Staff Paper

Topic **Progress report on the insurance contract project (for information)**

1. This report provides:

   (a) an overview of decisions taken on the IASB's project on insurance contracts.

   (b) a summary of the staff proposals for the meeting in the week of 22 March. We will provide an oral update on the decisions taken in response to those proposals

   (c) the project plan.

Summary of decisions to date

2. The critical technical issues in the project relate to volatility, unlocking the residual margin, presentation (both the summarised margin approach and how to present volatile changes), whether there should be a composite margin or a risk adjustment plus composite margin and the modified approach for short duration contracts. We comment on the progress we are making on each key topic below. In addition, we have provided in Appendix A a list of the tentative decisions to date.

Volatility

3. 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:

This paper has been prepared by the technical staff of the IFRS Foundation for discussion at a public meeting of the IASB working group identified in the header of this paper.

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 IASB.

The meeting at which this paper is discussed is a public meeting but it is not a decision-making meeting of the Board.

Official pronouncements of the IASB are published only after the Board has completed its full due process, including appropriate public consultation and formal voting procedures.

(a) *selection of the discount rate*. The boards acknowledged that many had interpreted the ED/DP as prescribing more narrowly than the boards had intended how to meet that objective. The boards tentatively confirmed that the objective of the discount rate is to adjust the future cash flows for the time value of money and to reflect the characteristics of the insurance contract liability but decided not to prescribe a single method for determining the discount rate. Thus an insurer could use different approaches that meets the objective. The boards' tentative decision on the discount rate are summarised in Appendix A and discussed in agenda paper 4.

(b) *locking in the discount rate at inception*. At its 1-2 March 2011 meeting, the boards tentatively confirmed that the discount rate used to measure all insurance contracts should be a current rate that is updated each reporting period (ie not to lock in the discount rate for any insurance contract). At its meeting in the week of 14 March, the boards had an educational session on an approach that would include locking the discount rate for part of an insurer's liability. We describe this approach in agenda paper 4.

(c) *presentation* eg by presenting the effects of volatility separately, or by defining a measure of 'operating profit' for insurers. We discuss presentation in agenda paper 6.

(d) *unlocking the residual margin*. We will ask the IWG for input on unlocking the residual margin at this meeting in agenda paper 5. Using this input, we intend to develop a paper on this topic, with a view to asking the boards for a decision at its next meeting.

(e) *unbundling*, which could allow investment components to be measured at amortised cost (see paragraph 18).

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

Unlocking the residual margin

5. One of the remaining challenging technical issues in the project is whether the residual margin should be unlocked and how to do it. Many propose that the residual margin be unlocked. There are three reasons for this:

   (a) Many find it counterintuitive that an insurer might recognise losses in a period, even though there will be gains from the release of the margin in future periods.

   (b) Some think it is inconsistent to prohibit day one gains, but permit such gains on day two.

   (c) Some propose that the residual margin should be used as a means of absorbing volatility that is expected to have no ultimate effect on profitability.

6. We consider unlocking the residual margin in agenda paper 5.

Presentation

7. Many also question how useful volatile changes in the insurance contracts liability might be to users of financial statements, and are concerned because they do not consider this volatility to be a faithful representation of the economics of insurers' business when considered in conjunction with related assets.

8. There was significant opposition by commentators to the summarised margin approach proposed in the ED. Many are reluctant to lose volume information about premiums, claims and expenses from the statement of comprehensive income.

9. We consider the presentation of volatile changes in agenda paper 6 and the presentation of volume information in agenda paper 7.

Three or four building blocks

10. The question of risk adjustment plus residual margin or composite margin divided both boards in finalising the ED, and the IASB and FASB came to different conclusions.

11. In February the boards tentatively decided that, if there are techniques that could faithfully represent the risk inherent in insurance liabilities, the inclusion of an explicit risk adjustment in the measurement of those liabilities would provide relevant information to users. The boards did not consider at that meeting whether a risk adjustment could be determined in a verifiable way that promotes comparability of financial statements, nor whether making the risk adjustment explicit would pass a cost-benefit test.

12. The March board agenda includes education sessions aimed at helping the boards understand how practitioners determine the risk adjustment in jurisdictions where they are already used.

Short duration contracts

13. We expect the boards to consider the modified approach for the pre-claims liability for short duration contracts in April. Among the topics to be discussed are:

    (a) Whether the proposals in the ED struck the right balance between competing objectives (closeness to the building block approach versus simplicity, closeness to current practice and closeness to the proposals in the exposure draft on revenue recognition.) Respondents generally suggested that the proposals were over-engineered and attempted to stay too close to the building block approach.

    (b) The eligibility criteria for using the modified approach.

(c) Whether the approach should be required (as proposed in the ED) or merely permitted.

(d) The presentation approach that should be used with the modified approach.

Summary of proposals for the March meeting

14. The paragraphs below describe the papers that we intend to discuss at the joint IASB and FASB board meeting in the week of 21 March.

Risk adjustment and residual or composite margin

15. The boards will have a mixture of decision-making and non-decision making papers on risk adjustments and on the residual or composite margin. We will follow up the presentation by Jo Oechlin, Munich Re with presentations from Tony Coleman, Lonergan, Edwards & Associates and Mark Swallow, Swiss Re. Those presentations discuss the practical considerations in implementing an explicit risk adjustment.

16. The boards will also discuss the objective of the risk adjustment and whether the composite margin should be run-off in a manner that reflects release from risk.

Discount rate

17. The board will consider the discount rate in cases where the yield curve is extended beyond observable market prices (so-called ‘ultra-long duration’ contracts).

Unbundling

18. The boards will consider its approach to unbundling in general and the unbundling of embedded derivatives in particular.

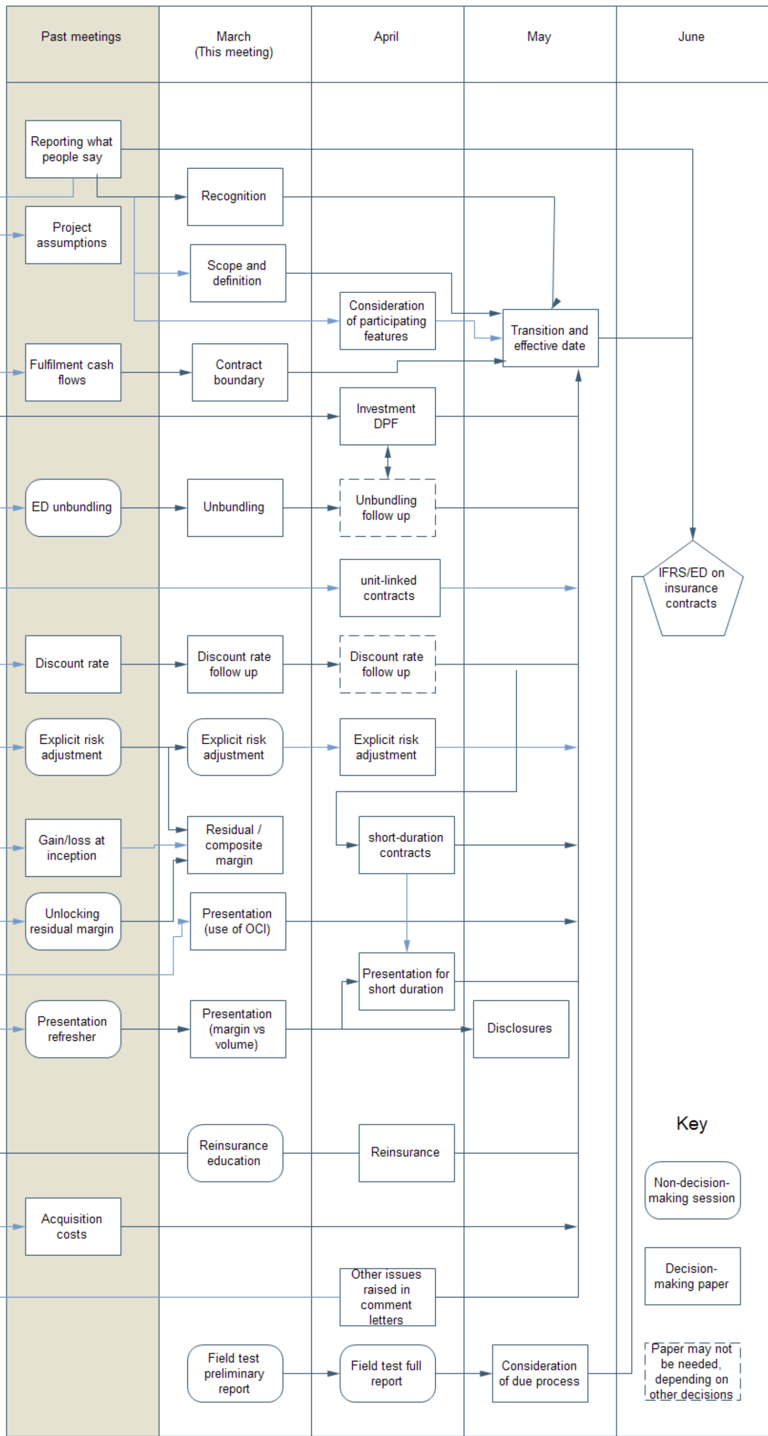
Contract boundary

19. The boards will consider whether to modify the contract boundary principle to address some (but not necessarily all) the concerns raised in the comment letters.

Project plan

20. We have set out the proposed project plan on the following page.

IASB Staff paper



Appendix A: Summary of previous decisions taken by the boards

Project axioms and assumptions

1. The boards tentatively confirmed the axioms and assumptions (listed below) that will underlie the development of the project's future direction. Those axioms and assumptions will provide a common understanding of the factors that will influence the staff in their analysis and will be a starting point for further decisions. In addition, the IASB noted that the model would be developed on the assumption that the financial assets backing the insurance contracts would be measured in accordance with IFRS 9 *Financial Instruments*. The IASB has no current plans to change the classification and measurement requirements in IFRS 9.

Axioms

(a) An ideal measurement model would report all economic mismatches (including duration mismatches) that exist and would not cause any accounting mismatches.

(b) An ideal accounting model should reflect both the intrinsic value and time value of options and guarantees embedded in insurance contracts.

(c) Money has a time value and an entity more faithfully represents its position when it measures its liabilities in a way that includes the time value of money.

Assumptions

(d) The boards will develop a standard for insurance contracts, rather than requiring current or proposed generic standards that might otherwise apply.

(e) The standard will deal with the accounting for insurance contracts from the perspective of the insurer, and not for the assets backing the

contracts or for the entities that issue those contracts. For the IASB, the financial assets backing the contracts would be measured in accordance with IFRS 9.

(f) The boards will develop a standard based on an accounting model that regards insurance contracts as creating a bundle of rights and obligations that work together to generate a package of cash inflows and outflows.

(g) In general, the final standard will measure insurance contracts at the portfolio level.
(We will assume that the unit of account is generally the portfolio, unless different considerations apply to specific instances.)

(h) The accounting model should be based on current estimates, rather than carrying forward estimates made at contract inception and inputs that are consistent with observable market data, where available.
(Paragraph 8 *describes the boards' conclusions on whether the discount rate should be locked-in at inception for some types of insurance contract.)*

(i) The cash flows incorporated in the measurement of the insurance liability are those that will arise as the insurer fulfils the insurance contract.
(Paragraph 15 describes the boards' conclusions on which cash flows arise as the insurer fulfils the contract.)

(j) The model will use the expected value of future cash flows rather than a single, most likely outcome.
(Paragraph 14 describes the boards' conclusions on expected value.)

(k) The measurement of the liability will not reflect changes in the insurer's own credit standing.

Scope

2. The boards tentatively confirmed the proposal in the ED/DP to exclude from the scope of the insurance contracts standard some fixed–fee service contracts which

have as their primary purpose the provision of services. The boards will consider in a future meeting how to identify such contracts.

3. The boards tentatively confirmed all the other scope exceptions that had been proposed by the ED/ DP.

4. The IASB tentatively decided that financial guarantee contracts (as defined in IFRSs) would not be in the scope of the insurance contracts standard as proposed in the ED. Instead, the IASB tentatively decided to retain the existing approach in IFRSs that:

   (a) permits an issuer of a financial guarantee contract (as defined in IFRSs) 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) requires an issuer to account for a financial guarantee contract (as defined in IFRSs) in accordance with the financial instruments standards in all other cases.

5. The IASB also tentatively decided it would not create an exception from the accounting for financial guarantee contracts for intragroup guarantees.

6. The FASB will consider at a future meeting which financial guarantee arrangements, if any, should be within the scope of the insurance contracts standard.

Recognition

7. The boards tentatively decided that insurance contract assets and liabilities should initially be recognized when the coverage period begins, and to require the recognition of an onerous contract liability in the pre-coverage period if management becomes aware of onerous contracts in the pre-coverage period.

Discount rate

Current vs locked- in

8. The boards tentatively confirmed the proposal in the IASB's exposure draft *Insurance Contracts* (ED) and the FASB's discussion paper *Preliminary Views on Insurance Contracts* (DP) that the discount rate used to measure all insurance contracts should be a current rate that is updated each reporting period (ie not to lock in the discount rate for any insurance contract).

For non-participating contracts

9. The boards tentatively confirmed the approach in the IASB's exposure draft (ED) *Insurance Contracts* and the FASB's discussion paper (DP) *Preliminary Views on Insurance Contracts* that the objective of the discount rate is to adjust the future cash flows for the time value of money and to reflect the characteristics of the insurance contract liability.

10. The boards tentatively decided not to prescribe a method for determining the discount rate and that the discount rate should:

    (a) 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;

    (b) 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

    (c) reflect only the effect of risks and uncertainties that are not reflected elsewhere in the measurement of the insurance contract liability.

For participating contracts

11. For insurance contracts that contain participating features, the boards tentatively decided:

    (a) to clarify that the objective of the discount rate used to measure participating insurance contracts should be consistent with the discount rate used to measure non-participating insurance contracts.

    (b) to 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.

For non-life contracts

12. The boards tentatively agreed that discounting of insurance liabilities should not be required when the effect of discounting would be immaterial. The boards asked the staff to develop, as part of the papers on the modified approach, additional guidance for determining when discounting a contract with a short-tail claim would be considered immaterial.

13. The boards tentatively decided to require discounting for all non-life long-tail claims.

Cash flows

14. In relation to **expected value**, the boards tentatively decided to clarify that:

    (a) the measurement objective of expected value refers to the mean that considers all relevant information; and

    (b) not all possible scenarios need to be identified and quantified, provided that the estimate is consistent with the measurement objective of determining the mean.

15. In relation to **costs included in fulfilment cash flows** the boards tentatively decided:

(a) to clarify that the cash flows used in measuring a portfolio of insurance contracts should include all costs that the insurer will incur directly in fulfilling the contracts in that portfolio, 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 that are directly 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.

(b) to 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;

(c) to provide application guidance based on IAS 2 *Inventories* and IAS 11 *Construction Contracts*; and

(d) to eliminate the term 'incremental' from the discussion of fulfilment cash flows that was proposed in the ED / DP (ie paragraph B61 of the ED).

16. In relation to **acquisition costs**, the boards tentatively decided that the contract cash flows should include those acquisition costs that relate to a portfolio of insurance contracts. However:

(a) The IASB tentatively decided that those acquisition costs should be all the costs that the insurer will incur in acquiring the portfolio. The IASB directed the staff to draft application guidance on this topic for the boards' consideration.

(b) The FASB tentatively decided that the acquisition costs included in the cash flows of insurance contracts will be limited to

(i) those costs related to successful acquisition efforts; and

(ii) direct costs that are related to the acquisition of a portfolio of contracts.

(c) The FASB directed the staff to develop implementation guidance on which direct costs related to the acquisition of a portfolio of contracts would be included in the cash flows of insurance contracts.

Explicit risk adjustment

17. The boards tentatively decided that, if there are techniques that could faithfully represent the risk inherent in insurance liabilities, the inclusion of an explicit risk adjustment in the measurement of those liabilities would provide relevant information to users.
The boards have not yet discussed the precise wording of the objective for an explicit risk adjustment, whether a risk adjustment could be determined in a verifiable way that promotes comparability of financial statements, or whether making the risk adjustment explicit would pass a cost-benefit test.

The recognition of gain and loss at inception

18. The boards tentatively confirmed the proposal in the ED and the DP that an insurer should:

(a) not recognise any gain at inception of an insurance contract.

(b) recognise any loss on day one immediately when it occurs, in profit or loss (net income).

Definition of an insurance contract

19. The IASB's exposure draft (ED) *Insurance Contracts* and the FASB's Discussion Paper *Preliminary Views on Insurance Contracts* (DP) proposed to define an insurance contract as 'a contract under which one party accepts significant insurance risk from another party by agreeing to compensate the

policyholder if a specified uncertain future event adversely affects the policyholder'. The boards tentatively confirmed the 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.