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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: February 2006, London

Project: **Insurance contracts (phase II):**
Liability adequacy test (Agenda Paper 10G)
Gain on initial recognition of insurance contracts (Agenda Paper 10H)
Non-life insurance contracts - Measurement attribute for pre-claims liabilities (Agenda Paper 10I)
Project planning (Agenda Paper 10J)

AGENDA PAPER 10G
Liability adequacy test

Purpose of this paper

1. This paper discusses how a liability adequacy test would operate.

Summary of staff recommendations

2. The staff recommends the following:

   (a) A liability adequacy test is needed:

      (i) in an unearned premium approach for pre-claims liabilities (at inception and subsequently)

      (ii) in a current entry value approach for non-life insurance pre-claims liabilities and for life insurance liabilities (at inception but **not** subsequently).

(b) No liability adequacy test is needed:

(i) In a current entry value approach for non-life insurance claims liabilities (either when the claims liability is first recognised or subsequently).

(ii) In a current exit value approach (for any form of insurance liability.

(c) The margin for a liability adequacy test should be consistent with current exit value. However, as an alternative, IAS 37 might also provide a convenient reference point.

(d) A liability adequacy test should reflect both the intrinsic value and the time value (optionality) of embedded options and guarantees, on a basis consistent with observable market prices.

(e) If the liability adequacy test identifies a shortfall, an insurer should first reduce the carrying amount of recoverable acquisition costs (if any are recognised as a separate asset) or, for contracts acquired in a business combination or in a portfolio transfer, the carrying amount of the present value of in force business acquired. If any further deficiency remains, the insurer should recognise an additional liability.

(f) If a shortfall is recognised, an insurer should subsequently:

(i) recognise income as it is released from the risk represented by the margins included in that shortfall (for both an unearned premium approach and a current entry value approach).

(ii) accrue interest on the shortfall in a current entry value approach, but not in an unearned premium approach. However, when interest is not added, an additional shortfall may arise later when the liability adequacy test is applied again.

(iii) reverse a shortfall if it no longer exists.

3. This paper does not discuss the following matters, which we will discuss that at a future meeting if the Board adopts an approach that requires a liability adequacy test:

(a) the unit of account for liability adequacy tests.

(b) whether a liability adequacy test should be net of reinsurance or gross.

(c) the income statement presentation of shortfalls and of subsequent related income and expense (release from risk, interest, reversals).

4. The rest of this paper is divided into the following sections:

   (a) What is a liability adequacy test and when is it needed? (paragraphs 5-10)

   (b) Input from the Insurance Working Group (paragraph 11)

   (c) Margins (paragraphs 12-21)

   (d) Embedded options and guarantees (paragraphs 22-23)

   (e) Allocation of a shortfall deferred acquisition costs and insurance liabilities (paragraphs 24-26)

   (f) Subsequent accounting after a shortfall (paragraphs 27-31)

   (g) reversal of a shortfall (paragraphs 32-35)

What is a liability adequacy test, and when is it needed?

5. Assets are generally subject to an impairment test (unless the asset is carried at fair value). For a liability, the counterpart of an impairment test is a liability adequacy test. In other words, this is a test of whether the carrying amount of the liability needs to be increased. IFRS 4 *Insurance Contracts* contains limited requirements for a liability adequacy test. The Board's objective was to permit existing liability adequacy tests to continue in phase I, if relatively undemanding conditions were met. Relevant extracts from IFRS 4 are attached in the appendix.

6. A liability adequacy test might also, as in IFRS 4, include items that are presented as assets, but whose measurement is closely related to the measurement of the liability (eg deferred acquisition costs and intangibles relating to insurance contracts acquired in a business combination or in a portfolio transfer).

7. In general, all measurements of insurance liabilities can be viewed as built up from three basic ingredients: estimates of future cash flows, adjustments to reflect the time value of money (discounting) and adjustments to reflect risks. Differences between different accounting models arise from differences in the way these three basic building blocks are

determined (eg whether cash flows estimates are current or 'locked in', whether and how discounting is incorporated explicitly and whether and how risk adjustments are incorporated.)

8. The Board concluded tentatively in May 2005 that any liability adequacy test would (a) involve discounting and (b) include adjustments to reflect risk. It is also clear that the liability adequacy test would involve a current estimate of the cash flows.

9. A liability adequacy test is needed only if one or more of the three building blocks does not reflect current conditions. In other words:

   (a) For an unearned premium approach, each of the three building blocks implicitly reflects conditions at inception and is not updated subsequently. Therefore, a liability adequacy test is needed both initially and subsequently.

   (b) For a current entry value approach for non-life insurance pre-claims liabilities and for life insurance liabilities:

      (i) the margin is implicit at inception, so a liability adequacy test is needed then.

      (ii) Subsequently, cash flows and the discount rate are current,[1] and the margin was already subject to a liability adequacy test at inception, so no further test is needed subsequently.

   (c) For a current entry value approach for non-life insurance claims liabilities, the cash flows and the discount rate are current and the margin was already subject to a liability adequacy test at inception of the contract, so no further test is needed.

   (d) For current exit value, all three building blocks reflect current information, so no liability adequacy test is needed.

10. The following table summarises when a liability adequacy test is needed.

[1] We believe it is implicit in the Board's decision in May 2005 that the discount rate would be current for claims liabilities. We will ask the Board to confirm this explicitly.

Liability type	*Measurement approach*	*Is a liability adequacy test needed?*	
		- initially	*- subsequently?*
Non-life pre-claims	Unearned premium	**Yes**	**Yes**
Non-life pre-claims	Current entry value	**Yes**	No
Life	Current entry value	**Yes**	No
Non-life pre-claims	Current exit value	No	No
Non-life claims	Current entry value	No	No
Non-life claims	Current exit value	No	No
Life	Current exit value	No	No

Input from the Insurance Working Group

11. The Insurance Working Group discussed liability adequacy tests most recently in January 2006, mainly in a non-life context. Participants:

    (a) generally supported the need for a liability adequacy test.

    (b) had mixed views on whether the reference point for determining the margin should be current entry value, current exit value or IAS 37.

    (c) generally felt that a liability adequacy test should reflect both the intrinsic value and the time value (optionality) of embedded options and guarantees. Participants did not discuss in detail whether the intrinsic value and time value should be determined on a basis consistent with observable market prices.

(d) any shortfall should be recognised by first reducing the carrying amount of recoverable acquisition costs (if recognised as a separate asset), or the present value of in force business if the contracts were acquired in a business combination.

(e) had mixed views on whether an insurer should (i) recognise the release from risk inherent in risk margins included in the shortfall and (ii) add interest to a shortfall. Some had concerns about the income statement presentation of these items.

(f) generally supported the reversal of shortfalls that no longer exist.

Margins

12. The Board concluded tentatively in May 2005 that the liability adequacy test would include adjustments to reflect risk. Neither the Board nor the Working Group has yet discussed how to articulate the nature of that adjustment by reference to any particular measurement objective.

13. To avoid a discontinuity in the accounting, it could be argued that the risk margin for the liability adequacy test should have the same objective as the risk margin for claims liabilities that will ultimately result from the contracts. In other words:

(a) If claims liabilities are measured at current exit value, the risk margin for a liability adequacy test should also be consistent with a current exit value.

(b) If claims liabilities are measured at current entry value, the risk margin for a liability adequacy test should also be consistent with a current entry value.

14. On the other hand, there is argument that the margin for the liability adequacy test should be consistent with current exit value even if subsequent claims liabilities are measured at current entry value. This argument arises because some insurance markets are subject to an insurance cycle. In other words, premium rates may fluctuate significantly from period to period, leading to high profitability in a hard market and low profitability (or even losses) in a soft market. When profitability is low or negative, the implicit or explicit margin is correspondingly low or negative. The following example illustrates some issues that arise.

Insurer A issues a one year non-life contract for a premium of CU 100. Expected (ie probability-weighted) claims are CU 110, to be paid in 12 months. The one year risk-

free rate is 5%. Over a complete cycle of several years, Insurer A requires (and expects to achieve) a target profitability of 8%. Insurer A's competitors also have a target profitability of 8% over a complete cycle. For simplicity, assume the insurer incurs no acquisition costs or other costs connected with contract.

Although this contract does not meet the profit target, Insurer A considers that it must remain in the soft market to benefit from more profitable business in a subsequent hard market, when it expects to earn more than 8%.

The current entry value of this insurance contract at inception is CU 100 (equal also to the unearned premium at that date). What amount should be determined using a liability adequacy test?

(a) CU 105 (CU 110 discounted at the risk-free rate of 5%)? This alternative avoids the need to determine a risk margin. However, omitting a risk margin does not represent faithfully the nature of an uncertain liability.

(b) CU 100 (CU 110 discounted at the risk-free rate of 5%, with a **negative** risk margin of 5%, as implied by the pricing)? This is the observed risk margin in the (entry) market with the policyholder. But it seems counter-intuitive for a risk margin to be negative - particularly if the resulting measurement implies that the liability is less onerous than a risk-free liability that has the same expected value.

(c) CU 113 (CU 110 discounted at the risk-free rate of 5%, with a **positive** risk margin of 8%, as implied by the required 'normal' return over the cycle)? This seems to give a more faithful representation of the obligation, because it (i) measures the liability at more than a risk-free liability with the same expected value (ii) includes a risk margin that reflects the 'normal' price required by the insurer (and, in this example, other market participants). On the other hand, if the 'normal' margin is used in a soft market, should the same margin be used in a hard market (which would lead to gains on sale)?

15. As background information, here are the arguments for including risk margins in a liability adequacy test:

(a) General purpose financial statements are intended to give users information that helps them assess the amount, timing and uncertainty of future cash flows. Including risk margins conveys information about their uncertainty.

(b) A risk-averse insurer would normally try to charge a premium that compensates it adequately for bearing the risk associated with the contract. If the unearned premium includes a risk margin, it would be inconsistent not to include a risk margin in the liability adequacy test.

(c) Including a risk margin is consistent with the measurement of provisions under IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* and impairment under IAS 36 *Impairment of Assets*.

16. One argument for an unearned premium approach or for a current entry value approach is that an observed price (the premium) can be used to calibrate the margin at inception. That argument is weakened if an insurer also needs to determine a margin on a different basis for a liability adequacy test at inception.

17. Both an unearned premium approach and current entry value use the margin (per unit of risk) implied by the original pricing. If those approaches use a liability adequacy test that incorporates a different margin, there could be a discontinuity in the accounting.

Staff recommendations

18. The staff recommends the following:

(a) In an unearned premium approach for pre-claims liabilities, a liability adequacy test is needed at inception and subsequently.

(b) In a current entry value approach for non-life insurance pre-claims liabilities and for life insurance liabilities, a liability adequacy test is needed at inception but **not** subsequently.

(c) In a current entry value approach for non-life insurance claims liabilities, no liability adequacy test is needed, either when the claims liability is first recognised or subsequently.

(d) In a current exit value approach (for any form of insurance liability), no liability adequacy test is needed.

19. What should be the reference point for the liability adequacy test (ie the amount compared with the pre-test carrying amount)? As already noted, current entry value could imply a negative margin. This would not be a faithful representation of an uncertain liability. Therefore, current exit value is a more useful reference point. In other words, the margin for the test should be consistent with current exit value.

20. The general standard for the recognition and measurement of liabilities not covered by other IFRSs is IAS 37. This provides much of the machinery needed for a liability adequacy test, though more guidance might be helpful in some areas (eg unit of account). Therefore, IAS 37 might provide a convenient reference point for a liability adequacy test, as an alternative to using current exit value as the reference point.

21. IFRS 4 *Insurance Contracts* requires insurers to use IAS 37 as the reference point for the liability adequacy test if the insurers do not already have a liability adequacy test that meets specified requirements. Relevant extracts from IFRS 4 are attached.

Embedded options and guarantees

22. If embedded options and guarantees are not measured separately at fair value, a liability adequacy test will need to address them. The possibilities include:

(a) Approaches that reflect intrinsic value, but not time value (optionality):

(i) Include them in the estimated cash flows if the insurer estimates that they will be in the money at exercise date.

(ii) Include their intrinsic value by including them in the estimated cash flows if they are in the money today.

(b) Approaches that reflect both intrinsic value and time value (optionality):

(i) Include them in the expected cash flows, with each scenario weighted by an estimate of its probability.

(ii) Include them, with each scenario weighted by a factor designed to achieve consistency with observable market prices (ie similar to fair value).

Staff recommendations

23. In the staff's view, a liability adequacy test should reflect both the intrinsic value and the time value (optionality) of embedded options and guarantees. They should be included on a basis consistent with observable market prices (ie fair value, or similar).

Allocation of a shortfall

24. For convenience, this paper describes any loss recognised as a result of a liability adequacy test as a **shortfall**. (Existing approaches sometimes use the term 'premium deficiency', but that implies an unearned premium approach).

25. Agenda paper 10F discusses whether deferred (recoverable) acquisition costs should be recognised as an asset, or considered in the initial calibration of the insurance liability. If a separate asset is recognised, it may be necessary to specify whether any shortfall reduces the carrying amount of the asset or increases the carrying amount of the liability. Similar issues arise if an intangible asset is recognised in relation to insurance contracts acquired in a business combination or otherwise acquired separately.

Staff recommendation

26. In the staff's view, any separate asset presented represents a net benefit that the insurer estimates that it will obtain after paying all contractual benefits. If a liability adequacy test is triggered, those net benefits are reduced, and it would be incongruous not to reduce the carrying amount of the asset. Therefore, the staff recommends that an insurer should recognise any shortfall as follows:

    (a) First by reducing the carrying amount of recoverable acquisition costs (if any are recognised as a separate asset) or, for contracts acquired in a business combination, the carrying amount of the present value of in force business acquired.

    (b) Then, if any further deficiency remains, by recognising an additional liability.

Subsequent accounting after a shortfall

27. It follows from the Board's tentative decisions in May that a shortfall reflects the time value of money and risk margins. If the insurer uses a current entry value approach for pre-claims liabilities, those liabilities also reflect the time value of money and risk margins. This implies that:

(a) Interest should be added over time to the shortfall.

(b) The insurer should recognise income as it is released from the risk reflected in the margin included in the shortfall.

28. If the insurer is using an unearned premium approach, no interest is added to the unearned premium, but the notion of release from risk is still relevant. To achieve consistency, this implies that:

(a) the insurer should recognise income as it is released from the risk reflected in the margin included in the shortfall.

(b) interest should not be added to the shortfall. However, because interest is not added, the passage of time may trigger the recognition of a further shortfall at a later date.

Staff recommendations

29. A shortfall includes risk margins. An insurer should recognise income as it is released from the risk represented by those margins. This applies in both an unearned premium approach and a current entry value approach, because in both cases the measurement of the underlying liability is reduced as the insurer is released from risk.

30. In an unearned premium approach, interest should not be accrued on a shortfall, to be consistent with the fact that interest is not accrued on unearned premium. However, because interest is not added, an additional shortfall may arise later when the liability adequacy test is applied again.

31. In a current entry value approach, interest should be accrued on a shortfall. This is consistent with the fact that interest is accrued on the underlying liability.

Reversal of a shortfall

32. It may sometimes happen that an insurer recognises a shortfall and revises its estimates at a later date. Should the insurer continue to recognise the original shortfall, or should it reverse the portion that is no longer needed? Under, IFRSs impairment losses on assets are generally reversed if the asset is no longer impaired. Although IFRSs prohibit reversal of impairment losses for the following, neither of these exceptions seems a relevant precedent for premium deficiencies:

(a) goodwill (because it is difficult to distinguish reversal of an impairment loss from changes in the value of internally generated goodwill)

(b) available-for-sale equity investments (because it is difficult to distinguish reversal of an impairment loss from other value changes).

33. For annual non-life insurance contracts, the pre-claims period does not often last long enough for a shortfall to both occur and then reverse. Therefore, reversals may be most relevant for longer-term contracts. They may be particularly relevant for longer-term contract containing embedded options and guarantees, because these may move into and out of the money during the pre-claims period.

Staff recommendations

34. A shortfall should be reversed if it no longer exists. This is consistent with the general approach in IFRSs. Although some IFRSs require a different treatment, the reasons for those treatments do not apply in this case.

35. The staff recommendation applies to both the unearned premium approach and the current entry value approach. It also applies equally to premium deficiencies recognised by reducing the carrying amount of assets (eg deferred acquisition costs) and those recognised by increasing the carrying amount of insurance liabilities.

Appendix

Extracts from IFRS 4

Liability adequacy test

15 An insurer shall assess at each reporting date whether its recognised insurance liabilities are adequate, using current estimates of future cash flows under its insurance contracts. If that assessment shows that the carrying amount of its insurance liabilities (less related deferred acquisition costs and related intangible assets, such as those discussed in paragraphs 31 and 32) is inadequate in the light of the estimated future cash flows, the entire deficiency shall be recognised in profit or loss.

16 If an insurer applies a liability adequacy test that meets specified minimum requirements, this IFRS imposes no further requirements. The minimum requirements are the following:

(a) The test considers current estimates of all contractual cash flows, and of related cash flows such as claims handling costs, as well as cash flows resulting from embedded options and guarantees.

(b) If the test shows that the liability is inadequate, the entire deficiency is recognised in profit or loss.

17 If an insurer's accounting policies do not require a liability adequacy test that meets the minimum requirements of paragraph 16, the insurer shall:

(a) determine the carrying amount of the relevant insurance liabilities* less the carrying amount of:

(i) any related deferred acquisition costs; and

(ii) any related intangible assets, such as those acquired in a business combination or portfolio transfer (see paragraphs 31 and 32). However, related reinsurance assets are not considered because an insurer accounts for them separately (see paragraph 20).

(b) determine whether the amount described in (a) is less than the carrying amount that would be required if the relevant insurance liabilities were within the scope of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. If it is less, the insurer shall recognise the entire difference in profit or loss and decrease the carrying amount of the related deferred acquisition costs or related intangible assets or increase the carrying amount of the relevant insurance liabilities.

18 If an insurer's liability adequacy test meets the minimum requirements of paragraph 16, the test is applied at the level of aggregation specified in that test. If its liability adequacy test does not meet those minimum requirements, the comparison described in paragraph 17 shall be made at the level of a portfolio of contracts that are subject to broadly similar risks and managed together as a single portfolio.

* The relevant insurance liabilities are those insurance liabilities (and related deferred acquisition costs and related intangible assets) for which the insurer's accounting policies do not require a liability adequacy test that meets the minimum requirements of paragraph 16.

19 The amount described in paragraph 17(b) (ie the result of applying IAS 37) shall reflect future investment margins (see paragraphs 27-29) if, and only if, the amount described in paragraph 17(a) also reflects those margins.

Extracts from Basis for Conclusions

BC94 Many existing accounting models have tests to confirm that insurance liabilities are not understated, and that related amounts recognised as assets, such as deferred acquisition costs, are not overstated. The precise form of the test depends on the underlying measurement approach. However, there is no guarantee that these tests exist everywhere and the credibility of IFRSs could suffer if an insurer claims to comply with IFRSs but fails to recognise material and reasonably foreseeable losses arising from existing contractual obligations. To avoid this, the IFRS requires a liability adequacy test* (see paragraphs 15-19).

BC95 The Board's intention was not to introduce piecemeal elements of a parallel measurement model, but to create a mechanism that reduces the possibility that material losses remain unrecognised during phase I. With this in mind, paragraph 16 of the IFRS defines minimum requirements that an insurer's existing test must meet. If the insurer does not apply a test that meets those requirements, it must apply a test specified by the Board. To specify a test on a basis that already exists in IFRSs and minimise the need for exceptions to existing principles, the Board decided to draw on IAS 37.

BC96 The liability adequacy test also applies to deferred acquisition costs and to intangible assets representing the contractual rights acquired in a business combination or portfolio transfer. As a result, when the Board revised IAS 36 *Impairment of Assets* in 2004, it excluded deferred acquisition costs and those intangible assets from the scope of IAS 36.

BC97 The Board considered whether it should retain the impairment model in IAS 36 for deferred acquisition costs, and perhaps also the related insurance liabilities. However, the IAS 36 model cannot be applied to deferred acquisition costs alone, without also considering the cash flows relating to the recognised liability. Indeed, some insurers capitalise acquisition costs implicitly through deductions in the measurement of the liability. Moreover, it would be confusing and difficult to apply this model to liabilities without some re-engineering. In the Board's view, it is simpler to use a model that is designed for liabilities, namely the IAS 37 model. In practice, a reengineered IAS 36 model and IAS 37 might not lead to very different results.

BC98 Some respondents suggested that the Board should specify that the cash flows considered in a liability adequacy test should include the effect of embedded options and guarantees, such as guaranteed annuity rates. They expressed concerns that many national practices have not required insurers to recognise these exposures, which can be very large.

BC99 Although the Board's objective was not to develop a detailed liability adequacy test, it observed that the size of exposures to embedded guarantees and options and the

* ED 5 described this as a 'loss recognition test'

failings of many national practices in this area warranted specific requirements, even in phase I. Accordingly, the Board decided that the minimum requirements for an existing liability adequacy test should include considering cash flows resulting from embedded options and guarantees. The Board did not specify how those cash flows should be considered but noted that an insurer would consider this matter in developing disclosures of its accounting policies. If an existing liability adequacy test does not meet the minimum requirements, a comparison is made with the measurement that IAS 37 would require. IAS 37 refers to the amount that an entity would rationally pay to settle the obligation or transfer it to a third party. Implicitly, this amount would consider the possible effect of embedded options and guarantees.

BC100 ED 5 did not specify the level of aggregation for the liability adequacy test and some respondents asked the Board to clarify this. Paragraph 18 of the IFRS confirms that the aggregation requirements of the existing liability adequacy test apply if the test meets the minimum requirements specified in paragraph 16 of the IFRS. If that test does not meet those minimum requirements, there is no conceptual justification for offsetting a loss on one contract against an otherwise unrecognisable gain on another contract. However, the Board concluded that a contract-by-contract assessment would impose costs that exceed the likely benefits to users. Therefore, paragraph 18 states that the comparison is made at the level of a portfolio of contracts that are subject to broadly similar risks and managed together as a portfolio. More precise definition would be difficult and is not needed, given the Board's restricted objective of ensuring at least a minimum level of testing for the limited life of phase I.

BC101 It is beyond the scope of phase I to create a detailed accounting regime for insurance contracts. Therefore, the IFRS does not specify:

(a) what criteria determine when existing contracts end and future contracts start.

(b) whether or how the cash flows are discounted to reflect the time value of money or adjusted for risk and uncertainty.

(c) whether the liability adequacy test considers both the time value and the intrinsic value of embedded options and guarantees.

(d) whether additional losses recognised because of the liability adequacy test are recognised by reducing the carrying amount of deferred acquisition costs or by increasing the carrying amount of the related insurance liabilities.

BC102 Some respondents asked the Board to clarify that no formal liability adequacy test is needed if an entity can demonstrate that its method of measuring insurance liabilities means that they are not understated. Paragraph 15 of the IFRS requires an insurer to 'assess whether its recognised insurance liabilities are adequate, using current estimates of future cash flows'. The fundamental point is that future cash flows must be considered in some way, and not merely be assumed to support the existing carrying amount. The IFRS does not specify the precise means of ensuring this, as long as the minimum requirements in paragraph 16 are met.

BC103 Some respondents read the liability adequacy test proposed in ED 5 as requiring fair value measurement as a minimum. That was not the Board's intention. An insurer needs to refer to IAS 37 only if the minimum requirements in paragraph 16 are not met.

BC104 Some respondents noted that many existing liability adequacy tests require measurements that do not include a risk margin. However, IAS 37 requires such a margin. To achieve consistency, these respondents suggested that a liability adequacy test under IAS 37 should also exclude these margins. The Board did not adopt this suggestion. The idea behind using IAS 37 for phase I was to take an existing measurement basis 'off the shelf' rather than create a new model.

AGENDA PAPER 10H
Gain on initial recognition of insurance contracts

Purpose of this paper

1. This paper discusses whether an accounting model for insurance contracts should prohibit the recognition of a net gain on initial recognition.

2. The possible recognition of a gain at inception is one of the main features that differentiate current exit value from current entry value (and from the unearned premium at inception). Therefore, we do not plan to ask the Board to reach a conclusion on gain at inception at this meeting. We plan to seek a conclusion when we ask the Board to select measurement attributes for life and non-life insurance contracts (tentatively, April 2006.)

3. The discussion in this paper applies equally to life and non-life insurance contracts.

4. This paper does not address losses at inception. We plan to discuss that topic at a future meeting when we discuss two related issues (discount rate and credit characteristics of insurance liabilities.)

Background

5. This paper assumes that an insurer should initially recognise its rights and obligations under an insurance contract when the insurer becomes a party to the contract. (The staff does not expect this view to be controversial, and does not plan specific discussion of it.)

6. In many cases, an insurer (or an agent or broker acting for the insurer) receives a premium up front when the insurer becomes a party to the insurance contract. That premium could be either a single premium, or the first of a series of instalments. Therefore, this paper uses the terms initial recognition and inception interchangeably. Nevertheless, in the staff's view, the issues discussed in this paper do not depend on whether the first (or only) premium is actually received at inception or later.

7. Some accounting models measure the liability prospectively solely by reference to future cash flows, without considering premiums already received. In these models, there could be a gain or loss at inception, unless the risk margin is calibrated at inception to the initial

entry value (ie the initial premium received, if any, less all acquisition costs). That gain or loss could arise from:

(a) premium pricing (eg in a niche market or if the insurer has special distribution systems), underpricing (eg to buy or maintain market share), regulatory pricing constraints or the state of the insurance cycle.

(b) an element captured in pricing but not reflected in accounting measurements (eg if pricing includes expected future investment margins but accounting measurements exclude those margins)

(c) other differences between the entry value of the contract and some feature of the measurement attribute selected. For example, if the measurement attribute is current exit value, the resulting measurement could be more or less than the entry value.

(d) accidental use of flawed assumptions (eg over-optimism).

(e) deliberate use of flawed assumptions.

8. Insurers aim to set premiums that cover various items, such as the cost of expected policyholder claims and benefits, expenses, acquisition costs and to provide a return that provides reasonable compensation for the risks undertaken and services provided. As background for the discussion of possible gains at inception, the appendix to this paper identifies implicit or explicit components of the premium that cover each of these items. The objective of this analysis is to determine whether any apparent gain at inception reflects a genuine economic event related to inception, or whether it might arise from the failure to consider some important feature of the insurer's contractual rights and obligations.

9. There is clearly a link between initial measurement of insurance liabilities (and recoverable acquisition costs, if presented separately) and the amount of any gain or loss recognised at inception.

10. As a minor point, we note that some accounting models recognise some gain at inception as a by-product of the allocation approach adopted, though these models were not constructed with this aim. For example, the US model for long duration insurance within

the scope of SFAS 60 aims to report profit as a constant proportion of premium. It follows that some profit is reported at inception if a premium is received then.

A common misconception

11. Some commentators appear to believe that an asset-and-liability model results in the immediate recognition, at inception, of the entire profit expected over the life of the contract. However, that is not the case for any approach that has ever been discussed by the Board, the Insurance Working Group or the former IASC Steering Committee (or anyone else, as far as we know). Even if some income is reported at inception, the following items would be reported as income or expense in later periods:

    (a) Compensation for bearing risk during the period (ie the difference between the opening risk margin and closing risk margin).

    (b) Compensation for providing services during the period (ie the difference between the opening amount attributed to the obligation to provide services during the remaining term of the contract and the closing amount attributed to that obligation).

    (c) Investment margin (ie investment return, less interest accumulated on the insurance liability)

    (d) Experience adjustments and changes in assumptions

Other relevant projects

12. The Board will also encounter the issue of gains at inception ('day one gains') in the projects on revenue recognition and fair value measurement.

Arguments against gains at inception

13. Some argue that insurers should not recognise significant gains at the inception of insurance contracts, on the following grounds:

    (a) Insurers are required to provide a service (ie bearing risk) throughout the contract term. The inception of a contract does not by itself, provide utility to the policyholder. The policyholder derives only from the subsequent provision of the service, and does not derive separately utility from the inception of the contract.

Therefore, an insurer should not begin to recognise profit until it begins to be released from risk.

(b) Financial statements will be less relevant and reliable if they include gains recognised at inception based on inherently subjective measurements. There is no reliable and non-arbitrary way to determine how much of a gain arises at inception and how much relates to bearing risk, and providing services, over the life of the contract. 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 a number of 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.

(c) Recognition of a gain at inception is imprudent.

(d) Unless the contract involves a single premium up front, cash realisation of any profit depends on the receipt of future premiums. The insurer cannot compel the policyholder to pay those premiums.

(e) Recognising a gain at inception would be inconsistent with IAS 39, which states: 'The best evidence of the fair value of a financial instrument at initial recognition is the transaction price (ie the fair value of the consideration given or received) unless the fair value of that instrument is 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.

Arguments for gains at inception (if applicable)

14. Some argue that 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. They argue that:

    (a) 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.

Input from the Insurance Working Group

15. 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 they should not be prohibited, if there are no doubts about the reliability of the liability measurement.

16. 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.

17. 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.

18. Embedded value information includes disclosure of gains generated by new business disclosure. The CFO Forum has stated that it sees embedded value information as useful supplementary disclosure, but as unsuitable for the face of the financial statements.

Questions for the Board

19. As noted above, we are not seeking a conclusion on this issue yet. However, we would appreciate thoughts on the following questions. Should an accounting model for insurance contracts:

    (a) prohibit the recognition of net profit on initial recognition?

    (b) limit the recognition of net profit on initial recognition? If so, what is the appropriate limit?

    (c) not prohibit the recognition of net profit on initial recognition, provided all contractual rights and obligations are recognised, and measured, appropriately (ie in accordance with the Framework) at that date?

Appendix
Explicit or implicit components of a premium

Component	**When are related expenses recognised?**	**When might it be appropriate to recognise this part of the premium?**
Expected present value of claims and benefits (including ancillary costs, such as claims handling, settlement, litigation, direct and indirect costs of contract administration).	When the claims and benefits are expected. (differences between expected and actual are considered separately below)	In line with the expected timing of the claims and benefits.
Differences between actual claims and benefits, and previous expected value	When the differences arise	-
Changes in expected value of actual claims and benefits	When expectations change	-
Compensation for bearing risk that claims and benefits will differ from expected value	The insurer may, over time, incur some unavoidable opportunity costs of holding necessary capital.	As the insurer is released from risk

Component	**When are related expenses recognised?**	**When might it be appropriate to recognise this part of the premium?**
Time value of money	-	Accrue interest on the liability (Dr interest expense, Cr insurance liability) At the same time, interest income is earned on the assets
Incremental costs of originating the contract (eg commission, underwriting costs)	When those costs are incurred	Arguably, at inception
Other costs of originating the contract (eg salaries, sales overheads, advertising)	When those costs are incurred	Arguably, at inception
Investment in distribution infrastructure:		
• cost of assets used in distribution (eg computer hardware and software)	As the assets are depreciated (at inception of the contracts)	Arguably, at inception
• other expenses (eg salaries of staff who set up distribution networks)	As incurred (before inception of contracts)	Arguably, at inception

Component	When are related expenses recognised?	When might it be appropriate to recognise this part of the premium?
• compensation for time lag before that investment is recovered.	Over time (before inception of contracts)	Arguably, at inception
Difference between the actual premium and the sum of the above components. (Could be various factors, eg ability to obtain above average pricing, branding, distribution capability, recognised or unrecognised intangibles, barriers to entry, state of the insurance cycle, regulatory or legal factors, credit characteristics of the liability, other identifiable or unidentifiable factors)		To be determined

AGENDA PAPER 10I
Non-life insurance contracts - Measurement attribute for pre-claims liabilities

Purpose of this paper

1. In May 2005, the Board directed the staff to work in parallel on two alternative approaches for non-life insurance contracts, until the Board determines how to select one of them. This paper asks the Board to choose between these two approaches.

Summary of recommendations

2. This paper:

    a. recommends that the Board adopt a prospective approach for non-life insurance pre-claims liabilities. The staff expects to ask the Board in April to express a preference between current exit value and current entry value.

    b. asks the Board to emphasise the following, without creating a specific exception to the prospective approach. For short duration contracts, unearned premium may often be a reasonable approximation to a prospective measurement. However, an insurer should not just make this assumption without testing, particularly if a contract is likely to be highly profitable or highly unprofitable, or circumstances have changed significantly since inception.

    c. asks the Board to confirm one point that the staff views as implicit in earlier discussion: the discount rate for non-life insurance claims liabilities should be current.

3. We plan to discuss at a future meeting:

    a. how an insurer should report premiums and claims information in a prospective approach.

    b. whether an insurer should accrue interest on pre-claims liabilities and account separately for the release from the risk embodied in pre-claims liabilities.

Arguments for an unearned premium approach

4. The following are possible arguments for an unearned premium approach:

    a. Most existing accounting models use an unearned premium approach.

    b. Users are accustomed to using information about earned premiums and incurred claims to derive important ratios, such as claims ratios[2] and combined ratios.[3] A prospective approach may imply that premiums should be reported as deposits (not revenue) and that claims should be reported as returns of deposits (not expenses).

    c. In many cases, unearned premium may be a reasonable proxy for a prospective measurement, but obtainable with less cost and effort. This may be particularly true for short duration contracts (eg many annual non-life contracts.)

    d. An unearned premium approach is more consistent than a prospective approach with the customer consideration approach that the Board and the FASB are exploring in the project on revenue recognition.

Arguments for a prospective approach

5. The following are possible arguments for a prospective approach:

    a. A prospective approach provides more relevant 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 prospective approach requires an insurer to make explicit estimates, rather than rely on the implicit margins that existed at inception. The requirement to make explicit estimates should reduce the risk that insurers will overlook changes in circumstances.

[2] Incurred claims divided by earned premiums
[3] (Incurred claims plus expenses) divided by earned premiums

c. A prospective approach requires margins that are explicit rather than implicit. Developing such margins is likely to require a deeper understanding of the risks. That may lead to more robust estimates of the expected cash flows.

d. A prospective approach reduces the need for a liability adequacy test. Any such test is likely to involve some elements that are arbitrary. Agenda paper 7G suggests that current entry value needs such a test at inception, but not subsequently, and current exit value eliminates the need for such a test entirely.

e. An unearned premium approach may be problematic if premium rates are subject to legal or regulatory controls.

f. A prospective approach provides a more consistent approach to favourable changes in estimates. In an unearned premium approach, some favourable changes are recognised implicitly by offset against other changes that are adverse. Thus, an unearned premium approach recognises favourable changes arbitrarily, based on whether other adverse changes occur at the same time and based on the size of implicit margins that existed at inception.

g. A prospective approach provides a more coherent framework for more complex contracts, such as multi-year, multi-line or stop loss contracts.

h. A prospective approach is more consistent with other IFRSs for non-financial liabilities (see IAS 37) and financial liabilities (see IAS 39). Both IAS 37 and IAS 39 already require current estimates of future cash flows. In addition, IAS 37 requires a current discount rate. IAS 39 requires a current discount rate for liabilities classified as 'at fair value through profit or loss', but the original discount rate for liabilities carried at amortised cost.

i. A prospective approach may reduce (and perhaps eliminate) the need to separate embedded derivatives.

j. A prospective approach may reduce (and perhaps eliminate) the need for anti-abuse rules to prevent selective recognition of previously unrecognised economic gains through reinsurance.

k. A prospective approach reduces possible accounting mismatches between insurance liabilities and the insurer's assets, and should highlight economic mismatches more clearly.

l. A prospective approach is consistent with the Board's tentative decision to adopt a prospective approach for life insurance contracts. There is no obvious reason to use different approaches for different types of insurance contract. Moreover, if the same approach is used for all types of insurance contract, there is no need to find a way to make the distinction.

Input from the Insurance Working Group

6. At the January 2006 meeting of the Insurance Working Group (IWG), participants noted that unearned premiums might often be a reasonable proxy for a prospective measurement, especially for short-duration contracts. However, perhaps unexpectedly, participants did not generally appear to view an unearned premium approach as preferable in principle.

Recommendation

7. The arguments for a prospective approach are compelling. The staff recommends it.

8. For short duration contracts, the pre-claims period is short (eg six months on average for an annual contract). Moreover, if an insurer identifies significant changes during that short period, the changes are much more likely to lead to losses than to gains. Therefore, for these contracts, unearned premium may often be a reasonable approximation to a prospective measurement. However, an insurer should not just make this assumption without testing, particularly if a contract is likely to be highly profitable or highly unprofitable, or circumstances have changed significantly since inception. The staff recommends that the Board emphasise these points, but not create an exception to the recommended general principle of using a prospective approach.

Current discount rate

9. In May 2005, the Board concluded that non-life claims liabilities should be discounted. We recommend that the discount rates used should be current. We believe this to be the

Board's intention, but we seek explicit confirmation. (We plan to address some other matters relating to discount rates at a future meeting).

AGENDA PAPER 10J
Insurance contracts (phase II)
Project planning

Purpose of this paper

1. This paper gives an overview of the topics that the staff expects to ask the Board to discuss over the next few months, and the projected timing.

Terminology

2. The discussion below for non-life contracts distinguishes:

   (a) pre-claims liabilities (ie stand-ready obligations to pay valid future claims under existing contracts), from

   (b) claims liabilities (obligations to pay valid claims for insured events that have already occurred.)

Topic and brief summary of content	**IASB meeting**
Contract cash flows that depend on policyholder behaviour. Should the accounting model incorporate expectations about cash inflows and outflows that are a consequence of policyholder renewals or cancellations of an insurance contract? How should an insurer distinguish existing contracts (included in measurement) from future contracts (not included)?	February 2006 AP10A-C
Acquisition costs. Should costs incurred to acquire insurance contracts be: • recognised as an asset? If so, which costs should be included and how should they be amortised? • considered in determining the initial measurement of an insurance liability? If so, which costs should be considered?	February 2006 AP10F

Liability adequacy test. Some approaches under consideration require a liability adequacy test. (This test is redundant in other approaches). What is the unit of account for the test? Which cash flows are included? How are embedded options and guarantees considered? What margins are included?	February 2006 AP10G
Gain or loss on initial measurement/ liability recognition. Should the accounting model prohibit (or limit) the recognition of net profit or loss on initial recognition? Should a cedant recognise gains or losses when it buys reinsurance?	February 2006 AP10H
Measurement attribute: non-life insurance pre-claims liability In May the Board decided tentatively to pursue two measurement approaches for pre-claims liabilities in parallel for the time being. • Unearned premium approach: measure pre-claims liabilities by reference to the unexpired portion of the consideration received. • Prospective approach: measure pre-claims liabilities in the same way as claims liabilities This paper will ask the Board to select one of these approaches. See April 2006 for measurement attribute for (i) non-life claims liabilities and (ii) life insurance liabilities.	February 2006 AP10I
Participating contracts. Are policyholder participation features embedded liabilities or embedded equity components? What is the effect of the insurer's discretion and of constraints on that discretion? How should participation features be recognised, measured and presented?	March 2006

Risk margins and profit margins. How should margins be developed at initial recognition and later? How should the release from risk be quantified? How do long-term guarantees of insurability affect margins What is the role of factors such as the insurance cycle, capital constraints? What are the implications for release of margins and for revenue recognition? Can the notion of a replicating portfolio help in quantifying traded market risks (eg interest rate risk)? Should margins be included in relation to explicit or implicit fees for future services (eg future investment management fees)?	March 2006
Estimates What guidance is needed on estimating cash flows? Should expected values be used? Should an entity's own estimates be used if they differ demonstrably from variables observable directly from market prices?	March 2006
Time value of money Discount rate issues: • Some argue that the long-term nature of insurance liabilities enables insurers to capture a liquidity premium by investing in illiquid assets. Should that premium be added to the discount rate for insurance liabilities (this reducing the measurement)? How should that premium be quantified? • What is the best benchmark for the time value of money (rates on government securities or swap rates)? • Should guidance be given on determining risk-free rates in markets where risk-free securities of appropriate duration are not available?	March 2006
Embedded options and guarantees. Should some or all embedded options and guarantees be measured separately? (Some measurement attributes may make this question redundant.)	March 2006

Universal life contracts. Universal life contracts give more discretion than traditional life insurance contracts to both policyholders and the insurer. What effect does such discretion have on recognition and measurement?	March 2006
Recognition and derecognition. When should rights and obligations under insurance contracts be recognised and derecognised?	March 2006
Unit of account. At what level should insurance contracts be aggregated for measurement?	April 2006
Measurement attribute: life insurance liabilities. What measurement attribute should be used for rights and obligations under life insurance contracts? The December 2005 Board papers recommend further consideration of two approaches (current entry value or current exit value, as described in agenda papers 10D and 10E for February 2006).	April 2006
Measurement attribute: non-life insurance claims liabilities The Board concluded tentatively in May 2005 that claims liabilities should be discounted and include risk margins, but the staff did not ask the Board to specify a measurement attribute. At this meeting (February 2006), the staff will ask the Board to specify as the measurement attribute for these liabilities either current entry value or current exit value. In April, the staff will ask the Board to select one of these as the measurement attribute and, if applicable, to explain the reasons for any differences between the measurement attribute(s) selected for non-life pre-claims liabilities, non-life claims liabilities and life liabilities.	April 2006

Unit-linked and index-linked payments contracts. How should an insurer: • measure obligations denominated in units of an internal or external investment fund? • measure and present the assets of an internal fund linked to such obligations? • account for revenue (eg investment management fees) and expense (including acquisition costs) related to such contracts? • measure guarantees of unit prices?	April 2006
Unbundling. Should an insurer unbundle the individual elements of an insurance contract and measure them individually?	April 2006
Credit characteristics of insurance liabilities. Should the measurement of insurance liabilities include the effect of their credit characteristics? If so, what is the effect of guarantee funds?	April 2006
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. To consider whether the Discussion Paper needs to address insurance contracts acquired in business combinations and portfolio transfers	May 2006
Long-term savings contracts. To consider whether any conclusions reached for insurance contracts have implications for the 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
Insurance Working Group meeting (tentative date)	29-30 June 2006
First pre-ballot draft	July 2006
Second pre-ballot draft	September 2006
Ballot draft	November 2006
Publication	December 2006