Project **Insurance contracts**

Topic **Overview of proposed model for insurance contracts**

Purpose of this paper

1. This paper gives an overview of the proposed model for insurance contracts, based on a summary of the tentative decisions the boards made so far. This overview is not intended to give a full description of the model.

2. The decision summary shows one single decision for those issues on which the boards reached 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 update is presented for each Board separately. Those different tentative decisions are also outlined in separate slides (paper 2B, FASB Memorandum 50B).

Topic	**IASB**	**FASB**
Definition	The boards tentatively decided to use the current definition of an insurance contract in IFRS 4 *Insurance Contracts* and the related guidance in Appendix B of IFRS 4. Specifically: • that compensation rather than indemnification be used in the definition of an insurance contract in describing the benefit provided to the policyholder; • that the guidance in IFRS 4 be used in determining whether insurance risk is significant, subject to matters discussed below.	
Definition-timing risk	On timing risk, the boards decided tentatively: • to change the factors considered in evaluating the significance of insurance risk from absolute amounts to present values; and • to amend the guidance in IFRS 4 to explain that contractual terms that delay timely reimbursement to the policyholder can significantly reduce insurance risk, so that some contracts containing such terms might not meet the definition of an	

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.

<table>
<tr><td></td><td colspan="2">insurance contract.</td></tr>
<tr><td>Definition-assessment of possible outcomes</td><td>For determining when insurance risk exists, the IASB expressed an initial preference for considering the range of possible outcomes.</td><td>For determining when insurance risk exists, the FASB expressed an initial preference for considering whether there are outcomes in which the present value of the net cash outflows can exceed the present value of the premiums.</td></tr>
<tr><td>Scope</td><td colspan="2">The boards tentatively decided that the scope of a standard on insurance contracts will exclude:
• warranties issued directly by a manufacturer, dealer or retailer;
• residual value guarantees embedded in a lease;
• residual value guarantees provided by a manufacturer, dealer or retailer;
• employers' assets and liabilities under employee benefit plans and retirement benefit obligations reported by defined benefit retirement plans; and
• contingent consideration payable or receivable in a business combination.
• fixed-fee service contracts

The boards decided tentatively not to exclude from the scope of the standard contracts that require the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make a payment when due in accordance with the original or modified terms of a debt instrument. IFRSs currently use the term financial guarantee contract as a defined term to describe these contracts.</td></tr>
<tr><td>Recognition</td><td colspan="2">The boards decided tentatively that an insurer should recognise an insurance obligation at the earlier of
• the entity being on risk to provide coverage to the policyholder for insured events, and
• the signing of the insurance contract.</td></tr>
<tr><td>Derecognition</td><td>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.</td><td>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.</td></tr>
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<tr><td>Unbundling</td><td colspan="2">The boards decided tentatively that
• account balances of account-driven contracts should be unbundled. For this purpose, the characteristics of these contracts will be defined in accordance with the guidance in US GAAP in ASC Topic 944-20-15;
• unbundling should be prohibited except in cases where it is required.
The boards asked the staff to refine the guidance supporting the proposed principle so as to explain more clearly how an insurer would assess whether interdependence is significant.</td></tr>
<tr><td>Embedded derivatives</td><td>The IASB decided tentatively that embedded derivatives should be unbundled when IAS 39 would require this.</td><td>The FASB decided tentatively that embedded derivatives should be unbundled using the unbundling principle being developed for insurance contracts.</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 contract, using the following building blocks:
• the unbiased, probability-weighted average of future cash flows expected to arise as the insurer fulfils the obligation;
• incorporation of time value of money;
• a margin. [The IASB and FASB reached different tentative conclusions on whether the margin should have two components (risk adjustment and residual margin) or one component (composite margin)].

The boards also tentatively decided that:
• the building blocks should be used to measure the combination of rights and obligations arising from an insurance contract rather than to measure the rights separately from the obligations. That combination of rights and obligations should be presented on a net basis.
• the objective for measuring an insurance contract should refer to a value rather than cost. The staff will refine the description of that objective.</td></tr>
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Measurement approach-decomposition of margins	The IASB decided tentatively that the measurement of an insurance contract should include: • a risk adjustment capturing the level of uncertainty inherent in the cash flows (from the perspective of the insurer, rather than from the perspective of a market participant); and • an amount that eliminates any gain at inception of the contract (residual margin).	The FASB tentatively decided that the measurement of an insurance contract should include a single composite margin.
Guidance on risk adjustments	The boards decided tentatively that, if the measurement of an insurance contract were to include a separate risk adjustment and residual margin: • the risk adjustment should be the maximum amount that an insurer would rationally pay to be relieved of the risk, taking into consideration that the amount of benefits and claim costs actually paid may exceed the amount expected to be paid. • the range of available techniques to measure the risk adjustment should be limited. The boards discussed draft guidance for limiting the techniques and will continue that discussion on 10 June. • an insurer should measure the risk adjustment at a portfolio level of aggregation. A portfolio of insurance contracts is defined as: "contracts that are subject to broadly similar risks and managed together as a single portfolio"	
Level of aggregation of residual and composite margins	The boards decided tentatively that that residual or composite margin should be determined at a cohort level of aggregation, by grouping insurance contracts by portfolio and, within the same portfolio, by date of inception of the contract and by length (or life) of the contract.	

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<tr><td>Measurement at inception</td><td colspan="2">The boards decided that:
the initial recognition of an insurance contract should not result in the recognition of profit at that date.
if the initial recognition of an insurance contract results in a loss, the insurer should recognise that loss in profit or loss at inception. The residual margin or composite margin cannot be negative.
For this purpose, a day-one loss exists only if:
(risk adjustment approach) at inception, the expected present value of the outflows plus the risk adjustment exceeds the expected present value of the premiums.
(composite margin approach) at inception, the expected present value of the outflows exceeds the expected present value of the premiums. In other words, no separate risk adjustment would be included in determining whether there is a day-one loss under a composite margin approach.</td></tr>
<tr><td>Acquisition costs</td><td>The IASB decided tentatively to exclude from the initial measurement of the residual margin an amount equal to the incremental acquisition costs. The staff will consider in drafting whether that tentative decision is best implemented by:
excluding the acquisition costs from the premium to which the contract liability is calibrated; or [the staff's work on drafting so far takes this first approach.]
including the acquisition costs in the contract cash flows at the inception of the contract.</td><td>The FASB decided tentatively that an insurer should:
expense all acquisition costs when incurred.
not recognize any revenue (or income) to offset those costs incurred.</td></tr>
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<tr><td>Subsequent treatment margins- risk adjustment and residual margin</td><td colspan="2">The boards decided tentatively that, if the measurement of an insurance contract were to include a separate risk adjustment and residual margin:
• the risk adjustment should be updated (remeasured) each reporting period.
• the insurer should release the residual margin over the coverage period in a systematic way that best reflects the exposure from providing insurance coverage, as follows:
  • on the basis of passage of time; but
  • if the insurer expects to incur benefits and claims in a pattern that differs significantly from passage of time, the residual margin should be released on the basis of the expected benefits and claims.
The boards also decided tentatively that the insurer should not adjust the residual margin in subsequent reporting periods for changes in estimates.</td></tr>
<tr><td>Subsequent treatment margins- composite margin</td><td colspan="2">The boards decided tentatively that, if the measurement of an insurance contract were to include a single composite margin, that margin should be released considering the following two factors:
• the insurer's exposure from the provision of insurance coverage, and
• the insurer's exposure from uncertainties related to future cash flows.
These factors shall be implemented through the following formula:

(Premium allocated to current period + current period claims and benefits) / (Total contract premium + total claims and benefits)

The boards also decided tentatively that the insurer should not adjust the composite margin in subsequent reporting periods for changes in cash flow estimates.</td></tr>
<tr><td>Interest accretion for residual and composite margins</td><td>The IASB decided tentatively that interest should be accreted to the residual and composite margin.</td><td>The FASB decided tentatively that interest should not be accreted to the residual and composite margin.</td></tr>
<tr><td>Classification and disclosure of residual and composite margins</td><td colspan="2">The boards decided tentatively that both residual and composite margins should be part of the insurance liability, rather than a separate liability outside the insurance liability. The residual margin should be disclosed separately.</td></tr>
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<tr><td>Discount rates</td><td colspan="2">The boards decided tentatively that the discount rate should reflect the characteristics of the contracts, rather than the characteristics of assets actually held to back the contracts, unless the contracts share those characteristics. More specifically:
if the cash flows for the insurance contracts do not depend on the performance of specific assets, the discount rate should be a risk-free rate plus an adjustment for illiquidity.
if the amount, timing or uncertainty of cash flows for the insurance contracts depends, wholly or partly, on the performance of specific assets, the measurement of these contracts should consider that fact
Other points on the discount rate:
The boards asked the staff to incorporate the existing requirements on discount rates from other standards when developing guidance for estimating a discount rate for insurance contracts. For example, the guidance should specify that the discount rate should not include any risk that is included in other parts of the measurement.
During the discussion the boards considered concerns raised by some commentators about the discount rate, particularly for long-duration non-participating insurance contracts. Those concerns include the possibility of significant losses at the inception of some contracts and possible accounting mismatches if the discount rate for insurance contracts does not change in response to changes in market credit spreads.
The boards discussed whether these concerns would diminish if the boards revisited their previous tentative decision that the measurement of an insurance liability should not be updated for changes in the risk of non-performance by the insurer. After the discussion, the boards did not change that tentative decision but they decided that the forthcoming exposure draft on Insurance Contracts should ask for specific input on this issue</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 did not add it to the list of candidates.</td><td>The FASB will consider on 9 June 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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Participating features in insurance contracts	The IASB tentatively decided that payments arising from the participating feature should be included in the measurement of insurance contracts in the same way as any other contractual cash flows (ie on an expected present value basis).	The FASB decided tentatively that the insurer should recognise a liability for participating benefits to the extent that it has a legal or constructive obligation to pay those benefits.
Non-performance risk	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.	
Use of inputs	The boards decided tentatively that the measurement should: • consider all available information that relates to the fulfilment of the insurance contract. 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 • should use current estimates of financial market variables that are as consistent as possible with observable market prices.	
Unearned Premium	The IASB decided tentatively that: • an unearned premium approach would provide decision-useful information about pre-claims liabilities of short-duration insurance contracts. • to require rather than permit the use of an unearned premium approach for those liabilities.	The FASB will discuss an unearned premium approach on 9 June.

Policyholder behaviour	The boards decided tentatively that the policyholder options, as well as options, forwards, and guarantees related to existing coverage, should be included in the measurement of the insurance contract on a look through basis using the expected value of future cash flows (to the extent that those options are within the boundary of the existing contract). As a consequence, no deposit floor would apply. The boards also discussed how to treat options, forwards, and guarantees that do not relate to the existing insurance contract coverage. The boards tentatively decided to exclude such features from the measurement of that contract. Instead, those features should be recognised and measured as new insurance contracts or other stand-alone instruments, according to their nature.
Contract boundary	The boards tentatively decided that the boundary of an insurance contract is the point at which the insurer either: • is no longer required to provide coverage; or • has the right to reassess the risk of the particular policyholder and, as a result, can set a price that fully reflects that risk.
Assets associated with unit-linked contracts	The boards decided tentatively that assets and related liabilities associated with unit-linked contracts, including those sometimes described as separate accounts, should be reported as the insurer's assets and liabilities in the statement of financial position. The boards also decided tentatively not to address in this project issues involving the consolidation of investment funds associated with unit-linked contracts (including separate account contracts). Such issues are within the scope of the project on consolidation.
Presentation of the performance statement	The boards decided tentatively that: • the measurement approach should drive the presentation model for the performance statement. • the staff should develop further an expanded margin approach.
Other comprehensive income (OCI)	The boards decided tentatively: • not to change the accounting for an insurer’s assets. • not to permit or require the use of OCI for insurance contracts.
Disclosures	The boards approved tentatively disclosure requirements, including a principle on the level of disaggregation for disclosure principles.

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<tr><td>Transition-measurement</td><td>The boards decided tentatively that for transition purposes the insurer should (for each portfolio of insurance contracts that already existed at the beginning of the earliest period presented):

determine the expected present value at that date of cash flows arising from the portfolio of contracts plus a risk adjustment. The risk adjustment would be included not only when using the approach that uses a separate risk adjustment (the IASB's approach), but also in the approach that uses a single composite margin (the FASB's approach);
compare that amount with the amount recognised at that date under the insurer's previous accounting policies; and
record any positive or negative difference arising from this calculation in opening retained earnings of the earliest period presented.
should not include a residual margin

The boards also decided tentatively that for the approach that uses a single composite margin, the insurer should treat the risk adjustment determined at the beginning of the earliest period as the composite margin at that date. The insurer should disclose the subsequent run-off of that composite margin separately from disclosure of the run-off of composite margins arising after transition.
The boards further decided tentatively: that any intangible assets arising from insurance contracts assumed in previously recognised business combinations and any existing balances of deferred acquisition costs shall be recognised as adjustments to the opening balance of retained earnings. (That adjustment would not affect intangible assets, such as customer relationships and customer lists, which relate to possible future contracts.)</td></tr>
<tr><td>Transition-disclosure</td><td>The boards decided tentatively:

to exempt insurers from disclosing previously unpublished information about claims development that occurred earlier than five years before the end of the first financial year in which it applies the standard;
not to require specific disclosures about transition, beyond those already required by IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors and FASB ASC Section 250-10-50 Accounting Changes and Error Corrections - Disclosure for changes in accounting policy.
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Transition-redesignation of financial assets	The boards decided tentatively that an entity issuing insurance contracts should be permitted, when it adopts the future insurance contracts standard, to redesignate a financial asset as measured at fair value through profit or loss at the start of the earliest period presented, if doing so would eliminate or significantly reduce an inconsistency in measurement or recognition. The entity should recognise the cumulative effect of that redesignation as an adjustment to opening retained earnings of the earliest period presented and remove any related balances from accumulated other comprehensive income.	
First time adoption	The IASB decided tentatively that first-time adopters of IFRSs should be subject to the same transitional arrangements provided for insurers that already apply IFRSs.	N/A

Portfolio transfers	The IASB tentatively agreed that for each portfolio of insurance contracts assumed in a legal transfer of a portfolio of insurance contracts (portfolio transfer) an insurer shall • determine the expected present value of the cash flows (plus a risk adjustment, in the model that uses such an adjustment); • compare the amount with the consideration received for those contracts (after adjusting the consideration for any other assets and liabilities acquired in the same transaction, such as financial assets and customer relationships); and • if the consideration received exceeds the amount determined in the first step, the insurer should treat the difference as the (residual) (composite) margin at that date; or • if the amount determined in the first step exceeds the consideration received, the insurer should recognise that difference in profit or loss on that date.	The FASB tentatively agreed that for each portfolio of insurance contracts assumed in a legal transfer of a portfolio of insurance contracts (portfolio transfer) an insurer shall • determine the expected present value of the cash flows (plus a risk adjustment, in the model that uses such an adjustment); • compare that amount with the consideration received (after adjusting the consideration for any other assets and liabilities acquired in the same transaction, such as financial assets and customer relationships), treating the difference as the residual or composite margin at that date.

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<tr><td>Business combinations</td><td>The boards decided tentatively that an insurer shall measure insurance contracts assumed in a business combination by:
• comparing the expected present value of the cash flows (plus the risk adjustment in the model that uses such an adjustment) with the fair value of those contracts; and
• if the fair value of the contracts assumed exceeds the amount determined in the first step, treating the difference as the (residual margin) (composite margin) at that date;
• if the amount determined in the first step exceeds the fair value of the contracts assumed, initially measuring the contracts assumed at the expected present value of the cash flows (plus the risk margin in the model that uses such an adjustment), rather than their fair value. This exception from the general requirement in IFRS 3 Business Combinations and ASC Topic 805 Business Combinations would increase the initial carrying amount of goodwill recognised in the business combination.</td></tr>
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