IASB/FASB Meeting February 2011

IASB Agenda reference	3
FASB Agenda reference	58

Staff Paper

Project	**Insurance contracts**
Topic	**Cover note and proposed project timetable**

What is this paper about?

1. This paper:

   (a) provides an overview of the papers for the boards' discussion at this meeting (paragraphs 2-5).

   (b) describes the papers that are relevant to the issue of volatility (paragraphs 6-7).

   (c) sets out a proposed project timetable that will enable the IASB to finalise a standard on insurance contracts, and the FASB to finalise an exposure draft by mid-2011 (paragraph 8).

Summary of papers

2. At this meeting, we ask the boards for important decisions on the key areas for the insurance contracts project. The staff intend to present the following papers for decisions:

   (a) **Agenda paper 3A/58A *Project assumptions***—This paper describes the axioms and assumptions that will underlie the development of papers that the staff will bring to the boards to finalise the proposals in the IASB's exposure draft *Insurance Contracts* ('the ED') and the FASB's discussion paper *Preliminary Views on Insurance Contracts* ('the DP').

   (b) **Agenda paper 3B/58B *Day one gains and losses*—**This paper asks the boards for decisions about the initial recognition of insurance contracts.

(c) **Agenda papers 3C-3E** on the discount rate as follows:

   (i) **Agenda paper 3C/58C *Locking in the discount rate***

   (ii) **Agenda paper 3D/58D *Discount rate for non-participating contracts***

   (iii) **Agenda paper 3E/58E *Discounting non-life contract liabilities*.**

   We will consider in a future meeting the discount rate for contracts with participating features and presentational approaches relating to the discount rate.

(d) **Agenda paper 3F/58F *Cash flows*** This paper discusses the estimate of cash flows in the first building block and discusses the treatment of specific cash flow items such as overhead costs.

(e) **Agenda paper 3G/58G *Risk adjustment*** This paper discusses whether, conceptually, the inclusion of an explicit risk adjustment in the measurement of insurance liabilities would provide relevant information. It also considers the implications of the existence of a measure for risk in the context of a two-margin versus one-margin approach.

3. A summary of the staff recommendations is in Appendix A.

4. In addition, we put forward papers for discussions that will not require decisions. The purpose of these papers is to provide background information that we believe would assist the boards in understanding issues that have arisen in the comment periods, and to provide context about those issues. We have three topics:

(a) **Agenda paper 3H/58H *Education session: Unbundling*—**This session is intended to help board members to understand the effect, costs and benefits of separating insurance contracts into insurance and non-insurance components. A cover note summarises the proposals in the ED/DP, presents the concerns raised in the comment letters and provides brief background information on the external speakers. The external speakers have provided the following slides for their presentations:

(i) **Agenda paper 3I/58I *Unbundling*—**Presentation from Gail Tucker and Sam Gutterman, PwC.

(ii) **Agenda paper 3J/58J *Unbundling of insurance contracts*** —Presentation from Len Reback, MetLife.

(b) **Agenda paper 3K/58K *Education session: Refresher on presentation models*.** This paper reminds the boards of the other approaches that were considered when they developed the presentation approach in the ED/DP, to place in context the respondents' concerns about the presentation approach.

(c) **Agenda papers 3L/58L and 3M/58M *Education session: unlocking the residual margin and illustrative examples*.** These papers are intended to prepare the boards for a future decision on whether the residual or composite margin should be unlocked or remeasured.

5. We are likely to discuss these papers in a different order from this list.

The volatility issue

6. The comment letter summaries from the January meeting noted that the critical issue raised in almost all jurisdictions and from most types of respondent is the volatility that would arise under the proposed model. There are five areas that would have an impact upon the volatility as reported, and we describe below how the papers at this meeting affect each of those areas:

(a) *the selection of the discount rate.* In agenda paper 3D/58D we recommend that the boards should confirm that the discount rate should be consistent with observable current market prices for instruments with cash flows whose characteristics reflect those of the insurance contract liability, including timing, currency and liquidity, but that the discount rate should exclude the effect of the insurer's non-performance risk.

(b) *locking in the discount rate at inception.* In agenda paper 3C/58C, we recommend that the boards should not lock in the discount rate for any insurance contract.

(c) *presentation* eg by presenting the effects of volatility separately from the underlying performance, or by defining a measure of ‘operating profit’ for insurers. We will consider these issues in a future meeting.

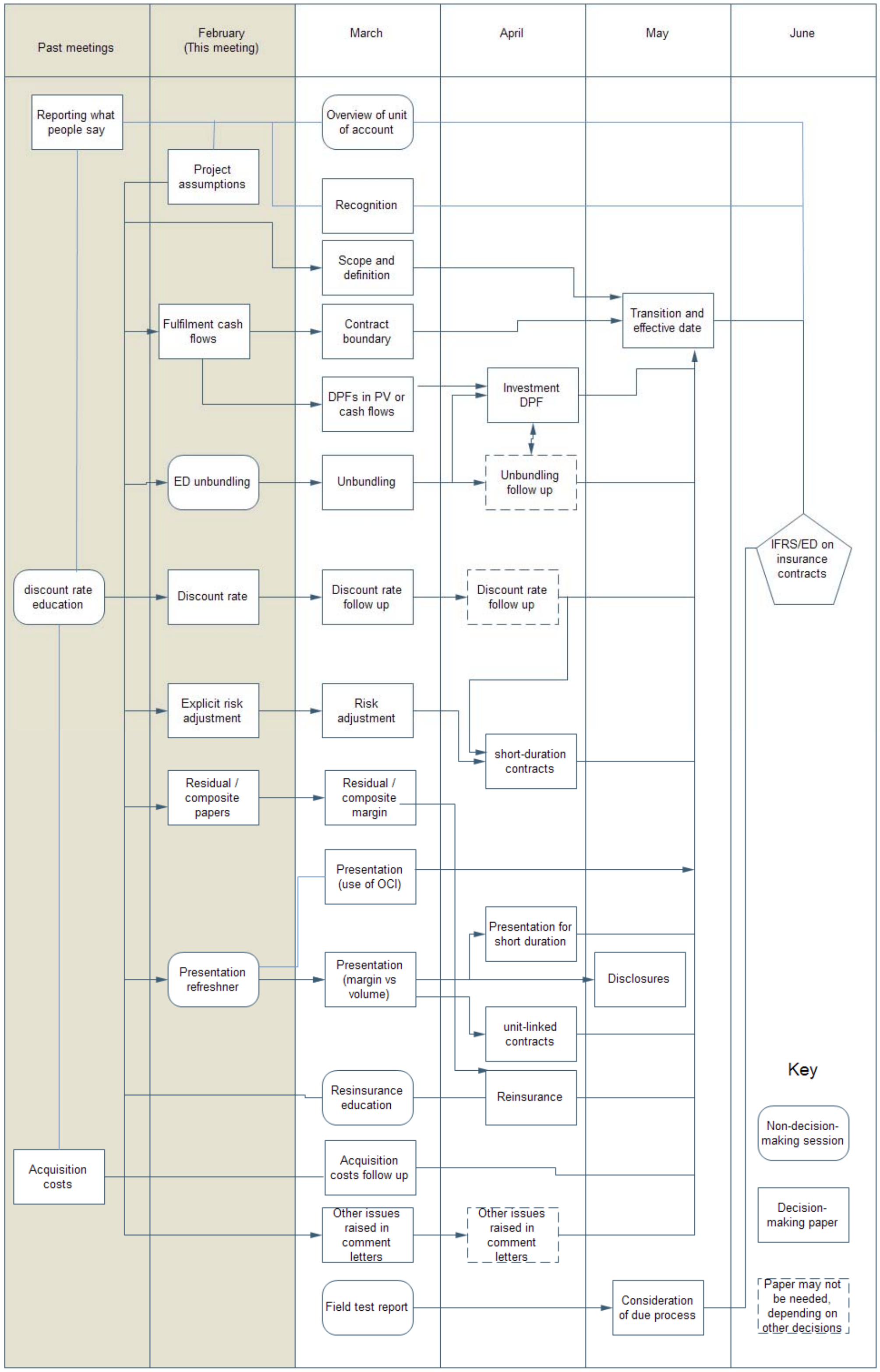
(d) *unlocking the residual margin.* In agenda papers 3L/58L and 3M/58M we provide material intended to assist the boards to discuss in a future meeting how the residual or composite margin would be recognised in profit and loss over time.

(e) *extensive unbundling*, with the investment components measured at amortised costs. In agenda papers 3H/58H-3J/58J we have asked the external presenters to discuss the effects, costs and benefits of unbundling, in preparation for a discussion in a future meeting.

7. Although our objective is not to minimise volatility, we believe that the boards should consider, throughout their discussions on this paper, whether any reported volatility is a faithful representation of the underlying economic phenomena.

Next steps and proposed project timetable

8. We hope that after this meeting the boards will have given the staff a clear indication of direction on many of the most important topics in the project. During March, the staff plan to follow up matters discussed at this meeting, and also to consider the topics set out in the proposed project plan on the next page.


Past meetings
February (This meeting)
March
April
May
June
Reporting what people say
Overview of unit of account
Project assumptions
Recognition
Scope and definition
Transition and effective date
Fulfilment cash flows
Contract boundary
DPFs in PV or cash flows
Investment DPF
ED unbundling
Unbundling
Unbundling follow up
IFRS/ED on insurance contracts
discount rate education
Discount rate
Discount rate follow up
Discount rate follow up
Explicit risk adjustment
Risk adjustment
short-duration contracts
Residual / composite papers
Residual / composite margin
Presentation (use of OCI)
Presentation for short duration
Presentation refreshner
Presentation (margin vs volume)
Disclosures
unit-linked contracts
Resinsurance education
Reinsurance
Acquisition costs
Acquisition costs follow up
Other issues raised in comment letters
Other issues raised in comment letters
Field test report
Consideration of due process
Key
Non-decision-making session
Decision-making paper
Paper may not be needed, depending on other decisions

Appendix A: Summary of staff recommendations

A1. This month, we make the following recommendations:

Agenda paper 3A/58A *Project assumptions*

A2. The staff recommend that the boards should approve the staff's use of the project axioms and assumptions described in the paper.

Agenda paper 3B/58B *Day one gains and losses*

A3. The staff recommend that the boards should confirm the proposal in the Exposure Draft/Discussion Paper *Insurance Contracts* that an insurer should not recognise any gain at inception of an insurance contract. Furthermore, the staff recommend that the residual/composite margin should not be less than zero, so that a loss at initial recognition would be recognised immediately when it occurs.

Agenda paper 3C/58C *Locking discount rate*

A4. The staff recommend that the boards should not lock in the discount rate for any insurance contract. In other words, the discount rate used to measure all insurance contracts should be a current rate that is updated each reporting period.

Agenda paper 3D/58D *Discount rate for non-participating contracts*

A5. The staff recommend that the boards:

(a) should confirm that the objective of the discount rate is to adjust the future cash flows for the time value of money.

(b) should not prescribe a method for determining the discount rate.

(c) should provide guidance on determining the discount rate, adjusted to reflect risks that are not otherwise included in the measurement of the liability.

Agenda paper 3E/58E *Discounting non-life contract liabilities*

A6. The staff recommend that:

(a) An exception to discounting should be made for short-duration, short-tail claims in lines where the claims settling period is typically less than one year.

(b) Discounting should be applied to long-tail claims where the expected payout pattern is reasonably determinable.

(c) Discounting should be applied to long-tail claims in which it is questionable whether the insurer will have to pay, and, if they will, when they will have to pay, or how much they will pay.

Agenda paper 3F/58F *Cash flows*

A7. The staff recommend that the boards should:

(a) clarify that the measurement objective of expected value refers to the mean, considering all relevant information.

(b) clarify that, in meeting the measurement objective, practical implementation would depend on circumstances and that there is no need for *all* possible scenarios to be identified and quantified, provided that the insurer is satisfied that the estimate is consistent with the measurement objective of determining expected value.

(c) confirm that the costs included in the cash flows used in measuring a portfolio of insurance contracts should be all the costs that the insurer will incur in fulfilling the contracts, including:

(i) costs that relate directly to the fulfilment of the contracts in the portfolio, such as payments to policyholders, claims handling, etc (described in paragraph B61 of the ED);

(ii) costs (including fixed and variable overheads) that are attributable to contract activity as part of fulfilling that portfolio of contracts and that can be allocated to those portfolios; and

(iii) such other costs as are specifically chargeable to the policyholder under the terms of the contract.

(d) confirm that costs that do not relate directly to the insurance contracts or contract activities should be recognised as expenses in the period in which they are incurred; and

(e) eliminate the term ‘incremental’ in the context of fulfilment cash flows.

Agenda paper 3G/58G *Risk adjustment*

A8. If there are techniques that could faithfully represent the risk inherent in insurance liabilities, the staff recommend that, conceptually, the inclusion of an explicit risk adjustment in the measurement of insurance liabilities would provide relevant information to users.

A9. The staff also recommend that, conceptually, the measurement of an explicit risk adjustment could add to the understandability of the measurement of insurance liabilities.

Agenda papers 3H/58H-3M/58M

A10. We do not ask for decisions in agenda papers 3H/58H-3M/58M.