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Project **Insurance Contracts**

Topic **Cover note**

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## Agenda papers for this meeting

1. We have prepared the following agenda papers for the May joint meeting:

Agenda Paper No. / (FASB Memorandum)	Title
2 (45)	Cover note
2A (45A)	Risk adjustment versus composite margin
2B (45B)	Risk adjustments
2C (45C)	Composite margins
2D (45D)	Level of measurement
2E (45E)	Follow-up on Unbundling
2F (45F)	Unbundling example
2G (45G)	Scope- financial guarantee contracts
2H (45H)	Scope- fixed-fee service contracts
2I (45I)	Follow-up on Disclosures

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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.

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## Objective of the meeting

2. Staff has several meetings scheduled for the insurance project at the May joint meetings. We will discuss those topics in the following sequence:
3. **Monday, May 17<sup>th</sup>**. Agenda papers 2A through 2D (FASB Memoranda 45A through 45D) deal with the topic of margins. Based on these papers, we ask the boards to make a choice between the approach with a separate risk adjustment plus residual margin and a composite margin approach and, where necessary, also ask the boards to agree on some aspects of those approaches.

At this meeting, we will also deal with agenda papers 2E and 2F (FASB Memorandum 45E and 45F) on unbundling.

4. **Tuesday, May 18<sup>th</sup>**. Agenda papers 2G and 2H (FASB Memorandum 45G and 45H) on scope.
5. **Wednesday, May 19<sup>th</sup>**. Agenda paper 2I (FASB Memorandum 45I) on disclosures.

## Tentative decisions to date

6. The appendix to this paper gives an overview of the boards' previous discussions.
7. The table in the appendix shows one single decision for those issues on which the boards reached a similar tentative conclusion. If the boards reached different tentative conclusions or one of the boards has an outstanding discussion for a particular topic, a status update is presented for each Board separately.

Appendix: Overview of topics discussed at previous meetings

Topic	IASB	FASB
Definition	<p>The boards tentatively decided to use the current definition of an insurance contract in IFRS 4 <i>Insurance Contracts</i> and the related guidance in Appendix B of IFRS 4. Specifically:</p> <ul style="list-style-type: none"> <li>• that compensation rather than indemnification be used in the definition of an insurance contract in describing the benefit provided to the policyholder;</li> <li>• that the guidance in IFRS 4 be used in determining whether insurance risk is significant, subject to matters discussed below.</li> </ul>	
Definition-timing risk	<p>On timing risk, the boards decided tentatively:</p> <ul style="list-style-type: none"> <li>• to change the factors considered in evaluating the significance of insurance risk from absolute amounts to present values; and</li> <li>• to amend the guidance in IFRS 4 to explain that contractual terms that delay timely reimbursement to the policyholder can significantly reduce insurance risk, so that some contracts containing such terms might not meet the definition of an insurance contract.</li> </ul>	
Definition-assessment of possible outcomes	<p>For determining when insurance risk exists, the IASB expressed an initial preference for considering the range of possible outcomes.</p>	<p>For determining when insurance risk exists, the FASB expressed an initial preference for considering whether there are outcomes in which the present value of the net cash outflows can exceed the present value of the premiums.</p>

**Staff paper**

<p>Scope</p>	<p>The boards tentatively decided that the scope of a standard on insurance contracts will exclude:</p> <ul style="list-style-type: none"> <li>• warranties issued directly by a manufacturer, dealer or retailer;</li> <li>• residual value guarantees embedded in a lease;</li> <li>• residual value guarantees provided by a manufacturer, dealer or retailer;</li> <li>• employers' assets and liabilities under employee benefit plans and retirement benefit obligations reported by defined benefit retirement plans; and</li> <li>• contingent consideration payable or receivable in a business combination.</li> </ul> <p>The boards expressed an initial preference that the scope of the standard should exclude fixed-fee service contracts, but noted that it would be undesirable to exclude contracts merely because they pay benefits in kind rather than in cash. The boards will consider this initial preference at a future meeting at which they will they discuss whether to include health contracts within the scope of the standard.</p> <p>The boards will also discuss at a future meeting whether financial guarantee contracts should be within the scope of the standard.</p>	
<p>Recognition</p>	<p>The boards decided tentatively that an insurer should recognise an insurance obligation at the earlier of</p> <ul style="list-style-type: none"> <li>• the entity being <i>on risk</i> to provide coverage to the policyholder for insured events, and</li> <li>• the signing of the insurance contract.</li> </ul>	
<p>Derecognition</p>	<p>The IASB discussed derecognition of insurance liabilities and decided tentatively that that an insurer should derecognise an insurance liability when it no longer qualifies as a liability of the insurer, applying the derecognition principle in IAS 39 <i>Financial Instruments: Recognition and Measurement</i>.</p>	<p>The FASB tentatively decided on a principle that an insurance liability should be derecognized by an entity when that obligation no longer qualifies as a liability. The liability is eliminated when the entity is no longer on risk and no longer required to transfer any economic resources for that obligation.</p>

**Staff paper**

<p>Measurement approach</p>	<p>The boards decided tentatively that the measurement approach should portray a current assessment of the contract, using the following building blocks:</p> <ul style="list-style-type: none"> <li>• the unbiased, probability-weighted average of future cash flows expected to arise as the insurer fulfils the obligation;</li> <li>• incorporation of time value of money;</li> <li>• a margin. [The IASB and FASB reached different tentative positions on margins during the March joint meeting and seek to reach a consistent answer at the May meeting].</li> </ul> <p>The boards also tentatively decided that:</p> <ul style="list-style-type: none"> <li>• the building blocks should be used to measure the combination of rights and obligations arising from an insurance contract rather than to measure the rights separately from the obligations. That combination of rights and obligations should be presented on a net basis.</li> <li>• the objective for measuring an insurance contract should refer to a value rather than cost. The staff will refine the description of that objective.</li> </ul>	
<p>Measurement approach-decomposition of margins</p>	<p>The IASB decided tentatively that the measurement of an insurance contract should include:</p> <ul style="list-style-type: none"> <li>• a risk adjustment for the effects of uncertainty about the amount and timing of future cash flows; and</li> <li>• an amount that eliminates any gain at inception of the contract (residual margin).</li> </ul> <p>The IASB decided tentatively that the risk adjustment should be the amount the insurer would rationally pay to be relieved of the risk.</p>	<p>The FASB tentatively decided that the measurement of an insurance contract should include a single composite margin.</p>

**Staff paper**

<p>Measurement at inception</p>	<p>The boards decided that:</p> <ul style="list-style-type: none"> <li>• the initial recognition of an insurance contract should not result in the recognition of an accounting profit.</li> <li>• if the initial recognition of an insurance contract results in a loss, the insurer should recognise that loss in profit or loss at inception. The residual margin or composite margin cannot be negative.</li> </ul> <p>For this purpose, a day-one loss exists only if:</p> <ul style="list-style-type: none"> <li>• (risk adjustment approach) at inception, the expected present value of the outflows plus the risk adjustment exceeds the expected present value of the premiums.</li> <li>• (composite margin approach) at inception, the expected present value of the outflows exceeds the expected present value of the premiums. In other words, no separate risk adjustment would be included in determining whether there is a day-one loss under a composite margin approach.</li> </ul>	
<p>Acquisition costs</p>	<p>The IASB decided tentatively to exclude from the initial measurement of the residual margin an amount equal to the incremental acquisition costs. The staff will investigate whether that tentative decision is best implemented by:</p> <ul style="list-style-type: none"> <li>• excluding the acquisition costs from the premium to which the contract liability is calibrated; or</li> <li>• including the acquisition costs in the contract cash flows at the inception of the contract.</li> </ul>	<p>The FASB decided tentatively that an insurer should:</p> <ul style="list-style-type: none"> <li>• expense all acquisition costs when incurred.</li> <li>• not recognize any revenue (or income) to offset those costs incurred.</li> </ul>

**Staff paper**

<p>Subsequent treatment margins</p>	<p>The boards decided tentatively that, if the measurement of an insurance contract were to include a separate risk adjustment and residual margin:</p> <ul style="list-style-type: none"> <li>• the risk adjustment should be updated (remeasured) each reporting period.</li> <li>• the insurer should release the residual margin over the coverage period in a systematic way that best reflects the exposure from providing insurance coverage, as follows: <ul style="list-style-type: none"> <li>• on the basis of passage of time; but</li> <li>• if the insurer expects to incur benefits and claims in a pattern that differs significantly from passage of time, the residual margin should be released on the basis of the expected benefits and claims.</li> </ul> </li> </ul> <p>The boards also decided tentatively that the insurer should not adjust the residual margin in subsequent reporting periods for changes in estimates.</p> <p>The boards decided tentatively that, if the measurement of an insurance contract were to include a single composite margin, that margin should be released over both the coverage period (during which the insurer provides insurance coverage) and the claims handling period (during which the insurer is expected to pay claims).</p>	
<p>Interest accretion for residual and composite margins</p>	<p>The IASB decided tentatively that interest should be accreted to the residual and composite margin.</p>	<p>The FASB decided tentatively that interest should not be accreted to the residual and composite margin.</p>
<p>Classification and disclosure of residual and composite margins</p>	<p>The boards decided tentatively that both residual and composite margins should be part of the insurance liability, rather than a separate liability outside the insurance liability. The boards also tentatively decided that the residual margin should be disclosed separately.</p>	

**Staff paper**

Discount rates	<p>The boards decided tentatively that the discount rate should reflect the characteristics of the contracts, rather than the characteristics of assets actually held to back the contracts, unless the contracts share those characteristics. More specifically:</p> <ul style="list-style-type: none"> <li>• if the cash flows for the insurance contracts do not depend on the performance of specific assets, the discount rate should be a risk-free rate plus an adjustment for illiquidity.</li> <li>• if the amount, timing or uncertainty of cash flows for the insurance contracts depends, wholly or partly, on the performance of specific assets, the measurement of these contracts should consider that fact</li> </ul> <p>Other discussion points on the discount rate:</p> <ul style="list-style-type: none"> <li>• The boards asked the staff to incorporate the existing requirements on discount rates from other standards when developing guidance for estimating a discount rate for insurance contracts. For example, the guidance should specify that the discount rate should not include any risk that is included in other parts of the measurement.</li> <li>• During the discussion the boards considered concerns raised by some commentators about the discount rate, particularly for long-duration non-participating insurance contracts. Those concerns include the possibility of significant losses at the inception of some contracts and possible accounting mismatches if the discount rate for insurance contracts does not change in response to changes in market credit spreads.</li> <li>• The boards discussed whether these concerns would diminish if the boards revisited their previous tentative decision that the measurement of an insurance liability should not be updated for changes in the risk of non-performance by the insurer. After the discussion, the boards did not change that tentative decision but they decided that the forthcoming exposure draft on Insurance Contracts should ask for specific input on this issue</li> </ul>	
Exclude discounting and margins in some instances?	<p>The IASB noted the arguments for and against an approach that uses an estimate of future cash flows with no margins and no discounting. The IASB considered whether to use such an approach for non-life claims liabilities and tentatively decided not to add it to the list of candidates.</p>	<p>The FASB will consider at a future meeting whether, in certain instances, a measurement of insurance contracts would use future cash flows with no margins and no discounting.</p>



**Staff paper**

Participating features in insurance contracts	The IASB tentatively decided that payments arising from the participating feature should be included in the measurement of insurance contracts in the same way as any other contractual cash flows (ie on an expected present value basis).	The FASB decided tentatively that the insurer should recognise a liability for participating benefits to the extent that it has a legal or constructive obligation to pay those benefits.
Non-performance risk	The boards decided tentatively that the measurement of an insurance liability should not be updated for changes in the risk of non-performance by the insurer.	
Use of inputs	<p>The boards decided tentatively that the measurement should:</p> <ul style="list-style-type: none"> <li>• consider all available information that relates to the fulfilment of the insurance contract. Available information includes, but is not limited to, industry data, historical data of an entity's costs, and market inputs when those inputs are relevant to the fulfilment of the contract, and</li> <li>• should use current estimates of financial market variables that are as consistent as possible with observable market prices.</li> </ul>	
Unearned Premium	<p>The IASB decided tentatively that:</p> <ul style="list-style-type: none"> <li>• an unearned premium approach would provide decision-useful information about pre-claims liabilities of short-duration insurance contracts.</li> <li>• to require rather than permit the use of an unearned premium approach for those liabilities.</li> </ul>	The FASB will discuss an unearned premium approach at a future meeting.

**Staff paper**

<p>Policyholder behaviour</p>	<p>The boards decided tentatively that the policyholder options, as well as options, forwards, and guarantees related to existing coverage, should be included in the measurement of the insurance contract on a look through basis using the expected value of future cash flows (to the extent that those options are within the boundary of the existing contract). As a consequence, no deposit floor would apply.</p> <p>The boards also discussed how to treat options, forwards, and guarantees that do not relate to the existing insurance contract coverage. The boards tentatively decided to exclude such features from the measurement of that contract. Instead, those features should be recognised and measured as new insurance contracts or other stand-alone instruments, according to their nature.</p>
<p>Contract boundary</p>	<p>The boards tentatively decided that the boundary of an insurance contract is the point at which the insurer either:</p> <ul style="list-style-type: none"> <li>• is no longer required to provide coverage; or</li> <li>• has the right to reassess the risk of the particular policyholder and, as a result, can set a price that fully reflects that risk.</li> </ul>
<p>Assets associated with unit-linked contracts</p>	<p>The boards decided tentatively that assets and related liabilities associated with unit-linked contracts, including those sometimes described as separate accounts, should be reported as the insurer's assets and liabilities in the statement of financial position.</p> <p>The boards also decided tentatively not to address in this project issues involving the consolidation of investment funds associated with unit-linked contracts (including separate account contracts). Such issues are within the scope of the project on consolidation.</p>
<p>Presentation of the performance statement</p>	<p>The boards decided tentatively that:</p> <ul style="list-style-type: none"> <li>• the measurement approach should drive the presentation model for the performance statement.</li> <li>• the staff should develop further an expanded margin approach.</li> </ul>
<p>Other comprehensive income (OCI)</p>	<p>The boards decided tentatively:</p> <ul style="list-style-type: none"> <li>• not to change the accounting for an insurer's assets.</li> <li>• not to permit or require the use of OCI for insurance contracts.</li> </ul>