30 Cannon Street, London EC4M 6XH, United Kingdom
Phone: +44 (0)20 7246 6410, Fax: +44 (0)20 7246 6411
Email: iasb@iasb.org Website: http://www.iasb.org

International Accounting Standards Board

This document is provided as a convenience to observers at IASB meetings, to assist them in following the Board's discussion. It does not represent an official position of the IASB. Board positions are set out in Standards.
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 7E, 7F and 7G

AGENDA PAPER 7E
UNIT-LINKED AND INDEX-LINKED PAYMENTS

Purpose of this paper

1. This paper discusses the measurement of policyholder payments that are denominated in terms of an internal or external investment fund or an index.

Summary of recommendations

2. This paper recommends the following:

   (a) If a unit-linked contract is set up in such a way that all the asset cash flows must ultimately go to policyholders (other than fees charged by the insurer to the fund for services provided), the carrying amount of the unit-linked portion of the liabilities should equal the carrying amount of the assets (paragraph 14).

   (b) Therefore, if the assets of the unit-linked fund cannot (even using all available accounting options) be recognised and measured at fair value, the carrying amount of the liabilities should exclude the portion of the benefit that depends directly on the difference between the carrying amount of the assets and their fair value (paragraph 15).

(c) No change should be made in this project to the accounting for properties owned by a unit-linked fund and occupied by the insurance for its own operations (paragraph 16).

(d) In some cases, a liability is linked to an index, but the issuer is not contractually required to hold the underlying assets. If the insurer holds the underlying assets and does not measure them at fair value, the carrying amount of the unit-linked liability should be consistent with the fair value of the underlying assets, not their carrying amounts (paragraph 19).

(e) Insurers should present assets of unit-linked funds separately from their other assets (paragraph 21).

Background

3. In some insurance contracts, some or all of the benefits to policyholders are contractually determined by the price of units in an internal or external investment fund (ie a designated pool of assets held by the insurer or a third party and operated in a way similar to a mutual fund). This paper describes these contracts as unit-linked contracts and the benefits that are determined by the unit prices as unit-linked benefits. In some countries, such countries have other names, for example variable contracts.

4. Unit-linked contracts can be insurance contracts or investment contracts, depending on the significance of insurance risk transferred by the contract.

5. Unit-linked contracts typically have most or all of the following features:

(a) the premium received from the policyholder is used to buy units in a fund, in some cases after the insurer has deducted a front-end fee or a bid-ask spread.

(b) The unit price at any time reflects the fair value of the assets held in the fund, possibly adjusted for a bid-ask spread.

(c) Charges are deducted from the fund (as a whole) for investment management, administrative and other expenses and tax.

(d) Other charges are often made to individual policyholder's account for insurance coverage (eg a fee for mortality protection), and perhaps also for contract administration and as a means of recovering acquisition costs. These charges are typically determined as a monetary amount, with units cancelled to provide that

amount (number of units cancelled equals the monetary amount, divided by the unit price). In some cases, the charges are levied by issuing special sub-classes of units that do not pass through all investment performance (eg where 'capital units' are used as a means of recovering acquisition costs)

(e) Depending on the structure and legal setup, the assets in the fund may or may not be insulated from the insurer's other activities. If the assets are not insulated, this may be an important difference from most mutual funds.

(f) A unit-linked contract may provide both unit-linked benefits and other non-unit benefits (eg life coverage). This paper deals only with the unit-linked benefits. The general principles being developed in this project would apply to the non-unit benefits.

(g) Insurers often provide some guarantees related to unit-linked benefits. The staff's recommendations in agenda paper 7A would require an insurer to measure these guarantees at current exit value.

6. This paper does not address the following topics, because they would be addressed by the general requirements we are developing for all insurance contracts:

(a) Revenue recognition relating to charges made to unit-linked policyholders.

(b) Customer relationships associated with the contract.

Accounting treatment

7. In most countries, insurers measure assets held in unit-linked funds at fair value and measure the unit-linked benefits on a similar basis: if the obligation is to pay benefits equal to 100 units, the benefit is measured at 100 times the current unit price.

8. Complications arise if the underlying assets are not measured at fair value, are not recognised at all, or if changes in their fair value are recognised outside profit or loss. The following cases are discussed below:

(a) Unrecognised assets (paragraphs 9-10)

(b) Assets not measured at fair value (paragraph 11)

(c) Assets remeasured outside profit or loss (paragraphs 12-13)

Unrecognised assets

9. One example of an unrecognised asset is treasury shares. Consider the following example:

   (a) A unit-linked fund is contractually required to invest in assets replicating the local stock market index. On 1 January, the fair value of the assets is CU 1,000 and the insurer represents 5% of the index. Thus, the funds holds share in the insurer with a fair value of CU 50. During the year, the index rises by 50%, and the insurer's shares rise to CU 80.

   (b) From the perspective of the insurer, its own shares are not assets and must be eliminated. Thus, on 1 January the insurer would recognise assets of CU 950 and liabilities of CU 1,000. On 31 December, the insurer would recognise assets of CU 1,420, liabilities of CU 1,500 and a loss of CU 30 for the period.

   (c) That result generates an accounting mismatch that does not seem helpful to users. The entity is reporting net liabilities (relating to this fund) of CU 50 at 1 January and CU 80 at 31 December, but does not expect a net cash outflow. Furthermore, the reported loss of CU 30 for the year does not correlate with any change in the future cash flows, or with changes in their present value.

   (d) It would not be appropriate to recognise the treasury shares as if they were assets of the insurer. The only other solution to the mismatch would be to eliminate the effect from the carrying amount of the liability.

10. A similar accounting mismatch arises if one of the assets in the fund is a subsidiary, associate or joint venture. The current exit value of the liability will reflect the full fair value of the investment in that subsidiary, associate or joint venture, but the recognised assets will not include internally generated goodwill. The accounting mismatch could be eliminated by either recognising the internally generated goodwill, either in whole or to the extent of the policyholders' interest (neither of which is very appealing conceptually), or by adjusting the measurement of the liability.

Assets not measured at fair value

11. An insurer would not be required to carry the following assets of a unit-linked fund at fair value: financial assets carried at amortised cost and investment property measured using

the cost model. However, financial assets would typically be eligible for the fair value option and a fair value option is also available for investment property.

Assets remeasured outside profit or loss

12. An accounting mismatch would also arise if an insurer classifies the assets of a unit-linked fund as available for sale. However, the assets would typically be eligible for the fair value option.

13. A unit-linked fund might own a building that is rented to the insurer for use in its own operations. The building would be an owner-occupied property, and therefore within the scope of IAS 16. Two issues arise:

    (a) An accounting mismatch would arise if the insurer uses the cost model. No measurement mismatch would arise if the insurer uses the revaluation model in IAS 16, but there would be a mismatch in profit or loss: the income statement would include (a) depreciation and (b) the change in the carrying amount of the unit-linked liability, but revaluation gains and losses would be recognised in equity.

    (b) Economically, the building is an investment of the policyholders and the rent is an expense of the policyholders. However, the rent is an internal transaction within the entity and cannot be recognised as an operating expense (and cash outflow) of the insurance operation and investment income (and incash flow) of the policyholder fund.

Staff recommendation

14. If a unit-linked contract is set up in such a way that all the asset cash flows ultimately go to policyholders (other than fees charged by the insurer to the fund for services provided), the carrying amount of unit-linked portion of the liabilities (ie the portion that is determined solely by the asset cash flows and asset prices) should, if all else is equal, be the same as the carrying amount of the assets. Otherwise, users would find it harder to assess the insurer's financial position and performance because of the inclusion of amounts that will not result in cash flows (other than indirect effects, for example through investment management charges).

15. Therefore, if the assets of the fund cannot (even using all available accounting options) be recognised and measured at fair value, the insurer should adjust the carrying amount of

the liabilities to exclude the portion of the benefit that depends directly on the difference between the carrying amount of the assets and their fair value.

16. No change should be made in this project to the accounting for properties owned by a unit-linked fund and occupied by the insurance for its own operations. Any such changes would require rule-based exceptions to the existing requirements for owner-occupied properties and to the existing requirements to eliminate internal transactions.

17. The principles discussed above would also be relevant in two other cases (provided the unit-linked fund is ring-fenced so that there can be no significant leakage of cash in or out):

    (a) If the assets of the fund are measured at mid-market (or, perhaps, bid price), the related liabilities would be measured by using a unit price determined on the same basis. This question has arisen because of IAS 39's requirement that the fair value of a financial liability is not less than the amount payable on demand. On a contract-by-contract basis, that amount may differ from the basis used to measure the assets because of bid-ask spreads. However, in aggregate, provided there can be no leakage, the assets provide the sole source of cash flows to pay the unit-linked benefits.

    (b) If there is an inconsistency between the deferred tax determined under IAS 12 and the basis on which tax is included in the unit price. Again, if there can be no leakage, the aggregate assets and aggregate liabilities of the unit-linked fund must be in balance.

Index-linked contracts

18. In some cases, a liability is linked to an index, but the insurer (or other issuer) is not contractually required to hold the underlying assets, though it may choose to do so to hedge the liability. Some argue that the liability should be adjusted in the same way as proposed above for unit-linked liabilities.

19. The staff does not recommend that approach, which would create a new form of hedge accounting

Presentation

20. National GAAPs commonly present assets of unit-linked funds as a single-line item. For example, if unit-linked funds hold CU 100 of equities and CU 50 of bonds, insurers would typically present those assets as a single line item of CU 150. Some argued that

IAS 1 does not permit this presentation, and that the insurer is required to present the unit-linked fund's CU 100 of equities among the insurer's other equities and the unit-linked fund's CU 50 of bonds among the insurer's other bonds. Such a presentation is unlikely to be helpful for users because the policyholders bear all the investment risk associated with the assets of the unit-linked fund.

21. The staff recommends that insurers should present assets of unit-linked funds separately from their other assets.

22. Agenda paper 7C on unbundling recommends, among other things, that some separate accounts should be excluded from the insurer's financial statements. Some unit-linked contracts might meet the criteria proposed there.

AGENDA PAPER 7F
PROFIT MARGINS

Purpose of this paper and summary of recommendation

1. The Board has previously concluded that the measurement of insurance liabilities should incorporate a margin. The Board's previous discussions have focused on margins designed to convey decision-useful information to users about the uncertainty associated with future cash flows (risk margins).

2. This paper concludes that the measurement of insurance liabilities should, in addition to a risk margin, also incorporate a margin that represents an unbiased estimate of the compensation that market participants would demand for providing services (a profit margin), other than the service of bearing risk (the risk margin covers the service of bearing risk)

Background

3. Consider the following example. An investment manager enters into a contract to manage a pool of investments for a fixed term of 5 years. The annual management fee is 1% of the fair value of the investments at the end of the year. The assets have an initial fair value of CU 1,000. For simplicity, the example includes the following assumptions, which are unrealistic, but more realistic assumptions would not make the example more illuminating:

   (a) Neither party can cancel the contract.

   (b) The investment manager incurs no costs.

4. How would we expect market participants to value the investment manager's contractual rights and obligations? We will initially ignore the costs that would be incurred to acquire the customer and enter into the contract. Later, we will add those costs to the example.

5. A traditional approach would discount the expected cash inflows to arrive at a present value. In this case, the cumulative management fees over the life of the contract have a present value equal to 4.9% of the fair value of the assets (see appendix A), in other words CU 49. The traditional approach would discount that present value for any risks not already picked up in the measurement. (In this simplified example, there are no other risks, so no such adjustment is required.)

6. Another approach is arguably more consistent with exit value notions. This approach would compare the actual management charge with comparable charges achieved by other market participants.[1]

   (a) If other market participants also generally require a management fee of 1% for identical contracts, the exit value would be zero, because other market participants would require a 1% fee, and this would be reflected in the price for transferring the contract. (In this example, there is no difference between the fee of 1% that market participants would charge to investors and the return of 1% that a potential transferee would require. Paragraph 7 extends the example so that these amounts would differ.)

   (b) If other market participants require a management fee of 0.8%, the contract has a **positive** exit value of CU 10 at inception, because the contract generates management fees with a present value of CU 49, but market participants only require a return of CU 39 (see appendix A).

   (c) If other market participants require a management fee of 1.2%, the contract has a **negative** exit value of CU 10 at inception, because the contract generates management fees with a present value of CU 49, but market participants require a return of CU 59 (see appendix A). This is an important difference from the traditional approach, which would always produce a positive net present value in this example. It might be smaller or larger depending on the discount rate, but it would always be positive.

7. Suppose now that investment managers generally need to incur costs of CU 6 in originating contracts of this kind. How would market participants now value the investment manager's contractual rights and obligations? Presumably, investment managers price the contract to recover their acquisition costs and to provide the return they require for providing the investment management service. Thus, market participants could be expected to value the contractual rights and obligations as follows:

   (a) If other market participants also charge investors a fee of 1% for identical contracts: As noted above, the present value of the investment management fee is CU 49. CU 43 of that is needed to provide the required return for investment management services and the remaining CU 6 is the required contribution to the acquisition costs.

[1] In a more realistic example, costs would also be included in the equation.

The exit value of the contract at inception is CU 6. (A potential transferee would require the CU 43, and would be willing to let the transferor retain as much as CU 6. Conversely, the transferor would expect any transferee to let it retain at least CU 6.).

(b) If other market participants require a management fee of 0.8%: the contractual rights and obligations have a positive exit value of CU 16 (management fees with a present value of CU 49, but market participants only require a return of CU 33. They would have required a return of CU 39 if they had incurred acquisition costs of CU 6, but they did not incur those costs).

(c) If other market participants require a management fee of 1.2%: contractual rights and obligations have a **negative** exit value of CU 4 at inception (management fees with a present value of CU 49, but market participants require a return of CU 53. They would have required a return of CU 59 if they had incurred acquisition costs of CU 6).

Recommendation

8. Agenda paper 7A recommends that the measurement attribute for insurance liabilities should be current exit value. The (hypothetical) transferee would not accept a price unless the price provides acceptable compensation for the services provided (in addition to the risk margin that compensates it for the service of bearing risk). Therefore, current exit value should incorporate, in addition to the risk margin, an unbiased estimate of the compensation that market participants would require for rendering services.

9. In developing IFRS 4 *Insurance Contracts*, the Board decided that this issue was urgent enough to prohibit insurers from adopting the 'traditional' approach, although to minimise disruption IFRS 4 did not eliminate that approach for insurers already using it. The relevant extract from the Basis for Conclusions on IFRS 4 is attached as appendix B.

Implications

10. In practice, the most likely area for insurers to be providing a significant service that might be separable from the service of bearing risk is investment management. This would arise particularly for contracts that pass on a significant proportion of the investment risk to policyholders, for example unit-linked contracts, universal life contracts and some participating contracts.

Implications: embedded value

11. In practice, the embedded values reported by some life insurers have often used the 'traditional' approach described in the above example. This may be one of the main reasons why new business often results in significant increases in embedded value at inception ('new business gains'). This approach may ultimately remain as the most important difference between current exit value and 'market-consistent embedded value' (MCEV). MCEV is beginning to emerge as a new version of embedded value, intended to be fully consistent with observed asset prices. MCEV was conceived as an attempt to respond to criticisms that previous versions of embedded value (a) did not pay sufficient attention to embedded options and guarantees and (b) appeared to reward investment in riskier assets by, for example, reporting CU 100 of equities as worth more than CU 100 of bonds.

12. # Appendix A

Example

Management fee details

Year	*Assets at start of year Units*	*Fee at 1% Units*	*Assets at end of year Units*
1	1,000.0	-10.0	990.0
2	990.0	-9.9	980.1
3	980.1	-9.8	970.3
4	970.3	-9.7	960.6
5	960.6	-9.6	951.0
Total fees		-49.0	

The above table assumes the assets are held in a unitised fund. The initial investment is CU 1,000 in 1,000 units of CU 1 each. The management charge at each year end is levied by cancelling 1% of the units and by paying the investment manager cash equal to 1% of the number of units, multiplied by the then current unit price.

At inception, the present value of 49 units is CU 49 (assuming all income from the assets is reinvested.)

Thus, over the life of the contract, the total management charge amounts to 4.9% of the total number of units.

The following table shows management fees at a level of 0.8%

Year	*Assets at start of year Units*	*Fee at 0.8% Units*	*Assets at end of year Units*
1	1000.0	-8.0	992.0
2	992.0	-7.9	984.1
3	984.1	-7.9	976.2
4	976.2	-7.8	968.4
5	968.4	-7.7	960.6
Total fees		-39	

The following table shows management fees at a level of 1.2%

Year	*Assets at start of year Units*	*Fee at 1.2% Units*	*Assets at end of year Units*
1	1000.0	-12.0	988.0
2	988.0	-11.9	976.1
3	976.1	-11.7	964.4
4	964.4	-11.6	952.9
5	952.9	-11.4	941.4
Total fees		-59	

Appendix B

Extract from Basis for Conclusions on IFRS 4 *Insurance Contracts*

Investment management fees

BC128 Under some insurance contracts, the insurer is entitled to receive a periodic investment management fee. Some suggest that the insurer should, in determining the fair value of its contractual rights and obligations, discount the estimated future cash flows at a discount rate that reflects the risks associated with the cash flows. Some insurers use this approach in determining embedded values.

BC129 However, in the Board's view, this approach can lead to results that are not consistent with a fair value measurement. If the insurer's contractual asset management fee is in line with the fee charged by other insurers and asset managers for comparable asset management services, the fair value of the insurer's contractual right to that fee would be approximately equal to what it would cost insurers and asset managers to acquire similar contractual rights.* Therefore, paragraph 25(b) of the IFRS confirms that an insurer cannot introduce an accounting policy that measures those contractual rights at more than their fair value as implied by fees charged by others for comparable services; however, if an insurer's existing accounting policies involve such measurements, it may continue to use them in phase I.

BC130 The Board's agenda includes a project on revenue recognition.

* [footnote in original] This approach is consistent with the discussion of servicing rights and obligations in IAS 39.

AGENDA PAPER 7G
CREDIT CHARACTERISTICS OF INSURANCE LIABILITIES

Purpose of this paper

1. This paper discusses whether the credit characteristics of an insurance liability should affect its measurement.

Summary of recommendations

2. This paper concludes the following:

   (a) The current exit value of a liability is, conceptually, the price for a transfer that neither improves nor impairs the credit characteristics of the liability. (paragraph 26)

   (b) At inception, the credit characteristics of an insurance liability are unlikely to have a material effect on either premium rates or the current exit value. Hence, they are unlikely to have a material effect on the measurement of an insurance liability. (paragraph 26)

   (c) Conceptually, the subsequent measurement of an insurance liability at current exit value should reflect changes in the effect of its credit characteristics (ie changes in the probability of default or changes in the price for possible default). (paragraph 26)

   (d) If the margin is calibrated initially to the premium and that margin is frozen at inception (ie implementation A), it could be argued that the margin would not incorporate subsequent changes in the effect of those credit characteristics. (paragraph 26)

   (e) If the measurement of an insurance liability does incorporate the effect of a change in its credit characteristics, the effect should be disclosed. (paragraph 26)

   (f) The current exit value of an insurance liability guaranteed by third parties or ranking ahead of virtually all other liabilities is generally unaffected by changes in the entity's creditworthiness. (paragraph 29)

Background

3. The impact of credit characteristics on the measurement of liabilities received little attention before people began discussing current value measurement models.

4. Although this topic is often described as relating to the entity's credit standing, in fact it relates to the credit characteristics of the instrument (ie risk of default on the particular instrument). Different instruments issued by the same borrower may have different credit characteristics. In many jurisdictions, liabilities to policyholders rank above most other liabilities: where that is the case, default is less likely for liabilities to policyholders than for other liabilities.

Regulation

5. In practice, for many regulated insurers, the impact of their own credit standing may be limited, given supervisory procedures that aim to minimise the possibility of any losses to policyholders. However, in some cases, the impact may be material. Furthermore, a decline in the *insurer's* credit standing may have little effect on the standing of the *instrument* (the insurance contract). Nevertheless, high quality supervision does not exist in all countries. Furthermore, although direct insurance sold to consumers is often regulated, reinsurance is not always regulated directly. Moreover, high quality supervision does not preclude the possibility that policyholders may suffer losses in some cases. Also, the project applies to all issuers of insurance contracts, not just to regulated insurers.

Overview of the rest of this paper

6. The rest of this paper is organised as follows:

   (a) As background, paragraphs 7-10 note that the credit characteristics of debt affect the initial measurement of debt issued for cash. Paragraphs 11-12 discuss whether the same principle applies to the initial measurement of liabilities incurred in exchange for goods and services.

   (b) Paragraphs 13-20 then discuss whether the credit characteristics of insurance liabilities should affect their initial measurement, on the assumption that initial measurement either is calibrated directly to the actual premium or is at current exit value, as determined at inception:

      (i) Paragraphs 14-16 consider whether the credit characteristics of an insurance liability are likely to influence premium rates.

      (ii) Paragraphs 17-18 discuss whether the credit characteristics of an insurance liability affect its current exit value.

(iii) Paragraphs 19-20 continue by discussing whether, if the premium and/or current exit value does reflect the credit characteristics of the liability, the initial measurement should reflect those credit characteristics.

(c) Paragraphs 21-23 discuss whether the subsequent measurement of insurance liabilities should reflect their credit characteristics, with particular reference to what is probably the most controversial question: whether the measurement should incorporate the effect of **changes** in the effects of credit characteristics.

(d) Paragraphs 24 and 25 summarise input from the Insurance Working Group and insurance supervisors and paragraphs 26-27 provide the staff's recommendation

(e) In some countries, some policyholder liabilities are guaranteed by government or sector guarantee funds. Paragraphs 28-29 comment on implications for the measurement of the guaranteed liabilities.

Initial measurement of debt issued for cash

7. In existing practice in most countries, a borrower measures its debt initially at the amount of cash received.[2] For example, suppose Issuer A issues debt of CU 1,000, repayable in one year with interest of 6% paid at maturity. Issuer A would typically measure the debt initially at the proceeds received (CU 1,000).[3] This is equal to the contractual cash flows (1,060) discounted at a rate (6%) that reflects the credit characteristics of the liability.

8. In effect, the initial measurement reflects the possibility that the borrower may default. A less credit-worthy borrower must pay a higher interest rate; stated differently, a less credit-worthy borrower will receive a smaller loan for the same contractual repayment of principal and interest.

9. That result is relatively uncontroversial, though some hesitate to extend it to insurance liabilities (see later in this paper for possible explanations).

10. If Issuer A instead discounted the contractual cash flows (CU 1,060) at the risk-free rate (say, 5%), it would recognise at inception a liability of CU 1,010, and a loss of CU 10. Thus, if the initial measurement of debt excluded the credit characteristics of the debt, a

[2] possibly net of transaction costs, but that does not affect the discussion in this paper.
[3] In fact, under IAS 39, the initial measurement of the debt is at fair value. However, in most cases, that fair value is assumed to equal the initial cash received.

loss would arise at inception because of the difference between the risk-free rate and the contractual rate.

Initial measurement of liabilities incurred in exchange for goods and services

11. It would be inconsistent to use a risk-free rate to measure liabilities incurred in exchange for goods or services and a different (higher) rate for liabilities (eg debt) incurred in exchange for cash.

12. As noted above, when an entity issues debt for cash, the issuer would recognise a loss at inception if the initial measurement of debt did not reflect its credit characteristics. However, on incurring a liability in exchange for receiving goods or services, an entity would not recognise a loss if the entity measures the liability initially at the same amount as the goods and services received.

Initial measurement of insurance liabilities

13. Agenda paper 7A discusses two implementations of a current value measurement objective for insurance liabilities. Implementation A is calibrated to the premium received, whereas the objective of implementation B is to estimate directly the price for a (hypothetical) transfer to another party. The following paragraphs discuss the role of credit characteristics in these implementations.

Credit characteristics and premium rates

14. Some argue that premium rates do not reflect the insurer's credit standing: if policyholders conclude that an insurer's credit standing exceeds an acceptable minimum level, they are prepared to transact with that insurer. Below that level, policyholders will not transact with the insurer at all. Their willingness to pay a particular level of premiums is not conditional on perceptions of further distinctions in the insurer's credit standing. In other words, supporters of this view argue that premium rates are not particularly sensitive to ratings until the insurer reaches a 'ratings cliff'.

15. Others argue that there are observable differences in premium rates between insurers with different credit standings. Some argue that these effects are stronger in some markets or in some lines (eg commercial lines) than in others. Some argue that insurers with a lower claims paying rating may be able to achieve the same premium rates as higher rated insurers, but may have to spend more on marketing, distribution and servicing to attract and retain policyholders.

16. At meetings of the Insurance Working Group, there have been supporters of both views.

Credit characteristics and current exit value

17. For the following reasons, some argue that the current exit value of a liability must reflect the price of a transfer to a party of equivalent credit standing:

    (a) A creditor would not generally permit the debtor to transfer its obligations to another party of **lower** credit-standing.

    (b) A transferee of **higher** credit standing would not assume the obligations for an amount that implicitly requires the transferee to pay interest at a higher rate (if it can borrow at 5%, why would it pay 6%?). Therefore, to induce the transferee to assume the obligation, the transferee would have to, in effect, buy a credit upgrade. But that credit upgrade does not benefit the transferee, so the transferee has no motive to pay for it.

18. It follows that the current exit value of a liability is, conceptually, the price for a transfer that neither improves nor impairs the credit characteristics of the liability. (Paragraphs 19-23 consider whether there are any arguments for ignoring those credit characteristics when measuring a liability, either initially or subsequently.)

Should an initial measurement of insurance liabilities exclude the effect of their credit characteristics?

19. Regardless of whether the credit characteristics of an insurance liability conceptually affect premiums or current exit value, some argue that the initial measurement of an insurance liability should not reflect its credit characteristics. They argue as follows:

    (a) Measuring insurance liabilities based on their credit characteristics would contradict the fact that insurers intend to meet all valid claims in full. Moreover, any other assumption would be contrary to public policy. Although similar considerations apply to all entities, this is particularly sensitive for insurers because of the need to protect policyholders.

    (b) Adjustments for credit characteristics are irrelevant if an insurer cannot realise them by transferring the obligations to another party.

    (c) Insurers cannot exit their liabilities except through settlement with the policyholder/claimant. If they try to do so in a manner that reflects their credit

standing, then they generally violate laws that cover unfair trade practices. Therefore, the actual exit price for an insurer's liabilities cannot in practice reflect its credit standing.

(d) Adjustments for the credit characteristics of liabilities may not be reliably measurable, especially if not calibrated to the actual premium charged. Such adjustments might be based on, for example, internal risk of ruin models, market spread data or credit ratings. Each of these approaches may have drawbacks:

(i) Internal risk of ruins models might be difficult and onerous to audit. Furthermore, only major groups have these models at present.

(ii) Bond market spread data may be very volatile. Furthermore, there are many potential sources of spread data and they may not give consistent answers.

(iii) If ratings are used this raises the following questions: Is the company rated? Are all of its obligations rated? Which agencies are involved? Do these agencies publish default data and is it consistent? If default data is used, which time horizon is appropriate? Should recovery (ie loss given default) be taken into account? One agency's debt ratings rate to the first currency unit of loss, which may just be a missed interest payment. That agency rates financial strength to regulator intervention.

(e) There is a difference between traded instruments and instruments, such as insurance contracts, that are not generally traded. It would be necessary to make explicit estimates to **exclude** the effect of credit characteristics from the measurement of a traded instrument. However, for a non-traded instrument, explicit estimates are needed to **include** that effect. If there is a concern that such estimates might be subjective, it might be best to exclude the effect of credit characteristics from the measurement of non-traded instruments.

20. Others give the following arguments for including the credit characteristics of an insurance liability in the initial measurement of the liability:

(a) If current exit value is the measurement attribute for insurance liabilities, it would be arbitrary to exclude the effect of the insurer's credit standing from the measurement.

(b) As noted above, it is uncontroversial that the initial measurement of debt issued for cash should reflect the credit characteristics of the debt. There is no obvious reason to treat insurance liabilities differently.

(c) The exclusion of credit characteristics ignores scenarios in which some or all contractual cash outflows do not occur. That is incompatible with measurements based on expected values (ie probability-weighted averages of all scenarios).

(d) In many cases, the liability of the owners of an insurer is limited to the capital they have contributed. The exclusion of credit characteristics ignores that fact and is, arguably, incompatible with pricing and measurement models based on economic or regulatory capital.

Subsequent measurement

21. Some give the following additional arguments for not accounting for **changes** in the effects of credit characteristics of liabilities[4] in general, and insurance liabilities in particular:

(a) If an insurer's reported insurance liabilities decline with an impairment of their credit characteristics, users may find it harder to assess the insurer's solvency by comparing the carrying amount of its assets with the carrying amount of its liabilities.

(b) A decline in an insurer's credit standing would normally occur at the same time as a loss in the value of an unrecognised asset – internally generated goodwill. Because that loss in value is not recognised as an expense, it would be misleading to recognise income relating to the impact on the liabilities.

(c) If income is recognised when the credit characteristics of liabilities change, that amount will, if there is no default, ultimately be reversed as an expense in later periods.

22. Proponents of including the effects of the credit characteristics of the liabilities argue the following:

[4] In this paper, **changes in credit characteristics** refers to changes in the possibility of default or to changes in the price for possible default, rather than to changes in contractual terms.

(a) Consider an entity that has two liabilities that require identical contractual cash outflows but were incurred at different times when the entity's credit standing was different. If measurement ignores changes in the effects of the credit characteristics, the entity will measure the liabilities at different amounts, even though their economic impact is identical.

(b) A measurement model would be inconsistent if it included the credit characteristics of liabilities at inception, but ignored them subsequently.

23. If the credit characteristics of an insurance liability do not have a significant effect at inception, the concerns expressed in the previous paragraph may have less weight.

Input from the Insurance Working Group and from insurance supervisors

24. Participants in the Insurance Working Group have generally been strongly opposed to measurements that incorporate the effects of the credit characteristics of insurance liabilities, and especially to measurements that incorporating **changes** in the effects of those credit characteristics.

25. 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*:* 'Allowing for own credit worthiness is inconsistent with the valuation of insurance liabilities in a going concern. The IAIS most strongly recommends that the Board consider this issue very carefully, as any adjustment of the valuation of insurance liabilities for own credit worthiness will be unacceptable for prudential purposes, and the IAIS feels strongly that it should also be unacceptable for general purpose accounting statements.'

Staff recommendations

26. The staff recommends the following:

(a) For the following reasons, the current exit value of a liability is, conceptually, the price for a transfer that neither improves nor impairs the credit characteristics of the liability:

(i) The transferor would not willingly pay the price that a willing transferee would require for a transfer that improves those characteristics.

(ii) The policyholder (and regulator, if any) would not consent to a transfer that impairs those characteristics.

(b) At inception, the credit characteristics of an insurance liability are unlikely to have a material effect on either premium rates or the current exit value. A policyholder is unlikely to buy insurance if the policyholder thinks the insurer may not satisfy its obligations in full.

(c) Conceptually, the subsequent measurement of an insurance liability at current exit value should reflect changes in the effect of its credit characteristics (ie changes in the probability of default or changes in the price for possible default).

(d) If the margin is calibrated initially to the premium and that margin is frozen at inception (ie implementation A), it could be argued that the margin would incorporate the effect of credit characteristics at inception (argued above to be negligible) and would not reflect subsequent changes in the effect of those credit characteristics.

(e) If the measurement of an insurance liability does incorporate the effect of a change in its credit characteristics, the effect should be disclosed. (In developing the improvements to IAS 39 and the amendments to the fair value option, the Board noted that it may be difficult to identify the portion of a change in fair values that relates to a change in the effect of credit characteristics. However, this problem should not arise for insurance liabilities, because the effect would need to be included explicitly in a measurement model, rather than estimated from observable market prices).

27. The appendix contains relevant extracts from the Basis for Conclusions on IAS 39.

Policyholder protection mechanisms

28. A policyholder protection fund or similar body guarantees to make payments to policyholders if an institution defaults on liabilities covered by the arrangements. These guarantees typically provide a blanket guarantee; that is, all deposits in the institution are automatically guaranteed if they meet specified requirements. Essentially all other obligations of the institution are subordinated to the claims of the relevant policyholders, and the insurers are subject to regulations intended to improve the probability that the institution will be able to settle its liabilities at face value. Regulatory approval is generally required for a transfer of the liabilities to another insurer, and the guarantee would typically still apply after the transfer. In practice, the regulator may seek to

negotiate a transfer of the obligations to another regulated entity before the risk of default becomes too significant.

29. IAS 39 notes that the fair value of liabilities guaranteed by third parties or ranking ahead of virtually all other liabilities is generally unaffected by changes in the entity's creditworthiness. Applying this conclusion, the current exit value of an insurance liability guaranteed by third parties or ranking ahead of virtually all other liabilities is generally unaffected by changes in the entity's creditworthiness.

Appendix

Extract from Basis for Conclusions on IAS 39

Own Credit Risk

BC87. The Board discussed the issue of including changes in own credit risk in the fair value measurement of financial liabilities. It considered responses to the Exposure Draft that expressed concern about the effect of including this component in the fair value measurement and that suggested the fair value option should be restricted to exclude all or some financial liabilities. However, the Board concluded that the fair value option could be applied to any financial liability, and decided not to restrict the option in the Standard because doing so would negate some of the benefits of the fair value option set out in paragraph BC74.

BC88. The Board considered comments on the Exposure Draft that disagreed with the view that, in applying the fair value option to financial liabilities, an entity should recognise income as a result of deteriorating credit quality (and a loan expense as a result of improving credit quality). Commentators noted that it is not useful to report lower liabilities when an entity is in financial difficulty precisely because its debt levels are too high, and that it would be difficult to explain to users of financial statements the reasons why income would be recognised when an entity's creditworthiness deteriorates. These comments suggested that fair value should exclude the effects of changes in own credit risk.

BC89. However, the Board noted that because financial statements are prepared on a going concern basis, credit risk affects the value at which liabilities could be repurchased or settled. Accordingly, the fair value of a financial liability reflects the credit risk relating to that liability. Therefore, it decided to include credit risk relating to a financial liability in the fair value measurement of that liability for the following reasons:

(a) entities realise changes in fair value, including fair value attributable to own credit risk, for example, by renegotiating or repurchasing liabilities or by using derivatives;

(b) changes in credit risk affect the observed market price of a financial liability and hence its fair value;

(c) it is difficult from a practical standpoint to exclude changes in credit risk from an observed market price; and

(d) the fair value of a financial liability (ie the price of that liability in an exchange between a knowledgeable, willing buyer and a knowledgeable, willing seller) on initial recognition reflects the credit risk relating to that liability. The Board believes that it is inappropriate to include credit risk in the initial fair value measurement of financial liabilities, but not subsequently.

BC90. The Board also considered whether the portion of the fair value of a financial liability attributable to changes in credit quality should be specifically disclosed, separately presented in the income statement, or separately presented in equity. The Board decided that separately presenting or disclosing such changes would often not be practicable because it might not be possible to separate and measure reliably that part of the change in fair value. However, it noted that disclosure of such information would be useful to users of financial statements and would help alleviate the concerns expressed. Therefore, it decided in IAS 32 to require disclosure of the changes in fair value of a financial liability that is not attributable to changes in a benchmark rate.

The Board believes this is a reasonable proxy for the change in fair value that is attributable to changes in the liability's credit risk, in particular when such changes are large, and will provide users with information with which to understand the profit or loss effect of such a change in credit risk.

BC91. The Board decided to clarify that this issue relates to the credit risk of the financial liability, rather than the creditworthiness of the entity. The Board noted that this more appropriately describes the objective of what is included in the fair value measurement of financial liabilities.

BC92. The Board also noted that the fair value of liabilities secured by valuable collateral, guaranteed by third parties or ranking ahead of virtually all other liabilities is generally unaffected by changes in the entity's creditworthiness.