Staff Paper

Project	**Insurance contracts**
Topic	**Cover note**

What is this paper about?

1. This paper:

   a. provides an overview of the papers for the meeting on week commencing 13 June, together with a summary of the staff recommendation for the papers (paragraphs 3-13)

   b. summarises the progress the boards have made (paragraph 14)

   c. describes next steps towards issue a new IFRS by the end of 2011 (paragraphs 15 - 16)

2. The Appendix provides a summary of previous decisions taken by the boards and describes what is still to come.

Overview of papers

3. **Agenda paper 3A/70A Presentation - *expanded margin*** discusses the proposal in the ED/DP for the presentation of the statement of comprehensive income and recommends how insurers should integrate volume information in the performance statement through disaggregation/

Residual margin

4. In previous meetings the IASB tentatively confirmed that:
    a. the measurement of an insurance contract should contain an explicit adjustment for risk,
    b. there should be no gain at inception of an insurance contract,
5. Thus, the measurement model will include a residual margin to calibrate the difference between expected cash inflows and expected cash outflows plus an explicit risk adjustment. The residual margin papers for this meeting are:
6. **In agenda paper 3B/70B *Residual margin –whether*** the staff recommends that the residual margin should not be locked in at inception, but adjusted for specified changes in estimates as explained in agenda paper 3C/70C
7. **Agenda paper 3C/70C *Residual margin –how*** discusses the changes that would **adjust the** residual margin, if the boards decide to unlock the residual margin in agenda paper 3B/70B. The staff recommends that an insurer should:
    a. adjust the residual margin for favourable and unfavourable changes in the estimates used to measure the insurance liability, other than for:
        i. changes in the discount rate if adjusting the residual margin for those changes would create an accounting mismatch (because the assets backing the insurance contract are measured at fair value through profit or loss). Instead, an insurer would be permitted, but not required, to recognise the effect of those changes in discount rate in profit or loss in the period of the change.
        ii. changes in the risk adjustment, which would be recognised in profit or loss in the period of the change.
    b. make any adjustments to the residual margin prospectively.

8. **Agenda paper 3D/70D *Residual margin –allocation*** discusses how the residual margin should be allocated over the life of an insurance contract. The staff recommends that:

   a. The residual margin should not be negative.

   b. Insurers should allocate the residual margin:

      i. over the coverage period, and

      ii. on a systemic basis that is consistent with the pattern of transfer of services provided under the contract.

   c. Insurers should not be required to determine the residual margin at the level of the individual contract. Instead, they should be permitted to determine the residual margin, both initially and subsequently, on a level that aggregates insurance contracts with similar expected profitability and pattern of transfer of services. The residual margin should not be negative.

   d. Insurers should allocate the residual margin:

      i. over the coverage period,

      ii. on a systemic basis that is consistent with the pattern of transfer of services provided under the contract.

   e. Insurers should be permitted to determine the residual margin, both initially and subsequently, on an aggregate level. The aggregation should embrace similar insurance contracts, similar in terms of expected profitability and pattern of transfer of services.

9. In previous meetings the FASB tentatively decided that an insurance contract measurement model should use a single margin approach, rather than the separate risk adjustment and residual margin required by the IASB's tentative decision. The single margin approach recognises profit as the insurer satisfies its performance obligation to stand ready to compensate the policyholder in the event of an occurrence of a specified uncertain future event that adversely affects that policyholder. An insurer satisfies its performance obligation as it is released from exposure to risk as evidenced by a reduction in the variability of cash outflows. An insurer would not remeasure or recalibrate the single margin to recapture the previously recognised margin. Agenda papers 3B-D/70B-D do not address the single margin approach.

Acquisition costs

10. On 2 February 2011, the boards tentatively decided that the contract cash flows should include those acquisition costs that relate to a ***portfolio*** of insurance contracts. On 2 March 2011, the IASB and FASB came to different tentative decisions on defining which acquisition costs could be included in the contract cash flows.

11. We have two papers on acquisition costs.

12. **Agenda paper 3E/70E *Acquisition costs revisited***:

    a. Provides background about the treatment of acquisition costs in the IASB's exposure draft *Insurance Contracts* (the ED) and the FASB's discussion paper *Preliminary Views on Insurance Contracts* (the DP)

    b. Describes the different tentative decisions that the boards reached

    c. Sets out the reasons supporting each decision

    d. Asks the boards whether in the light of the fuller explanation of the reasons, they continue to support their earlier tentative decisions.

13. **Agenda paper 3F/70F *Acquisition costs revisited – cross-cutting***:

    a. provides a comparison of the tentative decisions reached in each of the three projects as well as the current financial instruments standards regarding the specific criteria for incorporating acquisition costs into the various models, the unit of measurement for which it is determined, and how it is presented in the financial statements and recognised in the statement of comprehensive income.

    b. compares the activities of an insurer in acquiring new or renewal business to certain costs incurred in fulfilling a contract under the revenue recognition project and the existing inventory standards.

Summary of progress the boards have made

14. The following diagram summarises the boards' progress towards an insurance contracts standard and the key decisions still to come. The appendix gives more detail.

	Tentative decisions	To be determined
Residual margin	No gains at inception	Whether and how to unlock
Risk adjustment	[IASB only] Include independently measured and updated risk adjustment	Disclosures about risk adjustment
Time value of money	Adjust for time value of money using rate that reflects characteristics of liability	
Cash flows	Expected value considering all relevant information Includes all directly attributable costs incurred in acquiring and fulfilling contracts	

Other matters	• Broadly confirmed scope proposed in ED
	• Unbundle:
	  • embedded derivatives not closely related to host insurance contract
	  • using approach from revenue recognition for goods and services and some explicit account balances
	• Measurement of reinsurance assets
		• Scope for investment contracts with DPF, fixed fee service contracts and (FASB only) financial guarantees
		• Presentation
		• Disclosures
		• Short duration contracts
		• Disclosures
		• Transition

Next steps

15. The IASB is working to issue a new IFRS by the end of 2011. The FASB will consider the feedback received on its exposure draft with a view to finalising a standard in 2012. The boards will then consider any differences that may have arisen and how to address them.

16. The boards intend to continue discussion in July, including short duration contracts, disclosures and further discussion on the risk adjustment and unbundling.

Appendix: Progress report

The following table summarises the progress the boards have made and describes what is still to come.

Area	Topic	Tentative decisions	Open points
Building block 1 – Which cash flows?	Recognition point	• Recognise insurance contract assets and liabilities when the coverage period begins. • Onerous contract liability to be recognised in the pre-coverage period if management becomes aware of onerous contracts in the pre-coverage period. • A cedant should recognize a reinsurance asset when the underlying contract is recognized unless the amount paid under the reinsurance contract reflects aggregate losses of the portfolio of underlying contracts covered by the reinsurance contract. If the reinsurance coverage is based on aggregate losses, the cedant should recognize a reinsurance asset when the reinsurance contract coverage period begins.	• How to apply onerous contract test in pre-coverage period
	Contract boundary	• Contract renewals should be treated as a new contract: (a) when the insurer is no longer required to provide coverage; or (b) when the existing contract does not confer any substantive rights on the policyholder. • A contract does not confer on the policyholder any substantive rights when the insurer has the right or the practical ability to reassess the risk of the particular policyholder and, as a result, can set a price that fully reflects that risk. • In addition, for contracts for which the pricing of the premiums does not include risks relating to future periods, a contract does not	

Area	Topic	Tentative decisions	Open points
		confer on the policyholder any substantive rights when the insurer has the right or the practical ability to reassess the risk of the portfolio the contract belongs to and, as a result, can set a price that fully reflects the risk of that portfolio. • All renewal rights should be considered in determining the contract boundary whether arising from a contract, from law or from regulation.	
	Fulfilment cash flows – objective	Expected value, with guidance that: • expected value refers to the mean that considers all relevant information; and • not all possible scenarios need to be identified and quantified, provided that the estimate is consistent with the measurement objective of determining the mean.	
	Fulfilment cash flows – which cash flows	• Include all costs that the insurer will incur directly in fulfilling the contracts in that portfolio, ie: o costs that relate directly to the fulfilment of the contracts in the portfolio; o costs that are directly attributable to contract activity as part of fulfilling that portfolio of contracts and that can be allocated to those portfolios; and o such other costs as are specifically chargeable to the policyholder under the terms of the contract. • Exclude costs that do not relate directly to the insurance contracts or contract activities, which should be recognised as expenses in the period in which they are incurred.	

<table>
<tr><th>Area</th><th>Topic</th><th>Tentative decisions</th><th>Open points</th></tr>
<tr><td></td><td>Acquisition costs</td><td>IASB: Include in fulfillment cash flows all the directly attributable costs that the insurer will incur in acquiring a portfolio of insurance contracts.
FASB: Include in fulfillment cash flows:
those costs related to successful acquisition efforts; and
direct costs that are related to the acquisition of a portfolio of insurance contracts.</td><td></td></tr>
<tr><td rowspan="2">Building block 2 – Time value of money</td><td>Discounting</td><td>Objective is to adjust the future cash flows for the time value of money and to reflect the characteristics of the insurance contract liability
Current rate that is updated each reporting period
Not required when the effect of discounting would be immaterial.</td><td></td></tr>
<tr><td>Discount rate</td><td>No prescribed method to determining the discount rate, but 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 excluding the effect of the insurer's non-performance risk;
exclude any factors that influence the observed rates but that are not relevant to the insurance contract liability (eg risks not present in the liability but present in the instrument for which the market prices are observed, such as any investment risk taken by the insurer that cannot be passed to the policyholder); and
reflect only the effect of risks and uncertainties that are not reflected elsewhere in the measurement of the insurance contract liability.
To the extent that the amount, timing or uncertainty of the cash</td><td>Disclosures of yield curve</td></tr>
</table>

Area	Topic	Tentative decisions	Open points
		flows arising from an insurance contract depend wholly or partly on the performance of specific assets (ie for participating contracts), the insurer should adjust those cash flows using a discount rate that reflects that dependence. In some cases, the insurer determines the yield curve for the insurance contract liability based on a yield curve that reflects current market returns for either the actual portfolio of assets the insurer holds, or for a reference portfolio of assets with characteristics similar to those of the insurance contract liability. In doing so, the insurer excludes from those rates factors that are not relevant to the insurance contract liability (a 'top-down' approach). In a 'top down' approach: • An insurer shall determine an appropriate yield curve based on current market information. The insurer may base its determination of the yield curve for the insurance contract liability on a yield curve that reflects current market returns for the actual portfolio of assets the insurer holds or for a reference portfolio of assets with characteristics similar to those of the insurance contract liability. • If there are no observable market prices for some points on that yield curve, the insurer shall use an estimate that is consistent with the boards' guidance on fair value measurement, in particular for Level 3 fair value measurement. • to determine the yield curve, the cash flows of the instruments shall be adjusted so that they reflect the characteristics of the cash flows of the insurance contract liability. In adjusting the cash flows, the insurer shall make both of the following adjustments: o Type I, which adjust for differences between the timing of the cash flows to ensure that the durations of the assets in the portfolio (actual or reference) selected as a starting point are	

Area	Topic	Tentative decisions	Open points
		matched with the duration of the liability cash flows. o Type II, which adjust for risks inherent in the assets that are not inherent in the liability. In the absence of an observable market risk premium for those risks, the entity uses an appropriate technique to determine that market risk premium, consistent with the objective for the discount rate, as stated above. • an insurer using a 'top-down' approach need not make adjustments for remaining differences between the liquidity inherent in the liability cash flows and the liquidity inherent in the asset cash flows.	

Area	Topic	Tentative decisions	Open points
Building block 3 – Risk adjustment	Risk adjustment	• IASB: measurement of an insurance contract should include an explicit adjustment for risk, which represents the compensation the insurer requires to bear the risk that the ultimate cash flows could exceed those expected. The adjustment would be determined independently from the premium and would be re-measured in each reporting period. • FASB: measurement of an insurance contract should use a single margin approach that recognises profit as the insurer satisfies its performance obligation to stand ready to compensate the policyholder in the event of an occurrence of a specified uncertain future event that adversely affects that policyholder.	• Techniques • Disclosures • Level of aggregation (including diversification benefits) • FASB: inclusion of an onerous contract test. • Whether the two approaches could be made comparable through disclosures

Area	Topic	Tentative decisions	Open points
Building block 4 – Residual margin	Residual / composite margin	• No gain at inception of an insurance contract. • Any loss on day one recognised immediately when it occurs, in profit or loss (net income). *For single margin:* • An insurer satisfies its performance obligation as it is released from exposure to risk as evidenced by a reduction in the variability of cash outflows. • An insurer should not remeasure or recalibrate the single margin to recapture previously recognised margin.	*For residual margin* • Whether and how to unlock the residual or composite margin • Level of aggregation • Release of residual margin *For single margin:* • How the release from risk in a single margin approach is determined.

Special applications	Participating features	• Objective of the discount rate used to measure participating insurance contracts should be consistent with the objective for the discount rate used to measure non-participating insurance contracts.
		• Provide guidance that to the extent that the amount, timing or uncertainty of the cash flows arising from an insurance contract depend wholly or partly on the performance of specific assets, the insurer should adjust those cash flows using a discount rate that reflects that dependence.
		• IASB:
		  • The measurement of the fulfilment cash flows relating to the policyholder's participation should be based on the measurement in the IFRS financial statements of the underlying items in which the policyholder participates. Such items could be assets and liabilities, the performance of an underlying pool of insurance contracts or the performance of the entity.
		  • An insurer should reflect, using a current measurement basis, any asymmetric risk-sharing between insurer and policyholder in
			• Whether proposed measurement creates a need for any specific disclosures
			• FASB: whether to address accounting mismatches by adjusting the measurement of the items that a policyholder participates in

Area	Topic	Tentative decisions	Open points
		the contractually linked items arising from a minimum guarantee. • An insurer should present changes in the insurance contract liability in the statement of comprehensive income consistently with the presentation of changes in the linked items (ie in profit or loss, or in other comprehensive income). • The same measurement approach should apply to both unit-linked and participating contracts. • The insurer may recognise and measure treasury shares and owner – occupied property at fair value through profit or loss. • FASB: measurement of the liability should reflect the expected present value of the cash flows, discounted at current rates, using the contractual measurement basis for the underlying items in which the policyholder participates.	
	Short duration contracts	• [IASB only] An insurer should deduct from the pre-claims obligation measurement the acquisition costs that the IASB would include in the measurement of the insurance contract liability under the building block approach. • The insurer shall reduce the measurement of the pre-claims obligations over the coverage period as follows: o On the basis of time, but o On the basis of the expected timing of incurred claims and benefits if that pattern differs significantly from the passage of time. • An insurer should perform an onerous contract test if facts and circumstances indicate that the contract has become onerous in the pre-claims period.	• Objective of a modified approach • Criteria for eligibility for a modified approach • Time value of money for the pre-claims obligation • Whether the modified approach should be permitted or required • Whether to provide guidance on when the effect of the time value would be immaterial for a short-tail claim

Area	Topic	Tentative decisions	Open points
			• [FASB only: acquisition costs] • Presentation
	Reinsurance	• [IASB only] The ceded portion of the risk adjustment should represent the risk being removed through the use of reinsurance. • If the present value of the fulfillment cash flows (including the risk adjustment for the IASB) for the reinsurance contract is: a) Less than zero and the coverage provided by the reinsurance contract is for future events, the cedant should establish that amount as part of the reinsurance recoverable, representing a prepaid reinsurance premium and should recognise the cost over the coverage period of the underlying insurance contracts. b) Less than zero and the coverage provided by the reinsurance contract is for past events, the cedant should recognise the loss immediately. c) Greater than zero, the cedant should recognise a reinsurance residual or composite margin. • The cedant should estimate the present value of the fulfillment cash flow for the reinsurance contract, including the ceded premium and without reference to the residual/composite margin on the underlying contracts, in the same manner as the corresponding part of the present value of the fulfillment cash flows for the underlying insurance contract or contracts, after remeasuring the underlying insurance contracts on initial recognition of the reinsurance contract. • When considering non-performance by the reinsurer: a) The cedant shall apply the impairment model for financial instruments when determining the recoverability of the	• Interaction with requirements for short-duration contracts

Area	Topic	Tentative decisions	Open points
		reinsurance asset. b) The assessment of risk of non-performance by the reinsurer should consider all facts and circumstances, including collateral. c) Losses from disputes should be reflected in the measurement of the recoverable when there is an indication that current information and events suggest the cedant may be unable to collect amounts due according to the contractual terms of the reinsurance contract.	
Definition and scope and unbundling	Definition	• Confirm proposed definition in the ED and DP, together with the guidance that: (a) an insurer should consider the time value of money in assessing whether the additional benefits payable in any scenario are significant. (b) a contract does not transfer significant insurance risk if there is no scenario that has commercial substance in which the insurer can suffer a loss, with loss defined as an excess of the present value of net cash outflows over the present value of the premiums. • If a reinsurance contract does not transfer significant insurance risk because the assuming company is not exposed to a loss, the reinsurance contract is nevertheless deemed to transfer significant insurance risk if substantially all of the insurance risk relating to the reinsured portions of the underlying insurance contracts is assumed by the reinsurer. A loss is defined as an excess of the present value of the cash outflows over the present value of the premiums. • An insurer should assess the significance of insurance risk at the individual contract level. Contracts entered into simultaneously with	

Area	Topic	Tentative decisions	Open points
		a single counterparty for the same risk, or contracts that are otherwise interdependent should be considered a single contract for the purpose of determining risk transfer.	
	Scope	• Exclude from the scope of the insurance contracts standard some fixed–fee service contracts which have as their primary purpose the provision of services. • IASB: Financial guarantee contracts (as defined in IFRSs) would not be in the scope of the insurance contracts standard as proposed in the ED. Instead: (a) an issuer of a financial guarantee contract (as defined in IFRSs) is permitted to account for the contract as an insurance contract if the issuer had previously asserted that it regards such contracts as insurance contracts; and (b) an issuer of a financial guarantee contract (as defined in IFRSs) is required in accordance with the financial instruments standards in all other cases. • Confirm all the other scope exceptions proposed in the ED	• How to identify fixed-fee service contracts which have as their primary purpose the provision of services • Investment contracts with discretionary participation features • FASB: which financial guarantee arrangements, if any, should be within the scope of the insurance contracts standard.
	Unbundling	• An insurer should account separately for **embedded derivatives** that are contained in a host insurance contract that is not closely related to the embedded derivative. • An entity should account for a bundle of promised **good or service** as *one performance obligation* if the entity integrates those goods or services into a single item that the entity provides to the customer. (If this criterion is satisfied, the entity need not consider the further criteria). • An entity should account for a promised good or service as a *separate performance obligation* if: (a) the pattern of transfer of the good or service is different from the	• Issues related to contract riders • Allocation of expenses to unbundled components • Whether to permit unbundling where not required • How the decisions would apply to typical types of insurance contracts with account balances.

Area	Topic	Tentative decisions	Open points
		pattern of transfer of other promised goods or services in the contract, and (b) the good or service has a distinct function. • A good or service has a distinct function if either: i. the entity regularly sells the good or service separately, or ii. the customer can use the good or service either on its own or together with resources that are readily available to the customer. An insurer should unbundle **explicit account balances** that are credited with an explicit return that is based on the account balance. Such an explicit account balance should be separated from an insurance contract using criteria based on those being developed in the revenue recognition project for identifying separate performance obligations. An insurer would not unbundle implicit account balances. [IASB only] An insurer would account for an unbundled explicit account balance in accordance with the relevant requirements for financial instruments in IFRS, subject to future decisions on allocation.	• Whether to combine separate contracts in some circumstances
Presentation and disclosure	Presentation		• Whether and how to expand the summarised margin approach • Whether and how to disaggregate changes in the liability • Where to present any disaggregated components (ie within profit and loss, or

Area	Topic	Tentative decisions	Open points
			in other comprehensive income)
	Disclosures		• Address detailed issues raised
	Transition and effective date		• Consider how to approximate residual /composite margin on transition • Determine effective date