Project **Insurance Contracts**

Topic **Cash flows that arise as an insurer fulfils its existing insurance contract**

Purpose of this paper

1. This paper discusses how to define the cash flows to be included in the measurement of insurance contracts using the building block approach.

Staff recommendation

2. The staff recommend that the expected present value of cash flows used in measuring an insurance contract should include the expected present value of all the future cash outflows and inflows that will arise as the insurer fulfils the insurance contract.

Background

3. Throughout this project, the IASB and the staff have been working on the basis the measurement of insurance contracts should include all the cash flows expected to arise as the insurer fulfils those contract. However, during the joint meeting on 15 and 16 June, it became clear that at least some FASB members had in mind an approach that includes only a subset of those cash flows, perhaps excluding some or all of the following:

   (a) Future premiums (and perhaps some other cash inflows)

   (b) Cash flows that, even though they are an unavoidable consequence of having the existing insurance contracts, are paid under another contract.

An example might be initial or recurring commissions paid to intermediaries.

(c) Cash flows that arise as a result of a participating contract and are paid under the contract, but for which it may be difficult to establish whether the payment results from an enforceable obligation, competitive pressures (of a kind not normally regarded as giving rise to a recognisable obligation) or some mixture of the two.

4. In the staff's view, insurance contracts create a bundle of rights and obligations that work together to generate an often complex package of cash inflows and cash outflows. Those cash flows are often intertwined in a way that makes it difficult to pull them apart. It is doubtful whether more useful information would result from accounting separately for individual streams of cash flows that are so intertwined.

5. The following table identifies some of those cash flows and summarises how they relate to the underlying obligation to pay claims and other benefits to the policyholder. It also highlights some interdependencies between different cash flow streams resulting from the same contract.

6. To keep the table to a manageable size, we have simplified the description, so please remember the following points in reading the table:

(a) The table gives only summary information on the different types of cash flow. More detail is available in the draft application guidance on cash flows, set out in agenda paper 2C for the meeting on 15 and 16 June / FASB memo 50C.

(b) All references to cash flows relate to those cash flows from existing contracts that fall within the contract boundaries, as defined in this project.

(c) All references to cash flows refer expected present values (ie probability-weighted)

7. In the staff draft, the staff used the following defined term, created for the staff draft and intended to be understood with the broader of the two meanings discussed in this memo (for example, referring to both inflows and outflows, not just to outflows):

present value of the fulfilment cash flows	The expected present value of the future cash flows that will arise as the **insurer** fulfils the **insurance contract**, adjusted for the effects of uncertainty about the amount and timing of those future cash flows.

8. As an aside, the last part of that draft definition contains a reference to risk adjustments. The staff found that a convenient way to develop the drafting, in the context of the IASB's tentative decision to include such an adjustment. **For the discussion on 23 June, please ignore the reference to the risk adjustment.** It is beyond the scope of this paper to deal with the drafting question of whether it is clearer to include the risk adjustment in this definition, or to exclude it from the definition and deal with it as a separate step.

Cash flow	*Comment*
1. Claims and benefits paid to policyholders	Payments to policyholders are a direct consequence of the coverage under the contract and clearly relate directly to the fulfilment of the contract.

Cash flow	*Comment*
2. Claims handling costs, ie costs incurred in investigating whether claims are valid, and processing valid claims	As the insurer has an obligation to pay valid claims, it cannot avoid paying the costs of processing those claims. Therefore, the cash flows arising from fulfilment of the contract include those processing costs. The insurer cannot decline to investigate whether a claim presented by a policyholder is valid. Therefore, the cash flows arising from fulfilment of the contract include those processing costs. Also, there is a trade-off between claims costs and claims handling costs. The insurer may resist every claim and so incur large claims handling costs but small claims costs, or pay every claim and so incur large claims costs but small claims handling costs.
3. Recoveries from salvage and subrogation. Salvage refers to the insurer's right to sell a damaged item if it has paid the policyholder for a total loss of that item. Subrogation refers to the insurer's right to step into the policyholder's shoes to pursue a loss suffered by the policyholder for which the insurer has paid out.	Any cash recovered by exercising salvage or subrogation rights will ultimately reduce the net loss suffered by the insurer. Therefore, the cash flows arising from fulfilment of existing contracts include any cash inflows from the exercise of salvage or subrogation rights arising from future claims under those contracts. (Once the insurer obtains such rights on actually paying claims, those rights may qualify for recognition as separate assets.)

Cash flow	*Comment*
4. Participation benefits paid to policyholders of participating insurance contracts	These participation benefits arise from terms of the existing contract. Therefore, the cash flows arising from fulfilment of existing contracts include these benefits. There is an inverse relationship between non-participating benefits and participating benefits. For example, in scenarios where the death benefits in a portfolio of participating life insurance contracts are higher, the participating benefits are likely to be lower, and vice versa.
5. Costs of servicing insurance contracts during their life (contract administration and maintenance).	Policy maintenance costs are necessary to keep the contract in force over time. The insurer cannot avoid incurring those costs necessary to service its existing contracts. Therefore, the cash flows arising from fulfilment of existing contracts include those servicing costs. (As FASB Memo 50C / IASB agenda paper 2C for 15-17 June explains in paragraphs 14-16, the inclusion of servicing costs is consistent with the measurement of financial instruments, though for financial instruments, the service costs are included implicitly thorough the discount rate, rather than as explicit cash flows.)

Cash flow	*Comment*
6. Premium receipts from policyholders	The insurer is contractually required to accept premiums specified within the boundary of the existing contract and, if it receives those premiums, is obliged to pay any valid claims and benefits that result from those premiums. The cash flows arising from fulfilment of existing contracts include both those resulting claims and benefits and the premiums that generate them. Often, premium inflows are intertwined with claims and benefits payments in a way that would make it artificial to account for the inflows separately from the outflows. For example, in a 20 year life insurance contract, if premiums stop in year 6, no death benefits arise in years 7-20. And if the policyholder dies in year 4, premiums stop at that point.
7. Recurring commission paid to intermediaries, or perhaps the direct sales force, if policyholders continue to pay premiums under existing contracts originally sold by the intermediary / sales force (sometimes described as recurring acquisition costs)	As noted above, the cash flows arising from fulfilment of existing contracts include future premiums specified within the contract boundary. If the insurer receives those premiums, it cannot avoid paying that recurring commission. Therefore, the cash flows arising from fulfilment of existing contracts include that commission.

Cash flow	*Comment*
8. Persistency benefits (eg enhanced crediting rate) paid to policyholders if they continue to pay premiums	Because the cash flows arising from fulfilment of existing contracts include the underlying premiums that give rise to the persistency benefits, those cash flows also include the resulting persistency benefits.
9. Surrender benefits paid to policyholders if they surrender or cancel a contract	These cash flows arise from fulfilment of the insurer’s stand ready obligation to benefits if the policyholder surrenders the contract.
10. Acquisition costs incurred at the inception of a contract	Arguably, these costs arise from the creation of the contract, not from its fulfilment. We discuss in a separate paper how to deal with acquisition costs incurred at inception (eg as a contract cash flow or as an adjustment to the premium used to calibrate the residual or composite margin at inception).

Cash flow	*Comment*
11. In relation to acquisition costs incurred at inception, clawbacks from intermediaries or the sales force if the policyholder cancels the contract or stops paying premiums.	These clawbacks arise when the insurer satisfies its stand ready obligation to pay surrender values if the policyholder surrenders the contract. They arise from a separate contract (with the intermediary or sales force, not from the insurance contract itself). Therefore, arguably, the insurer should recognise its right to receive clawback on cancellation as a separate asset, rather than treat those cash flows as arising from fulfilment of existing contracts. However, it seems unnecessarily cumbersome to separate those cash flows from the other cash flows that could arise on surrender.
12. In relation to acquisition costs incurred at inception, **explicit** claw backs from the policyholder if the policyholder cancels the contract or stops paying premiums.	These clawbacks arise when the insurer satisfies its stand ready obligation to pay surrender values if the policyholder surrenders the contract. Therefore, the cash flows arising from fulfilment of existing contracts include those clawbacks.
13. In relation to acquisition costs incurred at inception, **implicit** claw backs from the policyholder (eg surrender charges) if the policyholder cancels the contract or stops paying premiums.	Same as for the explicit clawbacks discussed on the previous line.

Cash flow	*Comment*
14. Surrender charges (other than explicit or implicit claw backs of surrender charges). Surrender charges could be explicit to the policyholder, or could be implicit in the surrender value.	These cash flows arise from fulfilment of the insurer's stand ready obligation to pay the surrender value if the policyholder surrenders the contract. Therefore, the cash flows arising from fulfilment of existing contracts include those surrender charges.
15. For participating contracts, the portion of future premiums exceeding what is required to pay for the non-participating benefits. For example, suppose that the expected present value of future premiums is CU100 and the expected present value of future non-participating benefits is CU80. Thus, the amount exceeding what is required to pay for the non-participating benefits is CU20.	As already noted, the cash flows arising from fulfilment of existing contracts include both the non-participating benefits (eg the death benefits in the example) and the part of the premium needed to pay for those benefits. Moreover, the insurer cannot choose to accept only part of the premium, it must accept the whole premium. Therefore, the cash flows arising from fulfilment of existing contracts include the whole premium. As noted above, they also include the participating benefits that result from those premiums. As noted above, there is also an interdependency between the underlying non-participating benefits in different scenarios and the participating benefits in those scenarios.

Cash flow	*Comment*
16. Benefits paid to policyholders as a result of a contractual term that links the benefits to returns on assets held by the insurer.	The insurer has an obligation to pay those benefits. Therefore, the cash flows arising from fulfilment of existing contracts: • include the benefits resulting from the link to the returns on those assets. • exclude the cash flows on the underlying assets, which are implicit in the fair value of those assets.

9. The cash flows arising from fulfilment of existing contracts do not include, for example:

   (a) general overheads that do not contribute to the fulfilment of the existing contracts

   (b) income taxes, because the insurer accounts for these separately under standards on income taxes.

Staff recommendation

10. The staff believe that the cash flows used in measuring an insurance contract should all include all cash outflows and inflows that will arise as the insurer fulfils the obligation, for the reasons given in the table in this paper.

Staff recommendation and question for the boards
The staff recommend that the expected present value of cash flows used in measuring an insurance contract should include the expected present value of all the future cash outflows and inflows that will arise as the insurer fulfils the insurance contract. Do you agree?