STAFF PAPER

Insurance working group

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Insurance contracts	Reporting back on the cash flow decisions		
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This is only one change from the version posted on Thursday 6 October. The change is on page 11, in the illustrative drafting for paragraph 27(a). Text was mistakenly marked as deleted in the version posted yesterday ('is no longer required to provide coverage, or'), is *not* marked as deleted in the revised version here.

Introduction

1. This paper provides:

   (a) A feedback statement on the Board's tentative decisions on the cash flows to date, including an outline of significant matters raised with us and how we responded.

   (b) A working draft of how we propose to implement the boards' tentative decisions on the cash flows. This draft has been prepared by IASB staff and has not been reviewed by the Board. Official pronouncements of the IASB are published only after it has completed its full due process, including appropriate public consultation and formal voting procedures.

Next steps

2. In Agenda Paper 5 we consider the consequences of the boards’ decisions on contract boundary.

3. This paper does not include the following matters that the boards will consider in future meetings:

    (a) cash flows arising from discretionary participation features.

    (b) policyholder tax.

Question for working group members
Do you have any comments on the Board’s tentative decisions or the proposed drafting?

Feedback on the cash flow decisions

Introduction

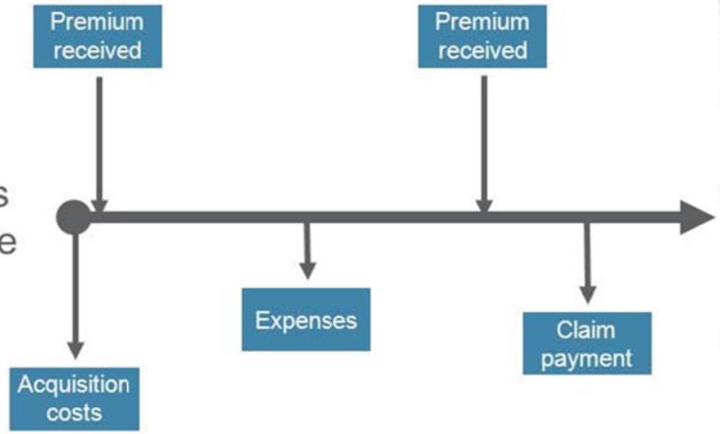
The IASB's exposure draft *Insurance Contracts* (the ED) proposed that an insurer should measure an insurance contract based on an explicit, unbiased and probability-weighted estimate of the future cash outflows less the future cash inflows that will arise as the insurer fulfils the insurance contract.

The cashflows required to fulfill a contract are those that occur between the recognition point and the contract boundary.

In the pages that follow we outline the more significant matters raised with us and how we responded.

Board's tentative decisions

Recognition point:
Contract starts when coverage period begins (may be after insurer is on risk)



Contract boundary:
Contract ends when:

- Not required to provide coverage
- Can reprice to reflect risks of policyholder
- In some cases, when insurer can reprice to reflect risk of portfolio

Included in cash flows:
All direct costs of *originating* and all directly attributable costs incurred in *fulfilling* a portfolio of insurance contracts

Recognition point

Proposal in the ED

The ED proposed that an insurer should recognise an insurance contract liability or an insurance contract assets at the earlier of:

(a) the date the insurer is bound by the terms of the insurance contract and

(b) when the insurer is first exposed to risk under the contract.

Respondents' comments

Most insurers disagreed with the recognition point proposed in the ED. They do not currently capture information about contracts until the contract term begins and believe it will be costly to capture this data.

Some insurers are concerned that movements in discount rates could result in a gain or loss on a contract before beginning of the coverage period of that contract when there has been no change in assumptions. Some question whether the benefits outweigh the operational costs.

Our response

We changed the recognition point, so that insurers recognise an insurance contract liability or an insurance contract asset at the beginning of the coverage period.

We introduced an onerous contract test in the pre-coverage period, to ensure that any significant liabilities would be captured.

Unbiased, probability-weighted estimate of cash flows needed to fulfil the contract

Proposal in the ED

The ED proposed that an insurer should measure an insurance contract liability on the basis of an explicit, unbiased and probability-weighted estimate of the future cash outflows (less the future cash inflows) that will arise as the insurer fulfils the insurance contract.

Respondents' comments

Most support the use of probability-weighted expected cash flows in principle. However, some are concerned that significant time and costs would be required to implement a full probability-weighted methodology with little to no difference or benefit compared to considering only a limited number of scenarios.

Some believe that the standard should clarify that the objective is to determine the statistical mean of the cash flows and to be explicit that a full stochastic approach or consideration of every remote scenario is not always required and that other methodologies to estimate the statistical mean may be used.

Insurers with non-life contracts raised the difficulty of calculating probability-weighted cash flows when the insured event is of low frequency and potentially high severity.

Our response

We confirmed the use of expected value but will emphasise in application guidance that:

- expected value refers to the mean that considers all relevant information; and
- not all possible scenarios need to be identified and quantified, provided that the estimate is consistent with the objective of determining the mean.

Overhead costs

Proposal in the ED	***Respondents' comments***	***Our response***
The ED stated that an insurer should not include general overhead costs in estimating the cash flows that will arise as the insurer fulfils an insurance contract	Some respondents stated that general overheads such as accounting, information technology and support, building rent, maintenance and utilities could relate directly to contract activities at a portfolio level, and that when they do, they should be included in the fulfilment cash flows. They argued that doing so would be consistent with the principle of fulfilment. A few respondents stated that consistent revenue and expense accounting across standards and across industries is important to improve comparability. Hence, they agreed with the exclusion of costs that do not directly relate to the contract or to contract activities, such as general overheads.	We confirmed that the costs included in the cash flows used in measuring a portfolio of insurance contracts should be all the costs that the insurer will incur in fulfilling the contracts, including: • costs that relate directly to the fulfilment of the contracts in the portfolio, such as payments to policyholders, claims handling, etc; • costs (including fixed and variable overheads) that are 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. We also confirmed 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.

Acquisition costs

Proposal in the ED

The ED proposed that an insurer should include the incremental acquisition costs for contracts issued as contractual cash flows in the initial measurement of the insurance liability.

Respondents' comments

Most of respondents that commented on this issue believe the definition of acquisition costs proposed in the ED was too narrow. Those respondents opposed its restriction to costs incremental at the contract level because this would exclude many of the costs of obtaining and underwriting new contracts. In particular, they note that the proposals would result in differences in deferred acquisition costs depending on an insurer's distribution system (that is, whether the insurer performs contract acquisition services in-house or sources it externally) and sales compensation plans.

Many argued that acquisition costs should be determined at the portfolio level, rather than at the contract level because the unit of account for most of the rest of the ED is the portfolio.

Some stated that the requirements in the recently issued FASB Accounting Standards Update No. 2010-26 *Accounting for Costs Associated with Acquiring or Renewing Insurance Contracts* (ASU 2010-26) should be incorporated in the standard.

Our response

The IASB and FASB came to different conclusions on this issue. In the IASB's view, both successful and unsuccessful costs are incurred in assembling a portfolio of insurance contracts. Therefore the IASB decided that an insurer should include in the fulfilment cash flows all the direct costs that the insurer will incur in acquiring the contracts in the portfolio. The FASB decided to limit the costs included in the fulfilment cash flows to those acquisition costs related to successful acquisition efforts.

Both boards also decided to exclude indirect costs such as:

- software dedicated to contract acquisition
- equipment maintenance and depreciation
- agent and sales staff recruiting and training
- administration
- rent and occupancy
- utilities
- other general overhead
- advertising.

Contract boundary

Proposal in the ED

The ED states that the boundary of an insurance contract would be the point at which an insurer either:

(a) is no longer required to provide coverage, or

(b) has the right or the practical ability to reassess the risk of the individual policyholder and, as a result, can set a price that fully reflects that risk.

Respondents' comments

Most agreed with the proposed contract boundary principle. However, some were concerned about how the contract boundary applies to contracts for which the pricing is assessed at the portfolio level so that future increases in expenses would be wholly covered by related future premiums. In those cases, some insurers believe that they have not conferred substantive rights on their policyholders when viewed at a portfolio level.

Some observe that the proposed contract boundary is different from the boundary proposed in Europe for Solvency II and that different boundaries would increase compliance costs.

Our response

We decided to amend the contract boundary so that the insurer is deemed not to confer substantive rights to the policyholder when it has the right or practical ability to reassess the price of a portfolio of contracts the contract belongs to and, as a result, can set a price that fully reflects the risk of that portfolio.

We discuss the consequences of these decisions in agenda paper 5.

Working draft

A working draft of the wording for the standard is as follows (changes from the ED are marked). This draft has been prepared by IASB staff and has not been reviewed by the Board. Official pronouncements of the IASB are published only after it has completed its full due process, including appropriate public consultation and formal voting procedures.

Recognition

13 **An insurer shall recognise an *insurance contract liability* or an *insurance contract asset* <u>at the beginning of the *coverage period*</u>. ~~when the insurer becomes a party to the insurance contract.~~**

14 <u>Before the beginning of the coverage period, an insurer shall recognise an insurance contract when facts and circumstances indicate that the portfolio of contracts is onerous. An insurer shall apply paragraphs 17-66 to measure contracts that are onerous.</u> ~~An insurer becomes a party to an insurance contract on the earlier of the following two dates:~~

~~(a) when the insurer is bound by the terms of the insurance contract, and~~

~~(b) when the insurer is first exposed to risk under the contract, which is when the insurer can no longer withdraw from its obligation to provide insurance coverage to the policyholder for insured events and no longer has the right to reassess the risk of the particular policyholder and, as a result, cannot set a price that fully reflects that risk.~~

[staff note: We intend to discuss the requirements for onerous contracts with the Boards at a future meeting and will insert a paragraph describing when an insurance contract is onerous in due course.]

15 An insurer shall not recognise as a liability or an asset any amounts relating to possible claims under future insurance contracts (such as the amounts described in some jurisdictions as catastrophe provisions or equalisation provisions). This [draft] IFRS does not prohibit an entity from presenting such amounts by appropriating retained earnings to reserves within equity. IAS 1 *Presentation of Financial Statements* requires an entity to describe the nature and purpose of each reserve within equity.

….

Present value of the fulfilment cash flows

22 The ~~following building blocks constitute the~~ present value of the fulfilment cash flows <u>comprises the following building blocks</u>:

(a) an explicit, unbiased and probability-weighted estimate (ie expected value) of the future cash outflows less the future cash inflows that will arise as the insurer fulfils the insurance contract (paragraphs 23–25);

(b) a discount rate that adjusts those cash flows for the time value of money (paragraphs 30–34); and

(c) an explicit estimate of the effects of uncertainty about the amount and timing of those future cash flows (risk adjustment—paragraphs 35–37).

Future cash flows

23 **Estimates of cash flows for a portfolio of insurance contracts shall include all ~~incremental~~ cash inflows and cash outflows that relate directly to the fulfilment of the contracts in ~~arising from~~ that portfolio, and shall:**

(a) be explicit (ie separate from estimates of discount rates that adjust those cash flows for the time value of money and the risk adjustment that adjusts those cash flows for the effects of uncertainty about the amount and timing of those future cash flows).

(b) reflect the perspective of the entity but, for market variables, be consistent with observable market prices.

(c) incorporate, in an unbiased way, all available information about the amount, timing and uncertainty of all cash flows that will arise as the insurer fulfils the insurance contract.

(d) be current (ie the estimates shall reflect all available information at the measurement date).

(e) include only those cash flows that arise from existing contracts (ie cash inflows and cash outflows that arise within the boundary of those contracts—see paragraphs 26 and 27).

24 At initial recognition, an insurer shall include in the measurement of the insurance contract an estimate of all cash flows that will arise as the insurer fulfils the insurance contract over the life of that contract. Some of those cash flows are received or paid on or before the day the insurance contract is initially recognised, for example initial premiums and ~~some incremental~~ direct acquisition costs (see paragraph 39(a)). Those cash flows result in a change in the carrying amount of the insurance contract liability on the day the insurance contract is initially recognised, but immediately after the moment of initial recognition.

[Staff note: we plan to consider in a future meeting the treatment of acquisition costs in the pre-coverage period.]

25 Appendix B provides guidance for estimating future cash flows (see paragraphs B37–B66).

Contract boundary

[Staff note: We will discuss the drafting of this section in agenda paper 5.]

26 The measurement of an insurance contract shall include premiums and other cash flows (eg claims and expenses) resulting from those premiums if, and only if:

(a) the insurer can compel the policyholder to pay the premiums, or

(b) the premiums are within the boundary of that contract.

27 The boundary of an insurance contract distinguishes the future cash flows that relate to the existing insurance

contract from those that relate to future insurance contracts. The boundary of an insurance contract is the point at which ~~an insurer~~ the contract no longer confers substantive rights on the policyholder. This occurs when ~~either:~~

(a) the insurer is no longer required to provide coverage; or

~~(b)~~ 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; or~~.~~ ~~In assessing whether it can set a price that fully reflects the risk, an insurer shall ignore restrictions that have no commercial substance (ie no discernible effect on the economics of the contract).~~

(b) if both of the following criteria are satisfied:

  (i) the insurer has the right or the practical ability to reassess the risk of the portfolio that contains the contract and, as a result, can set a price that fully reflects that risk of that portfolio; and

  (ii) the pricing of the premiums for coverage up to that date does not take into account risks relating to future periods.

27A An insurer shall determine the contract boundary considering all substantive rights held by the policyholder, whether arising from a contract, from law or from regulation. However, an insurer shall ignore restrictions that have no commercial substance (ie no discernible effect on the economics of the contract).

28 Many insurance contracts have features that enable policyholders to take actions that change the amount, timing, nature or uncertainty of the benefits they will receive. Such features include surrender options, conversion options and options to cease paying premiums but still receive some benefits. The measurement of insurance contracts shall reflect the future behaviour of policyholders on an expected value basis, with an adjustment for the risk that the actual behaviour of the policyholder may differ from the expected behaviour. For example, the measurement of an insurance contract:

(a) shall not assume that all policyholders surrender their contracts only because surrender would be unfavourable to the insurer.

(b) shall not assume that all policyholders continue their contracts only because continuation would be unfavourable to the insurer.

29 If options, forwards and guarantees do not relate to the insurance coverage under the existing insurance contract, they are not within the boundary of that contract. The insurer shall account for those features as new insurance contracts or other stand-alone instruments according to their nature.

Acquisition costs

39 At initial recognition, an insurer shall:

(a) include ~~*incremental*~~ *direct* *acquisition costs* in the present value of the fulfilment cash flows (see ~~also~~ paragraph B61(f)).

(b) recognise all acquisition costs other than those identified in (a) as an expense when incurred.

Application guidance

We propose to amend the application guidance on estimating the future cash flows as follows (changes from the ED are marked up).

Uncertainty and the expected present value approach

B38 The starting point for an estimate of cash flows is a range of scenarios that reflects the full range of possible outcomes. Each scenario specifies the amount and timing of the cash flows for a particular outcome, and the estimated probability of that outcome. The cash flows from each scenario are discounted and weighted by the estimated probability of that outcome in order to derive an expected present value. Thus, the aim is not to develop a single 'best' estimate of future cash flows, but~~, in principle,~~ to identify all possible scenarios and make unbiased estimates of the probability of each scenario. In some cases, an insurer has access to considerable data and may be able to develop those cash flow scenarios easily. But in other cases, the insurer may not be able to develop more than general statements about the variability of cash flows without incurring considerable cost. In those cases, the insurer shall use those general statements in estimating the future cash flows.

B39 When considering all possible scenarios, the objective is not necessarily to identify every possible scenario but rather to incorporate all relevant information and not simply ignore data or information that is difficult to obtain. In practice, it is not always necessary to develop explicit scenarios if the resulting estimate is consistent with the measurement objective of considering all relevant information in determining the mean. For example, if an insurer estimates that the probability distribution of outcomes is broadly consistent with a probability distribution that can be described completely with a small number of parameters, it will suffice to estimate those parameters. Similarly, in some cases, relatively simple modelling may give an answer within a tolerable range of precision, without the need for a large number of detailed simulations. However, in some cases, the cash flows may be driven by complex underlying factors and respond in a highly non-linear fashion to changes in economic conditions (eg if the cash flows reflect a series of interrelated implicit or explicit options). In such cases, more sophisticated stochastic modelling is likely to be needed, including the identification of scenarios that specify the amount and timing of the cash flows for particular outcomes and the estimated probability of those outcomes.

B40 The probability assigned to each scenario shall reflect conditions at the end of the reporting period. For example, there may be a 20 per cent probability at the end of the reporting period that a major storm will strike during the remaining six months of an insurance contract. After the end of the reporting period and before the financial statements are authorised for issue, a storm strikes. The present value of the fulfilment cash flows under that contract shall not reflect the storm that, with hindsight, is known to have occurred. Instead, the cash flows included in the measurement are multiplied by the 20 per cent probability that was apparent at the end of the reporting period (with appropriate disclosure, in accordance with IAS 10 *Events after the Reporting Period*, that a non-adjusting event occurred after the end of the reporting period ~~in accordance with IAS 10 *Events after the Reporting Period*~~).

B41 The scenarios developed shall include unbiased estimates of the probability of catastrophic losses under existing contracts. ~~However~~ Thus, the scenarios exclude possible claims under possible future contracts. For example, suppose there is a 5 per cent probability that an earthquake during the remaining coverage period of an existing contract will cause losses with a present value of CU1,000,000. In that case, the expected present value of the cash outflows includes CU50,000 (ie CU1,000,000 × 5 per cent) for those catastrophe losses. But the expected value of the cash outflows for that contract does not include the possible catastrophe losses from an earthquake that could happen after the end of the coverage period.

…

Which cash flows?

B61 Estimates of cash flows in a scenario shall include all cash flows within the boundary of an existing contract, assessed ~~that are incremental~~ at the level of a portfolio of insurance contracts, and no others. The c~~C~~ash ~~out~~flows ~~that are incremental to a portfolio of insurance contracts~~ shall include:

(a) ~~direct costs and systematic allocations of~~ costs that relate directly to the fulfilment of the insurance contracts in the portfolio. ~~or~~

(b) costs that are directly attributable to contract activity~~ies~~ as part of acquiring and fulfilling that portfolio of contracts and that can be allocated on a rational and consistent basis to the individual portfolio of insurance contracts.

(c) such other costs as are specifically chargeable to the policyholder under the terms of the contract.

B61A ~~Accordingly, the relevant cash flows~~ Costs that relate directly to the fulfilment of the insurance contracts in the portfolio include:

(a) premiums (including premium adjustments and instalment premiums) from policyholders and any additional cash flows that result from those premiums.

(b) payments to (or on behalf of) policyholders, including claims that have already been reported but have not yet been paid (ie reported claims), claims that have already been incurred but have not yet been reported (IBNR) and all future claims and other benefits under the existing contract.

(c) claim handling costs (ie the costs that the insurer will incur in processing and resolving claims under existing insurance contracts, including legal and adjuster's fees and internal costs of processing claim payments).

(d) the costs that the insurer will incur in providing contractual benefits that are paid in kind.

(e) cash flows that will result from options and guarantees embedded in the contract, to the extent those options and guarantees are not unbundled (see paragraph 12). When insurance contracts contain embedded options or guarantees, it is particularly important to consider the full range of scenarios.

(f) the direct ~~incremental~~ costs of acquiring a portfolio of insurance contracts, ie the costs of selling, underwriting and initiating ~~an~~ the insurance contracts in a portfolio, excluding those costs described in paragraph B62(d). ~~for those contracts that have been issued and that the insurer has incurred because it has issued that particular contract (i.e. the incremental acquisition costs).~~ ~~Thus, these costs are identified at the level of an individual insurance contract rather than at the level of a portfolio of insurance contracts.~~

(g) policy administration and maintenance costs, such as costs of premium billing and costs of handling policy changes (eg conversions and reinstatements). Such costs also include recurring commissions expected to be paid to intermediaries if a particular policyholder continues to pay the premiums specified in the insurance contract.

(h) transaction-based taxes (such as premium taxes, value added taxes and goods and services taxes) and levies (such as fire service levies and guarantee fund assessments) that arise directly from existing insurance contracts, or can be attributed to them on a reasonable and consistent basis.

(i) potential recoveries (such as salvage and subrogation) on future claims covered by existing insurance contracts and, to the extent they do not qualify for recognition as separate assets, potential recoveries on past claims.

(j) payments to current or future policyholders as a result of a contractual participation feature (including those features implied in the contract by regulatory or legal requirements) that provides policyholders with participation in the performance of a portfolio of insurance contracts or pool of assets.

B61B Costs that are directly attributable to contract activity include the labour and other costs of personnel directly engaged in fulfilling the portfolio of contracts, including supervisory personnel. They also include a systematic allocation of directly attributable fixed and variable overheads. These costs relate to contract activity and are not necessarily costs directly related to an individual insurance contract. Fixed overheads are those indirect costs of contract activity that remain relatively constant regardless of the volume of contract activity, such as accounting, human resources, information technology and support, building depreciation, rent and maintenance, and utilities. Variable overheads are those indirect costs that vary directly, or nearly directly, with the volume of contracts or contract activity, such as general overhead costs associated with servicing policyholders. Those fixed and variable overheads that cannot be directly attributed to the contract or contract activity are recognised as an expense in the period in which they are incurred.

B61C Some costs that arise from contract acquisition and contract fulfilment activity may relate to more than one portfolio. This is the case, for example, when one department services claims handling procedures for two or more portfolios. When the costs for each portfolio are not separately identifiable, an insurer shall allocate those costs on a rational and consistent basis to individual portfolios of insurance contracts. Even though such costs are allocations, they still relate directly to the fulfilment of the portfolio of insurance contracts.

B61D Contract activity costs are allocated to portfolios of insurance contracts using methods that are systematic and rational and that are applied consistently to all costs that have similar characteristics. This allocation is based on the normal activity of the insurer, ie the level of contract activity expected to be achieved on average over a number of periods under normal circumstances, taking into account any reduction in activity resulting from deliberate changes in strategy.

B62 The following cash flows shall not be considered in estimating the cash flows that will arise as the insurer fulfils a portfolio of ~~an~~ existing insurance contracts:

(a) investment returns. The investments are recognised, measured and presented separately. However, the measurement of a participating insurance liability is affected by the cash flows, if any, that depend on the investment returns.

(b) payments to and from reinsurers. Reinsurance assets are recognised, measured and presented separately.

(c) cash flows that may arise from future insurance contracts, ie cash flows that are outside the boundary of existing contracts (see paragraphs 26 and 27), or from options, forwards and guarantees that do not relate to the existing insurance contract. Nevertheless, estimates of cash flows from existing contracts are not performed on a run-off basis. In other words, those estimates do not incorporate changes in the cash flows from existing contracts that could take place if the insurer stopped issuing new contracts, unless the insurer actually stops issuing new contracts.

(d) acquisition costs other than ~~incremental~~ direct acquisition costs. Thus indirect costs such as software dedicated to contract acquisition, equipment manufacture and depreciation, agent and sales staff recruiting and training, administration, rent and occupancy, utilities, other general overhead and advertising costs associated with acquiring a portfolio of insurance contracts are not considered in estimating the cash flows that will arise as the insurer fulfils the portfolio of insurance contracts.

(e) cash flows arising from abnormal amounts of wasted labour or abnormal amounts of other resources used to fulfil the contract.

(f) costs that cannot be ~~do not relate~~ directly attributed to the contract or contract activity, ~~activities, such as general overheads~~ for example:

(i) any inefficiencies related to contract activities, such as under-absorption of costs if the work-force is not working at full capacity;

(ii) administrative overhead costs that do not contribute to acquiring or fulfilling the insurance contracts; and

(iii) product development and training costs.

(g) income tax payments and receipts. Such payments and receipts are recognised, measured and presented separately in accordance with IAS 12 *Income Taxes*.

(h) cash flows between different components of the reporting entity, such as between policyholder funds and shareholder funds.

(i) cash flows arising from components that are unbundled from the insurance contract (eg interest that the insurer expects to credit to policyholder account balances). See paragraphs 8 and 9.

~~B63 Some costs relate directly to insurance contracts or contract activities but are the result of activities that cover more than one portfolio (e.g. salaries of staff of a claims handling department working on more than one portfolio). An insurer shall allocate those costs, other than acquisition costs (see paragraph B61(f)), on a rational and consistent basis to individual portfolios of insurance contracts. Even though such costs are allocations, they are still incremental at the portfolio level. Costs that are not incremental at the portfolio (or lower) level because they do not relate directly to the insurance contract or contract activities, such as general overheads, are not allocated to portfolios and therefore are not included in the measurement of insurance contracts.~~

~~B64 In some cases an insurer incurs costs that in substance are the equivalent of cash outflows. For example, an insurer may own a workshop to repair cars for damages covered under an insurance contract. The cash flows include the depreciation of that workshop because it is a resource required to satisfy the insurer's obligation from its insurance contract.~~