IASB/FASB Meeting
Week commencing 21 March 2011

IASB Agenda reference **12**

FASB Agenda reference **61**

Staff Paper

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

What is this paper about?

1. This paper updates agenda paper 3 and provides:

   (a) an overview of the papers for the boards' discussions at the meeting in the week commencing 21 March (paragraphs 2 and 3);

   (b) a summary of staff recommendations for all the papers for 21-23 March (paragraphs 4-10); and

   (c) a summary of previous decisions taken by the boards (Appendix A).

Overview of papers and summary of staff recommendations

Education sessions

2. We advise board members to bring agenda paper 3B with them to the Norwalk meeting. We will follow-up the presentation by Joachim Oechslin, Munich Re (agenda paper 3C/60C) with further presentations as follows:

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

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

This paper has been prepared by the technical staff of the IFRS Foundation and the FASB for discussion at a public meeting of the FASB or the IASB.

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 FASB or the IASB.

Comments made in relation to the application of U.S. GAAP or IFRSs do not purport to be acceptable or unacceptable application of U.S. GAAP or IFRSs.

The tentative decisions made by the FASB or the IASB at public meetings are reported in FASB *Action Alert* or in IASB *Update*. Official pronouncements of the FASB or the IASB are published only after each board has completed its full due process, including appropriate public consultation and formal voting procedures.

These presentations will take place by video link between London and Norwalk. We thank all our presenters for making themselves available and providing the materials.

3. In ***Agenda paper 12F/61F Unbundling: Overall considerations*** we set out our proposed approach to the unbundling decisions.

Summary of staff recommendations

Agenda paper 12C/61C *Contract boundary*

4. The staff recommend that:

   (a) 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 on the policyholder any substantive rights.

   (b) 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.

   (c) All renewal rights should be considered in determining the contract boundary whether arising from contract, law or regulation.

Agenda paper 12D/61D *Objective for an risk adjustment*

5. The staff recommend that the boards amend the objective of the risk adjustment proposed in paragraph 35 the ED to explicitly include a point-of-indifference notion. Accordingly, the objective would no longer refer to:

   (a) ‘the risk that the actual cash flows exceed those expected’;

   (b) ‘the amount the insurer would rationally pay to be relieved of the risk’;

   (c) a ‘maximum amount’.

6. Accordingly, the staff propose that the objective of the risk adjustment would be:

The risk adjustment shall be the amount that makes the insurer indifferent between:

(a) undertaking or retaining the obligation to fulfil the insurance contract; and

(b) undertaking or retaining an obligation to pay an amount equal to the expected present value of the cash flows that will arise as the insurer fulfils the liability.

Agenda paper 12E/61E *Discount rate – ultra-long contracts*

7. The staff recommend. that the effects of changes in discount rate for ultra-long duration cash flows should be presented in other comprehensive income. The amount should reflect the changes in measurement attributable to changes in the difference between the observable and the unobservable part of the yield curve (**'spread approach'**).

8. The staff plan to bring to a future meeting a discussion of whether other comprehensive income should be used for other components of changes in the carrying amount of some or all insurance liabilities. The discussion of ultra-long insurance contracts is not intended to pre-empt that more general discussion, for which we will also seek input from next week's meeting of the insurance working group.

Agenda paper 12G/61G *Bifurcation of embedded derivatives*

9. The staff recommend that:

   (a) the IASB confirms the existing separation requirements in IFRS 4 and IAS 39/IFRS 9 for derivatives embedded in insurance contracts should be carried forward to forthcoming IFRS.

   (b) the FASB confirm that the current requirements in Topic 815 on the separation of embedded derivatives should be carried over to the forthcoming ED.

Other papers

10. No recommendations were made in Agenda papers 12A/61A, 12B/61B and 12F/61F.

Appendix A: Summary of previous decisions taken by the boards

Project axioms and assumptions

A1. 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

A2. An ideal measurement model would report all economic mismatches (including duration mismatches) that exist and would not cause any accounting mismatches.

A3. An ideal accounting model should reflect both the intrinsic value and time value of options and guarantees embedded in insurance contracts.

A4. 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

A5. The boards will develop a standard for insurance contracts, rather than requiring current or proposed generic standards that might otherwise apply.

A6. 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.

A7. 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.

A8. In general, the final standard will measure insurance contracts at the portfolio level.

A9. 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.

A10. The cash flows incorporated in the measurement of the insurance liability are those that will arise as the insurer fulfils the insurance contract.

A11. The model will use the expected value of future cash flows rather than a single, most likely outcome.

A12. The measurement of the liability will not reflect changes in the insurer's own credit standing.

Definition of an insurance contract

A13. 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 decided to confirm the proposal in the ED and DP 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.

Scope

A14. 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.

A15. The boards tentatively confirmed all the other scope exceptions that had been proposed by the ED/ DP.

A16. 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.

A17. The IASB also tentatively decided it would not create an exception from the accounting for financial guarantee contracts for intragroup guarantees.

A18. 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.

Recognition

A19. 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

A20. 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

A21. 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.

A22. 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.

A23. The boards tentatively decided not to provide a practical expedient for determining the discount rate.

For non-participating contracts

A24. The boards discussed the discount rate for insurance contracts that contain participating features. The boards tentatively decided to:

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.

For non-life contracts

A25. 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.

A26. The boards tentatively decided to require discounting for all non-life long-tail claims.

Cash flows

A27. 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.

A28. 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).

A29. 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

A30. 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

A31. 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).