Staff Paper

Contact(s)	**Andrea Pryde**	apryde@ifrs.org	+44 (0)20 7246 6491
	Jennifer Weiner	jweiner@fasb.org	+ 1 203-956-5305

Project **Insurance contracts**

Topic **Cover note**

What is this paper about?

1. This paper provides an overview of the papers for the meeting in the week commencing 19 September, together with a summary of the staff recommendation for the papers. We have two topics for this meeting: risk adjustment and disclosures. In addition, we report back on the FASB's discussions on their single margin approach in agenda paper 3A/73A *Report on FASB discussions of the single margin approach*.

2. The Appendix provides a summary of previous decisions taken by the boards and describes what is still to come.

Risk adjustment

3. The IASB's Exposure Draft *Insurance Contracts* (ED) includes the following three 'pillars' to ensure that a risk adjustment approach results in relevant and comparable information:

   a. the limitation of the techniques that an insurer may use to quantify the risk adjustment;

   b. a statement of the objective for the risk adjustment; and

c. the requirement to disclose the equivalent confidence level for a risk adjustment determined under the conditional tail expectation (CTE) or the cost of capital (CoC) techniques.

4. At this meeting, we propose to reconsider that approach:

    a. Agenda paper 3B/73B *Risk adjustment: Objective and confidence level disclosure* discusses: (a) wording refinements to the objective of the risk adjustment; and (b) an alternative disclosure requirement to the confidence level equivalent disclosure proposed in the 2010 Exposure Draft *Insurance Contracts* (the ED). In doing so, it draws parallels with the treatment of the risk premium in IFRS 13/ASC Topic 820 *Fair Value Measurement*.

    b. Agenda paper 3C/73C *Risk adjustment: Techniques and inputs* discusses whether the boards should restrict the range of available techniques for determining the risk adjustment.

5. We recommend that:

    a. the risk adjustment should be the ‘compensation the insurer requires for bearing the uncertainty inherent in the cash flows that arise as the insurer fulfils the insurance contract’. This is largely consistent with the objective of the risk premium in IFRS 13 and ASC 820, except that IFRS 13 and ASC 820 determine the risk adjustment using the risk aversion of a market participant whereas the insurance contracts standard would determine it using the risk aversion of the insurer; and

    b. The Board replaces the confidence level equivalent disclosure proposed in the IASB’s exposure draft with a requirement that, for the key inputs the insurer used to determine the risk adjustment, the insurer should:

        (i) provide quantitative disclosure of the range of values within which those inputs would lie if these inputs had been determined from a market participant perspective; or

        (ii) disclose that it believes those inputs do not differ from those of a market participant.

c. in line with the application of valuation techniques for Level 3 measurements in IFRS 13 *Fair Value Measurement*, the Board does not limit the range of available techniques and the related inputs to estimate the risk adjustment. Instead, the Board should resolve comparability issues that would arise as a result of the inherent subjectivity in the estimate of the risk adjustment by requiring an insurer to apply a technique that meets the objective of the risk adjustment and providing specific disclosures.

6. We also recommend that the application guidance should:

   a. clarify that:

      (i) the risk adjustment measures the compensation the insurer would require to make it indifferent between fulfilling the insurance contract liability and fulfilling an obligation to pay an amount equal to the expected present value of cash flows that would arise from the insurance contract;

      (ii) in estimating the risk adjustment, the insurer should consider both favourable and unfavourable outcomes in a way that reflects its degree of risk aversion;

      (iii) a risk averse insurer would place more weight on unfavourable outcomes than on favourable ones.

   b. retain the ED's list of characteristics (described in paragraph B72 of the ED) that a risk adjustment technique should exhibit if that technique meets the objective of the risk adjustment; and

   c. retains as examples the three techniques proposed in the ED (confidence levels, conditional tail expectation and cost of capital), together with the related application guidance.

Disclosures

7. Agenda paper 3D/74D *Disclosures* seeks the boards' views on improvements to the proposed disclosure requirements in the exposure draft *Insurance Contracts* (the ED). However, this paper does not address disclosure linked to presentation matters, including the reconciliation of contract assets and contract

liabilities. These will be considered in a future meeting, with future decisions on presentation.

8. The staff recommend retaining the proposed disclosures in paragraphs 90-97 of the ED, with changes as follows:

    a. not to retain the minimum disaggregation level for disclosures in paragraph 83-84 of the ED. The aggregation level of disclosures should be principle-based and may vary for different type of qualitative and quantitative disclosures.

    b. to retain the requirement to disclose information about methods and inputs used and add further guidance regarding disclosure of discount rate and yield curves. (However, as noted in paragraph 5.b, the staff propose amending the disclosure relating to the risk adjustment.)

    c. to retain the disclosure of effects of changes in inputs used to measure insurance contracts, but with more emphasis on quantitative information. Furthermore, to clarify that the disclosure would also apply to changes in methods and require an explanation of the reason for the change in methods, including the type of contracts affected.

    d. to delete the proposed requirement to disclose a measurement uncertainty analysis and to align (in due course) that disclosure with that for fair value measurements in IFRS 13 *Fair Value Measurement*, as appropriate.

    e. to require the maturity analysis based on expected maturities and remove the option to base maturity analysis on remaining contractual maturities. Furthermore, in context of time bands to require the insurer to disclose, at a minimum, the expected maturities on an annual basis for the first five years and in aggregate for maturities beyond five years.

Appendix: Progress report

The following table summarises the progress the boards have made and describes what is still to come.

	Topic	Tentative decisions	Open points
Building block 1 – Which cash flows?	Recognition point	• Recognise insurance contract assets and liabilities when the coverage period begins. • Onerous contract liability to be recognised in the pre-coverage period if management becomes aware of onerous contracts in the pre-coverage period. • A cedant should recognize a reinsurance asset: o when the reinsurance contract coverage period begins, if the reinsurance coverage is based on aggregate losses of the portfolio of underlying contracts covered by the reinsurance contract. o when the underlying contract is recognized, in all other cases.	• How to apply onerous contract test in pre-coverage period
	Contract boundary	• Contract renewals should be treated as a new contract: (a) when the insurer is no longer required to provide coverage; or (b) when the existing contract does not confer any substantive rights on the policyholder. • 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. • In addition, for contracts for which the pricing of the premiums does not include risks relating to future periods, a contract does not	Follow up on contract boundary, including review of drafting in light of feedback received.

	Topic	Tentative decisions	Open points
		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. • All renewal rights should be considered in determining the contract boundary whether arising from a contract, from law or from regulation.	
	Fulfilment cash flows – objective	Expected value, with 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 measurement objective of determining the mean.	

	Fulfilment cash flows – which cash flows	• Include all costs that the insurer will incur directly in fulfilling the contracts in that portfolio, ie:
		    o costs that relate directly to the fulfilment of the contracts in the portfolio;
		    o 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
		    o such other costs as are specifically chargeable to the policyholder under the terms of the contract.
		• Exclude costs that do not relate directly to the insurance contracts or contract activities, which should be recognised as expenses in the period in which they are incurred.
			Treatment of taxes paid on behalf of policyholders

	Topic	Tentative decisions	Open points
	Acquisition costs	Include in fulfillment cash flows all the direct costs that the insurer will incur in acquiring the contracts in the portfolio, and 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. FASB: additionally limit the costs to those related to successful acquisition efforts.	
Building block 2 – Time value of money	Discounting	• Objective is to adjust the future cash flows for the time value of money and to reflect the characteristics of the insurance contract liability • Current rate that is updated each reporting period • Not required when the effect of discounting would be immaterial.	
	Discount rate	• No prescribed method to determining the discount rate, but rate should: o 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; o 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	*To be addressed at this meeting* • Disclosure of yield curve

	Topic	Tentative decisions	Open points
		which the market prices are observed, such as any investment risk taken by the insurer that cannot be passed to the policyholder); and o reflect only the effect of risks and uncertainties that are not reflected elsewhere in the measurement of the insurance contract liability. • 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 (ie for participating contracts), the insurer should adjust those cash flows using a discount rate that reflects that dependence. In some cases, the insurer determines the yield curve for the insurance contract liability based on a yield curve that reflects current market returns for either 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. In doing so, the insurer excludes from those rates factors that are not relevant to the insurance contract liability (a 'top-down' approach). In a 'top down' approach: • 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. • 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.	

	Topic	Tentative decisions	Open points
		• to determine the yield curve, 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: o Type I, which adjust for differences between the timing of the cash flows to ensure that the durations of the assets in the portfolio (actual or reference) selected as a starting point are matched with the duration of the liability cash flows. o 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 those risks, the entity uses an appropriate technique to determine that market risk premium, consistent with the objective for the discount rate, as stated above. • 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.	

	Topic	Tentative decisions	Open points
Building block 3 – Risk adjustment	Risk adjustment	• IASB: measurement of an insurance contract should include an explicit adjustment for risk, which represents the compensation the insurer requires to bear the risk that the ultimate cash flows could exceed those expected. The adjustment would be determined independently from the premium and would be re-measured in each reporting period. • FASB: measurement of an insurance contract should use a single margin approach that recognises profit as the insurer satisfies its performance obligation to stand ready to compensate the policyholder in the event of an occurrence of a specified uncertain future event that adversely affects that policyholder.	*To be addressed at this meeting* • Techniques • Disclosures *For future meetings* • Level of aggregation (including diversification benefits) • FASB: inclusion of an onerous contract test. • Whether the two approaches could be made comparable through disclosures

	Topic	Tentative decisions	Open points
Building block 4 – Residual margin	Residual / composite margin	• No gain at inception of an insurance contract. • Any loss on day one recognised immediately when it occurs, in profit or loss (net income). *For residual margin (IASB only)* • Unlocked (prospectively) for changes in estimates of future cash flows • Changes in risk adjustment recognised in profit or loss in the period of the change • Residual margin allocated over the coverage period on a systematic basis that is consistent with the pattern of transfer of services provided under the contract *For single margin (FASB only):* • An insurer satisfies its performance obligation as it is released from exposure to risk as evidenced by a reduction in the variability of cash outflows. • An insurer should not remeasure or recalibrate the single margin to recapture previously recognised margin.	*At this meeting - for single margin (FASB only):* • Report back on FASB's single margin approach *For future meetings - for residual margin (IASB only)* • Whether to unlock the residual margin for changes in discount rate • Level of aggregation
Application guidance for building blocks	Participating features	• Objective of the discount rate used to measure participating insurance contracts should be consistent with the objective for the discount rate used to measure non-participating insurance contracts. • 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. • IASB: • The measurement of the fulfilment cash flows relating to the policyholder's participation should be based on the measurement	• Whether proposed measurement creates a need for any specific disclosures • FASB: whether to address accounting mismatches by adjusting the measurement of the items that a policyholder participates in

	Topic	Tentative decisions	Open points
		in the IFRS financial statements of the underlying items in which the policyholder participates. Such items could be assets and liabilities, the performance of an underlying pool of insurance contracts or the performance of the entity. • An insurer should reflect, using a current measurement basis, any asymmetric risk-sharing between insurer and policyholder in the contractually linked items arising from, for example, a minimum guarantee. • An insurer should present changes in the insurance contract liability in the statement of comprehensive income consistently with the presentation of changes in the linked items (ie in profit or loss, or in other comprehensive income). • The same measurement approach should apply to both unit-linked and participating contracts. • The insurer may recognise and measure treasury shares and owner – occupied property at fair value through profit or loss. • FASB: measurement of the liability should reflect the expected present value of the cash flows, discounted at current rates, using the contractual measurement basis for the underlying items in which the policyholder participates.	
	Short duration contracts	• [IASB only] An insurer should deduct from the pre-claims obligation measurement the acquisition costs that the IASB would include in the measurement of the insurance contract liability under the building block approach. • The insurer shall reduce the measurement of the pre-claims obligations over the coverage period as follows: o On the basis of time, but o On the basis of the expected timing of incurred claims and	• Objective for specifying a premium allocation approach • Criteria for eligibility • Simplifications or exceptions in a premium allocation approach • Whether the premium

	Topic	Tentative decisions	Open points
		benefits if that pattern differs significantly from the passage of time. • An insurer should perform an onerous contract test if facts and circumstances indicate that the contract has become onerous in the pre-claims period.	allocation approach should be permitted or required • Whether to provide guidance on when the effect of the time value would be immaterial for a short-tail claim • Presentation
	Reinsurance	• [IASB only] The ceded portion of the risk adjustment should represent the risk being removed through the use of reinsurance. • If the present value of the fulfillment cash flows (including the risk adjustment for the IASB) for the reinsurance contract is: a) Less than zero and the coverage provided by the reinsurance contract is for future events, the cedant should establish that amount as part of the reinsurance recoverable, representing a prepaid reinsurance premium and should recognise the cost over the coverage period of the underlying insurance contracts. b) Less than zero and the coverage provided by the reinsurance contract is for past events, the cedant should recognise the loss immediately. c) Greater than zero, the cedant should recognise a reinsurance residual [IASB] / composite margin [FASB]. • The cedant should estimate the present value of the fulfillment cash flow for the reinsurance contract, including the ceded premium and without reference to the residual/composite margin on the underlying contracts, in the same manner as the corresponding part of the present value of the fulfillment cash flows for the underlying	• Presentation • Interaction with requirements for short-duration contracts • Interaction with other requirements in standard

	Topic	Tentative decisions	Open points
		insurance contract or contracts, after remeasuring the underlying insurance contracts on initial recognition of the reinsurance contract. • When considering non-performance by the reinsurer: a) The cedant shall apply the impairment model for financial instruments when determining the recoverability of the reinsurance asset. b) The assessment of risk of non-performance by the reinsurer should consider all facts and circumstances, including collateral. c) Losses from disputes should be reflected in the measurement of the recoverable when there is an indication that current information and events suggest the cedant may be unable to collect amounts due according to the contractual terms of the reinsurance contract.	
Definition and scope and unbundling	Definition	• Confirm proposed definition in the ED and DP, together with the guidance 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. • If a reinsurance contract does not transfer significant insurance risk because the assuming company is not exposed to a loss, the reinsurance contract is nevertheless deemed to transfer significant insurance risk if substantially all of the insurance risk relating to the	

	Topic	Tentative decisions	Open points
		reinsured portions of the underlying insurance contracts is assumed by the reinsurer. • An insurer should assess the significance of insurance risk at the individual contract level. Contracts entered into simultaneously with a single counterparty for the same risk, or contracts that are otherwise interdependent should be considered a single contract for the purpose of determining risk transfer.	
	Scope	• Exclude from the scope of the insurance contracts standard some fixed–fee service contracts which have as their primary purpose the provision of services. • IASB: Financial guarantee contracts (as defined in IFRSs) would not be in the scope of the insurance contracts standard as proposed in the ED. Instead: (a) an issuer of a financial guarantee contract (as defined in IFRSs) is permitted to account for the contract as an insurance contract if the issuer had previously asserted that it regards such contracts as insurance contracts; and (b) an issuer of a financial guarantee contract (as defined in IFRSs) is required in accordance with to apply the financial instruments standards to these contracts in all other cases. • Confirmed all the other scope exceptions proposed in the ED	• How to identify fixed-fee service contracts which have as their primary purpose the provision of services • Investment contracts with discretionary participation features • FASB: which financial guarantee arrangements, if any, should be within the scope of the insurance contracts standard.
	Unbundling	• An insurer should account separately for **embedded derivatives** contained in a host insurance contract that is not closely related to the embedded derivative. • An entity should account for a good or service and insurance coverage bundled in an insurance contract as a single performance obligation if the entity integrates that good or service with the insurance coverage into a single item that the entity provides to the	• Issues related to contract riders • Allocation of expenses to unbundled components • Whether to permit unbundling where not required

<table>
<tr><th></th><th>Topic</th><th>Tentative decisions</th><th>Open points</th></tr>
<tr><td></td><td></td><td>customer. (If this criterion is satisfied, the entity need not consider the further criteria set out below).
• When a good or service is bundled with insurance coverage in an insurance contract and the entity does not integrate that good or service with the insurance coverage into a single item the entity provides to the customer, the entity should account for the promised good or service as a separate performance obligation if:
(a) 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
(b) the good or service has a distinct function.
• 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.
An insurer should unbundle explicit account balances that are credited with an explicit return applied to the account balance. Such an explicit account balance should be separated from the 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.
[IASB only] 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.</td><td>• How the decisions would apply to typical types of insurance contracts with account balances.
• Whether to combine separate contracts in some circumstances</td></tr>
</table>

Presentation and disclosure	Presentation	The boards indicated a preference for the model which presents the underwriting results of contracts measured under the building-block approach separately from contracts measured using the modified approach and includes volume information.	• Whether to require an insurer to present each of the line items in all cases on the statement of comprehensive income, rather than in the notes • Whether some changes in the insurance liability should be presented in other comprehensive income.
	Disclosures		• Address detailed issues raised
	Transition and effective date		• Consider how to approximate residual /composite margin on transition • Determine effective date