IFRS
FASB

IASB/FASB Meeting
Week commencing 14 March 2011

IASB Agenda reference **3**

FASB Agenda reference **60**

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 boards' discussions at the meeting in the week commencing 14 March (paragraphs 4-9).

   (b) describes the papers that are relevant to the issue of volatility (paragraphs 10-11).

   (c) describes next steps and 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 13).

2. We will provide a second cover note for the papers for the week commencing 22 March next week.

3. In addition:

   (a) Appendix A provides a summary of staff recommendations for all the papers for 14-16 March.

   (b) Appendix B provides a summary of previous decisions taken by the boards

(c) Appendix C provides an overview of the units of account used in the ED Insu*rance Contracts* and the DP *Preliminary Views on* Insurance *Contracts*.

Overview of papers

Risk adjustment and residual or composite margin

4. We present a mixture of decision-making and non-decision making papers on risk adjustments and on the residual or composite margin. We have invited external presenters to hold education sessions on practical considerations in implementing an explicit risk adjustment. The cover paper **Agenda paper 3B/60B** ***Explicit risk adjustment cover note*** describes the purpose of those sessions and introduces the presentations. The first presentation will be **Agenda paper 3C/60D** ***by Joachim Oechslin, Munich Re***. We have the remaining presentations during the week commencing 22 March as follows:

(d) Agenda **paper 12A/61A** ***Presentation by Tony Coleman, Lonergan, Edwards & Associates***

(e) **Agenda paper 12B/61B** ***Presentation by Mark Swallow, Swiss Re.***

We thank all our presenters for making themselves available and providing the materials.

2. **Agenda paper 3J/60J** ***Composite margin – examples of run-off patterns*** provides examples of different patterns to unlock the residual margin. In the February meeting, the boards asked the staff to prepare a paper discussing an approach in which changes could be made to the pattern of the run off of the composite margin that might have the same effect as having an explicit risk adjustment and unlocked residual margin. One of the patterns described in this paper would be consistent with that approach.

Presentation

5. We continue with educational material on presentation. **Agenda paper 3A/60A *Alternative presentation models*** was carried over from the 1-2 March meeting. It had not been discussed at that meeting due to lack of time. This paper provides alternative presentation approaches for the performance statement for insurance contracts and begins a discussion on the definition of revenue and a standardized definition of operating income as a performance measure.

6. We plan to follow up this session with papers asking for decision on revenue and on distinguishing an operating component for insurance contracts.

Discount rate

7. In February, the boards confirmed the proposal in the ED/DP 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. **Agenda paper 3F/60F *Discount rate for participating contracts*** discusses how to apply that objective to participating contracts.

8. 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 decided not to prescribe a single method for determining the discount rate. Thus an insurer could use any approach that meets the objective. However, the boards acknowledged that it may not always be easy for insurers to determine the discount rate. Accordingly, **Agenda paper 3G/60G *Discount rate – practical expedient for the discount rate*** discusses whether to provide a practical expedient to help insurers determine the discount rate.

Other matters

9. Other papers at this meeting are:

    (a) **Agenda paper 3D/60D *Definition of insurance contract*** asks the boards to confirm the definition of an insurance contract.

(b) **Agenda paper 3E/60E *Contract boundary*.** This paper proposes modifying the contract boundary principle to address some (but not necessarily all) the concerns raised in the comment letters.

(c) **Agenda paper 3I/60I *Recognition*** This paper considers the timing of initial recognition of insurance contract assets and liabilities. There are two staff views. Both intend that insurers should not have to change their accounting systems to recognise immaterial assets and liabilities. However, they disagree on the recommendation as to how to achieve that outcome.

The volatility issue

10. 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) *selection of the discount rate*. Appendix B lists the boards' previous decisions to date. At this meeting we intend to ask the boards to consider whether:

(i) any particular considerations apply in determining the discount rate for participating insurance contracts.

(ii) a practical expedient is needed for determining the discount rate for non-participating insurance contracts

(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).

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

3A/60A begins a discussion on a standardized definition of operating income as a performance measure. We intend to continue consider these issues in the week commencing 22 March.

(d) *unlocking the residual margin.* We will seek input on unlocking the residual margin from the insurance working group on 24 March. We intend to bring the topic back for decision in April.

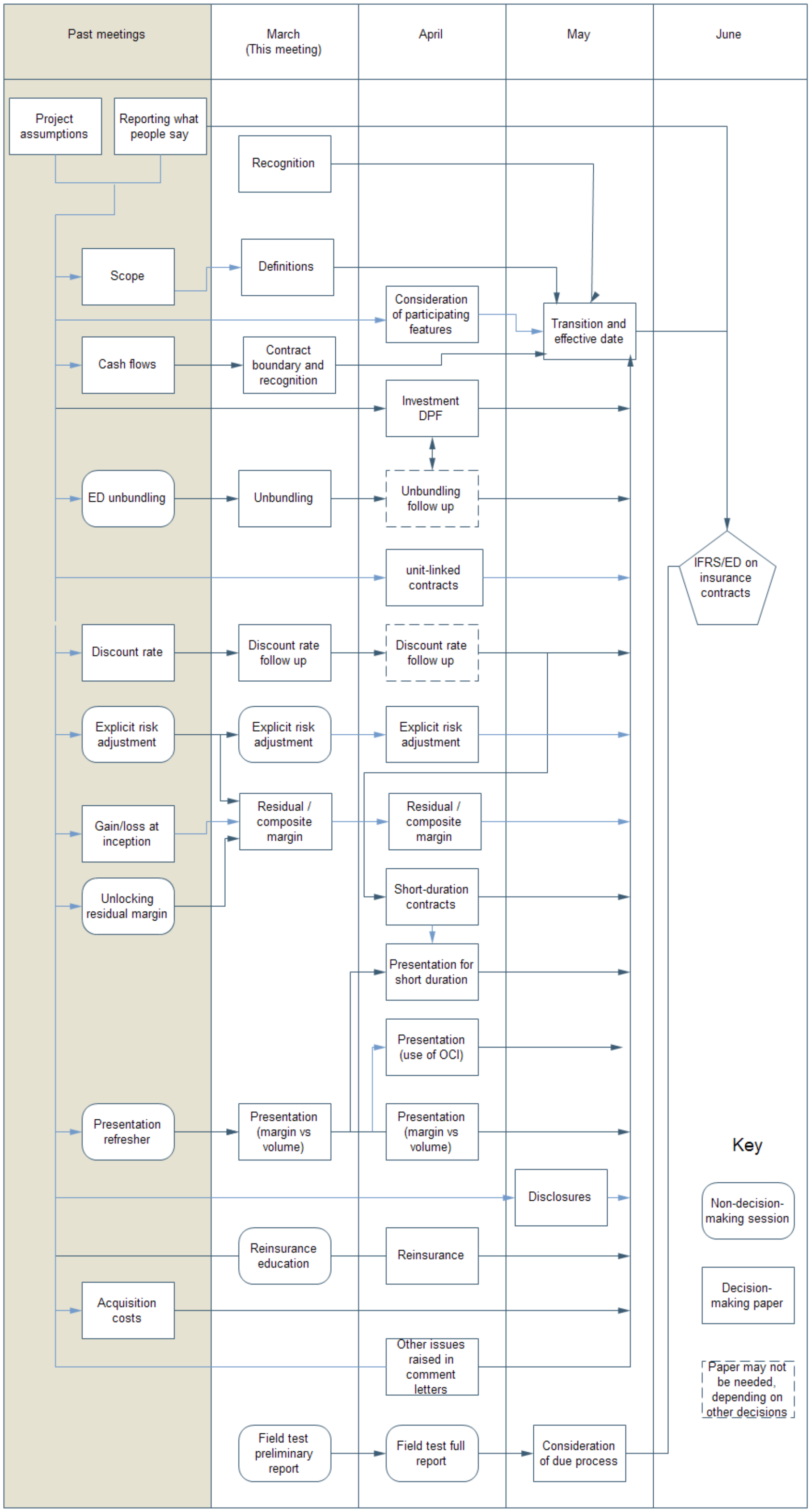
(e) *extensive unbundling*, with the investment components measured at amortised cost. We intend to discuss unbundling in the week commencing 22 March.

11. Although our 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.

Next steps and proposed project timetable

12. The Insurance Working Group will meet on 24 March, immediately after this meeting. We will describe in the cover note for the week commencing 22 March the agenda and papers for that meeting and will provide an oral report of the working group meeting on 28/29 March.

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


Past meetings
March
(This meeting)
April
May
June
Project assumptions
Reporting what people say
Recognition
Scope
Definitions
Consideration of participating features
Transition and effective date
Cash flows
Contract boundary and recognition
Investment DPF
ED unbundling
Unbundling
Unbundling follow up
unit-linked contracts
IFRS/ED on insurance contracts
Discount rate
Discount rate follow up
Discount rate follow up
Explicit risk adjustment
Explicit risk adjustment
Explicit risk adjustment
Gain/loss at inception
Residual / composite margin
Residual / composite margin
Unlocking residual margin
Short-duration contracts
Presentation for short duration
Presentation (use of OCI)
Presentation refresher
Presentation (margin vs volume)
Presentation (margin vs volume)
Disclosures
Reinsurance education
Reinsurance
Acquisition costs
Other issues raised in comment letters
Field test preliminary report
Field test full 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 3D/60D *Definition of insurance contract*

A2. The staff did not reach a common recommendation for agenda paper 3D:

(a) The papers sets out the primary staff recommendation that the boards withdraw the proposal in the ED/DP to amend the IFRS 4 guidance on the definition of an insurance contract to require that: :

(i) an insurer should consider the time value of money in assessing whether the additional benefits payable in any scenario are significant (paragraph B26 of the ED).

(ii) 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 (paragraph B25 of the ED).

(b) Appendix D describes the alternative staff recommendation that the boards retain those requirements.

Agenda paper 3F/60F *Discount rate for participating contracts*

A3. The staff recommend that recommend that the boards:

(a) 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) 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.

Agenda paper 3G/60G *Practical expedient for the discount rate*

A4. The staff recommend that the boards should not provide a practical expedient for determining the discount rate.

Agenda paper 3I/60I *Recognition*

A5. The staff did not reach a common recommendation on agenda paper 3I:

A6. The primary staff recommendation is that the boards:

(a) reaffirm the principle proposed in the exposure draft, ie that an insurer should recognise an insurance contract asset or liability from the date on which it becomes a party to the contract;

(b) emphasise that insurers need not change their accounting systems to recognise insurance contract assets and liabilities before the start of the coverage periods if those assets and liabilities—and any gains or losses that arise before the start of the coverage period—would not be material to the financial statements;.

A7. Some staff members disagree with this recomendation. These staff members agree that insurers should not have to change their accounting systems to recognise immaterial assets and liabilities. However, they disagree with the staff recommendation on how to achieve that outcome. They favour instead an approach that would defer the recognition of all insurance assets and liabilities until the coverage period begins and the recognition of an onerous contract if management became aware of an onerous contract in the pre-coverage period.

Other papers

A8. No recommendations were made in Agenda papers 3A/60A, 3B/60B, 3C/60C and 3J/60J. [Papers 3E and 3H were not used in this meeting.]

Appendix B: Summary of previous decisions taken by the boards

Project axioms and assumptions

B1. 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. (The observer notes for the February main meeting list some areas in which the staff plan specific follow-up work in some areas covered by the assumptions.) 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

B2. An ideal measurement model would report all economic mismatches (including duration mismatches) that exist and would not cause any accounting mismatches.

B3. An ideal accounting model should reflect both the intrinsic value and time value of options and guarantees embedded in insurance contracts.

B4. 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

B5. The boards will develop a standard for insurance contracts, rather than requiring current or proposed generic standards that might otherwise apply.

B6. 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.

B7. 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.

B8. In general, the final standard will measure insurance contracts at the portfolio level.

B9. 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.

B10. The cash flows incorporated in the measurement of the insurance liability are those that will arise as the insurer fulfils the insurance contract.

B11. The model will use the expected value of future cash flows rather than a single, most likely outcome.

B12. The measurement of the liability will not reflect changes in the insurer's own credit standing.

Scope

B13. 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.

B14. The boards tentatively confirmed all the other scope exceptions that had been proposed by the ED/ DP.

B15. 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 the contract as an insurance contract; and

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

B16. The IASB also tentatively decided it would not create an exception from the accounting for financial guarantee contracts for intragroup guarantees.

B17. The FASB decided to consider at a future meeting which financial guarantee arrangements, if any, should be within the scope of the insurance contracts standard.

Discount rate

Current vs locked- in

B18. 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

B19. The boards tentatively decided to confirm 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.

B20. 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 non-life contracts

B21. 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.

B22. The boards tentatively decided to require discounting for all non-life long-tail claims.

Cash flows

B23. In relation to **expected value**, the boards tentatively decided to clarify:

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

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

B24. In relation to **costs included in fulfillment cash flows** the boards tentatively decided:

(a) to clarify that all costs that an insurer will incur directly in fulfilling a portfolio of insurance contracts should be included in the cash flows used to measure the insurance liability, including:

- 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);
- 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
- 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).

B25. 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, including costs that relate directly to the acquisition of 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

B26. 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 recognition of gain and loss at inception

B27. 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).

Appendix C: Overview of unit of account

C1. In this appendix, we provide an overview of the units of account used in the ED *Insurance Contracts* and the DP *Preliminary Views on Insurance Contracts*. This overview is relevant to the board's discussions on contract boundary in agenda paper 3F/60F. We will continue to provide a similar overview in future whenever we discuss unit of account.

C2. Respondents to the ED/DP were not invited to comment specifically on the unit of account. However, many respondents observe that the ED specifies a number of different units of account and state that using different units of account introduces unnecessary complexity and can confuse users. Some suggest that a consistent unit of account should be used throughout the measurement model and think that the portfolio is appropriate because it reflects the way that contracts are priced and managed by insurers. Although the unit of account in other standards is generally the individual contract (eg in IAS 39 and IFRS 9), some believe this difference is appropriate to reflect that the insurance business model is predicated on the pooling of similar risks.

C3. This table summarises, for information only, the different levels of aggregation proposed in the ED/DP for measurement purposes.

Item	**Unit of account**	**Basis/observations**
Cash flows	At portfolio level.	In principle, the expected value from a portfolio of contracts equals the sum of the expected value of the individual contracts. Therefore the level of measurement does not affect the expected value of future cash flows. However, the *nature* of the cash flows included may depend on the unit of measurement. For example, costs that are regarded as direct for a portfolio may not be direct at the contract level.
Acquisition costs	At portfolio level	The ED/DP proposed that acquisition costs should be determined at the individual contract level. However, the boards tentatively decided on 2 February 2011 that the contract cash flows should include those acquisition costs that relate to a portfolio of insurance contracts.

Item	Unit of account	Basis/observations
Risk adjustment (if used)	At portfolio level.	Paragraphs BC118-BC120 of the Basis for Conclusions to the ED discuss the level of aggregation for the risk adjustment. Paragraph BC119(c) states: "The Board concluded that [determining risk adjustments at the level of individual portfolios] is the most practical solution and the most likely to produce relevant information for users at reasonable cost. Because the portfolio contains reasonably homogenous contracts, it is the most natural level at which to estimate the probability distribution of the cash flows. Furthermore, although an insurer might expect to derive some diversification benefits by grouping together various portfolios, determining the extent of those benefits is difficult because of the lack of full fungibility between portfolios. " Thus, the risk adjustment would not reflect the effects of diversification between portfolios or negative correlation between portfolios.
Determining the residual / composite margin at inception (gains / loss issue)	At cohort level, ie the level that groups contracts: (i) by portfolio; (ii) within the same	Paragraph BC130 of the Basis for Conclusions to the ED states: "Paragraph BC120 explains that the risk adjustment should be determined at a portfolio of contracts level that groups together contracts subject to similar circumstances (ie c contracts that are subject to similar risks and are managed together as a pool). However, because the residual margin is released over the

Item	Unit of account	Basis/observations
	portfolio, by date of inception of the contract; and (iii) by length of the contract.	coverage period, it is necessary to adopt a different level of aggregation for residual margins that group together only those contracts within the portfolio that have similar coverage periods. For that reason, the Board concluded that residual margins should be determined at a level that aggregates insurance contracts into a portfolio and, within each portfolio, by similar date of inception of the contract and by similar coverage period. An alternative would be to determine the release of the residual margin at an individual contract level, but the Board concluded that would be impracticable."
Determining the amount of any day one loss	At cohort level	The staff believes that the intention was to determine any day one loss at the cohort level. However some do not think this is clear in the ED/DP.
Determining the residual/composite margin after inception	At cohort level	The residual margin at contract inception date is determined at cohort level. It follows that subsequent measurement will also be performed at cohort level.
Onerous contract test (modified approach)	At cohort level.	Paragraph BC149(c) of the Basis for Conclusions to the ED states: "Considering the short duration of the coverage period, the level of aggregation for the onerous contract test would be within the portfolio of insurance contracts, by similar date of inception."