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International Accounting Standards Board

INFORMATION FOR OBSERVERS

Board Meeting: **24 May 2006, London**

Project: **Insurance contracts (phase II) (Agenda Papers 4A, 4B, 4C)**

Agenda papers 4A, 4B and 4C are amended reissues of agenda papers from the April meeting.
Additions are underlined and deletions are struck through.

AGENDA PAPER 4A
UNIVERSAL LIFE CONTRACTS

Purpose of this paper

1. This paper discusses the treatment of universal life contracts.

Summary of recommendations

2. The staff recommends that an insurer should measure liabilities under universal life contracts by reference to future cash flows (paragraph 20).

3. This paper:

   (a) does not address various implementation issues (listed in paragraph 12).

   (b) analyses the rate used to credit interest to policyholder balances as made up of the market rate for a pure deposit, less an implicit fee. The insurer typically has discretion to vary that implicit fee (within contractual and legal limits.) We plan to consider the implications of this discretion at a future meeting (paragraph 21).

(c) discusses the cash flows to be included, in the light of the Board's previous conclusions on customer relationships associated with insurance contracts (paragraphs 25-30).

4. The rest of this paper deals with the following topics:

(a) What is universal life insurance? (paragraphs 5-8)

(b) Possible accounting approaches (paragraphs 9-20)

(c) Crediting rates (paragraphs 21-22)

(d) Which future cash flows? (paragraphs 23-28)

(e) A final word on prospective measurement (paragraph 29)

(f) Some relevant extracts from US GAAP (appendix)

What is universal life insurance?

5. The American Council of Life Insurers (ACLI) defines **universal life insurance** (or **adjustable life**) as 'A type of permanent life insurance[1] that allows you, after your initial payment, to pay premiums at any time, in virtually any amount, subject to certain minimums and maximums. This policy also permits you to reduce or increase the death benefit more easily than under a traditional whole life policy. To increase your death benefit, the insurance company usually requires you to furnish satisfactory evidence of your continued good health.'[2]

6. A universal life contract will typically operate as follows:

(a) Premiums are added to a policyholder account.

(b) The contract may permit the policyholder to vary premiums, within specified limits.

(c) The contract may permit the policyholder to increase or decrease the amount of life insurance cover, within specified limits. In some cases, an increase in cover may not require a medical examination (up to a specified limit).

[1] The ACLI defines permanent life insurance as 'Life insurance designed to provide lifelong financial protection. As long as you pay the necessary premiums, the death benefit will be paid. Most permanent policies have a feature known as cash value that builds up, tax-deferred, over the life of the policy and can be used to help fund financial goals, such as retirement or education expenses.'

[2] http://www.acli.org/ACLI/Consumer/Glossary/Default.htm

(d) Depending on the contract, the death benefit may be:

(i) An amount specified in the contract. The insurer's risk is the difference between the specified amount and the policyholder account balance.

(ii) The policyholder account balance plus a specified amount.

(e) Deductions are made from the policyholder account for mortality charges and perhaps for other items, such as administration costs or acquisition costs. The contract may limit the level of mortality and/or other charges.

(f) Interest is added to the policyholder account, based on the account balance. Depending on the contract, this may be:

(i) Interest determined using a **crediting rate** set by the insurer. The crediting rate will reflect factors such as the returns on the assets backing the contract(s), market conditions, competitive considerations, expectations established in marketing literature and regulatory requirements. The contract may specify a minimum crediting rate.

(ii) The return on a specified pool of assets dedicated to a series of contracts. This is a form of unit-linking and is sometimes called **variable universal life**. The contract may specify a minimum crediting rate, for example a return of premiums. The contract may permit the insurer to deduct a periodic investment management fee from the pool of assets.

(g) The contract provides mortality coverage as long as funds remain in the policyholder account to pay the mortality and other charges. Some contracts contain 'secondary guarantees' that permit mortality coverage to continue even if the policyholder account is exhausted.

(h) The contract may permit the policyholder to withdraw the account balance. Withdrawals may be subject to surrender charges, and the contract may restrict the timing of withdrawals.

Further information

7. The appendix to this paper includes some extracts from the relevant US standard, SFAS 97 *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments*. This gives further information on the nature of these contracts and their treatment under US GAAP.

8. In April, the Insurance Working Group discussed a report by the American Council of Life Insurers and International Actuarial Association on *Renewal Premiums and Discretionary Participation Features of a Life Insurance Contract*. That report focused on an example of a universal life contract. We do not plan to discuss that paper at this meeting, but Board members may wish to refer to it if they wish to see a comprehensive example.

Possible accounting approaches

9. Two types of accounting approach could be considered for universal life contracts:

   (a) components approach

   (b) integrated prospective approach

Components approach

10. This approach would account separately for various components of the contract:

   (a) the account balance

   (b) obligation to provide mortality cover during the remainder of the current period for which mortality charges have already been deducted from the policyholder account. Essentially, this is term insurance for the current period. There may also be an element of prepayment if the charges already deducted are to compensate the insurer for mortality charges in future periods. Similarly, the insurer has an obligation to provide services (eg investment management) during the remainder of the period for which the insurer has already charged explicit fees.

   (c) options and guarantees embedded in the contract, for example:

      (i) guaranteed maximum mortality charges for future periods under the existing contract.

      (ii) guaranteed maximum expense charges

      (iii) guaranteed minimum crediting rates

      (iv) secondary guarantees (described in paragraph 6(g) above)

   (d) the portion of the customer relationship associated with the contract (see paragraphs 23-26 for further discussion). If recognised, this would, in existing practice, be

measured by reference to acquisition costs incurred (perhaps less front-end fees charged to the policyholder).

11. A components approach would probably not consider the following items (except perhaps if they are an unavoidable consequence of making payments under options and guarantees):

    (a) the profit the insurer expects to generate from future mortality and other charges

    (b) the estimated spread between the return on the assets backing the contract and the amount credited to policyholders. Some may view this spread as an implicit investment management charge.

    (c) the flexibility inherent in the insurer's ability, within specified limits, to vary crediting rates and mortality and other charges. Some may view this flexibility as a form of option.

Integrated prospective approach

12. An integrated prospective approach would discount all future cash flows arising from the contract. It would not account separately for the account balance. To implement this approach, various issues would need to be addressed, including:

    (a) estimating the cash flows.

    (b) determining appropriate margins for the risk associated with the cash flows, and for the profit that market participants would require for providing services under the contract.

    (c) determining a discount rate that reflects the time value of money and, to the extent not captured in margins in (b), the characteristics of the liability.

    (d) reflecting embedded options and guarantees.

    (e) customer relationships.

    (f) presentation of the income statement and balance sheet.

    (g) benefit of the insurer's ability to vary charges and crediting rates

13. This paper does not address these implementation issues because we are discussing them in the context of other types of life insurance contract.

Arguments for a components approach

14. Supporters argue that a components approach would create more consistency with other contracts in the financial services sector. For example, the policyholder account functions in some respects like a bank account.

Arguments for an integrated prospective approach

15. Supporters argue that an integrated prospective approach is more consistent with the way these contracts are priced and managed. They also argue that the components are interdependent and that separating them would be arbitrary. For example, if the death benefit is a specified amount including the account balance, the components approach would split the contract into the account balance and a separate death benefit (excess, if any, of the specified amount over the account balance). However, in this case, the amount of the death benefit depends on the account balance and so cannot be measured without considering the account balance and future movements in the account balance.

Implications for other forms of life insurance

16. In thinking about universal life insurance, it may be worth considering the implications for other forms of life insurance. Life insurance contracts form a continuum. At one end, a universal life contract unbundles many or all components (mortality, expenses, investments) and makes these transparent to the policyholder. At the other end, a traditional life insurance bundles together virtually all the components, and these are not typically transparent to the policyholder.

17. Some may feel that it would be conceptually appropriate to apply a components approach to all life insurance contracts, though they acknowledge that practical implementation would be more difficult for some contracts, and in some cases perhaps arbitrary or even impossible.

18. Others may feel that a components approach is feasible, and perhaps appropriate, for universal life, but not for, for example, traditional life insurance.

19. Still others may feel that a components approach is not feasible for traditional life insurance and that it would be undesirable to introduce a different approach for universal life contracts.

Staff recommendation

20. The staff recommends that the Board adopt the integrated prospective approach to universal life insurance contracts. In other words, an insurer should measure the contract

prospectively by reference to the future cash flows, not by reference to the account balance.

Crediting rates

21. As noted before, the insurer typically has discretion to change credits, though often subject to a contractually (or in some cases legally) required minimum crediting rate. If the measurement is based on estimates of future cash flows, we need to consider how to deal with crediting rates:

    (a) Guarantees of minimum crediting rates need to be measured using option pricing techniques that capture the inherent optionality.

    (b) If the crediting rate is always the market rate for similar deposit balances outside a universal life contract, cash flows would be projected using the crediting rate and discounted back at the same rate. This gives the same answer as just using the account balance.

    (c) If the crediting rate differs from the market rate, the answer may be more complex. This is because the contract provides various sources of income for the insurer (such as mortality charges, expense charges, interest spreads) and the insurer may be able to obtain the same overall result by different combinations of charges and by cross-subsidies between the different charges. It may be worth thinking of the crediting rate as made up of the market rate for a pure deposit, less an implicit fee. If this is done, the cash flows from the deposit could be projected and then discounted back at the market rate (giving the same rate) and the implicit fee could be treated in the same way as the explicit fees. The implicit fees would affect the measurement of the liability to the extent they differ from the fees that other market participants would require (as required by the Board's decision in April on profit margins).

22. The implicit fee discussed in the paragraph 21(c) has an important feature: the insurer has discretion to vary it (within the contractual or legal limits.) We plan to consider the implications of this at a future meeting.

Which future cash flows?

23. The Board has decided tentatively that:

    (a) 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. A right to guaranteed insurability permits continued coverage without reconfirmation of the policyholder's risk profile, at a price that is contractually constrained. (February 2006)

(b) An insurer should present the recognised portion of the customer relationship as part of the related liability, not as a separate asset. (April 2006)

24. The following table summarises the implications of that decision for universal life contracts.

Treatment	*Type of cash flow*
1. Included in the measurement of the insurance liability	1.1 Stand-ready obligations arising from guarantees of insurability, or other guarantees, for example, of (i) maximum mortality charges, (ii) maximum expense charges or (iii) minimum crediting rates. The measurement of the stand-ready obligation reflects both the additional payments resulting to policyholders resulting from the guarantees, and the additional premiums needed to keep the guarantees in force. The measurement would reflect both the intrinsic value and time value (optionality) of the guarantees. 1.2 Excess, if any, of the surrender value over the measurement assuming no surrender. Thus the liability is measured at the higher of (i) the amount assuming no surrender and (ii) the surrender value (see also 2.2 below for related customer relationship)

Treatment	*Type of cash flow*
2. Included in the measurement of the portion of the customer relationship associated with the contracts (and presented as part of the related liability in 1)	2.1 Future premiums that the policyholder must make to retain guaranteed insurability, and resulting additional benefits to policyholders (to the extent that the benefit to the insurer from receiving those premiums exceeds the resulting additional benefits to policyholders). 2.2 Excess, if any, of (i) the measurement using estimated surrender rates over (ii) surrender values (see also 1.2 for measurement of the related liability). However, this excess is capped at the level required to maintain guaranteed insurability.
3. Not included	3.1 Future premiums that the policyholder must make to retain guarantees of maximum mortality charges, maximum expense rates or minimum crediting rates 3.2 Future premiums beyond those needed to retain guaranteed insurability (for guaranteed insurability, see 2.1 customer relationship) 3.3 Net benefits to the insurer from surrender 3.4 Net benefits to the insurer if policyholders maintain account balances beyond the level needed to retain guaranteed insurability (including maintenance of account balances that are needed to keep other guarantees in force, but are not needed to maintain guaranteed insurability).

25. The above table notes that the cash flows resulting from a contract may need to be split into recognised and unrecognised portions. The motivation for this split is derived from an analysis of the rights and contractual rights and obligations. In principle, therefore, this split is made contract by contract, not in aggregate for an entire portfolio of contracts.

26. Some may have concerns about the relevance and operationality of this split. It may be worth seeking feedback from the Insurance Working Group in June.

Analogy to participating contracts

27. For some types of participating contract, policyholder benefits reflect returns on a specified pool of assets, although the insurer has some discretion to vary the amount and timing of that participation. The crediting rate mechanism for a universal life contract can have very similar effect in practice, because actual asset returns can be an important influence on crediting rates, though actual asset returns are not the sole determinant. Therefore, some argue that an insurer should account for interest credits on universal life contracts in the same way as for bonus distributions to participating policyholders.

28. Some may take the view that the insurer has no obligation to credit more than the guaranteed minimum and that the liability should be measured on that basis. If that approach is adopted, it would presumably be necessary to use lapse assumptions consistent with a strategy of crediting the contractual minimum and no more. We plan to analyse that approach more fully at a future meeting, using a framework that views the crediting rate as a market rate less an implicit fee (see paragraph 21(c)).

A final word on prospective measurement

29. Paragraph 20 recommends that an insurer should measure universal life insurance contracts prospectively by reference to the future cash flows, not by reference to the account balance. The following table summarises how the main components of these contracts would affect a prospective measurement. In some cases, shortcuts may be available to arrive at an answer that is within acceptable materiality bounds.

Component	*Amount included in the liability measurement for this component*
The account balance, and future interest on the account balance. (Paragraph 21 analyses the crediting rate as made up of the market rate for a pure deposit, less an implicit fee).	○ For the account balance, with interest at the market rate for a pure deposit: the account balance. ○ The implicit fee: the same way as for explicit fees (see below).
Prepaid deductions from the account balance for charges relating to future services (for mortality, investment management or other services)	Expected present value of the future cash flows relating to those services, with the risk margin and profit margin that market participants would require.
Deductions not yet made from account	Present value of those deductions (reduces

balance for services already provided.	measurement of the liability).
The profit the insurer expects from future mortality and other charges	If in line with what market participants require: no effect. If higher than the profit market participants require: reduces the liability (if either the insurer can compel payment or the policyholder must pay for the service to retain guaranteed insurability, as discussed in paragraphs 23-26) If lower than the profit market participants require: increases the liability
Options and guarantees embedded in the contract (eg guaranteed maximum charges or minimum crediting rates, secondary guarantees)	Include their current exit value (including both intrinsic value and time value).
The portion of the customer relationship associated with the contract. (may be particularly important if the insurer prices the contract to recover acquisition costs from future charges to the policyholder account)	Included in relation to guaranteed insurability (paragraphs 23-26). This component replaces the deferral of acquisition costs (but the amount may well differ).
Estimated spread between the return on the assets backing the contract and the amount credited to policyholders.	An implicit investment management charge (assuming the insurer has unlimited discretion to vary the crediting rate in line with the return on assets).
The flexibility inherent in the insurer's ability, within specified limits, to vary crediting rates and mortality and other charges.	A form of option. The staff plans to consider this item further.

Appendix

Extracts from FAS 97

APPLICABILITY AND SCOPE

10. Except as provided in paragraph 11, long-duration insurance contracts with terms that are not fixed and guaranteed are referred to in this Statement as universal life-type contracts. Universal life-type contracts include contracts that provide either death or annuity benefits and are characterized by any one of the following features:

    a. One or more of the amounts assessed by the insurer against the policyholder-including amounts assessed for mortality coverage, contract administration, initiation, or surrender-are not fixed and guaranteed by the terms of the contract.
    b. Amounts that accrue to the benefit of the policyholder-including interest accrued to policyholder balances-are not fixed and guaranteed by the terms of the contract.
    c. Premiums may be varied by the policyholder within contract limits and without consent of the insurer.

11. This Statement does not apply to conventional forms of participating and nonguaranteed-premium contracts. Those contracts are addressed by Statement 60 and Statement 120. A participating or nonguaranteed-premium contract is covered by this Statement, however, if the terms of the contract suggest that it is, in substance, a universal life-type contract. The determination that a contract is in substance a universal life-type contract requires judgment and a careful examination of all contract terms. Paragraphs 12 and 13 describe some circumstances in which a participating or nonguaranteed-premium contract shall be accounted for as a universal life-type contract. The provisions of paragraphs 12 and 13 are not intended to be either all-inclusive or limiting.

12. A participating contract that includes any of the following features shall be considered a universal life-type contract:

    a. The policyholder may vary premium payments within contract limits and without consent of the insurer.
    b. The contract has a stated account balance that is credited with policyholder premiums and interest and against which assessments are made for contract administration, mortality coverage, initiation, or surrender, and any of the amounts assessed or credited are not fixed and guaranteed.
    c. The insurer expects that changes in any contract element will be based primarily on changes in interest rates or other market conditions rather than on the experience of a group of similar contracts or the enterprise as a whole.

13. A nonguaranteed-premium contract that includes either of the following features shall be considered a universal life-type contract:

    a. The contract has a stated account balance that is credited with policyholder premiums and interest and against which assessments are made for contract administration, mortality coverage, initiation, or surrender, and any of the amounts assessed or credited are not fixed and guaranteed.

b. The insurer expects that changes in any contract element will be based primarily on changes in interest rates or other market conditions rather than on the experience of a group of similar contracts or the enterprise as a whole.

14. This Statement does not apply to the following types of long-duration insurance contracts:

a. Contracts with terms that are fixed and guaranteed and for which premiums are collected over the same period that benefits are provided
b. Contracts that provide benefits related only to illness, physical injury, or disability.

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

…

Universal Life-Type Contracts

17. The liability for policy benefits for universal life-type contracts shall be equal to the sum of:

a. The balance that accrues to the benefit of policyholders at the date of the financial statements[4]
b. Any amounts that have been assessed to compensate the insurer for services to be performed over future periods (paragraph 20)
c. Any amounts previously assessed against policyholders that are refundable on termination of the contract
d. Any probable loss (premium deficiency) as described in paragraphs 35-37 of Statement 60.

18. Amounts that may be assessed against policyholders in future periods, including surrender charges, shall not be anticipated in determining the liability for policy benefits. In the absence of a stated account balance or similar explicit or implicit contract value, the cash value, measured at the date of the financial statements, that could be realized by a policyholder upon surrender shall represent the element of liability described in paragraph 17(a). Provisions for adverse deviation shall not be made.

19. Premiums collected on universal life-type contracts shall not be reported as revenue in the statement of earnings of the insurance enterprise. Revenue from those contracts shall represent amounts assessed against policyholders and shall be reported in the period that the amounts are assessed unless evidence indicates that the amounts are designed to compensate the insurer for services to be provided over more than one period.

20. Amounts assessed that represent compensation to the insurance enterprise for services to be provided in future periods are not earned in the period assessed. Such amounts shall be reported as unearned revenue and recognized in income over the period benefited using the same assumptions and factors used to amortize capitalized acquisition costs. Amounts that are assessed against the policyholder balance as

[4] Accounting methods that measure the liability for policy benefits based on policyholder balances are known as retrospective deposit methods (FAS 97 footnote 4)

consideration for origination of the contract, often referred to as *initiation* or *front-end fees,* are unearned revenues.

21. Payments to policyholders that represent a return of policyholder balances are not expenses of the insurance enterprise and shall not be reported as such in the statement of earnings. Amounts reported as expenses shall include benefit claims in excess of the related policyholder balances, expenses of contract administration, interest accrued to policyholders, and amortization of capitalized acquisition costs.

22. Capitalized acquisition costs shall be amortized over the life of a book of universal life-type contracts at a constant rate based on the present value of the estimated gross profit amounts expected to be realized over the life of the book of contracts. The present value of estimated gross profits shall be computed using the rate of interest that accrues to policyholder balances (sometimes referred to as the *contract rate*). If significant negative gross profits are expected in any period, the present value of estimated gross revenues, gross costs, or the balance of insurance in force shall be substituted as the base for computing amortization.

23. *Estimated gross profit,* as the term is used in paragraph 22, shall include estimates of the following elements, each of which shall be determined based on the best estimate of that individual element over the life of the book of contracts without provision for adverse deviation:

    a. Amounts expected to be assessed for mortality (sometimes referred to as the *cost of insurance*) less benefit claims in excess of related policyholder balances
    b. Amounts expected to be assessed for contract administration less costs incurred for contract administration (including acquisition costs not included in capitalized acquisition costs as described in paragraph 24)
    c. Amounts expected to be earned from the investment of policyholder balances less interest credited to policyholder balances
    d. Amounts expected to be assessed against policyholder balances upon termination of a contract (sometimes referred to as *surrender charges*)
    e. Other expected assessments and credits, however characterized.

24. The amortization method based on the present value of estimated gross profits described in paragraphs 22 and 23 of this Statement differs from that provided in Statement 60, which is based on expected premium revenues. This Statement does not define the costs to be included in acquisition costs but does describe those that are not eligible to be capitalized under this Statement. Acquisition costs are addressed in paragraphs 28-31 of Statement 60. Acquisition costs that vary in a constant relationship to premiums or insurance in force, are recurring in nature, or tend to be incurred in a level amount from period to period shall be charged to expense in the period incurred.

25. In computing amortization, interest shall accrue to the unamortized balance of capitalized acquisition costs and unearned revenues at the rate used to discount expected gross profits. Estimates of expected gross profit used as a basis for amortization shall be evaluated regularly, and the total amortization recorded to date shall be adjusted by a charge or credit to the statement of earnings if actual experience or other evidence suggests that earlier estimates should be revised. The interest rate used to compute the present value of revised estimates of expected gross profits shall be either the rate in effect at the inception of the book of contracts or the latest revised rate applied to the remaining benefit period. The approach selected to compute the

present value of revised estimates shall be applied consistently in subsequent revisions to computations of expected gross profits.

AGENDA PAPER 4B
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 Board's decision in April on the measurement attribute would require an insurer to include these guarantees at current exit value within the measurement of the insurance liability.

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. (In line with the Board's decision in April on profit margins, if the charges are in line with charges by other market participants, the charges will not affect the measurement of the liability).

   (b) Customer relationships associated with the contract. (included to the extent the policyholder would lose guaranteed insurability if the policyholder either stops paying premiums cease or surrenders 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. The staff makes this recommendation **only** for cases in which there can be no material leakage of cash out of, or into the fund.

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 [for the April meeting] 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 4C
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. If the credit characteristics affect the measurement materially, the insurer should disclose the effect. (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 measurement of an insurance liability does incorporate the effect of a change in its credit characteristics, the effect should be disclosed. (paragraph 26)

   (e) 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 an initial measurement at current exit value:

      (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.[3] 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).[4] 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 an automatic by-product of approaches that use the amount of the proceeds received as the initial measurement of liabilities issued for cash. In that context, that result has been relatively uncontroversial, perhaps because it has not been particularly apparent to people who have not thought about consciously.

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

[3] possibly net of transaction costs, but that does not affect the discussion in this paper.
[4] 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.

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. In April, the Board discussed 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 Board decided tentatively to adopt implementation B. The following paragraphs discuss the effect of credit characteristics on premium rates and on current exit value.

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 inevitably reflects the price of a transfer to a party whose credit standing has an equivalent effect on the credit characteristics of the liability:

    (a) A creditor would not generally permit the debtor to transfer its obligations to another party of **lower** credit-standing.[5]

    (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.

[5] For simplicity, the rest of this paper describes an entity as having lower or higher credit standing if its credit standing differs sufficiently to cause a measurable effect on the price that market participants would require. Because of features such as priority, guarantees and collateral, the credit characteristics of some instruments may be relatively insensitive to small gradations in the credit standings of the issuer.

(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.

(f) The credit characteristics of a liability depend on the creditworthiness of the issuer, which is specific to that entity. Some view the incorporation of this entity-specific input as inconsistent with a measurement that reflects the price that market participants would require.

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.

    (e) Paragraph 19(f) reports a view that incorporating the credit characteristics of a liability is inconsistent with a measurement at the price that market participants would require. However, as discussed in paragraph 17, current exit value necessarily reflects a transfer to another entity whose credit standing has an equivalent effect on the credit characteristics of the liability. Thus, the original issuer's credit standing is not an entity-specific input in the measurement, but a screen to identify the pool of potential transferees.

Subsequent measurement

21. Some give the following additional arguments for not accounting for **changes** in the effects of credit characteristics of liabilities[6] 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.

[6] 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.

(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.

(d) It would be misleading to report a gain when there is a deterioration in the credit characteristics of their liabilities, because an insurer cannot typically realise that gain while it is a going concern.

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

(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.

(c) Reporting changes in the credit characteristics of a liability is intended not to signal the potential for realising a gain, but to use estimated market prices as a benchmark in presenting economically relevant information about the liability.

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 surpervisors

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.' A draft IAIS follow up paper of April 2006 reiterates this view.

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. If the credit characteristics affect the initial measurement materially, the insurer should disclose the effect.

(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.