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International Accounting Standards Board

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These notes are based on the staff papers prepared for the IASB. Paragraph numbers correspond to paragraph numbers used in the IASB papers. However, because these notes are less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

Board Meeting: **26 April 2006, London**

Project: **Insurance contracts (phase II)**
This note covers agenda papers 7 and 7A

AGENDA PAPER 7
OVERVIEW OF PAPERS FOR THIS MEETING

Objective

1. At this meeting, the staff will ask the Board to discuss:

   (a) Measurement attribute (agenda paper 7A)

   (b) Unit of account (agenda paper 7B)

   (c) Unbundling (agenda paper 7C)

   (d) Universal life contracts (agenda paper 7D)

   (e) Unit-linked and index-linked payments (agenda paper 7E)

   (f) Profit margins (agenda paper 7F)

   (g) Credit characteristics of insurance liabilities (agenda paper 7G)

Background

2. Since restarting phase II of this project, as well as various educational sessions, the Board has held five decision-making sessions. These covered:

   (a) the project plan (January 2005).

(b) non-life insurance contracts (May 2005). The Board decided tentatively to pursue two approaches in parallel for the time being (an unearned premium approach and a prospective approach). The Board subsequently decided (February 2006) to work only on prospective approaches (current entry value and current exit value).

(c) life insurance contracts (December 2005). The Board decided to focus on current value approaches (current entry value and current exit value).

(d) components of the current value approaches (February 2006). The Board decided, in summary:

(i) When an insurer recognises rights and obligations arising under an insurance contract, it should also recognise as an asset the portion of the customer relationship (relationship with the policyholder) that relates to future payments that the policyholder must make to retain a right to guaranteed insurability.

(ii) Acquisition costs should not be deferred and presented as if they were an asset. In a current entry value model, the initial measurement of the liability is calibrated to the initial premium received, less any acquisition costs already recovered from that premium.

(iii) A liability adequacy test is needed in a current entry value approach at inception, and perhaps subsequently (but is redundant in a current exit value approach). The margin should be consistent with the margin that would be included in current exit value.

(e) Further components of the current value approaches (March 2006). The Board decided, in summary:

(f) Policyholder participation rights do not create a liability until the insurer has an unconditional obligation that compels the insurer to transfer economic benefits to policyholders, current or future. More specifically:

(i) If participating policyholders have a prior claim on distributions of economic benefits generated by a pool of contracts and related assets, that fact does not, by itself, oblige the insurer to transfer those benefits to policyholders. Therefore, an insurer should not recognise that prior claim as a liability, unless some other factor creates an obligation.

(ii) A dividend scale approved by the regulator creates an obligation. The staff will investigate whether the insurer should measure that obligation using the dividend scale currently in force, or develop estimates of the dividend scale that would apply in each cash flow scenario.

(iii) To the extent that no unconditional obligation exists, an insurer should not recognise a liability in respect of expected transfers of economic benefits to policyholders. If an unconditional obligation comes into existence subsequently, the insurer should recognise the resulting liability and an expense at that time.

(iv) In assessing whether an insurer has a constructive obligation to pay dividends to participating policyholders, the Board will rely on the definitions being developed in its conceptual framework and IAS 37 projects. The Board decided in February 2006 that an equitable or constructive obligation can be a liability only if it legally or equivalently compels potential outflows of cash or other economic resources.

(v) Policyholder participation rights should not be regarded as the equity component of a hybrid contract (similar to convertible debt). Accordingly, no part of the premium should be regarded as proceeds received for issuing an equity instrument, dividends to participating policyholders are an expense, not a distribution of profit and the face of the income statement need not distinguish profit or loss attributable to equity holders of the insurer and profit or loss subject to prior claims of policyholders. However, the insurer should disclose the fact that part of its equity is subject to those prior claims.

(vi) Identical requirements should apply to shareholder-owned insurers and mutuals.

(vii) Participation rights in investment contracts should be treated in the same way as participation rights in insurance contracts.

(g) Board members suggested refinements to an early version of material for the Discussion Paper, dealing with estimating future cash flows.

(h) The objective of a risk margin is to convey decision-useful information to users about the uncertainty associated with future cash flows. A risk margin will satisfy that objective best if it is consistent with an unbiased estimate of the compensation that market participants would demand for bearing the risk in question. The Board does not intend to prescribe specific techniques for developing risk margins, but will explain in the Discussion Paper (and ultimately in an IFRS) the characteristics of

techniques that will enable risk margins to meet the objective. The Board did not object to the staff's recommendations on those characteristics.

(i) The objective of discount rates is to adjust estimated future cash flows for the time value of money. The discount rate should be consistent with observable market prices for cash flows whose characteristics match those of the insurance liability in terms of timing, currency and liquidity. The observed discount rate should be adjusted to exclude any factors that influence the observed rate but are not relevant to the liability (for example, risks that are not present in the liability but are present in the instrument used as a benchmark).

(j) An insurer should recognise rights and obligations created by an insurance contract when it becomes a party to the contract. An insurer derecognise an insurance liability (or a part of an insurance liability) when, and only when, it is extinguished—ie when the obligation specified in the contract is discharged or cancelled or expires.

Confirmation of an item discussed in March – extent of guidance on discount rates

3. When the Board discussed the material on discount rates in March, the staff forgot to ask explicitly whether the Board agreed with the following recommendations in agenda paper 7G, paragraph 5. 'The Board should not develop guidance in this project on the following topics:

(a) How to determine a discount rate for maturities beyond the term of instruments traded in observable markets. This may be an issue for emerging markets, but it may also be a problem to a lesser extent in more developed markets.

(b) How to develop interest rates for currencies in which there is little or no market in risk-free instruments.'

4. **Does the Board agree with this recommendation?**

Further background

5. If Board Members need more background, they may find the following material useful, although we will not refer to it at this meeting:

(a) More detailed descriptions of the current entry value and current exit value approaches (February 2006, agenda papers 10D and 10E)

(b) Illustrations of possible accounting approaches for life insurance contracts (December 2005, agenda paper 9C) and explanations of those illustrations (agenda paper 9D).

(c) Illustrations of possible accounting approaches for non-life insurance contracts (May 2005, agenda paper 4E) and explanations of those illustrations (agenda paper 4D).

(d) Summary of Phase II principles suggested in July 2005 by insurers (December 2005, agenda paper 9F)

Timetable

Topic and brief summary of content	**IASB meeting**
Reinsurance ceded How should a cedant measure its rights under a reinsurance contract? Does the answer have implications for policyholder accounting? (We do not plan to address policyholder accounting in the Discussion Paper, but plan to cover it in the Exposure Draft.)	May 2006
Reinsurance assumed Do reinsurance contracts have any characteristics that might justify treatments that differ from those proposed for direct insurance contracts?	May 2006
Changes in insurance liabilities. Which components of changes in insurance liabilities should an insurer report separately? Should an insurer recognise some or all premium receipts as deposit receipts rather than revenue?	May 2006
Salvage and subrogation How should salvage and subrogation rights be treated?	May 2006
Business combinations and portfolio transfers. Should the Discussion Paper address insurance contracts acquired in business combinations and portfolio transfers?	May 2006
Long-term savings contracts. Do conclusions reached for insurance contracts have implications for treatment of long-term savings contracts?	May 2006
Overview of relevant FASB projects. To review developments in FASB projects on risk transfer, life settlements and financial guarantees, and assess whether there are any implications for the discussion paper.	May 2006

Participation features (follow up issues). Follow up of issues discussed in March. Possible topics include impact of insurer discretion of guarantees and mutuals.	May 2006
Insurance Working Group meeting	29-30 June 2006
First pre-ballot draft	July 2006
Second pre-ballot draft	September 2006
Ballot draft	November 2006
Publication	December 2006

AGENDA PAPER 7A
MEASUREMENT ATTRIBUTE

Objective

1. This paper asks the Board to reach a preliminary conclusion on the measurement attribute for insurance liabilities.

Summary of recommendations

2. This paper recommends the following:

   (a) The measurement attribute for insurance liabilities should be current exit value. Current exit value should be defined as the amount that the insurer would expect to have to pay today to another entity if it transferred all its remaining contractual rights and obligations immediately to that entity (and excluding any payment receivable or payable for other rights and obligations). (paragraph 47(a))

   (b) An insurer should not be prohibited from recognising a net gain (ie net after acquisition costs) or net loss at the inception of an insurance contract. However, if an insurer identifies an apparently significant gain or loss at inception, it would need to check carefully for errors or omissions. (paragraph 47(b))

   (c) The Board might conclude in the fair value measurement project that current exit value is synonymous with fair value. However, it would be premature to reach a conclusion on that point now in the project on insurance contracts, because the project on fair value measurement is still at an early stage. The staff recommends that the Board should, for the time being, define the measurement attribute for insurance contracts as current exit value. As work proceeds on the fair value measurement project, the staff will assess periodically whether it is appropriate to recommend merging the two concepts for the project on insurance contracts. (paragraph 47(c))

   (d) The same measurement attribute should be used for all insurance liabilities, regardless of type (eg life or non-life), risk transfer type (eg participating, non-participating, unit-linked), issuer (direct insurer or reinsurer), ownership structure (eg shareholder-owned or mutual), or duration. (paragraphs 49-50)

   (e) The same measurement attribute should be used for both the insurance liability and the recognised portion of the customer relationship (ie the portion that relates to future payments that the policyholder must make to retain a right to guaranteed insurability). (paragraphs 51-53)

3. Using current exit value as the measurement attribute is not intended to imply that an insurer can, will or should actually transfer the liability to a third party. Indeed, in most cases, insurers cannot transfer the liabilities to a third party and would not wish to do so. The purpose of specifying this measurement attribute is to provide information that will provide users with useful information that will help them make economic decisions. Three key characteristics of current exit value make it more suitable for this purpose than other approaches we have considered:

   (a) The emphasis on current estimates of cash flows, and of the appropriate price for those cash flows.

   (b) The use of observable market inputs to the extent they exist.

   (c) The availability of a concise description of the measurement attribute.

Background

4. In previous discussions, the staff has not asked the Board to determine what measurement attribute should be used for insurance liabilities, but has instead asked the Board to consider various components of possible measurement attributes. The objective of the discussion at this meeting is to complete the review of those components and to draw the discussion together to a preliminary conclusion on one or more measurement attributes.

5. In December 2005, the Board narrowed down the range of possible measurement attributes under consideration to ones that can be described as current value approaches. In December 2005 and February and March 2006, the staff presented two such approaches, which the staff labelled for discussion purposes as current entry value and current exit value (see paragraph 42 for definitions).

6. In the light of discussions at those Board meetings, the staff now thinks of these not as separate approaches, but as different implementations of a single approach, differing mainly in emphasis. This paper labels them as implementation A and implementation B and does not give them separate names. Broadly, implementation A corresponds to what we previously called current entry value and implementation B corresponds to what we previously called current exit value.

7. In principle, the aim of current value approaches is to measure insurance liabilities at a current market price. In practice, that price cannot generally be observed, so the market price must be estimated, using the following ingredients:

(a) current unbiased probability-weighted estimates of future cash flows.

(b) current market discount rates that adjust the estimated future cash flows for the time value of money.

(c) a margin to reflect the compensation that market participants require (mainly for bearing risk, and perhaps also for other factors, see agenda paper 7F).

8. Both implementations estimate the cash flows in the same way and use the same discount rates. However, for estimating the margin in (c), implementation A puts more emphasis on the observed transaction price with the policyholder, whereas implementation B requires a more direct estimate of the margin that would be found in the price for a hypothetical transaction with another party.

9. The Board discussed each of these three ingredients (cash flows, discount rate, margins) in March.

Other features of current value approaches

10. For completeness, it is worth noting here some other features of the current value approaches we are considering:

(a) The measurement of the insurance liability is intended to capture the amount, timing and uncertainty of all rights and obligations created by the contract.

(b) Paragraphs 51-53 discuss whether the same approach should also be used for the portion of the customer relationship that relates to future payments that the policyholder must make to retain a right to guaranteed insurability.

(c) Insurance liabilities are measured without considering the effect of related reinsurance, because the reinsurance is addressed separately. We plan to discuss reinsurance in May.

(d) Agenda paper 7Gdiscusses whether the credit characteristics of an insurance liability should affect its measurement

(e) Acquisition costs are recognised as an expense when incurred (but might play some role in the initial calibration of the liability, see paragraph 13(c)).

(f) The Board noted in February that insurers may be able to develop reasonable approximations to a prospective measurement. For example, unearned premium

might sometimes provide such an approximation if the pattern of risk is linear, the contract is not likely to be highly profitable or highly unprofitable, and circumstances have not changed significantly since inception. The staff will investigate whether the Board should develop guidance on such approximations.

(g) An insurer would use existing IFRSs to measure assets.

Overview of the rest of the paper

11. The rest of this paper deals with the following subjects:

(a) Description of the two implementations (paragraphs 12-33)

(b) Arguments for implementations A (paragraph 34) and B (paragraph 35)

(c) Input from the Insurance Working Group (paragraphs 36-40)

(d) Definition of the measurement attribute (paragraphs 41-45)

(e) Benefits of current value approaches (paragraph 46)

(f) Recommendation on measurement attribute (paragraphs 47-48)

(g) Different types of insurance liability (paragraphs 49-50)

(h) Customer relationship (paragraphs 51-53)

Description of the two implementations

Implementation A

12. The rationale for implementation A is that, in general, the market price for an insurance liability is observable only once: at inception, when the insurer and policyholder agree a mutually acceptable price for the contract. Therefore, implementation A calibrates the margin at inception to the actual premium charged.

13. Some other things follow from this:

(a) Part of the premium is needed to pay for the acquisition costs, rather than to pay for expected benefits to policyholders (including the related margin). Because the objective is to measure the remaining obligation, the margin is calibrated by reference to the premium, less relevant acquisition costs. Implementation A would need to define the relevant acquisition costs.

(b) In some cases, insurers may underprice a contract, because of, for example, the state of the insurance cycle,[1] government restrictions on price changes or over-optimism. In those cases, the premium would not provide a faithful representation of the liability. Therefore, implementation A requires a liability adequacy test at inception. The Board has decided tentatively that the margin used in this test should be consistent with current exit value [ie with implementation B]. Paragraph 23 discusses whether implementation A should also require a liability adequacy test subsequently.

(c) Implementation A prohibits the recognition of a net gain at inception (a loss might be recognised in some cases because of the liability adequacy test). 'Net gain' refers here to the gain after recognising relevant acquisition costs as an expense. At a gross level, there is a gain at inception, equal to the relevant acquisition costs.

(d) The margin reflects changes over time in the insurer's estimate of the **amount** of risk, but freezes the **per-unit price** of risk at inception (see paragraphs 21-22).

(e) The insurer recognises income as it is released from risk under the contract and provides services under the contract. This feature is common to both implementations, though the amount of income recognised will depend on the method used to assess the risk released during the period and the risk remaining at the end of the period.

(f) If a contract is replaced, the margin for the new contract is calibrated to the new transaction price. Conversely, if a minor amendment is made to a contract, the margin remains frozen. Therefore, implementation A may need to set criteria to determine whether the insurer and policyholder have amended an existing contract or have cancelled it and replaced it with a new contract.

Implementation B

14. Implementation B puts less emphasis on calibration to the observed price transaction with the customer and puts more emphasis on the need to estimate the price (and, consequently, the margin) that would be expected if the insurer were willing and able to transfer its contractual rights and obligations to another party at the measurement date.

15. This has various consequences:

[1] The well-known observation that some insurance pricing displays a cycle of alternating 'hard' and 'soft' markets.

(a) The margin is not calibrated to the actual premium. However, the actual premium would still provide a reasonableness check. If the estimated margin differs significantly from the margin implied by the actual premium, further investigation may be needed, to ensure that significant factors have not been overlooked.

(b) Acquisition costs play no direct role in calibrating the margin. Therefore, implementation B does not need to define acquisition costs.

(c) Implementation B does not need a liability adequacy test, because all ingredients in the measurement are based on an assessment of current conditions.

(d) Implementation B does not prohibit the recognition of a net gain or loss at inception. However, as noted above, if a significant gain or loss appears to arise at inception, further investigation may be needed. Nevertheless, if the insurer concludes, after further investigation, that the estimated secondary market price for risk and profit differs from the price implied by the premiums that it charges, the insurer would recognise a gain or loss at inception.

(e) The margin after inception is the estimated margin that market participants would require for the remaining contractual obligations, contractual rights and related risks. The margin would vary over time if there are changes in the estimate of the margin that market participants would require. The Board decided in March 2006 not to prescribe specific techniques for developing risk margins. Instead, the Board will explain in the Discussion Paper (and ultimately in an IFRS) the characteristics of techniques that will enable risk margins to meet the objective. The Board did not object to the staff's recommendations on those characteristics.

(f) The insurer recognises income as it is released from risk under the contract and provides services under the contract. As already noted, this feature is common to both implementations, though the amount of income recognised will depend on the method used to assess the risk released during the period and the risk remaining at the end of the period.

16. The following highly simplified example illustrates the two implementations.

Example 1

Background

Insurer X issues an insurance contract on 1 January for a premium of CU 1,000, incurring acquisition costs of CU 100. Insurer X estimates on 1 January that the cash flows have an expected present value of CU 750 and a standard deviation of CU 50. Insurer X decides that, for this particular type of insurance contract, market participants would quantify the required compensation for bearing risk and providing services as a multiple of the standard deviation.[2] On 30 June, insurer X concludes that the remaining cash flows have an expected present value of CU 400 and a standard deviation of CU 30.

Implementation A

On 1 January (inception), insurer X measures the insurance liability at CU 900 (premium received: CU 1,000 less acquisition costs: CU 100). That measurement equals the expected present value of future cash flows (CU 750) plus an implicit risk margin of CU 150. Therefore, the implicit price per standard deviation is CU 3 (total margin of CU 150 divided by standard deviation of CU 50). Insurer X reports the acquisition costs (CU 100) as an expense, balanced out by a gross gain (before acquisition costs) of CU 100.

On 30 June, insurer X:

- measures the liability at CU 490 (expected cash flows: 400 plus margin of CU 90). The margin is CU 90 (standard deviation of CU 30 multiplied by the original price per standard deviation [CU 3]).
- reports the reduction of CU 60 in the margin as income (reduction of CU 20 in the standard deviation, priced at CU 3 per standard deviation).

Implementation B

For implementation B, assume insurer X estimates that market participants would require a margin of CU 2.8 per standard deviation at 1 January and CU 2.9 at 30 June.

At 1 January, insurer X measures the liability at CU 890 (expected cash flows of CU 750, plus margin of CU 140 = CU 50 * 2.8). Therefore, at inception on 1 January, insurer X

[2] The staff is not suggesting that standard deviation is always (or even often) the best measure of the amount of risk present. Standard deviation is used here to provide a simple example.

recognises a gross gain of CU 110 (premium of CU 1,000 less initial liability measurement of CU 890) and a net gain of CU 10 (gross gain of CU 110 less acquisition costs of CU 100).

At 30 June, insurer X:

- measures the liability at CU 487 (expected cash flows of CU 400, plus margin of CU 87 = CU 30 * 2.9).
- reports income of CU 53 relating to the release from risk (reduction of CU 20 in the standard deviation, priced at CU 2.8 per standard deviation [sub-total = CU 56], less the reduction in the estimated price required by market participants [CU 3 = CU 0.1 per standard deviation, multiplied by remaining standard deviation of CU 30].

17. The following paragraphs discuss various aspects of the two implementations:

    (a) Calibration at inception (paragraphs 18-20)

    (b) Freezing the margin (paragraphs 21-22)

    (c) Liability adequacy test (paragraphs 23-24)

    (d) Reference market (paragraphs 25-26)

    (e) Fee for assembling a portfolio (paragraph 27-29)

    (f) Embedded derivatives (paragraphs 30-33)

Calibration at inception

18. Implementation A takes the position that the only directly observable market input for the margin is the original transaction price. Therefore, this implementation requires the margin to be calibrated directly to the premium (less relevant acquisition costs), unless the liability adequacy test reveals a loss at inception.

19. Implementation B takes that position that the objective is to estimate the margin that market participants would require and that the original market price may provide evidence of that price, but has no higher status than other possible evidence.

20. A possible intermediate position would be to include a rebuttable presumption that the margin implied by the actual premium is the same as the premium that market participants would require.

Freezing the margin

21. As already noted, the rationale for implementation A is that (a) the observed price for the transaction with the policyholder is the best evidence of the margin that market participants would require and (b) sufficiently reliable evidence is generally not available at inception to support setting a margin on another basis. It would be inconsistent with that rationale to conclude that sufficiently reliable evidence has become available at a later date, when less market evidence of margins is likely to be at available (competitors' prices may be observable at inception, but are probably not observable for contracts that are part way through their contractual term). Therefore, this paper concludes that implementation A would determine the margin at inception and would not change it subsequently.

22. That conclusion needs to be refined somewhat, as already illustrated by example 1 above. In example 1, the quantity of risk was measured, for illustrative purposes, by the standard deviation of the expected present value of cash flows. As insurer X was released from risk, it recognised income accordingly. The quantity of risk (in this illustration, the number of standard deviations) comes directly from the estimates of cash flows and associated probabilities. Therefore, it is not the total risk margin that was frozen at inception, but the price per unit of risk.

Liability adequacy test

23. In February, the staff suggested that implementation A would require a liability adequacy test at inception, but not subsequently. The rationale is as follows: a liability adequacy test is needed if significant ingredients of the measurement are not based on current conditions. For implementation A, the cash flows, discount rates and quantity of risk (eg number of standard deviations) are current, but the margin per unit of risk is not current. The test is needed at inception, because the insurer might be issuing the contract at a loss, or with a margin that is inadequate. However, it would be inconsistent with the rationale for implementation A to keep retesting the margin at each date just to identify possible increase in the margin per unit that market participants would require.

24. For implementation B, all ingredients are current, so no liability adequacy test is needed.

Reference market

25. Some have suggested that there may be a systematic difference between the margin that would be likely in the (primary or retail) market between the insurer and the policyholder and the margin that would be likely in the (secondary or wholesale) market between the

insurer and a hypothetical transferee. However, in general, it seems unlikely that significant differences of this kind could occur systematically for long periods. If insurers were collecting margins that significantly exceed those that would be likely in wholesale markets, presumably other insurers would lower their premiums to gain market share. Therefore, it may not be important to define the reference market (unless the reference market influences the unit of account [see agenda paper 7B] or the treatment of implicit fees for assembling a portfolio of contracts [paragraph 27-29]).

26. Reinsurers sometimes charge lower premiums than those charged by the direct insurer for the same exposure. The staff has identified two plausible reasons for such differences:

    (a) The reinsurer may be diversifying the exposure more broadly. In effect, this is a unit of account issue (see agenda paper 7B).

    (b) If a reinsurer faces less onerous regulation (eg lower capital requirements), it may be able to satisfy the obligation at lower cost than the direct insurer does. In this case, presumably a potential transferee would maximise the use of reinsurance if this is the most cost-effective way to service the liability. It follows that the price for a hypothetical transfer of the liability to another insurer may be presumed to incorporate the benefit of cost advantages that the transferee could access through reinsurance. Furthermore, if the market with the policyholder is competitive, it may be presumed that price competition will lead insurers will to pass on to policyholders the benefits of cost advantages available through reinsurance. Thus, it may not be necessary to specify the reference market.

Fee for assembling a portfolio

27. The premium that an insurer charges may be viewed as made up of various elements:

    (a) the expected present value of the cash flows arising from the contract, plus the margin associated with those cash flows.

    (b) acquisition costs

    (c) fees for separate services, if any, provided to the policyholder at inception. The measurement of the liability would not reflect any margin attributable to services already rendered. It is beyond the scope of this paper to discuss what types of service might be regarded as separate (or separable) from the rest of the contract.

(d) compensation for the effort of assembling a portfolio of contracts (an implicit portfolio assembly fee). The price for a hypothetical transfer to another party may be presumed to be set so that the price enables the transferor to retain that compensation (see example 2).

28. Implementation A would not recognise the implicit portfolio assembly fee as revenue at inception. Instead, it would include it in the total margin and would recognise revenue pro rata to the release from risk. In this respect, implementation A could be regarded as consistent with the requirement in IAS 39 that the fair value of a financial instrument is the price at which a transaction would occur at the balance sheet date 'in that instrument (ie **without modifying or repackaging** the instrument) in the most advantageous active market to which the entity has immediate access.' (paragraphs AG 71 of the application guidance and BC98 of the basis for conclusions, emphasis added). Assembling a portfolio could be viewed as a form of 'repackaging'.

29. Implementation B would recognise the portfolio assembly fee as income at inception, because assembly of the portfolio has already occurred.

Example 2

Insurer Y issues an insurance contract on 1 January for a premium of CU 1,000, incurring acquisition costs of CU 100. Insurer X estimates on 1 January that the cash flows have an expected present value of CU 750 and that market participants would require a margin of CU 140. Thus, the premium covers the following elements:

Expected present value of cash flows (before margin)	750
Margin associated with cash flows	140
	890
Acquisition costs	100
Fee for portfolio assembly and services at inception	10
Total premium	1,000

The price for a hypothetical transfer to another party is likely to be about CU 890. The initial measurement of the liability is CU 900 in implementation A and CU 890 in implementation B.

If insurer Y estimates that the fee attributable to separable services provide at inception is CU 4 (and therefore the compensation attributable to assembling the portfolio is CU 6), the initial measurement would be CU 896 in implementation A and CU 890 in implementation B.

Embedded derivatives

30. If the host contract is not classified as at fair value through profit or loss, an embedded derivative must, with some exceptions,[3] be separated and classified as at fair value through profit or loss. Measuring a host insurance contract using implementation B is likely to satisfy this requirement (or come close to satisfying it, depending on the final definitions).

31. For a host insurance measured using implementation A, the question is more debatable. An estimate of the fair value of a derivative may be regarded as made up of (a) current unbiased estimates of the cash flows in each scenario, (b) discount rates consistent with current market interest rates, (c) current market estimates of the probability of each possible outcome and (d) a weighting to convey the relative value to market participants of each outcome, as implied by current market prices.

32. Implementation A would need to incorporate (a) and (b). In relation to (c), it would include current estimates of the probability of each scenario, but it would probably be difficult to demonstrate conclusively whether those probability estimates are consistent with the probability estimates that market participants would make. Changes in those probabilities over time will affect the expected present value of the cash flows. In relation to (d), the draft guidance on risk margins discussed by the Board in March emphasised the need for consistency with observable market prices. For purely financial risks (eg interest rates, that consistency may be reasonably easy to demonstrate. For non-traded risks (most insurance risks), that consistency is probably neither provable nor disprovable.

33. It follows that in implementation A embedded derivatives will often be included on a basis close to fair value, though this may not be so in every case. Depending on how large these differences are, there may or may not be a need to separate some embedded derivatives in approach A.

[3] Notably for embedded derivatives that are closely related to the host contract.

Arguments for implementation A

34. Arguments for implementation A are as follows:

(a) The transaction with the policyholder provides the only observable direct market benchmark for the margin. There is no reliable and non-arbitrary way to determine a margin on any other basis. Moreover, the required margins cannot be 'back-tested'. In other words, the actual cash flows from a book of contracts can never validate the margin that was estimated at an earlier date. This is because the margins reflect both the **quantity** of risk (eg the number of standard deviations) and the **price** per unit of risk (eg price per standard deviation). Actual outcomes over some years might give some level of confidence that the quantity of risk has been estimated reliably, but hindsight can never show whether the price per unit of risk was appropriate.

(b) Insurers are contractually required to provide a service (ie bearing risk) throughout the contract term. The policyholder derives utility from the subsequent provision of the service, but does not derive separate utility from the inception of the contract. Therefore, an insurer should recognise no profit until it begins to be released from risk.

(c) Implementation A is consistent with IAS 39, which prohibits the recognition of gains at inception that are not 'evidenced by comparison with other observable current market transactions in the same instrument (ie without modification or repackaging) or based on a valuation technique whose variables include only data from observable markets.' (IAS 39 appendix A, paragraph AG76) For insurance contracts, measurements would always rely on some data that is not from observable markets.

(d) Recognition of a gain at inception is imprudent, especially if based on inherently subjective estimates.

Arguments for implementation B

35. Arguments for implementation B are as follows:

(a) An IFRS should focus on the measurement of insurance liabilities and should not restrict the recognition of gains at inception if all assets and liabilities relating to the contract are recognised and measured appropriately. Prohibiting the recognition of gains at inception would lead to the reporting of deferred gains that are not liabilities. This would undermine the transparency of financial statements.

(b) If an insurer has added value by selling a contract, the financial statements should report that added value. Some users appreciate embedded value disclosures about gains generated by new business.

(c) Although subsequent losses, lapses or other events could reverse gains that were appropriately recognised at inception, it is more transparent to report those losses, lapses or other events when they occur, rather than to bury them by offsetting them against deferred gains.

(d) Given the cyclical nature of some insurance markets, it is inconsistent to recognise losses at inception when the market is 'soft' without recognising gains at inception in a 'hard' market.

(e) Implementation A needs a liability adequacy test at inception. For this, an insurer would need to estimate the margin that market participants would require. Although it might be possible to do this on a fairly broad brush basis if the actual premium is clearly adequate, the need to carry out this test would create an additional burden and would reduce the benefit of attempting to calibrate to an observed transaction price.

(f) Implementation A is likely to need guidance on some things for which guidance is not needed in implementation B:

(i) a definition of the unit of account for the liability adequacy test. The level of aggregation will affect the frequency and size of losses identified (because a high level of aggregation implicitly offsets losses on some contracts against gains on others).

(ii) a definition of relevant acquisition costs for the initial calibration of the margin.

(iii) criteria to distinguish amendments to an existing contracts from the cancellation of the old contract to be replaced by a new contract.

Input from the Insurance Working Group

36. The Insurance Working Group has discussed gains at inception several times. Some participants have opposed gains at inception in all cases. Others have argued that gains should not be prohibited at inception, if there are no doubts about the reliability of the liability measurement.

37. The Working Group's most recent discussion of this topic was in January 2006, mainly in the context of non-life contracts. Perhaps unexpectedly, participants generally expressed

the view that gains at inception should not be systematically excluded, but emphasised that significant gains should be rare and should be subject to close scrutiny to avoid errors or omissions.

38. In July 2005, we received two letters from the industry with suggestions for principles to be adopted in phase II (see agenda paper 9F, December 2005). The Group of North American Insurance Enterprises (GNAIE), with four major Japanese life insurers, suggested that no gains should be recognised at inception. The [European] CFO Forum suggested a rebuttable presumption against gains at inception, but subsequently (in a letter received just before the February Board meeting) proposed that no gains should be recognised at inception.

39. A paper of May 2005 from the International Association of Insurance Supervisors (IAIS), *Issues arising as a result of the IASB's Insurance Contracts Project – Phase II Initial IAIS Observations*, included the following comment*:* 'Profit should only be recognised where an appropriate and sufficiently reliable risk margin has been provided for in the value of liabilities. This would address the profits on inception problem, while at the same time helping to ensure that inappropriate underwriting in a soft market leads to immediate recognition of an expected loss. In practice some jurisdictions prefer to see this as a bottom up approach with a top down floor, and others in terms of adjustment to the risk margin.'

40. Analysts who use embedded value information often report that they find information about new business gains helpful. The [European] CFO Forum has stated that it sees embedded value information as useful supplementary disclosure, but as unsuitable for the face of the financial statements.

Definition of the measurement attribute

41. The following paragraphs summarise:

    (a) The definitions of current entry value and current exit value used in previous meetings (paragraph 42).

    (b) An alternative definition of current entry value discussed last year with the Insurance Working Group (paragraphs 43-45).

Most recent definitions of current entry value and current exit value

42. We previously used the following descriptions:

(a) Current entry value was described as the amount that the insurer would charge to a policyholder today for entering into a contract with the same remaining rights and obligations as the existing contract. At inception, the measurement would be calibrated to the actual premiums incurred (and recoverable acquisition cost incurred). That calibration is a starting point for determining risk margins at later dates.

(b) Current exit value was described as the amount that the insurer would expect to have to pay today to another entity if it transferred all its remaining contractual rights and obligations immediately to that entity (and excluding any payment receivable or payable for other rights and obligations, such as renewal rights). Because there is no secondary market for most insurance liabilities, that amount would need to be estimated.

Earlier definition of current entry value

43. The papers for the April 2005 meeting of the Insurance Working Group presented a slightly different version of current entry value. The April papers used the same definition ('the amount that the insurer would charge to a policyholder today for entering into a contract with the same remaining rights and obligations as the existing contract'). However, the detailed description placed more emphasis on the particular insurer's own pricing methodology. The measurement would have reflected items such as changes in estimates and changes in discount rates only to the extent that the insurer's own pricing methodology reflects them.

44. IWG participants did not generally favour that description. Some preferred a description along the lines given in this paper (ie using current estimates of cash flows and a current discount rate, with the margin calibrated at inception to the actual premium). The revised description was included in the models discussed at the September 2005 meeting of the IWG. Participants did not provide a reason for favouring this revised description, but we believe there are probably three main factors:

(a) Although a price may be available at inception, it is not generally available later in the contract because an insurer would not typically sell new contracts with the same remaining exposure. Thus, if price is estimated for a date after inception, that price is likely to be a theoretical construct. Among the reasons why new contracts are not available at a later date:

(i) By that stage, the portfolio of risks is only a subset of the original risks and the insurer would may not be willing set out to insure such a concentrated portfolio.

(ii) Prospective policyholders wishing to buy cover at a late stage are more likely to be drawn disproportionately from higher-risk groups. This would lead an insurer to charge a higher premium to protect itself against adverse selection.

(b) If considerable reliance is placed on an insurer's own pricing system to derive measurements, comparability may be lost.

(c) The current price for new contracts may be skewed by the insurer's desire to encourage some risk profiles, and discourage others, to achieve more balance in the portfolio. The price for those marginal new contracts may not be representative for equivalent contracts in the portfolio as a whole.

45. The definition of current entry value (in paragraph 42(a)) seems more compatible with the earlier (April 2005) description than with the more recent version. However, paragraph 44 gives compelling reasons for not using the earlier description. Moreover, the more recent description is hard to describe in a concise phrase. To convey helpful information to users, it would be preferable to find a concise, meaningful and accurate description of the measurement attribute. The above definition of current exit value meets these criteria more effectively than the above definition of current entry value.

Benefits of current value approaches

46. Before considering which particular measurement attribute to select, it is worth recalling the benefits of current value approaches in general:

(a) more relevant and representationally faithful information about the amount, timing and uncertainty of future cash flows arising from existing insurance contracts. Given the uncertainty associated with insurance liabilities and the long duration of many insurance contracts, such information is particularly important.

(b) a more consistent approach to favourable changes in estimates. In cost-based approaches, some favourable changes are recognised implicitly by offset against other changes that are adverse. Thus, cost-based approaches recognise favourable changes arbitrarily, on the basis of whether other adverse changes occur at the same time and the size of implicit margins that existed at inception.

(c) a more coherent framework to resolve emerging issues without resorting to unprincipled distinctions and arbitrary new rules.

(d) consistency with other IFRSs that already require current estimates of future cash flows in measuring non-financial liabilities (see IAS 37) and financial liabilities (see IAS 39).

(e) less (and perhaps no) need to separate embedded derivatives.

(f) less (and perhaps no) need for anti-abuse rules to prevent selective recognition of previously unrecognised economic gains through reinsurance.

(g) less (and perhaps no) need for arbitrary criteria to distinguish amendments to an existing contract (with unchanged estimates and an unchanged discount rate, in a cost-based approach) from new contracts (with new estimates and a new discount rate).

(h) margins that are explicit rather than implicit.

(i) clearer reporting of economic mismatches between insurance liabilities and related assets.

Recommendations on measurement attribute

47. The staff recommends the following:

(a) The measurement attribute for insurance liabilities should be current exit value. Current exit value should be defined as the amount that the insurer would expect to have to pay today to another entity if it transferred all its remaining contractual rights and obligations immediately to that entity (and excluding any payment receivable or payable for other rights and obligations).

(b) An insurer should not be prohibited from recognising a net gain (ie net after acquisition costs) or net loss at the inception of an insurance contract. However, if an insurer identifies an apparently significant gain or loss at inception, it would need to check carefully for errors or omissions.

(c) The Board might conclude in the fair value measurement project that current exit value is synonymous with fair value. However, it would be premature to reach a conclusion on that point now in the project on insurance contracts, because the project on fair value measurement is still at an early stage. The staff recommends that the Board should, for the time being, define the measurement attribute for insurance contracts as current exit value. As work proceeds on the fair value measurement project, the staff will assess periodically whether it is appropriate to recommend merging the two concepts for the project on insurance contracts.

48. Using current exit value as the measurement attribute is not intended to imply that an insurer can, will or should actually transfer the liability to a third party. Indeed, in most cases, insurers cannot transfer the liabilities to a third party and would not wish to do so. The purpose of specifying this measurement attribute is to provide information that will provide users with useful information that will help them make economic decisions. Three key characteristics of current exit value make it more suitable for this purpose than other approaches we have considered:

    (a) The emphasis on current estimates of cash flows, and of the appropriate price for those cash flows.

    (b) The use of observable market inputs to the extent they exist.

    (c) The availability of a concise description of the measurement attribute.

Different types of insurance liability

49. The staff has identified no reasons to use different approaches (or different implementations of the same approach) for different types of insurance liability.

Staff recommendation

50. The same measurement attribute should be used for all insurance liabilities, regardless of type (eg life or non-life), risk transfer type (eg participating, non-participating, unit-linked), issuer (direct insurer or reinsurer), ownership structure (eg shareholder-owned or mutual), or duration.

Customer relationship

51. The Board decided the following in February: When an insurer recognises rights and obligations arising under an insurance contract, it should also recognise the portion of the customer relationship that relates to future payments that the policyholder must make to retain a right to guaranteed insurability. That portion of the customer relationship and the contractual cash flows are closely inter-related. The staff has identified no reason to use different measurement attributes for them.

Staff recommendation

52. The same measurement attribute should be used for both the insurance liability and this portion of the customer relationship.

53. Agenda paper 7C on unbundling discusses, among other things, whether the insurance liability and customer relationship should be presented and disclosed separately or together.