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STAFF PAPER

REG IASB | FASB Meeting

Project	**Insurance Contracts**		
Paper topic	Cash flows that existing contracts require to be paid to future policyholders		
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What is this paper about?

1. This paper discusses whether an insurer should include in the cash flows used to measure insurance contracts all payments that result from existing insurance contracts, regardless of whether those payments are made to current or future policyholders.
2. This paper does not discuss the following topics:
   - (a) whether the 'mirroring approach' described in Agenda Paper 7E/77E should also apply for other than contractual obligations. This will be discussed at a future meeting.
   - (b) The treatment of options and guarantees. We discuss this in agenda paper 7F/77F.
   - (c) how and whether obligations to current vs. future policyholders might be disaggregated for presentation purposes (e.g. with a mutual insurer). This will discussed at a future meeting.
   - (d) the accounting for investment contracts with participation features (ie non-insurance contracts with participation features). This will be discussed at a future meeting.
   - (e) disclosure requirements for contracts with cash flows that depend on underlying items. This will be discussed at a future meeting.

Staff recommendation

3. Staff recommends that when an insurer measures an obligation created by a contract that depends wholly or partly on the performance of assets and liabilities of the insurer, an insurer should include in the measurement of the insurance contract liability all such payments that result from that contract, whether paid to current or future policyholders.

Background and staff analysis

Relevant question in the Exposure Draft and responses received

4. The IASB's Exposure Draft *Insurance Contracts* (ED) proposed in B61(j) that the estimates of cash flows in a scenario shall include

   > *'payments to **current or future policyholders** as a result of a contractual participation feature (including those features implied in the contract by regulatory or legal requirements) that provides policyholders with participation in the performance of a portfolio of insurance contracts or pool of assets.'*

5. The FASB's Discussion Paper *Preliminary views on insurance contracts* (DP) did not specifically discuss whether the cash flows included in the measurement of an insurance contract should include payments to future policyholders that might result from existing contracts.
6. Many comments received supported the proposal in the ED to include all cash flows from existing contracts in the measurement of the insurance contract liability, even if they result in payments to 'future' policyholders. However, some argue that there is no present obligation if the cash flow is not to a current policyholder (we address this concern in paragraphs 10 - 12). Some commented that cash flows to 'future' policyholders as a result of participation features of current contracts would be beyond the contract boundary (we address this concern in paragraph 13).

Staff analysis

7. The analysis in this paper is related to the measurement of any obligations arising from participating features that are both part of an insurance contract and contractually[1] depend wholly or partly on the performance of other assets or liabilities of the insurer (or the performance of the insurer itself). In many, if not most cases, this participation is not based on the performance of an individual contract, but on the overall performance of a portfolio of contracts and the performance of the portfolio is distributed to the 'community of policyholders[2]' in the portfolio at the time of distribution. However, it may happen that the distribution does not take place in the period that the performance is earned, and so the portfolio may have different contracts at the time the performance arises compared to when the result of that performance is distributed.
8. By leaving the community before the surplus is distributed, the individual policyholder gives up a portion of the amounts available for distribution (ie to the community of policyholders only), but not yet declared by the insurer. However, the shareholders will not benefit from that portion of participation because the insurer is required to distribute this portion to any remaining policyholders in the community at the date the distribution is declared.
9. The following example illustrates why the measurement model should include the cash flows to future policyholders, as well as current policyholders.

> **A simple example**
>
> Assume there is a participating contract where 100 policyholders participate in 90% of the realised income (including gains) from an equity instrument. The cost of the equity instrument is CU1,000. The insurer expects that 20 policyholders will surrender their contract in year 1 and 10 policyholders will join the portfolio in year 2.
>
> At the end of year one:

[1] Contractual features including those features implied in the contract by regulatory or legal requirements

[2] Examples of 'communities of policyholders' include the so-called 'closed blocks' which are portfolios of contracts segregated in some countries as part of a demutualization. In other countries, examples include a portfolio or pricing generation or even the entire group of policyholders of an insurer.

- the fair value of the equity instrument has increased to CU2,000.

- 20 policyholders have surrendered their contract, as expected.

At the end of year two:

- 10 new policyholders have joined the pool, as expected.

- The equity instrument is sold for CU2,000 and the realised income (ie 90% of the fair value increase of CU1,000, ie CU900) is distributed to the policyholders.

At the end of year one, the obligation related to the participation feature is 90% of the fair value increase of CU1,000, ie CU900. Of the existing 100 policyholders, the insurer expects that 20 will surrender the contract (i.e. prior to any income being realised by the insurer from the equity instrument) and thus only 80 will receive a share of the CU900. However, the insurer also expects that 10 policyholders will join the pool in year 2 (i.e. prior to any income being realised by the insurer from the equity instrument) and that the payment to each of the 90 policyholders that will be part of the pool at the end of year 2 will be CU10 (ie CU900/90).

If payments to future policyholders were not included in the measurement of the insurance contract liability, the insurer would include only payments of CU10x80 = CU800 to the existing policyholders in the measurement of the liability at the end of year 1. The payments expected to be made to the 10 policyholders joining the pool in year 2 (ie CU100) would not be included in the measurement of the liability. Furthermore, when those 10 policyholders do ultimately join the pool, the expected present value of future net cash outflows would increase by CU10 per new policyholder: this would decrease the residual or single margin arising at inception of the new contracts and might even trigger a day one loss on the new contracts.

Is there a liability?

10. The IASB's Conceptual Framework defines a liability[3] as

[3] US GAAP, Concepts Statement No. 6 Elements of Financial Statements (CON 6) has a similar definition for a liability. Paragraph 36 states, "A liability has three essential characteristics: (a) it embodies a present duty or responsibility to one or more other entities that entails settlement by probable future transfer or use of assets at a specified or determinable date, on occurrence of a specified event, or on demand; (b) the duty or responsibility obligates a particular entity, leaving it little or no discretion to avoid a future sacrifice; and (c) the transaction or other event obligating the event has already happened."

(a) a present obligation of the entity

(b) arising from past events,

(c) the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.

11. In this case, the present obligation is that existing insurance contracts require that some of the performance of underlying assets and liabilities be distributed to the community of policyholders. The past event is the insurer entering into the insurance contract with a current policyholder. The outflow of economic benefits is the cash flow to the current or future policyholders in the community eligible to participate.

Is there a need to know the counterparty?

12. As described above, the payment to future policyholders is a consequence of the present obligation to share a portion of the performance with the community of policyholders. That obligation exists even though some of the cash flows that are based on this performance might be paid to a policyholder who has yet to enter that community. The counterparty does not need to be known for the insurer to recognise or measure a liability. Other estimated fulfilment cash flows, such as external claims administrators cost etc, do not require that the addressee of the payment is known. There are also other liabilities under IFRS / US GAAP where the addressee of a payment is not known (eg decommissioning liabilities). This analysis is consistent with IAS 37.20:

> 'An obligation always involves another party to whom the obligation is owed. It is not necessary, however, to know the identity of the party to whom the obligation is owed—indeed the obligation may be to the public at large.'

Are the payments within the contract boundary?

13. Some argue that payments to future policyholders are outside the contract boundary. The contract boundary distinguishes between cash flows that arise

from an existing contract and those that arise from a future contract. As shown in the example above, existing contracts can result in cash flows that are paid to future policyholders and those cash flows would be within the contract boundary. The existing contracts specify that the amounts must eventually be distributed to the community, even though those amounts may not be declared in the current period. Therefore those payments arise from the current contract, and not from future contracts yet to be written, ie these payments are within the boundary. In essence the new policyholder 'inherits' the funds from the community he or she joins.

Staff recommendation

14. Staff recommends that the boards should not limit the measurement of the obligation based on the addressee of the payment and consequently should confirm the proposal in the ED. However, staff believes that the focus in the ED on future policyholders, rather than current contracts, confused some people. Consequently we intend to clarify the wording as follows to place emphasis on the fact that the payments arise from existing contracts.

Question: Current or future policyholders
Do you agree that, when measuring an obligation created by a contract that depends wholly or partly on the performance of assets and liabilities of the insurer, an insurer should include in the measurement of the insurance contract liability all such payments that result from that contract, whether paid to current or future policyholders?