Project: **Insurance Contracts**

Topic: **Eligibility for the modified approach for short duration contracts**

Introduction

1. The IASB and FASB discussed short duration contracts in February and April 2011.

2. At their February 2011 meeting, the boards tentatively agreed:

   (a) 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.

   (b) To require discounting for all non-life long-tail claims.

3. At their meeting on 27 April 2011, the boards discussed whether an approach other than the building block approach should be used for the accounting in the pre-claims period (coverage period) for contracts, typically short duration, that meet specified criteria. In particular, the boards discussed what those criteria might be and whether that different approach was a proxy for the building block approach or a separate model. The boards made the following tentative decisions:

   (a) They would consider whether the pre-claims obligation should reflect the time value of money, based on their tentative decision on reflecting the time value of money in the revenue recognition project.

(b) The insurer shall reduce the measurement of the pre-claims obligations over the coverage period as follows:

   (i) On the basis of time, but

   (ii) On the basis of the expected timing of incurred claims and benefits if that pattern differs significantly from the passage of time.

(c) An insurer shall perform an onerous contract test if facts and circumstances indicate that the contract has become onerous in the pre-claims period.

4. In addition, the IASB tentatively decided that an insurer should deduct from the pre-claims obligation measurement the acquisition costs that would be included in the measurement of the insurance contract liability under the building block approach.

5. This paper consider only the *preclaims* period for short duration contracts and not the claims period for those contracts.

The difference between the modified approach and the building block approach

6. Commentators generally thought that the modified approach proposed in the ED was too complicated and proposed instead that the approach be made more similar to the unearned premium approach. In the staff’s view, the unearned premium approach would be similar to applying the principles in the boards’ project on revenue recognition to the pre-claims liability.

7. The boards’ discussions in their 27 April meeting indicated some support for using a revenue recognition approach in the pre-claims period for some insurance contracts. That would simplify the measurement requirements in the pre-claims period compared to the proposals in the ED and make them more similar to an unearned premium approach. The staff plans to consider at a future meeting the details of the measurement in the pre-claims period. We will assume in this paper that the modified approach will be similar to a revenue recognition approach in the pre-claims period.

Objective of the modified approach

8. During the discussion at the meeting on 27 April, it became clear that board members have differing views as to the objective of the modified approach. Those views can be summarized as follows:

   (a) A modified approach should provide a simplification or proxy when the costs of applying the building block approach are not worth the benefits of doing so (the 'one-model view'). This would be the case when the results of applying the building block approach are not materially different from the results of applying a simpler approach.

   (b) A modified approach should be an alternative approach that is used in place of the building block approach for some insurance contracts (the 'two-model view').

Question 1 – Objective for the modified approach
What should be the objective for a modified approach?

Eligibility criteria for the modified approach

Background

9. Paragraph 55-60 of the IASB ED[1] describe a modified measurement approach that would apply to insurance contracts that meet both of the following conditions:

   (a) The coverage period of the insurance contracts is approximately one year or less.

   (b) The contract does not contain embedded options or other derivatives that significantly affect the variability of cash flows, after unbundling any embedded derivatives […].

10. Paragraphs BC145 and BC146 of the Basis for Conclusions to the ED discuss the IASB's view that:

[1] The FASB had not, in their Discussion Paper *Preliminary Views on Insurance Contracts* determined the extent to which, or the conditions under which, a modified approach would apply.

(a) provided that the contract contains no significant embedded derivatives, the unearned premium is a reasonable approximation of the present value of the fulfillment cash flows and the residual margin when the pre-claims period is approximately one year or less (and achieves a similar result at a lower cost).

(b) the modified approach is consistent with the customer consideration approach proposed in the exposure draft *Revenue from Contracts with Customers*.

11. Many respondents, in particular property / casualty and health preparers, opposed the one-year eligibility restriction for the modified approach. This opposition primarily stems from the facts that existing practice in many jurisdictions would apply an unearned premium approach to some insurance contracts with a coverage period of more than one year and that the proposal in the exposure draft would result in different accounting for similar products with different terms. For example, some non-life contracts may have durations longer than one year but share similar economic characteristics with one year contracts.

12. The staff paper for the meeting on 27 April considered and rejected determining eligibility for the modified approach based on the distinction between life and non-life. The staff's considerations in that paper are summarized in the appendix.

One-model view

13. In the one-model view, the modified approach would be permitted or required when the results of applying the modified approach are not materially different from the building block approach.

14. There have been a number of suggestions for the contracts for which this is the case:

(a) Those of short duration. The ED proposed that the modified approach should be applied when the coverage period is approximately less than 12 months.

(b) Those for which the is no significant financing element, ie for which

(i) the period of time between premium receipt and insurance coverage is not significant; or

(ii) the performance of the contract reflects primarily underwriting results rather than investment management results

(iii) The amount of premium charged is not substantially different if the policyholder paid at the beginning of the coverage period,

(c) Those for which there is little variability during the pre-claims period in the estimates of cash flows. Some believe this condition is implicit in the proposal in the ED to exclude from applying the modified approach contracts which contain embedded options or other derivatives that significantly affect the variability of cash flows.

15. Some suggest that the boards could develop indicators or criteria for contracts that would be eligible for the modified approach, but also permit insurers to apply that approach when the results of applying the modified approach are not materially different from the building block approach.

16. In addition, the boards could consider permitting or requiring insurers to use the modified approach for all the contracts in a portfolio in which most contracts would qualify for the modified approach.

Question 2: Eligibility in the one-model view
For the one-model view, the questions that arise are: Do the boards need to specify additional criteria or provide additional guidance about when the results of applying the modified approach are not materially different from the building block approach? If so, which criteria and why?

Two-model view

17. In the two-model view, the modified approach would be permitted or required for contracts that the boards identify as being more suited to a revenue recognition approach than the building block approach (ie a liability measurement approach).

18. In the staff's view, there could be substantial overlap between such contracts and those that meet the criteria in paragraph 14. However, the staff thinks that the eligibility criteria in a two-model view need not be constrained by requiring that

the results of applying the modified approach would be materially the same as applying the building block approach. Therefore, a two-model view might lead to insurers being permitted or required to apply the modified approach to a wider set of insurance contracts than might be the case for the one-model view.

Question 3: Eligibility in the two-model approach
In the two-model view, the question that arises is: To which insurance contracts should insurers apply the modified approach rather than the building block approach? Why?

Appendix

The staff paper for the 27 April meeting discussed whether eligibility for the modified approach should be based on the distinction between life and non-life contracts. If so, the modified approach would apply to the pre-claims period for non-life contracts. One industry group refers to the business model underlying most non-life contracts as the continuous risk re-underwriting business model and identified particular characteristics that differentiate between those and other insurance contracts. For simplicity and ease of reading, we will continue to refer to the contracts discussed as "non-life" and "life" as this is how many people typically think of them. The paper examined these characteristics to determine whether there were unique features that could be used to establish eligibility criteria for the modified approach, as follows:

Characteristic	Non-life	Life	Staff comment
Coverage duration	Shorter-duration	Longer-duration	Issues that may arise when the duration of coverage is used as the eligibility criterion include: • identical products in terms of risks and exposures, with different durations, could be accounted for and presented differently. This could create an opportunity to engage in accounting arbitrage. • Portfolios would need to be re-defined such that there are not contracts within a portfolio that are accounted for using two different approaches • Should the boards adopt the presentation approaches proposed in the ED, useful information could be made less transparent for contracts that do not meet the duration of coverage criterion.

Characteristic	Non-life	Life	Staff comment
			Given these potential issues, the staff concluded that the use of coverage duration alone would not be sufficient to determine a contract's eligibility for using the modified approach.
Type of risk	Can cover various commercial and personal losses with relatively short durations	Cover benefits paid to individual policyholders over time with significant time from inception of contract to payment of benefit	The staff does not think that it would be practicable to provide a list of the types of risk that would make contracts eligible for the modified approach because: • it would be cumbersome, if not impossible, to create and maintain a list of insurance contracts to compare by type of risk to determine if the contract is eligible for the modified approach • specifying particular risks that would make a contract eligible for the modified approach could result in accounting arbitrage and the list would potentially need to be re-visited in the future as new products are developed. • Excluding contracts with particular risks from the modified approach is not a viable option because it is conceivable that a contract could be developed that contained a risk deemed to be excluded yet be economically similar to other contracts included. Furthermore, the staff believe that any approach that focuses on a listing of contracts that could be in or out of the modified approach is not consistent with the development of a principles based standard on a global level and thus would be inappropriate.

Characteristic	Non-life	Life	Staff comment
Primary performance indicators and metrics managed - Investment results - Matching of asset and liability cash flows - Primary risk exposure - Amount of insurance risk	Combined loss ratios, claims development - Secondary consideration - Not the primary focus as shorter duration assets are required to fund liabilities that could become due immediately. Primary focus is underwriting. - Frequency and severity of claims; increased uncertainty of cash outflows - Variable up to policy limits	Margin analysis for investments, mortality, and morbidity and actual to expected experience measures - Primary consideration - Primary focus of the model because of the need to fund long duration liabilities over time. - Investment, mortality and morbidity experience - Amount of insurance coverage specified in contract	In general, non-life contracts have: • a higher frequency and severity of the insured events • a shorter duration than life contracts. This shorter duration and difference in frequency and severity, in turn, translates into a different approach for managing non-life contracts: • the focus is primarily one of underwriting instead of investment management because of the shorter duration, which means there is not time for investment returns to mature to fund liabilities or make up for potential losses due to underwriting. • while the non-life insurer attempts to match assets and liabilities, the uncertainty in the amount and timing of the payout effectively forces the insurer to invest in shorter term, highly liquid assets, in order to have the ability to fund liabilities that could come due immediately. • the performance of the entity is primarily a function of how the entity is released from its obligation to stand ready to pay claims if, and when, the insured event occurs. This is also consistent with why combined loss ratios and claims development are considered important performance metrics by non-life insurance entities while investment management is secondary. The

Characteristic	Non-life	Life	Staff comment
- Premiums	- Typically single and fixed; profitability issues typically addressed through pricing of future contracts; Insurance risks re-underwritten and re-priced annually or more frequently; Contracts cancelable during coverage period with mandatory pro-rata refunds	- Discretionary premiums may continue over coverage period; Risks not re-underwritten or re-priced annually or more frequently	compensation to the contract holder is based on the amount of the incurred insured loss, which is variable up to the amount of the policy limit versus a specified amount in the contract. Users look to the combined loss ratio to determine whether the premium charged will cover the losses and the loss adjustment expenses. Users also look at the loss development tables to determine trends and how well the company initially estimated its reserve for each accident year and subsequent adjustments to the ultimate losses expected.