IFRS
FASB
IASB/FASB Meeting
Week commencing 16 May 2011

IASB Agenda reference **3**

Staff Paper

FASB Agenda reference **68**

Project	**Insurance contracts**
Topic	**Cover note and introduction to the risk adjustment/composite margin papers**

1. This paper provides an overview of the papers for the meeting on week commencing 16 May. The Appendix provides a detailed summary of previous decisions taken by the boards.

Risk adjustment and composite margin series

2. This series of papers supports the question in Agenda paper 3H/68H *Risk adjustment or composite margin?*

Should an insurer should include an explicit risk adjustment in the measurement of the insurance contract liability?

3. The papers are as follows:

Supporting the risk adjustment approach:

4. Agenda papers 3A/68A – 3D/68D set out the IASB staff view.

5. **Agenda paper 3A/68A *Risk adjustment: the story so far*** provides an overview of and background on the risk adjustment approach, including a discussion of previous discussions by the boards since the end of the exposure period.

6. **Agenda paper 3B/68B *Risk adjustment: useful financial information*** provides an analysis of how the risk adjustment meets the objectives of financial reporting and provides users of financial statements with useful information.

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.

7. **Agenda paper 3C/68C *Risk adjustment: techniques to meet the objective*** discusses comparability as it applies to the risk adjustment and considers whether the boards should restrict the range of available techniques permitted for determining the risk adjustment.

8. **Agenda paper 3D/68D *Risk adjustment: comparability and verifiability through disclosures*** discusses the disclosures needed to achieve comparability and verifiability for a risk adjustment.

Supporting the composite margin approach

9. Agenda papers 3E/68E-3G-68G set out the FASB staff view.

10. **Agenda paper 3E/68E *Composite margin-overview*** provides an overview of and background material on the composite margin.

11. **Agenda paper 3F/68F *Composite margin – profit realisation*** discusses the way in which the composite margin should be recognised in profit or loss. It includes a recommendation for amending the formula for the run-off of the composite margin proposed in the FASB's discussion paper (DP) could be amended.

12. **Agenda paper 3G/68G *Composite margin – conceptual analysis*** provides a conceptual analysis of how the composite margin meets the objectives of financial reporting and provides users of financial statements with useful information.

Risk adjustment or composite margin? (Agenda paper 3H/68H)

13. Agenda papers 3B/68B-3G/68G, together with papers for previous meetings, show that both the risk adjustment approach and the composite margin approach would meet the objectives of financial reporting and provide users of financial statements with useful financial information, as defined in the boards' *Conceptual Framework for Financial Reporting* (the *Framework*). We note that the two approaches reflect different economic phenomena:

    (a) In the IASB staff's analysis, the economic phenomenon is the risk inherent in the insurance contract.

(b) In the FASB staff's analysis, the economic phenomenon is potential profit at risk.

14. **Agenda paper 3H/68H *Risk adjustment or composite margin?*** puts together the different pieces of discussion around the risk adjustment and single margin to provide a comparative analysis between a risk adjustment approach and a single margin approach. This paper compares the two approaches and considers:

(a) which approach better satisfies the fundamental qualitative characteristics of useful information of relevance and faithful representation.

(b) which approach better satisfies the enhancing qualitative characteristics of useful information, ie comparability, verifiability, timeliness and understandability.

(c) how the cost constraint applies to the two approaches.

15. If the boards decide to include an explicit risk adjustment in the measurement of the liability, they will be asked to consider at a future meeting:

(a) the level at which a risk adjustment shall be determined (eg contract or portfolio) and whether diversification benefits should be included in the measurement of this adjustment.

(b) how an insurer should account for changes in the valuation technique used to determine a risk adjustment.

Other issues

16. **Agenda paper 3H/68J *Reinsurance*** considers a number of issues relating to the application of the principles in the building block approach to reinsurance contracts.

17. **Agenda paper 3I/68I *Disclosures – Application of cross-cutting analysis*** builds on the framework provided in the cross-cutting disclosure discussion from the joint meeting in the week of 21 March 2011 and provides recommendations on disclosures relating to objectives, reconciliations, disaggregation and the judgements, assumptions, methods and inputs.

Appendix: 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 fulfills 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.

Contract boundary

A20. The boards tentatively decided that:

a) Contract renewals should be treated as a new contract:

i. when the insurer is no longer required to provide coverage; or

ii. when the existing contract does not confer any substantive rights on the policyholder.

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) In addition, for contracts for which the pricing of the premiums does not include risks relating to future periods, 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 portfolio the contract belongs to and, as a result, can set a price that fully reflects the risk of that portfolio.

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

Discount rate

Current vs locked- in

A21. 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

A22. 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.

A23. 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.

A24. The boards tentatively decided that in applying the top-down approach:

a) An insurer shall determine an appropriate yield curve based on current market information. The insurer may base its determination of the yield curve for the insurance contract liability on a yield curve that reflects current market returns for the actual portfolio of assets the insurer holds or for a reference portfolio of assets with characteristics similar to those of the insurance contract liability.

b) If there are no observable market prices for some points on that yield curve, the insurer shall use an estimate that is consistent with the boards' guidance on fair value measurement, in particular for Level 3 fair value measurement.

c) the cash flows of the instruments shall be adjusted so that they reflect the characteristics of the cash flows of the insurance contract liability. In adjusting the cash flows, the insurer shall make both of the following adjustments:

   i. Type I, which adjust for differences between the timing of the cash flows to ensure that the assets in the portfolio (actual or reference) selected as a starting point are matched with the duration of the liability cash flows.

   ii. Type II, which adjust for risks inherent in the assets that are not inherent in the liability. In the absence of an observable market risk premium for risks inherent in the asset but not inherent in the liability, the entity uses an appropriate technique to determine that market risk premium, consistent with (b).

d) an insurer using a 'top-down' approach need not make adjustments for remaining differences between the liquidity inherent in the liability cash flows and the liquidity inherent in the asset cash flows.

For participating contracts

A25. 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

A26. 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.

A27. The boards tentatively decided to require discounting for all non-life long-tail claims.

For ultra-long duration contracts

A28. The boards discussed the effects of changes in discount rate where the yield curve is extended beyond observable market prices-so-called 'ultra long duration' contracts. The boards indicated that they did not want the staff to develop a separate approach that deals solely with changes in discount rate for this particular type of contract.

Cash flows

A29. 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.

A30. 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).

A31. 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

A32. 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.

A33. The boards tentatively decided:

- to remove references in the objective of the risk adjustment proposed in paragraph 35 of the ED to 'the amount the insurer would rationally pay to be relieved of the risk' and to a 'maximum amount'. As a result, the objective of the risk adjustment would be as follows:
  'The risk adjustment shall be the compensation the insurer requires to bear the risk that the ultimate cash flows could exceed those expected."
- to provide application guidance that this amount would reflect both favourable and unfavourable changes in the amount and timing of fulfilment cash flows.

The recognition of gain and loss at inception

A34. 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).

Unbundling

A35. The boards confirmed the proposal in the ED and DP that an insurer should account separately for embedded derivatives that are contained in a host insurance contract that is not closely related to the embedded derivative.

A36. The boards discussed whether non-insurance goods and services should be unbundled from an insurance contract in accordance with the principles for identifying separate performance obligations in the revenue recognition project, ie that:

a) An entity should account for a bundle of promised good or services as *one performance obligation* if the entity integrates those goods or services into a single item that the entity provides to the customer. (If this criterion is satisfied, the entity need not consider the criteria in b.).

b) An entity should account for a promised good or service as a *separate performance obligation* if:

   i. the pattern of transfer of the good or service is different from the pattern of transfer of other promised goods or services in the contract, and
   ii. the good or service has a distinct function.

c) A good or service has a distinct function if either:

   i. the entity regularly sells the good or service separately, or
   ii. the customer can use the good or service either on its own or together with resources that are readily available to the customer.

The boards indicated their intention to be consistent with the approach in the revenue recognition project, subject to considering whether the pattern of transfer criterion is needed in this context and to future decisions on allocation. The boards will consult the Insurance Working Group on the practicality of implementing the approach being developed.

A37. The boards tentatively decided that an insurer should unbundle explicit account balances that are credited with an explicit return that is based on the account balance.

The boards indicated that such an explicit account balance should be separated from an insurance contract using criteria based on those being developed in the revenue recognition project for identifying separate performance obligations. An insurer would not unbundle implicit account balances.

The boards will consider further whether an explicit account balance exists only when the policyholder can withdraw the account balance without loss of insurance coverage.

A38. The IASB tentatively decided that an insurer would account for an unbundled explicit account balance in accordance with the relevant requirements for financial instruments in IFRS, subject to future decisions on allocation. The FASB did not vote on this question. The boards requested the staff to consider how the decisions would apply to typical types of insurance contracts with account balances.

Short duration contracts

A39. The boards discussed whether a different approach should be used for the accounting in the pre-claims 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.

A40. The boards tentatively decided that:

(c) 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.

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

a) On the basis of time, but

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

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

2. 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. The FASB has yet to conclude on this issue.