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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: **March 2006, London**

Project: **Insurance contracts (phase II) – Overview of papers for this meeting (Agenda Paper 7)**

Objective

1. The objective of the discussion at this meeting is to discuss further components of the two measurement models the Board is considering. The staff plans to ask the Board to choose between these models in April, after discussing the remaining components.
2. At this meeting, the staff will ask the Board to discuss:
 - (a) Policyholder participation rights. Agenda paper 7A contains the main discuss. Agenda paper 7B provides some case studies and agenda paper 7C provides relevant extracts from IFRS 4 *Insurance Contracts*.
 - (b) Estimating cash flows (agenda paper 7D)
 - (c) Risk margins (agenda paper 7E)
 - (d) Embedded derivatives (agenda paper 7F)
 - (e) Discount rates (agenda paper 7G)

(f) Recognition and derecognition (agenda paper 7H)

(g) Project planning (agenda paper 7I)

Models under consideration

3. The Board is considering two approaches, labelled for discussion purposes as current entry value and current exit value. A brief summary follows.

Current entry value

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

Is 'current entry value' the best description?

5. To avoid constant changes in terminology, the papers for this meeting still use the terms 'current entry value' and 'current exit value' that we have used in previous meeting. Some view the difference as arising from a difference in reference markets (eg retail versus wholesale), rather than from a difference between entry prices and exit prices. The staff has not yet identified a better term, and would welcome suggestions.
6. Current entry value is 'current' in the sense that the expected cash flows and discount rates are based on current information, and 'entry' in the sense that the margins are calibrated to the actual premium charged. (Agenda paper 7E discusses in more detail how this 'freezing' of the margin might actually work.)

Current exit value

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

Current entry value and current exit value compared

8. Both current entry value and current exit value:

- (a) reflect current unbiased estimates of future cash flows.
- (b) use a current risk-free market discount rate (see agenda paper 7G).
- (c) recognise acquisition costs as an expense (though acquisition costs recovered from premiums already received play some role in the initial calibration of the liability, particularly for current entry value).
- (d) use existing IFRSs to measure assets.

9. Current exit value and current entry value differ in the following respects:

- (a) Current entry value does not permit the recognition of a gain at inception (arguably, a loss might be recognised in some cases because of the liability adequacy test).

In contrast, current exit value could lead to the recognition of a gain or loss at inception if the insurer concludes that the estimated secondary market price for risk and profit differs from the price that is explicitly or implicitly embedded in the premiums that it charges. In practice, some constraints might be put on recognising such gains or losses if there is little or no observable market data. For example, IAS 39 restricts the recognition of initial gains and losses that are not supported 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.’¹

- (b) For both current exit value and current entry value, the insurer recognises income as it is released from risk under the contract and provides services under the contract.

However:

- (i) in current exit value, the margin after inception is the estimated margin that market participants would require for the remaining contractual obligations, contractual rights and related risks. The margin would vary over time if there are changes in the estimate of the margin that market participants would require.

- (ii) in contrast, current entry value calibrates the margin at inception to the observed transaction price with the policyholder (less recoverable acquisition costs incurred, if not presented as an asset). That margin reflects changes over time in the insurer's estimate of the **amount** of risk, but freezes the **per-unit price** of risk at inception.
- (c) Current exit value reflects the credit characteristics of the liability explicitly. Current entry value reflects them implicitly, or perhaps not at all. We plan to discuss this in April.
- (d) Current exit value does not include a liability adequacy test, because none is needed. Current entry value needs such a test at inception (and perhaps later, a subject for further discussion).
- (e) Embedded derivatives may need to be separated from a host insurance contract that is measured at current entry value (see agenda paper 7F).

Background

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

- (a) the project plan (January 2005).
- (b) non-life insurance contracts (May 2005). The Board decided tentatively to pursue two approaches in parallel for the time being (an unearned premium approach and a prospective approach). The Board subsequently decided (February 2006) to work only on prospective approaches (current entry value and current exit value).
- (c) life insurance contracts (December 2005). The Board decided to focus on current value approaches (current entry value and current exit value).
- (d) components of the current value approaches (February 2005). The Board decided, in summary:

¹ IAS 39 appendix A, paragraph AG76

- (i) When an insurer recognises rights and obligations arising under an insurance contract, it should also recognise as an asset the portion of the customer relationship (relationship with the policyholder) that relates to future payments that the policyholder must make to retain a right to guaranteed insurability.
- (ii) Acquisition costs should not be deferred and presented as if they were an asset. In a current entry value model, the initial measurement of the liability is calibrated to the initial premium received, less any acquisition costs already recovered from that premium.
- (iii) A liability adequacy test is needed in a current entry value approach at inception, and perhaps subsequently (but is redundant in a current exit value approach). The margin should be consistent with the margin that would be included in current exit value.

Further details

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

- (a) More detailed descriptions of the current entry value and current exit value approaches (February 2006, agenda papers 10D and 10E)
- (b) Illustrations of possible accounting approaches for life insurance contracts (December 2005, agenda paper 9C) and explanations of those illustrations (agenda paper 9D).
- (c) Illustrations of possible accounting approaches for non-life insurance contracts (May 2005, agenda paper 4E) and explanations of those illustrations (agenda paper 4D).
- (d) Summary of Phase II principles suggested in July 2005 by insurers (December 2005, agenda paper 9F)