when the entity has an obligation to make payments. |
| Recognition | The IASB discussed the recognition of rights and obligations arising under insurance contracts, including the treatment of the contract in the period (if any) between entering into the contract and the start of the coverage period. No clear consensus emerged. The Boards will return to the topic of recognition at a future meeting. | The FASB tentatively decided that an entity should recognize an insurance obligation at the earlier of (1) the entity being on risk to provide coverage to the policyholder for insured events and (2) the signing of the insurance contract. |
| Derecognition | The IASB discussed derecognition of insurance liabilities and decided tentatively that that an insurer should derecognise an insurance liability when it no longer qualifies as a liability of the insurer, applying the derecognition principle in IAS 39 *Financial Instruments: Recognition and Measurement*. | The FASB tentatively decided on a principle that an insurance liability should be derecognized by an entity when that obligation no longer qualifies as a liability. The liability is eliminated when the entity is no longer on risk and no longer required to transfer any economic resources for that obligation. |

| Topic | IASB | FASB |
|---|---|---|
| Unbundling | The IASB decided tentatively that, for recognition and measurement, an insurer should:<br>• unbundle a component of an insurance contract if it is not interdependent with other components of that contract,<br>• not unbundle a component that is interdependent. | The FASB decided tentatively that if unbundling is not required for recognition and measurement, it should not be a permitted option. The FASB asked staff to clarify further how unbundling for recognition and measurement relates to (a) the definition of an insurance contract and the scope of the proposed standard, (b) the presentation models for the performance statement, and (c) bifurcation of embedded derivatives. |
| Presentation of the performance statement | The boards tentatively rejected a model that recognises revenue on the basis of written premiums (rather than recognising revenue as the insurer performs under the contract). | |