



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' discussion at this meeting (paragraphs 3-6).
 - (b) describes the papers that are relevant to the issue of volatility (paragraphs 7-8).
 - (c) provides an overview of the units of account used in the ED *Insurance Contracts* and the DP *Preliminary Views on Insurance Contracts*.
2. We will provide an updated project timetable in the papers for the main March meeting.

Overview of papers

3. At this meeting, the staff intend to present the following papers for decisions:
 - (a) **Agenda papers 2A and 2B** were carried over from the main February meeting. They had not been discussed at that meeting due to lack of time. They cover:
 - a) **Agenda paper 2A/59A *Locking in the discount rate***

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b) **Agenda paper 2B/59B *Discount rate for non-participating contracts***

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

- (b) **Agenda paper number 2C/59C** is not used at this meeting.
- (c) **Agenda paper 2D/59D *Scope*** asks the boards to confirm the scope of the insurance contracts standard, with particular discussion of fixed fee service contracts.
- (d) **Agenda paper 2E/59E *Financial guarantee contracts*** asks the boards to exclude from the scope of the insurance contracts project the accounting for financial guarantee contracts as defined in IFRSs, and financial guarantees as defined in US GAAP. Agenda paper 2E contains separate recommendations for the IASB and FASB because of differences in IFRSs and US GAAP respectively. However, the underlying message in the recommendations is consistent.
- (e) **Agenda paper 2G/59G *Follow up on acquisition costs*** develops further the treatment of acquisition costs and is a follow-up to agenda paper 3B at the 1-2 February meeting. Agenda paper 3G contains two staff views and recommendations on the acquisition costs to be included in the measurement of an insurance liability.

- 4. A summary of the staff recommendations is in Appendix A and a summary of previous decisions taken by the boards is in Appendix B.
- 5. In addition, we put forward papers for discussion/information 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. These papers are:

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- (a) **Agenda paper 2F/59F *Field test preliminary report*** presents the preliminary results from the field tests of the proposals in the IASB's Exposure Draft *Insurance Contracts*.
 - (b) **Agenda paper 2H/59H *Presentation examples*** provide 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.
 - (c) **Agenda paper 2I/59I *Uncertainty in the measurement of insurance liabilities*** provides a comprehensive view of the measurement model considering all building blocks and analyses where the model intends to capture the elements of risk and uncertainty. This paper was prepared in response to the boards' concerns about possible double counting risk and uncertainty, expressed during the February joint meetings.
6. We are likely to discuss the papers for this meeting in a different order from this list.

The volatility issue

7. 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*. We will follow up on last month's discussions on the discount rate at the main March meeting. Appendix B lists the boards' previous decisions to date.
 - (b) *locking in the discount rate at inception*. In agenda paper 2A/59B, we recommend that the boards should not lock in the discount rate for any insurance contract.

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- (c) *presentation* eg by presenting the effects of volatility separately, or by defining a measure of ‘operating profit’ for insurers. Agenda paper 2H/59H begins a discussion on a standardized definition of operating income as a performance measure. We will consider these issues further in a future meeting.
 - (d) *unlocking the residual margin*. We intend to discuss in the main March 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 cost. We intend to discuss unbundling in the main March meeting.
8. 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.

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Overview of unit of account

9. In this section, 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 acquisition costs in paper 2G/59G. We intend to provide a similar overview in future whenever we discuss unit of account.
10. 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.
11. The ED defines a portfolio of insurance contracts as insurance contracts that are subject to similar risks and managed together as a single pool. We will ask the boards to discuss that definition at a future meeting.

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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, in determining which cash flows to include in the expected value calculation, measurement at a portfolio level means that more cash flows would be included.
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.

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Item	Unit of account	Basis/observations
Risk adjustment (if used)	At portfolio level.	<p>Paragraphs BC118-BC120 of the Basis for Conclusions to the ED discuss the level of aggregation for the risk adjustment. Paragraph BC119(c) states:</p> <p>“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 reasonable 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. ”</p> <p>Thus, the risk adjustment would not reflect the effects of diversification between portfolios or negative correlation between portfolios.</p>
Determining the residual / composite margin at inception (gains / loss issue)	<p>At cohort level, ie the level that groups contracts:</p> <p>(i) by portfolio;</p> <p>(ii) within the same</p>	<p>Paragraph BC130 of the Basis for Conclusions to the ED states:</p> <p>“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</p>

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Item	Unit of account	Basis/observations
	<p>portfolio, by date of inception of the contract; and (iii) by length of the contract.</p>	<p>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.”</p>
<p>Determining the amount of any day one loss</p>	<p>At cohort level</p>	<p>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.</p>
<p>Determining the residual/composite margin after inception</p>	<p>At cohort level</p>	<p>The residual margin at contract inception date is determined at cohort level. It follows that subsequent measurement will also be performed at cohort level.</p>
<p>Onerous contract test (modified approach)</p>	<p>At cohort level.</p>	<p>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.”</p>

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Appendix A: Summary of staff recommendations

A1. This month, we make the following recommendations:

Agenda paper 2A/59A Locking in the discount rate

A2. 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 2B/59B Discounting non-life contract liabilities

A3. 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 2D/59D Scope

A4. The staff recommend the boards:

- (a) narrow the scope exclusion proposed in the ED to exclude from the scope of the insurance contracts standard fixed-fee service contracts that have as their primary purpose the provision of services and that do not qualify for the modified approach for short-duration contracts.
- (b) confirm the remainder of the scope exclusions proposed in the IASB's exposure draft (ED) Insurance Contracts and the FASB's discussion paper (DP) *Preliminary Views on Insurance Contracts*.

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Agenda paper 2E/59E *Financial guarantee contracts*

IASB staff recommendations

A5. The staff recommend that the IASB:

- (d) carries forward in the IFRS for insurance contracts the existing option in IFRS 4 that:
 - a) permits an issuer of a financial guarantee contract (as defined in IFRSs) to account for the contract as an insurance contract if it had previously asserted that it regards the contract as an insurance contract; 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. Such contracts would be measured initially at fair value (typically equal to the consideration received), with subsequent amortisation of that amount, coupled with a test for credit losses.
- (e) does not provide an exception for intragroup guarantees from the accounting for financial guarantees and financial guarantee contracts.

FASB staff recommendations

12. The staff recommends that the FASB should:

- (a) exclude from the scope of the insurance contracts project the accounting for financial guarantees. This would mean that the insurance contracts standard would carry forward the existing guidance such that:
 - a) Financial guarantees currently within the scope of Topic 944 (formerly FAS 60) should be within the scope of the insurance contracts guidance
 - b) Financial guarantees within the scope of Topic 815 (formerly FAS 133) and Topic 460 (formerly FIN 45) as well as financial guarantee insurance contracts within the scope of Topic 944 (formerly FAS 163) should not be within

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the scope of the insurance contracts guidance and should retain current accounting under those standards.

- (b) continue current practice under existing U.S. GAAP that provides an exception from recognition requirements for intragroup guarantees.

Agenda paper 2G/59G Follow up on acquisition costs

A6. We have two alternative recommendations.

Main staff recommendation

A7. Some staff recommend that:

- (a) The acquisition costs included in the cash flows of insurance contracts should be limited to those costs related to successful acquisition efforts.
- (b) The acquisition costs included in the cash flows of insurance contracts should be limited to direct costs that are related to the acquisition of a portfolio of contracts.
- (c) Implementation guidance should be provided to clarify the types of acquisition costs that should be included in the cash flows of insurance contracts including the functions:
 - (i) Sales force contract selling;
 - (ii) Underwriting;
 - (iii) Medical and inspection;
 - (iv) Policy issuance and processing.

Alternative staff recommendation

A8. Other staff recommend that the acquisition costs to be included in the initial measurement of a portfolio of insurance contracts should be all the costs that the insurer will incur in acquiring the portfolio including:

- (a) costs that relate directly to the acquisition of the portfolio, such as commissions; and

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- (b) costs that are directly attributable to acquisition activity in general and that can be allocated to the acquisition of the portfolio?

All other acquisition costs should be recognised as expenses when incurred.

Other papers

Agenda paper 2C is not used at this meeting. No recommendations were made in Agenda papers 2F, 2H and 2I.

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Appendix B: Summary of previous decisions taken by the boards*Project axioms and assumptions*

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

- An ideal measurement model would report all economic mismatches (including duration mismatches) that exist and would not cause any accounting mismatches.
- An ideal accounting model should reflect both the intrinsic value and time value of options and guarantees embedded in insurance contracts.
- 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

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

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

- 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.
- In general, the final standard will measure insurance contracts at the portfolio level.
- 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.
- The cash flows incorporated in the measurement of the insurance liability are those that will arise as the insurer fulfils the insurance contract.
- The model will use the expected value of future cash flows rather than a single, most likely outcome.
- The measurement of the liability will not reflect changes in the insurer's own credit standing.

Discount rate for non-participating contracts

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.

The boards tentatively decided not to prescribe a method for determining the discount rate and 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 excluding the effect of the insurer's non-performance risk;

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- 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.

Cash flows

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

- that the measurement objective of expected value refers to the mean that considers all relevant information; and
- 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.

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

- 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 determine 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.
- 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;

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

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. In addition the FASB tentatively decided to include implementation guidance to clarify which acquisition costs should be included in the initial measurement of an insurance contract, rather than being recognised as an expense as incurred. The IASB did not vote on this proposal.

Explicit risk adjustment

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

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

- not recognise any gain at inception of an insurance contract.
- recognise any loss on day one immediately when it occurs, in profit or loss (net income).